HM TREASURY

Pre-Budget Report

Securing the recovery: growth and opportunity

Cm 7747

December 2009

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Pre-Budget Report

December 2009

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

Cm 7747 £45.00

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ISBN: 978-0-10-177472-7

Printed in the UK by The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office

ID 2334379 12/09 818

Printed on paper containing 75% recycled fibre content minimum.

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. After approval for the purposes of Section 5 of the European Communities (Amendment) Act 1993, these reports will form the basis of submissions to the European Commission under Article 99 (ex Article 103) and Article 104 (ex Article 104c) of the Treaty establishing the European Community.

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1 Overview

The Government's objective is to build a strong economy and a fair society, where there is opportunity and security for all. The 2009 Pre-Budget Report, *Securing the recovery: growth and opportunity* presents updated assessments and forecasts of the economy and public finances and reports on how, in the face of the downturn, the Government is delivering support to the economy, businesses and households to secure the recovery and provide a platform for growth and opportunity.

The Pre-Budget Report announces:

- support for business and growth, including extending empty property relief, extending the Enterprise Finance Guarantee and deferring the increase in the Small Companies rate for another year, a £200m addition to the Strategic Investment Fund in 2010-11, the establishment of Infrastructure UK, and the introduction of a patent box from April 2013;
- support for low carbon growth, through doubling from two to four the UK's commitment to fund carbon capture and storage demonstration projects, increasing support for low carbon vehicles, and additional funding for low carbon industries and energy efficiency, including Warm Front; and
- support for individuals, so that 18-24's claiming Jobseekers Allowance for six months will be guaranteed a job, work placement or work-related skills training, and extending free school meals to primary school pupils in low income working families.

The Pre-Budget Report announces that a temporary payroll tax of 50 per cent will apply to discretionary bonuses above £25,000 for each individual employee.

The Pre-Budget Report announces action to maintain the path of fiscal consolidation and to protect front line public services:

- an increase of 0.5 per cent in the employee, employers and self-employed rates of national insurance contributions (NICs) from April 2011, alongside an increase in the point at which individuals start to pay NICs to protect 15 million people on incomes below £20,000;
- a freeze in the point at which individuals start to pay the higher rate of income tax in 2012-13; and
- the restriction of pensions tax relief from April 2011 will apply to those with gross incomes over £150,000, where gross income incorporates all pension contributions, including those funded by an employer.

The Pre-Budget Report confirms that the Government will stick to planned levels of overall departmental spending in 2010-11, and announces that public sector current expenditure will grow by an average of 0.8 per cent a year in real terms from 2011-12 until 2014-15. It sets out a package to ensure that in 2011-12 and 2012-13, 95 per cent NHS front line spending rises in line with inflation, spending on front line schools rises by 0.7 per cent a year in real terms and that sufficient funding will be provided to enable the number of police officers to be maintained. To free up resources for this, it also announces £11 billion of savings through smarter government, £5 billion from targeting and prioritising spending and in addition reforms will be made to public sector pay and pensions.

The Pre-Budget Report sets out the Government's plans to reduce borrowing to 5.5 per cent of GDP in 2013-14, consistent with debt falling in 2015-16. These plans will be embedded in legislation through the Fiscal Responsibility Bill.

Global economic shocks and world downturn

1.1 In 2008 the global economy entered the most severe and synchronised recession since the Great Depression. By the end of the year, both advanced and emerging market economies were contracting – in many cases at rates not seen in the post-war period. In the UK, output at the start of the year fell more sharply than expected at Budget 2009. However, timely and effective action by governments around the world has helped to avoid a significantly worse outcome and there are tentative signs of recovery in the global and UK economies. In the UK there is evidence that, compared with the 1990s recession, employment has held up relative to output, fewer firms have gone into liquidation and fewer houses have been repossessed. This partly reflects the action that the Government has taken to promote labour market flexibility since 1997 and to support jobs and businesses with cash-flow problems during the downturn.

Global prospects

1.2 Largely due to this unprecedented level of international policy cooperation,[1] there are now emerging signs of recovery in the world economy. Confidence and financial conditions have improved and world trade volumes recovered in the second half of 2009. While prospects for the world economy remain uncertain, as the policy stimulus announced by advanced and emerging market economies earlier this year begins to take effect, the world economy is forecast to grow by 3¼ per cent in 2010, before rising to 4¼ per cent in 2011 and 2012.

UK and global policy response

1.3 Through the UK's G20 presidency, the Government has led the international response to the financial crisis mitigating its impact on the global economy. At the G20 summit in Pittsburgh, Leaders announced the *Framework for Strong, Sustainable and Balanced Growth* to ensure that G20 policies promote adequate and more balanced global demand.

Economic prospects

1.4 Given the opposing forces of a severe global downturn and an unprecedented international policy response, prospects for the world economy remain uncertain. The world economy is forecast to contract by 1 per cent in 2009. The contraction has been most severe among the advanced economies and, although the second half of 2009 is likely to see an improvement, G7 GDP is forecast to contract by 3½ per cent in 2009. As the policy stimulus announced earlier this year by advanced and emerging market economies begins to take effect, the world economy is forecast to grow by 3¼ per cent in 2010, before rising to 4¼ per cent in 2011 and 2012.

1.5 In line with Budget 2009 forecast, GDP growth is expected to return by the end of the year, before picking up progressively through 2010 and 2011.

1.6 For the economic forecast, GDP growth is forecast to pick up to 1¼ per cent in 2010 and to above trend rates of 3½ per cent in 2011 and 2012.

Pre-Budget Report 2009

1.7 The Government will continue to provide targeted support to businesses and households through the current downturn, while providing support for growth and ensuring the economy is able to make a strong and sustained recovery. The Pre-Budget Report describes the next steps that the Government is taking to make further progress in:

- **maintaining macroeconomic stability**, through supporting the economic recovery and building a strong economy for the future, while ensuring sound public finances;
- **reforming financial services**, through ensuring a strong, thriving and responsible financial sector that supports growth and prosperity across the UK;
- **supporting business and growth**, through ensuring UK businesses are well placed to meet the challenges and opportunities as the world moves into recovery;

[1] As noted by Dominique Strauss-Kahn, *An address to the Confederation of British Industry Annual Conference*, November 23 2009.

- **achieving fairness and providing opportunity**, through the tax credits and benefits system, support to help people back to work and a fair and sustainable personal tax system;
- **protecting public services**, through freeing up the resources necessary to protect key public service priorities and making tough choices and reforms elsewhere; and
- **supporting low-carbon growth**, through playing a leading role on international climate change and domestic support for business investment in low carbon growth.

MAINTAINING MACROECONOMIC STABILITY

1.8 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.

Policy response

1.9 Responding to the exceptional risks that the financial crisis has posed to UK economic stability, the Government has taken action to deliver a coherent and comprehensive package of support to the economy, and businesses and individuals within it, which the International Monetary Fund (IMF) has described as "bold and wide-ranging".[2]

1.10 First, the Government has undertaken major interventions to reinforce the stability of the financial system, to increase confidence and banks' capacity to lend, and in turn to support the recovery of the economy.

1.11 Second, a substantial macroeconomic stimulus has been put in place to help the economy through the recovery.

1.12 Third, through reprioritising existing budgets, targeted support has been provided to help those businesses and individuals who need it most, including measures to provide temporary support through the downturn for jobseekers, home-owners and businesses facing cash-flow problems.

1.13 A starting point of low public debt and the action that the Government is taking to ensure fiscal sustainability over the medium term, enables the Government to continue to provide support to the economy, where it is needed, through the downturn and in the early stages of recovery. The Government will continue to provide support where it is needed to secure sustainable growth; in particular, policies to ensure well-functioning financial markets are crucial to the future of the economy. The Bank Rate is at a historically low level of 0.5 per cent and is expected to continue to provide an ongoing and powerful stimulus throughout next year.

1.14 However, as the economy and financial markets recover after an exceptional period of risk and uncertainty, the role for macroeconomic policy will change. Based on its assessment of economic conditions and prospects, the Government's actions will move from supporting activity in the downturn to setting policy to provide the conditions for future growth.

Ensuring sustainability

1.15 This Pre-Budget Report announces measures that maintain the path of consolidation set in Budget 2009 and reinforce the fairness of the tax system. The measures include:

[2] *United Kingdom – 2009 Article IV Consultation, Concluding Statement of the Mission*, International Monetary Fund, 20 May 2009.

- **an increase of 0.5 per cent in the employee, employers and self-employed rates of national insurance contributions (NICs) from April 2011, alongside an increase in the point at which individuals start to pay NICs to protect 15 million people on incomes below £20,000;**
- **a freeze in the point at which individuals start to pay the higher rate of income tax in 2012-13; and**
- **the restriction of pensions tax relief from April 2011 will apply to those with gross incomes of £150,000 and over, where gross income incorporates all pension contributions, including those funded by an employer. This will be subject to an income floor, so that individuals with pre-tax incomes (excluding employer pension contributions) of less than £130,000 will be unaffected.**

Public finances **1.16** The 2009 Pre-Budget Report provides updated projections for the public finances. The projections take account of all firm decisions announced in this Pre-Budget Report, or since Budget 2009, consistent with the *Code for fiscal stability*. This Pre-Budget Report also sets out a new definition of net borrowing, PSNB excluding the temporary effects of financial interventions, which excludes the distortionary and temporary effects of the publicly-owned banks and the Bank of England Asset Purchase Facility Fund. This measure will be published in outturn by the ONS alongside the measure for PSND, which is already published.

1.17 The Pre-Budget Report public finance projections, summarised in Table 1.1, show that compared to Budget 2009:

- Public sector net borrowing (PSNB), excluding the temporary effects of the financial interventions, is broadly unchanged from the Budget 2009 forecast. Based on cautious assumptions, borrowing is projected to more than halve from 12.6 per cent of GDP in 2009-10 to 5.5 in 2013-14. It then falls to 4.4 per cent in 2014-15 in 2009-10; and
- Public sector net debt (PSND), excluding the temporary effects of the financial interventions, increases over the forecast period to 77.7 per cent of GDP.

Table 1.1: Summary of fiscal projections

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Public sector net borrowing (PSNB)	6.6	12.6	12.0	9.1	7.1	5.5	4.4
Total change since Budget 2009	*0.4*	*0.2*	*0.1*	*0.0*	*-0.1*	*0.0*	
Impact of discretionary measures on PSNB [1]	*0.0*	*0.0*	*0.3*	*0.3*	*0.1*	*0.0*	*-0.2*
Cyclically-adjusted PSNB	5.7	9.0	8.0	5.8	4.5	3.6	3.1
Surplus on current budget	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Public sector net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
Public sector net debt [2]	44.0	55.6	65.4	71.7	75.4	77.1	77.7

Note: All measures are presented on the basis which excludes the temporary effect of financial interventions.

[1] *Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13, 2013-14 and 2014-15.*

[2] *Debt at end March; GDP centred on end March.*

The fiscal framework

1.18 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.

1.19 **The Fiscal Responsibility Bill announced alongside the Pre-Budget Report will enshrine the Government's fiscal consolidation plans in legislation. The Bill requires the Government to set out at all times a statutory fiscal plan for delivering sound public finances, to be approved by Parliament, and places a binding duty on the Government to meet that plan.**

1.20 Furthermore, the Bill sets out the Government's first legislative fiscal plan, the Fiscal Consolidation Plan (FCP). The FCP extends from 2009-10 to 2015-16 and incorporates the 2009 Pre-Budget Report fiscal judgment by requiring that the Government:

- **halves public sector net borrowing as a share of GDP over four years from its forecast peak in 2009-10. The Government is setting a target, in secondary legislation enabled by the Bill, for borrowing to be 5.5 per cent of GDP or less in 2013-14;**
- **reduce borrowing as a share of GDP in each and every year from 2009-10 to 2015-16; and**
- **ensure that public sector net debt is falling as a share of GDP in 2015-16.**

1.21 This is a significant reform in the way that the Government is held to account for delivering its fiscal plans, giving Parliament a clear, central role in both setting and monitoring the Government's fiscal plans.

1.22 These are binding targets that cannot be changed except through new primary legislation. This demonstrates the Government's commitment to delivering consolidation, and the importance it places upon action to ensure sound public finances in the medium term.

REFORMING FINANCIAL SERVICES

1.23 A strong and thriving UK financial services sector supports UK growth and prosperity. In order for this positive contribution to be delivered, market participants and regulators need to ensure that the sector's development is sustainable and supports long term economic growth.

1.24 The Government attaches great importance to tackling the remuneration practices that contributed to the excessive risk-taking by the banking industry. The 2009 Pre-Budget Report announces that:

- **a temporary bank payroll tax of 50 per cent will apply to discretionary bonuses above £25,000 awarded in the period from Pre-Budget Report to 5 April 2010 for each individual employee.**

1.25 The Government has taken decisive steps to maintain financial stability and promote the flow of credit to the economy. The success of these financial sector interventions is reflected in a downward assessment of their eventual net fiscal cost. Building on these measures, the 2009 Pre-Budget Report announces that the Government will:

- **explore ways of encouraging more sustainable, transparent and standardised mortgage-backed securities markets;**
- **consult on and promote the UK regulated covered bond market; and**
- **publish a discussion paper on developing non-bank lending channels.**

I.26 The Government will shortly announce a package of measures to reduce the impact of any future failure of systematically important investment banks. It is also working at the national, EU and global level to shape the future development of the financial services sector. The 2009 Pre-Budget Report also announces:

- **the introduction of a Code of Practice on taxation for banks;**
- **a new advisory group on professional and financial services;**
- **measures to promote a level playing field for Islamic finance products;**
- **a specific Governance Code for Building Societies and other mutuals; and**
- **the commencement of a new regulatory framework for recognised inter-bank payments systems.**

I.27 Competition and choice are central to responsive and well functioning markets. The Government is taking steps to promote competition in financial services, and to ensure that consumers are empowered to make informed choices, have access to the services they need, and are appropriately protected. The 2009 Pre-Budget Report announces:

- **£20 million to fund the national rollout of the Money Guidance service in 2010-11, helping one million people to manage their money better; and**
- **£5 million to fund extended opening hours at Citizens Advice bureaux in 2010-11, helping an additional 300,000 people.**

SUPPORTING BUSINESS AND GROWTH

I.28 Following a year in which the global economy centered the most severe and synchronised recession since the Great Depression, the Government is determined that the UK remains an attractive place to do business, and to create a strong and stable platform for future growth.

I.29 The action that the Government is taking to put the public finances onto a sustainable footing, and to ensure that the financial markets are properly functioning, is key to providing the macroeconomic stability that business needs.

I.30 In addition to action economy-wide, the Government continues to take targeted measures to:

- support businesses into the recovery, by **continuing the Business Payment Support Service** that has already enabled over 160,000 businesses to spread over £4 billion of tax; **extending the temporary increase in the threshold for empty property rate relief; and further deferral of the increase in the Small Companies' Rate of corporation tax;**

- ensure that business has access to the capital it needs, through the legally binding lending commitments made by the Royal Bank of Scotland and Lloyds Banking Group; by making an additional £500 million of lending available to small and medium-sized enterprises **through a 12-month extension of the Enterprise Finance Guarantee** and by **creating a new Growth Capital Fund,** along with the £325 million UK Innovation Investment Fund;
- build on the unprecedented investment in infrastructure over the last decade and ensure the UK is ready to face the challenges of the transition to a low-carbon economy by **creating Infrastructure UK**, which will help facilitate private sector investment in infrastructure, and help ensure that publicly-funded infrastructure is effectively prioritised and delivered; and
- driving innovation by **introducing a Patent Box**, a reduced rate of corporation tax applying to income from patents from April 2013, to strengthen the incentives to invest in innovative industries, and through **additional funding of £200 million for the Strategic Investment Fund** that will include £150 million to support low-carbon investment.

ACHIEVING FAIRNESS AND PROVIDING OPPORTUNITY

1.31 Government support for people to move back into work, combined with a dynamic and flexible labour market, has helped over 3.2 million people to leave unemployment benefit since the 2008 Pre-Budget Report. This has helped unemployment remain lower than expected at the time of Budget 2009. The Government is therefore using some of the £3 billion funding for Jobcentre Plus and employment programmes from the 2008 Pre-Budget Report and Budget 2009 to provide additional support for those adversely affected by the recession. This additional support includes **bringing forward the young persons guarantee, so that 18-24s claiming Jobseeker's Allowance for six months will now be guaranteed a job, work placement or work-related skills training.**

1.32 The Government recognises that making the transition into work can be difficult and, to help families to make this move, the Government will **extend free school meals to primary school pupils in low income working families in England from September 2010.**

1.33 The 2009 Pre-Budget Report announces further Government action to provide support for households during the early stages of economic recovery, including increasing the basic State Pension by 2.5 per cent, the child element of the Child Tax Credit by £20 above earnings indexation, and **other benefits and tax credits normally linked to the Retail Prices Index (RPI) by 1.5 per cent.**

1.34 In 2009-10, just 2.5 per cent of estates are expected to pay inheritance tax. **The Government is therefore freezing the inheritance tax allowance at £325,000 in 2010-11.**

1.35 The Government continues to take action to protect revenues from those seeking to evade and avoid paying their fair share of tax. Building on existing measures, the Government will introduce **a package of measures which will protect around £5 billion per year from evasion and avoidance.**

PROTECTING PUBLIC SERVICES

1.36 Since 1997, record levels of investment matched by reform have enabled the Government to achieve lasting improvements in Britain's public services.

1.37 The Government's short-term priority is to continue to support the most vulnerable families and businesses until recovery is secured. The 2009 Pre-Budget Report announces new short-term spending measures, including **£300 million to bring forward the young persons guarantee, so that 18-24s claiming Jobseekers Allowance for six months will now be guaranteed a job, work placement or work-related skills training, and a freeze in the Standard Interest Rate used to calculate Support for Mortgage Interest at 6.08 per cent for a further six months, benefiting an estimated 220,000 homeowners.**

1.38 The 2009 Pre-Budget Report confirms that the Government will stick to planned levels of overall departmental spending in 2010-11 to help support the economy through the downturn, but from 2011-12 onwards spending growth will reduce to help halve the deficit over the next four years. The 2009 Pre-Budget Report announces an additional 0.5 per cent increase in employee, employer and self-employed rates of national insurance contributions. As a result, public sector current expenditure will grow by an average of 0.8[3] per cent a year from 2011-12 until 2014-15. Public sector net investment will move to 1¼ per cent of GDP by 2013-14 and will remain at that level in 2014-15.

1.39 The 2009 Pre-Budget Report sets out a package to ensure that, in 2011-12 and 2012-13, NHS front-line spending – the 95 per cent of spending that supports patient care – rises in line with inflation, spending on front-line schools rises by 0.7 per cent a year in real terms and spending on 16 to 19 participation rises in real terms by 0.9 per cent a year. Spending on Sure Start Children's Centres will be maintained in line with inflation. Sufficient funding will be provided to police authorities to enable them to maintain the number of police officers and community support officers, and spending on overseas aid will remain on track to reach 0.7 per cent of Gross National Income (GNI) by 2013.

1.40 At the same time, the 2009 Pre-Budget Report announces new efficiencies and reforms across the public sector including:

- £11 billion of savings by 2012-13 through smarter government for example through rationalising Arms Length Bodies, greater use of online systems for providing advice and information to the public, cutting consultancy spend by 50 per cent, and better management of government assets;
- £5 billion of savings by 2012-13 from targeting and prioritising spending including by reforming the Criminal Justice System and legal aid, reducing lower priority provision within the adult skills budget, phasing out temporary employment programmes, and reducing the cost and scope of the NHS IT Programme;
- a one per cent cap on public sector pay settlements in 2011-12 and 2012-13, delivering £3.4 billion of savings a year by 2012-13; and
- reforms to public service pensions to save £1 billion a year from 2012-13 onwards.

[3] Excluding the additional time limit resource expenditure announced in the 2009 Pre-Budget Report.

SUPPORTING LOW-CARBON GROWTH

1.41 The UK is playing a leading role on climate change, setting the agenda for the international negotiations and taking radical domestic action to promote low-carbon growth. The Government is committed to an ambitious global deal at the UN negotiations in Copenhagen.

1.42 The UK is at the forefront of a worldwide low-carbon economic recovery. The Pre-Budget Report provides a further £400 million to support business investment in low-carbon growth and help households reduce energy costs. Combined with policies announced since September 2008, this could support over £15 billion of additional public and private investment in the low-carbon and energy sectors over the next three years. The Pre-Budget Report announces:

- **additional support for offshore wind projects accredited from April 2010 to March 2014 via the Renewables Obligation;**
- **doubling to four the UK's commitment to fund carbon capture and storage demonstration projects via contributions from electricity suppliers;**
- **establishing Infrastructure UK to leverage further investment in low-carbon projects including by: investing €100 million in a European Investment Bank-led fund to deploy up to €1.5 billion of equity and €5 billion of debt in low-carbon infrastructure; and considering the case for a low-carbon investment institution;**
- **£120 million for low-carbon industries in the UK, including new manufacturing and testing facilities for offshore wind, a large-scale trial of smart grid technologies, and support to improve energy use in the chemicals industry;**
- **£200 million to improve energy efficiency and tackle fuel poverty by: offering £400 for up to 125,000 households to upgrade their old boilers to the latest efficient models with a greener boiler incentive; and providing extra resources for Warm Front to help 75,000 of the most vulnerable households with heating and insulation;**
- **confirming that the income received by those who generate small-scale renewable electricity for their home through the clean energy cash-back scheme, worth on average £900 in 2010, will be tax free;**
- **helping one million more vulnerable households with discounts on their energy bills by increasing support provided by energy companies from £150 million to £300 million by 2013-14;** and
- **increasing support for low-carbon vehicles through exempting electric cars from company car tax from 2010, introducing a 100 per cent first-year allowance for electric vans; and investing a further £30 million on low-carbon transport projects.**

PRE-BUDGET REPORT POLICY DECISIONS

1.43 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 in the Pre- Budget Report or since Budget 2009. 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 2009[1]

	Head	£ million			
		2009-10	2010-11	2011-12	2012-13
Measures announced since Budget 2009[2]					
Stamp Duty: exemption for company buybacks of shares of overseas branches	*Tax*	0	-5	-5	-5
Financial products avoidance	*Tax*	+50	+100	+100	+50
Pensions tax: anti-forestalling rules	*Tax*	-30	-40	0	0
Digital Britain: Landline Duty	*Tax*	0	+90	+175	+175
Childcare: employer supported childcare tax relief [3]	*Tax/Spend*	0	0	-	-
Gurkhas: removal of 1997 cut-off	*Spend*	-70	-240	-	-
Cold Weather Payments	*Spend*	-20	0	0	0
Funding for *Building Britain's Future*	*Spend*	-35	+35	0	0
Measures announced at Pre-Budget Report 2009					
Ensuring Sustainability of the Public finances					
Freeze Higher Rate Threshold in 2012-13	*Tax*	0	0	0	+400
Increase NICs Primary Threshold by £570 in 2011-12	*Tax*	0	0	-1,480	-1,500
Increase employer NICs rate by 0.5% from 2011-12	*Tax*	0	0	+2,350	+2,470
Increase main employee and self-employed NICs rate by 0.5 per cent from 2011-12	*Tax*	0	0	+1,970	+2,080
Increase additional employee and self-employed NICs rate by 0.5 per cent from 2011-12	*Tax*	0	0	+320	+340
Pensions tax: updated income definition	*Tax*	-10	-40	0	+500
Freeze Inheritance Tax Threshold in 2010-11	*Tax*	0	+80	+170	+190
Bank payroll tax	*Tax*	+550	0	0	0
Salary sacrifice: workplace canteens	*Tax*	0	0	+110	+110
Pensions auto-enrolment: slower introduction [4]	*Tax*	0	0	0	+100
Protecting Revenues					
Insurance Premium Tax: avoidance	*Tax*	+5	+10	+10	+10
Index linked gilts	*Tax*	0	+40	+65	+40
Substantial donors to charity: replacement of anti-avoidance legislation	*Tax*	0	-10	-10	-10
Supporting Business					
Rates on empty property: temporary exemption	*Tax*	0	-135	+10	0
Small Companies Rate of corporation tax: defer increase to April 2011	*Tax*	0	-10	-380	-110
Patent Box from April 2013 [5]	*Tax*	0	0	0	0
Bingo Duty: reduce to 20%	*Tax*	0	-5	-10	-10
Seafarer's Earning deduction	*Tax*	0	0	-5	-5
Venture Capital Schemes: State Aid changes	*Tax*	0	0	-20	-30
Strategic Investment Fund addition [6]	*Spend*	0	-110	0	0
Protecting the Environment					
Climate change levy: reduction of relief from 2011-12	*Tax*	0	0	+50	+50
Fuel Benefit Charge: increase multiplier	*Tax*	0	+50	+45	+45
Company Car Tax: extend bands from 2012-13	*Tax*	0	0	0	+120
Biofuels Duty Differential: limited extension	*Tax*	0	-10	-10	0
Electric vehicles: tax relief	*Tax*	0	-5	-5	neg
Warm Front and Greener Boiler Incentive [7]	*Spend*	0	-85	0	0

Table 1.2: Estimated costs for Pre-Budget Report policy decisions and others announced since Budget 2009[1] (continued)

	Head	£ million			
		2009-10	2010-11	2011-12	2012-13
Helping People Fairly [8]					
Tax relief for travel expenses	*Tax*	0	+35	+85	+85
Extension of free school meals	*Spend*	0	-140	-	-
Benefits uprating	*Spend*	0	-700	0	0
Local authority guideline rents [9]	*Spend*	0	-115	-	0
Money Guidance rollout in 2010-11	*Spend*	0	-10	0	0
Working Tax Credits: extension to over 65s from April 2010	*Spend*	0	-5	-	-
Tackling benefit error	*Spend*	0	+95	-	-
Housing Benefit: managing gains from Local Housing Allowance from 2011	*Spend*	0	-40	-	-
Support for Mortgage Interest [10]	*Spend*	-25	-70	0	0
TOTAL POLICY DECISIONS		**+415**	**-1,240**	**+3,535**	**+5,095**
Reserve: support for military operations	*Spend*	0	-2,500	0	0
Memo: Increase to Public Sector Current Expenditure	*Spend*	*0*	*0*	*-7,700*	*-6,900*

- Included within the current spending growth assumption for 2011-12 onwards.

[1] Costings shown relative to an indexed base.

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

[3] Employer supported childcare tax relief measure used to fund expansion of free childcare for 2 year olds.

[4] In 2013-14 the yield is £0.7 billion, in 2014-15 the yield is £1.6 billion.

[5] The costs of this measure will rise to £1.3bn in steady state.

[6] The total addition to the Strategic Investment Fund at this PBR is £210m in 2010-11, including Barnett consequentials for non-reprioritised funding. £100m of this is funded through reprioritisation.

[7] Total funding for Warm Front and the Greener Boiler Incentive is £215m in 2010-11 including Barnett consequentials for non-reprioritised funding. £130m of this is funded through reprioritisation.

[8] Employment support package costing £45 million in 2009-10 and £355 million in 2010-11 funded by DWP underspend.

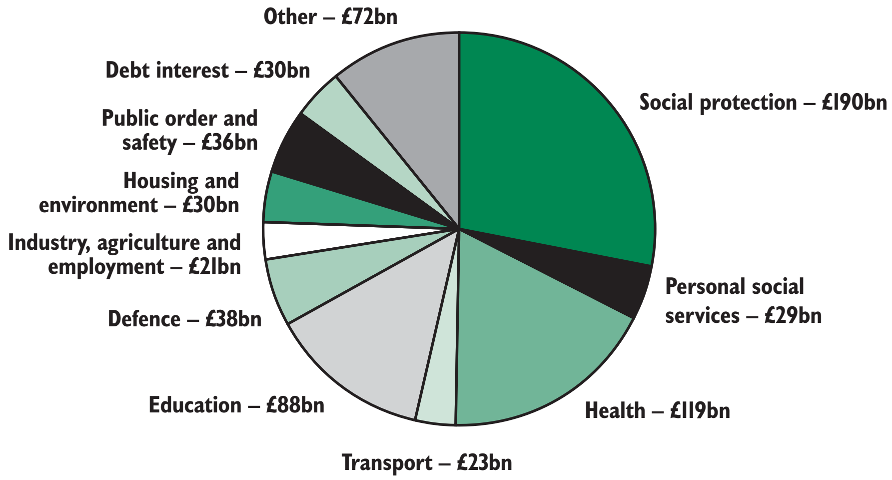
[9] Total support for Local Authority Guideline rents is £170m in 2010-11. £55m of this is funded through reprioritisation.

[10] Total Support for Mortgage Interest in 2009-10 is £70m, including Barnett consequentials for non-reprioritised funding. £45m of this is funded through reprioritisation.

1.44 Chart 1.1 presents public spending by main function. Total managed expenditure (TME) is expected to be around £676 billion in the current financial year, 2009-2010. TME is divided into Departmental Expenditure Limits (DEL), shown in table B17, and Annually Managed Expenditure (AME), shown in table B15.

Chart 1.1: Government spending by function

Total managed expenditure: £676 billion

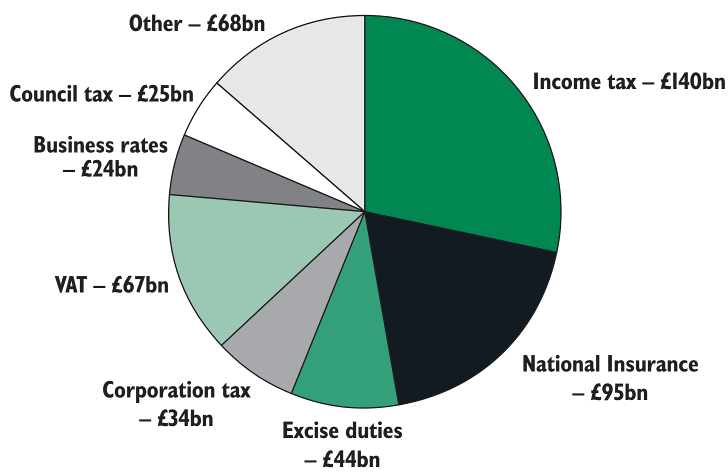


Source: HM Treasury 2009-10 near-cash projections. The allocation of spending to functions is largely based on the United Nations' Classifications of the Functions of Government (COFOG). Other expenditure includes general public services (including international services); recreation, culture, and religion; 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 in AME, in line with OECD guidelines. Figures may not sum due to rounding.

1.45 Chart 1.2 shows the different sources of government revenues. Public sector current receipts are expected to be around £498 billion in 2009-2010. Table B10 provides a more detailed breakdown of receipts consistent with this chart.

Chart 1.2: Government receipts

Total receipts: £498 billion



Source: HM Treasury, 2009-10 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 due to rounding.

2 MAINTAINING MACROECONOMIC STABILITY

Global shocks have precipitated the most severe and synchronised global recession since the Great Depression, leading to a sharper fall in UK output at the start of this year than was expected at Budget 2009. However, timely and effective action by governments around the world has helped to avoid a significantly worse outcome and there are tentative signs of recovery in the world and UK economies. In the UK there is evidence that, compared with the 1990s recession, employment has held up relative to output, fewer firms have gone into liquidation and fewer houses have been repossessed. This reflects the action that the Government has taken to promote labour market flexibility since 1997 and to support jobs and businesses with cash-flow problems during the downturn.

In line with the Budget 2009 forecast, GDP growth is expected to return by the end of the year, before picking up through 2010 and 2011. However, risks to the recovery remain and withdrawing support too quickly could undermine recovery. The Government will continue to provide support where it is needed to secure sustainable growth, in particular policies to ensure well-functioning financial markets are crucial to the future of the economy. Bank Rate is at a historically low level of 0.5 per cent and is expected to continue to provide an on-going and powerful stimulus throughout next year.

Setting a credible consolidation path to ensure sustainable public finances is a key element of the Government's macroeconomic strategy, and is essential for economic stability and the long-term health of the economy. Despite weaker than expected economic growth in the first part of the year, the Pre-Budget Report projection of public sector net borrowing in 2009-10 is broadly unchanged from Budget at 12.6 per cent. As a result, the estimate of cyclically-adjusted net borrowing has declined to 9.0 per cent of GDP. This Pre-Budget Report announces measures that maintain the path of consolidation set in Budget 2009 and reinforce the fairness of the tax system. The measures include:

- **an additional 0.5 per cent increase in the employee, employer and self-employed rates of national insurance contributions (NICs) from April 2011, alongside an increase in the point at which individuals start to pay NICs to protect 15 million people on incomes below £20,000;**
- **the point at which individuals start to pay the higher rate of income tax will be frozen in 2012-13; and**
- **the restriction of pensions tax relief from April 2011 will apply to those with gross incomes of £150,000 and over, where gross income incorporates all pension contributions, including those funded by an employer. This will be subject to an income floor, so that individuals with pre-tax incomes (excluding employer pension contributions) of less than £130,000 will be unaffected.**

In addition, public sector current expenditure will grow by an average of 0.8 per cent a year in real terms between 2011-12 and 2014-15.

Public sector net borrowing reaches 5.5 per cent of GDP in 2013-14, as forecast at the Budget, more than halving the 2009-10 level of the deficit over four years. Government borrowing falls year-on-year across the forecast horizon. The plans set out in this Pre-Budget Report are consistent with debt falling as a share of GDP in 2015-16. **These consolidation plans will be embedded in legislation through the Government's Fiscal Responsibility Bill.**

OVERVIEW OF ECONOMIC DEVELOPMENTS AND PROSPECTS

Global economic shocks and world downturn

2.1 In 2008 the global economy entered the most severe and synchronised recession since the Great Depression. By the end of the year, both advanced and emerging market economies were contracting – in many cases at rates not seen in the post-war period. Output continued its steep decline in the first quarter of 2009, amplifying the decline in trade volumes as integrated global financial and trade linkages spread the downturn across the world. These global developments have had a profound effect on the fiscal positions of most countries. In the UK, GDP has contracted sharply, by 5.8 per cent since its peak last year, and public sector net borrowing is forecast to peak at 12.6 per cent of GDP in 2009-10.

UK policy action

2.2 Responding to the exceptional risks that the financial crisis has posed to UK economic stability, the Government has taken action to deliver a coherent and comprehensive package of support to the economy, and businesses and individuals within it, which the International Monetary Fund (IMF) has described as "bold and wide-ranging".[1]

2.3 First, the Government has undertaken major interventions to reinforce the stability of the financial system, to increase confidence and banks' capacity to lend and, in turn, to support the recovery of the economy.

2.4 Second, a substantial macroeconomic stimulus has been put in place to help the economy through the recovery:

- the Government is delivering fiscal support worth 5 per cent of GDP in 2009-10 from the measures announced since the 2008 Pre-Budget Report, and the operation of the automatic stabilisers;
- Bank Rate was reduced from 5 per cent in September 2008 to 0.5 per cent in March 2009, its lowest level in the Bank of England's history; and
- in March 2009, the Government authorised the Bank of England to use the Asset Purchase Facility for monetary policy purposes, to raise nominal spending and thereby support demand. As of 3 December, the Banks' purchases of gilts and private sector assets amounted to £185 billion.

2.5 Third, targeted support has been provided to help those businesses and individuals who need it most, including measures to provide temporary support through the downturn for jobs, home-owners and businesses facing cash-flow problems.

2.6 The Government's action has been successful in averting the more severe downside risks to the economy, and has limited the severity of the downturn and its impact on businesses and individuals. In particular, evidence suggests that employment has held up relative to the 1990s recession and a smaller proportion of firms have gone into liquidation, reflecting action that the Government has taken to promote labour market flexibility since 1997 and to support jobs and businesses with cash-flow problems during the downturn. Box 2.1 provides more detail.

[1] *United Kingdom – 2009 Article IV Consultation, Concluding Statement of the Mission*, International Monetary Fund, 20 May 2009.

Box 2.1: The role of Government interventions in limiting the impact of the recession

It is difficult to quantify the precise impact of recent measures implemented by the Government and the Bank of England to mitigate the substantial economic risks posed by the financial crisis, and the full impact of some interventions will not be realised for some time. However, while risks remain, there are positive signs that they are supporting the economy and that timely and effective policy action has assisted the UK economy in avoiding a significantly worse outcome.

First, reflecting the Government's action to address system-wide risks and support the flow of lending, there has been a general improvement in financial conditions:

- the LIBOR/OIS spread, which measures the risk premium in inter-bank lending, has fallen substantially from an average of more than 200 basis points in October 2008 to an average of 19 basis points in November 2009;
- equity prices have risen significantly, with the FTSE All-share index up almost 50 per cent since early March;
- 5-year Credit Default Swap spreads for the five largest UK banks, which provide an indication of the perceived risk of lending to banks, fell by nearly 55 per cent between their peak in March and December 2009; and
- increasing amounts of unsecured bank debt has been issued outside of the Government's Credit Guarantee Scheme, suggesting improved appetite among investors to fund banks.

Second, expectations of the economic outlook have improved:

- external forecasts for economic growth have improved since the start of the year: in April 2009 the average of external forecasts predicted GDP growth in 2010 of 0.3 per cent, as of December the average forecast has risen to 1.3 per cent.

Third, there are indications that Government action may have mitigated the impact of the recession on jobs, homeowners and businesses. This has helped break the potential negative feedback loops of falling employment, lower asset values and lower lending that could have worsened the recession:

- the UK's flexible labour market and the additional £5 billion set aside for Jobcentre Plus and employment programmes have helped to ensure that the labour market has performed relatively well in the current recession – for every 1 per cent decline in output, employment has fallen by just ⅓ of a per cent compared with 1⅓ per cent in the 1990s recession;
- the rate of company insolvencies remains well below its peak in the 1990s recession, at 0.9 per cent of all those on the active register in the third quarter of 2009, compared with a peak of 2.6 per cent in the earlier recession. This may in part be due to measures to support businesses announced in January 2009 and Budget 2009; and
- there has also been a smaller than expected rise in mortgage repossessions. The Council of Mortgage Lenders (CML) has revised down its forecast for repossessions in 2009 by 27,000. The CML is now forecasting 48,000 repossessions in 2009, compared with over 75,500 in 1991.

International policy response

2.7 Through the UK's G20 Presidency, the Government has helped facilitate vital international coordination to tackle the financial crisis and its impact on the global economy. At the G20 summit in London in April 2009, G20 Finance Ministers and Leaders agreed a series of actions to stabilise the global financial system and restore growth to the global economy. Since then:

- G20 countries have continued to undertake fiscal expansion, which the International Monetary Fund (IMF) estimate will, by the end of 2010, amount to $5 trillion and raise global output by four per cent. Interest rates have also remained low in most countries and central banks have used the full range of instruments;

- government support for the financial sector has been maintained, including government guarantees for banks amounting to $4.6 trillion;
- to increase the IMF's capacity to support countries through the crisis, resources available to the Fund are being trebled to over $750 billion.; and
- to promote global trade and investment, support for $250 billion of trade finance has been made available.

2.8 At the final meeting of the UK's 2009 Presidency in St Andrews in November, G20 Finance Ministers and Central Bank Governors noted the improvement in economic and financial conditions, while acknowledging that the recovery is uneven and that unemployment remains a major concern. They reiterated their commitment to maintain support for the recovery until it is assured, while agreeing principles to guide the development of strategies for withdrawing the extraordinary support measures put in place.

Global prospects

2.9 In a large part due to this unprecedented level of international policy cooperation, there are now emerging signs of recovery in the world economy.[2] Confidence has improved and demand for consumer durables has stabilised. Manufacturing new orders have started to increase again in many countries although they remain at very low levels. Industrial production has picked up by more than 5 per cent from its trough in March and world trade volumes recovered in the second half of 2009.

2.10 Given the opposing forces of a severe global downturn and an unprecedented international policy response, prospects for the world economy remain uncertain. The world economy is forecast to contract by 1 per cent in 2009. The contraction has been most severe among the advanced economies and, although the second half of 2009 is likely to see an improvement, G7 GDP is forecast to contract by 3½ per cent in 2009. As the policy stimulus announced earlier this year by advanced and emerging market economies begins to take effect, the world economy is forecast to grow by 3¼ per cent in 2010, before rising to 4¼ per cent in 2011 and 2012.

Recent economic developments in the UK

2.11 Along with other leading economies, the UK entered recession in the first half of 2008. The intensification of the global financial crisis following the collapse of Lehman Brothers in September 2008 led to a collapse in confidence and a further reduction in the availability of credit. As a result, output fell sharply in the final quarter of 2008 and according to ONS data revisions, the fall in output was greater than anticipated at Budget 2009.

2.12 The deterioration in global economic demand at the end of 2008 triggered an involuntary build up in stocks, which firms unwound rapidly towards the end of the year, depressing growth. As confidence declined, output contracted by 2.5 per cent over the first quarter of 2009, the largest quarterly fall in over forty years. Since then, the pace of decline has eased, in line with the Budget forecast, as the substantial macroeconomic stimulus in place has increasingly taken hold.

2.13 A broad range of economic data suggests activity has improved in recent months. Business optimism indicators have picked up, retail sales continue to rise and the level of employment rose in the third quarter of 2009. House price indicators have persistently shown monthly gains and the latest Royal Institute of Chartered Surveyors (RICS) Housing Market Survey reported further increases in its sales to stock ratio – a leading indicator of future price movements. The Chartered Institute of Purchasing Managers' indices (PMI) have also picked up in recent months indicating a recovery in output growth.

[2] *An address to the Confederation of British Industry Annual Conference*, Dominique Strauss-Kahn, 23 November 2009.

2.14 Consumer price inflation has fallen back since its peak of 5.2 per cent in September 2008, as expected in the Budget forecast. CPI inflation was 1.5 per cent in October, while RPI inflation was –0.8 per cent.

UK growth prospects

2.15 The 2009 Pre-Budget Report economic forecast is for GDP to contract by 4¾ per cent over the year in 2009, larger than the 3½ per cent forecast at Budget 2009. However, given signs of stabilisation in recent economic data, growth is expected to return by the end of the year, in line with the Budget forecast. GDP growth is forecast to pick up through 2010 and 2011, as credit conditions continue to ease and the continuing and lagged effects of the significant monetary policy support and the depreciation of sterling take hold. Table 2.1 provides a summary of the UK forecast.

UK inflation prospects

2.16 CPI inflation is expected to continue to rise in the near term due to the pre-announced reversal of the cut in the VAT rate back to 17.5 per cent in January 2010 and with fuel prices above the lows of early 2009. The forecast assumes that businesses will smooth the pass-through of the rise in VAT back to 17.5 per cent, with inflation peaking in early 2010. After these temporary upward pressures have passed, inflation is forecast to fall through 2010 and in 2011, moving well below target, as the large negative output gap exerts downward pressure on prices. Although subject to the same factors shaping the profile for CPI inflation, RPI inflation is forecast to turn positive and then rise more rapidly with the additional upward pressure from rising house prices and the large reductions in mortgage interest payments falling out of the annual comparison.

Risks and uncertainty

2.17 While some of the more severe downside risks to the economy have been averted, economic forecasts remain subject to exceptional uncertainties across a broad range of factors, in particular: the size and timing of the impact of the financial shock on trend output; the pace and balance of the global recovery; the availability of sufficient credit to support recovery; and the speed and extent of private sector deleveraging. These issues are discussed in more detail in the summary of forecast issues and risks of Annex A.

Table 2.1: Summary of UK forecast[1]

		Forecast			
	2008	2009	2010	2011	2012
GDP growth (per cent)					
Upper end of forecast range	–	–	1 ½	3 ¾	3 ¾
Economic forecast	½	–4 ¾	1 ¼	3 ½	3 ½
Forecasts underpinning public finance projections	–	–	1	3 ¼	3 ¼
Inflation (per cent, Q4)					
CPI inflation	4	2	1 ¾	1 ½	2
RPI inflation	2 ¾	½	2 ½	3 ½	3 ½
GDP deflator	3 ½	1 ½	2	1 ½	2 ½

[1] *See footnote to Table B9 for explanation of forecast ranges.*

Implications for the public finances

2.18 Despite weaker than expected economic growth in the first part of the year, the Pre-Budget Report forecast of borrowing in 2009-10 is broadly unchanged from the Budget at 12.6 per cent of GDP. This reflects the caution in the Budget forecast, in particular in relation to VAT and stamp duties. With a wider output gap in 2009-10 and similar levels of borrowing, the estimate of cyclically-adjusted net borrowing is 0.8 per cent lower than assumed at Budget, at 9.0 per cent of GDP in 2009-10. This would suggest the structural position of the public finances has deteriorated less than forecast at Budget, though this assessment is dependent on economic assumptions about the output gap and trend growth.

2.19 This Pre-Budget Report sets out measures that maintain the overall Budget consolidation path. Although the Pre-Budget Report measures amount to a net loosening over the period, together with the consolidation measures announced in the 2008 Pre-Budget Report and Budget 2009, measures in this Pre-Budget Report reduce borrowing by £57 billion in 2013-14. This is supported by a cyclical reduction in borrowing as the economy returns to growth and receipts recover.

2.20 As a result, in the medium term, the Pre-Budget Report forecast for borrowing and debt is very close to the projections made at the time of the Budget, even though the recession has been deeper than expected. Based on cautious assumptions, in particular the NAO-audited assumptions on the VAT gap and claimant count unemployment, borrowing is projected to more than halve from 12.6 per cent this year to 5.5 per cent in 2013-14, unchanged from Budget. The Treasury's estimate of cyclically-adjusted borrowing is projected to fall to 3.1 per cent of GDP by 2014-15. Debt is forecast to peak at 77.7 per cent of GDP in 2014-15 and the projections are consistent with debt falling as a share of GDP in 2015-16. Table 2.2 provides a summary of the fiscal projections. Further detail is set out later in this chapter and in Annex B.

Table 2.2: Summary of fiscal projections

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Public sector net borrowing (PSNB)	6.6	12.6	12.0	9.1	7.1	5.5	4.4
Total change since Budget 2009	*0.4*	*0.2*	*0.1*	*0.0*	*-0.1*	*0.0*	
Impact of discretionary measures on PSNB [1]	*0.0*	*0.0*	*0.3*	*0.3*	*0.1*	*0.0*	*-0.2*
Cyclically-adjusted PSNB	5.7	9.0	8.0	5.8	4.5	3.6	3.1
Surplus on current budget	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Public sector net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
Public sector net debt[2]	44.0	55.6	65.4	71.7	75.4	77.1	77.7

Note: All measures are presented on the basis which excludes the temporary effect of financial interventions.

[1] Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13, 2013-14 and 2014-15.

[2] Debt at end March; GDP centred on end March.

PROVIDING THE CONDITIONS FOR FUTURE GROWTH

2.21 A starting point of low public debt and the action that the Government is taking to ensure fiscal sustainability over the medium term enables the Government to continue to provide support to the economy, where it is needed, through the downturn and in the early stages of recovery. However, as the economy and financial markets recover after a period of exceptional risk and uncertainty, the role for macroeconomic policy will change. Based on its assessment of economic conditions and prospects, the Government's actions will move from supporting activity in the downturn to setting policy to provide the conditions for future growth.

2.22 Much of the support that the Government has put in place is time-limited, designed to assist businesses and individuals during a period when financial markets have not been functioning properly. Over time, financial markets should continue to normalise and the economy's reliance on Government support should diminish. Unwinding this support will allow markets to once again take up their role in providing incentives for growth and ensuring the efficient allocation of resources. Some targeted measures will continue to be important to support businesses and households and prevent more persistent effects from the downturn.

2.23 As the recovery takes hold and economic growth becomes self-sustaining, this policy transition will assist future growth by ensuring sound public finances. Sustainable public finances are essential to macroeconomic stability and the long-term health of the economy.

2.24 The Government can help to ensure a smooth transition in the future, providing on-going support during the early stages of recovery and minimising any disruption to economic activity. There are close interactions between the policy interventions – financial, fiscal and monetary – supporting the economy. The Government will take these interactions into full account as it makes the policy transition.

Financial sector interventions

2.25 Financial stability and well-functioning financial markets are key to a sustainable economic recovery. A well-functioning and well-regulated financial system will promote productive investment and the efficient pricing of risk, supporting future economic growth and stability. The Government will continue to provide support for as long as necessary to ensure a stable and effective financial system, and will establish a strengthened regulatory and supervisory framework.

2.26 As financial conditions improve, the sector's dependence on government support will gradually reduce. This transition will need to be carefully managed. As the economy recovers and confidence in the financial sector grows, the Government expects and will actively encourage the private sector to cease accessing government support. In deciding when to withdraw from specific financial sector interventions, the Government will take into account the robustness of the economic recovery and resilience of the financial sector, as well as intervention-specific criteria such as usage of the scheme, impact on market confidence, distortions in competition and taxpayers' interests.

Monetary policy

2.27 Substantial monetary policy support is in place. Market expectations are for Bank Rate to remain at the historically low, expansionary rate of 0.5 per cent until the second half of 2010 and the MPC is expected to complete its £200 billion programme of asset purchases by the end of January 2010.[3] As a result, monetary policy is expected to continue to provide an on-going and powerful stimulus to spending by businesses and individuals throughout next year, as the lagged effects of policy action feed through and improving financial conditions strengthen the monetary policy transmission mechanism. Improved transmission should, all else equal, mean that more loans are available and mortgage holders and borrowers will face lower effective interest rates. This should allow monetary policy to continue to support the economy as fiscal policy shifts to consolidation.

Fiscal policy

2.28 Sustainable public finances are essential to macroeconomic stability and the long-term health of the economy. As confidence in recovery grows and financial sector conditions normalise, the economy's reliance on fiscal support will diminish. This will allow fiscal support to be withdrawn, gradually at first, so as not to harm recovery.

2.29 Over the medium term, the Government's fiscal plans will reduce public sector net borrowing as a share of GDP to 5.5 per cent by 2013-14. They put the public finances on a path to ensure that public sector net debt is falling as a share of GDP by 2015-16. In total, measures announced since the 2008 Pre-Budget Report will reduce borrowing by £57 billion in 2013-14.

2.30 This clear plan to ensure the sustainability of the public finances underpins continued fiscal support to the economy now. The Pre-Budget Report forecasts a return to economic growth by the end of the year and a gradual pick-up in growth through 2010

[3] The exchange of letters between the Chancellor and the Governor is available at www.hm-treasury.gov.uk.

and 2011. However, significant risks and uncertainties remain, so it will be important not to withdraw fiscal support too quickly. The Government therefore judges that a gradual transition for fiscal policy, from supporting activity in the recession to supporting the conditions for growth in the recovery, is appropriate. Exceptional and time-limited measures to increase economic demand, introduced to support the economy when it was at its weakest, will no longer be needed. But the Government will continue to provide fiscal support to the economy in 2010-11, during the early stages of recovery. This support will be provided through the automatic stabilisers, worth 4 per cent of GDP in 2010-11, planned increases in government spending and targeted support, where it is needed, to prevent more persistent effects from the downturn. Growth in public sector current expenditure then reduces from 2011-12, in order to ensure sustainable public finances.

Support for new sources of growth

2.31 The economic recovery is forecast to be shaped by a rebalancing of domestic and external demand. As the economy recovers, firms will be able to invest in new opportunities and take advantage of the competitiveness boost provided by the depreciation of sterling. Net exports and investment are expected to be more significant drivers of growth than in the recent past.

2.32 Fiscal consolidation will support investment and the rebalancing of growth, by helping to maintain low long-term interest rates and a stable macroeconomic environment; while the action the Government is taking to restore the flow of credit should help support business investment and enable companies to take advantage of new export opportunities

2.33 In addition, the Government has announced targeted measures to support business growth, such as the Enterprise Finance Guarantee, launched in January 2009, and a temporary enhanced first-year capital allowance, announced in Budget 2009. The 2009 Pre-Budget Report announces further measures in this regard, set out in Chapter 4. Infrastructure UK will develop a strategic vision for UK infrastructure, and the continued Enterprise Finance Guarantee and the new Growth Capital Fund will help small and medium-sized enterprises to access the finance they need. In addition, the Patent Box will strengthen incentives to invest in high-technology industries in the UK and, finally, the £200 million addition to the Strategic Investment Fund will enable further support for advanced industrial projects of strategic importance.

2.34 Rebalancing must also take place at an international level. G20 Leaders have agreed to adopt the policies needed to lay the foundation for strong, sustainable and balanced growth and the Government has also set out the need for an EU Compact for Jobs and Growth. Box 2.2 provides more details.

Box 2.2: G20 Framework for Strong, Sustainable and Balanced Growth

At their Pittsburgh Summit in September, the G20 Leaders agreed a 'Framework for Strong, Sustainable, and Balanced Growth'. Under the Framework, they agreed to

- implement responsible fiscal policies, attentive to short-term flexibility considerations and longer-run sustainability requirements;
- strengthen financial supervision to prevent the re-emergence in the financial system of excess credit growth and excess leverage and undertake macro-prudential and regulatory policies to help prevent credit and asset price cycles from becoming forces of destabilisation;
- promote more balanced current accounts and support open trade and investment to advance global prosperity and growth sustainability, while actively rejecting protectionist measures;
- undertake monetary policies consistent with price stability in the context of market-oriented exchange rates that reflect underlying economic fundamentals;
- undertake structural reforms to increase potential growth rates and, where needed, improve social safety nets; and
- promote balanced and sustainable economic development in order to narrow development imbalances and reduce poverty.

To underscore their new approach to economic cooperation, G20 Finance Ministers and Central Bank Governors launched the Framework at their meeting in St Andrews in November, adopting a detailed timetable and initiating a new consultative mutual assessment process to evaluate whether G20 policies will collectively deliver the agreed objectives. Leaders will consider options at their next Summit in June 2010.

The EU needs to play its part through a new Compact for Jobs and Growth to tackle the key concerns of Europe's citizens by: getting the exit from crisis measures right; creating jobs and equipping Europe's workforce with the skills they need to succeed in the jobs of the future; promoting sectors that will deliver future growth; supporting Europe's businesses; opening up global markets to trade; and strengthening Europe's banking system. This will require action at the regional, national, EU and international levels, including through a reprioritised EU budget. The UK initiated and led a debate among EU heads in October on a European strategy for jobs and growth - they will discuss the issue again at the December European Council.

ENSURING LONG-TERM FINANCIAL STABILITY

2.35 The financial system plays a crucial role in all modern economies, affecting the lives of every individual and business. It is the core mechanism by which resources are allocated through the economy, channelling funds from savers to creditworthy borrowers, and thereby supporting productivity, jobs and growth.

Financial sector interventions

2.36 Over the past 18 months, the Government has carried out a series of interventions in the financial system, aimed at tackling problems at individual institutions, addressing system-wide instability and getting credit flowing through the economy once more.

Credit conditions

2.37 Credit conditions remain restrictive, however recent evidence points to an improvement in the third quarter of 2009. While the absolute cost of new lending to borrowers has declined significantly, the effective interest rates paid by households and companies have not fallen by as much as the Bank Rate. As financial market and economic conditions improve, the demand for credit will improve and risks associated with lending to businesses and households will fall. Further analysis of credit conditions is provided in Annex A.

2.38 It is important to reduce barriers that may prevent borrowers from diversifying towards alternative channels of finances. If both business and banks have access to efficient and diverse sources of finance this would be beneficial for balanced and sustainable growth. The Treasury is looking at ways to diversify the development of non-bank lending channels for business and efficient funding markets to help improve the future performance and resilience of the economy, as detailed in Chapter 3.

Strengthening the regulatory framework

2.39 The Government is establishing a new regulatory and supervisory framework, to ensure that banks operate in a manner that promotes greater stability in future and which also protects and ensures a fair deal for customers. Over time, prudential regulatory standards will be strengthened, including improving the quantity and quality of bank capital, requiring the financial system to operate at lower levels of leverage and significantly tightening standards of liquidity regulation. The transition from support to a newly strengthened regulatory framework will need to be carefully managed. In particular, the implementation of these standards must be appropriately phased over time so as to avoid constraining prudent lending by banks and impeding the pace of recovery. Box 2.3 examines the role for macro-prudential regulation in addressing potentially harmful inter-linkages between the financial sector and the real economy.

Promoting choice and competition

2.40 Competition is vital in ensuring efficiency in financial markets, protecting the consumer's interests and providing them with value, innovation and choice. The Government is committed to encouraging new entrants into financial services in the UK and seeks to strengthen the ability of mutual societies to compete in the future. In addition, the Authorities will continue to examine any barriers to entry or ineffective markets to ensure that funds are competitively priced. More details on the actions that the Government is taking to promote competition within the sector are provided in Chapter 3.

Box 2.3: Macro-prudential regulation

Though financial markets are vital for the efficient matching of saving and investment, they can also serve to magnify the amplitude of the economic cycle. For example, rising asset prices can increase collateral and facilitate borrowing and may encourage risk taking. Indeed, the recent financial crisis, triggering the most severe global economic recession since the 1930s, clearly demonstrates the close ties between the financial sector and the broader economy. However, as the Government's recent White Paper *Reforming financial markets*[a] explained, there are various 'macro-prudential' tools that have the potential to mitigate these trends in the future:

- *Macro-prudential surveillance:* The recent crisis highlights the limitations of a regulatory approach that focuses on monitoring individual institutions, as complex interdependencies and joint exposures have meant that even previously sound institutions experienced serious difficulties. The Financial Services Bill establishes a statutory Council for Financial Stability to monitor systemic risks more closely and coordinate the Authorities' response to these risks. This will be complemented at the EU level with the establishment of the European Systemic Risk Board and internationally by the joint IMF-FSB early warning exercise;
- *Counter-cyclical tools: Reforming financial markets* identified a number of regulatory tools that might be useful for dampening the cyclicality of the financial sector. Examples include counter-cyclical capital buffers, through-the-cycle expected-loss provisioning, adjusting regulatory capital risk weights and loan-to-value limits. A recent discussion paper by the Bank of England on *The Role of Macro-prudential Policy*[b] analyses these issues in more detail. The Government is working closely with the FSA, the Bank and international partners to assess the merits of different policy options; and
- *Monetary policy:* Some have argued that monetary policy should be used to 'lean against' rapid growth in asset prices and financial imbalances. However, giving the Bank of England additional monetary-policy objectives could create policy tensions that undermine the framework's credibility and put at risk the Monetary Policy Committee's (MPC) successful record in delivering low inflation. Interest rates may also be an inappropriate instrument for targeting asset-price bubbles. The MPC's remit gives it a good deal of flexibility to respond to developments in financial markets to the extent that they influence future inflation trends.

[a] *Reforming Financial Markets*, HM Treasury, July 2009.
[b] *The Role of Macro-prudential Policy*, Bank of England Discussion Paper, 21 November 2009.

MONETARY POLICY ACTION

Monetary policy framework

2.41 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) to meet the Government's target of a 2 per cent annual rise in the Consumer Prices Index (CPI), which applies at all times. The Chancellor announced the creation of the Asset Purchase Facility (APF) on 19 January, and authorised its use for monetary policy purposes on 3 March.

2.42 The objectives of the monetary policy framework have not changed with the use of the APF for monetary policy purposes. 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.

Action taken by the MPC

2.43 Monetary policy has been an important element of the overall support provided to the economy. In response to the exceptional circumstances during the past year, the MPC has kept Bank Rate at 0.5 per cent since March, and continued with its programme of asset purchases financed by the issuance of central bank reserves. In May, the MPC extended its programme of asset purchases to £125 billion. At the request of the MPC, the Chancellor authorised an increase in the upper limit of the APF to £175 billion in August, and then to £200 billion on 5 November 2009. The MPC is expected to complete its planned schedule of asset purchases by the end of January. The Bank of England is also consulting on whether the liquidity of secondary corporate debt markets could be further improved if it were to sell as well as buy corporate bonds in its APF portfolio.

The impact of MPC action

2.44 It is likely that the effects on output of the reduction in Bank Rate since October 2008 and from the asset purchases are still feeding through to the economy, given the normal lags in the monetary policy transmission mechanism, and the impairment of this mechanism due to the impact of the global financial crisis. As financial market conditions continue to improve, the actions taken by the MPC will continue to provide a powerful stimulus to spending by businesses and individuals.

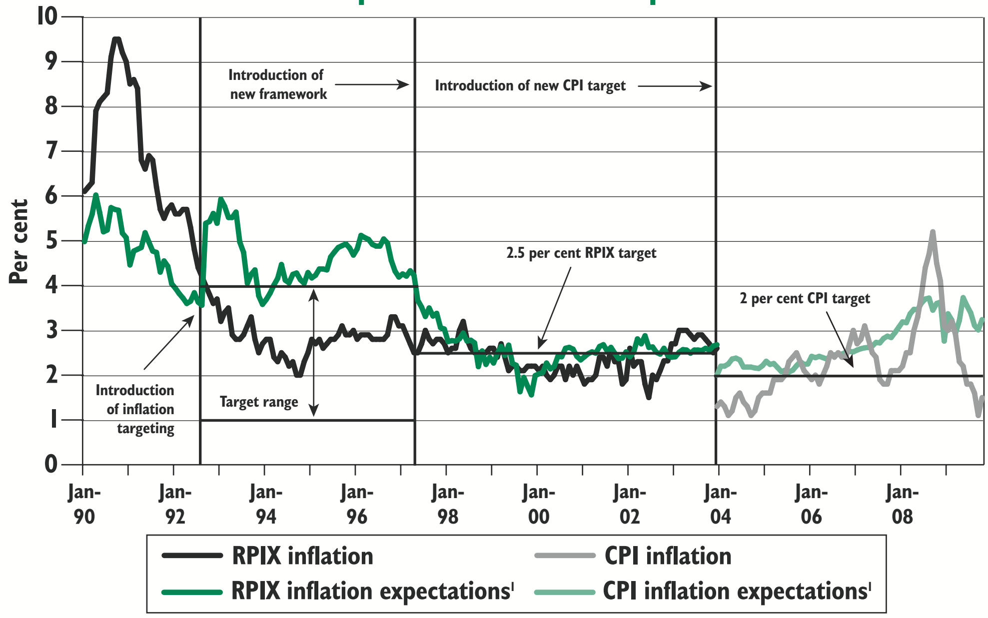
2.45 There is considerable uncertainty about the strength and pace with which the impacts of APF are feeding through to the economy, particularly as it is not possible to know what would have happened in its absence. However, a number of developments are consistent with its expected effects. As noted in the minutes of the October MPC meeting, although the counterfactual is hard to identify, the strength of broad money growth relative to nominal GDP is consistent with the asset purchase programme boosting M4 growth. Corporate bond and gilt yields fell significantly following the announcement of the APF's use for monetary policy purposes in March, with the decline in corporate bond yields exceeding the fall in gilt yields. Issuance of bonds by UK non-financial companies rose sharply in the first half of 2009, reflecting the lower cost of bond finance. Equity prices have risen by around 50 per cent since early March.

2.46 CPI inflation has fallen since its peak in September 2008, troughing in September 2009. Inflation has since increased to 1.5 per cent in October and the November Inflation Report stated that CPI inflation is likely to rise sharply above the 2 per cent target in the near term.[4] The MPC's remit, as restated in the Chancellor's letter to the Governor of the Bank of England on 22 April, allows it to look through short-term movements in inflation such as the forecast increase above its 2 per cent target resulting from the reversal of last year's reduction in VAT. The Bank of England's November Inflation Report projected that spare capacity in the economy would continue to apply downward pressure to inflation over the medium term.

2.47 Despite the volatility in actual inflation, inflation expectations have remained anchored, demonstrating the credibility that the monetary policy framework has built since 1997. As inflation has fallen from its peak of 5.2 per cent in September 2008 to 1.1 per cent a year later, market inflation expectations have moved within a much smaller range, moderating slightly over recent months. This is also reflected in survey expectations: the YouGov/Citigroup survey measure of household expectations for five to ten years ahead has moved within a narrow range of 0.5 percentage points over the past year. Financial market-derived measures of inflation expectations, as shown in Chart 2.1, can be affected by other market developments, including changes in market estimates of the wedge between RPI and CPI, and have been more difficult to interpret given recent financial market volatility. Although these measures are currently above the 2 per cent target, they do not appear to point to a significant de-anchoring of expectations.

[4] See www.bankofengland.co.uk

Chart 2.1: 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.

Monetary policy during the recovery

2.48 The Government will continue to support the Bank of England in the forward-looking decisions it takes to meet the inflation target. As the economy strengthens, it will be appropriate and necessary to tighten monetary conditions. The MPC will determine the timing and pace of the transition towards more normal monetary policy settings, based on their assessment of the policy stance required to meet the inflation target. Within this, the MPC will determine the appropriate combination of raising Bank Rate and the sale of assets.

2.49 The MPC will decide the scale and timing of any asset sales, but the Bank of England will consult closely with the Debt Management Office to minimise disruption to the gilt market. In his letter to the Chancellor of 17 February, the Governor said that the MPC would have due regard for the impact of those sales on the Government's debt management operations.

THE GOVERNMENT'S FISCAL STRATEGY

2.50 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.

2.51 The financial crisis and global downturn have had a profound and persistent impact on the public finances, resulting in a significant increase in Government borrowing and, as a result, debt. Responding to these developments, in line with its fiscal objectives, the Government's fiscal strategy has been to:

- base policy decisions on a realistic fiscal forecast, based on a range of assumptions, some of which are designed to provide caution to allow for uncertainty;
- set out a credible plan for delivering a sustained consolidation over the medium term, to ensure sound public finances and create space in the short term for continued fiscal support. This consolidation will take place over a timeframe consistent with economic recovery and growth; and
- ensure that the fiscal policy framework is set to deliver the Government's fiscal policy objectives given the outlook for the public finances and the economy, allowing the flexibility for fiscal policy to respond appropriately while remaining committed to clear long-term goals.

2.52 The Government judges that this strategy remains appropriate in light of developments since Budget and continuing uncertainty:

- the Government will continue to base its fiscal projections on cautious assumptions. In particular, for this Pre-Budget Report, the assumptions on the VAT gap and claimant count unemployment;
- while there are signs of stabilisation in the economy and the Government's judgement on the economic outlook remains unchanged, risks remain. The Government judges that the pace of consolidation set in Budget 2009 remains appropriate; and
- as the economy emerges from recession, and exceptional levels of uncertainty recede, the Pre-Budget Report announces a new Fiscal Responsibility Bill, which will strengthen the fiscal framework, established in 1997, to underpin a sustained period of consolidation.

The fiscal outlook

Impact of the global downturn

2.53 The financial crisis has had a profound and persistent impact on the public finances. It has resulted in a significant increase in borrowing relative to pre-crisis levels, which can be broken down into two categories:

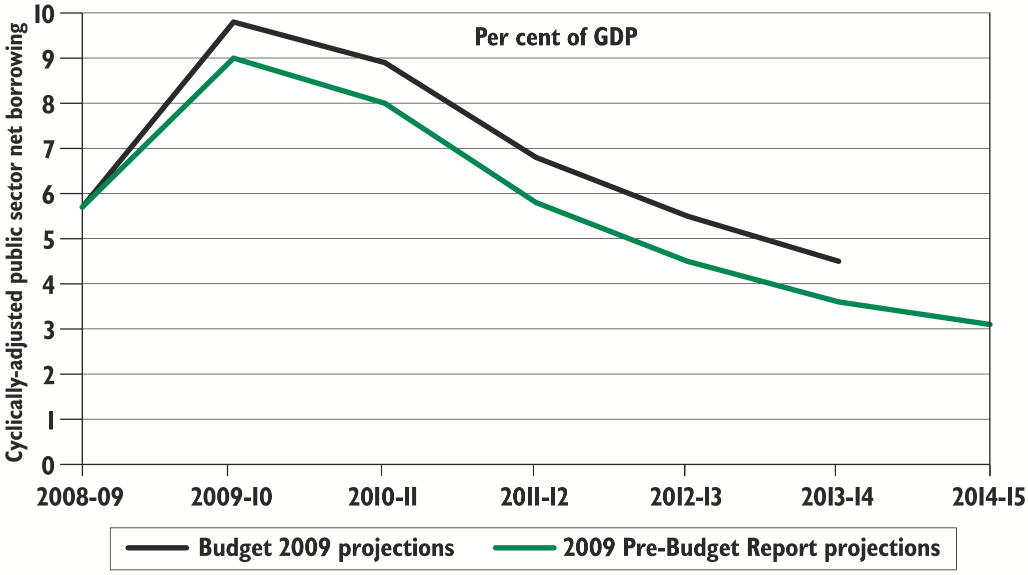
- *temporary and cyclical borrowing:* the recession has caused a temporary increase in borrowing, due to lower tax receipts and higher government spending as the Government allows the automatic stabilisers to operate to support the economy. The temporary discretionary measures that the Government has implemented to provide fiscal support to the economy also have a short-term impact on borrowing; and
- *structural impacts:* the financial crisis has also had a more persistent impact on the public finances, due to its downward impact on the trend level of output in the economy, which has been assumed to be 5 per cent, a permanent loss of tax receipts from the financial and housing sectors and the projected rebalancing of economic activity, which will result in less tax-rich growth in the recovery. The fiscal consolidation that the Government has planned over the medium term is necessary to address these persistent effects.

2.54 The *2009 End of year fiscal report,*[5] published alongside the Pre-Budget Report, provides a detailed analysis of the underlying reasons for the differences between the Budget 2008 forecasts for the public finances and outturn in 2008-09. This shows that the forecast differences were driven by the impact of the deterioration of the economy on tax receipts, the impact of the financial crisis on tax receipts from the financial and housing sectors, and the discretionary fiscal action taken by the Government to support the economy through the downturn. The US has experienced forecast differences of a comparable size to the UK, reflecting the similarities in the effects of the global financial crisis in both economies.

Developments since Budget

2.55 Despite weaker than expected economic growth in the first part of the year, the Pre-Budget Report forecast of borrowing in 2009-10 is broadly unchanged from the Budget at 12.6 per cent of GDP. This reflects the caution in the Budget fiscal forecast, in particular in relation to VAT and stamp duties. With a wider output gap in 2009-10 and similar levels of borrowing, cyclically-adjusted net borrowing is lower than assumed at the time of the Budget, at 9.0 per cent of GDP in 2009-10, compared with the Budget estimate of 9.8 per cent. This would suggest the structural position of the public finances has deteriorated less than forecast at Budget, though this assessment is dependent on economic assumptions about the output gap and trend growth.

Chart 2.2: Change in projection of cyclically-adjusted net borrowing since Budget 2009



Source: HM Treasury.

The fiscal outlook

2.56 Table 2.3 provides full projections for the key fiscal aggregates. Table 2.4 compares the projections for public sector net borrowing, the current budget, net investment and net debt with those published at Budget 2009. Fiscal aggregates presented in this chapter exclude the temporary effect of financial interventions, unless otherwise stated. These are explained further in Annex B.

2.57 In Budget 2009, the Government set out a provision for the fiscal cost of the financial interventions implemented since the onset of the financial crisis. As set out in Chapter 3, exceptional uncertainty has receded, the Asset Protection Scheme has now been finalised and the risks to the taxpayer have been reduced. The exceptional fiscal treatment of these interventions is therefore no longer appropriate. The Government will therefore move the

[5] *2009 End of year fiscal report*, HM Treasury, December 2009.

treatment of net losses on financial interventions to a National Accounts basis, which the Office for National Statistics will publish. More detail is set out in Annex B.

Table 2.3: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Fiscal stance							
Public sector net borrowing (PSNB)	6.6	12.6	12.0	9.1	7.1	5.5	4.4
Cyclically-adjusted PSNB	5.7	9.0	8.0	5.8	4.5	3.6	3.1
Surplus on current budget	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Cyclically-adjusted surplus on current budget	-2.6	-5.5	-5.4	-3.9	-3.0	-2.3	-1.9
Net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
Sustainability							
Public sector net debt[1]	44.0	55.6	65.4	71.7	75.4	77.1	77.7
Core debt[1]	42.8	50.8	57.1	60.7	62.4	63.0	63.0
Net worth[2]	22.4	17.3	6.6	0.4	-3.6	-6.2	-7.2
Primary balance	-4.9	-10.7	-9.2	-6.0	-3.9	-2.3	-1.1
Financing							
Central government net cash requirement	11.3	15.8	11.8	9.5	7.2	5.8	4.4
Public sector net cash requirement	4.2	13.5	12.3	9.7	7.5	6.1	4.6
Stability and Growth Pact							
Treaty deficit[4]	6.9	12.6	12.0	9.1	7.3	5.7	4.6
Cyclically-adjusted Treaty deficit[4]	5.9	9.0	8.1	5.9	4.7	3.7	3.2
Treaty debt ratio[5]	55.5	72.9	82.1	88.0	90.9	91.6	91.2
Memo: Output gap	*-2.0*	*-6.4*	*-5.3*	*-4.3*	*-3.4*	*-2.5*	*-1.6*

Note: All measures are shown on the basis which excludes the temporary effect of financial interventions, except net worth and the aggregates shown in the Financing and Stability and Growth Pact sections.

[1] Debt at end March; GDP centred on end March.

[2] Estimate at end December; GDP centred on end December.

[4] General government net borrowing on a Maastricht basis.

[5] General government gross debt measures on a Maastricht basis.

Table 2.4: Fiscal balances compared with Budget 2009

	Outturn[1]	Estimate[2]	Projections			
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Net borrowing (£ billion)						
Budget 2009	**90.0**	**175.4**	**173**	**140**	**118**	**97**
2009 Pre-Budget Report	**95.4**	**177.6**	**176**	**140**	**117**	**96**
Difference	5.5	2.2	3.0	-0.5	-0.7	-0.6
of which:						
Changes to current budget	-2.2	-3.5	- ½	- ½	- ½	- ½
Changes to net investment	7.7	5.7	3 ½	0	0	0
of which:						
Effect of revisions and forecasting changes	5.4	2.6	- ½	-4 ½	-2 ½	0
Effect of 2009 PBR policy decisions	0.0	-0.4	1	-3 ½	-5	-6
Effect of other discretionary changes[3]	0.0	0.0	2 ½	7 ½	7	5
Surplus on current budget (£ billion)						
Budget 2009	**-52.3**	**-131.6**	**-137**	**-111**	**-91**	**-74**
Effect of revisions and forecasting changes	2.2	3.1	3	4 ½	2 ½	- ½
Effect of 2009 PBR policy decisions	0.0	0.3	-1	3 ½	5	6
Effect of other discretionary changes[3]	0.0	0.0	-1 ½	-7 ½	-7	-5
2009 Pre-Budget Report	**-50.1**	**-128.1**	**-137**	**-111**	**-91**	**-74**
Net investment (£ billion)						
Budget 2009	**37.7**	**43.8**	**36**	**29**	**26**	**22**
Effect of revisions and forecasting changes	7.7	5.6	2 ½	0	0	0
Effect of 2009 PBR policy decisions	0.0	0.1	0	0	0	0
Effect of other discretionary changes[3]	0.0	0.0	1	0	0	0
2009 Pre-Budget Report	**45.3**	**49.5**	**39**	**29**	**26**	**22**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2009	-3.1	-6.7	-6.4	-4.9	-3.9	-3.2
2009 Pre-Budget Report	**-2.6**	**-5.5**	**-5.4**	**-3.9**	**-3.0**	**-2.3**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2009	5.7	9.8	8.9	6.8	5.5	4.5
2009 Pre-Budget Report	**5.7**	**9.0**	**8.0**	**5.8**	**4.5**	**3.6**
Net debt (per cent of GDP)[4]						
Budget 2009	43.0	55.4	65.0	70.9	74.5	76.2
2009 Pre-Budget Report	**44.0**	**55.6**	**65.4**	**71.7**	**75.4**	**77.1**

Note: Totals may not sum due to rounding.

Note: Budget 2009 aggregates, except for net debt, were on the basis which includes the temporary effects of financial interventions. All 2009 Pre-Budget Report aggregates are on the basis which excludes the temporary effects. In 2008-09 and 2009-10 some of the changes since Budget 2009 are therefore due to the different bases.

1 The 2008-09 figures were estimates in Budget 2009.

2 The 2009-10 figures were projections in Budget 2009.

3 Including changes to forecasting assumptions on spending growth in 2011-12, 2012-13 and 2013-14.

4 Debt at end March; GDP centred on end March.

Risks and uncertainties

2.58 While there are signs that the economy and financial markets are stabilising, both the economy forecast and public finance projections remain subject to a significant degree of uncertainty, in particular:

- the economic growth path is a key driver of borrowing and debt over the forecast period;
- the path of interest rates and inflation over the forecast period are also sources of significant uncertainties for the public finance projections; and

- the outlook for the financial sector, which has been an important source of tax receipts in the UK, is another key uncertainty in the fiscal forecast.

2.59 Estimates of cyclically-adjusted borrowing, in particular, are subject to considerable uncertainty in current circumstances:

- there are significant uncertainties around the cyclical position of the economy, as discussed further in Annex A. These uncertainties are important, since the judgement reached around the impact of the global economic shocks on trend growth is key to estimating the persistent impact of the shocks on the public finances; and
- since the Treasury's cyclical-adjustment methodology is calculated using data over full economic cycles, it may not fully pick up any disproportionate impacts on receipts and spending arising during recessions.

Caution in the public finances forecast

2.60 Recognising these uncertainties, the fiscal projections reflect a realistic view of the position of the public finances by incorporating some cautious assumptions. Overall, the forecast implies that the tax burden is broadly flat in the medium term, over 1 per cent below its level in 2007-08. The Pre-Budget Report projections are based on:

- a 5 per cent downward adjustment to the economy's trend (or potential) level of output in light of the global financial shock, consistent with the Budget 2009 forecast;
- the forecast for economic rebalancing, away from consumption and to investment and exports, which are less tax-rich sectors;
- the assumption that the financial sector expands from 2010-11 but profits as a share of GDP only return to the 20-year average by 2014-15, meaning that in 2014-15 the level of receipts from the sector remains below its 2007-08 level; and
- the NAO-audited assumptions, in particular on the VAT gap and claimant count unemployment, which build caution into the medium-term forecast. Further details on the NAO-audited assumptions are set out in Annex B.

Financing and debt management

2.61 The forecast for the central government net cash requirement for 2009-10 has been revised from £220.8 billion at Budget 2009 to £223.3 billion, an increase of £2.5 billion. The forecast for the net financing requirement for 2009-10 has been revised from £237.8 billion at Budget 2009 to £242.9 billion, an increase of £5.1 billion. It has been decided to meet the increase in the net financing requirement by increasing gross gilt sales. Gross gilt sales for 2009-10 are now projected to be £225.1 billion, an increase of £5.1 billion above that projected at Budget. The Government will continue to fully fund its net financing requirement. Full details and a revised financing table can be found in Annex B. As announced in 2007, the Government's policy is to skew gilt sales toward long-maturity and index-linked gilts as far as practicable and subject to the operational risks in doing so. At over 13 years, the average maturity of the UK's debt portfolio is significantly higher than that of other G7 countries, giving the UK a higher degree of funding flexibility relative to other countries.

Stability and Growth Pact

2.62 EU leaders have agreed that the flexibility provided for in the Stability and Growth Pact should be used, and that fiscal consolidation should be undertaken in line with economic recovery. Under the excessive deficit procedure of the Stability and Growth Pact, to which 20 EU member states are now subject, the EU's Economic and Financial Affairs Council has recommended that the UK brings its Treaty deficit below the 3 per cent reference value by 2014-15, with an average annual fiscal effort of 1.75 per cent of GDP from 2010-11. The Treaty debt and deficit projections are shown in Table 2.3.

Fiscal policy: supporting recovery while ensuring sustainability

2.63 Given its assessment of the economic and fiscal outlook, the Government's fiscal judgement is based on moving from supporting activity in the recession to delivering a sustained fiscal consolidation. This will ensure sound public finances, creating space for continued support to the economy during the early stages of recovery. Actions to reduce borrowing and to support growth are mutually reinforcing: sound public finances are necessary for sustainable economic growth, which will in turn help reduce borrowing over the medium term.

Exceptional and temporary fiscal stimulus

2.64 Discretionary fiscal stimulus was introduced to provide support when the economy was weakest. In particular, it was necessary for fiscal policy to support the economy during a period when financial markets were impaired, private sector demand was credit-constrained and the effectiveness of the monetary policy transmission mechanism was reduced.

2.65 The 2008 Pre-Budget Report announced a fiscal stimulus amounting to around 1 per cent of GDP in 2009-10. This included:

- 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, to provide temporary support, targeted on areas where it would have maximum impact.

2.66 The fiscal stimulus is complemented by the full operation of the automatic stabilisers and targeted support for those most affected by the downturn. Together, through these channels, fiscal support totals 5 per cent of GDP in 2009-10.

2.67 This fiscal support has helped to limit the severity of the downturn and its impact on businesses and individuals. The Government estimates that, as a result of the direct impact of the fiscal stimulus announced in the 2008 Pre-Budget Report, GDP growth in 2009 will be around ½ percentage point higher than it would otherwise have been. In particular, evidence suggests a smaller proportion of firms have gone into liquidation and employment has held up relative to the 1990s recession.

2.68 Fiscal stimulus was time limited to increase its impact during the downturn and support sustainable public finances over the medium term. The VAT reduction was designed to be temporary, and will expire on 31 December 2009. This reversal is an important part of the effectiveness of VAT as an instrument for fiscal stimulus, as it encourages consumers to bring forward spending at the end of 2009.

Supporting recovery

2.69 Tightening fiscal policy too quickly could undermine recovery and thereby result in a deterioration in the fiscal position. The Government will therefore ensure that fiscal policy continues to provide support to businesses and individuals during the early stages of recovery, when it is most at risk, while ensuring sound public finances over the medium term. Overall, Government borrowing of 12.0 per cent of GDP will continue to support the level of economic activity in 2010-11. In particular:

- the automatic stabilisers will continue to provide fiscal support worth 4 per cent of GDP in 2010-11;

- as described in Chapter 5, despite a period of negative RPI inflation this year, the cash and real terms value of tax credits and benefits will increase in April 2010 (including an increase in the basic state pension of 2.5 per cent), which will provide an effective real terms increase to transfer payments of over £4 billion, relative to the September RPI normally used for indexation;
- overall, planned increases in government spending will continue to support demand, with Total Managed Expenditure rising by £11 billion in real terms in 2010-11; and
- targeted interventions are providing support to businesses and individuals, including through funding to help the unemployed, action to support businesses with their cash flow and support for pensioners and low-income families with children.

Action to ensure sound public finances

2.70 The focus of the Government's fiscal policy shifts toward consolidation in 2011-12, when the economy should be better placed to support a more rapid tightening because:

- GDP growth is forecast to pick up to an above trend rate of 3½ per cent in 2011;
- market expectations are for Bank Rate to remain at 0.5 per cent until the second-half of 2010, then to rise moderately, while remaining below 4 per cent by the end of 2012. While still at relatively low levels by historical standards, this implies that there would be greater space for the MPC to use interest rates to support demand by 2011-12; and
- as financial market conditions improve and the monetary policy transmission mechanism becomes more effective, the low Bank Rate expected by the market will provide an ongoing and powerful stimulus to spending by businesses and individuals and reduce the economy's reliance on fiscal support.

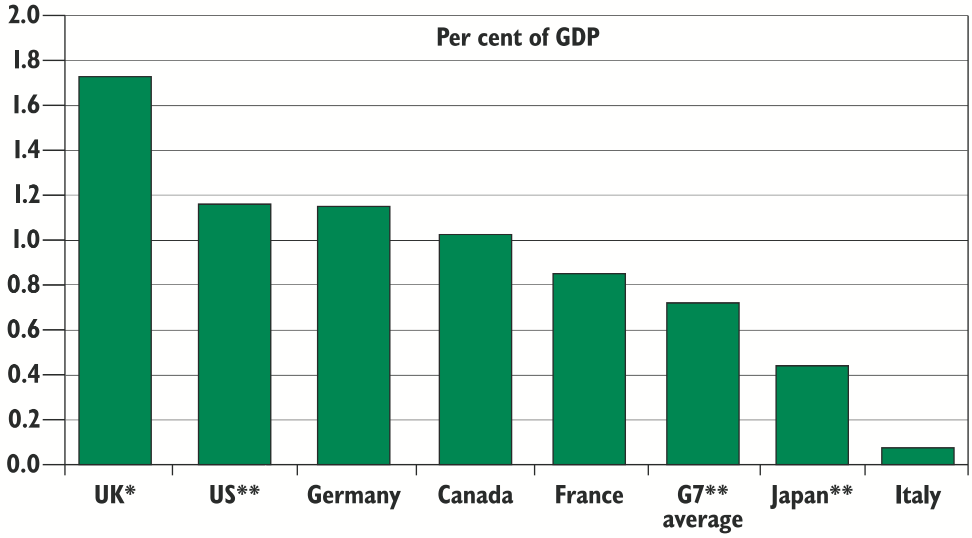
2.71 At Budget the Government took a judgement on the appropriate pace of fiscal consolidation, which recognised the uncertainty around prospects for the public finances given the exceptional nature and strength of the global downturn, the need to support the economy through the early stages of the recovery and the need to deliver sustainable public finances. Further information on the composition and pace of adjustment is provided in Box 2.4.

Box 2.4: Composition and pace of adjustment

The Government's fiscal consolidation plan is based on announced tax increases, revised spending plans and support for growth. In total, consolidation measures announced to date in this Pre-Budget Report, Budget 2009 and the 2008 Pre-Budget Report will reduce borrowing by £57 billion in 2013-14. Of this, around two-thirds derives from changes to spending plans, while around one-third is driven by tax increases. This approach conforms with research by the IMF, which suggests that spending restraint is more likely to generate lasting fiscal consolidation and better economic performance. In particular, the IMF has noted that *"expenditure restraint brings about longer lasting and larger adjustment episodes, which are more successful in achieving a debt stabilizing fiscal position. Expenditure reduction demonstrates a firmer commitment to feasible and substantial consolidation, and may trigger lower interest rates and boost private demand."*[a]

With monetary policy better able to manage aggregate demand as financial conditions normalise and GDP growth forecast to grow at above trend rates from 2011, the economy is expected to be able to support a reduction in public borrowing, though it will be important not to withdraw fiscal support too quickly. The annual pace of consolidation set out in this Pre-Budget Report is faster than the pace of deficit reduction forecast by the IMF for all other G7 economies in the period up to 2014, reflecting the size of the deficit and the Government's commitment to addressing it. The average pace of consolidation over the 2009-10 to 2013-14 period, albeit from a higher level, is comparable to the speed at which the deficit was reduced during the period of consolidation in the 1990s, when growth averaged 3¼ per cent a year for 5 years from 1993.

Chart a: Projected annual average fall in borrowing 2010-2014



Note: For the G7 average and the countires other than the UK, the projected annual average fall in borrowing is as forecast by the IMF on a calendar year basis.

**Based on 2009 Pre-Budget Report financial year projection of PSNB from 2009-10 to 2013-14.*

***For the countries indicated, borrowing is forecast to peak in 2009, so the pace of consolidation for these countries and the G7 average is taken over 2009 to 2014.*

Source: HM Treasury and IMF: The State of Public Finances Cross-Country Fiscal Monitor, November 2009.

[a] *United Kingdom: 2009 Article IV Consultation – staff report*, International Monetary Fund, 22 September 2009.

2.72 Although the Pre-Budget Report measures amount to a modest discretionary loosening over the period, borrowing is reduced to 5.5 per cent of GDP in 2013-14 as forecast at the Budget.

2.73 As set out in more detail in Chapter 5, the Government will take the following measures to support consolidation and reinforce the fairness of the tax system:

- **an additional 0.5 per cent increase in the employee, employer and self-employed rates of national insurance contributions (NICs) from April 2011, alongside an increase in the point at which individuals start to pay NICs to protect 15 million people on incomes below £20,000;**
- **the point at which individuals start to pay the higher rate of income tax will be frozen in 2012-13; and**
- **the restriction of pensions tax relief from April 2011 will apply to those with gross incomes of £150,000 and over, where gross income incorporates all pension contributions, including those funded by an employer. This will be subject to an income floor, so that individuals with pre-tax incomes (excluding employer pension contributions) of less than £130,000 will be unaffected.**

Public spending

2.74 As set out in Budget 2009, spending growth will reduce from 2011-12 onwards in order to ensure sustainable public finances over the medium term. Chapter 6 announces that public sector current expenditure[6] will grow by an average of 0.8 per cent a year in real terms between 2011-12 and 2014-15. In line with Budget 2009, public sector net investment will move to 1¼ per cent of GDP by 2013-14 and remain at that level in 2014-15.

Overall impact

2.75 Overall, the projection set out for public sector net borrowing is broadly the same as the Budget in each year from 2011-12 to 2013-14, and falls to 4.4 per cent of GDP in 2014-15.

[6] Excluding the additional time-limited expenditure announced in the 2009 Pre-Budget Report.

Halving the deficit

2.76 Over the medium term, borrowing is projected to fall markedly. Government consolidation measures announced in and since the 2008 Pre-Budget Report are supported by a cyclical reduction in borrowing as the economy returns to growth and receipts recover.

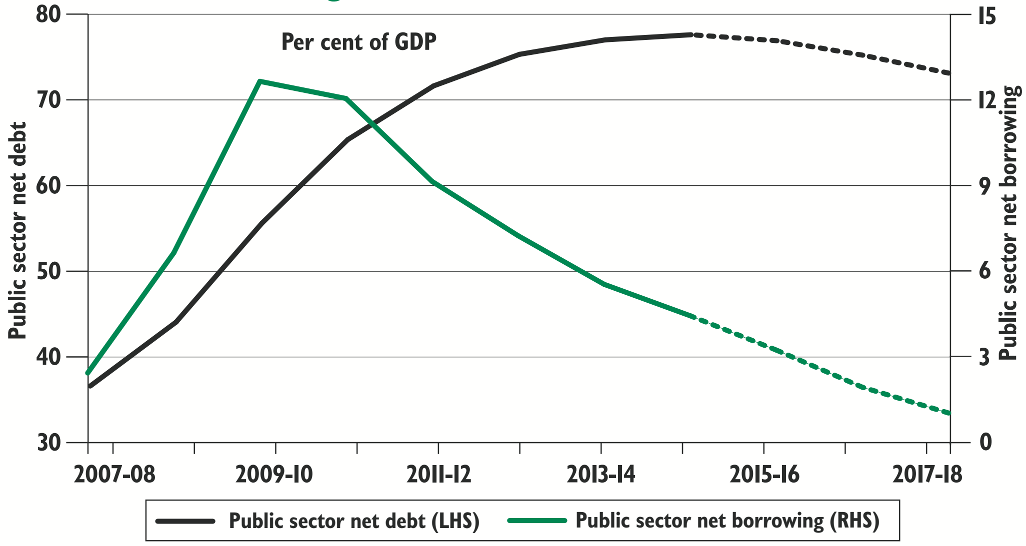
2.77 Based on cautious assumptions, public sector net borrowing is projected to fall from 12.6 per cent of GDP in 2009-10 to 5.5 per cent in 2013-14. This reduction represents a more than halving of the deficit as a share of GDP over this period. PSNB then falls further to 4.4 per cent of GDP in 2014-15.

Declining net debt to GDP ratio

2.78 The measure of public sector net debt (PSND) used for fiscal policy is around 3 percentage points of GDP lower than at Budget. This reflects new treatment of the net losses from financial interventions, as set out in Annex B. This reduces the level of PSND across the forecast horizon, but does not affect the path.

2.79 Public sector net debt increases over the projection period, in particular in 2009-10 and 2010-11, reflecting the high level of borrowing supporting the economy in those years. The public finances remain on a path consistent with ensuring that the level of PSND will fall as a proportion of GDP over the medium term. Chart 2.3 shows forecasts to 2014-15 and illustrative projections thereafter. These are based on a further improvement of 0.7 per cent of GDP a year in the cyclically-adjusted current budget, equivalent to the average improvement over the 2009-10 to 2014-15 period. Public sector net investment is assumed to be held constant at 1¼ per cent of GDP. The illustrative projections show that, under these assumptions, debt will peak in 2014-15 and will fall in the following year. The *2009 Long-term public finance report* provides illustrative projections for debt based on the firm fiscal consolidation plans set out to 2014-15 and stylised assumptions thereafter.[7]

Chart 2.3: Meeting the Fiscal Consolidation Plan



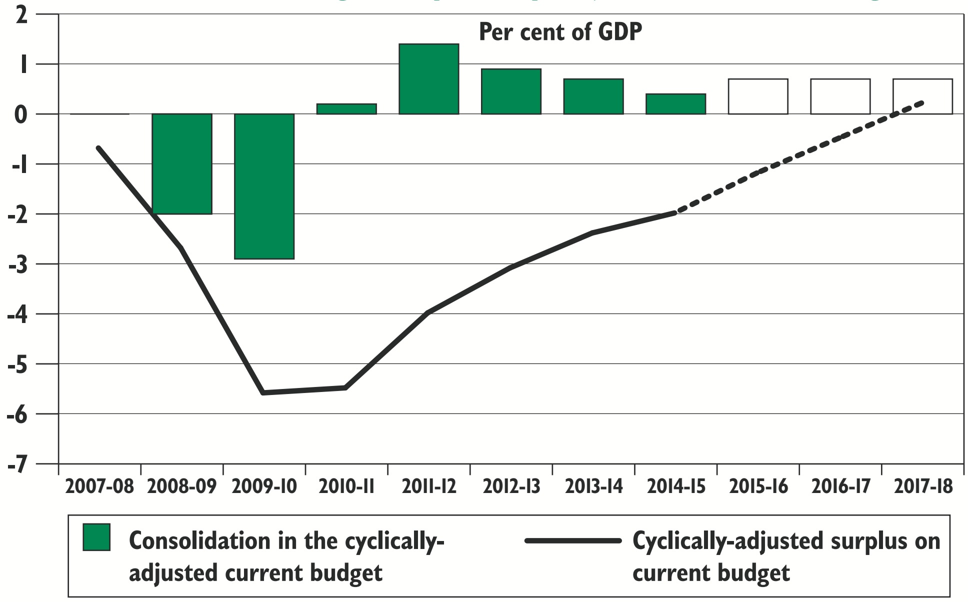
Note: For the financial years 2015-16 to 2017-18 the numbers presented here are illustrative projections.
Source: HM Treasury.

Balancing the cyclically-adjusted current budget

2.80 The cyclically-adjusted current deficit falls from 5.5 per cent in 2009-10 to 1.9 per cent in 2014-15, an average improvement of 0.7 per cent a year. Chart 2.4 shows that a further illustrative improvement of 0.7 per cent a year from 2015-16, in line with this average, would eliminate the deficit on the cyclically-adjusted current budget by 2017-18.

[7] *2009 Long-term public finance report*, HM Treasury, December 2009.

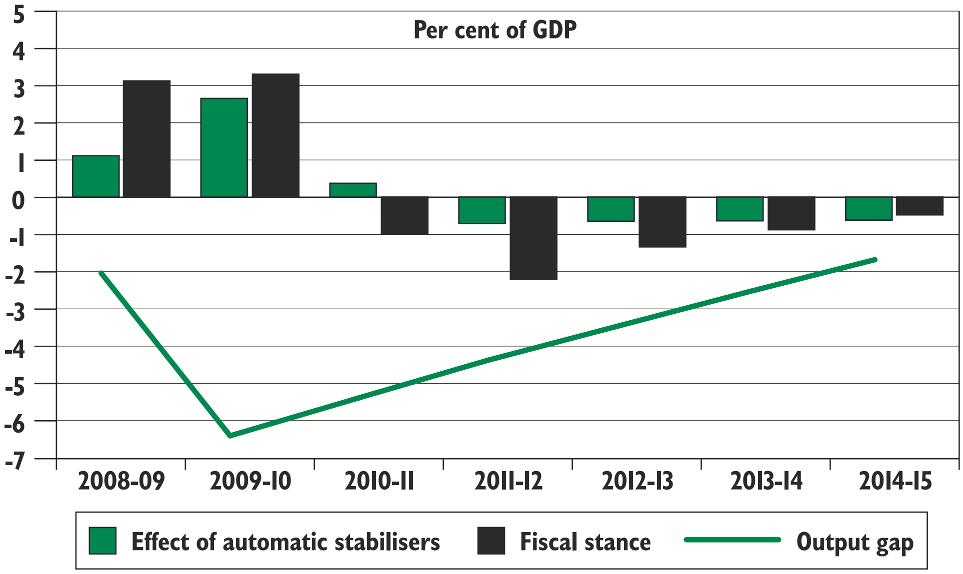
Chart 2.4: Balancing the cyclically-adjusted current budget



Note: For the financial years 2015-16 to 2017-18 the numbers presented here are illustrative projections.
Source: HM Treasury.

Economic Impact **2.81** The overall impact of fiscal policy on the economy can be assessed by examining the change in public sector net borrowing. Chart 2.5 shows that both the automatic stabilisers and the fiscal stance are acting to provide a considerable degree of support to the economy in 2008-09 and 2009-10, during the economic downturn. In 2011-12, the fiscal stance is tightening to deliver a reduction in borrowing at a time by which the economy is forecast to be recovering and able to support fiscal consolidation, while the effect of the automatic stabilisers remains positive in 2010-11, reflecting the lagged impact of the downturn on spending and receipts.

Chart 2.5: Fiscal policy supporting economic stablity



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 change in the difference between PSNB and the cyclically-adjusted PSNB.
Source: HM Treasury.

The Fiscal Responsibility Bill

2.82 The Government has set fiscal plans that show borrowing is more than halved as a share of the economy to 5.5 per cent of GDP in 2013-14 and falls year-on-year across the forecast period. These plans are consistent with debt falling as a per cent of GDP in 2015-16. **The Fiscal Responsibility Bill announced alongside the Pre-Budget Report will enshrine these consolidation plans in legislation.** This is a significant reform in the way that the Government is held to account for delivering its fiscal plans, giving Parliament a clear role in the setting and monitoring of medium-term fiscal plans.

Role of the fiscal framework

2.83 The design and operation of the fiscal framework needs to evolve in response to changing economic circumstances, in order to continue to ensure delivery of the Government's fiscal policy objectives. The temporary operating rule, set in the 2008 Pre-Budget Report, was designed to allow significant flexibility in the operation of fiscal policy during the recession. It facilitated an effective and necessary response to the downturn, while signalling a clear commitment to fiscal sustainability over the medium term.

2.84 With economic conditions beginning to normalise and the economy forecast to emerge from recession by the end of the year, the Government believes it is now appropriate to strengthen the fiscal framework. This is in line with moves that other governments around the world are also seeking to take. The IMF has set out that the strengthening of medium-term fiscal frameworks, including through fiscal responsibility laws, should help to support the fiscal adjustment that will be necessary in most economies following the financial crisis.[8]

Fiscal Responsibility Bill

2.85 As a result, **the Government is introducing a Fiscal Responsibility Bill to Parliament. The Bill requires the Government to set out at all times a statutory fiscal plan for delivering sound public finances, to be approved by Parliament, and places a binding duty on the Government to meet that plan. It also enables the Government to add further duties to the Fiscal Consolidation Plan through secondary legislation.**

2.86 The legislation gives Parliament a clear, central role in both setting and monitoring the Government's fiscal plans. In particular, Parliament must approve fiscal plans before they become law. This is a significant enhancement to Parliament's current role in setting medium-term fiscal policy, giving it a new opportunity to scrutinise the Government's plans. Further, the Government must report to Parliament on progress and compliance at each Budget and Pre-Budget Report. If its legislative fiscal plans are not achieved, the Government must set out why they were not met. The Government would then set out actions to remedy the situation. Combined, these provisions represent a significant evolution of the extent to which Parliament can hold the Government to account for its fiscal policy.

2.87 The Government will publish an updated *Code for Fiscal Stability,* setting out the requirements the Government must meet in the publication of its fiscal plans and projections, in the New Year.

Fiscal Consolidation Plan

2.88 The Bill sets out the Government's first legislative fiscal plan, the Fiscal Consolidation Plan (FCP). The FCP extends from 2009-10 to 2015-16 and incorporates the 2009 Pre-Budget Report fiscal judgment by requiring that the Government:

- halves public sector net borrowing as a share of GDP over four years from its forecast peak in 2009-10. The Government is setting a target, in secondary legislation enabled by the Bill, for borrowing to be 5.5 per cent of GDP or less in 2013-14;

[8] *A strategy for normalising fiscal and monetary policies in advanced economies,* International Monetary Fund staff position note, 22 September 2009.

- reduce borrowing as a share of GDP in each and every year from 2009-10 to 2015-16; and
- ensure that public sector net debt is falling as a share of GDP in 2015-16.

2.89 These are binding targets that cannot be changed except with the approval of Parliament through new legislation. This demonstrates the Government's commitment to delivering consolidation, and the importance it places upon action to ensure sound public finances in the medium term.

2.90 Debt is a key indicator of the sustainability of the public finances. The Fiscal Consolidation Plan targets debt and the main measure of the deficit – public sector net borrowing. It is the overall level of borrowing which determines the path of debt. Targeting this simple measure of borrowing enhances certainty on the scale of adjustment the Government is undertaking. The Government will continue to consider cyclically-adjusted measures of the public finances as a key indicator of the fiscal position. But given uncertainties over the structural position of the public finances at present, and the need to set clear and simple targets to which it can be held to account, deficit targets under the Fiscal Consolidation Plan will not be cyclically-adjusted.

2.91 The Fiscal Consolidation Plan will target a measure of net borrowing (PSNB ex) that excludes the temporary effects of financial interventions, but that will account for any permanent costs to the taxpayer. The independent Office for National Statistics will report on this measure alongside the Pre-Budget Report and further information on the measure is provided in Annex B. It is consistent with the current measure of public sector net debt excluding the temporary effect of the financial interventions (PSND ex).

LONG-TERM FISCAL ISSUES

2.92 The *2009 Long-term public finance report* is published alongside the Pre-Budget Report. It differs from previous reports in two main ways.

2.93 First, it does not attempt to project the government's primary balance over the next 50 years, based on projections of individual spending and revenue components. This type of mechanistic projection is informative under relatively normal economic circumstances as it helps to illustrate the implications of continuing along a given fiscal trajectory. However, such projections are misleading during times when the economy is operating significantly below its full potential, because current policy is set to deal with exceptional short-term issues. Projecting the fiscal stance resulting from these exceptional circumstances over the long term would result in long-run deficit projections that would be implausible. Instead, this year's *Long-term public finance report* provides projections for those areas of spending that are particularly affected by long-term challenges, such as education, pensions and health. It also provides illustrative projections for debt, based on firm fiscal consolidation plans set out to 2014-15 in this Pre-Budget Report and stylised assumptions thereafter. These show, for a range of potential interest and growth rates, that debt would fall over the long term, reaching between 0 and 30 per cent of GDP by 2050.

2.94 Second, this year's *Long-term public finance report* includes an expanded discussion of the long-term trends and the associated challenges facing the UK, and sets out their potential implications for the economy and public finances, under a range of different scenarios. This serves to develop understanding of long-term challenges for the public finances and provides valuable insights into the variability of projections.

2.95 The *2009 Long-term public finances report* illustrates the potential pressure that long-term challenges and trends could put on the public finances. The Government has set out fiscal consolidation plans that are consistent with debt returning to lower levels. These plans will ensure the public finances are on a sustainable path, which in turn will promote long-term economic growth. It will also ensure the public finances are able to manage any unexpected economic shocks in future.

3 REFORMING FINANCIAL SERVICES

A strong and thriving UK financial services sector supports UK growth and prosperity. In order for this positive contribution to be delivered, market participants and regulators need to ensure that the sector's development is sustainable and supports long term economic growth.

The Government attaches great importance to tackling the remuneration practices that contributed to excessive risk-taking by the banking industry. The 2009 Pre-Budget Report announces that:

- **a temporary bank payroll tax of 50 per cent will apply to discretionary bonuses above £25,000 awarded in the period from Pre-Budget Report to 5 April 2010 for each individual employee.**

The Government has taken decisive steps to maintain financial stability and promote the flow of credit to the economy. The success of these financial sector interventions is reflected in a downward assessment of their eventual net fiscal cost. Building on these interventions, the 2009 Pre-Budget Report announces that the Government will:

- **explore ways of encouraging more sustainable, transparent and standardised mortgage-backed securities markets;**
- **consult on and promote the UK regulated covered bond market; and**
- **publish a discussion paper on developing non-bank lending channels.**

The Government will shortly announce a package of measures to reduce the impact of any future failure of systemically important investment banks. It is also working at the national, EU and global level to shape the future development of the financial services sector. The 2009 Pre-Budget Report announces:

- **the introduction of a Code of Practice on taxation for banks;**
- **a new advisory group on professional and financial services;**
- **measures to promote a level playing field for Islamic finance products;**
- **a specific Governance Code for Building Societies and other mutuals; and**
- **the commencement of a new regulatory framework for recognised inter-bank payments systems.**

Competition and choice are central to responsive and well functioning markets. The Government is taking steps to promote competition in financial services, and to ensure that consumers are empowered to make informed choices, have access to the services they need, and are appropriately protected. The 2009 Pre-Budget Report announces:

- **£20 million to fund the national rollout of the Money Guidance service in 2010-11, helping one million people to manage their money better; and**
- **£5 million to fund extended opening hours at Citizens Advice bureaux in 2010-11, helping an additional 300,000 people.**

3.1 A strong and thriving financial services sector supports growth and prosperity across the economy. The UK financial services industry plays an important role in supporting individuals, households and businesses by transforming short-term deposits or investments into long-term loans; helping customers manage their risk and accumulate wealth; and providing payments services and other mechanisms to allow financial transactions to be made quickly, cheaply and reliably. In order for financial services to make as positive a contribution as possible to the economy, market participants and regulators need to ensure that the sector develops in a manner that is sustainable and supports long-term growth.

RESTORING STABILITY FOR A STRONG ECONOMY

3.2 The Government has taken a number of comprehensive and complementary policy steps to support the economy in the face of a global financial crisis. As this section demonstrates, the Government has acted and will continue to act decisively, both in dealing with the current global crisis and in guarding against future financial disruption and its impact on businesses and consumers.

Restoring stability

3.3 Since October 2008, the Government has taken steps to restore and maintain financial stability, ensure the ongoing supply of credit to the economy, and support economic recovery. Box 3.1 summarises the fiscal implications of these measures, which include:

- Recapitalisation – to address concerns about the solvency of financial institutions, the Government made commercial investments, through the purchase of shares or underwriting the issuance of new shares, to help strengthen banks' capital positions;
- Asset Protection Scheme (APS) – designed to protect financial institutions against exposure to exceptional future credit losses on certain portfolios of assets, helping banks to rebuild and restructure their investments and increase lending in the economy. Full details of the scheme were published on 7 December;[1]
- Credit Guarantee Scheme (CGS) – provides a guarantee on eligible new debt issued by qualifying institutions to supports banks' access to wholesale funding markets and, in turn, lending by banks to businesses and individuals. This scheme is considered in more detail below;
- Asset Backed Securities Guarantee Scheme – provides guarantees for AAA-rated residential mortgage-backed securities (RMBS), extending banks' and building societies' funding options alongside the CGS. In October this year, the entry window for the scheme was extended until 31 December 2009;
- Special Liquidity Scheme (SLS) – provides liquidity by allowing institutions to swap illiquid assets for Treasury Bills, which are more easily converted into cash, minimising the system-wide risks of illiquidity to financial stability. The scheme has been closed to new drawdowns since January this year but will run until January 2012; and
- Asset Purchase Facility (APF) – designed to enable the Bank of England to help improve the operation of credit markets through the purchase of corporate assets such as corporate bonds and commercial paper. This will improve liquidity, reduce funding costs and increase the availability of credit by stimulating the issuance of further instruments in those markets.

[1] *Royal Bank of Scotland: details of the Asset Protection Scheme and launch of the Asset Protection Agency* available at www.hm-treasury.gov.uk

Box 3.1 Fiscal implications of financial stability measures

At the time of the Budget 2009, estimates of the eventual net fiscal cost of the Government's financial sector interventions were subject to an exceptionally high degree of uncertainty reflecting both the prevailing macroeconomic and market conditions, and in a context of negotiations with the Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds) on the APS. The Government decided to reflect this unusual level of uncertainty by adopting a provision with the fiscal forecast for potential losses ranging from £20 billion to £50 billion. The high end of this range was included as a deliberately cautious judgement.

Since the Budget, and as set out in Chapter 2, there has been a general improvement in financial market conditions. Moreover, the finalisation of the APS terms and conditions has also considerably reduced the fiscal risks:

- Lloyds will not participate in the APS, but will instead raise as much as £22.5 billion in capital, more than £15 billion of which will come from the private sector, and pay a fee of £2.5 billion to the taxpayer for the implicit protection provided; and
- RBS will participate in the APS, but under significantly revised terms. RBS is now exposed to the first £60 billion of losses (from £42 billion announced in February) on the pool of insured assets before the Government is liable to make payments under the scheme, and the pool of insured assets has been reduced from £325 billion to £282 billion.

These changes mean that the central expectation for payouts to RBS under the APS is zero, and the Government's exposure to RBS and Lloyds has shifted away from the APS and towards the equity holdings. Annex B provides more detail on this assessment.

Credit Guarantee Scheme

3.4 The crisis has shown that very short-term wholesale funding can pose significant risks when there is a loss of confidence. In response, the Government put the CGS in place. As of 4 December 2009, the total guaranteed stock outstanding under the scheme was £134 billion, having declined from its peak in May 2009. The focus for banks should now be on rebuilding their funding portfolios through private sector solutions, helped by the guaranteed debt they already hold and can roll over for years to come.

3.5 However, to sustain confidence in light of continued uncertainty, **the Government will allow a short-term extension to the Credit Guarantee Scheme of two months subject to State aid approval.** Given the improvement in market conditions, there will be no automatic allocation of issuance to participating institutions.

Banking bonuses

3.6 The Government has made clear the importance of reforming the remuneration practices that contributed to excessive risk-taking by the banking industry. However, some banks may be intending to pay bonuses for the current year that are not consistent with a prudent approach to risk or with the need to ensure a sound capital base. To encourage banks to take full account of these and other relevant factors in their bonus decision-making, the Government today announces that **where bank (and building society) employees are awarded discretionary bonuses, in whatever form, above £25,000 in the period from the Pre-Budget Report to 5 April 2010, the banks paying these bonuses will pay an additional bank payroll tax of 50 per cent on the excess bonus over £25,000.** The background to this measure is discussed further in Box 3.2.

Box 3.2: Banking Bonuses

The Government attaches great importance to tackling the remuneration practices that contributed to excessive risk taking by the banking industry. The Government has made clear that the sector the needs to develop sustainable long-term remuneration policies that take better account of risk and facilitate the build up of loss-absorbing capital. However, evidence suggests that some may be intending to pay bonuses for the current year that are not consistent with a prudent approach to risk.

The Government today announces that where bank (and building society) employees are awarded discretionary bonuses, in whatever form, above £25,000 in the period from the Pre-Budget Report to 5 April 2010, the banks paying these bonuses will pay an additional bank payroll tax of 50 per cent on the excess bonus over £25,000. The tax will not be deductible in computing the taxable profits of affected companies. This tax will encourage banks to consider their capital position and to make appropriate risk adjustments when settling the level of bonus payments above the threshold, which is at the level of median earnings in the UK. If banks choose to make awards that are not consistent with a prudent approach to risk, it is only fair that they contribute more to the public finances, in a year when profits have been facilitated by significant taxpayer support for the banking sector as a whole.

It is intended that in the longer term, remuneration practices will be changed as a result of corporate governance and regulatory reforms, as outlined later in this chapter. The one-off bank payroll tax will apply until 5 April 2010, but the Government will consider extending the period of the charge so that the tax remains in place until the relevant provisions of the Financial Services Bill come into force. Where there is evidence of avoidance schemes being put in place, the Government will take action to close those schemes.

Support for lending

3.7 A fair and competitive credit market is a key component of a successful economy. Maintaining the flow of lending to creditworthy businesses and individuals is essential to growth and prosperity. The Government has taken a number of steps to support responsible lending and to promote best practice in the treatment of borrowers. The aim is not to return to the irresponsible lending practices of the pre-crisis period, but to ensure that the supply of credit meets recovering demand from creditworthy borrowers.

3.8 Analysis by the Bank of England in its July 2009 *Financial Stability Report*[2] of past recessions and financial crises in other countries suggests that bank lending typically remains weak in the early stages of recovery. Since the start of the economic downturn, while banks have continued to lend to both households and businesses, the rate of net lending has been on a downward trend in the UK.[3] This trend has also been seen in the US, the Euro area and Japan, and net lending to businesses in the UK is declining in percentage terms at a similar rate to that experienced in the 1990s recession.

3.9 The subdued level of lending evident in recent months may reflect a number of factors, including:

- a reappraisal of risk by lenders, investors and borrowers following the crisis;
- uncertainty about the prospects for the economy, impacting on the demand for finance by households and businesses;
- financial institutions restructuring to deliver higher capital levels and more conservative loan exposures;

[2] See *Financial Stability Report*, Bank of England, July 2009, available from www.bankofengland.co.uk

[3] See *Monetary & Financial Statistics*, Bank of England, October 2009, available at http://www.bankofengland.co.uk/statistics/ms/2009/oct/taba4.3.xls

- larger businesses have turned to reviving corporate bond and equity markets as an alternative source of external finance, raising £25 billion in net funds since March 2009;[4] and
- businesses restructuring and paying off debt during the recession. This has had an impact on the overall level of net lending to businesses. Repayments of business loans have, over the last six months, been £16 billion greater than the total level of new lending.[5]

3.10 It is important that creditworthy households and businesses should not suffer from constraints on the supply of lending, especially as demand recovers. To support access to competitively priced finance, the Government has secured legally binding lending commitments from RBS and Lloyds to lend an additional £25 billion and £14 billion respectively, subject to demand and on commercial terms, to mortgage customers and businesses. Both RBS and Lloyds have already made substantial amounts of lending available to borrowers. The Government expects both banks to continue to meet demand for lending from creditworthy households and businesses. Chapter 4 sets out the steps that the Government has taken, and will take, to improve access to finance and to increase transparency of pricing for small and medium-sized businesses.

Mortgage-backed securities

3.11 Mortgage-backed securities markets expanded strongly between 2003 and 2007. At the onset of the crisis, these markets saw a sudden drop in liquidity and a widening of spreads owing to uncertainty about risks. A lack of transparency and the complexity of some products may have contributed to the deterioration in market confidence.

3.12 It is important that lenders continue to have access to a diverse range of funding sources, including securitisation markets. These markets need, however, to be robust, more liquid and consistent with financial and macroeconomic stability more broadly. **The Government will explore ways of encouraging more sustainable, transparent and standardised UK mortgage-backed securities markets, working with the Bank and the FSA through the Council for Financial Stability, and in discussion with issuers and investors, in order to establish a broader investor base and lay the foundations for stronger markets in the future.** The Government will update on progress at Budget 2010.

Covered bonds

3.13 Covered bonds play a significant role in Europe, and the Government wishes to facilitate a robust Regulated Covered Bond market in the UK. In March 2008, the Government established a new legislative framework for covered bonds, supervised by the FSA. The Government and the FSA have consulted with market participants, and believe the current regulatory regime for covered bonds supports high quality products. They also recognise investors' desire for clarity and transparency about how the regulatory framework works. **The Government will consult in early 2010 on supplementary rules where greater clarity may be warranted on issues such as asset quality and asset capability standards for Regulated Covered Bonds.** Regulated covered bond issuers, the Government and the FSA will work together to promote familiarity with the UK's regulatory regime.

Non-bank lending channels

3.14 UK firms have historically relied extensively on banks for lending. Non-bank channels do play a role in the financing of UK corporates, but less so than in the US. Developing non-bank lending channels would help to improve the future resilience of the economy in the face of financial shocks.

[4]See *Trends in Lending*, Bank of England, October 2009, available at http://www.bankofengland.co.uk

[5]See *Trends in Lending*, Bank of England.

3.15 HM Treasury, working closely with the Bank of England, has been exploring with a range of stakeholders the different factors that could together constitute barriers to some corporates accessing non-bank investors. Of particular interest are issues around the credit assessment and monitoring process, including whether ways can be found of developing alternative credit assessment processes, the role of corporate transparency, transparency in the pricing of bank loans, the factors underpinning UK investor preferences, and loan and bond market infrastructure. These factors are closely interlinked and steps to encourage an increased role for non-bank investors would need to be carefully designed and sequenced.

3.16 **To address this issue, HM Treasury will launch a discussion paper on developing non-bank lending channels in the UK.** It will be advised by the Bank of England and FSA, working with the Department for Business, Innovation and Skills.

REFORMING FINANCIAL MARKETS FOR THE LONG TERM

3.17 Recent events have demonstrated the close ties between the financial sector and the broader economy. Chapter 2 outlined the importance of macroprudential regulation, and this section sets out the steps the Government is taking to enhance the stability and resilience of the financial markets by:

- introducing regulatory reforms to strengthen the UK's institutional framework for financial stability, with improved monitoring and mitigation of systemic risk;
- introducing reforms to reduce both the probability and impact of systemic firm failure; and
- pursuing these reforms not only at a national level but also leading the way in the EU and globally.

3.18 This section also describes how the Government is reforming the incentive structures and governance of financial services firms to restore trust and confidence in the sector, to the benefit of long-term growth across the economy as a whole.

Strengthening the institutional framework

3.19 The UK Authorities are taking forward a comprehensive package of reforms – through the Banking Act 2009[6] and the Financial Services Bill,[7] as well as the through the implementation of the recommendations and proposals coming from the FSA's *Turner Review*,[8] the *Reforming financial markets* White Paper,[9] and the *Walker Review of Corporate Governance*[10] – to strengthen the domestic regulatory architecture.

Financial Services Bill

3.20 On 19 November, the Government introduced the Financial Services Bill in the House of Commons. The Bill introduces a new Council for Financial Stability, with a responsibility for monitoring and coordinating the Authorities' response to challenges relating to systemic risk and financial stability.

[6] Banking Act 2009 is available at http://www.opsi.gov.uk

[7] Financial Services Bill is available at http://www.parliament.uk

[8] *Turner Review – a regulatory response to the global banking crisis* available at http://www.fsa.gov.uk

[9] *Reforming Financial Markets* is available at http://www.hm-treasury.gov.uk

[10] The *Walker Review of Corporate Governance in UK banks and other financial industry entities: Final recommendations* is available at http://www.hm-treasury.gov.uk

3.21 This increased focus on a more systemic approach to regulation is reinforced by a further provision in the Bill conferring on the FSA an explicit objective for financial stability. This is in addition to the statutory financial stability objective created for the Bank of England in the Banking Act 2009.

3.22 To support this strengthened approach to regulation, the Bill also enhances the FSA's regulatory powers, including those related to information-gathering and short selling practices, as well as its disciplinary powers.

Inter-bank payment systems

3.23 Inter-bank payment systems are important for the functioning of financial markets and the economy. The interlinkages between systems, banks and other financial intermediaries mean that deficiencies in the design of the payment system or disruption of its operation could have systemic or system-wide effects extending throughout the financial system, ultimately affecting its overall stability. The Banking Act confers powers on the Bank of England to enable it formally to oversee recognised systems where HM Treasury is satisfied that the design of the system or disruption of its operation would be likely to have systemic or system-wide effects. **The Government announces the commencement on 31 December 2009 of the new formal regulatory framework for the oversight of recognised inter-bank payment systems.**

Reducing the risk and impact of systemic firm failure

Investment banks resolution

3.24 The Government is also taking action to respond to the particular challenges involved in dealing with the failure of major investment banks and the impact of such failures on markets, clients, and creditors. The Government will shortly announce a package of policy measures designed to reduce the impacts of any future failure of systemically important investment banks.

Recovery and Resolution Plans

3.25 The Financial Services Bill legislates for Recovery and Resolution Plans (RRPs) (sometimes referred to as "living wills"), placing a duty on the FSA to make rules requiring firms to produce such plans. RRPs will be a key tool for the Authorities in maintaining financial stability as the plans are designed to reduce the probability of systemic firm failure and, should these firms fail, the impact on the financial system and wider economy.

3.26 The plans will comprise two elements: a recovery element setting out the range of credible actions the firm would take in a stress situation (e.g. restoring its capital or liquidity position, or preventing failure through de-risking and restructuring plans); and a resolution element setting out how the Authorities' resolution tools would be applied to a firm should it fail, and what actions firms might take to address any obstacles to such resolution. RRPs will be a significant means of dealing with the problems raised by some firms being viewed as too large, too complex and too interconnected. The FSA's pilot project on RRPs, working with a small number of large UK banks, is already underway to an ambitious timetable and these firms will have produced draft components of RRPs by 2010.

Rebalancing the risks of failure and the rewards of success

3.27 The costs of financial instability in terms of taxpayer support have been significant. We now need to consider whether it would be right to go further in addressing the balance of risks, rewards and responsibilities. As set out by the Prime Minister at the G20 Finance Ministers meeting in November, it is not clear that the distribution of the costs of failures in the financial sector is appropriate, compared with that of the rewards of success. Given the global nature of the financial services industry, any action to rebalance risks and rewards would need to be coordinated internationally, and the IMF have been asked by the G20 to report next year on options to ensure the financial sector makes a fair and substantial contribution. The Government will shortly publish a discussion paper as a contribution to this international debate.

Reform in the EU and global context

Global cooperation on reform

3.28 The global financial crisis has highlighted serious failures in the adequacy of international regulatory standards. The Government has been working at international and EU levels to achieve more robust international standards consistent with the domestic reform agenda. These measures are crucial in order to avoid the fragmentation of global financial markets, protectionism and regulatory arbitrage.

Objectives and priorities at an EU level

3.29 The UK is committed to making the European single market the most open, efficient and stable financial market in the world. The Government is therefore leading the global debate on higher standards of regulation and supervision; promoting harmonised standards based on robust use of consultation, analysis and impact assessment; safeguarding financial stability by ensuring that common financial risks are effectively managed; and discouraging protectionism in the EU and internationally.

3.30 In order to deliver these objectives within the EU, and in a manner consistent with the direction agreed internationally by the G20, the UK is focusing on the following key priorities: tackling systemic risks at an early stage; achieving stronger standards of prudential regulation and risk management; developing more effective rule making and enforcement by supervisory authorities; improving crisis management and resolution arrangements; and promoting competition and the single market.

3.31 Consistent with these objectives and priorities, the UK is:

- through its work on "Solvency II" contributing to the development of modern and risk-based EU-wide solvency requirements for insurers that protect Europe's claimants, savers and pensioners. The Government is also undertaking extensive consultation with the industry on the tax consequences of the Directive;
- closely involved in negotiating the proposed Alternative Investment Fund Manager Directive. The Government has been working to secure substantial improvements and will seek to build on this work with European partners; and
- actively engaged in EU efforts to amend the Capital Requirements Directive to provide a state-of-the-art prudential framework for credit institutions and investment firms in the EU. Current proposals will raise the amount of capital banks must hold against resecuritisations and assets held in their trading books. The UK is strongly supportive of the adoption of these rules and will continue to ensure that EU legislation appropriately strengthens prudential standards while being consistent with international agreements.

UK's G20 presidency

3.32 The UK has been at the forefront of international financial regulatory reform through its Presidency of the G20. Box 3.3 sets out progress made in reforming financial services under the UK's G20 Presidency.

Box 3.3 Progress in reforming financial services under the UK's G20 Presidency

Under the UK's leadership as G20 President, international consensus has emerged in support of a comprehensive package of financial regulatory reforms to strengthen the financial system for the future. Key achievements include:

- significantly enhancing the international regulatory architecture by replacing the Financial Stability Forum with a new Financial Stability Board (FSB) that has an expanded membership and a broader mandate to promote financial stability;
- establishing supervisory colleges for the largest cross-border firms, and endorsing principles for cross-border cooperation on crisis management;
- strengthening prudential regulation through the Basel Committee on Banking Supervision, including work on mitigating pro-cyclicality and enhancing the Committee's principles for banks' management of liquidity risk;
- revisions to accounting standards, including on the valuation of financial instruments and in the accounting treatment of off-balance sheet exposures; and
- endorsing FSB principles and standards for sound compensation practices, and calling on firms and authorities to implement these standards immediately.

The UK looks forward to working closely with G20 members under the Republic of Korea's Presidency to take forward the commitments made at Pittsburgh and St Andrews, in particular with respect to:

- maintaining pace on strengthening capital and liquidity regulation;
- ensuring that compensation policies and practices support financial stability and align with long-term value creation;
- strengthening regulation and oversight of systemically important firms; and
- tackling non-cooperative jurisdictions in relation to international standards in regulatory cooperation and information exchange.

Reforming incentives and governance in financial sector firms

Walker Review

3.33 In February 2009, Sir David Walker was commissioned to review corporate governance practices in the UK financial services sector and to identify failures that contributed to the onset and severity of the financial crisis. The Government has welcomed Sir David's final report, which was published on 26 November 2009 and included detailed recommendations on board size; composition and qualification; the functioning of the board and the evaluation of performance; the role of institutional shareholders and shareholder communication and engagement; governance of risk and remuneration.

3.34 A key theme in the review is the role of shareholders and their responsibilities for governance and good stewardship. Sir David recommends that the industry adopt a Stewardship Code, which should outline the principles of best practice according to which institutional shareholders can illustrate their commitments to good governance, and that the FSA should ensure that firms either comply or report their non-compliance with the Code. On 1 December the Financial Reporting Council welcomed the Government's request that it take on responsibility for a Stewardship Code, and announced a consultation to ensure the code can be operated effectively.

Remuneration framework

3.35 A key function of a governance framework is to ensure remuneration policies encourage a prudent approach to risk and are aligned with long-term value creation. The UK has taken the lead in bringing about change in financial services remuneration practices to ensure that these do not encourage excessive risk taking:

- the FSA has added a remuneration code to its Handbook.[11] This includes principles and guidance on sound remuneration practices. The code comes into force in January 2010, in advance of which regulated banks must work with the FSA to ensure they are compliant;
- the Government led calls for international standards for remuneration within the G20 and will continue to work with the FSB in implementing the principles and standards agreed at the Pittsburgh summit; and
- five major UK banks,[12] as well major foreign banks with significant UK operations, have released public statements outlining their commitments to the FSB Standards and the FSA Remuneration Code.[13]

3.36 The Government has designed legislative measures that will ensure remuneration is consistent with effective risk management and that shareholders have the information they require to provide the appropriate oversight. The Financial Services Bill includes a provision that:

- bestows a duty on the FSA to ensure that remuneration policies are consistent with effective risk management and in line with the FSB standards;
- gives the Treasury the power to direct the FSA to consider whether the remuneration plans of authorised persons comply with FSA remuneration policy requirements; and
- empowers the FSA to make rules that impose specific prohibitions on the way in which a person may be remunerated; make any provision of a remuneration contract that contravenes such a prohibition void and so unenforceable; and provide for the recovery of any payment that may have been made under such a provision.

3.37 The measures in the Bill will also provide the Government with the necessary powers to implement requirements for the disclosure of remuneration. These will involve aggregated and banded disclosure and the Government will consult on going further than Sir David's recommendations, including on a lower minimum threshold and narrower bands. The information disclosed will provide shareholders with valuable information and enable them to provide more effective oversight of the relation between risk and remuneration in the companies in which they are invested.

3.38 In advance of these measures taking effect, and as outlined in Box 3.2, the Government today announces that where bank (and building society) employees are awarded discretionary bonuses, in whatever form, above £25,000 in the period from the Pre-Budget Report to 5 April 2010, the banks paying these bonuses will pay an additional bank payroll tax of 50 per cent on the excess bonus over £25,000.

Stock lending

3.39 The FSA has been reviewing the governance and risk management of stock lending in the market. The Government welcomes this work and will work with the FSA and market participants as necessary to help develop thinking in this area.

[11] FSA draft code on remuneration practices is available at http://www.fsa.gov.uk
[12] Barclays, HSBC, Lloyds, RBS, and Standard Chartered
[13] The banks' joint statement is available at http://www.hm-treasury.gov.uk/press_92_09.htm

Tackling tax avoidance

3.40 An important step towards reversing the erosion of confidence and trust in the financial sector is to ensure that the industry is seen to be making an appropriate level of tax contributions to the public finances.

3.41 **After a period of consultation the Government is introducing a Code of Practice on taxation for banks.** The Code encourages clearer norms for behaviour, commitments to fairness and responsible behaviours facilitated through open and transparent relationships between banks and HMRC. The Government expects all banks operating in the UK to adopt the principles set out in the Code of Practice.

3.42 The Government remains determined to take action where firms engage in tax avoidance. Chapter 5 provides further detail of steps taken, and announces a series of measures to counter avoidance schemes and ensure that the financial sector complies fully with its tax obligations.

Ensuring that the UK financial sector remains internationally competitive

3.43 The Government remains committed to ensuring that the UK's financial services sector remains strong over the long-term, retains its comparative advantage internationally, and meet the needs of consumers and businesses in the wider economy.

Engagement with industry

3.44 Both Government and industry have a joint interest in developing and promoting the UK's long-term competitiveness as a global centre for financial and professional services. The Government is keen to engage with the financial services industry on important issues, and to make changes where appropriate to foster international competitiveness.

3.45 The High Level Group of industry leaders was asked by the Chancellor to identify challenges to, and trends in, the competitiveness of financial services.[14] The Government welcomes the reports, summarised in Box 3.4, and is building on its engagement with the industry to take forward a range of proposals.

[14] The High Level Group reports included: *UK International Financial Services – The Future; Professional Services Global Competitiveness Group Report; Vision for the Insurance Industry in 2020: A Report from the Insurance Industry Working Group; Asset Management: The UK as a Global Centre.* All available at http://www.hm-treasury.gov.uk

Box 3.4 Chancellor's High Level Group reports

The Group's four reports on financial services competitiveness, professional services, insurance, and asset management, focus on the long-term future of the wider industry. Common themes include the need for:

- ongoing constructive engagement between industry and Government;
- demonstration of the value of the industry internationally and domestically;
- high regulatory standards, with the UK playing a leading role in formulating and implementing EU and global reforms;
- practical and sustainable taxation arrangements;
- recognition of the importance of customer-centred products and services;
- increased consumer trust and confidence and financial capability;
- responsible innovation and investment in anticipation of future challenges and unmet needs; and
- attraction and nurturing of the best talent to meet current and future skills needs.

Industry action

3.46 Industry, for its part, must take the lead on a number of issues. The asset management industry should proactively focus on steps to restore consumer confidence and to respond to clients needs, while reforming processes of governance and stewardship. The Government also looks forward to proposals from the insurance industry for improving collaboration on risk management, and for managing the risks of unemployment, ill health, and the need for a retirement income or long-term care.

New Chancellor Advisory Group

3.47 **The Government announces that the Chancellor will convene a new advisory group on financial and professional services, as a smaller and more focused successor to the former High-Level Group.** It will act as a critical sounding board for the Government with respect to policies pertaining to the long-term future of the sector and their cumulative impact, and will ensure that the conclusions from the competitiveness reports are followed through.

TheCityUK

3.48 The Government supports the recent creation of TheCityUK as a single, independent and practitioner-led organisation that can take a clear lead in promoting the industry at home and internationally. It welcomes efforts taken so far to rationalise existing promotional structures, and looks forward to further progress by TheCityUK in achieving high standards in promotional work.

Global partnerships

3.49 The Government recognises the importance for future growth and investment of partnerships with European and emerging markets. Dialogues this year with China and India have further deepened bilateral financial market and regulatory cooperation, with strong participation from industry and Government.

Strengthening asset management and alternative finance

3.50 Over the past three years, the Government has taken significant steps to enhance the competitiveness of the UK's asset management sector, drawing on extensive consultation with the industry. The Government is committed to maintaining the UK's competitive position in light of broader changes in the regulatory and tax environment.

3.51 As part of an ongoing commitment to the UK's position as a centre for Islamic finance, **the Government intends to provide relief from tax on capital gains for alternative property refinance transactions, subject to satisfactory safeguards. The Government has also announced a commitment to ensure, as far as possible, a level playing field on VAT for retail consumers of Islamic finance products compared to consumers of their conventional equivalents. This includes a commitment to issue guidance on the VAT treatment of alternative finance investment bonds.**

PROMOTING AND ENSURING A FAIR DEAL FOR CONSUMERS

3.52 Competition and choice are central to responsive and well functioning markets. This section sets out steps the Government is taking to promote competition in financial services, and to ensure that consumers are empowered to make informed choices, have access to the services they need, and are appropriately protected.

Promoting choice for consumers

3.53 Competition and choice are vital for improving the efficiency and responsiveness of financial markets for consumers. The Government welcomes today's publication of a Memorandum of Understanding between the FSA and the Office of Fair Trading (OFT), embodying strengthened cooperation on competition matters.

Divestments by banks

3.54 The Government believes in competitive markets, and the UK is a strong supporter of the EU State aid framework that ensures that governments only give assistance to private institutions when absolutely necessary, and that, where aid is provided, appropriate steps are taken to mitigate distortions to competition. In light of the recapitalisations announced in October 2008 and the APS, the European Commission has approved a restructuring plan for Lloyds, and it is expected that RBS' restructuring plan will be approved in the coming weeks. Together the restructuring plans will result in the divestment of over 900 branches by 2013.

3.55 These divestments will lead to a genuine increase in competition in the UK banking market. The Government has made it clear that both banks will be required to sell these businesses as single viable packages, to either smaller competitors or new entrants to the market. This will reverse a 40-year trend of retail bank consolidation in the UK and ensure that these divestments increase diversity and competition in the UK banking market. Combined with the entity emerging from the splitting of Northern Rock, the divestments of Lloyds and RBS will potentially create three new banks on the high street in the space of five years, to the benefit of UK businesses and consumers.

Building societies

3.56 The Government is also taking steps to promote competition and consumer choice through supporting the development of a strong, competitive and sustainable building society sector. Despite weathering the financial crisis well, there remain challenges to the traditional building society model in the current market environment, including increased competition from banks for retail deposits, pressure on margins, and capital and funding constraints.

3.57 In *Reforming financial markets*, the Government announced that it would convene an expert group of key stakeholders to advise on the strategic issues affecting building societies. The Government welcomes the positive progress the group has made to date in taking this work forward, and urges the sector to identify and pursue opportunities for achieving efficiencies through shared services, but does not recommend moving towards a heavily integrated continental model given the potential impacts on competition and diversity. The Government also welcomes the work towards a sector-led pooled funding vehicle which could have significant funding benefits for societies; and it strongly encourages the sector to continue to seek new ways to raise core capital. The Government will continue to engage with the sector on this important work.

3.58 The Government applauds the good work of many societies in ensuring strong corporate governance, but recognises that mutuals face different governance challenges to companies with shareholders. Following the *Walker Review*, and the subsequent Financial Reporting Council (FRC) consultation on the Combined Code, **the Government proposes the introduction of a specific governance code for building societies and other financial mutuals**. The Government will also consider the introduction of a regular independent review of building societies (and other financial mutuals) adherence to the Code.

3.59 The merger of Co-op Financial Services and Britannia Building Society was the first under new legislation enabling building societies to merge with other mutual societies without losing the benefits of mutual ownership. The Government has recently laid regulations addressing the tax consequences of transfers of business by mutual societies under this legislation (the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007) and for pre-existing and continuing transfer rules. This ensures that tax does not act as a barrier to transfers of engagements between mutual societies, or to demutualisations, and provides a level playing field within the sector where appropriate, improving competition.

Empowering consumers

3.60 Informed, motivated and empowered consumers are key to a competitive and fair marketplace. The Government is taking steps to ensure that consumers have access to products that meet their needs, and are equipped to make informed financial choices.

Retail Financial Services Forum

3.61 The Retail Financial Services Forum (RFSF), announced at 2008 Pre-Budget Report, has a remit to promote a financial services industry that operates in the interests of consumers. Chaired by the Exchequer Secretary, it has discussed a wide range of issues over the course of the year and has played an important role in supporting the development of the consumer-focused measures in *Reforming financial markets*. It will continue to develop and support policy approaches to promote confidence and fairness.

Access to financial services

3.62 The Financial Inclusion Taskforce has confirmed that the Shared Goal agreed by the Government and industry in 2004, to halve the number of adults in 'unbanked' households, has been met. The number of such adults has fallen from two million in 2002-03 to fewer than 900,000 in 2007-08;[15] a reflection of the Government and industry working together effectively to make financial services work for the poorest households.

3.63 The Government believes that the banks have a vital role to play in supporting communities and tackling financial exclusion. It is important to understand how banks are supporting our broader community regeneration work. **The Government will therefore explore options with the banks to improve the information available on services delivered in deprived communities.**

Affordable credit

3.64 Access to affordable credit is an important aspect of financial inclusion. Since 2005, the Government has invested £98.75 million in a financial inclusion Growth Fund. This has enabled third sector lenders, such as credit unions and Community Development Financial Institutions to make some 190,000 loans to financially excluded individuals. Since Budget 2009, the Government has also procured contracts in a number of new areas including

[15] See Fourth Annual Banking Report, Financial Inclusion Taskforce, October 2009, available from http://www.hm-treasury.gov.uk

Lincoln, Newcastle-upon-Tyne, South and East Durham and South East Wales, helping to extend provision into high priority areas.

Money Guidance **3.65** The Government is committed to supporting and empowering consumers to plan for the future and manage their money well. A pilot or 'pathfinder' Money Guidance service was launched at Budget 2009 to test the recommendations of the *Thoresen Review of Generic Financial Advice*, published in 2008.[16] The pathfinder service, which is available through the Moneymadeclear website, helpline and via face-to-face sessions, has already helped 265,000 people in the North West and the North East of England and is on track to reach over 500,000 people by March 2010. Interim evaluation findings show that Money Guidance is proving effective in helping people deal with their finances, from making an informed decision when choosing financial products to dealing with debts before they get out of hand.

3.66 In the light of the pathfinder's success to date, **the Government and the FSA will provide £20 million in 2010-11 to fund the national rollout of the Money Guidance service from spring 2010. This will enable the service to help one million people by March 2011. The Government also announces its intention to commit at least 25% and up to £100 million of the funds expected to be released through the Dormant Accounts Scheme over a number of years to support delivery of Money Guidance service**, subject to the final volume of funds available for distribution in England and alongside funding other priorities through the scheme, including youth facilities and a Social Investment Wholesale Bank.

Consumer financial education body **3.67** The Government has brought forward provisions in the Financial Services Bill to establish an independent consumer financial education body. This body will lead the rollout of Money Guidance and take forward the National Strategy for Financial Capability, currently run by the FSA. The new body will bring greater profile, improved strategic leadership and a flexible and collaborative approach to delivering and funding consumer education initiatives.

Financial education in schools **3.68** Financial education in school is key to improving financial capability among future generations. While financial capability has featured in the secondary curriculum in England since September 2008, the Government has introduced provisions in the Children, Schools and Families Bill to make financial capability and economic wellbeing a statutory component of the secondary school curriculum in England from 2011.

Transparency of products and services **3.69** The Government announced in the *Reforming financial markets* White Paper that it would work on developing a simple, transparent product regime to help people navigate the complexity of choosing a financial product. Respondents to the White Paper broadly welcomed the proposals but had some concerns about the method of implementation. The Government will now undertake consumer research and seek advice from the RFSF, with the intention of issuing a consultation on detailed proposals early in 2010.

Open market option **3.70** The Government's Open Market Option (OMO) review group continues to make progress in improving the provision of information for those choosing an annuity to ensure that they get the best annuity deal when they come to draw their retirement income. Since the 2008 Pre-Budget Report:

- the annuity comparison table on the Moneymadeclear website has received 228,000 visits;
- the Association of British Insurers has published new guidance[17] requiring providers to inform customers of the potential benefits of using the OMO and

[16] *Thoresen Review of Generic Financial Advice: Final Report*, March 2008, available at http://www.hm-treasury.gov.uk/
[17] The ABI guidance is available from http://www.abi.org.uk

has worked with industry to reduce average OMO transfer times from 31 to 11 calendar days; and

- the Pensions Regulator has looked at a sample of trust-based defined contribution schemes and found that 98 per cent of schemes sampled did offer the OMO, though levels of compliance and good practice varied widely.

Protecting consumers

3.71 Appropriate consumer protection is central to well-functioning markets. The Government is taking forward reforms to ensure an effective framework of payments, mortgage and credit regulation; access to debt advice when needed; and swift redress if things go wrong.

Payment services

3.72 In order to protect consumers using financial institutions other than banks to make payments, **a new regulatory regime has been established under the Payment Services Regulations 2009.** This reform provides for an authorisation regime for non-bank payment service providers (such as money remitters) and introduces harmonised conduct of business rules to protect consumers.

Credit and mortgage regulation

3.73 The Government is committed to ensuring that the framework of credit and mortgage regulation is robust and up-to-date. In July this year, the Government published a White Paper on consumer rights, *A Better Deal for Consumers*,[18] which included proposals to strengthen the UK's consumer credit regime. In October, the Government published a review of the regulations governing credit and store cards, taking forward commitments in the White Paper.[19]

3.74 In November this year, the Government published a consultation document[20] setting out proposals to strengthen protections for UK mortgage borrowers. This included measures to protect borrowers whose mortgages are sold on to third parties, and an expansion of the scope of FSA regulation to include buy-to-let and second-charge mortgages. The FSA is also reviewing its mortgages regime, and in October published a mortgage market review discussion paper[21] with the aim of supporting borrowers and ensuring a sustainable mortgage market.

Home Finance Forum

3.75 Bringing together Government, mortgage lenders and consumer groups, the Home Finance Forum (HFF) monitors UK mortgage markets, encourages high standards of industry best practice and promotes better awareness of industry and Government initiatives, focusing on arrears and repossessions. The HFF has coordinated work to improve the evidence base on UK mortgage. This enhanced evidence base is supporting both industry and Government in strengthening the framework of support for mortgage borrowers in financial difficulty.

Debt advice

3.76 At the 2008 Pre-Budget Report the Government allocated £10 million to the Citizens Advice Bureau, to be spent from February 2009 to March 2010, to help expand their opening hours to meet rising demand for advice. This funding has enabled Citizens Advice to recruit and train over 1,700 new volunteers and will help an estimated minimum of 335,000 people by March 2010, which is equivalent to 290,000 people per year or £30 per person. **This Pre-**

[18] *A Better Deal for Consumers: Delivering Real Help Now and Change for the future*, March 2009, available at http://www.fsa.gov.uk

[19] *A Better Deal for Consumers: Review of the Regulation of Credit and Store Cards: A Consultation*, October 2009, available at http://www.bis.gov.uk

[20] *Mortgage Regulation: A consultation*, December 2009, available at http://www.hm-treasury.gov.uk

[21] *Financial Services Authority: Mortgage Market Review*, October 2009, available at http://www.fsa.gov.uk

Budget Report announces further funding of £5 million in 2010-11, which will enable Citizens Advice to help another 300,000 people.

Bank charges

3.77 On 25 November, the Supreme Court ruled that the OFT could not assess the fairness of bank charges for people who are overdrawn. The Government recognises that this outcome was disappointing for many consumers and is clear that the charging structure of the banks needs to change in the future. The Government will work with consumer groups, the OFT and the banks in order to agree a new framework that will make bank charges fairer, simpler and more transparent in the future. The Government will take action to deliver change if a voluntary approach does not result in a fair outcome for consumers.

Dealing with complaints

3.78 Consumers made 1.51 million complaints to financial services firms in the first half of 2009, compared with 1.48 million complaints in the first half of 2008. Cases referred to the Financial Ombudsman Service (FOS) also continue to rise, reaching 69,489 in the first half of 2009 compared to 57,139 in the first half of 2008. FOS expects its caseload to rise to more than 150,000 in 2009-10.

3.79 The Government believes that more can be done to drive up the standards of complaints handling by firms, reduce the number of cases referred to the FOS, and use the complaints systems to identify and close down emerging issues before they become widespread. It has worked with the Retail Financial Services Forum to consider how to identify and address the root causes of problems before they become widespread. The RFSF has welcomed the objective of creating an improved process for dealing with complaint issues that have wider implications.

3.80 Following on from this, the FSA, the OFT and FOS will publish a discussion paper in February 2010 setting out the actions that they are taking, including:

- improving the way that the three bodies work together, in order better to identify conduct risks that might lead to consumer detriment;
- identifying and handling widespread issues and clarifying the roles and responsibilities of each body and of stakeholders; and
- increasing the focus of regulators on facilitating redress through supervision and enforcement action.

Swift, effective redress

3.81 The Government has introduced two measures in the Financial Services Bill to facilitate the resolution of cases with mass complaints:

- a streamlined power for the FSA to establish a collective redress scheme on behalf of consumers covering a number of firms where there appears to have been a widespread failure. Firms will be required to investigate their past business; assess whether they have failed to comply with a relevant requirement; and determine whether consumers have suffered loss and if so, make redress; and
- a new form of collective proceedings through the courts, enabling a representative body to pursue an action on behalf of a group of consumers with the same or similar claims against financial services providers.

4 SUPPORTING BUSINESS AND GROWTH

Following a year in which the global economy entered the most severe and synchronised recession since the Great Depression, the Government is determined to ensure that the UK remains an attractive place to do business, and to create a strong and stable platform for future growth.

The action that the Government is taking to put the public finances onto a sustainable footing, and to ensure that the financial markets are properly functioning, is key to providing the macroeconomic stability that business needs.

In addition to action economy-wide, the Government continues to take targeted measures to:

- support businesses into the recovery: by **continuing the Business Payment Support Service** that has already enabled over 160,000 businesses to spread over £4 billion of tax; **extending the temporary increase in the threshold for empty property rate relief;** and **further deferring the increase in the Small Companies' Rate of corporation tax**;
- ensure that business has access to the capital it needs: through the legally binding lending commitments made by the Royal Bank of Scotland and Lloyds Banking Group; by making an additional £500 million of lending available to small and medium-sized enterprises through **a 12-month continuation of the Enterprise Finance Guarantee;** and by **creating a new Growth Capital Fund**, along with the £325 million UK Innovation Investment Fund;
- build on the unprecedented investment in infrastructure over the last decade and ensure the UK is ready to face the challenges of the transition to a low-carbon economy by **creating Infrastructure UK,** which will help facilitate private sector investment in infrastructure, and help ensure that publicly-funded infrastructure is effectively prioritised and delivered; and
- drive innovation by **introducing a Patent Box,** a reduced rate of corporation tax applying to income from patents from April 2013, to strengthen the incentives to invest in innovative industries, and through **additional funding of £200 million for the Strategic Investment Fund** that will include £150 million to support low-carbon investment, as set out in Chapter 7.

4.1 The world was hit by a succession of severe shocks during 2007 and 2008, creating a difficult environment in which to do business. As Chapter 2 sets out, the Government has taken timely action to protect the UK economy, and the substantial monetary policy support that is in place will provide an ongoing and powerful stimulus to spending by businesses and individuals. In addition, the Government's decisive action to support the financial system (as set out in Chapter 3) was vital to ensure that the financial markets could continue to meet the needs of business and the economy as a whole.

4.2 The Government has also provided a substantial amount of targeted support to help all businesses through the recession. This chapter describes how these measures, added to the underlying flexibility of the UK economy following a decade of investment and supply-side reforms, have helped UK firms to withstand the recession. Looking forward, the Government will ensure that the UK is well-placed to meet challenges and opportunities as the world economy recovers. This means creating a stable macroeconomic platform that gives UK firms the confidence to make long-term investment plans and provides businesses with access to the finance they need to support growth. It also means ensuring that the UK's infrastructure meets the needs of the future, particularly during the move to a low-carbon economy. Finally, it means creating the conditions that foster innovation and enterprise, including by maintaining open and competitive markets, and equipping people with the skills they need for the jobs of the future.

Sustainable public finances

4.3 Ensuring sound public finances is key to macroeconomic stability. The action that the Government is taking to reduce public sector borrowing, as set out in Chapter 2, will help to maintain low long-term interest rates. While some consolidation will come through increased taxation, the majority of the planned action will be through measures to reduce the growth in public expenditure. This action to reduce the deficit follows a decade of unprecedented levels of investment in transport infrastructure, skills, higher education, science and research, and action to support enterprise, innovation and competition. As set out in Chapter 5, further increases to national insurance contributions are also announced in this Pre-Budget Report in order to protect priority public services.

SUPPORTING THE RECOVERY

4.4 The Government has provided substantial support for cashflow and investment to help viable businesses through the downturn. Evidence suggests businesses are weathering this recession better than in the past. For example, in the 1990s recession, the average company liquidation rate in England and Wales was around two and a half times higher than the levels seen over the last four quarters. As the economy moves towards recovery, the Government will continue to provide support where it is needed.

Business Payment Support Service

4.5 The 2008 Pre-Budget Report launched HMRC's Business Payment Support Service to help viable businesses facing temporary financial difficulties to spread tax payments over an agreed timetable. The service has supported over 160,000 businesses, collectively employing more than 1.2 million people, spread over £4 billion of tax. Of this, more than £3 billion has already been repaid. All requests continue to be assessed on the same basis as when the service was introduced. **HMRC will continue to offer this service as part of its time to pay arrangements.**

Business Rates

4.6 The Government has provided business rates support worth in the region of £1 billion in 2009-10 to help businesses manage their cashflow. In March 2009, the Government announced that businesses could spread payment of the April 2009 inflation up-rating to business rates over three years, helping ratepayers for an estimated 1.8 million properties in Britain. The Government also temporarily increased the threshold at which empty properties are liable for business rates to £15,000, exempting an estimated 70 per cent of empty properties. In addition, the Government has legislated to allow certain businesses facing significant backdated business rates bills, including occupiers of ports, more time to pay their liability. On 18 September 2009, the Government removed the requirement for businesses receiving small business rate relief to reapply for relief at revaluation.

4.7 To give support during the transition to recovery, **the Government is maintaining for a further year the temporary increase in the threshold at which an empty property becomes liable for business rates.** For financial year 2010-11, empty properties with a rateable value of less than £18,000 will be exempt from business rates, exempting an estimated 70 per cent of empty properties. This higher threshold reflects the effects of business rates revaluation. 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 reuse empty property, and avoids subsidising owners of empty properties.

Small Companies' Rate of corporation tax

4.8 To provide further support for small companies during the recovery, **the Government is deferring, for an extra year, the planned increase in the Small Companies' Rate of corporation tax.** The rate will remain at 21 per cent during 2010-11. This will help around 850,000 payers of the Small Companies' Rate in the UK. The Government remains committed to the aims of the business package announced at Budget 2007, to refocus incentives towards investment and growth, and to reduce the differential between incorporated and unincorporated businesses.

Capital allowances **4.9** At Budget 2009, to encourage private sector investment, the Government temporarily introduced an enhanced first-year capital allowance of 40 per cent for expenditure incurred in 2009-10. This is providing substantial support for business investment during the worst of the downturn and the transition to recovery, and will come to an end as planned in April 2010. As long as the obligation to pay becomes unconditional during 2009-10, the enhanced capital allowance can be claimed, even if payment is not due for up to four months after. All businesses that invest will continue to benefit from the Annual Investment Allowance, which allows the first £50,000 of capital expenditure to be offset against taxable profits.

Loss carry-back **4.10** The temporary extension of trading loss carry-back from one to three years, for losses up to £50,000, continues to give loss-making businesses greater tax repayments to support their cashflow. This support applies for two years until 23 November 2010 for companies, and for the 2008-09 and 2009-10 tax years for unincorporated businesses. It allows an estimated 90 per cent of eligible businesses to claim full relief on their losses and is providing an average repayment worth more than £4,000.

Automotive sector **4.11** The temporary vehicle scrappage scheme was announced at Budget 2009. Over 274,000 orders have already been placed through the scheme. This has provided a timely boost to the automotive and trades sector. Building on this success, the Government announced in September 2009 that it would provide a further £100 million for the scheme, to support up to a total of 400,000 vehicle sales. The Automotive Assistance Programme also remains open to provide support where necessary for ongoing investment in the automotive sector.

VAT rates **4.12** As announced in the 2008 Pre-Budget Report, the standard rate of VAT will return to 17.5 per cent on 1 January 2010. The Government is working to minimise the associated administrative costs for businesses. The Government has given certainty about the end of the temporary reduction with a long lead-time from the announcement at the 2008 Pre-Budget Report. HMRC has also set out the arrangements for a period of grace for those businesses trading across midnight. The Department for Business, Innovation and Skills (BIS) is amending the rules enforced by trading standards on pricing to give retailers more time to display any changes to prices. **Rates for the VAT Flat Rate Scheme are also updated to reflect the standard rate change and the latest sectoral payment data from 1 January 2010.**

Trade Credit Insurance **4.13** The Trade Credit Insurance top-up scheme delivers targeted help for businesses, providing top-up cover for six months where suppliers have faced reductions in private sector insurance since October 2008. On 20 August 2009, the price of participating in the Government scheme was reduced and eligibility criteria were loosened. The scheme has given businesses breathing space to adapt to the new situation in the trade credit insurance market. As planned, the scheme will close to new customers at the end of December 2009.

Ensuring access to finance

4.14 The Government has taken decisive action to maintain financial stability, with the aim of restoring confidence in the banking sector and ensuring that creditworthy borrowers have access to funding. The Government and authorities will continue to strengthen stability and confidence in the UK financial services industry, to protect and enhance competitiveness in financial services, and to promote and ensure a fair deal for consumers. Further details are set out in Chapter 3.

Lending commitments **4.15** To help provide continued confidence to businesses in accessing bank finance, the Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds) lending commitments will remain in place until March 2011.

Bank Customer Charters

4.16 The Government also recognises that some small and medium-sized enterprises (SMEs) are still having problems accessing affordable finance. To help address this issue the Government has agreed Customer Charters with RBS and Lloyds. The Charters increase the transparency of pricing for SMEs, which will help these businesses understand the conditions of their loan and how the price they are paying has been arrived at. The Charters also include promises to cap fees on lending for the majority of SMEs. The Charters apply to over 98 per cent of these banks' customer base. More information can be found on the Lloyds and RBS websites[1].

Enterprise Finance Guarantee

4.17 The Enterprise Finance Guarantee (EFG) provides participating lenders with a 75 per cent Government guarantee on individual loans to viable businesses with turnover of less than £25 million, that are at the margins of commercial lending. Since its launch in January 2009, nearly £1 billion of eligible applications from almost 9,000 SMEs have been granted, are being processed or are being assessed. Recognising the continuing challenges that smaller businesses face in accessing finance, **the EFG will be continued for a further 12 months.** This will enable £500 million of additional bank lending to SMEs between April 2010 and March 2011 – lending that would not otherwise take place.

European Investment Bank funding

4.18 The 2008 Pre-Budget Report announced that small businesses stand to benefit from up to £4 billion of funding from the European Investment Bank (EIB) by the end of 2011 and that UK banks would secure £1 billion of this finance by the end of 2008. Box 4.1 sets out how the Government has supported UK businesses in accessing EIB funding over the last year.

Box 4.1: Access to lending from the European Investment Bank

Since the start of 2009, the EIB has signed or approved £8 billion worth of loans to the UK, which is £3.5 billion more than in 2008. The Government is committed to helping UK businesses and projects to continue to access EIB finance.

Following on from Government announcements since the 2008 Pre-Budget Report:

- UK banks have secured £1.39 billion of SME funding from the EIB and approved over £700 million for lending to small businesses;
- the EIB has approved £515 million worth of loans for green research and development to UK automotive companies;
- the EIB is helping to finance several UK energy and renewables projects by providing up to £4.5 billion of lending, supporting up to £9 billion of investment; and
- over £3 billion of EIB finance has also been agreed for vital UK infrastructure projects, such as Crossrail and the London Array offshore wind farm.

The EIB is also supporting JEREMIE regional lending schemes for SMEs in the North East, North West, and Yorkshire and Humber, worth a total of £380 million including grant support from the European Regional Development Fund.

Working Capital Scheme

4.19 The Working Capital Scheme (WCS) was introduced in January 2009 to encourage additional lending to business, by providing guarantees on the working capital loan portfolios of participating banks. Guarantees totalling over £2 billion have now been provided through the WCS and, as similar Government support is now available through the broader Asset Protection Scheme, the WCS will not be extending any further guarantees.

Capital for Enterprise Fund

4.20 Launched in January 2009 to support viable, but over-leveraged, businesses, the Capital for Enterprise Fund has so far made offers totalling over £45 million, which will convert debt into equity to support business growth. This temporary support measure will be closed to new investments, as planned, in March 2010.

[1] www.lloydsbankinggroup.com and www.rbs.com.

Growth Capital Fund

4.21 The *Rowlands Growth Capital Review*[2], published in November 2009, concludes that there is a structural problem in the availability of growth capital to SMEs. The Review recommends the creation of a growth capital fund to provide a new channel to attract private sector investment into UK SMEs seeking £2-10 million.

4.22 **The Government accepts these recommendations and announces the creation of a Growth Capital Fund that will target SMEs for which traditional bank finance is either inappropriate or unavailable.** Following an initial approach from the investment banking community and further contact with the retail banks, the Government is in discussions with a group of global and UK banks that want to ensure that they are able to play a meaningful role in ensuring thhe UK's economic recovery. The Government will work rapidly with these banks to establish a world-class, fully commercial Growth Capital Fund that will work for the benefit of the economy and will be announcing initial investors and fund structure in 2010.

UK Innovation Investment Fund

4.23 The UK Innovation Investment Fund (UKIIF) was launched by the Prime Minister in June 2009 as part of the Government's strategy for Building Britain's Future. It will invest venture capital in technology companies with high growth potential across important sectors such as life sciences, clean technologies, digital and advanced manufacturing. **The Government announces that, following a competitive tendering process and detailed due diligence, and subject to contract, the fund of funds manager mandates will be awarded to Hermes Private Equity and the European Investment Fund.** The UKIIF will provide for total funding of £325 million at first closing, which it is hoped will take place in January 2010. This funding will be divided as follows:

- £125 million for targeted investment in a fund of funds, focussed on low-carbon technology, to be managed by Hermes Private Equity; and
- £200 million for investment in a general technology fund of funds, to be managed by the European Investment Fund.

Tax-advantaged venture capital schemes

4.24 In April 2009, the Government received formal state aids approval from the European Commission for the UK's three tax-advantaged venture capital schemes: the Enterprise Investment Scheme (EIS), Venture Capital Trusts (VCTs) and the Corporate Venturing Scheme. To date, the schemes have raised around £10 billion, which has been invested in around 16,000 small companies.

4.25 A final set of changes are required to secure state aids approval. **Alongside this Pre-Budget Report the Government has published draft legislation on these changes, allowing time to consult before the legislation is introduced in Finance Bill 2010.** Introducing these changes will provide certainty to the venture capital industry, investors and small companies over the future of these important schemes. To ensure the EIS and VCT schemes continue to be targeted on companies affected by the equity gap, **the Government will also begin immediate discussions with industry to ensure the effectiveness of the current thresholds for qualifying companies, based on draft legislation also published alongside this Pre-Budget Report.**

Non-bank lending channels

4.26 The Government is looking at ways to diversify sources of finance available to business by facilitating the development of non-bank lending channels. Working closely with the Bank of England, HM Treasury has been exploring with a range of stakeholders the different factors that could constitute barriers to some businesses accessing non-bank lending. As set out in Chapter 3, HM Treasury will launch a discussion paper on non-bank lending channels in the UK. HM Treasury will be advised by the Bank of England and the Financial Services Authority, working with BIS.

[2] *Rowlands Growth Capital Review*, BIS, November 2009.

INVESTING IN INFRASTRUCTURE

Supporting infrastructure investment

4.27 Modern, resilient infrastructure is critical to the UK's economic growth and competitiveness. The Government has a strong track record of direct investment and supporting private sector investment in infrastructure. To support continued investment that enables economic growth, the Government will:

- **proceed with a £1.1 billion rail electrification programme for the Great Western Main Line and Liverpool to Manchester. A further announcement on electrification will be made shortly, and the Government will also continue to evaluate the case for electrification of the Midland Main Line from London to Sheffield;**

- **start work in December 2009 on the £400 million M1 improvement scheme. The Scheme will increase capacity from Junctions 10 to 13 through hard-shoulder running. This continues the Government's innovative and cost-effective 'managed motorways programme';** and

- **respond in the first quarter of 2010 to proposals from High Speed 2 Ltd for a new high speed line from London to the West Midlands and to Scotland.**

Facilitating private sector infrastructure investment

4.28 Over the last 10 years, the stable regulatory framework has led to over £100 billion in private sector infrastructure investment, which the Government continues to take action to facilitate. This includes making reforms to the planning arrangements for nationally significant infrastructure projects, most recently by publishing the first draft National Policy Statements, covering energy and ports[3]. The Government also supports private sector incentives to invest, such as through the Renewables Obligation, which has tripled the UK's renewable capacity since its introduction. Chapter 7 sets out further measures to facilitate and support investment in low-carbon infrastructure. In March 2009, the Government created The Infrastructure Finance Unit (TIFU) to ensure Private Finance Initiative (PFI) projects continue to reach financial close.

Improving market frameworks

4.29 The Government continues to take action to ensure that economic regulatory structures can meet the needs of the future. Following extensive consultation, **the Department for Transport (DfT) will publish shortly a package of measures to reform the economic regulation of airports, to encourage timely and appropriate investment in airport infrastructure, and to improve the passenger experience.** As set out in Chapter 7, the Government is also announcing that it is assessing the energy market and policy framework to facilitate investment in low-carbon infrastructure.

Infrastructure UK

4.30 Looking to the decades ahead, and as the UK moves to a low-carbon economy, the challenge to modernise and adapt the UK's infrastructure will only intensify. Up to £200 billion in infrastructure investment could be required over the next decade. While the majority of funding will need to come from the private sector, there is an important role for Government to facilitate the necessary investment. In Building Britain's Future the Government announced that it would establish Infrastructure UK, to identify the country's long-term infrastructure needs over a 5 to 50 year horizon and to consider the interdependencies between different types of infrastructure, and where there are efficiencies and synergies to be exploited.

4.31 The stakeholder consultation exercise carried out by Lord Davies of Abersoch has shown that Infrastructure UK has widespread support, with appetite from business for the long-term focus on infrastructure and clarity on priorities it will help bring. The Government intends to build on this, and establish Infrastructure UK as a focal point for the

[3] Published by the Department of Energy and Climate Change, and the Department for Transport, November 2009.

UK's infrastructure strategy and its long-term development and delivery. It will work with government departments, private sector infrastructure investors, contractors and operators, and with the independent regulators where appropriate, to ensure the UK develops and delivers the national infrastructure businesses and citizens need.

4.32 To achieve this **the Government intends, within Infrastructure UK, to bring together TIFU, HM Treasury's Public-Private Partnership (PPP) policy team and the capabilities within Partnerships UK (PUK), which support the delivery of major projects and programmes.** The Treasury has commenced discussions with PUK's Board with a view to achieving this during 2010. **Infrastructure UK will be based in HM Treasury and will be chaired by Paul Skinner,** former Chair of Rio Tinto, and previously a Group Managing Director of Royal Dutch Shell, who has a wealth of experience in the development of major capital projects. **The immediate priorities for Infrastructure UK are set out in box 4.2.**

Box 4.2: Infrastructure UK

Infrastructure UK's immediate priorities will be to:

- develop a strategy for the UK's infrastructure over the next 5 to 50 years, to be published at Budget 2010;
- work closely with infrastructure developers and funders to make recommendations at Budget 2010 to stimulate increased private sector investment in infrastructure, focussing on unlocking new sources of private capital and developing new funding models, building on the success of PFI/PPP;
- manage the Government's investment in the 2020 European Fund for Energy, Climate Change and Infrastructure;
- support HM Treasury in prioritising the Government's investment in infrastructure, to ensure value for money is achieved in a period of fiscal consolidation;
- consider how technological innovation can be supported by our future infrastructure; and
- work closely with the Office of Government Commerce and other government departments to support the delivery of major infrastructure projects and programmes and to build stronger infrastructure delivery capability across government.

Infrastructure UK's initial work programme will also include:

- supporting HM Treasury and the Department of Energy and Climate Change (DECC) in their work to report on how to ensure the electricity market framework can most effectively deliver the low-carbon investment needed in the long term. Infrastructure UK will explore, among other options, the case for a low-carbon investment institution;
- working with DfT on the Government's response to proposals for a new high speed line to the West Midlands and beyond, including on options for how such a new line could be funded and delivered; and
- supporting BIS in delivering a Universal Service Commitment in broadband by 2012 and providing further support to achieve private sector roll-out of next generation broadband to 90 per cent of the population by 2017.

North Sea fiscal regime

4.33 Maximising the economic production of the UK's oil and gas reserves is important to ensuring access to secure and affordable energy supplies. Following discussions with industry stakeholders, **the Government announces changes to the criteria for the Ultra High Pressure, High Temperature field allowance.** These changes could support the recovery of up to 300 million additional barrels of oil and gas from the North Sea. **The Government also announces a package of further technical changes to ensure the fiscal regime is effective in supporting investment.**

4.34 The area to the west of the Shetland Islands is still largely underdeveloped, and could contain up to 20 per cent of the UK's remaining reserves. The Government is currently in discussions with industry regarding the economics of developing infrastructure in this area, and the case for any fiscal support.

Local investment

4.35 Local government and city regions (further details of which are set out in Chapter 6) have a vital role in driving economic outcomes, including through delivering the investment in infrastructure and housing needed for growth. To support local infrastructure provision, following consultation the Government will shortly announce detailed arrangements for the implementation of the Community Infrastructure Levy (CIL) from April 2010. The Government is also interested in exploring, subject to the overall fiscal position, what further finance mechanisms, powers and flexibilities could support local authorities to drive growth and innovation most effectively.

4.36 In light of this, **the Government will continue to examine the framework that would be needed to implement Tax Increment Financing and consider the primary legislation that would be needed if schemes were to be introduced. The Government will also examine the scope for local authorities to borrow against:**

- **future CIL revenues, to enable further investment in the infrastructure required to support growth;**
- **Renewable Heat Incentive and Feed-in Tariff revenue streams, to support further investment in low-carbon technologies; and**
- **revenues from new council homes, to support the delivery of housing where this offers value for money, and the Government will consider interactions with wider reforms of the council housing finance system.**

Planning regime

4.37 An effective planning regime is a key enabler of investment and the Government is continuing to reform the planning system to deliver speed, clarity and consistency, supporting business, productivity and economic growth. The Infrastructure Planning Commission was launched in October 2009 to increase the speed and certainty of decision making for major projects. It will unite eight former consents regimes into a single process, cutting the time taken to make decisions from up to seven years to under a year and providing savings of up to £300 million a year. Alongside this, the local planning process is being reformed and streamlined, saving business £50-100 million per year. The Government will shortly publish a revised Planning Policy Statement for economic development, to ensure planning applications that secure sustainable economic growth are considered favourably.

DRIVING INNOVATION

4.38 Innovation is a key driver of productivity, and an innovative economy will help ensure that the UK is competitive in the global upturn. In support of this, the Government has more than doubled public investment in the research base and encouraged greater private sector investment through the R&D tax credit. It has also created the Technology Strategy Board (TSB) which, alongside the Research Councils and the Regional Development Agencies, will invest over £1 billion in business innovation between 2008 and 2011, and will be investing £150 million in knowledge exchange in 2010-11 to support innovative start-up companies. As a result, research is increasingly being translated into commercial products and economic benefit: patent applications have doubled since 2000, to 1,913 in 2006-07; 31 university spinout companies were launched between 2003 and 2007; and TSB investment is benefiting 3,000 businesses and 98 Higher Education Institutions.

New Industry, New Jobs

4.39 *Building Britain's Future: New Industry, New Jobs*[4], set out how the UK must further develop its strengths to drive business innovation in areas where there are major opportunities for growth. This is reflected in recent sector strategies covering a range of industries:

- Composites: the *UK Composites Strategy*[5] set out how the Government is supporting innovation in this area, for example through the 'Grand Challenge in Affordable Composites Manufacturing';
- Automotive: as set out in the *Government Response to the New Automotive Innovation & Growth Team Report*[6], the Government is working closely with business to drive further innovative activity in the sector, including £140 million investment in the Low Carbon Vehicle Innovation Platform over 2008-2011;
- Life Sciences: the *Life Sciences Blueprint*[7], published in July 2009 by the Office for Life Sciences, outlines a strategy for the pharmaceuticals, biotechnology and medical devices sectors to improve support for innovation in the NHS. The introduction of an 'innovation pass' to make selected innovative medicines available on the NHS for a time-limited period (to be piloted in 2010-11 with a budget of £25 million). In addition, the TSB is investing £18 million, in collaboration with other funders, to support commercial research and development in regenerative medicines.
- Low-carbon: *The UK Low Carbon Industrial Society*[8], published in July 2009, set out a blueprint for supporting low-carbon economic activity and enabling firms across the economy to realise growth opportunities presented by the transition to a low-carbon economy.

Taxation of innovative activity

4.40 Budget 2009 announced that the Government would work with business to examine the balance of taxation on innovative activity, including intellectual property (IP). As part of this work, the Government has looked at the case for a reduced rate of corporation tax applied to income from patents (a so-called "Patent Box"). **The Government announces that it will introduce a Patent Box applying to income from April 2013 to strengthen the incentives to invest in innovative industries and ensure the UK remains an attractive location for innovation.** The Government will consult with business in time for Finance Bill 2011 on the detailed design of the Patent Box, which will apply to patents granted after the legislation is passed.

R&D tax credits

4.41 The Government remains committed to promoting innovation through the R&D tax credit schemes. Since the introduction of the schemes, over 36,000 claims have been made for R&D tax credits with over £3 billion of relief claimed, supporting over £32 billion of research and development activity by companies.

4.42 To enable innovative companies to access more easily the R&D tax credit scheme for SMEs, **the Government announces the removal of the condition that any IP deriving from the research and development must be owned by the company making the claim.** This will allow companies to benefit from the UK's generous R&D tax credit for SMEs without distorting their commercial arrangements in relation to IP.

[4] *Building Britain's Future: New Industry, New Jobs,* HM Government, April 2009.
[5] *UK Composites Strategy*, BIS, November 2009.
[6] *Government Response to the New Automotive Innovation & Growth Team Report,* BIS, November 2009.
[7] *Life Sciences Blueprint*, Office for Life Sciences, July 2009.
[8] *The UK Low Carbon Industrial Strategy,* HM Government, July 2009.

Strategic Investment Fund

4.43 The £750 million Strategic Investment Fund was introduced in Budget 2009 to support advanced, innovative industrial projects of strategic importance, including £250 million for low-carbon projects. Box 4.3 sets out the projects benefitting from investment from the Fund so far.

Box 4.3: Projects benefitting from the Strategic Investment Fund

- £50 million addition to the TSB and £10 million temporary uplift to UK Trade & Investment (UKTI) funding over the Comprehensive Spending Review (both announced at Budget 2009);
- £61 million under the Advanced Manufacturing Strategy;
- £15 million for a Nuclear Advanced Manufacturing Research Centre;
- major projects under the £250 million low-carbon element of the Fund including £116 million to develop a UK-based offshore wind energy industry, and £30 million for the wave and tidal energy sectors;
- £75 million (out of a total Government investment of £150 million) for the UKIIF;
- contributions to total Government investments of £340 million to Airbus and £60 million to GKN Launch Investments for the A350XWB extra-wide body aircraft;
- a contribution to the total Government investment of £200 million for the roll-out of universal broadband under the Digital Britain programme; and
- projects put forward from across the UK including: investment in facilities for new life sciences companies in Edinburgh and the creation of a High Performance Computing Institute in Wales.

Further funding allocations are being developed with announcements covering the full £750 million likely before the end of the financial year.

Additional funding for the Strategic Investment Fund

4.44 **The Government announces additional funding of £200 million for the Strategic Investment Fund.** This will include a major contribution of £150 million to low-carbon investment as set out in Box 7.1. **The Government announces that £5 million from the Fund will be allocated to a new prize fund for open competition in key areas for innovative development.** £45 million of the extension of the Fund remains to be allocated.

Digital Britain

4.45 The *Digital Britain* White Paper[9], published in June 2009, gave a comprehensive strategic analysis of the UK's digital economy. It committed to achieving a Universal Service Commitment in broadband, to be achieved by 2012. Since publication of the White Paper, the Government has moved to enact a number of *Digital Britain's* policies through the Digital Economy Bill, which has received second reading in the House of Lords, and has published a consultation on proposals to enable the release of new spectrum to the market. *Putting the Frontline First: smarter government*[10] gives further impetus to online delivery of public services, and announces an investment of £30 million with UK Online to support development of the National Plan for Digital Participation to get more than 1 million people online in the next three years.

4.46 *Digital Britain* also announced a duty on fixed telephone lines to be used to help encourage private sector investment in digital infrastructure. **A consultation on the practical aspects of the new Landline Duty will be launched shortly and will be followed by a consultation on the procurement approach to investing in Next Generation Access.**

[9] *Digital Britain*, BIS and Department for Culture, Media and Sport, June 2009.
[10] *Putting the Frontline First: smarter government*, HM Government, December 2009.

Creative industries

4.47 The creative industries, including the video games industry, make a valuable economic and cultural contribution to the UK. The Government committed in *Digital Britain* to work with the video games industry to collect and review the evidence for the introduction of a tax incentive to promote the development of culturally British video games. While recognising the challenges currently faced by the sector in competing internationally, the Government is not currently persuaded that the evidence is sufficiently compelling to justify the introduction of a tax incentive for the development of culturally British video games at this time.

ENHANCING SKILLS

Skills for Growth

4.48 The *Skills for Growth* White Paper[11], published in November 2009, builds on the progress made since the *Leitch Review of Skills*[12] was published in 2006. It sets out a more strategic approach to ensure the skills system can anticipate and respond to the needs of the industries and sectors of the future. Box 4.4 sets out the main announcements.

Box 4.4: Skills for Growth main announcements

- Expand apprenticeships to create a modern class of technicians, with 35,000 more advanced and higher-level apprenticeships for 19-30 year olds over the next two years;
- work with the Regional Development Agencies, the UKCES and Sector Skills Councils, to prioritise more funding within Train to Gain at Levels 2 and 3, and in sectors key for future growth, and to pilot a Joint Investment Scheme at Levels 3 and 4;
- renew the commitment to the introduction of Skills Accounts to support progression and social mobility, and opening up the market by trebling the number of providers where entitlements can be used; and
- simplify the skills landscape, working with the UKCES to implement a reduction in the number of separate publicly funded agencies by over 30.

Higher Education

4.49 *Higher Ambitions*[13], published in November 2009, set the forward-looking framework for the Higher Education sector, and identified the challenges and opportunities facing the sector if it is to remain world-class. In November 2009, the Independent Review of Higher Education Funding and Student Finance was also launched. The Review, due to report in 2010, will examine the balance of contributions to higher education funding by taxpayers, students, graduates and employers.

Support for internships

4.50 *Unleashing Aspiration: The Final Report of the Panel on Fair Access to the Professions*[14] recommended that financial constraints be addressed to ensure students from poorer backgrounds could benefit from the opportunities internships offer. In response, **the Government will contribute £8 million towards a financial support scheme to provide bursary-style support for undergraduates undertaking short unpaid internships in professions with historically poor access.** The details of the scheme will be developed with the Higher Education sector and the professions, and it is intended that the Government funding will be used to leverage in other contributions. Support will be available as early as Summer 2010 and once fully operational the scheme will support around 10,000 internships a year. Further details will be published in the Government's full response to the Report, due early in 2010.

[11] *Skills for Growth*, BIS, November 2009.
[12] *Leitch Review of Skills*, HM Treasury, December 2006.
[13] *Higher Ambitions*, BIS, November 2009.
[14] *Unleashing Aspiration: The Final Report of the Panel on Fair Access to the Professions*, Cabinet Office, July 2009.

SUPPORTING ENTERPRISE

Enterprise support for ex-Service personnel

4.51 As part of the Government's commitment to supporting Service personnel returning from conflict, including those disabled as a result of their service, the Government announces new funding of up to £5 million for enterprise support. This funding will assist returning personnel by reducing the costs and barriers associated with self-employment and setting up a new business. It will also allow targeted mentoring support to help more businesses operated by ex-Service personnel to thrive and grow.

Prompt Payment Initiative

4.52 In November 2008 all central government departments committed to pay their suppliers within 10 working days. Since then, the median performance by departments against this target has risen to 95.7 per cent, an improvement of 24 percentage points since November 2008. **Prompt payment is essential to business survival and the Government remains committed to paying over 90 per cent of invoices within the ten-day target.** Payment times to suppliers have also improved in the NHS and local authorities, with a recent Audit Commission report showing that 89 per cent of local authorities have now introduced measures to reduce payment times to 20 days or fewer[15].

Policy through Procurement

4.53 Later in December 2009, **the Government will publish a Policy through Procurement Action Plan,** which will demonstrate how the Government will use procurement to deliver the Government's policy priorities of apprenticeships, skills and youth employment, small businesses, and low-carbon resource efficiency to stimulate economic growth.

Public procurement for SMEs

4.54 Good progress has been made in implementing the recommendations of the Glover Committee's report[16]. The Government announces further detail in this Pre-Budget Report:

- online training aimed at increasing SME understanding of the public procurement process is being enhanced and will be free of charge when it is re-launched on Learn Direct in January 2010;
- the Government will increase the transparency of its spend and **will publish in Summer 2010 the level of central government spend with SMEs;** and
- a free online portal will be delivered by HMRC and **accessed via the businesslink.gov.uk website by the end of 2010.** This will enable all contract opportunities above £20,000 from across the public sector to be viewed in one place.

Better Regulation

4.55 The Government remains committed to increasing transparency and certainty around regulatory plans, and to strengthening the way regulation and its costs are managed. In October 2009, the Government published its first *Forward Regulatory Programme*[17], including details of £3.5 billion worth of regulation that will be delayed to April 2011 or beyond. This short-term saving is reinforced by a longer-term commitment to cut a further £6.5 billion from the ongoing cost of regulation in 2010-15. The Government will approach its new simplification targets by theme rather than by department to tackle regulation in the way business experiences it. This more joined-up approach will address all policy areas where regulation impacts on business, including: business law, employment and skills, consumer law, workplace health and safety, natural environment, health and social welfare, built environment, and transport. So far, using this approach the Government has **identified proposals with the potential to deliver savings of over £1 billion,** towards the overall target of £6.5 billion by 2015. The Government has also established a new independent scrutiny

[15] www.audit-commission.gov.uk.

[16] *Accelerating the SME economic engine: through transparent, simple and strategic procurement*, HM Treasury, November 2008.

[17] *Forward Regulatory Programme*, BIS, October 2009.

body, the Regulatory Policy Committee, to ensure that regulation is challenged, underpinned by robust evidence and analysis, and effectively minimises costs and maximises benefits.

Business Support Simplification Programme

4.56 The Government announced in Budget 2006 that it would reduce the total number of publicly-funded business support products from the 3,000-plus products available in 2006 to no more than 100 by March 2010, and the Government is on track to meet this objective. The focus between now and March 2010 will be to ensure that any remaining non-aligned business support products at regional or local level are closed or moved to the Solutions for Business portfolio. Detail on progress to date, including the mapping of business support products nationally, regionally and locally, has been published on BIS's website[18].

Tax simplification

4.57 To further reduce burdens on business, the Government is progressing its three tax simplification reviews:

- VAT rules and administration: the Government is continuing discussions with business on simplification of the partial exemption regime and option to tax rules;
- Anti-avoidance legislation: the **Government is publishing alongside this Pre-Budget Report a summary of responses to the consultation on transactions in securities legislation and the discussion document on greater alignment of purpose tests in tax law**[19] ; and
- Corporation tax rules for related companies: the Government is consulting on further simplification of the associated company rules and **will publish a consultation document on simplifying capital gains legislation for groups of companies in early 2010.**

4.58 **The Government will consult on legislation to reduce administrative burdens on business by enabling connected employers to pool their PAYE references, returns and payment obligations.** Subject to consultation, the Government plans to introduce this by 2011.

MAINTAINING OPEN AND COMPETITIVE MARKETS

Taxation of foreign profits

4.59 Following the announcement made in the 2008 Pre-Budget Report to reform the taxation of foreign profits, the Government is now focused on reforming the Controlled Foreign Company rules. A policy principles document was published in July 2009 setting out the framework within which the reform should take place, with the overall aim of enhancing UK competitiveness while providing adequate protection of the UK tax base. Productive discussions and working groups have taken place in recent months, and the Government aims to release a document on the shape of the new regime early in 2010.

Foreign branch taxation

4.60 The Government recognises that foreign branch taxation is a matter of growing importance and will engage with business to identify and explore issues relevant to any potential future rule changes.

Debt cap legislation

4.61 In line with its announcement on 9 November 2009, the Government publishes, alongside this Pre-Budget Report, draft legislation aimed at improving the working of the debt cap rules, which will come into effect on 1 January 2010.

Competitive markets

4.62 The competition regime has an important role to play in ensuring markets are conducive to long-term productivity growth. Competitive markets help UK businesses by

[18] http://www.bis.gov.uk

[19] *Simplifying Transactions in Securities Legislation* and *Simplifying Unallowable Purpose Tests*, HMRC, December 2009.

keeping the price of inputs low and encouraging them to develop the high standards needed to be successful in global export markets. Competition also delivers significant benefits for UK households by lowering prices and increasing choice. The Government remains committed to maintaining a strong and effective competition regime in the UK. It will continue to examine the regime and will bring forward reforms as necessary to ensure it continues to rank amongst the world's best.

Trade finance

4.63 Trade finance serves as the life-blood of day-to-day international trade in goods and services, through providing financing for transactions between buyers and sellers around the globe. In response to concerns around the effects of scarcity and high pricing of short-term trade finance as a result of the financial crisis, the G20 agreed at the London Summit to ensure the availability of at least $250 billion to support trade finance in 2009-10 and 2010-11. In Pittsburgh, G20 Leaders welcomed the successful implementation of the trade finance initiative, which they will continue to monitor during 2010.

Additional support for exporters

4.64 The Government has provided further support to exporters:

- the Export Credits Guarantee Department (ECGD) introduced the Letter of Credit Guarantee Scheme on 20 October 2009. This new facility provides temporary support for exporters selling goods in emerging markets by risk-sharing with banks confirming letters of credit. In addition, ECGD's Fixed Rate Export Finance scheme has been extended until March 2011 within its existing budget;

- at Budget 2009 the Government announced a review of ECGD's operating framework to consider how to improve ECGD's services during the economic recovery. As a result of the review, ECGD is introducing some progressive changes that will make it more responsive and competitive in its support for exporters. ECGD has recently launched a public consultation on the operation of its Business Principles and ancillary policies. Further measures include introducing flexibility to enable ECGD to charge more competitive prices in some markets and strengthening its links with UKTI; and

- in the 2008 Pre-Budget Report BIS and HMRC were asked to report on simplifying trade regulation to help facilitate international trade. An action plan was published on 2 December 2009, setting out wide ranging proposals including an increased role for the UK Border Agency in the co-ordination of border regulators, development of an EU strategy for trade regulation, and new proposals for an International Trade Single Window with the ultimate goal of a single platform for trade clearances and forms. The cost of trade procedures is estimated at 2-15 per cent of the value of traded goods. An efficiency saving of one per cent of the value of traded goods would save almost £6 billion annually.

5 ACHIEVING FAIRNESS AND PROVIDING OPPORTUNITY

Government support for people to move back into work, combined with a dynamic and flexible labour market, has helped over 3.2 million people to leave unemployment benefit since the 2008 Pre-Budget Report. This has helped unemployment remain lower than expected at the time of Budget 2009. The Government is therefore using some of the £3 billion funding for Jobcentre Plus and employment programmes from the 2008 Pre-Budget Report and Budget 2009 to provide additional support for those adversely affected by the recession. This additional support includes **bringing forward the young persons guarantee, so that 18-24s claiming Jobseeker's Allowance for six months will now be guaranteed a job, work placement or work-related skills training.**

The Government recognises that making the transition into work can be difficult and, to help families to make this move, the Government will **extend free school meals to primary school pupils in low income working families in England from September 2010.**

The 2009 Pre-Budget Report announces further Government action to provide support for households during the early stages of economic recovery, including increasing the basic State Pension by 2.5 per cent, the child element of the Child Tax Credit by £20 above earnings indexation, and **other benefits and tax credits normally linked to the Retail Prices Index (RPI) by 1.5 per cent.**

The Government announces further action to ensure that fiscal consolidation is broad-based, with those on the highest income making the greatest contribution:

- **an additional 0.5 per cent increase in the employee, employer and self-employed rates of national insurance contributions (NICs) from April 2011, alongside an increase in the point at which individuals start to pay NICs to protect 15 million people on incomes below £20,000;**
- **the point at which individuals start to pay the higher rate of income tax will be frozen in 2012-13; and**
- **the restriction of pensions tax relief from April 2011 will apply to those with gross incomes of £150,000 and over, where gross income incorporates all pension contributions, including those funded by an employer. This will be subject to an income floor, so that individuals with pre-tax incomes (excluding employer pension contributions) of less than £130,000 will be unaffected.**

In 2009-10, just 2.5 per cent of estates are expected to pay inheritance tax. **The Government is therefore freezing the inheritance tax allowance at £325,000 in 2010-11.**

The Government continues to take action to protect revenues from those seeking to evade and avoid paying their fair share of tax. Building on existing measures, the Government will introduce **a package of measures which will protect around £5 billion per year from evasion and avoidance.**

5.1 Alongside Government action to support households through the downturn, many households have also benefited over the past year from the combination of falling energy and mortgage costs, and low inflation. In April 2009, households that rely on state sources of income, such as benefits or pensions, received the largest cash increase since the early 1990s. These gains have been reinforced by Government action to bring forward increases to tax credits and Child Benefit, increase the personal allowance, and temporarily reduce VAT to 15 per cent.

Personal tax changes from 2010-11 onwards

5.2 The Government is taking action to maintain the path of consolidation set out at the 2008 Pre-Budget Report and Budget 2009, and reinforce the fairness of the tax system, while continuing to support households, as follows:

- **an additional 0.5 per cent increase in the employee, employer and self-employed rates of NICs from April 2011, alongside an increase in the point at which individuals start to pay NICs to protect 15 million people on incomes below £20,000;**
- **the point at which individuals start to pay the higher rate of income tax will be frozen in 2012-13; and**
- **the restriction of pensions tax relief from April 2011 will apply to those with gross incomes of £150,000 and over, where gross income incorporates all pension contributions, including those funded by an employer. This will be subject to an income floor, so that individuals with pre-tax incomes (excluding employer pension contributions) of less than £130,000 will be unaffected.**

5.3 These measures ensure that fiscal consolidation is broad-based, with those on high incomes making the greatest contribution. The rise in the NICs primary threshold protects those on low incomes, meaning an employee with income below £20,000 paying the standard employee rate of NICs will pay less NICs in April 2011.

5.4 This follows the Budget 2009 announcement that, from April 2010, a new 50 pence tax rate will apply to those with incomes above £150,000, and that the personal allowance will be gradually withdrawn for those with incomes above £100,000. **For 2010-11 the basic and higher rates of income tax will remain at 20 pence and 40 pence respectively. The personal allowance and basic rate limit will be maintained at their current levels, providing a real-terms benefit relative to September's RPI. All NICs thresholds and rates for 2010-11 will also remain at their current levels.**

5.5 In 2010-11, low income taxpayers will also benefit from support brought forward from later years, through **a 1.5 per cent increase to benefits and tax credits in April 2010** (see paragraph 5.18).

Labour market performance

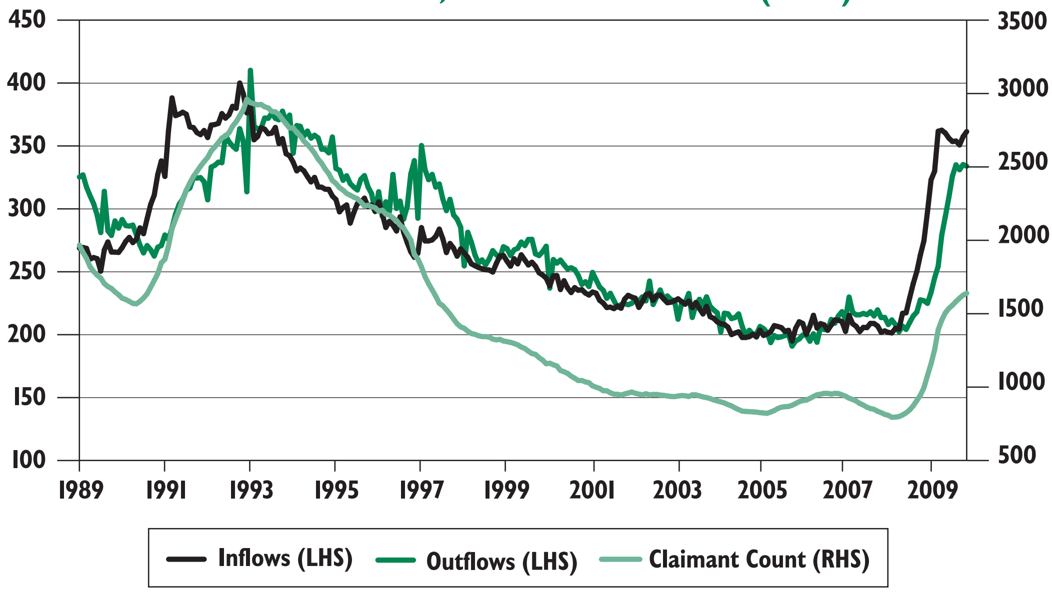
5.6 In 2008 the global economy entered the most severe and synchronised recession since the Great Depression, with a significant impact on labour demand. Unemployment has risen to 2.46 million in the three months to September 2009, compared with 1.83 million in the same quarter of 2008.[1] The Government recognises that, while the increase in unemployment has been less than independent forecasters predicted, it has caused hardship for many households.

5.7 That is why the Government took immediate and decisive action to help people move back into work quickly and prevent long-term detachment from the labour market. This built on welfare reforms since 1997, which have helped to create an open, dynamic and flexible labour market in the UK. Government support for the Jobcentre Plus regime has also played a crucial role in continuing to help move people off unemployment benefit and into work. Around half of claimants leave Jobseeker's Allowance (JSA) within three months and over 70 per cent leave by six months, compared with 64 per cent at the same point in the

[1] Labour Market Statistics, November 2009, Office for National Statistics.

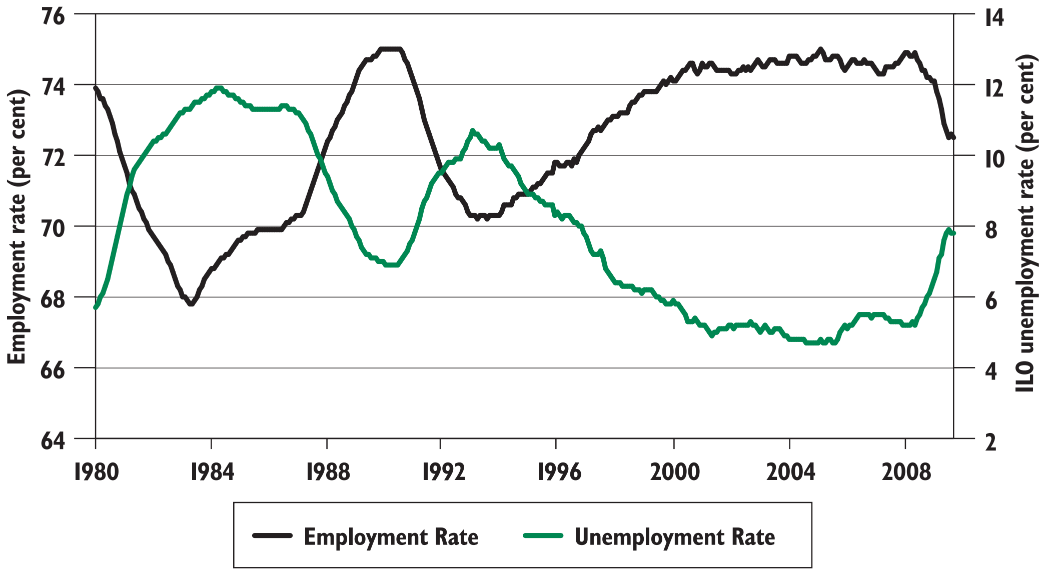
early 1990s recession.[2] In October alone, over 330,000 people moved off JSA, and over 3.2 million people have moved off JSA since the 2008 Pre-Budget Report (see chart 5.1[3]).

Chart 5.1: Claimant count, inflows and outflows (000s)



5.8 The large numbers of individuals finding work have helped to slow the increase in the claimant count in recent months. The average increase in the monthly claimant count fell to 18,800 in the three months to October 2009, down from 93,400 in the first quarter of 2009. This has also helped to moderate increases in the unemployment rate, which remains 2 percentage points below the Eurozone average, and 2.2 percentage points lower than in the US.

Chart 5.2: UK employment and unemployment rates



[2] Off-flow rates calculated by DWP using statistics from Office for National Statistics (www.nomisweb.co.uk).

[3] Labour Market Statistics, November 2009, Office for National Statistics.

5.9 Chart 5.2[4] shows that the unemployment rate is lower than in the recessions of the 1980s and 1990s, despite a relatively deep fall in output in the current recession (see Table 5.1). For every 1 per cent decline in output in the 1990s recession, employment fell by 1¹/₃ per cent. In the current recession, for every 1 per cent decline in output, employment has fallen by just ⅓ per cent (see Box A.4 for further details). Chapter 2 sets out the Government's projection for the claimant count which is now expected to peak at about 1¾ million around the middle of 2010 (see Annex A).

Table 5.1: Fall in output and employment in recessions

	Percentage change in recession[1]		
	1980s	1990s	2008-09
Gross domestic product	-6.0	-2.5	-5.8
LFS employment	-2.0	-3.4	-1.9

[1] *The percentage change is taken from the quarter in which output peaked to the last quarter in which output declined. For the current recession, the change is from 2008 Q1 to the latest data point: 2009 Q3.*

Responding to labour market conditions

5.10 The Government is committed to ensuring that any increase in the claimant count does not lead to longer-term detachment from the labour market, and has taken action to support people to return to work quickly.

[4] Labour Market Statistics, November 2009, Office for National Statistics.

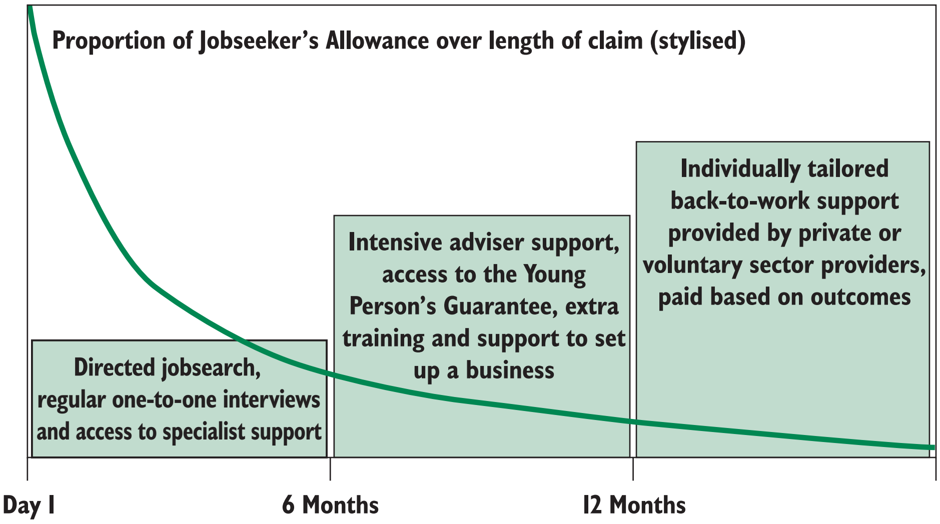
Box 5.1: Supporting the labour market through the downturn

- Budget 2009 announced a guaranteed job, work placement or training place for all 18-24 year olds on JSA for one year to ensure no young people are left behind due to long term unemployment. The 12 month Guarantee will be available from January 2010;
- the Guarantee includes 100,000 new Future Jobs Fund jobs for young people as well as adults in areas hardest hit by the downturn. Already, up to 95,000 jobs across the UK have been announced through the fund.[a] For example, in Liverpool there will be up to 6000 high-quality jobs and apprenticeships in fields including community care, environmental services and sports coaching;[b]
- Jobcentre Plus headcount has been increased by 15,000 to continue the personalised support and advice that has proved effective in helping nearly 70 per cent of jobseekers to leave JSA by six months of a claim;
- since April 2009, over 12,000[c] people have benefited from comprehensive support made available for the minority who are unemployed for more than six months. Support includes up to £2,500 for employers that recruit and train those in receipt of Jobseeker's Allowance for six months or more, as well as additional training places, volunteering opportunities and financial support and advice for those wanting to set up their own business;
- over 300 organisations have already committed to provide support to young people through the Backing Young Britain campaign. This support includes mentoring, apprenticeships, work experience and internships;
- over 3000 employers have used the Rapid-Response Service since the 2008 Pre-Budget Report announced a doubling of funding. This service provides on-site support for both small- and large-scale redundancies, to help employees find a new job even before they become unemployed; and
- all 16 and 17 year olds will be offered a place in education or training through the September Guarantee. Building on this every 16 and 17 year old who is not in education or training in January 2010 will be offered an Entry into Employment place supported by an Education Maintenance Allowance.

[a] DWP Press Notice, 11 November, 2009.
[b] DWP case study.
[c] Figure applies up to Sept 09, taken from Office for National Statistics.

5.11 The level of support provided to job seekers is tailored to personal needs over the length of a claim, from Rapid Response support before redundancy, to one-to-one dedicated support from the first day of a claim, and finally to intensive support through the Young Persons Guarantee or Flexible New Deal for those with the greatest barriers to work. Most job seekers find work quickly, which is why support increases the longer someone has been unemployed, as illustrated in Chart 5.3.

Chart 5.3: Preventing long-term detachment



Providing support and employment opportunities across the economy

5.12 The support described above has helped to keep the unemployment rate below independent forecasts made at the beginning of the downturn. This has enabled the Government to use some of the £3 billion funding for Jobcentre Plus and employment programmes announced at the 2008 Pre-Budget Report and Budget 2009 to provide additional support for those adversely affected by the recession. These further measures will ensure individuals remain close to the labour market and help prevent unemployment turning into long-term inactivity.

5.13 Young people can be especially affected by unemployment at the beginning of their career. Targeted support already in place has helped three in four young people move off unemployment benefits within six months, and the number of young people looking for work, not in full-time education, remains lower than the early 1990s.[5] The Government has introduced a guarantee from January 2010 that every young person unemployed for 12 months will be offered a job, work experience, or training (see box 5.1).

Employment package

5.14 However, youth unemployment remains high, and there is still scope for doing more to provide additional support for job seekers. Therefore the Government will use the resources freed up by lower than expected unemployment to go further, with details to be set out in the forthcoming Employment White Paper. The Government will:

- **bring forward the young persons guarantee.** Beginning from January 2010, 18-24s will now be guaranteed a job, work placement or work-related skills training from six months of their Jobseeker's Allowance claim, and will be required to take up this place from 10 months; and
- **provide new support for the over 50s.** The Government will make additional support available through Jobcentre Plus and specialist providers to ensure the over 50s move back into work quickly. Paragraph 5.24 also sets out additional support for those over State Pension Age.

[5] Labour Market Statistics, November 2009, Office for National Statistics.

Welfare reform

5.15 Over the last 12 years the Government has transformed a largely passive welfare state into an active one, based on a clear framework of rights and responsibilities. Alongside this the National Minimum Wage and a benefits and tax credits system focused on supporting people into employment means the vast majority of benefit recipients receive a higher income in work than they would receive on benefits. **To further strengthen work incentives the Government will roll out the 'Better Off in Work' credit.** This will ensure that all claimants who have been receiving benefits for six months will be entitled to a top up payment so that their in work income is greater than their benefit income.

Housing Benefit reform

5.16 The Local Housing Allowance (LHA) was introduced in April 2008 to give Housing Benefit customers more control over, and responsibility for, their choice of housing. However, the way that rates have been set has meant tenants in some areas have benenfited more than others and it has enabled some customers to live in more expensive properties that would not be affordable for low income working families. This has driven up costs compared with the previous scheme. In order to control these rising costs, Budget 2009 announced that customers would no longer be permitted to receive more in Housing Benefit than they have to pay in rent.

5.17 However, recent consultation suggests that there are disadvantages to withdrawing the excess. The Government will therefore delay the reform until April 2011 and launch an immediate consultation on its approach to Housing Benefit reform and affordability. **The Government will also introduce a package of administrative reforms that will save around £100 million per year by 2012-13. This includes measures to reduce the scope for fraud and error across the benefits system to ensure recipients receive correct payments.**

Providing support and stability for low income households

5.18 For the first time in half a century, the RPI decreased this year, driven in particular by falling mortgage interest costs. However, while many households have benefited from falling prices over the past year, it would not be appropriate to cut benefit and tax credit rates by 1.4 per cent in line with September's RPI – the month normally used to determine indexation in the following April – given that many recipients have not directly benefited from falling mortgage interest costs. The 2008 Pre-Budget Report therefore indicated that the Government would at least maintain the cash value of benefits and tax credits in 2010-11 – equivalent to a real terms increase – and then revert to indexation in line with RPI in subsequent years.

5.19 **To provide additional support to households during the early stages of economic recovery, the 2009 Pre-Budget Report announces that the Government will bring forward a proportion of the increases expected in April 2011 a year earlier, thereby providing a 1.5 per cent increase next April for those benefits and tax credits normally uprated by RPI.** In April 2011, rates will be increased by the remaining amount necessary to make up the difference with the RPI for September 2010. This locks in the real increase that arises from not reducing benefits next April, but avoids a further permanent increase in expenditure that would reduce the amount available for frontline services in the next spending review. The basic State Pension, additional State Pension, Pension Credit, income-related benefits and the child element of the Child Tax Credit are unaffected by this announcement. Full details of the increases for social security will be set out in DWP's uprating statement.

Supporting working households

Help through the downturn

5.20 Tax credits are available to nine out of ten families with children, and 1.5 million working people without children on low incomes. The Government's flexible system has risen to the challenges posed by the downturn and is delivering additional support to families when they need it most. So far in 2009-10, 400,000 families whose income has fallen have received extra help; on average £37 more per week. Families can report their changed circumstances over the phone to HMRC, and 95 per cent of changes are processed within 24 hours.[6]

Improving the delivery of support

5.21 Alongside this extra help, HMRC's customer service for tax credits continues to improve, with complaints down by 40 per cent. In 2009-10, the Tax Credits Transformation Programme will help over one million customers, including through offering additional advice to guide families through the tax credits claim process.

5.22 **HMRC will also improve its service to people who start living together, or who separate.** Where customers report these changes late, this results in an overpayment on their previous tax credits award. In January 2010, HMRC will reduce this overpayment by the amount customers would have been entitled to receive had they reported the change promptly.

5.23 Take-up of tax credits by families with children is very high. However, the Government recognises that more can be done for people without children, and has set an ambitious target to raise take-up of the Working Tax Credit (WTC) among this group by 100,000 by April 2011. HMRC is making good progress by using innovative measures to contact potentially eligible customers, such as 10,000 people identified through PAYE records.

Making work pay

5.24 The Government has taken significant steps to improve the financial incentives to work for low income households. As Table 5.2 shows, through the combined effect of the National Minimum Wage and WTC, the minimum income for a family with one child and one person working 35 hours a week has increased 28 per cent in real terms since 1999.

Table 5.2: Weekly minimum income guarantees

	April 1999	April 2010	Percentage increase in real terms[2]
Family[1] with 1 child, full-time work (35 hours)	£182	£309	28%
Family[1] with 1 child, part-time work (16 hours)	£136	£240	33%
Single person, no children, 25 or over, full-time work (35 hours)	£113	£198	32%
Couple, no children, 25 or over, full-time work (35 hours)	£117	£234	50%
Disabled person (single), working full-time (35 hours)	£139	£247	33%
Disabled person (single), working part-time (16 hours)	£109	£178	23%

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 couples with children and lone parents alike.

[2] Based on historical RPI, and projections from HM Treasury economic forecast.

[6] Number of families receiving additional support based on HMRC tax credits administrative data for April to October 2009. HMRC operational statistics (also in paragraph 5.20) are for the same period, and comparisons are with the same period in 2008.

Supporting older people in work

5.25 To increase the flexibility of the Government's support for older people and expand the choices available for those wishing to work after retirement, **the Government announces that from April 2011 people aged 65 and over will qualify for WTC if they work at least 16 hours a week, rather than 30 hours as currently.**

Tackling the poverty trap

5.26 Marginal deduction rates (MDRs) are one measure of the extent of the poverty trap, which occurs when those in work have limited incentives to move up the earnings ladder. They show how much of each additional pound of earnings is lost due to taxes and the withdrawal of benefits or tax credits. Table 5.3 shows that the number of families facing MDRs in excess of 70 per cent has more than halved since 1997. The increased numbers facing MDRs of between 60 and 70 per cent reflect the introduction and increased generosity of tax credits, which has extended financial support to many more households including, for the first time, those without children.

Table 5.3: Marginal deduction rates[1]

	Before Budget 1998	2010-11 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	70,000
Over 80 per cent	300,000	270,000
Over 70 per cent	740,000	330,000
Over 60 per cent	760,000	1,895,000

[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. These figures are estimates derived from HM Treasury's tax and benefit microsimulation model.

Note: Figures are cumulative. Estimates for the 2010-11 system of taxes and benefits are calibrated to tax credits statistics for April 2009, 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.

Supporting families to reduce child poverty

5.27 The Government has made considerable progress in reducing child poverty since 1997. Between 1998-99 and 2007-08, 500,000 children were lifted out of relative poverty.[7] Had the Government done nothing other than simply uprate the tax and benefit system, there might have been around two million more children in poverty than there are today.[8]

Additional support for families

5.28 To help low income families through the downturn, the Government brought forward increases in financial support, so that in April 2009 the child element of the Child Tax Credit (CTC) increased by £150 a year. The Government has committed to uprating the child element by earnings until the end of this Parliament, which means that the child element will increase by £65 in 2010-11, reflecting both earnings indexation and the additional £20 increase announced in Budget 2009. Meanwhile, the Health in Pregnancy Grant was launched in April 2009, and has already helped 540,000 mothers.[9]

Improving delivery

5.29 Take-up of existing financial support, especially tax credits, is high. However, as identified in the report of the Take-Up Taskforce[10], an additional 40,000 families could be lifted out of poverty if just 10 per cent of those not currently claiming did so. Joining up

[7] Progress to 2007-08 measured in *Households Below Average Income*, DWP, 2009 (http://research.dwp.gov.uk/asd/hbai.asp).
[8] HM Treasury analysis based on a comparison of simulated child poverty levels under today's tax and benefit system and the 1997-98 system indexed to today's prices.
[9] Based on HMRC Health in Pregnancy Grant administrative data for October 2009.
[10] *Take Up the Challenge*, Child Poverty Unit, HM Government, 2009.

delivery of financial support will be key to making sure help reaches these families. **The Government therefore announces a new online service for 2010 that brings together information on a whole range of benefits and entitlements.** It will allow front-line staff and advisers outside Government to direct families to relevant services.

5.30 Budget 2008 announced a number of pilots to test out new approaches to tackling child poverty such as the Local Authority Innovation Pilots. Around one in three local authorities are now delivering child poverty pilots. They will start being completed in early 2010, and there will be a comprehensive evaluation to inform effective policy to help the Government reach its 2020 target in an innovative and sustainable way.

Supporting working parents

5.31 Children in families with at least one parent in work are four times less likely to be in poverty than those in families without, and children in families with a second earner have an even lower poverty risk.[11] However, the Government recognises that making the transition back into employment can be difficult. To support low income families, and improve incentives to work, **the Government will extend eligibility to Free School Meals to primary school pupils in working families with a household income below £16,190.** The extension will be staged, with the first rollout to up to 50 per cent of eligible primary school pupils from September 2010. The Government's aim is that, from September 2011, all primary school pupils in low income working families will be entitled to receive Free School Meals, benefitting around 500,000 children. In addition, the Government will extend the current pilots of universal Free School Meals for children, so that there is a pilot in each English region. Once fully rolled out, this and other measures announced in and since Budget 2007 mean that around 550,000 children are expected to be lifted out of poverty.[12]

5.32 Flexibility and choice are important to parents in deciding how to balance work and caring for their child in the first year of its life. That is why the Government has announced that it intends to introduce legislation in April 2010 to allow fathers of children due on or after 3 April 2011 the right to take up to 26 weeks leave once the mother has returned to work. Some of the leave may be paid if taken during the mother's maternity pay period. For the first time, this will give parents the option of dividing a period of paid leave between them. To help parents with school-aged children, the Government will also promote existing guidance on affordable uniforms and support local authorities providing grants for school uniforms to further target support on vulnerable families.

Eradicating child poverty by 2020

5.33 The Government is committed to the long-term, sustainable eradication of child poverty and is taking forward the Child Poverty Bill to drive progress at a national and regional level. The Bill will create a clear and transparent accountability framework by enshrining the Government's targets in legislation, and the Government will report annually on progress. The Bill will also improve partnership working and collaboration at a local level: it will set a duty on local partners to work together to tackle child poverty. To support those working locally, the Government will provide guidance around the needs assessment that each local area must undertake.

The strategy for the long-term

5.34 The Child Poverty Bill requires the Government to publish a child poverty strategy setting out how it will achieve its goals. In preparing its strategy the Government will take into account the views of an expert child poverty commission. *Ending Child Poverty: Making it Happen* set out four core areas that will be key to the Government's strategy: employment and adult skills; financial support; housing and communities; and services for children and families.[13] In considering these building blocks, the Government announces five principles that will guide its strategy:

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[11] HM Treasury calculation based on HBAI 2007-08 microdata (*Households Below Average Income*, DWP, 2009).

[12] Estimate for impact of post 2007-08 measures derived from HM Treasury's tax and benefit microsimulation model.

[13] Child Poverty Unit, HM Government, 2009.

- **work is the best route out of poverty**. Parents should be supported to take up work and those in low paid jobs should be helped to progress;
- **families and family life should be supported**. Government support must be responsive to families' needs, and should promote strong and positive relationships. Government and employers should work together to provide family friendly working practices;
- **early intervention in childhood is necessary to break cycles of deprivation**. Action to tackle child poverty should aim to be preventative and prioritise early interventions even if the impact on child poverty is not immediate;
- **excellence in delivery**. The public sector should work in partnership with other agencies and voluntary groups to provide joined up and responsive public services to all families, with additional support for those who need it most; and
- **cost-effectiveness and affordability**. The long-term eradication of child poverty can only be achieved through a sustainable and affordable strategy.

Promoting savings

5.35 The Government seeks to support saving and asset ownership for all across the life cycle – from childhood, through working life and into retirement. Since 1997, the Government's savings strategy has focused on developing a range of savings opportunities suitable for each life stage, and providing incentives for saving through the tax and benefit system. This has been supported by action to empower individuals with the capability to make the right financial decisions, and to ensure consumers have access to competitively priced financial services (see Chapter 3 for further details).

5.36 Low interest rates are benefiting many people with mortgages, but the Government recognises that these rates have also meant that savers have seen their return from savings fall. This has particularly affected those people who have retired, or are beginning to prepare for retirement, who are more reliant on their income from savings to meet day-to-day needs or fund discretionary purchases.

Older people with savings

5.37 The Government announced significant support in Budget 2009 for older people who receive income from savings, by:

- raising the ISA limit for people aged 50 and over. Since 6 October 2009, the over-50s have been able to save £10,200 in their ISA, up to £5,100 of which can be saved in cash;
- increasing the Pension Credit capital disregard from £6,000 to £10,000 in November 2009, benefiting an estimated 540,000 pensioner households by an average of £4 a week[14]; and
- launching a new tax back campaign, contacting Pension Credit beneficiaries to encourage them to claim back tax they may have overpaid on their savings income and register to receive interest on their savings tax-free in future. **3.4 million pensioners have now been contacted.**[15]

Raising ISA limits for all savers

5.38 While older people with savings have been particularly affected by low interest rates during the downturn, it is important that everybody is helped to save once recovery is

[14] Estimates derived from DWP's tax and benefit microsimulation model.

[15] DWP management information.

secured. That is why Budget 2009 announced that the ISA limits for all savers will rise to £10,200, up to £5,100 of which can be saved in cash, from 6 April 2010.

Child Trust Fund **5.39** Over 4.6 million children now have a Child Trust Fund account, and Government payments to the accounts of seven year olds began in September 2009.The Government also announced that at Budget 2009 it would contribute an additional £100 a year to the Child Trust Funds of all disabled children, with severely disabled children receiving £200 a year. These payments will start from April 2010.

Saving Gateway **5.40** The Saving Gateway will also be introduced nationally in 2010, offering 8 million people on lower incomes the opportunity to earn 50 pence from the Government for each £1 they save.

Supporting people in later life

Financial support for pensioners **5.41** The Government is committed to providing help to those who need it most, while providing a solid foundation of support for all. In line with this, Budget 2009 announced help for pensioners who receive an income from savings (as set out in paragraph 5.36) and an additional payment, worth £100 for households with someone over the age of 80 or £50 for those with someone over 60. This will be paid alongside the Winter Fuel Payment, which is worth £300 for households with someone over 80 and £200 for households with someone over 60.

5.42 In recognition of the additional costs incurred by vulnerable families in heating homes when it is cold, **for this winter the Government has extended its 2008-09 increase to Cold Weather Payments** so that eligible households are receiving £25 for each seven day cold spell recorded or forecast where they live.

5.43 To support pensioners more broadly, **the level of the basic State Pension will increase in line with the Government's existing commitment by 2.5 per cent in April 2010, meaning a full basic State Pension will increase by £2.40 to £97.65 a week.** The full couples' rate for those whose entitlement is based on their spouse or civil partners' pension will increase by £3.85 to £156.15 a week. The Government also confirms that **the age-related allowances will be maintained at their current levels in 2010-11 at £9,490 for people aged 65 to 74 and £9,640 for people aged 75 and over**, providing a real terms benefit relative to September's RPI.

5.44 To provide additional targeted support for those who need it most, the Standard Minimum Income Guarantee within **Pension Credit will increase above indexation in April 2010, rising by £2.60 to £132.60 for single pensioners and by £3.95 to £202.40 for pensioner couples.** This will ensure those on the lowest incomes benefit from the rise in the basic State Pension. Pension Credit also rewards those pensioners that have made modest savings for their own retirement. From April 2010, the Savings Credit threshold will be £98.40 for single pensioners and £157.25 for pensioner couples.

5.45 The female State Pension Age will rise gradually from April 2010 until it is equalised with the male State Pension Age in April 2020. Those aged 60 and over have free access to some services, such as concessionary travel and free prescriptions. **The Government announces that the age at which pensioner benefits can be received will increase in line with the female State pension Age.** No one currently receiving these benefits will be affected.

Pension reform

5.46 State Pension reforms will be implemented in April 2010 to provide a simpler and more widely available State Pension. For those reaching State Pension Age on or after 6 April 2010, the number of years needed to qualify for a full basic State Pension will be reduced to 30, while carers will have improved opportunities to build their State Pension entitlement following changes to National Insurance credits.

5.47 The Government reaffirms its commitment to implementing a package of private pension reforms to ensure millions more people have the opportunity and incentives to save adequately for their retirement. Reflecting the changed economic and fiscal circumstances and the cost of this reform to business as the economy recovers **the Government announces a change to the implementation of private pension reform, including to the timetable for employers joining the reform.**

Pensions tax consultation

5.48 The Government provides generous tax relief on pensions, estimated to be worth around £28.4 billion in 2008-09,[16] to encourage and support pension saving. The cost of pensions tax relief has doubled over the last decade and the proportion of tax relief going to those on the highest incomes has risen markedly. Budget 2009 announced that, in order to ensure that the pensions tax relief system remains fair, affordable, and sustainable, tax relief on pension contributions would be restricted from April 2011 for individuals with incomes of £150,000 and over.

5.49 The Government is clear that the restriction of tax relief on pension contributions should apply as fairly as possible to individuals in different types of pension schemes and employment, and with different remuneration arrangements, while remaining targeted on those on the highest incomes. **The Government therefore announces that the restriction will apply to those with gross incomes of £150,000 and over, where gross income incorporates all pension contributions, including the value of any pension benefit funded by, or eventually funded by, an individual's employer.** This will be subject to an income floor so that those with pre-tax incomes (excluding the value of any employer contributions) of less than £130,000 are unaffected. Reflecting this change, **the Government announces that the anti-forestalling measures introduced at Budget 2009 will be extended from 9 December 2009 so that all those with incomes of £130,000 and over will be subject to the special annual allowance.**

5.50 **The Government is today launching a formal consultation on the implementation of this change and welcomes responses.** The consultation will run for 12 weeks until 3 March 2010.

Social care

5.51 As the number of people who need care and support increases, and expectations rise, the costs of providing care and support will increase significantly – both for the state and for individuals. If the system is left unchanged, growing numbers of people will go without the care and support they need. In recognition of this challenge, the Government published a Green Paper, *Shaping the Future of Care Together*, which set out a vision to build a new National Care Service in England that is fair, simple and affordable, underpinned by national rights and entitlements.[17] A large scale public consultation on the Green Paper, the Big Care Debate, ran from July to November 2009. **The Government will bring forward more detailed proposals in the New Year that deliver a fair, fiscally sustainable social care system that addresses both rising expectations and the changing demographics of the UK population in the coming decades.**

[16] *Costs of Tax Relief*, HM Revenue and Customs, Sept 2009 (http://www.hmrc.gov.uk/stats/pensions/table7-9.pdf).
[17] *Shaping the Future of Care Together,* HM Government, July 2009.

Helping homeowners and housing

Supporting homeowners in difficulty

5.52 The Government is committed to helping homeowners through the downturn and ensuring that there is an appropriate framework of support for mortgage borrowers. By working with the FSA, mortgage lenders and courts, the Government will ensure that reposession is treated as a last resort. In addition, the Mortgage Rescue Scheme and Homeowner Mortgage Support scheme provide targeted help for those who have exhausted all other options.

5.53 This support is making a difference – over 330,000 homeowners are projected to receive help or advice with their mortgage since April 2008.[18] 135,000 households are benefiting from lender forbearance, including 6,000 in an arrangement equivalent to the Homeowners Mortgage Support scheme. Total repossessions for the first three quarters of 2009 were less than half the Council of Mortgage Lenders (CML) original forecast for this year. The CML has now revised down its forecast and is predicting 27,000 fewer repossessions than were expected a year ago.

5.54 The Support for Mortgage Interest (SMI) scheme has helped homeowners who have experienced a fall in income to remain in their homes. **The standard interest rate used to calculate SMI will be maintained at 6.08 per cent for a further six months,** benefiting around 220,000 homeowners.[19] Once the freeze ends, the Government intends to move towards a fairer, more affordable approach, that more closely reflects mortgage interest rates.

Supporting local authority tenants

5.55 To encourage councils to set rents that are affordable and fair for their tenants and ensure that councils have sufficient resources for the coming year **the Government also announces that the average guideline rent increase for 2010-11 will be reduced from 6.1 per cent to 3.1 per cent for local authority tenants.**

Stamp duty land tax

5.56 A Stamp duty land tax (SDLT) holiday was announced on 2 September 2008 for all houses costing up to £175,000 to help address problems of affordability. The Government expects 240,000 transactions to benefit.[20] However, the stimulus offered by the SDLT holiday relies on it being temporary, so the holiday will end as planned on 31 December 2009.

Support for homebuyers

5.57 Chapter 3 sets out the actions the Government has taken to support mortgage lending, including the lending commitments agreed with RBS and Lloyds Banking Group.

5.58 HomeBuy Direct is helping first-time buyers to purchase a new build property from one of the participating developers, with the aid of an equity loan for up to 30 per cent of the property price, while continuing to support the house building industry. The Government expects that there will be 2,500 sales by the end of this year.[21] **The 2009 Pre-Budget Report announces the Government will, through moving £100 million forward from this year to 2010-11 and prioritising housing for first-time buyers within the Kickstart Housing Delivery programme, increase the development of HomeBuy Direct homes in 2010-11. This will deliver an investment of over £150 million in HomeBuy Direct that year and an increase of around 3,000 homes above the original 10,000 target, while sustaining delivery of the *Building Britain's Future* housing pledge of 112,000 affordable homes over two years.**[22]

[18] Department of Communities and Local Government (CLG) projections.
[19] DWP administrative data as at May 2009.
[20] HMRC projection from latest tax receipts data.
[21] Homes and Communities Agency (HCA) projections.
[22] HM Government, 2009

Support for house building

5.59 The Government has provided significant support to the house-building industry. The new housing investment announced at Budget 2009 and the £1.5 billion *Building Britain's Future* housing pledge will allow the Government to deliver 20,000 extra affordable homes, and unlock delivery of around 15,000 private homes. The Kickstart Housing Delivery programme announced at Budget 2009 has allocated £354 million in its first wave to unlock stalled housing sites. 145 schemes have been approved, to deliver over 10,000 homes, with work underway on some sites already.[23]

Supporting housing supply through the recovery

5.60 Budget 2009 reaffirmed the Government's commitment to address the long term challenge of increasing housing supply, and to maintain momentum towards the target of 240,000 net additions per annum by 2016. *Building Britain's Future* confirmed continued support for increasing the supply of social and affordable housing. Box 5.2 sets out the Government's wider strategy to support a timely and effective housing supply response.

Growing the private rented sector

5.61 The Government believes, building on the Rugg review, that a growing private rented sector can play an important role in increasing housing supply and meeting the need for a range of high quality housing tenure choices. **The Government will issue a consultation document early in 2010 to consider the contribution the private rented sector could make to addressing demand and increasing housing supply, and any barriers to investment.**

[23] HCA statistics, www.homesandcommunities.co.uk

Box 5.2: Supporting housing supply through the recovery

The Government will support an effective housing supply response through the recovery by:

- **bringing forward more land for development**, through improving local authorities' five year land supplies by undertaking comprehensive checks, publishing results and withholding incentive funding where a viable land supply is not in place. Budget 2010 will set out what further action is needed to secure delivery. HM Treasury will also work with CLG to explore innovative mechanisms to bring forward surplus public sector land, including through expanding the Public Land Initiative and CLG will undertake by Budget 2010 an end-to-end review of the call-in process, seeking to speed up decision-making.
- **ensuring cumulative regulation does not unduly constrain house building**.
  - by Budget 2010, establish a national baseline for regulatory costs across Government, to manage and mitigate the cumulative impacts of any new requirements, and explore with industry scope for reductions, whilst supporting the Government's Zero Carbon Homes policy and exploring practical ways to reduce the costs. As a first step, Government will consider in early 2010 the case for and form of regulation on lifetime homes standards (LHS), focusing on a proportionate approach. Any move to make LHS mandatory would not be until 2013 at the earliest; and
  - ensure local requirements are responding flexibly to economic conditions and supporting housing supply, aided by issuing guidance and support tools to local authorities. A scale back of section 106 requirements will also be introduced, as part of Community Infrastructure Levy (CIL) implementation after a transition period, to help provide local infrastructure in support of development. The Government will consult early next year on the appropriate usage of section 106.
- **promoting a strong and diverse house building industry** by carrying out a study of drivers of housing growth and the steps Government or industry could take to improve diversity and innovation, reporting by Budget 2010.
- **enhancing the role of local authorities** in enabling housing growth locally, and in building new social housing. Budget 2009 and *Building Britain's Future* announced a £460 million programme to support building up to 3,900 new local authority council homes. The Pre-Budget Report announces that the Government will examine the scope for local authorities to borrow against revenues from new council homes, to support delivery of housing where this offers value for money, and will consider interactions with wider reforms to the council housing finance system.
- **deliver effective and coordinated infrastructure** nationally and locally, including developing further reform proposals through Infrastructure UK and through six Total Capital case studies, working with the Homes and Communities Agency, local authorities and other government agencies.

Supporting the Third Sector

Social Investment Wholesale Bank

5.62 Following consultation on the design and functions of a Social Investment Wholesale Bank, **the 2009 Pre-Budget report announces a commitment to take forward further work towards the creation of a new institution**. The Social Investment Wholesale Bank will aim to leverage in investment for organisations with social impact from a wide range of sources and improve their access to finance. The Bank will also aim to increase financial inclusion by supporting Community Development Finance Institutions and credit unions, and contribute significantly to innovation in public service delivery. The Bank would be mission-driven, operate at a wholesale level, and would be independent from government.

5.63 **By Budget 2010, Government will finalise the model for the Bank setting out how the institution could grow over time**. To fund its initial capitalisation, **the Government announces its intention to commit up to £75 million of the funds expected to be released through the Dormant Accounts Scheme in England**, subject to the final volume of funds and alongside funding other priorities.

Dormant Accounts Scheme

5.64 To ensure progress towards the release of dormant account funds, **the Co-operative Financial Services (CFS) has agreed to support the Government and industry efforts to take forward the Dormant Accounts Scheme**, by preparing a plan for the establishment of the Reclaim Fund. The CFS intend to submit an application to the FSA for authorisation to establish and administrate the Reclaim Fund, subject to work going ahead as planned.

5.65 The Government confirms its commitment to use the majority of the investment from dormant accounts funds to deliver new and improved youth facilities across the country, with at least 25 per cent and up to £100 million of the fund for financial capability, and up to £75 million for the establishment of a Social Investment Wholesale Bank, subject to the final volume of funds available for distribution in England.

Gift Aid research

5.66 The Government continues to explore how best to support the third sector through the Gift Aid system, and Budget 2009 announced Government sponsored research into the possible effects of redirecting Gift Aid higher-rate relief from donors to charities. The research report will be published on the HM Treasury website on 15 December 2009. The Government is considering the findings and hopes the research will stimulate and move forward the discussion of the options for reforming Gift Aid.

Charities substantial donor rules

5.67 The Government proposes to replace the anti-avoidance rules relating to substantial donors to charities with new rules to deny tax relief on donations to charities where the donor is party to an arrangement, the purpose or one of the main purposes of which is to extract value from the charity.

A MODERN AND FAIR TAX SYSTEM

5.68 The economic downturn has placed major strains on government revenues and the tax system. Tax administrations around the world are facing growing compliance risks and greater demand for taxpayer support. In addition to continuing support to taxpayers through measures like the Business Payment Support Service and the new Charter, HMRC is responding to emerging risks through a developing strategy for compliance.

5.69 It is vital that everyone makes a fair contribution to the taxes that fund public services and that will ensure medium-term fiscal sustainability. Most people do this, and the Government is committed to ensuring that the tax system helps taxpayers to meet their obligations. However, the Government will tackle robustly those who do not pay their fair share, and is toughening its stance further through a package of measures that will raise up to £165 million each year, while protecting around a further £5 billion.

Tax Gap

5.70 The tax gap is broadly defined as the difference between the tax that is collected and the tax that should be collected. HMRC has published indirect tax gaps estimates for a number of years and today has published, for the first time, an estimate of the overall UK tax gap, including indirect and direct taxes. HMRC estimate the gap to be £40 billion in 2007-08.[24]

5.71 The tax gap estimates provide a useful tool for enabling the Government and HMRC to target action on protecting tax revenues. Today, the Pre-Budget Report sets out measures

[24] *Measuring Tax Gaps*, HMRC, 2009.

to tackle avoidance and evasion. Alongside this, HMRC has published a detailed overview of its strategy and actions to tackle the tax gap.[25]

Protecting tax revenues

5.72 The Government has a good record in protecting tax revenues from avoidance and evasion. Steps taken as a direct result of the disclosure regime for avoidance schemes are responsible for closing over £12 billion in avoidance opportunities. Initial disclosure arrangements for offshore bank account holders have delivered £450 million of previously unpaid tax and penalties. The Government is taking further steps against offshore evasion in partnership with other G20 members (as described in Box 5.3).

Box 5.3 International leadership in tackling tax havens and tax evasion

The UK has been at the forefront of international efforts to clamp down on tax havens and offshore tax evasion. The UK Presidency of the G20 has delivered improvements to international tax transparency, opening up tax havens so that tax evaders have nowhere to hide, by:

- setting a clear international standard for tax transparency;
- launching a robust peer review process that will ensure countries which sign up to the international standard actually deliver on their commitments;
- establishing a toolbox of sanctions which can be applied to countries that refuse to implement the international standard;
- reforming and expanding the Global Forum on Tax Transparency to create an international body capable of driving forward further progress; and
- beginning work on proposals that will allow developing countries to share in the benefits of this new transparency.

To protect UK taxpayers from the effects of tax evasion, the Government has entered into new tax agreements with key financial centers such as Switzerland, Liechtenstein and Luxembourg as well as with its own Crown Dependencies and Overseas Territories.

In addition, the Government commissioned Michael Foot to carry out an independent review of British Offshore Financial Centres, covering the Crown Dependencies and some of the UK's Overseas Territories. The review, which reported in October, sent a powerful signal that meeting international standards on tax information exchange, financial sector regulation and financial crime is no longer optional for jurisdictions wishing to maintain internationally active financial sectors. The UK will, through its G20 work, continue to press for action in tackling non-cooperative jurisdictions in these areas.

New disclosure opportunity

5.73 UK taxpayers hiding money and assets offshore in order to evade tax represent a significant drain on the public finances. Following a recent tribunal decision, HMRC is receiving details from over 300 financial institutions in the UK regarding offshore bank accounts. Alongside this, the Government is offering the New Disclosure Opportunity (NDO), giving those with undeclared assets a final chance to come forward to pay tax, interest and a reduced penalty. The notification window for the NDO runs until 4 January 2010, with a final disclosure and full payment required by 12 March 2010.

Tackling offshore evasion

5.74 It is right that, following this disclosure opportunity, those with offshore accounts who choose not to come forward should face greater sanctions. **The Government announces that it will legislate to ensure that those who fail to declare offshore tax liabilities will face the tough penalties attracted by deliberate tax evasion.**

[25] *Protecting Tax Revenues*, HMRC, 2009.

5.75 HMRC already receives substantial data on bank accounts, including details of interest on all UK accounts and similar information from most EU countries. **The Government announces a new notification requirement for offshore accounts in certain jurisdictions, supported by a separate penalty regime.** Evading tax offshore could therefore result in combined penalties of up to 200 per cent of the unpaid tax. **The Government is consulting on the implementation of these measures, including the potential for reforming information requirements on non-resident trusts.**

Hidden economy

5.76 In the ten years that have passed since the Grabiner Report, there have been significant institutional and socio-economic changes that have affected the hidden economy. **The Government announces the creation of a new Hidden Economy Advisory Group, which will consider what actions HMRC can take to increase the number of people that make the transition from the hidden to the formal economy.**

Tackling fraud and crime

5.77 Criminal attacks by organised gangs threaten tax revenues. The Government continues to take action:

- following evidence that commodity trading in emissions allowances (also known as carbon credits) was being used to fraudulently steal VAT revenues, the Government acted swiftly in July and zero-rated these supplies traded within the UK. Agreement has now been reached on a cross-EU approach to tackle this Community-wide threat;
- the latest official data estimates the illicit market share for cigarettes was further reduced in 2007-08, exceeding the Public Service Agreement target for the period. **HMRC will be consulting with interested parties on changes to strengthen customs powers to combat tobacco smuggling in the post**; and
- Budget 2009 announced a comprehensive programme of work to renew the "Tackling Alcohol Fraud" strategy. In addition to strengthening their operational response, HMRC is working closely with the UK Border Agency and businesses to reduce the opportunities for fraudsters. Further regulations are to be introduced by April 2010.

Tackling avoidance

5.78 There is a small minority of tax practitioners who constantly look for ways to bend the tax rules by exploiting tax legislation to generate avoidance schemes. The Government does not tolerate tax avoidance and responds quickly to close down these schemes. The Government is determined to break the cycle of scheme and counter-action by introducing robust solutions that firmly close potential avoidance opportunities and that stand the test of time. The Government is taking action to strengthen the avoidance disclosure regime, as set out in box 5.4.

Box 5.4 Disclosure of Tax Avoidance Schemes

The disclosure regime was introduced in 2004. It has been successful in providing real time information on new avoidance schemes and allows the Government to respond in a targeted and timely manner. To date information received through the disclosure regime has contributed to the closure of over £12 billion in avoidance opportunities. **Today the Government announces a consultation, *Disclosure of Tax Avoidance Schemes*,[27] on the implementation of a package of measures to strengthen and enhance the disclosure regime.** The amendments are:

- a change to the trigger point for disclosure of marketed schemes to ensure early disclosure;
- an information power to require that persons who introduce scheme promoters to clients identify who the promoter is;
- enhanced penalties for failure to comply with a disclosure obligation;
- a requirement for a promoter to provide HMRC with a periodic list of clients to whom they have issued Scheme Reference Numbers; and
- revised and extended hallmarks (the descriptions in regulations of main regime schemes required to be disclosed).

5.79 Since Budget 2009 the Government has acted swiftly against artificial avoidance to:

- prevent terminal loss relief being artificially triggered;
- prevent abuse of the apportionment rules for life insurance companies;
- prevent the abuse of rules on sideways loss relief; and
- counter the abuse of the double tax relief rules through the use of unauthorised unit trusts, manufactured overseas dividends and manufactured interest payments.

5.80 Today the Government announces, with immediate effect, further action:

- **counter avoidance through the artificial creation of excess capital allowances;**
- **closing a loophole through which fees are artificially carved out of a taxable insurance contract to avoid insurance premium tax;**
- **ensuring that the tax exemption for the inflationary return of an index-linked gilt cannot be exploited for avoidance purposes;**
- **preventing leasing schemes that generate artificial tax losses in excess of the value of taxable income taking income out of the charge to tax;**
- **preventing companies using consortium arrangements that attempt to deliberately circumvent the sale of lessors anti-avoidance legislation;** and
- **closing down schemes which have been used to avoid inheritance tax (IHT) through the use of trusts.** The Government is also examining wider solutions to the issue of IHT avoidance through trusts.

5.81 The Government announced at Budget 2009 that it was concerned about certain overhedging/underhedging transactions which, although not undertaken for tax avoidance purposes, are structured so that the Exchequer bears the full volatility risk. Following

[26] HMRC, 2009.

consultation, **the Government announces changes, to take effect from 1 April 2010, which will ensure that relief is given only for the genuine economic losses of the taxpaying group.**

5.82 The Government has also announced action to prevent tax avoidance where UK shares, intended for non-EU markets, are deliberately routed through EU clearance services of depository banks.

5.83 The Government has acted to tighten the rules dealing with debt buybacks to prevent companies not in financial difficulties bringing back debt at a discount to the amount borrowed, without being subject to tax.

Code of Practice on Taxation for banks

5.84 After a period of consultation, the Government will introduce a Code of Practice on Taxation for banks, which it expects all banks operating in the UK to adopt. The Code asks banks to have governance around tax integrated into business decision making and open and transparent relationships with HMRC.

Spotlights

5.85 HMRC is increasingly working with business and individuals to change behaviour and deter people from avoidance. Currently, HMRC's *Spotlights* publication warns people about avoidance schemes that HMRC considers do not work. **The Government announces that *Spotlights* will be expanded to set out the indicators that identify the kinds of arrangement that HMRC will challenge.** The aim of these buyer beware messages is to give potential users of avoidance schemes a better understanding of the risk they are taking.

Time To Pay requests over £1 million

5.86 As set out in Chapter 4, the 2009 Pre-Budget Report announces that HMRC will continue to offer the Business Payment Support Service. Around one in every thousand "Time To Pay" requests concerns an amount of £1 million or over. As the economy moves into recovery, it is important both for the businesses concerned and to protect taxpayers that HMRC can make an informed decision in these few, highly complex cases. **The 2009 Pre-Budget Report announces a new requirement for businesses asking for additional time to pay for debts over £1 million to provide an independent review of their needs.**

Collecting debts during litigation

5.87 The Government announces that HMRC is to apply a more consistent approach to the collection of debts when a tribunal or court has found against the taxpayer but there is a further appeal. This will apply to decisions made by the tribunals or courts on or after 1 April 2010.

Working with tax agents

5.88 Following the initial consultation over the summer, **the 2009 Pre-Budget Report announces a further consultation on how HMRC should work with agents to ensure that fewer inaccurate returns are submitted.** It includes proposals to:

- address deliberate wrongdoing by a small number of agents;
- work with representative bodies to resolve issues with individual agents; and
- control high-volume agents when they pose a risk to the tax system.

Review of HMRC Powers, Deterrents and Safeguards

5.89 The Government is committed to a fair tax system that keeps the burden of compliance at a minimum for those who pay, but that gives HMRC appropriate tools to address non-compliance. The Review of HMRC Powers, Deterrents and Safeguards has already delivered a range of measures in previous Finance Acts. The Government announces further measures to continue this work:

- **a further consultation on modernising the excise compliance checking regime;**
- **improving bulk and specialist information powers by publishing HMRC's response to a consultation on making these powers more up-to-date;** and

- **publishing draft legislation to complete the modernisation of the penalty regimes and the harmonisation of interest.**

Recovering overpaid tax **5.90** **The Government will modernise the regime governing claims to recover overpaid stamp duty land tax and petroleum revenue tax to provide a simpler and more consistent approach with enhanced taxpayer safeguards.**

Delivering fairness through a modern tax system

Pensions modernisation **5.91** To reflect the introduction of the 50 pence income tax rate announced in Budget 2009, **the Government makes some changes to the rates of pensions tax charges applied to short service refunds and to certain payments made by employer financed retirement benefits schemes (EFRBS), and sets new rates for the Special Annual Allowance charge with effect from 6 April 2010.**

Inheritance tax **5.92** In 2009-10 just 2.5 per cent of estates left on death are expected to pay inheritance tax. This will be the lowest number on record.[27] **The Government is therefore freezing the inheritance tax allowance at £325,000 in 2010-11.**

Salary sacrifice **5.93** **The Government will legislate to restrict the tax exemption for workplace canteens from April 2011 by removing the exemption when used in conjunction with salary sacrifice or flexible benefit arrangements.** Use of these arrangements enables a minority of employees to buy canteen meals out of pre-tax income, giving them an additional tax and NICs advantage that other employees do not enjoy. The exemption will continue to apply for subsidised canteens that are available to all employees.

Travel expenses and the National Minimum Wage **5.94** The Government is committed to addressing the problem of the potentially exploitative arrangements implemented for some workers paid at or near the National Minimum Wage (NMW). These arrangements, which make use of the tax and NIC expenses rules, can adversely impact on NMW workers' entitlement to earnings related social security benefits. **HM Treasury, HMRC and the Department for Business, Innovation and Skills, will launch a consultation in the New Year inviting views on proposed changes to the NMW Regulations and whether this is the best approach to tackling this problem.**

False self-employment in construction **5.95** Following the consultation on false self-employment in construction, which closed on 12 October 2009, **a summary of the responses received will be published in the New Year.** The Government remains committed to addressing the problem of false self-employment in construction and will continue to work with stakeholders to develop a legislative solution that is well targeted, effective and that allows the industry to retain a flexible labour supply.

Gambling **5.96** The Government is reviewing the responses received to the recent consultation on gaming machines taxation. The Government will continue to engage with the gaming machine industry before any decisions are taken.

5.97 The Government has reviewed new evidence provided by the bingo industry regarding the impact of taxation on bingo clubs. **Bingo duty will be reduced at Budget 2010 to 20 per cent.**

Alcohol & tobacco duties **5.98** Alcohol and tobacco duty rates were increased in the 2008 Pre-Budget Report to offset the temporary reduction in the standard rate of VAT. Existing rates will be maintained when the temporary VAT reduction ends.

[27] HMRC estimate based on latest estimates of inheritance tax taxpayer numbers and total UK deaths for the year 2009-10.

Cider duty 5.99 The cider duty regime will be reviewed and proposals brought forward at Budget 2010.

Isle of Man revenue sharing 5.100 The VAT and excise duties revenue sharing agreement between the UK and Isle of Man was recalibrated in October, with effect from 2010-11. The new agreement will increase the UK's share of joint revenues by £100-200 million a year over the coming years.

Extra Statutory Concessions 5.101 HMRC continues its review of extra statutory concessions (ESCs). **A consultation is launched today on legislation to retain the effect of a further seven ESCs.**[28] This is the third such consultation, final draft legislation from the second having been published last month. Nine ESCs will be withdrawn on 9 December 2010.[29]

Equitable Liability 5.102 **The Government will legislate the Equitable Liability ESC**, following work with taxpayers and representatives. Until then the concession will continue to operate.

Amendments to accounting standards 5.103 **To take account of changes, made or currently under consideration, to international and UK accounting standards, the Government will introduce a power in Finance Bill 2010 to enable amendments to be made to the corporation tax rules on financial instruments.**

Shared Lives relief 5.104 The Government is improving the tax arrangements for carers looking after vulnerable individuals under a qualifying 'Shared Lives' scheme (also known as adult placement carers). **From 6 April 2010, Shared Lives carers will receive a tax-free allowance for their caring income similar to the current Foster Care relief. From today the Government will also ensure there is no loss of capital gains tax private residence relief where adult placement carers use part of their home exclusively for the accommodation of an adult in care.**

Furnished Holiday Lettings 5.105 The Government announced at Budget 2009 that Furnished Holiday Lettings rules would be repealed from April 2010. **Today the Government is publishing draft legislation, an impact assessment, and guidance on this change.**

Seafarers' Earnings Deduction 5.106 **Legislation will be introduced in Finance Bill 2010 to extend the Seafarers' Earnings Deduction to EU and European Economic Area resident seafarers.**

[28] *Extra statutory concessions – third technical consultation on draft legislation*, HMRC, 2009.

[29] *Withdrawal of extra statutory concessions*, HMRC, 2009.

6 Protecting public services

Since 1997, record levels of investment matched by reform have enabled the Government to achieve lasting improvements in Britain's public services.

The Government's short-term priority is to continue to support the most vulnerable families and businesses until recovery is secured. The 2009 Pre-Budget Report announces new short-term spending measures, including **£300 million to bring forward the offer of a job, training or a work placement to every 18 to 24 year old who has been claiming Jobseeker's Allowance for six months, and a freeze in the Standard Interest Rate used to calculate Support for Mortgage Interest at 6.08 per cent for a further six months, benefiting an estimated 220,000 homeowners**.

The 2009 Pre-Budget Report confirms that the Government will stick to planned levels of overall departmental spending in 2010-11 to help support the economy through the downturn, but from 2011-12 onwards spending growth will reduce to help halve the deficit over the next four years. **The 2009 Pre-Budget Report announces an additional 0.5 per cent increase in employee, employer and self-employed rates of national insurance contributions. As a result, public sector current expenditure will grow by an average of 0.8 per cent a year from 2011-12 until 2014-15**. **Public sector net investment will move to 1¼ per cent of GDP by 2013-14 and will remain at that level in 2014-15**.

The 2009 Pre-Budget Report sets out a package to ensure that, in 2011-12 and 2012-13, NHS front-line spending – the 95 per cent of spending that supports patient care – rises in line with inflation, spending on front-line schools rises by 0.7 per cent a year in real terms and spending on 16 to 19 participation rises in real terms by 0.9 per cent a year. Spending on Sure Start Children's Centres will be maintained in line with inflation. Sufficient funding will be provided to police authorities to enable them to maintain the number of police officers and community support officers, and spending on overseas aid will remain on track to reach 0.7 per cent of Gross National Income (GNI) by 2013.

At the same time, **the 2009 Pre-Budget Report announces new efficiencies and reforms across the public sector including**:

- **£11 billion of savings by 2012-13 through smarter government** for example through rationalising Arms Length Bodies, greater use of online systems for providing advice and information to the public, cutting consultancy spend by 50 per cent, and better management of government assets;
- **£5 billion of savings by 2012-13 from targeting and prioritising spending** including by reforming the Criminal Justice System and legal aid, reducing lower priority provision within the adult skills budget, phasing out temporary employment programmes, and reducing the cost and scope of the NHS IT Programme;
- **a one per cent cap on public sector pay settlements in 2011-12 and 2012-13, delivering £3.4 billion of savings a year by 2012-13**; and
- **reforms to public service pensions to save £1 billion a year from 2012-13 onwards**.

SUSTAINING EFFICIENT AND EFFECTIVE PUBLIC SERVICES

Improvements in public services

6.1 Since 1997, a combination of investment and reform has radically improved the quality of Britain's public services, delivering real and lasting improvements. Total public spending has increased by 57 per cent in real terms, compared to 15 per cent in the preceding 12 years, enabling the Government to achieve sustainable front-line services that deliver high quality outcomes[1]. For example:

- NHS spending in England has more than doubled in real terms since 1997. This has allowed the NHS to deliver improved services, achieving the national level targets for hospital treatment within 18 weeks, referral to a cancer specialist within 2 weeks and A&E treatment within 4 hours;
- spending on education in the UK has increased in real terms by £31.2 billion since 1997. As a result, the number of schools with less than 30 per cent of pupils gaining five or more good GCSEs or equivalent, including English and maths, has fallen from 1,600 in 1997 to a projected 270 in 2009, according to self-reported results; and
- central government spending on the police has increased by 19 per cent in real terms since 1997. As a result, there are now 16,000 more police officers than in 1997 and this has helped the police to continue to play a vital role in keeping Britain's communities safe and secure.

A decade of investment

6.2 At the same time, record levels of capital investment have reversed a legacy of under-funding. Public sector net investment is now at its highest level in 30 years, up from 0.6 per cent of GDP in 1997-98 to 3.3 per cent in 2009-10[2]. For example:

- total capital investment in education in the UK has increased from £1.7 billion in 1998-99 to £8.3 billion in 2008-09, resulting in the rebuilding or significant refurbishment of 3,800 schools and over 3,000 Sure Start Children's Centres;
- capital investment in housing and community amenities has risen from £2.7 billion in 1998-99 to £11.3 billion in 2008-09, annual average real growth of 12.8 per cent. A £33 billion investment has reduced the number of social homes not meeting the Decent Homes standard by one million. This and other housing programmes are expected to have lifted over a million children out of poor housing; and
- UK transport spending has more than doubled since 1997, which has led to major improvements in the transport network including over 70 major motorway and trunk road schemes completed since 2001, a high-speed rail link from St Pancras to the South East, the West Coast Mainline upgrade, and the enhancement of over 100 stations across the London Underground network.

Value for money

6.3 This increased investment has been accompanied by a strong focus on value for money, improving efficiency and cutting down on waste. Over the 2004 Spending Review period, departments over-delivered on the Government's value for money target by 20 per cent, achieving savings of £26.5 billion. Over the 2007 Comprehensive Spending Review (CSR) period the Government has committed to a cash-releasing value for money target

[1] *ONS Statistical Bulletin: Public Sector Finances*, October 2009, available at www.statistics.gov.uk/pdfdir/psf1109.pdf

[2] Capital grants to financial institutions are treated as grants to the private sector.

worth £35 billion by the end of 2010-11. Departments are making good progress towards their 2007 CSR targets and **the 2009 Pre-Budget Report announces that £8.5 billion of efficiencies have been delivered so far**. This includes savings reported in 2008-09 departmental annual reports and, where available, departmental savings reported in the first half of 2009-10.

6.4 In addition, the 2004 Lyons Review[3] laid down a target of relocating 20,000 civil service posts out of London and the South East by 2010-11. Budget 2009 extended this target by an additional 4,000 posts and **the 2009 Pre-Budget Report announces that by June 2009 nearly 21,000 posts had been relocated**.[4] *Putting the Frontline First: smarter government*[5] published on 7 December 2009 announced that Ian Smith, former Chief Executive Officer of Reed Elsevier and Taylor Woodrow, would lead a review on the scope for further civil service relocations, to report by Budget 2010. The review will set out what specific efficiencies this might bring and outline how at least 10 per cent of civil service posts currently based in London and the South East can be relocated in the medium term.

6.5 Budget 2008 announced the next stage of the Government's programme of value for money reforms, setting up the Operational Efficiency Programme (OEP) and the Public Value Programme (PVP) to capitalise on best practice and leading thinking in the private and public sectors. Budget 2009 accepted the recommendations of the OEP reviewers that the Government could achieve £15 billion of additional efficiency savings a year by 2013-14 compared to 2007-08, in back office and IT, collaborative procurement, asset management, property and local incentives and empowerment. Budget 2009 also set out details of the early savings from the PVP and announced that the programme would be expanded to ensure demanding value for money reviews are conducted across a minimum of 50 per cent of each department's budget. Initial savings options identified by the PVP are set out later in this chapter.

Public service reform

6.6 Alongside this drive to improve efficiency, the Government has also implemented significant reforms to improve public services: with institutions such as Foundation Trusts and Academies to increase choice and raise standards; new performance management tools such as Public Service Agreements; more joined up inspections through Local Area Assessments; more front-line staff – 16,000 more police officers, 42,400 more teachers, and over 70,000 more nurses; and new services such as Sure Start Children's Centres, Jobcentre Plus and neighbourhood police teams.

6.7 In 1997, as the Government began to correct the legacy of under-investment in public services, clear national standards and targets were needed to drive up performance. But as services were repaired and rebuilt, the challenge became to increase standards while ensuring the necessary flexibility and incentives at the front line. The 2004 Spending Review focussed on fewer, sharper targets; new freedoms for front-line staff; and greater choice and diversity of services for citizens, including from private and third sector providers. The 2007 CSR announced just 30 cross-cutting Public Service Agreements setting out the Government's top priorities for improving outcomes and services for citizens, down from 600 targets in 1998.

6.8 In March 2009, the Government published *Working Together – Public Services on your Side*[6], which set out more detail on the three principles underpinning further public service reform:

[3] *Well placed to Deliver? Independent Review of Public Sector Relocation*, Sir Michael Lyons, March 2004

[4] Latest progress on relocations available at www.ogc.gov.uk

[5] *Putting the Frontline First: smarter government*, HM Government, December 2009

[6] *Working Together – Public Services on your Side*, HM Government, March 2009

- empowering citizens – through the creation of clear public service entitlements that make citizens more aware of what they can expect from public services, through giving them more choice and control, and providing more access to public data. For example, entitlements to be treated within 18 weeks under the NHS Constitution, or for the NHS to take all reasonable steps to offer alternative treatment; and the release of valuable public datasets which will be made free for reuse, including NHS Choices data;
- new professionalism – through giving front-line professionals the space, skills and power to respond to citizens' needs. For example, by giving service leaders the freedom to join up and tailor services across local areas; and
- strategic leadership – with central government setting standards and entitlements only. For example, by setting out clear entitlements in education but preserving local flexibility regarding the form of delivery.

6.9 *Building Britain's Future*[7] and *Putting the Frontline First: smarter government* show how going forward, these principles will be embedded into public service delivery.

The BBC

6.10 As recently stated in the Government's response to the Public Accounts Committee's April 2009 report[8] into the efficiency of radio production at the BBC, the National Audit Office (NAO) should have unrestricted access to the BBC in scrutinising the effectiveness and efficiency of its service delivery. The Government is encouraging the BBC to discuss with the NAO how this can be best achieved whilst maintaining the BBC's editorial independence.

SUPPORTING THE ECONOMY THROUGH THE DOWNTURN

6.11 Over the last year, all the world's major advanced economies have been affected by a steep and synchronised global downturn and, as the economic challenge has deepened, a key issue for governments has been how to continue to drive improvements in public services whilst ensuring sustainable public finances over the medium term. In line with the international consensus and the work of the G20, the Government's approach has been:

- to allow public spending to rise to support the economy through the global downturn in the short term; and
- to deliver fiscal consolidation once recovery is secured, to ensure sound public finances over the medium term, but doing so in a way that is in line with the Government's values, focussing on the priorities set out in *Building Britain's Future*.

Capital Fiscal Stimulus

6.12 The 2008 Pre-Budget Report announced that £3 billion of capital spending would be brought forward from 2010-11 into 2008-09 and 2009-10 to support aggregate demand and maintain jobs during the economic downturn. A projected £1.7 billion of accelerated investment has been delivered to date[9], which is supporting a number of jobs and industries across the country. For example:

- more than 800 GP practices have had additional funding to improve and extend training facilities. This will provide 1,400 extra training places,

[7] *Building Britain's Future*, HM Government, June 2009

[8] Available at www.official-documents.gov.uk/document/cm77/7717/7717.pdf

[9] Estimated spending to date based on projections and some initial estimates of financial management information. The first provisional outturns for fiscal stimulus spending will be published in the HM Treasury statistical release of public expenditure outturns in summer 2010.

primarily in areas that historically have had a lower provision of doctors. To date, over 200 schemes are in construction or have been completed;

- housing and regeneration capital funds brought forward will bring 10,000 council homes up to the Decent Homes standard in 2009-10;
- the Highways Agency is continuing to progress £400 million of high value schemes on the strategic road network. These include the A46 road-widening scheme and the acceleration of specific asset renewal and managed motorway works across the network. 21 of these schemes have been completed to date; and
- all of the £100 million funding allocated for the Warm Front Programme in 2009-10 has been spent, benefitting almost 38,000 households and saving them each up to £300 in energy bills every year. **The 2009 Pre-Budget Report announces an additional £200 million to fund the Warm Front Scheme and the greener boiler incentive scheme in 2010-11.** More details can be found in Chapter 7.

6.13 In addition, Budget 2009 announced £600 million of new investment to move forward stalled housing projects and kick-start house building. *Building Britain's Future* included an additional £1.5 billion to deliver 20,000 more affordable homes. Together, these contribute to the Government's aim of delivering over 55,000 affordable homes this year and over 56,000 in 2010-11.

Support for PFI projects

6.14 To ensure that Private Finance Initiative (PFI) projects continued as planned despite the current financial market conditions, the Infrastructure Financing Unit (TIFU) was established at Budget 2009 to lend to PFI projects that cannot raise sufficient debt finance, on acceptable terms, to reach financial close on a timely basis. Since then, 23 PFI projects involving some £3.7 billion of finance have reached financial close, compared to less than £1 billion for PFI projects in 2007-08[10].

Support for families and businesses during the downturn

6.15 As well as action to maintain financial stability and support economic demand, the Government is also providing targeted support to families and businesses most affected by the recession. As the economy starts to recover, it is right that these temporary measures are slowly withdrawn, but the Government is determined to continue to provide short-term support to particularly vulnerable groups.

Support for families and individuals

6.16 In the 2008 Pre-Budget Report and Budget 2009 the Government set aside £3 billion of additional funding over two years for Jobcentre Plus and the Flexible New Deal programme to ensure the employment interventions regime has the capacity to enable people to get back to work quickly. Over 70 per cent of Jobseekers Allowance (JSA) recipients leave unemployment benefit within six months[11].

6.17 Budget 2009 also introduced a £1.2 billion guarantee of 6 months meaningful activity for all young people who have been claiming JSA for 12 months to prevent individuals from becoming detached from the labour market. Up to 95,000 Future Job Fund jobs have already been announced across the country as a result of this intervention. Building on this success,

[10] HM Treasury Administrative data, November 2009

[11] Off-flow rates are calculated by the Department for Work and Pensions using official NOMIS data available at www.nomisweb.co.uk

the 2009 Pre-Budget Report announces £300 million to strengthen and bring forward the Youth Guarantee, offering 18 to 24 year olds who have been claiming Jobseeker's Allowance for six months a job, training or a work placement lasting at least six months. More details can be found in Chapter 5.

Support for homeowners

6.18 For homeowners, temporary schemes are helping the most vulnerable to stay in their homes and offering support to first-time buyers. **The 2009 Pre-Budget Report announces that the Standard Interest Rate used to calculate Support for Mortgage Interest will be frozen at 6.08 per cent for a further six months**. Around 220,000 homeowners will continue to benefit from this extra support. **In addition, the Government will make available over £150 million of funding through 2010-11 for the HomeBuy Direct shared equity loan scheme, helping an additional 3,000 households purchase their new homes.** More details can be found in Chapter 5.

Support for business

6.19 Over the past year the Government has provided significant temporary support for businesses, for example action to help small and medium-sized enterprises (SMEs) access the finance they need through the Enterprise Finance Guarantee scheme. In addition, to support innovative advanced industrial projects of strategic importance, the Government announced a £750 million Strategic Investment Fund (SIF) at Budget 2009.

6.20 As set out in Chapter 4, **the 2009 Pre-Budget Report does more to support business and create a platform for future economic growth**, including by:

- **supporting investment in low-carbon projects by providing £200 million additional funding to the SIF and investing £90 million in the 2020 European Fund for Energy, Climate Change and Infrastructure, to be overseen by Infrastructure UK**;
- **continuing the Enterprise Finance Guarantee scheme for a further twelve months**, recognising the continued challenges that smaller businesses face in accessing finance;
- **creating a Growth Capital Fund that will target SMEs** for which traditional bank finance is either inappropriate or unavailable; and
- **setting out details of a new body, Infrastructure UK, to advise the Government on the UK's infrastructure needs over the next 5 to 50 years**. Infrastructure UK will act as a focal point for the UK's infrastructure strategy and its long-term development and delivery.

6.21 These new measures on growth will continue to be supported by the Government's action to deliver key infrastructure projects now. For example, a significant milestone has been reached with the commencement of the Blackfriars station redevelopment as part of the £5.5 billion Thameslink upgrade, and construction has started on the £640 million Birmingham New Street station redevelopment. Construction of Crossrail has begun, with engineering underway to create the Isle of Dogs station, whilst work is progressing at Tottenham Court Road and Farringdon. In 2009-10, the Highways Agency is investing over £1.5 billion on capital infrastructure including major road improvements on the M1, M25, M40, A1 and A46. Further details on the Government's actions to improve UK infrastructure are set out in Chapter 4.

SUSTAINABLE MEDIUM-TERM PATH FOR PUBLIC SPENDING

6.22 **The 2009 Pre-Budget Report confirms that overall departmental spending in 2010-11 will be maintained as planned to help support the economy through recovery**. But, as set out in Budget 2009, spending growth will reduce from 2011-12 onwards in order to ensure sustainable public finances over the medium term. As set out in Chapter 5, **the 2009 Pre-Budget Report announces that employer, employee and self-employed rates of national insurance contributions will rise by an additional 0.5 per cent from 2011-2012. As a result, the 2009 Pre-Budget Report announces that public sector current expenditure will grow by an average of 0.8 per cent in real terms between 2011-12 and 2014-15.**[12] **In line with Budget 2009, public sector net investment will move to 1¼ per cent of GDP by 2013-14 and remain at that level in 2014-15**.

6.23 The Government is not doing a spending review at this stage, but the 2009 Pre-Budget Report sets out more detail on the Government's commitment to continuing to protect the key public service priorities which are vital for ensuring opportunity, social mobility and fairness for all; and to making the tough choices necessary to fund this by increasing efficiency and cutting lower value programmes and lower priority budgets.

PROTECTING PUBLIC SERVICE PRIORITIES

Health

6.24 Spending on the NHS has more than doubled in real terms since 1997[13]. In assessing the resources needed to maintain high quality healthcare, **the 2009 Pre-Budget Report announces a package to ensure that NHS near-cash front-line spending – the 95 per cent of spending that supports patient care – will rise in line with inflation in 2011-12 and 2012-13**.

6.25 Alongside this additional investment, the Government has a comprehensive programme in place to identify value for money savings in all parts of the NHS, including in front-line services. As an interim step towards the £15 to £20 billion savings that the NHS Chief Executive has challenged the NHS to achieve, **the 2009 Pre-Budget Report announces that value for money savings of around £10 billion per year will be delivered by 2012-13** through the work underway within the NHS and through the PVP, OEP and other value for money initiatives, including by:

- improving how the NHS buys services for patients and adjusting the price it pays, enabling all hospitals to reach the productivity levels achieved by the best, ensuring that people get the most appropriate treatment in the right place at the right time;
- delivering more efficient, integrated and people-centred community and mental health services, including by developing common prices to reduce variation and transforming the care and lives of those with long-term conditions; and
- driving down back office and procurement costs.

6.26 Budget 2010 will set out in detail the £15 to £20 billion savings.

6.27 Front-line NHS spending rising in line with inflation, combined with the progress that has already been made in identifying value for money savings will ensure that the NHS can continue to deliver key service outcomes. This includes the proposed new patient

[12] Excluding the additional time-limited resource expenditure announced in the 2009 Pre-Budget Report

[13] *Department of Health Annual Reports*, available at www.dh.gov.uk/en/Publicationsandstatistics/Publications/AnnualReports/index.htm

entitlements to hospital treatment within 18 weeks, referral to a cancer specialist within 2 weeks, and free NHS Health Checks every five years for all those aged 40-74, which will be set out in a revised version of the NHS Constitution. It will also allow the Government to introduce an entitlement to cancer diagnostics within 1 week, to be phased in from 2011-12.

Education **6.28** Since 1997, spending on education in the UK has increased in real terms by £31.2 billion[14]. **The 2009 Pre-Budget Report makes an assessment of the resources necessary to protect front-line education and announces a package for 2011-12 and 2012-13 that will ensure near-cash funding for front-line schools rises in real terms by 0.7 per cent a year, and near-cash funding for 16 to 19 participation rises in real terms by 0.9 per cent a year.** Near-cash spending on Sure Start Children's Centres will be maintained in line with inflation. **The 2009 Pre-Budget Report also announces an additional £202 million in 2010-11 to ensure that the September Guarantee of a place in education or training to every 16 and 17 year old who wants one is met in full.**

6.29 Alongside this additional investment the Government has a comprehensive programme in place to identify value for money savings in schools, 16 to 19 participation and Sure Start Children's Centres. **The 2009 Pre-Budget Report announces over £800 million of efficiency savings in front-line areas by 2012-13, including from increased collaborative procurement of goods and services and rationalising back-office costs.**

6.30 The commitment to protect all near-cash funding for front-line schools, 16 and 19 participation and Sure Start Children's Centres, and the progress that has already been made in identifying value for money savings, will ensure that every school in the country can guarantee an education that is individually tailored to each child, including through catch-up support in English and maths for every child aged seven to eleven who is behind expected levels of progress; and that the September Guarantee of a place in education or training to every 16 and 17 year old who wants one will be met in full. In addition, free childcare will continue to be available for all three and four year olds, and there will be more free childcare places for disadvantaged two year olds; and every community will have easy access to high quality, integrated early education and childcare, health, employment and family support services through Sure Start Children's Centres.

Police **6.31** Spending on the police by central government has increased by 19 per cent in real terms since 1997 and as a result, there are now 16,000 more police officers[15]. **The 2009 Pre-Budget Report announces that sufficient funding will be available in the years to 2012-13 to enable Police Authorities to maintain the current number of warranted Police Officers, Police Community Support Officers and other staff exercising police powers**.

6.32 This funding will be accompanied by reforms to increase value for money in policing, as set out in *Protecting the Public: Supporting the Police to Succeed*[11] on 2 December 2009. These will include, by 2013-14, increasing delivery to the public by an equivalent of at least £500 million by improving processes, and at least £70 million of savings from police overtime. At least £428 million of these savings will be delivered by 2012-13. The Government has also launched a PVP for the police that will, working closely with the service, identify opportunities to go even further to maximise value for money, reporting at Budget 2010.

6.33 These commitments will ensure that the police continue to play a vital role in keeping communities safe and secure. The Government will ensure that policing meets the

[14] *Public Expenditure Outturns National Statistics Release*, HM Treasury, December 2009, available at www.hm-treasury.gov.uk/national_statistics.htm
[15] *Protecting the Public: Supporting the Police to succeed*, Home Office, December 2009

needs of the public, including through the Policing Pledge which sets out minimum service standards in serving local communities.

Overseas Development Assistance

6.34 Spending on international development has increased from £2 billion in 1997 to £6.3 billion in 2008[16]. The Government has provided international leadership to a collective aid effort that has contributed towards lifting 250 million people out of poverty in the last ten years and provided primary school education to 40 million more children[17]. The Government remains committed to tackling global development challenges, playing a leading role in achieving the Millennium Development Goals, tackling climate change and promoting peace and stability around the world. In addition, the Department for International Development (DFID) is committed to ensuring efficiency and value for money in all of their operations, and **the 2009 Pre-Budget Report announces that DFID will make value for money savings of £593 million a year by 2013-14**. This will be achieved primarily through improving the allocation of funding to achieve greater impact, and through reducing consultancy spend, improving procurement practices and streamlining back office processes. The 2007 CSR set out spending plans that put the UK on track to spend 0.7 per cent of Gross National Income (GNI) on Overseas Development Assistance by 2013, two years ahead of the EU target. In September 2009, the Prime Minister announced plans to set in legislation the commitment to reach 0.7 per cent by 2013. Spending on international development will continue to rise in the next Spending Review period to meet that target.

Defence

6.35 By the end of 2009-10, more than £14 billion of Reserve funding will have been spent on resourcing the cost of operations in Iraq and Afghanistan[18]. This is additional to the core defence budget. Over £5.2 billion of this has been committed to spending on equipment to meet the specific threats and requirements of those theatres. **For 2010-11, the 2009 Pre-Budget Report announces that an additional £2.5 billion will be added to the Reserve to ensure that sufficient funding is available for military operations in Afghanistan.** At the same time, the Government is working to improve the efficiency and effectiveness of core defence spending. Since 1997, the Ministry of Defence's (MOD) civilian workforce has reduced in size by 45,000, so that it is now 86,000[19], including a 23,000 reduction in the last four years. MOD expects this to fall to around 81,000 by 2011 as a consequence of initiatives already in hand. The Secretary of State will be commissioning an independent review to look at the scope for further reductions as an input to the forthcoming Defence Review.

Infrastructure spending

6.36 Capital spending can boost public sector productivity and provide the physical infrastructure needed to enable economic growth. Record levels of investment over the past decade have allowed the Government to renew substantial parts of the public estate and transform public service delivery, and in real terms public sector net investment will remain over three times as high in 2014-15 as it was in 1997-98. **The 2009 Pre-Budget Report announces that the Government will focus capital spending in the next Spending Review in the areas where it generates high economic returns in order to achieve maximum long-term benefit for the taxpayer**. The new Infrastructure UK body will assist in this task by advising Government on the priorities for infrastructure investment, more details of which are provided in Chapter 4.

[16] *Figures for Official Development Assistance, Statistics on International Development 2009*, Department for International Development (DFID)

[17] *Eliminating World Poverty: Building our Common Future*, Department for International Development (DFID), July 2009

[18] HM Treasury Financial Management Data

[19] Ministry of Defence Annual Reports, available at www.mod.uk/DefenceInternet/AboutDefence/CorporatePublications/AnnualReports

Greater freedom and flexibilities for the front line

6.37 Protecting front-line priorities means not just protecting budgets but also accelerating the next phase of public service reform in order to improve outcomes for people. So the Government will provide greater freedoms for front-line services to give them more flexibility to respond to the priorities of communities and play a stronger role in promoting growth and tackling economic barriers. Commitments set out in *Putting the Frontline First: smarter government* included:

- letting local areas set priorities by: streamlining the national performance framework; removing a number of national indicators from April 2010 and further substantial reductions from 2011; and, by Budget 2010, setting out plans to further align sector-specific performance frameworks across key local agencies;
- letting local areas guide resources by: reducing the level of ring-fencing for local authorities and streamlining different funding streams, with specific plans set out by Budget 2010; publishing guidance on pooling and aligning of local-level budgets; and coordinating the timing of grant payments from departments to local authorities for 2011-12;
- supporting local investment by: allowing local authorities that wish to use their trading powers to create further commercial opportunities; setting out guidance on effective use of joint ventures by local authorities and their partners by February 2010; and considering single-area based capital pots with recommendations by Budget 2010;
- reducing burdens on the front line by: ensuring reporting, inspection and assessment frameworks only include what is necessary to guarantee accountability, access and quality; co-ordinating the timings of assessments and inspections by 2010-11; reviewing the work of inspectorates with firm proposals by Budget 2010; and removing as many burdens identified by Total Place pilots and government departments as possible in time for the 2011-12 financial year; and
- strengthening the role of civic society in public life by: announcing a pilot of the Social Impact Bonds model; promoting wider use of community shares; enabling community groups already owning community assets acquired with Government funding to maximise their finance-raising potential by considering the scope for removing clawback conditions; and producing a regularly updated Civic Health Index.

6.38 **The 2009 Pre-Budget Report announces further steps to increase professional freedoms within front-line organisations by:**

- **expanding freedoms and flexibilities for front-line staff: including in 2010-11 consulting on proposals to extend non-medical prescribing for certain allied health professionals, such as physiotherapists and podiatrists; and working with the NHS to explore options to support GPs in referring patients to high quality and cost-effective alternative settings;** and

- strengthening professionalism: for example tackling the variation in teachers' access to effective continuing professional development by encouraging peer learning; awarding Trust status to local probation areas that meet tough performance criteria, with greater flexibility to innovate and to pool local budgets; and more proportionate crime reporting in policing.

Total Place

6.39 The measures set out in *Putting the Frontline First: smarter government* take up the challenges presented by emerging evidence from Total Place, launched at Budget 2009. It has been led by local government and builds on the partnership work of recent years. By Budget 2010, the Government will respond to detailed evidence from Total Place about the added value of freeing up front-line services and encouraging collaboration in terms of better services at less cost. Early findings from the pilots are set out in Box 6.1.

Box 6.1 Total Place - A whole area approach to public services

Total Place counts the total public funding in one place and considers how local organisations can use their combined resources to generate efficiencies and transform local public services. Bottom-up learning from 13 pilot areas and more than 20 'parallel places' is generating new ideas about how local partnerships can deliver more efficient and effective services.

To find new solutions to complex public service challenges, each pilot is undertaking detailed analysis of public service challenges which have high and diverse cost impacts and wide-ranging effects on the lives of local people, and where there is significant scope for collaboration. The pilots are seeking to devise solutions that redesign services around users, while reducing duplication and overlaps between organisations. For example:

1. Leicestershire and Leicester City partners are exploring innovative joint commissioning arrangements to tackle drug and alcohol dependency, including interagency venues where people can be treated effectively as alternatives to A&E and police stations;
2. Bradford partners are working towards a single point of access to services for young people leaving care, elderly people with dementia leaving hospital and offenders leaving prison, underpinned by eight key service design principles that support links between agencies and reduce overlaps;
3. Kent partners are working together, transforming access to public services via the 'Gateway' multi-channel model. Associated with this is a single asset-management strategy to further increase the efficiencies gained from transformed public access; and
4. Lewisham partners are exploring the case for integration of health and social care, extending a joint commissioning approach across all of adult health and social care and testing whether and how joint working can be extended across adult and children's client groups.

Results of these pilots will be set out in the final report of Total Place at Budget 2010.

City regions

6.40 Budget 2009 announced two new pilot city-regions with which Government would put in place more devolved arrangements, in order to better drive growth. **The 2009 Pre-Budget Report announces agreements with both pilots.** For Manchester, this includes designation as the UK's fourth low-carbon economic area specialising in the built environment, new powers over adult skills and a stronger role on 16-19 learning, apprenticeships and transport. For Leeds, this includes greater control over housing and regeneration funding, a timetable for new powers on adult skills and work with Government to deliver low-carbon housing developments and to integrate transport funding.

6.41 In addition, the measures set out in Box 6.2 will strengthen the accountability of the Scottish Parliament.

Box 6.2 Flexibilities for the Scottish Parliament

As announced in *Scotland's future in the United Kingdom*[a] in November 2009, in response to the recommendations made by the Calman Commission, the Government agreed that the financial accountability of the Scottish Parliament should be strengthened by moving to a system where a greater proportion of the Scottish Executive's budget comes from its own decisions on taxation and where the Scottish Executive can increase borrowing subject to HM Treasury limits through increasing taxation. Taken together the plans set out in the White Paper represent the most radical changes to the way in which Scotland is funded for a generation.

These plans will require legislation in the United Kingdom Parliament. The Government envisages introducing the necessary legislation as soon as possible during the next parliament and will undertake further detailed work to establish viable timings for implementation.

[a] *Scotland's future in the United Kingdom*, The Scotland Office, November 2009

A SMARTER, MORE STREAMLINED GOVERNMENT

6.42 In order to continue to protect the key public service priorities set out earlier in the chapter, the 2009 Pre-Budget Report announces savings across the public sector by making government smarter, rationalising projects and programmes on the basis of the early findings of the Public Value Programme, and taking tough choices on public sector pay and pensions.

Making government smarter

6.43 The Government is determined to deliver services in a more effective way. **The 2009 Pre-Budget Report announces further details of the £12 billion a year of savings set out in *Putting the Frontline First: smarter government* and announces that £11 billion a year of these savings will be delivered by 2012-13.**

6.44 £8 billion of the £11 billion to be delivered by 2012-13 are savings identified across the public sector by five external advisers to the Operational Efficiency Programme (OEP), through improving back office functions, IT, collaborative procurement and property running costs. *Putting the frontline first: smarter government* outlined the next stage in realising savings from back office and IT by setting out comparator benchmarks for central government and departmental plans. For example:

- the Ministry of Justice will save around £65 million per annum in estates through rationalisation, co-location and moving posts out of London; and
- the Department for Communities and Local Government (CLG) have set an interim benchmark of 65:1 on Human Resources to be achieved by 2010-11, after which they will work towards benchmark levels of 77:1 in line with the new government comparators.

6.45 The additional £3 billion of savings a year by 2012-13 includes:

- at least £500 million by reducing duplication between organisations and streamlining Arms Length Bodies (ALBs). As a first step, *Putting the Frontline First: smarter government* announced a rationalisation of over 120 ALBs across government, including reducing the number of bodies performing advisory or related functions by over 25 per cent, subject to the necessary legislation and consultation. By Budget 2010, a review will identify further options for rationalisation. This will include considering options for rationalising up to a third of DCMS non-museum ALBs, including streamlining ten DCMS advisory bodies and bringing forward plans for merging the UK Film Council and the British Film Institute;

- £650 million from cuts of 50 per cent in consultancy spend and 25 per cent in marketing and communications spend across government;
- £300 million by improving energy efficiency across the public sector to reduce energy demand and costs, cutting bills by around 10 per cent and contributing to climate change goals;
- £170 million by taking further steps to maximise value for money in Home Office operational bodies focussing on immigration, crime and back-office support for the police, including through faster asylum claim processing saving;
- £550 million from local government, including more efficient waste collection and disposal, reducing the burdens of inspection, assessment and reporting requirements from across government and measures to reduce duplication and inefficiency between different tiers of local government;
- £120 million from improvements to the administration of concessionary travel including shifting responsibility to county councils, speeding up the rollout of smartcards across the bus network and, subject to consultation, streamlining arrangements for reimbursing bus operators;
- £600 million from greater use of online systems and streamlining contact with the public, including: £35 million from providing business services and advice online and charging for schemes with the greatest benefit to business, £15 million from national rollout of 'Tell Us Once' (through which people only have to inform the Government once about a change in circumstance), and £500 million from more efficient use of automation, e-channels and telephony and greater risk profiling within HM Revenue and Customs (HMRC) and the Department for Work and Pensions (DWP);
- £140 million from reducing the costs of the senior civil service by up to 20 per cent and cutting sickness absence amongst civil servants;
- £92 million from protecting the environment more cost-effectively and making more efficient use of funding available under the Rural Development Programme for England; and
- further action to better manage and sell Government assets as detailed in box 6.3.

Prioritising projects and programmes

6.46 Going further, the Government has also looked at what other efficiences can be achieved across the public sector through better procurement, or through cutting lower-value or lower-priority programmes or projects on the basis of the early findings of the PVP. The Government will continue to identify further opportunities for savings through the PVP, **but the 2009 Pre-Budget Report can already announce £5 billion of additional savings by 2012-13:**

- £340 million from improved targeting of regeneration and housing growth funding, concluding the New Deal for Communities programme, prioritising regeneration and growth programmes to maximise value for money as the economy recovers, and saving public money by directly tackling the barriers to housing growth with a reduction in the impact of regulation on house building. The Government, will assess the efficiency and effectiveness across government of interventions to tackle worklessness and promote growth and inclusion in deprived areas, and the institutions that deliver them;

- £500 million from reducing spend on IT, including by reducing the cost and scope of the NHS IT programme;
- £360 million of savings in the Criminal Justice System by improving case management, putting underperforming or expensive public sector prisons out to competition during 2010-11, and reforming legal aid;
- £250 million from reducing variations in spend on residential care, including greater use of preventative approaches to care for older people allowing people to stay longer in their homes;
- £170 million from smarter procurement of new rail franchises and additional trains, and by generating higher passenger revenues by increasing station car park capacity and clamping down on fare evasion. Reflecting long planning horizons for transport spending, the Department for Transport will be launching a study aimed at reducing future rail industry costs while increasing capacity, to get best value beyond 2014;
- £1.4 billion from ending additional employment schemes introduced during the downturn when the economy recovers;
- £300 million by reducing funding not directly supporting learner participation and lower priority adult skills budgets, increasing co-funding of training, and further efficiencies in the delivery of learning to focus spending on those people that need it most and on the skills most vital to Britain's future;
- £60 million from the costs of concessionary travel by aligning eligibility with forthcoming changes in the state pension age. No one currently receiving these benefits will be affected;
- £600 million from higher education and science and research budgets from a combination of changes to student support within existing arrangements; efficiency savings and prioritisation across universities, science and research; some switching of modes of study in higher education; and reductions in budgets that do not support student participation;
- £160 million from clamping down on fraudulent access to social housing tenancies, and rationalising smaller Communities and Local Government (CLG) funded community programmes as well as ending time-limited schemes in CLG;
- £350 million of savings from the Department for Children, Schools and Families to be found from central budgets, NDPB efficiency savings and from reviewing pilots and programmes to focus on the most effective interventions; and
- £13 million from ensuring payments made to public servants posted overseas reflect modern lifestyles and family circumstances.

6.47 At the next Spending Review, the Devolved Administrations' budgets will be determined in the normal way in line with the Barnett formula to reflect the budgetary changes made as a result of these savings and associated decisions on protecting key front-line priorities as outlined earlier in the chapter.

Box 6.3 Operational Efficiency Programme – Asset strand

Asset Portfolio:

On 7 December 2009 the Government published the *Operational Efficiency Programme: Asset Portfolio*[a] alongside *Putting the Frontline First: smarter government*, setting out the next steps to deliver £16 billion from asset and property sales by 2013-14.

The asset portfolio presents reviews of public sector businesses and seeks to open a dialogue with the private sector to explore alternative options for their management, including partial or full sale where appropriate.

In a number of cases the Government has now concluded that a partial or full sale is the right approach, and the following transactions are now being progressed:

- **the tote** – a sale process is expected to be launched during summer 2010 following the year end financial results of 31 March 2010;
- **Student Loans Portfolio** – as a securitisation option may not currently be a viable option, other ways to monetise the portfolio are now being explored and the Government will report on a feasibility study at Budget 2010;
- **Dartford Crossing** – following a review of capacity needs and concession structures currently underway, the necessary processes will commence during summer 2010;
- **High Speed 1** – preparations for sale are now at an advanced stage, and it is the Government's intention to launch a sale process as soon as practicable following the introduction of domestic services on the line in December 2009; and
- **URENCO** – the Government will explore options to realise value from the UK's stake, subject to security issues being addressed.

The portfolio also sets out the progress the Government has made in improving the management of its assets and the next steps to manage its assets more effectively – one of the five strategic priorities of *Putting the Frontline First: smarter government* – by laying out an asset management framework, and identifying new assets that will be considered in the next phase of work. Budget 2010 will report progress on the commercialisation of the assets presented in the portfolio, and the initial conclusions of the asset reviews under the new framework.

Property:

As *Putting the Frontline First: smarter government* also announced, the Government has created a strategic property team within the Shareholder Executive to undertake a strategic review of different public sector estates management and ownership options. This will include assessing the feasibility of creating one or more property companies that would own and manage portfolios of public sector properties with a view to maximising efficiency.

To improve the incentive for more effective asset management planning and lock-in the benefits of the significant growth in capital investment since 1997-98, CLG will progress the technical aspects of introducing a formal depreciation-based funding scheme in the local government sector, and progress will be reported at Budget 2010.

[a] *Operational Efficiency Programme: Asset Portfolio*, December 2009

Tough choices on public sector pay

6.48 Public sector workers are at the heart of delivering world-class public services and supporting long-term economic growth, prosperity and fairness. Following substantial investment in public sector pay since 1997, continued pay restraint will be important to support front-line service delivery while ensuring sustainable public finances over the medium term. The 2009 Pre-Budget Report sets out an ambitious package of measures on public sector pay.

6.49 The Government has already proposed awards in the range of up to one per cent in 2010-11 for key public service workforces not in multi-year deals. Going forward, **the 2009 Pre-Budget Report announces that the Government will seek a one per cent cap on basic pay uplifts across the public sector for 2011-12 and 2012-13, generating savings of £3.4 billion a year by 2012-13.**

6.50 The Government expects senior staff to show leadership in exercising pay restraint. For 2010-11 the Government has proposed a freeze for senior groups including chief executives of non-departmental public bodies (NDPBs), senior civil servants, judges, senior NHS managers, consultant doctors and GPs. **The 2009 Pre-Budget Report announces a set of fundamental reforms to pay-setting for senior staff,** aimed at increasing the robustness, transparency and accountability of decision making across the public sector, including:

- new scrutiny of pay levels above £150,000: the Chief Secretary to the Treasury will approve pay levels in excess of £150,000 for all civil service appointments and appointments to public sector bodies which are subject to Ministerial approval. This will also apply to all bonus payments of over £50,000 where Ministerial sign-off is needed. For public sector bodies where Ministerial approval is not required, the Government expects all organisations making senior managerial appointments in excess of £150,000 to publicly justify this level, and any bonus in excess of £50,000, to the relevant Secretary of State;

- transparency and accountability: all public sector bodies subject to direct Ministerial control will be required to publish the salary, including benefits in kind and the level of any bonus, of named individuals paid more than £150,000 to the nearest £5,000 and the number of staff paid more than £50,000 in £5,000 increments. The Government will expect all other public bodies to comply with this level of disclosure. Government departments will publish collective information on pay for senior staff in public sector bodies within their area of responsibility, and the Government has commissioned relevant audit or regulatory bodies to incorporate into their regimes certification that the relevant body operates remuneration policies which maximises value for money for the taxpayer; and

- reviewing senior pay across the public sector: the Prime Minister will ask Bill Cockburn as Chair of the Senior Salaries Pay Review Body (SSRB) to report by Budget 2010 on senior pay across the public sector. The Government will work with the review to determine what legislative and non-statutory means are most appropriate to enforce compliance with pay and bonus principles and caps across the wider public sector.

Public service pensions

6.51 Since 1997, the Government has introduced reforms to tackle increasing pension costs arising from longevity; these include higher pension ages and reform of ill health benefits. In addition to these cost saving measures, the Government is implementing further significant reforms to public service pensions. **Cap and share reforms to the Teachers, Local Government, NHS and Civil Service pension schemes will cap the contribution to pensions made by employers, thereby limiting the liability of the taxpayer as pensions become more valuable.** Cost increases below the cap will be shared equally between employers and employees, and those above the cap met solely by employees. **In addition, as part of cap and share, the Government will expect those earning the highest salaries to pay a greater contribution towards their pension.** These reforms will save an estimated £1 billion a year from 2012-13, and at least twice this amount over the long-term.

7 SUPPORTING LOW-CARBON GROWTH

The UK is playing a leading role on climate change, setting the agenda for the international negotiations and taking radical domestic action to promote low-carbon growth. The Government is committed to an ambitious global deal at the UN negotiations in Copenhagen.

The UK is at the forefront of a worldwide low-carbon economic recovery. The Pre-Budget Report provides a further £400 million to support business investment in low-carbon growth and help households reduce energy costs. Combined with policies announced since September 2008, this could support over £15 billion of additional public and private investment in the low-carbon and energy sectors over the next three years. **The Pre-Budget Report announces:**

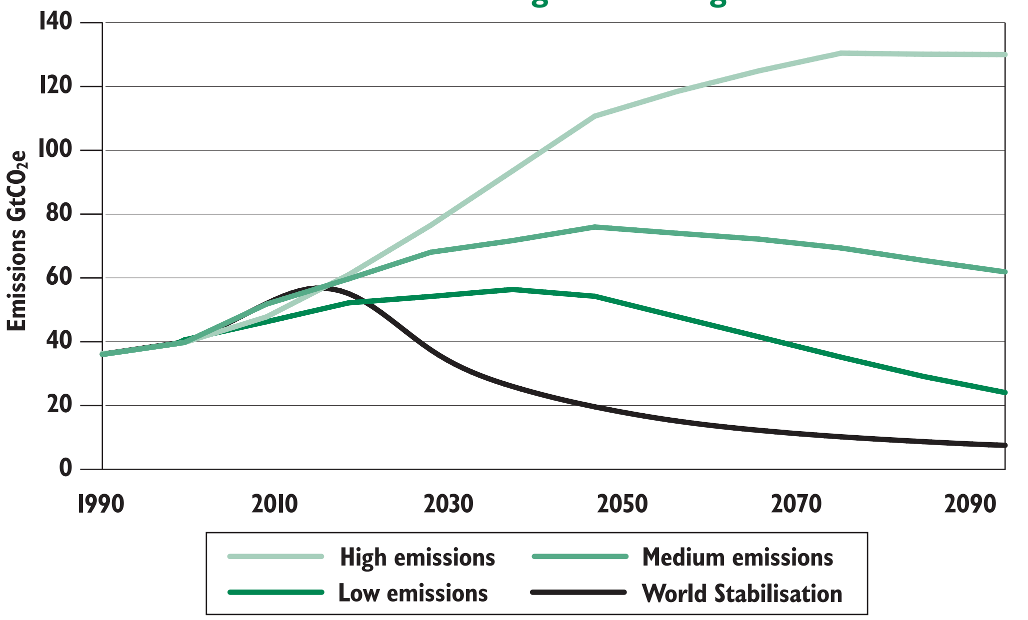
- **additional support for offshore wind projects accredited from April 2010 to March 2014 via the Renewables Obligation;**
- **doubling to four the UK's commitment to fund carbon capture and storage demonstration projects via contributions from electricity suppliers;**
- **establishing Infrastructure UK to leverage further investment in low-carbon projects including by: investing €100 million in a European Investment Bank-led fund to deploy up to €1.5 billion of equity and €5 billion of debt in low-carbon infrastructure; and considering the case for a low-carbon investment institution;**
- **£120 million for low-carbon industries in the UK, including new manufacturing and testing facilities for offshore wind, and support to improve energy use in the chemicals industry;**
- **£200 million to improve energy efficiency and tackle fuel poverty by: offering £400 for up to 125,000 households to upgrade their old boilers to the latest efficient models with a greener boiler incentive; and providing extra resources for Warm Front to help 75,000 of the most vulnerable households with heating and insulation;**
- **confirming that the income received by those who generate small-scale renewable electricity for their home through the clean energy cash-back scheme, worth on average £900 in 2010, will be tax free;**
- **helping one million more vulnerable households with discounts on their energy bills by increasing support provided by energy companies from £150 million to £300 million by 2013-14;** and
- **increasing support for low-carbon vehicles through exempting electric cars from company car tax from 2010, introducing a 100 per cent first-year allowance for electric vans, and investing a further £30 million on low-carbon transport projects.**

7.1 Climate change is the greatest long-term economic challenge facing the world today. The Stern Review on the economics of climate change showed that the benefits of strong and early action far outweigh the costs.[1] While failing to tackle climate change could threaten economic security, taking action presents economic opportunities. Tackling climate change will stimulate innovation and growth, providing jobs in new green industries, and encourage energy efficiency, reducing energy costs for businesses and households.

[1] *The Stern Review: The Economics of Climate Change*, Cambridge University Press, October 2006.

7.2 Only a global response can meet the challenge of climate change. As the Pre-Budget Report is published, world leaders are preparing to meet in Copenhagen to negotiate an ambitious, effective and fair global deal. This will be a critical step in ensuring global emissions start to decline by 2020 and fall to at least 50 per cent below 1990 levels by 2050 (Chart 7.1). Developed countries such as the UK will need to make a greater contribution and support developing countries through this global transition. The Pre-Budget Report sets out the Government's commitment to securing a global deal by providing funding for international climate finance.

Chart 7.1: Global scenarios of greenhouse gas emissions



Source: High, medium and low emissions scenarios correspond to the International Panel on Climate Change scenarios used in the UK Climate Projections 2009, and assume no action to tackle climate change. The world stabilisation scenario from the Committee on Climate Change is consistent with an ambitious global deal on climate change aimed at limiting global temperature increases to around 2°C above pre-industrial levels.

7.3 International action needs to be supported by continued action at home. The Government has established a comprehensive policy framework to ensure the UK will meet its carbon budget commitments, requiring a 34 per cent reduction in greenhouse gas emissions by 2020.[2] The UK is well prepared to make further carbon reductions once a global agreement is in place, in part through the continued support provided through the Pre-Budget Report.

7.4 The low-carbon economy requires a transformation in UK energy and transport infrastructure. This provides the UK with new opportunities for future business growth and the potential to be a world leader in the low-carbon and environmental sectors, estimated to be worth £3 trillion globally.[3] Budget 2009 provided £1.4 billion of targeted support during the downturn for low-carbon energy generation and advanced green manufacturing. The Pre-Budget Report builds on this by providing for further low-carbon investment across the economy, creating new highly skilled jobs in the UK and providing export opportunities, to support future growth (Box 7.1).

[2] *The UK Low Carbon Transition Plan*, HM Government, July 2009.

[3] *Low Carbon and Environmental Goods and Services: an industry analysis*, Innovas, March 2009.

Box 7.1: Supporting low-carbon growth

The Pre-Budget Report announces £400 million over the next two years (including funding reprioritised from other non-environmental programmes) to support green growth and the development of low-carbon technologies, building on the £1.4 billion package announced at Budget 2009. This will be part-funded through a £150 million increase to the Strategic Investment Fund for low-carbon projects. This new package will provide:

- £50 million to invest in the development of the UK offshore wind industry, including funding for new manufacturing and testing facilities;[a]
- £40 million support for low-carbon technologies, including additional support for small-scale and community level low-carbon generation;[a]
- £30 million for the chemicals industry, on Teeside to lead the way in demonstrating how to decarbonise the process industry across Europe, while maintaining its commpetitiveness;[a]
- £50 million to contribute towards the £90 million investment in a European equity fund for low-carbon infrastructure;[b]
- £30 million for green transport projects, including an expansion of the Technology Strategy Board's ultra-low carbon vehicles competition;[a]
- an exemption for electric cars from company car tax and the introduction of 100 per cent first-year allowance for electric vans from 2010;
- £150 million for Warm Front, which will provide better heating and insulation for an additional 75,000 of the most vulnerable households; and
- £50 million to fund the greener boiler incentive to encourage households to upgrade to more efficient heating systems.

Taken together, the measures announced since September 2008, including in this Pre-Budget Report, could support investment of more than £15 billion in the low-carbon and energy sectors over the next three years, taking into account the matched private sector funding leveraged as a result.

In addition, the Pre-Budget Report announces further long-term support for investments in low-carbon energy, including carbon capture and storage, and renewable energy.

[a] Funded from the Strategic Investment Fund.
[b] The remaining £40 million is being funded from the money allocated at Budget 2009 to support low-carbon technology.

SECURING A GLOBAL DEAL

Copenhagen 2009

7.5 The UK's overriding goal for a global agreement on reducing greenhouse gases at Copenhagen is to put the world on a path to limit global temperature rises to two degrees Celsius. The Government has worked through international fora to ensure that all major economies are ready to reach an ambitious agreement. In November, the UK chaired the G20 meeting of Finance Ministers and Central Bank Governors in St Andrews. At this meeting, the G20 committed to work towards an ambitious outcome at Copenhagen, and recognised the need to increase climate finance significantly.

7.6 To meet the two-degrees target, developed countries must take the lead and commit to ambitious economy-wide emissions reduction targets. EU member states have collectively agreed to move from their current aim of reducing emissions by 20 per cent by 2020, to a 30 per cent cut in the event of an ambitious global deal at Copenhagen. The Government believes that a global agreement should include firm caps on aviation and maritime transport emissions, and measures to reduce deforestation and degradation. To meet the two-degrees target, developing countries must also take action to limit their emissions, as they represent the largest future source of emissions growth.

Climate finance

7.7 For a fair global deal, international climate finance will be important to help developing countries take the necessary steps to reduce emissions growth and ensure that the poorest are helped to adapt. The UK has led the climate finance debate. At the October EU Council, the UK secured EU endorsement that public and private financial flows to developing countries should reach €100 billion per year by 2020. The UK will contribute its fair share of climate finance in the context of a global deal where all major economies participate in a full and fair manner. Recognising the additional costs that tackling climate change will place on developing countries, the Government is committed to putting forward some climate finance additional to existing official development assistance (ODA) commitments.[4]

7.8 Finance will be needed in the short-term to help developing countries address urgent climate challenges. **The Pre-Budget Report announces that for Copenhagen the Government will put forward a dedicated short-term climate finance package to address the urgent need to kick-start flows to developing countries**, as part of an ambitious global deal on climate change which includes comparable finance and mitigation offers from other major economies. Finance must be delivered efficiently by effective and legitimate institutions with robust mechanisms to measure results. In this context, a significant portion of this finance could be put into a new Green Fund established at Copenhagen, administered by an existing international financial institution.

Carbon markets

7.9 Private finance will play a critical role in supporting developing countries in the transition to a low-carbon economy. A truly global carbon market is the most efficient and effective way to deliver the scale of funds required. A well-designed carbon market could reduce the costs of addressing climate change by up to 70 per cent.[5] The carbon market already delivers finance at scale to developing countries with $6.5 billion mobilised in 2008.[6] These flows could increase significantly in 2020 in the event of an ambitious global deal which includes sectoral trading and crediting in developing countries.

CARBON BUDGETS IN THE UK

7.10 The UK is the first country in the world to have set legally binding carbon budgets. Budget 2009 set the levels of these carbon budgets, requiring a 34 per cent reduction in emissions by 2020 compared to 1990 levels. The UK has already reduced emissions by 21 per cent – nearly double the UK's Kyoto Protocol target. The UK Low Carbon Transition Plan published in July 2009 set out a comprehensive plan to increase the pace of emissions reductions to 1.4 per cent per year in order to reach 2020 target (Chart 7.2).[7,8] At the heart of the Government's approach is the EU Emissions Trading Scheme (EU ETS), which sets a declining limit for emissions and creates the biggest carbon market in the world (Box 7.2).

[4] The UK is committed to put forward 0.7 per cent of gross national income as ODA by 2013.

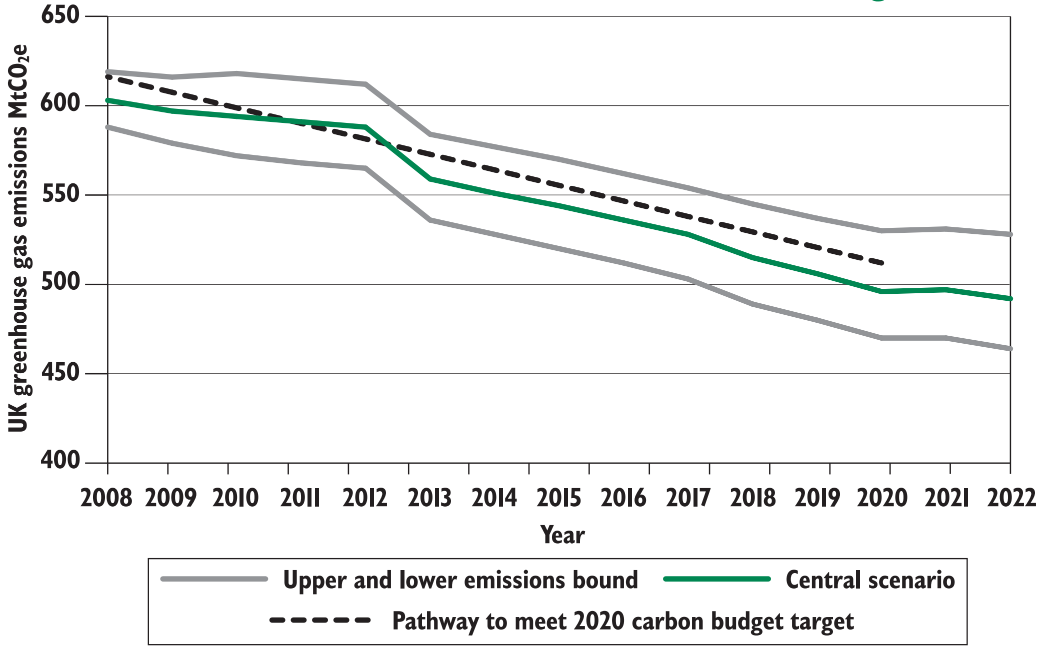
[5] *Lazarowicz Report: Global Carbon Trading: A framework for reducing emissions*, Office of Climate Change, July 2009.

[6] *State and Trends of the Carbon Market 2009*, The World Bank, May 2009.

[7] *The UK Low Carbon Transition Plan*, HM Government, July 2009.

[8] Meeting the 34 per cent reduction by 2020 requires a 1.4 per cent annual reduction in the level of the UK carbon account. This account covers emissions reductions required in the UK taking account of purchases of allowances through the EU Emissions Trading System. The Committee on Climate Change first progress report, which recommended a 1.7 per cent average annual reduction, did not take into account the impact of emissions trading.

Chart 7.2: The UK is on track to meet its carbon budgets



Source: The UK Low Carbon Transition Plan, HM Government, July 2009.

7.11 The Government recognises that the economic downturn will affect the delivery of carbon budget targets, both through impacts of the global financial crisis on investment in the low-carbon sector, and the reductions in emissions due to lower economic growth. To ensure that short-term reductions in emissions do not detract from the urgency of delivering low-carbon investment, **the Government accepts the recommendation of the Committee on Climate Change that any overachievement against the first carbon budget arising from the downturn should not be carried forward to allow for higher emissions in future**. This chapter also outlines further support to drive forward investment in low-carbon infrastructure and energy projects building on measures announced at Budget 2009. Together these measures will ensure the Low Carbon Transition Plan remains on track as the economy emerges from the downturn.

Box 7.2: Auctioning carbon allowances and the UK carbon market

The UK is the only EU country to hold regular carbon auctions as part of Phase II of the EU Emissions Trading System (EU ETS). To date over £350 million has been raised. This revenue and future EU ETS receipts, which are estimated to reach £2 billion in 2013-14, are already included within the public finances forecast and committed to support Government spending priorities, including on the environment, and deficit reduction.

Competition at UK carbon auctions has steadily increased, with institutions from fifteen European countries and the United States regularly participating. Reforms to the auction model announced at Budget 2009 have secured a higher clearing price to the benefit of UK taxpayers.

During this period, London has consolidated its position as the global centre of the carbon market. Eighty seven per cent of all international carbon trading now occurs in London.[a] With its growing pool of financial expertise in carbon products, London represents the natural centre for innovation in the carbon market.

The success of carbon trading in London underpins the UK Government's position in favour of Member States' sovereign right to continue to hold national or joint auctions in Phase III of the EU ETS (2013-20). The Government is therefore opposed to a single centralised approach, as proposed by the European Commission, which would stifle competition and restrict access to the carbon market.

More ambitious emissions targets worldwide will lead to further growth in the global carbon market and increase its role in channelling public finance to the developing world. The Government will therefore actively seek to manage its carbon assets and liabilities.

[a] *State and Trends of the Carbon Market 2009*, The World Bank, May 2009.

Committee on Climate Change

7.12 The independent Committee on Climate Change published its first report on the Government's progress towards carbon budgets on 12 October.[9] The Government will respond to the report in full in January 2010. In the meantime, the Pre-Budget Report addresses the Committee's key economic and fiscal recommendations, including on outperforming the first carbon budget, supporting low-carbon investment through the downturn, and strengthening support for carbon capture and storage.

SUPPORTING A LOW-CARBON RECOVERY: BUSINESS GROWTH AND GREEN JOBS

7.13 Providing a strong and sustainable platform for future business growth is essential for the UK economic recovery. The UK is progressively moving towards a low-carbon economy, reducing emissions to meet carbon budgets while creating opportunities for business growth and jobs in the sectors of the future. The Pre-Budget Report provides further support to decarbonise energy production, lower the cost of new technologies and innovation, and help businesses use energy more efficiently.

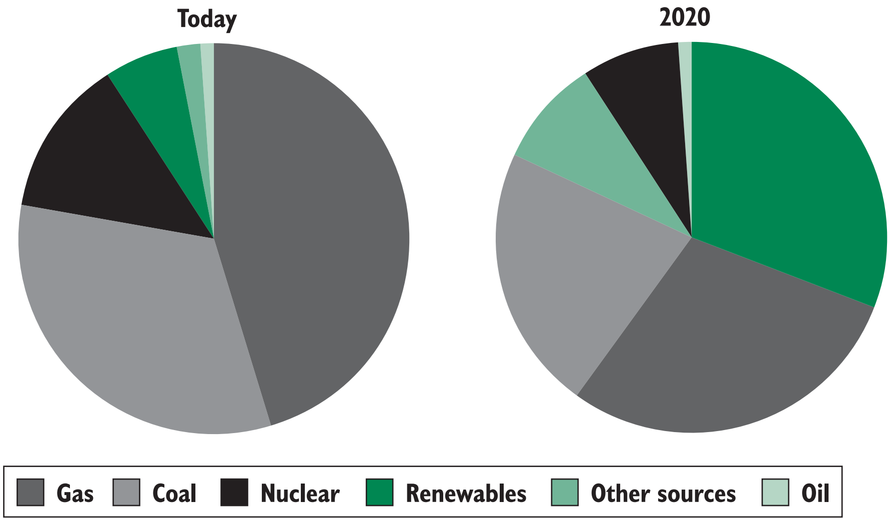
[9] *Meeting Carbon Budgets – the need for a step change,* Committee on Climate Change, October 2009.

Supporting deployment of low-carbon energy technologies

7.14 The Government has set out ambitious plans to decarbonise the UK's energy supplies, requiring a transformation of the UK's energy infrastructure (Chart 7.3).[10] This includes a target of supplying 15 per cent of the UK's energy from renewable sources by 2020 compared to 2 per cent today. The scale of the energy investment challenge is unprecedented in the longer term, with £200 billion of investment needed in energy infrastructure by 2025, requiring the sector to triple its annual rate of investment from 2008 levels.[11]

Chart 7.3: UK energy mix now and in 2020

Over two-thirds of the UK's electricity is currently generated from gas and coal; renewables will expand to around one-third of our generation by 2020[1]



Source: Energy Trends (2009 Quarterly) Department for Business Innovation and Skills (2009).
Source: Energy Trends (2020) Department of Energy and Climate Change.
[1]The 2020 chart is a projection of possible shares of electricity generated from different sources, from the DECC energy model which assumes existing nuclear power stations are closed in line with published retirement dates and 1.6 GW of new nuclear capacity is constructed by 2020. Estimated energy demand today and in 2020 is around 370 TWh.

7.15 To ensure that the required private sector investment comes forward to support low-carbon energy, the Government has put in place a long-term policy framework that encourages investment in low-carbon energy generation. This includes the EU Emissions Trading Scheme (EU ETS), which places a firm cap on emissions from the power sector and heavy industry, and support for specific low-carbon technologies, such as the Renewables Obligation, which requires electricity suppliers to source an increasing percentage of electricity from renewable sources.

7.16 The global financial crisis has had a significant impact on the availability of finance for energy investments, particularly for small to medium-sized renewables projects. The Government acted to protect investment in these projects during the downturn. The Pre-Budget Report provides an update on these actions (Box 7.3) and sets out the Government's plans to further strengthen the policy framework for energy investments going forward, both through support for specific low-carbon technologies and by ensuring a competitive energy market framework facilitates low-carbon investment.

[10] *The UK Low Carbon Transition Plan*, HM Government, July 2009.
[11] *Project Discovery – Energy Market Scenarios*, Ofgem, October 2009.

7.17 The Government is also taking action to tackle non-financial barriers to investment, such as streamlining the planning system to reduce delays and give investors greater certainty. Last month, the Government published new Energy National Policy Statements for consultation. These will be the foundation of an improved planning regime.[12]

Box 7.3: Progress on low-carbon targeted energy measures from Budget 2009

Budget 2009 announced over £1.4 billion additional targeted support for the low-carbon sector, over 5 years. Good progress has been made in delivering this support to date:

- following the Budget 2009 announcement to consult on an uplift in support through the Renewables Obligation for offshore wind, projects confirmed include the London Array, which will be the world's largest offshore wind farm;
- over £300 million out of the £405 million of additional funding directed towards low-carbon technologies has been allocated (with the remainder to be allocated over the coming months), including:
  - up to £120 million to support the development of a UK-based offshore wind industry;
  - up to £60 million to help accelerate the development and deployment of wave and tidal energy in the UK;[a] and
  - £45 million for research and technology development of low-carbon aerospace engines.

Significant progress has also been made with the package of European Investment Bank (EIB) lending, to enable up to £9 billion of investment in UK energy projects, comprising EIB direct lending and matched private sector lending. In November, the EIB signed deals with three banks to launch an intermediated lending scheme to small and medium-sized UK renewable projects, with an initial focus on onshore wind.

Energy investment has also been supported through the downturn by action the Government has taken across the economy. A number of energy companies have benefited from improved conditions in the corporate bond market, partly as a result of the Asset Purchase Facility. Energy sector investments have received a major share of the support provided through the temporary enhanced first-year capital allowances of 40 per cent (see Chapter 4).

[a] This includes £8 million from the Environmental Transformation Fund.

Renewable electricity

7.18 Renewable energy generation will play an important part in the UK's future energy mix. Budget 2009 announced the Government's intention to consult on temporarily increasing the support available for offshore wind projects under the Renewables Obligation. After completing the consultation, **the Pre-Budget Report announces that the eligibility criteria will be amended so that two Renewables Obligation Certificates will be available to all projects accredited between April 2010 and March 2014**, providing at least an additional £400 million of support for investment in offshore wind. **The Pre-Budget Report also brings forward technical changes to the Renewables Obligation** to provide those investing in renewable energy projects with greater certainty around the value of the incentive.[13]

[12] *Consultation on draft National Policy Statements for Energy Infrastructure, DECC*, November 2009.

[13] This includes increasing "headroom" to 10 per cent from 2011-12 rather than gradually. Further details will be set out in the Government's response to the consultation, to be published by the Department of Energy and Climate Change later this week.

Carbon capture and storage

7.19 Carbon capture and storage (CCS) is the process of capturing carbon dioxide from fossil fuels and storing it instead of releasing it into the atmosphere. This will enable fossil fuels to continue to play a role in a low-carbon energy mix. **The Pre-Budget Report announces that the Government is doubling its commitment to this important technology in order to fund four demonstration projects**. The Government intends to phase in these projects over the period 2014-18. The Government has introduced legislation in this Parliamentary session for a mechanism to fund these projects through contributions from electricity suppliers. These enabling powers will be capable of raising funds to retrofit CCS onto any generating units of the power station not fittted with the equipment from the outset.

7.20 Subject to receiving suitable bids and being able to reach appropriate terms, it remains the Government's intention to proceed with the current competitive procurement for a CCS demonstration project to contract award. As with any long-term procurement, final funding approval for this will depend on decisions taken at the next Spending Review.

Energy market framework

7.21 As well as strategies to help develop and deploy particular low-carbon technologies, the Government is committed to ensuring the energy market and policy framework supports private sector investment. Building on the Low Carbon Transition Plan to 2020, the Government comitted to publish decarbonisation pathways to 2050, consistent with secure, low-carbon energy. This will require significant private sector investment in low-carbon energy infrastructure. With this large investment challenge, the Government – working with Ofgem – needs to ensure that consumers get a fair deal. As part of this work, **the Department of Energy and Climate Change and HM Treasury will take forward work to ensure the electricity market framework can most effectively deliver a fair deal for the consumer and the low-carbon investment needed in the long term**. The work will take account of the available analysis and evidence, such as Ofgem's Project Discovery work and the advice of the Committee on Climate Change. This work will report back with initial findings at Budget 2010.

Facilitating investment in low-carbon infrastructure

7.22 Given the scale of the energy investment challenge, the Pre-Budget Report announces further action to support companies in accessing the necessary finance to underpin investment in low-carbon energy by establishing Infrastructure UK, to bring together commercial and financial expertise and help the Government identify and attract further investment in infrastructure, including low-carbon energy projects (see Chapter 4).

7.23 Infrastructure UK will work collaboratively with the Government to ensure the energy market framework facilitates private sector investment. A supportive framework should help investors better understand the opportunities, incentives and policy frameworks for green infrastructure. As a first step, **Infrastructure UK will support the Government in its work to ensure the energy market framework can most effectively deliver a fair deal for the consumer and the low-carbon investment needed in the long term. Their contribution will focus on the commercial and financing aspects of energy investments. This will explore, amongst other options, the case for a low-carbon investment institution**.

7.24 Infrastructure UK will also provide a route for Government investments to support the deployment of low-carbon energy infrastructure. **The Pre-Budget Report announces the Government's intention to invest €100 million (£90 million) in the 2020 European Fund for Energy, Climate Change and Infrastructure, to be overseen by Infrastructure UK**. This will establish the UK as a core sponsor of the Fund, alongside the EIB, enabling the UK to build on an already strong relationship with the EIB, and facilitate more support for vital energy projects. The innovative, diversified fund is intended to act as a model for the introduction of new private sector equity investment into key sectors including wind, biomass, gas storage, transmission and CCS. The 2020 Fund will soon start to provide equity to low-carbon infrastructure of national importance and is the fastest route open to support these projects.

The Fund plans to attract up to €1.5 billion of equity from a range of investors and has up to €5 billion (£4.5 billion) of associated debt co-financing waiting to be deployed.

Supporting investment in low-carbon innovation and manufacturing

Low-carbon manufacturing

7.25 The Government wants the UK to be a world leader in low-carbon innovation and manufacturing. As well as reducing the costs of meeting carbon budgets, this will underpin future low-carbon growth in the UK, creating new green jobs in highly skilled sectors and positioning the UK at the forefront of the export market for green technologies. In the offshore wind sector alone, this could support an additional 30,000 UK green jobs by 2020.[14] To support these aims, the **Pre-Budget Report announces**:

- **an additional £50 million investment in the development of the UK offshore wind industry, including funding for new manufacturing and testing facilities.** The Government will provide £15 million[15] at the New and Renewable Energy Centre in Northumberland to develop a world-leading UK capability for the testing of wind turbine blades, enabling businesses in the supply chain to gain affordable access to testing facilities;
- **an additional £40 million of support for the low-carbon energy and advanced green manufacturing sector in the UK,** building on the support made available to these sectors at Budget 2009. Amongst other projects, the funding will enable additional support for small-scale and community-level low-carbon energy generation; and
- **Manchester city region has been designated as the UK's fourth Low Carbon Economic Area, specialising in the built environment**. This will deliver accelerated economic growth, carbon abatement, increased employment and enhancement of the low-carbon supply chain (see Chapter 6).

Low-carbon innovation

7.26 Businesses in the low-carbon sector seeking to commercialise new innovations face several barriers, including the large scale of capital required, long lead times involved, and difficulties in capturing sufficient returns on investment. The Government has acted to support investment in the sector. The £500 million network innovation fund announced earlier this month by Ofgem will enable electricity distribution companies to make substantial investments in new technologies over the next five years. The Pre-Budget Report sets out further measures to help overcome the investment challenges that these businesses face.

Low-carbon venture capital

7.27 The Government is offering additional financial support to businesses with new technologies at the pre-commercial stage seeking to exploit opportunities in the low-carbon economy. In June 2009, the Government announced it was establishing a new equity finance vehicle, the UK Innovation Investment Fund (UKIIF) which will provide at least £125 million of targeted investment to clean technology, including low-carbon business.[16] The Government has also announced £18 million investment in venture capital through Carbon

[14] *Offshore wind power: big challenge, big opportunity*, The Carbon Trust, October 2009.

[15] From the original allocation to the low-carbon Strategic Investment Fund. This also includes £3.5 million from ONE North East.

[16] The Government has invested £25 million for low-carbon technologies in the UKIIF, which has leveraged £100 million of private sector investment.

Trust, together with existing investments, this will enable at least £160 million of private and public equity support for innovative low-carbon businesses.[17]

Growth Capital Fund **7.28** In response to the recommendations of the Rowlands review, the Government is announcing the new Growth Capital Fund which will focus on providing capital for SMEs for whom bank finance is not available or appropriate. This will help address the financing gap faced by innovative UK clean energy businesses, along with other sectors of the economy, by providing them with better access to the capital needed to grow their businesses (see Chapter 4).

Supporting energy efficiency in business

Energy and resource efficiency **7.29** Improving energy efficiency can help all businesses save money and become more competitive. Most UK businesses could save energy, reduce emissions and save money by making relatively simple changes to their processes and products. The Government seeks to support this behaviour by building a carbon price into the energy market, and by providing advice on how businesses can reduce their carbon footprint, for example through the Carbon Trust. In recognition of the upfront costs of some energy efficiency investments, Budget 2009 announced further support to small and medium-sized businesses, helping more than 500 firms to date.

Energy intensive businesses **7.30** Energy-intensive sectors have an important role to play in reducing emissions. The Government recognises the challenges that face some energy intensive users by the transition to a low-carbon economy, and is committed to ensuring that its climate change policies do not adversely damage their competitive standing relative to international counterparts. **The Pre-Budget Report announces £30 million of support focussed on the Teesside chemicals industry, to help the sector demonstrate new technologies and techniques to decarbonise their industrial processes**, which could be applied across the sector in the UK and abroad.

7.31 Climate Change Agreements (CCAs) have been an effective way to reduce emissions in energy-intensive sectors while giving the sectors a discount from the Climate Change Levy (CCL). **The Pre-Budget Report announces that from 2011 the discount obtained from the CCL by participating in a climate change agreement will be reduced from 80 to 65 per cent**, enabling the CCA scheme to continue to operate within the EU framework for energy taxation. The Pre-Budget Report also announces the entry of the plastics and laundries sectors to the CCA scheme.

Public sector **7.32** Rapid progress in reducing public sector emissions can play a valuable role in demonstrating new energy-saving and low-carbon technologies to the public. Reducing the public sector's spending on energy – currently around £3.2 billion – will improve the efficiency of delivery of public services, as well as creating business opportunities for the sector. **The Government is therefore committing to a 10 per cent saving in public sector energy spend by 2012-13, delivering savings of up to £300 million per year** (see Chapter 6).

HELPING HOUSEHOLDS WITH ENERGY COSTS

7.33 Reducing household energy bills helps consumers and reduces carbon emissions. The Government is helping all households control their energy bills through support with insulation and energy efficient heating, and advice on energy use while providing extra help for the most vulnerable. The 2008 Pre-Budget Report and Budget 2009 provided new

[17] Carbon Trust investment criteria require at least matched private sector funding, so the Government's investment of £18 million announced in October 2009 will leverage a further £18 million. Taken with the UKIIF £125 million of public and private investment, this provides £161 million in total.

resources to accelerate progress. Box 7.4 provides an update on these measures. The Pre-Budget Report sets out further action to:

- help households heat their homes using the most efficient and low-carbon technologies; and
- help the most vulnerable households with energy costs.

Box 7.4: Progress on energy efficiency and fuel poverty

The 2008 Pre-Budget Report and Budget 2009 announced £365 million additional funding for schemes that will help businesses, households and the public sector use less energy and generate low-carbon energy. As a result:

- 38,000 vulnerable households have received new efficient central heating systems, insulation and other measures as a result of additional resources allocated in the 2008 Pre-Budget Report for the Warm Front programme, with almost 235,000 households benefiting from the programme in total in 2008-09;
- cavity wall insulation is planned for 108,000 properties in the social sector by the end of 2010-11, which will save households £13 million a year;
- local authorities will build over 2,000 new energy efficient social homes through support provided at Budget 2009 and since, with construction work expected to begin early in 2010;
- fourteen low-carbon community heating schemes are being planned and constructed in London, Birmingham, Leeds, Exeter, Southampton and other communities around the country;
- energy-saving technologies have been installed in 640 small businesses and 540 projects in public sector organisations, including schools, hospitals and colleges, funded by interest-free loans averaging £30,000 to £50,000; and
- £15 million has been committed to support the installation of low-carbon energy technologies, such as solar panels and heat pumps, in more than 4,000 homes and public buildings.

Keeping energy bills low

7.34 A competitive and efficient energy market helps keep energy prices low. As wholesale energy prices have fallen, suppliers have cut prices by an average of seven per cent so far this year. The Government is keen to ensure that suppliers recognise pressures on consumers and pass on reductions in wholesale costs where possible, and for this reason asked Ofgem to report regularly on wholesale and retail prices. In line with their recent report, the Government expects retail prices to come down further and welcomes the changes being made by Ofgem to improve fairness and competitiveness in energy pricing.[18] The Government is actively monitoring the situation to see whether further action is required.

7.35 All households can take action to cut their bills by using energy more efficiently, for example installing loft and cavity wall insulation can save the average household up to £250 a year.[19] The Government's Home Energy Saving Programme has already helped 1.9 million households to be insulated since March 2008.[20] The Government's ambition is that by 2030 all homes will have undergone a whole-house retrofit.

[18] Ofgem reports can be found at http://www.ofgem.gov.uk

[19] For an average three-bedroom semi-detached house installing both cavity wall and loft insulation.

[20] Analysis by the Department of Energy and Climate Change.

Greener boiler incentive

7.36 Installing an efficient heating system can be another cost-effective way to cut household energy bills and carbon emissions, as domestic heating accounts for 13 per cent of UK greenhouse gas emissions. Replacing an older boiler with the latest efficient models can reduce a household's energy bill by around £230 a year. **The Pre-Budget Report announces a £400 incentive to help up to 125,000 households upgrade their boiler**, available to those who buy a new boiler or renewable heat unit to replace a working G-rated boiler. The Government will work with industry to launch the scheme at the earliest opportunity in 2010.

Clean energy cash-back

7.37 Households can also play a part in generating low-carbon energy by installing small-scale renewable electricity generation on site. Feed-in tariffs, worth on average £900 in 2010 for households, will provide a financial incentive to install renewable technologies, allowing homes to generate around half of their own electricity. **The Pre-Budget Report confirms that households who use renewable technology to generate electricity mainly for their own use will not be subject to income tax on feed-in tariffs**. This will save households paying the basic rate of tax £180 in 2010. If necessary, legislation to ensure this treatment will be introduced with effect from 1 April 2010.

7.38 The Government wants all households to play a part in generating renewable energy. Although feed-in tariffs and the Renewable Heat Incentive will make payments over the life of installations, low-income households may still find it difficult to meet upfront costs. Building on the experience of pilot projects for Pay as You Save financing and Warm Front, **the Government will consult next year on measures to help low-income households take advantage of clean energy cash-back**.

Help for the vulnerable

7.39 Vulnerable households need greater help. Higher energy prices have led to an increase in the number of households in fuel poverty. The Pre-Budget Report announces additional resources to help these households:

- **£150 million for Warm Front, which will help an additional 75,000 of the most vulnerable households in 2010-11**. The Warm Front programme provides heating systems and insulation to vulnerable households, and has helped over two million since its launch in 2000, including almost 235,000 households last year alone. The average household assisted saved over £300 a year as a result; and
- **an increase in the amount of help provided by energy companies from £150 million currently to £300 million a year by 2013-14**. These resources could provide discounts for an additional one million households. The Government is bringing forward new legislation to mandate the provision of this support from the end of the current voluntary agreement in March 2011. Around 750,000 households are already being helped through the voluntary agreement.

LOW-CARBON TRANSPORT

7.40 Transport plays an important role in the economy but can also have adverse environmental impacts. The Government is committed to moving towards a low-carbon transport system, through supporting the development of green technologies and providing the right signals to allow consumers to make efficient choices.[21] The Pre-Budget Report announces further measures to encourage the development and take-up of lower-emission vehicles and support the public finances while sending stronger signals through the

[21] *Low-carbon Transport: A Greener Future*, Department for Transport, July 2009.

transport taxation system. This includes a package of measures to further support the uptake of ultra-low carbon vehicles (Box 7.5).

EU emissions targets

7.41 At European level, the Government has been a strong proponent of a long-term emissions target for cars. In December 2008 the EU agreed to set binding targets on carbon emissions from new cars. This is one of the most ambitious targets in the world and is forecast to save the UK 7.6 million tonnes of carbon dioxide ($MtCO_2$) per year by 2020. The Government strongly supports the principle of similar regulation to reduce carbon emissions from vans, which is currently being proposed.

Support for the motor sector

7.42 The Government has taken temporary measures to support the transport sector during the downturn, including through the introduction of a vehicle scrappage scheme. As well as bringing forward sales and supporting the industry, the scheme has also led to the scrapping of less fuel-efficient cars – with an average of 179 grammes of carbon dioxide per kilometre (g CO_2 per km) – and the purchase of cars that are, on average, more fuel-efficient – with an average of 134g CO_2 per km. Average new car emissions in 2008 were 158g CO_2 per km.

7.43 The Government has worked with the European Investment Bank (EIB) to support the approval of loans worth £515 million to UK automotive companies for green projects this year. The Government will continue to work with the automotive sector and the EIB to help enable more companies to access EIB funding for R&D related activity in the UK.

Box 7.5: Support for low-carbon transport

The Government has committed over £15 billion to support investment in the rail network between 2009-14, including increasing capacity and a major electrification programme, both bringing passenger benefits and encouraging further shift from road to rail.

The Government has also committed £400 million of support to encourage the development, manufacture and uptake of ultra-low emission vehicles. Delivered by the Office for Low Emission Vehicles, this support is being targeted to create new jobs in a low-carbon automotive sector and to cut carbon from UK road transport.

Support includes the £30 million 'Plugged in Places' scheme, launched on 19 November, to support the development of charging infrastructure in three to six cities and regions across the UK. From 2011, consumer incentives worth £2,000 to £5,000 will be available to reduce the purchase price of electric and plug-in hybrid cars. In addition, Government support will enable 180 ultra-low carbon vans to be demonstrated in the public and private sector over the next 18 months.

To further support the development of low-carbon vehicles, Chapter 4 sets out details of **an additional £30 million, including an expansion of the Technology Strategy Board's ultra-low carbon vehicles competition.**

To encourage their use, the Government has already made electric vehicles exempt from vehicle excise duty (VED). To further encourage the purchase of electric vehicles by business, **the Government announces that, from April 2010, they will also be exempt from company car tax (CCT) for five years.** This will benefit both the companies that provide a company car, and the employees who drive them. **The Government will also exempt electric vans from van benefit charge from April 2010 for five years** supporting the purchase of electric vans for provision to employees.

Since 2002, electric cars have been eligible for a 100 per cent first-year allowance, in order to provide businesses with an incentive to buy cars with lower CO2 emissions. **The Pre-Budget Report announces that a 100 per cent first-year allowance will also be provided for the purchase of electric vans, from April 2010,** subject to confirming compatibility with state aid rules. This will help to catalyse the market for electric vans, as manufacturers continue to develop electric vehicle technology.

Transport tax

7.44 The principal role of transport taxes is to fund public services but they can also play an important role in encouraging fuel-efficient behaviour and the development of low-carbon vehicles. As part of the Government's medium-term fiscal consolidation strategy, transport taxes will be used to ensure that the burden of taxation falls in such a way as to support the transition to a low-carbon economy.

Fuel duty

7.45 Main road fuel duty rose by two pence per litre on 1 September this year. As announced at Budget 2009, fuel duty will also increase by one penny per litre in real terms on 1 April each year from 2010 to 2013. In addition to supporting the public finances in the medium-term, these increases will together save 2 $MtCO_2$ per year by 2013-14.

7.46 Budget 2008 announced that the 20 pence per litre duty differential for biofuels would cease in 2010-11, as the tax discount cannot distinguish between sustainable biofuels and those that increase greenhouse gas emissions or raise wider sustainability concerns. The Pre-Budget Report confirms that the duty differential will cease from 1 April 2010.

7.47 Support for biofuels will continue through the Renewable Transport Fuel Obligation, which provides a guaranteed demand for biofuels, with a sharper environmental focus through its carbon and sustainability reporting criteria. To support the value of biofuel production, the price for "buying out" of the Obligation will increase to 30 pence per litre from the 2010-11 obligation year. Biofuel from used cooking oil is used outside the Obligation, and is highly sustainable. **The Pre-Budget Report announces that the duty differential will continue for used cooking oil biofuel for two years.**

Vehicle excise duty

7.48 Budget 2009 confirmed reforms to vehicle excise duty (VED) for cars first registered from 1 March 2001 onwards, to encourage the purchase and manufacture of lower-carbon cars. From April 2010, new differential first-year rates of VED will be introduced, to further strengthen the environmental signal at the point of purchase. **The Pre-Budget Report announces the VED rates for motorbikes in 2010. From 1 April 2010, the top two bands by engine size will increase by £2 and £4 to £50 and £70 respectively. Rates for motorbikes in the lower bands will be frozen.**

Company car tax

7.49 Company car tax was reformed in 2002 and is now based on carbon emissions. Budget 2009 announced a number of reforms to respond to rapidly advancing vehicle technologies, as well as to support the public finances. This included indicating that, in 2012, the Government intends to remove the 10 per cent category for cars emitting 120g of CO_2 per km or less, and instead extend the system of bands so that they increase by 1 percentage point with every 5g CO_2 per km increase in emissions, from 10 per cent. **The Government can now confirm that from April 2012 the 10 per cent rate will apply to cars that emit 99g or less CO_2 per km.** This will ensure that, as EU targets come into force, bands continue to reflect advances in fuel efficiency.

Fuel benefit charge

7.50 The provision of free fuel to company car drivers provides a perverse environmental incentive. The Government is committed to increasing the fuel benefit charge multiplier – which is used to calculate the tax payable on free fuel – at least in line with inflation each year. **The Pre-Budget Report announces that to support the public finances and encourage more fuel-efficient travel, from 6 April 2010, the multiplier will increase from £16,900 to £18,000. The van fuel benefit charge – on which tax on free van fuel is payable – will also increase from £500 to £550.**

Heavy goods vehicles and road freight

7.51 Government policies continue to support the road haulage industry to increase safety and environmental performance. Hauliers will benefit from a range of Government measures on vans, including in particular the new Van Best Practice Programme, launched on 10 November; the extension of the scrappage scheme with shorter qualifying time for vans; and the 100 per cent first-year allowances for the purchase of electric vans outlined in Box 7.5. Other recent measures include the refresh of the Foreign Vehicle Data Survey, with provisional results to be published on 17 December, and the development of a new action plan on lorry parking.[22] In addition, the Graduated Fixed Penalty and Deposit Scheme allows authorities to issue on-the-spot fines to all road traffic offenders, regardless of whether they reside outside the UK or not; to date over 17,000 fixed penalty notices have been issued since 1 April 2009.

NATURAL RESOURCES AND ADAPTATION

Waste **7.52** Households and businesses generate around 100 million tonnes of waste each year. Just over half of this ends up in landfill, creating methane emissions and loss of material that could be put to more productive uses via re-use and recycling. The Government is committed to promoting sustainable waste management practices that will help reduce the impact of waste. Budget 2009 provided £10 million additional funding to divert waste from landfill through increased take-up of anaerobic digestion and in-vessel composting. Half of this funding has already been committed to projects that together will divert 200,000 tonnes of waste from landfill.

Landfill tax **7.53** Budget 2009 launched a consultation on reforms to landfill tax legislation to ensure the tax remains robust in the long term and continues to reduce the amount of waste sent to landfill. Over 100 responses were received and a summary of responses was published on 4 December.[23] The Government will now undertake further discussions with landfill operators on the proposals relating to what is a taxable disposal. Given the potentially significant impact on certain sectors of industry, the Government will also work with the relevant environmental authorities to understand in more detail the characteristics of materials the consultation proposed should no longer be covered by the lower rate of tax. Further details will be outlined in the Government response to the consultation next spring.

Single-use carrier bags **7.54** In December 2008, Britain's leading supermarkets, represented by the British Retail Consortium, entered into a voluntary agreement to reduce the number of single-use carrier bags they distribute by 50 per cent. By July 2009, retailers had achieved a 48 per cent reduction. The Government and retailers aspire to a 70 per cent reduction over the longer term. Progress will be reviewed in summer 2010.

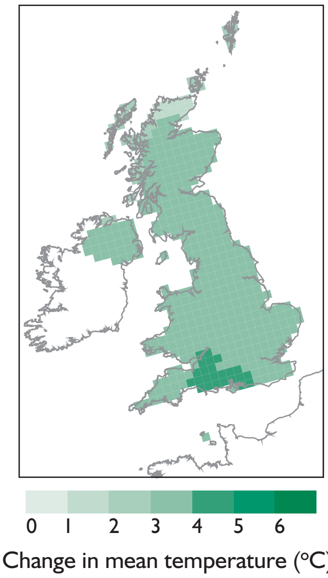
Adaptation **7.55** Cutting carbon emissions will avoid making the problems of climate change worse, but individuals, businesses and public authorities will also need to adapt to an altered climate. In July, the UK Climate Projections 2009 were published showing:[24]

- all areas of the UK will get warmer, with greater warming in summer than in winter (see Chart 7.4);
- little change in the amount of precipitation that falls annually, but likely that more of it will fall in the winter, with drier summers for much of the UK; and
- sea levels will rise, and to a greater degree in the south of the UK than the north.

[22] *Strategy for Lorry Parking Provision in England*, Department for Transport, launched on 24 November 2009.
[23] http://www.hm-treasury.gov.uk/bud_bud09_landfilltax.htm
[24] UK Climate Projections, UKCP09: http://ukcp09.defra.gov.uk/

Chart 7.4: Estimated change in summer temperature in the UK

Across the UK, estimates of the average regional summer (June, July, August) temperature rise in the 2080s are between 3 and 4°C.[1]



[1] Central estimates of temperature change in °C from the 1961-1990 baseline, (2080s, for the medium emissions scenario).

Source: UK Climate Projections 2009.

7.56 To prepare for these impacts, the Government is already investing more in flood and coastal erosion risk management, building adaptation into the planning system, and requiring priority public bodies and regulated utility companies to consider the risks from a changing climate. It has also established the Adapting to Climate Change programme in order to develop the evidence base, raise awareness and embed adaptation in Government policies and systems.[25] All Government departments will be producing Adaptation Plans by Spring 2010.

[25] http://www.defra.gov.uk/environment/climate/programme/index.htm

Table 7.1: The environmental impacts of measures in the 2009 Pre-Budget Report

Total sector savings in 2020 and measures by sector[1]	Environmental impact[2]
The Government does not plan to bank any over-achievement against first carbon budget	Ensures that any over-achievement against first carbon budget is not countered by increased emissions in second carbon budget, reducing UK's total emissions over first two carbon budget periods.
Power and heavy industry (EU ETS) – 51 $MtCO_2$[3]	
Extend increased support for offshore wind projects through Renewables Obligation	Designed to support 3 GW of investment in offshore wind, contributing to achievement of the UK's renewable energy target in the electricity sector.
Doubling commitment to four CCS demonstration plants	CCS has the potential to reduce CO_2 emissions from power stations by up to 90 per cent. Four demonstration plants will save around 6.7 $MtCO_2$ per year by 2020, comprising 2.9 $MtCO_2$ from precombustion demonstrations and 3.8 $MtCO_2$ from post-combustion demonstrations.
Infrastructure UK facilitating private sector financing of low-carbon energy investment, including overseeing Government's €100 million (£90 million) investment in EIB-facilitated equity fund, delivering more equity to support the development of low-carbon infrastructure	This will help bring forward new renewable energy projects, making a contribution to the achievement of the UK's renewable energy target in the electricity sector.
£50 million investment in UK offshore wind industry, including setting up new facilities for testing and development of offshore wind technologies	These measures are designed to help leverage additional private sector investment in the offshore wind industry, helping increase the deployment, and bring down the costs of the technology. This will make a contribution to the achievement of the UK's renewable energy target in the electricity sector.
Increasing the reduced rate of Climate Change Levy (CCL) for sectors in the Climate Change Agreement (CCA) scheme from 20 to 35 per cent across all taxable commodities, and extending CCAs to the plastics and laundries sectors	By 2010, CCL is estimated to reduce energy demand in the business and public sector by around 15 per cent a year, and reduce emissions by 12.8 $MtCO_2$ per annum. Increasing the reduced rate will provide savings of 0.2 $MtCO_2$ over the next 5 years that will contribute to the achievement of the EU ETS cap, whilst the entry of the two new sectors into the CCA scheme will provide additional savings of 0.05 $MtCO_2$ per annum.
£30 million to support the demonstration of decarbonisation technologies and techniques in the chemicals industry	This will help reduce emissions from the chemicals sector. It will support investment in new low-carbon techniques and technologies, helping to reduce future costs of tackling climate change.
Businesses and public sector – 9.2 $MtCO_2$[4]	
£40 million to support the development of low-carbon technologies including continued support for small-scale generation	This will help accelerate the development of low-carbon technologies ensuring the UK is a low-carbon technology and manufacturing hub.
Reducing public sector energy use	10 per cent reduction in public sector energy use is expected to give lifetime CO_2 savings of around 4.4 $MtCO_2$ across the traded and non-traded sectors.
Households – 12.9 $MtCO_2$[4]	
Greener Boiler Incentive	Reduced energy use as a result of old boilers being replaced by more efficient units is expected to save around 0.1 $MtCO_2$ per year by 2011-12.
Clarifying tax treatment for Feed in Tariffs	Small reduction of carbon emissions but clarification will ensure that the savings from the clean energy cash-back scheme are realised.
Social price support for energy bills	Intended to help tackle fuel poverty. Expected to lead to a small increase in emissions, due to assumed higher demand elasticity amongst low-income/fuel-poor households.
Additional support for Warm Front, providing heating and insulation to low-income and vulnerable households	Reduced energy use through energy efficiency and more efficient heating systems. Estimated savings from additional measures are 0.07 $MtCO_2$ per year in 2011-12.
Transport – 17.8 $MtCO_2$[4]	
£30 million funding for green transport projects	Investment including an expansion of the Technology Strategy Board's ultra low-carbon competition will encourage the uptake of low-carbon transport.
Extending for two years duty differential for used cooking oil biofuel	Additional support for a highly sustainable biofuel will contribute to CO_2 emissions reductions achieved through the Renewable Transport Fuel Obligation (RTFO).
Exempting electric cars from company car tax (CCT) for 5 years from 2010 and extending CCT bandings in 2012	Strengthening the incentive in CCT for businesses to own the lowest-emitting cars will help to reduce emissions in company car fleets and reward manufacturers of the cleanest vehicles, helping them to meet new EU car emissions standards.
Exempting electric vans from van benefit charge for 5 years and introducing a 100 per cent first-year allowance for business expenditure on electric vans	Encouraging business to purchase electric vans will help to reduce emissions from vans in business fleets.
Increase in fuel benefit charge (FBC) multiplier	Increasing the FBC multiplier should reduce the incentive for employers to provide unlimited free fuel to their employees, and for employees to take the fuel.
Managed motorways scheme: M1 junctions 10-13	Reduces carbon emissions per vehicle, but expected to lead to a 0.014 $MtCO_2$ increase in emissions in the year after scheme completion, due to increased vehicle kilometres travelled.

[1] *Savings in 2020 are estimated emissions savings from policies presented in Government's UK Low Carbon Transition Plan, published in July 2009. For further detail, see Tables A2, A3, A4, A5 and A6 of the UK Low Carbon Transition Plan.*
[2] *All savings come from Government modelling.*
[3] *Based on savings from the EU Emissions Trading System, Phase III. Savings from these measures contribute to achievement of the EU ETS cap.*
[4] *Savings from the non-traded sector, outside the EU ETS cap.*

A The economy

The shocks that hit the world economy in 2007 and 2008 precipitated the most severe and synchronised global recession since the Great Depression. At the end of 2008, output and trade in both advanced and emerging market economies were contracting sharply – in many cases at rates not seen in the post-war period. Output continued its steep decline in the first quarter of 2009, as global financial and trade linkages spread the downturn across the world.

The impact of the crisis on the UK economy has been larger than anticipated at Budget 2009, as output fell more sharply than expected in the first quarter of 2009 and the final quarter of 2008. The UK Government and the Bank of England, along with governments across the world, took swift and decisive action to prevent the collapse of the financial system and to support the wider economy. The significant monetary stimulus together with the Government's package of fiscal support has reduced uncertainty and helped to prevent a downward spiral of collapsing confidence and demand, lessening the severity of the recession. There are now signs that the economy is stabilising. The rate of contraction in output has eased, confidence has increased and financial conditions have improved.

Since Budget 2009, the world economy has shown signs of recovery, with rising confidence, an easing in credit conditions and a recovery in industrial production and world trade. Growth in the world economy is forecast to be 3¼ per cent in 2010, stronger than forecast at Budget 2009, rising to 4¼ per cent in 2011 and 2012.

The UK's macroeconomic policy stimulus and the recovery in world trade, reinforced by the depreciation of sterling help provide the conditions for the recovery in the UK economy. The 2009 Pre-Budget Report economic forecast is for:

- UK GDP to fall by 4¾ per cent in 2009, with the revision since Budget reflecting the weaker outturn of GDP in the first quarter of the year. From the second quarter of 2009, the GDP forecast remains broadly unchanged from that in Budget 2009. GDP growth is forecast to recover to 1 to 1½ per cent in 2010, as credit conditions ease and the macroeconomic stimulus continues to feed into the economy. Thereafter growth is forecast to rise to 3¼ to 3¾ per cent, supported by net exports and investment with the adjustment of the UK's flexible markets helping to bring the significant degree of spare capacity into use; and
- CPI inflation to rise sharply in the near term partly reflecting the pre-announced reversal of the VAT cut, before falling to 1¾ per cent in the final quarter of 2010 and to 1½ per cent towards the end of 2011, due to the large degree of spare capacity in the economy. Inflation then rises back to the Bank of England's target rate of 2 per cent by the end of 2012 as the economy recovers.

Output has fallen more sharply in the current downturn than in the early 1990s recession, but employment has held up compared with the labour market performance at that time. The ILO unemployment rate has risen from a pre-recession low of 5.2 per cent to 7.8 per cent in the third quarter of 2009. This Pre-Budget Report includes a projection for the claimant count for the first time: claimant unemployment is projected to peak around the middle of 2010, at about 1¾ million, before falling back to around 1½ million by the end of 2012.

Short and medium-term growth prospects in the UK remain subject to exceptional uncertainty and key risks include the pace and balance of the global recovery, availability of sufficient credit to support recovery, and the speed and extent of private sector deleveraging.

INTRODUCTION[1,2]

A.1 This annex discusses recent economic and financial market developments, and provides updated forecasts for the UK and world economies in the period to 2012. It begins with an overview of the global economy and prospects, which 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 the forecast issues and risks.

THE WORLD ECONOMY

Overview

Synchronised global downturn

A.2 In 2008 the global economy entered the most severe and synchronised recession since the Great Depression in the 1930s. By the end of the year, output and trade in both advanced and emerging market economies were contracting – in many cases at rates not seen in the post-war period. The high degree of synchronisation in the downturn reflects a global economy that has become more interconnected over the past two decades, with the process of globalisation leading to a significant increase in the importance of financial and trade linkages between countries.

Emerging signs of recovery

A.3 There are now emerging signs of recovery in the world economy. Confidence has increased and demand for consumer durables has stabilised. Manufacturing new orders have started to increase again in many countries although they remain at very low levels. Industrial production has picked up by more than 5 per cent from its trough in March and world trade volumes recovered in the second half of 2009.

Global financial markets

A.4 Global financial conditions have improved markedly alongside the better outlook for the world economy. Global stock markets have risen by around 30 per cent since Budget 2009, helping to reinforce business confidence, while spreads on corporate debt in advanced countries have narrowed. Access to funding markets has also improved; in the US, average monthly corporate debt issuance in the last three months has more than doubled compared with the end of 2008. In emerging markets the third quarter of 2009 saw the second largest level of bond issuance on record and, despite recent events related to Dubai World, conditions remain much better.

A.5 Notwithstanding this improvement in financial conditions, bank lending to the private sector has remained weak in the advanced economies, reflecting both supply and demand. The Senior Loan Officers' Survey in the US and the euro area show that banks' willingness to lend is only gradually improving from low levels. The demand for new loans from businesses and households in both the US and euro area remains weak.

Oil and other commodity prices

A.6 The turnaround in the world economy has raised commodity prices. Following increased volatility in 2008, oil prices fell to around $46 a barrel at the start of 2009, but have since risen to around $75-80 a barrel. Increases have not been confined to oil – food and metal prices have also risen significantly in response to increased demand from Asia, and in particular China.

[1] The UK forecast is consistent with National Accounts and balance of payments statistics to the second quarter of 2009 released by the Office for National Statistics on 29 September 2009, and the second estimate of GDP growth in the third quarter released on 25 November. A detailed set of charts and tables relating to the economic forecast is available in *2009 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.

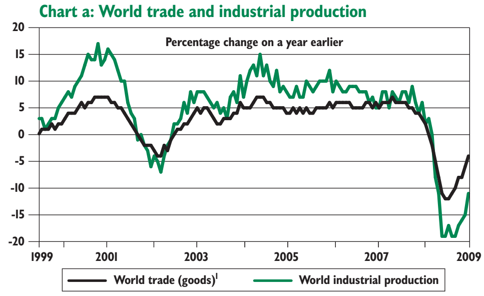
Global labour markets

A.7 Labour markets have deteriorated across advanced economies and in a number of the smaller emerging market economies. However, the depth of the deterioration has differed significantly. In the US, the unemployment rate has more than doubled during the crisis to 10 per cent, while in the EU and Japan, the unemployment rate has risen by only 2.5 and 1.3 percentage points respectively since the start of 2008. Aside from differences in labour market structure, some of the differences in experience can be explained by the introduction of employment subsidies in countries such as Germany and Japan.

Box A1: Transmission of the downturn through global trade linkages

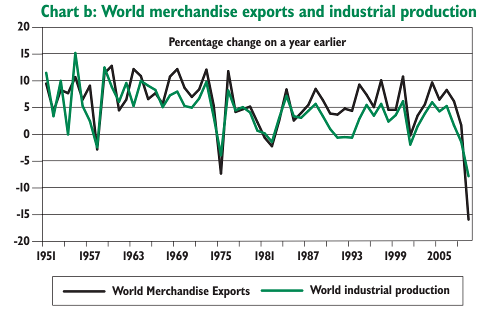
As the global downturn took hold, the combination of uncertainty over the future path of the economy and tight credit conditions led consumers to suspend purchases of durable goods and firms to cut investment. The consequent fall in world industrial production, by 12 per cent, and collapse in world trade volumes, by almost 20 per cent, was unprecedented in the post-war period. According to research by the CEPR[a], the fall in demand had an amplified effect on world trade due to the integrated nature of global supply chains. As OECD research[b] shows, and as noted in Budget 2009 Box B3, restricted access to trade financing is also likely to have played a role in amplifying the short-term response of trade to falling demand.

Chart a: World trade and industrial production



[1] Netherlands Bureau of Economic Policy Analysis.

Chart b: World merchandise exports and industrial production



[1] World Trade Organisation.

In the second half of 2009, world trade volumes have started to recover, climbing 8 per cent from their trough in May. Underlying this improvement has been the stabilisation in global demand; with global industrial production more than 5 per cent higher since March. Much of this recovery has been driven by emerging market economies such as China where stimulus measures have led to a sharp increase in economic activity – retail sales are up 16 per cent on the year and motor vehicle sales are up by over 40 per cent. While imports by advanced economies have recovered, so far growth has been relatively modest.

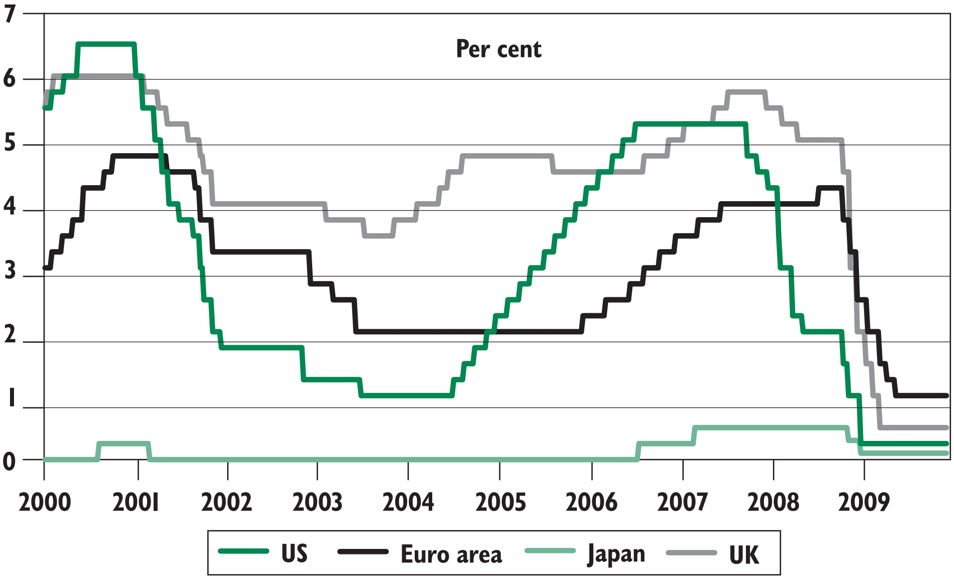
[a] *The Great Trade Collapse: Causes, Consequences and Prospects*, Baldwin, R., November 2009

[b] *Understanding the world trade collapse*, OECD working paper No. 729

The International policy response

A.8 A key factor behind the improvement in the outlook for the global economy has been the unprecedented, co-ordinated, global policy response. At the G20 London summit, Leaders agreed to act to stabilise the global financial system and promote growth in the global economy. Significant fiscal and monetary stimulus measures were put in place, alongside financial sector interventions and increased resources to support world trade and vulnerable economies in emerging markets, suffering from sharp declines in capital flows. These measures are discussed in detail in Chapter 2.

Chart A1: Official interest rates in the major advanced economies



World regional outlook

United States **A.9** The US economy returned to growth in the third quarter of 2009 after falling for four consecutive quarters in what was the deepest US recession in the post war period. The US authorities' policy response has been important to the turnaround for the economy. Official interest rates have remained historically low, additional measures by the Federal Reserve have reduced mortgage and short-term refinancing rates, and the effects of government transfers to individuals and businesses, as part of the American Recovery and Reinvestment Plan, have been seen in higher consumption and government spending.

A.10 However, the US economy still faces some headwinds to growth, as the outlook for consumption has been weakened by rising unemployment, slowing income growth, and past falls in asset prices which have damaged households' net worth. The saving rate has risen by 3.1 percentage points since the start of 2008, to 4.4 per cent in October 2009, as households have sought to repair their balance sheets. Consensus forecasts suggest that the US economy is set to contract by 2.4 per cent in 2009 before recovering to 2.7 per cent growth in 2010.

Euro area **A.11** The euro area is the UK's major export market, accounting for almost 50 per cent of UK exports, whereas the US accounts for about 17 per cent. The euro area was severely affected by the contraction in world trade at the beginning of 2009. Since then, world trade has stabilised and exports have picked up – significantly so in some countries. With a pick up in external demand, manufacturing new orders have started to increase, rising 7.8 per cent in the third quarter, and confidence is also increasing. Industrial production rose by over 2 per cent in the third quarter of 2009. Overall, the euro area grew in the third quarter of 2009, with the majority of countries returning to growth.

A.12 The euro area economy is forecast to contract by around 4 per cent in 2009, albeit recovering in the second half of the year as fiscal stimulus packages take effect, export demand picks up, and stockbuilding contributes to growth. Growth of 1¼ per cent is expected in 2010, before growth picks up into 2011 and 2012 as confidence and external demand continue to improve. However, domestic demand faces significant headwinds, not least from weak labour markets in many countries and deleveraging in some countries that is likely to weigh on credit demand even as supply conditions continue to improve.

Emerging europe **A.13** The impact of the global crisis on emerging Europe has been particularly pronounced given the region's dependence on bank finance and export demand from Western Europe, as well as the large external imbalances seen in many countries before the crisis. IMF programmes are in place for a number of countries and recent economic data show tentative signs of stabilisation in the region as demand in main export markets recovers. Notwithstanding large differences between countries in the region, the fundamentals continue to remain weak and economic recovery is likely to lag developments in Western Europe.

Asia **A.14** Of all the world's regions, Asia has been the quickest to rebound. Japan, the region's largest economy, returned to growth in the second quarter of 2009, following steep declines in output around the turn of the year. As the effects of the fiscal stimulus packages enacted during the crisis have begun to take hold along with an improvement in trade flows in the region, the near term outlook has improved.

A.15 Some countries continued to grow throughout the downturn and accommodative monetary and fiscal policies have helped boost growth this year. India grew by 7.9 per cent in the third quarter of 2009 compared with a year earlier, and China by 8.9 per cent. The initial rebound in China has largely been driven by the stimulus package introduced last November worth around 6 per cent of GDP and set to be in place until the end of 2010. Spending on investment projects, strong credit growth and tax incentives have helped to boost domestic demand significantly. This has kept growth close to pre-crisis levels despite a deterioration in export demand. Consensus forecasts for China are for 8.5 per cent growth in 2009 and 9.6 per cent growth in 2010.

Commodity exporting countries **A.16** Economies reliant on income from commodity exports were hit by the slump in prices earlier this year. In Latin America, GDP is set to contract by 2.1 per cent in 2009 according to consensus expectations, compared with 4.2 per cent growth in 2008. Russian output fell by 8.9 per cent in the third quarter of 2009 compared to the previous year. As policy measures and recent commodity price increases feed through, growth is set to recover in 2010.

Prospects for the world economy

World growth **A.17** Given the opposing factors of a severe global downturn and an unprecedented international policy response, prospects for the world economy remain uncertain. Although by less than at Budget 2009, the world economy is still forecast to contract by 1 per cent in 2009. The contraction has been most severe among the advanced economies and although the second half of 2009 is likely to see an improvement, G7 GDP is forecast to contract by 3½ per cent in 2009. As the policy stimuli announced earlier this year by advanced and emerging market economies feeds through fully, the world economy is forecast to grow by 3¼ per cent in 2010, before rising to 4¼ per cent in 2011 and 2012.

G7 inflation **A.18** The outlook for inflation among the G7 economies remains weak. Large output gaps in several economies are expected to weigh down on inflation, despite the forecast recovery in demand in 2010. Inflation in the G7 is forecast to slow to ¼ per cent in 2009 before rising to 1½ per cent in 2011.

Table A1: The world economy

	Percentage change on a year earlier, unless otherwise stated				
		Forecast			
	2008	**2009**	**2010**	**2011**	**2012**
World GDP	3¼	–1	3¼	4¼	4¼
Major 7 countries[1]:					
Real GDP	¼	–3½	1¾	3	3¼
Consumer price inflation[2]	1¾	¼	1¼	1½	1¾
Euro area GDP	½	–4	1¼	2¼	2½
World trade in goods and services	3	–12¼	2½	5½	7¼
UK export markets[3]	2¼	–11¼	2½	4	6¼

[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.*

World trade and UK export markets

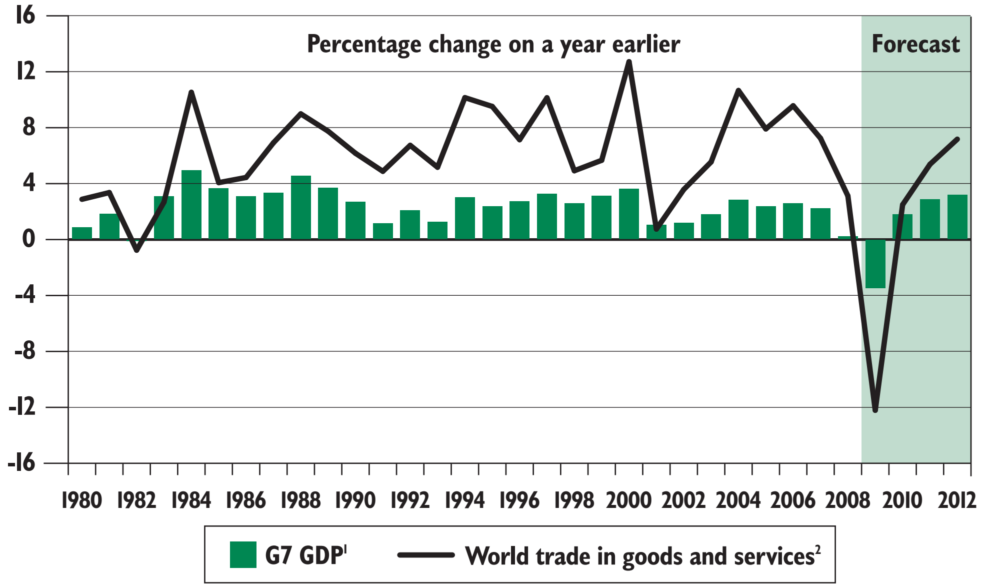
World trade

A.19 With the stabilisation in industrial production and the improved conditions for trade finance, partly as a result of G20 commitments, world trade has started to recover in recent months. World goods trade data from the Netherlands Bureau of Economic Policy Analysis show that in the third quarter of 2009, world goods trade volumes rose over 4 per cent on the previous quarter, the first quarterly increase since the start of 2008.

UK export markets

A.20 UK export market growth is a measure of world trade weighted to reflect the geographical pattern of UK exports. In recent years, UK export markets have grown more slowly than world trade as the majority of UK trade is with other advanced economies, where trade growth has been slower than among emerging markets. However, the synchronised nature of the downturn has meant that trade among advanced economies has fallen more in line with global trade. As a result UK export markets are forecast to move more closely in line with world trade and contract by 11¼ per cent in 2009. Growth in UK export markets is forecast to resume with 2½ per cent in 2010, before rising to over 6 per cent in 2012, close to its long-term average.

Chart A2: G7 GDP and world trade



[1] *Real GDP (Major 7 countries) at constant prices.*
[2] *HM Treasury estimates based on OECD data.*

THE UK ECONOMY

Overview of recent developments

A.21 Since Budget 2009, the impact of the financial crisis on the UK economy has been more severe than forecast, as a collapse in confidence and demand around the turn of the year led to a sharper than anticipated fall in output. Decisive interventions by governments around the world have helped to contain the crisis and reduce the severity of the downside risks to the economy.

GDP growth

A.22 Along with other leading economies, the UK entered recession in the first half of 2008. The intensification of the global financial crisis following the collapse of Lehman Brothers in September 2008 led to a collapse in confidence and a further reduction in the availability of credit. As a result, output fell sharply in the final quarter of 2008 and following ONS data revisions, the fall in output was greater than anticipated at Budget 2009.

A.23 The deterioration in global economic demand at the end of 2008 triggered an involuntary build up in stocks, which firms unwound rapidly towards the end of the year, depressing growth. As confidence declined, output contracted by 2.5 per cent over the first quarter of 2009, the largest quarterly fall in over forty years.

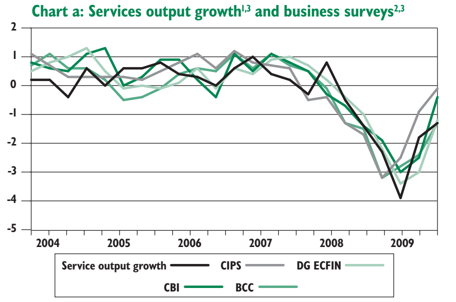
A.24 Since then, the pace of decline has eased, in line with the Budget forecast, as the substantial macroeconomic stimulus in place has increasingly taken hold.

A.25 A broad range of economic data suggests activity has stabilised in recent months. Business optimism indicators have picked up, retail sales continue to rise and the level of employment rose in the third quarter of 2009. House price indicators have consistently shown monthly gains and the latest Royal Institute of Chartered Surveyors (RICs) survey reported further increases in its stock to sales ratio – a leading indicator of future price movements. The Chartered Institute of Purchasing Managers' indices (PMI) have also picked up in recent months indicating a recovery in output growth.

Box A2: Indicators of GDP growth

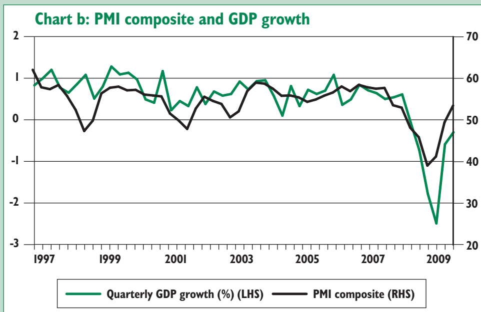
Over recent quarters, preliminary estimates for GDP growth have been consistently below market expectations. This partly reflects a tendency for external commentators to use past relationships between business surveys and GDP data to inform their short-term forecasts. While business surveys tend to correlate closely with GDP growth over the economic cycle, this relationship is likely to be weaker around turning points. This may be due to the way surveys are constructed, as respondents compare current levels of activity with an earlier period and the survey reports the average of these responses. The reported figure therefore reflects the breadth of the changes in output across businesses, but not its depth, and so such surveys may not fully capture the change in GDP when output is falling or rising more sharply than usual.

Chart a: Services output growth[1,3] and business surveys[2,3]



[1] Quarterly growth in private, non-distributive services output.
[2] CIPS Services Business Activity; BCC services home and export sales; CBI services volume of output; and DG ECFIN services demand.
[3] Standard deviation from 1999Q1-2009Q3 mean.

Chart b: PMI composite and GDP growth



There has also been some variation in the strength of different surveys. Recent ONS data seem more consistent with the British Chambers of Commerce (BCC) than with the PMI readings. Nonetheless, all the surveys have demonstrated a marked improvement in activity since the spring, confirming evidence from a broad range of other data (see paragraph A.25).

Table a: Revisions to recent quarterly GDP data

	2008Q4	2009Q1	2009Q2	2009Q3
Consensus forecast[1]	–1.2	–1.5	–0.3	0.2
Preliminary estimate	–1.5	–1.9	–0.8	–0.4
First Quarterly National Accounts[2]	–1.6[3]	–2.4	–0.6	
Latest estimate	–1.8	–2.5	–0.6	–0.3

[1] *Average of independent forecasters, as surveyed by Bloomberg prior to the preliminary estimate.*
[2] *Released around two months after the preliminary estimate.*
[3] *Latest data available at Budget 2009.*

As further information becomes available, revisions may bring official GDP data more into line with survey indicators. Preliminary estimates of GDP, in particular, tend to be revised as over half of the information contained in the first release are based on ONS forecasts rather than actual data, such as output of the construction sector.

Inflation **A.26** Consumer price inflation has fallen back from its peak of 5.2 per cent in September 2008, as forecast at Budget 2009. However, the decline in inflation has been less than expected due to higher oil prices and greater than expected pass-through from sterling's depreciation to goods with a high import content. CPI inflation rose to 1.5 per cent in October.

A.27 RPI inflation has been below zero since March 2009, due to declines in house prices and the lagged feed-through from the fall in Bank Rate to mortgage interest payments. These housing components are not included in the CPI and have driven the large difference between the RPI and CPI measures of inflation. As part of the annual update of the basket of goods and services that underpin CPI and RPI by the ONS, the UK Statistics Authority has endorsed a proposed change to the interest rate measure used in the calculation of mortgage interest payments in the RPI from a Standard Variable Rate to an Average Effective Rate[3].

Credit conditions

A.28 No single measure captures the transmission of the global crisis and its implications for credit conditions, but a good indicator of risk in the wholesale markets is the spread of interbank lending rates over market expectations of policy rates. Following the Government's interventions in the banking system during 2008 and 2009, and monetary easing by the Bank of England, this spread has fallen substantially, from an average of more than 200 basis points in October 2008, to an average of 19 basis points in November 2009.

A.29 However, as discussed in the 2008 Pre-Budget Report, this spread only captures one part of the price of credit to the real economy. While lower Bank Rate has reduced the absolute price of bank loans faced by households and companies, the spread between rates for new lending to households and small and medium sized companies over policy rates has widened and the availability of credit remains restricted. However, the latest Bank of England *Credit Conditions Survey* suggests some increase in credit availability to corporates is expected over the next three months.

Credit growth

A.30 Lending to households and private non-financial companies (PNFCs) has been weak in 2009. The stock of secured lending to households grew by less than 1 per cent and the stock of lending to PNFCs fell during 2009. However, the decline in lending to PNFCs in percentage terms is similar to that seen in the 1990s recession. According to the Bank of England Lending Panel, proceeds from capital market issuance by larger firms have been used to pay back bank debt.

A.31 The Government has carried out a series of interventions in the financial system, aimed at tackling problems at individual institutions; addressing system-wide instability; and getting credit flowing through the economy once more. In particular, the Bank of England's programme of quantitative easing, which involves buying assets financed by the creation of central bank money, has helped prevent further falls in liquidity outside of the banking system. See Chapters 2, 3 and 4 for more discussion on these actions and further measures in support of the economy.

THE UK ECONOMY FORECAST

The Treasury's approach to economic forecasting

A.32 Economic forecasting inevitably involves judgement about the uncertain path of future events and also about the current position of the economy.

Growth cycle approach

A.33 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

[3] The UK Statistics Authority plans to reach a final decision on the proposed change in January 2010 following public consultation as well as discussions with the Bank of England, and if required with the Chancellor, under the provisions of the relevant part of the Statistics and Registration Service Act 2007.

[4] See paragraph 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.

analysis of individual output, income and expenditure components of activity, informs the judgement on the path of the economy back towards trend. At a time when large shocks have hit the economy, these estimates and analyses are particularly challenging and the judgement they inform is very uncertain. For the 2009 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.

Assessment of trend growth

A.34 As set out in the 2008 Pre-Budget Report and Budget 2009, the global financial shock has significantly increased the uncertainties surrounding the prospects for trend output. In principle, the shock could affect trend output in a number of ways. For example, a higher cost of credit may impact on the trend level of output by reducing the sustainable level of capital, while the reduction in the supply of credit more generally may impair the role of the financial sector in efficiently allocating resources and spreading risk.[6] Hence Budget 2009 assumed a phased reduction of the level of trend productivity of around 4½ per cent between mid-2007 and mid-2010.

A.35 In light of a potentially weaker outlook for net migration, Budget 2009 also assumed a downward adjustment to the population component of trend output of around ½ per cent between mid-2007 and mid-2010, bringing the net migration assumption for these years into line with the assumptions underpinning the ONS' 2006-based low migration variant.

A.36 Official and administrative migration data released since Budget 2009 support the possibility of a slowdown in net migration inflows. ONS estimates indicate that net migration into the UK fell by 70,000 to 163,000 in 2008, broadly in line with the level of net migration implied by the adjusted trend population assumptions. National Insurance numbers allocated to non-UK nationals and the number of approved applications to the Worker Registration Scheme have also fallen back sharply. The ONS' latest 2008-based population projections, published on 21 October, assume slightly weaker net migration than the previous 2006-based projections. However, the ONS' principal projection for net migration remains slightly stronger than that implied by the Treasury's trend population projection.

2009 Pre-Budget Report assumptions

A.37 Table A2 sets out the 2009 Pre-Budget Report assumptions for trend output. Consistent with Budget 2009, the 2009 Pre-Budget Report assumes a phased reduction to the level of trend output of around 5 per cent between mid-2007 and mid-2010. Beyond mid-2010 the growth rate of trend output is assumed to return to 2¾ per cent, in line with the rate observed over the half-cycle between 2001Q3 and 2006H2. The downward adjustment to trend output of around 5 per cent is broadly in line with recent external estimates, as well as analysis of the impact of previous financial crises (see Box A3). Nevertheless, the size and timing of the adjustment to trend output remains subject to significant uncertainty.

[6] See Box B4 of Budget 2009 for more details of the ways in which the global financial shock may affect trend output.

Table A2: Contributions to trend output growth[1,2]

	Estimated trend rates of growth, per cent per annum, unless otherwise stated					
	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 2009	2.13	1.95	–0.11	0.36	0.26	**2.47**
Latest data	2.13	1.95	–0.11	0.36	0.26	**2.47**
Over the recent past 1997H1 to 2001Q3						
Budget 2009	3.12	2.87	–0.46	0.50	0.52	**3.45**
Latest data	3.12	2.88	–0.46	0.50	0.52	**3.45**
2001Q3 to 2006H2						
Budget 2009	2.12	2.07	–0.26	0.11	0.75	**2.68**
Latest data	2.23	2.18	–0.26	0.11	0.75	**2.80**
Projection[6] 2006H2 onwards						
Budget 2009	2.25	2.3	–0.25	–0.10	0.80	**2¾**
Level effect: from 2007Q3 to 2010Q3[7]	*–4½*	*–4½*	*0*	*0*	*–½*	**–5**
PBR 2009[8,9]	2.23	2.3	–0.20	–0.15	0.80	**2¾**
Level effect: from 2007Q3 to 2010Q3[7,8]	*–4½*	*–4½*	*0*	*0*	*–½*	**–5**

[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 the 2008 Pre-Budget Report are set out in 'Budget 2008: the economy and public finances – supplementary material', *and the* 2008 Pre-Budget Report.

[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 (LFS). Population aged 16 and over.

[6] Neutral case assumptions for trend from 2006H2.

[7] Adjustment reflecting a phased reduction to the level of trend output of around 5 per cent between mid-2007 and mid-2010.

[8] Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006H2 are anchored.

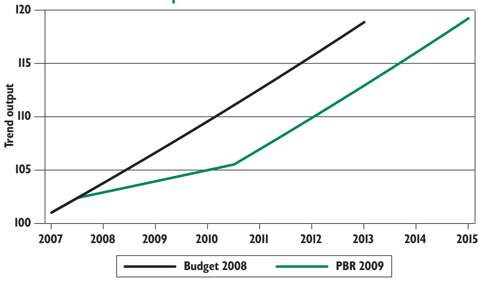
[9] Within the trend growth projection, small offsetting adjustments have been made to the projections of the individual components of trend growth for the 2009 Pre-Budget Report. In particular, the assumed decline in trend average hours has been adjusted up marginally from -0.25 per cent to -0.2 per cent in light of evidence pointing to a slowing in the pace of reduction in average hours prior to the downturn. An offsetting downward adjustment has been made to the trend employment rate projection from -0.1 per cent to -0.15 per cent per annum.

Box A3: Impact of the financial crisis on trend output

Consistent with Budget 2009, the 2009 Pre-Budget Report assumes a downward adjustment to the economy's trend level of output in light of the global financial shock. Chart a illustrates this trend assumption and compares it to the unadjusted trend output projection assumed for Budget 2008. For the 2009 Pre-Budget Report, the level of trend output is gradually adjusted from the middle of 2007 so that it is around 5 per cent lower from the middle of 2010 than the level implied by the Budget 2008 assumption.

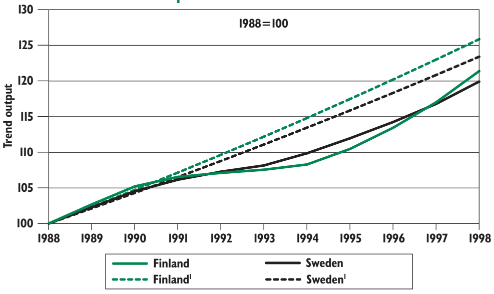
This adjustment is comparable to the range of recent external estimates. In their latest Economic Review, NIESR[a] present estimates of the impact of the financial crisis on the UK's sustainable level of output of 3 to 5 per cent, while scenarios published by the European Commission point to an impact on EU potential output of up to 4½ per cent.[b] Similarly, the OECD's latest Economic Outlook assumes an average trend output adjustment of 3½ per cent across the OECD[c].The 2009 Pre-Budget Report trend output adjustment is also broadly in line with the average output loss from previous financial crises reported in recent analysis by the IMF, based on the application of the IMF's methodology to UK data[d].It is also consistent with a number of previous episodes, including the period following the 'Nordic' financial crises in the early 1990s, with a downward adjustment to the level of trend output before reverting to the economies' pre-crisis trend growth rates (Chart b).

Chart a: Trend output[1]



[1] Adjusted PBR 2009 neutral trend growth assumptions consistent with annual trend growth rates of 2¾ per cent (2007); 1¼ per cent (2008); 1 per cent (2009); 1 per cent (2010); 2½ per cent (2011); 2¾ per cent (2012); 2¾ per cent (2013); and 2¾ per cent (2014).
Source: HM Treasury.

Chart b: Trend output: Nordic crises



Source: OECD Economic Outlook database.
[1] Extropolation of 1985-1990 average trend growth rate.

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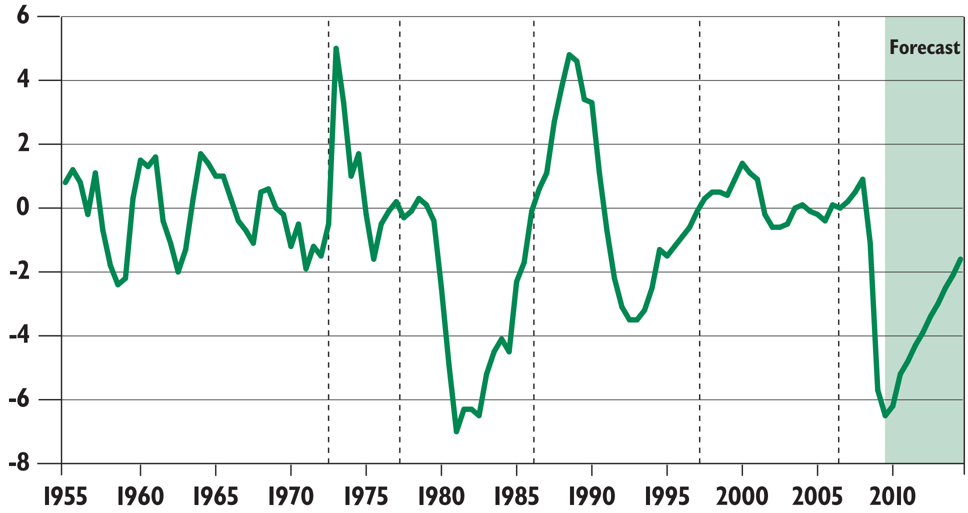
[a] *Long-term scarring from the financial crisis*, Barrell, R. in NIESR Economic Review, Vol.210, October 2009
[b] *Impact of the current economic and financial crisis on potential output*, European Commission, European Economy Occasional Paper No.49, June 2009.
[c] *OECD Economic Outlook No. 86 (Preliminary edition)*, OECD, November 2009.
[d] *World Economic Outlook October 2009: Sustaining the Recovery*, IMF, October 2009.

Assessment of the output gap

A.38 The output gap is the difference between actual output and the assumed trend level of output in the economy. Taken together with the 2009 Pre-Budget Report trend output assumptions, the latest National Accounts data imply a significant negative output gap opened up in 2009, reaching over –6 per cent in the third quarter of 2009.

Chart A3: The output gap[1,2]



[1] *Mechanical output gap estimates on a semi-annual basis, based on the latest National Accounts data and expressed as actual output less trend output as a percent of trend output (non-oil basis). Estimates post-1972 based on Treasury's assessment of on-trend points using a broad range of economic indicators as set out in 'Evidence on the economic cycle', published alongside the 2008 Pre-Budget Report. Estimates prior to 1972 derived using a Hodrick-Prescott filter as sufficient data from the cyclical indcators monitored by the Treasury are not available to assess on-trend points for this period.*
[2] *Vertical lines indicate start and end-cycle points as identified by HM Treasury.*

A.39 Evidence from the cyclical indicators monitored by the Treasury suggest the economy fell below trend during the second half of 2008. Survey evidence also suggests the degree of spare capacity subsequently increased markedly towards the end of 2008 and the beginning of 2009. However, there is uncertainty about the current estimate of the output gap. Some survey indicators suggest a moderation in the degree of spare capacity over the third quarter of 2009:

- Capacity utilisation indicators from the British Chambers of Commerce Quarterly Economic Survey rose in the third quarter of 2009 although the indicators remain below their long-term averages. However, indicators of capacity utilisation from the Confederation of British Industry (CBI) Industrial Trends Survey and the Bank of England's Regional Agents suggest a larger degree of spare capacity.

- While survey indicators of recruitment conditions showed some rises in the third quarter of 2009, there remains a degree of slack in the labour market. The unemployment rate has increased from 5.5 per cent in the second half of 2006 to 7.8 per cent in the third quarter of 2009 and the number of vacancies in the economy have declined from their peak of almost 700,000 in early 2008 to around 430,000 over the third quarter of 2009, indicating a significant degree of labour market slack.

A.40 The differences in the degree of slack implied by these alternative approaches reflects the significant uncertainties over the size of the total impact of the financial crisis on trend output; and measurement issues associated with survey indicators and National Accounts data.

GDP AND INFLATION FORECAST

Forecasting judgement

A.41 The 2009 Pre-Budget Report economic forecast reflects the balance of key forecasting considerations relating to the strength of the negative effect of the global financial crisis and private sector retrenchment, and the positive effect of continued macroeconomic policy stimulus, both domestically and internationally, on growth.

A.42 The 2009 Pre-Budget Report economic forecast is conditioned on the following assumptions:

- the G20 authorities continue to deliver on policy commitments which are effective, so that the world economy is forecast to grow by 3¼ per cent in 2010, picking up further to 4¼ per cent in 2011 and 2012;
- the Government's financial sector interventions continue to improve the flow of credit, so that the volume of credit available supports recovery; and
- the shape of the recovery in the UK economy embodies an orderly adjustment in the sectoral financial balances and a rebalancing of domestic and external demand supported by sterling's depreciation.

Uncertainty in the forecast

A.43 Given the impact of the global financial market shock and the scale of the global macroeconomic and financial policy response, these judgements and assumptions are subject to uncertainty. 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, and in more detail in the section on forecast issues and risks at the end of this Annex.

Macroeconomic stimulus

A.44 Significant monetary policy stimulus remains in place. The Monetary Policy Committee (MPC) has kept Bank Rate at ½ per cent since March, and continued with its programme of asset purchases financed by the issuance of central bank reserves. At the request of the MPC, the Chancellor authorised an increase in the upper limit of the Asset Purchase Facility to £200 billion in November, which the MPC intends to complete by the end of January 2010.

A.45 The Government and the Bank of England also carried out a series of interventions, which have been successful at preventing the collapse of the financial system and the Government is providing significant fiscal support to aggregate demand. Further detail on the measures taken by the Government can be found in Chapters 2 and 3. As confidence in the recovery grows and financial sector conditions continue to improve, it will become possible to tighten fiscal policy gradually to facilitate the rebalancing of private and public sector contributions to demand.

GDP growth

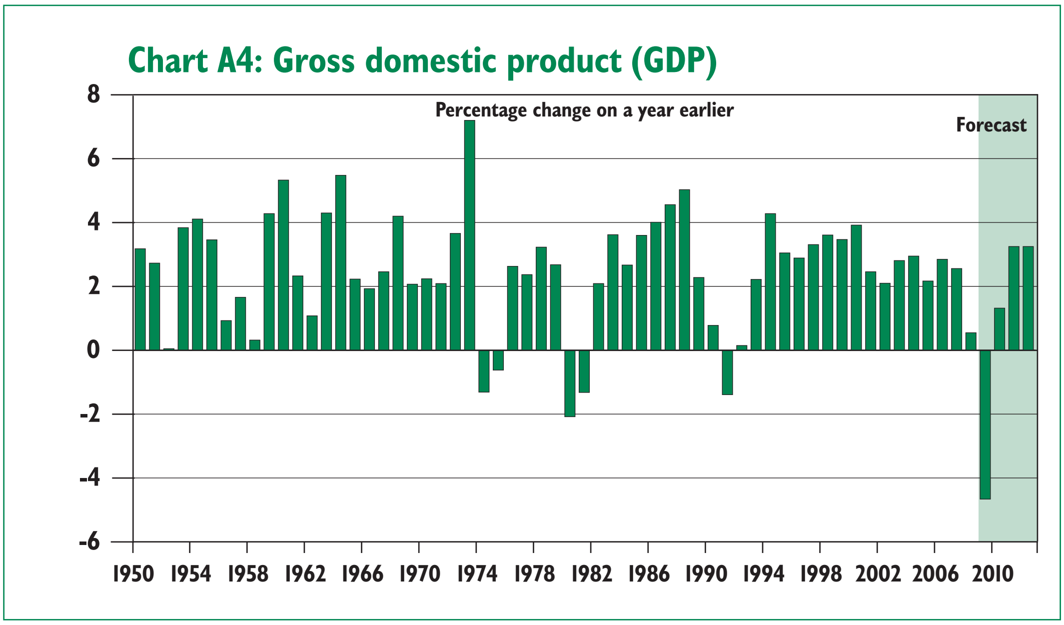
A.46 The rate of decline in GDP slowed in the second and third quarters of 2009, in line with the Budget 2009 forecast, but the contraction of 2.5 per cent in the first quarter was much larger than expected. The 2009 Pre-Budget Report economic forecast is for GDP to contract by 4¾ per cent over the year in 2009, larger than the 3½ per cent forecast at Budget 2009. However, given signs of stabilisation in recent economic data, growth is expected to return by the end of the year.

A.47 GDP growth is forecast to pick up through 2010 and 2011, as credit conditions continue to ease and the continuing and lagged effects of the significant monetary policy support, and the depreciation of sterling take hold.

Table A3: Summary of forecast

			Forecast		
	2008	2009	2010	2011	2012
GDP growth (per cent)[1]					
Upper end of forecast range			1½	3¾	3¾
Economic forecast	½	–4¾	1¼	3½	3½
Forecast underpinning public finance projections			1	3¼	3¼
CPI inflation (per cent, Q4)	4	2	1¾	1½	2

[1] *See footnote to Table A9 for explanation of different growth assumptions.*



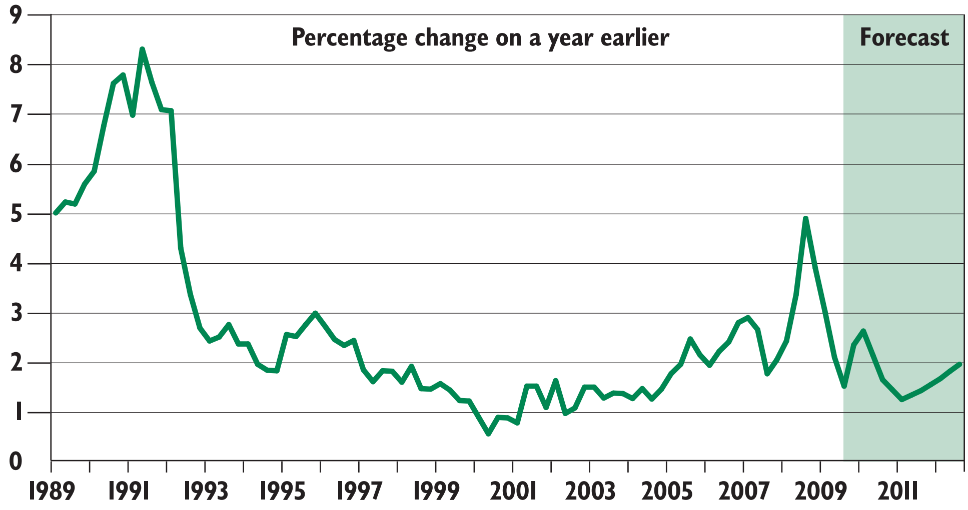
A.48 As discussed at Budget 2009, it is usual for GDP growth to pick up in a recovery as spare capacity is brought back into productive use. For example, as Chart A4 shows, GDP growth was strong in the five years from 1982 and again in the five years from 1993, averaging 3¼ per cent a year. Indeed, the rate at which the output gap is assumed to close over the projection period is comparable to the rate observed following the recession of the early 1990s, and slightly slower than the rate observed following the recession of the early 1980s (see Chart A3).

CPI Inflation

A.49 CPI inflation is expected to continue to rise in the near term, as the pre-announced reversal of the cut in the VAT rate back to 17.5 per cent in January 2010 will be anticipated by businesses, and fuel prices are expected to remain above the lows of early 2009. The forecast assumes that businesses will smooth the pass-through of the reversal of the VAT rate cut, with inflation peaking in early 2010.

A.50 After these temporary upward pressures have passed, inflation is forecast to fall through 2010 and in 2011, moving well below target, as the large negative output gap exerts downward pressure on prices. Reflecting this large degree of spare capacity, subdued earnings growth is also expected to exert downward pressure on inflation. As the economy recovers, with the economy growing at above-trend rates, increases in capacity utilisation will place upward pressure on inflation with CPI inflation rising back to target by the end of 2012.

Chart A5: CPI[1]



[1]Outturns until 2009Q3; forecasts for every second quarter from 2009Q4 to 2012Q4.

RPI Inflation

A.51 Although subject to the same factors shaping the profile for CPI inflation, RPI inflation is forecast to turn positive and then rise more rapidly with the additional upward pressure from rising house prices and large reductions in mortgage interest payments falling out of the annual comparison.

LABOUR MARKET

Unemployment and employment

A.52 Demand for labour weakened through the second half of 2008 and into 2009, as firms sought to cut costs. Flexibility within the labour market, coupled with measures to support firms' cash flow, may have limited job losses through the recession (see Box A4). However, as output fell sharply in early 2009, redundancies rose to around 300,000 per quarter, employment fell back and the ILO unemployment rate increased to 7.8 per cent. More recently, increases in ILO unemployment have eased substantially: in the third quarter of 2009, ILO unemployment rose by 30,000 – well below the rise seen during the first half of the year – to just under 2.5 million. Similarly, following the record monthly increase seen in February 2009, increases in the claimant count have moderated, averaging less than 19,000 per month in the three months to October, when the number of unemployed claimants rose to 1.64 million.

Average earnings

A.53 Average earnings growth has slowed markedly over the past year and pay settlements have eased. Private sector earnings growth on a year earlier (excluding bonus payments) has fallen from around 3¾ per cent in mid-2008 to 1½ per cent in the three months to September 2009 – the lowest rate on record. Initially the slowdown was driven by weaker pay drift, but through 2009 around one-third of pay settlements have been at zero, weighing down on nominal earnings growth.

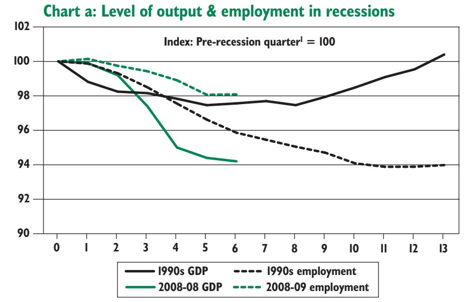
A.54 Although firms are no longer laying employees off in substantial numbers, vacancies have not increased from the lows recorded in recent months. Moreover, firms continue to expand part-time employment rather than full-time contracts. Private business surveys of employment intentions – such as those produced by Manpower and the British Chambers of Commerce – suggest that employers are likely to remain tentative in the near term.

Prospects **A.55** The claimant count is forecast to continue to rise, peaking at about 1¾ million around the middle of 2010 with the lag between output and employment much shorter than before. As the economic recovery takes hold, employment is forecast to rise and unemployment to fall. While a recession can put upward pressure on the structural rate of unemployment, evidence from the OECD[7] indicates that this is less likely to persist in countries with flexible product and labour markets such as the UK. The investment in employment support since 1997 coupled with additional funding put in place through the current downturn, has maintained off-flow rates from the claimant count above those seen in the previous recession. Taking all these factors into account, the claimant count is projected to fall back to around 1½ million by the end of 2012.

Box A4: Recessions and the labour market

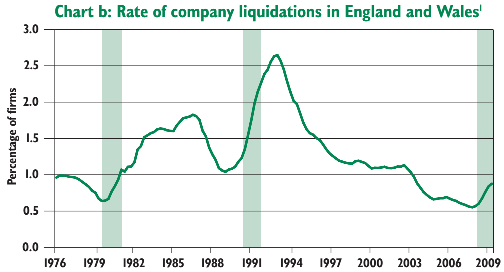
Output has fallen more sharply in the current downturn than in the early 1990s recession, but employment has held up relative to the labour market performance at that time and compared to expectations at the start of this recession (Chart a). A number of factors may have helped support employment through the current recession.

Chart a: Level of output & employment in recessions



¹ Pre-recession quarter=1990Q2 for 1990s GDP and employment curves. Pre-recession quarter=2008Q1 for 2008-09 GDP and employment curves.

Chart b: Rate of company liquidations in England and Wales[1]



¹ Calculated from company liquidations in the latest twelve month period divided by the average number of companies in that period. As from Q2 2008, register figures supplied by Companies House are counted at the end of each calendar month; previously they were monthly averages.

Firms and employees have reacted to the recession flexibly. Firms have succeeded in lowering total compensation of employees by agreeing shorter working hours, acting to freeze pay in nominal terms and reducing non-wage labour costs, while also laying off some workers. Individuals in the labour market have taken part-time employment as an alternative to unemployment. Part-time employment has risen over the course of the recession and at the same time the proportion of part-time employees saying they would prefer full-time employment has also increased. This flexibility is likely to have supported aggregate employment in the face of sharp declines in output. The substantial reforms to Jobcentre Plus and Jobseeker's Allowance since the late 1990s, and the additional funding for Jobcentre Plus and the extension of the Rapid Response Service announced in the 2008 Pre-Budget Report and Budget 2009 have helped to ensure the unemployed do not become detached from the labour market. At present, around half of claimants move off Jobseeker's Allowance within three months of making a claim.

The relatively modest decline in employment in the UK could also be due to a smaller rise in the proportion of firms going into liquidation compared with the 1990s recession (Chart b). The Bank of England have noted[a] this could be due in part to the extensive support the Government has provided for business cash flow through the tax system and spending measures since the 2008 Pre-Budget Report, as set out in Chapter 4.

With fewer people losing their jobs, there has also been a smaller than expected rise in mortgage repossessions. This has helped to reinforce the confidence of mortgage lenders, breaking the potential adverse feedback loop of lower asset values and lower lending.

[a] *Inflation Report*, Bank of England, November 2009.

[7] *OECD Economic Outlook No.86*, OECD, November 2009.

UK DEMAND AND OUTPUT IN DETAIL

Shape of the recovery

A.56 Private sector demand contracted significantly in the second half of 2008 and the first half of 2009. During this period, government spending has continued to contribute positively to growth, and accommodative macroeconomic policy is expected to boost private sector demand through 2010, helping smooth adjustment towards a more balanced economy. From next year onwards, as the economy moves to a more balanced composition of demand and confidence returns, private demand is expected to grow at above trend rates.

A.57 Macroeconomic adjustment is likely to entail increased investment by firms as they respond to new opportunities, and a rebalancing of domestic and external demand. In the third quarter of 2009, business investment levels were around three quarters of their previous peak. But as private sector demand becomes both stronger and less uncertain, and credit conditions continue to ease, investment is expected to rebound and so to contribute around 1 per cent to GDP growth in 2011 and 2012. Net trade is forecast to contribute ½ per cent to growth each year from 2010, reflecting a recovery in world demand, gains in export competitiveness and consumers substituting towards UK produced goods.

Table A4: Contributions[1] to GDP growth[2]

	Percentage points, unless otherwise stated					
	Average		Forecast			
	2000 to 2007	2008	2009	2010	2011	2012
GDP growth, per cent	**2¾**	**½**	**–4¾**	**1 to 1½**	**3¼ to 3¾**	**3¼ to 3¾**
Main contributions						
Private consumption	1¾	½	–2	¼	2	2
Business investment	¼	¼	–2	–¼	1	1¼
Dwellings investment[3]	¼	–½	–¾	0	¼	¼
Government[4]	¾	1	1	¼	–1	–¾
Change in inventories	0	–½	–1¼	¾	½	0
Net trade	–¼	½	¾	½	½	½

[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 improvement to dwellings.*
[4] *The sum of government consumption and general government investment.*

Households and consumption

A.58 Household consumption is the largest expenditure component of demand, accounting for around 64 per cent of nominal GDP in 2008. Between 2001 and 2008, the consumption share remained stable. However, since households received a declining share of national income, growth in consumption was maintained by spending a larger proportion of their income, with a fall in the household saving ratio from a high of 6 per cent in 2001 to 1.7 per cent in 2008.

Table A5: Household sector[1] expenditure and income

	Percentage change on a year earlier, unless otherwise stated					
			Forecast			
	Average 2000 to 2007	2008	2009	2010	2011	2012
Household consumption[2]	3	1	–3	0 to ½	2¾ to 3¼	2¾ to 3¼
Real household disposable income	2¼	2	1½	3¼ to 3¾	2¼ to 2¾	1½ to 2
Saving ratio[3] (level, per cent)	4¼	1¾	5¼	8	7½	6½

[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.59** In 2009 there have been a number of competing influences on disposable income. Real income growth has slowed due to very weak growth in wages and salaries and lower interest receipts, but it has been supported by lower mortgage payments, falling inflation and fiscal support from the tax and benefits system. Overall, real disposable income in the second quarter of 2009 was slightly higher than the year before.

A.60 Real incomes will continue to be supported by the automatic stabilisers throughout next year with real terms uprating of benefits. As the labour market recovers, the contribution of the automatic stabilisers will diminish as wage growth and employment picks up.

Consumer spending **A.61** Consumer spending growth fell from 2.1 per cent in 2007 to 1 per cent in 2008, with consumption falling sharply towards the end of 2008. Household consumption fell by almost 2½ per cent in the first half of 2009, as discretionary expenditure declined. The consumption of durable goods recovered in the second quarter after falling slightly at the beginning of 2009. Sales may have been supported, to an increasing degree, by the reduction in the standard rate of VAT and by the Government's car scrappage scheme. Retail sales, that make up around a third of total consumption, have been resilient and grew 3.4 per cent in volume terms in the year to October.

A.62 Household consumption stabilised in the third quarter of 2009 and, following recoveries in consumer confidence and household expectations of future income, this stabilisation is likely to be sustained.

Saving ratio **A.63** With recent declines in consumer spending, the saving ratio rose from a low of –½ per cent in the first quarter of 2008, to over 5½ per cent in the second quarter of this year. Estimates of the saving ratio can be revised quite heavily as new data on income and spending become available. The pace and extent of the adjustment currently reported are therefore subject to uncertainty. However, it seems clear that a significant adjustment is underway.

Prospects **A.64** Consumption is forecast to contract over 2009 as a whole. However, it is assumed that households will bring forward some consumption from 2010 to 2009 as a result of the lower relative prices associated with the reversion of the temporary cut in the standard rate of VAT. Consumer spending then strengthens later in 2010 as credit conditions ease and lower effective interest rates support household spending. Consumer spending is then forecast to grow at a rate closer to that of overall GDP and greater than that of real household disposable income in 2011 and 2012. As a result the saving ratio is forecast to fall back to under 7 per cent by 2012.

Risks **A.65** There are several risks and considerable uncertainty over the outlook for consumption. Weak availability of credit could constrain households in their ability to smooth consumption. There is also a risk that households aggressively cut consumption to rapidly pay down debt, and repair their balance sheets that have been damaged by falling asset prices. Households have already adjusted their financial balances, but the evidence from previous recessions suggests there may be further adjustment before consumption stabilises relative to income. On the other hand, as confidence improves the saving ratio could fall back more quickly than assumed.

A.66 Consumption may also be squeezed further by increases in precautionary saving driven by households' expectations over higher risk in the labour market or household finances. Stable and low interest rates that have reduced debt-servicing costs for households together with recent rises in house and equity prices have reduced this risk.

Housing

House prices

A.67 House prices have shown signs of stabilising in recent months and sooner than independent forecasters had expected. The Nationwide house price index, for example, has risen by over 8 per cent since February, though it is still nearly 13 per cent below its peak in late 2007. The number of property transactions and mortgage approvals are now substantially higher than the record lows seen at the end of last year. The Bank of England's latest *Credit Conditions Survey* also reported a rise in the demand for loans to purchase houses, supported by improved consumer confidence, affordability and reduced cost of borrowing.

A.68 There remains considerable uncertainty on the outlook for the housing market. Lenders are still constrained by a lack of access to funding as concerns over solvency and losses have caused several lenders to strengthen their balance sheets. In these circumstances, lenders continue to be cautious about products and pricing, and have moved away from higher-risk lending. This, together with pressure on householders' incomes may continue to limit the number of prospective buyers and so restrain further increases in house prices. As the market recovers, an increase in the supply of properties for sale may also serve to moderate prices.

Investment in dwellings

A.69 Following the large 11½ per cent decline over the year in 2008, dwellings investment continued to fall sharply in 2009. As the availability of mortgage lending remained constrained, and home purchasers anticipated further declines in house prices, dwellings investment fell by over 10 per cent in the first quarter of this year, its largest quarterly fall since 1993.

Companies and investment

A.70 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, as seen in the sharp contraction in investment at the start of 2009.

Company Finances

A.71 Companies finance investment internally, using the cash flow generated by their operations, or externally, either through bank lending or by issuing equity or debt to investors. In aggregate, firms' gross operating surplus has declined during the recession following falls in demand, although it continues to exceed beyond the level of investment and in aggregate, firms' financial balances continue to be far stronger than in the early 1990s recession.

A.72 In recent months, net funds raised by UK companies have been very volatile, although several general trends have emerged. In line with previous recessions, net lending growth to private non-financial companies has fallen and in recent quarters the net flow of lending has turned negative. The observed weakness in lending to companies partly reflects weaker demand for bank lending by UK companies as investment intentions have been scaled down in the face of uncertain demand.

A.73 Credit availability also remains a factor, as seen in recent surveys from the CBI. The Bank of England Agents' summary in November also reported that while some firms felt that the availability of credit had eased, there was a perception by some – particularly amongst smaller firms and those linked to the construction and property sectors – that credit was hard to access at any price.

A.74 Net debt and equity issuance rose significantly in the first half of 2009 compared with the year before. The move away from bank lending towards capital market finance can be explained in part by the constrained availability of bank credit and tighter lending conditions to companies, as discussed above. Survey evidence from the Bank of England's Regional Agents Survey and the most recent Deloitte survey of Chief Finance Officers also suggested it may reflect a desire to restructure balance sheets rather than to finance investment as companies have used the proceeds from capital issuance to pay down existing bank debt.

Table A6: Gross fixed capital formation

	Percentage change on a year earlier					
			Forecast			
	Average 2000 to 2007	2008	2009	2010	2011	2012
Whole economy[1]	4	–3¼	–14¼	–2 to –1½	4¼ to 4¾	8½ to 9
of which:						
Business[2,3]	3½	1¼	–18¾	–3¾ to –3¼	9¾ to 10¼	11¾ to 12¼
Private dwellings[3]	4¼	–11½	–24¼	–4½ to –4	7 to 7½	8¼ to 8¾
General government[3]	5¼	13	25¼	1	–21¼	–10¼

[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.75 Business investment has fallen very sharply since the start of the recession. As uncertainty over the global economic outlook increased and confidence collapsed, business investment fell by 10¼ per cent in the second quarter of 2009, taking the annual rate of decline to a record low of 21¾ per cent. The pace of contraction slowed markedly in the third quarter of this year. This is consistent with the latest evidence from private business surveys that suggest stabilisation in the near term.

Prospects

A.76 Reflecting the sharp fall in investment at the start of the year, business investment is forecast to contract by 18 per cent in 2009. Falls in business investment are likely to moderate going forward, aided by government measures to support investment such as the temporary enhanced first-year capital allowance introduced in Budget 2009. Investment is forecast to stabilise in 2010 as credit conditions ease and uncertainty over demand continues to subside. As the outlook for demand improves, investment growth is forecast to pick up strongly, to 10 per cent in 2011 and 12 per cent in 2012, as firms take up new opportunities in the rebalancing economy.

Risks

A.77 A revival in business investment could be held back if the availability of external finance to firms remains constrained, as banks try to restructure and strengthen their balance sheets or capital markets fail to meet the demand for funds. These supply-side constraints could be paralleled by limited demand, should businesses decide to continue paying down debt given concerns over the outlook.

Trade and the balance of payments[8]

A.78 The rebalancing of external and domestic sources of demand is likely to be driven by a combination of export competitiveness, and import substitution as UK consumers respond to higher import prices and switch towards domestically produced goods and services.

Exports of goods and services

A.79 UK export volumes were severely affected by the sharp contraction in global export demand. As global demand for UK goods and financial services continued to decline, the volume of UK exports fell by 7 per cent in the first quarter of 2009, the largest quarterly contraction on record. Consistent with the crisis in world financial activity, over two thirds of the fall in nominal exports of services in the first half of 2009 was due to declining exports from the financial services sector.

A.80 The pace of decline in export volumes started to ease in the second quarter of this year as the global economy stabilised. Growth in goods export volumes returned in the third quarter, bolstered by a pick up in demand in some of the UK's largest export destinations, such as the US and euro area, which together constitute about two thirds of the UK's export markets.

A.81 Export volume growth is forecast to pick up progressively through the forecast horizon as the US and economies in the EU strengthen and world trade demand recovers. As the full impact of sterling's depreciation takes effect and UK businesses take advantage of new export opportunities and a strengthening recovery in world trade, export growth is expected to rise into 2011 and 2012.

Imports of goods and services

A.82 Import volumes declined by 0.8 per cent over the year as a whole in 2008. As with exports, the pace of quarterly decline in import volumes increased further in the first quarter of 2009, in part due to a large contraction in inventories and investment demand. The rate of decline then eased and in the third quarter of 2009 import volumes rose by 1.3 per cent.

A.83 Import volumes are expected to remain relatively subdued into 2010, as higher import prices encourage UK consumers to switch to domestically produced goods and services. As UK demand and investment in particular recovers, the growth in import volumes is forecast to rise from 2011.

Net trade

A.84 Having subtracted from growth in 2007, net trade contributed positively in 2008 and in the first two quarters of 2009, reflecting greater falls in imports relative to export volumes. In the third quarter, the nominal net exports deficit declined, but in real terms it rose as relatively weaker export volumes were outweighed by imports, so that net trade subtracted from the quarterly change in output.

[8] The volume of exports and imports in the economic forecast abstracts from the effects of activity related to Missing Trader Intra-Community fraud (MTIC), which significantly inflated the value of measured goods trade in early 2006, by making a neutral assumption that the adjustment for MTIC-related activity remains constant throughout the forecast horizon at the latest quarterly estimate, and that trade grows in line with underlying determinants. For a fuller explanation of the effect of MTIC-related activity on trade in recent years, see paragraphs B.76 to B.82 of Budget 2008. All figures cited in this section and those reported in Table A7 relate to export and import growth excluding the MTIC adjustment.

A.85 Net trade is forecast to continue contributing to growth throughout the forecast horizon, as the depreciation of sterling and recovery in the global economy support the rebalancing of UK domestic and external demand. In line with the Budget forecast, the contribution to GDP growth from net trade is forecast to be ½ per cent in each year from 2010 to 2012, in contrast to the negative contribution on average from 2000 to 2007.

Table A7: Trade in goods and services

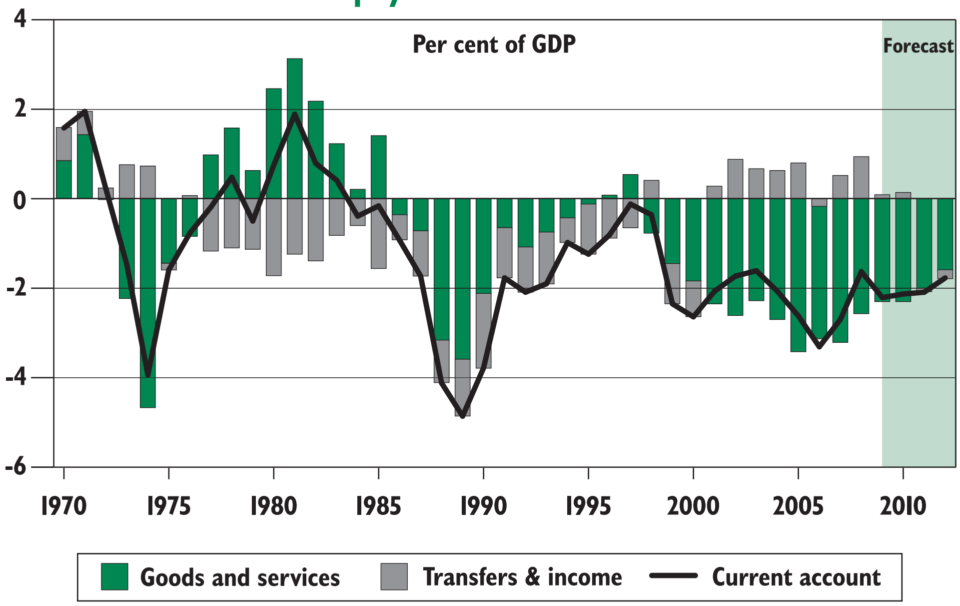
	Percentage points, unless otherwise stated					
			Forecast			
	Average 2000 to 2007	2008	2009	2010	2011	2012
Volumes (excluding MTIC)[1]						
Exports	4½	1	–10¾	2 to 2½	4½ to 5	5 to 5½
Imports	5¼	–¾	–12½	½ to 1	1¾ to 2¼	2¾ to 3¼
Prices[2]						
Exports	1	12¾	2	¼	¾	1¾
Imports	1	11¼	3½	1¾	2¼	2¼
Terms of trade[3]	0	1¼	–1½	–1½	–1½	–¾
Goods and service balance (£ billion)	–32¼	–37¼	–32	–33	–30¾	–25¼

[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.

Current account balance

A.86 In 2008, the UK current account deficit narrowed for the second consecutive year, from 2¾ per cent of GDP in 2007 to 1¾ per cent. More recently, the overall balance has been volatile, demonstrating the considerable uncertainty in the underlying trend due to flows related to the financial services sector. The current account deficit is forecast to narrow gradually from 2¼ per cent in 2009 to 1¾ per cent of GDP in 2012.

Chart A6: Balance of payments current account



Financial account

A.87 Flows of foreign direct investment (FDI) to and from the UK declined substantially in 2008 and into 2009; a pattern repeated across the world as the global financial crisis intensified. According to the 2009 UNCTAD World Investment Report[9], global FDI flows fell significantly in 2008, with global inflows of FDI declining for the first time in six years. Whilst flows of FDI have suffered with the onset of the financial crisis, the UK continues to have the largest stock of inward and outward FDI as a percentage of GDP in the G7.

A.88 The financial year ending in the first quarter of 2009, in particular the final quarter of 2008, saw large financial account inflows as UK resident banks reduced their outstanding loans to overseas banks, but this was balanced by large outflows as overseas banks reduced their loans to UK resident banks. However, as sterling's depreciation increased the value of UK assets in nominated foreign currencies, the international investment position (the stock of UK external assets less external liabilities) became positive for the first time since 1995.

Output sectors

Services **A.89** Over 75 per cent 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. Tighter credit conditions and a decline in confidence through the second half of 2008 and into 2009 triggered a reduction in discretionary spending by both consumers and firms. As a result, output fell significantly in sectors ranging from motor and catering trades, to the broad 'other business services' sector, which includes advertising activities. The pace of decline has moderated significantly over recent quarters, and the latest Index of Services release showed a 0.4 per cent increase in output in September. The services Purchasing Managers Index in October and November also showed increases over the third quarter.

Manufacturing **A.90** In common with advanced and emerging economies around the world, UK manufacturers were hit hard by the loss of confidence and steep falls in world trade through late 2008 and early 2009. Manufacturing output broadly stabilised over the second and third quarters and the latest Index of Production data shows a rise in September and output being maintained in October. Output within the consumer durables and capital goods industries rose in the three months to October. The 2009 Pre-Budget Report forecasts a recovery in manufacturing becoming increasingly evident over coming quarters, as firms look to replenish stock levels and also take advantage of the recovery in world trade. Sterling's depreciation will continue to provide some support to growth, as external demand strengthens and consumers substitute away from imported goods to domestically produced alternatives. The forecast pick-up in business investment will also act as a spur to manufacturing output.

Construction **A.91** Construction output contracted by around ½ per cent in 2008, following sharp falls in the latter half of the year. New work has continued to be reined in across the private sector, though orders picked up in the second quarter and remained stable in the third. Public investment spending has supported growth over recent quarters. Consequently, the latest construction output release shows output for the sector as a whole rising in the second quarter and continuing to rise by 2 per cent in the latest quarter[10]. Despite large falls in output over the recession, employment has held up, in part reflecting increased spending on infrastructure and regeneration projects. Going forward, debt accumulated within the sector over the past decade may hamper growth. However, medium-term prospects should benefit from the expected recovery in business and housing investment, described above.

[9] *World Investment Report 2009: Transnational Corporations, Agricultural Porduction and Development*, UNCTAD, September 2009.

[10] The ONS estimate this could, all else equal, add 0.2 per cent to GDP growth in the third quarter of 2009.

Independent forecasts

A.92 Since Budget 2009, the average of independent forecasts for GDP growth in 2009 has been revised down by over a percentage point, from –3.4 per cent to –4.5 per cent. This largely reflects much weaker than expected growth in the first quarter of the year. Prior to the first estimate, the consensus forecast for growth in the quarter, as polled by Bloomberg, was –1.5 per cent; the latest estimate points to a fall of 2.5 per cent. On the other hand, revisions to 2010 growth have tended to be positive:

- in the May 2009 *Inflation Report* the Bank of England mean forecast was around –¼ per cent for 2010; in the November 2009 Inflation Report the mean forecast for the year was revised up to 1½ per cent;
- the OECD's Economic Outlook, Interim Report published in March forecast growth of –0.2 per cent for the year; the November Economic Outlook forecast positive growth of 1.2 per cent for 2010;
- the IMF's World Economic Outlook publication in April forecast GDP growth in the UK at –0.4 per cent; the October World Economic Outlook forecast growth of 0.9 per cent; and
- since April, among forecasters included in the Treasury's Forecasts for the UK economy, Citigroup have revised their forecast up to 1.5 per cent, from –1 per cent; HSBC from –0.3 per cent to 1.7 per cent; JP Morgan from 0.5 per cent to 1.6 per cent and Goldman Sachs from 1.5 per cent to 1.9 per cent.

A.93 The average of independent forecasts for growth in 2010, at 1.3 per cent, is in line with the Pre-Budget Report forecast. This represents a 1 percentage point increase in the average since Budget. In terms of components, private consumption has moved from –0.4 per cent at Budget 2009 to 0.2 per cent in December, also within the 2009 Pre-Budget Report forecast range.

A.94 However, there is less consensus on the expected strength of the medium-term recovery and the composition of demand. The average of independent forecasts for growth in 2011 and 2012 within November's Forecasts for the UK economy, stood at 2 per cent and 2.3 per cent respectively, with the forecast range in 2011 at 0.9-3.5 per cent. The National Institute of Economic and Social Research's (NIESR) autumn Economic Review forecast growth in 2011 of 1.5 per cent, within which private consumption contracted slightly, and net trade contributed +1.4 per cent to growth. The latest Goldman Sachs forecast also assumes a significant boost from net trade in 2011, at around 0.8 per cent, and growth for the year of 3.4 per cent.

A.95 Inflation has been higher than market expectations in four out of the past seven months, and forecasts for CPI inflation in the final quarter of 2009 have been revised up by 1.1 percentage points since Budget to 1.8 per cent. This is in line with changes to the inflation forecast: the Pre-Budget Report CPI inflation forecast for the final quarter of 2009 is 1 percentage point higher than the Budget forecast. The average of independent forecasts is for CPI inflation to be at 1.8 per cent in the final quarter 2010. The broad range of forecasts for 2010, spanning 2.6 percentage points, illustrates the uncertainty surrounding current forecasts.

Table A8: Budget and independent forecasts[1]

	Percentage change on a year earlier, unless otherwise stated					
	2009			2010		
		Independent			Independent	
	PBR 2009	Average	Range	**PBR 2009**	Average	Range
GDP growth	–4¾	–4.5	–4.7 to –4.1	1 to 1½	1.3	–0.5 to 2.0
CPI (Q4)	2	1.8	1.2 to 2.2	1¾	1.8	1.1 to 3.7
Current account (£ billion)	–31	–27.9	–38.9 to –15.0	–31	–23.6	–50.8 to –8.0

[1] *'Forecasts for the UK economy: A comparison of independent forecasts', November 2009.*

SUMMARY OF FORECAST ISSUES AND RISKS

A.96 Given the severity of the recent financial crisis and the depth of the resultant recession, the 2009 Pre-Budget Report economic forecast is subject to significant uncertainty and a number of key risks that are discussed in this section.

Actual and trend output

A.97 As in Budget 2009, the forecast assumes a phased reduction to the level of trend output of around 5 per cent between mid-2007 and mid-2010. This judgement is subject to significant uncertainty that is unlikely to be resolved for some time given the difficulties in assessing the level of trend output in real time. A different adjustment period would change trend output and the shape of the output gap profile. Further uncertainties arise from the possibility of additional temporary supply constraints. For example, temporary financing constraints may limit trend output in the near term.

A.98 This compounds the uncertainties over the future path of inflation because the output gap will typically drive the prospects for inflation. The change in the output gap may also have a bearing on inflationary pressure as the economy grows at above trend rates to close the output gap. The responsiveness of prices to both the level and change in the output gap is another uncertainty over the outlook for inflation.

The global recovery

A.99 The rebalancing of UK demand in the forecast involves a move away from government and consumer demand, towards investment and the external sector. As in the recovery following the 1990s recession, the depreciation of sterling should help, giving a competitive edge to UK exporters in international markets as well as to UK producers who compete domestically with imports.

A.100 A sustained UK recovery underpinned by a positive contribution from net trade rests on a strong recovery in the global economy. There are now emerging signs that the global economy is recovering and that confidence has improved, partly due to the global policy stimulus but also a pick up in domestic demand in emerging economies. In the medium term, the recovery will depend heavily on domestic and international policy choices in countries across the world. There is a risk that these policy choices prove incompatible, such as attempts to support domestic economies by installing barriers to trade and investment. So far the G20 has been successful in preventing a resurgence in protectionist measures. It will be important to remain vigilant to this risk so global trade and investment flows continue to promote global growth in the future.

A.101 Similarly, policy choices at the national level that prove to be incompatible internationally may lead to further global imbalances, and as such pose a downside risk to global growth. The G20 framework for strong, sustainable and balanced growth, announced at the Pittsburgh G20 summit, mitigates some of this risk as it promotes coordination of international policy choices.

Credit conditions in the recovery

A.102 Credit plays an important role in the economy. In financing investment it promotes the future growth potential of the economy, through increasing the effectiveness with which resources are allocated to their most efficient uses.

A.103 Following the disruption in global financial markets triggered in July 2007, credit conditions faced by households and companies tightened, as the price of risk was reassessed and confidence plummeted. Conditions tightened further in 2008 and at the start of 2009 as banks and other lenders sought to rebuild their balance sheets and tighten their lending terms while the shadow banking system collapsed.

A.104 In recessions associated with financial crisis, it is usual for the recovery in lending growth to lag the recovery in GDP growth. The Bank of England's latest *Financial Stability Report*, published in June, showed that in the aftermath of a credit crisis, real credit growth typically does not return until several quarters after the resumption in GDP growth. However, while limited lending growth need not prevent the economy from recovering it could limit the pace of recovery.

A.105 The global macroeconomic policy stimulus and financial sector interventions have been successful in largely removing the immediate possibility of another financial stability event, as seen in the reduction in risk premia across financial markets. Together with similar domestic measures introduced by the Government and the Bank of England – discussed in Chapters 2 and 3 – these have helped to ease credit conditions faced by households and companies.

A.106 Credit conditions are expected to recover into 2010 and 2011 and so support the recovery. In recent months, asset prices have risen sharply and this has prompted some commentators to warn of a possible asset-price bubble. However, these increases have only partially reversed the sharp declines in asset prices experienced during the global financial crisis. They largely reflect a normalisation from the extreme levels of risk aversion seen at that time, together with the direct impact of global policy actions, notably private-sector asset purchases, and improved private-sector confidence in the economic outlook. That said, as the recent *Reforming Financial Markets* White Paper[11] explained, the Government believes international policymakers should consider ways to take more account of asset-prices and wider financial imbalances in setting policy. The Government is currently discussing these issues with the Bank of England, the FSA and international partners (see Box 2.3).

The speed and extent of private sector deleveraging

A.107 The forecast is for an orderly rebalancing of the economy over the forecast horizon between net lending in the public and private sector, with a smaller balance of payments deficit reflecting rebalancing between domestic and external demand.

A.108 Over the past decade, borrowing by the household sector was high even though the consumption share in GDP was broadly stable. This reflected the fact that borrowing

[11] *Reforming Financial Markets*, HM Treasury, July 2009

was principally used to finance house purchases and the acquisition of other assets. As the recession took hold, demand fell markedly, credit conditions worsened and both the demand and supply of household credit fell. Household net lending moved from a deficit of around 5 per cent of GDP at the start of 2008 to a surplus of around ¾ per cent in the second quarter of 2009.

A.109 Falls in asset prices, including housing, along with a weaker and more uncertain outlook for income, mean the ratio of net assets to income in the household sector is now lower than households might have desired previously. A significant adjustment has already begun with the household saving ratio rising sharply in the first half of 2009.

A.110 The saving ratio is expected to rise further in 2010 as households continue to rebuild their balance sheets, before settling to a rate closer to long-run averages. A risk is that the household sector cuts consumption more aggressively to achieve a much larger increase in the saving ratio and drive a more rapid adjustment in net assets. This could undermine aggregate demand and wider confidence in the recovery.

A.111 Some companies have markedly increased leverage, although this is largely concentrated in particular sectors of the economy such as real estate and finance. Unlike in the early 1990s, the corporate sector appears well-placed to support the rebalancing of the economy. In aggregate, the corporate sector entered the recession in a relatively healthy financial position, which suggests it can reduce its leverage without holding back business investment.

A.112 The decisive actions taken by the Government and the Bank of England in response to the crisis have reduced uncertainty and boosted confidence. The substantial macroeconomic stimulus that remains in place is expected to smooth the likely pace of deleveraging in the household and corporate sectors, as low interest rates have reduced the debt burden and the extent to which households and corporates need to pay down their debt. Easier credit conditions should also support spending, which combined with the comparatively stronger labour market performance in this recession, should help smooth the adjustment in household consumption.

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]
	2008	2009	2010	2011	2012	2010
Output at constant market prices						
Gross domestic product (GDP)	½	–4¾	1 to 1½	3¼ to 3¾	3¼ to 3¾	¾
Manufacturing output	–2¾	–10¾	1½ to 2	3½ to 4	3½ to 4	1¾
Expenditure components of GDP at constant market prices[6]						
Domestic demand	¼	–5¼	¾ to 1¼	2¾ to 3¼	2¾ to 3¼	¾
Household consumption[7]	1	–3	0 to ½	2¾ to 3¼	2¾ to 3¼	1¼
General government consumption	2½	2	1¼	–1½	–2	¾
Fixed investment	–3¼	–14¼	–2 to –1½	4¼ to 4¾	8½ to 9	2¾
Change in inventories[8]	–½	–1¼	¾	½	0	¼
Exports of goods and services[9]	1	–10¾	2 to 2½	4½ to 5	5 to 5½	3
Imports of goods and services[9]	–¾	–12½	½ to 1	1¾ to 2¼	2¾ to 3¼	3
Exports of goods and services (excluding MTIC)	1	–10¾	2 to 2½	4½ to 5	5 to 5½	–
Imports of goods and services (excluding MTIC)	–¾	–12½	½ to 1	1¾ to 2¼	2¾ to 3¼	–
Balance of payments current account						
£ billion	–23½	–31	–31	–32	–28¾	11½
Per cent of GDP	–1¾	–2¼	–2¼	–2	–1¾	¾
Inflation						
CPI (Q4)	4	2	1¾	1½	2	¾
Producer output prices (Q4)[10]	5½	1½	1	1¼	2	1¼
GDP deflator at market prices	3	1½	2¾	1½	2¼	½
Money GDP at market prices						
£ billion	1,448	1,400	1,454 to 1,460	1,525 to 1,539	1,611 to 1,633	13
Percentage change	3½	–3¼	3¾ to 4¼	5 to 5½	5½ to 6	1

[1] The forecast is consistent with output, income and expenditure data for the third quarter of 2009, released by the Office for National Statistics on 25 November 2009. 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 the past 10 autumn forecasts. 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 2010. The CPI average has been derived from only five years of data.

[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 up to and including 2010 are distorted by MTIC.

[10] Excluding excise duties.

Table A10: Gross domestic product and its components

	£ billion chained volume measures at market prices, seasonally adjusted									
	Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
2008	853.3	282.3	232.7	0.9	1370.4	361.1	1731.6	400.0	–1.4	1330.1
2009	827.1	287.9	199.3	–16.9	1298.2	321.9	1620.1	349.9	–2.2	1268.1
2010	828.0 to 831.5	291.4	195.5 to 196.3	–7.4 to –6.2	1307.5 to 1313.0	328.6 to 330.0	1636.0 to 1643.0	351.7 to 353.2	–2.3	1282.1 to 1287.6
2011	851.7 to 859.5	287.3	203.7 to 205.6	–0.7 to 1.9	1342.1 to 1354.4	343.1 to 346.2	1685.2 to 1700.6	358.2 to 361.5	–2.3	1324.7 to 1336.9
2012	876.2 to 888.5	281.3	222.1 to 224.2	0.3 to 4.2	1378.8 to 1398.2	360.1 to 365.2	1738.9 to 1763.4	367.6 to 372.8	–2.3	1369.0 to 1388.3
2008 1st half	428.8	140.2	119.0	4.1	692.7	183.0	875.7	204.5	–0.6	670.6
2nd half	424.5	142.1	113.7	–3.2	677.7	178.2	855.9	195.5	–0.9	659.5
2009 1st half	414.1	143.4	101.5	–9.3	650.2	161.0	811.2	174.7	–1.1	635.4
2nd half	413.0	144.6	97.8	–7.6	648.0	160.9	808.9	175.1	–1.1	632.6
2010 1st half	412.1 to 413.4	145.7	97.2 to 97.5	–5.3 to –4.9	649.7 to 651.7	162.7 to 163.2	812.5 to 814.9	175.2 to 175.7	–1.1	636.1 to 638.1
2nd half	415.9 to 418.2	145.7	98.2 to 98.8	–2.1 to –1.3	657.7 to 661.3	165.8 to 166.8	823.6 to 828.1	176.5 to 177.4	–1.1	646.0 to 649.5
2011 1st half	422.6 to 426.0	144.5	100.1 to 100.9	–0.6 to 0.6	666.6 to 671.9	169.6 to 170.9	836.3 to 842.8	178.1 to 179.5	–1.1	657.0 to 662.2
2nd half	429.1 to 433.5	142.8	103.6 to 104.7	–0.1 to 1.4	675.4 to 682.4	173.5 to 175.3	849.0 to 857.8	180.1 to 181.9	–1.1	667.8 to 674.7
2012 1st half	435.1 to 440.7	141.2	108.1 to 109.5	0.1 to 1.9	684.5 to 693.3	177.8 to 180.1	862.3 to 873.4	182.4 to 184.8	–1.1	678.8 to 687.5
2nd half	441.1 to 447.8	140.1	112.9 to 114.6	0.2 to 2.3	694.2 to 704.9	182.3 to 185.1	876.6 to 890.0	185.2 to 188.1	–1.1	690.2 to 700.8
	Percentage change on a year earlier[4,5]									
2008	1	2½	–3¼	–½	¼	1	¼	–¾	0	½
2009	–3	2	–14¼	–1¼	–5¼	–10¾	–6½	–12½	0	–4¾
2010	0 to ½	1¼	–2 to –1½	¾	¾ to 1¼	2 to 2½	1 to 1½	½ to 1	0	1 to 1½
2011	2¾ to 3¼	–1½	4¼ to 4¾	½	2¾ to 3¼	4½ to 5	3 to 3½	1¾ to 2¼	0	3¼ to 3¾
2012	2¾ to 3¼	–2	8½ to 9	0	2¾ to 3¼	5 to 5½	3¼ to 3¾	2¾ to 3¼	0	3¼ to 3¾

[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

This annex presents detailed information on the fiscal projections and the impact of policy decisions, consistent with the Government's fiscal policy objectives set out in the *Code for fiscal stability*.

The 2009 *End of year fiscal report* is published alongside this Pre-Budget Report, underlining the Government's commitment to transparency and accountability in fiscal forecasting by providing detailed information on the public finances forecast and outturns for 2007-08 and 2008-09. The 2009 *Long-term public finance report* is also published, describing the potential pressures that long-term challenges and trends could put on the public finances over the next fifty years.

This annex sets out a new definition of net borrowing, PSNB excluding the temporary effects of financial interventions, which excludes the distortionary and temporary effects of the publicly-owned banks and the Bank of England Asset Purchase Facility Fund. This measure will be published by the ONS alongside the parallel measure for PSND which is already published. This annex also sets out the new treatment of the potential net losses on the financial interventions and the Government's equity holdings in public sector banks.

B.1 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; and
- detailed analyses of the outlook for government receipts and expenditure.

MEASURES OF THE PUBLIC FINANCES

B.2 The Pre-Budget Report presents information on the public finances on two different bases:

- **including the temporary effects of financial interventions.** These measures include the temporary and exceptional effects from, for example, the inclusion of the balance sheets and operations of banks classified to the public sector; and
- **excluding the temporary effects of financial interventions.** These measures remove the temporary effects of financial interventions on the fiscal aggregates. As fees and losses are realised for central government, and so can be reliably included in the fiscal projections, they will score in these measures.

B.3 In Budget 2009, a third basis was used to represent a provision for potential net losses from the financial interventions. This was necessary because of the considerable uncertainty at that time. As uncertainty has receded the Government is moving the treatment of financial interventions into line with the fiscal aggregates reported by the ONS, so this basis is no longer needed.

[1] For further detail see *2009 Pre-Budget Report: the economy and public finances – supplementary material*. This includes tables on public expenditure and sub-sector and economic category analyses.

B.4 The long-term impact of the financial interventions on the taxpayer and the sustainability of the public finances will be determined by the eventual net profit or loss on these interventions. The Government will therefore base its assessment of the fiscal position on measures which account for these permanent effects and which exclude any temporary effects of assets or liabilities incurred as a result of the interventions. Therefore, fiscal aggregates in this annex are presented on the basis which excludes the temporary effect of financial interventions, unless otherwise stated.

B.5 Consistent with this approach, this Pre-Budget Report establishes a measure of Public Sector Net Borrowing that excludes the temporary effects of the financial interventions (PSNB ex). The components of net borrowing will also be measured on this basis. This measure is consistent with the parallel measure of Public Sector Net Debt (PSND ex) announced at Budget 2008, which the ONS publish in outturn. The ONS will also publish PSNB ex and are today publishing a technical note on its derivation.

B.6 Since the Budget the exceptional financial market and economic uncertainty has receded, and the APS policy agreement has been finalised. The risks to the taxpayer have been reduced. This Pre-Budget Report replaces the Budget provision for financial sector losses with a new treatment which books a paper loss on the shareholdings of the publicly owned banks using National Accounts methodology. This new treatment is set out in detail in Box B4.

FORECAST ASSUMPTIONS AND RISKS

Key assumptions

B.7 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 2009-10, 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;
- Departmental Expenditure Limits (DEL) to 2010-11 are adjusted to reflect the cost of the policy decisions listed in Table B4;
- 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 (excluding the additional time-limited resource expenditure announced in the 2009 Pre-Budget Report) is projected to grow at 0.8 per cent per year on average in real terms from 2011-12 to 2014-15; and
- public sector net investment is projected to move to 1¼ per cent of GDP in 2013-14.

B.8 The estimates for 2009-10 are based on all available data within the Treasury and other government departments involved in producing tax and spending forecasts.

Table B1: Economic assumptions for the public finance projections

	Percentage changes on previous year unless otherwise specified						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Output (GDP)	-1 ¼	-3 ½	2	3 ¼	3 ¼	3 ¼	3 ¼
Prices							
CPI	3 ¾	2 ¼	2	1 ½	1 ¾	2	2
GDP deflator	2 ½	2	2 ¼	1 ½	2 ½	2 ¾	2 ¾
RPI[1] (September)	5	-1 ½	3	3 ¼	3 ¼	3 ¼	3
Rossi[2] (September)	6 ¼	1 ¾	3	1 ½	2	2 ¼	2 ½
Nominal GDP[3]	1435	1409	1472	1544	1635	1735	1841

[1] *Used for revalorising excise duties in current year and uprating income tax allowances and bands in the following year.*

[2] *RPI excluding housing costs*

[3] *Not seasonally adjusted.*

Forecast differences and risks

B.9 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 the 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. 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 analyses of tax and spending of the risks to the public finances forecast.

B.10 The 2009 *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 2007-08 and 2008-09, including an explanation of differences between forecasts and outturn in those years. To ensure consistency between forecast and outturn, the EYFR reports on a National Accounts basis, so some aggregates for 2008-09 are different from those reported in this annex because of the introduction of PSNB ex. The information set out in the EYFR supplements the historical and provisional outturn data published in this Annex.

B.11 The EYFR provides a detailed analysis of the increase in borrowing in 2008-09 compared to the pre-crisis forecast. This shows that the increase was driven by the deterioration of the economy, the loss of receipts from the financial and housing sectors, and the Government's discretionary action to support the economy. The US has experienced an increase in borrowing of a similar scale to the UK, reflecting the global nature of the shock and the importance of the financial sector in both countries.

The use of NAO-audited assumptions

B.12 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 finances 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 A3.

Equity price assumption

B.13 For the 2009 Pre-Budget Report, the Comptroller and Auditor General has audited the Treasury's assumption for equity prices used for the purposes of projecting the public finances. He concluded that the Treasury's approach for modelling equity prices based on the growth of nominal GDP is simple, transparent and based in economic theory, but that the assumption did not perform well over the rolling review period as a whole, as it did not capture the major movements in UK equity prices following upheavals in the global financial system and stock markets. As a result, the assumption resulted in overprediction of tax receipts associated with equity prices, though these were a small percentage of overall government receipts. However, he also concluded that there is no case for adopting an alternative methodology on the basis that there is no obviously superior methodology. He recommended that the Treasury makes an assessment of formal methods to allow for uncertainty in its equity price projections.

Consistency of price indices

B.14 The Comptroller and Auditor General also audited the consistency of price indices assumption used for the Treasury's public finance projections. The report concluded that the Treasury ensured consistency between the CPI, RPI, Rossi index and the GDP deflator over the rolling review period. The report also noted that the same approach as for the rolling review period has been used for the 2009 Pre-Budget Report forecast, and concluded that the projected series are consistent with each other on this basis.

Box B1: Key assumptions audited by the NAO[a]

Trend GDP growth[e]	2½ per cent a year to 2014. A downward adjustment of around 5 per cent has been made to the level of trend output, phased in between mid-2007 and mid-2010.
Dating of the cycle[d]	The previous economic cycle, which began in the first half of 1997, ended in the second half of 2006.
Composition of GDP[b]	Shares of labour income and profits in national income are broadly constant in the medium term.
Consistency of price indices[f]	Projections of price indices used to project the public finances are consistent with CPI.
Oil prices[d]	\$72.7 a barrel in 2010, the average for the three months to 26 November, and then constant in real terms. This is lower than the \$73.3 average of independent forecasts for 2010.
Equity prices[f]	FTSE All-share index rises from 2718 (close 2 December) in line with nominal GDP.
VAT[b]	The underlying VAT gap will rise by 0.5 percentage points per year from the estimated outturn for the current year.
Tobacco[b]	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[c,g]	Projections are based on the average of independent forecasts. Under that convention, the most recent data result in a projection of the UK claimant unemployment rising from recent levels of 1.64 million to 1.72 million at the end of 2009, and to 1.91 million at the end of 2010.
Interest rates[e]	3-month market rates change in line with market expectations (as of 26 November).
Funding[b]	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Privatisation proceeds[e]	Credit is taken only for proceeds from sales that have been announced.
Cyclical adjustment methodology[e]	Estimates of the final balances adjusted for the effects of the economic cycle are produced in line with the ready-reckoner set out in *Public finances and the cycle*, Treasury Working Paper No. 5, 2008.

[a] For details of all NAO audits before Budget 2007, see the 2006 Pre-Budget Report, 6 December 2006 (Cm 6984).
[b] Audit of Assumptions for Budget 2007, 21 March 2007 (HC 393).
[c] Audit of Assumptions for Budget 2008, 12 March 2008 (HC 345).
[d] Audit of Assumptions for the 2008 Pre-Budget Report, 24 November 2008 (HC 1150).
[e] Audit of Assumptions for Budget 2009, 22 April 2009 (HC 408).
[f] Audit of Assumptions for the 2009 Pre-Budget Report, 9 December 2009 (HC 83).
[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.

FISCAL PROJECTIONS

B.15 Table B2 shows five-year projections for public sector net borrowing, current budget, cyclically-adjusted current budget, and public sector net debt. Except where indicated these aggregates are presented on the basis which excludes the temporary effect of financial interventions. Outturns, estimates and projections of other important measures of the public finances are also shown.

Table B2: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Fiscal stance							
Public sector net borrowing (PSNB)	6.6	12.6	12.0	9.1	7.1	5.5	4.4
Cyclically-adjusted PSNB	5.7	9.0	8.0	5.8	4.5	3.6	3.1
Surplus on current budget	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Cyclically-adjusted surplus on current budget	-2.6	-5.5	-5.4	-3.9	-3.0	-2.3	-1.9
Net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
Sustainability							
Public sector net debt[1]	44.0	55.6	65.4	71.7	75.4	77.1	77.7
Core debt[1]	42.8	50.8	57.1	60.7	62.4	63.0	63.0
Net worth[2]	22.4	17.3	6.6	0.4	-3.6	-6.2	-7.2
Primary balance	-4.9	-10.7	-9.2	-6.0	-3.9	-2.3	-1.1
Financing							
Central government net cash requirement	11.3	15.8	11.8	9.5	7.2	5.8	4.4
Public sector net cash requirement	4.2	13.5	12.3	9.7	7.5	6.1	4.6
Stability and Growth Pact							
Treaty deficit[3]	6.9	12.6	12.0	9.1	7.3	5.7	4.6
Cyclically-adjusted Treaty deficit[3]	5.9	9.0	8.1	5.9	4.7	3.7	3.2
Treaty debt ratio[4]	55.5	72.9	82.1	88.0	90.9	91.6	91.2
Memo: Output gap	-2.0	-6.4	-5.3	-4.3	-3.4	-2.5	-1.6

Note: All measures are shown on the basis which excludes the temporary effect of financial interventions, except net worth and the aggregates shown in the Financing and Stability and Growth Pact sections.

[1] Debt at end March; GDP centred on end March.

[2] Estimate at end December; GDP centred on end December.

[3] General government net borrowing on a Maastricht basis.

[4] General government gross debt measures on a Maastricht basis.

Public sector net borrowing

B.16 Public sector net borrowing is projected to fall in each year of the forecast period, from 12.0 per cent in 2010-11 to 4.4 per cent by 2014-15, as a result of economic recovery and the Government's action to ensure the sustainability of the public finances. This measure of PSNB is on the basis which excludes the temporary effects of financial interventions and captures the permanent effect on the taxpayer. It therefore captures the impact of capital grants to public sector banks in outturn for 2008-09 and 2009-10, and fees associated with the financial interventions. A full breakdown of these factors is presented later in this annex.

Current budget

B.17 The current budget is also presented on the basis which excludes the temporary effects of financial interventions. The Pre-Budget Report projections show that the current budget is in deficit throughout the forecast period, peaking at 9.3 per cent of GDP in 2010-11, and then falling to 3.2 per cent by 2014-15. The cyclically-adjusted current budget, which removes the estimated effect of the economic cycle, falls from a deficit of 5.4 per cent of GDP in 2010-11 to 1.9 per cent in 2014-15.

Net investment **B.18** Net investment rose to 3.5 per cent of GDP in 2009-10 and 2.7 per cent of GDP in 2010-11. Net investment will move to 1¼ per cent of GDP by 2013-14. In 2008-09 and 2009-10, net investment is increased by capital grants to public sector banks associated with the financial interventions.

Net debt to GDP ratio **B.19** Public sector net debt, excluding the temporary effect of financial interventions, is projected to rise over the forecast period to 77.7 per cent of GDP by 2014-15. The projections for core debt, which excludes the estimated impact of the economic cycle, are expected to rise to 63.0 per cent in 2014-15.

Contingent liabilities **B.20** Fiscal aggregates published by the 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. Measures based on Generally Accepted Accounting Practice (GAAP) take into account the extent to which past transactions have already committed future funding flows, such as nuclear decommissioning or public sector pensions. The Government has announced that it will publish a GAAP-based balance sheet as part of its move towards publishing Whole of Government Accounts (WGA) for 2009-10. 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 worth **B.21** Public sector tangible and financial assets net of financial liabilities can be calculated to provide an estimated measure of net worth. Because capital spending adds to assets and current spending does not, this measure is the approximate stock counterpart of the current budget. On this measure net worth is projected to become negative in the medium term as current borrowing continues. This borrowing reduces net worth, as it is not offset by an increase in the Government's existing assets. As such measures include liabilities accrued to date that will have to be met in the future, but do not take account of future government revenues, the concept of net worth is not comprehensive. Net worth is not used as a key indicator of the public finances, mainly as a result of the difficulties involved in accurately measuring many government assets and liabilities. The estimates of values of tangible assets are subject to wide margins of error because they depend on broad assumptions, for example about asset lives, which may not be appropriate in all cases.

Financing **B.22** The central government net cash requirement (CGNCR) is projected to be around 11.8 per cent of GDP in 2010-11 and is expected to fall steadily to 4.4 per cent in 2014-15 as net borrowing falls. The impact on the CGNCR of financial interventions is included in Table B20.

Stability and Growth Pact **B.23** Table B2 shows the Treaty measures of debt and deficit used for the purposes of the Excessive Deficit Procedure – Article 104 of the Treaty of Maastricht. The Treaty deficit is projected to fall from 12.0 per cent of GDP in 2010-11 to 4.6 per cent in 2014-15. Treaty debt is forecast to rise from 82.1 per cent of GDP in 2010-11 to 91.2 per cent in 2014-15.

CHANGES TO THE FISCAL BALANCES

B.24 Table B3 compares the latest estimates for the main fiscal balances with those in Budget 2009.

Table B3: Fiscal balances compared with Budget 2009

	Outturn[1]	Estimate[2]	Projections			
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Net borrowing (£ billion)						
Budget 2009	**90.0**	**175.4**	**173**	**140**	**118**	**97**
2009 Pre-Budget Report	**95.4**	**177.6**	**176**	**140**	**117**	**96**
Difference	5.5	2.2	3.0	-0.5	-0.7	-0.6
of which:						
Changes to current budget	-2.2	-3.5	- ½	- ½	- ½	- ½
Changes to net investment	7.7	5.7	3 ½	0	0	0
of which:						
Effect of revisions and forecasting changes	5.4	2.6	- ½	-4 ½	-2 ½	0
Effect of 2009 PBR policy decisions	0.0	-0.4	1	-3 ½	-5	-6
Effect of other discretionary changes[3]	0.0	0.0	2 ½	7 ½	7	5
Surplus on current budget (£ billion)						
Budget 2009	**-52.3**	**-131.6**	**-137**	**-111**	**-91**	**-74**
Effect of revisions and forecasting changes	2.2	3.1	3	4 ½	2 ½	- ½
Effect of 2009 PBR policy decisions	0.0	0.3	-1	3 ½	5	6
Effect of other discretionary changes[3]	0.0	0.0	-1 ½	-7 ½	-7	-5
2009 Pre-Budget Report	**-50.1**	**-128.1**	**-137**	**-111**	**-91**	**-74**
Net investment (£ billion)						
Budget 2009	**37.7**	**43.8**	**36**	**29**	**26**	**22**
Effect of revisions and forecasting changes	7.7	5.6	2 ½	0	0	0
Effect of 2009 PBR policy decisions	0.0	0.1	0	0	0	0
Effect of other discretionary changes[3]	0.0	0.0	1	0	0	0
2009 Pre-Budget Report	**45.3**	**49.5**	**39**	**29**	**26**	**22**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2009	-3.1	-6.7	-6.4	-4.9	-3.9	-3.2
2009 Pre-Budget Report	**-2.6**	**-5.5**	**-5.4**	**-3.9**	**-3.0**	**-2.3**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2009	5.7	9.8	8.9	6.8	5.5	4.5
2009 Pre-Budget Report	**5.7**	**9.0**	**8.0**	**5.8**	**4.5**	**3.6**
Net debt (per cent of GDP)[4]						
Budget 2009	43.0	55.4	65.0	70.9	74.5	76.2
2009 Pre-Budget Report	**44.0**	**55.6**	**65.4**	**71.7**	**75.4**	**77.1**
Memo: Budget 2009 - PSND including unrealised losses[5]	*46.5*	*59.0*	*68.4*	*74.0*	*77.5*	*79.0*

Note: Totals may not sum due to rounding.

Note: Budget 2009 aggregates, except for net debt, were on the basis which includes the temporary effects of financial interventions. All 2009 Pre-Budget Report aggregates are on the basis which excludes the temporary effects. In 2008-09 and 2009-10 some of the changes since Budget 2009 are therefore due to the different bases. This is explained in the accompanying text.

[1] The 2008-09 figures were estimates in Budget 2009.

[2] The 2009-10 figures were projections in Budget 2009.

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

[4] Debt at end March; GDP centred on end March.

[5] Measure of debt used for fiscal policy purposes at Budget 2009. This included a cautious provision for losses from the financial interventions of 3.5 per cent of GDP.

Changes to 2008-09

B.25 The outturn for net borrowing in 2008-09 was £95.4 billion, £5.5 billion higher than the Budget 2009 estimate of £90.0 billion. Since Budget, revisions to outturn based on latest data for local authority, public corporation and central government spending have reduced borrowing by around £5 billion. More than offsetting this are additions of around £10 billion, relating to the inclusion of capital grants to public sector banks and other transactions in PSNB ex, set out in detail in Table B18.

Changes to 2009-10

B.26 Net borrowing in 2009-10 is expected to be £177.6 billion, broadly unchanged from the Budget 2009 forecast of £175.4 billion.

B.27 The new treatment of financial interventions in PSNB ex raises expected borrowing in 2009-10 by around £2 billion compared to Budget 2009, as set out in detail in Table B18, with capital grants to public sector banks offset by fees paid by public sector banks to the Government and other transactions.

B.28 The underlying Pre-Budget Report forecast for borrowing in 2009-10 is very close to that at the Budget. With weaker than expected economic growth in the first part of the year this may reflect the caution in the Budget fiscal forecast. The fiscal projections use the low end of the GDP forecast range. The NAO-audited assumptions on the VAT gap and equity prices also built in caution to the forecast, and the housing market has been stronger than expected since Budget. This is reflected in higher receipts from VAT and stamp duties than expected at the Budget.

B.29 The deeper than forecast recession has resulted in a wider than previously estimated output gap in 2009-10, which with similar levels of borrowing has lowered the level of cyclically-adjusted net borrowing compared to Budget. Cyclically-adjusted PSNB is 9.0 per cent of GDP in 2009-10 compared to 9.8 per cent at the Budget.

Changes from 2010-11

B.30 In the medium term, the Pre-Budget Report forecast for borrowing and debt is very close to the projections made at the time of the Budget, even though the recession has been deeper than expected. Based on cautious assumptions, borrowing is projected to more than halve from 12.6 per cent of GDP this year to 5.5 in 2013-14 and 4.4 per cent in 2014-15, driven by the economic recovery and the consolidation measures announced in the 2008 Pre-Budget Report and Budget 2009. Cyclically-adjusted borrowing is lower than at Budget across the medium-term forecast.

B.31 Debt is forecast to peak at 77.7 per cent of GDP. This is lower than the forecast of debt used for fiscal policy at the Budget, reflecting the reduction in the provision for losses from the financial interventions, explained in Box B4.

PRE-BUDGET REPORT POLICY DECISIONS

B.32 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 2009 Pre-Budget Report or since Budget 2009. The fiscal impacts of these measures are set out in Table B4.

B.33 Expenditure measures affecting AME and DEL in 2009-10 have been added to total AME and total DEL, respectively.

B.34 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.

Calculating the costings

B.35 The Pre-Budget Report projections for the public finances take full account of all the measures announced in this and previous Budgets and Pre-Budget Reports. This is achieved through detailed modelling of the direct effect on receipts of individual measures, including their microeconomic behavioural effects where significant, and through the use of macroeconomic models which are able to estimate the indirect impact of the Pre-Budget Report package of measures as a whole. The detailed models tend to only consider the impact of a measure on the tax base the measure is being applied to, or closely related tax bases. The indirect impacts on other tax bases and the impact on economic growth are generally captured through the macroeconomic models. The costings shown in Table B4 are consistent with those produced using the detailed tax models.

B.36 The calculation of the expected effect of changes in duty rate on consumer demand for excise goods assumes that any change in duty is passed on in full to consumers. Where the effect of one tax change is affected by implementation of others, the measures are normally costed in the order in which they appear in Table B4.

B.37 The costings show the Exchequer impacts of the measures against a baseline that assumes allowances, thresholds and specific tax rates will be increased in line with either the appropriate price index or any pre-commitments (measures announced in previous Budgets or Pre-Budget Reports that are or were due to come into effect). As such they give an indicator of the impact of the decisions made in the current Pre-Budget Report.

B.38 Unless allowances, thresholds and specific tax rates have been pre-announced, the indexed baseline assumes the following:

- income tax and National Insurance allowances and thresholds (excluding the higher rate limit and the income above which the income tax personal allowance will be restricted); the child element and disabled and severely disabled child elements of the Child Tax Credit, the single person, couple, lone parent, 30 hour 50 plus, disabled and severely disabled worker elements of the Working Tax Credit; inheritance tax nil-rate band allowance threshold; business rates and the capital gains tax annual exempt amount all increase in line with the change in the Retail Price Index (RPI) in the year to the September prior to the respective Budget or Pre-Budget Report;

- the climate change and aggregates levy and the vehicle excise duty, amusement machine licence duty, air passenger duty, fuel, tobacco and alcohol duties all rise in line with the projected annual change in the RPI in the year to the third quarter following the respective Budget or Pre-Budget Report; and

- VAT thresholds and gaming duty bands rise in line with the change in the RPI in the year to the December prior to the respective Budget.

B.39 With the exception of business rates, when indexation rates are negative, the indexed baseline assumes allowances, thresholds and specific tax rates are held constant. The indexed baseline also takes account of statutory rounding rules.

B.40 The yields of measures that close tax avoidance loopholes or tackle tax fraud represent the estimated direct Exchequer effect of the measures with the existing level of avoidance activity.

Table B4: Estimated costs for Pre-Budget Report policy decisions and others announced since Budget 2009[1]

	Head	£ million			
		2009-10	2010-11	2011-12	2012-13
Measures announced since Budget 2009[2]					
Stamp Duty - Exemption for company buybacks of shares of overseas branches	*Tax*	0	-5	-5	-5
Financial products avoidance	*Tax*	+50	+100	+100	+50
Pensions tax: anti-forestalling rules	*Tax*	-30	-40	0	0
Digital Britain: Landline Duty	*Tax*	0	+90	+175	+175
Childcare: employer supported childcare tax relief [3]	*Tax/Spend*	0	0	-	-
Gurkhas: removal of 1997 cut-off	*Spend*	-70	-240	-	-
Cold Weather Payments	*Spend*	-20	0	0	0
Funding for *Building Britain's Future*	*Spend*	-35	+35	0	0
Measures announced at Pre-Budget Report 2009					
Ensuring Sustainability of the Public finances					
Freeze Higher Rate Threshold in 2012-13	*Tax*	0	0	0	+400
Increase NICs Primary Threshold by £570 in 2011-12	*Tax*	0	0	-1,480	-1,500
Increase employer NICs rate by 0.5% from 2011-12	*Tax*	0	0	+2,350	+2,470
Increase main employee and self-employed NICs rate from 2011-12	*Tax*	0	0	+1,970	+2,080
Increase additional employee and self-employed NICs rate from 2011-12	*Tax*	0	0	+320	+340
Pensions tax: updated income definition	*Tax*	-10	-40	0	+500
Freeze Inheritance Tax Threshold in 2010-11	*Tax*	0	+80	+170	+190
Bank payroll tax	*Tax*	+550	0	0	0
Salary sacrifice: workplace canteens	*Tax*	0	0	+110	+110
Pensions auto-enrolment: slower introduction [4]	*Tax*	0	0	0	+100
Protecting Revenues					
Insurance Premium Tax - avoidance	*Tax*	+5	+10	+10	+10
Index linked gilts	*Tax*	0	+40	+65	+40
Replacement of substantial donors to charity anti-avoidance legislation	*Tax*	0	-10	-10	-10
Supporting Business					
Rates on empty property: temporary exemption	*Tax*	0	-135	+10	0
Small Companies Rate of corporation tax: defer increase to April 2011	*Tax*	0	-10	-380	-110
Patent Box from April 2013 [5]	*Tax*	0	0	0	0
Bingo Duty: reduce to 20%	*Tax*	0	-5	-10	-10
Seafarer's Earning deduction	*Tax*	0	0	-5	-5
Venture Capital Schemes: State Aid changes	*Tax*	0	0	-20	-30
Strategic Investment Fund addition [6]	*Spend*	0	-110	0	0
Protecting the Environment					
Climate change levy: reduction of relief	*Tax*	0	0	+50	+50
Fuel Benefit Charge: increase multiplier	*Tax*	0	+50	+45	+45
Company Car Tax: extend bands	*Tax*	0	0	0	+120
Biofuels Duty Differential	*Tax*	0	-10	-10	0
Electric vehicles package	*Tax*	0	-5	-5	neg
Warm Front and Greener Boiler Incentive [7]	*Spend*	0	-85	0	0

Table B4: Estimated costs for Pre-Budget Report policy decisions and others announced since Budget 2009[1]

	Head	£ million			
		2009-10	2010-11	2011-12	2012-13
Helping People Fairly [8]					
Tax relief for travel expenses	*Tax*	0	+35	+85	+85
Extension of free school meals	*Spend*	0	-140	-	-
Benefits uprating	*Spend*	0	-700	0	0
Local authority guideline rents [9]	*Spend*	0	-115	-	0
Money Guidance rollout in 2010-11	*Spend*	0	-10	0	0
Working Tax Credits: extension to over 65s from April 2010	*Spend*	0	-5	-	-
Tackling benefit error	*Spend*	0	+95	-	-
Housing Benefit: managing gains from Local Housing Allowance from 2011	*Spend*	0	-40	-	-
Support for Mortgage Interest [10]	*Spend*	-25	-70	0	0
TOTAL POLICY DECISIONS		**+415**	**-1,240**	**+3,535**	**+5,095**
Reserve: support for military operations	*Spend*	0	-2,500	0	0
Memo: Increase to Public Sector Current Expenditure	*Spend*	*0*	*0*	*-7,700*	*-6,900*

- Included within the current spending growth assumption for 2011-12 onwards.

[1] Costings shown relative to an indexed base.

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

[3] Employer supported childcare tax relief measure used to fund expansion of free childcare for 2 year olds.

[4] In 2013-14 the yield is £0.7 billion, in 2014-15 the yield is £1.6 billion.

[5] The costs of this measure will rise to £1.3bn in steady state.

[6] The total addition to the Strategic Investment Fund at this PBR is £210m in 2010-11, including Barnett consequentials for non-reprioritised funding. £100m of this is funded through reprioritisation.

[7] Total funding for Warm Front and the Greener Boiler Incentive is £215m in 2010-11 including Barnett consequentials for non-reprioritised funding. £130m of this is funded through reprioritisation.

[8] Employment support package costing £45 million in 2009-10 and £355 million in 2010-11 funded by DWP underspend.

[9] Total support for Local Authority Guideline rents is £170m in 2010-11. £55m of this is funded through reprioritisation.

[10] Total Support for Mortgage Interest in 2009-10 is £70m, including Barnett consequentials for non-reprioritised funding. £45m of this is funded through reprioritisation.

B.41 These estimates are shown on a National Accounts basis. The National Accounts basis aims to recognise tax when the tax liability accrues irrespective of when the tax is received by the Exchequer. However, some taxes are accounted for when the Exchequer actually receives the tax, reflecting the difficulty in determining the period to which the tax liability relates. Examples of such taxes are corporation tax, self-assessment income tax, stamp duty land tax, inheritance tax and capital gains tax. This approach is consistent with other government publications.

Bands, rates and personal allowances

B.42 The income tax personal allowance available for the under 65s, age related allowances and limits, the starting limit for savings and the basic rate limit will be maintained at their 2009-10 levels, providing a real terms benefit relative to September's RPI.

B.43 Both the basic and higher rate of tax will remain the same in 2010-11, at 20 per cent and 40 per cent respectively. The additional rate of tax of 50%, applying to incomes over £150,000 will commence from 2010-11, as will the gradual withdrawal of the personal allowance for those with incomes over £100,000.

B.44 As announced in Budget 2004, the lifetime allowance for pensions tax relief will be £1.8 million in 2010-11. The annual allowance will be £255,000 for 2010-11.

Table B5: Bands of taxable income

2009-10	£ a year	2010-11	£ a year
Starting rate 10 per cent[1]	0-2,440	Starting rate 10 per cent[1]	0-2,440
Basic rate 20 per cent	0-37,400	Basic rate 20 per cent	0-37,400
Higher rate 40 per cent	over 37,400	Higher rate 40 per cent	37,401-150,000
Additional rate 50 per cent	n/a	Additional rate 50 per cent	over 150,000

[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 B6: Income tax allowances 2010-11

	£ per year		
	2009-10	2010-11	Increase
Personal allowance[1]			
age under 65	6,475	6,475	-
age 65-74	9,490	9,490	-
age 75 and over	9,640	9,640	-
Married couple's allowance[2]			
age 75 and over	6,965	6,965	-
minimum amount	2,670	2,670	-
Income limit for age-related allowances	22,900	22,900	-
Blind person's allowance	1,890	1,890	-

[1] *The personal allowance is gradually restricted for income over £100,000 at a rate of £1 for every £2 over £100,000 until completely withdrawn.*

[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.45 National insurance contributions (NICs) rates, thresholds and limits will be maintained at their 2009-10 levels, with the exception of the Lower Earnings Limit (LEL) and the special Class 2 rate for volunteer development workers which is linked to the LEL. The LEL will rise to £97 per week in line with the 2.5 percent increase in the basic State Pension.

Table B7: National insurance contribution rates 2010-11

Class 1 rates			Self employed NICs		
Earnings[1] £ per week	Employee (primary) NIC rate per cent	Employer (secondary) NIC rate[2] per cent	Profits[1] £ per year	Class 2 £ per week	Class 4 per cent
Below 97 (LEL)	0	0	Below 5,075 (SEE)[3]	0.00	0
97 to 110 (PT/ST)[4]	0	0	5,075 to 5,715 (LPL)	2.40	0
110 to 844 (UEL)	11	12.8	5,715 to 43,875 (UPL)	2.40	8
Above 844	1	12.8	Above 43,875	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 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.*

[3] *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*

[4] *No NICs are actually payable but Class 1 NIC are 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.46 As announced in Budget 2009, the child element of the Child Tax Credit will rise by £20 above indexation in April 2010, an increase of £65 in cash terms.

B.47 The Government will increase Child Benefit, Guardian's Allowance, the disability elements of the Child Tax Credit, all elements of the Working Tax Credit (WTC), apart from the childcare element, and the disregard for WTC in Housing Benefit by 1.5% in April 2010 and 2011. The threshold for receipt of the maximum Child Tax Credit award will rise to £16,190, reflecting the income level at which a family in receipt of the basic and couple or lone parent elements of WTC would have their entitlement to WTC tapered to zero. Other rates and thresholds in tax credits will remain unchanged.

B.48 From April 2011, people aged 65 and over will qualify for the Working Tax Credit if they work at least 16 hours a week, rather than 30 hours as currently.

Table B8: Working and Child Tax Credit rates and thresholds

	£ per year		
	2009-10	2010-11	Increase
Working Tax Credit			
Basic Element	1,890	1,920	30
Couple and lone parent element	1,860	1,890	30
30 hour element	775	790	15
Disabled worker element	2,530	2,570	40
Severe disability element	1,075	1,095	20
50 plus element, 16–29 hours	1,300	1,320	20
50 plus element, 30+ hours	1,935	1,965	30
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	2,235	2,300	65
Disabled child element	2,670	2,715	45
Severely disabled child element	1,075	1,095	20
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	16,040	16,190	150
Income disregard	25,000	25,000	-

RECEIPTS

B.49 This section analyses the projections for tax receipts in detail. It begins by looking at the main determinants of changes in the overall projections since Budget 2009, before looking at changes in the projections of individual tax receipts. Finally it provides updated forecasts for the tax-GDP ratio.

Changes in total receipts since Budget 2009

B.50 Table B9 shows outturns for cash receipts in the first seven months of 2009-10 and estimated receipts for the remainder of the year, along with percentage changes over the corresponding period in 2008-09. 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.51 Economic growth in the early part of 2009 was weaker than expected in Budget 2009. However, overall receipts growth in 2009-10 to date has been close to expectations in the Budget 2009 forecast. Receipts from stamp duties and VAT for the year-to-date in 2009-10 have been higher than expected. In part this is likely to be due to the caution in the Budget forecast assumptions on equity prices and the VAT gap, and higher property prices and transactions than expected at Budget. Income tax and NICs receipts have been weaker than expected in the year-to-date, which is likely to reflect lower earnings growth than expected at the Budget. For 2009-10 as a whole, overall receipts are expected to be £2.1 billion higher than in the Budget 2009 projection.

Table B9: 2009-10 Net taxes and national insurance contributions

	£ billion			Percentage change on 2008-09		
	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]	130.3	101.1	231.4	-7.0	-10.1	-8.4
Value added tax	41.0	26.2	67.2	-19.7	-4.3	-14.3
Corporation tax[2]	21.6	11.8	33.4	-30.1	-3.3	-22.5
Petroleum revenue tax	0.5	0.7	1.2	-72.7	-6.5	-52.9
Fuel duties	15.4	11.0	26.4	6.5	8.1	7.1
Inheritance tax	1.4	0.8	2.2	-26.1	-13.6	-22.1
Stamp duties	4.3	3.1	7.4	-23.7	31.6	-7.2
Tobacco duties	5.2	3.6	8.8	9.5	3.1	6.8
Alcohol duties	5.2	3.8	9.0	8.7	3.0	6.2
Other Customs duties and levies	5.9	4.1	10.0	-4.9	0.0	-2.8
Total HMRC	**230.7**	**166.3**	**397.0**	**-11.8**	**-6.4**	**-9.6**
Vehicle excise duties	3.4	2.3	5.7	-0.1	6.3	2.4
Business rates	16.5	7.2	23.7	2.0	6.0	3.2
Council tax	16.7	8.1	24.8	2.4	1.1	1.9
Other taxes and royalties	8.2	8.1	16.4	-10.8	25.1	4.0
Net taxes and NICs	**275.6**	**192.0**	**467.6**	**-10.1**	**-4.5**	**-7.9**

[1] *Provisional.*

[2] *Net of tax credits scored as negative tax in net taxes and national insurance contributions.*

B.52 Receipts growth is expected to be less weak in the remaining months of 2009-10 than in the first seven months. In part this is a consequence of policy measures such as VAT returning to 17.5 per cent at the end of the year. It also reflects the strengthening path of the economy over the course of 2009-10, with growth expected to return by the end of the year.

B.53 Changes to the medium-term receipts forecast since Budget are driven by primarily by changes to the inflation forecast and by the recovery in asset markets. In the medium term, the Pre-Budget Report forecast of the level of nominal GDP is lower than at Budget because CPI inflation is forecast to be below target for longer than previously expected. This results in a lower level of labour income, which generates around 45 per cent of total receipts through income tax and NICs. This drives a reduction in income tax and NICs receipts compared to Budget. This is partly offset by higher expected receipts from stamp and capital taxes, reflecting the strength in equity and property markets since Budget, and in higher North Sea receipts reflecting the increase since Budget in the NAO oil price assumption.

Tax by tax analysis

Income tax and NICs

B.54 Cash receipts of income tax and NICs in 2009-10 are expected to be £3.0 billion below the Budget 2009 forecast with the shortfall more than explained by lower PAYE and NIC1 receipts. Although the decline in employment has not been as steep relative to output as in previous recessions, earnings growth has slowed sharply. Receipts have been particularly weak in the manufacturing and construction sectors, and there have also been sustained falls in the retail, financial and business service sectors.

B.55 Receipts are expected to remain weak over the remainder of the year. Financial sector bonuses are expected to decline in 2009-10 by around 25 per cent to a level of around £5 billion reflecting the fall in financial sector profits, a greater proportion of awards deferred in line with the FSA code on remuneration, and the impact of the bank payroll tax announced in this Pre-Budget Report. Self assessment receipts are also expected to decline sharply, reflecting lower self-employment income and falls in both savings and dividend income. While tax on savings income has held up better than expected in 2009-10, it is still likely to have fallen by over a third from the previous year.

B.56 Receipts of income tax and NICs are expected to rise but will be held back by continued subdued earnings growth. The 2010-11 forecast allows for the Budget 2009 measure for an additional 50 per cent rate of income tax on incomes above £150,000. With CPI inflation expected to fall well below target in 2011 given the large degree of spare capacity in the economy, earnings growth is expected to remain subdued for longer than in the Budget 2009 forecast. The Pre-Budget Report projections assume that growth in wages and salaries reaches 5½ per cent in the medium-term, below the growth rate of nominal GDP. This leaves income tax and NICs lower than in the Budget forecast over the rest of the forecast horizon.

Box B2: Impact of NAO-audited assumptions on the fiscal forecast

The National Audit Office (NAO) audited assumptions are designed to add caution to the public finances forecast. Box B1 sets out details of all the NAO assumptions. This box illustrates how NAO-audited assumptions affect the 2009 Pre-Budget Report forecast.

Trend rate of GDP growth: The trend rate 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. The economy forecast is also based on a rebalancing of the economy towards growth in corporate incomes, investment and exports. This growth is less tax-rich than growth in wages and salaries and in consumption. On the income side, profits growth is less tax-rich than wages and salaries growth. From 2010-11 onwards, growth in both wages and salaries and in consumption is below the overall nominal growth in the economy.

Equity and oil prices: The NAO-audited assumption on equity prices is that the FTSE All-share index rises in line with nominal GDP from its current level. For the oil price the NAO-audited assumption is based on the average price over the past three months, which is then held flat in real terms over the forecast. This means the oil price remains at between $72–77 per barrel over the forecast period.

VAT gap: The NAO-audited assumption is that the underlying VAT gap (the difference between recorded VAT receipts and the theoretical tax liability) increases by 0.5 percentage points per year from the latest estimated outturn. With firms' cash flows under pressure due to the downturn, there was a rise in VAT debts, pushing up the VAT gap in 2008-09. While the growth in VAT debts has slowed during 2009-10, much of the higher downturn-related VAT gap is locked in by the NAO-audited assumption through the medium-term forecast. This provides considerable caution, as with the economy projected to recover over the forecast period, it is likely that the VAT gap will actually fall, which would increase VAT receipts.

Claimant count unemployment: The NAO-audited assumption on the claimant count rises to 1.94m by the end of 2011, which is the average of independent forecasts in the November comparison published by HM Treasury, and then remains flat through the rest of the forecast period. HM Treasury's projection, published for the first time in this Pre-Budget Report, is that claimant count unemployment will fall to 1¼ m by the end of 2014. This provides caution within the public expenditure projections.

Claimant count unemployment: NAO assumption and HMT projection (millions)

	2008	2009	2010	2011	2012	2013	2014
NAO Assumption (Q4)	1.09	1.72	1.91	1.94	1.94	1.94	1.94
HMT Projection (Q4)	1.09	1 ¾	1 ¾	1 ½	1 ½	1 ¼	1 ¼

Table B10: Current receipts

	£ billion			Changes since Budget 2009 (£ billion)		
	Outturn 2008-09	Estimate 2009-10	Projection 2010-11	Outturn 2008-09	Estimate 2009-10	Projection 2010-11
HM Revenue and Customs						
Income tax (gross of tax credits)	153.5	140.4	144.7	0.9	-0.1	0.0
Income tax credits	-5.6	-6.2	-6.5	0.1	0.0	-0.3
National insurance contributions[1]	96.9	94.8	98.1	0.4	-2.9	-1.5
Value added tax	78.4	67.2	74.2	0.0	3.5	0.8
Corporation tax[2]	43.7	34.1	40.9	0.3	-0.6	1.6
Corporation tax credits[3]	-0.6	-0.7	-0.8	0.0	0.0	0.0
Petroleum revenue tax	2.6	1.2	1.6	0.0	0.1	0.4
Fuel duties	24.6	26.4	28.0	0.0	-0.2	-0.1
Capital gains tax	7.8	2.5	2.6	0.0	0.2	0.9
Inheritance tax	2.8	2.2	2.3	0.0	0.0	0.4
Stamp duties	8.0	7.4	9.3	0.0	2.5	2.6
Tobacco duties	8.2	8.8	8.9	0.0	0.5	0.6
Spirits duties	2.4	2.6	2.6	0.0	0.0	0.0
Wine duties	2.7	2.9	3.0	0.0	0.2	0.3
Beer and cider duties	3.4	3.5	3.5	0.0	0.1	0.1
Betting and gaming duties	1.5	1.4	1.4	0.0	0.0	-0.1
Air passenger duty	1.9	1.9	2.3	0.0	0.1	0.1
Insurance premium tax	2.3	2.3	2.3	0.0	-0.2	-0.2
Landfill tax	1.0	0.9	1.2	0.0	-0.1	-0.1
Climate change levy	0.7	0.7	0.7	0.0	0.0	0.0
Aggregates levy	0.3	0.3	0.3	0.0	0.0	0.0
Customs duties and levies	2.7	2.6	2.5	0.0	-0.1	-0.2
Total HMRC	**439.1**	**397.0**	**423.1**	**1.7**	**2.8**	**5.3**
Vehicle excise duties	5.6	5.7	6.1	0.0	0.1	-0.1
Business rates	22.9	23.7	24.6	0.1	-0.2	0.0
Council tax[4]	24.4	24.8	25.8	0.0	-0.1	-0.1
Other taxes and royalties[5]	15.7	16.4	19.2	0.4	-0.4	0.3
Net taxes and NICs[6]	**507.7**	**467.6**	**498.8**	**2.3**	**2.2**	**5.5**
Accruals adjustments on taxes	-4.2	1.3	1.7	0.2	1.0	-1.2
Less own resources contribution to EC budget	-5.1	-3.7	-4.6	0.1	0.4	0.2
Less PC corporation tax payments	-0.2	-0.2	-0.2	0.0	0.0	0.0
Tax credits adjustment[7]	0.6	0.7	0.8	0.0	0.0	0.0
Interest and dividends	7.0	4.4	4.7	-0.5	-1.2	-1.6
Other receipts[8]	26.7	28.1	29.2	-0.4	-0.3	-1.0
Current receipts	**532.4**	**498.1**	**530.3**	**1.7**	**2.1**	**1.8**
Memo:						
North Sea revenues[9]	12.9	7.0	8.4	0.0	0.1	1.8

[1] *Includes Bank Payroll Tax*

[2] *National Accounts measure, gross of enhanced and payable tax credits.*

[3] *Includes enhanced company tax credits.*

[4] *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.*

[5] *Includes VAT refunds and money paid into the National Lottery Distribution Fund.*

[6] *Includes VAT and 'traditional own resources' contributions to EC budget.*

[7] *Tax credits which are scored as negative tax in the calculation of NTNIC but expenditure in the National Accounts.*

[8] *Includes gross operating surplus, rent and business rate payments by local authorities.*

[9] *Consists of North Sea corporation tax and petroleum revenue tax.*

Non-North Sea corporation tax

B.57 Non-North Sea corporation tax is one of the most cyclical taxes and receipts are expected to fall by around 15 per cent in 2009-10, with revenue from the financial sector around a third of its 2006-07 peak, at just £3¼ billion out of a total of £28¼ billion. The 2009-10 decline is driven not only by a decline in profits for both the financial and non-financial sectors, but also reflects the introduction of a first year capital allowance of 40 per cent for 2009-10 along with the impact of higher repayments as firms carry back losses to relieve against earlier liabilities. Overall, it is higher than expected repayments that are the key factor behind the £0.6 billion lower estimate for non-North Sea corporation tax in 2009-10.

B.58 Receipts from non-North Sea corporation tax are forecast to recover in 2010-11. Repayments in 2010-11 are expected to fall back as firms return to profit but also because loss-making firms can only carry back losses against recently paid tax for one year. Payments should also increase, driven by stronger forecast profits and a decrease in deductions as the enhanced capital allowances scheme draws to a close. Profits in the financial sector are expected to start to recover in 2010 from their depressed 2009 level. The Pre-Budget Report projections assume that taxable financial sector profits grow by 10 per cent in 2010-11 and 2011-12, before returning to rates of 7 per cent in each year. This is based on the assumption that profits as a percentage of GDP only return to close to the 20-year average in 2014-15. This leaves corporation tax from the sector below its 2007-08 level, even by 2014-15.

B.59 Receipts from the non-oil, non-financial sector should benefit from continuing profit growth from 2010-11 onwards, reflecting sustained economic growth. However, with a smaller contribution of the financial sector to overall activity than envisaged prior to the crisis, non-North Sea corporation tax as a proportion of GDP remains well below the recent peak of 2.9 per cent.

North Sea revenues

B.60 North Sea revenues in 2009-10 are expected to be around £6 billion lower than in 2008-09. Oil prices which averaged almost $100 a barrel in 2008 are likely to average around $62 a barrel in 2009. The sharp rise and subsequent fall in oil prices in 2008 meant that the first two corporation tax instalment payments on 2008 profits were much stronger than the final payment in January 2009. Instalment payments on 2009 profits are likely to be more even. This contributed to the sharp year-on-year decline of corporation tax in the first part of 2009-10, but is a key reason why the annual decline should be less strong over the remainder of the year.

B.61 Compared with the Budget forecast, oil prices are likely to be around $15 a barrel higher in 2009. However, North Sea revenues are expected to be just £0.1 billion above the Budget forecast for 2009-10. Higher oil prices have been offset by a combination of higher than expected operating and capital expenditure, weak gas prices and production over the summer and the appreciation of sterling against the dollar which has meant that the rise in oil prices in sterling terms has been more modest. From 2010, the forecast uses the NAO-audited assumption on oil prices. Based on the average of the past three months, oil prices are expected to be $72.7 a barrel in 2010 and then constant in real terms. With oil prices over $20 a barrel higher than in the Budget forecast from 2010 onwards and gas prices assumed to move back in line with oil prices, North Sea revenues are expected to be between £1¾ billion and £2½ billion higher than in Budget 2009 over the rest of the forecast period.

Capital gains tax and inheritance tax

B.62 Capital gains tax (CGT) is expected to fall from £7.8 billion in 2008-09 to £2.5 billion in 2009-10. CGT is paid in the final quarter of the financial year following the year in which the gains were realised. With financial assets accounting for the majority of chargeable gains, a sizeable element of the fall in receipts results from the sharp drop in equity prices through 2008-09. The year-on-year drop is accentuated by particularly strong receipts in 2008-09, reflecting investors rearranging their affairs ahead of the abolition of taper relief when the

CGT regime was reformed in the 2007 Pre-Budget Report. The expected drop in CGT is one reason why the decline in income tax, NICs and CGT is greater in the remaining months of the financial year than in the first seven months of 2009-10 in Table B9. The stabilisation of the housing market and higher equity prices have led to upward revisions to receipts from both CGT and inheritance tax from 2010-11 onwards.

Stamp duties **B.63** Stamp duty both on property and shares has been particularly affected by the financial crisis. Stamp duty in 2009-10 is expected to be around half of its 2007-08 level. However, the decline in stamp duty in 2009-10 is less than that assumed in the Budget forecast, reflecting the stabilisation in the housing market. House prices have recorded monthly rises, while property transactions have rebounded more strongly than assumed in the Budget, although they remain historically low. Stamp duty on shares have also benefited from higher equity prices and volumes since the start of this financial year.

B.64 Year-on-year growth in stamp duty is likely to turn positive over the remainder of 2009-10 given the annual comparison will be against the low point for both property transactions and equity prices. In 2010-11, the stamp duty land tax forecast is based on the average of independent forecasts for house prices which assumes broadly stable prices in the year to the final quarter of 2010. Thereafter, stamp duty land tax continues to rise as house prices grow at around 5 per cent per year consistent with the average growth of real house prices over the last thirty years and transactions return to a level consistent with the historical average duration of ownership.

VAT **B.65** Cash receipts of VAT are expected to fall by 14 per cent in 2009-10, reflecting the temporary reduction in VAT from 17½ per cent to 15 per cent, the impact of the fall in economic activity on the VAT base and repayments relating to the judicial ruling in Fleming/Condé Nast on the three year time limit for reclaiming overdeclared or underclaimed VAT for tax periods before May 1997. However, the drop in receipts this year is not expected to be as steep as forecast at Budget 2009. Receipts are expected to be around £3.5 billion higher, principally because unauthorised VAT debt has not grown as quickly as was assumed in the Budget and litigation repayments made in the first half of the financial year were not as high as had been forecast.

B.66 Higher than expected receipts in 2009-10 also reflect stronger consumer durable spending than anticipated. Durable spending, which is mainly standard rated, picked up in the second quarter and is likely to have risen further in the third quarter helped by the temporary reduction in VAT, the car scrappage scheme and low interest rates. Ahead of the Budget, the economic downturn and restrictive credit conditions had led to a rise in unauthorised VAT debt. This pushed up the VAT gap (the difference between the theoretical tax liability and actual receipts). The Budget forecast allowed for a further significant rise in the VAT gap on the assumption that VAT debt would continue to rise sharply into 2009-10. However, the growth in VAT debt has slowed in the first half of the financial year. The related document *Measuring Tax Gaps 2009* describes the VAT gap for 2008-09 and the methodology used to calculate the estimate including the impact of debt.

B.67 VAT receipts are expected to recover in 2010-11 reflecting the ending of the temporary reduction in the standard rate of VAT. However, there will be an offset from higher repayments relating to the Fleming judicial ruling than in 2009-10. The forecast also assumes that growth in VAT receipts will be held back by the rebalancing of demand in the economy, which will lead to nominal consumer spending growing by less than overall growth in the economy. In addition, the NAO-audited assumption on the VAT gap requires at least a 0.5 percentage point rise in the underlying VAT gap each year. This builds considerable caution into the forecast because with the economy recovering, it might be expected that new VAT debt would fall, which would reduce the VAT gap.

Excise duties **B.68** Fuel duties in 2009-10 are expected to be £0.2 billion below the Budget 2009 projection. Relative to the Budget, a deeper downturn in the first half of 2009 and a higher oil price negatively affected fuel duty receipts. With fuel duty charged on a per litre basis, higher pump prices would reduce demand and hence receipts. With oil prices over $20 a barrel higher from 2010 onwards, higher oil prices take around £0.7 billion per year off fuel duty receipts.

B.69 Alcohol and tobacco receipts in 2009-10 are expected to be £0.3 billion and £0.5 billion higher respectively than assumed in the Budget forecast. Spending has held up better than anticipated in the Budget. In particular duty paid consumption of tobacco may have been boosted by the weakness of sterling against the euro which would make cross-border shopping or illicit behaviour less attractive.

Council tax **B.70** 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 2010-11 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.71** Around three-quarters of the other taxes and royalties component of Table B10 is VAT refunds to central and local government. The temporary reduction in the VAT rate has lowered these refunds so far this year. Year-on-year growth over the remainder of the year is likely to be much stronger reflecting that the annual comparison in the final three months will reflect refunds at 17½ per cent relative to 15 per cent a year earlier. VAT refunds also score as public expenditure and thus have no effect on net borrowing.

Tax-GDP ratio

B.72 Table B11 shows projections of receipts from major taxes as a percentage of GDP, and Table B12 sets out projections of the overall tax-GDP ratio, based on net taxes and national insurance contributions.

Table B11: Current receipts as a proportion of GDP

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Income tax (gross of tax credits)	10.7	10.0	9.8	10.2	10.6	10.8	11.0
National insurance contributions[1]	6.8	6.7	6.7	6.9	6.9	7.0	7.0
Non-North Sea corporation tax[2]	2.3	2.0	2.3	2.4	2.5	2.4	2.4
Tax credits[3]	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
North Sea revenues[4]	0.9	0.5	0.6	0.6	0.6	0.5	0.4
Value added tax	5.5	4.8	5.0	5.3	5.2	5.1	5.0
Excise duties[5]	2.9	3.1	3.1	3.1	3.1	3.0	2.9
Other taxes and royalties[6]	6.8	6.6	6.8	6.9	6.9	6.9	6.9
Net taxes and NICs[7]	**35.4**	**33.2**	**33.9**	**34.9**	**35.3**	**35.3**	**35.3**
Accruals adjustments on taxes	-0.3	0.1	0.1	0.2	0.3	0.2	0.2
Less EU transfers	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Other receipts[8]	2.4	2.3	2.3	2.5	2.5	2.6	2.5
Current receipts	**37.1**	**35.3**	**36.0**	**37.3**	**37.7**	**37.8**	**37.7**

[1] *Includes Bank Payroll Tax*

[2] *National Accounts measure, gross of enhanced and payable tax credits.*

[3] *Tax credits scored as negative tax in net taxes and national insurance contributions.*

[4] *Includes petroleum revenue tax and North Sea corporation tax.*

[5] *Fuel, alcohol and tobacco duties.*

[6] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*

[7] *Includes VAT and 'own resources' contributions to EC budget; cash basis.*

[8] *Mainly gross operating surplus and rent.*

Table B12: Net taxes and national insurance contributions[1]

	Per cent of GDP						
	Outturn[2]	Estimate[3]	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Budget 2009	35.1	33.0	33.8	34.7	35.1	35.3	-
2009 Pre-Budget Report	**35.4**	**33.2**	**33.9**	**34.9**	**35.3**	**35.3**	**35.3**

[1] *Cash basis. Uses OECD definition of tax credits scored as negative tax.*

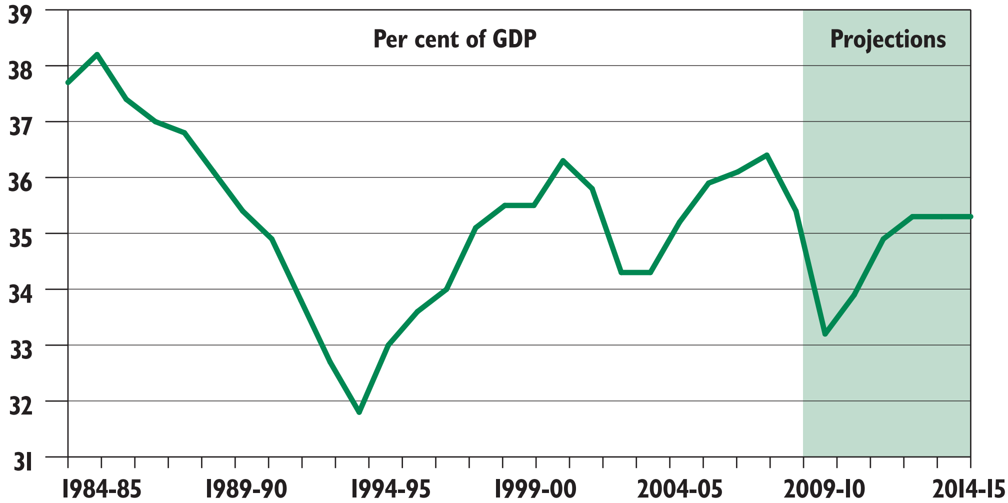
[2] *The 2008-09 figures were estimates in Budget 2009.*

[3] *The 2009-10 figures were projections in Budget 2009.*

B.73 The tax-GDP ratio is similar to the Budget 2009 projection throughout the projection period. The tax-GDP ratio falls by over 2 percentage points in 2009-10 reflecting the effect of the downturn, the further decline in receipts from the financial and housing sectors and policy measures for fiscal support such as the temporary reduction in the standard rate of VAT. While the tax-GDP ratio remains above its early 1990s low, the decline in the ratio of just over 3 percentage points since the last on-trend point in 2006-07 is similar in scale to the fall recorded between 1990-91 and 1993-94.

B.74 The ending of the temporary reduction in VAT will push up the tax-GDP ratio in 2010-11. Growth picking up to above-trend rates and the impact of the government's fiscal consolidation measures, lead the tax-GDP ratio to rise further in 2011-12. However, the forecasting judgments on the rebalancing of demand in the economy, a lower contribution to receipts from the financial sector than expected prior to the crisis and the NAO-audited assumptions all constrain the overall level of the tax-GDP ratio.

Chart B1: Tax-GDP ratio[1]



[1]Net taxes and NICs as defined in Table B12.

Box B3: Impact of the financial and housing sector on the public finances

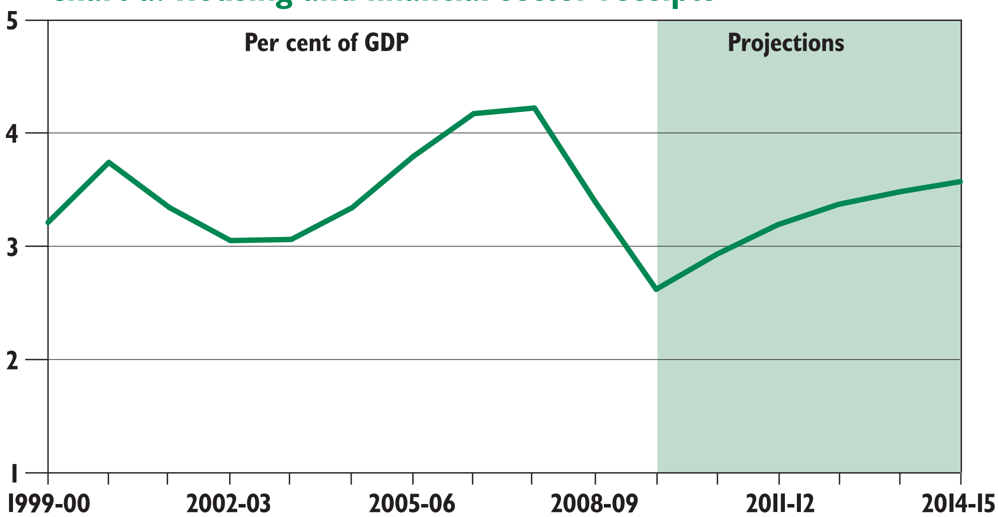
The financial crisis and global downturn has particularly affected the financial and housing sectors in the UK, which are sectors that have been a particularly important source of tax receipts.

Financial company corporation tax has in the past 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[a].

In recent years before the financial crisis, 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. 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.

In recent months there are signs that the economy is stabilising and that financial conditions are improving. However receipts from the financial sector are expected to fall further in 2009-10 compared to 2008-09 due to further falls in the profits of the financial sector. Receipts are then expected to recover but 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 to 2½ per cent of GDP in 2009-10, before rising to 3½ per cent of GDP in 2014-15, as these sectors see a cyclical recovery.

Chart a: Housing and financial sector receipts



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.

PUBLIC EXPENDITURE

B.75 This section looks in detail at the projections for public expenditure. It includes provisional outturns for 2008-09, the latest estimates for 2009-10 and public expenditure plans for 2010-11 to 2014-15. The spending projections cover the whole of the public sector, using the National Accounts aggregate Total Managed Expenditure (TME).

Total Managed Expenditure

B.76 A breakdown of TME up to 2010-11 is provided in Table B15. For fiscal aggregate 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 (which is large, volatile and demand-led, and is therefore not easily subject to firm multi-year limits). Changes to TME since Budget in the period until the end of the current spending review are set out in Table B16.

B.77 The 2009 Pre-Budget Report confirms that overall departmental spending in 2010-11 will be maintained as planned to help support the economy through recovery. But, as set out in Budget 2009, spending growth will reduce from 2011-12 onwards in order to ensure sustainable public finances over the medium term. As set out in Chapter 5, the Pre-Budget Report announces that self-employed, employer and employee rates of national insurance contributions will rise by an additional 0.5 per cent from April 2011. As a result, the 2009 Pre-Budget Report announces that public sector current expenditure[2] will grow by an average of 0.8 per cent a year in real terms between 2011-12 and 2014-15. In line with Budget 2009, public sector net investment will move to 1¼ per cent of GDP by 2013-14 and remain at that level in 2014-15.

AME forecast

B.78 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 2009 that affect the AME forecast are a lower NAO-audited assumption for unemployment, changes to RPI and Rossi inflation, which affect benefit and public service pension upratings, and changes to gilt rates which affect debt interest.

B.79 The AME forecasts include two elements – the AME margin and the forecast of social security spending based on the NAO claimant count assumption – which provide elements of caution to mitigate against the risks of additional spending from movements in inflation and interest rates. As shown in Box B2, the NAO claimant count assumption builds in caution, because it assumes that claimant count unemployment does not fall from 2011 onwards. This provides caution in the public expenditure projections.

[2] Excluding the additional time-limited expenditure announced in the 2009 Pre-Budget Report.

Table B13: Current and capital budgets

	£ billion						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Current budget							
Current receipts	532.4	498.1	530	576	617	656	694
Current expenditure	563.8	607.0	647	666	686	707	729
Depreciation	18.7	19.2	20	21	22	23	24
Surplus on current budget	**-50.1**	**-128.1**	**-137**	**-111**	**-91**	**-74**	**-59**
Capital budget							
Gross investment[1]	64.0	68.7	60	50	48	45	47
Less depreciation	-18.7	-19.2	-20	-21	-22	-23	-24
Net investment	45.3	49.5	39	29	26	22	23
Net borrowing	**95.4**	**177.6**	**176**	**140**	**117**	**96**	**82**
Public sector net debt - end year[2]	**618.8**	**798.9**	**986**	**1139**	**1270**	**1379**	**1473**
Memos:							
Treaty deficit[3]	97.8	177.9	177	141	119	98	84
Treaty debt[4]	796.9	1027.0	1209	1359	1485	1589	1679

Note: Measures of current budget, public sector net borrowing and public sector net debt are presented on the basis which excludes the temporary effect of financial interventions.

[1] *Net of asset sales; for a breakdown see Table [2.X] in* 2009 Pre-Budget Report: the economy and public finances - supplementary material.

[2] *Debt at end March.*

[3] *General government net borrowing on a Maastricht basis.*

[4] *General government gross debt on a Maastricht basis.*

Table B14: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Current budget							
Current receipts	37.1	35.3	36.0	37.3	37.7	37.8	37.7
Current expenditure	39.3	43.1	44.0	43.1	41.9	40.7	39.6
Depreciation	1.3	1.4	1.4	1.4	1.3	1.3	1.3
Surplus on current budget	**-3.5**	**-9.1**	**-9.3**	**-7.2**	**-5.6**	**-4.3**	**-3.2**
Capital budget							
Gross investment[1]	4.5	4.9	4.0	3.3	2.9	2.6	2.6
Less depreciation	-1.3	-1.4	-1.4	-1.4	-1.3	-1.3	-1.3
Net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
Net borrowing	**6.6**	**12.6**	**12.0**	**9.1**	**7.1**	**5.5**	**4.4**
Public sector net debt - end year[2]	**44.0**	**55.6**	**65.4**	**71.7**	**75.4**	**77.1**	**77.7**
Memos:							
Treaty deficit[3]	6.9	12.6	12.0	9.1	7.3	5.7	4.6
Treaty debt ratio[4]	55.5	72.9	82.1	88.0	90.9	91.6	91.2

Note: Measures of current budget, public sector net borrowing and public sector net debt are presented on the basis which excludes the temporary effect of financial interventions.

[1] *Net of asset sales; for a breakdown see Table 2.3 in* 2009 Pre-Budget Report: the economy and public finances - supplementary material.

[2] *Debt at end March; GDP centred on end March.*

[3] *General government net borrowing on a Maastricht basis.*

[4] *General government gross debt on a Maastricht basis.*

Table B15: Total Managed Expenditure 2008-09 to 2010-11

	£ billion		
	Outturn	Estimate	Projections
	2008-09	2009-10	2010-11
CURRENT EXPENDITURE			
Resource Departmental Expenditure Limits	**321.2**	**342.2**	**353.4**
of which:			
Near-cash Departmental Expenditure Limits	301.6	319.5	329.8
Non-cash	19.5	22.7	23.6
Resource Annually Managed Expenditure	**242.7**	**264.8**	**293.6**
of which:			
Social security benefits [1]	149.8	163.8	169.5
Tax credits [1]	19.8	22.1	22.8
Net public service pensions [2]	3.3	4.1	4.8
National Lottery	1.0	0.9	0.9
BBC domestic services	3.4	3.5	3.7
Other departmental expenditure	0.9	-0.4	2.0
Net expenditure transfers to EC institutions [3]	3.1	6.6	7.4
Locally-financed expenditure [4]	26.8	27.0	28.3
Central government gross debt interest	30.5	30.7	44.4
AME margin	0.0	0.9	1.8
Accounting adjustments	4.0	5.4	8.1
Public sector current expenditure	**563.8**	**607.0**	**647.1**
CAPITAL EXPENDITURE			
Capital Departmental Expenditure Limits	**48.1**	**56.6**	**52.7**
Capital Annually Managed Expenditure	**15.9**	**12.1**	**6.8**
of which:			
National Lottery	0.5	1.0	0.9
Locally-financed expenditure	7.4	5.8	4.7
Public corporations' own-financed capital expenditure	6.8	7.1	7.4
Central government grants to public sector banks [4]	9.9	3.0	0.0
Other capital expenditure	-0.4	1.4	1.4
AME margin	0.0	0.0	0.0
Accounting adjustments	-8.4	-6.2	-7.5
Public sector gross investment	**64.0**	**68.7**	**59.5**
Less public sector depreciation	-18.7	-19.2	-20.1
Public sector net investment	**45.3**	**49.5**	**39.5**
TOTAL MANAGED EXPENDITURE [5]	**627.8**	**675.7**	**706.6**
of which:			
Departmental Expenditure Limits	357.7	385.9	392.7
Annually Managed Expenditure	270.1	289.9	313.9

[1] For 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 other costs attributed to Departmental DELs, and the UK's net contribution to the EC Budget, which includes these attributed costs, are (in £ billion):

	2008-09	2009-10	2010-11
Net payments to EC institutions	2.3	3.9	5.1
Net contribution to EC Budget	3.0	4.8	6.0

[4] Included in PSNB, previously excluded under PSNB. See further details in B18.

[5] Total Managed Expenditure is equal to the sum of public sector current expenditure, public sector net investment, and public sector depreciation, on a basis which excludes temporary effects of financial interventions.

Table B16: Changes to Total Managed Expenditure since the Budget 2009

	£ billion		
	Outturn	Estimate	Projections
	2008-09	2009-10	2010-11
CURRENT EXPENDITURE			
Resource Departmental Expenditure Limits	**-3.1**	**0.1**	**1.2**
of which:			
Near-cash Departmental Expenditure Limits	-1.4	-0.4	1.0
Non-cash	-1.7	0.5	0.2
Resource Annually Managed Expenditure	**2.5**	**-1.1**	**1.1**
of which:			
Social security benefits	-0.3	-0.9	-1.4
Tax credits	0.0	0.5	1.0
Net public service pensions	0.3	0.0	0.2
National Lottery	0.1	0.0	0.1
BBC domestic services	0.0	0.0	0.0
Other departmental expenditure	0.1	-2.8	0.3
Net expenditure transfers to EC institutions	0.0	0.9	-0.5
Locally-financed expenditure	-0.6	-0.9	-0.2
Central government gross debt interest	0.1	3.5	1.5
AME margin	0.0	0.0	0.0
Accounting adjustments	2.9	-1.5	0.2
Public sector current expenditure	**-0.6**	**-1.0**	**2.2**
CAPITAL EXPENDITURE			
Capital Departmental Expenditure Limits	**-0.2**	**-1.1**	**1.1**
Capital Annually Managed Expenditure	**8.0**	**6.4**	**1.5**
of which:			
National Lottery	-0.1	0.0	0.0
Locally-financed expenditure	2.9	1.4	0.8
Public corporations' own-financed capital expenditure	-0.4	-0.3	-0.2
Central government grants to public sector banks [4]	9.9	3.0	0.0
Other capital expenditure	-0.8	-0.1	0.5
AME margin	0.0	-0.1	-0.2
Accounting adjustments	-3.6	2.4	0.6
Public sector gross investment	**7.8**	**5.3**	**2.7**
Less public sector depreciation	-0.1	0.4	0.6
Public sector net investment	**7.7**	**5.7**	**3.3**
TOTAL MANAGED EXPENDITURE	**7.1**	**4.3**	**4.9**
of which:			
Departmental Expenditure Limits	-3.0	-1.5	2.2
Annually Managed Expenditure	10.2	5.7	2.7

AME

Social security benefits **B.80** The forecast for social security expenditure is lower than at Budget 2009, primarily driven by decreases in the NAO-audited assumptions for claimant count unemployment since the Budget reflecting the better than expected performance of the labour market. The assumption uses the average of independent forecasts of claimant count, which is 1.94m at end of 2011, and is then held constant through the forecast period. This has a direct impact on forecasts for Jobseeker's Allowance, Housing Benefit and Council Tax Benefit in particular. As set out in Box B2, the Treasury's projection is that the claimant count will fall to 1¼m in 2014.

Tax credits **B.81** The forecast growth in tax credits spending is driven largely by uprating of the rates and thresholds in line with the Government's indexation policy. This forecast has increased since Budget 2009. The changes reflect revised economic assumptions for RPI inflation and average earnings, and updated estimates relating both to the current level of expenditure on in-work families claiming tax credits and the ongoing impact of the economic downturn on recipients. There are expected to be fewer out of work families than forecast at Budget 2009, reflecting revisions to the claimant count assumption, but falls in income among those in work, which can lead to increased entitlements, are expected to be more numerous. The changes also reflect a growing number of claims for Working Tax Credit by people without children, and the Budget 2006 commitment to index the child element of Child Tax Credit with earnings for the duration of this Parliament.

Public service pensions **B.82** Net public service pensions are measured on a National Accounts basis, and report benefits paid less contributions received by central government pay-as-you-go public service pension schemes. Forecast expenditure in 2010-11 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. Payments to pensioners are expected to increase because of increases in the number of pensioners. Net public service pensions expenditure remains relatively unchanged in 2009-10 compared to Budget 2009, whilst higher than expected pension payments increases net expenditure in 2010-11 compared to the Budget forecast.

National Lottery **B.83** The National Lottery figures reflect the latest view on timing of drawdown by distributing bodies. The 2009-10 estimates are broadly unchanged from Budget 2009. The forecasts for 2009-10 and 2010-11 are consistent with the latest information from the distributions funds, and projected revenues from ticket sales.

Other departmental expenditure **B.84** The large changes to other departmental current and capital expenditure in 2009-10 reflect fees received to date during 2009-10, in respect of the Asset Protection Scheme, the Credit Guarantee Scheme, and underwriting fees for the issuance of shares in Banks temporarily in the public sector. The figures for central government grants to public sector banks in 2008-09 and 2009-10 are newly included in the public finance aggregates, on the basis that excludes the temporary effects of financial institutions. Previously these would have been neutral within the public sector. Increases in other capital expenditure in 2010-11 are primarily due to increases in net lending to public corporations.

EU contributions **B.85** Net expenditure transfers to EU Institutions, which consist of Gross National Income (GNI) based contributions less the UK abatement, are unchanged in 2008-09, higher in 2009-10 and lower in 2010-11 than was estimated at the time of the 2009 Budget. The main factors are the use of later information on the size of the EC Budget for 2009 and the possible level of the 2010 EC Budget, and the level of UK payments to these Budgets, changes in UK GNI-based contributions resulting from the use of latest economic assumptions and other changes resulting from new information from the European Commission.

Locally financed expenditure

B.86 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 are based on stylised assumptions, which are not government forecasts, and are mirrored in the projections for council tax included in 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.87 The reductions in current LASFE since Budget 2009 mainly reflect the impact of lower forecast use of reserves to finance current spending and higher use of revenue to finance capital expenditure. Capital LASFE grows, reflecting higher capital expenditure financed from revenue, a forecast reduction in local authority asset sales (that net-off capital spend) and the one-off transfer of Salford's housing stock in 2008-09.

CG debt interest

B.88 The projections for central government gross debt interest payments have been revised in the light of the latest assumptions for the economic determinants. The level of debt interest rises in line with the developments in borrowing and the expected path of key determinants. The increases in debt interest payments since Budget 2009 are due to higher forecast RPI inflation, which has increased the expected uplift accruing on index-linked gilts, and also because market expectations of interest rates have risen since Budget 2009.

PC capital expenditure

B.89 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 lower, due to greater lending from central government, which offsets any increases in PC net capital expenditure.

AME margin

B.90 The figures for the AME margin shown in Table B15 above are as set in Budget 2009, but with the figures reduced as necessary to accommodate forecast increases in spending.

Accounting adjustments

B.91 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 2009 *Pre-Budget Report: the economy and public finances – supplementary material*. Changes to the current and capital accounting adjustments since Budget 2009 include a lower estimate 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 in capital DEL budgets, but is then switched out of capital and into current spending in the national accounting adjustments. Other changes to accounting adjustments reflect lower forecasts for VAT refunds and the imputed subsidy for the Housing Revenue Account (HRA), both of which are offset in current receipts.

Table B17: Departmental Expenditure Limits - resource and capital budgets

	Outturn 2008-09	Estimate 2009-10	Plans 2010-11
Resource DEL			
Children, Schools and Families	46.8	49.2	51.3
Health	92.3	100.1	104.0
of which: NHS England	90.7	98.4	102.3
Transport	5.7	6.4	6.4
CLG Communities	4.2	4.5	4.5
CLG Local Government	24.7	25.6	26.3
Business, Innovation and Skills	18.0	19.1	19.2
Home Office	9.2	9.6	9.8
Justice	9.1	9.6	9.4
Law Officers' Departments	0.7	0.7	0.7
Defence	36.7	38.9	36.7
Foreign and Commonwealth Office	2.1	2.1	1.6
International Development	4.8	5.4	6.2
Energy and Climate Change	0.4	1.1	1.1
Environment, Food and Rural Affairs	2.6	2.7	2.7
Culture, Media and Sport	1.6	1.7	1.7
Work and Pensions	8.0	8.9	9.8
Scotland	24.6	25.6	26.1
Wales	12.9	13.6	14.0
Northern Ireland Executive	8.0	8.4	8.7
Northern Ireland Office	1.3	1.2	1.2
Chancellor's Departments	4.5	4.4	4.2
Cabinet Office	2.1	2.3	2.4
Independent Bodies	0.8	0.9	1.0
Modernisation Funding	0.0	0.3	0.2
Reserve	0.0	0.4	4.0
Allowance for shortfall	0.0	-0.6	0.0
Total resource DEL	**321.2**	**342.2**	**353.4**
Capital DEL			
Children, Schools and Families	5.5	7.4	6.7
Health	4.4	5.4	4.7
of which: NHS England	4.2	5.3	4.6
Transport	7.2	8.0	7.3
CLG Communities	7.1	9.1	6.4
CLG Local Government	0.1	0.2	0.1
Business, Innovation and Skills	2.1	3.0	2.3
Home Office	0.8	0.8	0.8
Justice	0.9	0.9	0.7
Law Officers' Departments	0.0	0.0	0.0
Defence	8.7	9.0	8.8
Foreign and Commonwealth Office	0.2	0.2	0.2
International Development	0.9	1.4	1.6
Energy and Climate Change	1.7	2.1	2.0
Environment, Food and Rural Affairs	0.6	0.7	0.6
Culture, Media and Sport	0.9	0.5	0.6
Work and Pensions	0.1	0.3	0.3
Scotland	3.3	4.0	3.2
Wales	1.6	1.7	1.8
Northern Ireland Executive	1.2	1.1	1.1
Northern Ireland Office	0.1	0.1	0.1
Chancellor's Departments	0.3	0.4	0.2
Cabinet Office	0.4	0.4	0.4
Independent Bodies	0.0	0.1	0.1
Reserve	0.0	0.8	2.8
Allowance for shortfall	0.0	-0.8	0.0
Total capital DEL	**48.1**	**56.6**	**52.7**
Depreciation	11.6	13.0	13.5
Total Departmental Expenditure Limits	**357.7**	**385.9**	**392.7**
Total Education spending[1]	81.4	88.0	89.2

[1] *Education spending is defined according to the UN's Classification of the Functions of Government. Projections include spending by departments, Devolved Administrations and local authorities. Changes since Budget 2009 reflect updated departmental and Devolved Administration budgets.*

DEL

B.92 The detailed allocation of DEL is shown in Table B17. The departmental groupings have been updated to reflect the machinery of government changes announced in June 2009, and outturn years restated on the basis of current departmental responsibilities. In line with previous practice, resource and capital DEL for 2009-10 reflect the latest available information and include an allowance for shortfall reflecting likely underspends against departmental provisions.

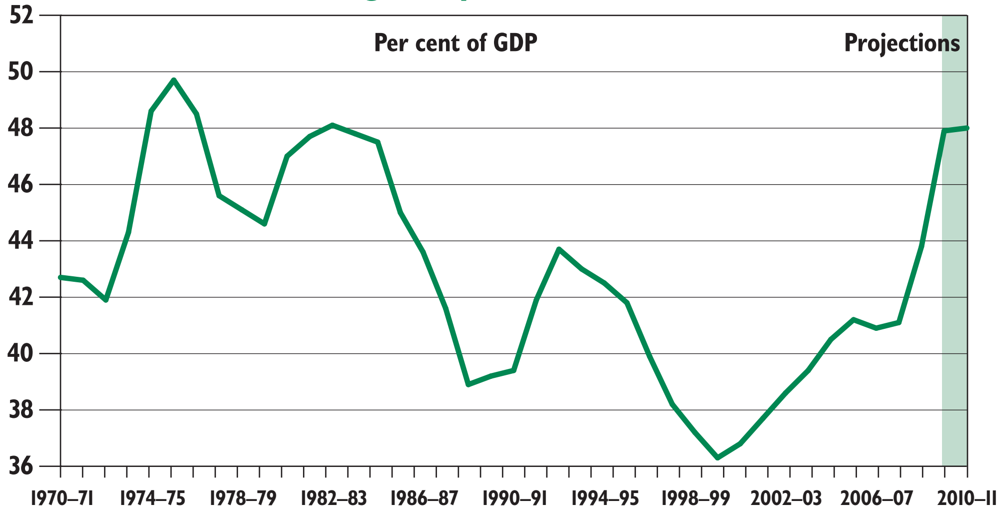
B.93 Final outturn spending for total DEL in 2008-09 was £357.7 billion, £3.0 billion below Budget 2009 forecast. Within this total underspend, capital DEL was £0.2 billion lower than forecast, near-cash resource DEL was £1.4 billion lower than forecast, and non-cash resource DEL was £1.7 billion lower than forecast. The 2008-09 capital DEL outturn includes £0.4 billion of accelerated investment planned for that year and announced within the 2008 Pre-Budget Report capital fiscal stimulus package. The near-cash resource DEL underspend reflected larger than expected underspending by a number of departments, most notably a £1.3 billion underspend by the Department of Health (DH), which mainly reflects the planned surplus in the NHS, the result of improving financial management. The unspent capital DEL largely relates to provision for contingency for the Olympic Delivery Authority.

B.94 There have been a number of changes to DEL budgets since Budget 2009. These mostly reflect:

- reprioritisation measures to fund new spending policies from within existing budgets, including £350 million transferred from the Department for Transport (DfT) to the Department of Communities and Local Government (CLG) to fund the Social Housing Package announced in *Building Britain's Future*;
- an addition to the Reserve of £2.5 billion in 2010-11 to provide an adequate contingency for the cost of Military Operations in 2010-11;
- an additional £130 million in 2009-10 for Department for Children, Schools and Families (DCSF) through access to End of Year Flexibility to fund the Building Schools for the Future and academies programmes; and
- adjustments to the resource and capital budgets for a number of departments following changes in International Financial Reporting Standards.

B.95 The latest figures also include classification and budgetary changes, which have no impact on National Accounts definitions or TME.

Chart B2: Total Managed Expenditure



Source: HM Treasury.

Central Government spending in 2009-10

B.96 Monthly spending information is only available for central government. The provisional outturn for current expenditure in the first seven months of 2009-10 is 6 per cent higher than in the corresponding period in 2008-09. Growth is lower in the year to date than the Pre-Budget Report estimate for the year as a whole, as a result of lower debt interest spending.

B.97 Debt interest payments for the year to date are 23.4 per cent lower than the same period last year, largely because of the effect of lower RPI inflation on the accruing uplift on index-linked gilts. The cumulative year-on-year decline will diminish later in the year as the RPI inflation rate for the relevant period (three or eight months previously depending on the gilt prospectus) rises.

B.98 Provisional outturn data for net social benefit expenditure for the first seven months of 2009-10 show growth of 10.1 per cent over the same period in 2008-09, as a continued result of the economic downturn. Net social benefit expenditure is estimated to grow at a lower rate for the year as a whole in the Pre-Budget forecast, due to the NAO-audited assumption for unemployment projecting slower growth in the second half of 2009.

B.99 Other current expenditure is 7.2 per cent higher for the year to date, compared to the relevant period a year ago. This is slightly lower than the Pre-Budget Report estimate of 7.6 per cent growth for the year as a whole.

FINANCIAL INTERVENTIONS

Classification in National Accounts

B.100 Following 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 the independent Office for National Statistics (ONS) issued comprehensive documentation on 6 November 2009 describing how measures to maintain financial stability and support the effective functioning of the financial sector should be classified in National Accounts and included in outturn data.

Treatment in the public finances

B.101 The long-term impact of the financial interventions on the sustainability of public finances will be determined by the eventual net profit or loss on these interventions, which will represent the permanent impact on the taxpayer. The Government will therefore base its assessment of the fiscal position on measures that account for these permanent effects and which exclude any temporary effects of liabilities incurred as a result of the interventions. The treatment of net losses from the financial interventions in the fiscal projections is described further in Box B4.

Public sector net borrowing

B.102 As set out at the start of this annex, and consistent with this approach, this Pre-Budget Report uses a measure of net borrowing and its components that excludes the temporary effects of the financial interventions (PSNB ex). As set out in Chapter 2, the Fiscal Consolidation Plan will target this measure of borrowing. This measure is consistent with the parallel measure of PSND ex announced at Budget 2008, which the ONS report in outturn. The ONS will also report PSNB ex in outturn and are today publishing a technical note on its derivation.

B.103 PSNB ex will exclude in outturn the temporary effects of financial interventions such as the gross operating surpluses of banks while they are temporarily in the public sector. Once the ONS have included data for RBS and LBG in the Public Sector Finances data these flows have the potential to be large and volatile. However, PSNB ex will capture in outturn the permanent effects to the taxpayer of the financial interventions such as:

- the fee income and any loss payments associated with interventions such as the Asset Protection Scheme and the Credit Guarantee Scheme;
- any interest payments from public sector banks to the Government and the interest flows associated with interventions, including the Asset Purchase Facility;
- any paper losses on the acquisition of equity or injection of capital in public sector banks; and
- any final indemnity payments on interventions such as the Special Liquidity Scheme and Asset Purchase Facility.

B.104 Table B18 sets out the impact in detail from 2008-09 to 2010-11. This shows:

- transactions between the banks and the private sector are excluded. These are currently small as the ONS has not yet included RBS and Lloyds in the National Accounts measure of PSNB. The net interest income of the Bank of England Asset Purchase Facility Fund (BEAPFF) is also excluded. The Government has indemnified the Bank of England with respect to any losses that may materialise on the Fund's operations and this would score in PSNB ex;
- public sector banks transactions with Government are included in PSNB ex, this currently includes fees paid to the Government by RBS and Lloyds related to recapitalisations and the APS. Any losses on the APS would also be included in this line;
- on a National Accounts basis the difference between the purchase price for equity injections into public sector banks and the market price of the equity on the day of purchase is included in PSNB ex as a capital grant. Other equity injections include funding for Northern Rock; and

- the Government's support for depositors in Bradford and Bingley over the FSCS depositor compensation limit is also included in PSNB ex as a capital grant.

B.105 The projections in this annex do not include any estimate of fee or dividend income from the interventions. Payments and receipts associated with interventions are only included in estimated outturn and in the Budget projections where these have already been made, or a firm announcement has been made of a future transaction. The additional borrowing to finance these payments gives rise to an increase in the Government's debt interest costs which is included in the projections in this annex. Net interest flows are included in the projections.

B.106 Consistent with National Accounts, a number of transactions relating to the financial interventions will not affect any measure of PSNB because they take the form of financial transactions, such as loans or share purchases, which do not constitute borrowing (as one financial asset is being exchanged for another), or they are offset by recoveries imputed in the National Accounts, such as for liabilities borne by the FSCS. This means that the cash receipts from the sale of shares in public sector banks will not score in PSNB ex as they will be classified as financial transactions. The sale of shares will be reflected in lower debt once the banks are reclassifed to the private sector.

Table B18: Financial interventions - impact on PSNB

	£ billion			
	Outturn	Estimate	Projections	
	2008-09	2009-10	2010-11	2011-12
PSNB including temporary effects of financial interventions	**84.7**	**170.4**	**170**	**136**
Temporary effects excluded from PSNB ex:				
Public sector banks and Bank of England Schemes: transactions with the private sector[1]	0.8	5.5	6	4
Included in PSNB ex:				
Public sector banks: transactions with government[2]	0.0	-3.8	0	0
Equity injections: acquisition of shares[3]	6.1	4.2	0	0
Other equity injections	0.0	1.4	0	0
Depositor compensation	3.8	0.0	0	0
PSNB excluding temporary effects of financial interventions	**95.4**	**177.6**	**176**	**140**
	Percentage of GDP			
PSNB including temporary effects of financial interventions	5.9	12.1	11.6	8.8
PSNB excluding temporary effects of financial interventions	6.6	12.6	12.0	9.1

[1] *Illustrative projections for the purposes of the public finances only. Do not represent the Governments' view on the future profits of public sector banks or the net interest income of the Asset Purchase Facility.*

[2] *This includes fees for outturn. No fee payments are included in the projection.*

[3] *Provisional estimate for 2009-10.*

Box B4: The net fiscal cost of financial interventions

At Budget 2009 the Government provisionally estimated that potential losses from the financial interventions might lie within a range of £20 billion to £50 billion. The estimate was set out as a range because of the significant uncertainty over potential outcomes from the interventions at that point. The high end of this range was adopted for fiscal policy purposes as a cautious judgement. It was used to create a measure of PSND including unrealised losses from the financial interventions. This measure was not on a National Accounts basis and was not reported by the ONS.

Exceptional financial market and economic uncertainty has receded since the Budget and, as set out in Chapter 3, significant changes to the APS policy agreement mean the risks to the taxpayer have reduced. Taking these changes into account, the eventual fiscal cost will be determined by a number of factors:

- the eventual net profit or loss on the recapitalisations of RBS and Lloyds. This will depend on the eventual sale price achieved compared to the purchase price. One way to value this is on the basis of current market prices which would point to a cost of £14 billion, net of the value of the Government's RBS dividend access share. The Government will also have received a total of £0.7 billion in underwriting fees, and this year will receive a £0.3 billion fee for the RBS contingent capital guarantee;
- net payouts under the APS scheme. Based on due diligence of APS assets and the outlook for asset prices and the economy, the central expectation is that net losses on the insured pool of assets will not exceed the revised £60 billion first loss that will fall to RBS. Under the APS the Government will receive fees of £2.5 billion from Lloyds and at least £2.5 billion from RBS; and
- the aggregate costs for all other interventions are expected to be close to zero overall once fees and other income are taken into account. They have been designed to minimise exposure and fair value fees are charged.

At current market prices the net cost of these components would total £8 billion. Any eventual profit or loss will only be realised on the sale of the shares.

Treatment in the public finances and for fiscal policy purposes

With the Government's exposure now focused on its share holdings and with uncertainty having receded since Budget, it is appropriate to remove the £50 billion provision and move the treatment of financial interventions into line with fiscal aggregates defined on a National Accounts basis and reported by the ONS:

- National Accounts scores a capital grant if the purchase price for equity exceeds the market price on the day of purchase. The value of these capital grants for the purchase of RBS and LBG shares in 2008-09 is £6 billion and in 2009-10 will be around £4 billion, net of the value of the dividend access share. The value in 2009-10 will depend on the share prices on the day of the transactions. These figures will then be fixed as at the day of purchase and will not move subsequently as share prices change in the market; and
- the value of fees to be received this year and so included in the 2009-10 projections totals over £4 billion, but fee receipts estimated to be of a similar value across the forecast period are excluded from the forecast.

As set out in Tables B18 and B19 the equity injections related to the acquistion of shares will increase the measures of net borrowing and net debt excluding the temporary effect of the financial interventions by around £10 billion over two years, representing on a National Accounts basis the treatment of potential losses from the interventions.

Impact on Public Sector Net Debt

B.107 Since September 2008 the ONS has published estimates of public sector net debt both including and excluding financial interventions (initially only the impact of Northern Rock) in the monthly Public Sector Finance statistical bulletin. Table B19 shows the composition of the difference between PSND including financial interventions and PSND excluding the temporary effects of financial interventions.

Table B19: Financial interventions - impact on PSND

	£ billion			
	Outturn	Estimate	Projections	
	2008-09	2009-10	2010-11	2011-12
PSND including temporary effects of financial interventions	**742.4**	**941.6**	**1118**	**1264**
Temporary effects excluded from PSND ex:				
Bank balance sheets[1]	122	130	126	122
Depositor compensation	9	10	10	10
Bank of England Schemes	2	15	10	6
Included in PSND ex:				
Equity injections: acquisition of shares[2]	6	10	10	10
Other equity injections	0	1	1	1
Depositor compensation	4	4	4	4
Public sector banks: transactions with government[3]	0	-3	-3	-3
PSND excluding temporary effects of financial interventions	**618.8**	**798.9**	**986**	**1139**
	Percentage of GDP			
PSND including temporary effects of financial interventions	**52.8**	**65.5**	**74.2**	**79.7**
PSND excluding temporary effects of financial interventions	**44.0**	**56.7**	**67.0**	**73.7**

[1] *RBS and Lloyds Banking Group cannot be included until ONS have calculated their specific contributions, this is consistent with ONS' treatment in Public Sector Finances.*

[2] *Provisional estimate for 2009-10.*

[3] *No fee payments are included in the projection.*

B.108 The main contributions to PSND from financial interventions are:

- the total liabilities, net of liquid assets, of the balance sheets of Northern Rock and Bradford & Bingley (B&B). ONS have not yet been able to calculate the impact of RBS and Lloyds' balance sheets on PSND;
- depositor compensation paid out by the FSCS and Treasury in respect of deposits with Kaupthing Singer & Friedlander (KSF), Heritable, Landsbanki, Dunfermline Building Society and London Scottish Bank which has yet to be recovered from the administrators of those institutions; and
- the BEAPFF is a monetary policy instrument which is also excluded from the measures excluding the temporary effects of financial interventions. As at the end of September 2009, the scheme had added some £17 billion to the National Accounts measure of PSND, mainly from gilts which for PSND are valued at face value and this was lower than the market price paid.

B.109 General government gross debt (GGGD), the Maastricht Treaty debt definition, is affected by all of the cash flows that impact on the CGNCR, whether or not they cross the public sector boundary. Thus the Government's purchases of equity in RBS and Lloyds Banking Group are included in GGGD even though these are classified by the ONS as intra-public sector transactions.

Table B20: Financial interventions - impact on CGNCR

	£ billion			
	Outturn	Estimate	Projections	
	2008-09	2009-10	2010-11	2011-12
Net effect of financial interventions	**84.0**	**44.0**	**-4.5**	**-3.2**
transactions which also affect net borrowing				
Equity injections: acquisition of shares	6.1	4.2	0.0	0.0
Other equity injections	0.0	1.4	0.0	0.0
Depositor compensation	3.8	0.0	0.0	0.0
Public sector banks: transactions with government[1]	-0.4	-2.8	0.0	0.0
financial transactions which do not affect net borrowing				
Loans	20.6	15.0	-4.6	-3.3
Equity injections (net acquisition of shares at market price)	30.8	25.2	0.0	0.0
Depositor compensation	23.1	1.1	0.1	0.0

[1] *No fee payments are included in the projection.*

Impact on Central Government Net Cash Requirement

B.110 Cash payments associated with the financial interventions increase the CGNCR in the year in which they are made. The transactions which also affect net borrowing in Table B20 are discussed earlier in this section. The transactions which directly affect the CGNCR include:

- the cash components of loan advances and capital injections into public sector banks; and
- the component of depositor compensation paid below the FSCS limit.

NET CASH REQUIREMENT

B.111 Table B21 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.

Table B21: Public sector net cash requirement

	£ billion 2009-10				£ billion 2010-11			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing ex	**170.7**	**6.9**	**0.0**	**177.6**	**171.7**	**5.0**	**-0.4**	**176.3**
Financial interventions impact	0.0	0.0	-7.2	-7.2	0.0	0.0	-6.0	-6.0
Net borrowing	**170.7**	**6.9**	**-7.2**	**170.4**	**171.7**	**5.0**	**-6.4**	**170.3**
Financial transactions								
Net lending to private sector and abroad	4.9	0.1	-0.2	4.8	5.7	0.1	-0.2	5.6
Cash expenditure on company securities	26.0	-0.5	-24.7	0.8	1.0	-0.7	0.7	1.0
Accounts receivable/payable	2.6	0.2	0.3	3.1	2.0	0.2	0.3	2.5
Adjustment for interest on gilts	1.6	0.0	0.0	1.6	-4.4	0.0	0.0	-4.4
Miscellaneous financial transactions	16.2	1.8	-6.8	11.2	-4.7	0.0	-5.4	-10.0
Own account net cash requirement	222.1	8.5	-38.7	192.0	171.3	4.6	-11.0	164.9
Net lending within the public sector	1.2	-0.8	-0.5	0.0	2.7	-2.2	-0.5	0.0
Net cash requirement[1]	**223.3**	**7.8**	**-39.1**	**192.0**	**174.0**	**2.4**	**-11.5**	**164.9**

Note: Including the effect of financial interventions except where stated.

[1] *Market and overseas borrowing for local government and public corporation sectors.*

B.112 The central government net cash requirement (CGNCR) for 2009-10 is now projected to be £2.5 billion higher than at Budget 2009, largely reflecting changes to the financial transactions. In order to derive the CGNCR it is necessary to use public sector net borrowing on a National Accounts basis, including the temporary effects of financial interventions. CG net borrowing is little changed from the Budget projection, though its composition is different with higher debt interest payments largely driven by higher inflation being offset by other changes. The changes to the financial transactions are as follows:

- net lending to the private sector and abroad is £0.6 billion lower at £4.9 billion largely as a result of a lower requirement for support for PFI projects;
- cash expenditure on company securities is £9.1 billion higher at £26.0 billion, the result of changes to the terms of the Asset Protection Scheme (APS) and the redemption of the preference shares in RBS and LBG earlier in the year. The latter reduced the net cash requirement by £2.2 billion as the Government's holding of LBG preference shares were only partially replaced by ordinary shares bought in the Open Offer. Under the APS the Government will make an equity injection of £25.5 billion into RBS, £9.5 billion higher than had been assumed in the Budget, and of £5.9 billion into LBG, which had not been assumed in the Budget. It is projected that some £4.0 billion of the £25.5 billion payment for unquoted RBS equity will count as a capital grant and so falls within CG net borrowing;
- accounts receivable/payable are £2.0 billion higher than at Budget, the result of changes to the projected tax accrual for 2009-10 which will not be received in cash in the financial year and to the timing of cash expenditures relative to their accrued equivalents It is also assumed that the RBS fees totalling £1 billion may not be paid in cash;

- the adjustment for interest on gilts is £3.4 billion lower at £1.6 billion, largely because inflation as it affects index-linked gilts is now projected to be higher than at the Budget. This change offsets the increase to CGNB resulting from a higher debt interest accrual on the index-linked gilts;
- miscellaneous financial transactions are £2.5 billion lower at £16.2 billion, the result of slightly lower projections of the new lending required to support the restructuring of Northern Rock and providing working capital facilities to Bradford & Bingley; and
- net lending within the public sector is £0.7 billion lower at £1.2 billion, the result of lower expected lending to local authorities.

FINANCING REQUIREMENT

Table B22: Financing requirement forecast

	£ billion	
	2009-10 April 2009 Original Remit	2009-10 December 2009 Pre-Budget Report
Central government net cash requirement	**220.8**	**223.3**
Gilt redemptions	16.6	16.6
Financing for the Asset Purchase Facility	-1.0	-1.0
Financing for the Official Reserves[1]	2.0	4.0
Buy-backs[2]	0.0	0.1
Planned short-term financing adjustment[3]	-0.6	-0.6
Gross financing requirement	**237.8**	**242.4**
Less Assumed net contribution from NS&I	0.0	-0.5
Net financing requirement	**237.8**	**242.9**
Financed by:		
1. Debt issuance by the Debt Management Office		
Treasury bills	21.6	21.6
Gilts	220.0	225.1
2. Other planned changes in short-term debt[4]		
Changes in Ways & Means[5]	-3.8	-3.8
3. Unanticipated changes in short-term cash position[6]	**0.0**	**0.0**
Total financing	**237.8**	**242.9**
Short-term debt levels at end of financial year		
Treasury bill stock in market hands[7]	65.6	65.6
Ways & Means	0.4	0.4
DMO net cash position	0.5	0.5

[1] This figure reflects an additional £2 billion of sterling financing for the Official Reserves in addition to the £2 billion announced at Budget 2009.

[2] 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.

[3] 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.

[4] 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.

[5] Reflects the Government's decision to repay £3.8 billion of the remaining balance of the Ways and Means Advance in 2009-10. The Government repaid £3.2 billion in 2008-09.

[6] A negative (positive) number indicates an addition to (reduction in) the financing requirement for the following financial year.

[7] The DMO has operational flexibility to vary the end-financial year stock subject to its operational requirements in 2009-10.

B.113 In line with the updated fiscal forecasts, the revised financing arithmetic for 2009-10 is shown in Table B22. The central government net cash requirement (CGNCR) is now forecast to be £223.3 billion, an increase of £2.5 billion from the Budget 2009 forecast. There has been an increase in the net financing requirement (NFR) for 2009-10 of £5.1 billion from Budget 2009, so that the NFR is now forecast to be £242.9 billion compared with £237.8 billion at Budget. The increase in the NFR is the net effect of:

- an increase in the CGNCR of £2.5 billion from the Budget 2009 forecast:
- a reduction in the forecast net contribution to financing of £0.5 billion in 2009-10 from National Savings and Investments (NS&I); and
- an increase of £2.0 billion in the financing for the Official Reserves.

B.114 In order to meet the increase in the NFR, the Debt Management Office's (DMO's) remit has been revised. Gross gilt issuance is projected to increase by £5.1 billion to £225.1 billion. The projected increase in the Treasury bill stock is unchanged at £21.6 billion.

B.115 Gross gilt issuance is expected to be split as follows:

- short-maturity gilt issuance is expected to be £74.2 billion (or 33 per cent of total issuance);
- medium-maturity gilt issuance is expected to be £70.1 billion (or 31 per cent of total issuance); and
- long-maturity and index-linked gilt issuance is expected to be £80.8 billion (or 36 per cent of total issuance).

B.116 Auctions will remain the Government's primary method by which to issue gilts. The Government will continue to use supplementary methods – syndication, mini-tenders and the post-auction 'top up' facility – to issue gilts in the remainder of 2009-10. It is anticipated that:

- £184.1 billion (82 per cent of total issuance) will be issued by pre-announced auctions;
- £30 billion (13 per cent of total issuance) will be issued by syndication; and
- £11 billion (5 per cent of total issuance) will be issued by mini-tenders.

B.117 Details of changes to the financing arithmetic and a revised financing table for 2009-10 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.

ADDITIONAL ANALYSES

B.118 Historical series for the main fiscal aggregates are included in Table B23 and B24. Further information on general government transactions and more detailed breakdowns of the public sector are included in the *2009 Pre-Budget Report: the economy and public finances – supplementary material.*

HISTORICAL SERIES

Table B23: 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	Net taxes and national insurance contributions	Public sector current receipts	Public sector net debt[1]	Public sector net worth[2]
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	42.7	53.8	
1976-77	-1.1	-0.6	5.5	5.0	6.3	35.1	43.0	52.3	
1977-78	-1.3	-1.2	4.3	4.1	3.6	34.1	41.3	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	40.5	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	45.4	46.2	
1982-83	-1.4	2.9	3.0	-1.4	3.1	38.2	45.1	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	73.0
1988-89	1.6	-1.0	-1.3	1.3	-3.0	36.1	40.2	30.5	78.2
1989-90	1.4	-1.4	-0.2	2.6	-1.3	35.4	39.4	27.7	70.1
1990-91	0.3	-1.2	1.0	2.6	-0.1	34.9	38.4	26.2	59.8
1991-92	-2.0	-1.5	3.7	3.3	2.3	33.8	38.1	27.4	52.6
1992-93	-5.6	-3.7	7.4	5.5	5.8	32.7	36.3	31.4	40.1
1993-94	-6.3	-4.0	7.7	5.4	6.9	31.8	35.4	36.5	29.6
1994-95	-4.8	-3.3	6.2	4.7	5.2	33.0	36.4	40.1	28.8
1995-96	-3.3	-2.4	4.7	3.8	4.2	33.6	37.2	41.9	21.5
1996-97	-2.7	-2.2	3.4	2.8	2.9	34.0	36.4	42.5	17.7
1997-98	-0.1	-0.1	0.7	0.6	0.1	35.1	37.5	40.6	15.3
1998-99	1.2	0.9	-0.5	-0.2	-0.7	35.5	37.7	38.4	14.4
1999-00	2.2	1.7	-1.6	-1.1	-0.9	35.5	37.9	35.6	17.4
2000-01	2.4	1.6	-1.9	-1.1	-3.7	36.3	38.6	30.7	23.0
2001-02	1.2	0.9	0.0	0.2	0.4	35.8	37.8	29.7	29.6
2002-03	-1.0	-0.7	2.3	2.0	2.3	34.3	36.3	30.8	28.2
2003-04	-1.5	-1.3	2.9	2.7	3.3	34.3	36.5	32.1	28.5
2004-05	-1.6	-1.5	3.3	3.2	3.2	35.2	37.3	34.0	28.6
2005-06	-1.1	-0.9	2.9	2.8	3.2	35.9	38.3	35.3	28.6
2006-07	-0.4	-0.4	2.3	2.3	2.6	36.1	38.6	36.0	29.2
2007-08	-0.4	-0.7	2.4	2.7	1.5	36.4	38.7	36.5	28.8
2008-09[3]	-3.5	-2.6	6.6	5.7	4.2	35.4	37.1	44.0	22.4

[1] *At end-March; GDP centred on end-March.*

[2] *At end-December; GDP centred on end-December.*

[3] *All measures are presented on the basis which excludes the temporary effect of financial interventions for 2008-09 except net worth and public sector net cash requirement which are presented on the basis that includes financial interventions.*

Table B24: Historical series of government expenditure

	£ billion (2008-09 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	195.2	37.3	59.6	254.8	32.7	6.2	10.0	42.7
1971-72	204.6	32.4	56.0	260.6	33.4	5.3	9.1	42.6
1972-73	213.0	31.1	55.7	268.7	33.2	4.9	8.7	41.9
1973-74	234.0	35.0	62.4	296.4	35.0	5.2	9.3	44.3
1974-75	257.9	37.5	66.4	324.3	38.7	5.6	10.0	48.6
1975-76	263.4	36.8	65.9	329.3	39.7	5.6	9.9	49.7
1976-77	270.6	30.2	60.3	330.9	39.7	4.4	8.8	48.5
1977-78	266.9	20.7	51.0	317.9	38.3	3.0	7.3	45.6
1978-79	274.9	18.0	49.1	324.0	38.2	2.5	6.8	45.1
1979-80	281.7	16.8	48.3	329.9	38.1	2.3	6.5	44.6
1980-81	289.9	13.4	45.4	335.3	40.6	1.9	6.4	47.0
1981-82	302.6	7.2	38.9	341.5	42.3	1.0	5.4	47.7
1982-83	309.6	11.4	42.2	351.8	42.3	1.6	5.8	48.1
1983-84	319.3	13.9	44.6	363.8	42.0	1.8	5.9	47.8
1984-85	327.6	12.2	41.4	369.0	42.2	1.6	5.3	47.5
1985-86	327.6	9.4	36.2	363.9	40.5	1.2	4.5	45.0
1986-87	332.9	5.7	32.7	365.6	39.7	0.7	3.9	43.6
1987-88	336.4	5.2	30.5	366.9	38.1	0.6	3.5	41.6
1988-89	328.9	3.2	28.6	357.6	35.8	0.3	3.1	38.9
1989-90	331.3	11.6	36.7	368.0	35.3	1.2	3.9	39.2
1990-91	333.6	12.6	35.5	369.1	35.6	1.3	3.8	39.4
1991-92	353.6	16.5	35.8	389.4	38.0	1.8	3.8	41.9
1992-93	371.3	17.2	36.1	407.4	39.8	1.8	3.9	43.7
1993-94	381.4	13.6	32.3	413.7	39.7	1.4	3.4	43.0
1994-95	393.1	13.9	32.7	425.9	39.3	1.4	3.3	42.5
1995-96	398.7	14.0	32.0	430.8	38.7	1.4	3.1	41.8
1996-97	397.7	7.2	23.8	421.5	37.6	0.7	2.3	39.9
1997-98	396.6	6.3	22.2	418.8	36.2	0.6	2.0	38.2
1998-99	398.5	7.6	23.0	421.4	35.1	0.7	2.0	37.2
1999-00	406.1	6.9	22.3	428.4	34.4	0.6	1.9	36.3
2000-01	426.9	6.3	21.9	448.8	35.0	0.5	1.8	36.8
2001-02	439.2	14.4	30.1	469.4	35.3	1.2	2.4	37.7
2002-03	459.6	16.1	32.5	492.0	36.0	1.3	2.5	38.6
2003-04	483.2	17.8	34.3	517.6	36.7	1.3	2.6	39.4
2004-05	504.9	22.7	39.5	544.4	37.6	1.7	2.9	40.5
2005-06	525.8	25.5	42.9	568.7	38.1	1.8	3.1	41.2
2006-07	534.6	27.3	45.2	579.8	37.7	1.9	3.2	40.9
2007-08	548.9	29.9	48.1	597.0	37.8	2.1	3.3	41.1
2008-09[2]	563.8	45.3	64.0	627.8	39.3	3.2	4.5	43.8

[1] *Net of sales of fixed assets.*

[2] *All measures are presented on the basis which excludes the temporary effect of financial interventions for 2008-09.*

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 Chamber of Commerce
BIS	Business for Innovation and Skills department
BRE	Better Regulation Executive
CAP	Common Agricultural Policy
CBI	Confederation of British Industry
CCAs	Climate change agreements
CCL	Climate change levy
CCS	Carbon capture and storage
CERT	Carbon Emissions Reduction Target
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
CPI	Consumer Prices Index
CSR	Comprehensive Spending Review
CTC	Child Tax Credit
CTF	Child Trust Fund
CVS	Corporate Venturing Scheme
DCMS	Department of Culture, Media and Sport
DCSF	Department for Children, Schools and Families
DEFRA	Department for Environment, Food and Rural Affairs
DEL	Departmental Expenditure Limit
DfES	Department for Education and Skills
DFID	Department for International Development
DfT	Department for Transport
DH	Department of Health
DMO	Debt Management Office
DTI	Department of Trade and Industry
DVLA	Driver and Vehicle Licensing Agency
DWP	Department for Work and Pensions
EC	European Communities
ECA	Enhanced Capital Allowance
ECF	Enterprise Capital Fund
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
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
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.
G20	A group of 20 Finance Ministers and Central Bank Governors representing nineteen countries plus the European Union
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
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
IWC	In Work Credit
JSA	Jobseeker's Allowance
LASFE	Local authority self-financed expenditure
LATS	Landfill Allowance Trading Scheme
LFS	Labour Force Survey
LHA	Local Housing Allowance
LIBOR	London Inter-Bank Offered Rate
LPG	Liquefied petroleum gas
LTCS	Landfill Tax Credit Scheme
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
NCIS	National Criminal Intelligence Service
NEET	Not in education, employment or training
NHS	National Health Service
NICs	National Insurance Contributions
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
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
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
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
SME	Small and medium-sized enterprise
STEM	Science Technology Engineering and Mathematics

TME	Total Managed Expenditure
TSB	Technology Strategy Board
UKFI	United Kingdom Financial Investments
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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Cover photography:
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Department for Business, Innovation and Skills
Getty Images / Mike Harrington
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Printed in the UK by The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
12/09

Printed on Paper containing 100% recycled content

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ISBN 978-0-10-177472-7
9 780101 774727