Pre-Budget Report

November 2008

Facing global challenges: Supporting people through difficult times

HM TREASURY

Cm 7484

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Pre-Budget Report

November 2008

Presented to Parliament by
the Chancellor of the Exchequer
by Command of Her Majesty

Cm 7484 LONDON: The Stationery Office £45.00

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ISBN: 978-0-10-174842-1

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

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Overview

The Government's objective is to build a strong economy and a fair society, where there is opportunity and security for all. The 2008 Pre-Budget Report, *Facing global challenges: supporting people through difficult times*, presents updated assessments and forecasts of the economy and public finances, and reports on how in the face of major global economic shocks the Government intends to support the economy, businesses and households through these uncertain times while delivering its long-term goals. The Pre-Budget Report:

Announces discretionary fiscal policy to support the economy through these difficult times followed by a sustained fiscal consolidation from 2010-11 when the economy is expected to be recovering and able to support a reduction in borrowing:

- **temporarily reducing the Value Added Tax (VAT) rate to 15 per cent with effect from 1 December 2008 to 31 December 2009;**
- **bringing forward £3 billion of capital spending from 2010-11 including introducing a green stimulus supporting low carbon growth and jobs;**
- **restricting the income tax personal allowance for those with incomes over £100,000 from April 2010, and introducing a new additional higher rate of income tax of 45 per cent for those with incomes above £150,000 from April 2011;**
- **increasing the employee, employer and self-employed rates of national insurance contributions by 0.5 per cent from April 2011;**
- **to offset the effects of the temporary reduction in VAT, increasing alcohol and tobacco duties, maintaining these increases after December 2009 to support fiscal consolidation; and following a fall in pump prices of over 20 pence per litre from their summer peaks, a two pence per litre increase in fuel duty from 1 December 2008; and**
- **an additional £5 billion value for money target for 2010-11 and setting assumptions for spending growth from 2011-12 onwards.**

Announces immediate action to help those individuals and businesses most affected by the economic downturn:

- **making permanent the £600 increase in the income tax personal allowance announced in May 2008 with a further increase of £130;**
- **bringing forward April's increase in Child Benefit to January, increases of the Child Tax Credit and a payment of £60 to all pensioners equivalent to bringing forward the April increase in the basic state pension;**
- **help through mortgage rescue and Support for Mortgage Interest schemes for eligible homeowners in difficulty and a commitment from major mortgage lenders not to initiate repossession action within at least three months of an owner-occupier going into arrears;**
- **an additional £1.3 billion to continue delivering effective support for the unemployed to find a new job;**
- **measures to help small and medium-sized enterprises facing credit constraints, including a new Small Business Finance Scheme and a £1 billion guarantee facility to support bank lending to small exporters;**
- **a new HMRC Business Payment Support Service to allow businesses in temporary financial difficulty to pay their HMRC tax bills on a timetable they can afford; and**
- **more generous tax relief for businesses now making losses and the modification of a number of planned tax reforms, including vehicle excise duty, air passenger duty, and the deferral of the increase in the small companies' rate of corporation tax.**

1.1 The Government's objective is to build a strong economy and a fair society, where there is opportunity and security for all.

1.2 In the face of recent global economic shocks, the Government's immediate priority at this Pre-Budget Report is to support the economy through these difficult times. The long-term decisions the Government has taken – giving independence to the Bank of England, the introduction of a fiscal framework, and reduction of public debt – have created a strong base for the UK to meet this challenge.

Global economic outlook

1.3 The world economies have been hit by major shocks. Developments in the US subprime mortgage market triggered a credit shock that intensified into the worst global financial crisis for generations. In September 2008, the global financial system was brought close to collapse. The Government acted decisively to implement comprehensive measures to stabilise the banking system, and other governments around the world have followed similar steps. Between Budget 2008 and early July, oil prices increased from $100 to almost $150 a barrel, but have since fallen to around $50. As a result of these shocks, growth prospects have deteriorated sharply, with many advanced economies already in recession. Growth in the major advanced economies is forecast to be negative in 2009, the first year of contraction since 1982, while world GDP growth is forecast to be just 2 per cent, well below recent trends.

Prospects for the UK economy

1.4 The UK economy has slowed as credit conditions tightened and high food and energy prices squeezed household incomes and company profits. The combined effects of these shocks has been to push the UK economy into recession and inflation to a 16-year high. Due to lower commodity prices, inflation has started to ease, but growth is forecast to be negative in 2009. From the second half of 2009, with support from fiscal policy stimulus, low interest rates and lower commodity prices, the economy is forecast to begin to recover, with growth picking up further in 2010 and 2011.

MAINTAINING MACROECONOMIC STABILITY

1.5 The Government's long-term economic goal is to secure and maintain macroeconomic stability, in order to promote a strong economy and achieve its objective of a fair society where there is security and opportunity for all. The immediate priority for the Government is to continue to support the economy through these difficult times.

The macroeconomic framework

1.6 The current economic and fiscal climate is exceptionally challenging. While economic prospects are subject to significant uncertainty, it is clear that the UK, like many advanced economies has moved into recession. As a result of the major global shocks, economic prospects have deteriorated since Budget 2008. The macroeconomic framework, introduced in 1997, means that the UK is facing these shocks from a solid foundation. Credible medium-term objectives and mechanisms for short-term flexibility mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective commitments to low inflation and sound public finances.

Supporting the economy now

1.7 The Government's immediate priority is to continue to support the economy through these difficult times. The Bank of England has reduced interest rates to a 50-year low, providing monetary policy support to the economy. A starting point of low public debt, and the action being taken to ensure sound public finances over the medium term, provide flexibility for fiscal policy to support the economy now, complementing low interest rates. This Pre-Budget Report announces that the Government will support families and businesses, including by:

- **temporarily reducing the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009;** and

- **bringing forward £3bn of capital spending from 2010-11 to 2008-09 and 2009-10,** the years when the impact of the shock is likely to be the strongest.

Ensuring sustainability

1.8 Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. This Pre-Budget Report sets out measures which put the public finances on a path to achieve a balanced cyclically-adjusted current budget and a declining debt to GDP ratio by 2015-16.

- **the income tax personal allowance will be restricted for those with incomes over £100,000 from April 2010 and a new additional higher rate of income tax of 45 per cent will be introduced for those with incomes above £150,000 from April 2011;**

- **the employee, employer and self-employed rates of National Insurance Contributions will increase by 0.5 per cent from April 2011**, when economic growth is forecast to be above trend rates and real incomes are growing strongly; and

- **the Government will increase its Value for Money target in 2010-11 by £5 billion. Current spending will grow on average from 2011-12 to 2013-14 at 1.2 per cent a year in real terms, and public sector net investment will move to 1.8 per cent of GDP by 2013-14.**

Economic prospects

1.9 Against the backdrop of major economic shocks, growth across the G7 economies is expected to have slowed to 1 per cent this year, and to turn negative in 2009, the first year of contraction since 1982. Many advanced economies are already experiencing falling output, with the euro area and Japan in recession in mid 2008. In the UK GDP, having slowed progressively over the past year, is forecast to grow by ¾ per cent in 2008 as a whole, with output falling in the second half of the year. The recession is forecast to continue into the first half of 2009, before GDP growth begins to recover in the second half of the year as credit conditions start to ease and the boost to real incomes from lower commodity prices, the stimulus from monetary and fiscal policy, and the effects of sterling's deprecation, take hold.

Public finances

1.10 The Pre-Budget Report provides updated projections for the public finances. The projections for the public finances take into account all firm decisions announced in this Pre-Budget Report, or since Budget 2008, consistent with the requirements of the *Code for Fiscal Stability*. Table 1.2 lists the key Pre-Budget Report policy decisions and their impact on the public finances. Further details are set out in Annex B.

1.11 The interim forecast update of the projections for the public finances, published in this Pre-Budget report and summarised in Table 1.1, shows:

- Public sector net borrowing (PSNB) increases from 2.6 per cent of GDP in 2007-08 to 8.0 per cent in 2009-10, reflecting the impact of the economic downturn on receipts, in particular from the financial and housing sectors, the effect of the automatic stabilisers and the action the Government is taking to support the economy. Of this around 1.1 per cent of GDP is as a result of discretionary action to support the economy. PSNB then declines to 2.9 per cent of GDP by 2013-14 as the economy recovers and the Government takes action to ensure the sustainability of the public finances; and

- Public sector net debt (PSND) increases over the forecast period, in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years, then begins to stabilise at just over 57 per cent by the end of the forecast period.

Table 1.1: Summary of fiscal projections

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Public sector net borrowing (PSNB)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Total change since Budget	*0.0*	*2.4*	*5.5*	*4.8*	*3.7*	*2.8*	*-*
Impact of discretionary measures on PSNB [1]	*0.0*	*0.6*	*1.1*	*-0.3*	*-0.9*	*-1.3*	*-1.6*
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Public sector net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net debt[2]	36.3	41.2	48.2	52.9	55.6	57.1	57.4

[1] *Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13 and 2013-14.*

[2] *Debt at end March; GDP centred on end March; excluding financial sector interventions.*

The fiscal framework

1.12 The Government's fiscal policy objectives remain unchanged – to smooth the path of the economy over the short term, and ensure sound public finances over the medium term. To implement these in current economic circumstances, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.

1.13 Consistent with the *Code for fiscal stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

1.14 The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

ENSURING FINANCIAL STABILITY

1.15 Financial markets influence the lives of every individual and business in the country. They are the core mechanism by which resources are efficiently allocated in an economy and a key driver of productivity, growth and opportunities. Financial instability, to the extent that it disrupts financial markets, can therefore affect everybody.

1.16 Since July 2007, the global economy has experienced levels of financial instability not seen for generations. The causes of this instability are varied and global. They include both macroeconomic factors, such as global financial imbalances, and microeconomic factors, such as the failure of banks to manage financial risk. The trigger for the instability was the downturn in the US housing market, the 'subprime' end of which was a feature of many of the financial products that have been created in recent years. The instability grew steadily, peaking in the weeks following the collapse of Lehman Brothers, a US investment bank, in September 2008.

1.17 The Government's objectives for addressing these threats to the financial system have been consistent, and focused around the need to:

- support stability and restore confidence in the financial system;

- protect depositors' money; and
- safeguard the interests of taxpayers.

1.18 In September 2008, the crisis intensified and it became clear that not just individual institutions but the entire banking system was at risk of collapse. That would have had devastating consequences for UK households and businesses. The Government therefore intervened decisively to prevent systemic collapse. First, to address concerns about liquidity, at least £200 billion was made available to the Bank of England's existing Special Liquidity Scheme. Second, to address concerns about solvency at least £50 billion was committed to a Bank Recapitalisation Fund. Third, to address concerns about funding, a credit guarantee scheme was established.

1.19 Other governments around the world have followed with similar steps and market reactions have been generally positive. However, markets remain fragile and volatile. The Government remains committed to taking action to meet its objectives.

1.20 Looking to the future, and given the global nature of this instability, the Government's international priorities include:

- **as the 2009 Chair of the G20, making rapid progress on priority issues for the future of the international financial regulatory system;**
- **ensuring that the EU learns the lessons from the crisis, in particular regarding supervision and deposit protection arrangements for banks operating across borders;** and
- **reviewing the long-term opportunities and challenges for the UK's crown dependencies and overseas territories as financial centres.**

1.21 Within the UK, the Government's immediate priorities include:

- **continuing to monitor the financial system to ensure it is able to support the wider economy, including through appropriate levels of lending to businesses and households;**
- **strengthening the Banking Bill to enhance the Authorities' ability to deal with banking group holding companies and the insolvency of investment firms;** and
- **introducing measures to facilitate the raising of equity capital.**

SUPPORTING BUSINESS

1.22 Businesses are facing an exceptionally challenging economic climate with uncertainty over the short to medium term. The decisive steps the Government has taken to help ensure financial stability are critical to businesses, and action such as the temporary reduction in the rate of VAT, which will provide significant support during the economic downturn. Further action that the Government is taking to help businesses respond to the current economic challenges over the short term include:

- **measures to help small and medium-sized enterprises (SMEs) facing credit constraints. The Government will launch: a new Small Business Finance Scheme to support up to £1 billion of bank lending to small exporters; a £50 million fund to convert businesses' debt into equity; and a £25 million regional loan transition fund;**

- **a new HMRC Business Payment Support Service to allow any business in temporary financial difficulty to pay their HMRC tax bills on a timetable they can afford;**
- **more generous tax relief for businesses now making losses, by allowing temporary additional carry-back of up to £50,000 of losses to be set against taxable profits from the last three years;** and
- **the modification of a number of planned tax reforms, including the deferral of the increase in the small companies' rate of corporation tax, a temporary increase in the threshold at which an empty property becomes liable for business rates, and the reform of air passenger duty rather than proceeding with a per-plane tax.**

1.23 The Government is committed to ensuring the UK is in a strong position to respond to longer-term challenges. The Government announces further measures to ensure the UK is well placed to deliver sustainable growth and prosperity over the decade ahead including:

- **a package of reforms to the taxation of foreign profits, including the introduction of a foreign dividend exemption for large and medium-sized businesses, supported by a worldwide debt cap on interest;**
- **a review of the Controlled Foreign Companies anti-avoidance rules consistent with a further move towards a territorial approach;**
- **measures to enhance SME access to Government contracts, including a new online portal for all Government contracts over £20,000; and**
- **a set of devolutionary proposals, to be agreed with local authorities in city-regions on a voluntary basis, to increase their ability to drive sustainable economic growth.**

HELPING PEOPLE FAIRLY

1.24 The Government has already taken action to help people through the current global economic difficulties. Building on this, the Government announces further packages of targeted support, providing additional help to those who need it most now.

1.25 To provide additional support for low-income and middle-income taxpayers, the Government will:

- **make permanent the £600 increase in the income tax personal allowance announced in May 2008 with a further increase of £130, meaning basic rate taxpayers pay £145 less tax a year in 2009-10.** The Government is also taking measures to consolidate the public finances. The combined effect of all its reforms will mean that taxpayers with incomes below £40,000 will pay less tax and national insurance contributions in April 2011 compared to April 2008;
- **bring forward April's increase in Child Benefit to January,** worth an additional £22 on average to families; and **bring forward its commitment to increase the child element of the Child Tax Credit by £25 above indexation in April 2010 to April 2009** meaning it will increase by £75 above indexation to £2,235 in April 2009; and
- **pay £60 to all pensioners in the New Year** which is equivalent to bringing forward the April increase in the basic State Pension for a single pensioner to January.

1.26 The Government is committed to supporting householders facing financial difficulties. **A new Lending Panel** will improve monitoring of lending to households and businesses

lending, as well as drive up best practice across the mortgage market and promote awareness of initiatives to support households against repossessions. Individuals can also expect:

- **help through mortgage rescue and Support for Mortgage Interest schemes for eligible homeowners in difficulty;**
- **a commitment from major mortgage lenders on the Panel not to initiate repossession action within at least three months of an owner-occupier going into arrears;** and
- **free and impartial debt advice through increased Government funding.**

1.27 The UK's dynamic labour market leaves it well placed to deal with rising unemployment, with 1.2 million people finding new jobs in the three months to September. To ensure that those facing redundancy and those seeking employment are helped back into work as quickly as possible, the Government announces:

- **an additional £1.3 billion to continue delivering effective support for the unemployed to find a new job;**
- **a National Employment Partnership,** bringing together Government and major employers to tackle rising unemployment; and
- **refocusing Train to Gain to provide support in pre-redundancy situations, expanding the Rapid Response Service to target small and large scale redundancies and extending Local Employment Partnerships to focus on the short-term unemployed.**

1.28 The 2008 Pre-Budget Report also announces further measures to continue the Government's established fairness agenda, including **contributing 50 pence for every pound saved in the Saving Gateway** and **reforms to modernise tax administration and protect tax revenues.**

IMPROVING PUBLIC SERVICES

1.29 Over the last ten years, record levels of investment coupled with reform have generated real and enduring improvements in Britain's schools, hospitals and other public services. The 2008 Pre-Budget Report continues high levels of investment to improve public services, reprioritises spending to support the economy through the downturn and announces an ambitious extension of its plans to increase value for money.

1.30 In the short term, the Government is focused on providing targeted support to the individuals and businesses most affected by the global economic shocks. **The 2008 Pre-Budget Report announces:**

- **as part of the Government's fiscal stimulus package, bringing forward £3 billion of capital spending from 2010-11 into 2009-10 and 2008-09** for housing, education, transport and other construction projects, supporting industries and jobs across the country; and
- **new spending measures** including additional funding for Jobcentre Plus to help people move back to work, the extension of the Support for Mortgage Interest Scheme and a new Small Business Finance Scheme for small and medium enterprises.

1.31 Over the last decade, the Government has made significant progress in delivering public services that represent good value for money and is determined to do even more in the period ahead. **The 2008 Pre-Budget Report announces that:**

- **the Government has over-achieved against the targets set by the Gershon Efficiency Programme,** including delivering £26.5 billion in savings and a reduction of 86,700 civil service posts between 2004 and 2007;
- departments are making good progress towards the 2007 Comprehensive Spending Review (CSR) value for money target of £30 billion of savings by 2010-11;
- **additional value for money savings have been identified through the work of the Operational Efficiency Programme (OEP)** including through collaborative procurement and back office efficiencies; and
- **further value for money savings will be delivered within the 2007 CSR period and beyond through a set of Public Value Programme (PVP)** reforms across major areas of spend.

1.32 Given the over-achievement against the 2004 target, and the scope for these additional efficiency savings, **the Government announces an additional £5 billion value for money target for 2010-11.**

1.33 To achieve continued improvement and investment in public services and maintain sustainable public finances in the medium term. The 2008 Pre-Budget Report:

- **sets assumptions for spending growth from 2011-12 onwards,** with current growing in real terms by 1.3 per cent in 2011-12, 1.2 per cent in 2012-13 and 1.1 per cent in 2013-14; and public sector net investment moving to 1.8 per cent of GDP by 2013-14; and
- announces the Government will continue and deepen work to improve value for money in the next Spending Review period, in particular by driving forward the OEP and PVP.

DELIVERING ON ENVIRONMENTAL GOALS

1.34 Action to achieve environmental goals remains a high priority for the Government in current economic circumstances. The Government is putting in place policies and investment to support a low-carbon recovery, with new jobs and businesses created through green growth. Government policies are driving £50 billion of investment in the low-carbon sector over three years. The Climate Change Bill introduces a legally binding target to cut greenhouse gas emissions by at least 80 per cent by 2050, the most ambitious in the G7, building on the Government's plans to deliver a one-third reduction in emissions from 1990 levels by 2020.

1.35 The Pre-Budget Report contributes to meeting the UK's ambitious long-term environmental goals, while supporting low-carbon growth by:

- **introducing a green stimulus – ensuring part of the fiscal stimulus supports low-carbon growth and jobs by accelerating £535 million of capital spending on energy efficiency, rail transport, and adaptation measures.** 76,000 low-income households will benefit earlier from better heating and energy efficiency, up to 200 new rail carriages will be delivered earlier and 27,000 homes will benefit sooner from flood defences;

- **successfully securing inclusion of aviation in the EU Emissions Trading Scheme from 2012, and holding Europe's first Phase II carbon auction on 19 November 2008;**
- **retaining the Renewables Obligation to provide financial support for large-scale renewable electricity and extending it by at least ten years, ensuring investors can plan with confidence for the future.** This will complement the introduction of a feed-in tariff for small-scale renewable electricity and a renewable heat incentive to reward households and businesses that generate renewable energy on site; and
- **following a fall in pump prices of over 20 pence per litre from their summer peaks, the postponed two pence per litre fuel duty increase will go ahead on 1 December 2008.**

1.36 At the same time, the Pre-Budget Report shows how environmental policies can respond flexibly to help people and businesses through tough times, while reducing carbon emissions by:

- **installing 600,000 insulation measures this winter, up 70 per cent on last winter, through the £6.8 billion Home Energy Saving Programme,** half of which is funded by energy companies. This will help households save up to £300 a year on energy bills and reduce carbon emissions;
- **continuing to provide a clearer environmental signal through reform to vehicle excise duty, while ensuring that no driver in any given band will pay more than £5 extra in 2009 or £30 extra in 2010:** and
- **reforming air passenger duty from 1 November 2009, moving from two to four distance bands to improve environmental signals. The Government has decided not to proceed with a per-plane tax in order to ensure greater stability and protect competitiveness at a time of economic uncertainty.**

PRE-BUDGET REPORT POLICY DECISIONS

1.37 Consistent with requirements of the *Code for fiscal stability*, the updated public finance projections in the Pre-Budget Report take into account the fiscal effects of all firm decisions announced in the Pre-Budget Report or since Budget 2008. The fiscal impact of these measures is set out in Table 1.2. Full details are provided in Annex B.

Table 1.2: Estimated costs for Pre-Budget Report policy decisions and others announced since Budget 2008[1]

	£ million			
	2008-09	2009-10	2010-11	2011-12
Measures announced since Budget 2008[2]				
Personal allowance and basic rate limit changes for 2008-09	-2,650	-270	+90	0
September housing package: spending measures	-200	-665	+865	0
SDLT holiday for residential homes	-130	-150	0	0
Local Housing Allowance: cap benefit at 5 bedroom rate	0	+5	+15	+15
Class 3 NICs: Pensions Bill amendment	0	+230	+10	+10
Supporting the economy and ensuring sustainability of public finances				
VAT rate reduction	-3,800	-8,600	0	0
Alcohol duties: increase in rates	+160	+640	+645	+675
Tobacco duties: increase in rates	+115	+340	+360	+365
Capital spending brought forward	-365	-2,545	+2,910	0
Indexation of personal allowance and basic rate limit	0	-2,930	-3,310	-3,270
£130 increase in personal allowance in 2009-10 and 2010-11	0	-630	-770	-100
Freeze basic rate limit in 2011-12	0	0	0	+180
Restrict personal allowance by half from £100,000 and to zero from £140,000 from 2010-11	0	0	+830	+1,320
Additional higher income tax rate of 45% above £150,000 and raise trust rate to 45% from 2011-12	0	0	0	+670
Align the NICs primary threshold with personal allowance in 2011-12	0	0	0	-1,610
Increase main employee NICs rate by 0.5% from 2011-12	0	0	0	+2,050
Increase additional employee NICs rate by 0.5% from 2011-12	0	0	0	+440
Increase employer NICs rate by 0.5% from 2011-12	0	0	0	+2,650
Increase main self-employed rate of NICs by 0.5% from 2011-12	0	0	0	+170
Increase additional self-employed NICs rate by 0.5% from 2011-12	0	0	0	+80
Public spending: additional value for money savings	0	0	+5,000	+5,000
Supporting business				
Foreign profits	0	+75	+25	-275
Loss carry back: temporary extension	-10	-175	-20	+15
Small Companies Rate of corporation tax: defer increase to April 2010	0	-20	-460	-130
Rates on empty property: temporary exemption	0	-185	+10	0
Backdated business rates bills	-80	-55	+25	+20
Income shifting: defer action	0	-25	-260	-200
Insurance claims equalisation reserves	-15	-35	-35	-35
Helping people fairly				
Child benefit: bring forward uprating from April 2009 to January 2009	-170	0	0	0
Child element of Child Tax Credit: bring forward £25 increase from 2010 to April 2009	0	-190	0	0
DWP Job Centre Plus funding[4]	0	-400	-400	0
Uprating of pension credit above indexation	0	-260	-300	-310
Additional payment to pensioners and others	-900	0	0	0
Freeze pension lifetime and annual allowance from 2011-12 for 5 years	+25	+100	+200	+400
Index housing benefit disregard in tax credits	0	-5	-5	-5
Support for mortgage interest	-30	-15	0	0
Further support for debt advice	-5	-10	-5	0
Protecting revenues				
Change of Accounting Practice Regulations	0	+10	+15	+15
Enhance tax avoidance disclosure regime	0	+10	+15	+10
Delivering on environmental goals				
Air passenger duty	0	-60	-160	-50
Vehicle excise duty - cars and vans	0	-465	-515	-545
Vehicle excise duty - heavy goods vehicles	0	-10	-10	-10
Fuel duty	-180	0	0	0
Additional spending on Warm Front	-50	-50	0	0
Capital allowances: business cars	0	+10	+10	+5
Other policy decisions				
Addition to DEL reserve	-1,000	0	0	0
TOTAL POLICY DECISIONS	**-9,285**	**-16,330**	**+4,775**	**+7,550**
Memo: Resetting AME margin	0	-1,000	-2,000	-2,000

[1] *Costings shown relative to an indexed base.*

[2] *Costings reflect Pre-Budget Report economic forecast and assumptions.*

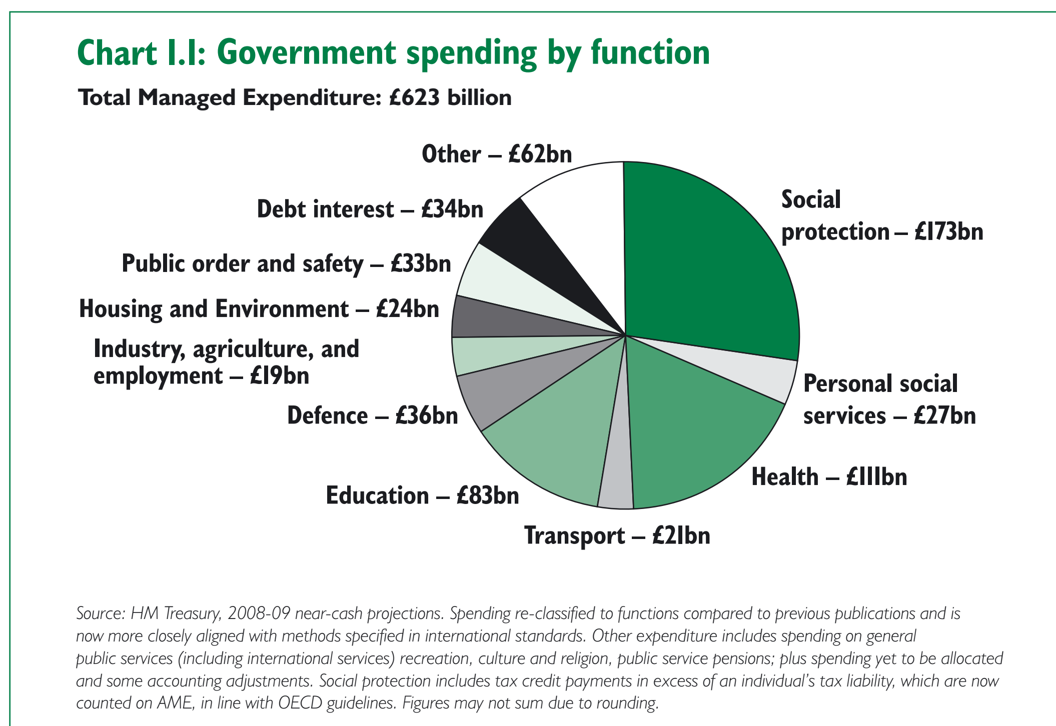
[3] *Yield increases due to lagged effects of self-assesment. For 2011-12 onwards, yield is £670 million / £1650 million / £1600 million.*

[4] *The remainder of the employment pachage totalling £1.3 billion announced in Chapter 5 is funded from DWP End of Year flexibility*

1.38 Chart 1.1 presents public spending by main function. Total managed expenditure (TME) is expected to be around £623 billion in the current financial year, 2008-09. TME is divided into Departmental Expenditure Limits (DEL), shown in Table B18, and Annually Managed Expenditure (AME), shown in Table B16.

Chart 1.1: Government spending by function

Total Managed Expenditure: £623 billion

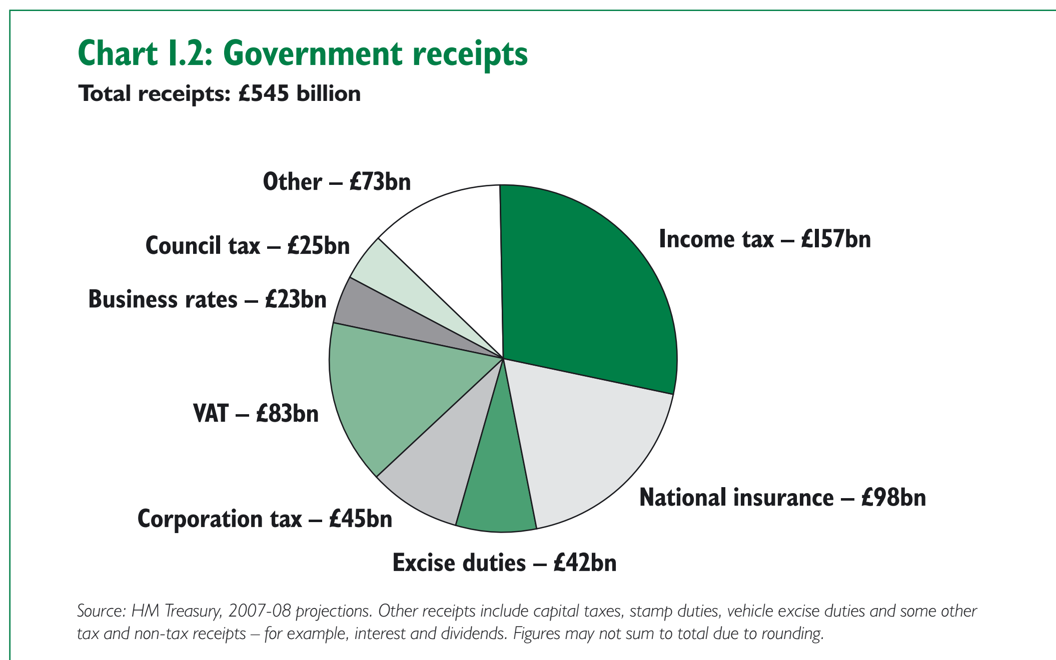


Source: HM Treasury, 2008-09 near-cash projections. Spending re-classified to functions compared to previous publications and is now more closely aligned with methods specified in international standards. Other expenditure includes spending on general public services (including international services) recreation, culture and religion, public service pensions; plus spending yet to be allocated and some accounting adjustments. Social protection includes tax credit payments in excess of an individual's tax liability, which are now counted on AME, in line with OECD guidelines. Figures may not sum due to rounding.

1.39 Chart 1.2 shows the different sources of government revenues. Public sector current receipts are expected to be around £545 billion in 2008-09. Table B13 provides a more detailed breakdown of receipts consistent with this chart.

Chart 1.2: Government receipts

Total receipts: £545 billion



Source: HM Treasury, 2007-08 projections. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts – for example, interest and dividends. Figures may not sum to total due to rounding.

2 MAINTAINING MACROECONOMIC STABILITY

Over the past year, major shocks have hit the economies of every country in the world. While commodity prices have recently eased, the credit shock has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. These developments mean economic prospects are subject to exceptional uncertainty, but it is clear that the UK, like many advanced economies, has moved into recession. Asset markets and the financial sector have been severely affected, with persistent implications for the public finances.

The economic and fiscal climate is exceptionally challenging, but because of the macroeconomic framework introduced in 1997 the UK is facing these shocks from a solid foundation. The Government remains committed to the macroeconomic framework and the objectives enshrined within it. Credible medium-term objectives and mechanisms for short-term flexibility mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective commitments to low inflation and sound public finances.

The Government's immediate priority is to continue to support the economy through these difficult times. This Pre-Budget Report announces that the Government will support families and businesses, including by:

- **temporarily reducing the Value Added Tax (VAT) rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and**
- **bringing forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10**, the years when the impact of the shock is likely to be the strongest.

Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. The Government will therefore deliver a sustained fiscal consolidation from 2010-11, when the economy is expected to be recovering and able to support a reduction in borrowing. In particular:

- **the income tax personal allowance will be restricted for those with incomes over £100,000 from April 2010 and a new additional higher rate of income tax of 45 per cent will be introduced for those with incomes above £150,000 from April 2011;**
- **the employee, employer and self-employed rates of National Insurance Contributions will increase by 0.5 per cent from April 2011, when economic growth is forecast to be above trend rates and real incomes are growing strongly; and**
- **the Government will increase its Value for Money target in 2010-11 by £5 billion. Current spending will grow on average from 2011-12 to 2013-14 at 1.2 per cent a year in real terms, and public sector net investment will move to 1.8 per cent of GDP by 2013-14.**

To underpin this consolidation, consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

RECENT ECONOMIC DEVELOPMENTS AND THE MACROECONOMIC RESPONSE

Global economic shocks

2.1 Since mid-2007, the world's economies have been hit by major shocks. Developments in the US subprime mortgage market triggered a credit shock that has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. The surge in commodity prices, which had built over a number of years, peaked in July 2008 and has since reversed.

2.2 These economic shocks have affected all countries. The squeeze on real incomes from high commodity prices and the global financial crisis has pushed many advanced economies into recession and led a growing number of emerging economies to require financial support from the International Monetary Fund (IMF) and other sources.

2.3 The Government's macroeconomic framework has been designed to ensure that policymakers have the flexibility to respond appropriately to shocks. Transparency and a commitment to medium-term goals mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective objectives of low inflation and sound public finances over the medium term. Further detail is provided in Box 2.1.

Monetary policy response

2.4 Since the onset of the global credit shock in August 2007, the Monetary Policy Committee (MPC) of the Bank of England has cut Bank Rate by a cumulative 2¾ percentage points, from 5¾ per cent to 3 per cent. On 8 October, the MPC cut rates by ½ a percentage point as part of a globally coordinated interest rate cut, and then on 6 November it reduced Bank Rate by a further 1½ percentage points to 3 per cent, its lowest level since 1955. Globally, since the 8 October coordinated action, the US Federal Funds rate has been cut to 1 per cent, and official interest rates have been reduced to 3¼ per cent in the euro area and 0.3 per cent in Japan.

Fiscal policy response

2.5 Since Budget 2008, the Government has taken a number of actions which deliver support to the economy, including raising the income tax personal allowance by £600, helping 22 million basic-rate taxpayers and packages of support for homeowners and households facing rising energy bills. This Pre-Budget Report announces that, to provide further support for growth and incomes during the economic downturn, the Government will complement the action taken to date with a fiscal stimulus through:

- **a temporary reduction in the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and**
- **bringing forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10,** the years when the impact of the shock is likely to be the strongest.

2.6 Further support for pensioners, families with children and all taxpayers with modest and middle incomes, including those affected by the removal of the 10 pence starting rate of tax in Budget 2007 – described in Chapter 5 – and to support businesses – set out in Chapter 4 – will also help to mitigate the impact of the economic downturn.

2.7 Discretionary action of £16 billion will deliver a fiscal stimulus package of around 1 per cent of GDP in total in 2009-10, in addition to the support provided by measures in 2008-09.

2.8 As set out in Chapter 3, G20 leaders, at their summit on 15 November, agreed a broader policy response, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging markets and developing countries. This includes using fiscal measures to stimulate domestic demand with rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.

Box 2.1: Operation of the macroeconomic framework in exceptional economic circumstances

The UK macroeconomic framework has been designed to ensure that policymakers have the flexibility to respond appropriately to shocks, while at the same time ensuring transparency in the way policy is formulated and a credible commitment to medium-term goals.

The primary objective of monetary policy is to deliver price stability. However, the monetary policy framework takes into account that the economy can suffer from external events or temporary difficulties. The remit for the MPC recognises that "the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances," and that "attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output."[1] The open letter system requires the Governor of the Bank of England to write to the Chancellor explaining the reasons for any deviation in inflation of more than one percentage point above or below target, plus the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC. The transparency and accountability provided by the open letter system allow the MPC the flexibility to deliver the inflation target while avoiding unnecessary volatility in output.

The Government's fiscal framework, as articulated in the *Code for Fiscal Stability* ("the Code") and approved by the House of Commons in 1998, was designed to ensure that the Government has the flexibility to respond appropriately to shocks. The Code requires the Government to set out its fiscal policy objectives and a set of operating rules to deliver them. It provides flexibility for the Government to either change its rules or depart from them on a temporary basis to ensure that at all times they are appropriate to deliver the Government's fiscal policy objectives, including when economic circumstances change significantly. To ensure transparency, the Code requires the Government to state clearly the reasons for any change.

The Government's fiscal policy objectives remain unchanged. To achieve its objectives, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.

Consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

[1] www.bankofengland.co.uk

Action to maintain financial stability

2.9 In addition to the macroeconomic policy response, with the financial crisis intensifying in early October, the Government acted to maintain financial stability and protect depositors, announcing a comprehensive package of measures:

- first, to address concerns about liquidity, the authorities announced that at least £200 billion would be made available to banks under the Bank of England's Special Liquidity Scheme (SLS);
- second, to address concerns about solvency, the Government established the Bank Recapitalisation Fund. This makes available new Tier 1 capital to eligible UK banks and building societies, allowing them to strengthen their resources, while maintaining their support for the wider economy; and

- third, to address funding concerns (reflecting a lack of mutual confidence and trust between financial institutions), the Government established a credit guarantee scheme. This makes available to eligible institutions a government guarantee to refinance maturing debt. The credit guarantee is intended to unblock the interbank money market, thereby allowing banks to continue to lend to the wider economy.

2.10 Further information on these measures is provided in Chapter 3. This action reflected the risk that a widespread bank failure poses to economic output and employment, as explained in Box 3.1, and was critical to mitigating the impact of financial market turbulence on individuals and businesses. Many countries have since taken similar action, modelled on the UK Government's response.

Recent economic developments

2.11 In 2006 and 2007, GDP grew by 2¾ and 3 per cent respectively. Reflecting the major shocks to the economy, growth has slowed progressively as credit conditions have tightened and real incomes were squeezed by high commodity prices. Quarterly GDP growth in the first half of 2007 averaged 0.8 per cent, before slowing progressively to average 0.6 per cent in the second half and 0.1 per cent in the first half of 2008. In the third quarter, GDP contracted by 0.5 per cent, the first fall in output since 1992, with negative growth across most sectors of the economy. The distribution sector experienced the largest contraction, consistent with discretionary spending having been held back as consumer sentiment weakened and real incomes were squeezed.

2.12 CPI inflation increased from 2.2 per cent in December 2007 to 5.2 per cent by September 2008 before falling back sharply to 4.5 per cent in October. Movements in the prices of goods that are most closely linked to global commodity prices accounted for virtually all of the increase. With commodity prices having eased significantly since the summer, petrol and diesel prices have already declined by 12 per cent and food price inflation appears to have passed its peak. Reflecting a combination of factors, including market expectations of substantial monetary policy easing, the sterling exchange rate index has declined by over 20 per cent since its peak in the summer of 2007.

Economic cycle

2.13 Evidence from the broad range of cyclical indicators monitored by the Treasury – described further in *Evidence on the economic cycle*, published alongside the Pre-Budget Report – suggests that the economy passed up through trend during the second half of 2006 and remained above trend during the course of 2007. Taken together with the latest National Accounts data, this evidence supports the Treasury's assessment that the economic cycle, judged to have started in the first half of 1997, ended during the second half of 2006.

2.14 The Comptroller and Auditor General has audited this judgement. Taking all the evidence available as a whole, he judged that it is reasonable to conclude currently that the second half of 2006 marked the end date of the most recently completed economic cycle, and recommended, given the uncertainties in dating economic cycles, including looking ahead and the impact new data might have in the future, that the Treasury keep this assessment under review.

Global economic prospects

2.15 Against the backdrop of major economic shocks, world growth is forecast to have slowed to 3½ per cent in 2008 and to fall to just 2 per cent in 2009, significantly below recent trends. Growth across the G7 economies is forecast to have slowed to 1 per cent this year, and to turn negative in 2009, the first year of contraction since 1982. The IMF forecasts output across 31 advanced economies to contract in 2009, for the first time in the post-war period. Many advanced economies are already experiencing falling output, with the euro area and Japan in recession.

UK growth prospects

2.16 As described more fully in Annex A, there are a number of channels through which the global credit and commodity price shocks could affect trend output in the UK. For the 2008 Pre-Budget Report, to take account of the likely negative effect of the credit shock on trend output, a phased reduction to the trend level of productivity (and therefore the trend level of output) has been assumed over the two years from mid-2007, a period consistent with the credit conditions assumption that underpins the economic forecast more generally. This adjustment is within the range of external estimates, though it is a key forecasting judgement around which there is very considerable uncertainty.

2.17 Having slowed progressively over the past year, GDP is forecast to fall by a ¼ per cent on a year earlier in the second half of 2008, leaving output in 2008 as a whole up ¾ per cent on a year earlier. The recession is forecast to continue into the first half of 2009, before GDP growth begins to recover in the second half as credit conditions start to ease and the boost to real incomes from lower commodity prices, the stimulus from monetary and fiscal policy, and the effects of sterling's depreciation, take hold.

2.18 Growth in 2009 as a whole is forecast to be negative, at –1¼ to –¾ per cent. The effect of fiscal stimulus, particularly the temporary cut in the rate of VAT and bringing forward of public investment to 2008-09 and 2009-10, in addition to other measures, is assumed to reduce the extent of the downturn by around ½ a percentage point. The UK also has relatively powerful automatic stabilisers, which will operate in full to further support the economy. In response to rising unemployment, as set out in Chapter 5 of this Pre-Budget Report, the Government has announced a package of measures to ensure that those facing redundancy and those seeking employment are helped back into work as quickly and efficiently as possible.

2.19 Credit conditions are assumed to settle at a new norm in 2010, such that the process of efficient credit allocation is restored and the UK's flexible markets can adjust more effectively to changed economic circumstances. As lagged effects feed through, including from fiscal and monetary stimulus and from the depreciation of sterling, growth is expected to pick up progressively through 2010 and 2011 to a little above trend rates. Past recovery phases point to the possibility that, once recovery has taken hold, growth could continue at strong rates for a number of years as spare capacity is brought back into productive use. For example, GDP growth averaged 3¼ per cent a year in the five years from 1982 and again in the five years from 1993. Rebalancing of demand in the economy is forecast to take place over the coming years, with net exports contributing positively to growth in each year and consumer spending forecast to grow at rates slightly below that of the whole economy as households continue to adjust their finances.

Box 2.2: Fiscal stimulus and economic recovery

The Government's fiscal stimulus is designed as a timely response to the UK economy entering recession. It supports and reinforces additional stimulus from monetary policy and depreciation of sterling, alongside the boost to real incomes from recent sharp falls in commodity prices. This stimulus, and the assumed easing of credit conditions, supported by the Government's comprehensive measures to stabilise the banking system, is forecast to deliver recovery from the second half of next year. The UK also has relatively powerful automatic stabilisers by international standards, which will operate in full to further support the economy. Consequently, while clear risks remain, particularly relating to prospects for credit conditions easing, the downturn will be shallower than would have been the case in the absence of fiscal support, and growth is forecast to pick up to 1½ to 2 per cent in 2010. This would contrast with the recession of the early 1980s, when the economy continued to contract for a second year, and that of the early 1990s, where the economy grew by only ¼ per cent in the second year of the downturn.

This earlier recovery also reflects differences in the origin of the downturn, and the foundations for recovery being laid sooner than in past recessions. The trigger for this downturn was the major global economic shocks that have hit since mid-2007, when the UK economy was operating close to trend, inflation was close to target and interest rates were below 6 per cent. This contrasts with the late 1970s oil price shock, and the late 1980s overheating domestic economy, which generated high inflation and, because inflation expectations were poorly anchored, high wage inflation. In order to bring inflation under control, interest rates were raised sharply, peaking at 17 per cent in 1980 and 15 per cent in 1990. In 1981 fiscal policy was tightened significantly, while in the early 1990s recession the fiscal stance loosened significantly only in 1992-93, when the economy had begun to grow again. As such, in the early stages of these past recessions, domestic macroeconomic policy acted as a brake on activity. By contrast, the Pre-Budget Report announces a significant fiscal stimulus, and Bank Rate is at a 53-year low of 3 per cent, providing policy stimulus at a time when the effects of the financial crisis on the availability of credit is weighing on growth.

Providing support to the economy now, through fiscal stimulus and support for the banking system, should reduce the extent of the downturn. A failure to provide fiscal stimulus would risk delaying economic recovery and reducing the effectiveness of the Government's intervention in the banking system, with potentially greater fiscal and economic costs in the future.

UK inflation prospects

2.20 CPI inflation fell from 5.2 per cent in September to 4.5 per cent in October, suggesting September marked the peak. Global commodity prices have fallen sharply since the summer, which should feed through to consumer prices for petrol, food and household energy with varying lags. Commodity price developments and the emergence of a negative output gap would suggest that inflation will decline rapidly from above 5 per cent to reach the target rate by the middle of 2009, although sterling's depreciation will exert upward pressure. In addition, the temporary reduction of the VAT rate from 17½ per cent to 15 per cent from December 2008 is expected to put further downward pressure on inflation as businesses pass the cut through to prices. The forecast assumes that due to the competitive nature of the UK retail sector, especially during the coming downturn, the majority of the VAT rate cut will be passed through to consumer prices, but that prices will be reduced progressively rather than immediately. This is in line with international evidence. As a result, CPI inflation is forecast to fall below 1 per cent in the second half of 2009.

2.21 Unlike the initial cut in the VAT rate, the subsequent pre-announced return to 17½ per cent will be anticipated by businesses and consumers, so will be taken into account in prices during the normal process of reviewing prices as other costs and demand factors evolve. Inflation is forecast to move a little above the 2 per cent inflation target following the reversal of the VAT rate cut and as the lagged effects of sterling depreciation on import prices continue to feed through, before returning to target in 2011 as the still negative output gap exerts downward pressure.

Table 2.1: Summary of UK forecast[1]

		Forecast			
	2007	2008	2009	2010	2011
GDP growth (per cent)	3	¾	–1¼ to –¾	1½ to 2	2¾ to 3¼
CPI inflation (per cent, Q4)	2	3¾	½	2¼	2

[1] See footnote to Table A9 for explanation of forecast ranges.

Risks and uncertainty

2.22 Economic forecasting inevitably involves judgement about the uncertain path of future events. Given the current context, of shocks that are likely to affect supply potential as well as demand and substantial macroeconomic and financial policy responses, the 2008 Pre-Budget Report forecast involves an even greater reliance on judgement.

2.23 As was the case at the last Budget and Pre-Budget Report, the key forecast judgement relates to the intensity and duration of the global tightening in credit conditions faced by households and companies. The forecast assumes that, with financial institutions having received significant support from governments around the world, credit conditions should ease over the coming year and return to a new norm from early 2010. The extent of government support and very low level of policy interest rates suggest there is an upside risk to this assumed path of credit conditions, with the possibility that the banking system is able to restore the efficiency of its financial intermediation operation more quickly. Against that, the experience of the past six months, when conditions appeared to be stabilising before deteriorating dramatically in September and October, underlines the significant downside risks that remain.

2.24 There are uncertainties over the degree to which monetary and fiscal policy easing will support activity. In terms of monetary easing, there have been some encouraging signs that it will filter through to households and companies, though there remain clear risks over how long the availability of credit will remain restricted and the extent to which households and companies will want to increase borrowing in an uncertain economic environment, and when outstanding household borrowing is historically high.

2.25 In terms of the fiscal stimulus, the key economic risks stem from the degree to which the lower VAT rate is passed through to consumer prices and the extent to which temporarily lower prices stimulate a greater volume of spending. It has been assumed that over time the majority of the VAT rate cut will be passed through to consumer prices. While this suggests a risk to consumer spending from lower pass-through, that would be tempered by the upside risk to corporate profits and perhaps therefore employment if companies were to retain more of the temporary VAT rate cut. With respect to stimulating spending, the forecast assumes that approximately half of the increase in real purchasing power translates into an increased volume of spending, with the remainder used by households to bolster their finances. There are clearly upside and downside risks to this assumption, particularly those related to developments in credit conditions. If credit conditions ease more rapidly than assumed, households will have greater scope to bring forward spending to capitalise on the temporarily lower rate of VAT.

2.26 From spring 2008 until recently, the risk to inflation was tilted to the upside, with commodity prices reaching record highs in the summer. As commodity prices have fallen sharply and growth has slowed, pressures on inflation have eased. While the depreciation of sterling means there are residual upside risks to inflation from import prices, it seems clear that inflation is set to fall sharply over the coming year. Further downward pressure on inflation will come as the cut in the VAT rate is progressively passed through to prices.

Public finance projections

2.27 Developments in the economy and financial markets since Budget 2008, and the updated economic forecast set out above, have substantial implications for the public finance projections. Table 2.2 provides a summary of the Pre-Budget Report projections for key fiscal aggregates, which are discussed later in this chapter and more fully in Annex B.

2.28 Public sector net borrowing (PSNB) peaks at 8.0 per cent of GDP in 2009-10, reflecting the impact of the economic downturn on receipts, in particular from the financial and housing sectors, the effect of the automatic stabilisers and the action the Government is taking to support the economy. Of this, the discretionary fiscal action the Government is taking to support the economy accounts for 1.1 per cent of GDP, of which around 0.2 per cent of GDP is capital spending. In total, borrowing for capital investment accounts for 2.7 per cent of GDP in 2009-10. Therefore, excluding borrowing for investment and for discretionary action, net borrowing in 2009-10 would be 4.4 per cent of GDP. PSNB then declines to 2.9 per cent of GDP by 2013-14, as the economy recovers and the Government takes action to ensure the sustainability of the public finances. Public sector net debt (PSND) increases over the forecast period, in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years, then begins to stabilise at just over 57 per cent of GDP by the end of the forecast period.

Table 2.2: Summary of fiscal projections

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Public sector net borrowing (PSNB)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Total change since Budget	*0.0*	*2.4*	*5.5*	*4.8*	*3.7*	*2.8*	*-*
Impact of discretionary measures on PSNB [1]	*0.0*	*0.6*	*1.1*	*-0.3*	*-0.9*	*-1.3*	*-1.6*
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Public sector net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net debt[2]	36.3	41.2	48.2	52.9	55.6	57.1	57.4

[1] *Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13 and 2013-14.*

[2] *Debt at end March; GDP centred on end March; excluding financial sector interventions.*

2.29 The uncertainty surrounding economic prospects in turn implies greater than usual risks surrounding the public finance projections. The projections are based on the recovery in economic growth set out above, and a pick up in financial sector profits and asset prices beginning in early 2010. Downside risks to the public finance projections include that the economic downturn is sharper or longer than expected, the economic recovery is slower than expected or that the contraction in the financial sector or the adjustment in the housing market are more protracted. If, however, the substantial stimulus from monetary and fiscal policy, sterling's depreciation and lower commodity prices, takes hold sooner than forecast, the public finance projections would be subject to upside risks.

SETTING FISCAL POLICY IN EXCEPTIONAL CIRCUMSTANCES

2.30 The economic downturn caused by these major economic shocks will have a large and persistent impact on the public finances. In the face of such adverse developments, it is important to focus on the purpose of the fiscal framework – to support economic growth by delivering economic stability – and to ensure that fiscal policy decisions are appropriate to achieve this.

2.31 The Government's objectives for fiscal policy in the face of these shocks remain unchanged:

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

2.32 In order to ensure sound public finances over the medium term, fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked their way through the economy in full. The cyclically-adjusted current budget is projected to reach balance in 2015-16. It improves as a proportion of GDP by over 0.5 per cent a year from 2010-11, when the economy is expected to be recovering and able to support a reduction in borrowing. This fiscal consolidation is underpinned by a temporary operating rule. A starting point of low public debt and the action that the Government is taking to ensure fiscal sustainability over the medium term mean borrowing can be allowed to rise to enable the Government to support families and businesses in the short term, including through discretionary fiscal action.

Delivering fiscal support to the economy

2.33 The Government's immediate priority is to support the economy through these difficult times, and this support needs to be tailored to address the particular problems that the economy is experiencing.

The role for active fiscal policy

2.34 In current economic circumstances, it is more important than usual for fiscal policy to play a role in supporting economic activity. In general, monetary policy is the primary tool for managing demand in the economy, while fiscal policy supports monetary policy through the automatic stabilisers, helping to smooth the path of the economy. However, while there have been encouraging signs that monetary easing is being passed through to interest rates paid by households and businesses, it is likely that monetary policy may be less effective than normal in stimulating economic activity at present, in particular due to constraints on the availability of credit. Given this, fiscal policy should play a more active, complementary role because it is able to support growth, and people's incomes and purchasing power, directly. In this way, fiscal policy can support monetary policy to limit the extent and duration of the downturn.

2.35 The role for fiscal policy was recently acknowledged by the Governor of the Bank of England, who stated: *"there are two changes which mean that in these circumstances it is reasonable to think about fiscal policy as a complement to monetary policy. One is… credit constraints on households, which make fiscal policy likely to be more effective, and secondly the fact that the transmission mechanism of monetary policy has been in part impaired through the banking crisis."* [1]

[1] Transcript of press conference, 12 November 2008, available at www.bankofengland.co.uk

2.36 There is also an important role for private sector investment to play in stimulating the economy, while also ensuring the right infrastructure is in place for longer-term prosperity. A significant level of investment is already planned for 2009-10, particularly in the regulated sectors, and there may be scope for companies to work with regulators within their existing processes to bring further investment forward.

Delivering fiscal support

2.37 The UK has relatively powerful automatic stabilisers by international standards, and these are operating in full to support the economy. This Pre-Budget Report announces that, to provide further support for growth and incomes during the economic downturn, the Government will complement the action taken to date with a fiscal stimulus, including through:

- **a temporary reduction in the VAT rate to 15 per cent with effect from 1 December to 31 December 2009;** and
- **bringing forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10,** the years when the impact of the shock is likely to be the strongest – further details are set out in Chapter 6.

2.38 Further support for pensioners, families with children and all taxpayers with modest and middle incomes, including those affected by the removal of the 10 pence starting rate of tax in Budget 2007 – described in Chapter 5 – and to support businesses – set out in Chapter 4 – will also help to mitigate the impact of the economic downturn.

2.39 Discretionary action of £16 billion will deliver a fiscal stimulus package of around 1 per cent of GDP in total in 2009-10, in addition to the support provided by measures in 2008-09. A number of advanced economies have announced fiscal support packages of similar magnitude in recent months. *The case for a concerted international fiscal response*,[2] published alongside this Pre Budget Report, sets out the case for a concerted international fiscal response to the current downturn, as endorsed by leaders of the G20 countries at their summit on 15 November 2008. Box 2.3 provides a summary of the document's conclusions.

[2] *The case for a concerted international fiscal response*, HM Treasury, November 2008.

Box 2.3: The case for a concerted international fiscal response

The case for concerted fiscal action has been endorsed by the leaders of the G20 countries. On 15 November they declared that they:

- had agreed to work together to restore global growth; and
- would "use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability".

A simple, but nonetheless powerful, argument for concerted fiscal action is that this is a global crisis, and therefore requires a global solution. The combined effect of coherent actions taken across countries will be more effective than each country acting alone. In open economies, such as the UK, a proportion of any stimulus will be spent on imports. A concerted stimulus among major trading partners would increase trade flows in both directions.

Decisive concerted action by the world's leading economies will also provide a strong signal to the private sector of the willingness of governments to act effectively together. This should raise the private sector's expectations of the economic outlook, and help to reduce the risk of an adverse feedback between low expectations, cautious spending and weak outcomes.

An effective international response does not mean that all countries should take identical actions. Instead, fiscal actions need to be tailored to the situation of each country, taking account of existing levels of public debt.

However, the effectiveness of international fiscal actions will be enhanced if they are concerted, and conform to the "timely, targeted and temporary" principles described below.

Choice of levers

2.40 For fiscal support to help stabilise the economy effectively it should be:

- timely – it needs to have a swift impact. This requires both that the policy change can be implemented quickly, and that it has a rapid impact on behaviour;
- temporary – to maximise its immediate impact and protect medium-term fiscal sustainability. If action is not taken to maintain sound public finances, there is a risk that higher long-term interest rates will outweigh its stimulus effect; and
- targeted – it is important that the support boosts spending, to maximise the impact on economic activity.

2.41 The Government has therefore chosen to take fiscal action that meets these criteria. A reduction in the rate of VAT has been chosen as the main lever for the fiscal action as this change can be implemented rapidly (timely), will impact immediately on the purchasing decisions of firms and individuals to boost spending (targeted) and is reversible (temporary). A temporary reduction in the rate of VAT will lower prices for households and should provide help immediately, when they need it most. It will also incentivise them to bring forward the purchase of goods, which will help support firms and the people they employ as the economy slows.

2.42 Furthermore, bringing forward valuable public investment also pursues these aims by impacting directly on economic activity in the UK (targeted), in particular supporting the construction sector, which is expected to be disproportionately affected by the economic downturn. In order to ensure that increased public spending acts as an effective economic stimulus, the Government has taken the decision to bring forward existing spending programmes, which can support the economy quickly (timely), rather than initiate new projects, which can take considerable time. As the spending plans are being brought forward, the boost to spending is offset in later years (temporary).

2.43 In addition, Chapter 5 sets out the measures the Government is bringing forward to benefit those on low and middle incomes, helping to boost spending as these households tend to have a higher propensity to increase consumption in response to an increase in income.

The benefits of support

2.44 The precise economic impact of the VAT measure depends on a number of factors, including the extent to which the reduction in prices is passed through to consumers, the extent to which temporarily lower prices stimulate a greater volume of spending, and the amount that is spent on domestically produced goods and services rather than imports. The reduction in the VAT rate is expected to support families' and businesses' finances and spending power in the short term:

- in Britain's competitive retail sector, it is expected that the majority of the VAT reduction will be passed on to consumers through lower prices, increasing the purchasing power of families and individuals;
- where households choose to use this increased purchasing power to increase consumption, it will support growth now, contributing to the profits of businesses and helping to support employment; and
- where it is saved, it will help households to adjust their finances.

2.45 The economic forecast has made realistic assumptions – informed by the experience of other changes in VAT both in the UK and abroad – on the extent to which a cut in VAT is passed on in the form of lower prices. The forecast assumes that, over time, the majority of the reduction in VAT will be passed on to consumers through lower prices, and that households will spend around half of the increase in real disposable income that results. The increase in public investment will deliver a direct increase in economic activity. Overall, GDP growth in 2009 is forecast to be around ½ a percentage point higher than it would be in the absence of the discretionary action that the Government has taken.

Ensuring medium-term sustainability

2.46 By acting quickly and decisively to provide support to the economy when it needs it most, fiscal action – working alongside monetary policy – can help to reduce the impact on individuals and households of the financial markets shock and the risk of a deeper or more prolonged recession.

2.47 This action will be financed by borrowing in the short term. Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. Fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked through the economy in full. This Pre-Budget Report sets out measures which put the public finances on a path to achieve a balanced cyclically-adjusted current budget and a declining debt to GDP ratio by 2015-16.

2.48 These measures are a combination of adjustments to both taxation and spending, implemented at a time when the economy is forecast to be recovering and able to support fiscal consolidation. As set out in more detail in Chapter 5, the Government will make a number of reforms to income tax and national insurance contributions (NICs):

- **the income tax personal allowance will be restricted for those with incomes of over £100,000 – the 2 per cent of people with the highest incomes – from April 2010,** when the economy is forecast to be growing;

- **a new additional higher rate of income tax of 45 per cent (and 37.5 per cent for dividend income) will be introduced for those with incomes above £150,000 from April 2011;** and
- **a 0.5 per cent increase in the employee, employer and self-employed rates of NICs from April 2011,** when economic growth is forecast to be above trend rates and real incomes are growing strongly.

Other tax measures

2.49 As set out in more detail in Chapter 5, alcohol and tobacco duties will be increased to offset the effects of the temporary reduction in VAT. Maintaining these increases after December 2009 will further support fiscal consolidation.

Adjusted public spending plans

2.50 **The Pre-Budget Report also announces action to bring forward £3 billion of capital spending to support the economy, increasing capital budgets for 2008-09 and 2009-10.** In turn, this means that capital budgets in 2010-11 can be set at a lower level, with total capital DEL budgets over the entire CSR period being no higher as a result. The Pre-Budget Report also announces a **£5bn increase in the Government's Value for Money target in 2010-11, with consequential adjustments in departmental resource budgets to be announced at Budget 2009.** Further details are provided in Chapter 6.

2.51 The 2008 Pre-Budget Report fiscal projections are based on an assumption of average growth in current spending of 1.2 per cent a year in real terms over 2011-12, 2012-13 and 2013-14. Net investment moves to 1.8 per cent of GDP by 2013-14, still three times higher as a proportion of GDP than in 1997-98. Taken together these assumptions mean Total Managed Expenditure (TME) growing by 1.1 per cent per year in real terms on average over 2011-12, 2012-13 and 2013-14.

Impact on the public finances

2.52 The improvement in the public finances from 2010-11 is shown in Table 2.2 above, with both Public Sector Net Borrowing (PSNB) and the deficit on the current budget declining from this year, including in cyclically adjusted terms. In 2013-14, the action the Government is taking reduces net borrowing by 1.6 per cent of GDP.

THE FISCAL OUTLOOK

2.53 Table 2.3 presents the key fiscal aggregates based on the five themes of fiscal consolidation, economic impact, sustainability, financing and European commitments; while Table 2.4 compares the projections for net borrowing, the current balance, net investment and net debt with those published in Budget 2008.

Impact of the economic downturn

2.54 The global credit and commodity price shocks have adversely affected economic growth and the financial and property markets in the UK, as they have around the world. These developments also have significant implications for the public finances:

- lower economic growth acts to significantly reduce tax receipts, in particular from income tax, VAT and corporation tax due to lower incomes, consumption and profits;
- the financial crisis additionally affects the tax take from the financial sector, which over recent years has generated about 25 per cent of corporation tax revenue. Earnings and bonuses in that sector are also affected, reducing income tax receipts;
- sharp falls in house and share prices reduce capital gains tax and stamp duty receipts;

- the automatic stabilisers are working to support the economy, increasing spending on social security benefits; and
- higher than expected inflation since Budget 2008 has resulted in higher social security expenditure, reduced tax receipts (due to higher allowances) in 2009-10, and increased the cost of servicing index-linked gilts in 2008-09. These pressures moderate significantly over the projection period, as inflation is expected to fall sharply next year.

2.55 While economic growth is expected to pick-up progressively through 2010 and 2011 to a little above trend rates, total economic growth over the forecast period is lower than forecast at Budget 2008. Consistent with a rebalancing of the economy, the recovery is expected to be led by investment and exports, sectors that tend to provide less tax receipts than consumption. Furthermore, it is expected that the financial and housing market shocks will have an additional, persistent effect on the public finances. The forecast therefore assumes a deterioration in the public finances over the full forecast period compared to Budget 2008.

Current balance and net borrowing

2.56 Table 2.3 shows that both the deficit on the current budget and public sector net borrowing (PSNB) are projected to increase significantly in 2009-10. This reflects the impact of the economic downturn on tax receipts, including from the financial and housing markets. It also reflects the action that the Government is taking to support the economy and mitigate the impact of the economic shocks on businesses and individuals. Table 2.4 shows that discretionary support is most significant in 2009-10, acting to reduce the impact of the economic shock when it is expected to be at its strongest. PSNB peaks at 8.0 per cent of GDP in 2009-10. Of this, the discretionary fiscal action the Government is taking to support the economy accounts for 1.1 per cent of GDP, of which around 0.2 per cent of GDP is capital spending. In total, borrowing for capital investment accounts for 2.7 per cent of GDP in 2009-10. Therefore, excluding borrowing for investment and discretionary action, net borrowing in 2009-10 would be 4.4 per cent of GDP.

2.57 In later years, borrowing declines as a result of the recovery of the economy and the Government's action to ensure the sustainability of the public finances, but remains higher than forecast at Budget because of the persistent effects of the downturn on the level of growth and on the financial and housing sectors in particular. Total public sector net borrowing falls to 2.9 per cent of GDP by the end of the forecast period, reflecting the action the Government is taking to ensure the sustainability of the public finances over the medium term, including through the tightening in discretionary spending set out earlier in this chapter and reflected in Table 2.4. The improvement in the public finances from 2010-11 is shown in Table 2.3, with both PSNB and the deficit on the current budget declining from that year, including in cyclically-adjusted terms.

Table 2.3: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Fiscal consolidation							
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Consolidation in the cyclically-adjusted surplus on current budget [1]	-	-	-	1.0	1.2	0.7	0.6
Economic impact							
Net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net borrowing (PSNB)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Cyclically-adjusted PSNB	2.9	5.3	7.2	5.6	4.3	3.5	2.8
Sustainability							
Public sector net debt[2,3]	36.3	41.2	48.2	52.9	55.6	57.1	57.4
Core debt[2,3]	36.5	41.3	47.5	51.0	52.8	53.9	54.2
Net worth[4]	28.8	23.5	16.6	12.9	10.6	9.1	8.7
Primary balance	-1.0	-3.6	-6.7	-4.7	-3.0	-1.6	-0.5
Financing							
Central government net cash requirement	2.3	10.5	8.5	6.9	5.9	4.6	3.7
Public sector net cash requirement[3]	1.5	4.8	8.9	6.9	5.7	4.3	3.4
European commitments							
Treaty deficit[5]	2.8	5.4	8.1	7.0	5.6	4.4	3.3
Cyclically-adjusted Treaty deficit[5]	3.1	5.4	7.3	5.8	4.5	3.8	3.1
Treaty debt ratio[6]	43.2	52.9	60.5	65.1	67.5	68.6	68.5
Memo: Output gap	0.6	-0.3	-1.5	-1.9	-1.3	-0.7	-0.1

[1] Change in the cyclically-adjusted surplus on the previous year.
[2] Debt at end March; GDP centred on end March.
[3] Excluding financial sector interventions.
[4] Estimate at end December; GDP centred on end December.
[5] General government net borrowing on a Maastricht basis.
[6] General government gross debt measures on a Maastricht basis.

Table 2.4: Fiscal balances compared with Budget 2008

	Outturn[1]	Estimate[2]	Projections			
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Net borrowing (£ billion)						
Budget 2008	**36.4**	**42.5**	**38**	**32**	**27**	**23**
Changes to current budget	-1.2	31.6	74	77	65	56
Changes to net investment	1.4	3.5	5 ½	-4	-5 ½	-8
2008 Pre-Budget Report	**36.6**	**77.6**	**118**	**105**	**87**	**70**
Surplus on current budget (£ billion)						
Budget 2008	**-7.9**	**-9.6**	**-4**	**4**	**11**	**18**
Effect of revisions and forecasting changes	1.2	-23.3	-61	-78	-75	-72
Effect of discretionary changes[3]	0.0	-8.3	-13	1	10	16
2008 Pre-Budget Report	**-6.7**	**-41.2**	**-78**	**-73**	**-54**	**-37**
Net investment (£ billion)						
Budget 2008	**28.5**	**32.9**	**35**	**37**	**38**	**41**
Effect of revisions and forecasting changes	1.4	2.5	2 ½	- ½	-2	-1 ½
Effect of discretionary changes[3]	0.0	1.0	3 ½	-3 ½	-4	-6 ½
2008 Pre-Budget Report	**29.9**	**36.5**	**40**	**33**	**33**	**33**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2008	-0.7	-0.5	0.1	0.5	0.8	1.0
2008 Pre-Budget Report	**-0.8**	**-2.8**	**-4.4**	**-3.4**	**-2.3**	**-1.6**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2008	2.7	2.7	2.2	1.8	1.5	1.2
2008 Pre-Budget Report	**2.9**	**5.3**	**7.2**	**5.6**	**4.3**	**3.5**
Net debt (per cent of GDP)[4]						
Budget 2008	37.1	38.5	39.4	39.8	39.7	39.3
2008 Pre-Budget Report	**36.3**	**41.2**	**48.2**	**52.9**	**55.6**	**57.1**

Note - Totals may not sum due to rounding.

[1] *The 2007-08 figures were estimates in Budget 2008.*

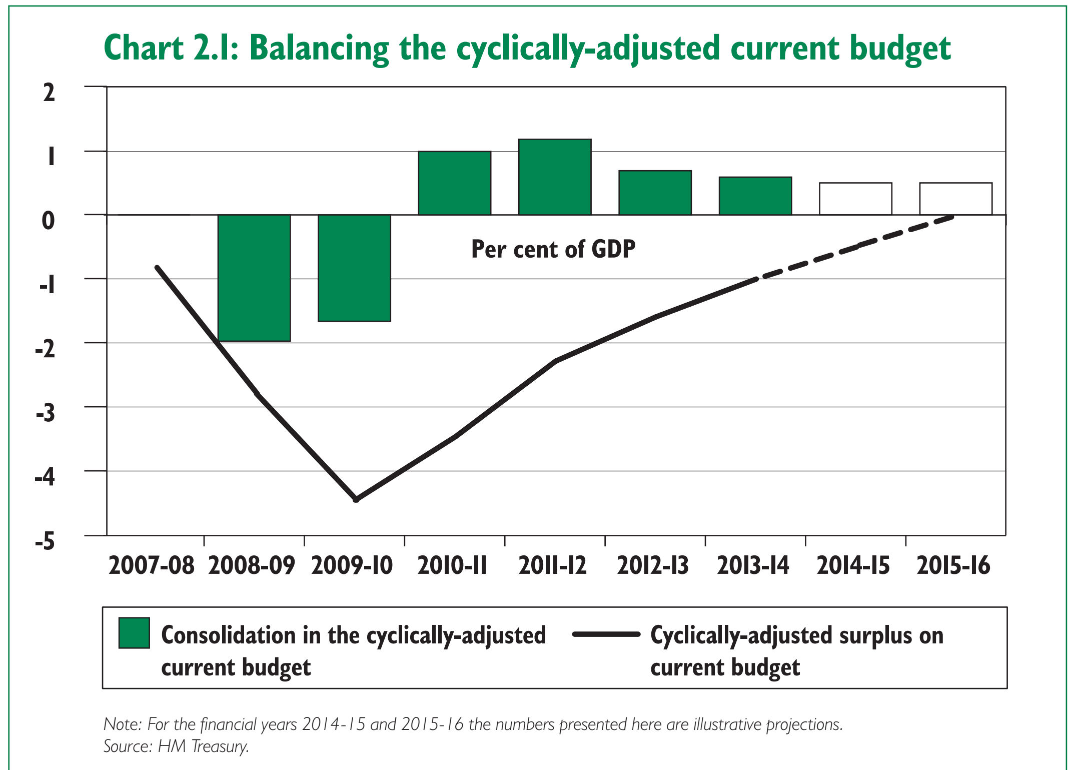
[2] *The 2008-09 figures were projections in Budget 2008.*

[3] *Including changes in forecasting assumptions on spending growth in 2011-12 and 2012-13.*

[4] *Debt at end March; GDP centred on end March; excluding financial sector interventions.*

Balancing the cyclically-adjusted current budget

2.58 This Pre-Budget Report puts the public finances on a path to achieve a balanced cyclically-adjusted current budget by 2015-16. The bars on Chart 2.1 show the planned fiscal consolidation in each financial year of the projection period. They show that the Pre-Budget Report fiscal projections entail a planned consolidation in the cyclically-adjusted current budget of over 0.5 per cent of GDP in each of the financial years from 2010-11 to 2013-14. As a result of this sustained consolidation, the cyclically-adjusted current deficit is projected to decrease from 4.4 per cent in 2009-10 to 1.0 per cent in 2013-14. A further adjustment of ½ a per cent of GDP per year in 2014-15 and 2015-16 would eliminate the deficit on the current budget by 2015-16. Therefore the fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a proportion of GDP by 2015-16 when the global shocks will have worked through the economy in full. This is consistent with the Government's temporary operating rule, described below.



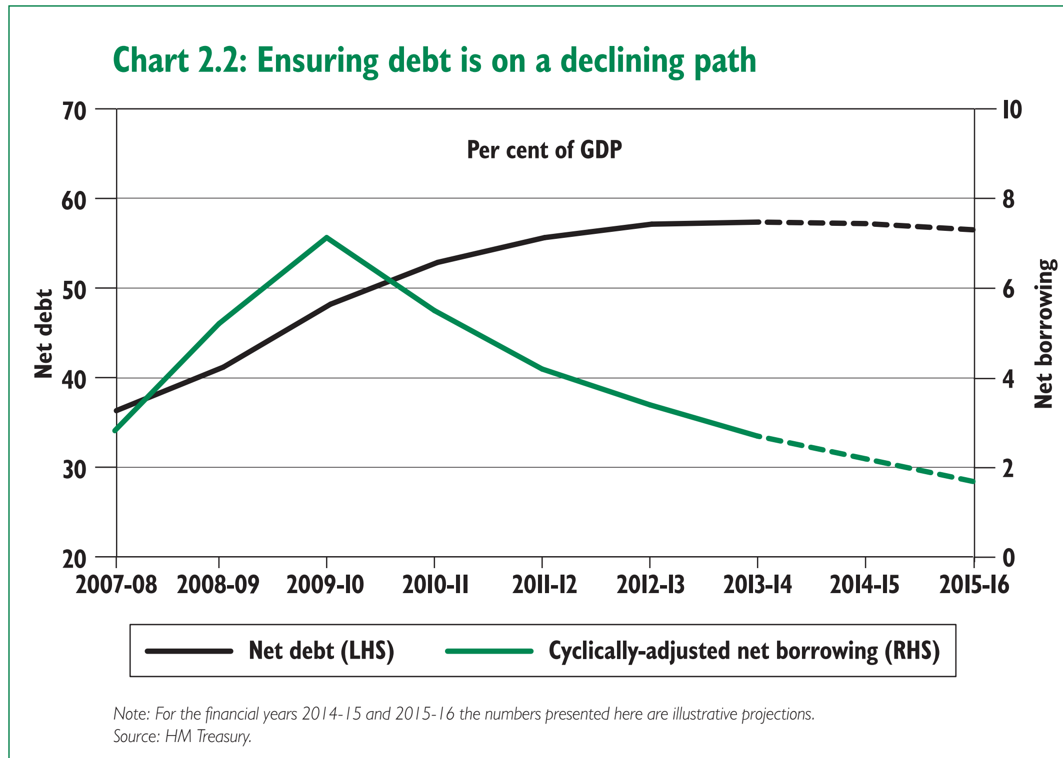
Note: For the financial years 2014-15 and 2015-16 the numbers presented here are illustrative projections.
Source: HM Treasury.

Declining net debt to GDP ratio

2.59 The Government reduced net debt as a proportion of GDP over the previous economic cycle – public sector net debt fell from 42.5 per cent GDP in 1996-97[3] to 36.0 per cent in 2006-07. Holding public debt at a prudent level in normal times allows space for debt to rise to accommodate shocks when they happen. The large and persistent impact of the financial markets shock in particular on the public finances means policy must adjust over a period of time, to avoid a short-term pro-cyclical tightening. This requires public debt to rise to absorb the shock and allow fiscal policy to support the economy, until adjustment has been completed and debt is set on a declining path as a proportion of GDP. Table 2.3 shows that, as a result of the impact of the economic downturn on borrowing, public sector net debt is forecast to increase over the projection period and stabilise at just over 57 per cent of GDP in 2013-14.

2.60 This Pre-Budget Report puts the public finances on a path that will ensure that the level of public debt will fall as a proportion of GDP in the medium term, once the global shocks have worked their way through the economy in full. Chart 2.2 shows that cyclically-adjusted PSNB is projected to decline from 2009-10, as a result of the planned fiscal consolidation, standing at 2.8 per cent at the end of the projection period in 2013-14. The chart shows illustrative projections based on a further improvement of ½ a per cent of GDP per year in the cyclically-adjusted current budget and assume that public sector net investment is held constant at 1.8 per cent of GDP. The illustrative projections show that, under these assumptions, cyclically-adjusted PSNB will continue to fall and the public debt to GDP ratio will be declining in 2015-16, once the global shocks have worked their way through the economy in full. This is consistent with the Government's temporary operating rule, described below.

[3] As debt is a stock measure, performance is measured against the end point of the previous cycle.



Note: For the financial years 2014-15 and 2015-16 the numbers presented here are illustrative projections.
Source: HM Treasury.

Economic impact

2.61 The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing. The overall impact of fiscal policy on the economy is made up of changes in:

- the automatic stabilisers – that part of the change in PSNB resulting from cyclical movements in the economy; and
- the fiscal stance – that part of the change in PSNB that is not a result of cyclical movements in the economy (as measured by changes in cyclically-adjusted PSNB).

2.62 Chart 2.3 shows the economic impact of planned fiscal policy over the forecast period. It shows that both the automatic stabilisers and the fiscal stance act to provide a considerable degree of support to the economy in 2008-09 and 2009-10, during the economic downturn. From 2010-11 the fiscal stance tightens to fund a reduction in borrowing at a time when the economy is expected to be recovering and able to support the fiscal consolidation.

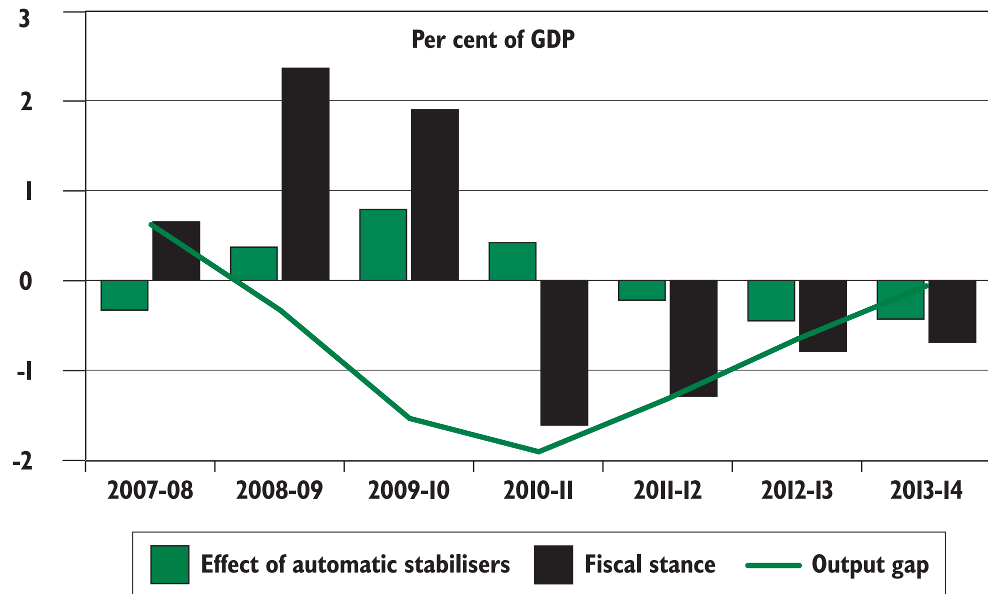
Box 2.4: The impact on net debt of action to maintain financial stability and protect depositors

The independent Office for National Statistics will determine how measures to maintain financial stability and protect depositors are classified within the National Accounts, in consultation with Eurostat (the Statistical Office of the European Union) and statistical offices in other member states to ensure consistent interpretation of international statistical guidance.

As any extra liabilities that may become classified to the public sector through these interventions will be temporary and backed by significant financial assets, they do not reflect future calls on the taxpayer. The long-term impact on the public finances, and any burden on future generations, would be determined by any eventual economic profit or loss incurred on the interventions. **As a result, consistent with the treatment of Northern Rock announced in Budget 2008, while the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on public sector net debt both including and excluding the impact of those interventions.**

The Government will base its fiscal policy, and measurement of its fiscal rules, on aggregates that exclude that impact. Any economic profit or loss on interventions will be included in both measures (and so within the fiscal rules) when that profit or loss crystallises for central government. Annex B sets out in full how the support has been accounted for in the public finances.

Chart 2.3: Fiscal policy supporting economic stability



Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, i.e. the difference between PSNB and the cyclically-adjusted PSNB.

Source: HM Treasury.

European commitments

2.63 As shown in Table 2.3, the Treaty debt ratio[4] is expected to rise from 43.2 per cent in 2007-08 to 68.5 per cent in 2013-14. European economies have all been affected by the unprecedented global economic shocks, and several European member states are already in recession.[5] Fiscal policy has an important role to play in these exceptional circumstances. The

[4] General government gross debt on a Maastrict basis.

[5] *European Commission Economic Forecast Autumn 2008*, European Commission, November 2008.

Government's objectives of smoothing the path of the economy in the short term while ensuring sound public finances over the medium term are consistent with the October European Council Conclusions, which confirmed that the Stability and Growth Pact should be applied in a manner that reflects current exceptional economic circumstances.[6]

Assumptions underpinning forecast

2.64 The projections for the public finances include the effects of firm decisions announced in this Pre-Budget Report or since Budget 2008, consistent with the requirements of the *Code for Fiscal Stability*. These include the measures set out above to support the economy in the short term and to ensure fiscal sustainability over the medium term, as well as all other decisions announced in this Pre-Budget Report, which are summarised in Chapter 1.

2.65 These forecasts are based on a range of assumptions and judgements on the public finances, the economy and the interaction between the two. A number of these are designed to provide caution and these are audited by the National Audit Office. A complete list of these assumptions is set out in Annex B.

2.66 For the 2008 Pre-Budget Report, in addition to auditing the Treasury's dating of the economic cycle, referred to earlier in this chapter, the Comptroller and Auditor General has audited the oil price assumption used for the Treasury's public finance projections. The report concludes that the convention was cautious over the past three years, is designed to provide caution in the future, and remains a reasonable assumption to use going forward.

Debt management

2.67 The forecast for the central government net cash requirement (CGNCR) for 2008-09 has been revised, from £59.3 billion at Budget 2008 to £152.9 billion, an increase of £93.6 billion. This significant increase in the Government's cash needs in 2008-09 reflects both the exceptional actions necessary to maintain the stability of the financial system, protect depositors' money and safeguard the interests of taxpayers, and developments in the wider economy, which have adversely affected the public finances forecast.

2.68 The increase in the Government's cash requirement in 2008-09 since Budget 2008 reflects:

- £37 billion for the Government's Bank Recapitalisation Fund;
- £21 billion to refinance the Bank of England's loans to the Financial Services Compensation Scheme (FSCS) for retail depositors in Bradford & Bingley and in UK subsidiaries of Icelandic banks eligible for payments from the FSCS and the Icelandic Depositors' and Investors' Guarantee Fund (ICS);
- £5.7 billion to refinance the Bank of England's working capital loan to Bradford & Bingley;
- a payment of £5.4 billion for retail depositors in Bradford and Bingley and UK subsidiaries of Icelandic banks covering that part of the deposits above compensation limits;
- partly offset by a downward revision in the forecast of the amount outstanding on the Government's loan to Northern Rock at 31 March 2009 from £14 billion at Budget 2008 to £12.2 billion; and
- a change of £26.5 billion mainly reflecting changes in the fiscal position.

[6] www.consilium.europa.eu

2.69 After having adjusted the cash requirement to obtain the financing requirement (see Annex B), the increase in the financing requirement will be met by:

- an increase in the projected contribution to net financing from National Savings and Investments (NS&I) of £7 billion (from £4 billion at Budget 2008 to £11 billion);
- an increase in projected net Treasury bill issuance of £8.7 billion (from £5.8 billion at Budget to £14.5 billion). £7 billion of this increase was announced on 14 October 2008; and
- an increase in planned gilt sales of £66.4 billion (from £80 billion at Budget to £146.4 billion). £30 billion of this increase was announced on 14 October 2008.

2.70 The Government's debt management objective, as set out in the *Debt and reserves management report 2008-09*, is to minimise, over the long term, the costs of meeting the Government's financing needs, taking account of risk, while ensuring that debt management policy is consistent with the aims of monetary policy. In line with this objective, the Government will, in addition to the issuance announced at Budget 2008, issue a further £37.8 billion in short maturity conventional gilts (of 1-7 year maturity), £20.3 billion in medium maturity conventional gilts (of 7-15 year maturity), £6.3 billion in long maturity conventional gilts (of 15 and over years maturity) and £2 billion in index-linked gilts in 2008-09. The increase in the skew of issuance towards short maturity conventional gilts also reflects the operational requirement to raise a significant amount of additional finance in a relatively short period of time and the short-term nature of some of the items raising the CGNCR in 2008-09. Further details and a revised financing table can be found in Annex B.

THE MACROECONOMIC FRAMEWORK

2.71 The Government's macroeconomic framework, introduced in 1997, was designed to maintain stability, in order to promote a strong economy and achieve its objective of a fair society where there is security and opportunity for all. Stability helps individuals, businesses and the Government to plan effectively for the long term, improving the quantity and quality of investment in physical and human capital, and helping to increase productivity.

2.72 The role of the macroeconomic framework in supporting strong and stable economic performance over the past decade has been acknowledged by international institutions, such as the IMF, as providing a strong foundation to weather global challenges.

2.73 The Government remains committed to this framework and the objectives enshrined within it. However, in the face of exceptional global economic challenges, it is important to consider the way that the framework is implemented, to ensure it continues to the deliver the Government's objectives of stability, growth and employment.

Financial stability framework

2.74 The core role of the banking system, and in particular the risk that bank failures pose for the wider economy, requires sector-specific regulation. In the UK, the framework to protect financial stability is enshrined in the 2006 Memorandum of Understanding (MoU) between HM Treasury, the Financial Services Authority (FSA) and the Bank of England (collectively known as 'the Authorities'). The division of responsibilities between the Authorities is based on four principles: clear accountability; transparency; avoidance of duplication; and regular information exchange.

2.75 International cooperation to ensure financial stability has become increasingly important as the degree of global financial integration has risen. Much of this cooperation takes place within the European Union or through engagement with non-legislative bodies such as the International Monetary Fund, the Financial Stability Forum or global standard-setting bodies like the International Accounting Standards Board.

2.76 While the Authorities have worked effectively to address the crisis (as discussed in Chapter 3), financial market developments since last summer have exposed shortcomings in both the domestic and international approach to financial regulation and the degree of international cooperation. Far-reaching changes are clearly needed and the Government's priorities in each area are set out in Chapter 3.

Monetary policy framework

2.77 The primary objective of monetary policy is to deliver price stability. The monetary policy framework introduced in 1997 provides full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times.

2.78 The adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment.

Performance of the framework

2.79 Since its introduction in 1997, the monetary policy framework has successfully delivered inflation that has been low and stable by historical and international standards:

- CPI inflation has averaged 2.3 per cent since CPI was made the operational target for monetary policy in December 2003, closely in line with the 2 per cent target;
- on average, the UK has had one of the lowest inflation rates in the G7 so far this decade. This compares with the period from 1980 to 1997 when UK inflation was the second highest of all G7 economies; and
- UK long-term interest rates have averaged 5.1 per cent since 1997 compared with an average of just over 9 per cent in the previous decade.

Response to economic shocks

2.80 Macroeconomic policymakers are currently facing difficult challenges in responding to the global credit and commodity price shocks. In these challenging economic circumstances, the monetary policy framework remains the right approach. Its design gives the independent MPC the means to deliver price stability while avoiding unnecessary volatility in output. The Government stands firmly behind the 2 per cent inflation target, and will continue to support the MPC in the forward-looking decisions it takes to ensure that inflation returns to target.

2.81 The remit[7] for the MPC states that if inflation deviates by more than one percentage point above or below the target, the Governor of the Bank of England must explain in an open letter the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC. The open letter system is an integral part of the macroeconomic framework. Open letters are published on the Bank of England and HM Treasury websites.

2.82 Since Budget 2008, the Governor of the Bank of England has written two open letters to the Chancellor, in June and September, as inflation moved more than 1 per cent above target. As the Governor stated in his September letter, this rise in inflation followed "sharp, largely

[7] www.bankofengland.co.uk

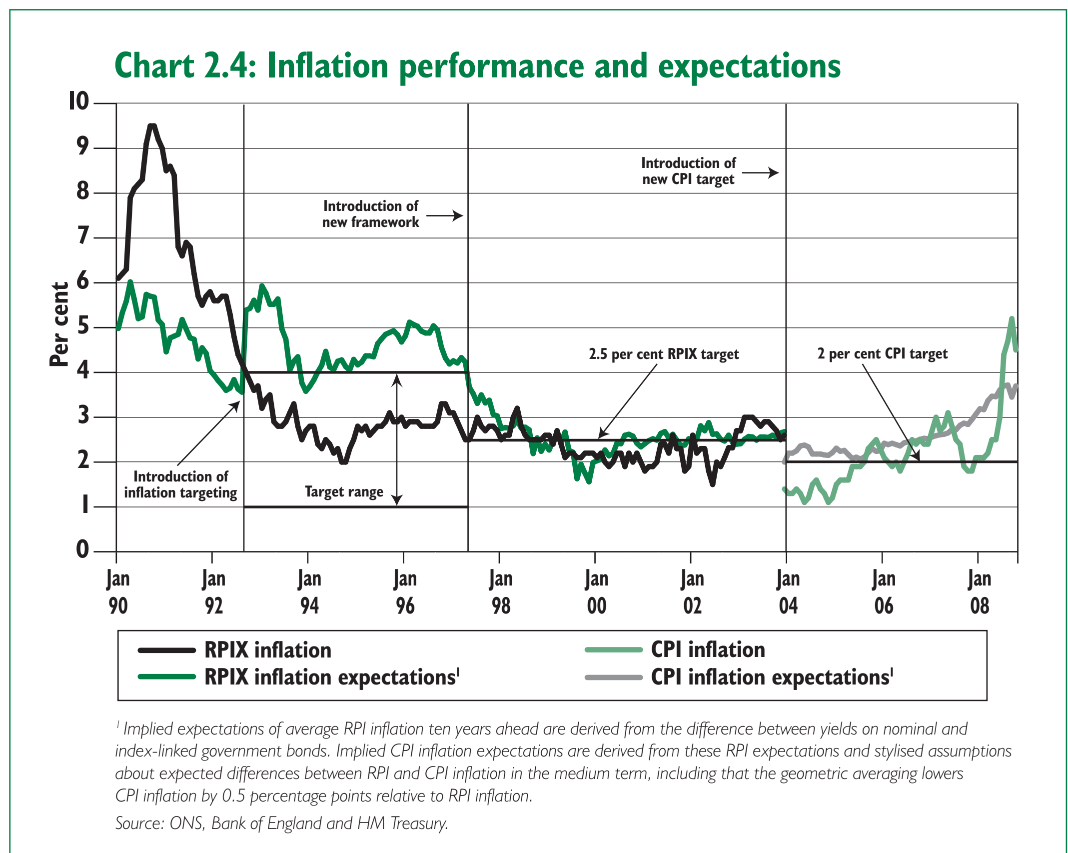
unanticipated, increases in the price of energy and food, reflecting developments in the global balance of demand and supply for these commodities." In the November Inflation Report, the projection was for inflation to fall back "rapidly in the near term, as the contribution from food and energy diminishes".

2.83 Responding to the intensifying global financial crisis, the MPC called a special meeting in October 2008, where the Committee decided to cut the policy rate by ½ a percentage point in a coordinated global action that involved six major central banks, including the Federal Reserve in the US and the European Central Bank. In November, the Bank of England reduced the policy rate by a further 1½ percentage points to 3 per cent, stating that "the risks to inflation have shifted decisively to the downside".

2.84 Inflation expectations appear to have remained anchored, testament to the credibility that the monetary policy framework has built since 1997. Survey measures of shorter-term inflation expectations have tended to move up in step with actual inflation, and while many of these measures have been elevated over the recent past, they have fallen back recently. The latest monthly surveys from GfK and YouGov/Citigroup showed a marked decline in inflation expectations – the October YouGov/Citigroup survey reported that the measure of household expectations for five to ten years ahead fell to its lowest level since the survey began in November 2005. Financial market-derived measures of inflation expectations can be affected by other market developments, and have been more difficult to interpret given recent market volatility. However, these data do not appear to point to a de-anchoring of expectations from the inflation target.

2.85 Throughout this period of above-target inflation, average earnings growth has remained stable and subdued showing that, despite a temporary increase in inflation, wage-setting behaviour remains consistent with achieving the inflation target.

Chart 2.4: Inflation performance and expectations



[1] Implied expectations of average RPI inflation ten years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI expectations and stylised assumptions about expected differences between RPI and CPI inflation in the medium term, including that the geometric averaging lowers CPI inflation by 0.5 percentage points relative to RPI inflation.

Source: ONS, Bank of England and HM Treasury.

2.86 The Pre-Budget Report measures have significant effects on the inflation outlook. In particular, the effect of the temporary cut in the rate of VAT is expected to lower inflation in 2009 and to raise it in 2010. The remit for the MPC states that there is a "recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output". The Pre-Budget Report measures could be considered an example of such a disturbance and therefore the MPC's remit allows it to look through the short-term movements in inflation that result.

Developments in the monetary policy framework

2.87 In June 2008, the Chancellor announced further details of reforms to the MPC appointments process. These changes, by injecting more openness and transparency into the process, demonstrate the Government's commitment to ensure that the monetary policy framework remains at the forefront of international best practice. The changes include a commitment to advertise vacancies for the Governor and Deputy Governors of the Bank of England and external members of the MPC, consistent with the principles of open competition.

2.88 These changes build on the reforms the Government has already made to the process for MPC appointments, announced in the 2007 Pre-Budget Report.

Fiscal policy framework

2.89 Recognising that "the conduct of fiscal policy has a critical influence on economic stability",[8] a new fiscal framework was outlined in the *Code for fiscal stability* ("the Code"), published alongside Budget 1998 and subsequently underpinned by legislation. The Code specifies five principles that underpin the formulation and implementation of fiscal policy: transparency, stability, responsibility, fairness and efficiency.

2.90 To increase the transparency and accountability of fiscal decision making, the Code requires the Government to set out in each Budget its fiscal policy objectives and the rules by which it intends to operate fiscal policy. It provides flexibility for the Government to either change its rules or depart from them on a temporary basis to ensure that at all times they are appropriate to deliver the Government's fiscal policy objectives, including when economic circumstances change significantly.

Fiscal policy objectives

2.91 Since 1997, the Government has had two clear and consistent objectives for fiscal policy:

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

Performance over the past cycle

2.92 Over the past cycle, these fiscal policy objectives were implemented through two fiscal rules, against which the performance of fiscal policy can be judged:

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

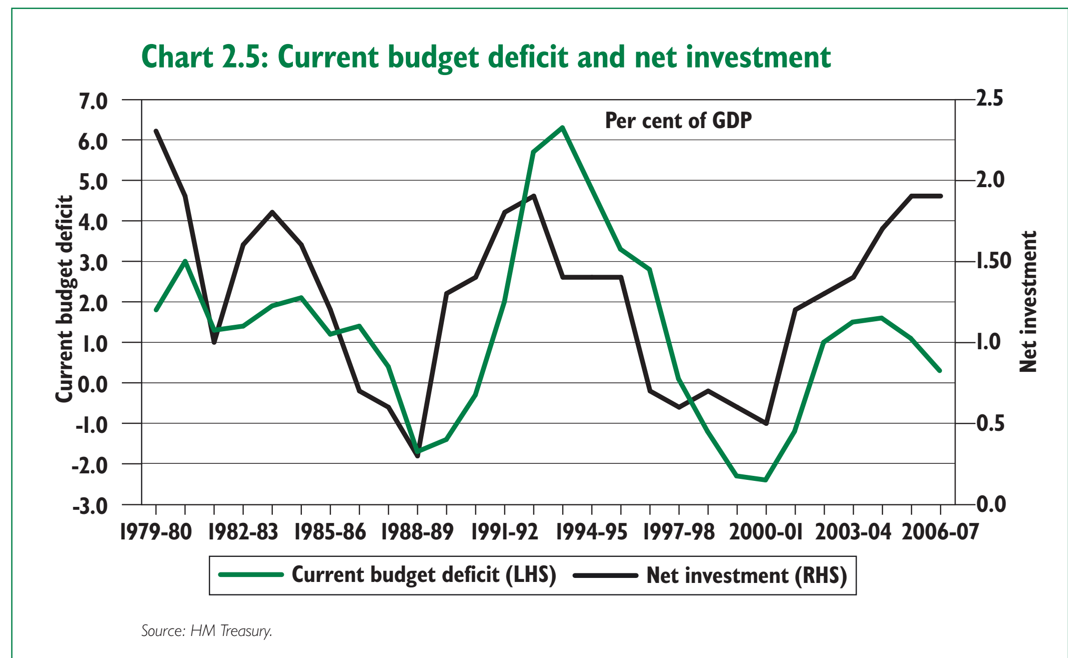
[8] *The Code for Fiscal Stability*, HM Treasury, November 1998.

2.93 As these rules were measured over the course of the economic cycle, the judgement that the cycle ended in the second half of 2006 makes it timely to review performance against them and their success in delivering the Government's fiscal policy objectives. *The Government's fiscal framework*[9] provides a more detailed assessment.

Supporting investment

2.94 The golden rule was measured by the average annual surplus on the current budget as a percentage of GDP. The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of fairness between generations. By requiring that the current budget be in balance or surplus over the cycle, the golden rule was designed to ensure that the current generation pay for the public services they consume. The golden rule was met over the economic cycle that started in 1997, with an average surplus on the current budget of 0.1 per cent of GDP.

Chart 2.5: Current budget deficit and net investment



Source: HM Treasury.

2.95 One of the key achievements of the fiscal framework has been to address the bias against capital spending that existed in the past and previous underinvestment in public services. Historically, it has been extremely rare for public investment to continue to grow during periods of fiscal consolidation, and prior to the introduction of the framework it had not happened for 40 years. The effectiveness of the golden rule is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment in Chart 2.5. Public sector net investment as a share of GDP has increased significantly, having risen from 0.6 per cent in 1997-98 to 2.1 per cent in 2007-08.

Maintaining a sustainable level of debt

2.96 The sustainable investment rule stated that '*public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level*'. In Budget 1998, the Government announced that it would maintain net debt below 40 per cent of GDP over the course of the cycle. In Budget 2003, the Government strengthened this commitment, stating that to meet the rule with confidence, net debt would be maintained below 40 per cent of GDP in each and every year of the then current cycle.

[9] *The Government's fiscal framework*, HM Treasury, November 2008.

2.97 The sustainable investment rule was met over the previous economic cycle. Net debt was reduced from 42.5 per cent of GDP at the end of 1996-97 to 36.0 per cent in 2006-07, and was maintained below 40 per cent of GDP on average over the cycle. The Government also met its additional commitment to maintain net debt below 40 per cent of GDP in each and every year from 2003-04 to 2006-07. According to latest IMF and OECD data, in 2007, UK net debt was lower as a percentage of GDP than all G7 countries, with the exception of Canada.

Supporting economic stability

2.98 A key consideration in the design of the fiscal rules was that fiscal policy should support monetary policy, in particular through allowing the full operation of the automatic stabilisers. In doing so, fiscal policy can help to support economic stability, reducing volatility in economic output and supporting the delivery of low and stable inflation and lower interest rates.

2.99 Compared to previous cycles, the introduction of the fiscal framework has helped to ensure that fiscal policy has acted in support of economic stability. During the period from 1997 to 2003, when the economy operated above trend until 2001 and then below trend during the global slowdown from 2001 to 2003, fiscal policy played a significant role in smoothing the path of the economy. Fiscal policy tightened to reduce demand in the economy while it was operating above trend and loosened to support demand, both through the operation of the automatic stabilisers and changes to the fiscal stance, as the economy moved below trend in 2001. Between 2004 and 2007, when the economy was operating close to trend, the degree of fiscal support moderated.

Responding to current economic circumstances

2.100 The Government's objectives for fiscal policy in the face of current economic circumstances – to help smooth the path of the economy in the short term, and ensure sustainability over the medium term – remain unchanged. The fiscal rules set for the last economic cycle were met, delivering the Government's objectives. However, applying the rules in these circumstances would not be consistent with achieving the Government's objectives for fiscal policy at a time when it needs to act with monetary policy to support the economy. Three key aspects of the current situation mean that seeking to meet the golden rule and the sustainable investment rule in the face of these shocks would not be appropriate:

- given the distinctive nature of the current global financial crisis, particularly the impact it has had on the monetary transmission mechanism, fiscal policy will need to play a more significant role in the year ahead in helping to support demand within the economy;
- the current economic cycle is projected to be unusual, with the up-phase interrupted by two major global economic shocks. This implies that aiming to balance the current budget on average over the cycle would require damagingly pro-cyclical fiscal policy; and
- the large and persistent impact of these shocks on the public finances mean policy must adjust over a period of time to avoid short-term pro-cyclical tightening. The right approach is to allow public debt to rise to absorb the shock and allow fiscal policy to support the economy, until adjustment has been completed and debt is set on a declining path as a proportion of GDP.

2.101 Supporting the economy in its recovery from these exceptional events will benefit not only current but also future generations. Responsible and sustainable management of the public finances therefore requires stabilising the financial sector and supporting the long-term growth of the economy. This means allowing borrowing to increase in the short term,

but ensuring a sustainable path for the public finances in the medium term, in addition to the measures the Government has undertaken to maintain financial stability and protect depositors.

A new fiscal operating rule

2.102 So, to achieve its objectives, and as provided for in the *Code for fiscal stability*, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full. Consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

2.103 The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

2.104 Charts 2.1 and 2.2 illustrate that the fiscal projections set out in the 2008 Pre-Budget Report are consistent with this fiscal operating rule and place the public finances on a path to meet the Government's fiscal objectives in the medium term.

Delivering the fiscal policy objectives

2.105 To ensure fiscal policy supports monetary policy and helps to smooth the path of the economy, the temporary operating rule:

- is designed to accommodate an increase in borrowing to support the economy in the short term; and
- is measured on a cyclically-adjusted basis, to allow the automatic stabilisers to operate in full at all times and avoid a sharp, pro-cyclical fiscal tightening.

2.106 Over the medium term, to ensure sound public finances and that taxation and spending impact fairly within and between generations, the temporary operating rule will:

- ensure that in the medium term borrowing is low and debt is stable and falling as a proportion of GDP;
- continue to protect capital spending and ensure that the public finances are in a position to deliver intergenerational fairness over the medium term; and
- ensure the Government remains on course to deliver sound public finances in the medium term, through a sustained improvement in the underlying position of the public finances.

Dealing with uncertainty

2.107 There is considerable uncertainty over the path of the economy and the public finances in the short term, and over the persistence of the economic shocks. Setting a rule focussed on steady improvement in the public finances allows the Government flexibility to cope with that uncertainty, while constraining fiscal policy to deliver sound public finances over the medium term.

Cyclical adjustment

2.108 The temporary operating rule is measured on a cyclically-adjusted basis. To ensure transparency, the Government is publishing alongside the Pre-Budget Report updated estimates of the effects of the economic cycle on the public finances,[10] which suggest that the Treasury's existing cyclical-adjustment coefficients should remain unchanged. In addition,

[10] *Public finances and the cycle: Treasury Economic Working Paper No.5*, HM Treasury, November 2008.

in the interests of transparency and accountability, **the Government will invite the National Audit Office to review the Treasury's approach to cyclical adjustment**.

The fiscal rules in the future

2.109 The fiscal projections in this Pre-Budget Report show how the Government intends to achieve its objectives in the medium term. In advance of the public finances reaching cyclically-adjusted current balance, the Government will set out how it will apply the fiscal framework in future to continue to deliver those objectives.

2.110 *The Government's fiscal framework*[11] provides further detail on the performance of the fiscal policy framework over the past cycle, along with the design and implementation of the new fiscal operating rules.

Public spending framework

2.111 The fiscal rules underpin the public spending framework. The recent period of strong growth in public spending was necessary to correct for previous under-investment in public services. Over the past ten years, public investment and reform of public service delivery have together generated real improvements in the quality of public services. Going forward, public spending must continue to be set at levels that ensure sustainability and protect intergenerational fairness. Faced with major global economic shocks, the Government's aim when setting its public spending plans is to support the economy in the short term and continue to improve public services, while ensuring fiscal sustainability over the medium term.

LONG-TERM FISCAL SUSTAINABILITY

2.112 The analysis above sets out how the Government will ensure sustainability in the medium term. In addition, the Government must also ensure that fiscal policy is sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects for long-term growth. It would also be inconsistent with the principles for fiscal management set out in the *Code for fiscal stability.*

2.113 With this in mind, the Government's fiscal framework will ensure a declining path for the level of public sector debt. There is no unique level of public debt, or debt-to-GDP ratio, that represents a prudent and sustainable level. In deciding what the right level of debt is, the Government therefore has to weigh up a number of factors. These include the need for investment, the intergenerational impact of spending and revenues and prospects for the long-term growth of the economy. In the past, evaluation of these different factors led the Government to conclude that over the previous cycle debt should be kept below 40 per cent of GDP.

2.114 The challenges facing the UK, and the rest of the world, today are very different. While the UK economy no longer suffers from the impacts of underinvestment it saw in 1997, it faces exceptional economic challenges brought on by the credit and commodity price shocks. Supporting the economy in its recovery from these exceptional events will benefit not only current but also future generations. Responsible and sustainable management of the public finances therefore requires stabilising the financial sector and supporting the long-term growth of the economy. This means allowing borrowing to increase in the short term, but ensuring a sustainable path for the public finances in the medium term, in addition to the measures the Government has undertaken to maintain financial stability and protect depositors. The long-term impact on the public finances, and any burden on future generations, of any extra

[11] *ibid.*

liabilities which may become classified to the public sector through these financial sector interventions will be determined by any eventual economic profit or loss incurred.

2.115 The Government is in a position to use debt to smooth the path of the economy because debt levels were low by both historical and international standards when the global economic shocks occurred. This highlights the importance of being prepared to deal with the challenges facing the economy, including those that may arise in the more distant future such as demographic change.

2.116 In the next decade the UK will begin to see the impacts of an ageing population, while further challenges lie ahead with the retirement of the 1960s baby boomers in the 2020s. The 2008 *Long-term public finance report* (LTPFR) provided a full assessment of the impact this will have on the public finances. The analysis showed that, while age-related spending is relatively low by international standards and projected to remain so, demographic change will put pressure on the public finances in the coming decades. To ensure long-term fiscal sustainability it is therefore vital to prepare for these events once the impact of the recent economic shocks has subsided, so the Pre-Budget Report sets fiscal policy to ensure that public debt is returned to a declining path once the global shocks have worked their way through the economy in full. The next Long-term public finance report will be published in 2009.

3 Ensuring financial stability

Financial markets influence the lives of every individual and business in the country. They are the core mechanism by which resources are efficiently allocated in an economy and a key driver of productivity, growth and opportunities. Financial instability, to the extent that it disrupts financial markets, can therefore affect everybody.

Since July 2007, the global economy has experienced levels of financial instability not seen for generations. The causes of this instability are varied and global. They include both macroeconomic factors, such as global financial imbalances, and microeconomic factors, such as the failure of banks to manage financial risk. The trigger for the instability was the downturn in the US housing market, the 'subprime' end of which was a feature of many of the financial products that had been created in recent years. The instability grew steadily, peaking in the weeks following the collapse of Lehman Brothers, a US investment bank, in September 2008.

The Government's objectives for addressing these threats to the financial system have been consistent, and focused around the need to:

- support stability and restore confidence in the financial system;
- protect depositors' money; and
- safeguard the interests of taxpayers.

In September 2008, the crisis intensified and it became clear that not just individual institutions but the entire banking system was at risk of collapse. That would have had devastating consequences for UK households and businesses. The Government therefore intervened decisively to prevent systemic collapse. First, to address concerns about liquidity, at least £200 billion was made available to the Bank of England's existing Special Liquidity Scheme. Second, to address concerns about solvency, at least £50 billion was committed to a Bank Recapitalisation Fund. Third, to address concerns about funding, a credit guarantee scheme was established.

Other governments around the world have followed with similar steps and market reactions have been generally positive. However, markets remain fragile and volatile. The Government remains committed to taking action to meet its objectives.

Looking to the future, and given the global nature of this instability, the Government's international priorities include:

- **as the 2009 Chair of the G20, making rapid progress on priority issues for the future of the international financial regulatory system;**
- **ensuring that the EU learns the lessons from the crisis, in particular regarding supervision and deposit protection arrangements for banks operating across borders; and**
- **reviewing the long-term opportunities and challenges for the UK's crown dependencies and overseas territories as financial centres.**

Within the UK, the Government's immediate priorities include:

- **continuing to monitor the financial system to ensure it is able to support the wider economy, including through appropriate levels of lending to businesses and households;**
- **strengthening the Banking Bill to enhance the Authorities' ability to deal with banking group holding companies and the insolvency of investment firms; and**
- **introducing measures to facilitate the raising of equity capital.**

FINANCIAL MARKETS AND STABILITY

3.1 Since July 2007, the global financial system has endured greater instability than at any time for generations. The implications of the instability have been felt by every household and business in the country and are covered throughout this Pre-Budget Report. This chapter analyses the origins and development of the crisis and describes the UK's policy response. The chapter concludes by outlining the UK's priorities for building a stronger, more resilient and more competitive financial system for the future.

The role of financial markets

3.2 Efficient, fair and stable markets are an essential part of the financial system in all developed economies. The financial system performs a crucial role in securing the efficiency of the economy by:

- providing firms and individuals with a secure means by which to make and receive timely payments;
- monitoring the performance of borrowers on behalf of savers to ensure that funds are used appropriately and loans repaid in a timely manner;
- allowing credit-worthy borrowers to have access to funds with which to tide-over temporary income shocks, thereby avoiding costly disruptions to consumption and investment plans;
- allocating the savings of households and businesses to opportunities expected to yield the highest risk adjusted return, raising the sustainable rate of economic growth and employment; and
- allowing the diversification of risk and the distribution of remaining risks to those most willing and able to hold them.

3.3 In addition, the financial services sector itself is an important part of the UK economy. In 2007, the sector accounted for 7½ per cent of GDP, employed around 1 million people and contributed around 25 per cent of corporation tax receipts. In the first half of 2008, the UK's trade surplus in financial and insurance services combined was £21 billion, up £4½ billion on the previous year. The Government therefore remains committed to the medium- and long-term competitiveness of the financial services sector in the UK and measures aimed at achieving this are outlined in Chapter 4.

Financial instability

3.4 Financial instability, to the extent that it creates losses in the financial system and disrupts its ability to support the economy, can affect everybody. If a retail financial institution fails, customers can be denied access to their savings unless adequate protections are in place. If the wholesale funding markets dry up, banks can no longer finance themselves to extend loans to individuals and firms on reasonable terms. And a lack of confidence in the financial system can have a very damaging effect on everyday economic activity. It is for these reasons that ensuring financial stability is central to the Government's economic objectives; not for the financial sector itself but for the economy as a whole.

Box 3.1: The economic importance of banks

Financial systems determine the efficiency with which savings by households and firms are channelled into the most productive investment opportunities in the economy. They are the core mechanism by which resources are efficiently allocated throughout an economy and a key driver of productivity, growth and opportunities. The prosperity of developed economies is underpinned by the existence of a well functioning financial sector and a number of influential studies show that the efficiency of a country's financial system is critically important in determining its growth and dynamism.[a]

The importance of banks rests on their business of making medium- and long-term loans to borrowers using the funds of depositors who may require repayment at very short notice. Banks pool customers' deposits together and act on their behalf by first assessing potential borrowers' ability to repay and then monitoring them to make sure the funds are used for the purpose agreed. Some banks rely on interbank markets to meet any additional funding requirements. By this process, banks enable households and businesses to borrow to purchase key items such as homes, or invest in new opportunities, repaying depositors with interest as loan repayments are made. This process creates an efficient allocation of finance at the centre of all modern economies.

However, the nature of this business carries inherent risk. If a large number of depositors demand immediate repayment of their savings, a bank without access to alternative funds would be forced to call in outstanding loans at short notice, causing severe disruption for borrowers and the wider economy. If the bank is judged to be solvent, central banks may provide access to funds, but at a penalty rate and secured against good quality collateral. In extreme cases, such distress at one bank can spread to other banks. Where this raises risks to the whole banking system, the potential cost in terms of bail-outs or loss of economic output and employment can be very high.

In the current global banking crisis, the inability to assess possible losses on complex assets has led to a sharp and widespread increase in the cost of funding for all banks around the world. This has led to higher borrowing costs for households and companies, pushing many advanced economies into recession. It also raised the risk of a systemic collapse, which would mean greater losses in output, employment and ultimately taxpayers' money. The Government's policy response to this challenge is described throughout this chapter.

[a] See for example: Levin, R (2004): *Finance and Growth: Theory and Evidence*, NBER Working Paper

The UK financial stability framework

3.5 The core role of the banking system, and in particular the risk that bank failures pose for the wider economy, requires sector-specific regulation. In the UK, the framework to protect financial stability is enshrined in the 2006 Memorandum of Understanding (MoU) between HM Treasury, the Financial Services Authority (FSA) and the Bank of England (collectively known as 'the Authorities'). The division of responsibilities between the Authorities is based on four principles: clear accountability; transparency; avoidance of duplication; and regular information exchange.

3.6 International cooperation to ensure financial stability has become increasingly important as the degree of global financial integration has risen. Much of this cooperation takes place within the European Union or through engagement with non-legislative bodies such as the International Monetary Fund (IMF), the Financial Stability Forum (FSF) or global standard-setting bodies like the International Accounting Standards Board.

Learning lessons

3.7 While the Authorities have worked effectively to address the crisis (as discussed below) financial market developments since last summer have exposed shortcomings in both the domestic and international approach to financial regulation and the degree of international cooperation. Far-reaching changes are clearly needed and the Government's priorities in each area are set out at the end of this chapter.

Box 3.2: Financial stability roles and responses

HM Treasury is responsible for the overall institutional structure of financial regulation and the legislation that governs it. Financial stability measures recently introduced by HM Treasury are described later in this chapter.

The FSA is responsible for the prudential supervision of firms and markets. Financial stability measures introduced in 2008 by the FSA include:

- publishing a thorough internal review into the supervision of Northern Rock, making recommendations for improvements and setting out areas of improvement already in train;
- introducing a temporary ban on active increases in net short positions on financial shares, on the basis that in extreme market conditions the short-selling of those shares was exacerbating disorderly markets; and
- issuing a strong statement on remuneration policy, making clear the need for firms to follow policies aligned with sound risk management systems and controls. The Authorities acknowledge the positive commitments already made by financial institutions in revising their remuneration polices.

The Bank of England contributes towards the maintenance of the stability of the financial system as a whole by supplying liquidity. Financial stability measures introduced in 2008 by the Bank of England include:

- coordinating liquidity management actions with other major central banks, which has been important given the international nature of the recent episode of financial instability. Specific measures include the introduction of dollar repo operations, as well as larger, more frequent long-term repo operations against wider collateral;
- introducing the Special Liquidity Scheme (SLS). The SLS is a temporary scheme that offers banks liquidity insurance by allowing them to exchange high-quality but currently illiquid securities for liquid UK government securities; and
- establishing new permanent liquidity insurance facilities which banks can access in stressed financial circumstances (the Discount Window), and permanent long-term repo open market operations against broader classes of collateral.

THE DEVELOPMENT OF THE FINANCIAL CRISIS

3.8 The origins of the financial crisis are numerous and global. They include the macroeconomic context, where increasingly integrated financial markets at differing stages of development and persistent global imbalances contributed to low interest rates. Low interest rates encouraged financial institutions to increase their leverage and to invest in new highly complex products, which were distributed to investors around the world. With hindsight, it is now clear that there was insufficient understanding and monitoring of the resulting risks in the private sector; internally in financial institutions; and in credit rating agencies; as well as by regulators across the world.

Macroeconomic factors

3.9 Over the past 20 years, global markets have become increasingly integrated, with enormous amounts of capital flowing across borders every day and emerging economies gaining an increasing share of international trade.[1]

[1] *Embracing financial globalisation*, HM Treasury, May 2008.

Drivers of low interest rates

3.10 In the aftermath of the late 1990s emerging markets' financial crisis, many emerging market governments followed fixed or managed exchange rate regimes and built up large foreign exchange reserves. This, in combination with traditionally high private saving rates and a sustained rise in commodity prices, resulted in large net foreign exchange positions in these countries. A large proportion of these were invested in developed countries' government bonds and private debt instruments, financing substantial current account deficits in developed economies (especially the US). Together, these cross-border investment flows helped to push global long-term interest rates lower.

3.11 In addition, improved domestic macroeconomic policy frameworks and increased supply of low-cost goods from the emerging markets reduced consumer price inflation and lowered longer term inflation expectations, contributing further to a low long-term interest rate environment. The result was low government bond yields and low returns on fixed-income financial assets across all advanced economies.

The search for yield

3.12 With returns on conventional fixed-income assets low, and against a stable macroeconomic environment, investors sought higher returns by taking on more risk – both in terms of the products they created and invested in, and by increasing exposure to these instruments through higher levels of borrowing. This pushed down spreads on riskier assets to historically low levels, both between countries and between corporate borrowers.

Microeconomic factors

Increasing financial complexity

3.13 Advances in information technology widened the scope for financial institutions to create new products, for example by bundling together and subsequently repackaging traditional loans such as mortgages. Whereas individual loans have different terms and are backed by specific collateral, these loans were repackaged into securities. Examples include the complex and sometimes opaque structures known as 'collateralised debt obligations' (CDOs).[2] These products were then offered to investors around the world to meet the demand for higher-yielding assets. It is now clear that investors were under-pricing risk, and some investors were exposing themselves to risks they had not understood. As a result, these new products became overvalued.

Increasing leverage

3.14 Banks also sought to increase returns by raising borrowing levels (referred to as 'leverage'), particularly in wholesale markets, faster than growth in their equity capital, to fund the expansion of both traditional lending and more innovative securities. While domestic and international regulation tried to address risk from growth in lending and other assets, it did not keep up with changes in how banks funded this expansion. Investors borrowed heavily in global capital markets that turned out to be more vulnerable to illiquidity than had been previously experienced. Structured investment vehicles and conduits were developed to hold assets like CDOs, increasing the degree of leverage without the requirement to hold as much regulatory capital as would have been the case if these assets had been held on the banks' own balance sheets.

3.15 The counterpart to the greater leverage and financial complexity was increased lending to businesses and households. Much of the increase in household debt fuelled rising house prices and, in turn, a greater willingness to accept more debt. Many non-financial businesses also increased their leverage, often through transactions intended to increase returns to shareholders, without fully recognising the risks.

[2] CDOs are securities backed by a portfolio of fixed income assets that are issued in tranches of varying seniority. As default losses accrue to the underlying portfolio they are applied to securities in reverse order of seniority.

Shortcomings in the management of risk

3.16 Market participants and internal risk management systems further contributed to the development of the crisis. Directors and shareholders, as well as debt investors in financial institutions, failed to recognise the inherent risks associated with remuneration policies that were based on bonuses rewarding short-term book profits irrespective of the longer-term implications when the financial cycle turned. Similarly, credit-rating agencies failed to provide accurate ratings for structured products and the credit-rating business model, whereby institutions paid the agencies for the ratings received, allowed the development of potential conflicts of interest. Equally, it is not clear that investors exercised their own due diligence regarding their investments, relying instead on inadequate valuations by banks and the credit-rating agencies.

3.17 Finally, regulation did not keep pace with financial innovation and market practices. It failed to focus sufficiently on the pace and nature of balance sheet expansion by many financial institutions, and the systemic consequences of liquidity and credit risk. The combination of product and technological innovation made it possible to design and trade financial instruments in such a way that the nature of the risk they contained, and where that risk was located, was difficult to determine. When concerns over the location and risk of certain assets became too large, the close integration of financial markets ensured that the withdrawal of liquidity in one area rapidly transmitted instability to other, seemingly unrelated, parts of the global financial system.

US subprime market trigger

The US housing market

3.18 Financial innovation provided prospective homeowners with access to greater sources of funding, either at attractive short-term fixed interest rates or to borrowers with weak credit histories. This was particularly true in the US, where subprime mortgages, which were often linked to low short-term fixed, or 'teaser', rates before re-setting to higher floating rates, funded an increase in demand for housing from individuals previously unable to afford a house. This increased demand for housing pushed up prices.

3.19 During 2006 there was a downturn in the US housing market after a decade long boom. As US interest rates rose and house prices fell, defaults on subprime loans increased markedly and it became clear that the structured investment products that had repackaged these loans were worth less than had been thought. As a result, financial institutions around the world have had to revalue these securities, with the Bank of England estimating that losses in the market value of assets linked to US subprime mortgages amount to $600 billion.[3] The complex nature of these assets made the recognition of the size and location of the losses difficult. This led to a sharp increase in actual (and an even sharper increase in perceived) counterparty risk, translating into mounting pressure on liquidity.

Liquidity concerns

3.20 At the onset of the crisis, banks became highly uncertain about their future funding needs and less confident about their ability to meet potential demands quickly due to the illiquidity of money markets. As a result, the demand for central bank reserves increased. Central banks responded by developing their liquidity supply operations and facilities, including the coordinated provision of US dollar liquidity by central banks in Europe.

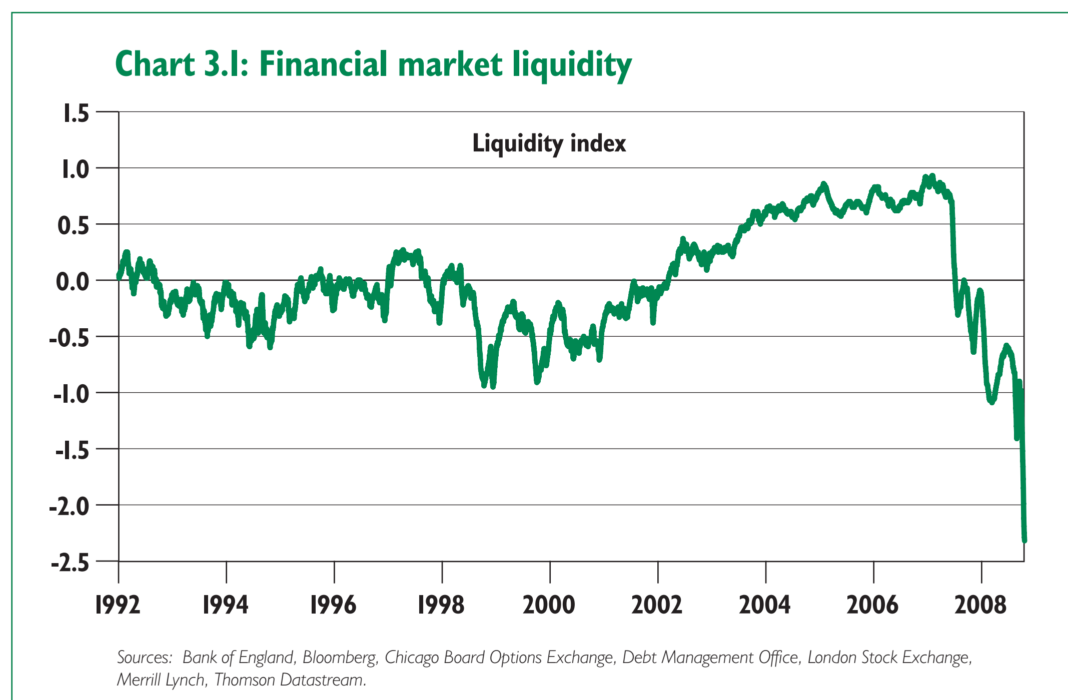
[3] *Financial Stability Report*, Bank of England (October 2008). Total mark-to-market losses on structured assets and corporate bonds were estimated to amount to $2.8 trillion.

Impact on individual institutions

3.21 As the crisis unfolded, interbank markets came under pressure as investors became reluctant to place funds in unsecured money markets at anything other than the shortest horizon. In such troubled market conditions, even major institutions were vulnerable. A liquidity run on Bear Stearns ended with the forced sale of the investment bank to JP Morgan Chase, supported and funded by a $29 billion Federal Reserve loan on 16 March 2008. Within the UK, concerns over liquidity became particularly acute in the market for retail mortgage backed securities (RMBS), where public issuance fell from a peak of £41 billion in the fourth quarter of 2006 to £0.4 billion in the first quarter of 2008.[4] Northern Rock's difficulties, caused by excessive reliance on money markets, are discussed later in the chapter.

3.22 As it became apparent that funding conditions were becoming tighter, asset prices began to adjust. In particular, house prices in many countries began to fall. Lower property values implied less collateral behind secured loans, thereby increasing the risk of banks across several countries. With this development, interbank markets became even less liquid.

Chart 3.1: Financial market liquidity



Sources: Bank of England, Bloomberg, Chicago Board Options Exchange, Debt Management Office, London Stock Exchange, Merrill Lynch, Thomson Datastream.

Solvency concerns

3.23 September 2008 marked the beginning of the most turbulent period of the current financial turmoil. US mortgage finance agencies Fannie Mae and Freddie Mac were placed into conservatorship, as doubts increased about their solvency. A few days later, the share price of Lehman Brothers fell sharply as concerns about its financial condition grew and other firms started to pull back from doing business with it. This liquidity run, and failure to find a private sector buyer, eventually forced Lehman Brothers to file for Chapter 11 bankruptcy protection on 15 September. Other US investment banks came under pressure, prompting the sale of Merrill Lynch to Bank of America, and subsequently the transformation of Morgan Stanley and Goldman Sachs into bank holding companies, allowing them similar access to the Federal Reserve's facilities as that of depository institutions.

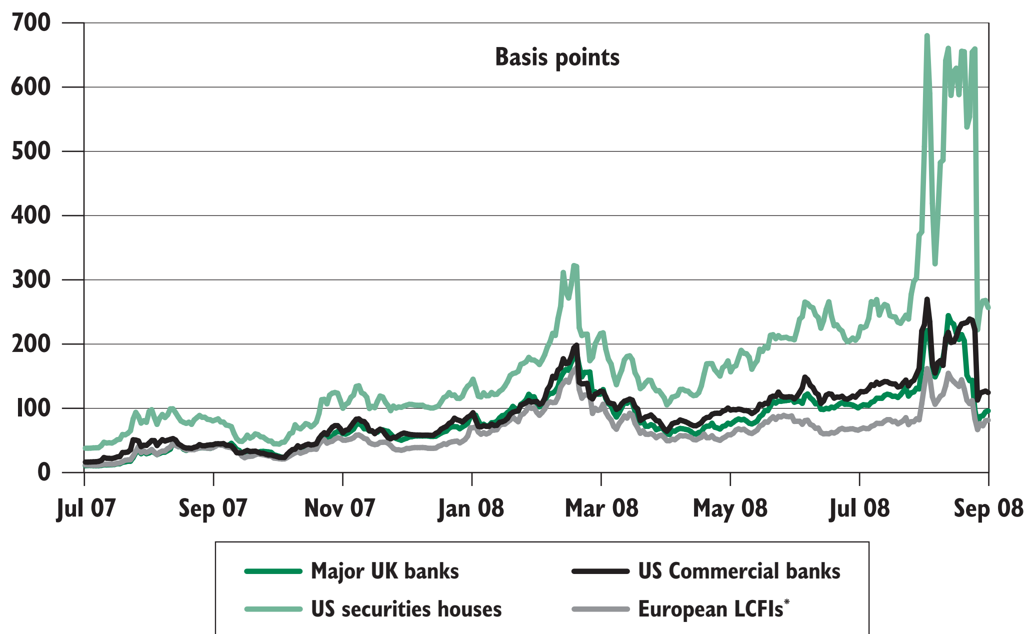
[4] *Mortgage finance: final report and recommendations*, Sir James Crosby, HM Treasury, 2008.

3.24 In the following days, the US insurer AIG came under pressure as investors became concerned that it could not raise enough cash to meet its growing obligations. The US Federal Reserve, with the support of the US Treasury, extended to the company an $85 billion loan, judging that the failure of AIG would present a systemic risk. This initial loan proved insufficient and further lending from the Federal Reserve and a recapitalisation by the US Treasury became necessary.

Interbank funding strains intensify

3.25 In the aftermath of Lehman Brothers' failure, institutions across Europe and the US experienced severe difficulties. The global financial system came under extreme stress as financial institutions and investors lost confidence in counterparties in general. Spreads on interbank lending reached unprecedented highs and stock markets fell 20 per cent or more in less than a month. The extreme financial volatility, and the threat it posed to the functioning of the banking system, necessitated a number of significant government interventions in the financial markets in the UK, US and across Europe.

Chart 3.2: Financial institutions' credit default swap premia



Source: Bank of England
**Large complex financial institutions*

Box 3.3: Financial instability in the emerging markets

In the past two months, the financial crisis has spread to the emerging markets. Investors have moved to the relative safety of dollar assets and economic prospects have deteriorated sharply around the world. A number of countries in eastern Europe and beyond have experienced economic instability, with important implications for UK interests.

A number of countries have approached the IMF for support, which has already fast-tracked multi-billion dollar support packages for Hungary and Ukraine. It has also created a new short-term liquidity facility for those emerging markets that have sound economic policies but are experiencing difficulties accessing funding from abroad as a result of the financial crisis. The EU has played an important role in supporting European countries experiencing difficulties, particularly through its balance of payments facility.

The Government is playing an important role working with the IMF, the EU, the G7 and the G20 in responding to emerging market risks, leading calls for the international community to take action to ensure that the IMF has sufficient resources to continue to provide support to countries affected by the financial crisis. The Government welcomes the ongoing work to review the IMF's lending instruments. It is important that these instruments remain relevant to today's challenges and adequately meet their members' needs.

UK POLICY RESPONSE TO THE FINANCIAL CRISIS

Consistent objectives

3.26 Strong banks, and confidence and trust in the financial system, play an integral role in supporting jobs and prosperity across the UK. Since the onset of the instability in August 2007, the strength of institutions has been questioned and confidence diminished, requiring the Government to intervene to protect the interests of individuals, businesses and the taxpayer. Throughout this period, the Government has been clear about the objectives of these interventions, which are to:

- support stability and restore confidence in the financial system;
- protect depositors' money; and
- safeguard the interests of taxpayers.

3.27 The Government has also made clear that pursuing these objectives will not compromise the UK's longstanding commitment to economic and financial openness, recognising that the benefits of financial globalisation, if underpinned by the appropriate systems of global financial regulation, can be significant.[5]

And a flexible approach

3.28 The scale and impact of turbulence in financial markets has evolved since July 2007, as described in the previous section. To accommodate the changing circumstances, the Government's strategy for achieving its objectives has also evolved through two key stages:

- as individual institutions came under pressure, the Government protected financial stability through targeted actions at an institutional level, as well as supporting measures to improve liquidity in the financial system; and
- as concerns over solvency escalated and it became more likely that the global banking system as a whole would be affected, with inestimable consequences for the UK and global economy, the Government led the international response by delivering a comprehensive and decisive package that addressed the root causes of the crisis.

[5] *Embracing financial globalisation*, HM Treasury, 2008.

Targeted actions at an institutional level

3.29 The initial manifestation of financial instability in the second half of 2007 was the rapid reduction in liquidity and equally rapid spike in perceived counterparty risk. The impact this had on banks varied according to institution-specific factors, such as an individual bank's business model and exposure to particular asset classes. While this persisted, the appropriate policy response was to deal with problems faced by institutions on an individual basis and to support actions to improve liquidity in the financial system.

Northern Rock

3.30 Northern Rock's business model was highly dependent on wholesale funding. As wholesale funding markets tightened during summer 2007, Northern Rock was left unable to fund its operations. On 17 September 2007, the Government announced guarantee arrangements in respect of all existing retail savings in, and certain existing wholesale liabilities of, Northern Rock. This was to prevent contagion from the large-scale withdrawals of deposits that followed the announcement of an emergency loan from the Bank of England. The guarantee arrangements were extended as necessary in the light of circumstances. However the bank's funding problems remained, and after exploring all options for a private sector solution (including options which included ongoing public support), the Government took Northern Rock into temporary public ownership using powers under the Banking (Special Provisions) Act, which is discussed below. In August 2008, the Government announced that it would strengthen Northern Rock's capital position by converting up to £3 billion of the Government loan into equity, and converting £400 million of preference shares into ordinary shares. Northern Rock is now pursuing a business plan aimed at creating a smaller, more viable mortgage and savings bank, repaying the Government loan and enabling release of the Government guarantee arrangements.

Box 3.4: New powers to achieve the Government's objectives

Immediately following the onset of financial instability in August 2007, the Government acknowledged that existing powers were insufficient to address a bank failure quickly and effectively. Over the autumn of 2007, the Government consulted extensively on delivering the appropriate powers while minimising unintended consequences.

In February 2008, the Government introduced the Banking (Special Provisions) Act, granting HM Treasury powers to transfer the securities or property rights and liabilities of distressed banks or building societies to the public sector, or any private sector company. The Act allowed the Government to respond effectively and expediently when Bradford & Bingley and the two Icelandic banks with UK subsidiaries encountered severe financial difficulties, which are both discussed below.

After further in-depth consultation, in October 2008 the Government introduced to Parliament the Banking Bill, which is described later in the chapter.

Bradford & Bingley

3.31 The Banking (Special Provisions) Act enabled the Government to take swift action in relation to Bradford & Bingley. The bank was heavily reliant on buy-to-let and self-certified mortgages, which were of poorer quality than prime residential mortgages and which were vulnerable to a sharp rise in the rate of arrears. As a result, it lost market confidence, causing its share price to fall sharply and making it increasingly difficult for it to access funding. On 27 September, the FSA determined that Bradford & Bingley was no longer meeting its threshold conditions to operate as a deposit-taker under the Financial Services and Markets Act 2000 and FSA rules. The FSA also declared the company to be in default for the purposes of the Financial Services Compensation Scheme (FSCS). The Government, on the advice of the FSA and the Bank of England, acted immediately. The retail deposits and branches of Bradford & Bingley were transferred to Abbey National plc following a competitive sale process. The remainder of Bradford & Bingley's business was taken into public ownership and will be wound down.

3.32 Under the Transfer Order, the FSCS has paid out approximately £14 billion to enable retail deposits held in Bradford & Bingley and covered by the FSCS to be transferred to Abbey National plc (a subsidiary of the Spanish bank Santander). This is financed through a short-term loan from the Bank of England, which will be replaced with a loan from the Government after a short period of time. HM Treasury has made a payment to Abbey National plc for retail deposit amounts not covered by the FSCS, amounting to approximately £4 billion. In return, the FSCS and the Treasury have acquired rights against Bradford & Bingley and will be repaid through the proceeds of the wind-down and realisation of the assets of the remaining business of Bradford & Bingley in public ownership.

Icelandic banks

3.33 By autumn 2008, the Icelandic financial services sector had become significantly over-leveraged, with profound implications for Iceland's economic stability. In an attempt to stabilise the country's financial system following a very serious deterioration in the principal Icelandic banks, the Icelandic authorities passed emergency legislation on 6 October 2008.

3.34 On 8 October, the Government froze the assets of Landsbanki in the UK. This was because there was great uncertainty as to whether UK creditors and depositors were receiving fair and equal treatment and whether the Icelandic authorities were complying with EEA and international law. Discriminatory and unlawful treatment would have had consequential impact on the UK economy (or part of it), including through an impact on depositor confidence. This action was taken under the Anti-terrosim, Crime and Security Act 2001. The 2001 Act includes a broad range of provisions and is not only about countering terroism. The UK's action was not taken on the basis of the anti-terrorism provisions in the Act.

3.35 Also, during the second week of October, the UK subsidiaries of two Icelandic banks, Kaupthing, Singer & Friedlander and Heritable, were facing serious difficulties as a result of market developments and the emerging situation in Iceland. It was therefore necessary for the FSA and the Treasury, in their respective capacities, to take action to resolve the situation. Kaupthing, Singer & Friedlander and Heritable were both placed into administration following due legal process. The Treasury exercised their powers under the Banking (Special Provisions) Act to transfer the retail deposits in certain accounts in KSF and in Heritable to the Dutch bank ING.

3.36 Through these actions, the Government has protected all FSCS-eligible retail deposits of Kaupthing, Singer & Friedlander and Heritable, as well as all FSCS-elibible retail deposits in the UK branch of Landsbanki.

Consolidation of the retail banking sector

3.37 The events described above, combined with other completed or planned mergers among UK banks and building societies, have led to some consolidation of the UK banking sector. Examples of this include:

- the transfer of the deposit books of Bradford & Bingley and the two Icelandic subsidiaries to Abbey National plc and ING respectively;
- the takeover of Alliance & Leicester by the Spanish bank Santander;
- the planned merger between Lloyds TSB and HBOS, for which the Secretary of State for Business, Enterprise and Regulatory Reform issued an intervention notice allowing the decision on whether to refer the merger to the Competition Commission to be made with reference to both competition and financial stability. The Secretary of State also made a general change to competition law, adding maintenance of UK financial stability to the list of public interest considerations in the Enterprise Act 2002. On 31 October 2008, the Secretary of State, having considered a report by the Office of Fair Trading and other

submissions put to him, concluded that the merger between Lloyds TSB and HBOS was in the overall public interest; and

- the planned mergers of a number of UK building societies: Catholic and Chelsea Building Societies; Cheshire, Derbyshire and Nationwide Building Societies; Barnsley and Yorkshire Building Societies; and Scarborough and Skipton Building Societies. These transactions are all expected to be completed before the end of the year.

3.38 Consolidation of the banking sector is neither a recent nor UK specific phenomenon: in the US, for example, there were 7,000 commercial banks at the end of 2007, compared with nearly 14,500 in 1984.[6] The Government remains committed to competition as an essential characteristic of fair and open markets. However, under certain circumstances, consolidation results in stronger and better-capitalised financial institutions, which will lead to greater financial stability; more protection for consumers; and better availability of competitive financial products.

A comprehensive and decisive UK policy response

3.39 As set out above, financial market conditions deteriorated significantly following the collapse of Lehman Brothers in September 2008. The problems were no longer confined to specific institutions but affected the entire system, irrespective of business models. The likelihood of the banking system collapsing, with profoundly damaging consequences for the wider economy, had increased.

The cost of a systemic collapse

3.40 It is difficult to estimate what the cost would be to the UK of a systemic financial collapse. Recent IMF analysis of previous banking crises suggests it would be very significant. In the six developed market crises most similar to the current crisis, the average fiscal cost was 9.4 per cent of GDP. However, there is great variance in these figures: the fiscal cost in Japan was estimated to be 24 per cent of GDP, while in Sweden some estimates suggest it was only 3.6 per cent.[7] This spread can in part be attributed to the speed and decisiveness of the relevant government's policy response.

Specific and comprehensive measures

3.41 Therefore, after consultation with the Bank of England and the Financial Services Authority, on 8 October the Government announced measures to address the three root causes of the crisis: concerns about liquidity, capital and funding:

- first, to address concerns about liquidity, the authorities announced that at least £200 billion would be made available to banks under the Bank of England's Special Liquidity Scheme (SLS). The SLS, which was first introduced in April 2008, provides banks and building societies with short-term liquidity by allowing them to swap temporarily pre-existing, illiquid financial assets, including mortgage-backed securities, for highly liquid Treasury bills. It is designed to provide financing for legacy illiquid assets existing at the end of 2007. Each swap is for a period of one year but can be renewed for a total of up to three years at the Bank's discretion. The SLS drawdown window will be open until 30 January 2009;

- second, to address concerns about solvency, the Government established the Bank Recapitalisation Fund. This makes available new Tier 1 capital to eligible UK banks and building societies, allowing them to strengthen their resources, while maintaining their support for the wider economy. The Bank

[6] Federal Deposit Insurance Corporation: www.fdic.gov

[7] International Monetary Fund: www.imf.org

Recapitalisation Fund, and the role of UK Financial Investments Ltd. in managing the investments, is described below; and

- third, to address funding concerns (reflecting a lack of mutual confidence and trust between financial institutions), the Government established a credit guarantee scheme. This makes available to eligible institutions a government guarantee to refinance maturing debt. The credit guarantee is intended to unblock the interbank money market, thereby allowing banks to continue to lend to the wider economy. Since 13 October, the Debt Management Office, an Executive Agency of HM Treasury, has been operating the scheme.

Impact of the measures

3.42 This package of measures was essential. In the short term, it has stabilised the UK banking system. Over the coming months and years, it will cushion the impact on households and businesses as banks seek to rebalance their funding needs away from wholesale funding and towards customer funding. The recapitalisation measures in particular will increase banks' capacity to absorb losses on legacy assets, reducing the impact of the economic downturn on banks' lending behaviour, thereby supporting the availability of bank credit to households and companies.[8]

International responses

3.43 Given the global nature of the disruptions in financial markets, and the interconnectedness of the international financial system, it is vital for countries to coordinate their actions and to take account of the potential cross-border effects of national decisions. The communiqué of the G7 Finance Ministers and central bank governors on 10 October agreed a plan of action for coordinated interventions concerning the recapitalisation of financial institutions and the unfreezing of credit and money markets that was consistent with the UK's policy response.

3.44 In line with action taken by the UK, both the US government and the euro area governments have announced their own proposals. The US Treasury has announced the introduction of a recapitalisation programme as part of its $700 billion financial rescue package and support the Federal Reserve's efforts to unlock lending. Euro area governments have committed to a common approach based on guaranteeing bank funding and the recapitalisation of banks as necessary; in particular, France and Germany have announced rescue packages of €860 billion, out of which up to €120 billion will be used for recapitalisation. Central banks have also coordinated injections of liquidity into the system.

[8] Bank of England: www.bankofengland.co.uk

Box 3.5: The Bank Recapitalisation Fund and the role of UK Financial Investments Ltd

In September 2008, concerns developed about whether the major UK financial institutions had sufficient capital. Though all exceeded the FSA's regulatory capital requirements, a sudden rise in the perceived default risk following the collapse of Lehman Brothers increased the probability that these financial institutions would need suddenly to sell their assets at market prices which, due to low levels of liquidity, would be far below their economic value. This implied lower asset values and higher potential capital needs for banks. Without the immediate provision of capital, the banks would have been compelled to reduce their loan exposures to UK households and businesses in order to build up their capital reserves.

To ensure that the banks did not withdraw their support to the wider economy, the Government has made available at least £50 billion through the Bank Recapitalisation Fund. Following detailed discussions with the UK's eight largest financial institutions, the Government announced that it would underwrite the raising of £37 billion by RBS and, upon successful merger, HBOS and Lloyds. Simultaneously, other financial institutions announced plans to raise their capital levels without Government support.

Access to the Fund remains open to all UK building societies and other eligible banks that can demonstrate they meet the necessary conditions, as set out by the Chancellor to Parliament on 18 November 2008. Those institutions that do subscribe to the Government's Fund do so on the terms and conditions that appropriately reflect the financial commitment made by the taxpayer, including in relation to dividend policy, remuneration and lending to small businesses and households.

The Government's investments in financial institutions will be managed on a commercial basis by an arm's-length company, 'UK Financial Investments Ltd' (UKFI), wholly owned by the Government. UKFI's overarching objective will be to protect and create value for the taxpayer as shareholder with due regard to the maintenance of financial stability and to act in a way that promotes competition. This includes:

- maximising sustainable value for the taxpayer, taking account of risk;
- maintaining financial stability by having due regard to the impact of its value realisation decisions; and
- promoting competition in a way that is consistent with a UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions.

UKFI will manage the Government's shareholdings in financial institutions: both those subscribing to the bank recapitalisation fund and Northern Rock and Bradford & Bingley, which the Government wholly owns. All these companies will continue to have their own independent Boards and management teams, determining their own commercial strategies. The governance of UKFI will be consistent with the Government's intention to manage its investments on a commercial and arm's-length basis. The Board will be accountable to the Government and, through the Chancellor, to Parliament for the delivery of its objectives.

The Government will not be a permanent investor in UK financial institutions and will, over time, seek to dispose of the investments in an orderly way through sale, redemption, buy-back or other means, in accordance with UKFI's objectives.

The market reaction

3.45 The market reaction to the Government's announcements was also generally positive. Credit default swap (CDS) premia, which measure the probability of banks defaulting on their obligations, declined as the recapitalisation was perceived to have reduced the probability of a future default. Falls in the CDS premia for most of the major UK banks have been broadly constant across CDS contracts of all maturities, suggesting that banks' prospects have been enhanced both in the near and longer term. Since the introduction of the credit guarantee scheme, LIBOR rates have also eased gradually, with the spread to Bank Rate falling to levels last seen in September.

LOOKING TO THE FUTURE

3.46 Though initial reactions to the Government's policy response have been positive, the current period of financial turbulence is not over. The Government is committed to achieving its financial stability objectives and will continue to monitor the financial system to ensure that it can continue to support the wider economy. The Government's Bank Recapitalisation Fund remains open to all UK building societies and eligible banks that can demonstrate that they meet the necessary conditions, as set out by the Chancellor to Parliament on 18 November 2008.[9]

3.47 Over the last year, the Government has taken a series of extraordinary measures to deal with the crisis and avoid a systemic collapse. These measures have been necessary to ensure that the financial system continues to support the economy as a whole. Interventions such as these inevitably have other effects on markets. So, while they have been essential, the Government will act over time to reduce and remove such distortions. This will require careful planning and international cooperation.

3.48 In addition, it is essential that finance ministries, supervisors and central banks address the supervisory, regulatory and social issues that the crisis has highlighted.

Leading the international response

Work with the EU

3.49 As a key global marketplace, the EU has an important role to play in shaping the appropriate international response. The Economic and Financial Affairs Council (ECOFIN) endorsed a programme of work in autumn 2007 on the issues raised by the market disruption, with work continuing during 2008. On 7 October 2008, common EU principles were agreed to guide public interventions at the national level to ensure a swift, appropriate and coordinated response with minimal disruption to the EU common market.

3.50 The modern economy depends on finance flowing freely across international borders, especially within the EU and European Economic Area (EEA). It is therefore crucial that the EU continually looks to improve the manner in which it legislates for cross-border financial transactions, and ensures that appropriate safeguards are in place. **The Government believes that recent events have illustrated the need to address a number of important EEA-wide issues, including:**

- **the regulatory safeguards for cross-border activity, in particular for risk assessment and monitoring; crisis prevention and mitigation; and crisis resolution.** This is especially important for branch-based activity, where the need for supervisory cooperation and coordination is even greater and

[9] HM Treasury: www.hm-treasury.gov.uk

- **increasing the level of guaranteed deposits and the speed of resolution or pay-out in the event of a failure.** More comprehensive arrangements are also needed to protect depositors in branches of foreign banks, for example to provide for a mutual evaluation of the compensation arrangements in force in the home and host States and better cooperation between deposit guarantee schemes.

3.51 The Government has written to the European Commission asking that these issues be considered urgently.

A global response to global events

3.52 Work is also under way to deliver a coordinated international community response to strengthen the stability and resilience of the global financial markets for the future. In October 2007, G7 Finance Ministers asked the Financial Stability Forum (FSF) to analyse the underlying causes of recent market turbulence and propose appropriate recommendations, with a focus on events in the markets for structured products. The FSF presented its report, Enhancing Market and Institutional Resilience, to G7 Finance Ministers in April. It recommended action in five areas:

- prudential oversight of capital, liquidity and risk management;
- transparency and valuation;
- the role and uses of credit ratings;
- the authorities' responsiveness to risks; and
- arrangements for dealing with stress in the financial system.

3.53 The report was strongly endorsed by the G7 Finance Ministers, who committed to its rapid implementation. The Authorities fully support this work, and are taking steps both here in the UK and through international fora to ensure the FSF's recommendations are implemented.[10] The FSF provided an update on progress to the G7 Finance Ministers' meeting in October, which explained that implementation of the priority actions is on track and that good progress is being made on the other recommendations in the FSF report.

Shaping the future of international finance

3.54 At the recent G20 Summit in Washington on 15 November, the Government pushed for action in three areas: encouraging world leaders to take concerted action to address the current causes of macroeconomic and financial instability; establishing applicable standards of financial regulation and supervision as well as improved cooperation between regulators to address cross-border issues; and reforming the global financial and economic architecture to ensure that all countries are better prepared to deal with future global economic events. More detail on the summit and next steps for the G20 work are described below.

[10] *Financial stability and depositor protection: further consultation*, HM Treasury, 2008.

Box 3.6: the international summit and the UK's Chair of the G20

Leaders and finance ministers of G20 countries met in Washington on 15 November and agreed that urgent action was needed in a number of areas to tackle the financial and economic crisis. Specifically, leaders tasked Finance Ministers to take work forward in the following five areas:

- Strengthening transparency and accountability to foster enhanced openness and disclosure so that value-impaired assets cannot be hidden. Executive compensation schemes should also be reviewed to ensure that they do not encourage excessive risk-taking.
- Enhancing sound regulation ensuring that all financial institutions, markets and products are appropriately regulated, including credit rating agencies, private capital funds and hedge funds; and making regulatory regimes more effective over the economic cycle.
- Promoting integrity in financial markets by implementing measures to prevent conflicts of interest, illegal market manipulation, fraudulent activities and illicit finance risks.
- Reinforcing international cooperation to ensure global consistency of national and regional regulation through enhanced collaboration on crisis prevention, management and resolution, including through the development of international colleges of regulators and cross-border stability groups.
- Reforming the International Financial Institutions so that the IMF, in collaboration with the expanded FSF and other bodies, can better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response.

The UK assumes the Chair of the G20 in 2009 and will play a leading role in driving the G20 work forward, alongside the previous and next Chairs of the G20, Brazil and South Korea. In doing so, the Governement will draw widely on domestic and international advice and expertise, including through a new panel. Finance Ministers will prepare immediate measures for implementation by 31 March 2009 and Leaders will meet again before 30 April to review the progress made.

Crown dependencies and overseas territories

3.55 Many crown dependencies and overseas territories are significant financial centres in their own right and the financial sector plays a vital role in their economies. The Government recognises the progress made by most offshore financial centres to improve financial regulation and transparency, and tackle financial crime. However, crown dependencies and overseas territories, like all offshore financial centres, face challenges and opportunities as the world is changing. In particular, severe financial turbulence has raised questions for all jurisdictions, while there is growing international pressure to line up standards of financial regulation and meet international norms with regards to taxation.

3.56 **The Government will shortly commission an independent review of British offshore financial centres; their role in the global economy; and their long-term business strategies. The review will not consider changes to the UK's constitutional relationship. It will work with the crown dependencies and overseas territories to identify current and future opportunities, risks and mitigation strategies, including issues such as:**

- **financial supervision and transparency;**
- **fiscal arrangements;**
- **financial crisis management and resolution arrangements;** and
- **international cooperation.**

Enhancing the UK's approach to financial stability

3.57 The Government has three clear domestic priorities. First, ensuring stability so that financial markets can resume their crucial role of supporting the wider economy. Second, achieving a sustainable banking sector that remains fair and open, offering the range and price of services that are demanded by consumers and firms. Finally, ensuring that the UK economy benefits from a successful financial services sector that is internationally competitive, value-adding and innovative, and that takes a lead in observing (and setting) global best practice in internal governance and risk management.

I) Restoring stability

FSA review of financial regulation

3.58 The FSA published in March 2008 a summary of the thorough internal review into its supervision of Northern Rock. The review identified a number of areas for improvement in the execution of supervision, which are being advanced urgently by the FSA's management, via a dedicated Supervisory Enhancement Programme.[11] The FSA is also currently conducting a review of its liquidity requirements for banks and building societies with a view to addressing practical shortcomings and improving standards of liquidity risk management.

3.59 A strong and effective system of outcome-focussed, principles-based regulation has a leading role to play in restoring stability and creating a framework for change. On 6 October, the Chancellor asked Lord Turner, the Chairman of the FSA, to make recommendations for reforming UK and international approaches to regulation, to ensure the future stability of the UK banking system. **The FSA's review will be published in March 2009 and will address the following issues:**

- **the FSA's supervisory approach, processes and resources** – in particular whether the changes already being implemented through the FSA's Supervisory Enhancement Programme are sufficient, given the further global developments since it was initially designed;
- **UK and international policies relating to: capital adequacy; liquidity; valuation and accounting; rating agencies and the originate and distribute model; market infrastructure in over-the-counter derivatives markets; and remuneration and incentive structures;**
- **the institutional coverage of prudential regulation** – whether recent steps to extend the appropriate accounting and regulatory coverage of near-bank and shadow bank institutions go far enough;
- **cross-border cooperation and coordination** – including international regulatory cooperation in non-crisis periods, and the scope for better international coordination during individual institutional crises; and
- **analysis and implications of macro trends in the financial system** – what actions may be required to ensure that analysis of macro financial trends feeds into adjustments to regulatory policy or supervisory focus, both at national level and internationally, including consideration of policies aimed at mitigating pro-cyclicality.

[11] Financial Services Authority: www.fsa.gov.uk

Box 3.7: Pro-cyclicality of the financial system

Financial systems have a tendency to be pro-cyclical, fluctuating with the economy and potentially amplifying business cycles. In a typical cycle, a development, such as a technological innovation, appears to boost returns and lower risk, setting off an expansion of credit. Market participants frequently exaggerate the impact on expected returns, resulting in the development of asset price bubbles and excessive risk taking and leverage. In these circumstances, a shock which destabilises financial markets can carry significant costs in terms of economic output.

In recent years, a number of policy options have been proposed at an international level to make accounting standards or prudential regulations more counter-cyclical. Such proposals would ensure that banks build up sufficient buffers of capital and liquidity in good times to enable them to absorb losses without triggering or amplifying an economic downturn. Options include a more active approach to provisioning, which would require banks to build up reserves against future losses, and introducing a counter-cyclical element into banks' capital requirements linked to measures of the financial cycle such as lending growth.

The Government strongly supports the technical work in train through the FSF to examine the forces that contribute to pro-cyclicality in the financial system and possible mitigating options. There are considerable challenges to designing and implementing effective counter-cyclical policies. The Authorities are working together to assess the policy options and contribute to international discussions, including through the FSA's review, referred to above.

Strengthening the legal framework

3.60 In October 2008, the Government introduced into Parliament the new Banking Bill. This Bill contains a number of significant provisions for supporting financial stability and protecting depositors, including:

- a 'special resolution regime' (SRR) to allow the Authorities to intervene when a bank gets into severe difficulties;
- the creation of a new insolvency procedure for banks, alongside changes to the legal framework for the FSCS, to facilitate faster pay out to depositors should their bank fail; and
- strengthening the role of the Bank of England, by providing it with a statutory objective for financial stability, new policy levers (such as formal oversight of payment systems and a key role in the SRR), and a new Financial Stability Committee to advise the Bank on this area.

3.61 The Bill has now completed scrutiny in committee in the House of Commons and will be introduced into the House of Lords in the new Parliamentary session. The Government is working with cross-party support to secure the passage of the Bill by 20 February 2009, when temporary powers taken under the Banking (Special Provisions) Act 2008 will expire.

Amendments to the Banking Bill

3.62 **The Government intends to bring forward amendments that would make two additions to the Bill in the House of Lords, to increase the Bill's effectiveness in allowing the Authorities to deal with risks to financial stability:**

- **first, the Government proposes to extend HM Treasury's power to take a failing bank into temporary public ownership (where this would be in the interests of financial stability or the protection of public funds) to include banking group holding companies.** This power would be used in cases where the resolution of a deposit-taker within a financial group would not by itself be sufficient to prevent a serious risk to financial stability, public funds, or both; and

- second, in response to emerging developments concerning the UK subsidiary of Lehman Brothers, which is currently under administration, the Government proposes to take a power in the Banking Bill to introduce, by secondary legislation, a new special insolvency procedure for investment firms, which hold client assets or client money.

Insolvency arrangements for investment firms

3.63 **Therefore, the Government will, in the coming months, conduct a review of the insolvency arrangements for these investment firms, to inform secondary legislation to be made under the Banking Bill. The review, which will conclude by summer 2009, will consider:**

- **the precise definition of the firms to which the new procedure should apply**;
- **the treatment of unencumbered client money and client assets;**
- **the treatment of client money and client assets which have been posted as collateral;**
- **arrangements to enable a temporary continuation of brokerage activities (including the matching of unsettled trades); and**
- **how an insolvency procedure would work having regard to 1-3 above, and particularly, what the objectives for the new procedure should be.**

3.64 This review will be conducted under the auspices of the expert liaison group, established by the Treasury in October 2008 to advise on and keep under review the Banking Bill and associated secondary legislation. The group, which includes industry practitioners, insolvency experts, legal specialists and representatives from the Authorities, will consult widely with stakeholders. Following the review, there will be a full formal consultation on draft secondary legislation, in line with the normal legislative procedure.

Facilitating equity capital raising

3.65 Efficient and orderly equity capital raising techniques are essential to enable companies to raise equity capital at the lowest cost and preserve the integrity of the market and the issuer's reputation. The Government therefore welcomes the report by the Rights Issues Review Group – a working party co-chaired by HM Treasury and the FSA. **The Government agrees with their recommendations, which make significant improvements to the duration of the rights issue process from the current 39 days it can take to 32 days, and for many issues down to 16 days. These improvements will benefit the market, companies and shareholders.**

2) Achieving a sustainable banking sector

Supporting competition

3.66 The Office of Fair Trading (OFT) is responsible for ensuring that markets are competitive and work well for consumers. It therefore has a key role to play in monitoring and tackling the potential anti-competitive effects of consolidation within the financial services sector. The OFT is already doing specific work on bad debt collection practices, irresponsible lending, and unfair terms. There are also orders in place, which can be enforced by the OFT and the Competition Commission, to promote competition in small business banking. The OFT will also look at market features which hinder competition and will promote change itself or through reference to the Competition Commission.

3.67 **Alongside its normal annual plan, the OFT will set out in the new year a specific financial services plan, detailing how it will build on its strong track record of tackling abusive behaviour and consumer detriment.**

Enabling an efficient mutuals sector

3.68 Financial mutuals can provide a valuable local alternative to banks over a range of financial services, and the Government is committed to enabling growth and efficiency across the sector as a whole.

3.69 The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007, which received Royal Assent in 2007, is part of a wider package of measures aimed at improving efficiency. Implementing the Act will, in time, allow building societies greater flexibility in their funding strategies; enhance members' rights in the event of insolvency; and make it easier for a mutual to transfer its business to a subsidiary of another mutual. **The Government is also planning to reform the legislation governing cooperatives and credit unions. It will set out its further plans, including a response to consultation on the Act, in December 2008.**

3.70 **In addition, the Treasury will undertake a review of the regulation of credit unions and industrial and provident societies in Northern Ireland, working closely with the relevant authorities in the Northern Ireland Executive.** These mutuals are currently regulated by the Department for Enterprise, Trade and Industry, Northern Ireland under Northern Ireland credit union and industrial and provident society legislation. The review will take account of the importance of mutuals to the Northern Ireland financial sector, and draw on good practice in other countries.

3.71 **Finally, the Government is taking steps, under the Banking Bill, to extend access to liquidity support from the Bank of England for building societies.**

Box 3.8: Restoring trust in the UK financial services sector

The Government has a qualitatively different relationship with the banking sector compared with other parts of the economy. If a systemically important bank gets into difficulties, there is a good case for the Government intervening, as the past fifteen months have shown. The Government has so far committed to invest up to £37 billion into the UK banks and, through the credit guarantee scheme, is providing further support to unblock interbank lending. These developments, which would have been unthinkable until very recently, now suggest the need to review what is, in effect, the social contract between banks and citizens.

The Government believes there is need for a debate with both the banking industry and consumer groups about the elements of this relationship. Particular priorities for the Government include:

- ensuring people can obtain trusted, impartial advice to help them make informed financial decisions and develop the financial capability to plan appropriately for their future;
- providing free, accessible and impartial sources of debt advice, to help people struggling with debt;
- supporting access for all to appropriate financial products and services; and
- promoting responsible lending and borrowing (including through the third sector), to the benefit of individuals, institutions and the economy as a whole.

Many of these objectives, such as maintaining the availability of lending and supporting measures to improve financial capability, underpin the conditions required of banks subscribing to the Government's Recapitalisation Fund. Implementation of these conditions will be overseen by UKFI.

The Government already encourages discussion between the financial sector and representatives of business and retail consumers. **To encourage this debate further, the Government will set up a discussion forum with membership drawn from across the retail financial services sector and representatives of personal customers. Chaired by the Economic Secretary to the Treasury, the group will look at how banks and other financial institutions can work better in the interests of consumers and society as a whole, and what measures may be needed to restore trust in financial institutions. Membership of the group will be announced shortly.**

The Government will use the output of the group to inform its views on the role of the financial sector in society, and will set out its emerging views during 2009.

3) Retaining UK excellence in financial services

3.72 The financial services sector has been, and will remain, an important part of the UK economy, not only contributing significantly to overall economic growth, but also providing the core mechanism through which households save for the future and businesses invest in opportunities. Looking ahead, one of the Government's overarching objectives remains the promotion of efficient, fair, stable and competitive financial markets. This is complemented by the Government's continued commitment to having an active dialogue with the financial services and related industries to ensure that London, as the world's leading international financial centre, and the UK, emerge from current difficulties equipped to respond to future challenges and opportunities.

3.73 Therefore, over the coming months, the Government will be working closely with senior executives in the asset management, insurance and wholesale financial markets to examine the strategic priorities facing these sectors and identify commercial and public policy challenges to be addressed. In addition, the Government looks forward to receiving by spring 2009 practical analysis from the Financial Services Global Competitiveness Group, led by Sir Win Bischoff, of the medium- to long-term trends impacting on the competitiveness of the global financial services industry, and considerations in due course from the UK professional services sector.

Box 3.9: Medium term perspective of the financial sector

Rapid growth in the financial sector contributed significantly to overall growth in the economy over the past decade. The financial sector's share of total UK Gross Value Added rose by half from 2000 to 2007. Much of this expansion was driven by sustainable factors. For example, the demand for financial services is supported by the need to:

- provide an increasingly wealthy population with wealth management and saving services;
- finance growing innovation in the wider economy by allowing investment opportunities to translate into actual investment, so boosting productivity and competitiveness; and
- efficiently monitor borrowers to ensure that funds are used appropriately and loans repaid in a timely manner.

On the supply side, financial innovations, especially risk diversification, also stimulated growth in the sector. Supporting these developments, the UK has consistently offered a favourable environment for financial services and related industries, attracting international talents and capital, and benefiting from an evident comparative advantage in the provision of financial services.

However, as discussed earlier in this chapter, rapid growth in financial services activity was also driven by the impact of under-priced risks; inadequate procedures for managing risk; and an excessive degree of leverage. As a consequence, the financial sector is likely to contract in the short term as it adjusts to reflect the impact of the ongoing credit shock.

Nevertheless, those sustainable demand drivers at work in the recent past will still continue to operate in the years to come. Benefiting from both its prominent position as a major financial centre, and well-balanced regulatory responses to the credit shock, the UK will continue to provide a favourable environment for global financial services.

4 Supporting business

Businesses are facing an exceptionally challenging economic climate with uncertainty over the short to medium term. Chapter 3 sets out the decisive steps the Government has taken to help ensure financial stability in support of the economy as a whole. Chapter 2 outlines the action that the Government is taking to support the economy, in particular through a temporary reduction in the rate of VAT, which will provide significant further support for businesses during the economic downturn. This chapter outlines further action that the Government is taking to help businesses respond to the current economic challenges over the short term. These include:

- **measures to help small and medium-sized enterprises (SMEs) facing credit constraints. The Government will launch: a new Small Business Finance Scheme to support up to £1 billion of bank lending; a separate £1 billion guarantee facility to support bank lending to small exporters; a £50 million fund to convert businesses' debt into equity; and a £25 million regional loan transition fund;**
- **a new HMRC Business Payment Support Service to allow businesses in temporary financial difficulty to pay their HMRC tax bills on a timetable they can afford;**
- **more generous tax relief for businesses now making losses, by allowing temporary additional carry-back of up to £50,000 of losses to be set against taxable profits from the last three years; and**
- **the modification of a number of planned tax reforms, including the deferral of the increase in the small companies' rate of corporation tax, a temporary increase in the threshold at which an empty property becomes liable for business rates, and the reform of air passenger duty rather than proceeding with a per-plane tax.**

The Government is committed to ensuring the UK is in a strong position to respond to longer-term challenges. This chapter sets out further measures to ensure the UK is well placed to deliver sustainable growth and prosperity over the decade ahead including:

- **a package of reforms to the taxation of foreign profits, including the introduction of a foreign dividend exemption for large and medium-sized businesses, supported by a worldwide debt cap on interest;**
- **a review of the controlled foreign companies anti-avoidance rules consistent with a further move towards a territorial approach;**
- **measures to enhance SMEs' access to Government contracts, including a new online portal for all Government contracts over £20,000; and**
- **a set of devolutionary proposals, to be agreed with local authorities in city-regions on a voluntary basis, to increase their ability to drive sustainable economic growth.**

SUPPORTING BUSINESS: RESPONDING TO CURRENT CHALLENGES

4.1 The economic shocks that have impacted on the global economy have created an exceptionally challenging environment for business. This chapter considers this impact, and sets out measures to support businesses through the short to medium-term challenges, while ensuring that the UK economy maintains its fundamental strengths and stability.

Impact of the financial crisis on business

4.2 Financial markets play a critical role in the operation of every business in the country. Businesses rely on properly functioning markets to be able to manage their cash flow and to fund investment. The recent instability in the financial system is having a damaging effect on everyday economic activity. Credit conditions have tightened significantly, directly affecting all sizes of business and contributing to slowing economic growth.

Government action to stabilise the financial system

4.3 The Government has responded decisively to restore stability to the financial markets through the measures outlined in Chapter 3. The Government's actions will help support stability in the financial system, in order to allow it to perform its role as the core mechanism by which resources are allocated in the economy. The Government has attached conditions to a number of institutions subscribing to the Bank Recapitalisation Fund, including maintaining the availability and active marketing of competitively priced lending to small businesses and homeowners at 2007 levels. The Government's investment in financial institutions, including compliance with these conditions, will be monitored by the newly established UK Financial Investments Ltd.

Maintaining business lending at competitive levels

4.4 The Government is continuing to monitor developments in the credit markets more generally. Where necessary, it is also acting to improve the dialogue between banks and business representative bodies, for example by establishing the Small Business Finance Forum to discuss and resolve concerns over business lending. Following the first meeting on 11 November 2008, a new panel has been set up to monitor individual lenders on the availability, risk and overall cost of lending to small and medium-sized enterprises (SMEs) from all the high street banks. This will now be transferred into the new Lending Panel which will address lending to both businesses and households. The Government is also listening to the concerns of large businesses through fora such as the Multinational Forum on Business Tax and Globalisation and the Business Council for Britain.

Fiscal stimulus and consolidation

4.5 **The temporary reduction in the standard rate of VAT to 15 per cent, set out in detail in Chapter 2, will increase economic activity, support employment, contribute to business and encourage economic recovery. To ensure maximum impact, the Government is introducing this 15 per cent rate from 1 December 2008.** In addition, the Government is bringing forward public sector capital spending, which will benefit businesses, in particular in the construction sector. The Government's long-term objective is to ensure a stable macroeconomic environment including sustainable public finances, and Chapter 2 sets out the action the Government is taking to achieve this, including reforms to income tax and national insurance contributions.

Action to support business

4.6 Small businesses in particular are more dependent on external finance to manage their short-term cash flow, and it has become clear from discussions with banks and businesses that many of these small businesses are struggling to access short-term credit. This chapter therefore sets out a package of short-term, targeted measures to help these businesses access the capital they need and manage their cash flow.

New loan facility for small firms

4.7 **The Government announces measures to improve the availability of finance for small and medium-sized businesses as set out in Box 4.1.**

Box 4.1 Measures to improve the availability of finance for SMEs which will be made available through an accessible single portal:

- to help SMEs with working capital and investment needs, early in 2009, **the Government, with Regional Development Agencies' (RDAs) support, will launch the Small Business Finance Scheme, a new temporary guarantee scheme to enable up to £1 billion of new Government supported lending by banks**;
- **the Export Credits Guarantee Department, in conjunction with the banks, will introduce a temporary guarantee scheme to support a £1 billion facility providing smaller exporters with better access to short-term working capital. Also, the Fixed Rate Export Finance Scheme will continue for another year after the end of 2008**;
- **the Government will also make available a capital fund of £50 million providing equity or quasi-equity to SMEs who are overleveraged.** This will be funded from the existing Mezzanine Fund, Enterprise Capital Funds and a £10 million RDA contribution;
- earlier in November 2008, Advantage West Midlands launched a transition loan fund for viable SMEs facing financial difficulties. **Other RDAs will launch similar loan funds, now totalling £25 million, to help businesses over the next six months.** The package of measures above includes £110 million of contribution from RDAs; and
- early in 2009, **the Government will launch, with Business Link, a new easily accessible portal, to direct credit-worthy SMEs who are experiencing problems accessing credit to the scheme appropriate for them**.

European Investment Bank

4.8 In addition to domestic measures, UK small businesses should also be able to benefit from around £4 billion of lending from the European Investment Bank (EIB) between 2008 and 2011. Following proposals by the Government, the EIB has increased by 50 per cent the total amount of lending available to small firms, and it has significantly simplified its approach to increase the attractiveness of its lending. The Government welcomes the commitment of UK lenders to approach the EIB to access these funds. As a first step towards this, **following negotiations between UK banks and the EIB, £1 billion of EIB funds will be available to SMEs in the UK by the end of 2008.** The Government is also working with the UK banks and EIB on its commitment to share greater risk with commercial banks lending to small businesses.

4.9 The Government has asked the EIB to offer additional help to large businesses through this difficult period, including to Private Finance Initiative (PFI) projects. In the medium to longer term, the Government, working with European Union (EU) partners, is encouraging the EIB to continue lending more, to lend faster and to take on more risk. This includes significantly increasing its volume of financing on infrastructure, for example projects that contribute towards the UK's and EU's energy security, and on projects that contribute towards a low-carbon economy.

HMRC Business Payment Support Service

4.10 The Government will also ensure the tax system is as flexible as possible to support businesses experiencing cash flow problems. **The 2008 Pre-Budget Report announces that HMRC will provide a new service for businesses in temporary financial difficulty to spread payment of their tax bills over a timetable they can afford.** Further information is set out in Box 4.2 below.

Box 4.2 Support for businesses in temporary financial difficulty to pay their tax bills

As more businesses experience worsening cash flow positions or difficulty accessing credit, they may struggle to pay their HMRC tax bills on time. HMRC has a key role to play in supporting businesses facing temporary financial difficulties and already offers 'time to pay' arrangements where businesses can spread tax payments over a timetable they can afford.

The 2008 Pre-Budget Report announces that HMRC has launched a new Business Payment Support Service to offer enhanced support to businesses finding it difficult to make tax payments on time, including corporation tax, VAT, PAYE, income tax and national insurance contributions. Businesses experiencing temporary financial difficulties, needing more time to pay an outstanding tax bill or a bill due soon, can call a dedicated phone service to agree arrangements tailored to need.[a]

[a] For further information refer to www.hmrc.gov.uk and www.businesslink.gov.uk

VAT Cash Accounting Scheme

4.11 The VAT Cash Accounting Scheme already provides businesses with a cash flow advantage by allowing them to defer paying VAT until their customers have paid them. The Government has made the scheme much more widely available to SMEs by doubling the turnover threshold to £1.35 million in 2007. 90 per cent of VAT registered traders are now eligible to use the scheme.

VAT Flat Rate Scheme

4.12 The VAT Flat Rate Scheme allows businesses with a turnover less than £150,000 to simplify their VAT accounting. **Alongside the temporary reduction of the standard rate of VAT, the Government will also amend the sectoral rates of the VAT Flat Rate Scheme in line with the standard rate reduction, allowing 180,000 small businesses in the scheme to benefit from the rate reduction.**

Loss carry-back

4.13 **To further help the cash flow position of businesses that have recently become loss-making, trading loss carry-back for businesses will be extended for a temporary period from one to three years, for up to £50,000 of losses.** Further information is set out in Box 4.3 below.

Box 4.3 More generous tax relief to businesses now making losses

The current loss relief rules already provide considerable support for businesses. Businesses can offset unlimited losses against profits in future years, reducing the tax to be paid, or 'carry-back' the loss to set against profits of the preceding year, resulting in a tax repayment.

The 2008 Pre-Budget Report announces that the Government will provide further support by temporarily extending the carry-back of losses from one to three years, for losses up to £50,000.

This temporary measure will apply for one year from 24 November 2008 for companies, and for the 2008-09 tax year for unincorporated businesses. Tax repayments from the extended relief will be made to businesses from Budget 2009.

Small companies' rate of corporation tax

4.14 To provide further support for small companies, **the Government is deferring, for one year, the planned increase in the small companies' rate of corporation tax. The rate will remain at 21 per cent during 2009-10.** The Government remains committed to the aims of the business tax package announced in Budget 2007, to refocus incentives towards investment and growth, and to reduce the differential between incorporated and unincorporated businesses.

Empty property relief

4.15 **The Government is temporarily increasing the threshold at which an empty property becomes liable for business rates. For financial year 2009-10, empty properties with a rateable value of less than £15,000 will be exempt from business rates,** exempting an estimated 70 per cent of empty properties. This one year relief for lower-value properties is best targeted at helping small businesses manage short-term pressures due to difficult property market conditions. The Government continues to believe that, in the long term,

beyond an initial rate-free period, it is right to charge rates when properties stand empty, since this increases incentives to re-let and re-use empty property, and avoids subsidising owners of empty properties.

Payment of backdated business rates bills

4.16 When premises are identified that should have always been subject to business rates, but have not previously received bills, business rates bills backdated to 2005 (the last business rates revaluation) are issued, for immediate payment. To reduce the cash flow impact on businesses, given current economic difficulties, **the Government will legislate to give businesses more time to pay certain backdated business rates bills issued before 31 March 2010. Businesses facing such bills will be able to pay their liability for previous years in equal interest-free instalments over 8 years, rather than immediately.** Beneficiaries will include several occupiers of ports who have been affected by recent rating reviews. Communities and Local Government will publish further details shortly, including the qualifying conditions.

Prompt payment

4.17 There are currently significant delays for many small businesses receiving payment of their bills from the companies they supply. To help businesses manage their cash flow, the Government has announced that it will aim to pay its suppliers as soon as possible and within 10 days. This commitment has since been adopted by the Scottish Government, Regional Development Agencies (RDAs) and by a number of local authorities. The Government is working with NHS trusts and the Local Government Association to extend this objective to the wider public sector.

4.18 In addition to its engagement with public bodies, the Government will continue to work with the private sector to encourage businesses to pay their bills promptly and has recently launched a series of guides to help businesses manage their cash flow.

Regions

4.19 *Meeting the economic challenges in every region*, published alongside the 2008 Pre-Budget Report, concludes this summer's consultation with regions to understand the regional impact of the current economic situation. It outlines the Government's response to support regions and localities, and sets out how regional partners are working together to focus on meeting the pressing challenges of their regions. Building on the successful dialogue between RDAs and the Government, RDAs have again been asked to provide input to Budget 2009.

Aviation taxation

4.20 The Government recognises the contribution that the aviation industry makes to the UK economy and believes that aviation taxation should ensure the sector pays its fair share towards public services and provide better environmental signals. **The Government has listened to the points made during the consultation process on aviation taxation. In light of responses received and, current economic conditions, it has decided to reform the air passenger duty (APD) regime rather than proceed with the per-plane tax.** Details of the reform, including the new rates, are set out in Chapter 7. This will ensure greater stability in tax policy at a time of economic uncertainty. Reforming APD also takes account of the need to mitigate the potential impact on the air-freight sector, and those who depend on the jobs and services supported by the aviation industry.

SUSTAINING FUTURE BUSINESS SUCCESS: ADDRESSING THE LONG-TERM CHALLENGES

4.21 In order to secure continuing growth and prosperity for the UK, the Government is responding to the significant immediate challenges. It is also determined to address the impact that long-term trends in the global economy will bring over the next decade.

Long-term trends for the economy

4.22 *The UK Economy: addressing the long-term strategic challenges*, published alongside the 2008 Pre-Budget Report, identifies four long-term trends that will affect the UK economy: global uncertainty; globalisation and technological change; environmental change; and

demographic change. It sets out the role that Government needs to play to help the UK face up to these challenges and make the most of the opportunities. This involves ensuring a stable macroeconomic environment, including sustainable public finances. It also sets out the Government's role to protect outcomes of investment programmes essential for long-term growth, to engage with sectors in order to tackle sector-specific constraints to growth, and to ensure that city-regions are able to make the most of economic opportunities.

4.23 The rest of this chapter sets out how the Government will play its part in helping to secure long-term growth and prosperity for the UK through reforms to the tax and regulatory regime, and measures to continue to promote higher productivity growth through action on enterprise, skills, innovation, investment and competition, building on significant progress over the last decade. This chapter also shows how Government programmes will be flexible and responsive to changing requirements of the economy.

Reforming tax and regulation

Foreign profits

4.24 The 2008 Pre-Budget Report announces the next stage in reforming the UK corporate tax system to enhance the competitiveness of the UK. Following discussions with businesses, **the Government will bring forward a balanced package of reforms to the taxation of foreign profits, including the introduction of an exemption for foreign dividends in Finance Bill 2009.** The details of the package are set out in Box 4.4.

Controlled foreign companies

4.25 **The Government will also continue to examine options to reform the UK's controlled foreign companies (CFC) rules.** These rules were originally designed to counter tax deferral and the artificial diversion of profits from the UK. Any reform will aim to enhance UK competitiveness by seeking to improve the way the CFC rules achieve their objective of taxing profits diverted from the UK. Coupled with the exemption for foreign dividends, this represents a clear further move towards a territorial approach to taxing foreign subsidiaries, so that a new CFC system should not tax profits that are genuinely earned in overseas subsidiaries. Consultation will continue through 2009.

Box 4.4 Taxation of foreign profits

Foreign dividends received by large and medium groups on ordinary shares and most non-ordinary shares will be exempt from UK tax. A Targeted Anti-Avoidance Rule will protect against avoidance activity seeking to exploit these dividend exemptions.

This new exemption will be supported by:

- **a worldwide debt cap on interest.** Tax deductions for interest claimed by UK members of a multi-national group will be restricted by reference to the group's consolidated net external finance costs;
- **extension of the unallowable purpose rules for loan relationships** to include schemes or arrangements; and
- **consequential changes to the CFC rules.** The acceptable distribution policy exemption and the holding company exemption will be repealed. There will be a 24 month transitional period to allow time for groups to unwind holding company structures.

In addition, the existing **Treasury Consent rules and notification requirements will be repealed and replaced with a quarterly reporting requirement for high-risk transactions with a de minimis limit of £100 million.**

Draft legislation will be published in December 2008 for consultation in order to implement these reforms in Finance Bill 2009.

Tax simplification **4.26** The Government announces further progress on tax simplifications from its four reviews:

- **VAT rules and administration review: from 1 April 2009, the Government will help small businesses reduce their administrative burdens by simplifying the eligibility tests for the Flat Rate Scheme and require fewer large retailers to agree a bespoke VAT accounting scheme by increasing this threshold to £130 million. From early 2009, the Government will make it easier to tax otherwise exempt supplies of land and property;**
- **anti-avoidance legislation review: the Government will simplify certain rules on Employment-Related Securities and repeal an outdated and complex anti-avoidance provision on transactions between associated persons;**
- **corporation tax rules for related companies review:** the Government will continue its discussions with business about further simplification of the associated company rules and also intends to consult on proposals for the simplification of group aspects of corporate gains in 2009; and
- **corporation tax calculations and returns for smaller companies review:** following initial discussions with stakeholders, **the Government publishes alongside the 2008 Pre-Budget Report emerging ideas for further discussion.**[1]

4.27 As set out in this chapter and in Chapter 5, the Government announces further targeted tax simplifications to reduce the burden of complying with tax obligations, including measures benefiting employers, the self-employed and the financial services sector.

North Sea fiscal regime **4.28** The UK's oil and gas supplies will continue to play a vital role in ensuring that the UK has access to secure, affordable energy supplies. The Government therefore remains committed to maximising the economic recovery of the UK's oil and gas reserves. **Following further discussions with stakeholders, the Government is today publishing its proposals for further reforms to the North Sea fiscal regime.** These will encourage investment through incentivising production from marginal fields, supporting asset trades and simplifying the regime. The Government also proposes a number of measures to remove fiscal barriers to the re-use of North Sea infrastructure for activities such as carbon capture and storage.

Regulatory reform **4.29** The Government is continuing the drive to reduce the costs to business of complying with regulation, without reducing the quality of regulatory outcomes. The Government has set itself a target of reducing the administrative burden of regulation by 25 per cent by May 2010, which will deliver £3.5 billion net annual savings to business. The Government is also consulting on the introduction of regulatory budgets, which would be a radical mechanism for capping the cost of new regulation.

Maintaining the competitiveness of UK financial services

A competitive financial sector **4.30** Further to the measures outlined in Chapter 3 to restore stability to the financial system, the Government remains committed to working with the financial services sector to ensure it emerges from the current difficulties in a competitive position. The 2008 Pre-Budget Report introduces measures that continue to modernise the tax system, to simplify where appropriate, and to maintain the UK's competitiveness on asset management, the Lloyd's insurance market and Islamic finance.

[1] *Simplification Review: corporation tax calculations and returns for smaller companies - a discussion document*, HM Treasury and HMRC, November 2008

Asset management

4.31 Building on the improvements to asset management taxation announced in Budget 2008, the Government announces:

- **the simplification of the rules for the Qualified Investor Scheme from 1 January 2009;**
- **amendments to legislation to facilitate the take up of Property Authorised Investment Funds;** and
- **its intention to discuss with industry the potential for increased legislative certainty on the distinction between trading and investment in relation to the tax treatment of transactions of Authorised Investment Funds.**

4.32 The Government is currently considering responses to consultations on Tax Elected Funds, the tax regime for Offshore Funds and the proposal to adapt the tax rules for Investment Trust Companies to enable tax-efficient investment in interest bearing assets. Complementing this work, further discussions will also be held with the industry on options for reform of Stamp Duty Reserve Tax Schedule 19. The Government will work closely with the industry in progressing these proposals with the aim of introducing legislation in Finance Bill 2009.

Insurance

4.33 The Government also today announces **its intention to legislate to align the tax treatment of Lloyd's claims equalisation reserves with that of other general insurers.** Furthermore, the Government will continue discussions with the general insurance industry on the ongoing tax treatment of claims equalisation reserves with a view to supporting the industry's competitiveness.

Islamic finance

4.34 The Government remains committed to promoting the UK as a centre for global Islamic finance and working towards a level playing field between conventional and alternative financing products. The Government today announces that:

- **new legislation will be introduced in Finance Bill 2009 to provide relief from stamp duty land tax for alternative finance investment bonds.** The Government will publish a response to its consultation in January 2009; and
- in conjunction with the **Financial Services Authority, the Government will examine the regulatory treatment of sukuk (alternative finance investment bonds) in the UK and will consult on this issue in the near future.**

4.35 **The Government has looked carefully at the case for issuing sovereign sukuk and concluded that it would not offer value for money at the present time** but it will keep the situation under review.

Promoting enterprise

Improved public sector procurement for SMEs

4.36 The 2008 Pre-Budget Report announces further support for dynamic and enterprising firms (see Box 4.5). In addition, **the Government accepts all of the recommendations put forward in the Glover Committee's report, published alongside the 2008 Pre-Budget Report.** The Committee was set up in Budget 2008 to provide advice on how the Government can help small firms win a greater share of public procurement. **The Government will advertise Government contracts worth more than £20,000 in a single free online portal, it will introduce measures to reduce bureaucracy and will make opportunities more transparent for small businesses.** In addition, it will standardise qualification criteria and encourage innovation by increasingly specifying outcomes rather than prescribing solutions. It will also help SMEs get a fair deal when they are sub-contractors.

Social enterprise

4.37 The current economic challenges also offer opportunities for new and sustainable business models. This is a time when social enterprises, with their focus on the creation of social and environmental, as well as financial, value, may come into their own, as they prove increasingly attractive to consumers, investors, and potential entrepreneurs. Support for social enterprise across Government has never been greater (championed by the Office of the Third Sector), aimed at creating an environment in the UK for social enterprises to thrive.

Box 4.5 Enterprise

The Government announces the following measures to support dynamic and enterprising firms:

- the Government recently launched a £12.5 million risk capital fund to encourage women led businesses to seek appropriate equity finance. This scheme will be managed by Capital for Enterprise Ltd who will seek to invest these funds alongside private sector risk capital;
- international trade represents a significant proportion of GDP and it is crucial that domestic trade regulation is as easy to comply with as possible, in order for UK based firms to remain internationally competitive. **The Government will take forward a Department for Business, Enterprise & Regulatory Reform and HMRC led work programme to review the cost to business of complying with international trade regulation** and put forward an action plan alongside the 2009 Pre-Budget Report setting out how it will reduce costs to business;
- the Government is taking steps to ensure that Government-funded support is effective and easily accessed by business. **The Business Support Simplification Programme of reform has made good progress and will be completed by March 2010;**
- **the Department for Children, Schools and Families will conduct a new in-depth primary research study into enterprise education in schools and colleges** in order to better assess the value of this investment and disseminate good practice. It will report back in autumn 2009; and
- **the Government's response to the consultation on the Enterprise Investment Scheme (EIS), announced in Budget 2008, is published alongside the 2008 Pre-Budget Report.** It sets out how the Government will ensure the rules and processes that govern the EIS are simplified and improved.

Strengthening the flexible and skilled workforce

4.38 The Government has recently announced short-term measures to support individuals and employers to develop their skills during the downturn. The Government also remains committed to its longer-term ambition, as set out by the Leitch Review, to achieve a world-class skills profile for the UK by 2020.[2] In addition to the measures below, further measures on skills are set out in Box 4.6.

Support for people facing redundancy

4.39 The Government announced in October 2008 that it would set aside £100 million from the European Social Fund (ESF) and the Department for Innovation, Universities and Skills (DIUS) to deliver an integrated employment and skills support for those facing redundancy. The funds available from the ESF now total £158 million, and will form part of a wider package on employment, as set out in Chapter 5, to develop the skills and support the job search of those facing redundancy or already looking for work. **DIUS will match their ESF money with a further £79 million, through Train to Gain, to increase resources for Next Steps advice services, and to provide a more tailored and flexible training offer, working with regional and local partners.** This could include allowing shorter, more focused units of training, or retraining at the same level in a new sector, where this would help individuals to find work with a new employer. Further details on the joint package will be announced by DIUS, the

[2] *Leitch Review of skills: Prosperity for all in the global economy – world-class skills,* HM Treasury, December 2006

Department for Work and Pensions (DWP), and the Department for Business, Enterprise & Regulatory Reform (BERR) shortly.

Public procurement and apprenticeships

4.40 The Government is committed to using its leverage with contractors and suppliers to promote training in the workplace, particularly through apprenticeships. **In letting contracts for construction projects, Government Departments and their Agencies will now consider, on a case-by-case basis, making it a requirement that successful contractors have apprentices as an identified proportion of their workforce.** The Government will ensure that its contracts remain accessible to small businesses. Therefore, before creating such a requirement, procurers will consider the likely effect on small businesses. In addition, the Government will consider whether there is scope to build on this approach in other sectors, including IT.

Train to Gain

4.41 Train to Gain is an employer, demand-led, training service that delivers training in the workplace, and is central to the Government's reforms in response to Leitch. The Government announced in October 2008 that all £350 million of the planned growth in Train to Gain funds between 2008-09 and 2010-11 will be used to fund a short-term package, specifically to help SME employers in the downturn, and will be kept under review. Building on this package, **the Government will route further resources from within existing budgets through Train to Gain and Apprenticeships in future years if individual and employer demand allows.**

Productivity and progression pilots

4.42 **The Government wants city-regions to be able to take a coordinated approach to their skills needs and will encourage and support the development of sector productivity and progression pilots.** These will operate at a local level, building on Multi-Area Agreements and employer-led Employment and Skills Boards to test how the provision of sector coordinated training and business support services can boost productivity and help create higher-value job opportunities.

Strategic skills audit

4.43 **The Government and Devolved Administrations have asked the UK Commission for Employment and Skills to carry out a periodic strategic skills audit to identify where future demand and supply for skills in the UK could be better aligned.** Further details will be set out in the Commission's Five Year Strategic Plan for 2009-2014, due to be published in April 2009.

National Skills Academies

4.44 **The Government will expand the successful National Skills Academies programme by providing funding for an additional four academies in 2009-10,** bringing the total number to 20. The Government is on course to meet its ambition to have at least one academy in every major sector of the economy, resources permitting.

Higher education

4.45 **The Government has asked universities to outline how they can work with partners to support their local and regional economies during the downturn.** Universities will shortly set out how they can provide such support, including short courses in high level management skills, professional retraining, and using their research expertise to promote innovative product development.

Box 4.6 Skills

As part of the Public Value Programme reviews outlined in Chapter 6, DIUS will take further steps to drive forward Leitch reforms and maintain the pace of reforms to move to a simpler and more demand-led system both for individuals and employers by:

- **fast-tracking units and qualifications into the Qualifications and Credits framework** where they are needed for training in particular areas to support the recent package for SMEs and provide greater flexibility in the range of training that receives public funding;
- **streamlining commissioning for apprenticeships and Train to Gain to reduce barriers to entry in the market for new providers.** Further detail has been announced in DIUS's and DCSF's Statement of Priorities for 2009-10, published on 18 November 2008; and
- **ensuring that, from 2009-10, learners are able to exercise choice between different courses and providers in a contestable market,** through the trials and roll-out of the Adult Advancement and Careers Service and Skills Accounts; and reviewing whether the timetable to channel £1.5 billion of funding through Skills Accounts can be brought forward from 2014-15 following regional and national trials in 2008-09 and 2009-10.

DIUS will also ensure that any future decisions on subsidies reflect their role in driving up demand for economically valuable skills, and will continue to be based on evidence about their impact for different groups and types of training. To support this, colleges and providers should collect appropriate fee levels from individuals and employers, who are expected to contribute towards the cost of learning. This will enable them to offer a full range of adult learning and respond to demand. The Learning and Skills Council will work with the sector to communicate this message and support progress.

Supporting innovation

4.46 Science and innovation are critical drivers of long-term economic growth. The Government will publish its first Annual Innovation Report (AIR) in December 2008, updating on progress in delivering the strategy set out in *Innovation Nation* in March 2008.[3]

Small Business Research Initiative

4.47 The Government is implementing reform of the Small Business Research Initiative (SBRI) to provide better access to research and development procurement opportunities for innovative SMEs, as recommended by the Sainsbury Review[4]. **Pilots have been launched with the Ministry of Defence and the Department of Health (DH), and to date the Technology Strategy Board (TSB) and Government Departments have committed over £15 million to the scheme.** The SBRI budget will be confirmed before full roll-out in April 2009.

TSB and procurement

4.48 The TSB is already working with Government Departments, for example DH, as part of its Innovation Platforms programme to invest in the development of higher performing healthcare technologies for assisted living. **The TSB will advise the Government, in conjunction with business, on the better use of innovative technologies in four key areas of Government procurement: construction, low-carbon vehicles, food, and business waste management,** reporting back in time for the 2009 Annual Innovation Report.

TSB and international best practice

4.49 The TSB will continue to learn from international best practice in providing support for technological and non-technological innovation, and is exploring a number of areas including: challenge-based innovation, the management of risk, recruitment and accessing business expertise, and support to clusters. **The TSB will set out further opportunities for applying best practice in time for Budget 2009.**

[3] www.dius.gov.uk

[4] *The Race to the Top*, Lord Sainsbury of Turville, HM Treasury, October 2007

Health research **4.50** The Office for the Strategic Coordination of Health Research (OSCHR) published its first Annual Report on 18 November 2008.[5] Under OSCHR's oversight, the Medical Research Council, the National Institute for Health Research and its equivalents in Scotland and Wales are developing a shared Vision for UK Health Research, and are putting in place new measures to plug gaps in the pathway from research to drug development, underpinned by dedicated investment of £200 million.

4.51 **The Prime Minister has asked DH and DIUS for the development of a set of new National Ambitions for Translational Health Research,** to accelerate the translation of research breakthroughs into practical new treatments and services in the NHS within a decade. These will be developed under the auspices of OSCHR by the research funding bodies, working collaboratively with the medical and research communities as well as with industry.

University research **4.52** In consultation with other funding bodies, the Higher Education Funding Council for England (HEFCE) is developing a Research Excellence Framework which will reduce the burden on institutions and take better account of the impact research makes on the economy and society. A pilot exercise for bibliometric indicators of excellence is now underway, and HEFCE will set out its plans for all aspects of assessment, including user-focused research and subjects where bibliometrics are not appropriate, by summer 2009.

4.53 **The Charity Commission has consulted the university sector, HMRC and Government on the tax treatment of knowledge transfer activities, and will issue jointly agreed guidance early in 2009 which provides greater clarity on this issue,** consistent with both the requirements of charity law and the Government's commitment to encourage closer collaboration between higher education institutions and business.

Re-use of public sector information from trading funds **4.54** The HM Treasury/Shareholder Executive assessment of trading funds has considered the potential for innovation and growth from increasing commercial and other use of public sector information. It will shortly publish some key principles for the re-use of this information, consider how these currently apply in each of the trading funds and how they might apply in the future, and the role of the Office of Public Sector Information in ensuring that Government policy is fully reflected in practice. For the Ordnance Survey, this will involve consideration of its underlying business model. Further details will be announced in Budget 2009.

Investing in infrastructure

Transport infrastructure **4.55** Effective transport infrastructure is fundamental for a productive economy. Government spending on transport has increased by 70 per cent over the past ten years. The Government remains committed to investment across the road and rail networks and supporting investment in new airport capacity.

4.56 On 27 November 2008, **the Department for Transport will publish a consultation on the transport goals and priorities for 2014-19 and beyond.** This is part of the continuing response to the Eddington Transport Study[6] and the Stern Review[7] ensuring that transport contributes to economic growth and tackling climate change.

Roads **4.57** The Government is acting to reduce road congestion and to improve journey-time reliability. A demonstration project to trial the technology and processes that could underpin more sophisticated road charging systems will be underway by early 2009. In addition, the Government will bring forward schemes where capacity can be increased at peak times through the opening of the hard shoulder.

[5] www.dh.gov.uk

[6] *Transport's role in sustaining the UK's productivity and competitiveness*, HM Treasury, December 2006.

[7] *Stern Review: The Economics of Climate Change*, HM Treasury, October 2006.

Road freight **4.58** The Government continues to support the UK road haulage industry. The Freight Best Practice programme has worked to improve the sustainability and competitiveness of the industry, helping UK hauliers to save around £41 million and 0.12 $MtCO_2$ each year. The £24 million of enforcement funding, announced in April 2008 to tackle hauliers not complying with UK road safety law, has already delivered 100 additional enforcement staff, who will carry out an additional 100,000 checks, an increase of 60 per cent on 2007-08 levels. In addition, as announced in Budget 2008, the Government is refreshing the foreign vehicle data survey, which will take place in spring 2009.

Rail **4.59** The Government remains fully committed to delivering Crossrail, with services starting in 2017. The land purchase process began in October 2008 to enable early works to start on schedule in 2009. The Government continues to support the 2008 Rail Periodic Review and, when finalised, this will deliver major improvements to the rail network including significantly increased capacity and improved performance and safety.

4.60 Following the passing of the Channel Tunnel Rail Link (Supplementary Provisions) Act 2008 **it is the Government's intention (depending on prevailing market conditions) to proceed with the restructuring of London and Continental Railways Ltd and eventual sale of key assets such as High Speed 1** (the rail link between London St Pancras and the Channel Tunnel), to deliver best value for the taxpayer.

Aviation **4.61** The Government's review of the regulatory framework for UK airports, which will report early in 2009, will aim to ensure airport operators are incentivised to deliver timely, efficient, and necessary investment in new airport capacity.

Private Finance Initiative **4.62** The Government remains strongly supportive of the benefits Public Private Partnerships can bring to the public sector, and the pipeline of future PFI deals is strong: £21.3 billion worth of projects are due to be signed over the coming years. As part of supporting world-class public services, and the infrastructure on which they are based, the Government will continue to deliver on the objectives set out in the Budget 2008 document *Infrastructure procurement: delivering long-term value.* Over the short term, the Government is working with procuring authorities and departments to ensure that they are able to close PFI projects during the current difficult conditions in the banking market.

Communication infrastructure **4.63** Information and communication technologies (ICT) play a critical role in underpinning commercial activity and driving economic growth. Digital technology creates significant opportunities for business and consumers alike but, going forward, a range of decisions will be required from Government and industry to maintain the UK's position at the forefront of the digital infrastructure and content industries. The *Digital Britain* report is developing a strategic framework for the digital communications sector. An interim report in early 2009 will inform Government of the options and prospects for a universal broadband infrastructure, a liberalised and fully functioning spectrum market providing the spectrum to support new ICT services, and investment in digital content – in particular maintaining quality and competition in news and other UK-originated content.

4.64 The Government will shortly publish its response to the Caio Review of Next Generation Access broadband (NGA). **The Government agrees with the Review's conclusion that investment, can, and should, be driven by the market.** The response will also outline Government's plans to address planning, access and other supply-side issues, to lower the cost of the build out and create the conditions to favour adoption of new investment models. **In addition, the Government will set out a vision for NGA and implement a benchmarking process to review NGA roll-out in order to inform future policy.**

Spectrum released by digital switchover

4.65 Plans for the release of up to 112 MHz of spectrum cleared by the switch from analogue to digital terrestrial television were set out in November 2005. Since then, a number of other EU nations have also revealed their plans to release a similar 'digital dividend'. This development could present significant new efficiencies and benefits to UK and EU consumers and industry, many of whom are making increasing use of devices and technologies that rely on a supply of suitable spectrum. However it also presents the UK with some challenges, especially in the context of the UK's television transmitter networks. In light of this, and as part of the Government's response to the Caio Review, **the Government will work with Ofcom and other stakeholders, in preparation for the *Digital Britain* report, to capture the maximum benefits from radio spectrum in these and associated bands.**

Maintaining competitive markets

4.66 Strong and competitive markets protect businesses and individuals from high prices and encourage innovation and more efficient operations. Competition remains fundamental to the Government's economic policy and continues to be pursued in national and international markets.

Water markets

4.67 In the face of economic and environmental challenges, there is an increasing need to find ways to use water more efficiently. In February 2008, the Government commissioned the *Independent Review of Competition and Innovation in Water Markets* to assess the potential to increase efficiencies in water and wastewater markets that would lower prices, improve customer service and deliver environmental benefits. The Review published its Interim Report on 18 November 2008,[8] advocating a phased approach to furthering competition that could deliver significant benefits to the economy over the coming decades. The Government accepts this approach and will take it forward, while bearing in mind the need for the sector to retain access to capital at keen prices.

4.68 As a first step, and in response to the Review's recommendations, **the Government announces a package of measures to extend and enhance retail competition in the water markets for large non-domestic customers in England.** The Government will lower the usage threshold above which businesses and other non-domestic customers are eligible to switch supplier from 50 ML to 5 ML, extend the competition regime to retail wastewater services, remove the current access pricing arrangement for water from legislation (replacing it with simplified criteria to be introduced by Ofwat), and introduce nationally agreed codes to be coordinated by Ofwat in conjunction with stakeholders. The Government is strongly minded to mandate the legal separation of the retail arm of a company from the rest of its operations, in order to deliver further efficiencies and drive non-domestic competition. It will respond to this, and any further recommendations of the Cave Review, once it receives the final report.

4.69 **The Government will also keep the merger regime for water companies under review.** The Department for Environment, Food and Rural Affairs will launch a public consultation on the implementation of the 5 ML eligibility threshold early in 2009, and will consult on the implementation of the other reforms as part of the Floods and Water Bill. Water is a devolved matter and the Welsh Assembly Government will await further analysis on Wales-specific issues in the final report before providing a response.

Public service markets

4.70 As announced in Budget 2008, HM Treasury and other Government Departments have considered ways to make competition more effective in mixed markets for public services. This has focused on the markets for childcare, prisons and probation and the Train to Gain adult skills market. Box 4.7 sets out emerging findings from this work. The Ministry of Justice (MoJ), DIUS and the Department for Children, Schools and Families are taking forward these issues

[8] www.defra.gov.uk

in forthcoming documents, and the Government will subsequently publish a short report summarising the analysis and key issues.

4.71 This work has built on the BERR-led public services industry review, led by Dr DeAnne Julius, which reported in July 2008. The review analysed this sector and the factors that have contributed to success, and made recommendations as to what more the Government can do to realise its full potential. The Government is presently developing its response to this review.

Box 4.7 Public service markets – emerging findings

Emerging findings from work to date have suggested five broad success factors for effective public service markets:

- strategic market management – for example, MoJ and the National Offender Management Service Agency (NOMS) developing an offender management competition strategy and programme, to help drive value for money and build supplier capacity;
- effective commissioning and procurement frameworks – DIUS and the Learning and Skills Council (LSC) strengthening commissioning processes, including more effective contracts and enhancing market information for providers, employers and individuals;
- capability and capacity of commissioners – local authorities building capacity to undertake the childcare sufficiency duty effectively, mapping and managing markets to deliver sufficiency;
- competitive neutrality – MoJ and NOMS developing ways to treat all prison providers equally, during the bidding process, performance management, and ethical walls to separate the commissioner and provider functions of NOMS; and
- low barriers to entry and exit – DIUS and LSC tackling barriers for training providers to enter the Train to Gain market.

Given that each public service market is very different in terms of structure, design and management, it is important to tailor the approach and strategy to best deliver value for money, in terms of efficiency, quality of service, and impact on the workforce.

Energy markets

4.72 The Government's energy strategy is focused on ensuring secure, affordable and clean energy, based on the principle that independently regulated, competitive energy markets are the most cost-efficient means of delivering its objectives. In October 2008, EU leaders agreed on a new package of legislation to take forward energy market liberalisation across Europe. The package will help to improve the way that electricity and gas markets function and, in the medium term, deliver more competitive prices and greater energy security for EU citizens and businesses.

4.73 Chapter 7 sets out measures to accelerate the move towards a low-carbon economy, including measures to support renewables, and the Government's action to help businesses realise the opportunities of nuclear energy.

The Lisbon Strategy for Growth and Jobs

4.74 The EU is one of the most important markets for UK business. Challenging economic circumstances emphasise the importance of implementing structural reform in the EU, now and in the future, to boost both resilience and responsiveness during the downturn. Looking ahead, the Lisbon Strategy – the EU's current agenda for structural reform – ends in 2010. A successor strategy needs to set the framework for further and faster progress, still rooted in jobs and growth in a low-carbon economy. **The Government believes the strategy should have: a clear set of goals that are based on the principles of openness, flexibility, fairness and**

sustainability; a refined scope that recognises the new realities of the global economy; and a reformed governance structure that better drives reforms.

Devolving responsibilities to city-regions

4.75 *The UK Economy: addressing the long-term strategic challenges* sets out the increasingly vital role that cities and their city-regions will play in driving regional and national prosperity and responding to new challenges. Building on the Sub-National Review, and Multi-Area Agreements in particular, **the Government will support city-regions to fulfil this role by agreeing, on a voluntary and tailored basis, a set of devolutionary proposals with local authorities in city-regions, to increase further their ability to drive economic growth and contribute to sustainable development.** The Government intends to announce new agreements with at least two forerunner city-regions at Budget 2009.

4.76 These proposals will support stronger integration of planning, housing, transport, regeneration, employment and skills to drive sustainable growth and economic development, ensuring policy decisions are made at the right spatial level. **The proposals will be underpinned by new statutory arrangements for sub-regional cooperation between local authorities, supporting strong local capacity, governance and accountability at the city-region level.**

4.77 RDAs will play a key role supporting sustainable growth within city-regions, as part of their broader role in driving up regional economic performance, and ensuring that city-region policies remain coordinated with those of other sub-regional and local economies. RDAs will support city-regions in developing proposals for devolutionary measures and work with city-regions to increase capacity where it is needed, as they increasingly take on a strategic programme management role. RDAs will also support strong city-regions through their role in formulating regional strategies.

4.78 New agreements will be developed with the local authority city-region leadership, in order to suit particular needs. The Government envisages that the following components will be available:

- increased statutory responsibilities for strategic transport issues;
- integration of the DWP three levels of devolution model, as announced in the Welfare Reform Green Paper;
- a city-region Employment and Skills Board, with strong employer representation and formal powers to influence provision in line with employer demand;
- a joint board between the city-region and the Homes and Communities Agency to provide strategic direction of housing and regeneration spending, in line with the Agency's area-based approach to working with local and regional partners;
- integrated city-region planning within the context of the Single Regional Strategy; and
- joint investment planning with key partners. As part of this, Government would consider the merits of greater flexibility over capital funding to support the more effective programme management of projects.

5 HELPING PEOPLE FAIRLY

The Government has already taken action to help people through the current global economic difficulties. Building on this, the Government announces further packages of targeted support, providing additional help to those who need it most now.

To provide additional support for low- and middle-income taxpayers, the Government will:

- **make permanent the £600 increase in the income tax personal allowance announced in May 2008 with a further increase of £130, meaning basic rate taxpayers pay £145 less tax a year in 2009-10.** The Government is also taking measures to consolidate the public finances. The combined effect of all its reforms should mean that taxpayers with incomes below £40,000 will pay less tax and national insurance contributions in April 2011 compared to April 2008;
- **bring forward April's increase in Child Benefit to January,** worth an additional £22 on average to families; and **bring forward its commitment to increase the child element of the Child Tax Credit by £25 above indexation in April 2010 to April 2009** meaning it will increase by £75 above indexation to £2,235 in April 2009; and
- **pay £60 to all pensioners in the New Year** which is equivalent to bringing forward the April increase in the basic State Pension for a single pensioner to January.

This, alongside other measures announced in the Pre-Budget Report, will focus support on those who need it most.

The Government is committed to supporting householders facing financial difficulties. **A new Lending Panel** will improve monitoring of lending to households and businesses, as well as drive up best practice across the mortgage market and promote awareness of initiatives to support households against repossession. Individuals can also expect:

- **help through mortgage rescue and Support for Mortgage Interest schemes for eligible homeowners in difficulty;**
- **a commitment from major mortgage lenders on the Panel not to initiate repossession action within at least three months of an owner-occupier going into arrears;** and
- **free and impartial debt advice through increased Government funding.**

The UK's dynamic labour market leaves it well placed to deal with rising unemployment, with 1.2 million people finding new jobs in the three months to September. To ensure that those facing redundancy and those seeking employment are helped back into work as quickly as possible, the Government announces:

- **an additional £1.3 billion to continue delivering effective support for the unemployed to find a new job;**
- **a National Employment Partnership**, bringing together the Government and major employers to tackle rising unemployment; and
- **refocusing Train to Gain to provide support in pre-redundancy situations, expanding the Rapid Response Service to target small and large scale redundancies and extending Local Employment Partnerships to focus on the short-term unemployed.**

The 2008 Pre-Budget Report also announces further measures to continue the Government's established fairness agenda, including **contributing 50 pence for every pound saved in the Saving Gateway** and **reforms to modernise tax administration and protect tax revenues.**

5.1 The Government has made significant progress in ensuring that the tax and benefit systems are fair and help people find and stay in work. Central to this strategy is providing the right incentives for individuals to work and save, and reducing child and pensioner poverty. The reforms to date provide a solid foundation for helping individuals and families to get through the current global economic difficulties.

5.2 However, the Government is determined to provide further help to those most affected now. The Government expects that, over time, the majority of the VAT reduction will be passed on to consumers in the form of lower prices. For those families in most need of support, this temporary reduction is expected to support their finances in the short term in the form of increased purchasing power. For others, where it is saved or used to pay off debt, it will help households to adjust their finances enabling them to fund future spending.

5.3 Lower commodity prices and easing inflation are set to support real incomes in 2009, while monetary and fiscal policy is responding to support the economy and provide help for people now. This Chapter sets out the Government's plans to support households during these challenging times while also continuing to pursue its established fairness agenda.

Supporting motorists

5.4 The Government is also taking action to support motorists. The 2008 Pre-Budget Report confirms the Government's commitment to reform of vehicle excise duty (VED), including the introduction of new bands in 2009. However, to reduce pressures on motorists during the current economic downturn, no driver will pay more than £5 extra in any given band in 2009, and there will be no significant rate changes until 2010, when no driver will pay more than £30 extra in any given band, and many will see a reduction in tax paid of up to £30. Further details on VED rates and bands are set out in Chapter 7.

Supporting low and middle income taxpayers

5.5 Budget 2007 continued the Government's reforms of the tax and benefit system by reducing the basic rate of income tax and increasing support for many low-income households. To provide further support for low- and middle-income households, the Government announced in May an additional £600 increase in the personal tax allowance for 2008-09, providing up to £120 to around 22 million basic rate taxpayers aged under 65. These measures helped those affected by the removal of the 10p tax rate.

Further support for basic rate taxpayers

5.6 **The 2008 Pre-Budget Report makes permanent the £600 increase in the personal allowance and the £1,200 reduction in the basic rate limit announced in May,** and announces further reforms to personal tax. These changes will provide additional help for low- and middle-income families next year. **In April 2009, the Government will increase the personal allowance by £130 above indexation.** This goes further than the announcement in May, and is on top of the £600 increase for 2008-09. It means 22 million basic rate taxpayers under 65 will pay £145 less tax in real terms in 2009-10.

5.7 **The Government will also maintain the additional £130 of personal allowance in April 2010**, continuing this extra support for a further year. The real terms benefit will increase in 2010-11, when the Retail Price Index (RPI) measure of inflation is projected to be negative, as described in box 5.1. To reduce the gain for higher rate tax payers from the real terms benefit of negative inflation on tax allowances and limits, **the basic rate limit will be held at its 2010-11 value in 2011-12.**

Income tax and NICs changes from 2010-11 onwards

5.8 As set out in Chapter 2, this Pre-Budget Report sets out measures which put the public finances on a path to achieve cyclically-adjusted current balance and a declining debt to GDP ratio by 2015-16. These measures are a combination of adjustments to both taxation and spending, including reforms to income tax and national insurance contributions (NICs):

- **the income tax personal allowance will be restricted for those with incomes over £100,000 – the two per cent of people with the highest incomes – from April 2010, when the economy is forecast to be growing.** From that level of income, the personal allowance will be reduced at a rate of £1 of allowance lost for every £2 of income over that level until it is halved in value. At this value, the personal allowance will be worth the same as for a basic rate taxpayer. **From £140,000 of income, the remaining allowance will be completely withdrawn at the same withdrawal rate**, so that people with the very highest incomes do not benefit from the personal allowance;
- **a new additional higher rate of income tax of 45 per cent (and 37.5 per cent for dividend income) for those with incomes above £150,000 from April 2011.** This will ensure that people with the very highest individual incomes pay a greater share of their income in tax; and
- **a 0.5 per cent increase in the employee, employer and self-employed rates of NICs from April 2011, alongside an increase above indexation in the point at which individuals start to pay NICs –** known as the primary threshold – so that it is aligned with the personal allowance. This will ensure that the fiscal consolidation is broad based, without affecting those over state pension age, who do not pay NICs. These changes will be introduced from 2011, when the economy is forecast to be growing above trend rates and real incomes are growing strongly.

Effect of personal tax changes from 2011-12

5.9 The measures above mean that people with incomes below £40,000 will not pay more income tax and NICs in April 2011 than in April 2008. People with incomes between £40,000 and £100,000 a year will pay slightly more income tax and NICs, around £3 a week on average. Those with incomes between £100,000 and £140,000 will pay around £22 a week more on average in income tax and NICs, while those between £140,000 and £200,000 will pay on average £61 a week, and progressively more as income rises.

5.10 These reforms, and the measures announced in May, will permanently reduce the number of households paying more net tax as a result of Budget 2007 personal tax changes from 5.3 million originally to 500,000 by 2011-12. As a result of all the measures taken since Budget 2008, in April 2011, 23 million taxpayers with incomes below £40,000 will pay less tax and NICs than in April 2008 in real terms. The increase in the NICs primary threshold and the 0.5 per cent NICs rate rise in April 2011 will reduce the amount of NICs payable by those earning less than £20,000.

Box 5.1: The effect of negative RPI inflation on the value of tax and benefits

The Government's economic projections show RPI inflation as negative in September 2009. This means general prices using this measure of inflation are expected to fall. RPI inflation for that month is used to index income tax, tax credits and national insurance allowances, thresholds and limits for 2010-11. September measures of inflation are also used to index social security benefits.

With projected negative RPI inflation, the Government would maintain the cash value of tax allowances and thresholds, and the RPI-indexed social security benefits, consistent with statute. Holding these constant with lower prices means that in 2010-11, their real terms value would rise in relation to RPI, and that people would be better off in real terms. Analysis in real terms shows the effect on tax and benefit changes in terms of people's purchasing power.

The basic State Pension is indexed by RPI inflation or 2.5 per cent, whichever is greater. This means that there will be an even larger real terms benefit for pensioners in 2010-11. Some benefits are uprated by earnings, and negative RPI inflation increases the real terms value of those increases. For 2011-12, when RPI inflation is projected to be positive, allowances, thresholds and benefit levels will be increased from their 2010-11 levels in line with standard indexation. This will maintain the real terms gain from 2010-11 for future years.

Giving everyone the best start in life

Tackling child poverty

5.11 The consequences of child poverty are far reaching and extend beyond the individual, impacting on families, communities, the taxpayer and the economy. This is why the Government remains committed to eradicating child poverty. Since 1998-99 substantial progress has already been made, with 600,000 children lifted out of relative poverty and absolute poverty halved. Measures announced since Budget 2007 will lift around a further 500,000 children out of relative poverty.

Financial support

5.12 Especially in these difficult times for the global economy, the Government will continue to increase financial support for children. The tax credits system is already providing an average of £3,400 a year to six million families, benefiting ten million children. The spending increases announced in previous Budgets and Pre-Budget Reports will build on this foundation. **From April 2009:**

- **the child element of the Child Tax Credit will increase by £75 above indexation to £2,235**, providing additional support to families with low or moderate incomes. This builds on the Government's commitment to increase by £50 above indexation in April 2009 by **bringing forward the Government's commitment to increase the child element by £25 above indexation in April 2010 to April 2009**;
- **Child Benefit will increase from £18.80 to £20 a week for the first child, and from £12.55 to £13.20 a week for subsequent children**, providing further support to all families with the costs of raising children. To provide additional support, **these increases will be brought forward from April 2009 to January 2009**; and
- **the Health in Pregnancy Grant will be introduced at a value of £190 for all women after the 25th week of pregnancy.**

5.13 Low-income families and children will also benefit from the wider measures on personal taxation and VAT, as well as the uprating of benefits and tax credits above earnings this year and the real terms gains from projected inflation next year. In the light of the wide

range of changes coming into effect in the coming months, the Government will take stock of progress towards its 2010 and 2020 child poverty target in the Budget.

5.14 Take-up of tax credits is higher than for any previous system of income-related support, with 82 per cent of eligible families claiming what they are entitled to, rising to 96 per cent for those on the lowest incomes. The Government will ensure that as many families as possible take up the available help. **The Government is setting up a taskforce of experts from local authorities and the third sector which will report in spring 2009. It will assist local authorities in further improving take up of tax credits and benefits.**

5.15 HM Revenue and Customs (HMRC) has rolled out four new services nationally over the last twelve months to assist customers to claim, renew and manage their tax credit awards. These initiatives will help up to 400,000 customers each year get the right tax credits award, and by the beginning of next year around 100 Children's Centres will offer tax credits advice.

5.16 In May the Government invited views on proposals to further improve the tax credit system,[1] including a series of options to simplify the childcare element of the Working Tax Credit. The Government welcomes the engagement of interested parties. Following input from stakeholders, as part of the Childcare Affordability Pilot **the Government intends to trial making childcare payments that more closely reflect childcare costs at the time they were incurred. Further proposals for childcare reform, updating the Government's ten year framework for childcare policy, will be brought forward in the New Year.**

Public services

5.17 The family environment in which children are raised is important and public services play a key role in providing disadvantaged families with opportunities to enhance their life chances and break cycles of deprivation. Looking towards 2020, public services will play an increasingly central role in achieving this sustainable eradication of child poverty. Budget 2008 announced an additional £125 million across the UK for pilots to develop new methods of tackling child poverty. Two have been rolled out already in 18 local authorities including Birmingham, Blackpool and Nottingham, testing the value of having HMRC and Jobcentre Plus advisors based in Children's Centres. Others will begin in January 2009:

- trialling innovative local approaches proposed by local authorities to tackle child poverty in their communities;
- testing whether helping families financially with a Child Development Grant will help them to engage with local services and improve children's outcomes in their early years;
- extending Family Intervention Projects to support an additional 500 families with complex needs; and
- developing new ideas around accommodating teenage parents.

5.18 The Government is now well on the way to delivering a nationwide network of 3,500 Sure Start Children's Centres by 2010. These centres deliver coordinated, comprehensive family, childcare, health and employment support to all families, particularly reaching out to those families most in need of support.

Improving the quality of children's housing

5.19 Eradicating child poverty requires a sustainable strategy that focuses on improving children's life chances as well as tackling material deprivation. Improvements in housing quality will help children achieve their potential in later life. Living in poor quality, overcrowded or temporary accommodation has been shown to have detrimental effects on the physical

[1] *Tax Credits: improving delivery and choice - a discussion* document, HM Treasury, May 2008.

and mental health of children. It has therefore been a key aim of the Government to reduce the number of children living in such conditions.

5.20 Since 1997 the Government has already reduced the number of children living in bad housing (non-decent or overcrowded homes and temporary accommodation) by over 1.4 million. By 2010 the Government will increase this figure to over two million. Measures announced in the Pre-Budget Report to bring forward spending will accelerate progress in lifting children out of poor quality housing. The £250 million for Decent Homes and £150 million spend for new social housing will help an estimated 9,000 more households with children move into high quality accommodation more quickly. In addition, the £150 million spend for Warm Front programmes will benefit 60,000 households more quickly.

Child poverty bill

5.21 Eradicating child poverty requires a renewed approach that makes sustainable progress in improving children's life chances for the longer term. Demonstrating its commitment to this approach, **the Government will introduce a child poverty bill in 2009**. As Budget 2008 set out, the Government is committed to working with stakeholders to develop its strategy and **the Government will launch a consultation asking stakeholders how legislation can best reflect its long-term ambition to eradicate child poverty**.

Local authorities and regions

5.22 If child poverty is to be eradicated, it must be a priority at all levels of Government. Central Government has prioritised tackling inequalities through schools funding. Local authorities have a vital role to play by leading local action, developing joined up local strategies and delivering front-line services. Many local authorities have shown their commitment to this by putting child poverty among their top priorities, but more needs to be done. In some cases, local authority distribution of resources to their schools does not fully reflect the distribution of deprivation. The Department for Children, Schools and Families (DCSF) is working with the local authorities concerned in this spending review period to ensure low-income families and their children do not miss out.

5.23 Local authorities have a key role to play in tackling child poverty and the Government is committed to working together with them and their partners to ensure that issues around child poverty are tackled effectively and the voices of vulnerable families are heard. **The Government will work now to identify more clearly the indicators that impact most directly on child poverty.** It will work with stakeholders to refine the set of national indicators from which local authorities can select child poverty priorities in future. **Building on the progress made to date, the consultation on child poverty legislation will include the role that local authorities have in eradicating it.**

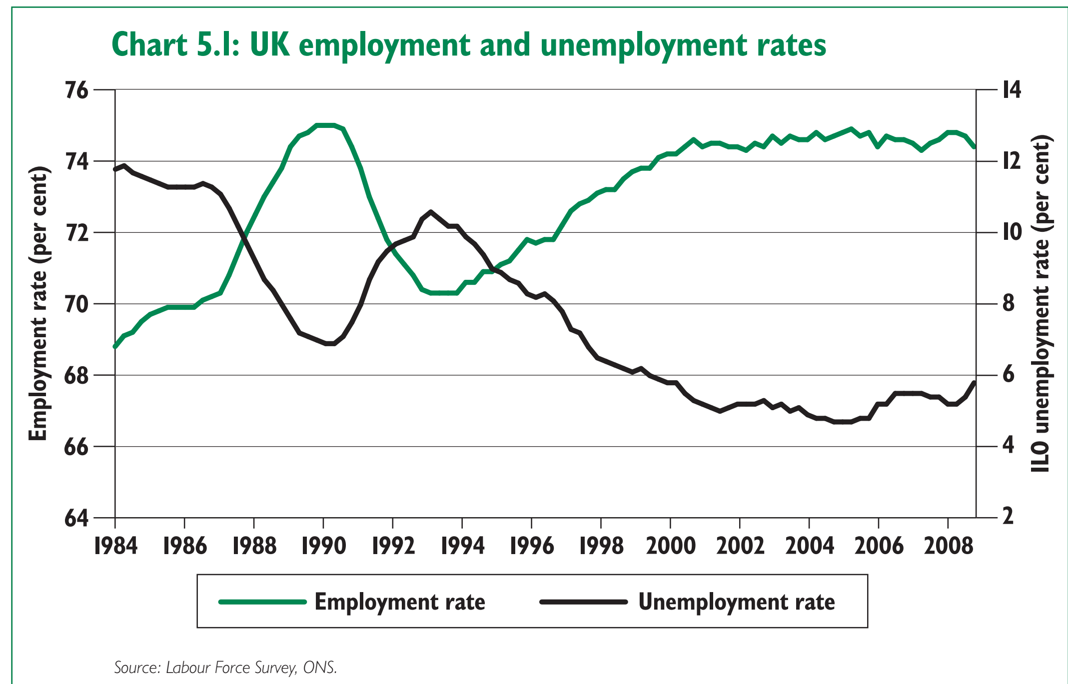
5.24 While good progress has been made nationally, child poverty in London has fallen by less than elsewhere in the UK. In Budget 2008, the Government asked delivery agencies to collectively identify better ways of working together to tackle child poverty and increase parental employment in the capital. The Government, in conjunction with delivery partners, on 19 November published a document setting out a framework, and key principles, to improve delivery and co-ordination of services in the capital.[2] A wider range of organisations, including employment services, local authorities, health services, and charities have also signed the London Child Poverty Pledge and set out specific actions they will take to improve their services and employment terms.

Labour market performance

5.25 The Government's labour market policies are focussed on improving incentives to work and providing active help for people who need it, with a tax and benefits system that

[2] *London's children: our future capital*, http://www.everychildmatters.gov.uk

supports these aims. A series of welfare reforms over the past ten years have led to record increases in employment and falls in the number of people claiming unemployment benefits. It is from this historically strong labour market position that unemployment is now rising as the economy slows. The latest unemployment data, released in November 2008, shows an increase in the claimant count of 36,500 in October and a rise in International Labour Organisation (ILO) unemployment of 140,000 in the three months to September.



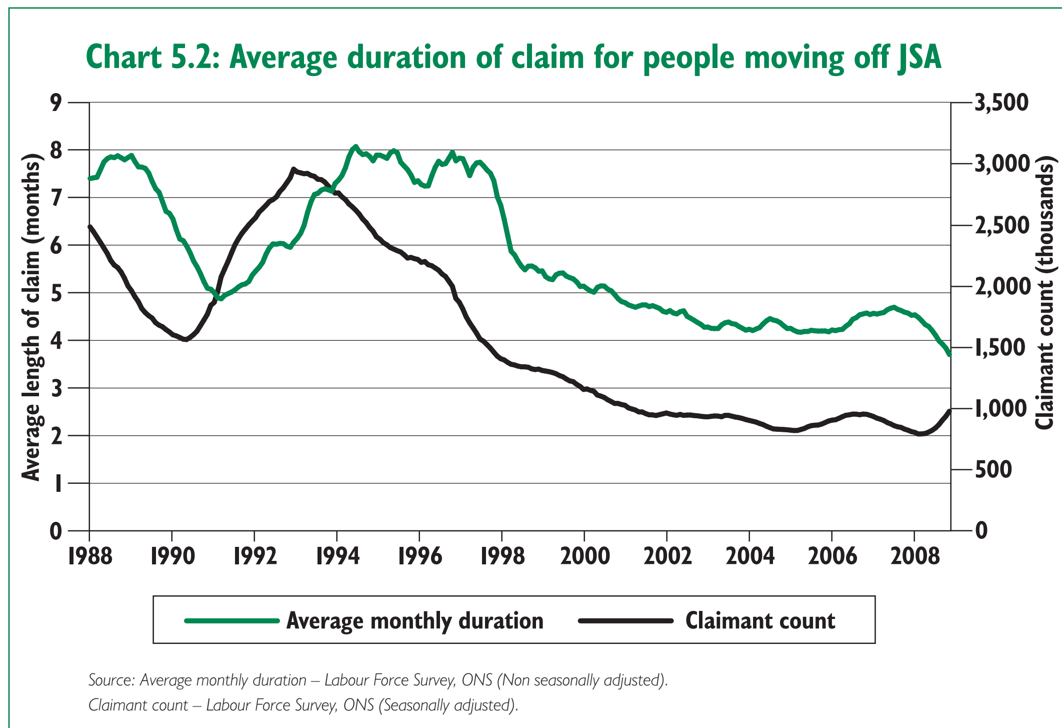
Responding to the labour market conditions

Jobcentre Plus support

5.26 There are real challenges in responding to the current labour market conditions. The UK's dynamic labour market and welfare reforms of the past ten years put the country in a good position to respond to the consequences of the economy slowing. The key to meeting this challenge is to build on the strong foundations that are already in place, focusing support on the interventions that are most effective in helping people move quickly back into work.

5.27 Reforms to Jobcentre Plus and Jobseeker's Allowance (JSA) since the late 1990s have provided a strong regime that will enable the UK to meet the challenges of rising unemployment. The JSA intervention regime has been successful in ensuring that the newly unemployed find work again, by facilitating and actively supporting swift and effective job matching. As a result, the majority of new claimants find new jobs quickly.

5.28 With these reforms, the rise in unemployment is now starting from a much lower base than was the case in the previous recession. In addition, unlike during the last recession, off-flows from JSA remain high and there is currently still significant demand for new workers, with over half a million unfilled vacancies in the economy. In the three months to September, 1.2 million people – or four per cent of the workforce – started a new job. Furthermore, as chart 5.2 shows, the average time spent on JSA is short compared with the late 1980s and early 1990s. At 3.7 months, the average for October is broadly consistent across all regions of the UK.



5.29 The most effective way of limiting a rise in the claimant count is to ensure that the existing regime continues to deliver a rapid return to work for the majority of new claimants. Additionally, the Government is putting in place measures to strengthen support for the newly unemployed, those faced with redundancy and the groups most at risk of being marginalised from the labour market as the economy slows.

Partnership with employers

5.30 Efficient matching between jobseekers and vacancies requires effective cooperation between employers, workers and the Government. Partnership working between Jobcentre Plus and employers is already taking place at the local level through the Government's highly successful Local Employment Partnerships (LEPs), in which employers commit to taking on the long-term unemployed. Businesses report that, through LEPs, they have received a much improved recruitment service from Jobcentre Plus. To date, over 70,000 people have found work through LEPs.

National Employment Partnership

5.31 The Government intends to significantly expand this successful approach of working with employers, and **is setting up a National Employment Partnership, including Chief Executives from across British business as well as the public sector.**

5.32 The Prime Minister will chair the Partnership's discussions of how employers will support the Government's efforts to help the rapid re-employment of people facing redundancy. Members of the Partnership will work with the Government to agree what more employers can do to help tackle rising unemployment by helping widen and expand LEPs – such as committing to advertise vacancies through Jobcentre Plus, speeding up recruitment, and enabling greater access to work-related training. Members will work as ambassadors within their respective sectors, and with their supply chains, to engage the commitment of as many employers as possible to offer this support through LEPs.

5.33 **To support the aims of the National Employment Partnership, this Pre-Budget Report announces a substantial expansion of Jobcentre Plus' local and regional employer engagement capacity** to enable LEPs to focus on the short-term unemployed as well as the harder to help groups.

Box 5.2: Government support for people facing redundancy

Many people facing redundancy find a new job even before they are actually made redundant, and most of those who do become unemployed find work again quickly. The Government offers a wide range of support to help people move straight back into work.

Jobseekers are entitled to:

- financial support, through Jobseeker's Allowance, for those who fall out of work;
- personalised jobsearch planning and job-matching, with direct access to vacancies. **The refocusing of LEPs will expand the number and range of vacancies available**; and
- access to intensive support and training for people with difficulty finding suitable work.

In addition, **the Rapid Response Service – which will now be available to small as well as large scale redundancies – offers support for those facing redundancy**, delivered in the work-place:

- help with looking for suitable jobs, including direct access to nearly 400,000 vacancies;
- help with writing a CV, and interview skills;
- a personal analysis of the additional skills or training that might be needed to find work;
- advice and support on self-employment and setting up a business; and
- training for developing the skills to change career path, where necessary. **The extension of Train to Gain will enable individuals to re-train before they are made redundant, to equip them with the skills to move swiftly into a new job.**

Support for people facing redundancy

5.34 As set out in Chapter 4, the Government has already put aside additional money over the next three years to support people faced with redundancy and those looking for work. This additional funding will contribute to the further steps the Government is taking to strengthen pre-redundancy support, which includes:

- **extending Train to Gain programmes to provide training and support to individuals in pre-redundancy situations**, to help them to develop the skills needed to move seamlessly into a new job, either in their existing sector or in a new one;
- **the Government will establish Skills Hubs – networks of local partners providing job brokerage services, training and other support – in response to large-scale redundancies.** Skilled employees in sectors with long term skills shortages will be matched into new jobs to ensure their skills are not lost to the sector;
- **the Rapid Response Service is being further expanded so that support can be made available to smaller redundancies as well as larger ones;** and
- to ensure that every region is well placed to respond to redundancies, **regional Ministers will work with Regional Development Agencies to develop contingency plans to enable coordinated responses to large-scale redundancies, as soon as they are notified.**

Additional funding for Jobcentre Plus

5.35 As well as strengthening partnerships and increasing support, it is critical that Jobcentre Plus is able to maintain its strong record and deliver the core JSA regime effectively for higher numbers of people. This will ensure all claimants continue to get the dedicated support they need to move rapidly back into work. **The Government is setting aside an**

additional £1.3 billion[3] for the Department for Work and Pensions (DWP) over the next two years to deliver effective support for the unemployed.

Welfare Reform Green Paper

5.36 Although the key priority in times of rising unemployment must be to prevent short-term unemployment leading to long-term detachment from the labour market, it is important to maintain support for those with greater labour market barriers to prevent them getting left further behind. The last eleven years have seen a transformation from a largely passive welfare state into an active one. The Government will continue to build on this progress, with further radical reforms to the UK welfare system to tackle long-term unemployment and economic inactivity, based on the principles of rights and responsibilities.

5.37 The Welfare Reform Green Paper[4] set out a radical package of new measures, including further personalised support to help disabled people address the particular barriers to work that they face, piloting 'work for your benefit' programmes for the long-term unemployed and the payment of private and voluntary sector providers who work with long-term Incapacity Benefit claimants for a number of years from benefit savings. The Government has consulted on these proposals and will respond shortly.

Supporting working households

5.38 The Government recognises that working households are facing uncertainty in the current economic climate. In addition to the employment package set out in this Chapter to respond to labour market conditions, the Government will continue to take action to make work pay by improving incentives to participate and progress in the labour market. Through the Working Tax Credit (WTC) and the National Minimum Wage (NMW), the Government has boosted in-work incomes, improving work incentives and tackling poverty among working people.

Working Tax Credit

5.39 The WTC provides financial support to working households on low incomes. In April 2008, 1.7 million working families and 375,000 working households without children were benefiting from the support it provides. To ensure work continues to pay, **the Government will maintain the childcare element of the WTC and uprate all other elements in line with RPI.** To ensure that all people on low incomes will benefit from the uprating of WTC, **from April 2009 the disregard for tax credits in Housing Benefit will increase by RPI.**

Take-up of Working Tax Credit

5.40 The Government is also taking steps to ensure that childless workers claim and receive the support they are entitled to. Since last year, HMRC has been working in partnership with other organisations to promote WTC in innovative ways. They are currently reaching over 500,000 employees at 40 organisations. **In the coming year HMRC will aim to double this coverage, working with employers' Corporate Social Responsibility programmes and using the National Employment Partnership to raise employers' awareness of the WTC.** HMRC will also work alongside Jobcentre Plus, ensuring that people who find employment receive integrated advice on the support available.

National Minimum Wage

5.41 The NMW ensures a fair minimum rate of pay while retaining flexibility for employers. The Government, accepting the recommendations of the independent Low Pay Commission, increased the adult rate of NMW to £5.73 from 1 October 2008, the development rate for 18-21 year olds to £4.77, and the youth rate for 16-17 year olds to £3.53.

Tackling the unemployment trap

5.42 The unemployment trap occurs when those without work find the difference between in-work and out-of-work incomes too small to provide an incentive to enter the labour market.

[3] As set out in table B5, £800 million of this will be funded via the 2008 Pre-Budget Report scorecard. The remainder will be funded from DWP's stock of money not spent in earlier years.
[4] *No one written off: reforming welfare to reward responsibility*, DWP, July 2008.

Table 5.1 shows that, since the introduction of the NMW in April 1999, the Government has increased the minimum income that people can expect when moving into work which has increased the gains to work and reduced the unemployment trap.

Table 5.1: Weekly minimum income guarantees (MIGs)

	April 1999	April 2009	Percentage increase in real terms[2]
Family[1] with 1 child, full-time work	£182	£304	29%
Family[1] with 1 child, part-time work	£136	£236	34%
Single person, 25 or over, full-time work	£113	£196	34%
Couple, no children, 25 or over, full-time work	£117	£231	52%
Single disabled person in full-time work	£139	£244	35%
Single disabled person in part-time work	£109	£176	24%

Assumes the prevailing rate of NMW and that the family is eligible for Family Credit/Disability Working Allowance and Working Tax Credit/Child Tax Credit. Full-time work is assumed to be 35 hours. Part-time work is assumed to be 16 hours.

[1] Applies to lone parent families and couples with children alike.

[2] RPI growth is taken from HM Treasury's economic forecasts.

The poverty trap

5.43 The poverty trap occurs when those in work have limited incentives to move up the earnings ladder because it may leave them little better off. Marginal deduction rates (MDRs) are one measure of the extent of the poverty trap. They show how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefits or tax credits. Budget 2007 noted that there are a number of limitations to MDRs as a measure of incentives to progress. In particular, MDRs are calculated with respect to an additional pound earned whereas most evidence shows that in-work labour market transitions are much more substantial, for example, movements from part to full-time working.

5.44 Table 5.2 shows the reduction in the number of families facing MDRs in excess of 70 per cent as compared to 1997. Increased numbers facing MDRs between 60 and 70 per cent are primarily due to the extension of financial support to a greater number of families through tax credits, including, for the first time, support for families without children. In 2009-10 there will be a smaller increase in the number of families who may face MDRs above 70 per cent. This is largely due to the introduction of a disregard for Child Benefit in Housing and Council Tax Benefits from October 2009. This contributes to a package of measures since Budget 2007 that is expected to lift around 500,000 children out of poverty. The disregard delivers an improvement in in-work incomes, and so incentivises work, for all low-income families facing withdrawal of Housing Benefits under the 2008-09 benefit system. In practice, such families will face increased MDRs over relatively short income intervals, meaning MDRs may exaggerate any changes in effective incentives to progress.

Table 5.2: The effect of the Government's reforms on high marginal deduction rates

Marginal deduction rate[1]	Before Budget 1998	2009-10 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	60,000
Over 80 per cent	300,000	225,000
Over 70 per cent	740,000	305,000
Over 60 per cent	760,000	1,960,000

[1] Marginal deduction rates are for working heads of families in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week, and the head of the family is not receiving pensioner or disability premia.

Note: Figures are cumulative. Estimates for the 2009-10 system of taxes and benefits are calibrated to tax credits statistics for April 2008, and earlier data for Housing and Council Tax Benefits. The estimates make explicit allowance for families newly entitled to Housing and Council Tax Benefits from October 2009, but any such estimates are subject to significant uncertainties, in particular concerning likely take-up.

Reform of Housing Benefit

5.45 The Housing Benefit (HB) review, announced at Budget 2008, is now underway. It is focussing on ensuring work incentives are protected and that the system represents better value for money for the taxpayer. The review covers those of working age in both the private and social rented sector. The current HB rules for those in the private rented sector can result in claimants living in properties that cannot be afforded by their working peers on a low income. The review is therefore looking at ways to ensure households receiving HB are no better off than working households in the same area who are not receiving HB.

Local housing allowance

5.46 The Local Housing Allowance (LHA), introduced in April 2008, is a flat rate of HB based on the area in which the claimant lives and family size. The Government is concerned that the costs of the LHA are greater than had been anticipated. **From April 2009, the maximum amount of LHA that can be received will be the five bedroom rate**, and the Government will be urgently looking at the scope to constrain these costs.

Helping homeowners and first time buyers

5.47 The housing market has recently experienced significant challenges as a result of turbulence in the global financial markets. However, the long-term challenge remains to meet the housing needs of an ageing, growing population, while helping families and first time buyers priced out of the property market. The Government is committed to promoting the long-term stability of the housing market and meeting the long term challenge of increasing the housing supply, including through releasing more public sector land for housing, while providing support to homeowners through these difficult times.

Support for homeowners in difficulty

5.48 In September, as part of a £1 billion package to support homeowners, first time buyers and the house building industry, the Government announced a new suite of mortgage rescue schemes, which aim to reduce by up to 6,000 the number of repossessions of vulnerable households over the next two years. The Government also strengthened the Support for Mortgage Interest system by reducing waiting times and increasing the maximum value of eligible mortgages, which could prevent up to a further 5,000 to 10,000 repossessions. The 2008 Pre-Budget Report takes further steps to support homeowners facing difficulties.

Box 5.3: Supporting homeowners in financial difficulty

The Government is committed to providing additional support for those facing financial difficulties in order to help protect households against repossessions. Individuals can expect:

- the Government to provide direct support to vulnerable individuals through the recently announced mortgage rescue scheme. **This new scheme will be extended to include second charge mortgages;**
- the Government to provide direct support to some individuals through the Support for Mortgage Interest regime which has been strengthened following reforms in September;
- fair treatment by lenders, who will only move to repossession as a last resort. **The major lenders are committed not to initiate repossession proceedings within at least three months of an account going into arrears, and will work to develop creative and sustainable solutions to help borrowers stay in their homes;**
- support from mortgage lenders who will do everything possible to restructure payments, including providing payment holidays, and adjusting the terms of the mortgage – taking into account borrowers' individual circumstances; and
- access to high quality information and independent debt advice at the earliest possible opportunity. **The 2008 Pre-Budget Report announces an extension of debt advice services.**

5.49 **The Government announces the creation of a new Lending Panel.** Reporting to the Chancellor of the Exchequer and the Secretary of State for the Department for Business, Enterprise and Regulatory Reform (BERR), the Panel will monitor lending to both businesses and households. The Panel will bring together lenders (including banks, building societies and specialist lenders), trade bodies, consumer groups, and the Government, regulators and the Bank of England. On lending to small businesses, the Panel will incorporate the activities of the Small Business Finance Forum, which had its first meeting on 11 November. With respect to mortgage lending, the Panel will:

- establish a reporting framework to allow improved monitoring of the mortgage market;
- encourage the highest standards of industry best practice in supporting borrowers with mortgage repayment problems, consistent with statutory regulation; and
- promote better awareness of industry and Government initiatives to find alternatives to repossession and allow borrowers in financial difficulties to remain in the their homes.

5.50 The Government is committed to ensuring that the right framework is in place to help homeowners facing financial difficulties. In order to strengthen the framework of support for borrowers:

- as previously announced, **the Government will bring forward a consultation on extending the scope of FSA regulation to include the sale and rentback market;** and
- **the Office for Fair Trading will bring forward sector guidance early next year to help ensure that second charge lenders do everything possible to treat customers sympathetically and only repossess as a last resort.**

The Government will continue to keep the framework for consumer protections in the mortgage market under review.

5.51 Supervisory and enforcement action to ensure lenders treat borrowers in arrears fairly remains a critical priority for the FSA. The FSA will also continue to keep its regime for borrowers, including those facing repayment problems, under review.

5.52 On 22 October the Master of the Rolls approved a new protocol for mortgage possession cases, setting out the steps that judges will expect any lender to take before starting a claim. In October and November respectively, the Council of Mortgage Lenders and the Finance and Leasing Association published best practice guidance to ensure lenders continue to provide a fair deal for borrowers, including providing borrowers with early access to debt advice, and considering the full range of options to help borrowers stay in their homes. The aim is to ensure lenders have done everything possible to avoid repossession if a case comes to court.

5.53 **The major mortgage lenders on the new Panel have confirmed that they will adopt the best practice of the leading lenders for the coming year and not initiate repossession action for at least three months after the owner-occupier is in arrears.** This moratorium will of course be subject to the wishes of the individual borrower, and does not apply in cases of fraud. This commitment gives both lender and borrower time to consider properly the options available and to find, where possible, a sustainable solution. The commitment will be kept under review and is intended to drive up best practice across the market.

5.54 The Government intends to discuss urgently with the Lending Panel further actions to help ensure that those who are in work, but facing difficulties, can remain in their homes. Mortgage lenders will continue to explore with borrowers in difficulty all appropriate options to avoid repossession. The major mortgage lenders participating in the Lending Panel are committed to working individually and through the Panel to develop creative and sustainable solutions that will help borrowers stay in their homes, including giving their full support to mortgage rescue products (including shared equity).

5.55 The Government will provide direct support to individuals through the recently announced mortgage rescue scheme, which will help up to 6,000 vulnerable borrowers facing repayment difficulties remain in their homes. **This new scheme will now be extended to include second charge mortgages, in order to help more vulnerable households.**

5.56 The Government will also provide direct support to individuals through the Support for Mortgage Interest scheme. The Government has already announced reforms in September, which will strengthen the system of support for new claimants of working age by reducing the waiting period from 39 to 13 weeks, and raising the capital limit to £175,000. **The Government will increase eligibility for this support by raising the capital limit further to £200,000. The Government will also maintain the level of support at the current interest rate for the next six months for existing claimants so that net support to such claimants is increased.**

Social rented homes

5.57 As well as supporting households facing difficulties meeting mortgage costs, the Government remains committed to increasing the supply of affordable and social housing. The September housing package, announced additional support to sustain delivery of social homes, bringing forward £400 million of spending to help provide up to 5,500 new social rented homes over the next 18 months. **As part of a broader fiscal stimulus package, the Government will bring forward a further £775 million of housing and regeneration investment, including £575 million to provide additional support for social rented homes,** with £150 million to support delivery of new social housing, £250 million to sustain and accelerate the Decent Homes programme and £175 million on major repairs. [0320]

First time buyers

5.58 Since 1997 110,000 households have been helped into home ownership through shared equity and shared ownership schemes. In September the Government announced

further support for first time buyers, offering 10,000 more people the opportunity to purchase a home through a new shared equity scheme. The Government also announced a one year stamp duty holiday for all purchases of houses costing up to £175,000.

Long term fixed-rate mortgages

5.59 At Budget 2008 HM Treasury published *Housing Finance review: analysis and key proposals* which identified a number of key challenges for the UK mortgage market. Since then, countries around the world, including the UK, have experienced instability in financial markets. Budget 2008 invited views on options to deliver more affordable long-term fixed rate mortgages. Unlike many other countries, there is very little mortgage debt in the UK with the interest rate fixed for more than a few years. Long term fixed rate mortgages can bring benefits for some borrowers by protecting them from unexpected interest rate rises. The Government recognises the merits of promoting a deeper market in longer-term fixed rate mortgages in the longer term and will continue to work with stakeholders and experts on how this may best be achieved.

Crosby Review

5.60 In April 2008 the Chancellor invited Sir James Crosby to advise the Government on options to improve the functioning of mortgage finance markets. Sir James's interim analysis was published on 29 July, and his final recommendations are published alongside the 2008 Pre-Budget Report. The Government welcomes the publication of the report and thanks Sir James for the considerable work he has undertaken since the summer.

5.61 The financial markets have experienced instability in recent months. In response, the Government implemented the bank recapitalisation scheme and the Credit Guarantee Scheme, as described in Chapter 3, to restore liquidity to the financial markets and increase confidence in banks with the purpose of enabling them to continue to fund the needs of businesses and customers. In devising the Credit Guarantee Scheme, which makes available to eligible financial institutions a Government guarantee to refinance maturing debt, the Government was informed by and benefited from Sir James's analysis. Box 5.4 summarises Sir James's findings and recommendations. Sir James finds that the closure of the securitisation market and the pressures on banks to deleverage could reduce severely the availability of mortgage finance in 2009 and 2010. Sir James's principal recommendation is that the Government should support the mortgage market by providing, for a temporary period, guarantees on the interest and principal of high quality mortgage-backed bonds backed by lending for new housing transactions.

5.62 The Government shares concerns about the availability and cost of mortgage finance to homeowners in the future, and has taken steps to help banks continue to lend, including supporting the Special Liquidity Scheme, the bank recapitalisation plan and the Credit Guarantee Scheme. In the case of RBS, Lloyds and HBOS, where the Government is expected to take a significant shareholding, these banks have made commitments to the Government to support the mortgage market going forward. It is not yet clear how far the measures recently taken will mitigate the risks to the mortgage market which Sir James highlights in his report.

5.63 To implement Sir James's recommendation, the Government would need to obtain State Aid approval from the European Commission and resolve a number of technical and practical considerations. The Government:

- **supports Sir James's encouragement of new industry standards on transparency and standardisation;**
- **supports ongoing dialogue on the issue of the application of fair value accounting principles;** and
- **will now proceed to work up a detailed scheme based on Sir James's recommendations and seek State Aid approval to proceed. The Government**

will take into consideration the interaction between Sir James's recommendations and the Credit Guarantee Scheme and update on its position by the Budget. It will continue to keep under review what more can be done to ensure the continued supply of secured and unsecured credit in the economy.

Box 5.4: Summary of Sir James Crosby's findings

Securitisation markets have been a very important source of finance for mortgage lenders. These markets involve packaging and reselling mortgage assets to investors. Well-functioning securitisation markets have helped to ensure the supply of a wide range of affordable products to individuals and have grown rapidly over the last decade. Following developments in the US sub-prime market, however, there has been a significant reappraisal and re-pricing of risk in financial markets. Securitisation markets around the world have been particularly affected and the UK has been no exception. Primary markets remain effectively closed to new issuance, and secondary markets are illiquid as evidenced by extremely high spreads. The collapse in demand for UK mortgage backed bonds reflects the disappearance of a large proportion of the previous investor base, as well as the reluctance of remaining and new investors to enter these markets. While securitisation markets are expected to recover in time, their closure has significant implications for the UK mortgage market and the macro-economy. Sir James's interim report considered a wide range of proposals made by stakeholders, including market-led initiatives to strengthen the markets over the longer term and a Government guarantee of mortgage-backed debt issued by financial institutions. His final report is published alongside the Pre-Budget Report. In summary, Sir James recommends that the Government should:

- encourage the industry, both domestically and internationally, to adopt new standards of transparency and standardisation in the mortgaged-backed securities market, to help ensure that, as the market recovers, it functions more effectively;
- encourage the International Accounting Standards Board to continue to review the application of fair value accounting to illiquid assets, without compromising the principle of transparent disclosure; and
- consider a temporary guarantee at a commercial rate, of the interest and principal on residential mortgage-backed securities or covered bonds backed by new mortgage lending.

Helping people manage their finances

5.64 The Government recognises that in difficult times people can require additional support in managing their finances. The Government wants to support everyone in making informed financial decisions and in accessing help if they need it.

Debt advice

5.65 The Government is committed to ensuring that every household struggling with debts can access free impartial debt advice and get the help they need. Since April 2006, BERR's face-to-face advice project has helped over 169,000 clients with their debt problems. The Government also provides £2 million funding a year to support telephone debt advice. Building on this, the Pre-Budget Report announces:

- **an additional £5.85 million in funding between November 2008 and March 2011 to increase the provision of free telephone debt advice** which could assist 70,000 people each year with their debt problems;
- **a further £10 million in funding between November 2008 and March 2010 for Citizens Advice Bureaux** to expand local face-to-face advice capacity which could assist a further 335,000 people each year; and

- **the Government will establish an online destination on Directgov which will provide people with free and impartial sources of advice and support.** Information on financial support, along with debt advice, will be further promoted from January 2009, as part of a campaign to promote Directgov services.

Illegal lending

5.66 Households' ability to access mainstream, unsecured credit may become more restricted in a challenging economic climate. More people may come under greater pressure to use sources of credit they cannot afford, or even turn to loan sharks. Since September 2004, the Government has committed £11 million to tackling the problem of loan sharks. BERR will continue to fund teams to tackle illegal money lending in every region in Britain until March 2011.

Affordable credit

5.67 Since 2005 the Government has committed £80 million to increase the capacity of third sector lenders, including credit unions and community development finance institutions, to make personal loans. This has enabled over 110,000 affordable loans to be made since July 2006, providing an alternative to high cost credit and loan sharks. In December 2007 the major retail banks made a commitment to support third sector affordable credit, including actions to develop new provision in 25 high priority areas. The Government now seeks to build on this commitment from the banks and ensure that clear plans are in place in each of the high priority areas.

Money Guidance

5.68 The Government also wants to ensure that people have the support and guidance to help them tackle financial choices. **The Government and the FSA are on track to launch the £12 million Money Guidance pathfinder in the North West and North East of England in spring 2009.** It will target those who are vulnerable to the consequences of poor financial decisions. The service will be available via the internet, phone and face-to-face and aims to reach between 500,000 and 750,000 people.

Financial inclusion

5.69 The Government remains committed to ensuring that everyone has the opportunity to access the financial services products needed to participate fully in modern-day society and the economy. In December 2007 the Government published *Financial Inclusion: an action plan for 2008-11*, which set out how the Government will use the £130 million Financial Inclusion Fund over the current spending period.

Saving and asset ownership

5.70 The Government recognises the importance of savings and assets in providing people with independence throughout their lives and security if things go wrong. The Government's savings strategy has focused on seeking to support savings and asset ownership for all across the lifecycle – from childhood, through working life and into retirement.

5.71 Since 1997 the Government has improved incentives to save by introducing the Child Trust Fund (CTF) and Individual Savings Accounts (ISAs). To support people going forward, the Government now wants to do more to ensure that children are taught about the benefits of saving, to improve incentives for people on lower incomes to save and to consider whether first time buyers need additional tax-free incentives to help them to save for their first home.

Financial education

5.72 The Government is committed to ensuring that children learn money skills in school. Financial capability and economic wellbeing is now a strand in Personal Social Health and Economic (PSHE) education for the secondary school curriculum in England. In October, the Government announced its intention to make all strands of PSHE statutory, including financial capability, and established an independent review to investigate how to achieve this. Financial education in schools is being supported by an £11.5 million personal finance education package. This will teach children how to open a bank account, understand basic financial

concepts like interest rates and learn important skills to plan for their financial future. A national Money Week will take place in schools in summer 2009.

Child Trust Fund

5.73 The CTF, introduced in 2005, will ensure that, in future, every child has an asset at the age of 18, regardless of family background. Every child receives a Government contribution of £250 (£500 for children from lower income families) at birth and a further payment when they reach age seven. An important part of the Government's strategy for the CTF is to use it as a tool to make personal finance real and tangible for children. The first children that benefited from the CTF started school last year and teachers are already using the CTF as a way of teaching financial education in maths lessons.

5.74 The £11.5 million package of support will be used in part to create financial materials based on the CTF, to bring finance to life in the classroom. Further Government contributions into children's CTF when they reach age seven will provide another opportunity for schools to focus on financial education. Combining financial education with the experience of having their own savings product will help children to understand the value of money, help to teach them how to interact with financial services providers, and better equip them to avoid financial problems in later life.

Saving Gateway

5.75 Since 2001, the Government has been exploring matching – a Government contribution for each pound saved – as an incentive to save for those on lower incomes. Two pilots have taken place confirming the success of matching as a saving incentive and in promoting financial inclusion.

5.76 Following the success of the pilots, as announced in Budget 2008, the Government is introducing the Saving Gateway nationally, with the first accounts available to savers in 2010. **The Government announces that, to provide a strong and easily understood incentive to save, it will contribute 50p for each pound saved in the scheme.** Around eight million people will have the opportunity to open an account and to earn a Government contribution of up to £300. Saving Gateway accounts will be provided by financial institutions and will be available through the Post Office. The Government also continues to work closely with a range of potential account providers on the design of the Saving Gateway and will publish a summary of responses setting out the final details of the scheme later this year.

Individual Savings Accounts

5.77 The Government introduced ISAs in 1999 with the aim of extending the saving habit and ensuring a fairer distribution of tax relief. Over 18 million people now have an ISA. Earlier this year the Government made ISAs simpler, more flexible, and extended the ISA allowance to £7,200 of which £3,600 can be held in cash. **The Government is now extending the range of qualifying investments for ISAs to include securities issued by Multilateral Development Institutions.**

First time buyers

5.78 Many young people already use their ISA allowance to save for a deposit for a house. Following the Government's support for first time buyers in September, the Government is now considering whether it needs to do more to help first time buyers save for their first home. **The Government welcomes views from industry and from individuals on whether creating a new tax-relieved savings scheme targeted at first time buyers would be a helpful step forward.**

Protecting people's savings

5.79 The Government has also demonstrated its commitment to protecting people's savings by its recent actions in response to problems within the worldwide banking system. The FSA raised the limit for deposits covered by the Financial Services Compensation Scheme to £50,000, meaning 98 per cent of all savings accounts are now covered by the scheme. The Government acted swiftly to ensure that ISA savings that have been invested in Icesave retained their tax-advantaged status.

Supporting people in later life

5.80 The Government is committed to tackling pensioner poverty, rewarding saving, and helping people meet their income aspirations in retirement. It does this through providing incentives for people to save, and supporting all pensioners in retirement, with additional support targeted on those who need it most. The Government is also taking forward pension reforms for the long term that will help meet the challenges of an ageing population.

Financial support for pensioners

5.81 The Government recognises the importance of continuing to support pensioners appropriately through the global economic downturn and to providing a safety net for the very poorest. To provide additional support for the poorest pensioner households, **the standard minimum income guarantee in Pension Credit will have an above indexation increase, rising by £5.95 to £130.00 a week for single pensioners and by £9.10 to £198.45 a week for pensioner couples.**

5.82 To support pensioners more broadly, **the level of the full State Pension will rise in line with prices by £4.55 to £95.25 a week in April 2009.** For those women whose entitlement is based on their husbands' pension, the full couples' rate increases to £152.30. In addition, in order to provide further support for pensioners during the economic downturn, **the Government announces that it will make a payment in the New Year of £60 for each pensioner, equivalent to bringing forward uprating of the basic State Pension from April to January.** Around 12.5 million pensioners will benefit. A £60 payment will also be made to 2.5 million individuals who are in receipt of certain other benefits.[5]

5.83 Winter Fuel Payments of £200 for households with someone over 60, £300 if over 80, have been committed for the lifetime of this Parliament. As announced at Budget 2008, this winter, households with those aged over 60 will receive an additional £50 or £100 for those with someone aged over 80.

5.84 The Government wants to ensure that all pensioners claim the benefits they are entitled to and are taxed fairly. In October the Government introduced a simplified claims process for eligible pensioners to claim Housing Benefit and Council Tax Benefit alongside Pension Credit. **To support those pensioners who pay income tax, the Government will raise in line with prices the age-related tax allowances in April 2009 to £9,490 for people aged 65 to 74 and to £9,640 for people aged 75 and over.** By April 2010 only 40 per cent of pensioners aged 65 or over will pay income tax.

5.85 **The Government is launching a campaign to encourage people on low-incomes, in particular pensioners, to register to receive interest on their bank or building society accounts tax-free and to claim back any tax they have overpaid.** The campaign is aimed at around 1.5 million pensioners who could be getting more value from their savings every year by registering to receive their interest tax-free.

Pension reforms

5.86 The pension reforms already legislated for will provide a more simple and generous State Pension. From 2010, the number of years needed to qualify for the basic State Pension is being reduced to 30 and the contributory system is being modernised to ensure that carers have improved opportunities to build State Pension entitlements. Building on this, and as announced in October, **the Government will change the class 3 voluntary national insurance contribution rules to allow those reaching state pension age between April 2008 and April 2015 with 20 qualifying national insurance years to purchase up to six additional years from 1975-76. The package is intended to be cost neutral overall and the class 3 rate will therefore rise accordingly to £12.05 a week in April 2009.** The changes will particularly benefit women and carers, and help 110,000 people improve their state pension outcomes. Pensioners and

[5] Eligibility will be the same as for the annual Christmas Bonus.

those relying on savings income will not be affected by the wider changes to NICs set out earlier in the chapter, since employee NICs do not apply to those over state pension age or to income from savings or a pension.

5.87 The reforms to private pension saving in the current Pensions Bill will mean that for the first time employers will be required to contribute to workers' pensions, providing a clear incentive to save and helping those on lower incomes to build a pension. The package of pension reforms will be supported by an information and communications strategy to ensure individuals auto-enrolled into a pension scheme will have the information they need to make informed pension choices.

Pensions tax simplification

5.88 The Government's simplified tax regime for pensions was introduced in April 2006, to help maintain stability and fairness and to encourage long-term pensions saving. Generous tax reliefs, estimated to be worth around £30 billion in 2007-08,[6] incentivise pensions saving and produce an income that lasts across retirement.

5.89 On the introduction of the simplified pensions rules in April 2006, the Government set a lifetime allowance (LTA) to provide an overall cap on tax-relieved pension savings, set at an initial £1.5 million in 2006-07, rising to £1.8 million by 2010-11. In line with its core principles[7] and to ensure fairness, affordability and sustainability of tax reliefs, **the Government will maintain the LTA at £1.8 million for a further five years, up to and including 2015-16.** This only affects the largest pension pots, those above £1.8 million over this period. **The annual allowance will also be held constant at £255,000.**

Open Market Option

5.90 The Government continues to work with industry to ensure that savers are able to get the best annuity deal when they come to draw their retirement income. **Shortly after the Pre-Budget Report, the Government will publish an update on the review of the operation of the Open Market Option**, detailing progress against the recommendations of the review published at the 2007 Pre-Budget Report.

A MODERN AND FAIR TAX SYSTEM

Modernising tax administration to support taxpayers

Review of HMRC powers, deterrents and safeguards

5.91 The Review of HMRC's powers, deterrents and safeguards continues to take forward a programme of work that will provide greater consistency across taxes; strong safeguards for taxpayers; and a modern framework of law and practice for HMRC. This work will reduce costs for compliant businesses and individual taxpayers by supporting those who seek to comply, while preventing a minority gaining an unfair advantage through not meeting their obligations. **The Government announces that HMRC will set up a new joint forum with representatives from the private sector to oversee the implementation of the legislative outcomes of the Review. Additionally, HMRC is publishing the Review's Work Programme alongside the Pre-Budget Report.**

5.92 **This Pre-Budget Report also announces consultations on:**

- **modernising and aligning penalties for late filing of tax returns and late payment of tax and harmonising and simplifying the rules for interest on tax paid late and on repayments of tax overpaid**;

[6] Gross tax relief is estimated at £29.3 billion in 2007-08. Income tax on pensions in payment is approximately £10.4 billion, making net tax relief £18.9 billion.

[7] The Government's principles for the taxation of pensions were set out in the speech by the Economic Secretary to the Treasury to the NAPF Investment Conference, Edinburgh on 15 March 2007.

- **repeal of a number of specialist compliance checking powers which will no longer be needed following Finance Act 2008 and on the application of the new compliance checking framework to other taxes administered by HMRC**; and
- **further changes to make it easier for taxpayers to pay what they owe on time and to support HMRC in effectively tackling those who pay late.**

A Charter for HMRC

5.93 An important complement to the Review of HMRC's powers is a clear statement of the principles governing HMRC's relationship with citizens and businesses. HMRC does not currently have a single document that clearly sets out in one place the rights and responsibilities of customers. The Government has, therefore, consulted on the scope of a Charter for HMRC. In the light of responses, published alongside the Pre-Budget Report, the Government has decided to include in next year's Finance Bill a clause giving the Charter explicit legislative authorisation. **The Government announces that it will begin a new consultation in January on the wording of the Charter, and that HMRC and DWP will work towards a joint launch for their respective charters in 2009.**

Reducing burdens

5.94 In support of the Government's programme of tax simplification highlighted in Chapter 4, the Government will reduce burdens on employers and the self-employed and make the administration of tax more straightforward by:

- **simplifying the collection of Class 2 NICs, initially by aligning payment dates with those for Self Assessment liabilities,** to reduce the number of bills issued, and **improving the information provided to contributors;** and
- **simplifying, from April 2011, the Pay As You Earn arrangements for all working students** and reducing burdens on their employers.

In addition, the Government will continue to explore with stakeholders the scope for collecting tax on benefits in kind and expenses through the payroll.

Protecting tax revenues

5.95 The vast majority of taxpayers seek to contribute their fair share towards funding public services. The small minority who do not put pressure on the public finances and impose costs on others, undermining fairness and economic performance.

Tobacco and alcohol strategies

5.96 **HMRC and the UK Borders Agency (UKBA) are publishing a joint counter tobacco smuggling strategy alongside the Pre-Budget Report.** This explains how, building on successes to date, they will work together to tackle the evolving smuggling threat. **The Government also announces that HMRC, together with the UKBA, will publish a refreshed alcohol strategy by the time of Budget 2009.** This will strengthen the current spirits fraud strategy and extend it to cover all forms of alcohol fraud ensuring that the approach to tackling alcohol fraud and smuggling keeps pace with developments in this area.

Missing Trader Intra-Community (MTIC) fraud

5.97 **HMRC is publishing *Measuring Indirect Tax Gaps – 2008* alongside the Pre-Budget Report.** This sets out the latest estimates of revenue losses in VAT and excise duties. Estimates of Missing Trader Intra-Community fraud included in this publication show a further reduction in fraud levels in 2007-08, demonstrating the continuing effectiveness of the Government's anti-fraud strategy. The targeted reverse charge introduced in 2007 has played a key role in driving down MTIC fraud. The Government has applied to the European Commission to renew the reverse charge derogation.

Offshore disclosure

5.98 **The Government announces that HMRC will be giving offshore account holders a new opportunity in 2009 to disclose, of their own accord, if they have unpaid tax or duties and to settle debts.** A further announcement will be made in early 2009.

Tackling avoidance

5.99 Avoidance schemes identified by HMRC are unfair on the majority of taxpayers who do pay their fair share. **Since Budget 2008, the Government has taken action to:**

- **prevent loss of tax through the leasing of plant and machinery;**
- **prevent a loss of tax on the sale of a company that is an intermediate lessor of plant or machinery;** and
- **counter avoidance involving businesses leasing films to others under a long funding lease.**

5.100 **The Government will also take action to provide certainty that authorised investment funds cannot be used by financial traders to reduce corporation tax.**

Principles-based anti-avoidance legislation

5.101 At the 2007 Pre-Budget Report the Government announced it would consult on the possible introduction of principles-based legislation to counter avoidance in the area of financial products. Following that consultation and subsequent work with stakeholders on the proposals, **the Government is publishing a further consultation document, that includes draft legislation on disguised interest and transfers of income streams, with the intention, if appropriate, of introducing legislation in Finance Bill 2009.**

Change of accounting practice regulations

5.102 **The Government can announce its intention to amend the Change of Accounting Practice (COAP) Regulations dealing with the taxation of loans and derivatives.** This will prevent future double taxation or double relief under the COAP Regulations with regard to foreign exchange gains or losses on certain foreign currency denominated financial instruments. This measure will apply with effect from 1 January 2009. The Government will publish draft legislation shortly.

Income shifting

5.103 The Government firmly believes it is unfair to allow a minority of individuals to benefit financially from shifting part of their income to someone else who is subject to a lower rate of tax, known as income shifting. The Government has consulted on this issue but, given **the current economic challenges, the Government is deferring action and will not bring forward legislation at Finance Bill 2009.** The Government will instead keep this issue under review.

Tax relief for travel expenses

5.104 Following the consultation *Tax relief for travel expenses: temporary workers and overarching employment contracts*, the Government has decided to leave the current rules unchanged. However, in the light of evidence from the consultation confirming poor levels of compliance in this area HMRC will refocus its efforts to ensure that the current regime is properly applied. If compliance does not improve, the Government may return to this at a later date.

False self-employment in construction

5.105 The Government is concerned about false self-employment within the construction industry. This can result in an unfair commercial advantage and possible exploitation of vulnerable workers. The Government will continue to work with the construction industry and others to find a way to address this problem, taking account of challenges facing the industry and its need for a flexible labour supply.

REITs

5.106 **The Government will legislate in Finance Bill 2009 to restore the original objectives of the UK Real Estate Investment Trusts (UK REITs) regime** by preventing groups of companies which own property, but are not property rental companies, from being part of the UK REITs regime unless at least 75 per cent of their gross income comes from the rental of property to tenants.

VAT anti-forestalling 5.107 To prevent the creation of artificial arrangements to avoid the return of the VAT rate to 17.5 per cent, **anti-forestalling legislation will be presented to Parliament as part of Finance Bill 2009.**

Disclosure regime 5.108 The Disclosure of Tax Avoidance Schemes regime uses scheme reference numbers (SRNs) to identify users of disclosed schemes. Following discussions with business, **regulations will be introduced to simplify and improve the way users report a SRN back to HMRC.**

5.109 In April 2008 the Government announced that the Stamp Duty Land Tax (SDLT) disclosure regime would be extended to residential property. **Following consultation, the Government has decided that it will also introduce a means to identify SDLT scheme users.** Draft regulations to this effect will be published for consultation.

Making a fair contribution

Income tax and NICs rates 5.110 For 2009-10 the basic and higher rates of income tax will remain at 20p and 40p respectively. The starting rate for savings income only will remain at 10p and its threshold will be increased by indexation. All NICs thresholds and limits will be increased in line with indexation in 2009-10, with the exception of the Upper Earnings and Profits limits which will be aligned with the higher rate threshold, the level at which higher rate tax starts to be paid. There will be no change to NICs rates for employers and employees in 2009-10, or to the profit related NICs paid by the self employed. Annex B provides further details of rates and allowances. Paragraphs 5.8, 5.9 and 5.10 set out reforms to income tax and NICs for future years.

Alcohol duty 5.111 **The Government will increase the overall duty on alcohol from 1 December so that the total VAT and duty remain broadly unchanged following the reduction in VAT to 15 per cent.** The increase in duty will be maintained when the VAT rate is returned to 17.5 per cent in January 2010.

Tobacco duty 5.112 Maintaining high levels of tax on tobacco helps to reduce overall tobacco consumption. **Tobacco duties will, therefore, be increased from 6pm on 24 November** to ensure that the overall level of taxation on tobacco remains broadly unchanged following the reduction in VAT to 15 per cent. The increase in duty will be maintained when the VAT rate is returned to 17.5 per cent in January 2010.

National Lottery 5.113 Following in depth analysis of the impact of switching lottery duty to a gross profits tax, **the Government announces that it will retain the stakes based system of lottery taxation** due to uncertainty over the likely impact of a change at this time.

Tax charges on stock lending 5.114 Current financial instability and related insolvencies could cause some companies which have entered into stock lending arrangements to face tax charges as a result of a borrower's insolvency. In response to this, and subject to appropriate safeguards, **the Government will introduce measures with effect from 1 September 2008 to limit such charges.**

Further modernisation 5.115 The Government also announces further measures to modernise the tax system, to support taxpayers and, where appropriate, provide clarification by:

- **extending small business rate relief** by allowing eligible small businesses in England to claim relief from business rates from the day they begin to occupy a new property with a low rateable value;
- **modifying the tax law relating to trade debt releases** to ensure that releases between connected companies are tax-neutral for both debtor and creditor; and

- **continuing discussions with business on options for changing the corporation tax rules on the late payment of interest between connected parties** before introducing legislation in Finance Bill 2009.

Charities **5.116** The Government is considering carefully the responses to the recent consultation on the anti-avoidance rules around substantial donors to charity, and will give its detailed response early next year. The Government continues to explore some of the more complex suggestions arising from the 2007 Gift Aid consultation.

6 IMPROVING PUBLIC SERVICES

Over the last ten years, record levels of investment coupled with reform have generated real and enduring improvements in Britain's schools, hospitals and other public services. The 2008 Pre-Budget Report continues high levels of investment to improve public services, reprioritises spending to support the economy through the downturn and announces an ambitious extension of its plans to increase value for money.

In the short term, the Government is focused on providing targeted support to the individuals and businesses most affected by the global economic shocks. **The 2008 Pre-Budget Report announces:**

- **as part of the Government's fiscal stimulus package, bringing forward £3 billion of capital spending from 2010-11 into 2009-10 and 2008-09** for housing, education, transport and other construction projects, supporting industries and jobs across the country; and
- **new spending measures** including additional funding for Jobcentre Plus to help people move back to work, the extension of the Support for Mortgage Interest Scheme and a new Small Business Finance Scheme for small and medium enterprises.

Over the last decade, the Government has made significant progress in delivering public services that represent good value for money and is determined to do even more in the period ahead. **The 2008 Pre-Budget Report announces that:**

- **the Government has over-achieved against the targets set by the Gershon Efficiency Programme**, including delivering £26.5 billion in savings and a reduction of 86,700 civil service posts between 2004 and 2007;
- departments are making good progress towards the 2007 Comprehensive Spending Review (CSR) value for money target of £30 billion of savings by 2010-11;
- **additional value for money savings have been identified through the work of the Operational Efficiency Programme (OEP)** including through collaborative procurement and back office efficiencies; and
- **further value for money savings will be delivered within the 2007 CSR period and beyond through a set of Public Value Programme (PVP)** reforms across major areas of spend.

Given the over-achievement against the 2004 target, and the scope for these additional efficiency savings, **the Government announces an additional £5 billion value for money target for 2010-11.**

To achieve continued improvement and investment in public services and maintain sustainable public finances over the medium term, the Government also announces:

- **assumptions for spending growth from 2011-12 onwards**, with current spending growing in real terms by 1.3 per cent in 2011-12, 1.2 per cent in 2012-13 and 1.1 per cent in 2013-14; and public sector net investment moving to 1.8 per cent of GDP by 2013-14; and
- continuing and deepening its work to improve value for money in the next Spending Review period, in particular by driving forward the OEP and PVP.

DELIVERING EFFICIENT AND EFFECTIVE PUBLIC SERVICES

Investment in priorities

6.1 Since 1997, the economy has grown by 2.75 per cent a year, on average and in real terms. As a result of this economic growth, and increasingly ambitious targets for efficiency savings, the Government has been able to focus resources on priority areas of Britain's public services such as health, education and transport. Since 1997:

- total public spending has increased by 42 per cent in real terms, compared to an increase of 15 per cent in the previous decade;
- spending on the National Health Service (NHS) has doubled in real terms;
- spending in education is today nearly 60 per cent higher, and, as a proportion of GDP, has risen from 4.6 per cent in 1997-98 to 5.5 per cent in 2007-08;
- spending on transport has increased by over 70 per cent in real terms; and
- spending on public order and safety has increased by 50 per cent in real terms.

Long term capital investment

6.2 The fiscal framework put in place in 1997 has also protected capital spending, reversing a legacy of underfunding and enabling the Government to build new schools, hospitals and transport infrastructure. Public sector net investment as a share of GDP has increased significantly, having risen from 0.6 per cent in 1997-98 to 2.1 per cent in 2007-08. As a result:

- total capital investment in education has risen from £1.7 billion in 1998-99 to £7.2 billion in 2007-08, annual average real growth of 14 per cent;
- total capital investment in housing and community amenities has risen from £2.6 billion in 1998-99, to £9 billion in 2007-08, annual average real growth of 12 per cent;
- total capital investment in transport has risen from £2.9 billion in 1998-99, to £11.4 billion in 2007-08, annual average real growth of 13 per cent;
- total capital investment in the NHS has risen from £0.8 billion in 1998-99, to £3.6 billion in 2007-08, annual average real growth of 10 per cent; and
- total capital investment by local authorities has risen from £6.7 billion in 1998-99 to £18.3 billion in 2007-08, annual average real growth of 8 per cent.

Public service reforms

6.3 The Government has matched rising public investment since 1997 with significant new reforms to modernise Britain's public services:

- during the first stage of reform, the Government introduced stronger performance management, with stretching Public Service Agreements (PSAs) setting priorities for delivery, the introduction of tough minimum standards and enhanced inspectorates to tackle poor performance across services; and
- the second stage of reform saw greater incentives for continuous innovation and improvement, encouraging diversity of provision, increasing competition and ultimately putting more power into the hands of service users.

Improvements in public services

6.4 As a result of this increased investment and reform, Britain's public services have significantly improved. For example:

- the NHS will meet its ambition of a 20 per cent reduction in mortality rates of cancer patients aged under 75 by 2010 and has already achieved the target of a 40 per cent reduction in mortality rates of heart disease patients aged under 75 by 2010;
- in the last decade, the number of operations has increased by over 1 million and there are now 2.9 million more emergency and elective admissions each year;
- in 1997, over 280,000 patients were waiting over six months for an inpatient appointment. By the end of this year, virtually no one will wait longer than 18 weeks from being referred by their GP until the start of treatment;
- since peaking in 1995, crime has reduced by 35 per cent, bringing the chance of being a victim of crime to its lowest ever level;
- over 64 per cent of 15 year olds now achieve five or more good GCSEs or equivalent, up from 45 per cent in 1997; and
- the 800 Jobcentre Plus offices that have been created since 2001 have acted as the cornerstone of the Government's welfare to work policy, dealing with benefit claims and employment advice in one place.

6.5 The Government recognises that services must continue to improve further if they are to be consistently world class. As set out in the recent publication, *Excellence and Fairness: achieving world class public services* (see Box 6.1),[1] the next stage of the reform will drive improvement and increase value for money by:

- further empowering users so they can hold public services to account and participate more fully in shaping the services they receive;
- giving professionals and public sector workers the power and responsibility to innovate and drive up performance; and
- ensuring a more strategic leadership role for central government.

6.6 The Government's new performance management framework announced at the 2007 Comprehensive Spending Review (CSR) is key in supporting delivery of improved outcomes and driving forward the vision for public service improvement set out in *Excellence and Fairness*. It is based around a streamlined set of 30 PSAs, which articulate the Government's highest priority outcomes for citizens and span departmental boundaries, setting out a shared vision and providing strategic leadership for collaboration and new professionalism at all levels in the delivery system. Progress in delivering outcomes will be reported in the lead Department's Annual Performance Report for 2008.

[1] *Excellence & Fairness, Achieving World Class Public Services*, Cabinet Office, June 2008.

Box 6.1: *Excellence and Fairness*

Excellence and Fairness: achieving world class public services sets out the Government's aspiration for world class public services that deliver consistently high quality outcomes for users while providing a fair deal for taxpayers. In this challenging economic period, central government will have an important role in driving efficiency and value for money but it is also essential to unleash the skills, motivation and local knowledge of front-line services and citizens. The Government will do this by:

- *empowering citizens* – increasing the role of users in delivering outcomes, giving citizens more say in what services are required and how they are provided, and providing accessible information about the performance of services so they can hold them to account. The Government is already piloting the use of individual budgets for social care, increasing the control people have over the services they receive. The Government is determined to go further to empower citizens by radically improving the quality and availability of information on the performance of services. **The Government announces that Communities and Local Government will work to ensure that the cross-service performance information held on their datahub is timely, easily accessible and available in a reuseable format.**
- fostering a *new professionalism* in services – where managers and front-line staff have the freedoms and flexibility to shape how services are delivered, cutting waste, increasing efficiency and reducing bureaucracy. For example, Modern Matrons have been given the authority to lead by example, to drive up basic standards and empower nurses to take on a greater range of clinical tasks. The Government is committed to going further to ensure front-line professionals are able to innovate, become more flexible and responsive to users needs. **The Government announces that the Ministry of Justice will develop probation standards so that offender management professionals can be more flexible and responsive, while maintaining necessary minimum standards and driving efficiency**; and
- providing *strategic leadership* for public services – for example through the streamlined Public Service Agreement framework announced at the 2007 Comprehensive Spending Review, by agreeing clear priorities for delivery and reform, ensuring minimum standards, building capacity, enabling quality improvements and putting decision-making in the hands of front-line professionals. For example, over 2,000 clinicians and other staff in health and social care helped create and develop the recommendations of Lord Darzi's Next Stage Review of the NHS.[a]

The current economic challenges mean it is more important than ever before that services are both better for users and more efficient. **The Government will therefore set out priorities for delivering further service improvements supporting the implementation of Excellence and Fairness in the New Year.** This will draw on the work of every major service department.

[a] *High Quality Care for All: NHS Next Stage Review Final Report,* Lord Darzi, June 2008.

Public sector pay

6.7 Public sector workers are at the heart of delivering essential public services, supporting economic growth, long-term prosperity and fairness. This is why the Government has invested in services and raised the number of front-line professionals[2], with 36,000 more doctors than in 1997, 66,000 more nurses, 41,000 more teachers and 116,000 more teaching assistants, alongside 14,000 more police officers. Following a period of underinvestment in the early 1990s, the public sector reward package, which includes pension benefits as well as pay, is now competitive. Looking forward, the objectives for public sector pay remain unchanged – recruiting and retaining a high quality workforce; affordability and value for money for the taxpayers; and consistency with achieving the Bank of England's inflation target. Continued discipline in pay awards, with multi-year settlements where appropriate, is essential to drive value for money and maintain high quality public services, particularly in the context of a global economic downturn.

Role of the third sector

6.8 The third sector has a growing importance to the economy and society and makes a very important contribution to the delivery of public services. In the current economic context its agile, community-driven approach makes it well placed to respond to new and emerging needs. Through volunteering and its promotion of civic participation, the third sector can help to build trust and cooperation, fostering strong and active local communities and reducing social isolation and exclusion. The Government acknowledges that the sector is facing challenges with rising levels of demand for its services. However, the implementation of the 2007 third sector review policies, as well as a more sustainable funding framework, mean that the sector is in a good position to meet the challenges ahead. The Government will work with the third sector to help ensure its continued strength in the current economic climate.

SUPPORTING THE ECONOMY THROUGH THE GLOBAL ECONOMIC DOWNTURN

6.9 The Government's immediate priority is to support the economy through these difficult times. As set out in Chapter 2, the Government will respond to the current economic challenges in the short term by pursuing a fiscal policy that supports economic growth. Chapters 4 and 5 set out the targeted support that the Government is providing to families and businesses.

6.10 Public services play a vital role in supporting Britain's long-term growth and competitiveness, and increased investment over the last ten years has strengthened the ability of the British economy to respond to difficulties now. For example, investment in the science base has helped make Britain one of the best places in the world for science, research and innovation. Investment in higher education and adult skills has ensured businesses have access to the skilled workers they need to respond rapidly to new market opportunities. Rising investment in the transport network has enabled Britain to complete major projects including the Channel Tunnel Rail Link and upgrading of the West Coast mainline.

6.11 Building on the record level of investment in public services achieved since 1997, a wide range of government services are now playing their part in supporting the economy. For example:

- in September 2008, the Prime Minister announced £1 billion from the private and public sectors, including additional spending through the Warm Front programme, to provide help with energy saving and heating for households facing high energy bills;

[2] All figures are on full-time equivalent basis. Headcount figures for doctors are 39,000 and for nurses 80,000.

- Communities and Local Government (CLG) has brought forward a £1 billion housing package to help first time buyers get onto the housing ladder, help homeowners in difficulty and support the construction industry;

- the Government announced in October that it would set aside £100 million from the European Social Fund (ESF) and the Department for Innovation, Universities and Skills (DIUS) to provide integrated employment and skills support for those facing redundancy. **The 2008 Pre-Budget Report announces that the total funding available from the ESF is now £158 million, and that this will be matched on the skills side by £79 million of Next Steps advice service and Train to Gain funds;**

- the Department for Business, Enterprise and Regulatory Reform is providing ongoing finance for face-to-face advice on debt problems, with new provisions for Debt Relief Orders from April 2009 to reduce the costs of bankruptcy for the poorest;

- the Working Neighbourhoods Fund is promoting employment and enterprise in 65 areas with significant levels of unemployment, inactivity and deprivation. This fund will enable local authorities to create local solutions to local problems including by providing careers and interview advice, information about flexible working and childcare, and advice on starting a business; and

- the Regional Development Agencies (RDAs) are supporting the most vulnerable sectors in every part of the country by reprioritising business support networks, assisting business with the efficient use of resources, and delivering bespoke sector support packages. For example, One North East is now investing £6 million per annum to strengthen and grow the region's manufacturing sector, including bespoke support for over 600 businesses and skills development for over 2,000 individuals, safeguarding around 1,000 jobs.

Fiscal stimulus

6.12 In the face of continuing global uncertainty, the Government is now taking further action to support the economy through the downturn. To provide a fiscal stimulus to the economy, **the 2008 Pre-Budget Report announces that £3 billion of capital spending from 2010-11 will be brought forward into 2009-10 and 2008-09.** This additional spending during the downturn will support a number of different industries and jobs across the country. In order to ensure that the spending has maximum economic impact the Government has brought forward a package that is:

- timely – focused on projects that can be brought forward in the time available;

- targeted – focused on supporting the domestic UK economy; and

- temporary – focused on bringing forward spending in a sustainable way.

6.13 **The package includes:**

- **£700 million to advance the Department for Transport's (DfT) existing plans to increase capacity on the motorways and other critical highways, and to accelerate the delivery of up to 200 new carriages on the rail network,** helping Government to deliver on its targets to relieve congestion on the road network and reduce crowding on the railways;

- **£775 million of housing and regeneration investment brought forward to help offset the impact of economic shocks on priority programmes,**

including £200 million on Decent Homes programmes to fund improvements and improve energy efficiency in 24,000 council homes, £150 million on social rented housing to deliver up to 2,000 more social rented homes and reduce the number of households in temporary accommodation, £175 million for major repairs to council housing stock, and £100 million to support key regeneration and housing infrastructure projects. The RDAs will also consider the scope for bringing forward up to £100 million nationally to provide a fiscal stimulus to regional and national economic development;

- **£800 million brought forward in the priority schools capital programmes, providing opportunities for small businesses locally and allowing schools and children to benefit early from important projects.** In particular, the additional capital spending in 2009-10 will fund accelerated renewal of the primary school estate and boost local authority capital funds for modernising school infrastructure. This could bring forward the adaptation of 2,000 secondary classrooms to improve personalised learning, energy-saving measures in around 140 secondary schools, the building of kitchens in around 300 primary schools, and the conversion of rooms for mother-and-baby groups and other community uses in 800 primary schools;

- **£442 million to accelerate support for around 25 capital projects to improve Further Education infrastructure and around 50 projects to improve facilities at Higher Education Institutions,** and to bring forward development of scientific research facilities and improvements to university research infrastructure;

- **£50 million of investment brought forward, and £100 million of additional funding, for the Warm Front programme.** This means 60,000 homes will benefit more quickly from energy efficiency and heating measures, helping people heat their homes affordably during difficult economic times. Further details can be found in Chapter 7;

- **£100 million to advance the upgrading of up to 600 GP surgeries to training practices,** creating opportunities for small firms and targeting funding on those areas that have historically had a lower provision of doctors;

- **£20 million of investment on flood defences brought forward,** delivering earlier protection for over 27,000 homes, and **£5 million of improvements to the British Waterways network infrastructure;**

- **£20 million to improve the estates of the Serious Organised Crime Agency and the National Police Improvement Agency,** developing and installing high technology systems and enhancing intelligence gathering against serious organised crime. This enables the redeployment of posts out of London a year earlier than planned, in line with the Lyons relocation policy; and

- in the case of devolved areas of spending, the devolved administrations may reprofile spending in line with the Barnett formula in the normal way.

Support for families and business

6.14 The Government also announces a number of other spending measures to support individuals and businesses through the downturn including:

- additional help for small and medium enterprises facing credit constraints through a new Small Business Finance Scheme to support up to £1 billion of bank lending. Further details can be found in Chapter 4;

- the extension of the Mortgage Rescue scheme, to include cover for second charge lending, and the Support for Mortgage Interest scheme for homeowners who lose their jobs. Additionally there will be increased funding to ensure people in financial difficulties can access free and impartial debt advice. Further details can be found in Chapter 5; and
- £1.3 billion to increase the help Jobcentre Plus gives to those out of work and looking for a job, ensuring that they continue to get the dedicated and personal support they need to move rapidly back into work. There will also be increased provision for those facing redundancy through an expansion of the Rapid Response Service (RRS) to cover short-term as well as long-term redundancies, offering a range of on-site support such as retraining and job-matching. Further details are in Chapter 5.

A RELENTLESS FOCUS ON VALUE FOR MONEY

6.15 Clear priorities, strong accountability and effective performance management are fundamental in ensuring that increased resources result in higher standards across public services. Over the last decade, the Government has made significant progress in delivering more efficient and effective services and is determined to do even more in the period ahead.

6.16 In the current economic climate, at a time when families and businesses are tightening their belts, it is more important than ever that the Government ensures that investment is targeted effectively at improving front-line services, locking in the improvements delivered over the last decade. Building on this record, the Government can now announce key parts of the next stage of the value for money programme.

Over-delivery of the 2004 SR Gershon efficiency targets

6.17 As part of the 2004 Spending Review (SR), the Government set stretching efficiency targets for departments to deliver by March 2008 as recommended by Sir Peter Gershon in *Releasing Resources to the Front Line – Independent Review of Public Sector Efficiency*[3]. **The 2008 Pre-Budget Report announces significant over-delivery against each efficiency target set in 2004. In particular, the Government announces:**

- **over £26.5 billion of efficiency savings[4], substantially exceeding the target of £21.5 billion set in 2004.** Further details on departmental efficiency savings can be found in Chart 6.2 and the supplementary document *2004 Spending Review: final report on the efficiency programme;*
- **over 86,700 net workforce reductions, significantly over-delivering against the target of 70,600 net workforce reductions** and allowing the Government to employ more front-line professionals such as doctors, nurses, teachers and police officers; and
- **over 17,100 staff relocated out of London and the South East by June 2008,** putting the Government on track to deliver the Lyons relocation target to move 20,000 posts by 2010.

[3] *Releasing Resources to the Front Line – Independent Review of Public Sector Efficiency*, Sir Peter Gershon, July 2004.

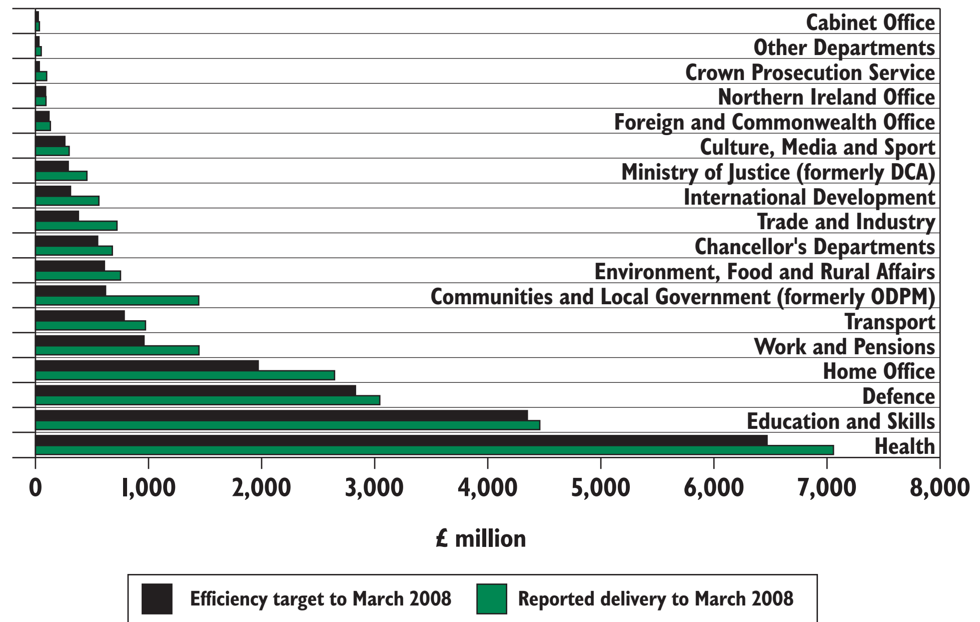
[4] Departments have classified all efficiency gains as "Final," the most robust measurement classification as set out in *HM Treasury Measurement Guidance*.

Box 6.2 Delivering the 2004 Spending Review Efficiency targets

During the 2004 Spending Review, departments focused on delivering more efficient public services, over-achieving the targets set by the Gershon efficiency programme, for example:

- the Department for Children, Schools and Families delivered over £630 million of efficiency savings by improving schools' financial management skills and capability through the introduction of new standards, benchmarking systems, and improved training to make better use of their resources to deliver pupil outcomes;
- the Department for Transport delivered, through the Highways Agency, £238 million of efficiency gains against a target of £200 million through improved procurement and achieving better value in maintenance contracts for the Strategic Roads Network, for example by using pre-cast arches rather than onsite built arches over a railway line;
- the Home Office renegotiated accommodation contracts for asylum support services and substantially reduced the number of people housed in temporary emergency accommodation. This has saved over £500 million whilst providing greater stability of accommodation for asylum seekers; and
- the Department for Work and Pensions saved around £1 billion of transactional costs over the last five years by introducing direct payments, saving taxpayers' money while being more convenient for customers.

Chart 6.1: Departments' efficiency savings (agreed target and reported delivery)



Source: HM Treasury

2007 CSR targets

6.18 The 2007 CSR went further and agreed a more ambitious value for money programme, which will deliver savings worth £30 billion by 2010-11. By using the capability developed within departments over the previous three years it has been possible to require all gains to be cash-releasing and reported net of costs. Departments are in the process of delivering

these savings and will report on progress in their Autumn Performance Reports. Examples of Departments' plans to deliver the 2007 CSR value for money targets are set in Box 6.3 below.

Box 6.3 Delivering the 2007 CSR value for money targets

The public sector has been actively engaged in identifying value for money savings over the Comprehensive Spending Review period. For example:

- local government will achieve £4.9 billion of annual net cash-releasing efficiency savings by 2010-11 through - business process improvements and collaboration initiatives, which could deliver up to £1.8 billion by 2010-11; smarter procurement, which could deliver up to £2.8 billion by 2010-11; and better asset management which could deliver up to £300 million by 2010-11;
- HM Revenue and Customs transformation programme is expected to save over £190 million through more efficient property management. A further saving of £57 million is expected as more customers use on-line services;
- the Ministry of Defence (MoD) plans to achieve £31 million of savings by reducing non-operational energy consumption by at least 15 per cent, also reducing the Department's carbon footprint. MoD also expects to reduce its civilian workforce by some 10 per cent over the period 2008 to 2011, yielding a further £25 million per annum saving for each of the remaining Comprehensive Spending Review years;
- HM Court Service plans to make over £140 million of savings through modernising processes and making use of new technology. There will be significant improvements in the way in which caseloads are managed, increased electronic links with other agencies and better access to services; and
- the Department of Health announced agreement in November 2008 to a new Pharmaceutical Price Regulation Scheme (PPRS), including a price cut of 3.9 per cent in the first year of the new agreement with a further price cut of 1.9 per cent with the introduction of generic substitution in January 2010. This deal is expected to deliver savings in the UK of around £350 million in 2009-10, and approximately £550 million per year thereafter.

The Operational Efficiency Programme

The Operational Efficiency Programme

6.19 As the next stage in the Government's rolling programme of value for money improvements, Budget 2008 launched the Operational Efficiency Programme (OEP) to examine opportunities for further efficiency savings in five cross-cutting areas. The five OEP workstrands are – back office and IT, collaborative procurement, asset management, property and local incentives and empowerment. Although the Operational Efficiency Programme is due to report at Budget 2009, significant progress has already been achieved and **the 2008 Pre-Budget Report announces a number of emerging findings for each of the five workstrands.**

Back office operations

6.20 **In the first OEP workstrand, a programme of work led by Martin Read, former Chief Executive of Logica, has identified substantial additional savings from 2010-11 onwards through greater efficiencies in back office operations** including human resources, finance, estate, security, marketing, travel and legal services.

6.21 Martin Read has examined examples of good practice that already exists in the public sector. For example, following a review of back office functions as part of the 2004 Spending Review, HM Prison Service set up a shared services centre for 128 Prison Service establishments to deliver finance, procurement and human resources functions. As a result, 32 per cent savings in staff costs are expected with just over 30 per cent savings against gross costs of back office operations. In the NHS, a shared services centre established through a 50:50 joint venture between the Department of Health (DH) and Steria now serves over

100 organisations in England. The shared services centre uses best practice processes and solutions to deliver improved management information and cost efficiencies. Organisations are guaranteed savings against gross costs when entering NHS Shared Business Services and industry standards show that shared services deliver 20-30 per cent savings on like for like services.

6.22 However, considerable cost variation still exists across the public sector including areas such as human resources, where the cost per employee can vary by 300 per cent. Rigorous benchmarking, sharper management information and greater standardisation and simplification of back office operations will deliver billions of further savings across the public sector.

Collaborative procurement

6.23 **In the second OEP workstrand, a programme of work led by Martin Jay, Chairman of Invensys, has identified substantial additional savings from 2010-11 onwards through actions such as improving compliance on centrally negotiated deals and optimising the complex and fragmented public sector buying landscape.**

6.24 Martin Jay has examined a number of examples of best practice across the public sector where collaborative procurement is already saving money. For example, four new pan-government fleet deals have been put in place covering vehicle purchase, vehicle leasing, glass and tyres, which are collectively leveraging over £200 million in fleet spend, delivering at least £25 million in annual savings. Also, the prices public sector organisations pay for their office stationery, printer cartridges, paper and magnetic media will be cut by up to 62 per cent in a collaborative deal led by the Ministry of Defence (MoD). Significantly reduced prices were achieved here by holding the largest UK public sector e-auction to date, with the greatest savings for UK taxpayers ever achieved using an auction process.

6.25 However, considerable price variation still exists, and the OEP is working to achieve billions of savings through raising performance across the public sector. For example, the OEP is working with the Department for Children, Schools and Families (DCSF) and the Office of Government Commerce to help schools identify ways of reducing energy costs using professional buying organisations to aggregate demand and realise efficiencies of scale. Some schools already do this, but many still have individual contracts with energy companies, contributing to the current variation of more than 50 per cent in the rate paid for one kilowatt hour of electricity across the public sector.

Asset management and sales

6.26 It is vital for the public sector to make efficient use of its assets in order to deliver value for money for the taxpayers. **As part of the third OEP workstrand which is focused on asset management and sales, Gerry Grimstone, Chairman of Standard Life, will work with departments and the Shareholder Executive to take forward studies on a range of assets (see Box 6.4), reporting progress at Budget 2009.** These studies will look into ways of using different public sector assets more efficiently, including the potential for alternative business models, commercialisation, new market opportunities and, where appropriate, alternatives to public ownership.

Property

6.27 On property, the fourth OEP workstrand, Lord Carter of Coles is leading work to examine the efficiency savings that could be achieved across the UK's public sector property holdings, which have an estimated book value of around £370 billion. He will be focusing on some of the larger holdings in areas such as health, local government, defence and justice. Work will also link in with Baroness Ford's review on the release of surplus land for housing. Lord Carter will continue to work with these sectors to develop a series of recommendations for Budget 2009 that will incentivise more efficient public sector management of property assets.

Local incentives

6.28 As identified in *Excellence and Fairness* (see Box 6.1), innovation at the front line is key to delivering customer-focused public services and driving value for money. Parts of the public sector are already enabling this kind of innovation. Operation QUEST, for example, empowers front-line staff in the police service to reform everyday working practices, cutting out wasteful processes to focus on meeting citizens' needs. As a result, Norfolk Constabulary realised £3 million savings (of which £500,000 is cash-releasing) through improved efficiency and effectiveness, and customer confidence and satisfaction increased from 86 per cent to 97 per cent. The Government is determined to ensure that this sort of innovation and reform is the norm across the public sector, and therefore **the 2008 Pre-Budget Report announces that**:

- **the Chief Secretary to the Treasury has appointed Sir Michael Bichard, Executive Director of the Institute for Government, to lead the local incentives and empowerment workstrand of the OEP,** to analyse how best to facilitate front-line innovation, reporting by Budget 2009;
- the Government will empower and support front-line staff to drive bottom up innovation, **with a new efficiency award for public servants on the front line** who have reformed public services and delivered greater value for money; and
- to provide the space to innovate, **the Better Regulation Website is being redesigned to make it even easier for citizens, businesses and front-line staff to suggest ways to reduce bureaucratic burdens.**

Box 6.4: Operational Efficiency Programme – Asset strand

Gerry Grimstone is heading the asset strand of the Operational Efficiency Programme (OEP), and will be working with departments, agencies, and the Shareholder Executive to consider, for a number of Government assets, the potential for alternative business models, commercialisation, new market opportunities and, where appropriate, alternatives to public ownership. The work includes:

- a review of British Waterways' model for managing its canal-side property portfolio which will assess how best public value might be delivered from these assets in the medium term;
- options for the Queen Elizabeth II conference centre, after a recent study concluded there was no public policy rationale for the Government to own it;
- a strategic review into the future business model of the Ordinance Survey, that will take into account its role as a public sector information provider, together with providing value for money for the taxpayers;
- work with the Land Registry to explore ways to improve its operating framework;
- widening the scope of the study of capacity requirements at the Dartford Crossing to include the potential to realise value for the taxpayers and, in addition, continuing to explore options for the commercialisation of other transport assets;
- a study to explore the potential benefits of alternative future models for the Royal Mint; and
- reviews of the Met Office, Oil & Pipeline Agency, and Defence Storage & Distribution Agency examining alternative business models.

Budget 2009 will report on progress, and will also take into account market conditions and the views of relevant stakeholders. Gerry Grimstone will work with Lord Carter of Coles, who heads up the OEP Property workstrand, in ensuring that any appropriate efficiencies in relation to property associated with these assets are taken in account.

Departments are also working to achieve efficiencies on other Government assets:

- the Ministry of Defence will shortly publish its response to a recent consultation on its plans to release and share parts of its electromagnetic spectrum holdings, with the release process for initial spectrum bands beginning in Spring 2009;
- the Government continues to explore options for realizing value from its stake in Urenco;
- a study of the Forestry Commission's portfolio in England is being launched to examine options for delivery of public value from the estate in the long term; and
- a major redevelopment by Covent Garden Market Authority will aim to put it on a sustainable financial footing, enabling the Government to achieve its long-term objective of disengagement.

In addition, it was concluded in October not to pursue a sale of the Tote in light of current market conditions, and that it should be retained in public ownership for the medium term, to be brought to the market when conditions are likely to deliver value for the taxpayers and the racing industry.

The Public Value Programme

The Public Value Programme

6.29 In Budget 2008, the Government also launched the Public Value Programme (PVP), to look at all major areas of public spending in order to identify smarter ways of doing business and taking wider policy decisions. The PVP will inform the Government's value for money frameworks for 2010-11 and for the post-CSR period.

Key PVP Reforms

6.30 **The 2008 Pre-Budget announces that the Public Value Programme has already identified key reforms that will deliver savings and efficiency improvements in 2010-11 and in the next Spending Review period.** Key reforms include:

- **improvements to NHS estate utilisation which will reduce the need for new hospital space by up to £3 billion, and save up to £100 million per annum of estate costs over the next spending period.** In addition, **DH will introduce new models for providing primary care estate** by enabling Primary Care Trusts (PCTs) to extend Local Improvement Finance Trust (LIFT) public-private partnerships to the management of their entire estate;

- **the Ministry of Justice (MoJ) will increase its use of competition to improve efficiency and effectiveness in the National Offender Management Service (NOMS).** Specifically, this will mean that all new build prisons are to be built and managed by the private sector over the next three years; five commercially let contracts will be competed by 2010-11 to new NOMS specification standards with bids invited from the public, private and third sectors; high cost or under performing prisons will be identified against the new NOMS standard specifications and failure to improve will lead to services being contracted out without a public sector bid. Further details on the NOMS competition programme will be published in the NOMS Agency Corporate and Business Plan in January 2009;

- the Policing Green Paper contains proposals which relate to increasing, over time, the productivity of the police workforce, including by supporting forces in streamlining working practices. Similar work in other sectors, and also by some police forces, has delivered productivity increases of 15 per cent. **The 2008 Pre-Budget Report announces that this will be worth around £1 billion, equivalent to increasing the size of the police service by around 20,000 officers.** The plans will be reinforced by a targeted inspection, in 2010, of the police workforce, to ensure resources are being deployed to maximum effect, and continued roll-out of Operation QUEST, a programme of front-line improvement work that has already delivered substantial successes, such as increasing customer satisfaction to over 90 per cent;

- the Highways Agency has been investigating how it can go further to deliver efficiencies over the 2007 CSR period. **The Highways Agency will seek to double the efficiency savings it aims to deliver, which could potentially save an additional £150 million by 2010-11.** The Government will continue to consider where it can go further over the longer term, and will provide a further update at Budget 2009; and

- as set out in Chapter 4, **DIUS will take further steps to drive forward the Leitch reforms and move to a more demand-led system for skills, and will ensure that subsidies are targeted on raising demand in the most economically valuable areas.**

Further PVP Reviews

6.31 The Public Value Programme will continue to focus on the scope for additional value for money across all major areas of spending policy, with further investigation in the following key areas:

- all PCTs have submitted to Strategic Health Authorities their draft five year strategic commissioning plans to improve local health care. As PCTs enhance their commissioning skills towards world class standards over the next years they will develop their strategic and financial plans to ensure they unlock cashable value for money improvements across the £70 billion of commissioned health services. **Budget 2009 will set out the projected value for money impact of World Class Commissioning. Budget 2009 will also report on the scope to increase efficiency further in the hospital sector through the tariff prices paid by PCTs and progress on extending pricing to new areas of the health service;**
- **DCSF is assessing the value for money of Building Schools for the Future (BSF), childcare and teaching assistants.** Building on the success to date of BSF and Academies, the PVP will inform decisions on the cost effective delivery of key strategic objectives through the schools capital programmes, including the roll-out of Waves 7 to 15 of BSF. On teaching assistants, the PVP is assessing their deployment, and impact on educational outcomes. The PVP has also developed the evidence-base on how best to deliver the Government's long-term childcare objectives. The value for money evidence demonstrates that providing a level of free provision for the most deprived 2 year olds, in line with the Prime Minister's commitment, is likely to have a greater positive impact on child outcomes than extending the number of free hours of childcare available to 3 and 4 year olds beyond the 15 hours per week they will receive by 2010-11;
- **MoJ will continue to consider the scope for value for money improvements within legal aid procurement;**
- following its successful pilot on the M42, **the Government will announce in the New Year the conclusions of its work to investigate where hard shoulder running should be rolled out more widely on the motorway network in preference to motorway widening.** Initial results suggest that hard shoulder running schemes can be delivered on average around 40 per cent cheaper than the equivalent motorway widening schemes. **DfT will also assess how best to provide transport funding to local authorities so that it continues to be targeted to areas of greatest need;**
- **MoD is developing work on value for money reforms, building on existing work being taken forward in the Defence Acquisition Change Programme.** This will further improve the MoD's commercial capability and will ensure better commercial value for money by changing the terms of the MoD's relationship with industry;
- **CLG's forthcoming regeneration framework will improve the efficiency of regeneration spending,** including strengthening accountability for delivering improvements in economic growth and employment, providing clear regional prioritisation of capital investment and strengthening local coordination;
- in the context of wider work on energy saving and rising activity to help low income households, **the new Department of Energy and Climate Change**

(DECC) is considering how to maximise value from the Warm Front programme.

- **the Department for International Development will build on its current work to improve the effectiveness of its aid, by analysing key aspects of its spending on health and education to identify opportunities to improve its effectiveness in the future.** The initial findings of this work, focused on education spending, will be reported in Budget 2009;
- the RDAs are playing a vital role supporting the regions in dealing with the economic downturn and laying the foundations for future economic growth. **The Government will work with the RDAs to maintain and where possible increase the value realised from the Single Pot Funding;** and
- **the Student Loans Company (SLC), working with DIUS, is undertaking a review to establish the extent of income-related fraud within the student support system, with a particular focus on fraudulent grant claims.** Depending on the outcome, DIUS will work with the SLC to implement measures to reduce the level of fraud and ensure that financial support to students goes only to those that are genuinely entitled to it.

FUTURE SPENDING GROWTH

New 2010-11 value for money target

6.32 These initiatives all show that there is considerable scope to go further on value for money. So, at this time of global economy uncertainty, and with the need to ensure our public finances are sustainable over the medium term, the Government believes it is right to do more. Building on the record of delivery – and as a result of the new announcements on the OEP and PVP set out above – **the Government announces that the existing cross-Government value for money target for 2010-11 will increase from £30 billion to £35 billion, releasing £5 billion of additional recoverable savings in 2010-11.** Savings which can be achieved by individual departments will be set out, and allocations for 2010-11 adjusted accordingly, at Budget 2009, alongside the final report from the OEP. The Barnett formula will be applied as usual to the devolved administrations' budgets when reductions to departments' budgets are announced.

Spending growth assumptions

6.33 The Government is determined to support the economy in the short term and continue to improve and invest in public services in the years ahead. To secure the improvements and investment within a framework that delivers sustainable public finances over the medium term, **the 2008 Pre-Budget Report therefore also sets assumptions for spending growth in the period from 2011-12 onwards:**

- total spending will continue to grow by 1.1 per cent a year in real terms over the years 2011-12 to 2013-14 ;
- current spending will grow by 1.3 per cent in 2011- 12, 1.2 per cent in 2012-13 and 1.1 per cent in 2013-2014; and
- public sector net investment will remain at historically high levels moving to 1.8 per cent of GDP by 2013-14.

6.34 These new spending assumptions will ensure continued real terms increases in current spending and protect the historically high levels of capital investment achieved since 1997. By 2013-14, total spending will be sixty per cent higher in real terms than in 1997. Public sector net investment will be three times larger as a proportion of GDP than in 1997-98.

Value for money in the next SR

6.35 To ensure that the Government continues to deliver high quality public services in a way that represents value for money in the next Spending Review period, the Government will broaden and deepen work to drive efficiency from 2011-12 onwards, in particular by driving forward the OEP and the PVP. In addition to early announcements set out in paragraphs 6.19-6.28 and Box 6.4, Budget 2009 will announce the final conclusions of the OEP's work in all five workstrands, identifying further savings for the next Spending Review period. In addition to this, the PVP will continue working on a range of specific areas to explore whether further savings can be achieved in the next Spending Review period, as set out in paragraph 6.31. By releasing these efficiency savings the Government will be able to guarantee that front-line public services will continue to grow and improve in the years ahead.

7 Delivering on environmental goals

Action to achieve environmental goals remains a high priority for the Government in current economic circumstances. The Government is putting in place policies and investment to support a low-carbon recovery, with new jobs and businesses created through green growth. Government policies are driving £50 billion of investment in the low-carbon sector over three years. The Climate Change Bill introduces a legally binding target to cut greenhouse gas emissions by at least 80 per cent by 2050, the most ambitious in the G7, building on the Government's plans to deliver a one-third reduction in emissions from 1990 levels by 2020.

The Pre-Budget Report contributes to meeting the UK's ambitious long-term environmental goals, while supporting low-carbon growth by:

- **introducing a green stimulus – ensuring part of the fiscal stimulus supports low-carbon growth and jobs by accelerating £535 million of capital spending on energy efficiency, rail transport, and adaptation measures.** 76,000 low-income households will benefit earlier from better heating and energy efficiency, up to 200 new rail carriages will be delivered earlier and 27,000 homes will benefit sooner from flood defences;
- **successfully securing inclusion of aviation in the EU Emissions Trading Scheme from 2012, and holding Europe's first Phase II carbon auction on 19 November 2008;**
- **retaining the Renewables Obligation to provide financial support for large-scale renewable electricity and extending it by at least ten years, ensuring investors can plan with confidence for the future.** This will complement the introduction of a feed-in tariff for small-scale renewable electricity and a renewable heat incentive to reward households and businesses that generate renewable energy on site; and
- **following a fall in pump prices of over 20 pence per litre from their summer peaks, the postponed two pence per litre fuel duty increase will go ahead on 1 December 2008.**

At the same time, the Pre-Budget Report shows how environmental policies can respond flexibly to help people and businesses through tough times, while reducing carbon emissions by:

- **installing 600,000 insulation measures this winter, up 70 per cent on last winter, through the £6.8 billion Home Energy Saving Programme,** half of which is funded by energy companies. This will help households save up to £300 a year on energy bills and reduce carbon emissions;
- **continuing to provide a clearer environmental signal through reform to vehicle excise duty, while ensuring that no driver in any given band will pay more than £5 extra in 2009 or £30 extra in 2010; and**
- **reforming air passenger duty from 1 November 2009, moving from two to four distance bands to improve environmental signals. The Government has decided not to proceed with a per-plane tax in order to ensure greater stability and protect competitiveness at a time of economic uncertainty.**

7.1 Following the unprecedented shocks that have affected the world economy over the past year, the Government is supporting the UK economy through these challenges. Action to achieve environmental goals remains a high priority for the Government in these circumstances. The Government is putting in place policies and investment to support a low-carbon recovery (Box 7.1), with new jobs and businesses created through green growth. Government policies are driving £50 billion of investment in the low-carbon sector over the three years to 2011. The sector already employs 350,000 people;[1] over the next 20 years, more than one million people could be employed in the UK's environmental industries.

Box 7.1 – Green stimulus

As part of the fiscal stimulus, the Government is providing £535 million of accelerated capital spending and additional resources to promote its environmental objectives and support low-carbon growth. This stimulus will help to sustain and expand the estimated 350,000 jobs in the low-carbon sector, alongside measures set out in the Pre-Budget Report to develop skills and attract low-carbon investment.

The green stimulus comprises:

- £100 million of new funding for Warm Front, on top of £50 million of spending on the programme brought forward now to support the economy. This will help around 60,000 low-income households cut their energy bills through insulation and improved heating systems;
- £60 million to provide 16,000 social houses with energy efficiency and heating measures as part of an accelerated Decent Homes programme (based on historical patterns of spending on energy efficiency);
- £300 million to accelerate the delivery of up to 200 new carriages to expand capacity on the rail network;
- £20 million of spending on flood defences, to deliver earlier protection for 27,000 homes; and
- £5 million of spending on British Waterways network infrastructure.

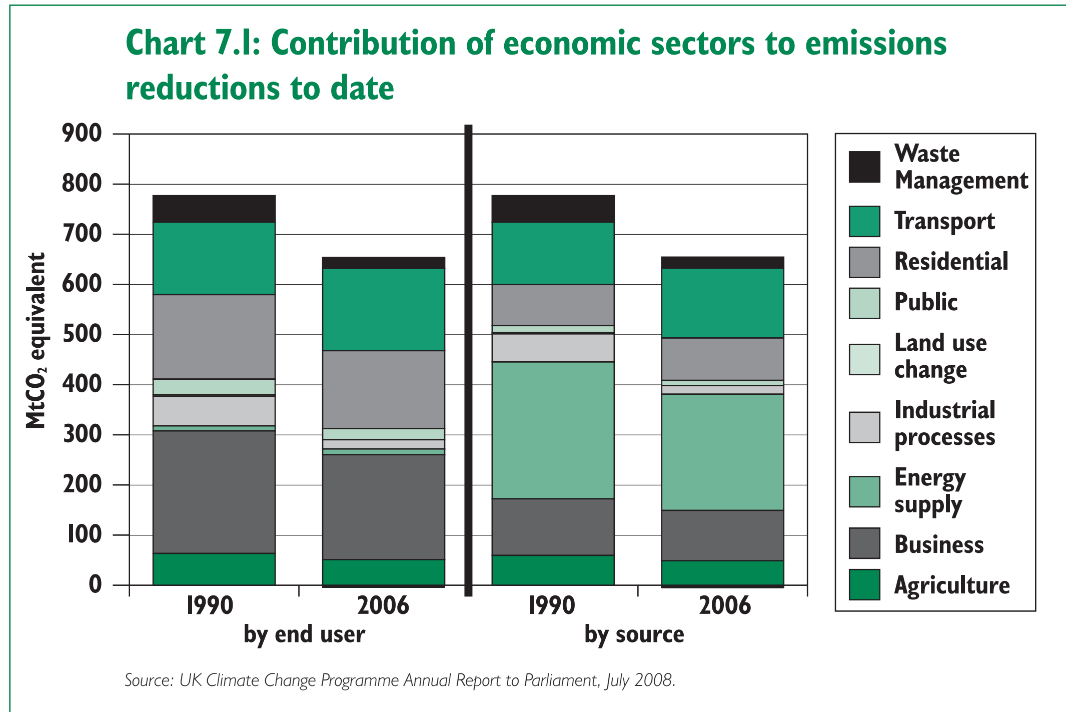
7.2 Climate change represents a significant economic and environmental threat for all countries. Unchecked climate change could increase global temperatures by more than 5°C, causing hundreds of millions of people to suffer hunger, drought and flooding and having serious impacts on world output. Strong action is required to put the world economy on a low-carbon path – both through coordinated global efforts and the leadership of individual countries and regions.

Progress to date

7.3 The UK is already on track to meet emissions reduction targets under the Kyoto Protocol. Greenhouse gas emissions fell from 780 $MtCO_2e$ in 1990 to 619 $MtCO_2e$ in 2006 – more than a 20 per cent reduction, compared to a target of 12.5 per cent reduction by 2008-2012.[2] Emissions reductions have been achieved alongside economic growth – greenhouse gas emissions per unit of GDP have fallen by 45 per cent since 1990. Much of the reduction to date has come about through changes in the power generation mix, in particular an increase in gas generation. Looking ahead, reductions will increasingly be driven by the framework of government policy.

[1] BERR, Innovas and K-matrix, 2008.

[2] This figure includes the impact of the EU Emissions Trading Scheme (ETS). Emissions from activity within the UK's borders – excluding the allowances purchased through the EU ETS – fell by around 16 per cent between 1990 and 2006. Emissions are given in million tonnes of carbon dioxide equivalent ($MtCO_2e$) and refer to the basket of greenhouse gases to which the Kyoto Protocol applies.



Source: UK Climate Change Programme Annual Report to Parliament, July 2008.

7.4 To drive greater reductions in greenhouse gas emissions, the UK has put in place the Climate Change Bill.[3] This sets the UK a long-term legally binding target to reduce greenhouse gas emissions by at least 80 per cent by 2050 – the most ambitious target in the G7. The Bill introduces carbon budgets that set binding limits on emissions over consecutive five-year periods. Alongside other major reforms being put in place by the Energy and Planning Bills, the Climate Change Bill will drive progress towards a low-carbon economy in the UK, while demonstrating leadership to support UK efforts to secure a global deal.

INTERNATIONAL PROGRESS ON CLIMATE CHANGE

Post 2012 framework

7.5 Global action needs to be on a scale sufficient to deal with the urgency of the threat, particularly to the world's most vulnerable countries and communities. The UK is working closely with international partners to agree a durable, cost-effective and fair framework after the existing Kyoto term runs out in 2012. This needs to be agreed at the UN meeting in Copenhagen at the end of 2009.

7.6 President-elect Obama has recently announced his commitment to concrete steps the US will take to tackle climate change. This represents a significant step forward in building momentum internationally for the climate change negotiations. The Government welcomes this commitment, and looks forward to working closely with the United States and other governments through the UN Framework Convention on Climate Change negotiations, the G20 and other channels.

Carbon markets

7.7 Expanding carbon markets to increase investment finance for low-carbon technologies in developing countries is essential. The Climate Change Bill gives the UK flexibility to purchase international credits to meet carbon budgets, enabling the UK to demonstrate commitment to a global carbon market while ensuring emissions reductions are made in a cost-effective manner in the UK and internationally.

[3] The Climate Change Bill has been agreed by both Houses of Parliament and is awaiting Royal Assent.

7.8 Development assistance also has an important role to play. The UK, through the G7 and G8 Finance Ministers' meetings, successfully led international negotiations this year on the creation of the $6.1 billion Climate Investment Funds at the World Bank. Financing for climate change will be one of the key issues on which the Government seeks to build international consensus during 2009, and a core theme for the UK as chair of the G20 grouping of finance ministers and central bank governors, which brings together developed and emerging economies.

European action

7.9 The UK is playing a central role in the negotiations to agree a 2020 EU Climate and Energy Package. This package will ensure that Europe sets out a clear and coherent legislative framework to deliver its commitment to reduce greenhouse gas emissions by 20 per cent by 2020 against a 1990 baseline and by 30 per cent under a new international climate change deal. It also includes a target for 20 per cent of Europe's energy to come from renewable sources by 2020.

CARBON BUDGETS IN THE UK

7.10 At a time of global financial shocks and impacts on the real economy, it is more important than ever that Government policies reduce greenhouse gas emissions in the most cost-effective manner. By introducing a legally binding framework to keep the UK on a trajectory to meet its long-term goals, carbon budgets will require the Government to put the transition to a low-carbon economy at the heart of economic decision-making and policy appraisal (Box 7.2).

Carbon budgets

7.11 Budget 2008 announced that the Government would set the levels of the first three carbon budgets, covering the period 2008 to 2022, alongside Budget 2009. The Climate Change Bill also requires the Government to set out its policies and proposals to meet carbon budgets. **The Government now announces that it will fulfil this requirement in a final report, laid before Parliament, in mid 2009**. The report will:

- provide a comprehensive overview of the emissions savings required;
- set out the European and international context for our domestic action;
- build on existing measures and incorporate new proposals emerging from consultations on renewable energy, heat, and energy saving; and
- take account of the impact on the economy and overall fiscal position, on the competitiveness of particular sectors, and on energy security.

Box 7.2 – Explaining carbon budgets

What is a carbon budget? The Climate Change Bill requires the Government to set a limit on emissions of greenhouse gases covered by the Kyoto protocol over a five-year period. The limit is known as a carbon budget. The first three carbon budgets will cover the periods 2008-2012, 2013-2017 and 2018-2022.

How are budgets set? The Government will take into account advice from the Committee on Climate Change and must consider the emissions reductions targets for 2020 and 2050 set by the Bill. Both the Government and Committee on Climate Change must take into account scientific and technology developments; economic, fiscal and social circumstances; the impact of carbon budgets on energy policy and energy security; any different circumstances in Scotland, Wales and Northern Ireland; expected emissions from international aviation and shipping; and the European and international framework.

What is the Committee on Climate Change? The Committee is an independent, expert, advisory body established under the Climate Change Bill to advise the Government on its long-term emissions reduction targets, levels of carbon budgets and the potential for emissions reductions across the economy.

Who is responsible for ensuring the budget is met? Carbon budgets set a legal requirement on the Government to ensure that emissions fall, and the Government is accountable to Parliament and the public for ensuring carbon budgets are met.

How will carbon budgets lead to emissions reductions in the real world? Carbon budgets will require the Government to put in place the policies required to deliver emissions reductions across the economy, and will provide a very strong incentive to ensure that the Government places a high priority on monitoring the consequences of new and existing policies on reducing emissions.

What do carbon budgets mean for me as an individual? The policies put in place by the Government to meet carbon budgets should support individuals in reducing their own carbon footprint, as well as reducing the cost to them of doing so. For example, lower rates of vehicle excise duty for fuel efficient cars will reward those who choose to drive lower emission cars, while the Home Energy Saving Programme is expected to deliver over six million energy efficiency and heating measures to households.

Long-term emissions savings

7.12 The UK's first three carbon budgets, covering the period 2008 to 2022, will be set alongside Budget 2009, taking into account advice from the Committee on Climate Change. The UK will need to make substantial emissions reductions over this period, with principal long-term policies expected to deliver between 114–128 $MtCO_2e$ of reduction per year by 2020 (nearly a one-third reduction on 1990 levels) by:[4]

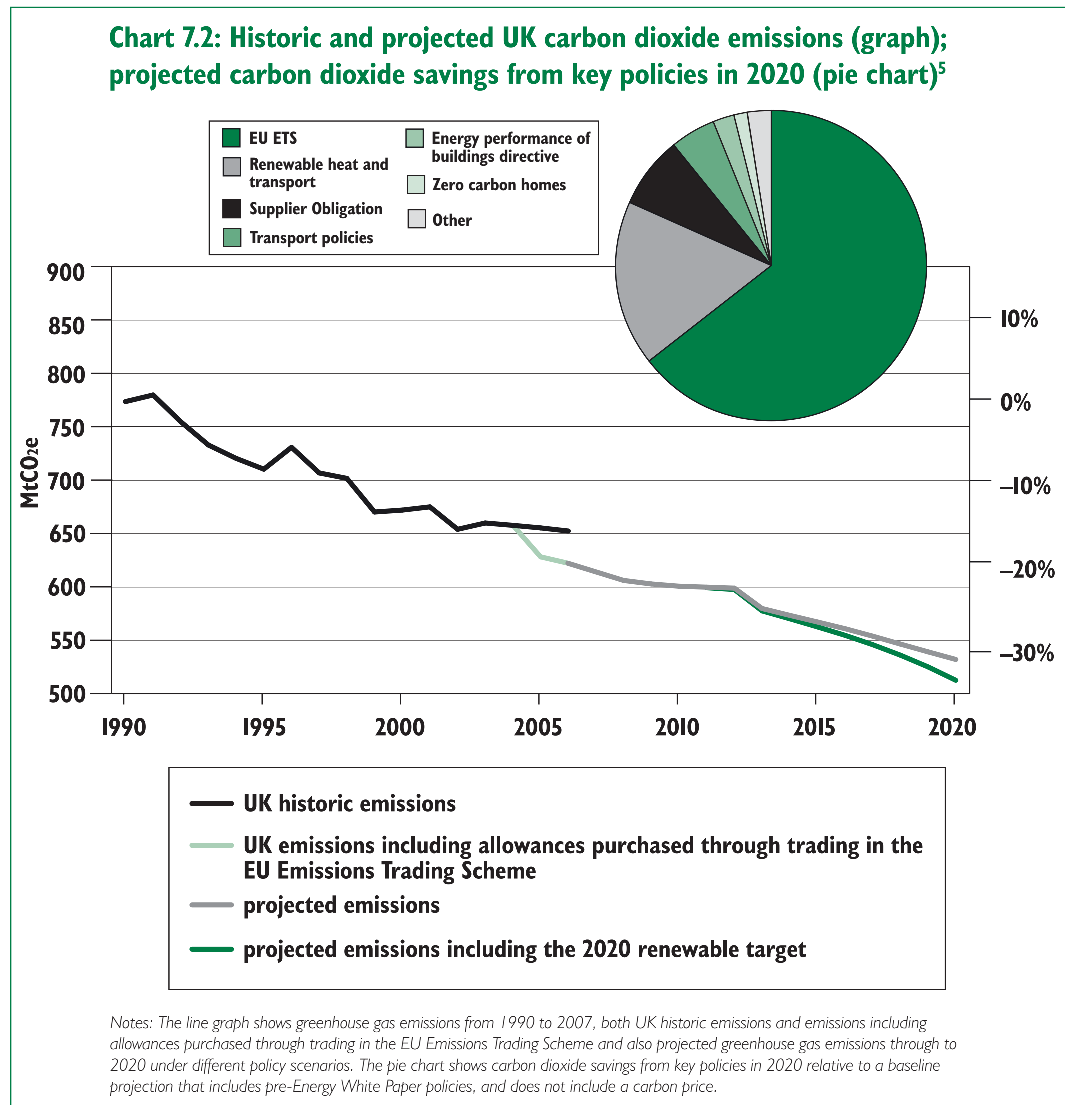
- capping emissions from power generation and heavy industry through the EU Emissions Trading Scheme, which covers around half of UK carbon dioxide emissions and is the centrepiece of the Government's climate change strategy;
- delivering a ten-fold increase in renewable energy in order to meet the UK's share of the EU's 20 per cent target for renewable energy by 2020;
- improving fuel efficiency in the transport sector by negotiating an ambitious long-term EU wide target for car fuel efficiency; and

[4] This includes 19 $MtCO_2e$ expected savings from renewable heat and transport to meet the UK share of the EU 2020 renewables target. The range spans the low to high estimates of policy delivery, and savings are compared to emissions in 2005.

- improving energy efficiency in households including through the Home Energy Saving Programme and obligations on energy suppliers.

7.13 The impacts of these policies are set out in Chart 7.2 below.

Chart 7.2: Historic and projected UK carbon dioxide emissions (graph); projected carbon dioxide savings from key policies in 2020 (pie chart)[5]



Notes: The line graph shows greenhouse gas emissions from 1990 to 2007, both UK historic emissions and emissions including allowances purchased through trading in the EU Emissions Trading Scheme and also projected greenhouse gas emissions through to 2020 under different policy scenarios. The pie chart shows carbon dioxide savings from key policies in 2020 relative to a baseline projection that includes pre-Energy White Paper policies, and does not include a carbon price.

7.14 To ensure that the UK meets these domestic climate change targets in the most cost-effective manner, the Government has adopted the three pillars for policy action set out in the Stern Review:

- pricing carbon through trading, tax or regulation – ensuring that emissions reductions are delivered in the most cost-effective way;
- supporting investment in low-carbon technologies and infrastructure; and
- tackling barriers to action, including policies to encourage long-term behavioural change and energy efficiency.

[5] Source for graph: *Updated energy and carbon emissions projections*, DECC, November 2008. Details of the pre-Energy White Paper policies in the baseline can be found in Table C1 of that document. Source for pie chart: DECC modelling.

PUTTING A PRICE ON CARBON

EU Emissions Trading Scheme

7.15 Carbon pricing is the central tool of climate change policy. The EU Emissions Trading Scheme (ETS) sends a price signal through the economies of Europe by capping emissions of energy generators and heavy industry. The UK strongly supports the European Commission's proposals to set an ambitious EU-wide cap on emissions under the ETS from 2013, with the cap reducing each year to 2020 and beyond, giving certainty to businesses to plan investment. The proposed cap would deliver 60 per cent of the cuts required for the EU to meet its 2020 emission reduction commitment.

7.16 **On 19 November, the UK was the first country to hold an auction of carbon allowances under Phase II of the EU ETS (2008-2012)**. Four million allowances were sold, raising over £54 million. Auctioning carbon allowances removes the potential for windfall gains by ensuring companies pay the market price for allowances, in line with the polluter pays principle. The Government's forecast of revenue from auctioning Phase II EU ETS allowances, based on market prices, has been included in the Pre-Budget Report forecast.

7.17 The Government has also succeeded in its aim of obtaining unanimous agreement to include aviation in the EU ETS from 2012. This will enable the aviation sector to take responsibility for its carbon emissions in the most cost-effective way. The cap will be set at 97 per cent initially, with 15 per cent of allowances to be auctioned. Aviation emissions reductions[6] across Europe will be 133 $MtCO_2$ a year in 2015, rising to 194 $MtCO_2$ a year by 2020.[7]

SUPPORTING LOW-CARBON TECHNOLOGY AND INFRASTRUCTURE

7.18 The development and deployment of low-carbon and energy saving technologies will be critical in meeting the Government's ambitious emissions reduction targets. A carbon price provides a strong incentive for investment in existing low-carbon technologies, but may not alone be sufficient to overcome barriers to the development and deployment of new technologies. The Government is therefore actively providing further support for the development of these technologies towards commercial deployment.

[6] The reductions may not arise through abatement of aviation emissions, but through the purchase of allowances from the market by aircraft operators to account for any additional carbon dioxide that they emit over and above the cap. Any increase in carbon dioxide emissions from aviation above the 95 per cent cap will be effectively offset by reductions in carbon dioxide emissions from other participants in the EU ETS or from Clean Development Mechanism carbon dioxide reduction projects in developing countries.

[7] These figures are based on the European Commission paper, *Impact Assessment of the inclusion of aviation activities in the scheme for greenhouse gas emission allowance trading within the Community,* 2006. This paper gave an estimate of emissions reductions if the cap were set at 100 per cent. These figures have been adjusted to reflect the agreement reached in July 2008 that the emissions cap for aviation will be 95 per cent of average 2004-06 emissions from 2013 onwards.

Box 7.3 – The Government is supporting technology innovation through the stages of research, development, demonstration and deployment (RDD&D):

- **Research Councils** are supporting £300 million of energy research and postgraduate training over the CSR period, including large multidisciplinary research projects and blue-skies research;
- the business-led **Technology Strategy Board**, established by the Government, stimulates innovation through a range of activities, such as funding a £100 million low carbon vehicle programme;
- the **Energy Technologies Institute**, a partnership between the Government and industry (including BP, Caterpillar, EDF Energy, E.ON UK, Rolls Royce and Shell) aims to raise £1.1 billion over the next 10 years for applied research and development projects such as the £60 million 'Offshore Wind' and 'Wave and Tidal Stream' energy programmes;
- the **Carbon Trust** recently launched their Offshore Wind Accelerator Programme that aims to cut the cost of offshore wind energy;
- the **Energy Saving Trust** promotes energy efficiency in the domestic and public sector, providing technical support for innovative energy efficiency projects across the UK; and
- the £400 million **Environmental Transformation Fund** focuses on demonstration projects and the pre-commercial deployment of low carbon technologies, for example, project support for biogas generation from organic waste decomposition.

Carbon capture and storage

7.19 Carbon capture and storage (CCS) is a key technology for tackling global emissions and has the potential to reduce emissions from fossil fuel power stations by up to 90 per cent. The Government is supporting proposals in the EU to provide funding for up to 12 demonstration projects and to provide an EU-wide regulatory framework for the geological storage of carbon dioxide. The Energy Bill will provide the Government with the powers to permit offshore storage of carbon dioxide from electricity generation. In November 2007, the Government launched a competition to design and build a full-scale demonstration of the full capture, transport and storage chain. The procurement exercise is ongoing.

Renewable energy

7.20 The UK has made substantial progress in increasing the contribution made by renewables to its energy mix. For example, the UK recently overtook Denmark to be the world-leader in offshore wind capacity. Existing policies, together with those brought forward from the renewable energy strategy consultation, will bring about a ten-fold increase in renewable energy generated in the UK. These are expected to generate around £100 billion of investment, and deliver carbon savings of around 67 $MtCO_2$ per year by 2020, of which 19 $MtCO_2$ will be additional to the EU ETS cap.

7.21 The Government is bringing forward measures to increase certainty and incentives for investment in renewable technologies. In the Energy Bill, the Government is taking powers to introduce:[8]

- banding to the Renewables Obligation to provide more targeted support for newer technologies, such as offshore wind; and
- a renewable heat incentive and feed-in tariffs for electricity below 5 MW. These provisions will ensure communities, households and businesses can receive financial reward for the renewable heat and electricity they generate.

[8] The Energy Bill is nearing Parliamentary approval, and is expected to receive Royal Assent shortly.

7.22 Large-scale generation will make up most of the new renewable electricity capacity needed. **The Secretary of State for Energy and Climate Change today confirms that the Government is committed to retaining the Renewables Obligation to provide financial support for large-scale renewable electricity and will extend it to at least 2037.** This will ensure that investors can plan with confidence and underpin growing investment in renewable electricity.

Grid infrastructure

7.23 A major investment is underway in Britain's energy networks that will provide the necessary infrastructure to deliver security of supply for electricity and gas, as well as supporting the move to a low-carbon economy. Ofgem has approved £5 billion of revenue allowances until 2012, just under £4 billion of which is for National Grid. There is flexibility in the current settlement for a further £1 billion of investment in electricity transmission. In addition, Ofgem has approved a further £5.7 billion for electricity distribution (from 2005-2010) and £5 billion for gas distribution (from 2008-2013). The regulator will be ensuring that the National Grid and the other transmission and distribution companies meet their commitments.

7.24 Further investment in electricity networks will be needed in order to connect new renewable and other low-carbon and conventional generation. Ofgem expects to consult shortly on revised incentives for the network companies that will enable timely, strategic investment in network reinforcements and extensions.

Nuclear power

7.25 New nuclear build is a key element of the Government's energy strategy for a secure low-carbon energy supply. The Government is looking to facilitate investment in this technology through the recently created Office of Nuclear Development (OND), which will work to enable companies to bring forward new nuclear power stations in the UK from the earliest possible date. The OND will help to create and support a globally competitive supply chain for nuclear build.

Opportunities from a low-carbon economy

7.26 Chapter 4 sets out action to help businesses respond to the downturn caused by global economic shocks, and new measures to ensure that UK businesses are well placed to meet long-term global challenges.[9] In this context, the Government's ambitious climate change targets provide an opportunity for significant expansion in low-carbon goods and services, leading to significant job growth in the sector, and helping with economic recovery. The UK is well placed: it is estimated that 350,000 people are already employed directly in the sector. Over the next 20 years, more than one million people could be employed in the UK's environmental industries. Next year, the Government will publish its low-carbon industrial strategy, providing a vision for how companies can adapt and take advantage of the growing business opportunities from a low-carbon economy.

7.27 Appropriate skills will be needed for a low-carbon economy – this is one of the strategic priorities for the Government's National Skills Academies (NSAs). NSAs bring together employers and networks of specialist training providers to tackle the key skills challenges facing their sector. The Government will convene a forum on low-carbon skills to identify the action needed to ensure that the right training and vocational qualifications are in place to successfully manage the transition to a low-carbon economy.

[9] *The UK Economy: Addressing long term strategic challenges*, published alongside the 2008 Pre-Budget Report sets out the challenges and opportunities facing the UK, including the transition to a low-carbon economy.

7.28 The Government is calling for the EU budget to be reoriented towards supporting Member States to ensure the EU has the skills to compete in a low-carbon, global economy, maximising the opportunities for growth and jobs. As a first step towards this, the UK is working to improve the European Globalisation Adjustment Fund, which aims to help workers made redundant as a result of changing global trade patterns, accordingly.

Attracting low-carbon investment

7.29 Building international partnerships and developing export markets will help the UK take advantage of the global shift to low-carbon goods and services. The Government will publish a new low-carbon marketing strategy in early 2009, promoting the UK as a global hub for low-carbon solutions. Earlier this month, the Government announced a long-term strategic partnership between the UK and Qatar, involving an agreement between the Carbon Trust and the Qatar Investment Authority to set up a new £250 million Clean Technology Investment Fund, and to investigate the creation of a Low Carbon Innovation Centre in Qatar. The Fund will seek to make venture capital investments in clean energy businesses primarily located in the UK.

CHANGING BEHAVIOUR IN TRANSPORT

7.30 Transport is of fundamental importance for both private and business travel, and is a key building block of the economy. Road transport is also a large source of greenhouse gas emissions, accounting for 19 per cent of emissions.[10] As set out in Chapter 4, the Department for Transport will publish *Delivering a sustainable transport system*, which will consult on the transport goals and priorities for the future. To ensure a long term framework for cleaner road transport is in place, the Government is pushing for an ambitious EU wide 2020 target for new car emissions to be included in the EU CO_2 from cars directive. The UK consultation on the directive, published in July 2008, estimated savings in the region of 6-11 $MtCO_2$ per year by 2020, depending on the design of the regulation.

7.31 To deliver this target and help motorists and businesses manage the short-term impacts of the current downturn caused by global shocks, the Government continues to ensure fiscal policy encourages greater fuel efficiency. This will help people and businesses reduce fuel bills, while ensuring transport contributes to long-term environmental goals.

Vehicle excise duty

Post-2001 cars

7.32 Since 2001, vehicle excise duty (VED) has been based on different rates depending on carbon dioxide emissions from cars. The Government announced further reforms of vehicle excise duty at Budget 2008 to incentivise the purchase and manufacture of more fuel-efficient cars. These included an increase in the number of VED bands from seven to thirteen, from April 2009. These new bands will reflect changes in the fuel efficiency of vehicles and will also provide a greater incentive for drivers choosing a lower-carbon version of car within their preferred class, whether purchasing in the new or second-hand market.

7.33 The Pre-Budget Report confirms the introduction of the new bands in 2009. However, it also announces that to reduce pressures on motorists during the current economic downturn, there will be no significant rate changes until 2010, and no driver in any given band will pay more than £30 more in that year. Details of this reform include:

- **from April 2009, six new bands of VED will be introduced, taking the total to 13**. However, VED rates will not increase by more than £5 for any car in this year;

[10] Emissions from road transport are reported by source rather than by end user.

- **from April 2010, in order for the new bands to create an environmental incentive, the Government will start to separate out the 13 differential rates.** As a result, cars below 150 g/km will see a real terms cut in their VED, of up to £30. Cars up to 175 g/km will see no real terms increase in their VED. Cars of 176 g/km and above will see a tax increase of between £20 and £30;
- **from April 2010, a differential First-Year Rate for new vehicles will be introduced** as announced in Budget 2008, in order to provide a stronger signal for consumers at the point of purchase; and
- **cars that emit over 225 g/km, but were registered between 1 March 2001 and 23 March 2006, will be moved into the new band K in 2009 and stay there in 2010.** This will mean that they maintain their exemption from the top rate of VED.

7.34 As a result of these reforms to graduated VED, no driver in any given band will pay more than £5 extra in 2009. In 2010-11, when more significant rate changes are introduced, a majority of drivers will either pay less or the same as in 2009. When the Government introduces First-Year Rates for newly purchased cars in 2010, new cars under 130 g/km will pay no VED at all in the first year of use, whereas the very highest emitting cars will pay £950. The full set of rates is set out in Table 7.1 below.

Table 7.1: Vehicle excise duty for cars registered from March 2001 onwards; 2009-10, 2010-11 rates

VED band	CO_2 emissions (g/km)	Standard rate 2009-10*	Standard rate 2010-11*	First-year rate 2010-11
A	Up to 100	£0	£0	£0
B	101-110	£35	£20	£0
C	111-120	£35	£30	£0
D	121-130	£120	£90	£0
E	131-140	£120	£110	£110
F	141-150	£125	£125	£125
G	151-165	£150	£155	£155
H	166-175	£175	£180	£250
I	176-185	£175	£200	£300
J	186-200	£215	£235	£425
K**	201-225	£215	£245	£550
L	226-255	£405	£425	£750
M	Over 255	£405	£435	£950

**Alternative fuel discount: 2009-10, A-I £20, J-M £15; 2010-11 onwards, £10 all cars*

*** Includes cars emitting over 225g/km registered between 1 March 2001 and 23 March 2006*

Pre-2001 cars and vans

7.35 Cars registered before 2001 – which account for around a third of the fleet – are not subject to the graduated VED regime, because comprehensive data on their carbon dioxide emissions is not available. In Budget 2008, it was announced that in 2009 the lower rate of VED for these vehicles would be frozen and the higher rate would be increased by £15. **In line with the changes to main VED rates, this change will be postponed for a year, and on 1 April 2009 both rates will instead increase by £5. These rates will also apply to light goods vehicles registered before 2001.**

Post-2001 vans **7.36** Budget 2008 also announced the standard VED rate for light goods vehicles registered after 2001 would increase by £15 from 1 April 2009. **This change will now instead take place from 1 April 2010, with rates increasing by only £5 in 2009-10. The discounted VED rate for light goods diesel vehicles that met Euro 4 emissions standards before these became mandatory will be increased by £5 to £125 in 2009-10.** From 1 January 2009, vans that meet Euro 5 emissions standards, and are first registered between this date and 31 December 2010, will also be eligible for the discounted rate.

Motorbikes and HGVs **7.37** **The Government also announces that VED rates for motorbikes and heavy goods vehicles will be frozen in 2009**, as will all related rates including special types vehicles, combined transport vehicles and all vehicle categories linked to the basic goods rate.

Fuel duty

7.38 It is the Government's policy that fuel duty rates should rise each year at least in line with inflation as the UK seeks to reduce polluting emissions and fund public services. However, in response to record peaks in fuel prices earlier this year, the Chancellor announced that the 2 pence per litre increase planned for April 2008 would be postponed.

7.39 As a result of falling oil prices, pump prices have now fallen by more than 20 pence per litre from their July peaks. **The Pre-Budget Report therefore announces that the 2 pence per litre increase in fuel duty planned for 2008 will now take place on 1 December 2008.** However, as a result of the 2.5 per cent cut in VAT this December, the cost of petrol and diesel will fall for private motorists who should see no increase in the price they pay at the pump this year from this measure.

7.40 **The Pre-Budget Report also confirms that, as pre-announced in Budget 2008, main fuel duties will further increase by:**

- **1.84 pence per litre on 1 April 2009; and**
- **0.5 pence per litre above indexation on 1 April 2010.**

7.41 **Duty rates for rebated oils will also rise in proportion to main road fuel duties on these dates. The duty differential for compressed natural gas will be maintained until 2010-11 and the differential for liquefied petroleum gas will decrease by 1 pence per litre on these same dates.**

Low-carbon vehicles

7.42 The Government recognises that low-carbon and electric vehicles will have an important role to play as the UK reduces emissions from road transport. The public sector has invested £100 million to date into the Technology Strategy Board's research, development and demonstration programme for low-carbon vehicles. The Government has also acted to ensure that electric vehicles are incentivised through the tax framework. Pure electric vehicles are exempt from VED, while hybrid electric vehicles are also incentivised through lower rates of graduated VED. In addition, the less conventional fuel a car uses, the bigger the incentive offered to motorists in reduced fuel duty, and therefore reduced running costs.

7.43 The Government's response to the King Review of low-carbon cars will be published shortly. As part of this, the UK and India will jointly sponsor a workshop early in 2009, bringing together governments, business and academia from the two countries to consider how collaboration on developing low-carbon, low-cost cars should be taken forward.

7.44 **The Government is calling on the European Investment Bank to double its financial support for the next generation of greener cars by making available €8 billion over the next two years.** This support should target significant carbon dioxide reductions through research, development and innovation expenditure as well as improving the energy efficiency of related infrastructure and production. The funds should be made available quickly on a fair, equitable and commercial basis across all EU Member States.

7.45 The Department for Transport DfT has consulted on changes to the bus service operators grant, aiming to modernise bus services and align incentives to wider climate change objectives. **The Pre-Budget Report announces that reforms to the grant will introduce incentives for low-carbon buses, smartcard ticketing and global positioning systems (GPS).** These steps will bring benefits for passengers – with smartcard ticketing systems offering an easier journey and quicker boarding; and GPS helping to improve punctuality and real-time information. DfT is also challenging the industry to improve its fuel efficiency and will announce further measures shortly.

Biofuels

7.46 In light of emerging evidence on indirect impacts from biofuels production, the Government in spring 2008 asked Professor Ed Gallagher to lead a study into the wider environmental and economic impacts of biofuels. Professor Gallagher reported that biofuels could contribute to a sustainable transport system, but that there is a risk that current policies could lead to a net emissions increase; loss of biodiversity; and contribute to rising prices for some commodities, notably oilseeds. As a consequence he recommended that the rate at which biofuels are incentivised through the Renewable Transport Fuel Obligation should be slowed, reaching 5 per cent only in 2013-14. The Government accepted this recommendation and recently published a consultation on the change, which will close on 17 December 2008. In addition, the Government is negotiating in Europe to ensure sustainable biofuel criteria across the EU.

Taxation of business travel

7.47 Over half of new car purchases each year are made by business and over 10 per cent of journeys are made for work. The Government is therefore committed to supporting businesses that both purchase and use cleaner cars. For this reason, company car tax and fuel benefit charge were reformed and placed on a carbon dioxide basis in 2002.

7.48 Budget 2006 announced that HMRC would carry out a review into the taxation of employee car ownership schemes (ECOS). **A report summarising the findings of this review is published today.**[11] This sets out the background to the Government's decision not to impose a specific tax on ECOS, or alter the structure of AMAPs at the current time, but to continue to provide a clear and simple system for business and employees.

Capital allowances for business cars

7.49 At Budget 2008 the Government announced its intention to modernise the tax relief for business expenditure on cars by adopting a carbon dioxide emissions based approach. **The Pre-Budget Report confirms this reform will take effect from 1 April 2009 for corporation tax and 6 April 2009 for income tax. A technical note and draft legislation will be published shortly.**

[11] *Report on company cars, employee car ownership scheme cars and mileage allowance payments*, HM Revenue and Customs, November 2008.

Disabled driver relief

7.50 Disabled company car drivers of automatic cars are able to use the carbon dioxide emissions figure of an equivalent manual car when calculating their company car benefit charge. **The Government today announces that from 6 April 2009 these drivers will also be able to use the list price of an equivalent manual car when calculating their company car benefit charge.**

AVIATION AND REDUCING EMISSIONS

7.51 The Government recognises the contribution that the aviation industry makes to the UK economy: providing around 200,000 jobs directly in the industry, employing up to 500,000 people in the supply chain, and contributing at least £11.4 billion to national GDP[12]. The Government believes that aviation taxation should ensure the sector pays its fair share towards public services and provide better environmental signals.

7.52 The Air Transport White Paper (2003) set out the Government's support for the sustainable growth of aviation. In 2006 the sector accounted for around six per cent of the UK's carbon dioxide emissions; however this share is forecast to grow to around 10 per cent by 2020, and by 2050, it is estimated that the sector will account for 35 per cent[13] of the UK's carbon dioxide emissions.

Aviation in EU ETS

7.53 Aviation is by its nature international, so the Government believes that action at an international level is needed to ensure the sustainable development of this sector. For this reason, in Budget 2005, the Government highlighted its commitment to aviation joining the EU ETS. The Government made this a priority for the UK's presidency of the EU in 2005. The Government has succeeded in its aim of obtaining unanimous agreement to include aviation in the EU ETS from 2012 at a cap of 97 per cent of 2004-06 emissions. Phase III details are being negotiated as part of the EU Climate and Energy package.

Air passenger duty

7.54 At the 2007 Pre-Budget Report, the Government announced it would consult on proposals to replace air passenger duty (APD) with a per plane tax. Since the 2007 Pre-Budget Report:

- agreement has been successfully reached to include aviation within the EU ETS, as set out above; and
- the Government has completed a formal consultation exercise.[14]

7.55 The Government has listened to the points made during the consultation process, and in particular recognises the need to ensure greater stability in tax policy at a time of economic uncertainty, while maintaining its environmental objectives. **The Government has therefore decided to reform the air passenger duty regime rather than proceed with a per plane tax.** Reforming APD avoids the disruption and costs associated with the transition to a new tax, while continuing to send environmental signals to passengers and the industry alike, and ensuring that the sector contributes fairly to public services.

7.56 **From 1 November 2009, APD will be structured around four distance bands, set at intervals of 2,000 miles from London.** This reform will ensure that those flying farther, and therefore contributing more to emissions from aviation, will pay more. Table 7.2 provides details of the reformed APD rates.

[12] Oxford Economic Forecasting, *The Economic Contribution of the Aviation Industry in the UK*, December 2006.

[13] This is based on UK aviation carbon dioxide forecasts from the Department for Transport (DfT) and assumes the UK domestic target for carbon dioxide reductions in 2050 is 80 per cent below 1990 levels and that abatement effort to meet the target is predominantly in the rest of the economy. These estimates are based on central emissions forecasts. DfT is currently updating its forecasts of aviation emissions for all years to 2050 and these are expected to be published before the end of the year.

[14] A summary of the responses to the consultation exercise is published today, alongside the Pre-Budget Report.

Table 7.2: Air passenger duty rates

Band and approximate distance in miles from the UK	In the lowest class of travel (reduced rate) from:		In other than the lowest class of travel (standard rate) from:	
	1 November 2009	1 November 2010	1 November 2009	1 November 2010
Band A (0-2000)	£11	£12	£22	£24
Band B (2001-4000)	£45	£60	£90	£120
Band C (4001- 6000)	£50	£75	£100	£150
Band D (over 6000)	£55	£85	£110	£170

** If only one class of travel is available and that class provides for seating in excess of 40" then the standard (rather than the reduced) rate of APD applies.*

7.57 Reforming APD takes account of the need in the present economic circumstances, to mitigate the potential impact on the air-freight sector, the impact on employment in this sector, and the wider business community which relies on air-freight services; as well as mitigating the potential regional employment and connectivity impacts.

7.58 Recognising the short-term economic pressures and consequential reduction in demand for air travel, revenues from the aviation industry have also been revised in the short-term from Budget 2008 forecasts. The Government estimates the carbon dioxide impacts of this reform of APD to be 0.6 $MtCO_2$ in 2011-12, and when a radiative forcing factor is applied, this rises to 1.2 $MtCO_2$.[15] Coupled with savings from the doubling of APD rates in 2007, this will achieve a combined reduction of 2.4 $MtCO_2$ in 2011-12.

CHANGING BEHAVIOUR AT HOME AND AT WORK

7.59 Homes, businesses and the public sector together account for around 59 per cent of UK greenhouse gas emissions by end user, primarily through the use of gas and electricity for heating, lighting and to run appliances and equipment. Emissions from heating are particularly significant, accounting for half of total carbon emissions and 60 per cent of the average energy bill. Saving energy and increasing the supply of low-carbon heating therefore helps to reduce emissions, cut bills, and enhance energy security.

7.60 Energy costs provide a direct incentive for households and businesses to install energy efficiency measures. Policy interventions can help to overcome barriers to the uptake of energy saving measures. The Government has put in place a range of policies, including improved building regulations, challenging energy efficiency targets for energy suppliers, moves to enhance product standards, and information campaigns about how to save money and carbon.

7.61 **The Government will shortly bring forward proposals to support householders and businesses further in improving the energy efficiency of their properties, and installing low-carbon heating in existing buildings. In addition, the Government will also shortly set out its proposals for new zero-carbon homes and non-domestic buildings.**

7.62 The Government welcomes the European Commission's work examining where economic instruments, including VAT rates, can have a role to play to increase the use of energy efficient products, and calls on the Commission to bring forward a proposal to introduce reduced VAT rates for these products as soon as possible, for rapid adoption by the European Council.

[15] The radiative forcing factor is the additional impact of emissions when released at altitude. The Government's latest estimate is a radiative forcing multiplier of 1.9.

Home Energy Saving Programme

7.63 Many of the most cost-effective opportunities for the UK to reduce carbon emissions between now and 2020 are in the household sector. The Home Energy Saving Programme (Box 7.4) will substantially increase the number of homes receiving subsidised insulation and other energy saving measures. The programme was substantially enhanced in September to support higher take-up of energy efficiency measures. This winter, this will lead to the installation of 600,000 insulation measures, up 70 per cent on last winter.

Landlords Energy Saving Allowance

7.64 Landlords in the private rented sector may be deterred from installing insulation because cost savings from investing in energy efficiency are difficult to recover in increased rent. In 2004, the Government took action to correct this by introducing the Landlords Energy Saving Allowance (LESA), which provides an allowance of up to £1,500 for landlords who invest in improvements such as cavity wall and loft insulation. **Following receipt of state aids approval from the European Commission, LESA has been expanded to corporate landlords from 8 July 2008. The Government is continuing work to raise awareness of this allowance.**

Box 7.4 – Home Energy Saving Programme (£6.8 million over three years)

The Government recently announced an additional £1 billion to the Home Energy Saving Programme to increase energy saving and help vulnerable households heat their homes:

- twenty per cent higher targets proposed for energy suppliers under the **Carbon Emissions Reduction Target (CERT)**, an obligation on energy suppliers to achieve reductions in carbon emissions by installing energy efficiency measures such as loft and cavity wall insulation over the period 2008-2011. Including this proposed increase, CERT is expected to deliver emissions savings of 185 $MtCO_2$ over the projected lifetime of the measures, equivalent to annual savings of around 5 $MtCO_2$ a year by 2011. Measures such as loft and cavity wall insulation are now available to all households at a discount of 50 per cent, saving those householders that install insulation up to £300 a year on fuel bills. A priority group of eleven million households, comprising those on qualifying benefits and the over 70s, qualify for these measures at no cost;
- a proposed new **Community Energy Saving Programme**, which will take a whole house approach to energy efficiency, in areas of high deprivation. Energy suppliers and electricity generators are expected to deliver around £350 million of energy efficiency measures under the programme, delivered with local partners, which could include local authorities, community organisations and social enterprises. It is hoped that this will deliver up to 100 schemes across the country, potentially benefiting some 90,000 homes over the next three years;
- a **£74 million increase** in funding for the Government's Warm Front programme, which provides free central heating and energy efficiency measures to vulnerable low income households. In addition, the Pre-Budget Report announces £100 million of new funding for Warm Front on top of £50 million of spending on the programme brought forward now to support the economy;
- **measures to help vulnerable groups** including a tripling of cold weather payments to £25 a week for this year, as well as the already announced one-off additional payments this winter for households over 60, and increased social assistance provided by energy suppliers; and
- a major information campaign across press, radio and TV to publicise the help available.

Climate change levy and climate change agreements

7.65 For business and public sectors, the climate change levy (CCL) has been successful in reducing energy demand by nearly 15 per cent a year.[16] Climate change agreements (CCAs) complement the CCL by allowing energy intensive industries to pay a reduced rate of the levy in return for making improvements in the efficiency of their energy usage, saving £1.5 billion and 16.4 $MtCO_2$ in 2006. The Government will shortly consult on the form and content of new CCAs, including a proposal to split CCA targets where they overlap with EU ETS, simplifying the scheme. **This proposal will not result in a change to eligibility for the CCL discount**.

Low-carbon heating

7.66 Low-carbon heating, such as solar water heating, sustainable biomass or good-quality combined heat and power (CHP) can also play its part in reducing carbon emissions. It can also contribute to enhanced security of supply by reducing the UK's dependence on gas. As set out above, the Energy Bill brings forward powers to introduce a renewable heat incentive, which will provide financial support for households or businesses that install renewable heating. CHP is already used in industrial settings or to supply domestic heating in heat networks. The Government has put in place a range of support measures to encourage CHP investment, including through fiscal incentives and favourable treatment under the EU ETS, and will consider remaining barriers in the forthcoming heat and energy saving consultation.

Energy prices and fuel poverty

Fuel poverty

7.67 Households which need to spend more than 10 per cent of their income to maintain satisfactory heating are defined as being in fuel poverty. Fuel poverty fell between 1996 and 2004 but rising energy prices since then have increased the numbers of households in fuel poverty, now estimated at 3.5 million in the UK as a whole. The Government remains committed to tackling fuel poverty and has provided increased support for vulnerable households. Winter fuel payments were increased at Budget 2008 for this winter from £200 to £250 for over-60s households and from £300 to £400 for over-80s households. **The Government is accelerating £110 million of capital spending on the Decent Homes and Warm Front programmes and providing a further £100 million for Warm Front, which will bring forward benefits for household energy bills and contribute to the wider fiscal stimulus.** This funding will assist 76,000 low-income households with better heating and energy efficiency.

7.68 In the medium to longer term, competitive energy markets are the best way to deliver lower energy prices. Ensuring that all households can benefit fairly from the competitive energy market will contribute to tackling fuel poverty. To address concerns about the operation of the competitive retail markets for electricity and gas, Ofgem recently carried out a detailed study of the markets.[17] Ofgem concluded that many customers have benefited from lower prices and better service. However, certain groups of consumers – including many at risk of fuel poverty – have not benefited fully from the market and are disproportionately affected by practices such as unjustifiable differential pricing. The Government welcomes Ofgem's report and looks to Ofgem and the energy companies to address the issues identified. **As announced by the Secretary of State for Energy and Climate Change on 18 November 2008, the Government stands ready to consult on legislation to tackle unfair pricing differentials between methods of payment for energy, if there is not a speedy and satisfactory resolution to the issues identified in Ofgem's probe.**

7.69 Clear and transparent information is needed for all consumers to manage their own energy costs through engaging effectively with the energy market. In addition to the measures already proposed by Ofgem in its study, **the Chancellor and Secretary of State for Energy and Climate Change have asked Ofgem to publish quarterly reports over the coming year**

[16] *Modelling the Initial Effects of the Climate Change Levy*, Cambridge Econometrics, March 2005, available at www.hmrc.gov.uk

[17] *Energy Supply Probe – Initial Findings Report*, Ofgem, 2008.

showing the relationship between wholesale prices, estimated hedged wholesale costs and average retail prices for gas and electricity. This will make it clearer when companies are passing the benefits of downward price changes through to their consumers and will ensure greater transparency over future price changes.

Smart meters **7.70** Smart meters are a more advanced type of electricity or gas meter that can provide businesses and households with visible, real-time feedback on their energy usage and the amount it is costing them. They also allow communication between the meter, the energy supplier and the consumer, which ensures more accurate billing to manage and prevent debt. The Government has recently concluded its consultation on introducing smart meters for businesses. **During the progress of the Energy Bill, the Government committed to mandating a roll out of electricity and gas smart meters to all households.** The Government's indicative plans would see smart meters available to all by the end of 2020, to align with delivery of the renewables targets.

ADAPTING TO CLIMATE CHANGE AND PROTECTING NATURAL RESOURCES

7.71 The Government is committed to preparing the UK for the challenges posed by the physical impacts of a changing climate and the increased incidence of extreme weather events such as heat waves, storms and floods. To embed better climate risk management in all public spending, the Government is reviewing its own appraisal guidance (the Green Book) to ensure that policy and investment decisions incorporate adaptation. The Government will develop the first national Climate Change Risk Assessment by 2011 and a national adaptation programme by 2012, as required by the Climate Change Bill.

Flood management **7.72** The Government has recognised the importance of flood risk management by providing substantial uplifts in spending reviews to fund flood defences and adaptation measures. Public expenditure has increased from £427 million in 2002-2003 to £599 million in 2005-2006, and will rise to £800 million in 2010-2011. This level of investment will reduce the risk of flooding and coastal erosion for over 145,000 households, and maintain 39,000 kilometres of flood defences around the country. As part of the fiscal stimulus, £20 million of this investment will be brought forward to 2009-10, delivering earlier protection for 27,000 homes. A draft Floods and Water Bill, to be published in spring 2009, will deliver improved management of flood risk and streamline current legislation. £5 million of improvements to the network infrastructure of British Waterways will also be brought forward in the fiscal stimulus.

Protecting natural resources

7.73 The Government is taking steps beyond its carbon commitments to put in place the right policies to protect the environment and natural resources.

Landfill tax **7.74** Landfill tax increases the price of waste sent to landfill, encouraging sustainable ways of managing waste. The tax – working alongside other measures such as the Landfill Allowance Trading Scheme – has been successful with overall quantities of waste recorded at landfill sites registered for the tax falling by around 32 per cent. The UK is on track to meet its 2010 targets to reduce biodegradable municipal waste to 75 per cent of 1995 levels under the Landfill Directive.

7.75 As announced in Budget 2007, from 1 April 2008 and until at least 2010-11, the standard rate of landfill tax will increase by £8 per tonne each year. The Government expects the standard rate to continue to increase beyond 2010-11. In Budget 2007, the Government also announced that the lower rate, applying to inactive waste, would increase from £2 to £2.50 per tonne from 1 April 2008, but would be frozen at £2.50 per tonne in 2009-10. (1410) Following the announcement in Budget 2008 and a subsequent consultation in the summer, **the Government has legislated to phase out the landfill tax exemption for waste arising from the clearance of contaminated land. The revenue derived from removing this exemption will be used to extend land remediation relief. The exemption will be phased out by 1 April 2012.**

Land remediation relief

7.76 Following the announcement in Budget 2008, **draft legislation to extend land remediation relief to expenditure on long-term derelict land will be published for comment by stakeholders today.** This legislation will also include a number of changes to give companies greater certainty about what categories of expenditure qualify for relief for the remediation of land contaminated by previous industrial activity. In particular, the costs of eradicating Japanese Knotweed will qualify for relief.

Packaging

7.77 The Government will publish a new packaging strategy in early 2009, setting out how packaging policy can help the UK move towards a low-carbon economy by reducing waste at source and increasing recycling. In 2007, an estimated 10.6 million tonnes of packaging was placed on the UK market of which more than 6.7 million tonnes of packaging waste was diverted from landfill.

Carrier bags

7.78 Budget 2008 announced that the Government would introduce legislation to impose a charge on single-use carrier bags if there was not sufficient progress on a voluntary basis, and the Government has done so in the Climate Change Bill. Responses by major retailers have been encouraging with all the major supermarkets making plans to reduce the bags they issue by around 50 per cent from 2006 levels by 2009, and other retailers also taking action, for instance by introducing their own charging schemes. These welcome developments build on progress already made by retailers in reducing the environmental impact of the bags they issue. Discussions with the British Retail Consortium about the scope for further voluntary action are continuing.

Competition in water markets

7.79 The Government welcomes the interim report of the Cave Review for Competition and Innovation in Water Markets, published on the 18 November 2008, which recommends changes aimed at providing better prices, more choice and better service for consumers, as well as encouraging more efficient and sustainable use of water. In response, the Government has announced a package of measures to extend and enhance retail competition for large non-domestic customers in England and this is described in Chapter 4.

7.80 There is £7 billion of capital investment planned in the water sector up until April 2010 under the existing price review process. The UK could also see a further £1 billion come forward in the time period, consisting of investment that has previously been delayed and new investment that water companies have applied to undertake in the interests of long term value for money for their customers. The Government strongly encourages water companies to proceed with their planned investment. It also encourages them to work with Ofwat within its existing regulatory framework to bring further investment forward where this would be in the interests of water customers.

Table 7.3: The environmental impacts of measures in the 2008 Pre-Budget Report

Sector	Environmental impact[1]	Overall annual saving in 2020 from cap/target[2]
Power Generation and Heavy Industry		**72 $MtCO_2$ – UK's share of the EU Emissions Trading Scheme (ETS) cap.**
First auction of ETS allowances	Auctioning strengthens the incentives for companies to reduce emissions by making them pay the full financial cost of the allowances	Based on an estimate of the implications for the UK of the current EU Commission proposal. This is under negotiation and subject to change.
Renewables and Low Carbon Technology		**19 $MtCO_2$ – from renewable target, additional to EU ETS savings**
Carbon capture and storage (CCS)	CCS has the potential to reduce carbon dioxide emissions from power stations by up to 90 per cent. The CCS demonstration will deliver savings of 0.7 $MtCO_2$ per year by 2020 (not additional to EU ETS cap).	Savings come from renewable heat and transport carbon dioxide reductions outside of the EU ETS cap. Savings based on meeting an ambitious 15% renewable energy target for the UK.
Introduction of feed-in tariffs and a renewable heat incentive	Feed-in tariffs and renewable heat incentive reduce carbon dioxide emissions by providing financial support for small-scale electricity generation and generation of heat from renewables. Policies in the renewable energy strategy consultation as a whole are expected to save around 67 $MtCO_2$ in 2020, with one-third additional to the EU ETS cap.[3]	
Renewables Obligation (RO)	An extended RO would deliver up to 46 $MtCO_2$ in 2030 – these savings will be part of a future EU ETS cap assuming the ETS continues beyond 2020.	
Transport		**5.4 $MtCO_2$**
Fuel duty increases in December 2008, April 2009 and April 2010	Fuel duty increases up to 2010-11 are expected to result in carbon savings of around 0.5 $MtCO_2$ in 2010-11	Illustrative saving from the successor to EU voluntary agreements on new car CO_2 emissions, plus illustrative saving from the UK domestic aviation in the EU ETS.
Duty rates for rebated oils increasing in proportion with main fuel duty rates	Increasing rebated oil rates in proportion to main fuel duty rates will help deliver small CO_2 and local air pollution benefits through less use of rebated oils which are more polluting.	
Staged implementation of VED reform	Reforms to VED including the introduction of new bands from April 2009 and First-Year Rates from April 2010 is estimated to result in a cumulative saving of 1.0 $MtCO_2$ by 2020, including the impacts of staggering the reforms. This assessment only includes impacts in the new car market but the measure will also apply in the second hand market.	
Freight best practice	Freight Best Practice continues to help hauliers improve operational efficiency and reduce costs. Best practice and smarter driving techniques have helped companies make real savings and a small reduction in emissions.	
Incentives for low-carbon dioxide buses	This package will deliver carbon dioxide and other pollutant savings, depending on the level of take-up. If low-carbon buses made up 10 per cent of the UK bus fleet, the expected saving would be around 0.1 $MtCO_2$ per year.	
Inclusion of aviation in ETS	Estimated CO_2 savings across Europe will be 133 $MtCO_2$ per year in 2015 and 194 $MtCO_2$ per year in 2020.[4]	
Reform of air passenger duty regime (APD)	The reformed APD delivers savings of 0.4 $MtCO_2$ in 2010-11, compared to current APD, and with radiative forcing applied this rises to 0.7 $MtCO_2$. APD will deliver savings of 0.6 $MtCO_2$ in 2011-12 (1.2 $MtCO_2$ with radiative forcing applied). Coupled with savings from doubling APD rates, in 2007, this achieves a combined reduction of 2.4 $MtCO_2$ (with radiative forcing applied) in 2011-12.[5]	
Energy Saving and Heating		**13 $MtCO_2$ from (i) the supplier obligation, (ii) zero carbon homes[6] and (iii) Energy Performance of Buildings Directive**
Home energy saving programme	Existing CERT obligation expected to deliver annual savings in 2011 of 1.8 $MtCO_2$ within the EU ETS cap and 2.4 $MtCO_2$ outside. Updated figures including the impact of the proposed 20% uplift will be published shortly.	A further energy supplier obligation will replace CERT when it comes to an end in 2011, and the level of ambition is committed to be equal to that under CERT. Savings assume rate of new house building will be in line with the Government's projected house building estimated savings to 2016.
Extension of Landlords Energy Saving Allowance	Small reduction in carbon dioxide emissions	
Natural resources		
Landfill tax escalator announced in Budget 2007 increasing standard rate to £8 per tonne each year until at least 2010-11.	Landfill tax is expected to save up to 0.7 $MtCO_2e$ a year by 2010. Households recycled or composted 34% of their waste in 2007-08.	
Removal of exemption from landfill tax for waste arising from the clean up of contaminated land to extend land remediation relief.	The extension of land remediation relief will enable more than 10,000 hectares of long-term derelict land to be developed and brought back into use.	

[1] All CO_2 savings, unless otherwise stated, come from HMG modelling.
[2] CO_2 savings in 2020 are based on UEP32 emissions projections. Savings are relative to a baseline projection that includes pre-Energy White Paper policies and does not include a carbon price. For further detail of the UEP32 please see Updated Energy and Carbon Emissions Projections, DECC, November 2008.
[3] Renewable energy strategy consultation, 2008.
[4] Based on European Commission estimates (2006) and a cap of 95 per cent of 2004-2006 emissions. UK estimates will be available in due course.
[5] The radiative forcing factor is the additional impact of emissions when released at altitude. The Government's lastest estimate is a radiative multiplier of 1.9.
[6] Zero carbon homes: savings as estimated in 'Building a greener future: towards zero carbon development', December 2006.

A THE ECONOMY

Since mid-2007, the world's economies have been hit by major shocks. Developments in the US subprime mortgage market triggered a credit shock that has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. The surge in commodity prices, which had built over a number of years, peaked in July 2008 and has since reversed.

These economic shocks have affected all countries. The squeeze on real incomes from high commodity prices and the global financial crisis pushed many advanced economies into recession and led a growing number of emerging economies to require financial support from the IMF and other sources.

In the UK and globally, support for the banking system has reduced the risk of systemic failure, but nevertheless growth prospects have deteriorated sharply. After a period of very strong growth, world GDP is forecast to expand by 3½ per cent in 2008 and by just 2 per cent in 2009, with the G7 economies overall forecast to contract in 2009 for the first time since 1982.

In the UK, these shocks struck after a prolonged period of strong and stable growth in output and employment underpinned by low inflation. GDP grew by 3 per cent in 2007 and employment reached a record high of around 29½ million. The global credit shock affected property markets in the UK quickly while the rise in commodity prices until the summer squeezed household real incomes and company profit margins. Together with financial market distress, the combined effect has been to push the UK economy into recession and inflation to a 16-year high.

Lower commodity prices and interest rates, together with comprehensive measures to support the banking system, lay foundations for recovery. Bank Rate has been cut by 2¾ percentage points over the past year and CPI inflation fell from 5.2 per cent in September 2008 to 4.5 per cent in October. In addition, to support real incomes and employment during the recession, the Pre-Budget Report announces timely fiscal policy action including via a temporary cut in the rate of VAT and the bringing forward of public investment spending from 2010-11 to 2008-09 and 2009-10.

Short and medium-term growth prospects in the UK remain subject to exceptional uncertainty. The 2008 Pre-Budget Report forecast has been based on a number of key forecasting judgements, in particular relating to the path of credit conditions back to a new norm and the structural and cyclical implications of the global financial crisis. Against this backdrop of significant policy stimulus and support for real incomes, but exceptional uncertainty, the Pre-Budget Report forecast is for:

- UK GDP growth of ¾ per cent in 2008 with the economy contracting in the second half of the year. The recession is forecast to continue into the first half of 2009, with GDP contracting by –1¼ to –¾ per cent in the year as a whole. Thereafter growth is forecast to recover to 1½ to 2 per cent in 2010 and 2¾ to 3¼ per cent in 2011 as the lagged effects of monetary and fiscal stimulus, lower commodity prices and sterling's depreciation feed through, credit conditions normalise and the UK's flexible markets adjust and bring spare capacity back into productive use; and
- CPI inflation to fall sharply over the coming year as the inflationary pressure from global commodity prices reverses, below-trend output exerts downward pressure on domestically-generated inflation and the temporary cut in the VAT rate is passed through to consumer prices. Thereafter inflation returns close to its 2 per cent inflation target under the influence of offsetting factors.

INTRODUCTION[1,2]

A.1 This chapter discusses recent economic and financial market developments and provides updated forecasts for the UK and world economies in the period to 2011. It begins with a discussion of the major global economic shocks that have affected the world economy over the past year and the forecasting uncertainties they have generated. This provides the backdrop to the overview of developments and prospects in the world economy, which in turn provides the global context for developments and prospects in the UK economy. The chapter then outlines the UK economic forecast, before concluding with a more detailed discussion of sectoral issues, components of growth and a summary of the forecast issues and risks that are addressed throughout each section.

GLOBAL ECONOMIC SHOCKS AND UNCERTAINTIES

Global economic shocks

A.2 Between the summer of 2007 and summer 2008, the world economy progressively suffered from the unprecedented confluence of two major economic shocks. The global financial markets shock was triggered in July 2007. What began as a disruption to the functioning of specific credit and money markets has spread and intensified to the extent that all financial markets have been affected and financial institutions and financial systems around the world have been put under severe pressure. As a result, credit conditions facing households and companies have tightened very significantly. The availability of credit has been restricted, the terms on lending tightened, and the price of private credit has soared relative to official policy rates and government borrowing costs, factors that have caused growth in advanced and emerging economies to slow significantly.

A.3 The effect of restricted credit on household and company spending was exacerbated by a surge in global commodity prices in the first half of 2008 that put strong upward pressure on food and energy prices around the world. Stresses in financial markets intensified dramatically in September and October, with a number of large and small financial institutions across a broad range of advanced and emerging economies receiving government support, in conjunction with unprecedented generalised support for banking systems across the world. As output growth has slowed in response to these shocks, commodity prices have fallen sharply, thereby removing one of the factors detracting from world growth prospects.

A.4 Developments in global financial markets and global commodity prices over the past year are described in Boxes A1 and A2.

[1] The UK forecast is consistent with National Accounts and balance of payments statistics to the second quarter of 2008 released by the Office for National Statistics on 30 September 2008, and the preliminary estimate of GDP growth in the third quarter released on 24 October. A detailed set of charts and tables relating to the economic forecast is available in *2008 Pre-Budget Report: the economy and public finances – supplementary material* on the Treasury's internet site. Copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

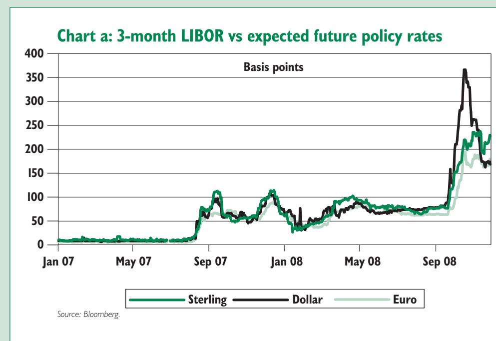
Box A1: Developments in global financial markets

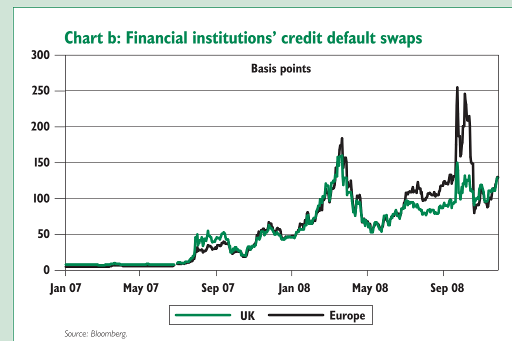
In summer 2007, the announcement of unanticipated losses on assets related to US subprime mortgages, where default rates had risen sharply, triggered adverse market conditions across an array of credit and money markets. Spreads on asset-backed securities and interbank lending rates moved up very sharply relative to risk-free interest rates.

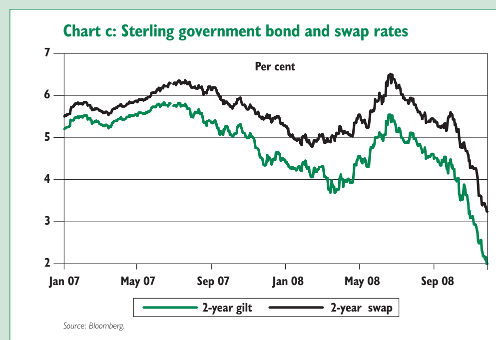
Since then, financial markets have experienced periods of greater and lesser stress, though always at levels far in excess of those seen in recent years. Following the rescue of Bear Stearns in the US on 16 March, money markets and banks' credit default swaps showed severe strains building (charts a and b). Concerted global liquidity provision, including via the Bank of England's Special Liquidity Scheme, helped to ease those strains. Government bond yields increased as high commodity prices raised concerns over inflation prospects (chart c).

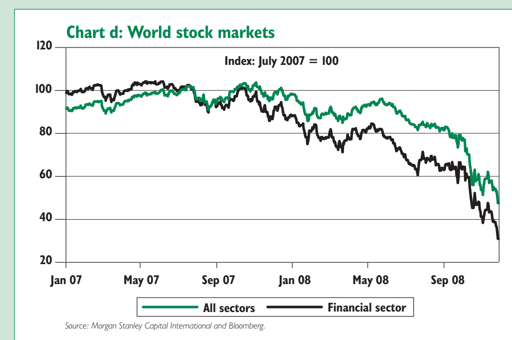
On 15 September 2008, the US investment bank Lehman Brothers filed for bankruptcy and Bank of America acquired another US investment bank, Merrill Lynch. The failure of Lehman Brothers proved the catalyst for a dramatic intensification of the credit shock into the worst global financial crisis for generations. Strains in money markets increased sharply, with little activity beyond overnight maturities and spreads rising to unprecedented highs. As concerns about recession replaced concerns about inflation in investors' perceptions, government bond yields declined and world stock markets fell (chart d).

On 8 October, the UK Government announced comprehensive measures to address the liquidity, capital and funding issues that were worsening the distress in financial markets, and central banks implemented a coordinated cut in interest rates. Following the announced measures, credit default premia on UK financial institutions eased significantly and interbank lending rates began to fall. The 1½ percentage point cut in Bank Rate on 6 November was followed by significant falls in interbank lending rates, although the spread over expected policy rates remains high.









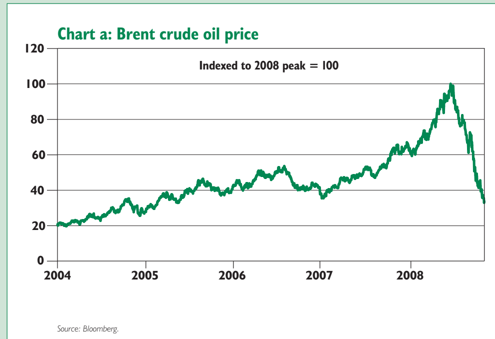
Box A2: Developments in global commodity markets

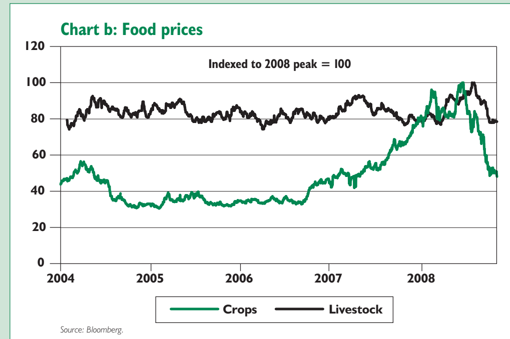
The price of a barrel of Brent crude oil, the European standard, increased from around $75 a barrel in July 2007 to peak at $146 on 3 July 2008 (chart a), a record high in real and nominal terms, surpassing the oil price shocks of the 1970s. Since July, oil prices have fallen back sharply to around $50 a barrel in response to concerns about falling demand in the advanced economies, and increased supply, despite OPEC having cut its production quota by 1.5 million barrels a day.

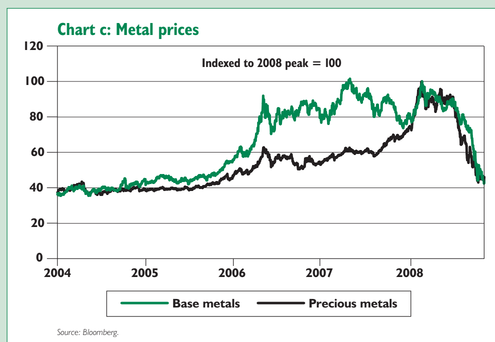
Prices of agricultural commodities picked up sharply during the first half of 2008 amid trade restrictions imposed by major exporters and tight supplies (chart b). Wheat prices reached record-high nominal levels in early March, while meat and poultry prices increased due to higher animal feed costs. Agricultural commodity prices have also fallen back since the summer.

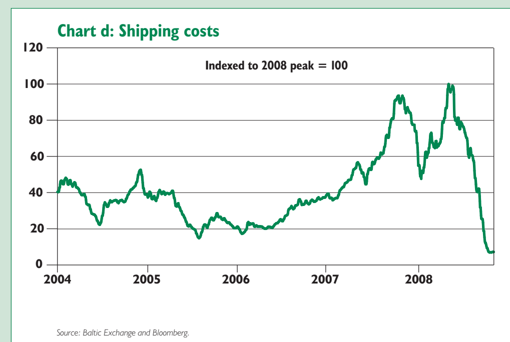
In metals markets, demand for copper and aluminium has weakened along with industrial activity in 2008, but supply from key producers has been adversely affected by disruptive power shortages, shoring up prices. In contrast, rising production and declining demand have caused zinc and nickel prices to fall sharply. Base metals prices could fall further in line with expectations of weakening global industrial production.

Driven by high raw material demand and port congestion, mainly in Australia, shipping costs reached unprecedented heights in the first half of 2008 (chart d). Since May, prices have fallen by over 90 per cent due to reduced demand, notably from China for Brazilian iron ore, the easing of port congestion, and worsening access to trade credit and insurance facilities.









Economic shocks and uncertainty

A.5 The combination of major economic shocks and the unprecedented global policy response to the banking crisis has generated exceptional uncertainties for households, businesses and governments across the world, and therefore economic forecasts. Forecasts made at times when economies are reaching cyclical peaks or troughs typically exhibit larger errors than those when developments are more stable, even at times when underlying supply potential remains steady. Given the current context of shocks that are likely to affect supply potential as well as demand, current economic forecasts inevitably involve an even greater reliance on judgement.

THE WORLD ECONOMY

Overview

A.6 Global economic prospects have been hit hard since summer 2007, and particularly since Budget 2008. The credit shock described above caused credit conditions to tighten across advanced economies and growth to slow. The surge in commodity prices in the first half of 2008 lifted inflation, squeezing real incomes and pushing many advanced economies into recession. The escalation of the global banking crisis in recent months has increased uncertainty over prospects for growth in advanced economies and the risk of contagion to emerging markets. But the global financial policy response has limited the downside risks from systemic banking collapse, and an increasing number of countries have eased monetary policy and announced fiscal stimulus measures. At the same time, lower commodity prices should provide support for real incomes next year.

A.7 Against the backdrop of major economic shocks, world growth is forecast to have slowed to 3½ per cent in 2008 and to fall to just 2 per cent in 2009. That would represent a serious slowdown from the 4¾ per cent expansion in 2007, reflecting slower domestic demand growth in advanced economies and weaker trade growth around the world. Growth across the G7 economies is forecast to have slowed to 1 per cent this year, and to turn negative in 2009, the first year of contraction since 1982. Many advanced economies are already experiencing falling output, with the euro area and Japan in recession.

A.8 The outlook for world trade has deteriorated in line with world growth prospects, exacerbated by the effect of the global financial crisis on the availability of trade finance. UK export markets are expected to grow more slowly than world trade as advanced economies, particularly the euro area and US, make up a larger proportion of UK export markets.

Table A1: The world economy

	Percentage change on a year earlier, unless otherwise stated				
		Forecast			
	2007	**2008**	**2009**	**2010**	**2011**
World GDP at purchasing power parity	4¾	3½	2	3¾	4½
Major 7 countries[1]*:*					
Real GDP	2¼	1	–¾	1½	2½
Consumer price inflation[2]	3	2¾	1¼	2	2
Euro area GDP	2¾	1	–1	1	1¾
World trade in goods and services	7	5¼	2	4¼	7
UK export markets[3]	6½	3¾	½	3¼	6

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

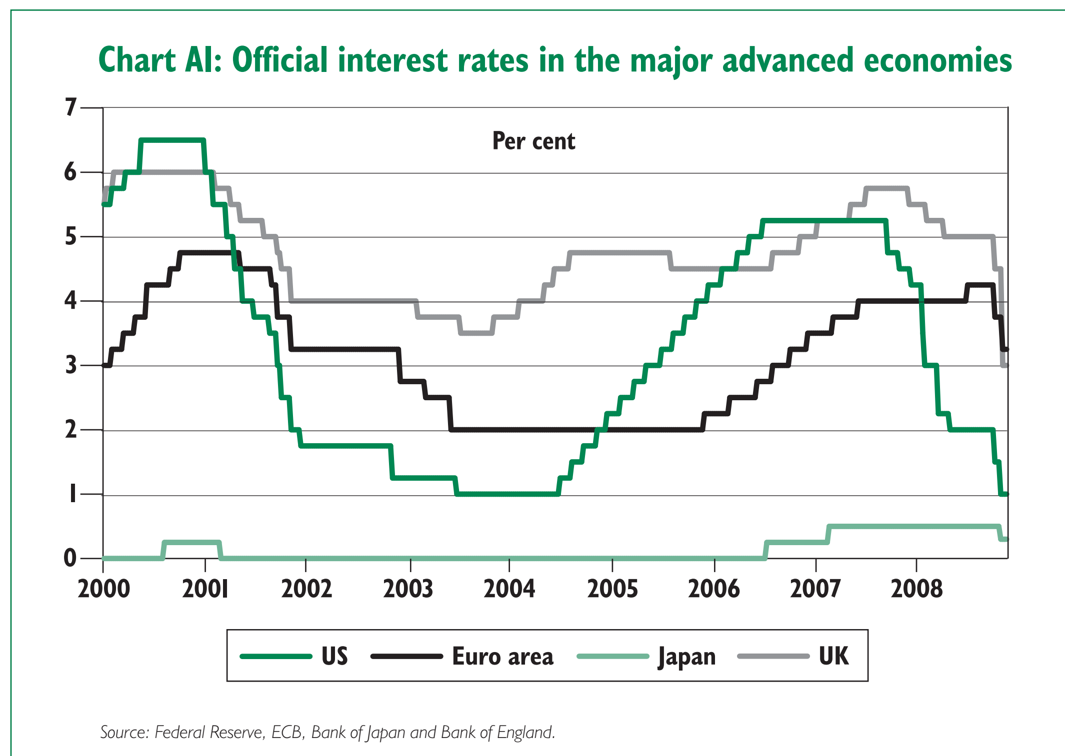
[2] *Per cent, Q4.*

[3] *Other countries' imports of goods and services weighted according to the importance of imports from the UK in those countries' total imports.*

A.9 Inflation, which picked up in the first half of 2008 following the surge in commodity prices, is expected to moderate quickly towards the end of the year. G7 inflation is forecast to hit an 8-year low of 1¼ per cent by late 2009. The inflation outlook for emerging economies is less clear, as many currencies have depreciated rapidly and a number of monetary policy frameworks are not yet well established.

A.10 Receding inflation risks in the G7 countries have provided greater scope for monetary easing. On 8 October, six major central banks, including the Federal Reserve, European Central Bank (ECB) and Bank of England, announced a coordinated ½ percentage point interest rate cut. Subsequently, the Federal Funds rate was cut further to 1 per cent, down from a peak of 5¼ per cent prior to the onset of the global credit shock, and official interest rates have been reduced to 3¼ per cent in the euro area, 0.3 per cent in Japan and 3 per cent in the UK. As set out in Chapter 3, G20 leaders, at their summit on 15 November, agreed a broader policy response, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging markets and developing countries. This includes using fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.

Chart A1: Official interest rates in the major advanced economies



Source: Federal Reserve, ECB, Bank of Japan and Bank of England.

Prospects for 2010 and beyond

A.11 While growth in 2009 is likely to be very weak, the foundations for recovery are in place. Lower commodity prices are expected to feed through to lower inflation, boosting real incomes, and monetary and fiscal policy support is forthcoming across a large number of advanced and emerging economies. Though there are risks to the outlook, notably over the duration of strains in banking systems, prospects for recovery in 2010 and 2011 appear reasonably well founded, and world output growth is forecast to rebound to 3¾ per cent in 2010 and 4½ per cent in 2011.

Advanced economies

Euro area

A.12 After unexpectedly strong growth in the first quarter of 2008, euro area output has since contracted, with the economy in recession for the first time since the euro area's inception in 1999. Private consumption fell during the first half of the year as rising inflation reduced real purchasing power. Investment also dropped sharply after a strong first quarter as tighter lending conditions, falling global demand and housing market adjustments in some Member States acted to limit activity.

A.13 Headline inflation increased sharply through 2008 to reach over 4 per cent in July, prompting the ECB to increase interest rates by a ¼ percentage point to 4¼ per cent on 3 July. Since then, inflation has started to ease as commodity prices have fallen. Interest rates currently stand at 3¼ per cent following consecutive ½ percentage point cuts on 8 October, as part of the coordinated global rate cut, and 6 November.

A.14 The euro area is expected to begin to recover in the second half of 2009. Consumer spending is expected to fall in the near term as tighter lending conditions, deteriorating consumer sentiment and a weakening labour market more than offset the improvement to purchasing power from lower inflation. Investment is also set to adjust sharply as housing market corrections in some economies coincide with weak and uncertain demand prospects and reduced access to finance. Since Budget 2008, the consensus forecast for euro area GDP growth in 2009 has been revised down by 2.1 percentage points to a contraction of 0.2 per cent. From 2010, as credit conditions ease, policy stimulus takes hold and spare capacity is brought back into productive use, growth is expected to pick up progressively towards trend rates. With fiscal policy responses evolving, the prospect of greater fiscal stimulus supporting earlier or stronger recovery represents an upside risk to these forecasts.

United States

A.15 The US outlook has deteriorated substantially. Strong GDP growth in the second quarter of 2008 was almost entirely reliant on two factors: the fiscal stimulus Congress passed in February, and net exports, bolstered by past dollar depreciation. Since then the stimulus from the February fiscal package appears to have waned, US export markets have slowed in line with global developments and the dollar has appreciated significantly. Households have suffered substantial falls in wealth from falling house prices and equity markets, along with declining real incomes and rising unemployment. Consumer confidence has deteriorated dramatically, and private consumption, which accounts for around 70 per cent of demand in the US economy, contracted sharply in the third quarter. Consequently, GDP fell 0.1 per cent in the third quarter.

A.16 Even after substantial fiscal, monetary and financial policy support, it now looks inevitable that the US economy has entered recession in late 2008. Business investment and private consumption are expected to contract further over the coming year as credit conditions remain tight and the labour market continues to deteriorate. The broad global downturn and recent appreciation of the dollar are expected to weigh on US export performance. Forecasters have cut their US GDP growth estimates for 2009 from 2.6 per cent at the time of Budget 2008 to a contraction of 0.6 per cent, as analysts have factored in the impact of the financial crisis and considered the rapidly deteriorating data.

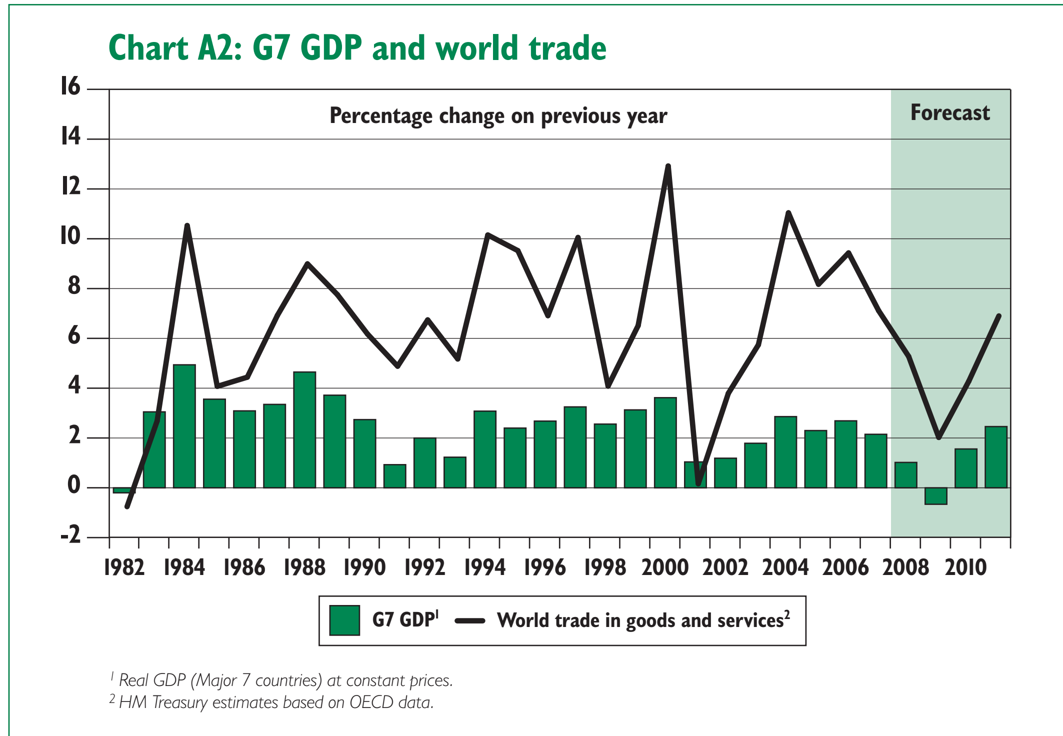
A.17 The boost to real incomes from sharply lower inflation, plus likely further fiscal stimulus – President-elect Barack Obama has indicated that he will introduce a further fiscal stimulus, probably in time for when he takes office in January 2009 – should support recovery from later in 2009 and into 2010.

Japan

A.18 The Japanese economy moved into recession in mid-2008 as falling business investment and export volumes, reflecting slowing global demand and a strongly appreciating currency, pulled GDP growth lower. Increased financial market volatility and uncertainty over

demand prospects are likely to mean that GDP growth will remain sluggish through 2009. Since Budget 2008, the consensus forecast for growth has been revised down from 1.4 per cent to 0.6 per cent for 2008 and from 1.9 per cent to a contraction of 0.1 per cent for 2009.

A.19 Headline inflation reached 2.3 per cent in July 2008, largely accounted for by upward pressure from food and fuel prices. The recent moderation in commodity prices means that headline inflation is likely to have peaked. The policy interest rate is currently 0.3 per cent, leaving little room for further loosening.



Emerging economies

A.20 Emerging markets are now experiencing the impact from the global slowdown and global credit shock. Growth in larger emerging economies is expected to slow to below recent strong rates, while the risk of much sharper contraction in smaller emerging economies has increased significantly. Countries with large current account deficits and external financing needs are particularly vulnerable. Prospects for 2010 and 2011 are highly uncertain, with a broad range of possible outcomes for emerging markets, both individually and as a group.

A.21 While falling commodity prices are reducing inflationary pressure across emerging markets, a large-scale capital flight has taken place as investors in advanced economies have acted to increase liquidity and reduce their exposure to perceived higher-risk assets. These capital movements have exposed vulnerabilities in many emerging markets. A number of countries have become at risk of a full-scale economic crisis and have sought assistance from the International Monetary Fund (IMF), which is currently engaged in various negotiations to provide financial support to help stabilise those economies. More countries may need to follow this route. The effects of the global financial crisis on emerging markets is discussed further in Chapter 3 of the Pre-Budget Report.

Emerging Europe and Russia

A.22 Recent booms in many emerging European countries were driven by cheap and plentiful credit. This led to overheating in some economies, adding to underlying inflationary pressures, lifting asset prices and, in some countries, leading to the accumulation of large

current account deficits, raising the risk of a hard landing. In Russia, this has coincided with rapid growth in personal credit. Growth in Russia and other big resource exporters, like Ukraine, is expected to weaken in 2008 and 2009 as a result of the higher cost of and reduced access to finance, and falling commodity prices.

Emerging Asia

A.23 China and India are likely to experience a more significant slowdown than forecasters were expecting earlier in the year, largely due to weaker export prospects, though both have recently cut interest rates to support growth. China, with $1.9 trillion reserves and strong domestic demand, is expected to remain relatively insulated from global conditions. The Chinese government is well placed to support the economy, and has recently announced a substantial fiscal stimulus package focused primarily on infrastructure investment. The Indian economy is more exposed, with domestic demand at risk from a domestic liquidity crunch and delayed investment. Relatively high public borrowing means that the Indian government's fiscal policy options are constrained. Most countries in emerging Asia are likely to see a significant slowdown in growth as a result of falling foreign direct investment (FDI) inflows and reduced demand for their exports.

Latin America

A.24 In Latin America, the global financial market stresses, together with tighter domestic credit conditions and lower commodity prices, point to a more pronounced slowdown than expected at the time of Budget 2008, with the possibility of sharp contractions in some countries. Growth in Brazil is expected to moderate from the strong pace of recent years, but the government has scope for policy intervention to support the economy. Mexico, Central America and the Caribbean are particularly exposed to the US slowdown through reduced remittances, FDI inflows and exports. Lower commodity prices are exacerbating macroeconomic imbalances in Argentina, Ecuador and Venezuela, all countries that have previously experienced periods of external debt crisis and default.

Global imbalances

A.25 Movements in commodity prices have heavily influenced developments in global current account imbalances during 2008. Many commodity-exporting countries have seen already large current account surpluses increasing, while deficits have increased in a number of importing countries, largely due to oil trade deficits. Some commodity-importing emerging economies have seen a degree of rebalancing of current account surpluses, due to both the higher oil price and stronger domestic demand.

A.26 Looking ahead, prospects for domestic demand growth in large deficit and surplus countries point to the ratio of global imbalances to GDP declining overall, though the IMF has identified three key challenges to this benign outcome.[3] First, the adjustment of the dollar has mainly been against a number of flexibly managed currencies, while some major currencies continue to be tightly managed or pegged to the dollar, which could create new imbalances over time. Second, the challenges facing commodity exporters for recycling petrodollars remain significant. Third, persistent imbalances, coupled with economic slowdowns, may give rise to protectionist pressures, which if not resisted would damage world growth prospects. In addition to these factors, as discussed in *The case for a concerted international fiscal response*, published alongside the Pre-Budget Report, fiscal measures being taken by many governments around the world could also affect current account imbalances.

[3] In Chapter 1 of *World Economic Outlook*, International Monetary Fund, October 2008.

World trade and UK export markets

World trade

A.27 World trade growth has been very strong since 2005, averaging almost 8 per cent a year, with the largest contributions coming from emerging economies in Central and Eastern Europe, and in Asia. World trade growth is set to slow substantially, in line with slower world GDP growth. The slowing could be exacerbated in the near term by the global financial crisis, with anecdotal evidence that the system of trade finance through letters of credit has been disrupted. The slowdown is expected to be broad-based across all regions of the world. As world output growth picks up from late 2009, world trade flows are expected to respond, with growth approaching historical averages by 2011.

UK export markets

A.28 UK export markets growth is forecast to slow more sharply than world trade growth, given the greater weight of advanced economies in the UK's export markets. UK export markets are forecast to grow by 3¾ per cent in 2008 and just ½ a per cent in 2009, a large downward revision of almost 6 percentage points compared with the Budget 2008 forecast. The recent strong import demand from Europe is not expected to continue in 2009, while recession in the US is also likely to reduce demand for UK exports. In 2010, UK export markets are expected to rebound in line with the recovery of domestic demand in Europe and the US described above.

THE UK ECONOMIC FORECAST

The Treasury's approach to economic forecasting

A.29 Economic forecasting inevitably involves judgement about the uncertain path of future events. The following paragraphs set out the Treasury's general approach to economic forecasting. Given the nature of the global financial market shock that has broadened and intensified since Budget 2008, and the scale of the global macroeconomic and financial policy response, the judgements and assumptions on which the 2008 Pre-Budget Report forecast are based are subject to exceptional uncertainty.

Growth cycle approach

A.30 The Treasury's approach to forecasting macroeconomic developments, set out in detail in Budget 2007,[4] accords with the growth cycle approach favoured by many policymakers. The essential building blocks of this approach are estimates of the 'trend' level and rate of growth of output, and analysis of cyclical movements around that trend, the 'output gap'.[5] The trend output projection provides the medium-term anchor for the forecast. The current output gap estimate, and an assessment of the economy's momentum based on analysis of individual output, income and expenditure components of activity, informs judgement on the path of the economy back towards trend.

Implications of global shocks for the Treasury's approach to forecasting

A.31 The growth cycle approach is normally underpinned by a view that markets function properly, allowing resources to be reallocated to new activities in line with changing price signals. The implications of the severe disruption in global financial markets for the efficient allocation of credit are clearly negative. While this process of credit allocation is impaired, economic forecasts are subject to additional uncertainties relating to the speed and extent to which the economy can adjust to changing circumstances. The longer this impairment persists, the greater the risk that the period of adjustment could have permanent effects. This generates uncertainties over the impact on the economy's supply potential. The growth cycle approach has provided the framework within which the Treasury's forecast judgements on this issue, set out below, have been made.

[4] See paragraphs B.30 to B.35 of Budget 2007.

[5] The Treasury assesses trend output growth on the basis of non-oil gross value added (GVA) rather than overall GDP because, while the oil and gas sector affects output, it has little direct impact on capacity pressures in the rest of the economy, and hence the sustainable level of non-oil economic activity and employment.

Treatment of uncertainty in the forecast

A.32 The Treasury has typically adopted two approaches to treating uncertainties in economic forecasts. Firstly, the average absolute forecast errors from past forecasts are always presented alongside the latest forecasts, as in Table A9 in this annex. Secondly, uncertainties relating to the world economy and financial markets, the balance of demand and supply, individual components of demand and policy developments are discussed in the text on economic developments and prospects. Discussion of risks and uncertainties has been increasingly prominent since the financial market shock hit prior to the 2007 Pre-Budget Report, and is a feature throughout this annex.

A.33 There are alternative approaches to treating uncertainty in economic forecasts. In the context of the role of the Treasury's forecasts in underpinning fiscal projections, the Treasury has considered these alternatives and, as set out in Box A3, has concluded that bolstering its existing approach is the most appropriate method of presenting the exceptional uncertainties surrounding the outlook set out in this Pre-Budget Report. For the purpose of this Pre-Budget Report, the Treasury has maintained its usual forecast ranges, which represent alternative assumptions about the supply-side performance of the economy, not forecast uncertainties. The external forecasts reviewed at the end of this annex give a sense of the magnitude of current forecast uncertainties.

Box A3: How to reflect uncertainty in economic forecasts

There are many approaches to communicating the uncertainty inherent in economic forecasts. The Treasury typically publishes information on past forecast errors, as in Table A9, and a full discussion of the risks to the economic forecast in each Budget and Pre-Budget Report. Some external organisations illustrate forecast uncertainty using different methods, often assigning specific values to the probability of GDP growth being above or below a certain rate. These probabilities can be formulated in a number of ways:

- past forecast error distributions can be projected into the future to produce a range of possible outcomes around the central forecast;
- simulations from econometric models can be used to gauge the probability of certain outcomes;[a]
- they can purely reflect the subjective judgement of the forecaster; or
- they can represent some combination of these approaches.

The Bank of England's fan charts provide an example of the combined approach. The calibration of uncertainty is based on forecast errors over the preceding 10 years, adjusted to reflect the Monetary Policy Committee's collective judgement about the risks to the forecast.[b]

Past forecast errors are typically used to generate probability distributions around forecasts on the grounds that the errors summarise the risks inherent in the forecasting model as well as the effects of past economic shocks. However, there are significant limitations to a purely statistical approach in the context of economic forecasts, and especially so in the context of fiscal forecasts and judgements:

- frequency distributions and models based on past experience will fail to account properly for rare, high impact events: future shocks cannot, by definition, be forecast, and those that are rare or unprecedented imply a hidden randomness not apparent in past data;
- as the structure of the economy changes over time, models run the risk of centring forecasts on an outdated view of the economy's underlying structure; and
- the results depend heavily on the subjective choice of the central forecast, meaning that forecasting judgements remain a key source of uncertainty.

For the 2008 Pre-Budget Report, the Treasury has chosen to bolster the discussion of the risks surrounding forecasting judgements and economic prospects. Despite differing approaches, this expanded discussion reflects the same factors that have driven most forecasters to widen the range of expected possible outcomes over recent months. For example, in the Bank of England's November *Inflation Report*, the fan charts were widened and the MPC noted that *"the heightened level of uncertainty means that the Committee has more confidence in the broad shapes of the fan charts than the precise calibrations."*[c]

[a] For example, see 'Prospects for the UK economy', Kirby, S., Barrell, R., Fic, T. and Oraganzi A., *National Institute Economic Review No.206*, October 2008.

[b] See 'The Inflation Report projections: Understanding the fan chart', Britton, E., Fisher, P. and Whitley, J., Bank of England Quarterly Bulletin, February 1998, for a detailed explanation of the MPC's fan charts.

[c] *Inflation Report*, Bank of England, November 2008.

Overview of recent developments

Credit conditions

A.34 The prospective impact of the global credit shock on the credit conditions facing households and companies was the key forecasting assumption underpinning the Budget 2008 economic forecast. With evidence that the intensity and duration of the negative impact would be greater than assumed at the time of the 2007 Pre-Budget Report, the Budget 2008 forecast was conditioned on an updated forecasting assumption that credit conditions would remain strained through the first half of 2008, would start easing during the second half and would only normalise by mid-2009. That assumption was viewed as consistent with progressively greater information disclosure by the world's financial institutions helping the price discovery process in the credit markets that were then strained. This key assumption was subject to great uncertainty and was therefore set out transparently to ensure that as events continued to unfold it would be clear whether the assumption was proving valid.

A.35 There is no single measure that captures the evolution of the global credit shock and its implications for credit conditions facing households and companies, but one commonly used indicator is the spread of interbank lending rates over market expectations of policy interest rates.[6] Since the disruption in global financial markets was triggered in July 2007, this indicator, shown in Chart A3, has provided an illustration of the varying degrees of stress in money markets and the banking system.

A.36 At the time of Budget 2008, the sterling spread stood at around 60 basis points,[7] so a path consistent with the Budget forecasting assumption on credit conditions would have seen the spread hold at around that level until mid-2008 before easing slowly to closer to its historical average by mid-2009, though remaining above the levels of early 2007. The events described in Box A1 quickly overtook the Budget assumption. In particular, after the rescue of Bear Stearns in March, strains in money markets intensified and the spread increased to more than 100 basis points. Then, having stabilised at around 70 to 80 basis points between May and mid-September, the spread increased very sharply after the failure of Lehman Brothers in September, reflecting more generalised systemic distress.

A.37 Following the Government's announced measures of support for the banking system in October, and November's 1½ percentage point cut in Bank Rate, sterling interbank lending rates have fallen by more than 2 percentage points. However, the spread over expected policy rates has remained high as investors have marked down their policy rate expectations on the back of downgraded assessments of prospects for growth and inflation in the UK.

GDP growth

A.38 In 2006 and 2007, GDP grew by 2¾ and 3 per cent respectively. Reflecting the impact on the economy of the major shocks it has faced, growth has slowed progressively as credit conditions tightened and real incomes were squeezed by high commodity prices. Quarterly GDP growth in the first half of 2007 averaged 0.8 per cent, before slowing progressively to average 0.6 per cent in the second half and 0.1 per cent in the first half of 2008. In the third quarter, GDP contracted by 0.5 per cent, the first fall in output since 1992, with negative growth across most sectors of the economy. The distribution sector experienced the largest contraction, consistent with discretionary spending having been held back as consumer sentiment weakened and real incomes were squeezed.

[6] This indicator is typically proxied by the spread between the 3-month London interbank offered rate (LIBOR) and the 3-month overnight index swap (OIS) rate, where the rate on an overnight index swap reflects the market's expectation of what overnight interest rates will average over the period of the contract.

[7] A basis point is equal to 0.01 percentage points.

A.39 Private sector business surveys weakened further in October, suggesting that output in the final quarter of 2008 is likely to fall again, placing the UK economy in technical recession. Surveys of purchasing managers compiled by the Chartered Institute of Purchasing and Supply indicate that output growth in the manufacturing, construction and services sectors was very weak. Similarly, the Economic Sentiment Indicator compiled by the European Commission fell to its lowest level since 1991.

Labour market developments

A.40 Strong output growth in 2007 fed through to strong employment growth, with employment rising by more than 100,000 a quarter from the second quarter of 2007 to the first quarter of 2008. As output growth has slowed, employment flattened in the second quarter and fell by around 100,000 in the third quarter.

A.41 Unemployment has begun to increase, with the Labour Force Survey (LFS) measure of the unemployment rate rising from 5¼ per cent to 5¾ per cent over recent months. The more timely claimant count measure has risen by 186,000 since the start of the year, though from a very low level: January 2008 was the first time since mid-1975 that the claimant count had fallen below 800,000.

Inflation

A.42 In common with experience across the world, UK inflation increased during 2008 as the surge in global commodity prices fed through to retail prices of food, petrol and diesel, and household energy bills. In the UK, CPI inflation increased from 2.2 per cent in December 2007 to a peak of 5.2 per cent by September 2008 before falling back to 4.5 per cent in October. Movements in prices of goods that are most closely linked to global commodity prices accounted for virtually all of the increase: food price inflation increased from 6 per cent in December to a peak of 14½ per cent in August; petrol and diesel price inflation increased from 17 per cent to a peak of 26 per cent in July; and household energy price inflation increased from -7 per cent to 39 per cent in October.

A.43 With commodity prices having fallen sharply since the summer, petrol and diesel prices have already declined by 12 per cent and food price inflation appears to have passed its peak. The effects of lower house prices and Bank Rate cuts have pushed RPI inflation below CPI inflation for the first time in six years.[8]

A.44 As sterling has depreciated significantly over the past year, import prices have been a source of inflationary pressure, with imported goods price inflation rising from 6½ per cent in December 2007 to 14 per cent in September 2008. Producer price inflation followed a similar pattern through the year. Input price inflation increased from around 13 per cent in December to a peak of 34 per cent in June before easing significantly to 14 per cent by October. Output price inflation picked up from less than 5 per cent to 10 per cent in July and currently stands at 7 per cent.

A.45 Much of the rise in inflation has been accounted for by frequently purchased items, and survey measures of shorter-term inflation expectations have unsurprisingly tended to move up in step with actual inflation. It is too soon to be sure whether falls in petrol prices and the easing of food price inflation will fully reverse the rise in short-term inflation expectations, but the latest monthly surveys from GfK and YouGov/Citigroup have been encouraging. The latter reported inflation expectations over the coming year falling from 4.4 per cent in the September survey to 2.9 per cent the following month. Survey measures of firms' pricing intentions have also receded.

[8] The RPI measure of retail prices includes categories for housing costs and mortgage interest payments that are not included in the CPI measure of consumer prices. These are not, though, the only differences between the CPI and RPI measures of inflation. More information on CPI and RPI can be found on the UK Statistics Authority website, www.statistics.gov.uk

Property markets **A.46** Property markets in the UK have been adversely affected by the global credit shock, which has sharply curtailed the availability of finance for residential and commercial property purchases. These adverse effects have been broadly based, with house prices lower since the beginning of 2008 across all regions of the UK and commercial property prices down sharply across the commercial, retail and industrial sectors.

Monetary policy **A.47** Since the onset of the global credit shock in summer 2007, the Monetary Policy Committee (MPC) of the Bank of England has cut Bank Rate by a cumulative 2¾ percentage points, from 5¾ per cent to 3 per cent. On 8 October, the MPC cut rates by ½ a percentage point as part of a globally coordinated interest rate cut, and then on 6 November it reduced Bank Rate by a further 1½ percentage points to 3 per cent, the lowest rate since 1955. With inflationary pressures easing and weaker near-term UK growth prospects, financial markets have increasingly come to expect further monetary policy easing. This trend has been evidenced by the lowering of external forecasters' expectations of Bank Rate by the middle of 2009 to below 2 per cent.

Sterling **A.48** The combination of financial sector fragility and increasing risk premia demanded on sterling assets, UK growth prospects being revised down and expectations of substantial further monetary policy easing over the coming year has been associated with significant depreciation of sterling. Overall, the sterling exchange rate index has declined by over 20 per cent since its peak in the summer of 2007 and by around 11 per cent since the beginning of August 2008. The Government's objective is for a stable and competitive exchange rate in the medium term, consistent with meeting the inflation target.

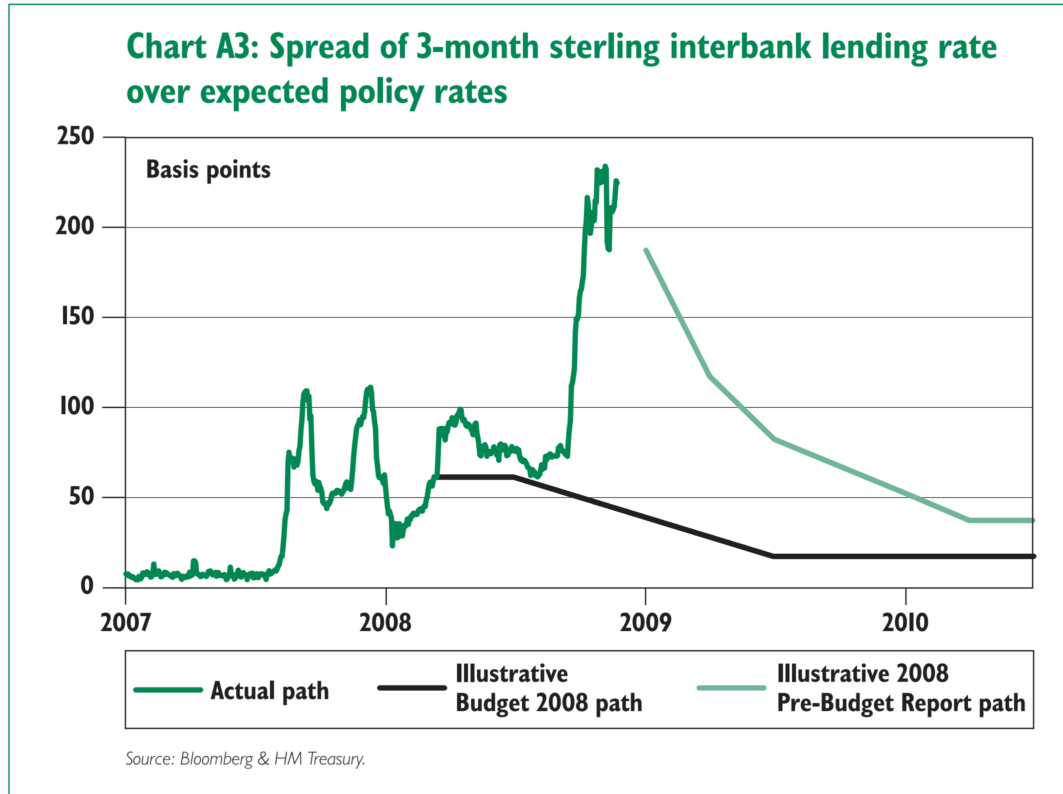
Prospects for credit conditions

Forecasting judgement **A.49** As was the case at Budget 2008, the key forecasting assumption underpinning the 2008 Pre-Budget Report forecast concerns prospects for the unwinding of tight credit conditions and normalisation of banking and financial markets. As set out above, conditions in global markets deteriorated dramatically in September and October. Following unprecedented global policy action in recent weeks, money markets have stabilised and the risk of systemic failure of the global financial system looks to have receded, but global credit markets have remained severely strained with stock markets falling sharply and some markets remaining closed.

A.50 Despite extensive government support for financial systems worldwide, it will take time for conditions to normalise, and recent experience is likely to mean that 'normal' credit conditions will be materially less accommodative than they were in the years to mid-2007. The 2008 Pre-Budget Report forecast is therefore conditioned on the assumption that credit conditions will remain tight in 2008, and ease slowly through 2009 before stabilising in 2010 at a level where risk is more appropriately priced. This assumption is consistent with a view that the value of underlying property collateral will have stopped falling around the end of 2009 and that lower policy interest rates and funding costs will enable banks to lend profitably, bolstering their capital positions. These developments should allow lenders to return to a normal process of intermediating funds from savers to borrowers, while pricing risk competitively, but more warily, so as to avoid the mistakes of recent years. The Government's comprehensive package of measures to support the banking system should limit the downside risks to this assumption, enhancing prospects for credit conditions to ease over the coming year.

A.51 Chart A3 shows the actual spread between interbank lending rates and expected policy rates against illustrative paths representing the 2008 Budget and Pre-Budget Report forecast assumptions for credit conditions more broadly. However, the interbank spread only picks up the price dimension of factors influencing credit conditions faced by households and companies: it does not capture the important quantity effects of credit rationing.

Chart A3: Spread of 3-month sterling interbank lending rate over expected policy rates



Source: Bloomberg & HM Treasury.

Assessment of trend growth

A.52 This section first reviews recent developments against the Treasury's Budget 2008 trend growth assumptions, before discussing the 2008 Pre-Budget Report forecast judgements on trend output to reflect the impact of the global credit shock.

National Accounts revisions

A.53 Looking back, the 2008 Blue Book revisions to National Accounts data imply a somewhat stronger trend rate of output growth between the on-trend points in 1997 and 2001 than was set out at the time of Budget 2008, reflecting upward revisions to non-oil GVA growth over the period. The Blue Book data confirm that trend output growth between the on-trend points in 2001 and 2006 was 2.7 per cent a year, validating the Treasury's 2¾ per cent a year assumption for the period, which has been maintained since it was first set out in Budget 2002.

Population growth

A.54 Latest ONS estimates indicate that net inward migration increased to 237,000 in 2007, somewhat above the projection set out by the Treasury at the time of the 2006 Pre-Budget Report. More recently, there have been signs of a slowdown in net migration from the new EU Member States. In particular, the number of National Insurance applications from A8 and A2 citizens[9] has levelled off since the final quarter of 2007 and the number of approved applications to the Worker Registration Scheme has declined since mid-2007. Set against these trends, data on the number of visits to the UK by A8 nationals picked up in the first half of 2008.

Labour market

A.55 As set out in Budget 2008, the projected change in the age structure of the adult population means that, on an adult population basis, the trend employment rate is projected to decline slightly over the forecast horizon. The adult employment rate picked up during the first half of 2008 to just over 60¼ per cent, before subsequently falling back slightly in the third quarter to close to its estimated trend level, consistent with the expected lagged response of the labour market to changes in output growth.

A.56 The fall in average hours worked since the start of 2008 implies that they are currently close to their estimated trend level, assuming a trend rate of decline of a ¼ per cent a year post 2006, in line with the trend over the second half of the economic cycle that ended in 2006.

Productivity growth

A.57 Revisions in the 2008 Blue Book suggest that productivity grew by just over 2 per cent a year between the on-trend points in 2001 and 2006, slightly below the Budget 2008 estimated trend rate. Average productivity growth subsequently slowed from the second half of 2006 as total hours continued to grow at above-trend rates. As set out in Box A4, the global credit shock has significantly increased the uncertainties surrounding trend productivity and it is therefore difficult to assess to what extent lower rates of productivity growth over the course of 2007 and 2008 are likely to reflect cyclical or structural developments. Challenges in decomposing recent developments into cyclical and structural elements are likely to persist for some time.

[9] The 'A8' refers to the eight Central and Eastern European countries – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia – that joined the EU in May 2004 alongside Cyprus and Malta, whose citizens already had the right to work in the UK. The 'A2' refers to Bulgaria and Romania, which joined the EU in January 2007.

Box A4: Economic shocks and potential output

As with other aspects of economic forecasting, recent economic shocks, in particular the global financial crisis, have generated uncertainties over prospects for trend output,[a] the assessment of which plays a central role in the Treasury's approach to forecasting. Theoretically, credit or commodity price shocks could affect trend output in a number of ways.

The global credit shock is likely to increase the price of credit, thereby raising the cost of capital, which would lead to a downward adjustment in the stock of capital in the economy and so to a lower level of trend output. To the extent that the pricing of risk was unsustainably low before the onset of the credit shock, this effect could be persistent. More generally, the shock is likely to reduce the supply of credit, by impairing the pivotal role that the financial system plays in intermediating funds from savers to investors and spreading concentrations of risk. This reduces the efficiency of the process by which producers bring together 'factor inputs' – labour, capital, raw materials, energy – to their most productive use, with a subsequent impact on the level of trend output.

Developments in commodity markets could also have implications for trend output. The shock to commodity prices has reversed significantly since the first half of 2008, but the price of oil has in general trended upwards over the past few years and remains high by historical standards. To the extent that this is reflected in higher costs of inputs of production rendering certain activities uneconomic, trend output would be affected as the capital stock adjusts to a lower equilibrium.

Further uncertainties surround the prospects for trend population growth. Aggregate net migration in 2007 was somewhat higher than the projection set out by the Treasury at the time of the 2006 Pre-Budget Report.[b] Looking forward, a slowdown in economic activity could be associated with weaker net migration over the next few years, although it is not clear whether any prospective reduction would be indicative of cyclical or more structural factors.

[a] A number of commentators and policymakers have highlighted the implications of the credit shock for potential output. For example, in a recent speech, the Governor of the Bank of England noted "...the credit crunch affects not just demand but also the supply potential of the economy" (Speech by the Governor of the Bank of England to the Confederation of British Industry, Institute of Directors, Leeds Chamber of Commerce and Yorkshire Forward, 21 October 2008). Similarly, former member of the MPC, Willem Buiter, suggested in a recent article that "...credit conditions can influence potential supply even in the short run" (Financial Times, 19 October 2008).

[b] *Trend growth: recent developments and prospects*, HM Treasury, December 2006.

2008 Pre-Budget Report projection

A.58 As set out in Box A4, there are a number of channels through which the global credit and commodity price shocks could reduce the level of trend output. In light of commodity price developments since July 2008, credit related channels are the most likely to have persistent effects to trend output. Table A2 presents estimates of trend output growth and its decomposition to the second half of 2006, and the Treasury's projections thereafter. For the 2008 Pre-Budget Report, to take account of the likely negative effect of the credit shock on trend output, a phased reduction to the trend level of productivity (and therefore the trend level of output) of about 4 per cent has been assumed over the two years from mid-2007, a period consistent with the credit conditions assumption that underpins the economic forecast more generally. This adjustment is within the range of external estimates of the impact of the shocks to credit and energy markets on medium-term potential output,[10] though it is a key forecasting judgement around which there is very considerable uncertainty. The Treasury will continue to keep its trend output assumptions under review.

[10] External estimates of the impact of the credit and commodity price shocks on the level of trend output range from 2 per cent up to around 6 per cent, depending on the assumptions used. See, for example, *The budgetary implications of global shocks to cycles and trends in output: impacts of housing, financial and oil shocks*, Barrell, R. and Kirby, S., October 2008; *The implications of supply-side uncertainties for economic policy*, OECD Economic Outlook No.83, June 2008; and, *Economic Forecast*, European Commission, Autumn 2008.

Table A2: Contributions to trend output growth[1,2]

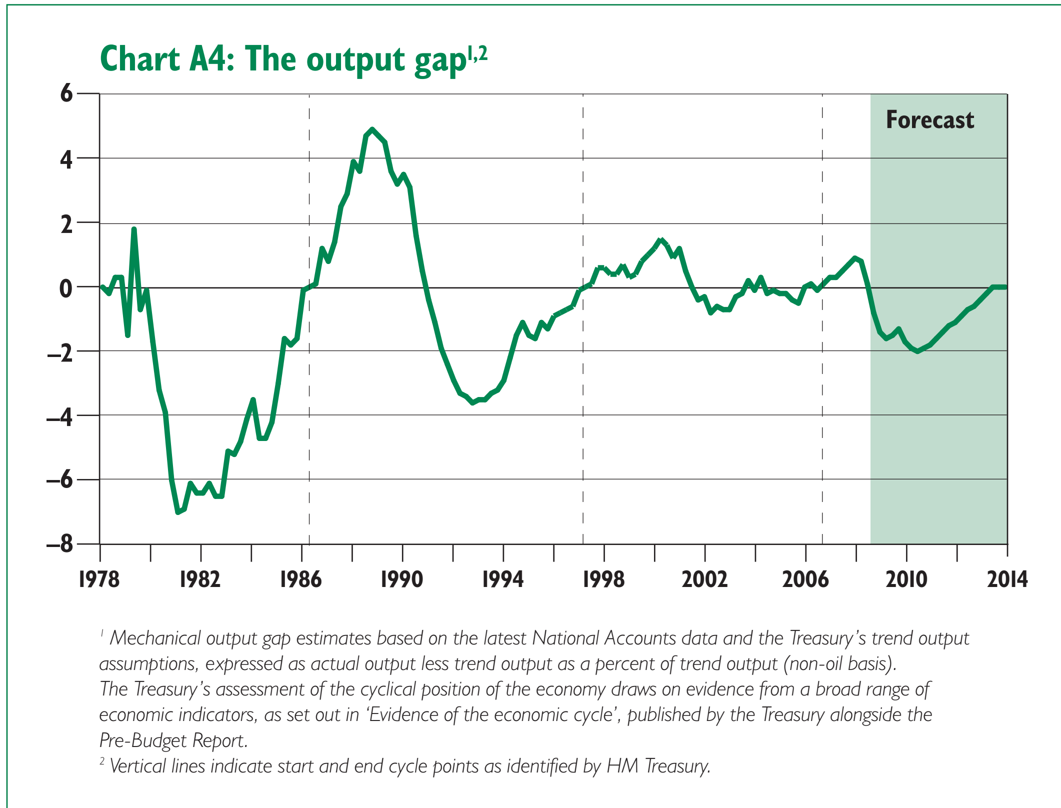
	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[3,4]		Trend average hours worked[4]	Trend employment rate[4]	Population[5]	**Trend output**
	Underlying (1)	Unadjusted (2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1						
Budget 2008	2.12	1.93	–0.11	0.37	0.26	**2.46**
Latest data	2.13	1.95	–0.11	0.36	0.26	**2.47**
Over the recent past						
1997H1 to 2001Q3						
Budget 2008	2.86	2.61	–0.45	0.49	0.51	**3.17**
Latest data	3.12	2.87	–0.46	0.50	0.52	**3.45**
2001Q3 to 2006H2						
Budget 2008	2.26	2.21	–0.31	0.09	0.75	**2.76**
Latest data	2.12	2.07	–0.26	0.11	0.75	**2.68**
Projection[6]						
2006H2 onwards						
Budget 2008	2.25	2.30	–0.25	–0.1	0.8	**2¾**
PBR 2008[7]	2.25	2.30	–0.25	–0.1	0.8	**2¾**
PBR 2008 level effect from 2007Q3 to 2009Q3[8]	*–4*	*–4*	*0*	*0*	*0*	***–4***

[1] Treasury analysis based on judgement that 1986Q2, 1997H1, 2001Q3 and 2006H2 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward.
Full data definitions and sources are set out in Annex A of 'Trend growth: new evidence and prospects', HM Treasury, December 2006.
[2] Interim projections between Budget 2002 and PBR 2007 were provided in an expanded table in 'Budget 2008: the economy and public finances – supplementary material'.
[3] The underlying trend rate is the unadjusted trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant. Column (1) = column (2) + (1-a).column (4), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.
[4] The decomposition makes allowances for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that average hours worked lag output by just one quarter, though this lag is harder to support by econometric evidence.
[5] UK resident household basis. Population aged 16 and over.
[6] Neutral case assumptions for trend from 2006H2.
[7] Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006H2 are anchored.
[8] Adjustment reflecting a phased reduction to the level of trend output of around 4 per cent between mid-2007 and mid-2009.

Assessment of the output gap

National Accounts revisions and latest data

A.59 The 2008 Blue Book revisions to recent National Accounts data were relatively small, with non-oil GVA growth in both 2006 and 2007, of 3 per cent, still estimated to have been at an above-trend rate. Since the beginning of 2008, growth has slowed to below-trend rates of 0.3 per cent and 0.0 per cent in the first two quarters of the year, before falling to -0.5 per cent in the third quarter. Taken together with the 2008 Pre-Budget Report assumptions on trend output, this would imply that the economy was recently operating close to trend, with an output gap of around zero in the third quarter of 2008.



[1] Mechanical output gap estimates based on the latest National Accounts data and the Treasury's trend output assumptions, expressed as actual output less trend output as a percent of trend output (non-oil basis). The Treasury's assessment of the cyclical position of the economy draws on evidence from a broad range of economic indicators, as set out in 'Evidence of the economic cycle', published by the Treasury alongside the Pre-Budget Report.
[2] Vertical lines indicate start and end cycle points as identified by HM Treasury.

Evidence from the cyclical indicators

A.60 Evidence from the broad range of cyclical indicators monitored by the Treasury continues to support the Budget 2008 assessment that the economy passed up through trend during the second half of 2006, marking the end of the economic cycle judged to have started in the first half of 1997, as set out in Box A5. The cyclical indicators suggest the economy remained above trend during 2007 before falling back towards trend during the first half of 2008.

A.61 Evidence from quarterly business surveys conducted by the Confederation of British Industry (CBI) and British Chambers of Commerce (BCC) suggests that capacity utilisation rates have recently been at levels near to or below their long-term averages, and that a degree of labour market slack opened up in 2008. The Bank of England's Regional Agents have reported significant declines from above-average capacity utilisation rates since late 2007, and that since the second half of 2007 labour market conditions have eased more swiftly than shown in the BCC survey.

A.62 The unemployment rate has increased from 5¼ per cent at the end of 2007 to 5¾ per cent. Demand for labour has dropped, with the number of vacancies in the economy declining from the peak in March 2008. Average earnings growth has remained stable and subdued, with private sector earnings growth in the third quarter, excluding bonuses, of 3½ per cent on a year earlier.

Uncertainty relating to the economy's cyclical position

A.63 As set out above, the Treasury's forecasting judgements on the impact of the credit shock on trend output are subject to significant uncertainty. This has implications for assessing the balance between cyclical demand and potential supply, and hence prospective inflationary pressures and the labour market implications of the economic downturn. In terms of cyclical pressures, signals conveyed by the Bank's Regional Agents and the BCC and CBI quarterly business surveys do not deliver a clear picture of the degree of slack that has been generated by slowing growth over the past year. The evidence from the cyclical indicators is in general supportive of the assessment that the economy was recently operating close to trend, but clear uncertainties remain.

Box A5: Treasury judgement on the end of the economic cycle

Since Budget 2008, Blue Book revisions to National Accounts data show below-trend non-oil GVA growth of 0.4 per cent in the third quarter of 2006 and above-trend growth of 0.9 per cent in the fourth quarter. This, alongside evidence from a broad range of cyclical indicators suggesting that the economy was close to trend during the second half of the year, but not unambiguously discriminating between the third and fourth quarters of 2006 as on-trend points, suggests the economy passed up through trend during the second half of 2006.

The latest evidence from the cyclical indicators continues to suggest that the economy moved up through trend during the second half of 2006 and that the economy subsequently remained above trend during 2007. In particular:

- private sector business surveys of capacity utilisation picked up during the second half of 2006 to levels close to or above their long-term averages, and in a number of cases had moved to levels seen at the last point when the economy clearly moved upwards through trend in the first half of 1997;
- labour market data, supported by evidence from private sector business surveys, suggest that the slack in the labour market evident towards the end of 2006 diminished over subsequent quarters, which, taking into account the lags between output and the labour market, is consistent with output moving upwards through trend at some point during the second half of 2006; and
- annual CPI inflation excluding energy and seasonal food, a proxy for domestically generated inflation, increased steadily from 1.3 per cent in the second quarter of 2006 to 2.2 per cent a year later, although official earnings growth remained relatively subdued over the period.

Taken together with the latest National Accounts data, the evidence from the range of cyclical indicators supports the assessment that the economic cycle judged to have started in the first half of 1997 ended during the second half of 2006.[a] Uncertainties continue to surround this assessment, in particular those relating to further possible revisions to National Accounts data. As set out in Chapter 2, the National Audit Office has audited the Treasury's judgement that the last economic cycle ended in the second half of 2006.

[a] More details of the Treasury's assessment of the economic cycle are set out in *Evidence on the economic cycle*, published alongside the Pre-Budget Report.

GDP and inflation forecasts

Factors underpinning demand prospects

A.64 Lower commodity prices and easing inflation are set to support real incomes in 2009, sterling has depreciated, and monetary and fiscal policy have both been eased to support the economy through the downturn. Together these factors lay the foundations for recovery. Uncertainty remains over how effectively the global financial crisis can be resolved and therefore how soon the financial system can resume its normal function of intermediating funds from savers to borrowers, in order efficiently to finance investment, house purchase and consumption and spread concentrations of risk.

GDP growth

A.65 Having slowed progressively over the past year, GDP is forecast to fall by a ¼ per cent on a year earlier in the second half of 2008, leaving output in 2008 as a whole up ¾ per cent on a year earlier. The recession is forecast to continue into the first half of 2009, before GDP growth begins to recover in the second half of the year as credit conditions start to ease and the boost to real incomes from lower commodity prices, the stimulus from monetary and fiscal policy, and the effects of sterling's deprecation, take hold.

A.66 Growth in 2009 as a whole is forecast to be negative, at –1¼ to –¾ per cent. The effect of fiscal stimulus, particularly the temporary cut in the VAT rate and bringing forward of public investment to 2008-09 and 2009-10, in addition to other measures, is assumed to reduce the extent of the downturn by around ½ a percentage point. The UK also has relatively powerful automatic stabilisers, which will operate in full to support the economy. In response to rising unemployment, as set out in Chapter 5 of this Pre-Budget Report, the Government has announced an ambitious package of measures to ensure that those facing redundancy and those seeking employment are helped back into work as quickly and efficiently as possible.

A.67 Credit conditions are assumed to settle at a new norm in 2010, such that the process of efficient credit allocation is restored and the UK's flexible markets can adjust more effectively to changed economic circumstances. As lagged effects feed through, including from fiscal and monetary stimulus and from the depreciation of sterling, growth is expected to pick up progressively through 2010 and 2011 to a little above trend rates. Experience of past recoveries points to the possibility that, once recovery has taken hold, growth could continue at strong rates for a number of years as spare capacity is brought back into productive use. For example, GDP growth averaged 3¼ per cent a year in the five years from 1982 and again in the five years from 1993.

Table A3: Summary of forecast[1]

		Forecast			
	2007	2008	2009	2010	2011
GDP growth (per cent)	3	¾	–1¼ to –¾	1½ to 2	2¾ to 3¼
CPI inflation (per cent, Q4)	2	3¾	½	2¼	2

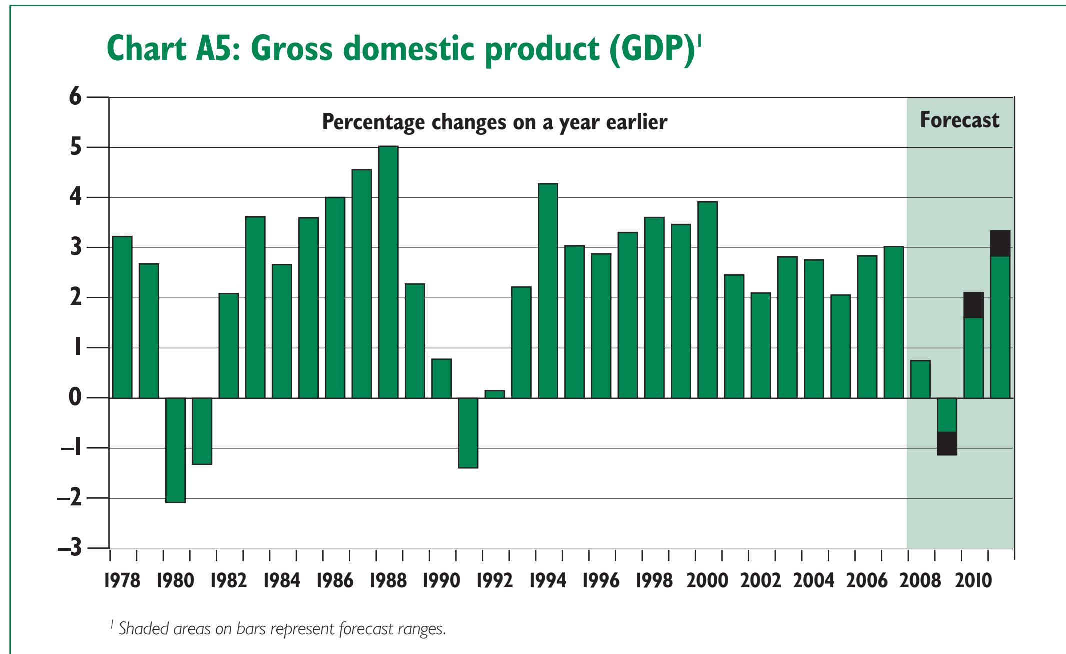
[1] *See footnote to Table A9 for explanation of forecast ranges.*

Comparison with past recessions

A.68 With GDP forecast to contract in 2009, it is natural to compare the coming downturn with past periods of falling output. While there are similarities in the prospects for growth, the current contraction is different in origin, which should have implications for the subsequent recovery. The late 1970s oil price shock, and the late 1980s overheating domestic economy, generated high inflation, which reached 20 per cent in 1980 and 10 per cent in 1990. High retail price inflation quickly fed through to high wage inflation because inflation expectations were poorly anchored. In order to bring inflation under control, interest rates were raised sharply, peaking at 17 per cent in 1980 and 15 per cent in 1990, while in 1981 fiscal policy was tightened significantly. The ensuing recessions were, in that respect, domestically generated. In early 2007, the economy was operating close to trend, inflation was close to target and interest rates were below 6 per cent.[11]

A.69 The trigger for this downturn was the unprecedented confluence of the severe shock to the global financial system and record high commodity prices, with oil prices doubling in the year to July 2008. One of these factors, high commodity prices, has already reversed, while global policy action, in many aspects modelled on the UK Government's response described in Chapter 3, has reduced the downside risks from the global financial crisis, although strains in the financial system remain severe.

[11] At the November Inflation Report press conference, the Governor of the Bank of England noted that "One of the big differences between then [the early 1980s and early 1990s] and now – between those recessions and now – is that because inflation has been kept under control and we have a monetary policy framework which I think is credible, that it is possible to take quick and substantial action on interest rates in order to ameliorate the effects of a prospective recession and to head off the worst outcomes. That wasn't always possible in the past because of concerns about inflation. It is now."



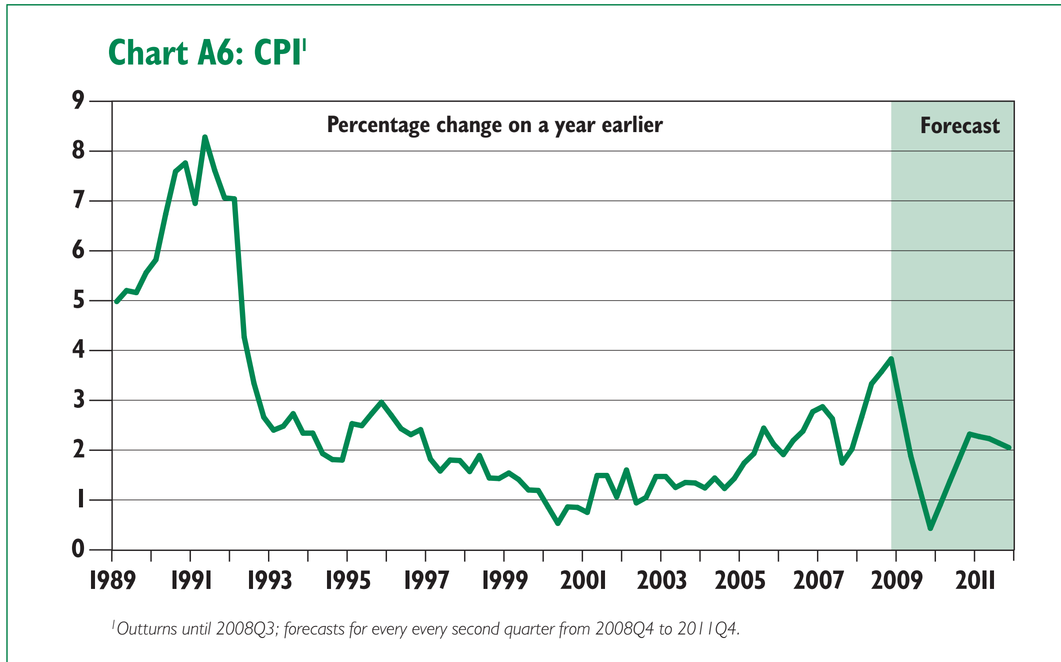
CPI inflation

A.70 CPI inflation fell from 5.2 per cent in September to 4.5 per cent in October, suggesting September marked the peak. Global commodity prices have fallen sharply since the summer, which should feed through to consumer prices for petrol, food and household energy with varying lags. Energy prices contributed more than 2 percentage points to CPI inflation in September 2008, which means that even if energy prices were to remain unchanged from that level, by September 2009 they would subtract around 1 percentage point from the annual rate of inflation.[12] In addition, with output contracting there is a degree of spare capacity opening up that will progressively reduce domestically generated inflationary pressure.

A.71 Commodity price developments and the emergence of a negative output gap would suggest that inflation will decline rapidly from above 5 per cent to reach the target rate by the middle of 2009, although the pass-through from sterling's depreciation will exert upward pressure. In addition, the temporary reduction of the VAT rate from 17½ per cent to 15 per cent from December 2008 is expected to put further downward pressure on inflation as businesses pass the cut through to prices. The forecast assumes that due to the competitive nature of the UK retail sector, especially during the coming downturn, the majority of the VAT rate cut will be passed through to consumer prices, but that prices will be reduced progressively rather than immediately. This is in line with international evidence. As a result, these factors mean that CPI inflation is forecast to fall below 1 per cent in the second half of 2009.

A.72 Unlike the initial cut in the VAT rate, the subsequent pre-announced increase back to 17½ per cent will be anticipated by businesses and consumers, so the forecast assumes that businesses will smooth the pass-through of this change during the normal process of reviewing prices as other costs and demand factors evolve. Inflation is forecast to move a little above the 2 per cent inflation target following the reversal of the VAT rate cut and as the lagged effects of sterling depreciation on import prices continue to feed through, before returning to target in 2011 as the still negative output gap exerts downward pressure.

[12] The negative contribution from flat energy prices through to September 2009 would be less than the positive contribution in September 2008 partly because some of that contribution reflects a base effect from falling energy prices in September 2007.



[1] Outturns until 2008Q3; forecasts for every every second quarter from 2008Q4 to 2011Q4.

RPI inflation

A.73 RPI inflation is forecast to fall below zero in 2009. In addition to the factors pushing CPI inflation lower, further declines in house prices and interest rates, in line with market expectations, put downward pressure on the measures of housing depreciation and mortgage interest payments included in the RPI. As a result, RPI inflation is forecast to fall below -2 per cent in the third quarter of 2009. This period of negative RPI inflation is expected to be relatively brief, with RPI inflation moving above zero again in 2010 as these additional downward pressures recede.

UK DEMAND AND OUTPUT IN DETAIL

Rebalancing of demand

A.74 Private consumption accounts for around two-thirds of UK demand. Since 2000, it has contributed around 2 percentage points to the annual average GDP growth rate of 2¾ per cent. The contribution of business investment to growth in the early part of the decade was low, but between 2005 and 2007 it increased substantially, reaching 1 percentage point in 2007. Housing investment contributed on average a ¼ percentage point to GDP growth, a somewhat smaller contribution than business investment. With government spending also contributing positively on average, the contribution of domestic demand growth averaged 3 percentage points a year with net exports subtracting a ¼ percentage point on average.

A.75 In 2007 and the first half of 2008, private consumption remained the key driver of growth. With private domestic demand expected to contract in the near term as tight credit conditions, demand uncertainty and other factors impinge, and with sterling having depreciated significantly since mid-2007, the conditions are in place for net exports to contribute positively to growth over the forecast period even as private domestic demand growth recovers.

Table A4: Contributions[1] to GDP growth[2]

	Percentage points, unless otherwise stated					
	Average		Forecast			
	2000 to 2006	2007	2008	2009	2010	2011
GDP growth, per cent	**2¾**	**3**	**¾**	**–1¼ to –¾**	**1½ to 2**	**2¾ to 3¼**
Main contributions						
Private consumption	2	2	1	–¾	1	1¾
Business investment	¼	1	0	–1	¼	¾
Dwellings investment[3]	¼	¼	–¼	–½	0	¼
Government[4]	¾	½	¾	¾	¼	0
Change in inventories	0	¼	0	–¼	0	0
Net trade	–¼	–¾	0	¾	¼	¼

[1] Based on central case. For the purpose of projecting public finances, forecasts are based on the bottom of the GDP forecast range.
[2] Components may not sum to total due to rounding and omission of transfer costs of land and existing buildings and the statistical discrepancy.
[3] The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.
[4] The sum of government consumption and general government investment.

Households, consumption and housing

A.76 Household consumption is the largest expenditure component of demand in the UK, accounting for just under 64 per cent of nominal GDP in 2007. Having trended lower over the past five years, the share of nominal consumer spending in total demand increased slightly over the year to mid-2008 as energy and food prices rose sharply.

Table A5: Household sector[1] expenditure and income

	Percentage change on a year earlier, unless otherwise stated					
	Average		Forecast			
	2000 to 2006	2007	2008	2009	2010	2011
Household consumption[2]	3	3	1½	–1½ to –1	1¼ to 1¾	2¼ to 2¾
Real household disposable income	2¾	0	–¼	½ to 1	1 to 1½	2¾ to 3¼
Saving ratio[3] (level, per cent)	4¾	2½	¾	2¾	3	3½

[1] Including non-profit institutions serving households.
[2] Chained volume measures.
[3] Total household resources less consumption expenditure as a percent of total resources, where total resources comprise households' disposable income plus the increase in their net equity in pension funds.

Disposable income

A.77 Real household disposable income is estimated to have been flat in 2007, as negative growth in non-wage income, particularly net interest and dividend payments, offset the impact of strong employment growth on total wages and salaries. Sluggish real disposable income growth continued in the first half of 2008, as the commodity-price related pick-up in inflation squeezed real incomes further. With the global price level having increased as a result of commodity price developments, there are likely to be lasting effects on real incomes in the UK and many advanced economies. Adjusting to this changed global environment will require a period of slower growth in the real standard of living and a rebalancing of demand away from real consumption and towards net trade in order to maintain GDP growth rates. As set out in Box A6, the depreciation of sterling provides incentives for that rebalancing to take place over time.

A.78 The effects of lower commodity prices and the temporary cut in the rate of VAT should support real income growth in 2009, which is forecast to pick up to ½ to 1 per cent. As the recovery takes hold from 2010, a strengthening labour market is expected to take over as the main driver of real income growth as inflation returns to close to target and the effects of fiscal stimulus recede.

Consumer spending

A.79 Private consumption grew by 3 per cent in 2007, in line with GDP growth as a whole. Consumer spending continued to grow strongly in the first quarter of 2008 before contracting slightly in the second quarter. The breakdown of consumer spending in the second quarter shows clearly how the global economic shocks impacted UK consumers, with spending on housing and transport-related durable goods falling by around 5 per cent on the previous quarter, while spending on discretionary services like recreation and restaurants was down by around 3 per cent.

A.80 Retail sales growth remained firm in the first half of 2008, but has recently eased. Survey evidence from the Confederation of British Industry, British Retail Consortium and Bank of England's Regional Agents points to further easing during the remainder of the year, a signal that is consistent with real incomes remaining under pressure, credit conditions remaining tight and consumers downbeat about near-term economic prospects.

Saving ratio

A.81 With consumer spending growth having remained strong over the past year and a half despite flat real incomes, the saving ratio has declined from 3½ per cent at the end of 2006 to ½ a per cent in the second quarter of 2008, with the latest estimates currently showing the ratio falling below zero in the first quarter. The saving ratio can be revised quite heavily as new data on income and spending become available, as was evidenced by the significant revisions in the 2008 Blue Book. While clearly subject to further revision, the broad pattern of households' finances having come under greater pressure is unlikely to change markedly.

Household balance sheets

A.82 Over the past decade, households have accumulated assets and liabilities at a faster rate than their disposable income has grown. Households' total assets, including housing, increased from around 7 times income at the end of 1997 to more than 9½ times income by the end of 2007. Over the same period, rising house prices have meant households' outstanding loans, mostly mortgages, have increased from 91 to 157 per cent of disposable income. With house prices and equity prices having fallen, reducing the value of households' assets, the precautionary desire to increase saving in order to adjust their finances is likely to increase.

Prospects for consumer spending and the saving ratio

A.83 Consumer spending is forecast to decline in 2009, reflecting various factors. Apprehension over labour market prospects and increased saving from the very low level of 2008 are likely to put downward pressure on consumer spending. The temporary cut in the rate of VAT, by boosting real purchasing power as it is passed through to lower prices and by incentivising purchases before the lower rate reverses, is expected to increase the volume of spending relative to the level that would have prevailed in the absence of such a cut. The forecast assumes that around half of the increase in real purchasing power will feed through to an increased volume of spending and half to the adjustment of household finances.

A.84 As real incomes recover further and credit conditions normalise, consumer spending is forecast to grow by 1¼ to 1¾ per cent in 2010, and then to continue to grow at rates slightly below that of the whole economy as households continue to adjust their finances. This pattern of growth, with a gradual rise in the household saving ratio, will support the rebalancing of demand in the UK from domestic to external sources.

House prices

A.85 House price inflation began to slow from early 2007, as higher interest rates acted to ease demand pressures. The disruption in global financial markets turned that gradual easing into a more abrupt adjustment in UK house prices. As mortgage securitisation markets closed and interbank lending costs increased, the availability of mortgages contracted sharply. With prices continuing to fall, lenders increased required deposits leading to the removal of virtually all 95 per cent loan-to-value mortgages from the market, and demand for new mortgages declined as buyers anticipated lower prices in the future. According to indices compiled by the Nationwide and Halifax, house prices in the UK have fallen by around 15 per cent since their peak in late 2007.

A.86 Prospects for the depth and duration of the adjustment in UK house prices are highly uncertain, with developments in global financial markets and the real economy key. External forecasts compiled by the Treasury in the November *Comparison of independent forecasts* indicate further declines in prices are expected through 2009, although the range of forecasts is relatively wide. The average of new independent forecasts is for a fall of just over 20 per cent in the two years to the end of 2009. Beyond 2009, as credit conditions normalise, house prices are expected to recover and are assumed to grow at rates slightly above average earnings growth, supported by buyers who have delayed purchases returning to a housing market still characterised by restricted supply.

Investment in dwellings

A.87 Between 2000 and 2007, investment in dwellings increased from around 2¾ per cent to 4 per cent of GDP in nominal terms, with around half of the rise accounted for by strong growth in house prices. As such, while real activity has been relatively strong, growing by 8½ per cent in 2006 and 5 per cent in 2007, the UK has not witnessed the kind of housing construction boom that took place in some countries, notably the US, Ireland and Spain.

A.88 Prospects for housing investment have been adversely affected by the impact of the global credit shock on the UK housing market. After contracting 7¾ per cent on a year earlier in the first half of 2008, investment is forecast to fall 9½ per cent in 2008 as a whole and by a further 11 to 11½ per cent in 2009. However, with the fundamental drivers of demand for housing – principally the rate of household formation – still in place, and credit conditions assumed to settle at a new norm, housing investment is expected to recover from later in 2010.

Risks

A.89 The forecast for consumer spending is subject to a range of uncertainties representing both upside and downside risks. While it is considered very likely that most of the cut in the VAT rate will over time be passed through to prices, it is less clear to what extent consumers will choose to increase their volume of spending in light of increased purchasing power, or prefer to maintain their volume of spending such that lower prices allow them to adjust their finances more quickly. Restricted access to credit could limit some consumers' ability to bring forward spending to take advantage of the temporarily lower rate of VAT. Conversely, in anticipation of higher prices in 2010, a greater proportion of consumers could choose to bring forward spending to 2009.

A.90 Other uncertainties include the degree to which lower interest rates will support spending, the speed at which credit conditions normalise, and the degree to which households choose to adjust their finances more abruptly than assumed in the face of labour market and asset price uncertainties. Risks around the depth and duration of the adjustment in the UK housing market are linked to the ability of banks to resume profitable lending, further rebuilding their capital positions and increasing the availability of mortgage finance.

Companies and investment

A.91 On conventional measures, business investment accounts for around 10 per cent of nominal GDP, but its role in the economy extends beyond that, affecting future growth by raising the amount of physical capital available to each worker with which to produce goods and services. It is a feature of firms' investment spending that it typically exhibits much larger cyclical fluctuations than other components of demand.

Company finances

A.92 Companies can finance investment internally, using the cashflow generated by their operations, or externally, either through bank lending or by issuing equity or debt to investors. In aggregate, the private non-financial corporate sector's gross operating surplus increased by 8¼ per cent on a year earlier in the first half of 2008, enabling the sector to run a net lending position of 3 per cent of GDP. This suggests the availability of internal sources of finance at the aggregate level remained above normal. However, recent data on the flow of company financing and bank deposits suggest that the combination of rising cost inflation and slowing consumer spending have put company finances under increasing pressure. Companies' deposit balances have fallen by 5 per cent since peaking in February, while lending to companies, which averaged around £15 billion a quarter in 2007 and the first half of 2008, was flat in the third quarter.

A.93 Credit conditions faced by companies have continued to tighten since Budget 2008, both for bank lending and for equity and debt finance. Equity prices are more than 30 per cent lower than at the time of Budget 2008. While the cost of debt finance has risen, with borrowing costs high relative to government bond yields, a recent positive development has been lower interest rates on commercial paper, a source of short-term financing used mainly by larger companies, which have fallen sharply following the November cut in Bank Rate. However, recent surveys carried out by the CBI suggest that, after a year when companies had appeared to have been less affected by the global credit shock than households, the cost and availability of finance has begun to affect firms' operating and investment plans.

Table A6: Gross fixed capital formation

	Percentage change on a year earlier					
			Forecast			
	Average 2000 to 2006	2007	2008	2009	2010	2011
Whole economy[1]	3¼	7	–4½	–8¼ to –7¾	2¼ to 2¾	6½ to 7
of which:						
Business[2,3]	2¼	9¾	–1	–8¼ to –7¾	1 to 1½	6¾ to 7¼
Private dwellings[3]	4½	5	–9½	–11½ to –11	–1½ to –1	4¾ to 5¼
General government[3]	5	–½	9¾	10	–4¼	–2 ½

[1] *Includes costs associated with the transfer of ownership of land and existing buildings.*

[2] *Private sector and public corporations' non-residential investment. Includes investment under the Private Finance Initiative.*

[3] *Excludes purchases less sales of land and existing buildings.*

Business investment

A.94 Business investment grew strongly between 2005 and 2007, by more than 4 per cent a year in 2005 and 2006 and almost 10 per cent in 2007, a pattern consistent with the economy having passed up through trend in the second half of 2006. In the first half of 2008, business investment contracted by 1 per cent on a year earlier as uncertainty over demand prospects increased. The contraction was broadly based across sectors.

A.95 With company finances under pressure, near-term demand prospects weakening and credit conditions remaining tight, business investment is set to contract relatively sharply in 2008 and 2009. In keeping with the strongly cyclical nature of investment, after falling 1 per cent in 2008 and 7¾ to 8¼ per cent in 2009, business investment is forecast to begin recovering in 2010 as credit conditions normalise and demand uncertainties recede, and to grow strongly in 2011.

Public investment

A.96 General government investment is forecast to grow by 9¾ per cent in 2008 and 10 per cent in 2009, in part reflecting the Government's action to bring forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10, supporting employment and activity during the downturn.

Risks **A.97** There are risks to the business investment forecast from developments in credit availability and company finances more generally, which will in turn be affected by the degree to which fiscal stimulus supports consumer spending and the depreciation in sterling supports net exports. The substantial decline in commercial property prices could exacerbate the tightening of credit conditions that has taken place over recent months by reducing the value of collateral against which companies can borrow. As noted in Box A4, there are longer-term risks to productivity depending on how long the efficient allocation of credit by the financial system remains impaired. On the upside, with Bank Rate and government bond yields low, if sentiment turns and spreads on corporate borrowing narrow, borrowing costs for companies could fall to more supportive levels, stimulating activity sooner than expected.

Trade and the balance of payments

A.98 As noted in previous Budget and Pre-Budget Reports, annual growth in recorded exports and imports of goods and services has been distorted by activity related to missing-trader intra-community fraud (MTIC), which significantly inflated the value of measured goods trade in the first half of 2006. Since the second half of 2006, Government measures to tackle MTIC fraud have led to a sharp fall in estimated MTIC-related activity, to a low level.[13] The economic forecast abstracts from MTIC effects by making a neutral assumption that the adjustment for MTIC-related activity remains constant throughout the forecast at the latest quarterly estimate, and that trade grows in line with underlying determinants. Table A7 presents export and import growth forecasts excluding the MTIC adjustment.

Exports of goods and services **A.99** Growth in the measured volume of goods and services exports, excluding the MTIC adjustment, is estimated to have eased from 8 per cent in 2006 to 1¼ per cent in 2007. It seems possible that this exaggerates the extent of the genuine slowdown between those years, reflecting difficulties in applying the MTIC adjustment. With MTIC-related activity estimated to have been stable for more than a year, growth rates in the first half of 2008 should be subject to somewhat reduced uncertainty. On current estimates, the volume of exports of goods and services grew 2½ per cent on a year earlier in the first half of the year. On a quarterly basis, the volume of goods exports dipped in the third quarter while the volume of services exports declined in the second quarter, and current estimates of the value of services exports in the third quarter suggest volumes fell sharply.

A.100 In the near term, prospects for UK export growth are likely to be dictated by the downturn in key export markets, notably the euro area, so that export growth is likely to be weak in 2008 and 2009 despite the support from sterling's depreciation. The forecast for UK export market growth in 2009 has been revised down by almost 6 percentage points since Budget 2008 to ½ a per cent. Export volumes growth in 2009 is forecast to be 0 to ½ per cent, but as growth in the UK's export markets recovers and the effects from sterling gradually encourage more companies to pursue export opportunities, growth is forecast to pick up in 2010 and further in 2011.

[13] In view of the inevitable measurement difficulties involved in adjusting for MTIC-related activity, the ONS continues to advise in its monthly trade releases that comparisons of trade volumes and prices "should be treated with a great deal of caution". Consistent with the view set out in paragraph B.77 of Budget 2008, it remains hard to reconcile the trade data for 2006 and 2007 with evidence from private business surveys and domestic demand growth in the UK's main trading partners.

Imports of goods and services

A.101 Growth in the measured volume of goods and services imports, excluding the MTIC adjustment, shows a similar pattern to exports, with strong growth in 2006, of 6¾ per cent, followed by slower growth of 3½ per cent in 2007. In the first half of 2008, the volume of goods imports grew by 2¼ per cent on a year earlier, having fallen on a quarterly basis since the final quarter of 2007. By contrast, the volume of services imports grew by 6 per cent on a year earlier following strong quarterly growth in the first quarter of 2008. The volume of goods imports was flat in the third quarter, while current estimates of the value of services imports suggest the volume fell sharply.

A.102 With consumer spending and business investment forecast to contract in 2009, the volume of imports is also expected to fall. In line with the recovery in domestic demand from 2010, but tempered by the effect of sterling's depreciation on consumers' incentives to substitute domestically produced goods for imports, as set out in Box A6, import volumes growth is forecast to pick up from 2010.

Net exports

A.103 Despite sluggish export growth in 2008 and 2009, the slowdown in import growth in 2008 and decline in import volumes in 2009 mean that net exports are forecast to contribute positively to overall GDP growth. At around ¾ of a percentage point in 2009, the contribution of net exports to growth would be of a similar order of magnitude to that seen in the past three UK recessions.

Table A7: Trade in goods and services

	Percentage change on a year earlier, unless otherwise stated					
			Forecast			
	Average 2000 to 2006	2007	2008	2009	2010	2011
Volumes (excluding MTIC)[1]						
Exports	4¾	1¼	¾	0 to ½	3¼ to 3¾	5¼ to 5¾
Imports	5½	3½	½	–2¾ to –2¼	2½ to 3	4 to 4½
Prices[2]						
Exports	1	2½	10¼	2¼	2¾	1¼
Imports	1	1	9½	4¼	3¾	2¼
Terms of trade[3]	0	1½	¾	–1¾	–¾	–¾
Goods and service balance (£ billion)	–30¾	–47½	–48½	–45¾	–48½	–49

[1] *Table A9 contains figures including the effects of MTIC-related activity. The forecast is therefore based on the neutral assumption that the level of MTIC-related activity stays flat at the latest quarterly estimate throughout the forecast.*

[2] *Average value indices.*

[3] *Ratio of export to import prices.*

Risks

A.104 There are clear risks to export growth from developments in UK export markets. If recessions in the euro area and US prove more severe than expected, export growth could turn negative in 2009. However, if policy stimulus and lower commodity prices deliver earlier recovery, export growth could pick up sooner than forecast. Risks to consumer spending and investment growth in the UK set out above would feed through to similar risks to import growth. Finally, the extent to which sterling's depreciation will attract companies into exporting or to produce goods and services competing with more expensive imports is uncertain, although a rapid effect should not be expected.

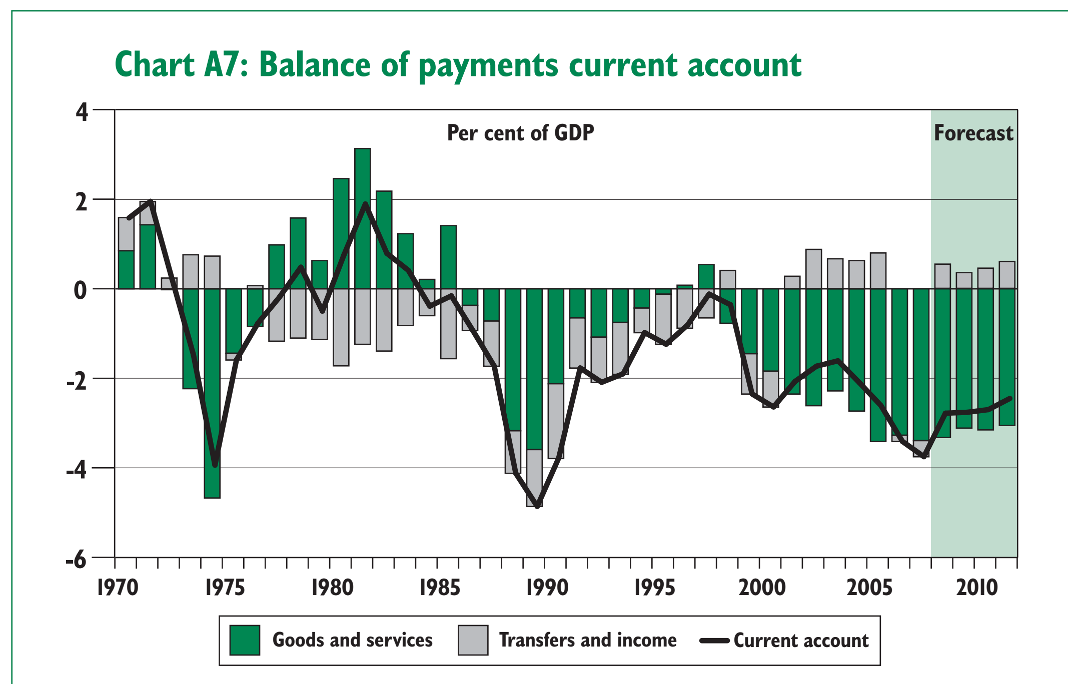
Current account balance

A.105 The UK's deficit on trade in goods was 6¼ per cent of GDP in 2007. In the first half of 2008, the goods trade deficit was little changed as a slight decline in the deficit on manufactured goods was offset by a slight increase in the deficit on oil and other fuels. Partly offsetting the UK's goods trade deficit, trade in services generated a surplus of 3 per cent of GDP in 2007, up from 2½ per cent of GDP in 2006 due to a ½ per cent of GDP increase in the surplus on trade in financial services to 2¼ per cent. During the first half of 2008, perhaps reflecting the

volatility in global financial markets, the value of exports and imports of financial services respectively grew by 29 per cent and 26 per cent on a year earlier, leading to a further increase in the surplus on financial services trade to 2½ per cent of GDP.

A.106 The recent large losses incurred by the world's financial institutions provided a temporary boost to the UK's investment income balance, due to the reduction in the flow of profits that would normally be repatriated from UK-based foreign financial institutions. Overall, the surplus on income increased from ½ a per cent of GDP in 2007 to 3 per cent in the first quarter of 2008 as FDI-related debits fell from 3¾ per cent of GDP to 1¾ per cent. This temporary effect began to unwind in the second quarter as FDI-related debits increased to 3 per cent of GDP, and the income surplus declined to 1¼ per cent.

A.107 Overall, the UK's current account deficit was 3¾ per cent of GDP in 2007. After temporarily narrowing to 1½ per cent in the first quarter of 2008, it returned to 3 per cent of GDP in the second quarter. The balance of domestic demand growth in the UK and overseas, supported by the various effects of sterling's depreciation explained in Box A6, should lead to the current account deficit narrowing in the second half of 2008 and 2009. The balance is forecast to remain broadly stable thereafter, with 2007 expected to have marked the peak for the current account deficit.



Box A6: Sterling, net trade and the balance of payments

Sterling has depreciated by over 20 per cent since mid-2007. Theory suggests that currency depreciation should have a positive impact on the net trade contribution to GDP over the medium term via the positive effect on export volumes and negative effect on import volumes.

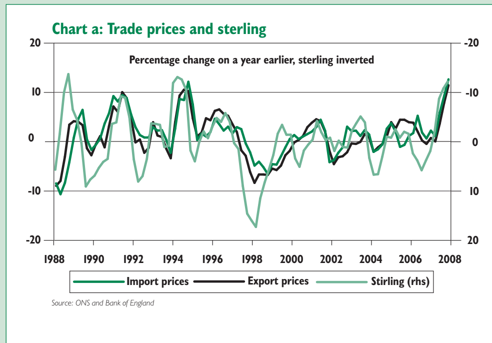
As sterling has depreciated, exporters should have become more competitive in overseas markets, which in turn should encourage domestic producers to switch production to profitable export opportunities. However, previous episodes of significant depreciation, such as that following the UK's exit from the European Exchange Rate Mechanism in 1992, have shown that UK exporters tend to raise sterling prices in order to boost profits in the short term, with effects on the volume of exports more lagged and muted. A similar pattern of sterling export prices rising in line with sterling's depreciation has been seen over the past year (chart a), suggesting the short-term boost to export volumes may be limited. Empirically, overseas demand for UK exports has proved the primary driver of UK export volume growth.

For UK consumers and producers, as sterling depreciates the sterling cost of imports rises. If prices of imported goods and services rise faster than prices of domestically produced goods and services, consumers and producers have an incentive to substitute away from imports into similar UK-produced goods and services. In the short term, the ability to substitute is limited by the availability of similar goods and services, although over time domestic producers could move into these activities. Overall, the impact of higher relative import prices would be to reduce the volume of imports consumed.

Given the outlook for global economic growth, sterling depreciation is more likely to support a positive contribution from net trade to UK GDP growth via the negative impact on import growth. In terms of sterling's impact on the overall balance of payments, as well as the trade balance, the impact on the net asset position and net investment income must also be considered.

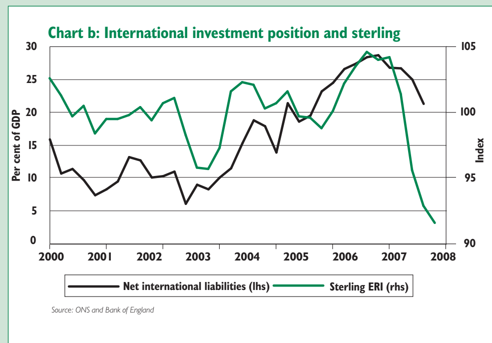
Sterling depreciation increases the sterling value of UK assets abroad because a significant proportion of those assets are denominated in foreign currencies, and similarly increases the sterling value of income received from abroad. Sterling's impact on the UK's international investment position can already be seen, with the UK's net liabilities falling from 29 per cent of GDP to 21 per cent over the past year (chart b). A smaller net international liability position, and the resulting increase in the net investment income surplus, would, all else equal, reduce the UK's current account deficit.

Chart a: Trade prices and sterling



Source: ONS and Bank of England

Chart b: International investment position and sterling



Source: ONS and Bank of England

Foreign direct investment

A.108 The UK continued to attract large flows of inward foreign direct investment (FDI) in 2007 and the first half of 2008. At £111 billion in 2007, the UK was once again the top European recipient of inward FDI and second in the world after the US. FDI inflows to the UK continued at a similar pace in the first half of 2008, reaching almost £52 billion. As a ratio to GDP, the UK has the largest stock of inward FDI among the G7 economies, while in absolute terms the UK is host to the second largest stock of FDI in the world after the US.

Output sectors

Services

A.109 Around three quarters of UK gross value added (GVA) is accounted for by service sector activity. This share has risen steadily in recent years, as has the service sector's share of UK exports. Service sector output grew by 3¾ per cent in 2007, supported by strong growth in the finance and business services sector. In the first three quarters of 2008, service sector growth has slowed more sharply than expected, with output in the third quarter up ½ a per cent on a year earlier, having fallen 0.4 per cent in quarterly terms. Demand uncertainty and the squeeze on real incomes and profit margins have impacted on growth within the wider private service sector, as consumers and businesses have restricted discretionary spending.

A.110 The financial sector has experienced very strong growth over the past 11 years, with real growth rates ranging between 4 and 8 per cent a year since 1996. However, the financial sector's share of nominal GVA has not risen as quickly as might have been expected, with the 2008 Blue Book estimates showing the share to have increased from a low of 5¼ per cent in 2000 to 7½ per cent in 2007. As a result of the global financial crisis, financial sector employment, earnings and profits are likely to fall, perhaps sharply, in the near term and, while the sector is expected to resume strong growth, it is likely to make up a smaller share of activity for some time.

Construction

A.111 Construction accounted for around 6½ per cent of nominal GVA in 2007. The sector grew by 3 per cent in 2007, in line with the economy as a whole, following slower growth of 1 per cent in 2005 and 2006. Following relatively strong growth in the first quarter of 2008, construction sector output contracted in the second and third quarters. In addition, new construction orders fell by 19 per cent on a year earlier in the third quarter, suggesting the contraction in output is likely to continue over coming quarters. Private housing construction orders fell 53 per cent on a year earlier, having been particularly hit by the effects of reduced supply of mortgage finance and falling house prices on activity. The bringing forward of public investment spending into 2008-09 and 2009-10 should provide some offsetting demand for the construction sector in the near term, while medium-term prospects should benefit from the expected recovery in business and housing investment described above.

Manufacturing

A.112 The manufacturing sector accounted for around 12½ per cent of nominal GVA in 2007. The sector grew by ½ a per cent in 2007, which was somewhat below the rate consistent with evidence from a range of private sector business surveys. In more recent quarters, manufacturing output has contracted, particularly production of consumer durables. Production is forecast to fall by 2¾ to 3¼ per cent in 2009, as demand in the UK and globally remains subdued, but to recover in 2010. Sterling's depreciation should provide some support for manufacturing growth, although in the near term this support is likely to be more than outweighed by the weaker growth prospects of the UK's main trading partners. As set out in Box A6, over time sterling's depreciation should support domestic manufacturing as consumers partly substitute away from imported goods to domestically produced alternatives.

North Sea output

A.113 Output from the North Sea oil and gas sector fell by around 25 per cent over the three years to 2006, as temporary disruptions exacerbated an underlying decline. The pace of this decline was arrested somewhat in 2007, as oil started flowing from the new Buzzard field, but overall production fell by 2½ per cent in the year. Output in 2008 has also been constrained by temporary factors, including the brief closure of the Forties pipeline. Output is expected to continue to fall over the forecast horizon.

Independent forecasts

A.114 Since Budget 2008, the average of independent forecasts for GDP growth in 2008 has been revised down from 1.7 per cent to 0.9 per cent, close to the 2008 Pre-Budget Report forecast. With independent forecasters expecting contractions in private consumption and investment in 2009, forecasts for GDP growth next year have been revised down progressively and significantly, from 1.9 per cent at the time of Budget 2008 to -0.9 per cent. Since August 2008, this downward trend has quickened as the independent average has fallen from 0.9 per cent to -0.9 per cent. Following the pick-up in inflation this year, forecasts for CPI inflation in the final quarter of 2008 have risen to 4.5 per cent. However, inflation is expected to fall back over the coming year, moving below target by the end of 2009. The average of independent forecasts for 2010 and 2011 show inflation at or close to target.

A.115 Among external forecasters that produce medium-term growth forecasts, expectations are for a relatively sluggish recovery in 2010 and 2011, with the independent average somewhat below the Pre-Budget Report forecast ranges for those years at 1.2 and 2.4 per cent respectively. Illustrating the uncertainty surrounding the timing and strength of the recovery, the range of independent growth forecasts for 2010 is over 1 percentage point wider than that for 2009 despite there being a smaller number of forecasters in the sample.

A.116 Table A8 also presents forecasts from a selection of international institutions, research institutes and private sector forecasters that illustrate the range of views held. Compared with the Pre-Budget Report forecast, Goldman Sachs and Morgan Stanley forecast a milder recession in 2009 and a similarly swift rebound in 2010. By contrast, Citigroup and HSBC forecast a more severe downturn in 2009 and a slower medium-term recovery. The international institutions and the National Institute forecast a similar recession in 2009, although most point to a slower recovery in 2010. As with all forecasters, these institutions will be constantly reviewing economic developments, such that Table A8 can only represent a snapshot of external views. For example, it is very unlikely that any will have correctly anticipated all of the actions announced in this Pre-Budget Report and some may be revised as a result.

Table A8: Pre-Budget Report and independent forecasts[1]

			Percentage change on a year earlier, unless otherwise stated			
			2008	**2009**	**2010**	**2011**
GDP	**2008 Pre-Budget Report**		¾	–1¼ to –¾	1½ to 2	2¾ to 3¼
	Independent:	**average[2]**	**0.9**	**–0.9**	**1.2**	**2.4**
		range	0.7 to 1.1	–2.1 to 0.4	–1.0 to 2.6	1.0 to 3.5
	Selected	Citigroup	0.8	–1.6	0.3	2.0
	external	Goldman Sachs	0.8	–0.4	1.8	2.8
	forecasters[3]	HSBC	0.8	–1.7	0.5	1.0
		Morgan Stanley[4]	0.8	–0.3	1.9	–
		IMF[5]	0.8	–1.3	1.1	–
		OECD[6]	0.8	–1.1	0.9	–
		EC[7]	0.9	–1.0	0.4	–
		NIESR[8]	0.8	–1.5	0.8	2.6
CPI (Q4)	**2008 Pre-Budget Report**		**3¾**	**½**	**2¼**	**2**
	Independent:	**average[2]**	**4.5**	**1.7**	**1.8[9]**	**2.0[9]**
		range	3.7 to 5.0	0.7 to 2.6	1.2 to 2.6	1.5 to 2.4

[1] *Published in 'Forecasts for the UK economy: A comparison of independent forecasts', November 2008 unless otherwise stated.*

[2] *Independent forecasts for 2010 and 2011 are based on the medium-term projections containing a smaller pool of contributors.*

[3] *No significance should be attached to the inclusion or exclusion of any particular forecasting organisation.*

[4] *Morgan Stanley forecasts published 10 November 2008 in 'UK Economics – Forecast Update'.*

[5] *IMF (International Monetary Fund) forecasts from 6 November 2008 'World Economic Outlook Update'.*

[6] *OECD (Organisation for Economic Co-operation and Development) forecast published 6 November 2008 in 'Economic Outlook 84'.*

[7] *EC (European Commission) forecast published 3 November 2008 in 'Economic Forecast – Autumn 2008'.*

[8] *NIESR (National Institute of Economic and Social Research) forecast published 24 November 2008 in 'Prospects for the UK economy'.*

[9] *Independent CPI forecasts for 2010 and 2011 refer to annual average rather than Q4.*

SUMMARY OF FORECAST ISSUES AND RISKS

A.117 The events of September and early October 2008, when the global financial system came close to collapse prompting an unprecedented global policy response, illustrate vividly the exceptional uncertainties now surrounding any economic forecast, even for near-term prospects. This section summarises the many risks and uncertainties that have been discussed throughout this annex.

A.118 Many of the larger downside risks to activity, for example the economic consequences of systemic banking collapse or from sharply weaker income and spending growth, which would have been associated with disproportionately large welfare costs, have been significantly reduced by recent and prospective policy action in the UK and globally.

Global economy

Global financial markets and credit conditions

A.119 As was the case at the last Budget and Pre-Budget Report, the key forecast judgement relates to the intensity and duration of the global tightening in credit conditions faced by households and companies. The forecast assumes that, with financial institutions having received significant support from governments around the world, credit conditions should ease over the coming year and return to a new norm from early 2010. The extent of government support and very low level of policy interest rates suggest there is an upside risk to this assumed path of credit conditions, with the possibility that the banking system is able to restore the efficiency of its financial intermediation operation more quickly. Against that, the experience of the past six months, when conditions appeared to be stabilising before

deteriorating dramatically in September and October, underlines the significant downside risks that remain. There is also a growing risk of more widespread financial contagion across emerging markets.

Commodity prices

A.120 Since mid-July, the price of a barrel of oil has fallen from $146 to around $50, a drop of over 65 per cent. According to futures contracts and independent forecasters, this drop is not expected to reverse significantly. While another surge in oil and other commodity prices seems very unlikely given slowing world output growth, the experience of the first half of 2008 suggests that rising commodity prices could again pose a risk to activity at some point over the forecast horizon.

Global monetary and fiscal stimulus

A.121 Since the beginning of October, a large number of central banks around the world have cut interest rates sharply as inflationary pressures have receded and risks to growth have crystallised. Markets are expecting further easing across many countries, although interest rates in some have already reached very low levels. There are uncertainties over the extent and speed with which monetary policy easing can support activity, especially given dislocations in the global financial system and the decline in business and consumer confidence globally. If significant easing boosts confidence in the non-financial sector, and profitability in the financial sector, it could feed through to consumer spending and business investment more quickly or more forcefully than assumed.

A.122 Recent weeks have also seen a pick-up in the number of countries announcing fiscal stimulus measures, and, in line with agreement at the G20 summit on 15 November, there are expectations that more will be forthcoming. Again, there are uncertainties over the extent to which fiscal policy will support near-term private sector activity in an environment of unusually tight credit conditions.

Protectionism

A.123 Protectionism is a major risk to global economic prospects and to lifting developing countries out of poverty. As global growth slows while global imbalances remain significant, there is a risk that countries retreat to protectionism or trade-distorting subsidies in a futile attempt to support their domestic economies. Further economic cooperation will help to boost trade and investment flows to the benefit of global growth. A successful conclusion of the Doha Round of world trade talks is a matter of urgency in terms of boosting global trade, and reassuring markets that policymakers will not repeat the mistakes of past global downturns.

UK economy

UK monetary and fiscal stimulus

A.124 In the UK, Bank Rate has been cut by 2 percentage points over the past two months to a 53-year low of 3 per cent, while the Pre-Budget Report announces discretionary action that will deliver a fiscal stimulus package of around 1 per cent of GDP in 2009-10, in addition to the support provided by measures in 2008-09. As with stimulus packages around the world, there are uncertainties over the degree to which easing will support activity. In terms of monetary easing, there have been some encouraging signs that it will filter through to households and companies, though there remain clear risks over how long the availability of credit will remain restricted and the extent to which households and companies will want to increase borrowing in an uncertain economic environment, and when outstanding household borrowing is historically high.

A.125 In terms of the fiscal stimulus, the key economic risks stem from the degree to which the lower VAT rate is passed through to consumer prices and the extent to which temporarily lower prices stimulate a greater volume of spending. It has been assumed that the majority of the VAT rate cut will be passed through to consumer prices progressively. While this suggests a risk to consumer spending from lower pass-through, that risk would be tempered by the

upside risk to corporate profits and perhaps therefore employment if companies were to retain more of the temporary VAT rate cut. With respect to stimulating spending, the forecast assumes that approximately half of the increase in real purchasing power translates into an increased volume of spending with the remainder used by households to bolster their finances. There are clearly upside and downside risks to this assumption, particularly those related to developments in credit conditions. If credit conditions ease more rapidly than assumed, households will have greater scope to bring forward spending to capitalise on the temporarily lower rate of VAT.

Inflation

A.126 From spring 2008 until recently, the risk to inflation was tilted to the upside, with commodity prices reaching record highs in the summer. As commodity prices have fallen sharply and growth has slowed, pressures on inflation have eased. While the depreciation of sterling means there are residual upside risks to inflation from import prices, it seems clear that inflation is set to fall sharply over the coming year. Further downward pressure on inflation will come as the cut in the VAT rate is progressively passed through to prices. For CPI inflation, this suggests that over the coming year the greater risk is that inflation will fall well below 1 per cent, a level that would trigger an open letter from the Governor of the Bank of England to the Chancellor of the Exchequer.

A.127 RPI inflation is likely to turn negative for a period, reflecting the inclusion of measures of housing costs and mortgage interest payments, both of which are expected to continue falling over the coming year. While this period of falling prices is expected to be both short and confined to the RPI measure of headline inflation, it should be recognised there would be risks to activity should inflation expectations be affected.

Trend output and the cyclical position

A.128 The Treasury's forecasting judgements on the impact of the credit shock on trend output are subject to significant uncertainty. This uncertainty has implications for assessing the balance between cyclical demand and potential supply, and hence prospective inflationary pressures and the labour market implications of the economic downturn. If the shock has a greater impact on trend output than assumed, demand pressures are likely to bite sooner than expected, putting upward pressure on inflation earlier and reducing the extent of labour market adjustments. Conversely, if the shock has had a smaller impact on trend output, then a larger degree of spare capacity will open up as output contracts, placing additional downward pressure on inflation.

Consumer spending and housing

A.129 As well as VAT-related risks to the consumer spending forecast, other uncertainties include the degree to which lower interest rates will support spending, the speed at which credit conditions normalise, and the degree to which households choose to adjust their finances more abruptly than assumed in the face of labour market and asset price uncertainties. Risks around the depth and duration of the adjustment in the UK housing market are linked to the ability of banks to resume profitable lending, further rebuilding their capital positions and increasing the availability of mortgage finance.

Business investment

A.130 There are risks to the business investment forecast from developments in credit availability and company finances more generally, which will in turn be affected by the degree to which fiscal stimulus supports consumer spending and the depreciation in sterling supports net exports. The substantial decline in commercial property prices could exacerbate the tightening of credit conditions that has taken place over recent months by reducing the value of collateral against which companies can borrow. On the upside, with Bank Rate and government bond yields low, if sentiment turns and spreads on corporate borrowing narrow, borrowing costs for companies could fall to more supportive levels, stimulating activity sooner than expected.

Trade **A.131** There are clear risks to export growth from developments in UK export markets. If recessions in the euro area and US prove more severe than expected, export growth could turn negative in 2009. However, if policy stimulus and lower commodity prices deliver earlier recovery, export growth could pick up sooner than forecast. Risks to consumer spending and investment growth in the UK would feed through to similar risks to import growth. Finally, the extent to which sterling's depreciation will attract companies into exporting or to produce goods and services competing with more expensive imports is uncertain.

Table A9: Summary of economic prospects[1]

	Percentage change on a year earlier, unless otherwise stated					
		Forecast[2,3,4]				Average errors from past forecasts[5]
	2007	2008	2009	2010	2011	2009
Output at constant market prices						
Gross domestic product (GDP)	3	¾	–1¼ to –¾	1½ to 2	2¾ to 3¼	¾
Manufacturing output	¾	–1¼	–3¼ to –2¾	1 to 1½	1¾ to 2¼	1¼
Expenditure components of GDP at constant market prices[6]						
Domestic demand	3¾	¾	–2 to –1½	1½ to 2	2½ to 3	1
Household consumption[7]	3	1½	–1½ to –1	1¼ to 1¾	2¼ to 2¾	1
General government consumption	1¾	2¾	2¾	1	0	1
Fixed investment	7	–4½	–8¼ to –7¾	2¼ to 2¾	6½ to 7	2¾
Change in inventories[8]	¼	0	–¼ to 0	0	0	¼
Exports of goods and services[9]	–4½	¾	¼ to ¾	3¼ to 3¾	5¼ to 5¾	3
Imports of goods and services[9]	–1¾	½	–2½ to –2	2½ to 3	4 to 4½	2¾
Exports of goods and services (excluding MTIC)	1¼	¾	0 to ½	3¼ to 3¾	5¼ to 5¾	–
Imports of goods and services (excluding MTIC)	3½	½	–2¾ to –2¼	2½ to 3	4 to 4½	–
Balance of payments current account						
£ billion	–52½	–41¾	–41	–41½	–39¼	12¼
Per cent of GDP	–3¾	–2¾	–2¾	–2¾	–2½	¾
Inflation						
CPI (Q4)	2	3¾	½	2¼	2	–
Producer output prices (Q4)[10]	4	6	2	2½	2	1¼
GDP deflator at market prices	2¾	3½	1¾	2½	2¾	½
Money GDP at market prices						
£ billion	1,401	1,461	1,469 to 1,477	1,529 to 1,545	1,615 to 1,640	12
Percentage change	6	4¼	½ to 1	4 to 4½	5½ to 6	¾

[1] *The forecast is consistent with the preliminary estimate data for the third quarter of 2008, released by the Office for National Statistics on 24 October 2008. See also footnote 1 on the second page of this Annex.*

[2] *All growth rates in tables throughout this Annex are rounded to the nearest ¼ percentage point.*

[3] *As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2¾ per cent. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances, which is a ¼ percentage point below the neutral assumption.*

[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.*

[5] *Average absolute errors for year-ahead projections made in autumn forecasts over the past 10 years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2009.*

[6] *Further detail on the expenditure components of GDP is given in Table A10.*

[7] *Includes households and non-profit institutions serving households.*

[8] *Contribution to GDP growth, percentage points.*

[9] *Figures upto and including 2008 are distorted by MTIC.*

[10] *Excluding excise duties.*

Table A10: Gross domestic product and its components

	Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
	£ billion chained volume measures at market prices, seasonally adjusted									
2007	818.4	253.2	227.2	6.8	1306.2	349.3	1655.5	389.7	0.6	1266.4
2008	831.6	260.3	216.9	6.5	1315.9	351.8	1667.8	392.1	0.8	1276.4
2009	819.7 to 824.2	267.7	198.8 to 199.9	4.1 to 5.6	1290.3 to 1297.4	352.3 to 354.3	1642.6 to 1651.7	382.0 to 384.1	0.8	1261.4 to 1268.3
2010	830.8 to 839.4	270.7	203.1 to 205.2	3.7 to 6.6	1308.2 to 1321.9	364.0 to 367.8	1672.2 to 1689.6	391.3 to 395.4	0.8	1281.7 to 1295.1
2011	850.3 to 863.3	270.9	216.3 to 219.6	3.2 to 7.4	1340.7 to 1361.2	383.2 to 389.1	1723.9 to 1750.3	406.5 to 412.7	0.8	1318.2 to 1338.4
2007 1st half	405.4	126.1	112.7	2.1	646.6	172.9	819.5	191.0	0.3	628.8
2nd half	413.1	127.1	114.5	4.8	659.6	176.4	836.0	198.7	0.4	637.6
2008 1st half	418.0	128.8	111.6	1.6	660.7	177.0	837.7	197.2	0.4	640.9
2nd half	413.7	131.5	105.3	4.9	655.3	174.8	830.1	194.9	0.4	635.5
2009 1st half	408.8 to 410.6	133.3	100.2 to 100.6	2.3 to 2.8	644.5 to 647.3	175.3 to 176.1	819.9 to 823.4	191.3 to 192.1	0.4	629.0 to 631.7
2nd half	410.9 to 413.7	134.4	98.7 to 99.3	1.8 to 2.7	645.8 to 650.1	177.0 to 178.2	822.8 to 828.3	190.8 to 192.0	0.4	632.4 to 636.7
2010 1st half	413.5 to 417.3	135.1	100.3 to 101.2	1.8 to 3.1	650.7 to 656.7	179.9 to 181.5	830.6 to 838.2	193.5 to 195.2	0.4	637.6 to 643.4
2nd half	417.3 to 422.1	135.6	102.8 to 104.0	1.9 to 3.5	657.5 to 665.2	184.1 to 186.2	841.6 to 851.4	197.9 to 200.2	0.4	644.1 to 651.6
2011 1st half	422.6 to 428.5	135.7	106.3 to 107.8	1.6 to 3.6	666.1 to 675.5	189.0 to 191.7	855.1 to 867.2	201.5 to 204.4	0.4	654.0 to 663.2
2nd half	427.7 to 434.8	135.2	110.0 to 111.8	1.6 to 3.8	674.5 to 685.7	194.2 to 197.4	868.7 to 883.1	204.9 to 208.3	0.4	664.2 to 675.2
	Percentage change on a year earlier[4,5]									
2007	3	1¾	7	¼	3¾	–4½	1¾	–1¾	0	3
2008	1½	2¾	–4½	0	¾	¾	¾	½	0	¾
2009	–1½ to –1	2¾	–8¼ to –7¾	–¼	–2 to –1½	¼ to ¾	–1½ to –1	–2½ to –2	0	–1¼ to –¾
2010	1¼ to 1¾	1	2¼ to 2¾	0	1½ to 2	3¼ to 3¾	1¾ to 2¼	2½ to 3	0	1½ to 2
2011	2¼ to 2¾	0	6½ to 7	0	2½ to 3	5¼ to 5¾	3 to 3½	4 to 4½	0	2¾ to 3¼

[1] *Includes households and non–profit institutions serving households.*

[2] *Also includes acquisitions less disposals of valuables.*

[3] *Expenditure adjustment.*

[4] *For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.*

[5] *Growth ranges for GDP components do not necessarily sum to the ½ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

B THE PUBLIC FINANCES

The Government's fiscal policy objectives are:

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

Chapter 2 sets out the action the Government is taking to achieve these goals. This Annex presents more detailed information on the fiscal projections, consistent with the *Code for fiscal stability*.

The 2008 *End of year fiscal report* is published alongside this Pre-Budget Report, underlining the Government's commitment to transparency in fiscal policy by providing detailed information on the public finances in 2006-07 and 2007-08.

INTRODUCTION

B.1 Since August 2007 the world's economies have been subject to unprecedented global economic shocks. In this challenging economic and fiscal climate, the Government's immediate priority is to support the economy. Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability, employment and growth. Chapter 2 sets out the action the Government is taking to achieve these goals consistent with the fiscal framework. This Annex explains the latest public finance outturns and the fiscal projections in more detail[1]. It includes:

- five-year projections of the current budget, the cyclically-adjusted current budget, public sector net borrowing and public sector net debt, the key aggregates for assessing performance against the fiscal framework and the impact of fiscal policy on the economy; and
- detailed analyses of the outlook for government receipts and expenditure.

FORECAST ASSUMPTIONS AND RISKS

Key assumptions

B.2 This section sets out the key assumptions on which the fiscal projections are based:

- the economy follows the path described in Annex A. The fiscal projections continue to be based on the assumption that trend output growth will be ¼ percentage point lower than the Government's neutral view, which is designed to add caution;
- there are no tax or spending policy changes beyond those announced in or before this Pre-Budget Report. Rates, thresholds and limits, including for 2008-09, increase in line with projected indexation or announced policy. Consistent with the *Code for fiscal stability*, the forecast does not take account of measures proposed in this Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken;

[1] For further detail see, *2008 Pre-Budget Report: the economy and public finances – supplementary charts and tables*. This includes tables on public expenditure, sub-sector and economic category analyses.

- Departmental Expenditure Limits (DEL) to 2010-11 are adjusted as set out in Chapter 2, in order to bring forward spending to support the economy and help to ensure fiscal consolidation in the medium term;
- total Annually Managed Expenditure (AME) programmes to 2010-11 have been forecast consistent with the economic assumptions and policy decisions in this Pre-Budget Report;
- public sector current expenditure is projected to grow at 1.2 per cent on average in real terms from 2011-12 to 2013-14; and
- net investment is projected to move to 1.8 per cent of GDP in 2013-14.

Table B1: Economic assumptions for the public finance projections

	Percentage changes on previous year unless otherwise specified						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Output (GDP)	3	- ¼	- ½	2	3	3	3
Prices							
CPI	2 ¼	3 ¾	1	2	2	2	2
GDP deflator	3	3 ¼	1 ½	2 ¾	2 ¾	2 ¾	2 ¾
RPI[1] (September)	4	5	-2 ¼	2 ½	4	3 ½	3
Rossi[2] (September)	2 ¼	6 ¼	0	1 ¾	2 ½	2 ½	2 ½
Money GDP[3] (£ billion)	1,421	1,463	1,480	1,549	1,638	1,735	1,836

[1] *Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year. Unless a fall is specifically allowed for in statute, tax parameters and benefit levels depending on the negative RPI value for 2009 are assumed to remain unchanged from their previous values.*

[2] *RPI excluding housing costs, used for uprating certain social security benefits.*

[3] *Not seasonally adjusted.*

B.3 The projections for 2008-09 are based on all available data within the Treasury and other government departments involved in producing tax and spending forecasts.

The use of NAO audited assumptions

B.4 The use of assumptions audited by the National Audit Office (NAO) under the three-year rolling review process is designed to add caution into the public finance projections. Details of the audited assumptions are given in Box B1. The trend rate of GDP growth is assumed to be ¼ per cent below the neutral view, which means that the rate of economic growth on which the public finances projections are based is the lower end of the forecast range, as set out in Table B1.

B.5 For the 2008 Pre-Budget Report, the Comptroller and Auditor General has audited the Treasury's judgement that the end date of the previous economic cycle was in the second half of 2006. Taking all the evidence as a whole, he judged that it is reasonable to conclude that the second half of 2006 marked the end date of the most recently completed economic cycle, which was judged to have started in the first half of 1997. The Comptroller and Auditor General recommended, given the uncertainties in dating the economic cycles, including looking ahead and the impact new data might have in the future, that the Treasury keep this assessment under review. The NAO will be asked to audit the end date of the current and future cycles once the Treasury has made a firm judgement.

B.6 The Comptroller and Auditor General also audited the oil price assumption used for the Treasury's public finance projections. The report concluded that the convention was cautious over the past three years, is designed to provide caution in the future, and remains a reasonable assumption to use going forward. No other assumptions were due for review in this Pre-Budget Report.

Forecast differences and risks

B.7 Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been around 1 per cent of GDP. This difference tends to grow as the forecast horizon lengthens. The fiscal balances represent the difference between two large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. This is particularly the case at times such as now when the economy has been subject to significant shocks and there is increased uncertainty about its future path. The uncertainty surrounding economic prospects at the current time, therefore implies greater than usual risks surrounding the public finance projections. This Annex supplements the analysis of the main risks to the economic forecast in Annex A and Chapter 2 by providing further detail in the analysis of tax and spending of the risks to the public finances forecast.

B.8 The 2008 *End of year fiscal report* (EYFR) is published alongside this Pre-Budget Report. The EYFR underlines the Government's commitment to transparency in fiscal policy by providing detailed retrospective information on the public finances in 2006-07 and 2007-08, including an explanation for differences between forecasts and outturn in those years. The information set out in the 2008 *End of year fiscal report* supplements the historical and provisional outturn data published in this Annex.

Box B1: Key assumptions audited by the NAO[a]

Trend GDP growth [c]	2½ per cent a year to 2014.
Dating of the cycle [f]	The previous economic cycle, which began in the first half of 1997, ended in the second half of 2006.
Composition of GDP [d]	Shares of labour income and profits in national income are broadly constant in the medium term.
Consistency of price indices [c]	Projections of price indices used to project the public finances are consistent with CPI.
Oil prices [f]	$60.1 a barrel in 2009, the average for the month to 19 November, and then constant in real terms. This is lower than the $71.8 average of independent forecasts for 2009.
Equity prices [c]	FTSE All-share index rises from 1998 (close 19 November) in line with money GDP.
VAT [d]	The underlying VAT gap will rise by 0.5 percentage points per year from the estimated outturn for the current year.
Tobacco [d]	The underlying level of duty paid consumption of cigarettes will be set at least three per cent per year lower than the estimated outturn for the current year.
UK claimant unemployment [e, g]	Rising from recent levels of 0.98 million to 1.41 million at the end of 2009, and to 1.55 million at the end of 2010, based on the average of independent forecasts.
Interest rates [b]	3-month market rates change in line with market expectations (as of 13 November).
Funding [d]	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Privatisation proceeds [b]	Credit is taken only for proceeds from sales that have been announced.

[a] For details of all NAO audits before Budget 2006, see the 2005 Pre-Budget Report, 5 December 2005 (HC 707).
[b] Audit of Assumptions for Budget 2006, 22 March 2006 (HC 937).
[c] Audit of Assumptions for the 2006 Pre-Budget Report, 6 December 2006 (HC 125).
[d] Audit of Assumptions for Budget 2007, 21 March 2007 (HC 393).
[e] Audit of Assumptions for Budget 2008, 12 March 2008 (HC 345).
[f] Audit of Assumptions for the 2008 Pre-Budget Report, 24 November 2008 (HC 1150).
[g] Seasonally-adjusted UK claimant unemployment. This is a cautious assumption based on the average of external forecasts and is not the Treasury's economic forecast.

MEETING THE FISCAL RULES OVER THE PREVIOUS CYCLE

B.9 As set out above, the Treasury's assessment, audited by the NAO, is that the previous economic cycle, judged to have started in the first half of 1997, ended during the second half of 2006. Table B2 shows that the Government met both of its fiscal rules over the economic cycle from 1997-98 to 2006-07.

Table B2: Summary of performance of fiscal policy over the previous cycle

	Per cent of GDP										
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Golden rule											
Surplus on current budget		-0.1	1.2	2.2	2.4	1.2	-1.0	-1.5	-1.6	-1.1	-0.3
Average surplus since 1997-1998		-0.1	0.5	1.1	1.4	1.4	1.0	0.6	0.3	0.2	0.1
Cyclically-adjusted surplus on current budget		-0.1	0.9	1.7	1.6	0.9	-0.7	-1.3	-1.5	-1.0	-0.3
Sustainable investment rule[1]											
Public sector net debt[2]	42.5	40.6	38.4	35.6	30.7	29.7	30.8	32.2	34.1	35.4	36.0
Core debt[2]	41.1	39.2	37.4	35.1	31.0	30.2	31.0	32.2	34.0	35.2	35.9

[1] *As debt is a stock measure, performance against the sustainable investment rule is measured against the end point of the previous cycle.*

[2] *Debt at end March; GDP centred on end March.*

The golden rule over the previous cycle

B.10 The golden rule required, over the previous economic cycle, the average surplus on the current budget expressed as a ratio to GDP to be equal to or greater than zero[2]. Table B2 shows that on this basis, the Government met the golden rule for the cycle that began in 1997-98, with an average surplus of 0.1 per cent of GDP.

The sustainable investment rule over the previous cycle

B.11 The sustainable investment rule required public sector net debt (PSND) as a proportion of GDP to be held at a stable and prudent level over the previous economic cycle. In 1998, the Government announced that it would maintain net debt below 40 per cent of GDP over the course of the economic cycle beginning in 1997-98. In 2003, the Government stated that to meet the sustainable investment rule with confidence, net debt would be maintained below 40 per cent of GDP in each and every year of the economic cycle. Table B2 shows that net debt was maintained below 40 per cent of GDP on average over the previous cycle, and was below 40 per cent of GDP in every year from 1998-99 onwards, therefore meeting the sustainable investment rule.

[2] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002. Performance over past cycles is described further in Chapter 2 of the 2008 Pre-Budget Report.

FISCAL PROJECTIONS

B.12 Table B3 shows five-year projections for the current budget, cyclically-adjusted current budget, public sector net borrowing and public sector net debt[3], the key aggregates for assessing performance against the new fiscal framework. Outturns and projections of other important measures of the public finances are also shown.

Table B3: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Fiscal consolidation							
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Consolidation in the cyclically-adjusted surplus on current budget [1]	-	-	-	1.0	1.2	0.7	0.6
Economic impact							
Net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net borrowing (PSNB)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Cyclically-adjusted PSNB	2.9	5.3	7.2	5.6	4.3	3.5	2.8
Sustainability							
Public sector net debt[2,3]	36.3	41.2	48.2	52.9	55.6	57.1	57.4
Core debt[2,3]	36.5	41.3	47.5	51.0	52.8	53.9	54.2
Net worth[4]	28.8	23.5	16.6	12.9	10.6	9.1	8.7
Primary balance	-1.0	-3.6	-6.7	-4.7	-3.0	-1.6	-0.5
Financing							
Central government net cash requirement	2.3	10.5	8.5	6.9	5.9	4.6	3.7
Public sector net cash requirement[3]	1.5	4.8	8.9	6.9	5.7	4.3	3.4
European commitments							
Treaty deficit[5]	2.8	5.4	8.1	7.0	5.6	4.4	3.3
Cyclically-adjusted Treaty deficit[5]	3.1	5.4	7.3	5.8	4.5	3.8	3.1
Treaty debt ratio[6]	43.2	52.9	60.5	65.1	67.5	68.6	68.5
Memo: Output gap	0.6	-0.3	-1.5	-1.9	-1.3	-0.7	-0.1
Memo: PSND including financial sector interventions	42.8	48.9	54.7				
Memo: PSNCR including financial sector interventions	1.5	6.1	8.0				

[1] *Change in the cyclically-adjusted surplus on the previous year.*
[2] *Debt at end March; GDP centred on end March.*
[3] *Excluding financial sector interventions.*
[4] *Estimate at end December; GDP centred on end December.*
[5] *General government net borrowing on a Maastricht basis.*
[6] *General government gross debt measures on a Maastricht basis.*

Current budget

B.13 The Pre-Budget Report projections show that the current budget is in deficit throughout the forecast period, peaking at 5.3 per cent of GDP in 2009-10, and then falling to 1.1 per cent by 2013-14. The cyclically-adjusted surplus removes the estimated effects of the economic cycle on the current balance. The cyclically-adjusted deficit falls from 4.4 per cent of GDP in 2009-10 to 1.0 per cent in 2013-14 when the economy is projected to return to trend, driven by a recovery of tax receipts and lower spending growth. A further adjustment of ½ a per cent a year in 2014-15 and 2015-16 would eliminate the deficit on the current budget by 2015-16.

[3] As set out in Budget 2008 and Chapter 2, the measure of public sector net debt used for the assessment of fiscal sustainability excludes the impact of financial sector interventions. Table B3 also reports on PSND including the impact of these interventions.

Net debt to GDP ratio

B.14 PSND is projected to grow over the forecast period and stabilise just over 57 per cent of GDP in 2013-14. The projections for core debt, which excludes the estimated impact of the economic cycle, rise to 54.2 per cent of GDP in 2013-14.

B.15 This Pre-Budget Report puts the public finances on a path that will ensure public sector net debt will fall as a proportion of GDP in the medium term. Chapter 2 sets out illustrative projections based on a further improvement of ½ per cent a year in the cyclically-adjusted current balance and net investment held constant at 1.8 per cent of GDP, that show the public debt to GDP ratio will be declining in 2015-16.

Contingent liabilities

B.16 Fiscal aggregates published by Government, such as net debt and net worth, reflect public sector liabilities that have been accrued in the past and are certain to require future transfers to meet the obligations. In addition, there are provisions or contingent liabilities that may have to be met in the future but where the timing or existence of the liability is not certain, these include for example nuclear decommissioning liabilities. The Government considers these types of liabilities in the sustainability analysis published in the *Long-term public finance report*. For example, the report publishes estimates of net liabilities, which include provisions and are based on dry run Whole of Government Accounts (WGA). When WGA are published for the year 2009-10, contingent liabilities will be disclosed as a note to the accounts. However, measures of contingent liability are subject to significant uncertainties, which limits the extent to which they can be used to determine fiscal policy in the short run.

Net investment

B.17 Public sector net investment has increased rapidly in recent years from 1¼ per cent of GDP in 2003-04 to 2 per cent of GDP in 2007-08. As a result of decisions taken in this Pre-Budget Report, net investment will increase to 2¾ per cent in 2009-10 before falling back to 1.8 per cent of GDP in 2013-14.

Public sector net borrowing

B.18 Public sector net borrowing (PSNB) is projected to increase to 5.3 per cent of GDP in 2008-09 and then to 8.0 per cent in 2009-10, as the economic downturn reduces tax receipts, the automatic stabilisers increase spending, and borrowing rises to finance the temporary fiscal action to support the economy. PSNB is then expected to fall each year to 2.9 per cent in 2013-14 as a result of recovery of the economy and the Government's action to ensure the sustainability of the public finances.

Financing

B.19 The central government net cash requirement (CGNCR) was 2.3 per cent of GDP in 2007-08. It is projected to be around 10.5 per cent in 2008-09 as a result of additional borrowing and the financial costs of the Government's action to preserve financial stability and protect retail depositors, set out in Chapter 3. The CGNCR then falls to 3.7 per cent of GDP by 2013-14. Further details of the impact on the public finance projections of the Government's measures to ensure financial stability are set out in Box B3.

European commitments

B.20 Table B3 shows the Treaty measures of debt and deficit used for the purposes of the Excessive Deficit Procedure – Article 104 of the Treaty. The Pre-Budget Report projections meet the EU Treaty reference value for general government gross debt (60 per cent of GDP) in 2008-09, but rise above it in subsequent years. The treaty deficit in 2007-08 was 2.8 per cent of GDP. The deficit is expected to rise to 8.3 per cent of GDP in 2009-10. The treaty deficit is then expected to fall to 3.3 per cent of GDP in 2013-14.

CHANGES TO THE FISCAL BALANCES

B.21 Table B4 compares the latest estimates for the main fiscal balances with those in Budget 2008.

Table B4: Fiscal balances compared with Budget 2008

	Outturn[1]	Estimate[2]	Projections			
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Net borrowing (£ billion)						
Budget 2008	**36.4**	**42.5**	**38**	**32**	**27**	**23**
Changes to current budget	-1.2	31.6	74	77	65	56
Changes to net investment	1.4	3.5	5 ½	-4	-5 ½	-8
2008 Pre-Budget Report	**36.6**	**77.6**	**118**	**105**	**87**	**70**
Surplus on current budget (£ billion)						
Budget 2008	**-7.9**	**-9.6**	**-4**	**4**	**11**	**18**
Effect of revisions and forecasting changes	1.2	-23.3	-61	-78	-75	-72
Effect of discretionary changes[3]	0.0	-8.3	-13	1	10	16
2008 Pre-Budget Report	**-6.7**	**-41.2**	**-78**	**-73**	**-54**	**-37**
Net investment (£ billion)						
Budget 2008	**28.5**	**32.9**	**35**	**37**	**38**	**41**
Effect of revisions and forecasting changes	1.4	2.5	2 ½	- ½	-2	-1 ½
Effect of discretionary changes[3]	0.0	1.0	3 ½	-3 ½	-4	-6 ½
2008 Pre-Budget Report	**29.9**	**36.5**	**40**	**33**	**33**	**33**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2008	-0.7	-0.5	0.1	0.5	0.8	1.0
2008 Pre-Budget Report	**-0.8**	**-2.8**	**-4.4**	**-3.4**	**-2.3**	**-1.6**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2008	2.7	2.7	2.2	1.8	1.5	1.2
2008 Pre-Budget Report	**2.9**	**5.3**	**7.2**	**5.6**	**4.3**	**3.5**
Net debt (per cent of GDP)[4]						
Budget 2008	37.1	38.5	39.4	39.8	39.7	39.3
2008 Pre-Budget Report	**36.3**	**41.2**	**48.2**	**52.9**	**55.6**	**57.1**

Note - Totals may not sum due to rounding.

[1] *The 2007-08 figures were estimates in Budget 2008.*

[2] *The 2008-09 figures were projections in Budget 2008.*

[3] *Including changes to forecasting assumptions on spending growth in 2011-12 and 2012-13.*

[4] *Debt at end March; GDP centred on end March; excluding financial sector interventions.*

Changes to 2007-08

B.22 The outturn for the current budget in 2007-08 shows a deficit of £6.7 billion, a £1.2 billion lower deficit than expected at Budget 2008. The changes since the Budget largely reflect revisions following reclassification of some central and local government expenditure from current to capital expenditure, which was partly offset by downward revisions to current receipts. The 2007-08 outturn for net borrowing is £0.2 billion higher than the Budget 2008 estimate, due to the revised capital expenditure.

Changes to 2008-09

B.23 The current deficit in 2008-09 is higher than forecast in Budget 2008 due to falls in receipts and higher spending driven by the economic downturn, and by additional borrowing to support the economy. Receipts are lower than expected at the Budget from the housing and financial sectors, and from the wider economy due to lower wages, consumption and profits growth. The impact of the fiscal stimulus and other measures increases the current deficit in 2008-09 by £8.3 billion. Net borrowing in 2008-09 is expected to be £35.1 billion above the Budget forecast driven by the higher current budget deficit and by higher net investment. As

a result of increased borrowing, PSND, excluding financial sector interventions, for 2008-09 is forecast to be 41.2 per cent of GDP, 2.7 per cent of GDP higher than the Budget 2008 forecast.

Changes from 2009-10

B.24 Net borrowing peaks in 2009-10 at £118 billion, which is £80 billion above the Budget forecast, due to the continuing downturn and further borrowing to support the economy. Net borrowing in 2009-10 is 8.0 per cent of GDP. Of this, the temporary fiscal action that the Government is taking to support the economy accounts for 1.1 per cent of GDP, of which around 0.2 per cent of GDP is capital spending. In total, borrowing for capital investment accounts for 2.7 per cent of GDP in 2009-10. Therefore, excluding borrowing for investment and for discretionary action, net borrowing in 2009-10 would be 4.4 per cent of GDP.

B.25 Net borrowing falls to 2.9 per cent by the end of the forecast period, reflecting the action the Government is taking to ensure the sustainability of the public finances over the medium term, including through discretionary action, as shown in Table B4. PSND increases over the forecast period in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years, then begins to stabilise at 57.4 per cent by the end of the forecast period.

PRE-BUDGET REPORT POLICY DECISIONS

B.26 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all firm decisions announced in this 2008 Pre-Budget Report or since Budget 2008. The fiscal impacts of these measures are set out in Table B5.

B.27 Expenditure measures affecting AME and DEL in 2008-09 have been added to total AME and total DEL, respectively.

B.28 Consistent with the *Code for fiscal stability*, the projections do not take account of decisions where the impact cannot yet be quantified or of measures where consultation is proposed in this Pre-Budget Report, or where final decisions have yet to be taken.

Table B5: Estimated costs for Pre-Budget Report policy decisions and others announced since Budget 2008[1]

	£ million			
	2008-09	2009-10	2010-11	2011-12
Measures announced since Budget 2008[2]				
Personal allowance and basic rate limit changes for 2008-09	-2,650	-270	+90	0
September housing package: spending measures	-200	-665	+865	0
SDLT holiday for residential homes	-130	-150	0	0
Local Housing Allowance: cap benefit at 5 bedroom rate	0	+5	+15	+15
Class 3 NICs: Pensions Bill amendment	0	+230	+10	+10
Supporting the economy and ensuring sustainability of public finances				
VAT rate reduction	-3,800	-8,600	0	0
Alcohol duties: increase in rates	+160	+640	+645	+675
Tobacco duties: increase in rates	+115	+340	+360	+365
Capital spending brought forward	-365	-2,545	+2,910	0
Indexation of personal allowance and basic rate limit	0	-2,930	-3,310	-3,270
£130 increase in personal allowance in 2009-10 and 2010-11	0	-630	-770	-100
Freeze basic rate limit in 2011-12	0	0	0	+180
Restrict personal allowance by half from £100,000 and to zero from £140,000 from 2010-11	0	0	+830	+1,320
Additional higher income tax rate of 45% above £150,000 and raise trust rate to 45% from 2011-12	0	0	0	+670
Align the NICs primary threshold with personal allowance in 2011-12	0	0	0	-1,610
Increase main employee NICs rate by 0.5% from 2011-12	0	0	0	+2,050
Increase additional employee NICs rate by 0.5% from 2011-12	0	0	0	+440
Increase employer NICs rate by 0.5% from 2011-12	0	0	0	+2,650
Increase main self-employed rate of NICs by 0.5% from 2011-12	0	0	0	+170
Increase additional self-employed NICs rate by 0.5% from 2011-12	0	0	0	+80
Public spending: additional value for money savings	0	0	+5,000	+5,000
Supporting business				
Foreign profits	0	+75	+25	-275
Loss carry back: temporary extension	-10	-175	-20	+15
Small Companies Rate of corporation tax: defer increase to April 2010	0	-20	-460	-130
Rates on empty property: temporary exemption	0	-185	+10	0
Backdated business rates bills	-80	-55	+25	+20
Income shifting: defer action	0	-25	-260	-200
Insurance claims equalisation reserves	-15	-35	-35	-35
Helping people fairly				
Child benefit: bring forward uprating from April 2009 to January 2009	-170	0	0	0
Child element of Child Tax Credit: bring forward £25 increase from 2010 to April 2009	0	-190	0	0
DWP Job Centre Plus funding[4]	0	-400	-400	0
Uprating of pension credit above indexation	0	-260	-300	-310
Additional payment to pensioners and others	-900	0	0	0
Freeze pension lifetime and annual allowance from 2011-12 for 5 years	+25	+100	+200	+400
Index housing benefit disregard in tax credits	0	-5	-5	-5
Support for mortgage interest	-30	-15	0	0
Further support for debt advice	-5	-10	-5	0
Protecting revenues				
Change of Accounting Practice Regulations	0	+10	+15	+15
Enhance tax avoidance disclosure regime	0	+10	+15	+10
Delivering on environmental goals				
Air passenger duty	0	-60	-160	-50
Vehicle excise duty - cars and vans	0	-465	-515	-545
Vehicle excise duty - heavy goods vehicles	0	-10	-10	-10
Fuel duty	-180	0	0	0
Additional spending on Warm Front	-50	-50	0	0
Capital allowances: business cars	0	+10	+10	+5
Other policy decisions				
Addition to DEL reserve	-1,000	0	0	0
TOTAL POLICY DECISIONS	**-9,285**	**-16,330**	**+4,775**	**+7,550**
Memo: Resetting AME margin	0	-1,000	-2,000	-2,000

[1] *Costings shown relative to an indexed base.*

[2] *Costings reflect Pre-Budget Report economic forecast and assumptions.*

[3] *Yield increases due to lagged effects of self-assesment. For 2011-12 onwards, yield is £670 million / £1650 million / £1600 million.*

[4] *The remainder of the employment pachage totalling £1.3 billion announced in Chapter 5 is funded from DWP End of Year flexibility*

Bands, rates and personal allowances

B.29 The income tax personal allowance available for the under 65s will be increased by £130 above statutory indexation to £6,475 for 2009-10.

B.30 Age related allowances and limits will rise in line with statutory indexation in 2009-10.

B.31 Both the basic and higher rate of tax will remain the same in 2009-10, at 20 per cent and 40 per cent respectively.

B.32 The starting rate limit for savings will be increased in line with statutory indexation, and as announced in Budget 2007, the basic rate limit will be increased by £800 above statutory indexation to £37,400 in 2009-10.

B.33 As announced in Budget 2004, the lifetime allowance for pensions tax relief will be £1.75 million in 2009-10. The annual allowance will be £245,000 for 2009-10.

Table B6: Bands of taxable income

2008-09	£ a year	2009-10	£ a year
Starting rate 10 per cent[1]	0-2320	Starting rate 10 per cent[1]	0-2,440
Basic rate 20 per cent	0 - 34,800	Basic rate 20 per cent	0-37,400
Higher rate 40 per cent	over 34,800	Higher rate 40 per cent	over 37,400

[1] *There is a starting rate for savings only. If an individual's non savings taxable income exceeds the starting rate limit, the 10p starting rate for savings will not be available for savings income.*

Table B7: Income tax allowances 2009-10

	£ per year		
	2008-09	2009-10	Increase
Personal allowance			
age under 65	6,035	6,475	440
age 65-74	9,030	9,490	460
age 75 and over	9,180	9,640	460
Married couple's allowance[1]			
aged less than 75 and born before 6 April 1935	6,535	6,865	330
age 75 and over	6,625	6,965	340
minumum amount[2]	2,540	2,670	130
Income limit for age-related allowances	21,800	22,900	1,100
Blind person's allowance	1,800	1,890	90

[1] *Tax relief for this allowance is restricted to 10 per cent.*

[2] *This is also the maximum relief for maintenance payments where at least one of the parties is born before 6 April 1935.*

National insurance contributions

B.34 The national insurance contributions (NICs) threshold, limit and self-employed flat rate will increase in line with statutory indexation for 2009-10, with the exception of the Upper Earnings and Upper Profit Limits (UEL/UPL). These will rise to £844 per week, £43,875 per year, to align with the level at which higher rate tax begins to be paid.

Table B8: National insurance contribution rates 2009-10

Class 1 rates			Self employed NICs		
Earnings[1]	Employee (primary) NIC rate[2]	Employer (secondary) NIC rate[3]	Profits[1]	Class 2	Class 4
£ per week	per cent	per cent	£ per year	£ per week	per cent
Below 95 (LEL)	0	0	Below 5075 (SEE)[4]	0.00	0
95 to 110 (PT/ST)[5]	0	0	5075 to 5,715 (LPL)[5]	2.40	0
110 to 844 (UEL)	11	12.8	5,715 to 43875 (UPL)	2.40	8
Above 844	1	12.8	Above 43875	2.40	1

[1] *The limits are defined as LEL - lower earnings limit; PT - primary threshold; ST - secondary threshold; UEL - upper earnings limit; LPL - lower profits limit; UPL - upper profits limit; SEE - small earnings exception.*

[2] *The contracted-out rebate for primary contributions in 2007-08 is 1.6 per cent of earnings between the LEL and UEL for contracted-out salary-related schemes (COSRS) and contracted-out money purchase schemes (COMPS).*

[3] *The contracted-out rebate for secondary contributions is 3.7 per cent of earnings between the LEL and UEL for COSRS and 1.4 per cent for COMPS. For COMPS, an additional age-related rebate is paid direct to the scheme following the end of the tax year. For appropriate personal pensions, the employee and employer pay NICs at the standard, not contracted-out rate. An age-related rebate is paid direct to the personal pension provider following the end of the year.*

[4] *The self-employed may apply for exception from paying Class 2 contributions if their earnings are less than, or expected to be less than, the level of the small earnings exception.*

[5] *No NICs are actually payable but a Class 1 NIC is treated as having been paid in respect of earnings between the LEL and PT to protect benefit entitlement.*

Working and child tax credit rates

B.35 From April 2009, the child element of the Child Tax Credit (CTC) is increasing by £75 above average earnings growth, by £125 to £2,235 per year. This builds on the Government's commitment to increase the child element by £50 above indexation in April 2009 by bringing forward the Government's commitment to increase the child element by £25 above indexation in April 2010 to April 2009. The elements for both disabled children and severely disabled children will increase in line with inflation (the increase in the RPI in the year to September 2008), as set out in Table B9. The income threshold for receiving maximum CTC only is increasing to £16,040. The Government is maintaining the childcare element of Working Tax Credit (WTC), and the other WTC elements are increasing in line with inflation. All other tax credit rates and thresholds are unchanged. Child Benefit is increasing to £20 for the first child, and in line with inflation for subsequent children. These increases are being brought forward from April 2009 to January 2009. The Guardian's Allowance will increase in line with inflation in April 2009.

Table B9: Working and Child Tax Credit rates and thresholds

	£ per year		
	2008-09	**2009-10**	**Increase**
Working Tax Credit			
Basic Element	1,800	1,890	90
Couple and lone parent element	1,770	1,860	90
30 hour element	735	775	40
Disabled worker element	2,405	2,530	125
Severe disability element	1,020	1,075	55
50 plus element, 16–29 hours	1,235	1,300	65
50 plus element, 30+ hours	1,840	1,935	95
Childcare element			
maximum eligible cost for one child	£175 per week	£175 per week	-
maximum eligible cost for two or more children	£300 per week	£300 per week	-
per cent of eligible costs covered	*80%*	*80%*	-
Child Tax Credit			
Family element	545	545	-
Family element, baby addition	545	545	-
Child element	2,085	2,235	150
Disabled child element	2,540	2,670	130
Severely disabled child element	1,020	1,075	55
Income thresholds and withdrawal rates			
First income threshold	6,420	6,420	-
First withdrawal rate (per cent)	*39%*	*39%*	-
Second income threshold	50,000	50,000	-
Second withdrawal rate (per cent)	*6.67%*	*6.67%*	-
First threshold for those entitled to Child Tax Credit only	15,575	16,040	465
Income disregard	25,000	25,000	-

FISCAL AGGREGATES

B.36 Tables B10 and B11 provide more detail on the projections for the current and capital budgets.

Table B10: Current and capital budgets

	£ billion						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Current budget							
Current receipts	547.5	545.5	535	576	621	664	708
Current expenditure	536.4	568.0	594	628	653	679	705
Depreciation	17.8	18.7	20	21	22	23	24
Surplus on current budget	**-6.7**	**-41.2**	**-78**	**-73**	**-54**	**-37**	**-21**
Capital budget							
Gross investment[1]	47.7	55.1	60	54	55	56	57
Less depreciation	-17.8	-18.7	-20	-21	-22	-23	-24
Net investment	29.9	36.5	40	33	33	33	33
Net borrowing	**36.6**	**77.6**	**118**	**105**	**87**	**70**	**54**
Public sector net debt - end year[2]	**526.8**	**602.0**	**729**	**842**	**938**	**1020**	**1084**
Memos:							
Treaty deficit[3]	39.4	79.5	120	109	91	75	60
Treaty debt[4]	614.4	773.8	896	1008	1106	1191	1258

[1] *Net of asset sales; for a breakdown see Table 17 in 2008 Pre-Budget Report: the economy and public finances - supplementary material.*

[2] *Debt at end March; excluding financial sector interventions.*

[3] *General government net borrowing on a Maastricht basis.*

[4] *General government gross debt on a Maastricht basis.*

Table B11: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Current budget							
Current receipts	38.5	37.3	36.2	37.2	37.9	38.3	38.6
Current expenditure	37.8	38.8	40.1	40.6	39.9	39.1	38.4
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget	**-0.5**	**-2.8**	**-5.3**	**-4.7**	**-3.3**	**-2.2**	**-1.1**
Capital budget							
Gross investment[1]	3.4	3.8	4.1	3.5	3.3	3.2	3.1
Less depreciation	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Net borrowing	**2.6**	**5.3**	**8.0**	**6.8**	**5.3**	**4.1**	**2.9**
Public sector net debt - end year[2]	**36.3**	**41.2**	**48.2**	**52.9**	**55.6**	**57.1**	**57.4**
Memos:							
Treaty deficit[3]	2.8	5.4	8.1	7.0	5.6	4.4	3.3
Treaty debt ratio[4]	43.2	52.9	60.5	65.1	67.5	68.6	68.5

[1] *Net of asset sales; for a breakdown see Table 17 in PBR 2008: the economy and public finances - supplementary material.*

[2] *Debt at end March; GDP centred on end March; excluding financial sector interventions.*

[3] *General government net borrowing on a Maastricht basis.*

[4] *General government gross debt on a Maastricht basis.*

B.37 The current budget surplus is equal to public sector current receipts less public sector current expenditure and depreciation. The reasons for changes in receipts and current expenditure are explained in later sections. The current deficit peaks at £77.6 billion in 2009-10 as the impact of the downturn reduces receipts and as a result of discretionary action to support the economy. The current deficit then declines to £21 billion in 2013-14 as the economy recovers and current expenditure grows at lower rates.

B.38 Table B11 also shows that net investment is projected to increase from 2.1 per cent of GDP in 2007-08 to around 2¾ per cent in 2009-10, as the Government brings forward capital spending from 2010-11 to 2008-09 and 2009-10, and then moves to around 1.8 per cent of GDP in 2013-14 ensuring the medium-term sustainability of the public finances.

RECEIPTS

B.39 This section looks in detail at the projections for public sector tax receipts. It begins by looking at the main determinants of changes in the overall projections since Budget 2008, before looking in detail at changes in the projections of individual tax receipts. Finally, it provides updated forecasts for the tax-GDP ratios.

B.40 With the impact of the global credit and commodity shocks slowing the economy rapidly, receipts growth in the first part of 2008-09 was weak. Net taxes and national insurance contributions (NICs) were up just 1.8 per cent year-on-year in the first seven months of 2008-09. With the economy having entered a downturn, receipts growth on a year earlier is likely to turn negative over the remainder of 2008-09. Receipts are expected to weaken further in 2009-10 with net taxes and NICs projected to fall by 3.3 per cent on 2008-09.

Changes in total receipts since Budget 2008

B.41 Lower levels of output across the economy act to significantly reduce tax receipts, in particular from income tax, NICs, VAT and corporation tax due to lower incomes, consumption and profits. With income tax and NICs accounting for around 45 per cent of total receipts, lower labour income results in a shortfall in receipts in 2009-10 of £16 billion, compared with Budget 2008 forecast. By 2010-11, lower consumer spending and profits of industrial and commercial companies reduce receipts by £4½ billion and £7½ billion respectively. Total economic growth over the forecast period is lower than assumed in Budget 2008. Coupled with a recovery led by investment and exports, which is likely to generate less receipts than a consumer-led rebound, a substantial element of the receipts shortfall due to economic factors persists.

Impact of the financial market crisis on receipts

B.42 Box B2 looks at the impact of the financial and housing sectors on the public finances. The intensification of the global financial crisis since Budget 2008 will significantly reduce receipts from the financial sector. The impact on corporation tax, income tax and VAT from the financial sector is likely to reduce receipts by £7½ billion in 2008-09 and by around £10 billion in 2009-10, relative to the Budget 2008 forecast. The Budget had assumed that the negative impact on receipts from financial sector disruption would be at its greatest in 2008-09 before the sector picked up as credit conditions normalised in mid-2009. Consistent with the assumption underlying the Pre-Budget Report economic forecast that credit conditions will ease only slowly through 2009 and stabilise in 2010, no rebound in financial sector profits and City bonuses is assumed in 2009. Thereafter, activity in the sector recovers but remains lower than assumed in earlier Budgets and Pre-Budget Reports.

B.43 Equity prices have fallen sharply since Budget 2008. The public finances forecast uses a NAO audited assumption for equity prices, which assumes that prices will rise in line with

money GDP from their current level. Equity prices are around 35 per cent lower than assumed in the Budget throughout the forecast horizon. Equity prices have a direct impact on stamp duty on shares, onshore corporation tax, and with a lag, capital gains tax and inheritance tax. Receipts driven by equity prices are expected to be £1 billion lower in 2008-09 and around £3½ billion a year lower in 2009-10 and thereafter.

Impact of housing market downturn on receipts

B.44 Residential and commercial property markets have also been affected by the global credit shock. The availability of property finance has declined rapidly, impacting on both house prices and transactions. Allied with a continued drop in commercial property prices, stamp duty land tax has fallen sharply in 2008-09. The public finance forecasts have used external forecasts, from the Treasury's published *Comparison of independent forecasts* as the basis for the Treasury's assumptions. The average of independent forecasts is for house prices to fall by 20 per cent in the two years to the end of 2009. Coupled with continued weakness in property transactions and a lagged impact on receipts of capital gains tax and inheritance tax, housing-related receipts are likely to be £7 billion lower in 2009-10, relative to the Budget 2008 forecast. With the level of house prices lower throughout the forecast than assumed in the Budget, a sizeable element of the shortfall persists.

Risks and uncertainty

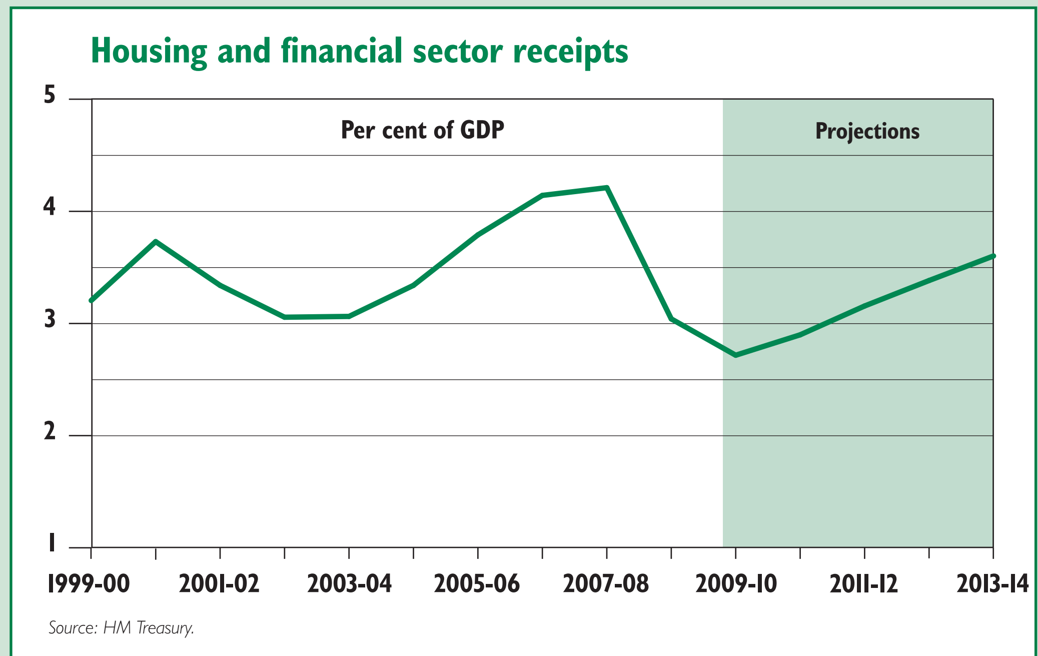
B.45 The uncertainty surrounding economic prospects in turn implies greater than usual risks surrounding the public finance projections. The projections are based on the key forecast judgment that credit conditions will normalise in 2010 at a level where risk is more appropriately priced. Downside risks to the public finance projections include that the economic downturn is sharper or longer than expected, the economic recovery is slower than expected or that the contraction in the financial sector or the adjustment in the housing market are more protracted. If, however, the substantial stimulus from monetary and fiscal policy, sterling's depreciation and lower commodity prices, takes hold sooner than forecast, the public finance projections would be subject to upside risks.

Box B2: The impact of the financial and housing sector on the public finances

The global credit shock has particularly affected the financial and housing sectors in the UK – both of which are typically a significant source of tax receipts. Financial company corporation tax has accounted for around 25 per cent of overall corporation tax, and the sector provides significant amounts of income tax and NICs on salaries and bonuses. The housing sector provides revenue directly through stamp duty, inheritance tax and capital gains tax and indirectly through the VAT collected on housing-related consumption.

In recent years, the financial and housing sectors saw rapid growth in activity and asset values. This growth was reflected in receipts from taxes linked to the two sectors[a]. In 2002-03, financial and housing sector receipts were equivalent to 3 per cent of GDP. By 2007-08, these receipts had increased to 4¼ per cent of GDP. The rise in housing and financial sector receipts from 2002-03 to 2007-08 accounted for half of the increase in total current receipts over this period.

Consistent with the economic forecast, the public finance projections assume a sharp drop in receipts from the housing and financial sectors in the next two years and then a recovery in the medium term. However, over the forecast horizon the sectors do not recover to the levels of activity, and associated receipts, experienced in 2007-08. Receipts from the two sectors are predicted to decline from 4¼ per cent of GDP in 2007-08 to 2¾ per cent in 2009-10, before rising to 3½ per cent of GDP in 2013-14.



Source: HM Treasury.

[a] *These revenues include receipts from financial sector corporation tax, financial sector PAYE and NICs, Capital Gains Tax, Inheritance Tax and stamp duties.*

Tax by tax analysis

B.46 Table B12 shows outturns for cash receipts in the first seven months of 2008-09 and estimated receipts for the remainder of the year, along with percentage changes over the corresponding period in 2007-08. These growth rates can vary considerably across the year, partly because of the rules governing payment of each tax and the various time lags.

B.47 Table B13 contains updated projections for the main components of public sector receipts for 2007-08, 2008-09 and 2009-10, as well as the changes to the projections of individual taxes since Budget 2008.

Table B12: 2008-09 Net taxes and national insurance contributions

	£ billion			Percentage change on 2007-08		
	Outturn[1]	Estimates		Outturn[1]	Estimates	
	Apr-Oct	Nov-Mar	Full year	Apr-Oct	Nov-Mar	Full year
HM Revenue & Customs						
Income tax, NICs and capital gains tax[2]	138.8	114.9	253.8	1.9	-1.7	0.2
Value added tax	51.0	31.6	82.6	4.3	-0.5	2.4
Corporation tax[2]	30.7	14.2	44.8	2.1	-13.3	-3.3
Petroleum revenue tax	1.8	0.8	2.6	120.6	-6.0	55.4
Fuel duties	14.5	10.6	25.1	0.0	1.4	0.6
Inheritance tax	1.9	1.2	3.1	-19.8	-18.7	-19.4
Stamp duties	5.6	2.7	8.3	-38.0	-47.6	-41.5
Tobacco duties	4.8	3.4	8.2	-0.4	3.0	1.0
Alcohol duties	4.8	3.6	8.4	2.0	-0.2	1.1
Other Customs duties and levies	6.1	4.2	10.3	2.8	0.2	1.7
Total HMRC	**259.9**	**187.2**	**447.1**	**1.0**	**-3.5**	**-0.9**
Vehicle excise duties	3.4	2.3	5.8	5.4	8.9	6.8
Business rates	16.2	7.3	23.5	7.0	15.9	9.6
Council tax	16.4	8.2	24.6	5.3	7.1	5.9
Other taxes and royalties	8.7	7.0	15.7	8.0	6.7	7.4
Net taxes and NICs	**304.6**	**212.0**	**516.6**	**1.8**	**-2.1**	**0.1**

[1] *Provisional.*

[2] *Net of tax credits scored as negative tax in net taxes and national insurance contributions.*

Table B13: Current receipts

	£ billion			Changes since Budget 2008 (£ billion)		
	Outturn 2007-08	Estimate 2008-09	Projection 2009-10	Outturn 2007-08	Estimate 2008-09	Projection 2009-10
HM Revenue and Customs						
Income tax (gross of tax credits)	151.9	156.7	151.2	-3.7	-3.5	-19.9
Income tax credits	-4.4	-5.5	-6.0	0.2	-0.3	-0.5
National insurance contributions	100.4	97.7	100.8	3.0	-6.9	-7.1
Value added tax	80.6	82.6	72.6	0.1	-1.2	-16.3
Corporation tax[1]	46.9	45.5	42.4	-0.1	-6.4	-13.9
Corporation tax credits[2]	-0.6	-0.6	-0.7	0.0	0.0	0.0
Petroleum revenue tax	1.7	2.6	1.5	0.0	0.9	-0.3
Fuel duties	24.9	25.1	26.2	0.0	-0.7	-0.9
Capital gains tax	5.3	4.9	2.4	0.5	-0.1	-1.8
Inheritance tax	3.8	3.1	2.4	-0.1	-0.1	-0.7
Stamp duties	14.1	8.3	6.9	-0.2	-5.2	-8.3
Tobacco duties	8.1	8.2	8.2	0.0	0.6	0.4
Spirits duties	2.4	2.3	2.5	0.1	0.0	0.2
Wine duties	2.6	2.8	2.9	0.1	-0.2	-0.2
Beer and cider duties	3.3	3.4	3.3	0.0	-0.1	-0.3
Betting and gaming duties	1.5	1.5	1.4	0.0	0.0	0.0
Air passenger duty	2.0	1.9	1.9	0.0	-0.1	-0.5
Insurance premium tax	2.3	2.3	2.5	0.0	-0.1	0.0
Landfill tax	0.9	0.9	1.2	0.0	-0.2	-0.1
Climate change levy	0.7	0.7	0.7	0.0	0.0	0.0
Aggregates levy	0.3	0.4	0.3	0.0	-0.1	-0.1
Customs duties and levies	2.5	2.6	2.8	0.0	0.1	0.2
Total HMRC	**451.2**	**447.1**	**427.5**	**0.0**	**-23.4**	**-69.9**
Vehicle excise duties	5.4	5.8	6.0	-0.2	-0.4	-1.1
Business rates	21.4	23.5	24.6	-0.4	-0.3	-0.2
Council tax[3]	23.2	24.6	25.7	-0.5	-0.3	-0.4
Other taxes and royalties[4]	14.6	15.7	15.9	-0.1	-0.1	-0.9
Net taxes and NICs[5]	**515.9**	**516.6**	**499.6**	**-1.2**	**-24.4**	**-72.5**
Accruals adjustments on taxes	1.0	-3.1	2.5	-0.4	-5.1	0.0
Less own resources contribution to EC budget	-5.0	-4.3	-4.8	0.0	0.4	0.2
Less PC corporation tax payments	-0.3	-0.2	-0.2	-0.1	0.0	0.0
Tax credits adjustment[6]	0.6	0.7	0.7	0.0	0.0	0.0
Interest and dividends	8.3	7.7	8.1	0.4	0.7	1.1
Other receipts[7]	27.0	28.0	29.5	-1.1	-1.4	-1.6
Current receipts	**547.5**	**545.5**	**535.5**	**-2.4**	**-29.8**	**-72.7**
Memo:						
North Sea revenues[8]	7.8	13.2	8.7	0.1	3.3	-1.1

[1] *National Accounts measure, gross of enhanced and payable tax credits.*
[2] *Includes enhanced company tax credits.*
[3] *Council tax increases are determined annually by local authorities, not by the Government. As in previous years, council tax figures are projections based on assumptions and are not Government forecasts.*
[4] *Includes VAT refunds and money paid into the National Lottery Distribution Fund.*
[5] *Includes VAT and 'traditional own resources' contributions to EC budget.*
[6] *Tax credits which are scored as negative tax in the calculation of NTNIC but expenditure in the National Accounts.*
[7] *Includes gross operating surplus, rent and business rate payments by local authorities.*
[8] *Consists of North Sea corporation tax and petroleum revenue tax.*

Income tax and national insurance contributions

B.48 Cash receipts of income tax and NICs in 2008-09 are expected to be £10.4 billion below the Budget projection, of which around £2.7 billion relates to the £600 rise in the personal allowance announced in May. With the labour market already slowing and earnings growth subdued, growth in PAYE and NIC receipts from wages and salaries in the first seven months of 2008-09 has been weaker than assumed in the Budget forecast. Receipts from sectors such as the financial sector, construction, retail and manufacturing have been particularly weak. The year-on-year drop assumed in income tax, NICs and capital gains tax receipts over the remainder of 2008-09 reflects a continuation of recent trends and a projected sharp reduction in receipts from financial sector bonuses.

B.49 Receipts of PAYE and NIC are forecast to remain weak in 2009-10, reflecting the response of the labour market to the contraction in the economy in late 2008 and early 2009. Overall labour income is only expected to rise by 2½ per cent in 2009-10. With credit conditions only assumed to ease slowly in 2009, receipts from financial sector bonuses are not expected to recover in 2009-10. In addition, there is a sharp drop in tax on savings income in 2009-10, related to the recent base rate reductions and a decline in self assessment receipts. The latter will be affected by weaker growth in self-employment income, and a drop in savings income and dividends.

B.50 Income tax and NIC receipts recover from 2010-11 as the economy picks up momentum and the financial sector recovers. However, receipts remain significantly lower than in the Budget 2008 projection.

Non-North Sea corporation tax

B.51 Non-North Sea corporation tax has historically been one of the more cyclical of taxes with receipts expected to fall by almost 15 per cent in 2008-09, due to the downturn in the economy and the financial sectors. With profits in the financial sector forecast to fall by 14 per cent, financial sector corporation tax in 2008-09 is likely to be around 35 per cent down on 2007-08. Profits from industrial and commercial companies are forecast to fall by ½ per cent in 2008 with corporation tax from the larger companies who pay quarterly instalments projected to be down around 10 per cent in 2008-09.

B.52 Onshore corporation tax receipts are not expected to recover in 2009-10. Financial sector profits are assumed to remain flat, while other non-oil profits are expected to fall a further 2¼ per cent. From 2010-11, profits in the financial sector are forecast to increase from very low levels, growing at above-trend growth rates of 14 per cent per year, consistent with the sector recovering but activity remaining lower than assumed in earlier Budgets and Pre-Budget Reports. Onshore corporation tax increases as a proportion of GDP, but remains well below the Budget 2008 projection. This reflects lower projected levels of economic output throughout the forecast period resulting in lower profit levels for non-financial firms, while the contribution of the financial sector to overall activity is likely to be smaller than previously envisaged.

North Sea revenues

B.53 North Sea revenues in 2008-09 are expected to be £3.3 billion above the Budget 2008 forecast, reflecting the rapid rise in both oil and gas prices up to July. Since then, oil prices have fallen back sharply, but are likely to still average just over $100 a barrel in 2008 as a whole, well above the $83.8 a barrel assumed in the Budget 2008 forecast. There are a number of offsets that limit the overall impact of high oil prices on the public finances and mean that there is no significant windfall to the government. Temporarily higher inflation will push up the indexation of tax thresholds and benefits and increase the cost of servicing index-linked gilts, whilst increased costs will reduce tax yields by squeezing the profit margins in the remainder of the economy and any drop in the demand for fuel will reduce fuel duties.

B.54 The projections of North Sea revenues for 2009 and beyond use the NAO audited oil price assumption. This is either the average of independent forecasts for the year ahead, or if lower, the average of the past month's oil price in nominal dollar terms, as is the case with this forecast. This gives an oil price of $60.1 a barrel for 2009, which is the key driver of the projected 33 per cent fall in North Sea revenues in 2009-10. The depreciation of sterling against the dollar means that the drop in the oil price in sterling terms is less steep than in dollar terms. This helps limit the downward revision in North Sea revenues in 2009-10 since the Budget to £1.1 billion.

Capital gains tax and inheritance tax

B.55 Receipts from capital gains tax (CGT) are expected to halve between 2007-08 and 2009-10, reflecting the sensitivity of CGT to equity price changes. Such a fall would not be unprecedented, as receipts fell by 50 per cent between 2001-02 and 2002-03, reflecting the dotcom-related drop in equity prices. CGT is particularly volatile because financial assets account for around two-thirds of chargeable gains and it is charged on the gain rather than the whole disposal price. With CGT paid in the financial year following the year in which the gains were realised, the main impact from lower equity prices will not be felt until 2009-10. CGT receipts will also be affected by the downturn in the property market.

B.56 Declines in asset prices will also affect inheritance tax, which is particularly affected by developments in the property market. Housing accounts for around 50 per cent of assets in estates notified for probate. The lagged response of inheritance tax to the drops in both equity and house prices in 2008 is expected to reduce receipts by £0.7 billion in 2009-10, relative to the Budget 2008 forecast.

Stamp duties

B.57 Total stamp duty is expected to fall by over 40 per cent in 2008-09. The sharp drop in stamp duty land tax is from a combination of falls in house prices, the commercial property market and in particular that residential property transactions in 2008-09 are likely to be less than half their 2007-08 level. Stamp duty on shares has also been adversely affected by the steep drop in equity prices. With much of the drop occurring through the autumn, substantial year-on-year falls in stamp duty on shares are likely over the remainder of 2008-09.

B.58 A further decline in stamp duties is likely in 2009-10. The average of independent forecasts is for a fall in house prices of just over 20 per cent in the two years to the end of 2009. In addition, property transactions are likely to remain low given that credit conditions are only expected to ease slowly through 2009. Thereafter, the economy and the housing market are expected to pick up, with house prices assumed to grow by 6 per cent per year broadly in line with long term average growth in house prices, but stamp duty receipts remain well below Budget 2008 projections. This reflects lower house and equity prices throughout the forecast.

VAT receipts

B.59 Year-on-year growth in cash receipts of VAT in the first seven months of 2008-09 was 4.3 per cent, stronger than the overall growth in receipts, partly reflecting one-off factors and that nominal consumer expenditure held up in the early part of the year. With growing evidence of weaker consumer spending, VAT receipts are expected to slow over the remainder of the financial year. The reduction in VAT from 17½ per cent to 15 per cent at the start of December will reduce cash receipts of VAT by around £1.9 billion in 2008-09. Some of the VAT relating to the last four months of 2008-09 will be paid in the first few months of 2009-10 and accrue back to 2008-09. This is incorporated in the 'accruals adjustments on taxes' line in Table B13.

B.60 With the VAT rate at 15 per cent until the end of December 2009, receipts are expected to be over 12 per cent lower in 2009-10 than in 2008-09. The sharp fall in VAT receipts in 2009-10 also reflects the impact of economic developments on the VAT base. Consumer spending which accounts for around two-thirds of the total VAT base is expected to decline in real terms in 2009, although the reduction in the VAT rate partly ameliorates this. In nominal terms, consumer spending is expected to grow by just 0.7 per cent in 2009. The VAT base will

also be affected by the financial sector crisis. While financial sector businesses do not charge VAT on final products they cannot claim back the VAT incurred from buying other business inputs to produce these exempt products. These partially-exempt businesses thus incur 'stuck VAT' and this is likely to be affected by the downturn in the sector.

B.61 Beyond 2009-10, growth in the VAT base is held back by consumer spending growing at rates slightly below that of the whole economy, as households adjust their finances. In addition, the forecast assumes a 0.5 percentage point rise per year in the underlying VAT gap (the difference between the theoretical tax liability and actual receipts), in line with the NAO audited assumption.

Excise duties

B.62 Fuel duties in 2008-09 are expected to be £0.7 billion below the Budget 2008 projection. This partly reflects that the Budget 2008 duty rise was deferred from October to December, but also the effect on the demand for fuel from the higher pump prices earlier in 2008. With fuel duty charged on a per litre basis, lower demand for fuel reduces receipts. While pump prices have fallen in recent months, the demand for fuel in 2009-10 is likely to be affected by the near-term contraction in the economy.

B.63 Alcohol duties in 2008-09 are expected to be £0.3 billion below their Budget 2008 forecast. Forestalling ahead of Budget 2008 brought forward some receipts expected in 2008-09 into 2007-08. With the economic forecast assuming a decline in overall consumer spending in 2009, alcohol sales are likely to be affected. Lower consumer spending could reduce alcohol receipts by £0.5 billion in 2009-10. However, there will be an offset from the decision to raise alcohol duty.

B.64 Tobacco receipts in 2008-09 are expected to be £0.6 billion above the Budget 2008 projection. This reflects that duty paid consumption is not expected to fall by as much as assumed in the Budget 2008 forecast. The impact from the smoking ban could be less than was incorporated into the Budget projection, or alternatively there could have been a fall in cross border shopping or the illicit market share. Tobacco receipts will also be affected by the decision to raise tobacco duty.

Business rates

B.65 Receipts from business rates are expected to be £0.3 billion below the Budget 2008 forecast. Year-on-year growth is expected to be stronger in the remainder of the year reflecting the timing of payments and repayments. Business rate bills are calculated by multiplying the rateable value by the multiplier, which is uprated in line with inflation each year. The higher than expected RPI inflation for September 2008 will be reflected in the multiplier used for 2009-10. However, in line with legislation, a negative RPI in September 2009 would reduce the multiplier used for 2010-11, exercising downward pressure on business rates receipts.

Council tax

B.66 Council tax increases are determined annually by local authorities, not by the Government. The council tax projections are based on stylised assumptions and are not Government forecasts. The council tax figures for 2009-10 onwards are based on the arithmetic average of council tax increases over the past three years. Since changes to council tax are broadly balanced by changes to locally financed expenditure, they have little material impact on the current balance or on net borrowing.

Other taxes and royalties

B.67 The 'other taxes and royalties' line in Table B13 includes the auction receipts from the EU Emissions Trading Scheme. This line also includes VAT refunds to central and local government. The reduction in VAT until the end of December 2009 will lower such refunds. VAT refunds also score as public expenditure and thus have no impact on net borrowing.

Other taxes and receipts

B.68 Interest and dividend receipts will be boosted in 2009-10 by interest from the preference shares related to the Bank Recapitalisation Fund. However, the gross operating surpluses of public corporations have been revised down, reflecting the weaker economic outlook. This is included in the 'other receipts' line in Table B13.

Tax-GDP ratio

B.69 Table B14 shows projections of receipts from major taxes as a per cent of GDP; and Table B15 sets out projections of the overall tax-GDP ratio, based on net tax and national insurance contributions.

B.70 The tax-GDP ratio drops sharply through 2008-09 and 2009-10 reflecting the downturn in the economy, lower receipts from the housing market and the financial sector, and the temporary reduction in VAT from 17.5 per cent to 15 per cent. The ratio falls to just under 34 per cent in 2009-10, the lowest since 1996-97.

B.71 With growth expected to pick up through 2010 and 2011 to a little above trend rates, the tax-GDP ratio is forecast to start to rise from 2010-11 onwards. The increase in the tax-GDP ratio also reflects the VAT rate returning to 17½ per cent at the start of 2010 and the fiscal consolidation measures from 2011-12. At the end of the forecast period, the tax-GDP ratio remains significantly below the Budget projection, reflecting the lower level of economic output, less financial sector activity and lower levels of asset prices than previously assumed.

Table B14: Current receipts as a proportion of GDP

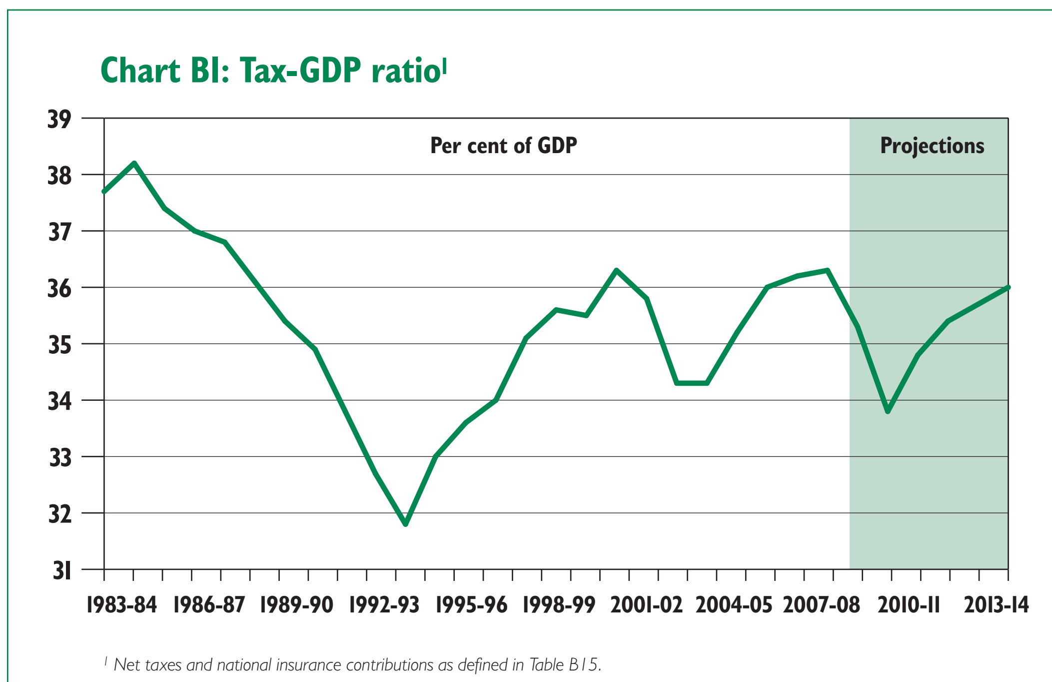
	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Income tax (gross of tax credits)	10.7	10.7	10.2	10.5	10.8	11.1	11.3
National insurance contributions	7.1	6.7	6.8	6.8	7.0	7.1	7.2
Non-North Sea corporation tax[1]	2.9	2.4	2.4	2.5	2.5	2.6	2.7
Tax credits[2]	-0.4	-0.4	-0.5	-0.4	-0.4	-0.4	-0.4
North Sea revenues[3]	0.5	0.9	0.6	0.6	0.5	0.5	0.4
Value added tax	5.7	5.6	4.9	5.5	5.5	5.4	5.4
Excise duties[4]	2.9	2.8	2.9	2.9	2.8	2.8	2.7
Other taxes and royalties[5]	6.9	6.6	6.4	6.5	6.6	6.7	6.7
Net taxes and NICs[6]	**36.3**	**35.3**	**33.8**	**34.8**	**35.4**	**35.7**	**36.0**
Accruals adjustments on taxes	0.1	-0.2	0.2	0.2	0.2	0.3	0.2
Less EU transfers	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Other receipts[7]	2.5	2.5	2.6	2.6	2.7	2.7	2.7
Current receipts	**38.5**	**37.3**	**36.2**	**37.2**	**37.9**	**38.3**	**38.6**

[1] *National Accounts measure, gross of enhanced and payable tax credits.*
[2] *Tax credits scored as negative tax in net taxes and national insurance contributions.*
[3] *Includes petroleum revenue tax and North Sea corporation tax.*
[4] *Fuel, alcohol and tobacco duties.*
[5] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*
[6] *Includes VAT and 'own resources' contributions to EC budget; cash basis.*
[7] *Mainly gross operating surplus and rent.*

Table B15: Net taxes and national insurance contributions[1]

	Per cent of GDP						
	Outturn[2]	Estimate[3]	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Budget 2008	36.8	36.7	36.9	37.3	37.4	37.4	-
2008 Pre-Budget Report	**36.3**	**35.3**	**33.8**	**34.8**	**35.4**	**35.7**	**36.0**

[1] *Cash basis. Uses OECD definition of tax credits scored as negative tax.*
[2] *The 2007-08 figures were estimates in Budget 2008.*
[3] *The 2008-09 figures were projections in Budget 2008.*



[1] Net taxes and national insurance contributions as defined in Table B15.

PUBLIC EXPENDITURE

B.72 This section looks in detail at the projections for public expenditure. It includes provisional outturns for 2007-08, the latest estimates for 2008-09 and public expenditure plans for 2009-10 to 2010-11. The spending projections cover the whole of the public sector, using the national accounts aggregate Total Managed Expenditure (TME).

B.73 For fiscal aggregates purposes, TME is split into national accounts components covering public sector current expenditure, public sector net investment and depreciation. For budgeting and other purposes, TME is split into DEL (firm three-year limits for departments' programme expenditure) and AME (expenditure that is not easily subject to firm multi-year limits). Departments have separate resource budgets, for current and capital expenditure.

B.74 Table B16 sets out projected spending on DEL and the main components of AME to the end of the 2007 Comprehensive Spending Review period in 2010-11. Table B17 shows changes since Budget 2008.

Changes in TME since Budget 2008

B.75 The provisional outturn for TME in 2007-08 was £2.3 billion lower than estimated in Budget 2008. Current expenditure was lower by £3.8 billion, mainly due to larger than expected departmental underspends. Public sector net investment was higher by £1.4 billion mainly due to a reclassification of Ministry of Defence (MoD) expenditure from current to capital expenditure.

B.76 The main changes to TME in the 2007 Comprehensive Spending Review period since Budget 2008 are to DEL, where the totals for 2008-09 to 2010-11 have been revised as a result of changes to spending announced in this Pre-Budget Report, and changes to the forecasts of individual AME components.

B.77 TME for 2008-09 is estimated to be around £5.3 billion higher than at Budget 2008 and then higher over the forecast period, mainly due to increased spending on social security benefits, and increased forecasts of local authority self-financed expenditure. The reasons for changes in TME are explained in more detail in the projections of individual DEL and AME components.

B.78 Chart B2 shows TME as a percentage of GDP from 1971-72 to the end of the CSR period in 2010-11.

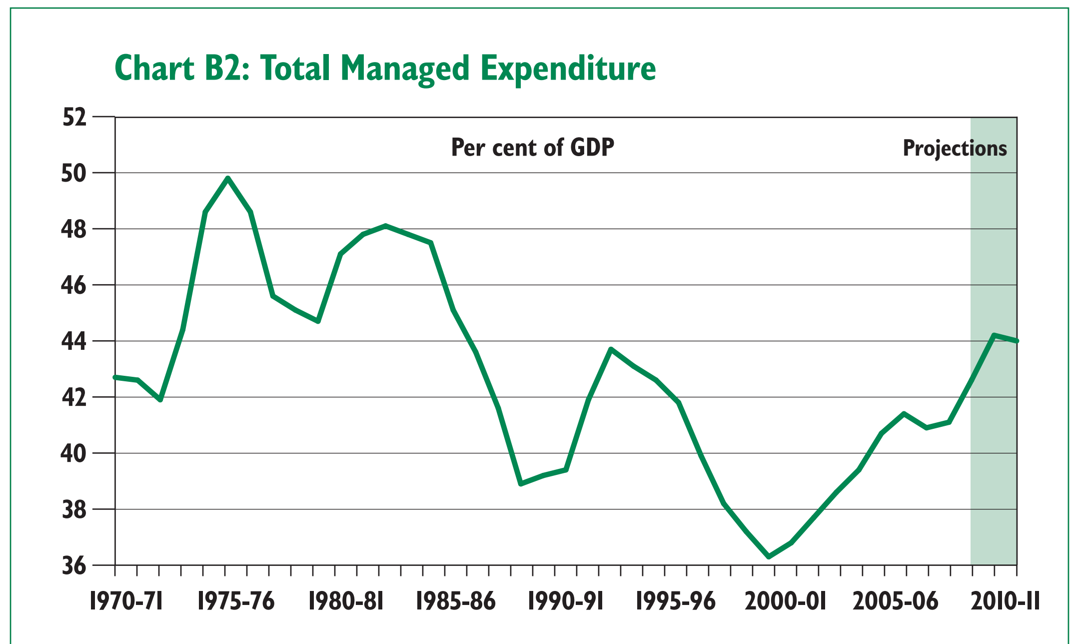


Table B16: Total Managed Expenditure 2007-08 to 2010-11

	£ billion			
	Outturn	Estimate	Projections	
	2007-08	2008-09	2009-10	2010-11
CURRENT EXPENDITURE				
Resource Departmental Expenditure Limits	**310.0**	**325.3**	**339.2**	**350.0**
of which:				
Near-cash Departmental Expenditure Limits	288.7	304.4	317.3	326.5
Non-cash	21.4	20.9	21.9	23.5
Resource Annually Managed Expenditure	**226.3**	**242.6**	**254.5**	**278.2**
of which:				
Social security benefits[1]	138.8	149.2	159.6	164.0
Tax credits[1]	17.1	19.5	20.6	20.4
Net public service pensions[2]	2.3	2.9	3.8	3.9
National Lottery	0.9	1.0	0.8	0.8
BBC domestic services	3.3	3.5	3.6	3.7
Other departmental expenditure	2.6	2.1	2.2	1.6
Net expenditure transfers to EC institutions[3]	5.4	3.8	5.3	7.1
Locally-financed expenditure[4]	24.4	26.1	26.8	28.3
Central government gross debt interest	29.9	30.8	26.6	40.0
AME margin	0.0	0.0	0.9	1.8
Accounting adjustments	1.6	3.8	4.4	6.4
Public sector current expenditure	**536.4**	**568.0**	**593.7**	**628.2**
CAPITAL EXPENDITURE				
Capital Departmental Expenditure Limits	**44.1**	**48.8**	**53.8**	**50.1**
Capital Annually Managed Expenditure	**3.6**	**6.3**	**6.3**	**3.5**
of which:				
National Lottery	0.8	0.7	0.9	0.8
Locally-financed expenditure[4]	3.6	5.3	4.6	3.5
Public corporations' own-financed capital expenditure	5.9	6.4	7.1	6.0
Other capital expenditure	-1.2	-0.4	0.5	0.6
AME margin	0.0	0.0	0.1	0.2
Accounting adjustments	-5.4	-5.6	-6.8	-7.6
Public sector gross investment	**47.7**	**55.1**	**60.1**	**53.6**
Less public sector depreciation	-17.8	-18.7	-19.7	-20.9
Public sector net investment	**29.9**	**36.5**	**40.4**	**32.7**
TOTAL MANAGED EXPENDITURE[5]	**584.1**	**623.1**	**653.8**	**681.8**
of which:				
Departmental Expenditure Limits	343.5	362.1	380.6	386.8
Annually Managed Expenditure	240.6	261.0	273.1	295.0

[1] For 2007-08 to 2008-09, child allowances in Income Support and Jobseekers' Allowance have been included in the tax credits line and excluded from the social security benefits line.

[2] Net public service pensions expenditure is reported on a National Accounts basis.

[3] AME spending component only. Total net payments to EC institutions also include receipts scored in DEL, VAT based contributions which score as negative receipts and some payments which have no effect on the UK public sector in the National Accounts. Latest estimates for total net payments, which exclude the UK's contribution to the cost of EU aid to non-Member States (which is attributed to the aid programme), and the UK's net contribution to the EC Budget, which includes this aid, are (in £ billion):

	2007-08	2008-09	2009-10	2010-11
Net payments to EC institutions	3.5	1.2	3.2	5.7
Net contribution to EC Budget	4.2	2.0	4.0	6.5

[4] This expenditure is mainly financed by council tax revenues. See footnote to Table B13 for an explanation of how the council tax projections are derived.

[5] Total Managed Expenditure is equal to the sum of public sector current expenditure, public sector net investment, and public sector depreciation.

Table B17: Changes to Total Managed Expenditure since Budget 2008

	£ billion			
	Outturn	Estimate	Projections	
	2007-08	2008-09	2009-10	2010-11
CURRENT EXPENDITURE				
Resource Departmental Expenditure Limits	**-3.1**	**1.1**	**0.5**	**-4.6**
of which:				
Near-cash Departmental Expenditure Limits	-1.6	0.6	0.5	-4.6
Non-cash	-1.5	0.4	0.0	0.0
Resource Annually Managed Expenditure	**-0.7**	**0.6**	**0.9**	**10.5**
of which:				
Social security benefits	0.2	2.8	5.9	4.3
Tax credits	0.0	0.5	0.6	-0.1
Net public service pensions	0.0	0.0	0.2	-0.1
National Lottery	0.0	0.1	0.0	0.1
BBC domestic services	0.0	0.0	0.0	0.0
Other departmental expenditure	-0.3	0.1	0.3	-0.2
Net expenditure transfers to EC institutions	0.0	-1.7	-1.0	0.4
Locally-financed expenditure	-0.3	0.5	0.2	0.5
Central government gross debt interest	0.0	0.5	-3.8	6.1
AME margin	0.0	-0.9	-0.9	-0.9
Accounting adjustments	-0.3	-1.3	-0.6	0.4
Public sector current expenditure	**-3.8**	**1.7**	**1.4**	**5.9**
CAPITAL EXPENDITURE				
Capital Departmental Expenditure Limits	**0.2**	**0.7**	**3.0**	**-5.2**
Capital Annually Managed Expenditure	**1.3**	**2.9**	**2.8**	**1.3**
of which:				
National Lottery	0.0	0.1	0.0	0.0
Locally-financed expenditure	-0.6	0.7	0.6	0.2
Public corporations' own-financed capital expenditure	1.2	1.2	1.5	0.3
Other capital expenditure	-0.9	-1.0	-0.3	-0.5
AME margin	0.0	-0.1	-0.1	-0.1
Accounting adjustments	1.7	2.0	1.1	1.4
Public sector gross investment	**1.5**	**3.6**	**5.8**	**-3.9**
Less public sector depreciation	-0.1	-0.1	-0.1	-0.2
Public sector net investment	**1.4**	**3.5**	**5.7**	**-4.1**
TOTAL MANAGED EXPENDITURE	**-2.3**	**5.3**	**7.2**	**2.0**
of which:				
Departmental Expenditure Limits	-1.8	1.3	2.8	-10.7
Annually Managed Expenditure	-0.5	4.1	4.4	12.7

Central Government spending in 2008-09

B.79 Monthly spending information is only available for central government. The provisional outturn for current expenditure in the first seven months of 2008-09 is 6.0 per cent higher than in the corresponding period in 2007-08. Growth is slightly higher in the year to date than the Pre-Budget Report estimate for the year as a whole, as a result of higher debt interest spending.

B.80 Debt interest payments for the year to date are 14.4 per cent higher than the same period last year, largely because of the impact of higher RPI inflation on the accruing uplift of index-linked gilts payments. However, debt interest payments are expected to grow more slowly for the year as a whole because payments in the remaining five months of the year are expected to be lower than in the corresponding period in 2007-08, as a result of falls in interest rates and RPI.

B.81 Provisional outturn data for net social benefit expenditure for the first seven months of 2008-09 show growth of 7.0 per cent over the same period in 2007-08, as a result of the economic downturn. Net social benefit expenditure is estimated to grow at a slightly higher rate for the year as a whole in the Pre-Budget forecast, in line with the NAO audited assumption for unemployment and the rest of the economic forecast, and reflecting the additional spending announced to support pensioners through the economic downturn.

B.82 Other current expenditure is 4.9 per cent higher for the year to date, compared to the relevant period a year ago. This is broadly comparable with the Pre-Budget Report estimate of 5.0 per cent growth for the year as a whole.

DEL and AME analysis

B.83 The detailed allocation of DEL is shown in Table B18. The departmental groupings have been updated to reflect the machinery of government changes announced in October 2008, and outturn years restated on the basis of current departmental responsibilities.

B.84 Final outturn spending for total DEL in 2007-08 was £343.5 billion, £1.8 billion below the Budget 2008 forecast of £345.3 billion. Within this total underspend, capital DEL was £0.2 billion higher than forecast, near-cash resource DEL was £1.6 billion lower than forecast, and non-cash resource DEL was £1.5 billion lower than forecast. The near-cash resource DEL underspend reflected larger than expected underspending by a number of departments, most notably an additional underspend of £0.6 billion by the Department of Business, Enterprise & Regulatory Reform (BERR), which reflected the receipt of additional income late in the financial year by the Nuclear Decommissioning Authority. The £1.5 billion non-cash resource DEL underspend was mainly due to a £1.0 billion underspend in defence, from lower than expected depreciation and future liabilities.

B.85 There have been a number of changes to DEL budgets since Budget 08:

- the inclusion of a £5.0 billion allowance for Additional Value for Money Savings in 2010-11 Resource DEL;
- an additional £400m in both 2009-10 and 2010-11 for Department for Work and Pensions (DWP) DEL, which, alongside DWP End-Year Flexibility (EYF), fund the additional resources to respond to rising unemployment, set out in Chapter 5.
- adjustments to the capital budgets of a number of departments, set out in Chapter 6, bringing forward spending from 2010-11 to 2009-10 and 2008-09 in order to support the economy;
- an addition to the Resource Reserve of £600m and to the Capital Reserve of £400m to provide an adequate contingency for 2008-09. Funding from the

Resource Reserve has been allocated to the Capital Reserve to account for the capital cost of military operations in 2008-09; and

- changes in public sector investment in 2010-11 are a result of revised forecasts for local authority self-financed capital spending, bringing forward capital spending, the updating of Department of Health (DH) capital plans to a level consistent with the latest planned spend and adjustments to Devolved Administrations DEL plans in line with the normal application of the Barnett formula.

B.86 The latest figures also include classification and budgetary changes, which have no impact on national accounts definitions or TME. The only significant change is the reclassification from DEL to AME of Scotland and Northern Ireland Executive transactions relating to student loans.

Table B18: Departmental Expenditure Limits - resource and capital budgets

	Outturn	Estimate	Plans	
	2007-08	2008-09	2009-10	2010-11
Resource DEL[1]				
Children, Schools and Families	44.9	46.9	49.2	51.9
Health	88.4	94.0	99.9	106.3
of which: NHS England	86.4	92.5	98.3	104.6
Transport	6.8	6.4	6.4	6.6
Innovation, Universities and Skills	15.5	16.4	17.2	18.2
CLG Communities	4.2	4.4	4.5	4.6
CLG Local Government	22.8	24.7	25.6	26.4
Home Office	8.5	9.0	9.4	9.6
Justice	8.8	9.5	9.4	9.4
Law Officers' Departments	0.7	0.7	0.7	0.7
Defence	35.8	37.3	35.2	36.7
Foreign and Commonwealth Office	1.9	2.0	1.6	1.6
International Development	4.5	4.9	5.5	6.4
Energy and Climate Change	0.6	0.9	1.0	1.1
Business, Enterprise and Regulatory Reform	1.8	1.6	1.5	1.4
Environment, Food and Rural Affairs	2.7	2.7	2.8	2.8
Culture, Media and Sport	1.6	1.6	1.7	1.8
Work and Pensions	8.1	8.0	8.2	7.9
Scotland	23.8	24.6	25.4	26.5
Wales	12.3	13.0	13.5	14.2
Northern Ireland Executive	7.7	8.1	8.4	8.8
Northern Ireland Office	1.3	1.2	1.2	1.2
Chancellor's Departments	4.8	4.8	4.6	4.5
Cabinet Office	1.8	2.1	2.2	2.4
Independent Bodies	0.8	0.9	0.8	0.9
Moderisation Funding	0.0	0.4	0.4	0.1
Reserve	0.0	0.5	2.8	2.9
Allowance for shortfall	0.0	-1.2	0.0	0.0
Additional Value for Money savings	0.0	0.0	0.0	-5.0
Total resource DEL	**310.0**	**325.3**	**339.2**	**350.0**
Capital DEL[1,2]				
Children, Schools and Families	5.2	6.0	7.2	6.8
Health	3.8	4.7	5.6	4.8
of which: NHS England	3.6	4.6	5.4	4.7
Transport	7.1	7.3	8.3	7.4
Innovation, Universities and Skills	2.1	2.2	2.5	1.8
CLG Communities	6.1	7.4	8.4	6.0
CLG Local Government	0.0	0.2	0.1	0.1
Home Office	0.7	0.9	0.8	0.8
Justice	0.8	0.9	0.8	0.7
Law Officers' Departments	0.0	0.0	0.0	0.0
Defence	7.9	8.0	8.2	8.9
Foreign and Commonwealth Office	0.2	0.2	0.2	0.2
International Development	0.7	0.9	1.4	1.6
Energy and Climate Change	1.5	1.7	1.7	1.8
Business, Enterprise and Regulatory Reform	0.0	0.0	0.0	0.0
Environment, Food and Rural Affairs	0.6	0.6	0.7	0.6
Culture, Media and Sport	0.5	1.0	0.4	0.6
Work and Pensions	0.1	0.1	0.1	0.1
Scotland	3.6	3.3	3.3	3.5
Wales	1.5	1.6	1.7	1.8
Northern Ireland Executive	1.0	1.0	1.1	1.1
Northern Ireland Office	0.0	0.1	0.1	0.1
Chancellor's Departments	0.3	0.3	0.3	0.3
Cabinet Office	0.3	0.4	0.4	0.4
Independent Bodies	0.1	0.1	0.1	0.0
Reserve	0.0	0.8	0.6	0.8
Allowance for shortfall	0.0	-0.6	0.0	0.0
Total capital DEL	**44.1**	**48.8**	**53.8**	**50.1**
Depreciation	**10.7**	**12.0**	**12.3**	**13.3**
Total Departmental Expenditure Limits	**343.5**	**362.1**	**380.6**	**386.8**
Total Education spending[3]	77.8	83.0	87.7	90.4

[1] *Figures for the Departments for Business, Enterprise and Regulatory Reform, Environment, Food and Rural Affairs, and Energy and Climate Change are provisional.*

[2] *The 2010-11 capital figures reflect changes including updating Department of Health's capital plans to a level consistent with the latest planned spend and adjustments to Devolved Administrations DEL plans in line with the normal application of the Barnett formula, as set out in paragraph B.85.*

[3] *The definition of education is now more closely aligned to the UN's Classification of the Functions of Government, including education not definable by level. The total DCSF budget, although reprofiled to bring forward capital spending, is unchanged over the 2008-09 to 2010-11 period. Projections also reflect updated information in respect of Devolved Administration and Local Authority spending plans*

AME **B.87** AME spending is forecast on the basis of the economic assumptions set out in Table B1 and the NAO audited assumptions set out in Box B1. The main changes to these assumptions since Budget 2008 that affect AME are changes to RPI and Rossi inflation, which affect benefit and public sector pensions upratings, and a higher NAO audited assumption for unemployment.

Social security benefits **B.88** Forecasts for social security expenditure have been increased since Budget 2008, due to the impact of the economic downturn, measures announced in this Pre-Budget Report, and higher inflation outturns for September 2008, which have increased the level of benefits for 2009-10. Apart from the basic state pension, which is increased by 2.5 per cent when this is higher than RPI inflation, benefit levels in 2010, which depend on the negative RPI value for September 2009, are assumed for the purposes of these forecasts to remain unchanged from their previous level. The higher projection of claimant count unemployment from the NAO audited assumption, have also contributed to higher social security spending from 2009-10 onwards, and higher projections of several benefit caseloads have contributed to the increase in for 2009-10 onwards.

Tax credits **B.89** The forecast for expenditure on Child and Working Tax credits has increased since the Budget 2008, reflecting the impact of the economic downturn. The revised projection incorporates revisions in line with higher than expected in-work entitlement, due to changes in the composition of the population in receipt of tax credits, and lower than expected growth in earnings among those in receipt of tax credits.

Public service pensions **B.90** Net public service pensions are measured on a National Accounts basis, and report benefits paid less contributions received by central government unfunded public service pension schemes. Forecast expenditure from 2008-09 reflects actuarial advice on the rate and level at which benefits are expected to come into payment, the rate of future employer and employee contributions and the latest information relating to scheme demographics. The forecast for net public service pensions expenditure is broadly unchanged since Budget 2008. The increase in the forecast for net expenditure in 2009-10 is largely due to higher inflation outturn for September 2008, which increases the projected level of payment of pensions.

National Lottery **B.91** The National Lottery figures reflect the latest view on timing of drawdown by the distributing bodies. The 2008-09 estimates are broadly unchanged from Budget 2008. The forecasts for 2009-10 to 2010-11 are consistent with projections of revenue from ticket sales.

Other departmental expenditure **B.92** Other departmental capital expenditure was lower in 2007-08 than forecast in Budget 2008, and is projected at lower levels in future years mainly because of reductions in net lending to public corporations and other bodies. These reductions are offset elsewhere in AME, either in public corporations own-financed capital expenditure (which removes departments' finance to public corporations, as set out below), or in the capital accounting adjustments (where other departmental lending is removed because loans are financing transactions, which are not included in public sector net investment or TME).

EU contributions **B.93** Net expenditure transfers to EU Institutions, which consist of Gross National Income (GNI) based contributions less the UK abatement, are unchanged the 2008 Budget estimate in 2007-08, lower in 2008-09 and 2009-10 and higher in 2010-11. The main factors are the use of updated information on the size of the EC Budget for 2008 and the likely level of payments to the 2009 EC Budget, changes in UK GNI-based contributions resulting from use of the latest economic assumptions and changes to the value of the UK abatement as a result of new information from the European Commission.

Locally financed expenditure **B.94** Locally financed expenditure mainly consists of local authority self-financed expenditure (LASFE) and Scottish spending financed by local taxation. LASFE is the local authority spending financed by local authorities' own sources of net income, other than central government support. The main determinant of the LASFE forecast is council tax. The

council tax projections used to derive current LASFE from 2008-09 onwards are based on stylised assumptions, which are not government forecasts, and are mirrored in the projections for council tax included within current receipts, so that these assumptions have no material effect on the fiscal aggregates. The current forecast also reflects historical information on movements in reserves, interest receipts and debt repayment. Capital LASFE reflects forecasts on the level of capital expenditure financed by the use of capital receipts, revenue sources of capital finance, private sector contributions and self-financed borrowing. Capital LASFE is net of local authority asset sales.

B.95 The increases in current LASFE projections since Budget 2008 mainly reflect the impact of higher levels of local authority reserves on forecast spending. The increases in capital LASFE projections since Budget 2008 are largely because of forecast falls in local authority asset sales, particularly in 2008-09 and 2009-10.

CG debt interest

B.96 Forecasts for central government gross debt interest payments have been revised in the light of latest economic determinant assumptions. With the exception of 2009-10, the projections for central government gross debt interest payments over the 2007 Comprehensive Spending Review period have increased since Budget 2008. A rise in forecast RPI inflation for 2008-09 has increased the debt interest payments on index-linked gilts. Forecast market interest rates have fallen since Budget 2008, which has the effect of reducing debt interest payment costs. However, these reductions are more than offset by the effects of higher borrowing in 2008-09 and 2010-11. The decrease in forecast debt interest payments for 2009-10 is due to a combination of lower forecast inflation and market interest rates.

PC capital expenditure

B.97 Public corporations' own-financed capital expenditure (PCOFCE) measures the total amount of public corporations' net capital expenditure, less the amount of this spending that is financed by central government departments, which is already included in DEL and elsewhere in AME. PCOFCE is higher in 2007-08 and across the forecast years reflecting public corporations' higher capital spending in 2007-08 outturn, and lower forecast sales of housing from local authority Housing Revenue Accounts.

AME margin

B.98 The AME margin has been reset at £1 billion and £2 billion for the years 2009-10 and 2010-11 respectively.

Accounting adjustments

B.99 The accounting adjustments reconcile the budgeting aggregates DEL and AME with the National Accounts definition of TME, removing items that score in DEL or AME but not in TME, and adding in items included in TME but not in DEL or AME. A breakdown of these accounting adjustments is given in the *2008 Pre-Budget Report: the economy and public finances – supplementary material*. Changes to the current and capital accounting adjustments since Budget 2008 are mainly due to lower estimates of the amount of defence capital spending that is classified as 'single use military equipment', which is treated as current spending in the National Accounts. This spending is included in capital DEL budgets, but is then switched out of capital and into current spending in the national accounting adjustments. Since Budget 2008, sizable reductions in estimates of this spending in 2007-08 and all future years have reduced the current accounting adjustments and increased capital accounting adjustments.

B.100 The projections of the capital accounting adjustments have also increased to reflect reductions in the adjustments that remove student loan transactions included within capital DEL, following the classification and budgetary changes reported above.

FINANCING REQUIREMENT

Central government net cash requirement

B.101 Table B19 presents projections of the net cash requirement by sub-sector, giving details of financial transactions that do not affect net borrowing (the change in the sector's net financial indebtedness) but do affect its financing requirement.

B.102 The central government net cash requirement in 2008-09 is projected to be £93.6 billion higher than at Budget 2008, reflecting higher net borrowing and changes to financial transactions. Details of financial sector interventions outlined in Chapter 3 are given in Box B3. Cash expenditure on company securities now includes:

- £37 billion for the Government's Bank Recapitalisation Fund; and
- receipts of £4.7 billion from the sale of the Government's holdings in Qinetiq and British Energy.

B.103 Miscellaneous financial transactions now include:

- £21 billion to refinance the Bank of England's loans to the Financial Services Compensation Scheme (FSCS) for retail depositors in Bradford & Bingley and UK subsidiaries of Icelandic banks eligible for payments from the FSCS and the Icelandic Depositors' and Investors' Guarantee Fund (ICS);
- £5.7 billion to refinance the Bank of England's working capital loan to Bradford & Bingley;
- a payment of £5.4 billion for retail depositors in Bradford & Bingley and UK subsidiaries of Icelandic banks covering that part of the deposits above the compensation limits; and
- a downward revision in the forecast of the amount outstanding on the Government's loan to Northern Rock, at 31 March 2009 from £14 billion at Budget 2008 (when it was included in lending within the public sector) to £12.2 billion.

B.104 In the main, these central government miscellaneous financial transactions offset in the public corporations (PC) sub-sector as they have been treated as loans (the FSCS is still regarded as a PC for this purpose pending decisions by ONS on how its transactions should be scored). For the public sector as a whole miscellaneous financial transactions includes Northern Rock's contribution to the net cash requirement.

Table B19: Public sector net cash requirement

	£ billion 2008-09				£ billion 2009-10			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**75.3**	**4.2**	**-1.8**	**77.6**	**116.4**	**3.8**	**-1.9**	**118.3**
Financial transactions								
Net lending to private sector and abroad	4.6	0.1	-0.3	4.4	3.9	0.1	-0.3	3.7
Cash expenditure on company securities	33.0	-0.9	0.9	33.0	0.7	-0.9	0.9	0.7
Accounts receivable/payable	-1.9	0.2	0.3	-1.4	3.3	0.2	0.3	3.8
Adjustment for interest on gilts	-5.0	0.0	0.0	-5.0	5.1	0.0	0.0	5.1
Miscellaneous financial transactions	44.0	0.0	-63.9	-19.9	-6.4	0.0	-7.3	-13.7
Own account net cash requirement	150.0	3.6	-64.8	88.8	122.9	3.2	-8.3	117.8
Net lending within the public sector	2.9	-2.2	-0.7	0.0	2.9	-2.2	-0.7	0.0
Net cash requirement[1]	**152.9**	**1.4**	**-65.5**	**88.8**	**125.9**	**1.0**	**-9.0**	**117.8**

[1] *Market and overseas borrowing for local government and public corporation sectors.*

Net financing requirement

B.105 In line with the updated fiscal forecasts, the revised financing arithmetic for 2008-09 is shown in Table B20. The central government net cash requirement (CGNCR) for 2008-09 is now forecast to be £152.9 billion, an increase of £93.6 billion from the Budget 2008 forecast. The net financing requirement (NFR) for 2008-09 is now forecast to be £157.7 billion compared with £78.8 billion at Budget. The increase of £78.9 billion in the NFR is the net effect of:

- an increase in the CGNCR of £93.6 billion;
- an increase in the forecast net contribution to financing of £7 billion from National Savings and Investments (NS&I);
- a reduction of £6.7 billion in the planned short-term financing adjustment;
- the Government's decision not to refinance the official reserves by £2 billion; and
- an increase in gilt redemptions of £1 billion.

Debt Management Office's remit

B.106 In order to meet the increase in the NFR, the Debt Management Office's (DMO's) remit has been revised as follows:

- forecast gross gilt issuance has increased by £66.4 billion to £146.4 billion. £30 billion of this increase was announced on 14 October 2008. The increase in gross gilt issuance will be met by an increase in conventional and index-linked gilt issuance with the majority of the increase in gilt issuance accounted for by an increase in short maturity conventional gilt issuance (from £25 billion at Budget to £62.8 billion); and
- the stock of Treasury bills will be increased by £14.5 billion instead of £5.8 billion as announced at Budget. £7 billion of this increase was announced on 14 October 2008.

B.107 The financing arithmetic set out in Table B20 also takes account of the change in the projected remaining balance of the Ways and Means Advance as at 31 March 2009 from £0.4 billion at Budget 2008 to £4.2 billion.

B.108 Details of changes to the financing arithmetic and a revised financing table for 2008-09 together with information on the progress of gilts sales so far this year against the DMO's financing remit can be found on the DMO's website at www.dmo.gov.uk

Table B20: Financing requirement forecast

	£ billion		
	2008-09		
	Original Remit Budget 2008	Revised Remit April 2008[1]	2008 Pre-Budget Report[2]
Central government net cash requirement	**59.3**	**59.3**	**152.9**
Gilt redemptions	17.3	17.3	18.3
Financing for the official reserves[3]	2.0	2.0	0.0
Buy-backs[4]	0.0	0.0	0.0
Planned short-term financing adjustment[5]	4.2	-2.5	-2.5
Gross financing requirement	**82.8**	**76.1**	**168.7**
Less Assumed net contribution from NS&I	4.0	4.0	11.0
Net financing requirement	**78.8**	**72.1**	**157.7**
Financed by:			
1. Debt issuance by the Debt Management Office			
(a) Treasury bills[6]	**5.8**	**-0.9**	**14.5**
(b) Gilts	**80.0**	**80.0**	**146.4**
2. Other planned changes in short-term debt[7]			
Changes in Ways & Means[8]	-7.0	-7.0	-3.2
3. Unanticipated changes in short-term cash position[9]	**0.0**	**0.0**	**0.0**
Total financing	**78.8**	**72.1**	**157.7**
Short-term debt levels at end of financial year			
Treasury bill stock in market hands	22.0	16.7	32.1
Ways & Means	0.4	0.4	4.2
DMO net cash position	0.5	0.5	0.5

[1] *The financing arithmetic in Budget 2008 was revised on 18 April 2008 to reflect outturn data for 2007-08.*

[2] *The Debt Management Office's (DMO's) remit for 2008-09 was revised on 14 October 2008 to reflect the need to raise £37 billion for the Bank Recapitalisation Fund. The financing will be raised through £30 billion of additional gilt issuance in the third quarter of 2008-09 and £7 billion of additional Treasury bill issuance.*

[3] *The change in the financing of the official reserve reflects a changed assumption about financing for the foreign exchange reserves, in line with the monthly gross reserves outturn: http://www.hm-treasury.gov.uk/d/pn_115_08_reserves.pdf.*

[4] *Purchases of "rump" gilts which are older, small gilts, declared as such by the DMO and in which Gilt-edged Market Makers (GEMMs) are not required to make two-way markets. The Government will not sell further amounts of such gilts to the market but the DMO is prepared, when asked by a GEMM, to make a price to purchase such gilts.*

[5] *To accommodate changes to the current year's financing requirement resulting from: (i) publication of the previous year's outturn CGNCR; (ii) an increase in the DMO's cash position at the Bank of England; and / or (iii) carry over of unanticipated changes to the cash position from the previous year.*

[6] *The projected change in the stock of Treasury bills is a planning assumption and may change slightly depending primarily on the extent to which other short-term cash instruments are used to raise finance.*

[7] *Total planned changes to short-term debt are the sum of: (i) the planned short-term financing adjustment; (ii) Treasury bill sales; and (iii) changes to the level of the Ways & Means Advance.*

[8] *The plan to repay the Ways and Means Advance has been revised from £7 billion at Budget 2008 to £3.2 billion. The Government repaid £7 billion of the Ways and Means Advance on 17 April 2008. It subsequently decided to increase the balance of the Ways and Means Advance temporarily, by £3.8 billion, in order to smooth the impact of the refinancing of part of the Bank of England's loans to the Financial Services Compensation Scheme.*

[9] *A negative (positive) number indicates an addition to (reduction in) the financing requirement for the following financial year.*

Box B3: Impact of financial stability measures on the public finances projections

As set out in Chapter 2, the main public finance projections exclude the impact of recent support measures for the financial sector, as these are exceptional and mostly temporary. This is an extension of the approach adopted in Budget 2008 to exclude Northern Rock from net debt. The independent Office for National Statistics (ONS) has yet to rule on how some of the transactions should be scored and issued a special background note on 16 October 2008 (*Financial Support for the banking industry: classification issues*). These classification decisions will take some time as a large volume of detailed information and legal documents will need to be examined before definitive rulings can be made. ONS are also in consultation with Eurostat (the Statistical Office of the European Union) and statistical offices in other member states to ensure consistent interpretation of international statistical guidance. Chapter 3 sets out financial stability measures taken by the Government in support of the wider economy.

Northern Rock: The projections are consistent with the company's Business Plan published after Budget 2008 and assume a reduction in both the size of its balance sheet and in the loan from the Government, which was projected in Budget 2008 to remain at £14 billion from end 2008-09.

Special Liquidity Scheme (SLS): The scheme was introduced in April 2008, and extended in October 2008, to provide liquidity support from the Bank of England to the banking system. The Government is lending Treasury bills to the Bank of England to run the scheme. The classification of the scheme is a matter for the ONS, and until there is a ruling, it has been assumed that there will be no impact on PSND as the transaction is back-to-back stock lending (for a fee) and therefore no debt is regarded as having been issued.

Bradford & Bingley: The company was taken into public ownership in September 2008 and restructured. This has added £18.2 billion to CGNCR through transactions associated with transfer of retail deposits to Abbey. £14.2 billion of this represents the assumption by Government of a loan from the Bank of England to cover the liabilities borne by the Financial Services Compensation Scheme (FSCS) and the remaining £4 billion is Government compensation for deposits above the FSCS depositor compensation limit. In addition there is a further £5.7 billion for the provision of a working capital facility. The company is currently producing a business plan, and the exact size of the working capital will be finalised as a part of that process. Although ONS announced on 14 November 2008 the classification of Bradford & Bingley to the public sector they have not yet been able to publish relevant data so no allowance can be made for including the debt of remainder of the company on the Government's balance sheet.

Kaupthing Singer & Friedlander (KSF) and Heritable: These were taken into public ownership in October 2008 and restructured. This has added £3.6 billion to CGNCR through transactions associated with transfer of retail deposits to ING Direct. £3 billion of this represents a Government loan to cover the liabilities borne by the FSCS.

Landsbanki (Icesave accounts): Transactions are taking place in November to compensate retail depositors in this account. These are expected to add around £4.5 billion to CGNCR. £3.8 billion of this represents Government refinancing of Bank of England loans to cover the liabilities borne by the FSCS and the Icelandic Depositors' and Investors' Guarantee Fund (ICS).

Bank Recapitalisation Fund: The Chancellor made a statement on 18 November 2008 detailing how future applications to the scheme would be dealt with from those banks which may seek to negotiate a substantively new proposal or new agreement with HM Treasury about the terms of any recapitalisation. Given the banks have agreed to raise capital, and the Government has given a commitment to support this, the Pre-Budget Report projections assume that the Government will acquire preference shares, and underwrite the issuance of ordinary shares, in Royal Bank of Scotland Group, Lloyds and HBOS at the terms set out in the statement on 13 October 2008, at a total cost of £37 billion, in 2008-09. In line with the NAO audited assumption (on privatisation proceeds) no disposal of these shares has been assumed over the entire projection period. However the impact on debt interest payments is largely offset by return on the preference shares.

Credit Guarantee Scheme (CGS): This scheme was introduced in October 2008. It is an insurance contract to repay new senior bank debt should the participating bank default. ONS have indicated that generally guarantees are contingent liabilities of Government and so do not score in the accounts unless the guarantee was called. No transactions from the CGS have been recorded in the Pre-Budget Report projections.

ADDITIONAL ANALYSES

B.109 Historical series for the main fiscal aggregates are included in Table B19. Further information on general government transactions and more detailed breakdowns of the public sector are included in *2008 Pre-Budget Report: the economy and public finances – supplementary material*, along with a detailed description of the conventions used in presenting the public finances.

HISTORICAL SERIES

Table B21: Historical series of public sector balances, receipts and debt

	Per cent of GDP								
	Public sector current budget	Cyclically-adjusted surplus on current budget	Public sector net borrowing	Cyclically-adjusted public sector net borrowing	Public sector net cash requirement[1]	Net taxes and national insurance contributions	Public sector current receipts	Public sector net debt[1,2]	Public sector net worth[3]
1970-71	6.8		-0.6		1.2	36.3	43.3		
1971-72	4.2		1.1		1.4	35.0	41.5		
1972-73	2.0		2.8		3.6	32.6	39.0		
1973-74	0.4	-0.7	4.9	6.0	5.8	31.9	39.5		
1974-75	-0.9	-2.5	6.5	8.1	8.9	34.5	42.1	52.1	
1975-76	-1.4	-1.6	7.0	7.2	9.2	35.3	42.8	53.8	
1976-77	-1.1	-0.6	5.5	5.0	6.3	35.1	43.2	52.3	
1977-78	-1.3	-1.2	4.3	4.1	3.6	34.1	41.4	49.0	
1978-79	-2.5	-2.3	5.0	4.8	5.2	33.1	40.1	47.1	
1979-80	-1.8	-1.7	4.1	4.0	4.6	33.5	40.6	43.9	
1980-81	-2.9	-1.5	4.8	3.4	5.1	35.5	42.2	46.0	
1981-82	-1.3	2.5	2.3	-1.5	3.3	38.0	45.5	46.2	
1982-83	-1.4	2.9	3.0	-1.4	3.1	38.2	45.2	44.8	
1983-84	-1.9	1.8	3.7	0.0	3.1	37.7	44.1	45.1	
1984-85	-2.1	0.9	3.6	0.6	3.0	38.2	43.9	45.3	
1985-86	-1.2	0.6	2.4	0.6	1.6	37.4	42.7	43.5	
1986-87	-1.4	-1.2	2.0	1.9	0.9	37.0	41.6	41.0	
1987-88	-0.4	-1.7	1.0	2.2	-0.7	36.8	40.6	36.8	72.2
1988-89	1.6	-1.0	-1.3	1.3	-3.0	36.1	40.2	30.5	77.4
1989-90	1.4	-1.4	-0.2	2.6	-1.3	35.4	39.4	27.7	69.3
1990-91	0.3	-1.2	1.0	2.6	-0.1	34.9	38.4	26.2	59.0
1991-92	-2.0	-1.5	3.7	3.3	2.3	33.8	38.1	27.4	51.9
1992-93	-5.6	-3.7	7.4	5.5	5.8	32.7	36.3	31.8	39.2
1993-94	-6.3	-4.0	7.7	5.4	6.9	31.8	35.4	36.5	28.7
1994-95	-4.8	-3.3	6.2	4.7	5.2	33.0	36.4	40.1	28.0
1995-96	-3.3	-2.4	4.7	3.8	4.2	33.6	37.2	41.9	20.7
1996-97	-2.7	-2.2	3.4	2.8	2.9	34.0	36.4	42.5	16.9
1997-98	-0.1	-0.1	0.7	0.6	0.1	35.1	37.5	40.6	14.2
1998-99	1.2	0.9	-0.5	-0.2	-0.7	35.6	37.7	38.4	13.4
1999-00	2.2	1.7	-1.6	-1.1	-0.9	35.5	37.9	35.6	16.4
2000-01	2.4	1.6	-1.9	-1.1	-3.7	36.3	38.6	30.7	22.3
2001-02	1.2	0.9	0.0	0.2	0.4	35.8	37.8	29.7	29.0
2002-03	-1.0	-0.7	2.3	2.0	2.2	34.3	36.3	30.8	27.6
2003-04	-1.5	-1.3	2.9	2.7	3.3	34.3	36.5	32.2	27.9
2004-05	-1.6	-1.5	3.3	3.2	3.2	35.2	37.4	34.1	28.3
2005-06	-1.1	-1.0	3.0	2.8	3.2	36.0	38.4	35.4	27.3
2006-07	-0.3	-0.3	2.3	2.3	2.6	36.2	38.6	36.0	25.6
2007-08	-0.5	-0.8	2.6	2.9	1.5	36.3	38.5	36.3	28.8

[1] *Excluding measures to ensure financial stability.*

[2] *At end-March; GDP centred on end-March.*

[3] *At end-December; GDP centred on end-December.*

Table B22: Historical series of government expenditure

	£ billion (2007-08 prices)				Per cent of GDP			
	Public sector current expenditure	Public sector net investment	Public sector gross investment[1]	Total Managed Expenditure	Public sector current expenditure	Public sector net investment	Public sector gross investment[1]	Total Managed Expenditure
1970-71	190.8	36.4	58.3	249.1	32.7	6.2	10.0	42.7
1971-72	200.6	31.8	54.8	255.4	33.4	5.3	9.1	42.6
1972-73	207.8	30.4	54.3	262.1	33.2	4.9	8.7	41.9
1973-74	229.1	34.2	61.1	290.1	35.0	5.2	9.3	44.4
1974-75	252.0	36.6	64.8	316.8	38.7	5.6	10.0	48.6
1975-76	257.9	36.0	64.4	322.3	39.8	5.6	9.9	49.8
1976-77	265.4	29.6	59.0	324.3	39.8	4.4	8.8	48.6
1977-78	260.9	20.2	49.8	310.7	38.3	3.0	7.3	45.6
1978-79	268.7	17.6	47.9	316.6	38.3	2.5	6.8	45.1
1979-80	275.7	16.4	47.1	322.8	38.1	2.3	6.5	44.7
1980-81	283.2	13.1	44.3	327.5	40.7	1.9	6.4	47.1
1981-82	296.0	7.0	38.0	334.1	42.3	1.0	5.4	47.8
1982-83	302.6	11.1	41.2	343.8	42.4	1.6	5.8	48.1
1983-84	312.2	13.6	43.5	355.7	42.0	1.8	5.9	47.8
1984-85	320.3	11.9	40.4	360.7	42.2	1.6	5.3	47.5
1985-86	320.4	9.2	35.4	355.8	40.6	1.2	4.5	45.1
1986-87	325.3	5.6	31.9	357.2	39.7	0.7	3.9	43.6
1987-88	328.7	5.0	29.8	358.5	38.1	0.6	3.5	41.6
1988-89	321.4	3.1	28.0	349.3	35.8	0.3	3.1	38.9
1989-90	323.7	11.3	35.8	359.5	35.3	1.2	3.9	39.2
1990-91	325.7	12.3	34.7	360.4	35.6	1.3	3.8	39.4
1991-92	345.3	16.1	35.0	380.3	38.0	1.8	3.8	41.9
1992-93	362.7	16.8	35.2	397.9	39.8	1.8	3.9	43.7
1993-94	372.8	13.3	31.6	404.4	39.7	1.4	3.4	43.1
1994-95	384.3	13.6	31.8	416.2	39.3	1.4	3.3	42.6
1995-96	389.5	13.7	31.4	420.9	38.7	1.4	3.1	41.8
1996-97	388.4	7.1	23.3	411.6	37.6	0.7	2.3	39.9
1997-98	387.4	6.1	21.7	409.0	36.2	0.6	2.0	38.2
1998-99	389.0	7.4	22.4	411.5	35.1	0.7	2.0	37.2
1999-00	396.6	6.7	21.8	418.4	34.4	0.6	1.9	36.3
2000-01	416.9	6.2	21.4	438.3	35.0	0.5	1.8	36.8
2001-02	428.9	14.0	29.4	458.3	35.3	1.2	2.4	37.7
2002-03	448.8	15.7	31.7	480.5	36.0	1.3	2.5	38.6
2003-04	471.9	17.4	33.6	505.5	36.8	1.4	2.6	39.4
2004-05	493.4	22.4	38.7	532.1	37.7	1.7	3.0	40.7
2005-06	513.0	25.1	42.1	555.1	38.2	1.9	3.1	41.4
2006-07	522.6	26.6	44.0	566.6	37.7	1.9	3.2	40.9
2007-08	536.4	29.9	47.7	584.1	37.8	2.1	3.4	41.1

[1] *Net of sales of fixed assets.*

List of abbreviations

AEF	Aggregate External Finance
AME	Annually Managed Expenditure
AMLD	Amusement Machine Licence Duty
APD	Air passenger duty
APR	Annual Percentage Rates
BCC	British Chambers of Commerce
BERR	Department for Business, Enterprise & Regulatory Reform
CAP	Common Agricultural Policy
CBI	Confederation of British Industry
CCAs	Climate change agreements
CCL	Climate change levy
CCS	Carbon capture and storage
CDO	Collateralised Debt Obligation
CERT	Carbon Emissions Reduction Target
CFC	Controlled Foreign Companies
CGT	Capital Gains Tax
CGNCR	Central government net cash requirement
CHP	Combined Heat and Power
CIPFA	Chartered Institute of Public Finance and Accountancy
CO2	Carbon dioxide
COAP	Change of Accounting Practice
CPI	Consumer Prices Index
CSR	Comprehensive Spending Review
CTC	Child Tax Credit
CTF	Child Trust Fund
CVS	Corporate Venturing Scheme
BERR	Department for Business, Enterprise & Regulatory Reform
DCMS	Department of Culture, Media and Sport
DCSF	Department for Children, Schools and Families
DECC	Department of Energy and Climate Change
DEFRA	Department for Environment, Food and Rural Affairs
DEL	Departmental Expenditure Limit
DFID	Department for International Development
DfT	Department for Transport
DH	Department of Health
DIUS	Department for Innovation, Universities and Skills
DMO	Debt Management Office
DVLA	Driver and Vehicle Licensing Agency
DWP	Department for Work and Pensions

EC	European Communities
ECA	Enhanced Capital Allowance
ECF	Enterprise Capital Fund
ECOFIN	Economic and Financial Affairs Council
EEA	European Economic Area
EEC	Energy Efficiency Commitment
EFSR	Economic and Fiscal Strategy Report
EIS	Enterprise Investment Scheme
EMI	Enterprise Management Incentive
EPC	Economic Policy Committee
ESA	Employment and Support Allowance
ESA95	European System of Accounts 1995
ESF	European Social Fund
EU	European Union
EU ETS	EU Emissions Trading Scheme
FDI	Foreign direct investment
FE	Further Education
FRS	Financial Reporting Standard
FSA	Financial Services Authority
FSBR	Financial Statement and Budget Report
FSCS	Financial Services Compensation Scheme
G7	A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, UK and US).
G8	The G8 is an informal group of eight countries: Canada, France, Germany, Italy, Japan, Russia, the UK and the US.
GAAP	Generally Accepted Accounting Practices
GAD	Government Actuary's Department
GCSE	General Certificate of Secondary Education
GDP	Gross domestic product
GGNB	General government net borrowing
GLA	Greater London Authority
GNI	Gross National Income
GVA	Gross Value Added
HB	Housing Benefit
HMRC	Her Majesty's Revenue and Customs
HMT	Her Majesty's Treasury
IAS	International Accounting Standards
IB	Incapacity Benefit
ICS	Icelandic Depositors' and Investors' Guarantee Fund

IFRS	International Financial Reporting Standards
IFS	Institute for Fiscal Studies
IHT	Inheritance Tax
ILO	International Labour Organisation
IMF	International Monetary Fund
IPCC	Intergovernmental Panel on Climate Change
ISA	Individual Savings Account
ISB	Invest to Save Budget
JSA	Jobseeker's Allowance
LASFE	Local authority self-financed expenditure
LCFI	Large Complex Financial Institutions
LDA	London Development Agency
LFS	Labour Force Survey
LHA	Local Housing Allowance
LIBOR	London Inter-Bank Offered Rate
LTPFR	Long Term Public Finance Report
MDRs	Marginal deduction rates
MIG	Minimum income guarantee
MoD	Ministry of Defence
MORI	Market and Opinion Research International
MPC	Monetary Policy Committee
MTIC	Missing Trader Intra-Community
NAO	National Audit Office
NEA	National Enterprise Academy
NHS	National Health Service
NICs	National Insurance Contributions
NIE	Northern Ireland Executive
NIESR	National Institute of Economic and Social Research
NMW	National Minimum Wage
NVQ	National Vocational Qualification
ODPM	Office of the Deputy Prime Minister
OECD	Organisation for Economic Cooperation and Development
OEP	Operational Efficiency Programme
OFCOM	Office of Communications
OFGEM	Office of Gas and Electricity Markets
OFT	Office of Fair Trading
OGC	Office of Government Commerce
ONS	Office for National Statistics
OPEC	Organisation of Petroleum Exporting Countries

PAC	Public Accounts Committee
PAYE	Pay As You Earn
PBR	Pre-Budget Report
PCOFCE	Public corporations' own financed capital expenditure
PCT	Primary Care Trust
PEP	Personal Equity Plan
PFI	Private Finance Initiative
PGS	Planning gain Supplement
PSA	Public Service Agreement
PSNB	Public sector net borrowing
PSND	Public Sector Net Debt
PSNI	Public sector net investment
R&D	Research and Development
RDA	Regional Development Agency
REITs	Real Estate Investment Trusts
RES	Regional Economic Strategy
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
RTFO	Renewable Transport Fuels Obligation
SBRI	Small Business Research Initiative
SDLT	Stamp Duty Land Tax
SDRT	Stamp Duty Reserve Tax
SERPS	State Earnings Related Pension Scheme
SFLG	Small Firms Loan Guarantee
SLS	Special Liquidity Scheme
SME	Small and medium-sized enterprise
SRR	Special Resolution Regime
STEM	Science Technology Engineering and Mathematics
TME	Total Managed Expenditure
TSB	Technology Strategy Board
UKBA	UK Borders Agency
UKTI	UK Trade and Investment
VAT	Value Added Tax
VCT	Venture Capital Trust
VED	Vehicle excise duty
WGA	Whole of Government Accounts
WTC	Working Tax Credit

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Janine Wiedel Photolibrary/Alamy
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Ian Shaw/Alamy
www.JohnBirdsall.co.uk
Tony Page/Ecoscene
Ashley Cooper/Corbis

Printed in the UK by The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
412774 11/08 19585
Printed on Paper containing 75% fibre content minimum.

Published by TSO (The Stationery Office) and available from:

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