# Pre-Budget Report

November 1998

## Steering a stable course for lasting prosperity

**Pre-Budget Report November 1998**

# Contents

**Chapter 1 Overview**

**Chapter 2 Macroeconomic strategy and prospects**

**Chapter 3 The Productivity Challenge**

**Chapter 4 Encouraging and rewarding work**

**Chapter 5 Fairness**

**Annex A The economy**

**Annex B The Public Finances**

**Annex C Living standards and sustainable developments**

**List of tables**

**List of charts**

**Prepared for the Internet by The Stationery Office**
from Cm 4076
published by The Stationery Office
as ISBN 0 10 140762 9
Price: £25.00 [pounds sterling]
© Crown copyright 1998

# OVERVIEW

**1.1** The Government's central economic objective is high and stable levels of growth and employment. Its aim is an economy which is equal to every challenge of the global economy and which will close the productivity gap with our major competitors. It has strengthened the framework of monetary and fiscal policy to provide a stable platform of sustained growth and is addressing the fundamental structural weaknesses that have held back the UK economy for decades. By setting a sound macroeconomic framework, supported by tough policy decisions, the Government is steering a stable course for lasting prosperity in an uncertain world.

**1.2** The key elements of the Government's strategy are:

- promoting national and international economic stability;
- improving productivity performance;
- encouraging and rewarding work; and
- creating a fairer society and protecting the environment.

**1.3** Over the last 18 months the Government has begun to put this strategy into practice. Progress is being made on all fronts: rising living standards and productivity have to go hand in hand with a fairer society in which everyone has the opportunity to succeed. Economic development must also take place in a sustainable way, which safeguards the environment. The Government's aim is to ensure a better quality of life for everyone - now and for future generations to come.

1.4 **This report:**

- **provides a progress report on what has been achieved so far;**
- **updates forecasts on the economy and the public finances; and**
- ***sets out the direction of Government policy and further measures that are under consideration in the run up to the 1999 Budget. It will form the basis for a wide-ranging consultation over the coming months on the steps that need to be taken to rise to the productivity challenge and secure high and stable levels of growth and employment.***

# MACROECONOMIC STRATEGY AND PROSPECTS

**1.5** Economic instability damages long-run growth and employment. The Government has taken tough decisions to provide a stable platform for long-term sustained growth and to prevent a return to the boom and bust cycles of the past. The Government inherited an economy expanding at an unsustainable rate with inflation set to rise sharply above target and a large structural budget deficit, including a deficit on the current budget of £23 billion and net borrowing of £28 billion.

**1.6** The Government has put in place a credible long-term macroeconomic framework to get the economy back on track:

- a new monetary policy framework to deliver low inflation: the Bank of England has been given operational independence to set interest rates to meet the Government's inflation target - ensuring that interest rate decisions are taken on the basis of the long-term needs of the economy, not short-term political considerations;
- a new fiscal framework underpinned by tough fiscal rules to get public finances back under control: a significant fiscal tightening - equivalent to 3¾ per cent of Gross Domestic Product (GDP) over 1996-97 to 1998-99 - reduced borrowing by £20 billion last year and tight control has been maintained over public spending; and
- a new public expenditure regime, together with the firm three year public expenditure plans announced in the Comprehensive Spending Review (CSR) in July, will provide greater certainty, encourage longer-term planning and remove the bias against investment.

**1.7** These reforms have been underpinned by a commitment to greater openness and transparency: the Bank of England Act and the 1998 Finance Act respectively gave statutory underpinning to the new arrangements for conducting monetary policy

and to the Code for Fiscal Stability, which is laid before Parliament today. For example, the publication of the Monetary Policy Committee minutes helps to make the UK monetary framework one of the most transparent in the world.

**1.8** The new macroeconomic framework has helped to:

- reduce long-term interest to their lowest level in 35 years. After rising to get inflation under control, short-term interest rates are now at less than half the peak level of 15 per cent reached in the last cycle;
- bring inflation back to its 2½ per cent target compared to nearly 10 per cent in the early 1990s;
- strengthen the public finances so that the Government is on track to meet the two strict fiscal rules - the Golden Rule and the Sustainable Investment Rule; and
- focus public expenditure on the Government's priorities. Following the CSR, an additional £40 billion will be invested in education and health and public investment is set to double as a proportion of GDP over the next three years.

**Recent World Events and Prospects**

**1.9** With one quarter of the world, including Japan, now in recession, no country is immune from the effects of the current instability in the world economy. Prospects for the world economy have deteriorated over the last six months following the crisis in East Asia and Russia and recent turbulence in Latin America and other emerging markets. Growth forecasts have been revised down across the world. World trade growth is expected to fall by more than half this year, hitting UK export markets: UK exports to Indonesia and Malaysia are already down 50 per cent this year.

**1.10** The International Monetary Fund (IMF) has revised down its forecast for world growth next year from 4 per cent to 2½ per cent. The Treasury forecast for G7 leading industrialised countries growth has been revised down to 1¾ per cent this year and next, from 2¾ per cent in 1997. World economic growth is expected to pick up again in 2000. But there remains a risk of a sharper world economic downturn if the crisis in emerging markets deepens, G7 financial market volatility increases or the Japanese economy deteriorates further.

**1.11** The UKGovernment, in its Presidency of the G7 leading industrial nations, has played a leading role in developing key reforms to promote international stability and strong financial systems. In response to a proposal by the Chancellor of the Exchequer, G7 Finance Ministers and Central Bank Governors agreed on 30 October to modernise the financial system and put in place new rules and procedures to promote international stability and growth. The statements commit the G7 to:

- create and sustain conditions for strong, domestic demand-led growth;
- develop improved procedures for managing crises and preventing them from spreading, including an enhanced IMF financing mechanism supported by private and bilaterial finance as appropriate;
- develop and implement international principles and codes of best practice on: fiscal policy, financial and monetary policy, corporate governance, and accounting; and to work to ensure that private sector institutions comply with new standards of disclosure;
- improve global regulation through co-operation and co-ordination of the activities of key international institutions and national authorities in the management and development of policies to foster stability and reduce systemic risk in the international financial system; and
- support reforms to improve the effectiveness of the IMF, including transparency and accountability and changes in lending policies and terms of lending.

**1.12** The Government has also been very active in developing responses to assist those countries most affected by the present difficulties, including involvement in IMF and World Bank support arrangements. An increase in the IMFQuota, combined with the New Arrangements to Borrow, will provide additional resources to the IMF of $US 90 billion.

**UK Prospects**

**1.13** The UK is one of the most open of the major industrial economies, exporting around one third of GDP. Slower world growth therefore makes it inevitable that growth in the UK next year will be lower than expected at the time of the March Budget. UK GDP is now forecast to grow by between 1 and 1½ per cent in 1999 - ¾ per cent lower than forecast at Budget time, which can be more than accounted for by the effect of the deterioration in the world economy. In cutting interest rates at its October meeting, the Bank of England stressed that 'the international economic and financial environment has deteriorated'.

**1.14** The slowdown in growth will, in turn, dampen domestic inflationary pressures. But with import price inflation (currently negative) likely to start picking up through 1999, Retail Prices Index excluding Mortgage Interest Payments

(RPIX) inflation is forecast to return to its target level of 2½ per cent by the end of 1999, after temporarily dipping below it earlier in the year.

**1.15** The Government's forward-looking, long-term policy framework is designed to reduce economic instability in the UK compared to previous cycles and to lay the foundation for a sustainable recovery. Slower growth in 1999 is forecast to be followed by GDP growth of 2¼ to 2¾ per cent in 2000.

**1.16** There are risks that the UK slowdown could be sharper than forecast if the world outlook deteriorates further. But the consensus of independent forecasts, with which the Treasury agrees, is that the cyclical downturn will be less pronounced than in the past.

CHART 1.1 HERE

**Table 1.1: Summary of UK** forecast

| | Forecast | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| GDPgrowth (per cent) | 3½ | 2¾ | 1-1½ | 2¼-2¾ | 2¾-3¼ |
| RPIX Inflation (per cent, Q4) | 2¾ | 2½ | 2½ | 2½ | 2½ |

**Fiscal Prospects**

**1.17** Slower growth will inevitably impact on revenues and therefore the public finances but the current budget is forecast to remain in surplus in 1999 and 2000.

**1.18** As a result of the cautious assumptions built into the Economic and Fiscal Strategy Report (EFSR) forecasts and the prudent spending plans announced in July, the Government will:

- remain on track to meet the two fiscal rules over the cycle; and
- deliver the CSR spending commitments, including the £40 billion investment in health and education.

**1.19** In summary, the UK is better placed, because of the decisive action the Government has taken domestically and internationally, to steer a course of stability in an uncertain and unstable world. In the longer run, further steps also have to be taken to tackle the long-standing structural weaknesses in the economy: that is why the Government will continue to take action to promote productivity, encourage employment and create a fairer society.

# THE PRODUCTIVITY CHALLENGE

**1.20** The long-term prosperity of the UK depends on the productivity of UK business and employees. This Pre-Budget Report focuses on the approach that will be necessary to help all firms to rise to the productivity challenge facing our economy and British business.

**1.21** The scale of the challenge is spelt out in chart 1.1, which shows that the UK has a productivity gap of around 40 per cent with the US and around 20 per cent with France and Germany. Closing the gap will require a sustained drive over the long-term.

**1.22** The Government has already put in place a number of the key planks of a productivity strategy:

- the first two Budgets lowered corporation tax to its lowest ever level and introduced tax measures to encourage investment for the long-term and reward successful entrepreneurs;
- the CSR delivered a significant boost to education and skills - an extra £19 billion over the next three years - which will help to improve the skill base of tomorrow's labour force and increase the adaptability of those already in the labour market;
- the CSR delivered an additional £1.4 billion in funding for science which will generate high quality research and innovation across the economy; and
- net public investment will be doubled over the next three years, including substantial investments in education and transport, which will help to provide infrastructure essential to a modern, dynamic economy.

**1.23** Much more needs to be done. A series of seminars convened by the Chancellor of the Exchequer and the Secretary of

State for Trade and Industry in recent months have examined some of the underlying causes of the UK's poor productivity performance and the key next steps for improvement. There has been a striking consensus amongst the participants, business people and others alike, that a significant gap does exist and that government, in partnership with business, needs to address the central problem: the lack of a culture of enterprise, ambition and growth which is reflected in long-term under-investment in new skills and new equipment.

**1.24** The Government's future strategy is built around tackling four of the UK's historic weaknesses: it will aim to promote innovation and enterprise; tackle the causes of under- investment; strengthen competition; and improve the skills base. Chapter 3 sets out for consultation an initial package of specific policy proposals:

- a review of policies on employee share ownership to encourage more employees to take a stake in their companies and high quality managers to share in the risks and rewards of running small and medium sized enterprises (SMEs);
- a review of possible tax options to encourage growth and investment in SMEs, as well as to encourage entrepreneurs and other investors to make serial investments in smaller growing companies;
- consultation on a range of proposals to encourage more investment in R&D;
- a £25 million Science Enterprise Challenge to endow up to 8 new Institutes for Enterprise in universities. These Institutes will bring enterprise and business skills into the science curriculum and equip scientists to commercialise their work;
- a wide ranging review of the banking sector. The Government has asked the banks to work with Don Cruickshank, former Telecommunications regulator, in a review of the current levels of innovation, competition and efficiency in the banking industry in the UK, excluding investment banking: one of the key issues the review will consider, in co-operation with SMEs, is whether there is more the banks could do to build on their partnership with growing businesses;
- proposals to encourage transparency in institutional investment;
- consultation on incentives to promote corporate venturing. A range of incentives is being considered to promote investment by big companies in innovative small firms;
- more resources for the Office of Fair Trading (OFT). In recognition of the importance of open and competitive markets, the OFT has been given new resources worth over 20 per cent of its current budget;
- building on the extra £19 billion for education and training announced in the CSR by: ensuring that the National Curriculum better prepares young people for the world of work; improving partnerships between business and schools; a determination to increase the employability of students in higher education; new National Learning Targets for skills levels; and further encouragement for lifelong learning;
- a review of the tax treatment of intellectual property, with the aim of delivering a simpler, more coherent, system;
- work by the Financial Services Authority to help promote a more competitive, innovative and trusted savings market;
- a review of the impact of regulation on productivity by the Better Regulation Task Force;
- forthcoming DTI reviews of corporate rescue procedures and insolvency and bankruptcy law; and
- an examination of how the planning system can best promote business competitiveness, particularly in growth industries.

**1.25** Improving productivity in the public sector - which accounts for around 20 per cent of national output - is just as important as in other parts of the economy. The Government is therefore committed to improve public sector productivity through:

- Public Service Agreements (PSAs) - published later this year - which will set out stretching targets for improving the effectiveness of public spending;
- targets to reduce sickness absence;
- a review of civil procurement, led by Peter Gershon of GEC-Marconi, will explore the scope for efficiency savings;
- a second review of the Private Finance Initiative, led by Sir Malcolm Bates;
- a new Public Services Productivity Panel, chaired by the Paymaster General, of senior managers from business, including Byron Grote of BP-Amoco, and the public sector, will advise Cabinet Ministers on how best to improve the productivity of public services.

# ENCOURAGING AND REWARDING WORK

**1.26** The Government has set out a new approach to employment and tax and benefit policy - to promote employment opportunity for all, the new definition of full employment for the 21st century. The Government's strategy has three key elements: helping people from welfare to work; making work pay; and investing in skills. In the modern economy, countries

that succeed will be those that get the best out of all their people. And providing employment opportunities for all is the single most effective means of tackling poverty and social exclusion.

**1.27** The Government has already announced a number of steps to encourage and reward work:

- the Welfare to Work initiative, funded through a £5.2 billion Windfall Tax on the privatised utilities, is helping unemployed young people and other disadvantaged groups into jobs:
  - 160,000 young people have entered the New Deal. So far, 60,000 have completed the gateway phase, and already 30,000 have started work;
  - the New Deal has started on a national basis for the long-term unemployed and lone parents, and the New Deal for disabled people on a pilot basis;
  - a new single work-focused gateway will provide a framework for advice on employment opportunities at the point where people enter the benefit system.
- tax and benefit reform is helping to make work pay:
  - the Government announced the introduction of the Working Families Tax Credit (WFTC) and the Disabled Person's Tax Credit in the 1998 Budget. The WFTC will provide a guaranteed minimum income for families with one member in full-time work of at least £190 a week from October 1999. And those families with earnings of less than £220 a week will no longer pay any net income tax;
  - a national minimum wage will be introduced in April 1999, helping to promote incentives for individuals to find work and benefiting almost two million workers. Combined with the WFTC, this will give a minimum hourly wage of at least £5 per hour for a family with one child;
  - reform of employer National Insurance Contributions will help to remove disincentives to job creation.

**1.28** Chapter 4 charts the progress the Government is making. It:

- sets the income tax personal allowance at £4335 a year for 1999-2000, in line with the employers threshold for National Insurance Contributions (NICs), which is set at £83 a week;
- considers future reforms of employee NICs and a new 10p starting rate of income tax, which will be introduced when it is economically right to do so, and which would further improve work incentives;
- sets out a new fastrack gateway to the Disabled Person's Tax Credit as part of the first ever strategy to help employees disabled while in work stay in their jobs; and
- outlines how family-friendly working practices can help the labour market to operate more flexibly to match the needs of employers with those of employees and their families.

# FAIRNESS

**1.29** The Government has also taken a number of steps to create a fairer society:

- the CSR provided an extra £40 billion over the next three years for health and education;
- the cut in VAT on fuel to 5 per cent, the lowest level allowed under EC law, provides particular help to those on lower incomes;
- the CSR also provided a £2.5 billion package for pensioners, including a guaranteed minimum income for single pensioners of at least £75 per week, a tax guarantee so pensioners have no income tax to pay unless their income rises above a level to be specified in the next Budget and the winter fuel payment to pensioners;
- Child Benefit will increase by £2.95 a week for the eldest child from next April, following decisions in the last Budget, and new help will be provided towards childcare costs;
- new targeted initiatives will help to tackle the underlying causes of poverty. The Sure Start programme will make sure children from all backgrounds are ready to learn when they reach school. And the New Deal for Communities will help people in Britain's most deprived areas take up new enterprise and employment opportunities; and
- Individual Savings Accounts (ISAs), when they are available next April, will help to spread the savings habit to those on low incomes.

**1.30** Chapter 5 sets out further measures to promote a fairer society:

- an extra £250 million for the National Health Service to improve services this winter;
- tightening up on avoidance and evasion: the Government is consulting on the use of a General Anti-Avoidance Rule

and taking steps to improve compliance.

**1.31** The growth of international trade and capital flows calls for increasing co-operation between national authorities on taxation. The Government is promoting fairness and prosperity through international co-operation on tax.

**1.32** The tax system must be designed in a way that is fair to future as well as present generations. It has an important role to play in underpinning the Government's strategy on sustainable development. This means securing economic growth, higher living standards and social progress, while protecting and, where possible, enhancing the environment. As the Statement of Intent on Environmental Taxation published last year made clear, the Government is committed to exploring the scope for using the tax system to deliver environmental objectives.

**1.33** This PBR reports progress on a number of fronts:

- the Government is committed to reducing the UK's greenhouse gas emissions; this will require better use of energy by all sections of the economy. The Government welcomes Lord Marshall's report, which is published today, on the possible use of new economic instruments for improving the industrial and commercial use of energy. The Government will be considering Lord Marshall's recommendations very carefully and will continue work and consultation on the further design issues he has identified;
- in the last Budget the Chancellor announced a reduction of £50 in Vehicle Excise Duty (VED) for the least polluting cars. A consultation document issued today contains proposals for putting that policy into effect. The Government is also reviewing the VED rates for lorries to ensure rates better reflect the environmental impact of different lorry types;
- the sustainability of waste management needs to be improved. As part of its National Waste Strategy, and following the increase in the standard rate of the landfill tax announced in the last Budget, the Government will continue to keep under review the appropriate basis for setting the rate of landfill tax;
- the extraction of aggregates, such as gravel, can have a damaging impact on the environment. The Government will consider the case for an aggregates tax, in the light of the responses to the recent consultation and proposals made by the industry to reduce the environmental impact of aggregates extraction; and
- better water quality is an important environmental goal. The Government will be looking at the case for possible fiscal measures to tackle the problems of water pollution - including a system of water pollution charging and a possible tax or charge on pesticides - in the light of recent research and the responses to its consultation exercise.

# NEXT STEPS

**1.34** The Government will be consulting widely in the run up to the 1999 Budget. A number of regional road shows will focus on how government, business and workforce can together work to achieve higher productivity and prosperity in the long term.

**1.35** The extent and speed with which the Government is able to take forward measures discussed in this report will of course depend on the prevailing economic circumstances and the Government's continuing commitment to sound public finances.

# MACROECONOMIC STRATEGY AND PROSPECTS

**This chapter discusses the Government**'s macroeconomic strategy and how this will improve the prospects for greater stability in the long term. It also summarises the latest economic and public finance forecasts, the details of which are at Annexes A and B.

- **Economic instability damages long-term growth and employment. The British economy has been less stable than its competitors. The Government has therefore developed a new framework to promote long-term economic stability:**
- **the new monetary framework, with the Bank of England setting interest rates to meet the Government**'s inflation target, is now well on track to deliver low inflation: recently interest rates have fallen;
- **the strengthened fiscal framework, underpinned by tough fiscal rules and policy tightening, reduced borrowing by £20 billion last year and has re-established sound public finances; and**
- **the new public spending regime provides greater certainty for long-term planning, has locked in the tight fiscal position and has removed the bias against investment.**
- **The UK, as G7 chair, has also been playing a leading role in developing initiatives to tackle global instability.**
- **As an open economy, the UK is bound to be affected by the slowdown in world growth. The UK economy is now expected to expand by 1-1½ per cent in 1999. But lower inflationary pressures, in the context of a forward-looking long-term policy framework, make a sustainable cyclical recovery likely thereafter, provided risks from the world economy can be contained.**
- **Slower growth will impact on the public finances in the short term, but the underlying position remains sound. The Government is on track to meet the fiscal rules over the cycle and will deliver the spending plans set out in the Comprehensive Spending Review in July.**

## Introduction

**2.1** Recent world events have emphasised the need to promote stability. No country can expect to be immune from global developments; and this is especially true of the UK which is one of the most open economies in the world. In an increasingly interdependent world economy, the Government has a role to play in developing an economic framework - both domestic and global - that is able to cope with adverse developments.

**2.2** Economic instability creates uncertainties and difficulties for individuals and businesses. It damages investment and long-term growth, wastes valuable resources and has significant economic and social costs. The key task for domestic macroeconomic policy is to create a platform of stability to allow people and firms to plan ahead with confidence. It is also important to address directly the causes of international instability to minimise the risks of disruption from external events.

**2.3** In pursuit of economic stability, fiscal and monetary policies need to operate consistently, with clear objectives and to focus on the long term. If the objectives of high growth and employment are to be achieved, sound public finances and low inflation are essential. By setting in place a sound macroeconomic framework, supported by tough policy actions, the Government is steering a course of stability in an uncertain world.

**The historical legacy**

**2.4** In each of the last two economic cycles, Britain's economic performance was poor compared with other G7 countries. During this period, the UK had one of the highest average inflation rates and below average growth. Fluctuations in output and inflation were higher than elsewhere, with growth ranging from around -2 to +5 per cent and inflation from 2 to 21 per cent. Interest rates and fiscal deficits were almost twice as volatile as those in France, Germany and the USA. All this

damaged business' and consumers' ability to plan ahead effectively. It also contributed to Britain's poor productivity growth, which is examined in Chapter 3.

**2.5** In the first half of 1997, as output approached and then moved beyond its sustainable level, the economy was in danger of repeating the boom and bust cycle. Momentum in the economy had built up and output was accelerating sharply, pushing GDP to an annualised rate of growth of nearly 5 per cent by the middle of the year - around double its sustainable rate. Growth had become unbalanced with household consumption rising sharply and was set to do so further on the back of a rising equity market and additional windfalls from building society flotations. Inflationary pressures were also building up, with private sector earnings growth reaching 6 per cent - a rate inconsistent with achieving the inflation target in the medium term. In addition, a large structural deficit in the public finances (of 3 per cent of GDP in 1996-97) needed to be tackled.

# A framework for stability

**The Government's response**

**2.6** The most pressing priority for the Government on arrival in office was to take swift action to prevent a return to boom and bust. Steps were therefore taken to develop a new long-term macroeconomic policy framework. Three elements lie at its heart:

- a new monetary policy framework to deliver low inflation: the Bank of England's Monetary Policy Committee (MPC) was given operational responsibility to set interest rates to meet the Government's inflation target of 2½ per cent annual growth in the Retail Prices Index excluding mortgage interest payments (RPIX). The Bank of England Act 1998 gave statutory effect to the new arrangements;
- a transparent fiscal framework set out in the Code for Fiscal Stability, underpinned by the 1998 Finance Act, and two tough fiscal rules to bring the public finances back under control; and
- a new regime for planning and controlling public spending, based on firm three-year public expenditure allocations: the plans announced in the Comprehensive Spending Review (CSR) in July provided better incentives for departments to manage their budgets efficiently and for the long term, reduced the bias against investment and locked in the tight fiscal position over the rest of the Parliament.

**Consistently low inflation**

**2.7** The monetary policy framework now ensures that interest rate decisions are taken on the basis of the long-term needs of the economy and not on the basis of short-term political considerations. The MPC is tasked with achieving the inflation target set by the Government. The Bank of England's remit requires that deviations below the target level be treated just as seriously as outcomes above that level. As the Governor of the Bank of England has said: ìI give you my assurance that we will be just as rigorous in cutting rates if the overall evidence begins to point to our undershooting the target as we have been in raising them when the balance of risks was on the upsideî.

**Box 2.1** - HICP inflation

**The harmonised index of consumer prices (HICP) is a relatively new measure of inflation that has been prepared to provide a consistent comparison of inflation across EU countries. The European Central Bank (ECB) has recently announced that it will use the HICP as the basis for assessing its price stability objective. This measure has a narrower base than the RPIX which is used to specify the inflation target to be met by the Bank of England. HICP inflation in the UK was 1.5 per cent in the year to September 1998.**

CHART HERE

**2.8** The new arrangements are among the most transparent in the world. MPC votes and minutes are now published two weeks after the monthly meetings; and a full analysis of inflationary pressures and developments, along with a forecast, is published in the Bank's quarterly Inflation Report.

**Sound public finances**

**2.9** The primary responsibility of fiscal policy is to contribute to economic stability - which underpins high growth and employment - through sound public finances. As with monetary policy, transparency and accountability are central features of the new arrangements. The framework is defined in the Code for Fiscal Stability, a draft of which was published in March, and is being laid before Parliament today. The Code enshrines five key principles of fiscal management - transparency,

stability, responsibility, fairness and efficiency. It also includes comprehensive reporting requirements to ensure Parliament and the public are well informed about economic and fiscal developments and requires that information is based as far as possible on best-practice accounting principles.

**2.10** Within the framework, the Government's two strict fiscal rules define how sound public finances are to be delivered:

- the Golden Rule - on average over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the Sustainable Investment Rule - net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.

**2.11** This framework is based firmly on achieving sound public finances and long-term economic stability. Within the framework, there is an inbuilt capacity to respond to changing economic circumstances by allowing the automatic stabilisers to operate (as discussed later in this chapter). The Government is also able to support monetary policy with appropriate fiscal policy settings, as with the fiscal tightening introduced in the July 1997 Budget (see Table 2.1), consistent with meeting the fiscal rules. In this way, the framework sets a long-term goal for policy without imposing inappropriate restrictions on the flexible operation of policy.

**Table 2.1: The fiscal tightening**[1]:cumulative change since 1996-97

| | per cent of GDP | |
|---|---|---|
| | 1997-98 | 1998-99 |
| **Public sector net borrowing** | | |
| EFSRUpdate | -2¾ | -3½ |
| PBR98 | -2¾ | -3¾ |

*1* Excluding windfall tax receipts and associated spending

**2.12** Progress against these rules is assessed later in this chapter. Their rationale is the subject of a forthcoming paper, Fiscal policy: understanding the fiscal rules.

**Modern public services and investing in reform**

**2.13** The fiscal framework is supported by a new spending regime, set out in the June Economic and Fiscal Strategy Report (EFSR), that is designed to promote stability and increase efficiency as well as to control overall public spending. It removes the bias against investment and gets away from the continuous negotiations and incremental adjustments embodied in annual spending rounds. This framework also prepares the way for the introduction of Resource Accounting and Budgeting (see Box 2.2).

**2.14** Consistent with the fiscal rules, the spending regime makes a clear distinction between current and capital spending to ensure worthwhile investment is not sacrificed to meet short-term pressures. Under the new framework, firm three-year plans have been set for all the main public services through Departmental Expenditure Limits (DEL). This gives greater certainty and flexibility for long-term planning and management which should lead to a more efficient and effective delivery of services. Where this cannot be done, spending is managed annually as part of the budget process.

**2.15** The Investing in Britain Fund will finance a doubling of public sector investment over the next three years and Departmental Investment Strategies are being prepared, and will be published in the spring, to ensure an efficient use of these funds. The new framework and a steady and well-targeted increase in public investment will support growth. This is discussed further in a forthcoming paper, Fiscal policy: a new framework for investment. Part of the funds will be channelled through a Capital Modernisation Fund to provide resources for innovative projects that improve key services or public infrastructure. The allocation of this Fund will be on a competitive basis, determined in part by Departmental Investment Strategies.

**Box 2.2** - Resource accounting and budgeting

- **Resource Accounting and Budgeting (RAB) will build on and enhance the effectiveness of the new fiscal regime. It is therefore a priority for the Government. In particular, RAB takes the distinction between current and capital spending one stage further by planning, controlling and accounting for departmental spending on a full accruals basis. This involves recognising the capital costs (ie depreciation and interest) of**

**public investments and assets as they occur, consistent with and alongside other current spending. New capital spending will continue to be budgeted for separately.**

- **The fiscal framework already measures current spending including the cost of capital in terms of debt interest and depreciation. Departmental spending measured on a RAB basis will therefore fit readily with this framework.**
- **The Treasury has provided Parliament with regular progress reports on the development of RAB. Departments are on course to produce the first set of audited** 'dry-run' resource accounts for 1998-99. The first full set of published audited resource accounts will be for 1999-2000. The intention is that the next review of expenditure, in 2000, will be the first undertaken on the basis of resource budgeting and using resource accounting information. Subject to Parliament's agreement, estimates for the year 2001-02, the first year of the new plans, will also be presented on a resource basis.

**The publication of the National Asset Register in November 1997 represents a precursor to the introduction of RAB. In addition, the Comprehensive Spending Review has introduced two new elements which are also natural forerunners of RAB: Public Service Agreements, which will bring forward the use of aims and objectives and output and performance measures being developed as part of the implementation of RAB; and Departmental Investment Strategies, which anticipate the development and preparation of capital management plans under RAB.**

**Benefits of the new framework**

**2.16** The strengthening of the macroeconomic framework, and increased credibility of policy-making, have already brought tangible results. Specifically:

- low inflation: in recent months inflation has reached the 2½ per cent target level;
- lower inflation expectations: from September, the average year ahead RPIX inflation forecast of independent forecasters monitored by the Treasury fell to the target level of 2½ per cent for the first time - over ½ percentage point lower than the consensus view before the new monetary policy framework was introduced. Implied long-term inflation expectations from financial markets have also fallen from 4.2 to 2.5 per cent over this period;
- lower long-term interest rates and forward differentials: yields on 10 year bonds have fallen by 2.4 percentage points to 5.0 per cent since the new monetary framework was put in place - the lowest level for 35 years; and, over the same period, the five year forward differential with Germany has narrowed by 0.8 percentage points;
- low government borrowing: a significant fiscal tightening helped reduce net borrowing by £20 billion last year;
- increased funding for key spending priorities: an additional £40 billion has been provided over the next three years to improve education and health services; and
- higher public investment: net public sector investment will double over the next three years adding an extra £25 billion to the stock of capital.

# Economic prospects and developments

**2.17** The new economic framework, based on transparency and openness, means the UK is now well placed to steer a course of stability. Of course, considerable uncertainties remain, particularly in the face of the recent increase in global economic risks. This next section considers the effects and consequences of recent international developments.

**International economic prospects**

**2.18** In the last six months, a number of factors have combined to produce a weaker international economic outlook. Difficulties in Asia and Russia have led to a dramatic re-evaluation of emerging market risk and a flight of capital from many emerging market economies, especially in Latin America. Recessions in some Asian countries have turned out to be more severe than expected. World financial markets have been highly volatile, with the major stock markets falling back significantly since July.

**2.19** Growth among G7 countries - with the exception of Japan - has held up well so far, with strong consumption and investment in the US driving robust growth in the first half of the year and increases in consumer confidence and falling unemployment strengthening European domestic demand. Nevertheless, the outlook for G7 activity is affected by the recent global turbulence. As a result, G7 growth is forecast to slow from 2¾ per cent in 1997 to 1¾ and 1½ per cent in 1998 and 1999 respectively.

**2.20** World trade growth has slowed rapidly in 1998 and is expected to grow at less than half its 1997 rate. Much of this is due to the fall in Asian trade. However, as Asia accounts for a proportionally smaller share of the UK's export markets, UK

export market growth is expected to slow less sharply than world trade this year. In 1999, growth in UK export markets is expected to slow further reflecting a slowdown in G7 growth.

**2.21** The slowdown in world growth is likely to keep world inflation subdued. Falling oil and commodity prices have helped to keep inflation low during 1998, and it is unlikely that prices will increase sharply in the near term.

**International stability**

**2.22** Recent events have shown that in an increasingly interdependent global economy, problems and difficulties in one part of the world can quickly have an adverse impact on other countries. The G7 have acknowledged this and in recent statements have made it clear that the balance of risks in the world economy has shifted from high inflation to concerns about low growth.

**2.23** A number of events could produce a sharper downturn in world and G7 growth. For example, the crisis in emerging markets could deepen or the risk of a 'credit crunch' might increase. However, there are some encouraging signs. The recently announced financial package for banking sector reform in Japan, together with the government's fiscal packages, should assist the Japanese economy. Recent interest rate cuts in the US, Canada, Japan and elsewhere will also help support world demand. In addition, there are positive signs in some Asian economies, where stabilising currencies have allowed interest rates to fall.

**2.24** It is, of course, vital that policy-makers take every possible action to minimise the global risks. In this context, G7 Finance Ministers and central bank governors have recently again made clear their commitment to create or sustain conditions for strong domestic demand-led growth.

**2.25** The Government, particularly as G7 chair, has been taking a lead in strengthening international structures and cooperation to foster global stability, for example, by encouraging the development of international codes of best practice on fiscal policy, financial and monetary policy, corporate governance and accounting and social standards and by seeking better global financial regulation (see Box 2.3).

Domestic economic prospects

**2.26** As an open economy, the UK is directly affected by the slowdown in world growth. Against this background, Annex A sets out the details of revised projections for the UK economy.

**2.27** As in the March Financial Statement and Budget Report, projections for output are presented as 'opportunity ranges', with the higher outcomes dependent upon responsible private sector wage bargaining and the success of Government labour market policies. While the main risks to the forecast (also examined in Annex A) are large and frequently beyond domestic control, an improvement in the supply-side performance of the economy offers the opportunity to maximise UK growth and employment prospects regardless of how these risks may evolve. These projections also reflect the Government's commitment to take a firm and fair approach to public sector pay which provides funds to retain, recruit and motivate staff, but which is consistent with the spending plans and output targets announced in the CSR and the inflation target.

**2.28** The March Budget projected a temporary slowing of growth to below trend rates during 1998 and 1999, due to the impact of tighter policy on domestic demand, the impact of strong sterling on trade and events in Asia. To date, the economy has developed broadly in line with this Budget forecast with GDP growth slowing further - to an annualised rate of 2.0 per cent in the third quarter of 1998. Within total GDP, service sector output growth has slowed but remains relatively strong compared to the more modest growth in manufacturing.

**Box 2.3** - Promoting international stability and strong financial systems

- **The UK Government, in its Presidency of the G7 industrial nations, has played a leading role in developing key reforms to promote international stability and strong financial systems. In response to a proposal by the Chancellor of the Exchequer, G7 Finance Ministers and Central Bank Governors agreed on 30 October to modernise the financial system and put in place new rules and procedures to promote international stability and growth.**
- **The statements commit the G7 to:**
- **create and sustain conditions for strong, domestic demand-led growth;**
- **develop improved procedures for managing crises and preventing them from spreading, including an enhanced IMF financing mechanism supported by private and bilateral finance as appropriate;**
- **develop and implement international principles and codes of best practice on: fiscal policy, financial and**

**monetary policy, corporate governance, and accounting; and to work to ensure that private sector institutions comply with new standards of disclosure;**

- **improve global regulation through co-operation and co-ordination of the activities of key international institutions and national authorities in the management and development of policies to foster stability and reduce systemic risk in the international financial system;**
- **developing ways to ensure greater private sector involvement in crisis prevention and resolution; and**
- **;support reforms to improve the effectiveness of the IMF, including transparency and accountability and changes in lending policies and terms of lending.**

**The Government has also been very active in developing responses to assist those countries most affected by the present difficulties, including involvement in IMF and World Bank support arrangements. An increase in the IMF Quota combined with the New Arrangements to Borrow provide additional resources to the IMF of $US 90 billion. The Government is also working to ensure that all industrial countries share the readjustment burden and do not resort to protectionist measures. It is important to maintain the benefits that open trade and capital markets have brought to long-term growth and opportunity.**

**Good progress has also been made in promoting financial stability in the UK, notably by introducing a single financial services regulator in place of the existing regulatory patchwork. The close links between the quality of financial regulation and economic well-being, as evident from events in Japan and elsewhere, emphasise the importance of transparent systems of supervision and regulation. The reform and modernisation of the regulatory regime under the Financial Services Authority is therefore an important opportunity to maintain and enhance the confidence of savers and investors in UK financial services and markets.**

**Table 2.2: Summary of UKforecast**

| | Forecast | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| GDPgrowth (per cent) | 3½ | 2¾ | 1-1½ | 2¼-2¾ | 2¾-3¼ |
| RPIX (per cent, Q4) | 2¾ | 2½ | 2½ | 2½ | 2½ |
| Current account (per cent of GDP) | 1 | -¼ | -¾ | -1 | -1 |

**2.29** Much as expected, the main driving force has been the deceleration in domestic final demand and, in particular, a slowing of growth in household consumption. Nevertheless, the labour market has remained strong with employment now having risen by around 400,000 since May 1997.

CHART HERE

**2.30** Independent forecasts for UK growth changed little between March and late summer, remaining in line with the Budget forecast. However, two broad strands of recent evidence point to more moderate short-term growth than anticipated in March:

- underlying trade performance has been weaker than expected, accounted for by a worsening in net trade with countries outside the EU and particularly in Asia; and
- business surveys, especially in manufacturing, have indicated lower trade, output and confidence in the second and third quarters of 1998.

**2.31** On the assumption of no further deterioration in the world economic outlook, GDP is now forecast to grow between 1 and 1½ per cent in 1999: ¾ percentage points lower than anticipated in the March Budget.

**2.32** The lower projection can be more than accounted for by the effects of the deterioration in the world economy on UK exports, financial markets and other economic activity. UK export markets are now expected to grow more slowly than forseen in March. As UK exports represent around one third of GDP, this effect alone reduces GDP by around ½ per cent in 1999. In addition, global instability has, for example, contributed to a significant fall in UK equity prices since July, which is likely to impact on domestic spending.

**2.33** As output growth slows further, and the level of output falls below trend, downward pressure will be exerted on domestically-generated inflation and reflected in lower business margins and, later on, slower growth of unit labour costs. Over time, however, import price inflation is likely to increase as the effects of exchange rate movements unfold. RPIX

inflation is therefore expected to dip temporarily just below the Government's target in the first half of 1999, before returning to 2½ per cent by the end of the year.

**2.34** The scale of the cyclical slowdown, combined with a forward-looking policy approach that provides an inbuilt capacity to respond to developments, is expected to permit a somewhat stronger subsequent cyclical recovery in output from early in the year 2000, with output returning to its trend level in 2002. GDP is expected to grow by 2¼ to 2¾ per cent in 2000 and by 2¾ to 3¼ per cent in 2001. As domestically-generated inflation falls, offset by receding external downward pressures on prices, RPIX is expected to remain on target.

**2.35** Prospects for a stronger cyclical recovery are also supported by currently robust household balance sheets. This contrasts with the downturn in the 1990s which was preceded by a strong increase in household borrowing, particularly in secured loans, leaving households extremely vulnerable to the subsequent housing market downturn. In addition, the financial position of the corporate sector is far more secure than in the late 1980s. Firms have spent much of the 1990s

repairing their balance sheets following earlier sharp increases in gearing. The current lower levels of corporate gearing mean that firms are at less risk of running into financing difficulties.

**2.36** The slower pace of the overall economy will make it even more important that the labour market functions effectively, both enhancing incentives to work and tackling long-term unemployment. Chapter 4 discusses the wide range of Government policies designed to achieve this aim.

**Smoothing the economic cycle**

**2.37** The Government's new macroeconomic framework has helped the UK economy to become more resilient and provides a defence against the risk of a return to 'boom and bust'. The new framework provides not only the means to avoid unnecessarily large fluctuations in activity caused by excessively short-term policy decisions, but also allows responses that limit the adverse effects of external shocks.

**2.38** The UK's relatively large cyclical behaviour reflects, in part, the consequences of policy mistakes as fiscal and monetary decisions were taken without a clear framework and with changing objectives. Required corrective action was typically not forthcoming until it was too late, resulting in greater than necessary problems and excessive corrective action.

**2.39** The coherent and transparent framework now in place offers assurance that short-term political factors will no longer interfere with proper and timely policy action required to maintain stability and that there will be a more informed policy debate in which risks and options are discussed openly. This means that business, investors and the public can take effective decisions and plan with confidence on the basis that economic policy will promote stability, not the opposite.

**2.40** In the context of the current economic cycle, a number of developments are already evident.

- Monetary policy was tightened much earlier in this cycle than in the previous cycle. This has meant that despite rises since May 1997, the present level of interest rates - 7¼ per cent - is less than half the peak of the previous cycle - 15 per cent.
- Fiscal policy was tightened as the economy moved above its trend level in 1997. The £20 billion fall in public sector net borrowing in 1997-98 has not only dealt with the structural problems in the public finances but it has also meant that fiscal policy has been supporting monetary policy in countering the inflationary pressures that had built up.
- The MPC has acknowledged the new global downside risks to the outlook for output in industrial countries and has made it clear that this is a factor they take into account in assessing the prospects of meeting the UK's inflation target.
- Addressing long-standing under-investment in the public sector at this stage - by doubling the capital budget over the next three years - should help promote steady growth by raising the productive capacity of the economy over time.

**Table 2.3: The public finances**[1]

| | Outturn | Estimate | | | Projections | | |
|---|---|---|---|---|---|---|---|
| £billion | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
| Surplus on current budget | | | | | | | |
| **EFSR(old basis)** | **0·0** | **5** | **7** | **10** | **13** | **13** | **14** |
| Forecasting changes | -0·9 | 4 | -1 | -3 | -1 | 1 | 1 |
| **1998 PBR (old basis)** | **-0·9** | **9** | **5** | **7** | **12** | **14** | **15** |
| Classification changes | -3·5 | -4 | -4 | -4 | -4 | -4 | -4 |
| **1998 PBR(ESA95)** | **-4·4** | **6** | **1** | **3** | **8** | **10** | **11** |
| Net borrowing | | | | | | | |
| **EFSR (old basis)** | **5·9** | **1** | **2** | **0** | **0** | **1** | **0** |
| Forecasting changes | 0·1 | -5 | 1 | 3 | 0 | -1 | -1 |
| **1998 PBR(old basis)** | **6·0** | -4 | **2** | **3** | **0** | **-1** | **-1** |
| Classification changes | 2·0 | 2 | 2 | 2 | 2 | 2 | 2 |
| **1998 PBR (ESA95)** | **8·2** | -2 | **4** | **5** | **2** | **2** | **1** |

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

**2.41** The new framework means the UK is better placed than in the past to withstand the pressures of external and other turbulence. While one quarter of the world is currently in recession, the prospective slowdown in growth for the UK is expected to be more moderate, and a sustainable cyclical recovery more likely, than otherwise might have been the case. A more stable economy will also help provide the foundations for the necessary convergence should the UK wish to join EMU early in the next Parliament.

# Fiscal position and prospects

**2.42** Slower growth will affect the public finances in the near term. Nonetheless, the underlying position is sound and on track to meet the fiscal rules over the cycle. In calculating the public finance projections, the lower end of the opportunity ranges for economic growth are used. This prudent and cautious approach helps ensure that policy is set in the UK's long-term interests and strengthens policy credibility. The fiscal projections are based on cautious assumptions audited by the National Audit Office - including those for trend GDP growth, unemployment, inflation, interest rates, effective VAT rates and privatisation proceeds.

**2.43** In examining the details of new projections, it is important to note the effects of changes to the national accounting framework resulting from the introduction of the new European System of Accounts (ESA95). These changes are explained in Box 2.4 and in more detail in Annex B.

**Box 2.4** - ESA95 and public finance statistics

- **The Office for National Statistics (ONS) introduced the new European System of Accounts (ESA95) on 24 September. This has meant a number of changes to the definitions and numbers for fiscal aggregates. For example, a reclassification of the transactions of certain notionally funded public sector pension schemes has increased recorded net borrowing. The recorded current budget surplus has been reduced by this change and also by an upward revision to the estimates of depreciation. The effects of the introduction of ESA95 on the public finance statistics are described in detail at the end of Annex B. Classification changes have reduced the current budget surplus by £3.5 billion and increased net borrowing by around £1·8 billion in 1997**-98. These effects will grow slightly in value terms in future years.
- **The forecasts in this** Pre-Budget Report **are on an ESA95 basis, consistent with the latest published national accounts. However, this means that comparisons with previous forecasts do not give an accurate picture of how underlying fiscal prospects have changed. Table 2.3 in this chapter and Table B2 in Annex B therefore show the new forecast on the old definitions for comparison with previous forecasts. It is also intended to include a similar comparison against estimated outturns on the old basis in next year's** Financial Statement and Budget Report.

**2.44** Table 2.3 compares the new projections with those in the EFSR and distinguishes between forecasting and ESA95-based changes.

**2.45** Following the sharp fall in government borrowing in 1997-98, the public finances continued to improve in the first six months of 1998-99. Public sector net borrowing was over £10 billion lower than in the first half of 1997-98.

**2.46** Prospects for this year look better than expected in June, reflecting the outturns to date. The expected current budget surplus contrasts with deficits in all but three of the past twenty five years. A small surplus on the overall budget is also forecast for this year - ie public sector net lending rather than borrowing.

**Table 2.4: Summary of public sector finances**[1]

| | | | | per cent of GDP | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | Estimate | | Forecast | | | |
| | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
| **Surplus on current budget** | **-0·5** | **0·6** | **0·2** | **0·3** | **0·9** | **0·9** | **1·0** |
| *Average surplus since 1997-*98 | -0·5 | *0·1* | *0·1* | *0·2* | *0·3* | *0·4* | *0·5* |
| Net investment | 0·5 | 0·5 | 0·7 | 0·9 | 1·1 | 1·1 | 1·1 |
| **Net borrowing** | **1.0** | **-0·2** | **0·5** | **0·5** | **0·2** | **0·2** | **0·1** |
| Net cash requirement | 0·4 | -0·3 | 0·1 | 0·6 | 0·4 | 0·2 | 0·3 |
| **Net debt** | **42·1** | **40·2** | **38·9** | **37·8** | **36·4** | **35·1** | **33·9** |
| *Memo:Maastricht measure (including windfall tax)* | | | | | | | |
| *General government net borrowing* | *0·6* | -0·8 | *0·3* | *0·3* | *0·1* | -0·2 | -0·1 |
| *General government gross debt* | *50·4* | *47·9* | *46·7* | *45·4* | *43·7* | *42·0* | *40·4* |

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

**2.47** Slower growth in 1999-2000, however, is forecast to result in lower tax receipts than previously expected. This affects the current budget which, though it remains in surplus, is expected to be reduced as the automatic stabilisers operate. It also affects net borrowing which is expected to be higher than previously forecast. Nevertheless, as a result of the cautious approach taken by the Government, the prospects remain fully consistent with meeting the fiscal rules over the economic cycle.

**2.48** After 1999-2000, the cyclical recovery in growth acts to move the current budget more substantially into surplus and reduce net borrowing close to the low levels set out in the EFSR. Table 2.4 shows these projections as a per cent of GDP.

**Table 2.5: Cyclically-adjusted budget balances**[1]

| | | | | per cent of GDP | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | Estimate | | | Projections | | |
| | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
| Surplus on current budget | -0·6 | 0·3 | 0·5 | 1·0 | 1·2 | 1·0 | 1·0 |
| Net borrowing | 1.1 | 0.2 | 0·2 | -0·1 | -0·1 | 0·1 | 0·1 |

[1] Excluding windfall tax receipts and associated spending

**2.49** Past experience shows the danger of letting cyclical movements in the public finances disguise changes in the underlying fiscal position. For both the current budget and net borrowing, cyclically-adjusted figures, which abstract from the temporary effects of higher or lower growth, therefore give a clearer view of the underlying fiscal position expected over the remainder of the Parliament. Table 2.5 shows that a nearly 1 percentage point improvement in the structural position this year has led to a recorded structural surplus on current budget and structural net borrowing being close to balance. These cyclically-adjusted measures1 also indicate stronger underlying public finances over the next few years than is evident in the unadjusted numbers.

**2.50** Net public sector debt is projected to continue to fall relative to GDP. Despite the changed outlook for growth, keeping

public borrowing at low levels means that the debt ratio is projected to be reduced consistently over the medium term.

**Meeting the fiscal rules**

**2.51** For the reasons explained earlier, an important feature of the two fiscal rules is that they are set over the economic cycle. This means that any current deficits recorded during an economic slowdown must be offset by current surpluses during a period of stronger economic growth. In this way, the framework provides the basis for long-term economic stability, but allows some flexibility within the economic cycle.

**2.52** The framework provides an inbuilt capacity to respond to changing economic circumstances by allowing scope for the automatic stabilisers to help reduce output fluctuations (see
Box 2.5). Furthermore, it does not rule out fiscal policy supporting monetary policy, as appropriate, as it did last year when fiscal policy was tightened and public sector net borrowing was reduced by £20 billion. Consistent with this, meeting the fiscal rules over the cycle must remain the primary objective of fiscal policy.

**Box 2.5** - The 'automatic stabilisers'

- **Fiscal policy can help to stabilise the economy through the operation of the** 'automatic stabilisers'. As the economy strengthens, incomes tend to rise, resulting in higher income and corporation tax receipts and lower unemployment rates reduce social security spending. Government borrowing will therefore tend to fall when growth is relatively high, and rise when growth is relatively low. Over most economic cycles, these effects would come close to balancing out.
- **Setting the fiscal rules over the economic cycle means that the automatic stabilisers can continue to dampen economic cycles while safeguarding the long-term sustainability of the public finances. While their effect may be less visible than say changing interest rates, acting to suppress the operation of the stabilisers would significantly increase the swings in output over the economic cycle.**

**2.53** The current budget projections in Table 2.4 suggest that the average surplus from 1997-98, the first year of the present cycle, to 2002-03, when the economy is projected to be back close to trend, is around ½ per cent of GDP. This is consistent with meeting the golden rule over this economic cycle plus some margin.

**2.54** The Government explained in the EFSR why it believes that it is desirable to reduce net public debt below 40 per cent of GDP over the economic cycle. Chart 2.2 shows that, consistent with this view, the projected net public sector debt ratio is forecast to fall to 40 per cent by the end of this financial year and to continue falling over the medium term. This reflects very low levels of government borrowing - even in the face of slower than expected growth - and compares with a peak in the net debt ratio of around 44 per cent of GDP in March 1997.

**2.55** The projections in Table 2.4 show that UK government borrowing and the debt ratio remain well below the Maastricht reference levels for general government net borrowing of less than

3 per cent of GDP and general government gross debt below 60 per cent of GDP. Borrowing in 1998-99 is also well below the levels in the other major EU countries and is close to balance in the medium term; the debt ratio is currently lower than all other EU countries with the exception of Luxembourg. The fiscal prospects are consistent with the terms of the European Union Stability and Growth Pact.

**Dealing with uncertainty**

**2.56** As noted above, the public finance projections are based on a prudent and cautious approach. This prudent approach reflects not only the fact that growth in any given year is to some extent uncertain, but that the cyclical path of the economy is also uncertain. If the profile of growth were to differ from that assumed, the short-term outlook for the public finances would be affected. However, as the fiscal rules apply over the whole economic cycle they will tend to be robust to errors in short-term growth forecasts. For a given path of trend output, higher or lower growth in the short term will be followed by correspondingly lower or higher growth later, and the public finances may be little affected on average over the cycle.

**2.57** Whereas errors in short-term growth forecasts may have only a temporary effect on the public finances, errors in estimating the current cyclical position of the economy - the output gap - will have a permanent effect on prospects. If output were higher relative to trend than had been assumed, the prospects for the public finances would be less favourable, as lower economic growth would be implied on average over the remainder of the cycle.

**2.58** In previous forecasts, the effects of uncertainty over the cyclical position of the economy have been illustrated by showing cyclically-adjusted measures based on a pessimistic, but possible, assumption that the output was 1½ per cent further above trend than in the central assessment. Substantial revisions to output data, following rebasing and introduction of ESA95, have increased - by approximately ½ per cent - the estimate of the extent to which the economy was above trend. In addition, higher than expected output growth in the third quarter of 1998 means that output is thought to have been around ¾ per cent above trend in mid-1998 rather than at trend as implied by the Budget forecast - this represents ¾ percentage points of the 1½ per cent pessimistic case.

**2.59** Chart 2.3 illustrates a pessimistic case which, on top of the prudent assumptions, assumes trend output to be 1 per cent lower than suggested by the present assessment. In light of the revised assessment of output relative to trend, this case is therefore marginally more pessimistic than the previous pessimistic case, illustrated in the EFSR. As before, it also takes account of the effects of uncertainty from a variety of influences. In this scenario, the cyclically-adjusted current budget is in deficit in the early years of the cycle but this is broadly balanced out by surpluses in later years. Even on this more pessimistic view, the Government remains on track to meet its fiscal rules over the economic cycle. The sustainable investment rule would also be met in this case by a good margin.

# THE PRODUCTIVITY CHALLENGE

**This chapter sets out for consultation the next steps in the Government**'s evolving strategy to tackle the productivity gap:

- **encouraging innovation and enterprise with:**
  - **a £25m Science Enterprise Challenge to endow up to eight new Institutes for Enterprise in universities;**
  - **consultation on ways to encourage more investment in R&D and on reforming the taxation of intellectual property and royalty payments;**
  - **reviews of tax options to encourage investment and growth in small and medium-sized businesses, to encourage social entrepreneurship in smaller growing companies and on incentives to promote corporate venturing;**
  - **forthcoming DTI reviews of corporate rescue procedures and insolvency and bankruptcy law.**
- **ensuring that capital markets work effectively to provide investment:**
  - **a review of policies on employee share ownership and equity incentives for managers in smaller high-tech ventures;**
  - **working with the banks in a review of the banking sector;**
  - **proposals to encourage transparency in institutional investment;**
  - **work by the Financial Services Authority to help promote a more competitive, innovative and trusted savings market.**
- **ensuring that competitive pressures are strengthened and that regulation promotes economic growth:**
  - **a substantial increase in resources for the Office of Fair Trading;**
  - **a review of the impact of regulation on productivity, by the Better Regulation Task Force;**
  - **work on the effects of the planning system on the competitiveness of businesses, particularly in growth industries.**
- **ensuring that the UK**'s skills base is geared to the needs of a modern economy, building on the £19 billion additional funding provided in the Comprehensive Spending Review:
  - **ensuring that the National Curriculum better prepares young people for the world of work and working to improve partnerships between business and schools;**
  - **a determination to increase the employability of students in higher education;**
  - **new National Learning Targets for skills levels and further encouragement for lifelong learning.**
- **In parallel the Government has embarked on an ambitious programme to improve productivity in the public sector:**
  - **it will publish departmental Public Service Agreements, setting out stretching targets for improving delivery;**
  - **a Public Services Productivity Panel, drawn from business and the public sector, will advise on ways of improving the productivity of public services;**
  - **reviews of civil procurement and the Private Finance Initiative.**

## The Challenge

**3.1** Productivity - the quantity of output each of us on average produces - is a fundamental yardstick of economic performance. No economy can grow sustainably unless its productivity improves. And poor productivity condemns a nation to be held back.

**3.2** This is precisely the position in the United Kingdom. We are not as productive as our major trading partners, and the extent of the under-performance is very substantial. This shortfall holds back our living standards and our potential. Tackling it must be a central national priority.

**3.3** The UK has a productivity gap with the United States of around 40 per cent and around 20 per cent with France and Germany. In most sectors of the economy the UK is far short of the best in the world. For instance, even though our best automotive plants are amongst the best in the world, average automotive productivity is still only just over half that of Japan.

**Box 3.1** - Measuring productivity

- **Measuring productivity across countries is complex. But the UK**'s performance lags that of the US, France and Germany by far more than can be accounted for by data uncertainty. The most important problems are:
- **Difficulties on the output side, for example well known problems measuring GDP. The problems may get worse as economies become more** 'weightless', with economic value residing in ideas and computerised transactions, rather than physical goods.
- **Productivity measures rely on splitting changes in volume and quality from price inflation. In a steel plant for example one can use a measure of the number of tonnes of a given grade of steel per worker. But identifying similar measures in, for instance, the output of a television station is difficult, since changes in quality of the output are also at work. In general productivity is harder to measure in services than manufacturing.**
- **International comparisons use Purchasing Power Parity exchange rates, to remove the impact of sudden changes in market exchange rates. But PPP rates are estimates, not actual rates, so introducing a margin of uncertainty.**
- **Output per hour, rather than per worker, is arguably the best measure of productivity. However, there are particular difficulties with hourly data.**

**The central point, however, is that much the same basic picture of the relative weakness of UK performance emerges, whichever data source or approach is used. Looked at in different ways the gaps may appear somewhat more or less. But they are there and they are substantial.**

**3.4** Moreover, the productivity gaps are deep-seated. The UK has lagged behind our major competitors for decades. Beginning in the last century the UK was overtaken, first in manufacturing and then in service sector productivity, by its major competitors. Chart 3.1 shows the extent of the gaps they have opened up on the UK.

CHART 3.1 HERE

**3.5** Closing these gaps amounts to a formidable challenge. However, the productivity gap is also a productivity opportunity. There is no intrinsic reason why UK productivity could not be world-class; indeed in some areas - such as software services - it is. Such a prospect, long-term as it might be, would be one of dramatically increased opportunities and living standards for all.

**3.6** It is to this prospect that the Government wishes to lift the nation's sights. Even comparatively small progress would be worth a great deal. For example if just ¼ per cent could be added to the UK trend rate of growth - itself an ambitious goal - this would add around £30 billion to GDP in five years.

**The Government's Approach**

**3.7** The Government has already begun laying the foundations on which better productivity performance can be built:

- first, stability has been key to the Government's economic strategy, as Chapter 1 sets out;
- second, the changes made to the tax system in the Government's first two Budgets will help encourage investment for the long term and reward successful entrepreneurs;
- third, the Comprehensive Spending Review (CSR) delivered an additional £19 billion investment in education that will help deliver improved skills for both those in education and those already in the workforce;
- fourth, the CSR delivered an additional £1.4 billion in funding for science, including a unique partnership with the Wellcome Foundation, that will help generate high quality research and innovation across the economy;
- finally, the doubling of net public investment over the next three years, including substantial investments in education and transport, will help to provide infrastructure fit for a world-class economy.

**Box 3.2** -The Chancellor's Northern Ireland Economic Initiative **The £315 million economic strategy to modernise the Northern Ireland economy announced in May is already making significant progress. The Initiative, widely welcomed by Northern Ireland business, recently saw the Chancellor and the Northern Ireland Secretary launch an**

**11 city tour of North America to promote investment opportunities in Northern Ireland. This strategy boosts jobs and productivity through action on:**

- **Innovation and Tourism: challenge funds for research and development and tourism projects have been launched; investment in a science park and in schools**' IT will follow;
- **Enterprise: 100 per cent first year capital allowance for small and medium sized enterprise (SME) expenditure on plant and machinery were incorporated in the 1998 Finance Act; a venture capital scheme for SMEs is being established;**
- **Investment: a £150 million capital investment fund to modernise physical infrastructure includes the construction of key link roads, developing integrated schools and tackling worst housing estates; and**
- **Employment and Skills: extending the Welfare to Work programme for the long-term unemployed and the disabled; Modern Apprenticeships and Bridge to Employment programmes have already been established.**

**The Initiative also focuses on the greater use of Public Private Partnerships in public transport. Belfast Port and water services.**

**3.8** However, the Government believes there is more that can be done.

**The productivity seminars**

**3.9** Earlier this year the Chancellor of the Exchequer and the Secretary of State for Trade and Industry jointly launched a series of seminars. The aim of these seminars was to examine some of the underlying causes of the UK's poor productivity performance and to explore options for improvement. These were fora for business people, financiers, union leaders, teachers and academics to suggest and discuss ideas and policies that might help tackle this central economic challenge. The seminars have examined specific issues such as finance, skills, management and entrepreneurship. Other seminars looked at case studies of specific industries such as the software and automotive sectors. A number of seminars began with detailed presentations from McKinsey, whose independent analysis of the underlying causes of the productivity gap was published on 30 October.

**3.10** There has been wide agreement at the seminars that there are very substantial and damaging productivity gaps and that this a key economic challenge for the Government to tackle in partnership with business.

3.11 The key theme to emerge from the seminars is this: Britain still lacks a widespread culture of enterprise and ambition. Participants were concerned that British competitive pressures were often too weak. Although Britain has some world-class companies and managers, management can sometimes be unambitious in the face of the grind of continuous improvement or of the challenges of a strategy based on innovation in products, working methods and investment.

**3.12** Ultimately, these are challenges for businesses. The Government therefore particularly welcomes the business-led 'Fit for the Future' campaign, spearheaded by the CBI and supported by the DTI. This aims to promote the transfer of best practice across every industry sector in the economy. The Government urges all businesses to take advantage of it.

**3.13** Later this year the Department of Trade and Industry will explore further in a White Paper how its principles of modernisation and fairness apply to competitiveness. This will set out more of the Government's thinking on economic reforms. It will focus in particular on the increasing importance of knowledge and information in creating and sustaining economic activity throughout the economy.

**The next steps**

**3.14** The Pre-Budget Report aims to begin to build on the steps the Government has already taken to tackle the productivity problem. The strategy is built round tackling four of the UK's historic weaknesses:

- innovation and enterprise
- investment
- competition
- skills

**3.15** These weaknesses are not independent; they are closely interrelated. For instance, a poor record of innovation and making a success of new businesses leads to limited competitive challenge; barriers to competitive entry hold back innovation and potential entrepreneurs; a poor skills base holds back both investment and innovation. And the shortfalls in

some areas of management, which were much highlighted at the productivity seminars, are both a root cause and a product of all four.

**3.16** Set out below, for consultation, is an analysis of how each of the weaknesses the Government has identified contributes to the productivity gap and how the Government proposes to begin to tackle these problems. These first steps will be developed further in the 1999 Budget.

# Enterprise and Innovation

### The problem

**3.17** Innovation and enterprise are key driving forces in improving productivity. The introduction and exploitation of new ideas, and the creation and growth of new enterprises, not only drive growth directly but are also prime sources of improvement and competitive challenge throughout the economy.

CHART 3.2 HERE

**3.18** The Government strongly believes the UK needs to do more to encourage entrepreneurship. It needs new businesses which grow, and provide an engine of innovation and job creation. This view was strongly echoed in the productivity seminars. In particular:

- there is a widespread perception that cultural factors - risk aversion, a stigma associated with failure - are a significant barrier to the entrepreneurial spirit;
- problems in getting firms to grow are as large, if not greater, than those of establishing the firms in the first place.

**3.19** In addition:

- there is evidence that large UK companies are much less effective and imaginative than those in the US at stimulating the small firm sector through acting as expert investors in start-ups ('corporate venturers'). By 1994 large firms in the US were investing some $500 million in small firms in the computer, biotechnology, engineering and other industries. The UK has nothing remotely comparable;
- there is also a particular difficulty in getting good people out of mature companies into growing businesses;
- there was a strong impression in the seminars that sometimes UK universities contrast unfavourably with the entrepreneurialism - and close involvement with the business world - of their US counterparts;
- UK entrepreneurs seem much more likely to experience financing difficulties than in the US possibly because, although the UK venture capital sector is reasonably strong, it is heavily biased towards investing in management buy outs (MBOs) rather than new start ups and the liquidity of equity markets for smaller companies is less than in the US.

**3.20** Innovation - the exploitation of ideas and products that entrepreneurs and others can exploit and grow - is a further part of the story. Critical for the economy as a whole, new products, production methods and organisational changes can create substantial improvements in productivity.

**3.21** The UK has a good record in producing ideas. The science base continues to produce research that is respected throughout the world. Nevertheless the UK also needs to improve its record of exploiting these ideas to create new products and then bring them to market, generating new businesses and growth:

- British universities could do more to focus on exploiting the commercial potential of their research and there is much that businesses could do to pull this through. UK business also needs to focus on improving its own research and development and the exploitation that follows;
- as Chart 3.2 shows, over the past decade the aggregate amount of R&D conducted by UK firms has continued to lag our international competitors. Aggregate R&D spending by small and medium-sized enterprises in particular is low.

**<u>Policy Approach</u>**

### Innovation and Science

**3.22** The UK needs to enhance a first-rate science base, putting proper systems in place for exploiting the commercial value of research, and getting scientists and business to take a much closer interest in each other.

**3.23** The Government has begun by taking vital first steps to enhance the science base and maximise the economic value

derived from it:

- the Comprehensive Spending Review set out an additional £1.4 billion injection of funds to ensure that the UK continues to be world-beating at generating research knowledge. At the centre of the DTI's programme is a £600 million infrastructure fund, endowed equally by Government and the Wellcome Trust, for new equipment and buildings. Bids for the first round were invited in October, with an initial deadline of 4 December, they will be considered by an expert committee shortly after. There has been a high level of interest from universities;
- the University Challenge scheme, also jointly funded by the Wellcome and Gatsby Trusts, to help pull ideas with commercial potential out of the laboratory. This scheme will provide £50 million in early-stage seed funding to help exploit the commercial potential of university research. By the deadline of 15 October, 44 bids had been received by the DTI, involving a total of 73 universities.

**3.24** The Government will begin by ensuring that the substantial capital renewal provided by the joint Government/Wellcome infrastructure fund is used to underpin research in leading research areas - particularly those, like biosciences, that offer the opportunity for levering in further private funding and for commercial exploitation.

**3.25** The Government also proposes to build on the potential of University Challenge to further strengthen exploitation of the science base by creating a £25 million Science Enterprise Challenge that will invite universities to compete for funds to endow up to eight new Institutes for Enterprise. These Institutes will bring the teaching of entrepreneurship and business skills into the science curriculum, helping to inspire and equip scientists and engineers to commercialise their knowledge. They will also be centres of excellence for the technology transfer process, bringing together specialist teams to organise science commercialisation effectively. The Institutes will be expected to draw on best international practice, and to match world-class standards. Details of the competition for Science Enterprise Challenge will be announced at the time of the DTI's forthcoming White Paper. Universities will be expected to bring forward proposals that involve significant funding from other sources.

**3.26** The Government is also determined to ensure that the Government's own research institutes and other public sector research establishments are fully engaged in efforts to commercialise their research, where possible in collaboration with universities.

**3.27** To complement this drive to push research into the market, the Government is examining proposals aimed at enhancing the incentives for businesses to draw on these ideas, as well as investing in their own home-grown R&D.

**3.28** The Government published, in this year's Budget, a joint DTI and Treasury consultation paper - 'Innovating for the Future' - exploring how best to remove barriers to R&D investment.

**3.29** The Government has looked at a number of ideas for incentives to encourage R&D investment. These included:

- a research and development corporation tax credit open to all firms based on the incremental increase in R&D spending;
- a tax credit based on the volume of R&D spending for small and medium enterprises (SMEs). One method of ensuring that firms not yet in profit, and hence not paying corporation tax, would still be able to gain immediate benefit from this type of incentive would be to make the credit payable directly to these companies.

**3.30** The Government believes the case for extra incentives is strongest in the SME sector so it will consult with business further during the pre-Budget period on the feasibility and effectiveness of a volume-based R&D tax credit for SMEs. This work will also look at ways of encouraging R&D spending by companies not yet in taxable profit.

**3.31** As a first step in working towards a potential new tax incentive, and also to assist the operation of the existing Scientific Research Allowance scheme, the Inland Revenue and the DTI will review the definition of business research and development for fiscal use, and consult business further on proposed new clearer guidelines on the Government's interpretation of that definition.

**3.32** Establishing a rational and less complex system for the taxation of intellectual property (IP) was the second central conclusion to emerge from the 'Innovating for the Future' consultation exercise. Intellectual property is one of the key outputs of firms' innovation and R&D investment.

**3.33** The Government will consult by the next Budget on two possible measures to reduce tax compliance costs and distortions on business decisions affecting intellectual property transactions:

- moving towards a simpler system of IP taxation, essentially following the accounting treatment for relieving

expenditure on IP purchases and taxing proceeds; and

- simplifying the taxation of royalty payments which accrue to the owners of intellectual property rights. In place of the variable treatment at present, the aim would be to allow as many payments as possible to flow gross, consistent with maintaining effective UK taxing rights. In addition, if the definition of 'royalty' income for tax purposes were to be aligned with the simpler and more rational OECD model, the remaining deduction of tax at source rules would be more recognisably tied to the terms of a relevant double-taxation treaty - thus simplifying their application by business.

**3.34** These potential tax measures for intellectual property reform are complex and need further work and consultation. But the Government hopes that a broadly revenue-neutral package, based on the ideas set out in paragraph 3.33, can be found which brings worthwhile simplification for consideration by the 2000 Budget.

**3.35** As well as these tax issues, the consultation exercise has also highlighted the importance of measuring and reporting the value of innovation if firms are to manage their R&D activities effectively. The Government encourages companies to use the framework provided by current accounting standards as a means to inform their own R&D investment decisions and to disseminate information about their R&D activities to the market as a whole. The DTI's forthcoming White Paper will set out an initiative to be carried forward with the Accounting Standards Board and others on intangible assets more generally.

**3.36** Finally, the review confirmed the importance of a balanced IP rights system, with sufficient protection to encourage investment, and efficient means of disseminating information to widen the process of innovation. The consultation highlighted the need to ensure that the IP system is kept up to date and readily accessible to smaller enterprises. Again, the DTI will be addressing this aspect of the environment for innovation in its forthcoming White Paper.

**Enterprise**

**3.37** The Government has already acted in the March 1998 Budget to encourage enterprise in small and medium sized firms through a package of tax reforms, including the introduction of the Capital Gains Tax taper.

**3.38** The Government is examining how best to build on those steps to develop an environment which encourages investment and growth in enterprising small and medium sized businesses. That work includes reviewing the case for continuing with enhanced first year capital allowances and other issues such as the effective rates of tax borne by small businesses, for decision in the next Budget.

CHART 3.3 HERE

**3.39** In November 1997 the Paymaster General commissioned an independent group to examine the financing of high technology companies. The group, chaired by Sir Peter Williams of Oxford Instruments, looked at areas including investor incentives, support for R&D, and information about investment opportunities. The Government will consider the group's tax and regulatory suggestions in developing proposals for coming Budgets and in work on the proposed Financial Services and Markets Bill.

**3.40** The Government is particularly keen to ensure that the tax system not only encourages long-term investment but also incentivises successful entrepreneurs. This year's Budget introduced a new Capital Gains Tax (CGT) paper to encourage long-term investment. The Enterprise Investment Scheme (EIS) and CGT reinvestment relief were unified in a new more generous EIS, with improved targeting to provide more effective support for smaller higher risk ventures. The Government will examine further how these two aspects of the tax system can together encourage entrepreneurs and other investors to make serial investments in smaller growing companies, so that as these enterprises graduate to new sources of equity funding the original investors will be better able to reinvest their funds into other similar ventures.

**3.41** In the March 1998 Budget, comments were invited on changes to the taxation of capital gains of companies. The Government is grateful to those who commented and will be considering the issues with the possibility of bringing forward changes in future Budgets.

**3.42** Smaller quoted companies (SQCs) are another vital component of the UK's business sector. Earlier this year, the Paymaster General commissioned an independent group to report to the Treasury on the barriers to growth faced by SQCs. The group focused on improving equity markets through incentives for individual investors, better information flows, and more support for smaller firms. The group has made a number of recommendations which the Government will consider in work on coming Budgets and on the proposed Financial Services and Markets Bill.

**3.43** A thriving small and medium sized business sector need not be supported by conventional financial institutions alone.

There is also a role for corporate venturing: large companies providing support and investment in smaller businesses. This can make powerful commercial and economic sense because:

- corporate investors can be better placed to judge investments in firms in their industries - particularly in high-technology areas - than generalist venture capitalists. Thus corporate venturing can be a more efficient form of capital for smaller firms;
- it can also create synergy, combining the dynamism and creativity of smaller firms and the capacity and market reach of larger corporates. Cross-fertilisation between the two can be of strong mutual benefit.

**3.44** Corporate venturing has been one of the driving forces behind the emergence of Silicon Valley. But it is much less common in the UK: the 'Cambridge phenomenon', for instance, comes as close as any UK experience to Silicon Valley, yet recent research has suggested that overseas corporate venturers have made twice the number of investments in Cambridge as venture capitalists and three times as many as UK corporations.

**3.45** The Government believes there may be a case, subject to affordability and feasibility, for incentivising corporate venturing in various ways, including potentially through the tax system. The Government will be consulting on this possibility, but in the meantime would welcome views on corporate venturing more generally.

**3.46** Finally, businesses cannot grow without taking sensible commercial risks which often take time to pay off. The temporary financial problems which this can create for growth-oriented businesses should not be confused with business failure. Businesses facing short-term difficulty need the opportunity to overcome their problems and to grow and flourish.

**3.47** The Government is therefore concerned to keep to a minimum the number of unnecessary corporate failures as well as to shift the traditional British attitude to business risk more generally. Britain needs to move away from an undue stigma associated with failure. The DTI will be announcing, in its forthcoming White Paper, plans for reviews of corporate rescue procedures and a separate review of how insolvency and bankruptcy law might be changed to reduce the stigma of financial failure.

**3.48** Meanwhile, business people themselves can help to generate and renew a culture that values entrepreneurs. The forthcoming launch of an entrepreneurship campaign by the British Chambers of Commerce, CBI, IOD, and Federation of Small Businesses should be a major step forward. This campaign will create entrepreneurship ambassadors to champion enterprise in schools and universities, provide mentors for new businesses, and facilitate improved understanding between banks and small businesses. The Government will also continue to support efforts to make more use of business incubation techniques, including through its support for UK Business Incubation.

INVESTMENT

**The problem**

**3.49** The Government believes that at the root of much of the productivity problem in the UK lies a long history of under-investment. Investment is fundamental to growth and the creation of wealth. New investment underpins the introduction of new techniques and innovations. Without adequate investment the UK will fail to make the best use of its resources today, and it will fail to seize new opportunities for growth in the future.

**3.50** For decades, the UK has invested less than our major competitors. As Chart 3.3 shows, the UK has a much lower level of capital stock per worker - a key determinant ofproductivity.

**3.51** The reasons for under-investment are complex. And of course there can be bad investment as well as good. Nevertheless, lack of investment can be a critical productivity constraint if human input is not backed by the investment necessary to make the most of it. Better productivity performance must be about both the quality and quantity of investment; investment which helps us work smarter, not simply harder. And it must recognise that investment in capital is not a substitute for investment in skills - they must complement each other.

**3.52** The Government has already begun to act to improve investment in the UK by establishing a more stable macroeconomic framework, implementing tax changes to promote investment and establishing the new Regional Development Agencies. And it has radically improved the framework for public investments as will be set out in the forthcoming paper 'Fiscal Policy: A New Framework for Public Investment'.

**3.53** However the Government does not believe this is all that can be done. The UK needs to look also at its markets and institutional structures to ensure they are working to their full potential. Strong and open capital markets are essential preconditions to businesses obtaining the investment they need to grow. The UK's financial markets are generally perceived

to be one of its strengths, yet under-investment persists - on the face of it, a curious mismatch.

**3.54** There are various factors that could be at work here:

- communications between companies and shareholders may not be as transparent or effective as they could be. Many seminar participants perceived UK businesses to be less effective than US firms at explaining and justifying their long-term investment plans to their shareholders or using employee share-ownership to build commitment from the workforce;
- some seminar participants believed the UK banking sector might not be as vibrant as elsewhere;
- other potential inefficiencies in the capital markets, in particular sometimes a perceived focus on the part of institutional investors on shorter-term at the expense of longer-term returns;
- problems in valuing businesses effectively. Increasingly the value of a company's brand, R&D, knowledge and its people substantially outweighs the value of a firm's physical assets. Yet information on the former can be scant; companies might do more to provide it and investors more to demand it.
- promote widespread employee share ownership - in small firms as well as large;
- improve long-term company performance;
- encourage high-quality managers to share in the risks and rewards of running SMEs, particularly early stage high-technology companies, by supporting equity-based remuneration.

**3.55** Britain's vibrant capital markets remain one of its strengths. But to keep them so, openness, transparency and effective competition are essential. Set out below are four areas where the Government believes there may be room for improvement: employee share ownership, the banking system, the equity market, and the market for savings products.

**Employee Share Ownership**

**3.56** The Government wants to encourage more employees to take a stake in their companies and to maximise the contribution of share ownership schemes to productivity. The Government's objectives are to:

- promote long-term shareholding by employees to build a stronger sense of partnership in industry and increase productivity;

**3.57** Evidence, particularly from the US experience, clearly indicates the benefits which can accrue to firms using schemes involving a wide range of employees, especially when these are combined with other forms of worker participation in their companies.

**3.58** There are already several tax-advantaged schemes designed to promote employee share ownership. Currently around one million employees are given shares and a similar number are granted share options each year through these schemes.

**3.59** But the Government wants to examine what more could be done to promote a long-term partnership between employees as shareholders and the company. For example, only around a third of SAYE Sharesave participants appear to hold on to company shares. Retention of shares under the Approved Profit Sharing scheme appears higher, and employees have the same rights as other shareholders while the shares are held in the trust, including receiving dividends and exercising voting rights. The Government is looking at ways in which this scheme might be redesigned to provide stronger incentives for long-term shareholding by all employees.

**3.60** Sir Peter Williams in his group's report on the financing of high technology business, the Smaller Quoted Companies group and the DTI Competitiveness Working Party on Investment have all suggested that special tax-advantaged share incentive schemes might help encourage more high calibre managers to join and stay with smaller companies, particularly early stage high-technology companies, which in turn could enhance their growth prospects.

**3.61** Given the benefits for the economy as a whole of creating the right environment for dynamic and innovative smaller firms to grow, it is worth considering whether tax incentives might tilt the risk-reward balance to encourage entrepreneurial ambition and focus the incentives where they can be most effective. Limiting any incentives to key managers in a targeted group of smaller companies could avoid problems of earlier executive share option schemes which were indiscriminate in the tax advantages they provided, and were often unrelated to the risk taken on by managers benefiting from the options.

**3.62** The Treasury will issue a consultation document seeking views on the current tax-advantaged employee share schemes and possible alternatives, both for all employee schemes and a targeted incentive for managers in smaller, dynamic enterprises such as early stage high technology companies. The conclusions of the review will be announced in the 1999 Budget.

**Banking**

**3.63** The Government believes that the banking sector plays a central role in the UK economy - the investment it finances is a key driver of growth and productivity. High levels of innovation, competition and efficiency are vital to an effective banking industry - and are essential to meeting the productivity challenge. So too, in particular, is an effective partnership between the banks and growing businesses.

**3.64** The Government very much welcomes increasing competition in some parts of the retail banking sector, with the entry of supermarket and telephone banking, and the newly-converted building societies. There are also some welcome signs of improving SME lending techniques, based on the use of more sophisticated methods of risk assessment.

**Box 3.3** - Do UK consumers pay excessive prices?

**US consumers pay less than those in the UK for a significant range of products. For example figures from the OECD show, adjusting for movements in exchange rates, British prices are higher than in the US by an average of:**

- **56 per cent for furniture and carpets;**
- **54 per cent for hotels and restaurants;**
- **29 per cent for cars.**

**Why are prices higher?**

**Some of the factors underlying these higher prices are clear. For example, economies of scale and lower input costs (such as for transport) will give US manufacturers a clear price advantage. The sales taxes are also generally well below EU VAT rates, though not in all areas.**

**However, these factors do not offer a complete explanation for the price differences. Retail margins in the UK are higher than in the US, despite the UK having relatively lower margins overall. A lack of competitive intensity overall would mean UK businesses may not be under the same pressure to innovate, or cut costs and then pass on those savings to the consumer.**

**The Government is determined to continue to press businesses to ensure that consumers get the best value for their money. More widely, as this Report sets out, the Government is acting to promote rigorous competition across the economy.**

**3.65** The Government also welcomes the improving relationship between the banks and the SME sector, including the broader range of lending techniques that have been developed. Given the overriding importance of this sector, the Government nevertheless believes it would be valuable to review the current levels of innovation, competition, and efficiency in the banking industry and the services it provides and to establish whether there is more that the banks could be doing in cooperation with the SME sector. The Government has therefore asked the banks to work with Don Cruickshank, who will lead the review. This will:

- examine the banking industry in the UK, excluding investment banking;
- examine the levels of innovation, competition and efficiency in various sub-markets, including relationships with SMEs;
- look at how these levels compare with international standards; and
- consider whether there are any options for change which the industry or the Government should consider.

**3.66** The review will aim to report within a year. This will be a genuinely open-minded review. Everyone - the banks, their customers and potential competitors - will have a proper chance to put forward their views.

**Equity markets**

**3.67** Britain's equity markets are widely regarded as one of its strengths. In recent years there has been useful progress in improving the clarity and effectiveness of dialogue between companies and their shareholders, enhancing the markets' role in directing capital towards its most efficient uses.

**3.68** However, this is just one aspect of a broader system, not all of which always operates as well as it might. Just as the Government has an interest in effective communications and accountability between companies and their shareholders, for instance, it also has an interest in similarly effective relationships higher up the chain - between institutional investors and their clients, notably pension and life funds. It is through these relationships that fund managers' incentives are set, and their

behaviour and attitudes determined.

**3.69** The Government believes there could be room for improvement here. An effective market structure, in the UK context, could be one in which:

- fund managers were expected to set out, to their clients and publicly, their objectives, how they assess investment performance and the basis on which key staff are remunerated;
- they were also expected actively to vote their shares, and to explain their voting (or abstaining); and in addition building on, for instance, the existing requirements of pensions legislation:
- fund managers' institutional clients' boards and/or trustees were expected to set out, again publicly, their objectives and how they assess the performance of their investments;
- including, in particular, their attitude towards venture capital investments and how they evaluate them;
- as well as how, and over what time period, they assess the performance of fund managers, and basis on which they remunerate them.

**3.70** These are expectations that would support, and go with the grain of, rational commercial decision-making. The Government is keen to see progress in this area and would welcome views from industry in the coming months as to how improvements could be established.

**Savings**

**3.71** Although there is no necessary link between national savings and investment, in practice they tend to be closely correlated. The Government believes saving is an important priority, one which it has already begun to address through the introduction of ISAs and the development of CAT standards.

**3.72** However there is clearly further to go before the UK can credibly claim to have developed a portfolio of savings products which provide the optimum efficiency and transparency which is necessary to build consumer trust. This is a key concern for the new Financial Services Authority (FSA). In particular the FSA will work with the thrust of the overall productivity agenda, to:

- develop a better understanding of the competitiveness of UK financial services, and the ways in which regulation impacts upon it. The FSA will have a specific duty to have regard to the desirability of maintaining the competitiveness of the UK's financial services;
- promote customer understanding of the risks and benefits of investing in different financial products and services, thereby sharpening competitive pressures in the industry;
- do more to promote disclosure.

**3.73** There are two intertwined objectives here. One is competitiveness and productivity in the financial services industry itself. The other is a more competitive, innovative and trusted savings market, providing a healthy flow of finance for investment. These aims are mutually supporting and both are important components of the broader productivity agenda.

COMPETITION AND REGULATION

**The problem**

**3.74** The Government believes that businesses deliver world-class innovative performance only when they are exposed to tough, open and fair competition. It is competition which drives companies to invest in people and machinery, to match the best in management and marketing, and to innovate in process and products. It also gives consumers a better deal.

**3.75** Competitiveness abroad begins with competition at home. This means:

- tackling vested interests;
- exposing management to international best practice; and
- bringing down unnecessary market barriers to new entrants and new ideas.

**3.76** Rigorous competition is also about giving consumers a better deal - academic research suggests the costs to UK consumers of lack of competition are considerable (see Box 3·3).

**3.77** In addition, some seminar participants were concerned that there were signs that competitive pressures in the UK were not always sufficient to encourage businesses to tackle weaknesses in a determined and effective way. As the seminars showed, the scope for gains in UK productivity from matching best practice - both internally and through the supply chain -

is perceived by managers themselves to be very considerable.

**3.78** The Government therefore particularly welcomes the contribution the CBI's best practice campaign should have towards disseminating the benefits of benchmarking throughout industry. However it is competitive pressures which are potentially the most powerful driver of improvements; it is essential that these pressures are not artificially subdued.

**3.79** One way in which they sometimes can be is through regulation. Regulation, although often for desirable social or environmental reasons, can reduce competition by making it expensive for businesses to join a market, or restricting innovation in products or processes.

**Policy Approach**

**3.80** The Government has already implemented measures to begin to ensure that UK markets are as open and as competitive as possible. The Competition Bill models UK law on the competition provisions of EC law. It combines a tough approach to preventing abuse without placing undue compliance burdens on businesses. Special rules will help small firms avoid unnecessary costs.

**3.81** Under the Bill the OFT will have new powers building on its existing important role in policing competition policy. It has, for instance, recently decided to review the profitability of supermarkets in the grocery trade and pricing in the car industry, both markets of key concern to consumers.

**3.82** However tough competition regulation is only possible if it is underpinned by sufficient resources. In recognition of the central priority the Government places on open and competitive markets, the Office of Fair Trading will receive new resources worth more than 20 cent of its current budget. At the same time the OFT is carrying out a thorough going review of its own strategy and structure designed to give the organisation a sharper focus.

**3.83** There is also an important international dimension to competition. Open international markets in trade and investment increase competition. The Government is playing a leading role in fighting for reductions in barriers to the free flow of goods, services and investment. It is pursuing open markets through all possible channels:

- multilaterally - for example, by strongly supporting a new round of World Trade Organisation (WTO) trade negotiations;
- bilaterally - for example, through active support for the EU's Transatlantic Economic Partnership with the US; and
- unilaterally - for example, to help promote competition in the car sector the Government is consulting on removing the ceiling on Single Vehicle Approvals (SVAs), which if removed would allow volume import of cars from non-EU countries direct into the UK.

**3.84** In addition, the Voluntary Export Restraints agreement which currently restricts the number of car imports from Japan to the UK will expire at the end of 1999. Thereafter the EU will become an open market for car imports which should result in increased competition and lower prices for consumers. The expiry is required by WTO rules and is fully supported by the Government.

**3.85** Better regulation is an important factor for international business too. Barriers to trade, such as differing or burdensome standards between countries, add costs to trade and discourage its growth. The UK is working to identify these problems and negotiate with our trading partners to eliminate them. One example is the Transatlantic Economic Partnership between the EU and the US, which have the world's biggest bilateral trading relationship. This is seeking ways mutually to recognise each others' standards so a product that already meets EU standards will meet US ones too.

**3.86** The Government is also committed to ensuring that other forms of regulation strike the best balance between protecting the consumer and environment and encouraging prosperity and jobs. These can be difficult balances to strike. That is why the Government established the Better Regulation Task Force, chaired by Lord Haskins, to ensure that Government as a whole takes the best and most effective approach to regulation matters. As part of its work the Better Regulation Task Force will undertake a review looking at the role of regulation in relation to productivity, with a view to identifying a possible range of specific areas for further Task Force scrutiny. The Task Force will review McKinsey's concerns in this area, looking for instance, at the points McKinsey have raised about building control regulations.

**3.87** More generally, the Government does not believe there is room for complacency, either in relation to the level of competitive intensity in UK markets or to the regulatory regime. A key part of the Government's productivity strategy must be to ensure that robust competition in product markets thrives, over time driving productivity improvements towards world-class levels, and that there is a sufficiently strong competition regime to ensure that it does.

**3.88** Businesses also need to be able to expand and modernise. International experience suggests there can be an additional premium from locating clusters of similar businesses in the same area. But parts of the UK are already amongst the most built up and densely populated regions of the world. It is clear that the planning system has a key role to play in delivering sustainable growth.

**3.89** Planning regulations can in some cases act as an obstacle to economic expansion. At the same time, there is widespread support amongst businesses for using the planning system as a positive tool for wealth creation and sustainable development.

**3.90** The Government has been undertaking a root and branch overhaul of the planning system to see where planning regulations can be made more attuned to the needs of enterprise and business start-ups while still meeting the Government's wider environmental objectives. Following publication of 'Modernising Planning' last January, the Government has already started a major campaign to reduce planning delays and remove inconsistencies. It has introduced a programme of measures which will provide for a more efficient process for major projects, a more strategic role for regional planning, speedier local and unitary development plans and quicker resolution of local planning applications. But much remains to be done to deliver a more efficient, streamlined and integrated approach to planning that can improve business competitiveness without devaluing the quality of decision-making or public accountability.

**3.91** The Government will be examining in detail how the planning system can best help promote business competitiveness and in particular clusters of similar businesses.

**SKILLS**

**The problem**

**3.92** Skills are critical to productivity and investment. Yet there is much evidence that skills in the UK do not compare well with our leading international competitors.

**3.93** Of those joining the work force for the first time, in 1995 only 54 per cent of those aged 18 had stayed on in education in the UK, compared with 84 per cent in France and Germany. Even in areas where the UK does perform well, such as in higher education, there was a strong perception amongst seminar participants that the skills that are taught do not always match the needs of the economy.

**3.94** In the existing workforce, there is a major skills deficiency in intermediate level vocational skills (Levels 2 and 3) compared to our main European competitors, particularly Germany.

**3.95** Many people find it difficult to develop and upgrade skills because of their lack of basic literacy and numeracy skills. 22 per cent of adults in the UK have very poor literacy skills, compared to 14 per cent in Germany. This severely restricts the range of jobs they can do and diminishes their ability to re-train - as they must in a modern economy - for new jobs and new ways of working.

**Policy Approach**

**3.96** The Government's strategy is to give:

- new entrants to the workforce (school and college leavers) the skills they and businesses need to succeed; and
- give the existing workforce lifelong learning opportunities to obtain new skills, to adapt to new industries and new economic challenges

Skills for new entrants to the workforce

**3.97** The Government's drive for higher standards in schools will raise attainment; and closer links between business and schools will make clear the opportunities available to those with the right skills. Both policies will help motivate young adults to gain more from a longer period in education.

**3.98** The Department for Education and Employment (DfEE) published on 15 October a consultation paper “Schools and Business - Sustaining Partnerships” to seek views on how these can work more effectively.

**3.99** The Government also intends to provide a further incentive for businesses to engage with schools, by reintroducing tax relief on the salaries of staff seconded from business to educational establishments.

3.100 The Government believes that an understanding of the world of work and of the economic realities of adult life is central to future employability and should be reflected in the school curriculum. The Government is already undertaking a

number of measures to prepare young people for work. In addition, the Qualifications and Curriculum Authority's Preparation for Adult Life Group will be considering a number of options for the revised National Curriculum, which is to be in place from 2000.

**3.101** On 28 October the Secretary of State for Education and Employment announced a new set of National Learning Targets for England, reflecting the proposals of the National Advisory Council for Education and Training Targets (NACETT). By 31 December 2002:

- at least half of 16 year olds should have a qualification at level 2 (five GCSEs at grade C or above, an Intermediate GNVQ or an NVQ level 2), compared to 46 per cent in summer 1998;
- 95 per cent should have one GCSE at grade G or an equivalent qualification, reducing by between a quarter and a third the proportion that leave school with no qualifications at all;
- 85 per cent of 19 year olds should be qualified to level 2 compared to 73 per cent in summer 1998;
- 60 per cent of 21 year olds should be qualified to level 3 (two A levels, an Advanced GNVQ or an NVQ level 3) compared to 50 per cent in summer 1998.

**3.102** In support of these targets, and those below for adults, there will be a significant expansion in Government supported education and training. There will be more than 500,000 extra students in HE and FE by 2002. There will also be an expansion in skills training in the workplace by way of National Traineeships and Modern Apprenticeships. The Government has recently introduced legislation which will give young people in jobs the right to time off for study or training. And it will also pilot an Educational Maintenance Allowance for those aged 16 to 18 to raise the rate at which those from lower household incomes stay on in education.

**3.103** Given the substantial public investment in university students, it is particularly important that they find productive work after graduation. Better information is crucial to achievement of this aim. Work is already in progress on improving performance indicators for Higher Education (HE) Institutions that will better inform the choice of prospective students. Those relating to the key issue of employment outcomes will take effect in 2000.

**3.104** In addition, the quality assurance system is being adapted to emphasise the clear specification of programme content and outcomes, making it easier to judge what skills a graduate will bring to the work place. This will include the key skills required by employers. Trials of the new quality framework will begin next year, with a view to implementation in September 2000. The Government will look further at ways in which Higher Education Institutions should work to improve their graduates' employability. As part of the employability agenda, a new 'reach out' fund will, from 1999, support HE institutions in building links with business and meeting employer needs. This will be complementary to the Science Enterprise Challenge initiative described above.

**Lifelong learning**

**3.105** The Government is committed to a step change in the participation of adults in lifelong learning. For adults, the Secretary of State for Education and Employment has announced the following targets:

- 50 per cent to reach Level 3 by 2002, compared with 44 per cent in summer 1998;
- 28 per cent to reach Level 4 (degree level) compared with 25 per cent in summer 1998.

**3.106** On 21 October, the Secretary of State announced the £40 million budget for the University for Industry (UfI) for 1999-2000. The UfI will help individuals and businesses identify the learning they need and to gain access to it.

**3.107** Work continues on the arrangements for Individual Learning Accounts, through which many adults will be encouraged to take responsibility for their own learning. Twelve development projects are already under way. These will inform the arrangements for the first 100,000 'starter' accounts to be opened in 1999-2000. The priority groups for this first phase of ILAs will include people with no qualifications and in low skill jobs; people working in small firms and those seeking to return to work. There will be a national framework for ILAs in place from 2000 for a sustainable system of ILAs, setting out incentives for participation.

**3.108** The Secretary of State for Education and Employment has already announced a number of initiatives on skills:

- in March this year, the Government set up the Skills Task Force to advise on the development of a National Skills Agenda which will deliver the skills needed for the UK's economic success. The Task Force is currently considering issues such as employability and key skills and learning in the workplace;

- a group led by Sir Claus Moser is advising the Government on how best to achieve its target of doubling the help available to adults to address their literacy and numeracy skills so that over 500,000 adults a year are being helped by 2002. It will report later this year;
- 20 Centres of Excellence for IT and High Technology training together with new training facilities to tackle other skill shortage areas are to be set up. They will be operational by March 1999;
- £6 million over three years for the Union Learning Fund to support trade unions to do innovative work to promote and provide lifelong learning for their members. 45 successful bids were announced in September 1998.

**3.109** Although the Government has a key part to play, the UK's productivity over the coming years will depend largely on the effects of employers to 'upskill' their work forces. The trend is in the right direction: 82 per cent of employers with 25 or more staff funded or arranged off-the-job training in 1997, compared with 76 per cent in 1991.

**3.110** Investors in People' was launched in 1991, setting a standard for organisations in the training and development of employees. 33 per cent of organisations with 200 or more staff are now recognised as meeting this standard. The Government has set new targets for organisations: 45 per cent of organisations employing 50 or more staff, and 10,000 organisations with between 10 and 49 staff to be recognised as Investors in People by 2002.

PRODUCTIVITY IN THE PUBLIC SECTOR

3.111 The Government can also play a further direct role by improving productivity in the public sector. Public services account for about a fifth of the real resources of the economy. It is crucial that these are well targeted and that they are provided in the most efficient and effective way possible. Many government policies also directly impact on businesses in ways which can affect their performance.

3.112 Earlier this year the Government published its spending plans for the next three years as a result of the Comprehensive Spending Review (CSR). It committed itself to a wide-ranging programme of reform in the public sector, with:

- tough efficiency targets - 3 per cent a year for the NHS; 2 per cent a year for the police - and reforms to modernise and improve key public services;
- a new Best Value regime for local authorities to force them to compare performance between similar authorities;
- reforms to tackle absenteeism in the public sector, with a target of reducing sick absence by 20 per cent over the next three years;
- a crackdown on fraud which is estimated to cost the country £2 to £7 billion a year;
- a new Invest to Save budget which will encourage different parts of the public sector to work together to improve service delivery and cut costs;
- innovative ways of improving management in the public sector, including a new Centre for Management and Policy Studies in the Cabinet Office, drawing on best practice and new approaches to management.

3.113 To ensure that these and other reforms are delivered, the Government is committed to publishing Public Service Agreements (PSAs), setting out key targets for improving delivery. These will be published in a White Paper later this year. Departments will also produce Departmental Investment Strategies (DISs), which will demonstrate that capital investment is being efficiently and effectively used. Summaries will be published next spring.

3.114 Progress against the PSAs will be overseen by a Cabinet Committee (PSX) chaired by the Chancellor of the Exchequer. A Public Services Productivity Panel will bring in outside experts, senior business people and public sector managers to advise the Government on ways of improving the productivity and efficiency of government departments and other public sectors bodies. The Chairman will be the Paymaster General, the vice-chairman will be Byron Grote of BP-Amoco.

3.115 The Government will also set up a new Productivity and Competitiveness Cabinet Committee, also chaired by the Chancellor, which is being created to scrutinise those policies and regulations which may erect barriers to the productivity of the private sector and the level of competition in the economy.

**Procurement**

3.116 Central Government civil procurement costs £12 billion a year. Its proper management and coordination is essential. The Government has commissioned a review, to be led by Peter Gershon of GEC-Marconi, which will examine current arrangements for civil procurement. The review will recommend any changes that would support the Government's efficiency, modernisation and competitiveness objectives and ensure the success of the Government's drive for improved

productivity through the better management of relationships with suppliers.

**Private Finance Initiative**

3.117 By the beginning of October 1998, around £11 billion worth of PFI projects had been agreed. The Government wants to build on the success of the Private Finance Initiative and ensure it continues to thrive when the existing Treasury Task Force is wound up. The Government has therefore decided to establish a second review - under Sir Malcolm Bates - to consider what institutional arrangements should be made following the expiry of the Task Force's mandate. He will be guided by the Government's objectives of introducing the best of private sector skills and practices into public sector procurement, and ensuring that a steady flow of PFI and PPP deals contribute to a higher sustainable level of investment in public sector infrastructure.

# Next steps

3.118 These are first steps in developing a strategy for improving productivity which will be developed further in the DTI's forthcoming White Paper and the 1999 Budget. The Government would welcome views on its planned approach; publication of the Pre-Budget Report is the beginning, not the end, of the consultative process.

# ENCOURAGING AND REWARDING WORK

The Government has begun an ambitious series of reforms to increase employment opportunities, work incentives and skills. Taken together, these reforms will play a critical role in tackling poverty and benefit dependency and contributing towards improved growth and productivity.

The chapter shows how the Government has:

- made substantial progress in delivering its Welfare to Work programme, including the New Deal for the young and the long-term unemployed, lone parents and the disabled;
- embarked on a series of reforms over the next year to make work pay; the introduction of the Working Families Tax Credit, the National Minimum wage and national insurance reform; this chapter also sets out the personal income tax allowance, and the linked earnings threshold for employer NICs, for 1999-2000;
- confirmed its future agenda including:

  - introducing the 10p starting rate of income tax, when it is economically right to do so;

  - aligning the threshold for employee National Insurance Contributions with personal allowances for income tax;

  - introducing a Disabled Person's Tax Credit that will help employees who become disabled keep their jobs;

  - policies to encourage a family friendly labour market.

- undertaken a series of reforms to the welfare system guided by the principle 'work for those who can, security for those who cannot' which include:

  - a new single work-focused gateway to benefit;

  - reforms to the All-Work Test to provide information on capacity rather than incapacity for work;

  - measures to improve the help given to the poorest and most severely disabled people.

**4.1** In previous Budgets, the Government has set out a strategy for high and stable levels of employment, through the promotion of employment opportunities for all - the modern definition of full employment for the 21st century.

**4.2** Since the objective of full employment was first set out in 1944 there have been major demographic and social changes, new developments in the labour market and the global economy and a rise in female and part-time employment. Over the last 20 years structural unemployment has increased, alongside the wide swings in the level of employment associated with the boom and bust economic cycle. The labour market participation rates of particular groups of individuals including men aged over 50, lone parents and disabled people have seen a substantial decline. And the number of households where no-one is in work has risen dramatically.

**4.3** We have also come to understand more about the way the labour market works, and to look more closely at features of the labour market - in particular the operation of the tax and benefit system - which place barriers in the way of greater employment opportunity. In May 1997, for example, around three quarters of a million families faced a poverty trap where over 70 pence of every extra £1 they earned was lost in tax and benefit clawback.

**4.4** The old approach to full employment relied heavily on the levers of macroeconomic management to secure full-time male employment. Active welfare to work policies were not as important when a high proportion of the unemployed could find work relatively quickly. Skills mattered less when there were plentiful job opportunities for people without qualifications. Distortions in the tax and benefit system had a much weaker impact when work took people substantially above the level of benefits. Family-friendly work practices were less relevant when fewer people needed to balance work and family responsibilities. And it was more valid to focus only on the claimant unemployed when those outside the work force

altogether were there from personal choice, and not because they lacked employment opportunity. Now that we face a new set of labour market problems, this approach has become an outdated and inadequate response.

**4.5** That is why the Government adopted a new approach with three key elements:

- the New Deal programmes to help people from Welfare to Work, focusing help on groups detached from the labour market; the young and long-term unemployed, lone parents, disabled people and partners of the unemployed;
- reforms to make work pay, bringing in an entitlement to a minimum level of take home pay through the national minimum wage and changes to the tax and benefit system, including the Working Families Tax Credit and the Disabled Person's Tax Credit;
- investment in education and skills, to ensure that everyone has access to the skills they need to progress in the workforce, and to align the UK skills base with the needs of the modern economy. The Government has begun a substantial programme of investment in skills across the workforce of today and tomorrow.

**4.6** Increasing numbers of people combine caring for their children or elderly, sick or disabled relatives with paid work. That calls for family-friendly employment practices, that help match the needs of employers, employees and their families.

**4.7** The Government also aims to address the 'low pay-no pay' cycle, as part of its overarching strategy to tackle poverty. Improving employability is the key to tackling poverty. Most of those with low incomes are poor because no one in their household has paid work. As box 4.1 demonstrates, there is strong evidence that work is the best route out of poverty for those of working age.

**4.8** The build up of long-term worklessness associated with previous recessions was immensely damaging for individuals - destroying their connections with the labour market, their skills and employability. It meant that, when the economy moved into the recovery phase, labour market bottlenecks, skill shortages and wage inflation stalled recovery while worklessness remained at unacceptable levels. The long experience of high unemployment in the UK has, therefore, strengthened the Government's view that a stable and prudent framework for fiscal and monetary policy - set out in Chapter 2 - is a vital precondition for an extension of employment opportunities.

**4.9** This agenda of structural reform and stability for the long term will help to ensure that the economy is well placed to meet the challenges of the global economic slowdown. The prospect of slower economic growth comes against a background of growing employment and falling unemployment. The Labour Force Survey shows that since the last election employment has risen by over 400,000, whilst unemployment has fallen by almost 300,000 on the ILO definition, and by over 350,000 on the claimant definition.

**4.10** These figures are the product of substantial labour market flows into and out of employment. Every quarter, around 2 million people move into a new job of whom around 40 per cent were previously out of work (see chart 4.1). This means that, despite the fact that overall economic activity is projected to grow more slowly next year, millions of new job opportunities will continue to emerge. A slowdown of growth in the year ahead is consistent with an economy that generates a large number of employment opportunities. The Government's employment strategy will mean that individuals are better placed to take advantage of those opportunities.

Chart 4.1

**4.11** Alongside the development of this strategy in the UK, employment has been central to the Government's international and European agenda. The Government has played a leading role in promoting agreement on the first ever set of European Union Employment Guidelines in November 1997, and agreed with other Member States to produce National Employment Action plans each year. Under the UK Presidency of the EU it was agreed that:

- these action plans should identify best practice between Member States;
- measures were needed to reinforce the development of a skilled and adaptable workforce, including through lifelong learning;
- existing regulatory frameworks should be reviewed at all levels; and
- tax and benefit systems should be reviewed to make it easier for employers to create new jobs and more attractive for employees to fill them.

**Box 4.1** - Work as the best way out of poverty

The Government's programme for work will help provide an exit route out of poverty for large numbers of families with low incomes. Lack of work is the most important pathway into poverty and work is the best way out. Most of those with

low incomes are poor because no-one in their household has paid work.

Since 1979 the number of non-pensioner families living in workless households has more than doubled as households have polarised between 'work-rich', multiple earner households and 'work-poor' workless households. In 1995-96, eight out of ten working age households with less than half average income - almost eight million people - had no full-time worker, up from five in ten in 1979. A third of children now live in relative poverty. This is almost three milion more poor children than in 1979. Over 80 per cent of these children live in households where no-one has a full-time job.

Getting a job gives families the best chance to leave poverty. Over three-quarters of people who get a job will move out of the poorest 20 per cent of households, compared to less than a third of those who remain workless.

The New Deal programmes to help more people from welfare to work will extend work opportunities to many of the groups who are most at risk of poverty. The substantial programme of investment in education and skills will help tackle the problem of poverty at its roots, ensuring that more people have the skills and qualifications they need to gain employment.

The reforms to make work pay will ensure that workless families who get work see a real improvement in their living standards. From October 1999 when the Working Families Tax Credit is introduced, a lone parent family with one child who gets a job paying £90 a week will be more than £80 a week better off in work. A couple with two children with one earner with a job paying £220 a week, will be more than £100 a week better off in work.

Chart here

The Government is currently engaged in reviewing the evidence on the dynamics of poverty and factors which lead people to be at greater risk of persistent poverty.

**Box 4.2 Experiences of the New Deal**

The New Deal for 18-24 year olds has already succeeded in moving over 30,000 young people into work. The early success stories include:

- Lisa, 20, from Merseyside had been unemployed for 18 months before joining the New Deal. She is partially sighted and has literacy and numeracy problems. She attended five job interviews as part of the Gateway. She was successful at the fifth and is now working as a care assistant.
- Julia, of Cumbria has just completed her Environmental Task Force option with the National Trust. During her placement she had access to a variety of training courses and when a Trainee Land Agent post came up at a National Trust office in Cheshire, Julia was ideally placed. She started a permanent job with the Trust in September.
- Scott, 23, desperately wanted to be a football coach. He had previously worked cleaning cars, but had obtained a Community Coaching Certificate. His personal adviser visited Middlesborough Football Club, which agreed to take Scott on as a subsidised employee. Scott is now training for his European/UEFA coaching badge.
- Abdulah, 24, was unemployed for nearly a year before joining the New Deal in May. He attended a course on job search skills where he improved his interview techniques and learned to write more effective application forms and covering letters. He now works in the Treasury's Welfare to Work team.

The first to be helped by the New Deal for the long-term unemployed aged 25+ include:

- Eve, aged 56, from Yorkshire had been unemployed since being made redundant from her job as a clerical worker three years ago. She blamed her age for her persistent failure to be accepted for interview. Once on the New Deal, her personal adviser found a vacancy matching her skills. Although the employer was initially concerned about Eve's age, the personal adviser persuaded them of her enthusiasm and she was accepted for the job.

Almost 17,700 lone parents have chosen to participate in the early stages of the New Deal for lone parents. They include:

- Bridget, aged 31 with two children aged seven and twelve. Her personal adviser helped her put together a CV, improved her job search skills, and showed her she would be better off than on benefits. She is now £34 a week better off, after starting work at a local supermarket.
- Ray, a widower, with three children felt that childcare was the only real barrier preventing him from finding employment. His adviser helped him to find childcare and, following some IT training, Ray has found work in a warehouse with a view to becoming a supervisor.

**4.12** The UK has also taken the lead on moves to increase employment in the G8, and held a successful conference in February which agreed a set of policy principles to guide policy development in G8 countries.

**4.13** The strategy set out in this paper will make a major contribution to the government economic agenda. But it also plays a central role in the reform of the Welfare State. The Government has embarked upon a far-reaching programme of welfare reform to create a welfare state that meets the challenges of the 21st century. The Green Paper 'A New Contract for Welfare', published in March, set out the principles that will guide reform.

**4.14** In October 1998 the Secretary of State for Social Security set out the next phase of reform:

- a new, single work-focused gateway onto benefit (see paragraph 4.36-37); and
- reforms to benefits for people who are long-term sick and disabled.

**4.15** These reforms are guided by a clear principle - work for those who can, security for those who cannot. The measures include:

- changes to Incapacity Benefit to strengthen the link between entitlement and work and to achieve a fairer partnership between state and private provision;
- reforming the All-Work Test for Incapacity Benefit to provide information on capacity for work, to inform back to work advice where that is requested and appropriate;
- a new Disability Income Guarantee for severely disabled people;
- extending Disability Living Allowance to 3 and 4 year olds with mobility needs;
- reforming Severe Disablement Allowance, with a more generous benefit paid to those disabled before the age of 20.

**4.16** The Government will be announcing further welfare reforms, in particular in the Pensions Green Paper later this year.

# WELFARE TO WORK

**4.17** As a major part of the strategy to ensure employment opportunities for all, the Government is targeting groups of people who are at risk of becoming detached from the labour market. Long periods of dependence on benefits are deeply damaging for individuals and, as box 4.1 demonstrates, a major cause of poverty and social exclusion. They are also costly in economic terms - as people spend long periods out of work, their chance of moving into work declines significantly. They cease to be effective in their search for work - to all intents and purposes leaving the labour market altogether. If more people can be helped back into the labour market, we can increase the numbers who are in a position to compete for the job opportunities that exist. That means that the economy can grow more rapidly without running into skill shortages and wage inflation. In other words, the welfare to work programme can help raise the sustainable level of employment.

**4.18** Most of the elements of the welfare to work programme are now in place. Throughout 1998, the New Deal for 18-24 years olds, for long-term unemployed people aged over 25, and for lone parents, have been rolled out on a national basis. The last Budget announced that a further £60 million of windfall tax receipts would be spent on the New Deal for partners of the unemployed. The New Deal for disabled people has already started on a pilot basis, which will inform the further development of the initiative beyond April 2000. Already the New Deal is delivering results. Box 4.2 sets out some of the examples of the thousands of individuals who have secured work through the New Deal.

**The New Deal for 18-24 year olds**

**4.19** The New Deal for 18-24 year olds has now been running on a nationwide basis for 6 months. Its objective is to help young unemployed people to secure jobs as the most effective way of enhancing their earnings, increasing their skills and securing their future economic independence.

**4.20** Over 160,000 young people have joined the New Deal, initially entering a gateway where they receive intensive support from a personal adviser. Young people have said that they find this an especially valuable element of the programme. During the gateway, particular help is targeted on people with problems such as homelessness, or alcohol or substance abuse. For example, in Brighton a mediation programme for homeless people has been founded to help New Dealers find accommodation.

**4.21** So far 60,000 have completed the gateway phase. And already over 30,000 have started work, a figure which we expect to rise significantly in the months ahead, as more young people move through the gateway and into work. Over 21,000 of the jobs secured so far are unsubsidised.

**4.22** To help maximise the numbers finding work, the Government is working closely with employers to address any barriers they face in recruiting through the New Deal. For example, the hospitality and construction industries are working closely with the Government to develop new ways in which the New Deal can help to address their skills shortage problems.

**4.23** The Government is committed to ensuring the continuous improvement of every element of the New Deal. The New Deal Advisory Task Force, led by Sir Peter Davis of the Prudential, plays a crucial role here. The Task Force continues to assist the Government in developing challenging performance measures, and strategies to improve the effectiveness of local delivery.

**4.24** An effective balance between rights and responsibilities is an important element of the New Deal for 18-24 year olds. The vast majority of young people have engaged enthusiastically with the New Deal and are taking full advantage of the new opportunities it offers. Given the substantial public investment involved, and the wide ranging opportunities provided by employers and by the voluntary and environmental sector, all young people should meet their side of the deal.

**New Deal for the long-term unemployed**

**4.25** Since June 1998 those unemployed for over two years have been eligible for a £75 per week subsidy to help them into work. The last Budget announced the extension of this New Deal through a series of innovative pilots which will start at the end of this month. These are based on the intensive approach pioneered for 18-24 year olds. Those unemployed over 18 months, or over 12 months in some areas, will start an intensive gateway. Those who do not find work will enter a period of full-time activity for three months. The choice of options depends on individual need but can include work trials with employers, training, work experience, and support for self employment. On-going support will be available to those most at risk of remaining unemployed.

**4.26** Since the Budget, and following a competition between different areas, 28 local partnerships have been selected to deliver the pilots, with the private sector leading delivery in 10 areas. Partnerships have been given flexibility to develop innovative ideas. For example:

- in Cornwall, the GROW group will run a project specifically for the over 50s, to help people leaving declining industries to adapt their existing skills to new work. GROW has previously assisted land workers in making the transfer to woodland management and timber processing.
- in Hackney, the Reed Group is providing a transition grant to help people meet the up-front costs associated with a new job.

**4.27** 60,000 people are expected to enter the pilots in Great Britain. In Northern Ireland, as part of the Chancellor's economic regeneration initiative (see box 3.2), these opportunities will be open to all those who have been unemployed for over 18 months - some 30,000 people.

**4.28** The pilots will be extensively evaluated, to yield evidence about what works and what does not. This evidence will inform the future development of the Welfare to Work programme. In two pilot areas (Ealing, Hounslow and Richmond; and Bexley and Greenwich) the programme will be delivered and evaluated using random assignment techniques. Under random assignment the piloted programme is made available to some people within the area, the 'pilot group', and not available to others, the 'control group'. The assignment of individuals between the two groups is decided randomly. Comparison between the experience of the pilot and control groups provides strong evidence of the effectiveness of different approaches.

The New Deal for lone parents

**4.29** The New Deal for lone parents was tested in eight pilot areas from July 1997. Many lone parents would like help to get into work and 87 per cent of those attending initial interviews have agreed to participate in the New Deal. Of the 17,700 lone parents who chose to participate, more than a quarter have already successfully moved into employment.

**4.30** An independent evaluation of the pilot areas concluded that the New Deal for lone parents is already having a real and marked effect on the rate at which lone parents move off Income Support. The results of the pilots compare favourably with programmes in other countries which have been running for much longer. Evaluation evidence shows that those lone parents who have moved into work through the New Deal are on average £39 per week better off. After the introduction of the Working Families Tax Credit, this figure will increase further.

**4.31** The New Deal for lone parents was launched nationwide on 26 October. All lone parents on Income Support with children of school age are now being invited to participate and parents of younger children can also volunteer to join. Lone parents will be offered a personalised service which combines job search help, advice on in work benefits and childcare, and

training, where appropriate. This is the first serious national attempt to help lone parents improve their prospects and living standards by taking up and increasing paid work.

**The New Deal for disabled people**

**4.32** In the past, the benefit system has defined people with disabilities by what they cannot do, condemning them to a life of benefit dependency and low expectations. Already, the New Deal for disabled people is offering people with disabilities the opportunity to work and achieve their full potential. Pilots of a Personal Adviser service for disabled people who want to find work started in September 1998. A further six pilots start in Spring 1999, with private, voluntary and public sector agencies invited to bid to provide innovative and individually-tailored services. The single work-focused gateway pilots and the reforms to the All-Work Test announced by the Secretary of State for Social Security and the new, more generous Disabled Person's Tax Credit will play a key role in enhancing the difference this New Deal will make.

**The New Deal for partners of the unemployed**

**4.33** Partners of the unemployed, mainly women, are themselves disproportionately likely to be unemployed. In the past, the benefit system has assumed that partners of unemployed people cannot or do not want to work, denying them help and opportunities. The last Budget announced that £60 million would be made available from the Windfall Tax to ensure that partners over 25 have the option to receive the help they need to get back to work. Childless partners, aged 18-24, will become eligible for the full range of services under the New Deal for 18 to 24 year olds.

**Further development of Welfare to Work**

**4.34** The New Deal is targeted mainly on those who have been out of the labour market for some time. But the Government is also developing new approaches to improve the service available to people when they lose their jobs, or make an initial claim for benefits.

**4.35** To help people who lose their jobs through major redundancies, Rapid Response Units have been established, coordinated by the Employment Service and bringing together a wide variety of local agencies. The units provide tailor made services including access to vacancies, individual counselling from a named contact, and early access to Employment Service programmes including training. They can be active within hours of redundancies being announced. For example, following the announcement of redundancies at Fujitsu in Durham, and Vickers in Leeds, local task forces were set up to coordinate assistance, guiding people to the help they need to move rapidly into new jobs.

**4.36** The Government will also introduce a single work-focused gateway onto the benefits system for people of working age. This will bring together the Employment Service, Benefits Agency and other services in a more coherent and seamless service, and provide a personal adviser to help claimants become more independent. There will be a fundamental shift away from asking simply 'what money can we pay you?' to asking 'how can we help you become more independent'. This will complement changes to the All-Work Test introduced by the Secretary of State for Social Security, and reforms to make work pay. The Government will pilot the single gateway in four areas, from June 1999, and in a further eight areas, making use of call centre technology and the innovations and efficiency of the private and voluntary sectors, from November 1999.

**4.37** The Government does not want anyone to miss out on opportunities to discuss the help that is available to them. So, from April 2000, subject to legislation as announced by the Secretary of State for Social Security, it will make it a condition of receiving benefit that, when asked to do so, people take part in an interview about their prospects of finding work. For some, such as the recently bereaved, single parents with very young children, people with heavy caring responsibilities or those suffering from acute illnesses, an immediate interview about work would not be appropriate. For them the priority will be to pay benefits. There is no question of forcing lone parents and disabled people into work, but too many people are labelled as unemployable when in fact they not only want to work, but also have a good chance of finding a job. The earlier support is given, the more likely people are to focus on the sort of work they could do in the future, and the less likely they are to become resigned to a lifetime on benefit. The Government believes that the principle of giving everyone a real chance to get back into work is right, and that the requirement to attend an interview is reasonable.

**Funding Welfare to Work**

**4.38** The Welfare to Work programme is funded from the receipts from the one-off Windfall Tax on the excess profits of the privatised utilities. The Windfall Tax is expected to raise
£5.2 billion, with the second and final installment of £2.6 billion due in December 1998. Table 4.1 sets out the latest estimates of the allocation of the Windfall Tax receipts between programmes. The main change since the March 1998 Budget is the additional resources for the New Deal for those aged over 25 in Northern Ireland, and an additional £10 million for

measures to help disabled people into work. The table also provides a revised profile of spending over the Parliament.

**Table 4.1: Funding Welfare to Work-the allocation of the Windfall Tax receipts**

| £million | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 | **1997**-02 |
|---|---|---|---|---|---|---|
| Spending by programme[1] | | | | | | |
| A New Deal for 18-24 year olds | 50 | 580 | 660 | 650 | 650 | **2590** |
| A New Deal for the over 25s | 0 | 130 | 180 | 90 | 80 | **480** |
| A New Deal for lone parents | 0 | 40 | 60 | 50 | 40 | **190** |
| A New Deal for disabled people[2] | 0 | 10 | 30 | 80 | 80 | **210** |
| A New Deal for partners of the unemployed | 0 | 0 | 20 | 20 | 20 | **60** |
| A New Deal for schools[3] | 90 | 310 | 270 | 360 | 270 | **1300** |
| Childcare[4] | 0 | 40 | 0 | 0 | 0 | **40** |
| University for Industry[5] | 0 | 5 | 0 | 0 | 0 | **5** |
| **Total Expenditure** | **140** | **1110** | **1220** | **1240** | **1150** | **4860** |
| Unallocated | | | | | | **340** |
| **Windfall Tax receipts** | **2600** | **2600** | | | | **5200** |

[1]*Rounded to the nearest £10 million. Constituent elements may not sum to totals because of rounding. Outurns for 1997-98, estimates for 1998-99 onwards.*
[2]*Includes £10 million in 1999-00, an element of the recent announcements on Welfare Reform.*
[3]*Capital spending on renewal of school infrastructure, to help raise standardsóannounced in the 1997 Budget.*
[4]*Includes £30 million for out-of-school childcare. The costs of the 1997 Budget improvements in childcare support through Family Credit are included from April 1998 until October 1999, when the measure will be incorporated within the Working Families Tax Credit.*
[5]*Start-up and development costs. Other costs of the Ufl are funded from within departmental expenditure limits.*

# MAKING WORK PAY

**4.39** People are understandably reluctant to take work that does not pay. Too often, the gap between in-work and out-of-work income is too small to encourage people to move off benefits. And, once in work, many people on low income face an unacceptable poverty trap, in which improvements in their pay are clawed back by the combined effects of the tax and benefit system. These distortions are frustrating the ambitions of people on low income, and contributing to family poverty. They also contribute to high levels of structural unemployment and low levels of labour market participation. Measures to address tax and benefit distortions are, therefore, an important element of the Government's economic programme, as well as a crucial element of the reform of the welfare state.

**4.40** The last Budget signalled a major step towards the reform of the poverty and unemployment traps. The Government is pressing ahead with new incentives to work - through the development of a new Working Families Tax Credit (WFTC). Combined with the National Minimum wage, the WFTC provides a minimum level of weekly take-home pay. It also provides the opportunity to develop greater support for the costs of childcare and new incentives for disabled people who want to work alongside the WFTC. These reforms are accompanied by a major reform of National Insurance reducing the distortions facing employers and employees that have, in the past, limited work opportunities.

**Working Families Tax Credit**

**4.41** The March 1998 Budget announced the introduction of a Working Families Tax Credit to replace Family Credit to ensure that work is rewarded not penalised. The WFTC which will be introduced from 5 October 1999:

- will provide a guaranteed minimum income of £190 for families with one member in full time work earning the national minimum wage; and
- will reduce the tax burden on families so that those with earnings of less than £220 a week, half male average earnings, will no longer pay any net tax.

**4.42** It was also announced that as part of the WFTC a childcare tax credit would be introduced. The tax credit will be more generous than the childcare disregard in Family Credit and will assist the poorest families. At the moment a family earning less than £79 a week cannot in practice get help with childcare costs.

**4.43** The credit will play a key role in underpinning the National Childcare Strategy by ensuring that childcare is affordable for low and middle-income families. The Government will ensure that the definition of 'eligible childcare' is consistent with the approach being pursued in the National Childcare Strategy following its review of the regulation of early education and daycare. The Government has therefore decided:

- to relax the age-limits applicable under Family Credit so that parents will be able to claim for childcare for children up to age 14, ensuring that the credit is in line with the National Childcare Strategy;
- to raise further the age limit in the case of children with a disability so that their parents will be able to claim childcare costs up to the age of 16.

**4.44** The WFTC will reduce the disincentives caused by the combination of Housing Benefit and Family Credit. But reform of Housing Benefit is also necessary, with a view to further reducing the barriers to work, encouraging personal responsibility, reducing fraud and supporting better housing management. As a next step, the Government is working with local authority associations to make Housing Benefit easier for claimants to understand; to make the benefit fairer; and to tackle fraud and abuse.

**Box 4.3** - The personal income allowance and employer NICs threshold for 1999-2000

The Chancellor announced in the last Budget that the threshold for employers NICs would be aligned with the personal income tax allowance. In line with this decision, the personal allowance for 1999-2000, taking into account indexation, will be £4335 a year, and the threshold for employers' NICs will be £83 a week.

**Disabled Person's Tax Credit**

**4.45** The March 1998 Budget announced that from October 1999 a new Disabled Person's Tax Credit (DPTC) would replace the Disability Working Allowance (DWA). The new Credit would be more generous than the benefit it replaces, with increases in the thresholds and reductions in the taper. The DPTC will provide a guaranteed minimum income of at least £150 a week for a single disabled person who moves from benefit to full-time work earning the national minimum wage, and £220 for a couple with one earner and one child.

**4.46** The two key flaws with the DWA are that:

- it does little to help people who become disabled while working to stay in work - despite all the evidence showing that disabled people are most likely to be re-employed by their existing employers and that the longer disabled people are out of the labour market, the less likely they are to find work again;
- it has not been as successful as anticipated in encouraging people to move from out of work benefits into work.

**4.47** To address the first point, the Government proposes creating a fast-track gateway to the Disabled Person's Tax Credit for people who have been on Statutory Sick Pay for 20 weeks and who can demonstrate (a) medical evidence that their condition represents an obstacle to their participation in the labour market for the next six months, and (b) a drop in income from returning to work. This would be coupled with information to employers on the role they have to play and the help available to them to keep disabled employees working. The Government welcomes views on how this new gateway could most effectively and efficiently be operated.

**4.48** To tackle the second failing of DWA and encourage more disabled people to move into work, the Government proposes two measures:

- easing the 'qualifying benefit' rule. Presently to be eligible for DWA a claimant must first either be claiming Disability Living Allowance or have claimed Incapacity Benefit within the last 56 days. But 56 days may not be long enough for someone to find a job whose entitlement to Incapacity Benefit has been withdrawn because of improvements in their condition, but who are still at a disadvantage in the labour market. The Government therefore proposes extending this period to 6 months;

- extending the Housing Benefit and Council Tax extended payment scheme to former Income Support claimants who were incapacitated, by continuing to pay Housing Benefit at the out of work rate for four weeks after the claimant has started work. This measure will ease the transition to work by removing any worry that the rent won't

be paid.

**4.49** The Government will also be examining the extent to which people with exceptionally high care costs face unemployment and poverty traps, and would welcome views on this issue.

**4.50** Together with the New Deal for disabled people and measures announced by the Secretary of State for Social Security, these policies aim to tackle one of the Government's key priorities, helping people with disabilities who want to work get back to work.

**National Insurance Reform**

**4.51** As announced in the last Budget, major changes will also be made to National Insurance from April 1999. These reforms will simplify National Insurance Contributions (NICs) for both employees and employers and, by removing the existing 'entry fees' and 'steps' in the system, will remove labour market distortions and reduce the burden on the low paid.

**4.52** Under the current employee NICs system, as table 4.2 shows, employees currently pay no national insurance where weekly earnings are less than the lower earnings limit (£64 in 1998-99). But once they reach the lower earnings limit an entry fee of two per cent is paid on earnings up to that point. Thereafter employees pay ten per cent on earnings between £64 per week and the Upper Earnings Limit (£485 per week). So an increase of one penny in weekly earnings can therefore lead to an increase of £1.28 in employees' NICS. This places an excessive burden on the low paid and acts as a major disincentive to work.

**Table 4.2: The current NICs system**

Examples

| Weekly earnings | NICs due | Pay (net of National Insurance) |
|---|---|---|
| £63.99 | NIL | £63.99 |
| £64.00 | £1.28 | £62.72 |
| £65.00 | £1.38 | £63.62 |

**4.53** To tackle this, the Government has announced that from April 1999 the two per cent entry fee will be abolished so that employees will pay no NICs at all on their first £64 (at 1998-99 levels) of earnings. The present situation in which someone can be faced with a drop in net pay as a result of an extra penny of earnings will no longer arise. The removal of the entry fee cuts National Insurance for every employee in the country. From next April, twenty million employees will benefit by paying at least £66 a year less.

**Box 4.4** - Making work pay: an example

The following example of a fictional family compares hourly rates before and after the introduction of the WFTCand NMW, and the changes to NICs and Child Benefit. Martin current works 35 hours at £3.20 an hour. Gail works 25 hours at £2.80 an hour.

Chart here

**4.54** As chart 4.2 shows, there will also be a major simplification of employers' NICs, as a result of which the cost of hiring someone on half average earnings will fall by £250 per year. Currently employers also face a steep entry fee of £1.92 in respect of employees who earn over £64 a week. This distorts the labour market and discourages employers from taking on more low paid employees. Once in the system, employers also face four different NICs rates for their employees - distorting pay decisions. For example, an employer would pay NICs of £14.70 (7 per cent) on earnings of £209.99. But once earnings reach £210 per week the employer pays NICs at 10 per cent on all earnings, an increase of £6.30 per week on an extra penny of earnings. The reforms to be introduced from April 1999 make the NICs system simpler, fairer and more employment-friendly, without increasing the amount of NICs employers as a whole will pay.

Chart 4.2

**The National Minimum Wage**

**4.55** The National Minimum Wage will help underpin the Government's welfare reforms. Together with tax and benefit reforms, the minimum wage will help to promote work incentives. It will ensure greater fairness at work and remove the

worst exploitation.

**4.56** From April 1999 the following rates will apply:

- £3.60 for adult workers aged 22 and over;
- £3.20 for trainees - workers aged 22 and over and in the first six months of employment and receiving training leading to a recognised qualification;
- £3.00 for workers aged 18-21 inclusive, rising to £3.20 in June 2000.

**4.57** Some 1.9 million workers will benefit from the minimum wage. These include 1.3 million women, over 1.2 million part-time workers, some 200,000 young people, around 110,000 home workers and approximately 175,000 lone parents who work. About 13 per cent of young workers will benefit, as will 7 per cent of workers aged over 22.

**4.58** The Government published the draft Regulations on 11 September. These set out the detailed implementation plans for the National Minimum Wage, including how the minimum wage is to be calculated, the pay reference periods, what employers need to do to comply with the legislation and the regime for enforcing it. The consultation period ends on 6 November.

**4.59** Chart 4.3 shows that taken together, the National Minimum Wage and Working Families Tax Credit will significantly boost the effective hourly pay rates of people on low incomes, making it substantially more worthwhile to take a job. Box 4.4 illustrates this for a fictional low paid family. Below are some examples of effective hourly wage rates, excluding Housing Benefit and Council Tax Benefit, but including the WFTC and Child Benefit:

- a lone parent, with one child under 11, working 35 hours at the NMW of £3.60 will, with the WFTC, have an effective hourly wage rate of £5.50;
- a one earner couple, with two children, one under 11 and one aged 11-15, working 35 hours at the NMW will, with the WFTC, have an effective hourly wage rate of £6.37;
- a lone parent aged 21 working 35 hours a week at the NMW of £3.00 an hour, will, with the WFTC, have an effective hourly wage rate of £5.31.

Chart 4.3

**Box 4.5** -An example of family friendly employment policies

Midland Bank provides a good example of the link between family-friendly employment practices and wider business objectives. In recognition of the growing pressures on employees to cope with the challenges of providing high quality customer service whilst managing their home life, Midland Bank has introduced a wide range of initiatives for its staff - including nurseries, flexible work arrangements and LifeWorks - a telephone advice service on childcare, eldercare, parenting and disability. These initiatives have enabled Midland to retain many skilled staff who otherwise may have had to leave the bank or would have experienced a greater level of stress in the workplace. Because banking sector companies depend greatly on their employees to deliver services effectively, Midland firmly believes that the results of investing in its employees will be reflected in its service to its customers, both now and in the future.

**4.60** These measures also significantly alleviate the worst aspects of the poverty trap. Along with the other measures announced in the March 1998 Budget, they will significantly cut the numbers of families facing high marginal deduction rates. Table 4.3 shows that instead of ¾ million families losing 70 per cent of any extra income they earn there will only be ¼ million.

**Table 4.3: Tackling the Poverty Trap: Effect of the March 1998 Budget on combined marginal tax and benefit withdrawal rates**[1]

| | Before | After |
|---|---|---|
| 100 per cent+ | 5,000 | 0 |
| 90 per cent+ | 130,000 | 20,000 |
| 80 per cent+ | 300,000 | 200,000 |
| 70 per cent+ | 740,000 | 260,000 |
| 60 per cent+ | 760,000 | 1,010,000 |

[1]*Figures are for families in the UK in receipt of income-related benefits or the WFTC where at least one partner works 16*

*hours a week or more. They are based on 1997*-98 caseloads and take-up rates.

**Tax and Benefits reform: future agenda**

**4.61** The Government is committed to further tax and benefit reforms to reinforce the measures already in place. It will introduce a 10 pence starting rate of income tax when it is economically right to do so and, as set out in the March 1998 Budget, it plans to raise the threshold for employee National Insurance Contributions to align it with the personal allowance for income tax.

**4.62** In particular it is concerned to improve work incentives in two ways:

- by further boosting take-home pay in low-paid jobs, making it more worthwhile to work and;
- by further reducing marginal tax rates for the very lowest paid workers.

**4.63** The Government wishes to design the new 10p rate in the way that best meets its objectives of improving work incentives and promoting a fair and efficient tax system. Introducing the 10p rate as well as the WFTC will ensure that it is low-paid families with children in particular that will receive a boost to their take-home pay.

**4.64** As announced in the Budget, the Government is committed to protecting employees' rights to benefits when the threshold for employee National Insurance Contributions is raised. It is considering how this can most effectively be achieved.

**4.65** The Government is looking at the scope for reform of National Insurance Contributions for the self employed. Without change, the self employed will face higher contributions than employees if their incomes are low, but substantially lower contributions if they have high incomes. Martin Taylor recommended a restructuring similar to that already being introduced for employers. The Government is considering his recommendations carefully.

# IMPROVING SKILLS IN THE LABOUR FORCE

**4.66** Improving skills is an essential element of building a modern labour market that gets the best out of all its people. As set out in Chapter 3, skills and education are central to the Government's productivity agenda. The last Budget set out a package of measures worth over £100 million to improve investment in skills, and to address emerging skill shortages - particularly in the IT sector. The New Deal, described above, has a significant emphasis on training and will contribute towards the improvement of employment related skills in the labour force. The last Pre-Budget Report announced the introduction of a New Deal upfront skills shortage subsidy to help employers facing high upfront training costs to meet skills shortages. The Government will now introduce these arrangements on a national basis, following the completion of the pilot phase this month.

# MAKING A REALITY OF A FAMILY-FRIENDLY LABOUR MARKET

**4.67** The Government places a high priority on policies designed to enable parents and people with caring responsibilities to balance family and working life. The Government has already started delivering on this agenda. It has introduced new rights to combat excessive working hours and new rights to parental leave. The Part-time Work directive will remove discrimination against part-time workers and increase access to part-time work. The Working Families Tax Credit will deliver improved help to parents with the costs of childcare via the childcare tax credit and £300 million is being invested in out-of-school childcare provision as part of the National Childcare Strategy.

**4.68** People with family and caring responsibilities form a significant and increasing proportion of the UK labour force. Around 55 per cent of women with children under five are now in paid work. Approximately two-thirds of working mothers now return to paid work within 11 months of having a baby. Fathers have the highest employment rate of any group - 85 per cent - and the longest hours. Around two-thirds of people of working age caring for a sick, elderly or disabled relative are in employment and more would like to be.

**4.69** Measures to improve opportunities of access to the labour market for parents and other carers who want to work, as well as increasing opportunities for the individuals concerned, can increase the effective labour supply and thereby increase sustainable employment levels and growth. As such, they have the capacity to play a powerful part in the Government's flexible labour market strategy.

**4.70** The Government has already made considerable progress in breaking down some of the barriers to work faced by those with caring responsibilities. The New Deal for lone parents provides individualised advice to lone parents who wish to work. The National Childcare Strategy aims to ensure access to a range of high quality childcare in every neighbourhood and the Working Families Tax Credit includes increased help towards childcare costs. The forthcoming national strategy for carers will look at ways to help people combine caring responsibilities with paid work.

**4.71** The Government has also indicated its commitment through new legislation in a number of areas:

- Working Time Regulations now in force (from 1 October 1998) provide new rights for workers ensuring that they do not have to work excessive hours and setting basic standards for paid leave;
- the Part-time Work directive will ensure that part-time workers are not treated less favourably than full-time colleagues;
- the Parental Leave directive will provide new rights to three months parental leave on the birth or adoption of a child and time off work for urgent family reasons. Employees will be protected against dismissal, or other action, if they exercise these rights.

**4.72** The Government will ensure that this legislation promotes employability and flexibility, not high social costs, as we monitor its impact and evaluate its effectiveness.

**4.73** The Government will also encourage employers and employees to look carefully at the costs and benefits of more widespread family friendly working practices. Many employers have already begun to see the benefits of operating family-friendly employment practices (see box 4.5). The Government will work in partnership with business and employees to take forward this agenda, drawing on the responses to its consultation paper, Fairness at Work.

# FAIRNESS

The Government is committed to creating a fairer society in which everyone can share in higher living standards and has the opportunity to fulfil their potential. This chapter highlights the reforms the Government has already undertaken and discusses further ways of achieving this objective, including:

- £250 million extra for the NHS this winter
- progress with the Government's plans for Individual Savings Accounts
- plans to encourage individuals and businesses to pay their fair share of tax
- promotion of fairness and prosperity through international cooperation on tax
- further work directed at protecting the environment, including:
  - Lord Marshall's report on the role of economic instruments and the business use of energy;
  - a consultation document on how graduated vehicle excise duty for cars might be introduced;
  - other measures designed to tackle climate change, improve local air quality and limit the impact of land use and water pollution.

**5.1** The Government is committed to creating a fairer society in which everyone can share in higher living standards and has the opportunity to fulfil their potential.

**5.2** The tax system encourages this by:

- rewarding work;
- raising sufficient revenue to pay for the public services society needs;
- ensuring that no sector or individual bears an unfair burden or enjoys an unfair competitive advantage;
- encouraging individuals to save, both to underpin long-term investment and to secure their own financial welfare for the future, by distributing tax relief more fairly.

**5.3** The Government is also taking steps to ensure that the tax system is seen to be fair by:

- consulting on tax and wider Budget issues, where it is practicable to do so;
- reducing the cost of the tax system wherever possible, whether in its administrative costs, the compliance burden on the taxpayer, or wider costs to the economy;
- pursuing tax evasion and artificial avoidance, so that businesses and individuals pay what they should, and when they should;
- simplifying the existing tax law, to make it easier to use, so taxpayers understand more clearly their rights and obligations.

**5.4** The tax system must be designed in a way that is fair to future as well as present generations. It has an important role to play in underpinning the Government's strategy on sustainable development. This means securing economic growth, higher living standards and social progress, while protecting and, where possible, enhancing the environment. As the Statement of Intent on Environmental Taxation published last year made clear, the Government is committed to exploring the scope for using the tax system to deliver environmental objectives.

**Box 5.1 - Moving towards a fairer society**

The Government's commitment to enhance fairness can be seen throughout its approach to tax and spending. Amongst the many measures already announced which promote fairness are:

- an extra £2¼ billion for the NHS in its first two years (including the £250 million announced today) and £2½ billion for education;
- a £40 billion boost over the next three years to health and education services, announced as part of the Comprehensive Spending Review;

- an increase in Child Benefit by £2.95 a week for the eldest child from April 1999, together with new help towards childcare costs;
- a guaranteed minimum income for single pensioners of at least £75 per week through an increase in Income Support of over three times the increase they would have received under normal uprating;
- a reduction in VAT on domestic fuel and power from 8 per cent to 5 per cent, the lowest level allowed under EC law;
- the introduction of winter fuel payments to help all pensioner households with their winter fuel bills;
- continued development and expansion of the New Deal which will help move more people from welfare to work;
- new targeted initiatives - such as Sure Start and the New Deal for Communities - which will help to tackle the underlying causes of poverty by making sure children from poor neighbourhoods are ready to learn when they reach school and people in Britain's most deprived areas are able to take up new enterprise and employment opportunities;
- a major programme of tax and benefit reform to make work pay, including the Working Families Tax Credit and restructuring of employee and employer National Insurance Contributions (NICs);
- a new tax-free Individual Savings Account to be launched in April 1999, to extend the savings habit to those on more modest incomes;
- environmental measures aimed at tackling climate change, improving local air quality, and limiting the environmental impact of land use and water pollution.

**Fairness to pensioners**

**5.5** The Government is committed to providing help for pensioners. An additional £2.5 billion package of support for pensioners was announced in the Comprehensive Spending Review (CSR). This package includes:

- a guaranteed minimum income for single pensioners of at least £75 per week through an increase in Income Support of over three times the increase they would have received under the normal uprating;
- a minimum guarantee on tax, so that pensioners have no income tax to pay unless their income rises above a level to be determined in the next Budget;
- an allocation of £500 million over three years from April 1999 to pay winter fuel payments to pensioners;
- the introduction of free eye tests for pensioners from April 1999, reversing the previous Government's decision to charge and protecting primary health care for pensioners.

**5.6** In addition, the Government has introduced a national programme of personal advisers for pensioners on Income Support. Taking effect from April 1999, the programme will get help to pensioners who are entitled to Income Support, but not claiming it. The Government estimates that almost one million pensioners are not getting what they are entitled to and this programme should help bring the guaranteed minimum income to them.

**5.7** All these measures will help give pensioners higher spending power and a better standard of living in years to come. However, the programme does not stop there. The Government is drawing up a Green Paper on pensions which will be published later this year. This will examine the causes of hardship in retirement and will set out some ideas for long-term changes to the system to deliver opportunity and fairness for the next generation of pensioners.

**Reform of Child Benefit**

**5.8** The Government is committed to supporting families with children and tackling child poverty. Following decisions in the last Budget, Child Benefit will be increased by £2.95 a week for the eldest child from April 1999, with additional increases in the child premiums in income-related benefits. The Budget also gave further help to poorer families with young children with an increase of £2.85 a week for each child under 11 on all income-related benefits.

**5.9** At the same time, the Chancellor said that if Child Benefit were raised in future there would be a case in principle for higher rate taxpayers paying tax on it. He emphasised the Government's commitment to keeping Child Benefit universal where it is already universal, and made clear it would continue to be paid, as now, directly to the mother. The Government is currently considering options for bringing Child Benefit into higher rate tax.

**ISAs and CAT standards**

**5.10** Following consultation, the Government announced details of its proposals for Individual Savings Accounts (ISAs) in the March Budget. The objectives of the ISA are to develop and extend the savings habit, particularly to those on modest incomes, and to ensure that tax relief on savings is more fairly distributed.

**5.11** Since March, the Inland Revenue has also published for consultation draft regulations, which have now been laid before Parliament, and guidance on their operation.

**5.12** The Treasury has, following consultation, recently announced voluntary CAT standards for each kind of ISA. These define fair charges, easy access and decent terms for savings products which might appeal to people new to saving, or thinking of saving more. It is already clear that a good number of ISA managers are actively considering providing ISAs which will meet these standards.

**5.13** The Government is continuing the dialogue on ISAs and is, for example, continuing to work with the industry on publicity. Many firms in the financial industry have now applied to be approved as ISA managers and even more have expressed an interest in ISAs. The Government is therefore confident that in April 1999 there will be a large number of ISA managers offering savers a wide variety of ISAs.

**The Review of Charities' Taxation**

**5.14** Charities are important partners of Government in dealing with many different issues in our society.

**5.15** The Government has established a Review of Charities' Taxation to identify a taxation system for charities which is clear, simple and less costly for charities to comply with. The review covers direct and indirect taxation, as well as business rate relief. Following careful consideration of the responses to the initial consultation with charities, businesses and other interested parties, Customs and Excise, the Inland Revenue and the Treasury intend to publish a consultation document outlining options for change as soon as possible.

**Anti-avoidance : General Anti-Avoidance Rule**

**5.16** When individuals and businesses develop schemes to avoid paying tax, or defer or reduce their liability, it leads to higher burdens falling on the majority of taxpayers. The Government is committed to countering abuses and artificial avoidance, whilst recognising that businesses and individuals may operate in a tax-efficient way.

**5.17** The Inland Revenue is consulting on the usefulness of a General Anti-Avoidance Rule (GAAR) as a way of spreading the tax burden as fairly as possible. A GAAR would need to balance fairness with the interests of companies, and be applied in a way which would not add unreasonably to the requirements placed on business. The Revenue recognises the importance of a GAAR. As well as listening to the views expressed in this consultation, it will also consult on any proposed legislation. If it is decided to introduce a GAAR, the legislation could be enacted in the year 2000 Finance Bill.

**5.18** Although a GAAR in VAT is not ruled out for the future, Customs and Excise will shortly be consulting about the option of a 'mini-GAAR';, a general anti-avoidance rule limited to a specific area within VAT. They will use as an illustration a measure intended to negate any tax advantage arising from the use of artificial arrangements to purchase construction services.

**Ensuring better compliance**

**5.19** The Government is also considering additional measures to encourage everybody to pay their fair share of tax. In some areas of tax legislation the interest and penalty provisions to deal with non-compliance are out of date and, as a result, fairness in the tax system is undermined. The Stamp Duty interest and penalty regimes need to be brought up to date and the Government will include a Stamp Duty compliance package in the 1999 Finance Bill.

**5.20** The Government is also considering introducing interest on Customs duty debts. And if agreement is reached on a draft EC directive, there will also be improvements in the mutual assistance arrangements for the recovery in the UK of debts owed to tax authorities in other member states and vice versa. The scope of these arrangements will also be extended to include direct taxes.

**Alcohol and tobacco fraud**

**5.21** The outcome of the Alcohol and Tobacco Fraud Review (ATFR) was announced in July. Customs has been allocated £35 million over the next three years to implement the review recommendations. Money has also been made available in the current year so that implementation could begin immediately.

**5.22** The ATFR recommended a number of measures to counter the revenue lost through cross-channel smuggling, including extra resources. The recruitment process for the new staff to counter cross-channel smuggling at the channel ports is well underway and they should all be in post before Christmas. By 2001-02, Customs aim to increase the revenue value of

detected alcohol and tobacco goods by £80 million.

**5.23** Some of the recommendations have already been implemented including tougher policies on prosecution of offenders and restoration of seized vehicles, the introduction of sentencing guidelines and the revocation of licences of those businesses who are caught smuggling. The Government is considering what measures are required to implement the remaining recommendations.

**Fairness in indirect tax**

**5.24** In the Budget, the Chancellor announced a consultation on the VAT grouping facility to achieve a better balance between the revenue costs to the Exchequer and the compliance costs to business, and to minimise tax avoidance opportunities. Responses to that consultation are now being considered. Responses are also being considered to a consultation on the VAT registration threshold.

**Box 5.2 - Prosperity and fairness through international cooperation on tax**

Taxation is a national responsibility but the development of the global economy is making international cooperation more important. The UK therefore is working with its partners to develop international agreements that support fair and effective taxation while at the same time promoting economic growth and prosperity. In some areas action through the OECD is the best way forward. In others, action will be appropriate through the European Union (EU) within which the UK will retain a national veto on tax legislation.

Improved communications, the expansion of international trade and capital flows, and the continued growth of multinational companies are increasing the mobility of businesses, capital and people worldwide. The further development of the single market and the elimination of exchange risk within European Monetary Union will only add to that mobility. Together these developments present both risks and opportunities. For national tax systems, the challenge is to minimise the risks without stifling the opportunities or harming the competitiveness of business.

The challenge is partly technical - for example how to treat new types of business like electronic commerce, how to avoid the double taxation of cross-border activity and how to prevent technology from opening new gateways to evasion. But the growing mobility of capital and the removal of barriers to international trade has also brought a new urgency to a familiar issue: the risk that unfair tax competition between countries through preferential tax regimes could lead to the erosion of the tax base and distortions in the allocation of resources.

The Government fully recognises the importance of these challenges for business, for international trade and for the tax base, and is playing an active role in the modernisation of international practice.

On the **domestic** front, it has:

- modernised the transfer pricing legislation;
- set in train a review of double taxation relief;
- modernised the corporation tax system;
- come forward with a range of ideas and proposals on the use of taxation to deal with global problems in the environment.

On the **international** front the Government has:

- played a leading role in the negotiation and implementation of the EU Code of Conduct. The Code is targeted against the use by member states of unfair tax competition to affect the location of business investment. Dawn Primarolo, the Financial Secretary, has been elected chair of the Group that is implementing the Code;

- worked actively to secure the OECD ministerial agreement to tackle harmful tax practices, including the activities of tax havens;

- through the Chancellor's chairmanship, promoted and seen to a successful conclusion, a G7 Initiative which seeks better flows of information from money laundering authorities to tax authorities and better information from tax havens;

- through its presidency of the EU, secured agreement to the extension of the Arbitration Convention, a measure keenly sought and welcomed by UK industry;

- played a prominent role in the Ottawa conference on electronic commerce at which government and industry agreed to work together to ensure that tax policy and administration keep up with developments and do not stifle the opportunities for business that electronic commerce presents.

The Government is actively engaged on taxation issues in the EU and other international fora and will continue to look for effective solutions to specific problems, while protecting the competitiveness and prosperity of the UK and the EU as a whole.

## PROTECTING THE ENVIRONMENT

### Sustainable development

**5.25** The Government's overall aim is a long-term increase in prosperity. Economic development must therefore take place in a sustainable way, ensuring a better quality of life for everyone - now and for future generations.

**5.26** The Government's approach to sustainable development is based on four broad objectives: maintenance of high and stable levels of growth and employment; effective protection of the environment; prudent use of natural resources; and social progress which recognises the needs of everyone.

**5.27** Early next year, the Government will publish its strategy on sustainable development. It will set out the Government's aims, outline the measures being undertaken to achieve those aims, and highlight what further action might be undertaken - by all of us - to achieve them. This follows an extensive consultation exercise in the first half of this year.

**5.28** The tax system has an important role to play in underpinning this strategy. It must be designed in a way that is fair to future as well as to present generations. As the Statement of Intent on Environmental Taxation published last year made clear, the Government is committed to exploring the scope for using the tax system to deliver environmental objectives.

**5.29** Environmental taxes must meet the general tests of good taxation. Introducing new environmental taxes, or making changes to existing taxes to deliver environmental aims, therefore requires detailed research, careful planning, and extensive consultation.

**5.30** Much has been achieved already. The 1998 Financial Statement and Budget Report detailed a number of measures, and areas of further work, aimed at:

- reducing emissions of greenhouse gases;
- improving local air quality;
- limiting the environmental impact of land use and water pollution.

**5.31** It also included, for the first time, an assessment of the environmental impact of those Budget measures which are expected to have a significant effect on the environment. An updated version of that assessment, showing the expected impact of the Government's environmental tax measures to date, and those under consideration, is shown in Table 5.1. We will be looking to build on this approach in future Budgets.

**5.32** Progress continues on a number of fronts. The main developments are summarised below under the following headings - climate change, local air quality, land use and water pollution.

### Climate change

**5.33** Climate change is recognised as one of the greatest environmental threats facing the world today. The UK is committed under the Kyoto Protocol to reducing greenhouse gas emissions by 12.5 per cent on 1990 levels by 2008-2012. The UK must now develop a programme of measures to deliver its climate change targets.

**5.34** On 26 October, the Government published a consultation document, the UK Climate Change Programme, on policy options for achieving this legal commitment, and how we might move beyond that towards our own domestic goal of a 20 per cent reduction in emissions of carbon dioxide on 1990 levels by 2010.

**5.35** As the consultation document shows, the Government is keen to look across all sectors of the economy, and at all kinds of instruments, to find the right combination of measures which meets its targets in the most cost-effective way. An important strand of this work is the study carried out by Lord Marshall into the industrial and commercial use of energy.

### Industrial and commercial use of energy

**5.36** In March this year, the Chancellor asked Lord Marshall to report on whether, and if so, how best to use new economic instruments to improve the industrial and commercial use of energy and help reduce emissions of greenhouse gases.

**5.37** Lord Marshall's report is published today. It follows a widespread consultation exercise. The main conclusions and recommendations of Lord Marshall's report are summarised in the box below.

**5.38** The Government will be considering Lord Marshall's recommendations very carefully in developing its strategy on climate change, and will continue work and consultation on the further design issues identified in his report. The Government will take into account any potential impacts on competitiveness in seeking to find the most cost-effective means of meeting its targets for reductions in emissions of greenhouse gases.

**Box 5.3 - Lord Marshall's report on economic instruments and the business use of energy**

Lord Marshall's main conclusions and recommendations on the role of economic instruments and the business use of energy are as follows:

*On the role of business and other sectors:*

- It is clear to me that all sectors of the economy - business, domestic and transport - will need to play their part if we are to meet our legally binding target for reducing greenhouse gas emissions set under the Kyoto Protocol, and the UK's domestic goal of a 20 per cent cut in carbon dioxide emissions on 1990 levels by 2010.
- I am also keenly aware that the commitments agreed at Kyoto were only the beginning. Even more challenging requirements are expected to emerge from future international negotiations. This emphasises the need for Government to look beyond the current targets and timetable, and provide clear, long-term signals to reduce emissions.

*On whether economic instruments have a role to play:*

- In my view, a mixed approach will be necessary. Within that context, I believe that there is a role for economic instruments in helping improve business use of energy and reducing greenhouse gas emissions as part of a package of measures, alongside existing regulations, voluntary and negotiated agreements, and other measures, and appropriate action on the part of other sectors. However, any measures must be subject to careful design in order to protect the competitiveness of British industry and maximise their environmental benefit.

*On the two leading options:*

*(a) A system of tradeable emissions permits*

- The system of international greenhouse gas trading provided for in the Kyoto Protocol, which should be in place by 2008, will be part of the long-term solution to reducing emissions. I am very pleased that international trading will be available to the UK as part of the solution to achieving its commitments.
- Any trading scheme will require a robust system of monitoring and verification. A starting point for this may be the framework provided by the Integrated Pollution Prevention and Control (IPPC) directive.
- Practical considerations lead me to the conclusion that it may not be sensible for Government to introduce a fully fledged, statutory scheme domestically in the UK at this stage.
- But I urge the Government to step up its consultations with interested parties to resolve the complex issues involved in designing a trading scheme. Strong business input into design will be essential. Such consultation should inform the UK's negotiating position for the international scheme as well as developing expertise domestically so that British firms are ready, and our financial institutions well positioned, to lead in these new markets.
- As a first step, I recommend that the Government seriously consider a dry-run pilot with interested players, as soon as possible, as a means of learning lessons for the participation of our industry in the international scheme.

*(b) On tax*

- Even when the international trading scheme is fully developed, it is unlikely that all businesses will be involved. Indeed, I doubt whether it will ever be practical for the majority of small and medium sized enterprises (SMEs)

and less intensive users in industrial and commercial sectors to participate in the international trading scheme. Taken together, these firms account for around 60 per cent of total carbon dioxide emissions from business, and may offer scope for significant improvements in energy efficiency and reductions in emissions.

- Hence, my conclusion is that there probably is a role for a tax if businesses of all sizes and from all sectors are to contribute to improved energy efficiency and help meet the UK's emissions targets.
- In order to help businesses plan for future investment and maximise the environmental impact of a tax, a clear signal should be given of the long-term direction of policy, with changes in the rates of tax made in a gradual and predictable way.
- Any tax must be designed in a way that protects the competitive position of British industry. To this end, I recommend that:
- the revenues are recycled in full to business, with at least some of the revenues channelled into schemes aimed directly at promoting energy efficiency and reducing greenhouse gas emissions - perhaps through 'carbon trust' type schemes to promote low carbon technologies, and/or energy audits/advice for SMEs;
- consideration be given to the treatment of energy intensive industries, with the aim of reducing the overall impact on the heaviest users, whilst retaining some incentive for all users to save energy at the margin; a system of rebates, perhaps with the relief targeted at plant level, seems the leading option here;
- any measures are subject to detailed consultation about their design.
- Given current policy objectives for the domestic sector, the leading option for a tax would, in my view, appear to be a 'downstream' tax on the final use of energy by industrial/commercial consumers, with the tax rates reflecting (at least in broad terms) the carbon content of different fuels.
- The design of any tax should ensure that Combined Heat and Power (CHP) is not disadvantaged. It should also aim, where possible, to increase incentives for the take-up of renewable sources of energy.

**Table 5.1: The Government**'s environmental tax measures: principal measures in place or under consideration

| **Measure/Issue** | **Environmental function** | **Environmental impact**[1] |
| --- | --- | --- |
| 1. Economic instruments for the industrial and commercial use of energy | Improve energy efficiency and reduce $CO_2$ emissions | Reduce emissions of $CO_2$ and other air pollutants (see Lord Marshall's report for further details) |
| 2. Fuel duty increases[2,3] | Reduce $CO_2$ emissions | Escalator over the period 1996 to 2002 produces carbon savings of 2 to 5 MtC by 2010 and a reduction of 1% in $NO_X$ emissions and 1.2% in particulate emissions |
| 3. Increase in duty on standard diesel[3] | Improve air quality and move towards fairer treatment of fuels | Reduction of 1-3% of particulates and $NO_X$. Very small increase in emissions of $CO_2$ |
| 4. Increase duty differential for ULSD[3] | Improve air quality | Reduction of 20% of particulates and up to 2% of $NO_X$ |
| 5. Maintain 1997 duty differential between road fuel gases and diesel | Improve air quality | Reduction in emissions of particulates and $NO_X$ |
| 6. Minor oils duties | Reduce $CO_2$ emissions and other air pollutants | Small reduction in emissions of $CO_2$ and other air pollutants |
| 7. Reduction in VAT on installation of energy saving materials | Improve energy efficiency and reduce $CO_2$ emissions | Small reduction in emissions of $CO_2$ |

| | | |
|---|---|---|
| 8. Graduated car VED | To provide an incentive for less polluting cars | A reduction in emissions of $CO_2$, $NO_X$ and particulates. |
| 9. VED for lorries | To ensure that the environmental damage caused by lorries is reflected in VED | Reduce road wear and emissions of $CO_2$, $NO_X$ and particulates |
| 10. £500 VED discount for clean lorries/buses | Improve air quality | Reduction in particulates and $NO_X$ highly dependent on long-run level of take up. |
| 11. Increase in scale charges for free fuel provided with company cars[3] | Discourage the provision of free fuel and reduce $CO_2$ emissions | Reduction of 0.3 billion car kilometres. Reduction of $CO_2$ of <0.1MtC |
| 12. Increase in bus fuel duty rebate | To encourage bus use relative to private motoring | Small reduction in car kilometres |
| 13. Workplace parking tax | Reduce congestion, emissions of $CO_2$ and other local air pollutants | Depends on take up. Reduction in $CO_2$, $NO_X$ and particulate emissions |
| 14. Road user charging | Reduce congestion, emissions of $CO_2$ and other local air pollutants | Depends on take up. Reduction in $CO_2$, $NO_X$ and particulate emissions |
| 15. Changes to landfill tax<br>-exemption for inert waste used for restoration of sites and filling of quarries<br>-increase in standard rate<br>-freeze in lower rate on inert wastes | Reduce amount of waste going to landfill. To ensure inert waste materials available to landfill sites | Will reduce volumes of landfill with associated methane savings and reduction in overall environmental impact of landfilling. Land used for landfill or quarrying will continue to be brought back into beneficial use |
| 16. Extraction of aggregates | To help ensure environmental costs of aggregates extraction are reflected in price | Possible reductions in noise, dust, visual intrusion, damage to wildlife habitats and other environmental impacts |
| 17. Options for dealing with water pollution | To cost-effectively minimise the environmental damage from water pollution | Reductions in emissions of pollutants into rivers |
| 18. Use of pesticides | To encourage less harmful pesticides and alternative techniques | Improve water quality, biodiversity and reduce impact on wildlife |

[1] *These estimates are subject to significant margins of uncertainty.*

[2] *Based on assumption that the fuel duty escalator continues at its present level, increases of at least 6 per cent on average in real terms a year, until the end of this Parliament.*

[3] *The reductions in particulates and* $NO_x$ emissions are calculated as a percentage of 2010 emissions from urban road transport. The reduction in car kilometres and $CO_2$ emissions are the estimated annual reduction by 2010.

**Local air quality**

**5.39** In addition to playing its part in tackling the global problem of climate change, the Government is actively seeking to improve local air quality.

**5.40** Air quality in our urban centres is currently improving. However this downward trend in pollution is predicted to reverse early in the next century as the growth in road traffic offsets the reduction in emissions from individual vehicles.

**5.41** The Government's policies for tackling air pollution are set out in the National Air Quality Strategy. This is currently

being reviewed and proposals will be published for consultation in early 1999.

**5.42** The Government is pursuing a mix of policy instruments in addressing the environmental problems associated with road transport. In July, the Government published its White Paper on the Future of Transport, A New Deal for Transport: Better for Everyone. The White Paper aims to extend choice in transport and secure mobility in a way that supports sustainable development. The White Paper proposed a number of new measures affecting road traffic, such as powers for local authorities to introduce road user charges and workplace parking charges to reduce congestion and to generate revenue to fund complementary local transport projects.

**5.43** There have also been important developments within the context of the European Union that are relevant to both local air quality and climate change.

**5.44** The Auto-Oil programme provides for improvements in vehicle technology and fuel quality. As part of this programme, tighter emission standards for new cars and light vans will apply from October 2000. These will be 20 to 50 per cent more stringent than those currently in force, and will tighten further in 2005. Cleaner fuels will be required from 1 January 2000, and further improvements in fuel quality will also be made in 2005.

**5.45** In addition, a voluntary agreement has recently been concluded between the European Commission and European car manufacturers to reduce fleet emissions of carbon dioxide. The motor industry agreed, through their trade association ACEA, a 25 per cent reduction in average carbon dioxide emissions per kilometre to 140 grammes by 2008. This will apply to new cars across the European fleet.

**Road fuel duty differentials**

**5.46** In the Spring 1998 Budget, the Chancellor increased duty on diesel by 1 penny per litre more than duty on unleaded petrol, and announced that future Budgets would further increase the duty on ordinary diesel relative to unleaded petrol. This is a step towards the Government's objective of a fairer treatment of petrol and diesel, when calculated on an energy or carbon basis.

**5.47** The Chancellor also tightened the specification for ultra-low sulphur diesel (ULSD), and widened the duty differential between this cleaner fuel and ordinary diesel to 2 pence per litre. The Government expects to increase this by a further 1 penny in the next Budget. The Government will also continue the policy of increasing road fuel duties by at least 6 per cent on average in real terms a year.

**Vehicle Excise Duty for cars**

**5.48** In the March 1998 Budget, the Chancellor announced a significant reform of Vehicle Excise Duty (VED) to encourage cleaner cars. In particular, VED for the cleanest cars will be cut by £50. A consultation document issued today sets out a range of car characteristics which could, in future, be used in determining VED for cars:

- carbon dioxide emission rates, and possibly the ability to meet EU engine emission standards (for new cars); and
- engine size and possibly age (for existing cars); and possibly
- fuel type.

VED rates will be announced, as usual, at the time of the next Budget.

**5.49** By encouraging more fuel-efficient and cleaner cars, the proposals aim to help reduce emissions of greenhouse gases and local air pollutants.

**Box 5.4 - Using contingent valuation to measure environmental costs and benefits**

Government guidance is clear that appraisal systems should try to take into account all environmental costs and benefits[1]. The Government accepts that there will be difficulties in trying to place a value on the environment, whether by monetary or non-monetary means. But the monetary valuation of environmental costs and benefits can help integrate the environment more fully in the policy making process.

Placing monetary values on environmental costs and benefits is not straightforward because there are usually no prices for environmental goods. But a number of techniques are available for doing so, some of which are summarised in Environmental Appraisal in Government Departments[2].

Contingent valuation is one such technique. This approach tries to identify individuals' preferences directly by exploring,

through detailed surveys, the value they would place on specific improvements or deterioration in the quality of the environment. Typically, people are asked either:

- how much they would be willing to accept by way of compensation for a specific environmental deterioration, or for foregoing an improvement; or,
- how much they would be willing to pay in order to receive a specific environmental improvement, or to avoid a deterioration.

The survey results can then be aggregated to provide an estimate of the overall impact.

There are some criticisms of contingent valuation. Some question the assumptions on which it is based, and the weight given to individual preferences; others question how much weight should be placed on the results where the environmental effects being measured are complex and may not be widely understood. But the technique has an extensive academic pedigree and support, and is now used around the world both by government agencies and the International Bank for Reconstruction and Development. In the UK, for example, it has been used to value impacts on road safety and time savings in transport appraisals. Careful design of the survey techniques can help limit any unintentional bias in the results. The Government believes that, although it is not universally appropriate, contingent valuation may often be the best approach available.

One example where the Government is currently using the contingent valuation method is in research on the environmental costs and benefits of aggregates extraction. An independent expert review of the first research project undertaken for the Government confirmed that contingent valuation was appropriate for a study of this kind[3]. Further work in this area will continue to use contingent valuation to build on the initial findings.

*References*:

[1] *Appraisal and Evaluation in Central Government*, HM Treasury, 1997.

[2] *Environmental Appraisal in Government Departments*, Department of the Environment, 1994.

[3] *The Environmental Costs and Benefits of the Supply of Aggregates: A Review of the London Economics Report*, Department of the Environment, Transport and the Regions, 1998.

**Vehicle Excise Duty for lorries**

**5.50** Vehicle Excise Duty rates for lorries are under review, to ensure that rates better reflect the environmental impact of different lorry types.

**5.51** From 1 January 1999 new classes of heavy goods vehicles will be allowed on UK roads. These vehicles will fit into the current VED rates structure until the next Budget (details are provided in the VED press notice issued today). At the time of the Budget new higher rates will be announced for these lorries. These rates will be set to discourage strongly the use of such vehicles with 11½ tonne axle weights, in view of the additional road damage that they cause.

**Taxation of company cars**

**5.52** In the March 1998 Budget, the Chancellor announced he would be considering, in relation to income tax charged on company cars, the case for replacing the existing business mileage discounts with discounts for driving fewer private miles. Views were invited. Since then, the Inland Revenue has received a number of comments.

**5.53** Many of those who commented supported the proposal, as business mileage discounts were seen as an incentive to drive unnecessary, extra miles. Others were neutral or opposed to the change suggested. A concern about giving discounts for low private mileage is that it would simply shift private miles from company cars to private cars, which would not help reduce congestion or pollution. It would also mean extra record keeping for company car drivers and their employers.

**5.54** In light of the views expressed, the Government is continuing to review how the company car tax regime might be altered to send better environmental signals.

**Bus fuel duty rebate**

**5.55** In the last Budget, the Chancellor announced that the Government would be consulting on how bus fuel duty rebate

could be better targeted to provide for lower emission vehicles, and to support rural services.The Department of the Environment, Transport and the Regions will shortly publish a consultation document setting out the options for reform.

### Land use and water pollution

### Landfill and waste strategy

**5.56** The Government's consultation document on waste strategy for England and Wales, Less Waste: More Value, set out the need to improve the sustainability of waste management. A draft strategy will be published in Spring 1999, with a view to adopting a final strategy by the end of next year. Parallel strategies are being developed for Scotland and Northern Ireland.

**5.57** The new strategy will set out the Government's vision of sustainable waste management over the next twenty years. Several key factors are shaping this vision: the development of the Government's strategy for sustainable development; the draft European Union landfill directive, which would require a reduction in biodegradable municipal waste to landfill to 35 per cent of 1995 levels by 2020; and the packaging regulations, which set staged targets for recovery and recycling of packaging by 2001.

**5.58** As part of that strategy, and following the increase in the standard rate of the landfill tax announced in the last Budget, the Government will continue to keep under review the appropriate basis for setting the rate of landfill tax.

**5.59** The last Budget also announced that an exemption for inert waste used in the restoration of landfill sites and the filling of quarries will be introduced from October 1999. The exemption will help ensure that suitable materials continue to be available for bringing land back into beneficial use. Having consulted site operators, regulatory bodies and other stakeholders, the Government will bring forward legislation in the next Budget.

### Extraction of aggregates

**5.60** The Government believes that it is essential that there continues to be an adequate supply of aggregates. However, the Government also recognises that aggregates extraction can have a significant environmental impact and often takes place in areas of attractive countryside.

**5.61** Initial research commissioned by the Department of the Environment, Transport and the Regions into the environmental costs and benefits associated with the supply of aggregates was published in April 1998. This demonstrated that there are significant environmental costs not already covered by regulation. Further research, building on the initial findings, and taking account of the conclusions of an independent expert review of the preliminary findings, is ongoing. One of the methodologies used in the research to measure the environmental costs and benefits is described in the box below.

**5.62** Over the summer, Customs and Excise have been consulting on how a possible aggregates tax might work. The responses to the consultation are now being analysed.

**5.63** Ministers have also offered to consider carefully alternative proposals to a tax made by the industry. Such proposals would have to amount to a deliverable package of measures which would permanently secure equivalent or greater benefits than a tax. The aggregates industry has recently taken some welcome steps to curtail its activities in the National Parks. There may be scope to build on that positive approach in dealing with the remaining environmental impacts of its activities.

### Water pollution and pesticides

**5.64** Better water quality is an important environmental goal. Water pollution tends to arise either from point sources - such as industry and sewage treatment works - or diffuse sources - such as run-off from agricultural and urban areas, including pesticide or fertiliser use.

**5.65** Last November, the Government issued a consultation paper entitled Economic Instruments for Water Pollution. That contained a number of possible measures to help maintain and improve water quality, and meet standards at lower cost. The consultation period has now ended, and the Government is considering the responses.

**5.66** Two of the options on which the consultation paper sought views were a system of water pollution charging, applying to point sources, and a possible tax or charge on pesticides.

**5.67** The Department of the Environment, Transport and the Regions has since commissioned research both on how a system of water pollution charging might work and into whether a tax or charge on pesticides would be an effective way to reduce pollution. There is evidence to suggest that pesticides have harmful effects on wildlife, terrestrial and aquatic

ecosystems, and on human health. The current study on pesticides is focusing on various design options for a charge scheme or tax. The Government will evaluate the findings of the research projects, and the results of other ongoing work, in considering how best to proceed.

**This annex provides an overview of recent economic developments and prospects against the background of recent turbulence in the world economy. The UK economy will not be immune to the deterioration in the world economic outlook. However, the Government**'s decisive action to put in place a stability-orientated policy framework means that the economy is better equipped to deal with the world economic slowdown, and withstand the full impact of global instability.

**The key points are:**

- **Developments since the Budget confirm that the economy had used up its spare capacity in early 1997, and revised figures show that subsequent growth through 1997 moved output further above sustainable levels than previously thought. This reinforces the need for a slowing of activity to maintain low inflation and put the economy back on-track for sustainable growth.**
- **The new monetary framework, supported by sound public finances, is designed to moderate the size of swings in output. Last year**'s prompt policy tightening is heading off inflationary pressures and only a modest further slowing is required to set a course for stable growth.
- **Domestic developments so far this year have been broadly in line with the Budget forecast. But looking ahead, the short-term prospect is now one of more moderate growth than previously anticipated. The UK cannot be insulated from world developments, where prospects have deteriorated and the downside risks to growth and trade have increased.**
- **Nevertheless the economy is well placed to steer a course of stability in an unstable world environment. The cyclical downturn is expected to be more moderate than has been seen in the UK in recent decades.**

# INTRODUCTION[1]

A1. Prospects for the world economy have deteriorated in the period since the March Budget. The evolving situation in East Asia, recent events in Russia and turbulence in Latin America and other emerging markets will continue to reduce growth in world output and trade. This annex provides a more detailed account of recent economic developments and prospects in the context of the changed world environment. It provides projections for the path of the UK and world economy over the next three years.[2]

A2. Revised national accounts data show that the economy had more momentum in 1997 than previously estimated. This implies an upward revision to the estimated current output gap (ie output relative to trend), reinforcing the need for a slowing of economic growth this year in order to head off inflationary pressures.

A3. Although GDP growth since the end of last year has been broadly as expected at Budget time, it is forecast to slow further than previously expected from now on, reflecting global developments. In cutting interest rates at its October meeting, the Bank of England's Monetary Policy Committee noted that the international economic and financial environment had deteriorated since the Committee met in September. The overall impact of the deterioration in the world economy can probably account for more than the total downward revision to growth prospects next year, with the effect from reduced world trade alone accounting for most of the revision.

**Table A1: Summary of forecast**

| | | | Forecast | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| GDP growth (per cent) | 3½ | 2¾ | 1 to 1½ | 2¼ to 2¾ | 2¾ to 3¼ |
| RPIX inflation (per cent, Q4) | 42¾ | 2½ | 2½ | 2½ | 2½ |

A4. The cyclical downturn is still expected to be more moderate than in the past, when output has fallen sharply during the downswings of previous economic cycles. The Government's tough and decisive action to promote long-term stability, by introducing new monetary and fiscal policy frameworks, is designed to reduce economic instability in the UK compared to previous cycles.

A5. The more pronounced slowdown in 1999 will dampen inflationary pressures. This, in the context of room for manoeuvre within the new policy framework, will permit a stronger cyclical recovery from early 2000 to bring the economy back to its trend level by 2002. Thereafter, GDP is projected to grow at its trend rate. While output is below its trend level, domestically generated inflation is forecast to fall. But with import price inflation (currently negative) picking up beyond the near term, RPIX inflation is forecast to remain close to target.

A6. As in the March Budget, projections for output growth are presented as opportunity ranges. These are intended to give an indication of how differing degrees of supply side improvement, including responsible wage bargaining, could affect prospects for the economy over the next few years. The ranges are not an indication of the degree of forecast uncertainty. There are substantial risks to the short-term economic outlook both in the UK and world economy, and outcomes could be outside the opportunity ranges. These risks are examined in more detail later in this annex.

A7. The impact on the sustainable rate of growth of the Government's strategy for raising productivity will build up over time. However, the lower end of the opportunity ranges, and projections for the public finances, are based on the deliberately cautious assumption of 2¼ per cent a year for the trend rate of economic growth.

# THE MACROECONOMIC INHERITANCE

A8. Chapter 2 notes how long-term UK economic performance has been harmed by macroeconomic instability, and that in spring 1997 the economy was set to repeat its previous pattern of overheating, followed by large falls in output and employment.

A9. GDP accelerated sharply in late 1996, following a steady expansion in previous years. By mid-1997, GDP was expanding at an annualised rate of approaching 5 per cent, well above its sustainable rate. The remaining degree of spare capacity in the economy was quickly absorbed, with demand and output probably moving above productive potential during the first half of 1997. Over the same period, the economy became unbalanced with annual growth in household consumption expenditure rising to more than 4½ per cent in the second quarter of 1997. This was mirrored by a rapid expansion of output in the service sector, where price inflation had increased to 3¼ per cent at the beginning of the year. By contrast, manufacturing output had begun to falter in the second quarter, in response to the 17 per cent appreciation of sterling over the previous year.

A10. In the summer of 1997, unemployment on the Labour Force Survey (LFS) measure fell below 7 per cent, around the mid-point of the range for most outside estimates of the sustainable rate of unemployment. Private sector earnings growth increased from below 3½ per cent in the second half of 1995 and early 1996 to an average of over 5½ per cent in the first half of 1997, exceeding the rate that would be consistent with the achievement of the inflation target in the medium term. This build-up of inflationary pressures had been widely anticipated. Moreover, in early 1997 the average of independent forecasts showed underlying inflation was expected to rise sharply above target over the following two years. However, official interest rates were lowered during 1996 and then left unchanged in the period to May 1997.

A11. The full impact of unsustainable growth became apparent only some time later. Despite uncertainty surrounding earnings data (see box A3), it seems clear that underlying growth in unit labour costs has been running at well above the rate that would be consistent with achieving the inflation target in the medium term. Moreover, service sector price inflation has continued to edge up, with the underlying rate (excluding rent and utilities) recently reaching almost 5 per cent. At the overall retail price level, these domestic forces have been countered by more favourable downward pressures on goods price inflation, stemming from external events, including the strength of sterling and falling commodity prices.

A12. The March Budget projected a slowing of growth to below-trend rates from spring 1998 through to spring 1999, in order to offset the inflationary pressures created by the positive output gap and to meet the inflation target in the medium

term. Net exports have restrained growth since early 1997 and this was expected to continue, reflecting the appreciation of sterling and the impact of financial turbulence in Asia. Domestic demand growth was also expected to slow in response to the twin tightening of monetary and fiscal policy.

A13. In March 1998, the average of independent forecasts for growth was in line with the Budget forecast and remained so until late summer. However, more recently turbulence in world markets has intensified significantly, with clear implications for UK short-term prospects.

**Box A1** - Changes to national accounts data

**On 24 September 1998 the Office for National Statistics (ONS) published revised national accounts and balance of payments data incorporating the most extensive changes to the accounts since the publication of the first National Income and Expenditure Blue Book in 1952.**

**These changes[1] reflect a number of factors, including:**

- **the adoption of the new European System of Accounts (ESA95) and a consistent balance of payments methodology. This includes changes to the classification of sectors and the structure of the accounts; the use of GDP at constant market prices (instead of factor cost) as the headline measure of GDP; a widening of the scope of capital formation; and various changes in terminology - for example,** 'stocks' are now known as 'inventories';
- **rebasing of national accounts volume measures to 1995 prices, instead of the previous 1990 prices. Such rebasing is carried out at five yearly intervals and is intended to improve estimates of growth in more recent years by using a more up-to-date price structure;**
- **inclusion of survey data based on the Inter-Departmental Business Register (IDBR), a common register from which samples for business surveys are selected. While the IDBR has been used as the basis for all business surveys since 1996, the register effects were introduced into the national accounts only at this stage to enable consistent introduction across the board;**
- **an improved methodology for measuring public sector output at constant prices. This uses direct output measures for education, health and social security - which together account for around half of public sector output. Previously input measures were used and therefore did not take account of productivity changes.**

**Major effects of these combined changes include an upward revision to the growth rates of constant price GDP over the past ten years and stronger investment growth in recent years. Further details are given in the relevant sections of this annex.**

[1] Full details can be found in an article in the August 1998 edition of Economic Trends, published by the ONS.

WORLD DEVELOPMENTS AND PROSPECTS

A14. Prospects for the world economy have deteriorated since the Budget. Japan is in recession, the Asia crisis economies are experiencing much larger falls in output than previously expected and the crisis in Russia has triggered contagion to other emerging markets. Latin America has been suffering financial market turbulence, while the world's stock markets have also fallen back. Several countries, accounting, in total, for around a quarter of world GDP, are expected to suffer a fall in output this year.

A15. No country is immune from the effects of the current slowdown in the world economy. Nevertheless, providing demand growth in the US and Europe is maintained, the outlook for global activity should remain one of continued expansion. Table A2 summarises the most likely outlook for the world economy. Growth in the G7 overall is expected to fall below trend this year and next but nonetheless remain relatively firm.

**Table A2: The world economy**

Percentage changes on a year earlier

| | Forecast | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| Major 7 countries[1] | | | | | |
| Real GDP | 2¾ | 1¾ | 1½ | 2¼ | 2¼ |
| Consumer price inflation[2] | 2¾ | 1½ | 1½ | 2¼ | 2¼ |
| World trade in manufactures | 11½ | 4½ | 5½ | 5¾ | 7¼ |
| UK export markets[3] | 10½ | 7¼ | 6¼ | 6¾ | 7¼ |

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

[2]*Final quarter of each period. For UK, RPI excluding mortgage interest payments.*

[3]*Other countries*' imports of manufactures weighted according to their importance in UK exports.

A16. However, as the recent statements by G7 Finance Ministers and Central Bank Governors have made clear, the balance of risks has shifted, with an increase in the downside risks surrounding the global economic outlook.

**Recent developments in developing countries**

A17. Developing countries around the world are experiencing severe difficulties. The economies in Asia hit hardest by the crisis have seen very sharp falls in demand, and output will probably fall in a number of these countries by more than 4 per cent, and by as much as 15 per cent in Indonesia. This is much more than previously expected. More recently, however, there have been some encouraging signs that the situation is beginning to stabilise. Currencies have become more stable, which has allowed interest rates to fall.

A18. Russia devalued the rouble on 17 August 1998 and announced a restructuring of domestic debt and a moratorium on private sector debt repayments to foreign creditors. Since then global investors have sought to reduce sharply their exposure to emerging market risk. Many borrowers, particularly in Latin America, have witnessed a dramatic increase in interest rate spreads over US Treasury Bonds. Higher financing costs and reduced net capital inflows will lead to slower growth in these economies. In Brazil, the Government has announced a substantial fiscal adjustment programme, and negotiations are under way with the IMF for a financial support package.

A19. The IMF has lowered its forecast for growth in the developing economies to 2¼ per cent in 1998 - a downward revision from over 4 per cent in their May forecast - and to 3½ per cent in 1999. This is a significant slowing of growth from the 5¾ per cent recorded in 1997 and, as the IMF acknowledge, there is a risk of a sharper downturn. The biggest revisions have been in Asia. But in Latin America growth is also expected to slow sharply in 1998 and 1999 to around half the rate seen in 1997. The IMF expect the Russian economy to contract by 6 per cent in 1998 and a further 6 per cent in 1999.

**G7 activity**

CHART A1 HERE

A20. Outside Japan, growth in the G7 economies has been holding up so far. US growth remained well above trend in the first half of the year, despite a significant drag from net trade. In Europe, the recovery is now more firmly grounded on domestic demand. European bond and exchange markets have remained quite stable in the face of the recent instability in financial markets. This augurs well for the start of the third stage of EMU on 1 January 1999.

A21. But in Japan, output has fallen for three consecutive quarters. This reflects a sharp downturn in domestic demand, itself partly reflecting earlier fiscal tightening, in combination with the impact of the crisis in emerging Asia.

A22. The weaker outlook for developing countries, and the recent global financial market instability, will reduce growth in the G7 this year and next. As trade adjustment proceeds in Asia and other developing countries, net trade is likely to make a significantly weaker contribution to growth in the US and Europe. Over and above this, recent falls in equity prices could also reduce domestic demand growth.

A23. Growth forecasts for 1999 have been revised downwards for all the G7 economies. For the G7 overall, growth is expected to average 1¾ per cent in 1998 and 1½ per cent in 1999, compared with 2¾ per cent growth in both 1996 and 1997.

**World trade**

A24. World trade growth has fallen sharply this year, largely reflecting a collapse in Asian trade. For 1998 as a whole, world trade growth in manufactures is expected to slow to 4½ per cent, under a half of the estimated 1997 growth rate. But with Asia accounting for a proportionately smaller share of UK trade and with some pick up in demand in Europe, UK export market growth is expected to slow by considerably less than world trade, to 7¼ per cent in 1998.

A25. With some recovery in Asian trade in 1999, world trade growth is likely to increase to 5½ per cent next year, and then gradually recover towards trend. However, UK export market growth is expected to fall further in 1999 to 6¼ per cent. This reflects the anticipated further slowdown in G7 growth, including in the US.

A26. Private capital flows to the developing world have fallen rapidly. The IMF expect net private capital flows to all developing countries to fall in 1998 by around $70 billion, compared with 1997. As a counterpart to this, some major shifts are under way in global trade patterns. Compared with 1997, the IMF expect the five Asian crisis economies to experience a swing into surplus on their current account of $81 billion in 1998. This implies a significant deterioration elsewhere. With Japanese demand remaining weak, a significant worsening can be expected in the trade balances of the US and European economies.

A27. These changes in trade patterns are a crucial element of the adjustment that is required in order for world growth to continue in the aftermath of the Asia crisis. Maintenance of sustainable demand growth in the US and Europe will be important in facilitating this adjustment. Attempts to resist trade adjustments through protectionist measures would be highly detrimental to global prosperity, and would raise the risk of a global slowdown evolving into a world recession. Further liberalisation of trade policy in the multilateral trading system, however, would be beneficial for global growth.

CHART A2 HERE

**World inflation**

A28. As the recent G7 Finance Ministers and Central Bank Governors' statement made clear, the balance of risks on global inflation has shifted. G7 consumer price inflation is currently running at less than 1½ per cent. Non-oil commodity prices have fallen by around 20 per cent over the past year. Oil prices have been in the range of $11 to $15 per barrel over the past six months, compared with an average of $19 per barrel last year.

A29. With the weaker outlook in world activity and low commodity prices, G7 consumer price inflation is expected to average 1½ per cent this year and next. These would be the lowest annual rates seen since at least 1960.

**Risks to the world economic outlook**

A30. While the global economic outlook is expected to remain relatively firm, there are a number of downside risks to the outlook which could, individually or in some combination, produce a sharper downturn in the world economy. These include an intensification of contagion in emerging markets; further volatility in G7 financial markets; and a deterioration in the economic and financial situation in Japan. In addition, there have been some recent concerns about a market-driven tightening of credit conditions in some G7 countries.

A31. It is extremely difficult to attach a probability to these risks or quantify their potential economic impact. However, it is possible to envisage a sharper slowdown in developing countries, with further transmissions through global financial markets culminating in significantly lower G7 growth than forecast.

A32. It is crucial that every effort is made to avoid these downside risks becoming a reality. In their recent statements, G7 Finance Ministers and Central Bank Governors have emphasised their commitment to create or maintain the conditions for sustainable demand growth in their own economies.

A33. In Japan, the Government's fiscal packages and financial sector reform should help restore confidence and support domestic demand. Amongst the G7, the recent cuts in US, UK, Canadian and Japanese interest rates will help maintain global growth. In the Euro-zone, interest rate convergence in advance of the single currency's launch has led to a monetary loosening.

# UK DEVELOPMENTS AND PROSPECTS

**Trend output**

A34. At the time of the March Budget, the UK economy was estimated to have been on trend, on average, in the first half of

1997. There seem no compelling reasons to change this judgement. It is formed on the basis of various survey and labour market indicators of the pressure of demand and so is not directly affected by recent changes to the national accounts.

A35. Some leading business survey measures of capacity utilisation passed through their long-run averages in 1994. These include the Confederation of British Industry (CBI) survey measure for manufacturing, and the British Chambers of Commerce (BCC) survey measures for both the manufacturing and service sectors. However, it seems unlikely that output could have returned to trend so shortly after the protracted recession of the early 1990s. This early peak in survey measures of capacity utilisation is probably a reflection of the pace at which output moved back towards potential - so-called ìspeed limitî effects. Rapid growth first in manufacturing, and then service sector output, began to put upward pressure on earnings and inflation, even when output in both sectors was still below trend.

A36. This view is supported by other indicators. In particular, the CBI measure of skilled labour shortages did not move above its long-run average until late 1997. Indicators of recruitment difficulties may provide a better guide than capacity utilisation to the degree of slack in the economy as a whole, because labour is relatively mobile across sectors. A later return to trend also fits better with the range of outside estimates of the sustainable rate or non-accelerating inflation rate of unemployment (NAIRU), which centres around 7 per cent. Unemployment did not fall below 7 per cent until summer 1997. Moreover, despite doubts as to the reliability of the official data for average earnings (see box A3), there is no evidence that earnings growth began to run at unsustainable rates until at least late 1996.

A37. The revised national accounts data are, of course, relevant to the assessment of trend output growth. The new data have not altered longer-term measures of UK growth performance where, in the post-war period, economic growth has averaged 2¼ per cent a year. However, over the last full economic cycle - judged to cover the period from the second quarter of 1986 to the first half of 1997 - growth is now estimated to have averaged just under 2½ per cent a year, an upward revision of about 0.2 percentage points a year. Nevertheless, for the purposes of projecting the public finances on a cautious and prudent basis, the trend rate of growth is still assumed to be 2¼ per cent a year.

A38. However, as in the March Budget, the upper ends of the opportunity ranges shown in the Pre-Budget Report are based on the assumption that improved labour market performance delivers a fall in the sustainable rate of unemployment (the NAIRU) of ½ percentage point a year through both 1999 and 2000, and ¼ percentage point in 2001. This is equivalent to trend output growing at 2¾ per cent a year through 1999 and 2000 and gradually reverting back to the assumed rate of 2¼ per cent by the end of 2001. The forecast employs the stylised assumptions that the forecast path for inflation and the ratios of demand components to GDP are invariant within the forecast ranges. More information on the use of the ranges can be found in the Pre-Budget Report of November 1997, pages 65-66.

**The output gap**

A39. The latest national accounts data also show that the economy had more momentum last year than previously estimated. For 1997 as a whole, growth is now estimated at 3½ per cent, well in excess of its sustainable rate. Compared to the Budget projection, the new data for non-oil gross value added (which is used to estimate the output gap - see chart A4) show almost ¾ percentage point stronger growth between the first half of 1997 (when the economy is estimated to have last been on trend) and the third quarter of 1998. Most of this is accounted for by higher growth through the course of last year. As a result, the output gap is now estimated at around ½ per cent in the third quarter of 1998, compared to just below zero implicit in the Budget forecast. This reinforces the need for a further slowing in activity in the period ahead to reduce domestically generated inflationary pressures.

**Overview of recent developments and prospects**

A40. Most domestic economic indicators have so far evolved much as expected in the March Budget forecast. Compared to the position in March, there is now much clearer evidence that the tightening of the policy stance is acting to bring growth in domestic spending back to more sustainable rates. Overall, the picture is one of continued expansion though, as expected, at a necessarily slower pace.

A41. GDP grew by ½ per cent in the third quarter of 1998, the same as in the second quarter, and a little below its trend rate. Growth in service sector output has slowed to around ½ per cent in the latest quarters, and the manufacturing sector has recorded more modest growth, reflecting the impact of sterling's appreciation.

A42. Growth in final domestic demand has slowed markedly compared to the unsustainable rates seen last year. The main driving force has been the slowing in household consumption, which rose by around ½ per cent in both the first and second quarters of this year. Having acted as a restraint on the economy during much of the previous year, net exports made a small positive contribution to GDPgrowth in the second quarter of 1998. However, the underlying trend in export growth is almost

certainly weaker than these figures suggest.

A43. Labour market activity has remained relatively strong, with ILO unemployment remaining on a downward trend this year. However, consistent with the slowing of growth in output and demand, the pace of labour market tightening has eased during 1998.

A44. Although much of the Budget forecast has remained broadly on-track until now, two broad strands of evidence point to a more pronounced slowing of activity over the short-term horizon than anticipated in March. First, underlying trade performance has been weaker than expected. Second, there has been a clear deterioration in business survey indicators since March.

A45. In the three months to August, there was a deficit on trade in goods of nearly £4 billion, compared to just over £2½ billion a year earlier. This deterioration began in the second half of 1997, reacting to the appreciation of sterling with the normal lag of around a year. Although the trade in goods balance with EU countries has actually improved a little over the past year, the impact of sterling's strength is still evident in that a larger improvement would have been expected, given the relative position of the UK and EU cycles.

CHART A3 HERE

A46. In the third quarter of 1998, the value of UK exports to Asia was almost 30 per cent lower than a year earlier. This included a fall of around 25 per cent in exports to Japan, and in the case of the majority of smaller crisis countries, UK exports have more than halved. Although the region typically accounts for only around 15 per cent of total UK exports, the severity of the crisis - much deeper than expected six months ago - has been sufficient to account for most of the widening of the trade deficit in goods over the past year. Overall, the trend in UK export volumes is now quite weak.

A47. The decline in business survey indicators since March has been closely related to weaker trading prospects and the deterioration in the world environment. Indicators of manufacturing output and orders have fallen markedly during the second and third quarters, both in the CBI and other surveys, accompanied by a sharp decline in business optimism and lower investment intentions. However, recorded growth in manufacturing output has held firm, albeit at low levels. Although some weakening may be expected in the period ahead, very few independent forecasters expect a downturn commensurate with the latest survey readings.

A48. Recent trends in service sector surveys have confirmed the deceleration in services activity during 1998, consistent with the slowing of growth evident in official data. However, this softening has come relative to a starting position of considerable strength and the surveys indicate continued expansion. For example, the BCC survey measures of domestic sales activity remain well above the readings in 1992 when service sector output was broadly stable. Nevertheless, the surveys have increasingly highlighted the important knock-ons to the domestic service sector from muted export and manufacturing activity.

A49. Growth in output and demand is expected to continue to slow further below trend rates, in response to the deterioration in world economic prospects and tight monetary and fiscal policy. Slower growth in UK export markets and the decline in business confidence, also reflecting conditions in the world environment, will lead to a sharper slowdown than expected at Budget time. In addition, an unanticipated build-up of inventories in the first half of 1998 has taken the ratio of inventory accumulation to GDP well above trend. This is expected to reverse, providing a further temporary restraint to growth in the period ahead.

A50. Depending on the extent of any improvement in labour market performance, GDP is forecast to grow by between 1 and 1½ per cent in 1999, ¾ percentage point lower than anticipated in the March Budget forecast. The deterioration in world economic developments and prospects can probably more than account for this moderation. The impact on UK exports of slower growth in world output and trade accounts for most of the downward revision to UK activity. Other global impacts, including the possibility of weaker domestic spending due to recent falls in equity prices, can readily account for the remainder.

A51. UK export markets are now expected to grow by 7¼ per cent in 1998 and 6¼ per cent in 1999, respectively ¾ and 1¼ percentage points lower than expected at the time of the Budget. The direct consequences for UK output are more or less instantaneous, reflecting the share of exports of goods and services in GDP - approximately one third. Taking account of second round effects feeding through from lower domestic incomes, the downward revision to UK export markets growth is expected to reduce GDP growth by around ½ percentage point in 1999.

A52. But this is not the whole story. For example, increased global instability has triggered a significant reduction in UK

equity prices from their peak in July, as in the United States and the rest of Europe. This is likely to exert some restraining influence on household consumption during the course of 1999. It could also lead to lower investment, as might heightened volatility in UK stock prices. However, such additional impacts are much less certain than the trade effects.

CHART A4 HERE

A53. Currently, RPIX inflation is at its 2½ per cent target: negative import price inflation is compensating for excess domestically generated inflation. The forecast slowdown in GDP growth implies that the economy moves below trend from early 1999, with the emerging negative output gap putting downward pressure on domestically generated inflation. Given that import price inflation is likely to remain negative for a while, this could imply that RPIX inflation falls below target during the first half of 1999. But the favourable (negative) trend in import price inflation is likely gradually to unwind, especially as the impact of the recent fall in the exchange rate feeds through, bringing RPIX inflation back to target by the end of 1999.

A54. The scale of the prospective cyclical slowdown, combined with room for manoeuvre within the new policy framework, will permit a stronger subsequent cyclical recovery in output than previously expected from early 2000, when underlying growth in output is expected to move back above its trend rate. GDP is expected to grow by 2¼ to 2¾ per cent in 2000 and by 2¾ to 3¼ per cent in 2001. The cyclical path implies that the negative output gap is not eliminated until 2002, further removing excess domestically generated inflationary pressure in the interim. With import price inflation continuing to rise in 2000 and 2001, RPIX inflation is expected to remain at target.

A55. It is important to consider short-term economic prospects in their historical context. Until the 1970s, the UK economic cycle had been relatively moderate. By contrast, recent cycles have been much more severe with output falling quite sharply in each of the last three economic downturns. One of the key aims of Government economic policy is to moderate these damaging swings in economic activity. Despite recent world events, the current economic cycle is expected to be relatively shallow, a result of timely policy decisions under the new monetary and fiscal frameworks, designed to reduce economic instability. The peak in GDP relative to its potential level has been contained, limiting the build up of domestic inflationary pressures. By contrast, the positive output gap rose above 4 per cent in the late 1980s, necessitating a very steep loss of output relative to trend.

**Box A2** - Impact of the 'Year 2000' problem

**The** 'Year 2000' or 'Millennium Bug' problem poses a significant global economic and governmental challenge.

**Outside estimates of the spending required to deal with the problem range from £25 billion to £60 billion, spread over several years. Such expenditure will be largely directed towards keeping existing computer systems in working order, and so will not directly raise UK output. Although final investment will be boosted where companies decide to replace computer systems, this will most likely be offset by lower investment in other areas or in later years. Value added in the computer industries will rise significantly, largely offset by a squeeze on the profits of other companies. In addition, some precautionary build-up of inventories may be expected in late 1999 as producers and consumers guard against potential disruption to supply chains, but there would be an offsetting effect in early 2000.**

**Some loss of output immediately following the date change seems likely. Irrespective of how well preparations are proceeding in this country, the economy will remain vulnerable to disruptions in other economies. Estimates of the potential shock vary quite widely and are necessarily based on a number of very uncertain assumptions. Moreover, although the level of GDP, and its growth, may be depressed in 2000, permanent output effects are not generally anticipated. On this basis, and because of the wide margins of error,** 'Year 2000' effects are excluded from the Pre-Budget Report forecast.

**The Government body, Action 2000, is working with the public and private sectors to minimise any impact of the date change on the UK economy. More information can be found on the Action 2000 internet site: http://www.bug2000.co.uk**

CHART A5 HERE

A56. The forecast does not make any allowance for the potential economic effects of the 'Year 2000' computer problem. Whilst a potentially significant impact cannot be ruled out at this stage, any single estimate would fail to reflect the very large degree of uncertainty surrounding the issue. Moreover, the potential impact on GDP - in terms of both changed spending patterns and possible disruptions to output after the date change - is likely to be entirely transitory. These issues are discussed in box A2.

**Labour market**

A57. Labour market activity remains relatively robust, with employment rising strongly and unemployment declining sharply over the past year. In the three months to August, the Labour Force Survey (LFS) measure of employment was around 160,000 higher than six months earlier, and up around 300,000 on a year earlier. ILO unemployment rose marginally compared to the previous three months, but this looks to have been an erratic movement. It still seems to have been on a downward trend, and has fallen by 225,000 over the past year.

A58. In some respects, the latest labour market data are surprisingly buoyant. Consistent with the slowing in economy activity, growth in employment had appeared to moderate during the first half of 1998, only to have picked up again more recently. In addition, vacancy data remain high by historical standards and new notifications have yet to show any signs of turning down. With economic activity slowing, past experience suggests a fall in vacancies might have been expected.

A59. This further tightening in the labour market since the Budget seems consistent with the judgement that GDP was around 1/2 per cent above its potential level in the third quarter. For example, ILO short-term unemployment - less than one year - remains well below its pre-recession trough. Reported recruitment difficulties, though they have eased recently, are at a similar level to those reported at the peak of the previous economic cycle, at least in the service sector. Against this background, recently revised figures for average earnings are puzzling, showing a significant moderation in the growth of earnings through 1997 and early 1998 (see box A3).

A60. Overall, the weight of evidence points to a labour market that is already tight enough to be putting upward pressure on inflation. A further rapid tightening would provide no security in terms of longer-term employment prospects.

A61. For the economy to get back quickly to a sustainable growth path, the labour market will need to remain fluid. Currently, around 2 million people move into employment or change jobs each quarter. Each month, over 200,000 new vacancies are notified to Job Centres across the country and around 1/4 million people leave the claimant unemployment count. As the economy slows further, it will become even more important that the labour market functions effectively. In particular, it is vital that those flowing into unemployment do not become permanently detached from the labour market. Those who are able to work should not be prevented from doing so by the tax and benefit system.

A62. The Government has introduced a wide range of policies to achieve these aims, as discussed in chapter 4. These policies make the UK labour market better equipped to deal with the dislocations associated with the global economic downturn.

**Box A3**

**The Office for National Statistics recently rebased the Average Earnings Index (AEI), and at the same time introduced a number of other changes to the way the data are constructed. In particular, the AEI is now chain-linked using more up-to-date employment weights for each industry, replacing the old 1987 employment weights; uses the current sample/whole economy ratio of the number of enterprises in each size band to gross up sample results to whole economy level, instead of the previous practice of using fixed grossing factors; and uses new industrial and sectoral classification procedures, especially for the public/private sector split.**

**These changes have led to large-scale revisions to the AEI dating back to 1990, and to growth rates from 1991. The revisions are particularly marked for the period from early 1997 to date, and make the profile of earnings growth over this period very hard to reconcile with other economic indicators. On the old basis, whole economy earnings growth (12-month rate) had appeared to trend upwards more or less continuously since mid-1995, to around 5 per cent on average in recent months. But, on the new basis, it appears to have fluctuated a lot more. It rose sharply from under 3 per cent in early 1996 to peak at well over 5 per cent in early 1997, before falling back to under 4 per cent earlier this year, only to rise sharply again to over 6 per cent in May and then fall back to around 4 1 /2 per cent.**

**The new private sector series shows even more erratic movements, with growth rising from 2 per cent in January 1996 to a peak of 6 1 /2 per cent in March 1997, then falling to 3 1 /4 per cent in March 1998 before increasing sharply to about 7 per cent in May 1998 and then falling back to under 5 per cent. The new public sector series, on the other hand, shows an upward trend in growth from a bit above 2 per cent in spring 1997 to around 4 1 /2 per cent recently, compared to the relatively flat, if volatile, path of the old series which showed growth averaging under 3 per cent since early 1997.**

**Chart - Private sector average earnings growth**

**Chart - Public sector average earnings growth**

**The behaviour of these new series runs counter to what might have been expected. The economy is judged to have moved above trend during the first half of 1997 and grew strongly through the year, which would normally have been expected to put upward pressure on private sector earnings growth, yet the new series suggests the opposite occurred through to early 1998, with pressure on earnings growth receding. Moreover, the recent pick-up in public sector earnings growth to around 4 1 /2 per cent looks odd in the sense that it exceeds estimates based on what is known about public sector settlements and independent estimates of wage drift. In contrast, on the old basis it had been difficult to explain why public sector earnings growth appeared so low.**

**The difficulty in rationalising the volatile movements in the new AEI series, and associated uncertainty about statistical quality, urge caution in accepting the data at face value. So it cannot safely be inferred that private sector earnings growth has yet come back down to sustainable rates. Moreover, New Earnings Survey data tend to support this view, indicating that the earnings of private sector full-time employees grew by 5.1 per cent in the year to April 1998, compared to 5.2 per cent in April 1997 and 4.1 per cent in April 1996.**

**The Chancellor has initiated an external review of the recent revisions, led by Martin Weale, Director of the National Institute for Economic and Social Research.**

### The household sector

A63. Under ESA95, the household sector is now more clearly and separately identified in the national accounts. Key aggregates, including consumption, real disposable income and saving, are now framed in terms of households rather than the old personal sector which included some other bodies.[3]

A64. Indicators of consumer demand still showed considerable buoyancy at the time of the March Budget. Despite the slowing in activity elsewhere in the economy, and an easing from the temporary boost to spending from building society windfalls, consumer confidence remained well above its long-run average. In the first quarter of 1998, aggregate household consumption was 41/4 per cent higher than a year earlier.

A65. However, as expected in March, household spending has weakened during the course of this year. Growth in consumption slowed to just under 1/2 per cent in the second quarter of 1998, well below the unsustainable rates recorded in the second half of 1997. This partly reflects increases in interest rates since last May though, by historical standards, the increase in the mortgage interest burden has been quite modest. Within the total, the share of spending allocated to consumer durables, which had been on sharply rising trend in recent years, now looks to have turned down. This has been a good indicator of past turning points in the consumer cycle.

**Table A3: Household sector[1] expenditure and income**

| | | | Percentage changes on a year earlier | | |
|---|---|---|---|---|---|
| | | | Forecast | | |
| | **1997** | **1998** | **1999** | **2000** | **2001** |
| Household consumption[2] | 4¼ | 3 | 1¾ to 2¼ | 2¼ to 2¾ | 2¼ to 2¾ |
| Real household disposable income | 3½ | 2½ | 1¾ to 2¼ | 1¾ to 2¼ | 1¾ to 2¼ |
| Saving ratio (level, per cent) | 9½ | 8¼ | 8 | 7¾ | 7¾ |

[1]Including non-profit institutions serving households.

[2]At constant prices.

A66. As the economy has slowed, consumption has been supported by a reduction in the household saving ratio over the past year. This is a natural response as consumers attempt to smooth their spending patterns in the face of the cyclical downturn in the growth of real disposable income. In the short term, some further slowing in real income growth is expected, a necessary consequence of relieving conditions of excess tightness in the labour market, but also partly reflecting the impact of recent world events. Recent declines in equity prices are likely to limit any further decline in the saving ratio.

A67. Overall, household consumption is forecast to grow by 3 per cent this year and by 13/4 to 21/4 per cent in 1999 before

picking up thereafter. A prolonged or severe retrenchment in household spending is not in prospect, unlike in the early 1990s when households found it necessary to cut their spending in absolute terms.

A68. During the 1980s, financial sector liberalisation unleashed a surge in personal borrowing, especially in secured loans, with a near doubling of the debt to income ratio. Gross wealth also grew rapidly during the period, but the household sector was left vulnerable to the inevitable correction in asset prices, especially in house values, which fell sharply in nominal terms during the early 1990s. This experience has made consumers more cautious during the current upswing, leading to a substantial strengthening of the household balance sheet. The net financial wealth to income ratio rose to record levels by end-1997, accompanied by little change in the debt ratio. Although global instability still poses a serious risk to the equity market, house prices do not appear to have risen beyond sustainable levels.

A69. The reduction of excess domestic inflationary pressures during 1999 will permit a recovery in household spending from 2000. Household consumption is forecast to grow by 2¼ to 2¾ per cent in both 2000 and 2001. The household sector saving ratio is expected to fall to a cyclical low of 7¾ per cent in 2000, and stabilise in 2001, before the economy gets back to trend.

CHART A6 HERE

**Investment**

A70. The recent revisions to the national accounts show that growth in investment has been somewhat stronger in recent years than previously estimated. Whole economy investment is now estimated to have grown by 5 per cent in 1996 and 6 per cent in 1997, an average upward revision of 2½ percentage points each year. Business investment grew by nearly 9 per cent in both 1996 and 1997, again a significant upward revision compared to the previous estimates.

A71. These upward revisions to recent investment growth mean that between 1994 and 1997 the ratio of business investment to GDP rose by around 1¾ percentage points (from a trough of 10¼ per cent in 1994), compared to an increase of 1 percentage point on the old figures. But rising business investment has been heavily offset by large falls in general government investment in recent years, contributing to a still subdued overall recovery in investment during the upswing. The whole economy investment ratio declined until 1995, before rising by ¾ percentage point by 1997. Nevertheless, its level in 1997 has been revised down by ½ percentage point, and the business investment ratio is little changed. So the new data still imply that the UK's investment performance has been poor by international standards. With a lower ratio of investment to GDP than the OECD as a whole, at least at whole economy level, and a below average level of GDP per head, UK investment per worker has been relatively low, leading to a deficient capital stock per worker. Reversing this poor performance is an important factor in closing the productivity gap with other major industrial countries. The UK's productivity performance is examined in more detail in chapter 3.

A72. Growth in business investment has been erratic so far in 1998, rising strongly in the first quarter before falling back in the second quarter. The underlying trend in business investment is probably softening, though, to date the weakening is only readily apparent in the manufacturing sector. Manufacturing surveys indicate that this component of business investment is likely to remain subdued, with measures of confidence, capacity utilisation and investment intentions all declining in recent quarters.

CHART A7 HERE

A73. Business investment will slow along with the economy in general. Past experience suggests that the slowdown may gather pace during the course of 1999, as companies try to contain the deterioration in their finances in the face of the squeeze on profits. Service sector investment intentions have also weakened in recent quarters. Precautionary capital expenditure associated with the 'Year 2000' computer problem may provide some support to fixed investment in 1999, as could spending associated with the introduction of the Euro and preparations for EMU. However, such effects are unlikely to be large and, in any event, would mainly tend to bring forward investment from future years.

**Table A4: Gross fixed capital formation**

| | | | Percentage changes on a year earlier | | |
|---|---|---|---|---|---|
| | | | Forecast | | |
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| Whole economy[1] | 6 | 6¼ | 1¾ to 2¼ | 3 to 3½ | 3½ to 4 |
| of which: | | | | | |
| Business[2,3] | 8¾ | 8¾ | ¾ to 1¼ | 1¾ to 2¼ | 2¼ to 2¾ |
| Private dwellings[2] | 7 | 3¼ | 2¼ to 2¾ | 3¼ to 3¾ | 2 to 2½ |
| General government[2,4] | -10½ | -4¼ | 5¼ | 11 | 15 |

[1]Includes costs associated with the transfer of ownership of land and existing buildings.

[2]Excludes purchases less sales of land and existing buildings.

[3]Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.

[4]Includes National Health Service Trusts.

A74. Nevertheless, prospects are likely to be for weaker growth rather than absolute falls in investment as seen in the early 1990s. UK companies had borrowed heavily prior to the downturn, leading to a sharp rise in the company sector gearing ratio. With a large proportion of company capital already effectively tied up in loans, companies were left vulnerable to the profit squeeze and tighter credit conditions in the early 1990s. As in the household sector, there has not been any build up in gearing during the current upswing, meaning that the financial position of the company sector is more secure.

A75. Whole economy investment is expected to rise faster than business investment as the Government's CSR commitment to raise public investment takes effect and reverses the large falls seen in recent years. General government investment is expected to accelerate sharply from now on and reach double-digit rates of growth in 2000 and 2001, before stabilising as a per cent of GDP. This large scale boost to public investment is well timed to support the cyclical recovery of the economy.

CHART A8 HERE

**Trade and the balance of payments**

A76. After recording a surplus of £8 billion in 1997, the current account is expected to move to a deficit of £1¾ billion, or ¼ per cent of GDP, in 1998. This implies a larger swing into deficit between 1997 and 1998 than expected at the time of the March Budget, though the projected 1998 deficit is smaller, reflecting recent upward revisions to the estimated surplus in 1997. Continued strong surpluses on trade in services and income from overseas, both of which managed record performances in 1997, help partly to offset the deterioration in the traded goods sector. In the service sector, the strong performance of UK financial services and insurance, the traditional areas of UK strength, has been important in maintaining a high overall surplus. The investment income performance is harder to explain, given that in the past a rise in sterling has fairly quickly translated into lower income from overseas.

A77. The strength of sterling and the Asian crisis have been the key issues for UK trade in the past year. Many commentators had expected the balance of trade in goods to deteriorate quickly in response to sterling's rise. In the event, the goods deficit shrank through to early 1997, and only moved above early 1996 levels later in the year. Exports and imports tend to respond to exchange rate shifts with a lag, as prices adjust and existing contracts are wound down. So a lag of a year or so before a deterioration in the trade balance is not unusual. Moreover, the appreciation was set against a backdrop of healthy world trade growth. Nonetheless, the deficit on trade in goods has widened sharply over the past year. At around £4 billion in the three months to August, it was £1.3 billion up on a year earlier. This deterioration is more than accounted for by trade with countries outside the EU, with more than half due to Asia.

A78. Trade in services has behaved very differently to trade in goods, where the second quarter of 1998 saw a record surplus of £3.3 billion in the traded services sector. This was the fifth consecutive quarterly increase in the surplus. Part of the story is that service exports are likely to be less price sensitive than goods. In addition, a smaller proportion of service exports goes to countries against whose currencies sterling has risen the most. However, this resilience is still somewhat surprising.

A79. The deterioration in the trade position since the March Budget has been driven by adverse global economic developments. The impact of financial market turmoil in Asia has depressed demand for UK exports and intensified competition from Asian exporters in third markets. In terms of imports, the total value of the goods bought from the affected

countries has increased less sharply. This is because the sharp depreciations of the Asian currencies have lowered the prices to UK importers, reducing the cost of a given volume of goods. As a result, the official figures on trade values with Asia may be masking rapid growth in import volumes from these countries.

**Table A5: Trade in goods and services**

| | Percentage changes on a year earlier £billion | | | | | |
|---|---|---|---|---|---|---|
| | Volumes | Prices[1] | Goods and | | Terms of | services |
| | Exports | Imports | Exports | Imports | trade[2] | balance |
| 1997 | 8½ | 9½ | -4¼ | -6¾ | 2½ | -¾ |
| Forecast | | | | | | |
| 1998 | 3¼ | 7¼ | -4¾ | -6¼ | 1¾ | -5¼ |
| 1999 | 2¾ to 3¼ | 4¼ to 4¾ | -2¼ | -1¾ | -½ | -9½ |
| 2000 | 4¾ to 5¼ | 4½ to 5 | 1¾ | 2 | -¼ | -10¼ |
| 2001 | 6 to 6½ | 5½ to 6 | 2¼ | 2¼ | 0 | -10¼ |

[1]Average value indices

[2]Ratio of export to import prices

A80. In addition to a greater impact from Asia, recent months have seen increasing numbers of countries affected by the financial turbulence. Although the countries concerned account for a small share of UK trade, the indirect and third market effects are likely to be more significant. Devaluations around the world make competition in third markets even fiercer for UK exporters, already affected by sterling's appreciation and slower overall growth in world output and trade.

A81. The strength of sterling and the Asian crisis have had a key impact on import and export prices. Import price falls have helped to counteract domestically generated inflation, though it is difficult to identify the precise impact of the strength of sterling because import prices began to fall before sterling started to rise in August 1996.

A82. But since sterling began its sharp rise, total import prices have fallen by about 12 per cent. These large falls have fed through the supply chain, and also had the effect of exerting downward competitive pressure on the prices charged by domestic producers. However, this dampening effect on inflation will not last forever. Once import and export prices have adjusted to the exchange rate movements there will not be a continuing effect on price changes year on year.

A83. Export volume growth has slowed sharply over the past year, and is forecast to remain subdued next year, reflecting the further fall in the growth of UK export markets and continued, albeit eased, exchange rate effects. Import volume growth has started to slow this year with the deceleration in final domestic demand, and this is expected to continue next year. But exports are expected to pick up from 2000 and grow more in line with imports, as UK export market growth recovers and the effects of the recent easing of the exchange rate feed through. As a result, after a large swing into deficit between 1997 and 1999, the current account deficit is forecast to stabilise at around 1 per cent of GDP thereafter. This is modest by historical standards.

CHART A9 HERE

**Inflation**

A84. RPIX inflation peaked in May 1998 and averaged 3 per cent during the second quarter as a whole. This was in line with the Budget forecast and partly reflected the timing of Budget excise duty measures. RPIX inflation has gradually fallen back in subsequent months. It was 2½ per cent in September, in line with the Government's target rate for the second consecutive month. Recent inflation outturns have benefited from the continued decline in import prices, caused by global developments, including falling commodity prices. In the three months to August, import prices for goods were down over 6 per cent on a year earlier and, abstracting from excise duty effects, producer output prices for manufacturing products fell marginally in the year to September. The goods component of RPI inflation drifted down to just 1¼ per cent in September. This compares with services price inflation of 3½ per cent (around 5 per cent excluding rent and utilities), reflecting domestically generated inflationary pressure.

A85. Survey evidence suggests further weakening of inflationary pressure in the near term and falls in output prices in

manufacturing, where capacity utilisation now appears to be below its long-run average. Import prices are unlikely to start rising for a while, despite the recent fall in sterling. As the economy moves below trend early next year, domestic margins are expected to be simultaneously squeezed. This is likely to be intensified by continued competition from low-priced imports, particularly from Asia. Earnings growth should also ease back progressively, particularly the bonus component, but it may take longer for slower growth in unit labour costs to materialise.

A86. Thus with downward pressure on domestically generated inflation from early next year, and the near-term prospect of import prices remaining subdued, RPIX inflation may dip temporarily below its 2½ per cent target in the first half of 1999. However, import price inflation is likely to start picking up through next year, as the effects of the previous exchange rate appreciation unwind, and combine with the effects of the recent depreciation. So RPIX inflation is expected to return to target by the end of the year. Thereafter, it is expected to remain at target, with further downward pressure on domestically generated inflation until the economy returns to trend in 2002, offset by a continued rise in import price inflation.

CHART A10 HERE

A87. Import prices have fallen more sharply than export prices over the past two years, the normal response to a sustained appreciation of sterling. This has the effect of boosting GDP deflator inflation relative to consumer price inflation, because the GDP deflator includes the price of UK exports but excludes the price of imports. However, in financial year 1997-98 GDP deflator inflation at 2½ per cent was slightly below RPIX inflation at 2¾ per cent. Although GDP deflator inflation was boosted relative to its household consumption expenditure deflator (CED) component by the terms of trade effect, CED inflation was unusually low relative to RPIX inflation. This primarily reflected relatively low inflation for UK consumer spending overseas, which scores in the CED but not in RPIX, and relatively high housing depreciation and council tax increases, which score in the RPIX but not in the CED. In financial year 1998-99, CED inflation is assumed to move back in line with RPIX inflation. But the terms of trade effect is still expected to boost the GDP deflator, albeit by less than in 1997-98. So GDP deflator inflation is expected to rise to 2¾ per cent in 1998-99, before falling back to 2½ per cent thereafter, as the terms of trade effect subsides.

# FORECAST RISKS

A88. The Pre-Budget Report forecasts are broadly in line with the independent averages for 1998 and 1999. In March, the Budget forecast was exactly in line with the independent consensus, and it remained so until the world outlook deteriorated significantly in the late summer.

---------------------------------------------

Notes:
1 A full set of charts and tables relating to the economic forecast is available on the Treasury's internet site, http://www.hm-treasury.gov.uk, and copies can be obtained on request from the Treasury's Public Enquiry Unit (0171-270 4558). [Back]

2 The projections are consistent with the revised national accounts data released with the 1998 Blue Book on 24 September. This introduced wide-ranging changes to the UK system of national accounts which are explained in more detail in box A1. [Back]

3 In particular, insurance corporations, pension funds and unincorporated businesses. But the household sector accounts still include non-profit institutions serving households. [Back]

Summary

- **The public finances have continued to improve this year, and the current budget is likely to move into surplus. This would be the first surplus for eight years, and compares with an average deficit of over 4 per cent of GDP between 1991**-92 and 1996-97. The overall budget is expected to swing from net borrowing of 3¾ per cent of GDP in 1996**-97 to a small surplus in the current year.**
- **On the path for the economy presented in Annex A, there is some cyclical worsening in the public finances next year. But the current budget is projected to remain in surplus.**
- **As economic growth recovers over the medium term, the current budget moves more substantially into surplus. Net borrowing remains low, despite higher public investment.**
- **The burden of public debt, which rose sharply over the first half of the 1990s, peaked last year. With new borrowing remaining low, it is projected to go on falling throughout the medium term.**
- **The fiscal rules are met with a margin for uncertainty.**

# THE CURRENT YEAR

### Outturns for first six months

B1. Over the first six months of 1998-99, the public sector borrowed only £5 billion, compared with £15 billion in the first six months of 1997-98. The reduction was in central government borrowing; local authorities borrowed more than last year. Cash receipts were 7½ per cent higher than in the first half of last year, with income tax payments and national insurance contributions especially buoyant, while departmental outlays rose by less than 2 per cent.

**Table B1: Net borrowing in April-September**

| | | £billion | |
|---|---|---|---|
| | 1997-98 | 1998-99 | Change |
| Central government | 16·2 | 5·4 | -10·8 |
| Local government | -0·5 | 0·4 | 0·8 |
| Public corporations | -0·6 | -0·7 | -0·1 |

### ESA95 and comparisons with Budget forecasts

B2. Table B2 compares the current forecasts of the current budget surplus and net borrowing for 1998-99 as a whole with the forecasts in the March Budget. This comparison is complicated by the introduction of the new European System of Accounts (ESA95). Table B2 disentangles the resulting classification changes from other (forecasting) changes. The classification changes reduced the measured current budget surplus by £3·5 billion and increased measured net borrowing by £1·8 billion in 1997-98 - see the section on classification changes at the end of this annex. On unchanged definitions, the prospects for this year have improved significantly, reflecting the outturns for the first six months.

**Table B2: Changes from Budget forecast**[1]

| | £billion | |
|---|---|---|
| | 1997-98 | 1998-99 |
| **Surplus on current budget:** | | |
| 1998 FSBR | -1·3 | 3·6 |
| Effect of classification changes | -3·5 | -3·7 |
| Effect of revisions/forecasting changes | 0·4 | 5·6 |
| 1998 Pre-Budget Report | -4·4 | 5·5 |

| | | |
|---|---|---|
| **Net investment:** | | |
| 1998 FSBR | 6·2 | 6·7 |
| Effect of classification changes | -1·6 | -1·7 |
| Effect of revisions/forecasting changes | -0·7 | -1·0 |
| **1998 Pre-Budget Report** | 3·8 | 4·0 |
| **Net borrowing:** | | |
| **1998 FSBR** | 7·5 | 3·1 |
| Effect of classification changes | 1·8 | 2·0 |
| Effect of revisions/forecasting changes | -1·2 | -6·6 |
| **1998 Pre-Budget Report** | 8·2 | -1·5 |

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

B3. The effects of the reclassifications carry through into future years. They should be taken into account when attempting any comparisons between projections given here and earlier forecasts (see Table 2.3 in Chapter 2).

**Sources of improvement in current budget**

B4. The forecast surplus on current budget of ¾ per cent of GDP in 1998-99 compares with a deficit of 3 per cent of GDP two years earlier. Roughly ¾ per cent of this 3¾ per cent improvement is accounted for by tax changes in the 1997 and 1998 Budgets. An estimated 1 per cent is accounted for by above-trend economic growth. The remainder mainly reflects relatively slow growth of public expenditure, as the Government has fulfilled its Manifesto commitment to keep within the limits it inherited for the first two years.

**Table B3: Change in current budget surplus between 1996-97 and 1998-99**[1]

| | Per cent of GDP |
|---|---|
| **Outturn for 1996-97** | **-3** |
| Effect of tax changes[2] | ¾ |
| Estimated effect of economic cycle | 1 |
| Other (mainly public spending) | 2 |
| **Forecast for** 1998-99 | **¾** |

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

[2]*Tax changes (relative to an indexed base) in 1997 and 1998 Budgets.*

Chart B1

**Longer-term perspective**

B5. Charts B1 and B2 put the improvement in the fiscal position into a longer-term perspective. Apart from three years during the late 1980s boom, the current budget was continuously in deficit during the past twenty five years. The deficits in the early 1990s were the largest since the Second World War. Although public net investment was falling as a share of GDP, net borrowing also reached its highest post-war level in the early 1990s.

Chart B2

**Cyclically-adjusted fiscal balances**

B6. Cyclically-adjusted, or 'structural', deficits rose during most of the 1980s and early 1990s. From a peak of 3½ per cent of GDP in 1993-94, the deficit on the cyclically-adjusted current budget is estimated to have fallen to just ½ per cent of GDP last year, and a small surplus is forecast for 1998-99. Cyclically-adjusted net borrowing of just ¼ per cent of GDP is forecast for this year.

**Public sector debt and net wealth**

**Table B4: Public sector debt**[1]

| | | | | Estimate |
|---|---|---|---|---|
| | 1991 | 1997 | 1998 | 1999 |
| **Net public sector debt** | | | | |
| £ billion | 153 | 350 | 352 | 349 |
| -per cent of GDP[2] | 27 | 44 | 42 | 40 |
| **General government gross debt** | | | | |
| £ billion | 194 | 413 | 410 | 409 |
| -per cent of GDP[3] | 34 | 54 | 50 | 48 |

[1]*End-March.*

[2]*GDP centred on end-March.*

[3]*Maastricht basis.*

Chart B3

B7. The debt burden rose sharply over the first half of the 1990s as a result of the high levels of government borrowing and slow growth in money GDP. Net public debt rose from 27 per cent of GDP in March 1991 to a peak of 44 per cent of GDP in March 1997. The estimated net wealth of the public sector fell from around 70 per cent of GDP in the late 1980s to just 16 per cent of GDP at end-1997 - in part because of rising debt and in part because privatisations and historically low levels of public investment reduced the stock of government assets. With borrowing now much lower, net debt is forecast to fall to 40 per cent of GDP by March 1999. With the current budget probably now in surplus, net wealth is likely to have stabilised as a percentage of GDP.

# PROSPECTS

**Assumptions**

B8. The projections assume:

- public spending is in line with the plans set out in July's Comprehensive Spending Review;
- there are no tax changes beyond those already announced in past Budgets; and
- the economy follows the path described in Annex A. In the interests of caution, the lower end of the opportunity range for GDP growth shown in Annex A has been used.

**Table B5: Economic assumptions**

| | Percentage changes on previous year | | | | | |
|---|---|---|---|---|---|---|
| | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
| Output (GDP) | 2¼ | 1 | 2½ | 2¾ | 2½ | 2¼ |
| Prices | | | | | | |
| RPIX | 2½ | 2¼ | 2½ | 2½ | 2½ | 2½ |
| GDP deflator | 2¾ | 2½ | 2½ | 2½ | 2½ | 2½ |
| **Money GDP (£ billion)** | **855** | **884** | **930** | **979** | **1028** | **1078** |

B9. The eleven key assumptions and conventions audited by the National Audit Office (NAO) and used for the Budget projections (see page 109 of the Financial Statement and Budget Report and the NAO report Audit of Assumptions for the Budget, 19 March 1998, HC 616) are unchanged. In accordance with these assumptions and conventions, UK claimant unemployment is assumed flat at its September level of 1.30 million, oil prices are assumed flat at $13 a barrel (in real terms), equity prices are projected in line with money GDP (with no reversal of the fall since July), and interest rates are projected in line with market expectations.

**Current and capital budgets**

B10. Table B6 shows projections for the current and capital budgets in £ billion and Table B7 shows them as percentages of GDP. The public finances are inevitably affected by the economic slowdown projected for next year. The current budget surplus is reduced, as slower growth in income and expenditure and the fall since July in equity prices reduce growth in tax revenues. This reduction is cyclical: the structural surplus continues to improve - Table B8.

**Table B6: Current and capital budgets**

| | | | | £ billion | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | Estimate | | | Projections | | |
| | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
| **Current budget** | | | | | | | |
| Current receipts | 316·3 | 335·9 | 348 | 367 | 390 | 410 | 430 |
| Current expenditure | 304·1 | 314·1 | 333 | 349 | 366 | 384 | 403 |
| Depreciation | 14·1 | 14·5 | 15 | 15 | 16 | 16 | 17 |
| Surplus on current budget (including windfall tax) | -1·8 | 7·3 | 0 | 2 | 7 | 10 | 11 |
| **Surplus on current budget[1]** | **-4·4** | **5·5** | **1** | **3** | **8** | **10** | **11** |
| **Capital budget** | | | | | | | |
| Gross investment | 22·0 | 22·5 | 25 | 27 | 30 | 31 | 32 |
| less asset sales | -4·0 | -3·7 | -4 | -4 | -4 | -4 | -4 |
| less depreciation | -14·1 | -14·5 | -15 | -15 | -16 | -16 | -17 |
| **Net investment** | **3·9** | **4·3** | **6** | **8** | **11** | **11** | **12** |
| Public sector net borrowing (including windfall tax) | 5·7 | -2·9 | 6 | 6 | 3 | 2 | 1 |
| **Public sector net borrowing1** | **8.2** | **-1·5** | **4** | **5** | **2** | **2** | **1** |
| Financial transactions: | | | | | | | |
| Loans and sales of financial assets | -2·1 | 0.4 | -2 | 1 | 1 | 1 | 1 |
| Accruals adjustments[2] | -2·5 | -1·7 | -1 | -1 | 1 | -1 | 0 |
| Public sector net cash requirement (including windfall tax) | 1·1 | -4·3 | 2 | 6 | 5 | 2 | 3 |
| **Public sector net cash requirement[1]** | **3·6** | **-2.8** | **1** | **5** | **4** | **2** | **3** |

[1] *Excluding windfall tax and associated spending*

[2] *Includes accruals adjustments for the capital uplift on the redemption of the 2½ per cent 2001 and 2003 index-linked gilts.*

B11. The slower rate of economic growth assumed for next year continues to have some effect on projected revenues - particularly from corporation tax - in 2000-2001. From then onwards, the projected current budget surpluses increase gradually. Current expenditure rises roughly in line with GDP, while receipts rise slightly faster because of the growing impact of past Budget measures and the real increases in road fuel and tobacco duty.

B12. The overall budget is projected to move back into deficit next year (ie net borrowing). This is partly because of the reduction in the current budget surplus and partly because of higher public investment. Although net investment is projected to double as a share of GDP between 1998-99 and 2001-02, net borrowing remains low. The ratio of public debt to GDP continues to fall steadily as GDP grows.

B13. Table B7 also shows the definitions of the budget deficit (general government net borrowing on an ESA79 basis) and debt (general government gross debt) used in the Excessive Deficits Procedure of the Maastricht Treaty. The reference levels of 3 per cent of GDP for the deficit and 60 per cent of GDP for debt are achieved very comfortably.

**Table B7: Current and capital budgets**

| | Per cent of GDP | | | | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | Estimate | | | Projections | | |
| | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
| **Current budget** | | | | | | | |
| Current receipts | 38·9 | 39·3 | 39·3 | 39·4 | 39·8 | 39·9 | 39·9 |
| Current expenditure | 37·4 | 36·8 | 37·6 | 37·6 | 37·4 | 37·4 | 37·3 |
| Depreciation | 1·7 | 1·7 | 1·7 | 1·6 | 1·6 | 1·6 | 1·6 |
| Surplus on current budget (including windfall tax) | -0·2 | 0·8 | 0·0 | 0·2 | 0·8 | 0·9 | 1·0 |
| **Surplus on current budget[1]** | **-0·5** | **0·6** | **0·2** | **0·3** | **0·9** | **0·9** | **1·0** |
| **Capital budget** | | | | | | | |
| Gross investment | 2·7 | 2·6 | 2·8 | 2·9 | 3·1 | 3·0 | 3·0 |
| less asset sales | -0·5 | -0·4 | -0·4 | -0·4 | -0·4 | -0·4 | -0·3 |
| less depreciation | -1·7 | -1·7 | -1·7 | -1·6 | -1·6 | -1·6 | -1·6 |
| **Net investment** | **0·5** | **0·5** | **0·7** | **0·9** | **1·1** | **1·1** | **1·1** |
| Public sector net borrowing (including windfall tax) | 0·7 | -0·3 | 0·6 | 0·7 | 0·3 | 0·2 | 0·1 |
| **Public sector net borrowing[1]** | **1·0** | **-0·2** | **0·5** | **0·5** | **0·2** | **0·2** | **0·1** |
| Financial transactions: | | | | | | | |
| Loans and sales of financial assets | -0·3 | 0·0 | -0·3 | 0·1 | 0·1 | 0·1 | 0·1 |
| Accruals adjustments[2] | -0·3 | -0·2 | -0·1 | -0·1 | 0·1 | -0·1 | 0·0 |
| Public sector net cash requirement | 0·1 | -0·5 | 0·3 | 0·7 | 0·5 | 0·2 | 0·3 |
| **Public sector net cash requirement[1]** | **0·4** | **-0·3** | **0·1** | **0·6** | **0·4** | **0·2** | **0·3** |
| **Net public sector debt** | **42·1** | **40·2** | **38·9** | **37·8** | **36·4** | **35·1** | **33·9** |
| Memos: | | | | | | | |
| Net taxes[3] | 36·4 | 37·2 | 37·0 | 36·7 | 37·0 | 37·2 | 37·2 |
| Maastricht deficit[4] | 0·6 | -0·8 | 0·3 | 0·3 | 0·1 | -0·2 | -0·1 |
| General government gross debt | 50·4 | 47·9 | 46·7 | 45·4 | 43·7 | 42·0 | 40·4 |

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

[2] *Includes accruals adjustments for the capital uplift on the redemption of the 2½ per cent 2001 and 2003 index-linked gilts.*

[3] *Total tax receipts and social security contributions net of tax credits, cash basis.*

[4] *General government net borrowing. The Maastricht definition does not exclude the windfall tax and associated spending.*

**Table B8: Budget balances[1]**

| | Per cent of GDP | | | | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | Estimate | | | Projections | | |
| | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
| **Budget balances** | | | | | | | |
| Surplus on current budget | -0·5 | 0·6 | 0·2 | 0·3 | 0·9 | 0·9 | 1·0 |
| Average surplus since 1997-98 | -0·5 | 0·1 | 0·1 | 0·2 | 0·3 | 0·4 | 0·5 |
| Net borrowing | 1·0 | -0·2 | 0·5 | 0·5 | 0·2 | 0·2 | 0·1 |
| **Cyclically-adjusted budget balances** | | | | | | | |
| Surplus on current budget | -0·6 | 0·3 | 0·5 | 1·0 | 1·2 | 1·0 | 1·0 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Average surplus since 1997-98 | -0·6 | -0·2 | 0·0 | 0·3 | 0·5 | 0·6 | 0·6 |
| Net borrowing | 1·1 | 0·2 | 0·2 | -0·1 | -0·1 | 0·1 | 0·1 |
| Memo: Net cash requirement | 0·4 | -0·3 | 0·1 | 0·6 | 0·4 | 0·2 | 0·3 |
| Cyclically-adjusted net cash requirement | 0·5 | 0·0 | -0·2 | -0·1 | 0·0 | 0·1 | 0·3 |

1Excluding windfall tax and associated spending

**Receipts**

B14. The forecast takes account of the measures in the March Budget (which increased receipts by £1¾ billion in the current year, £2½ billion in 1999-2000 and £2¾ billion in 2000-01) and the real increases in tobacco and fuel duties announced in the July 1997 Budget. Otherwise, it assumes no tax changes, beyond the indexation of rates and allowances.

B15. Table B9 gives medium-term projections of receipts as percentages of GDP. A more detailed breakdown in £ billion for 1998-99 and 1999-2000 is given in Table B10. It is forecast that total receipts will rise by 0.4 per cent of GDP this year. About 0.3 per cent of this increase is accounted for by Budget measures. Income tax receipts and national insurance contributions have been particularly buoyant, while corporation tax and VATreceipts remain unchanged as a percentage of GDP.

B16. Excluding the windfall tax, the ratio of total receipts to GDP is projected to increase next year by 0.3 per cent. This increase is wholly accounted for by past Budget measures (mainly the abolition of payable tax credits in the July 1997 Budget, and corporation tax measures in the March 1998 Budget). The slowdown in economic growth is reflected in lower receipts of corporation tax and the underlying ratio of receipts to GDP - after allowing for Budget changes - falls slightly in 1999-2000 and 2000-01. Thereafter, total receipts are projected to increase slightly in relation to GDP. This reflects the real increases in fuel and tobacco duties and the effects of real fiscal drag on income tax. A slight downward trend is projected in the underlying ratio of VAT receipts to consumers' expenditure. After falling steadily between the late 1980s and mid-1990s, this ratio appears to have stabilised over the past two years. But this could reflect the buoyancy of consumer spending (the VAT base tends to be more cyclical than consumer spending generally), and it could be premature to assume that the downward trend in the ratio has come to an end. Other taxes are projected to yield a fairly constant proportion of GDP over the medium term.

**Table B9: Current receipts**

| | Per cent of GDP | | | | | | |
|---|---|---|---|---|---|---|---|
| | Outurn | Estimate | | | Projections | | |
| | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
| Income tax (gross of tax credits) | 9·8 | 10·2 | 10·5 | 10·7 | 10·7 | 10·9 | 11·0 |
| Income tax credits[1] | -0·4 | -0·2 | -0·3 | -0·7 | -0·7 | -0·7 | -0·7 |
| of which Working Families' Tax Credit: | 0·0 | 0·0 | -0·1 | -0·5 | -0·5 | -0·5 | -0·5 |
| Corporation tax | 3·7 | 3·7 | 3·4 | 3·3 | 3·5 | 3·6 | 3·5 |
| Windfall tax | 0·3 | 0·3 | 0·0 | 0·0 | 0·0 | 0·0 | 0·0 |
| Value added tax | 6·2 | 6·2 | 6·2 | 6·2 | 6·2 | 6·1 | 6·1 |
| Excise duties[2] | 4·1 | 4·2 | 4·4 | 4·5 | 4·5 | 4·6 | 4·7 |
| Social security contributions | 6·2 | 6·4 | 6·4 | 6·4 | 6·4 | 6·4 | 6·4 |
| Other taxes and royalties[3] | 6·4 | 6·5 | 6·4 | 6·4 | 6·3 | 6·3 | 6·2 |
| **Net taxes and social security contributions[4]** | **36·4** | **37·2** | **37·0** | **36·7** | **37·0** | **37·2** | **37·2** |
| Other receipts and accounting adjustments[5] | 2·5 | 2·1 | 2·4 | 2·7 | 2·8 | 2·7 | 2·7 |
| Current receipts (including windfall tax)[6] | 38·9 | 39·3 | 39·3 | 39·4 | 39·8 | 39·9 | 39·9 |
| **Current receipts (excluding windfall tax)[6]** | **38·6** | **39·0** | **39·3** | **39·4** | **39·8** | **39·9** | **39·9** |
| Memo: | | | | | | | |
| Current receipts (£bn)[6] | 316·3 | 335·9 | 348 | 367 | 390 | 410 | 430 |

[1] *Mainly MIRAS and tax reliefs under the Working Family Tax Credit scheme.*

[2] *Fuel, alcohol and tobacco duties.*

[3] *Includes Council Tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes. Net of bus fuel duty rebate.*

[4] *Includes VAT and* 'own resources' contributions to EU budget. Net of income tax credits. Cash basis.

[5] *Includes tax credits (and accruals adjustments), and nets off VAT and* 'own resources' contributions to EU budget.

[6] *Accruals basis.*

Chart B4

**Table B10: Public sector current receipts**

| | £billion | | |
|---|---|---|---|
| | Outturn | Estimate | Forecast |
| | 1997-98 | 1998-99 | 1999-00 |
| *Inland Revenue* | | | |
| Income tax (gross of tax credits) | 79·7 | 87·0 | 92·7 |
| Income tax credits | -2·9 | -2·0 | -2·8 |
| Corporation tax[1] | 30·4 | 31·4 | 30·0 |
| Windfall tax | 2·6 | 2·6 | 0·0 |
| Petroleum revenue tax | 1·0 | 0·6 | 0·3 |
| Capital gains tax | 1·5 | 2·3 | 2·4 |
| Inheritance tax | 1·7 | 1·8 | 2·0 |
| Stamp duties | 3·5 | 4·6 | 4·7 |
| **Total Inland Revenue (net of tax credits)** | **117·4** | **128·4** | **129·3** |
| *Customs and Excise* | | | |
| Value added tax | 50·6 | 52·6 | 55·0 |
| Fuel duties | 19·4 | 21·8 | 23·5 |
| Tobacco duties | 8·4 | 8·3 | 8·9 |
| Spirit duties | 1·5 | 1·6 | 1·6 |
| Wine duties | 1·4 | 1·5 | 1·6 |
| Beer and cider duties | 2·8 | 2·9 | 3·0 |
| Betting and gaming duties | 1·6 | 1·6 | 1·6 |
| Air passenger duty | 0·5 | 0·8 | 0·9 |
| Insurance premium tax | 1·0 | 1·3 | 1·4 |
| Landfill tax | 0·4 | 0·4 | 0·4 |
| Customs duties and levies | 2·3 | 2·0 | 1·8 |
| **Total Customs and Excise** | **90·0** | **94·9** | **99·7** |
| Vehicle excise duties | 4·5 | 4·7 | 4·8 |
| Oil Royalties | 0·5 | 0·3 | 0·2 |
| Business rates[2] | 15·2 | 15·2 | 15·0 |
| Social security contributions | 50·6 | 54·8 | 57·0 |
| Council Tax | 11·0 | 11·8 | 12·8 |
| Other taxes and royalties[3] | 7·2 | 7·7 | 8·0 |
| **Net taxes and social security contributions**[4] | **296·4** | **317·7** | **326·8** |

| | | | |
|---|---|---|---|
| Interest and dividends | 6·0 | 6·0 | 5·5 |
| Gross trading surpluses and rent | 13·0 | 13·6 | 14·2 |
| Other receipts and accounting adjustments[5] | 1·0 | -1·5 | 1·4 |
| **Current receipts** | **316·3** | **335·9** | **347·9** |
| Memo: | | | |
| North Sea revenues[6] | 3·4 | 2·6 | 1·3 |
| [1]*Includes advance corporation tax (net of repayments):* | *11·5* | *11·5* | *0·9* |

*Also includes North Sea corporation tax after ACT set off, and corporation tax on gains.*

[2]*Includes district council rates in Northern Ireland.*

[3]*Net of bus fuel duty rebate (previously netted off excise duties). Includes money paid into the National Lottery Distribution Fund.*

[4]*Includes VAT and* 'traditional own resources' contributions to EU budget. Net of income tax credits. Cash basis.

[5]*Includes accruals adjustments and tax credits, and nets off VAT and* 'own resources' contributions to EU budget.

[6]*North Sea corporation tax (before ACT set-off), petroleum revenue tax and royalties.*

Chart B5

**Public expenditure**

B17. Table B11 shows forecasts for general government expenditure for the current year - the last of the old control regime. Control Total spending is estimated to be some £1¼ billion lower than planned, mainly as a result of lower than expected social security spending. This estimate is still subject to considerable uncertainty. The forecast of cyclical social security has also been revised down by some £0.3 billion since July, largely on account of falling unemployment. The forecast assumes that UK claimant unemployment remains flat at its September level of 1.30 million. Central government gross debt interest has been revised down £½ billion (excluding reclassifications), reflecting lower government borrowing this year.

**Table B11: General government expenditure**

| | | £billion |
|---|---|---|
| | Outturn | Estimate |
| | 1997-98 | 1998-99 |
| **Control Total** | **262·7** | **274·4** |
| Welfare to Work spending | 0·1 | 1·2 |
| LA spending under the capital receipts initiative | 0·2 | 0.7 |
| Cyclical social security | 12·8 | 12·2 |
| Central government gross debt interest | 29·8 | 29·5 |
| Accounting and other adjustments | 13·6 | 13·0 |
| Privatisation proceeds | -1·8 | -0·1 |
| **General government expenditure** | **317·5** | **330·9** |

B18. Table B12 shows the plans set in the July Comprehensive Spending Review (CSR) for the three years 1999-2000 to 2001-02. These plans cover the whole public sector, using the aggregate Total Managed Expenditure (TME). TME is split into Departmental Spending Limits (DEL), for which firm three-year plans are set, and Annually Managed Expenditure (AME), the components of which will be subject to annual review as part of the Budget process.

**This annex discusses the measurement of economic activity, standards of living and the sustainability of development.**

**The Government is promoting the development of a wide range of indicators to be used alongside GDP. The Office for National Statistics is developing household and environmental accounts, including an estimate of the value of unpaid care work; and the Government will shortly publish its new proposals for Indicators of Sustainable Development.**

C1. Gross domestic product (GDP) and GDP per head are widely used as summary indicators of living standards. GDP is an indicator of market traded production or economic activity. The level of production determines the quantity of goods and services a country can afford to consume, which is one of the most important factors influencing living standards.

C2. There are, however, statistical and conceptual problems with GDP as a measure of production. The output of much of the services sector can only be measured indirectly through the value of sales and price indices need to adjust for technological advance which leads to quality improvements and new products. Household and other voluntary work is excluded from conventional measures of GDP, whereas the inclusion of collective defensive expenditures such as law and order and national security is arguable.

C3. GDP is not intended to embrace distributional and environmental changes or other quality of life indicators. As an aggregate measure, GDP pays no regard to the incidence of poverty, deprivation and social exclusion. The interpretation of and weight attached to inequality is inevitably highly subjective. Harmful by-products of economic activity such as pollution - for example of air and water quality - can be difficult to value. The depletion of resources such as forests and fish stocks can impact on the sustainability of growth. A host of other factors, such as hours worked, travel times, public safety, and the quality of public services such as health and education, also impact directly on living standards.

C4. In view of the limitations to GDP, the Government is promoting the development of a wider range of measures, to underpin sound policy making for current and future generations.

C5. A key part of this agenda is the work that the Office for National Statistics (ONS) is taking forward to develop satellite accounts, which are conceptually related to the main national accounts. Household accounts estimate the value of time use in unpaid housework, care work and voluntary work for charities and other organisations. Environmental accounts deal substantially in physical quantities which may be difficult to value in monetary terms. The ONS work is further advanced than that of many other statistical bodies: ONS published a report on UK Environmental Accounts in May 1998, and estimates for the value of time use in household work were published in an article in October 1997 Economic Trends.

**Box C1 - Taking account of unpaid work**

Household accounts can be used to measure the value of unpaid production in the household sector. In the UK such production is estimated as ranging from 40 to 120 per cent of GDP, depending on the method of evaluation. The ONS is carrying out research to develop this area of the UK**'s accounts, and intends to construct a ìsatelliteî account to the national accounts for unpaid household production.**

**It is likely that, in time, household satellite accounts will enable a more effective analysis of policy issues where significant amounts of unpaid time need to be taken into account (for example, where policy changes might affect the balance between the formal and the informal economy). The value of unpaid care of adults and children in the home has been estimated at anywhere between 4 per cent and 9 per cent of GDP, depending on the method of evaluation. This could be doubled if unpaid care as a secondary activity or outside the home is also taken into account.**

C6. The Government will shortly publish its new proposals for headline indicators of sustainable development, which consider social and environmental information alongside economic data. These will inform policy decisions and help business and individuals to understand how their own actions might contribute to a more sustainable future.

C7. Comparisons of GDP may still be good indicators of some aspects of relative welfare. As we have grown richer, many

aspects of our quality of life have improved. For example, hours worked have fallen and standards of health and education have improved, as economies have grown richer. However, the global deterioration of key environmental resources - water, soil, forests, fish stocks and biodiversity - and the growth in pollution and waste by-products raises important issues for the future sustainability of development.

C8. Sustainable development means meeting the needs of the present generation without compromising those of future generations. This means ensuring that adequate resources - physical, human and natural - must be available for the future. Government policies therefore aim at economic growth whilst respecting the environment and promoting fairness and opportunity for all.

1.1 Summary of UK forecast
2.1 The fiscal tightening:cumulative change since 1996-97
2.2 Summary of UK forecast
2.3 The public finances
2.4 Summary of public sector finances
2.5 Cyclically-adjusted budget balances
4.1 Funding Welfare to Work - the allocation of the Windfall Tax receipts
4.2 The current National Insurance system
4.3 Tackling the poverty trap: effect of the March 1998 Budget on combined Marginal Tax and benefit withdrawal Rates
5.1 The Government's environmental tax measures: principal measures in place or under consideration
A1 Summary of forecast
A2 The world economy
A3 Household sector expenditure and income
A4 Gross fixed capital formation
A5 Trade in goods and services
A6 Pre-Budget Report and independent forecasts
A7 Summary of economic prospects
A8 Gross domestic product and its components
B1 Net borrowing in April-September
B2 Changes from Budget forecast
B3 Change in current budget surplus between 1996-97 and 1998-99
B4 Public sector debt
B5 Economic assumptions
B6 Current and capital budgets
B7 Current and capital budgets
B8 Budget balances
B9 Current receipts
B10 Public Sector current receipts
B11 General government expenditure
B12 Total Managed Expenditure 1997-98 to 2001-02
B13 Average errors in Budget forecasts of public sector net borrowing
B14 Effects of ESA95 changes, 1997-1998
B15 Impact of ESA95 on expenditure aggregates, 1997-98
B16 Financing requirement for 1998-99
B17 Departmental Expenditure Limits - Current and Capital budgets 1996-97 to 2001-02
B18 Public sector capital expenditure 1998-99 to 2001-02
B19 Historical series of deficits, receipts and public expenditure

1.1 The productivity gap

2.1 Gross Domestic Product (GDP)

3.1 The productivity gap

3.2 The R&D gap

3.3 Under-investment in the UK

4.1 Number of people leaving unemployment

4.2 Removing the distortions in the Employer NICs System

4.3 Making work pay for families

A1 G7 GDPand world trade

A2 Commodity prices

A3 Gross Domestic Product (GDP)

A4 The output gap

A5 LFS employment, unemployment and participation rate

A6 Financial balances and the current account

A7 Whole economy investment-GDP ratio

A8 Business and non-residential investment-GDP ratios

A9 Balance of payments current account

A10 RPIX

B1 Net borrowing and current budget surplus

B2 Cyclically-adjusted current budget deficit and net borrowing

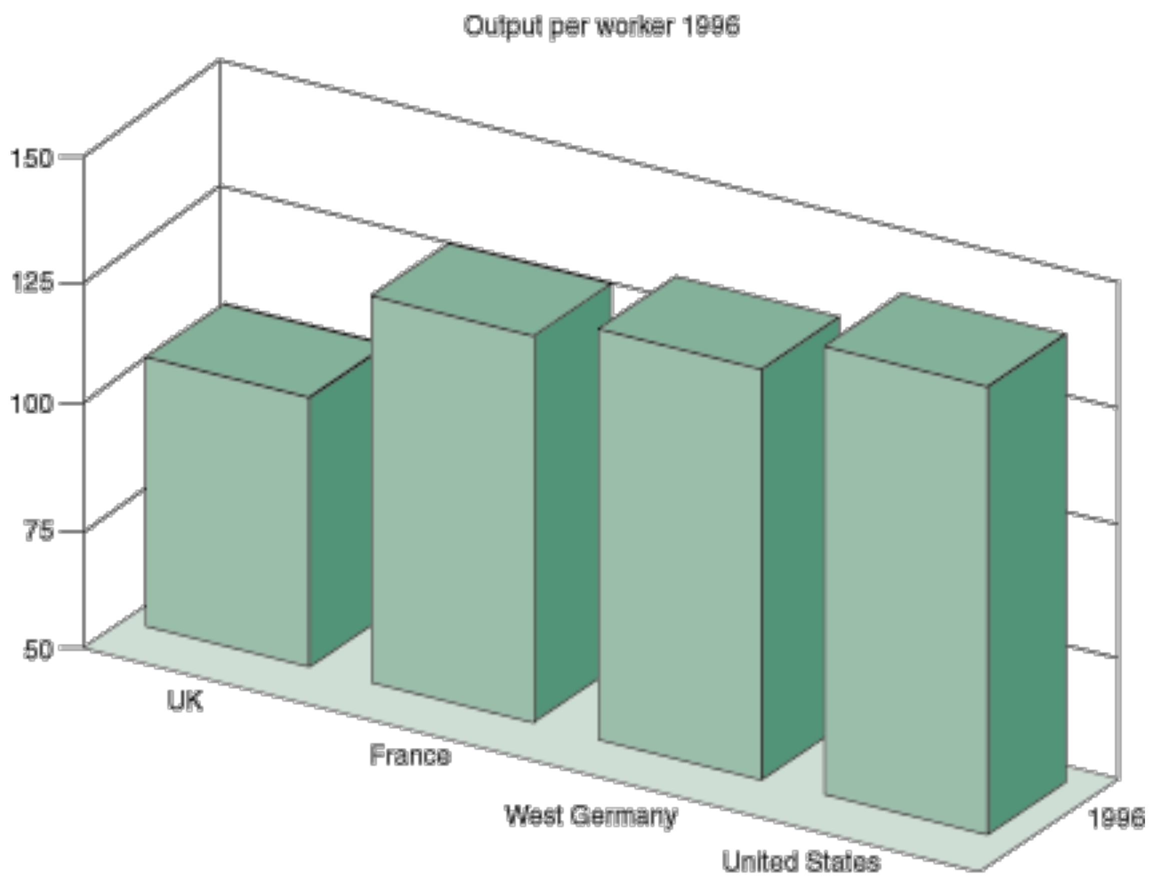
B3 Public debt and net wealth

B4 Tax/GDPratio

B5 Projections of Total Managed Expenditure

B6 Cyclically-adjusted budget balances

**Chart 1.1 - The Productivity gap**



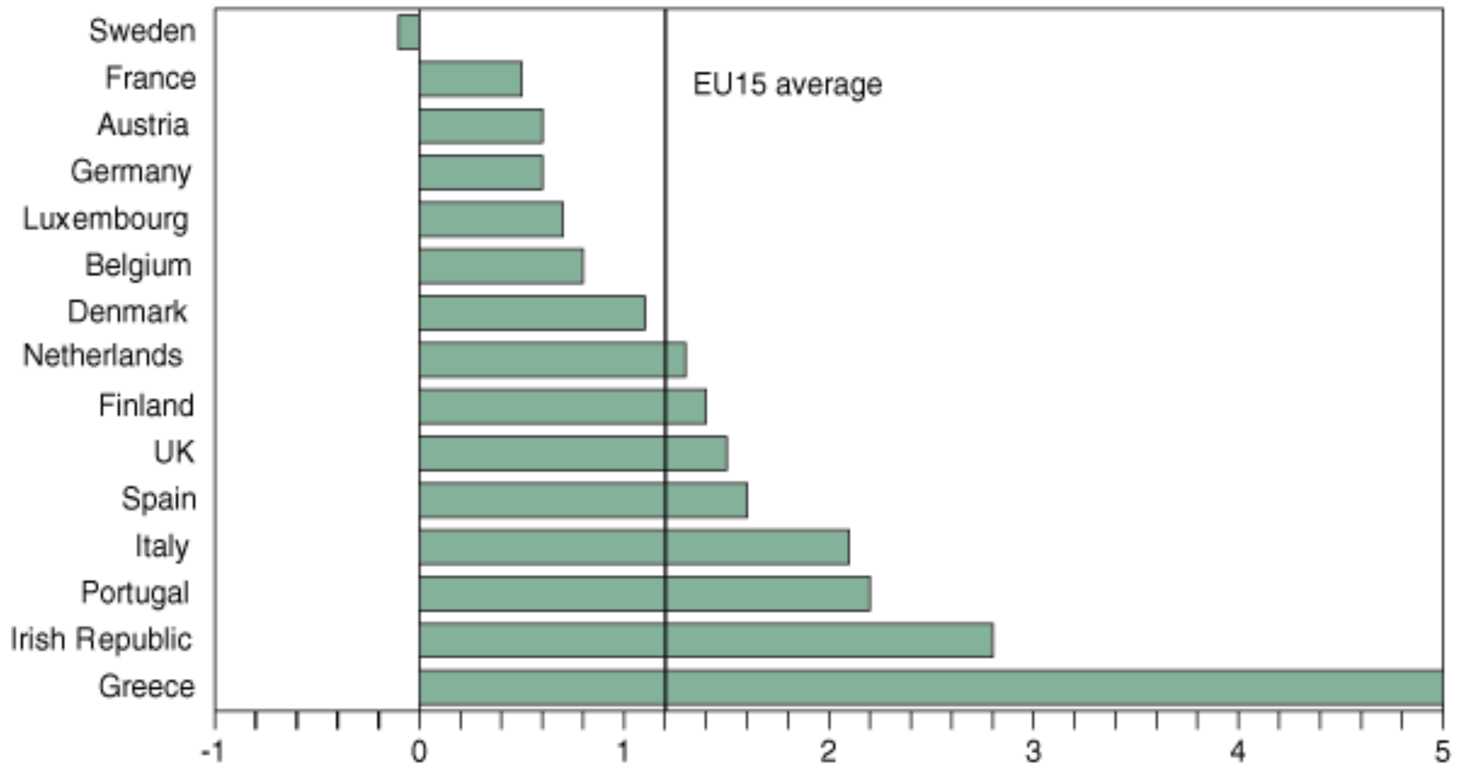
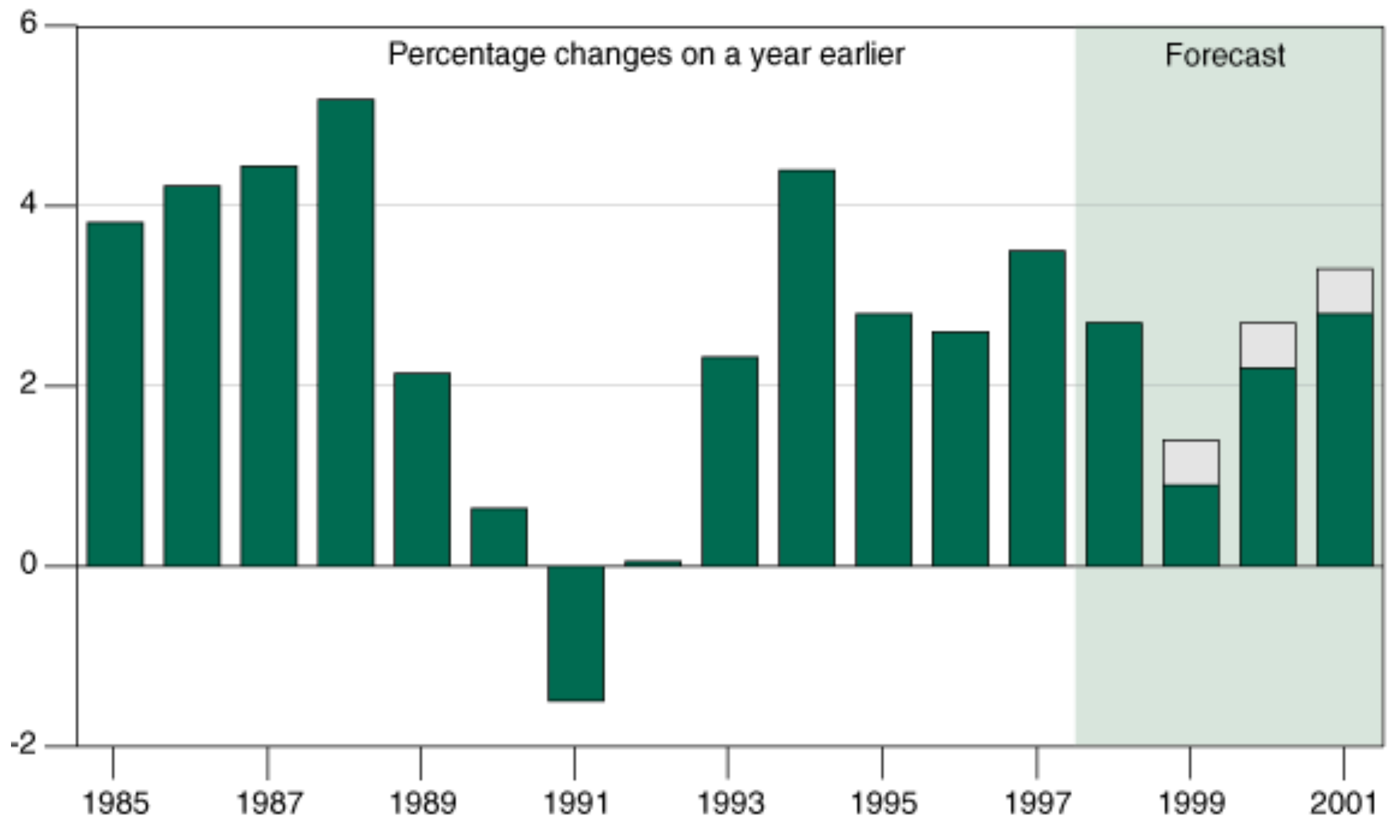

HICP inflation•
per cent (year to September)
Sweden
France
Austria
Germany
Luxembourg
Belgium
Denmark
Netherlands
Finland
UK
Spain
Italy
Portugal
Irish Republic
Greece
EU15 average
-1
0
1
2
3
4
5

**Chart 2.1 - Gross Domestic Product (GDP)[1]**



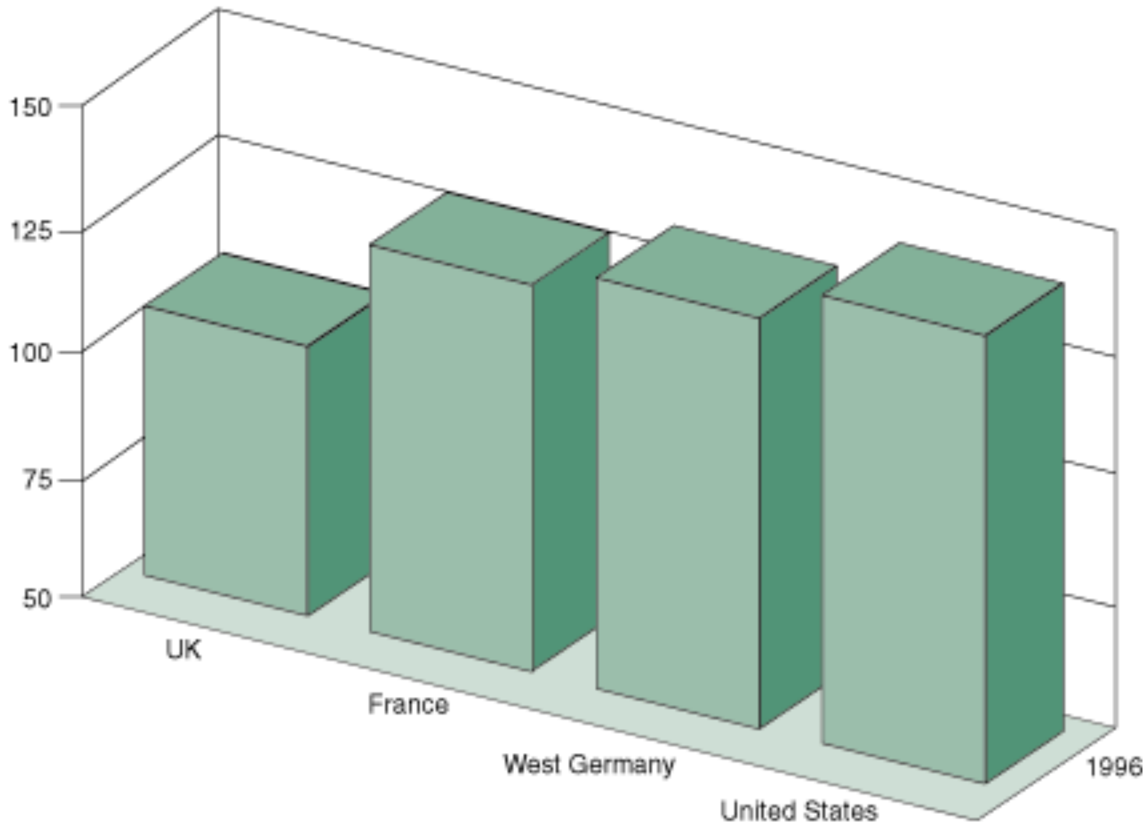


Chart 3.1 - The productivity gap•
Output per worker 1996
150
125
100
75
50
UK
France
West Germany
United States
1996

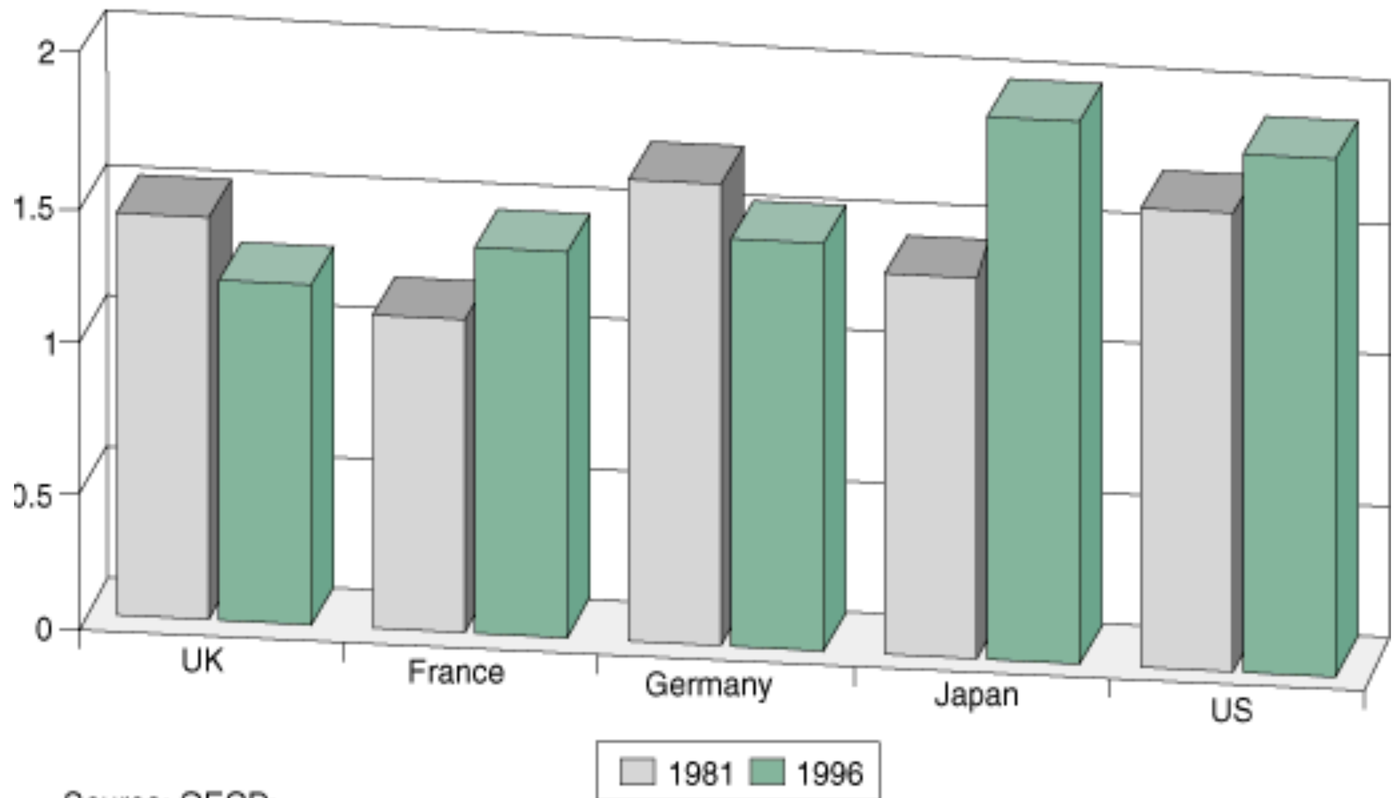


Chart 3.2 - The R&D gap
R&D Expenditure as percentage of GDP - UK 1996 =100
2
1.5
1
0.5
0
UK
France
Germany
Japan
US
1981
1996
Source: OECD
Note - German figures distorted by unification

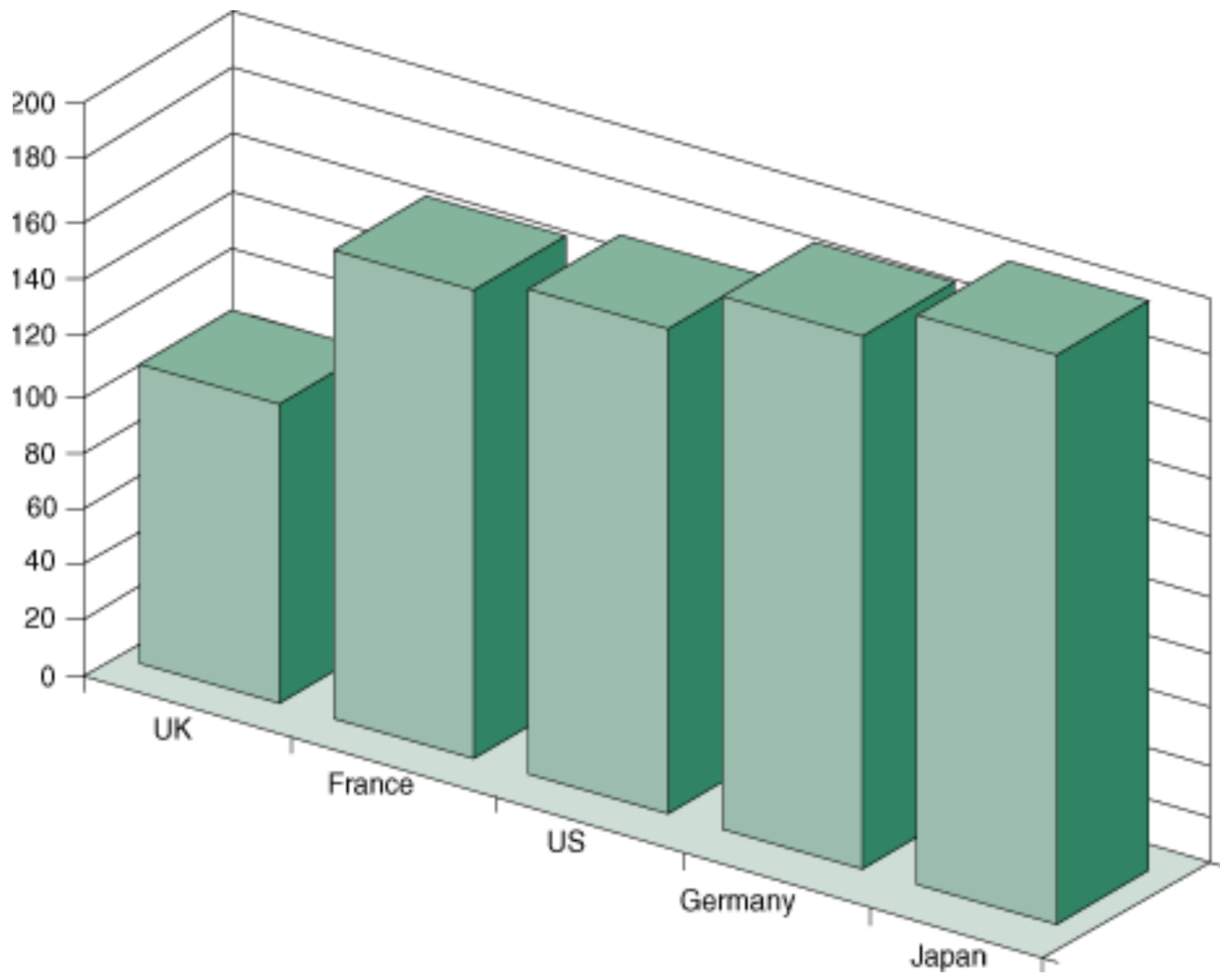
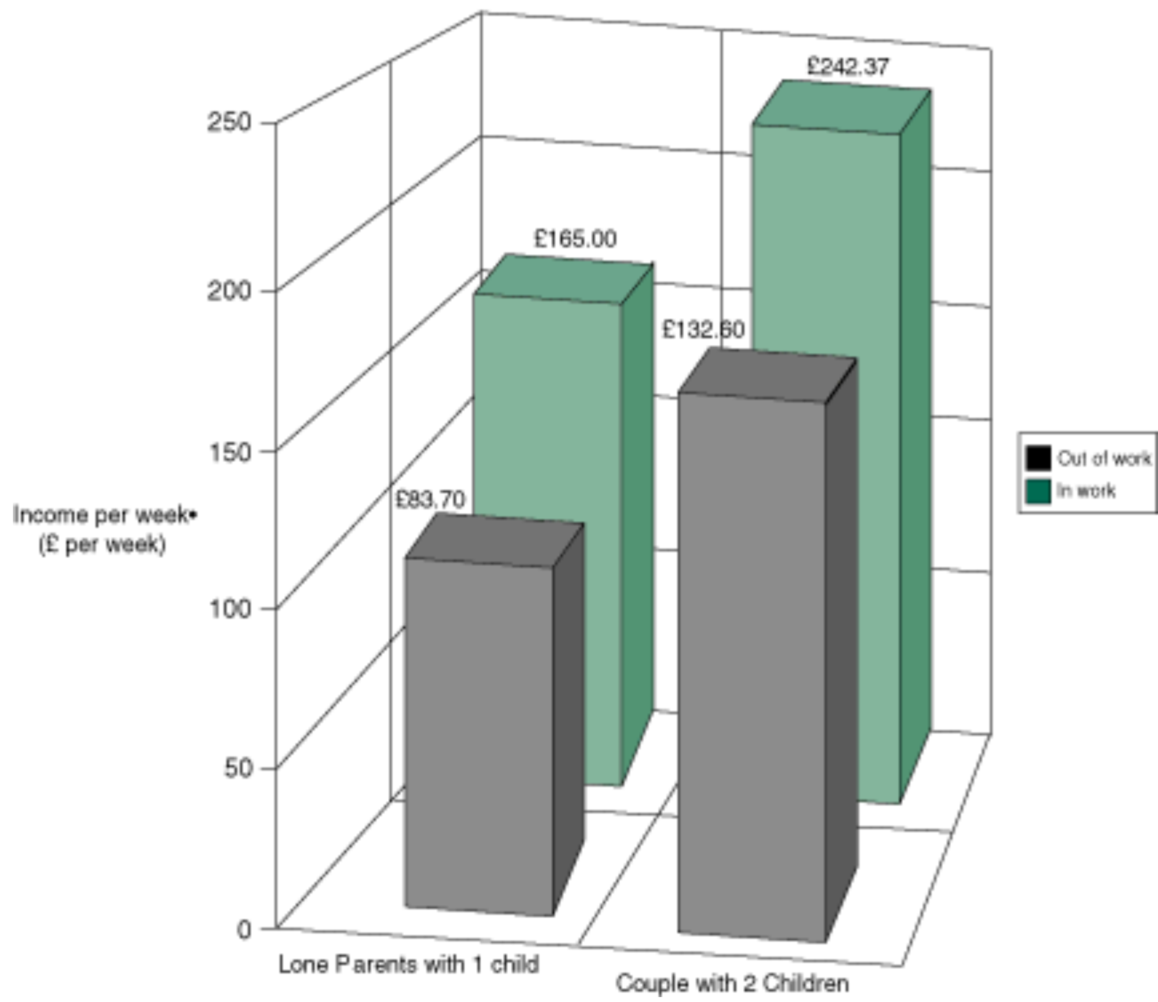

200
180
160
140
120
100
80
60
40
20
0
UK
France
US
Germany
Japan

Chart 4.1
Number of people leaving unemployment
No. of people
3,500,000
3,000,000
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
Total unemployment
No. leaving unemployment in the previous 3 months
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998


Work as the best way out of poverty•
Income per week, ignoring housing costs, at 1998-99 prices
Income per week•
(£ per week)
0
50
100
150
200
250
£83.70
£165.00
£132.60
£242.37
Lone Parents with 1 child
Couple with 2 Children
Out of work
In work

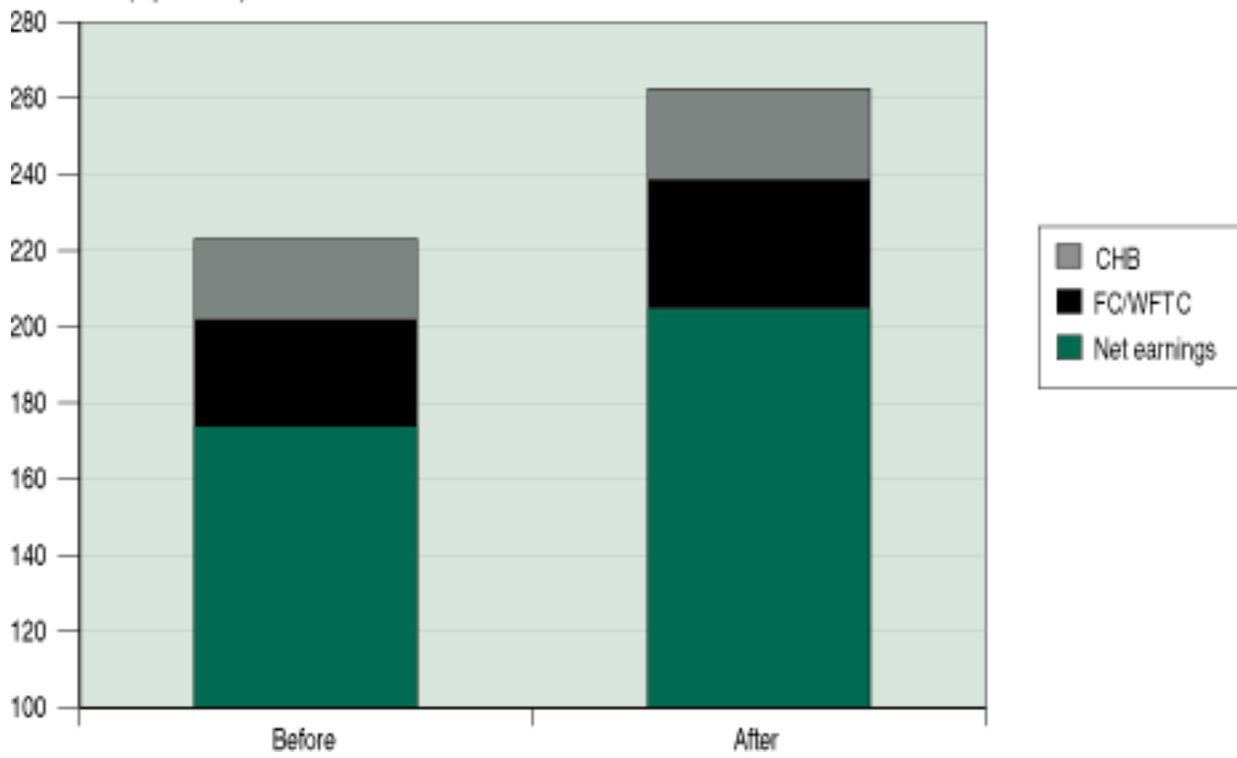

Change in the Net income as result of WFT C and NMW
Net income (£ per week)
280
260
240
220
200
180
160
140
120
100
Before
After
CHB
FC/WFTC
Net earnings

Chart 4.2 Removing the distortions in the Employer NICs System

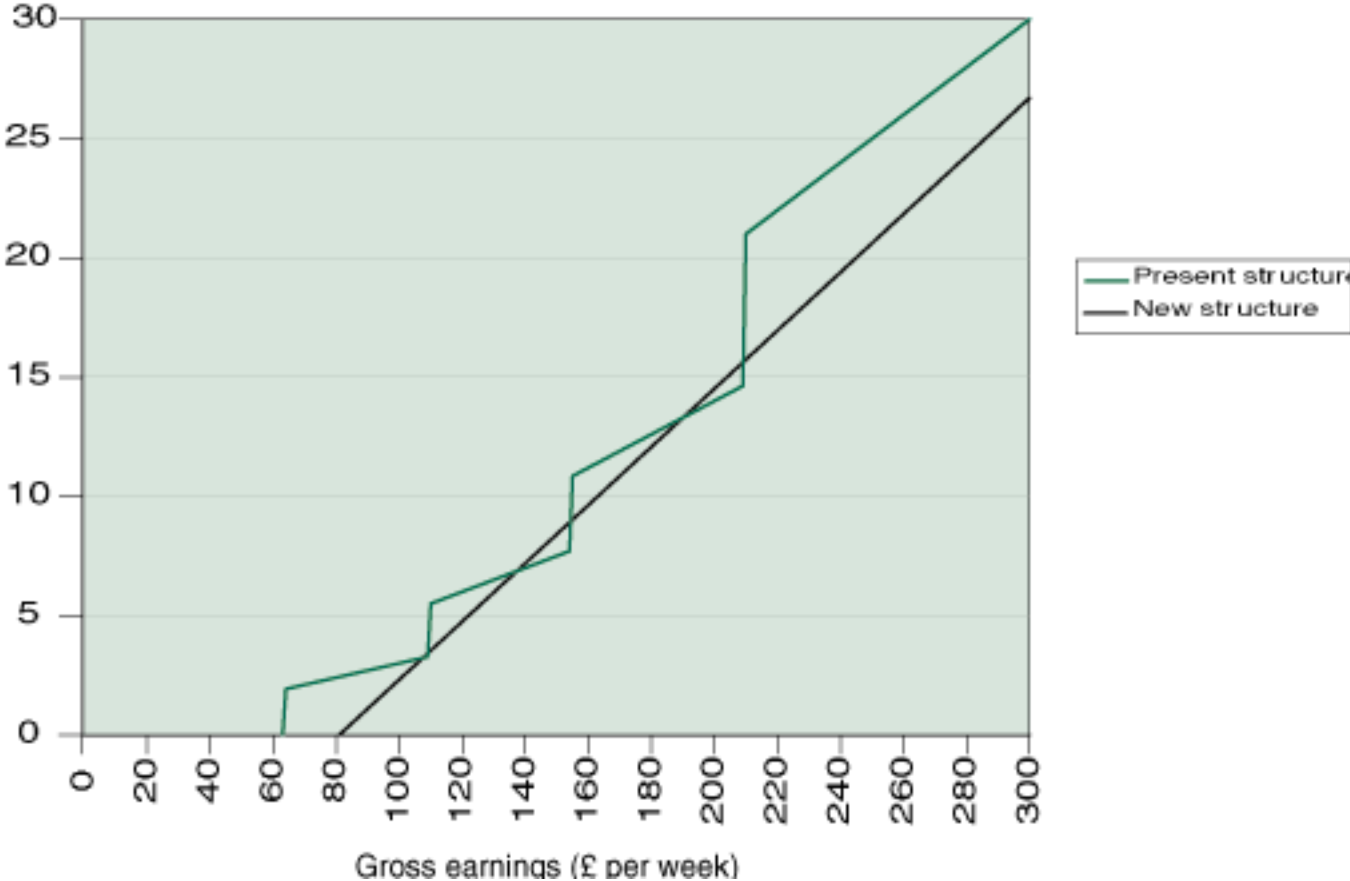


Chart 4.3 Making Work Pay for Families
Effect of the Budget and NMW on a one-earner couple with two young children

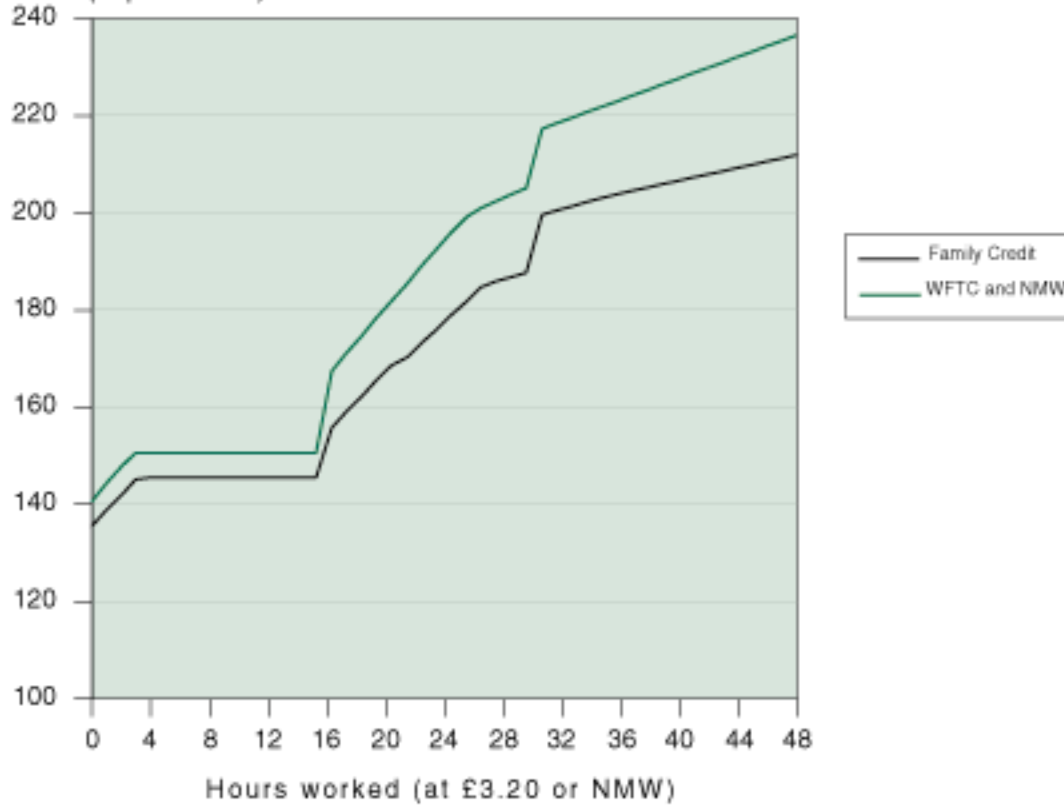


**Chart A1 - G7 GDPand world trade**

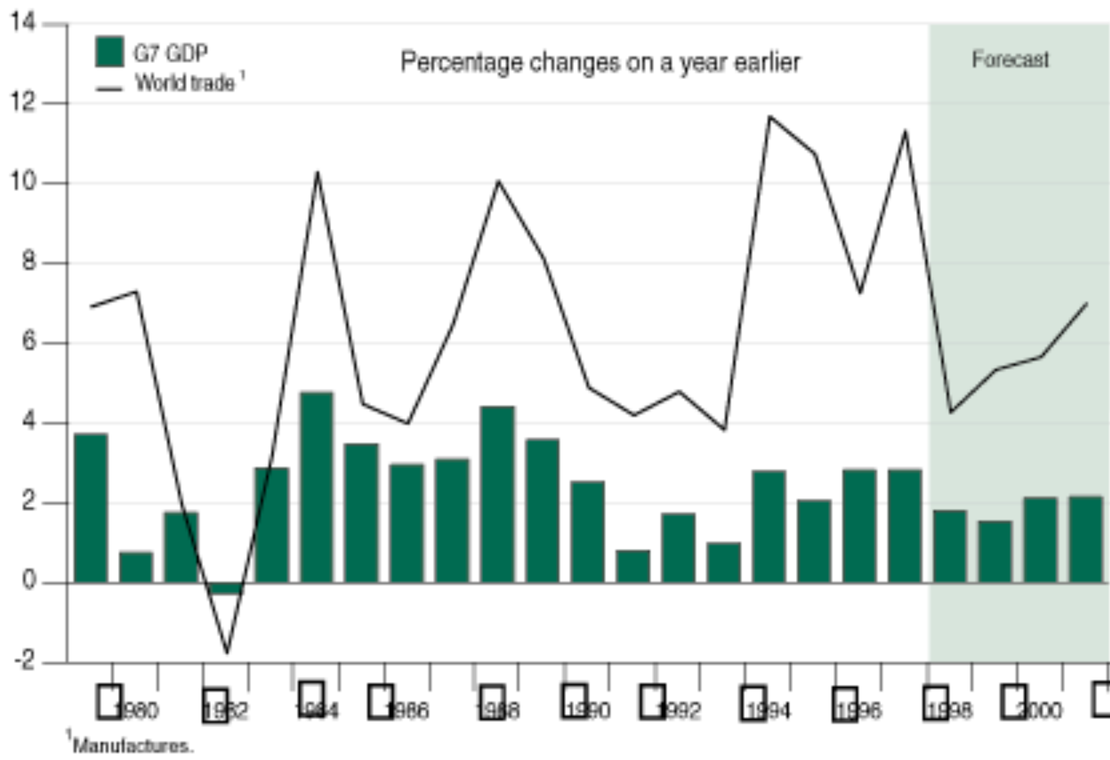
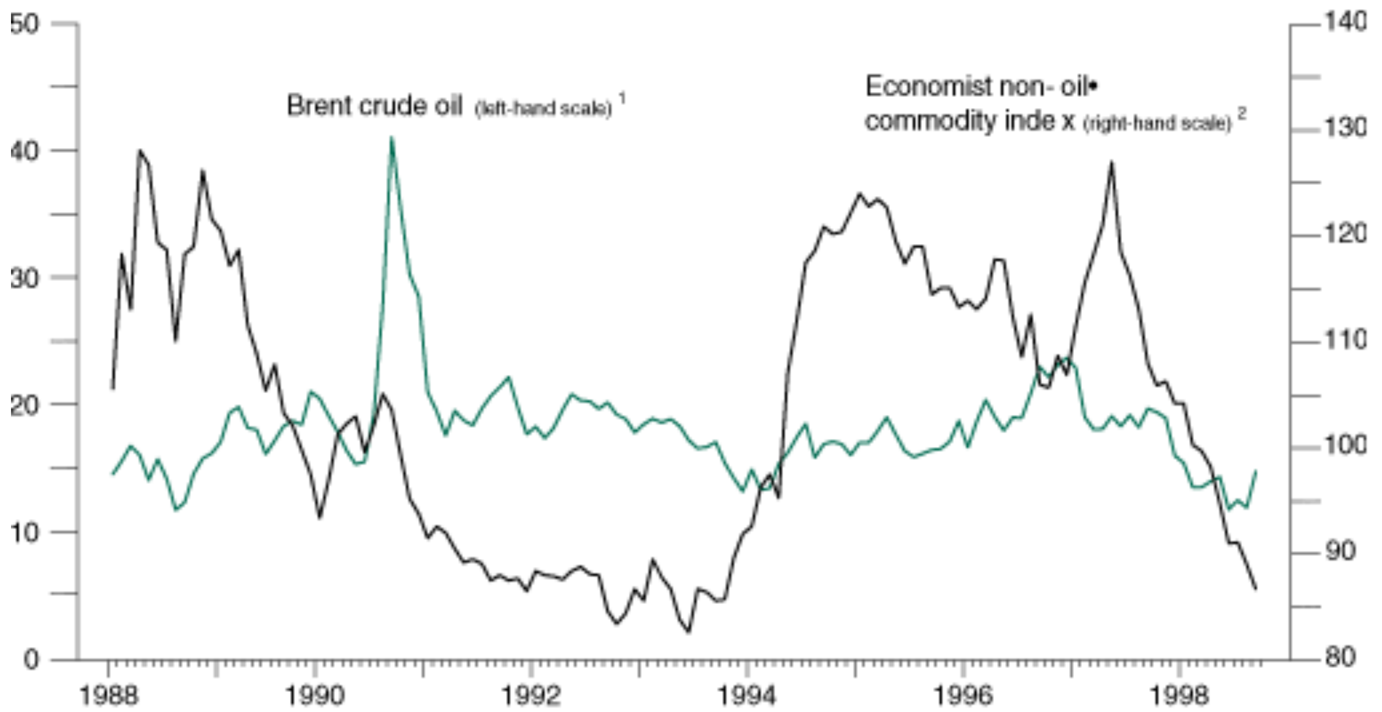


**Chart A2 - Commodity prices**




[1]Price per barrel in US dollars.
[2]1990 = 100.

**Chart A3 - Gross Domestic Product (GDP)**

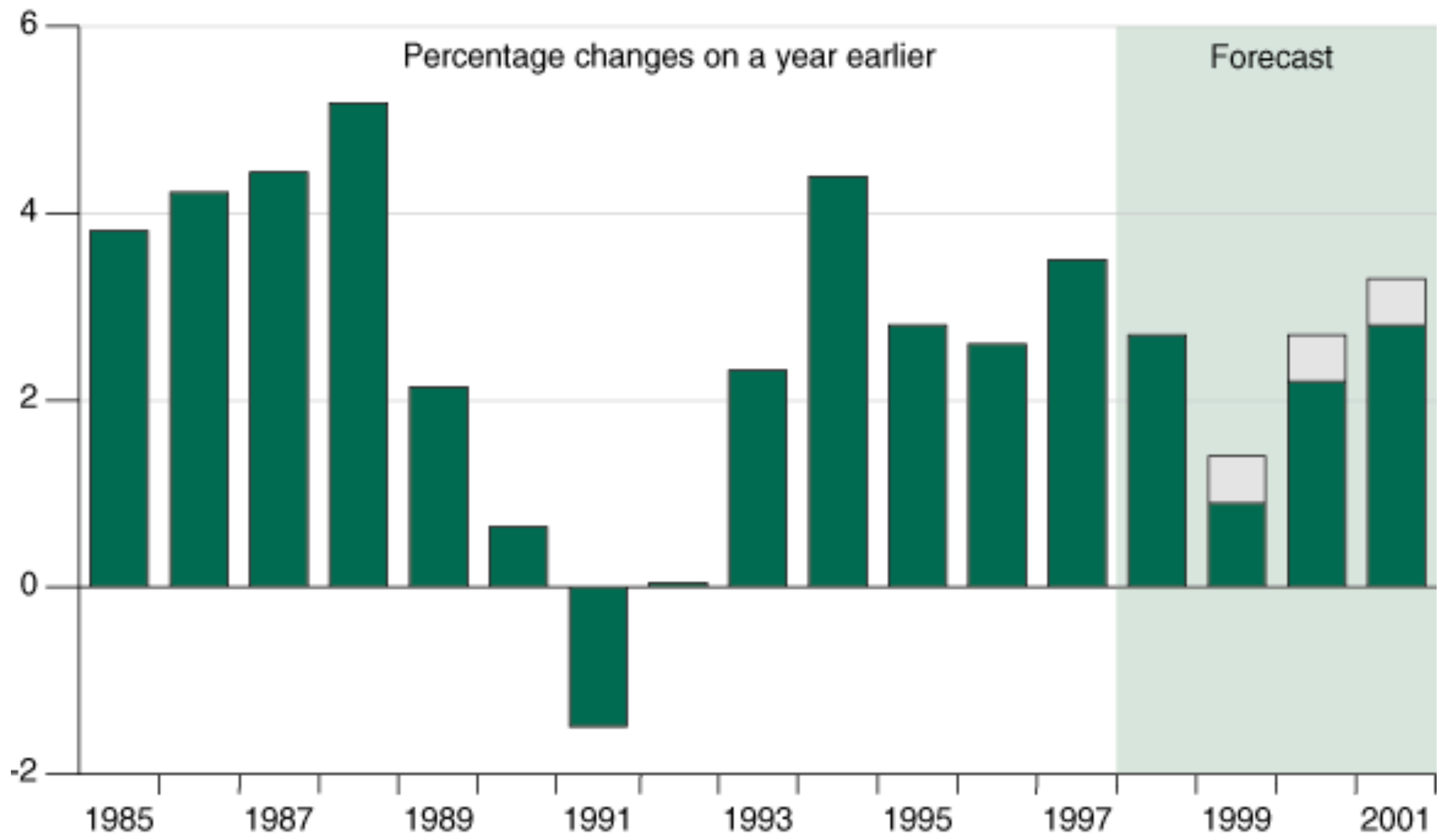


**Chart A4 - The output gap**

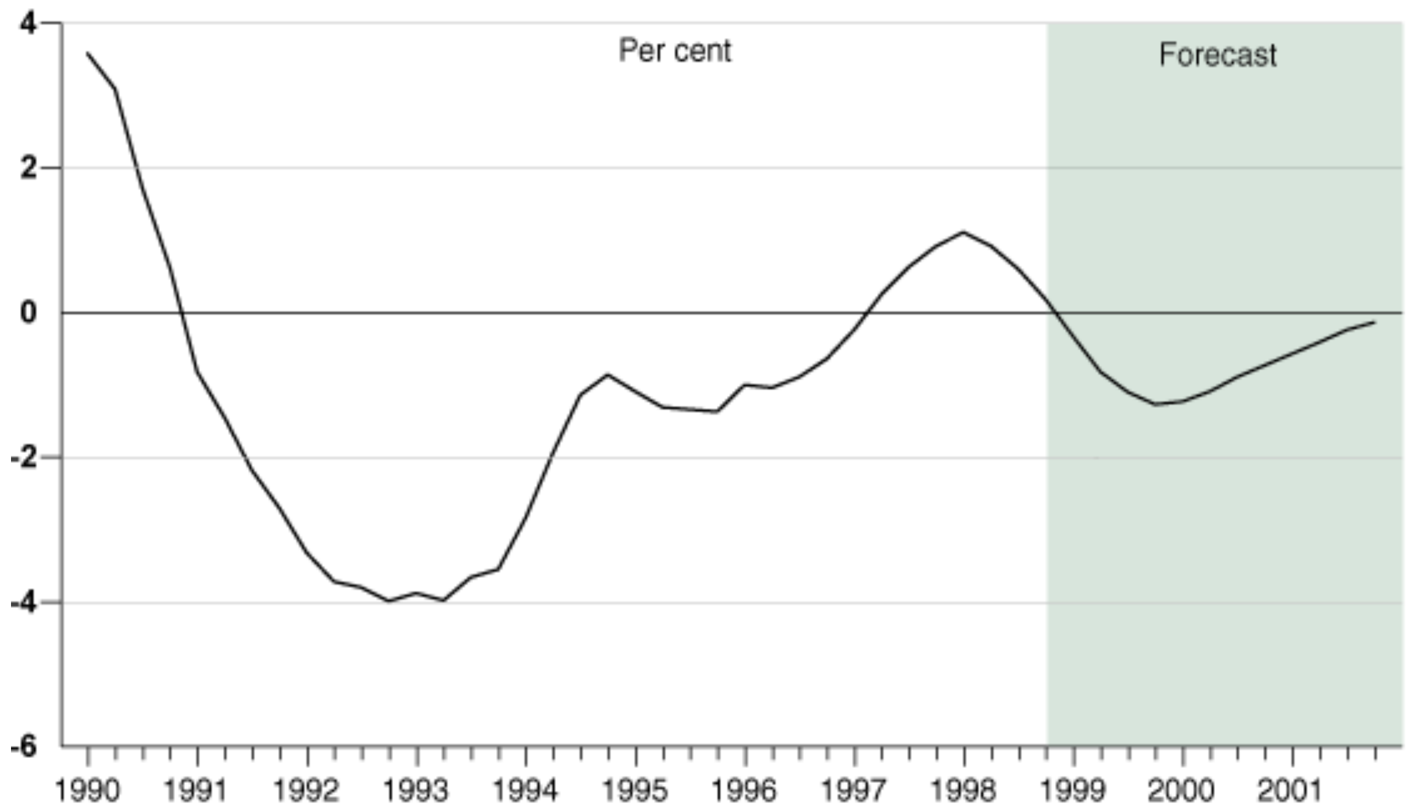


**Chart A5 - LFS employment, unemployment and participation rate**

**Chart - Private sector average earnings growth**

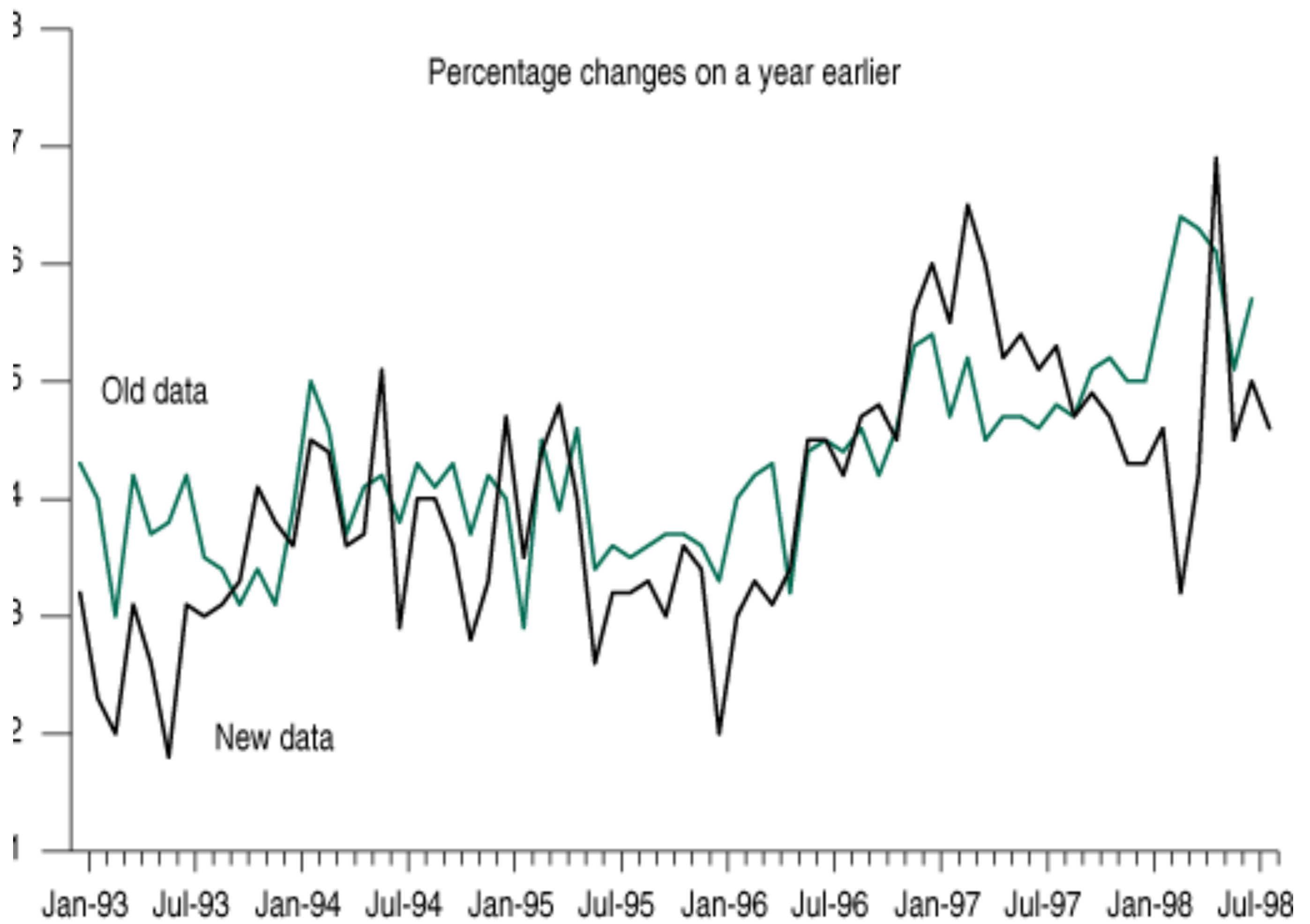


**Chart - Public sector average earnings growth**

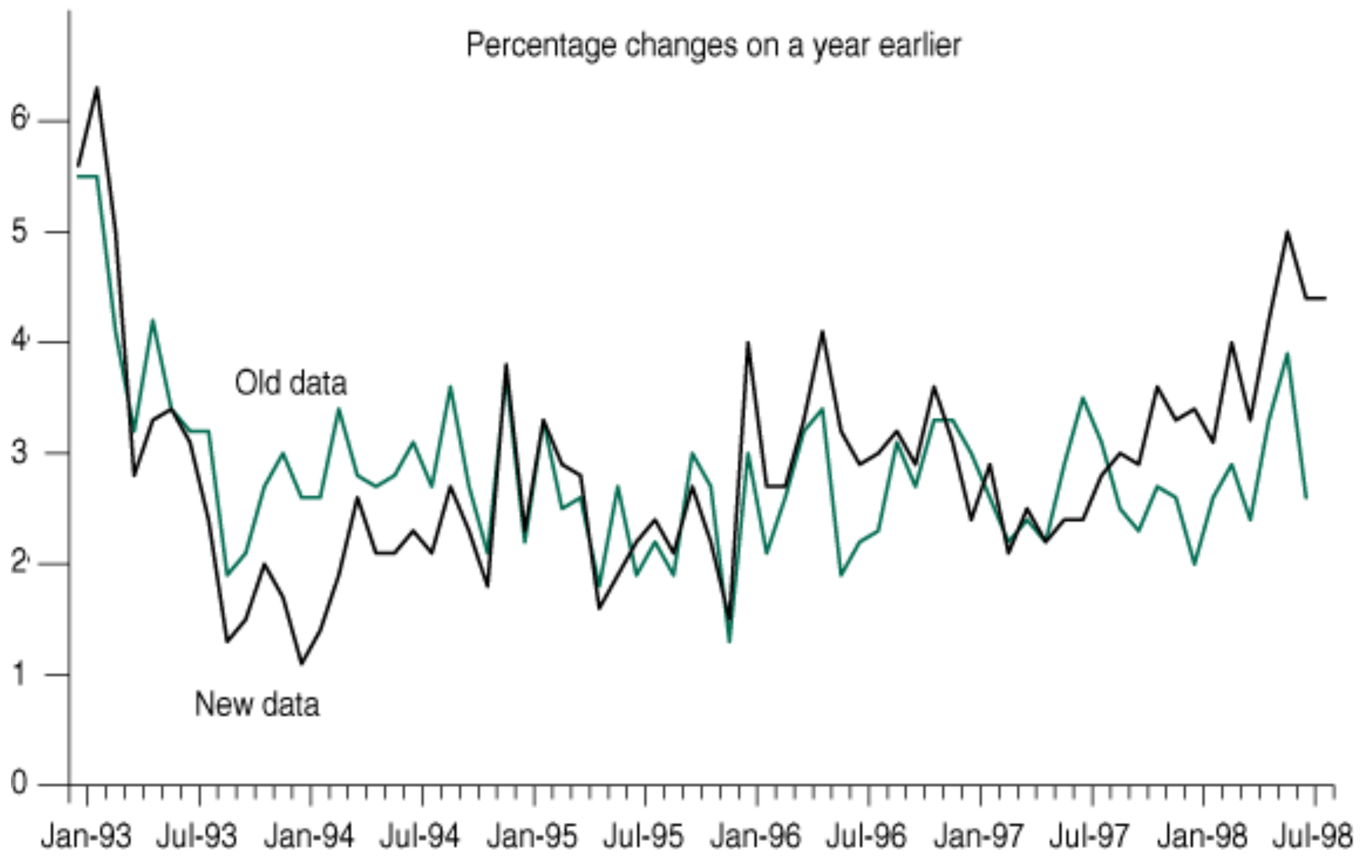
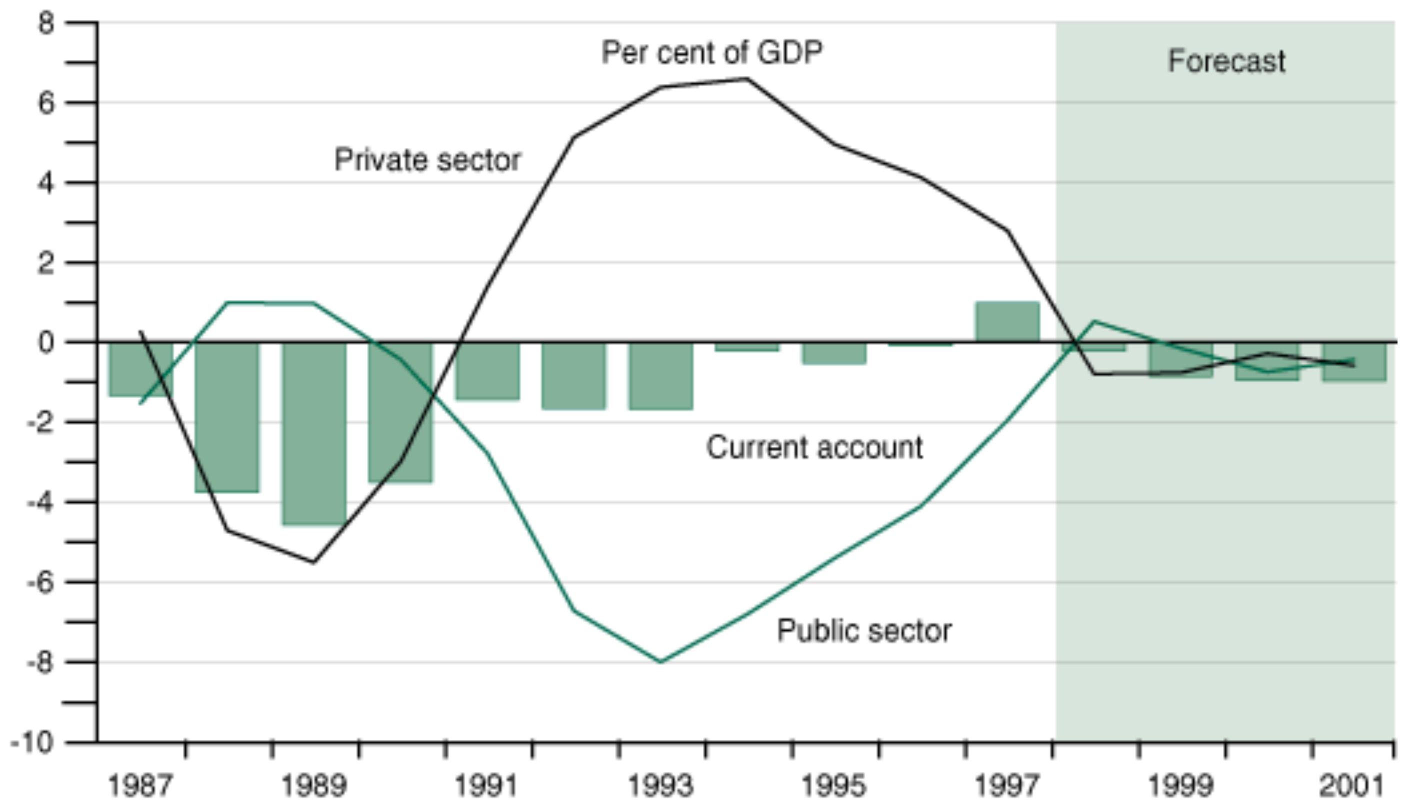


**Chart A6 - Financial balances and the current account**




[1]The projected public sector financial balance (and hence its private sector counterpart) shown here is based on the assumption of 2 1/ trend ouput growth that applies generally for the projections of the public finances.

**Chart A7 - Whole economy investment-GDP ratio**

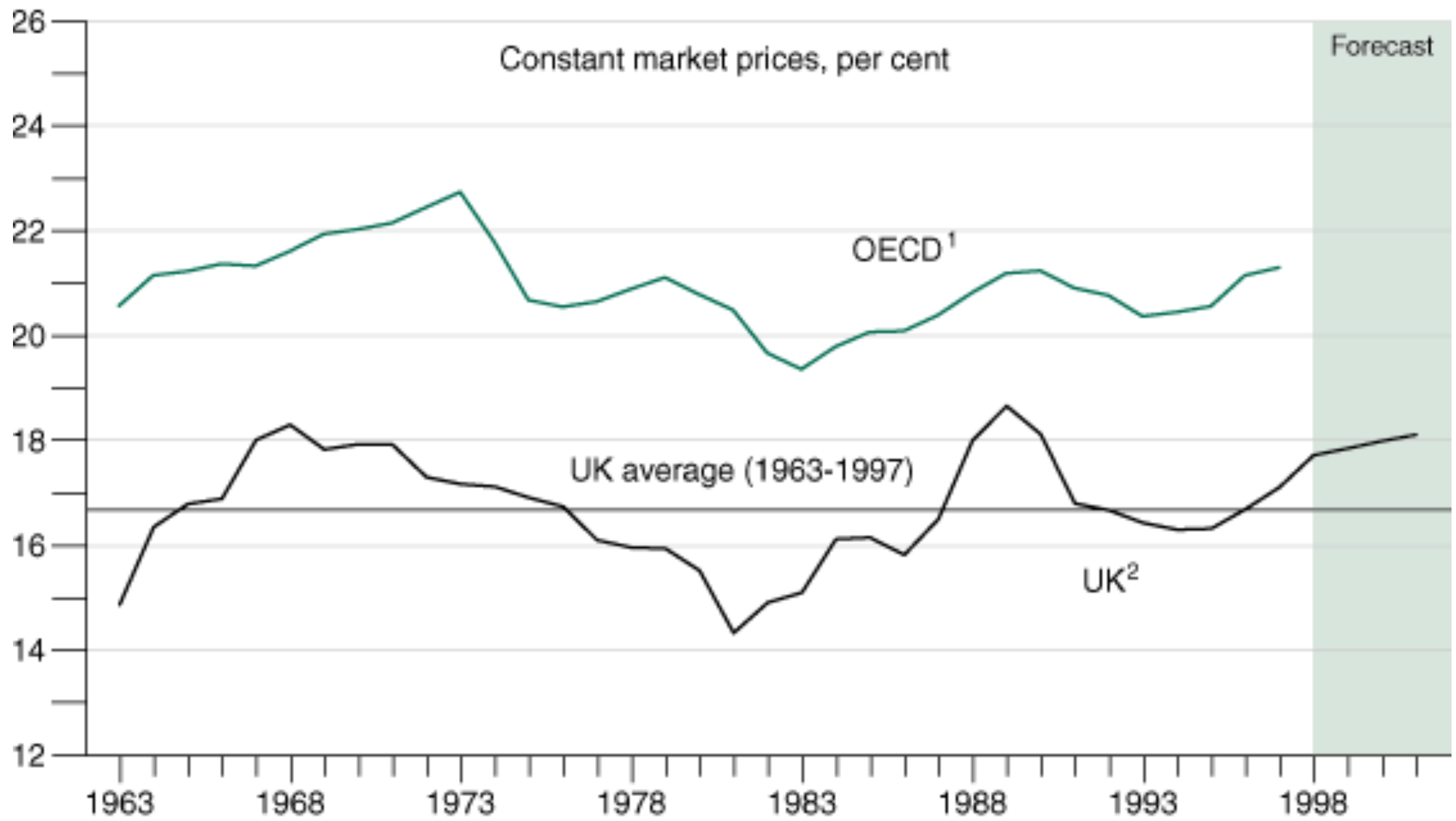
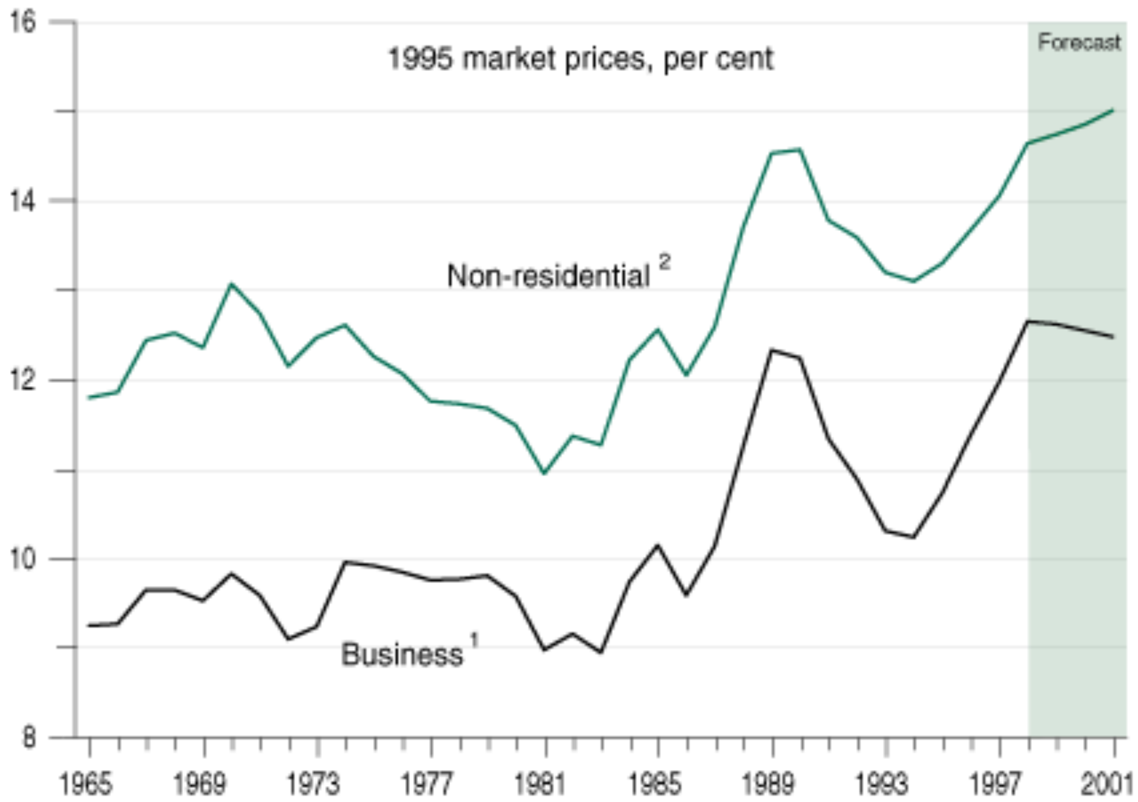


**Chart A8 - Business and non-residential investment-GDP ratios**




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

[2] Non-residential investment defined as whole economy investment less investment in dwellings.

**Chart A9 - Balance of payments current account**

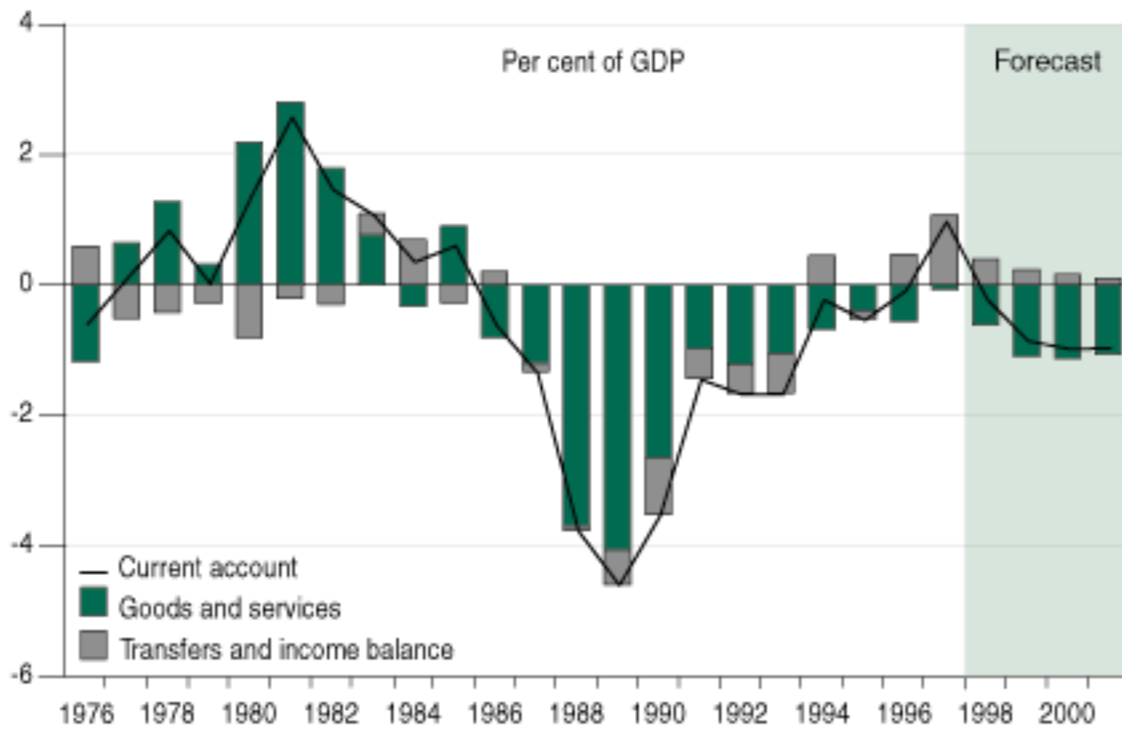


**Chart A10 - RPIX**

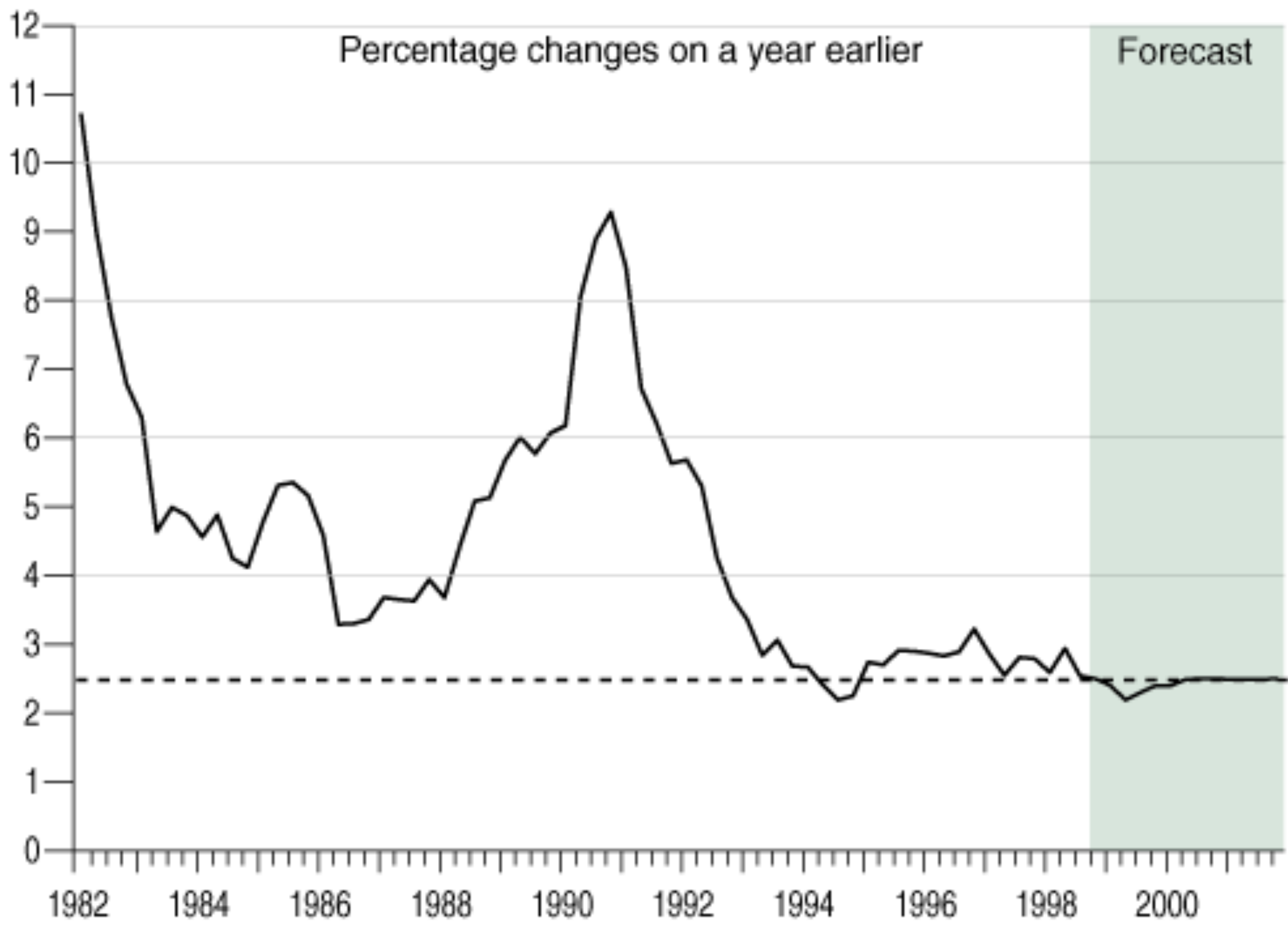


**Table A6: Pre-Budget Report and independent**[1] forecasts

Percentage changes on a year earlier unless otherwise stated

| | 1998 | | | 1999 | | |
|---|---|---|---|---|---|---|
| | | Independent | | | Independent | |
| | Pre-Budget Report | Average | Range | Pre-Budget Report | Average | R |
| Gross domestic product | 2¾ | 2·4 | 2·0 to 2·7 | 1 to 1½ | 1·1 | 0 |
| RPIX (Q4) | 2½ | 2·6 | 2·3 to 3·2 | 2½ | 2·5 | 2 |
| Current account (£billion) | -1¾ | -5·6 | -13·8 to 0·8 | -7½ | -8·7 | - |

[1]'Forecasts for the UK Economy: A Comparison of Independent Forecasts', October 1998.

A89. As always, there are considerable risks, either side of the latest forecast. Risks to the world economic outlook were examin in this annex.

A90. Nevertheless, as far as individual countries are concerned, nothing is more important for maintaining stability than the pur prudent economic policies that ensure an economy is capable of sustained and steady growth in the face of external shocks.

A91. On the domestic side, consumer confidence is at its long-run average, and the household wealth-income ratio remains histo addition, real income growth is relatively strong at the moment. If the saving ratio falls more sharply than expected, on the back financial position of the household sector, growth in private consumption might, in turn, be stronger.

A92. The forecast assumes that the exchange rate moves in line with an uncovered interest parity condition. A somewhat lower level of the exchange rate could result in higher import prices, which could put upward pressure on UK inflation. Other things ec UK exports would also be boosted in the near-term.

A93. As the recent statement of G7 Finance Ministers and Central Bank Governors made clear, G7 countries are striving to crea conditions for sustainable growth in their own economies. This is likely to entail more aggressive use of monetary policy than ot Bank of England's Monetary Policy Committee mentioned the deterioration of the international economic and financial environm October statement on their decision to reduce interest rates. A greater easing of interest rates across G7 countries than expected v significant implications for the UK economic outlook.

**Table A7: Summary of economic prospects**[1]

Percentage changes on a year earlier unless otherwise stated

| | Average errors from past Forecast[2] | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| **Output at constant market prices[4]** | | | | | |
| Gross domestic product (GDP) | 3½ | 2¾ | 1 to 1½ | 2¼ to 2¾ | 2¾ to 3¼ |
| Manufacturing output | 1 | ¼ | -¼ to ¼ | ¾ to 1¼ | 2 to 2½ |
| **Expenditure components of GDP at constant market prices[4]** | | | | | |
| Domestic demand | 4 | 4 | 1½ to 2 | 2¼ to 2¾ | 2¾ to 3¼ |
| Houshold consumption[5] | 4¼ | 3 | 1¾ to 2¼ | 2¼ to 2¾ | 2¼ to 2¾ |
| General government consumption | 0 | 2¼ | 2½ | 1¾ | 2¼ |
| Fixed investment | 6 | 6¼ | 1¾ to 2¼ | 3 to 3½ | 3½ to 4 |
| Change in inventories[6] | ¼ | ½ | -½ to -¼ | 0 | ¼ |
| Exports of goods and services | 8½ | 3¼ | 2¾ to 3¼ | 4¾ to 5¼ | 6 to 6½ |
| Imports of goods and services | 9½ | 7¼ | 4¼ to 4¾ | 4½ to 5 | 5½ to 6 |
| **Balance of payments current account** | | | | | |
| £ billion | 8 | -1¾ | -7½ | -8¾ | -9¼ |
| per cent of GDP | 1 | -¼ | -¾ | -1 | -1 |
| **Inflation** | | | | | |
| RPI excluding mortgage interest payments (RPIX) (Q4) | 2¾ | 2½ | 2½ | 2½ | 2½ |
| Producer output prices (Q4)7 | -¼ | -¾ | ½ | 1¾ | 2¼ |
| GDP deflator at market prices (financial year) | 2½ | 2¾ | 2½ | 2½ | 2½ |
| **Money GDP at market prices (financial year)** | | | | | |
| £ billion | 814 | 855 | 884 to 890 | 930 to 940 | 979 to 994 |
| percentage change | 6½ | 5 | 3½ to 4 | 5 to 5½ | 5¼ to 5¾ |

[1]Data in this chapter are consistent with the national accounts and balance of payments statistics to the second quarter of 1998 r
Office for National Statistics on 24 September 1998, and the preliminary GDP estimate for the third quarter released on 23 Octo

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

[3]Average absolute errors in autumn forecasts over the past ten years; they apply to forecasts for 1999. The average errors for the
are calculated as a percent of GDP. The £ billion figures are calculated by scaling the errors as a percent of GDP by money GDP

[4]Further detail on GDP and its components is given in Table A8.

[5]Includes households and non-profit institutions serving households.

[6]Contribution to GDP growth, percentage points.

[7]Excluding excise duties.

**Table A8: Gross domestic product and its components**

| General | Exports | Less imports of | Plus |
|---|---|---|---|

| | Household consumption1 | government consumption | Fixed investment | Change in inventories | Domestic demand | of goods and services | Total final expenditure | goods and services | statist discre |
|---|---|---|---|---|---|---|---|---|---|
| **1997** | 490·6 | 142·9 | 129·5 | 3·1 | 765·8 | 236·0 | 1,001·8 | 245·2 | -0·5 |
| **1998** | 505·4 | 146·2 | 137·7 | 6·9 | 796·2 | 243·5 | 1,039·7 | 262·7 | 0·0 |
| **1999** | 513·8 to 516·3 | 150·0 | 140·0 to 140·7 | 3·9 to 4·6 | 807·7 to 811·6 | 250·4 to 251·6 | 1,058·1 to 1,063·2 | 274·0 to 275·4 | 0·0 |
| **2000** | 525·6 to 530·8 | 152·6 | 144·1 to 145·6 | 3·0 to 4·5 | 825·4 to 833·5 | 262·1 to 264·7 | 1,087·5 to 1,098·2 | 286·4 to 289·2 | 0·0 to |
| **2001** | 538·1 to 545·8 | 156·1 | 149·3 to 151·4 | 5·0 to 7·2 | 848·4 to 860·5 | 277·9 to 281·9 | 1,126·3 to 1,142·4 | 302·5 to 306·8 | 0·0 to |
| **1997** 1st half | 242·9 | 71·3 | 63·3 | 1·0 | 378·5 | 115·9 | 494·4 | 119·8 | -0·2 |
| 2nd half | 247·7 | 71·5 | 66·1 | 2·1 | 387·3 | 120·0 | 507·4 | 125·4 | -0·3 |
| **1998** 1st half | 251·2 | 72·7 | 68·6 | 2·7 | 395·1 | 121·1 | 516·2 | 129·3 | 0·0 |
| 2nd half | 254·2 | 73·5 | 69·1 | 4·2 | 401·0 | 122·5 | 523·5 | 133·5 | 0·0 |
| **1999** 1st half | 255·9 to 256·8 | 74·0 | 69·7 to 70·0 | 3·0 to 3·2 | 402·6 to 404·0 | 124·2 to 124·6 | 526·7 to 528·6 | 135·8 to 136·2 | 0·0 |
| 2nd half | 257·9 to 259·5 | 75·9 | 70·3 to 70·8 | 1·0 to 1·4 | 405·2 to 407·6 | 126·2 to 127·0 | 531·4 to 534·6 | 138·3 to 139·1 | 0·0 |
| **2000** 1st half | 261·0 to 263·3 | 75·5 | 71·4 to 72·0 | 1·9 to 2·5 | 409·8 to 413·3 | 129·2 to 130·3 | 539·0 to 543·6 | 141·3 to 142·6 | 0·0 |
| 2nd half | 264·6 to 267·5 | 77·2 | 72·7 to 73·5 | 1·2 to 2·0 | 415·6 to 420·2 | 132·9 to 134·3 | 548·5 to 554·6 | 145·0 to 146·6 | 0·0 |
| **2001**1st half | 267·6 to 271·2 | 77·3 | 74·0 to 75·0 | 2·5 to 3·6 | 421·4 to 427·1 | 136·9 to 138·7 | 558·2 to 565·8 | 149·1 to 151·2 | 0·0 |
| 2nd half | 270·5 to 274·6 | 78·8 | 75·3 to 76·4 | 2·5 to 3·7 | 427·1 to 433·4 | 141·0 to 143·1 | 568·1 to 576·6 | 153·3 to 155·6 | 0·0 |

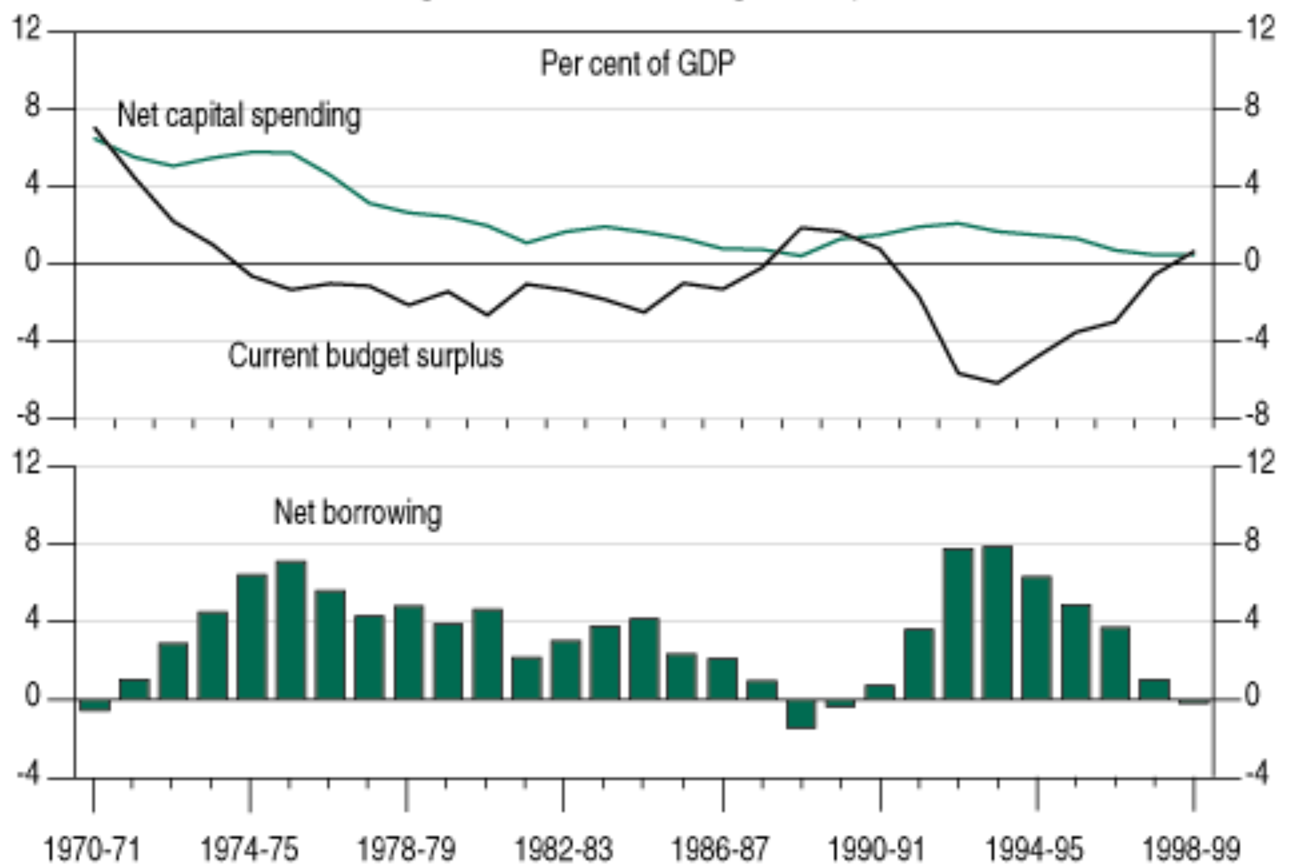
| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Percentage changes on a year earlier[3] | | | | | |
| **1997** | 4¼ | 0 | 6 | ¼ | 4 | 8½ | 5 | 9½ | 0 |
| **1998** | 3 | 2¼ | 6¼ | ½ | 4 | 3¼ | 3¾ | 7¼ | 0 |
| **1999** | 1¾ to 2¼ | 2½ | 1¾ to 2¼ | -½ to -¼ | 1½ to 2 | 2¾ to 3¼ | 1¾ to 2¼ | 4¼ to 4¾ | 0 |
| **2000** | 2¼ to 2¾ | 1¾ | 3 to 3½ | 0 | 2¼ to 2¾ | 4¾ to 5¼ | 2¾ to 3¼ | 4½ to 5 | 0 |
| **2001** | 2¼ to 2¾ | 2¼ | 3½ to 4 | ¼ | 2¾ to 3¼ | 6 to 6½ | 3½ to 4 | 5½ to 6 | 0 |

[1]*Includes households and non-profit institutions serving households*.

[2]*Expenditure adjustment*.

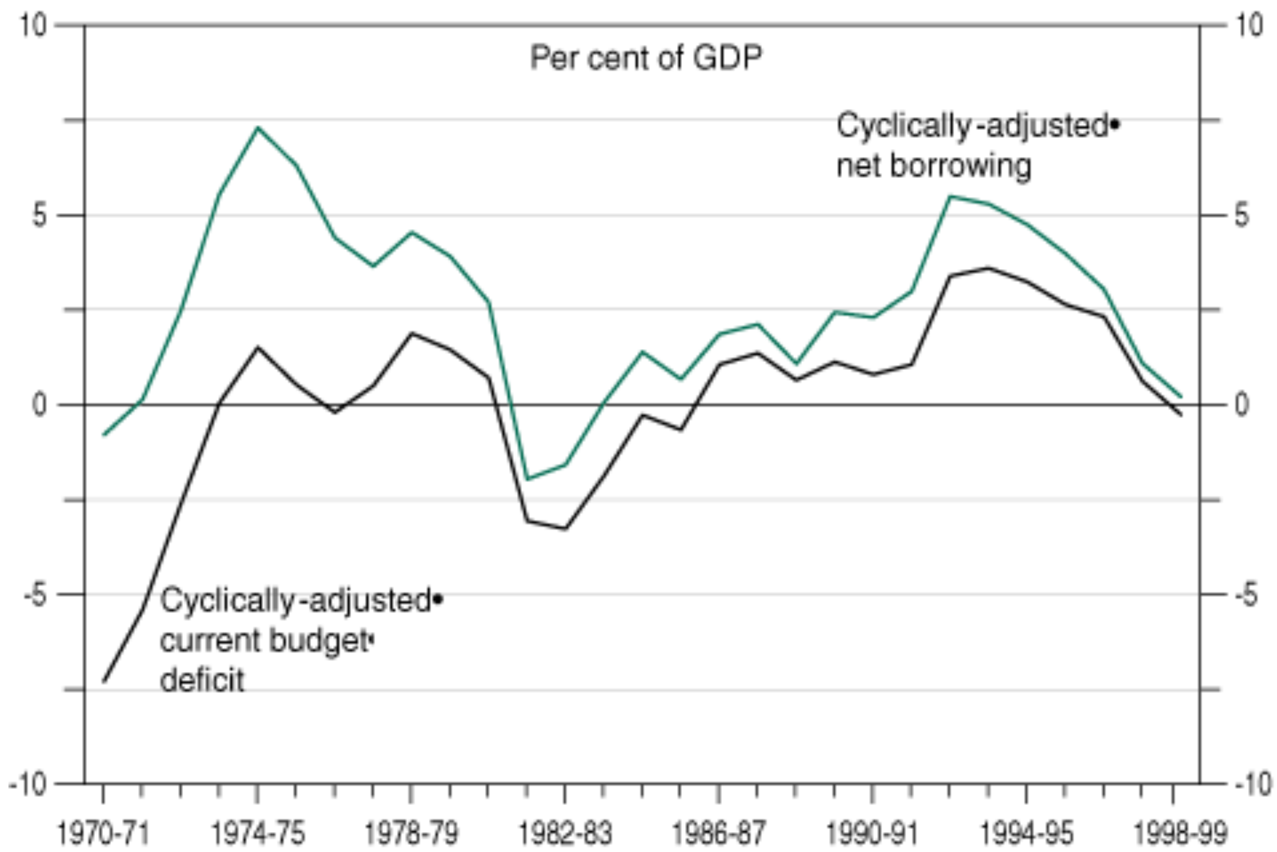
[3]*For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.*

Chart B1: Net borrowing and current budget surplus [1]




[1] Net borrowing and current budget surplus exclude windfall tax receipts and associated spending

Chart B2: Cyclically -adjusted current budget deficit and net borrowing[1]




[1] Excluding windfall tax and associated spending

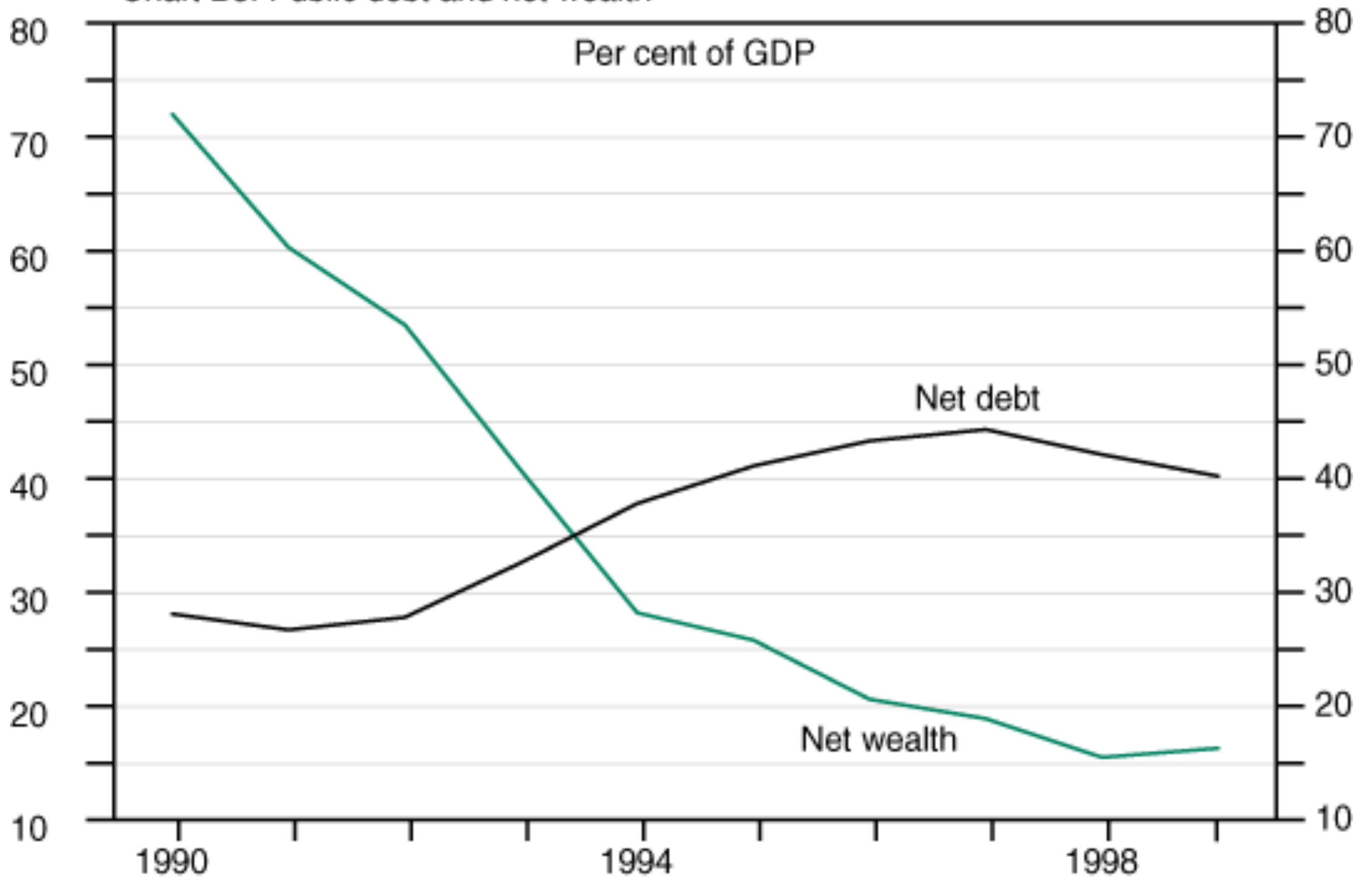


Chart B3: Public debt and net wealth
Per cent of GDP
Net debt
Net wealth
80
70
60
50
40
30
20
10
1990
1994
1998

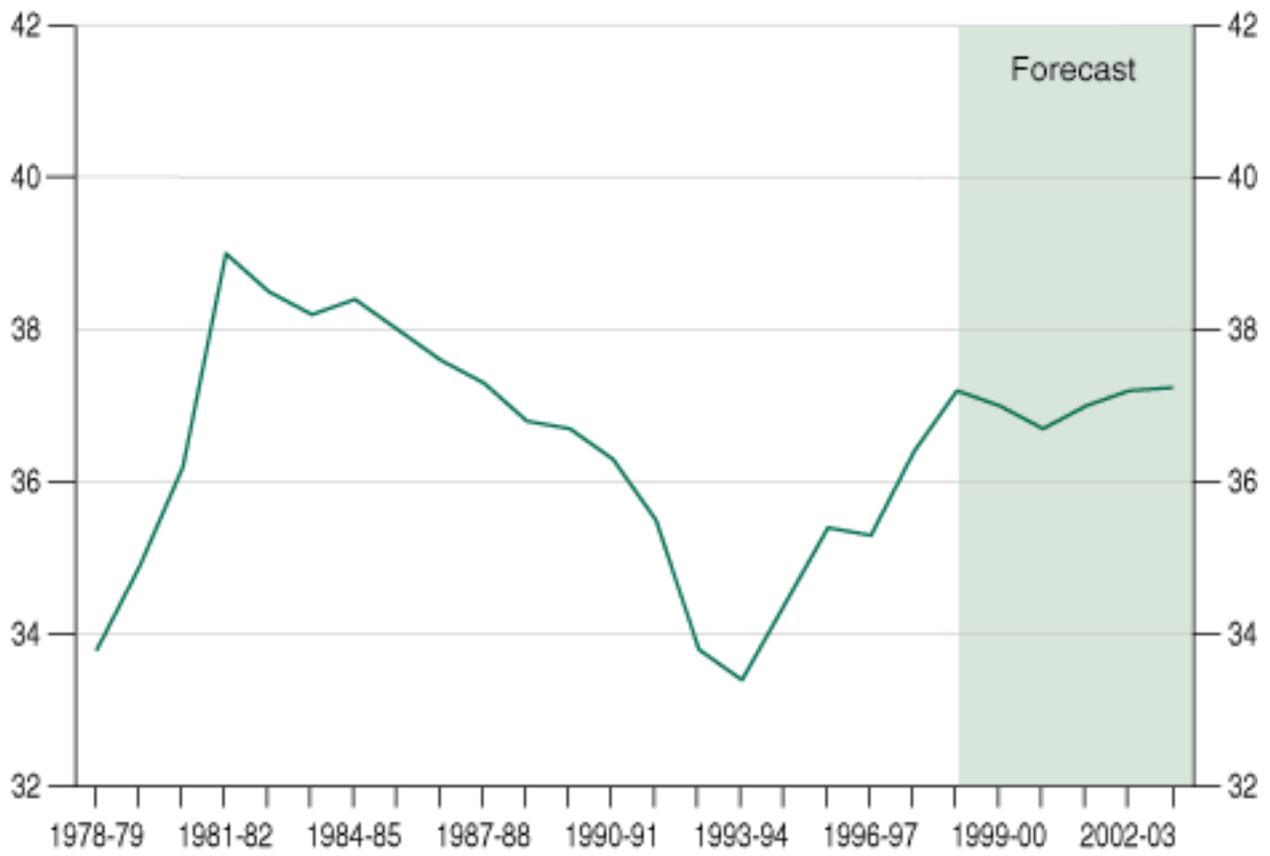
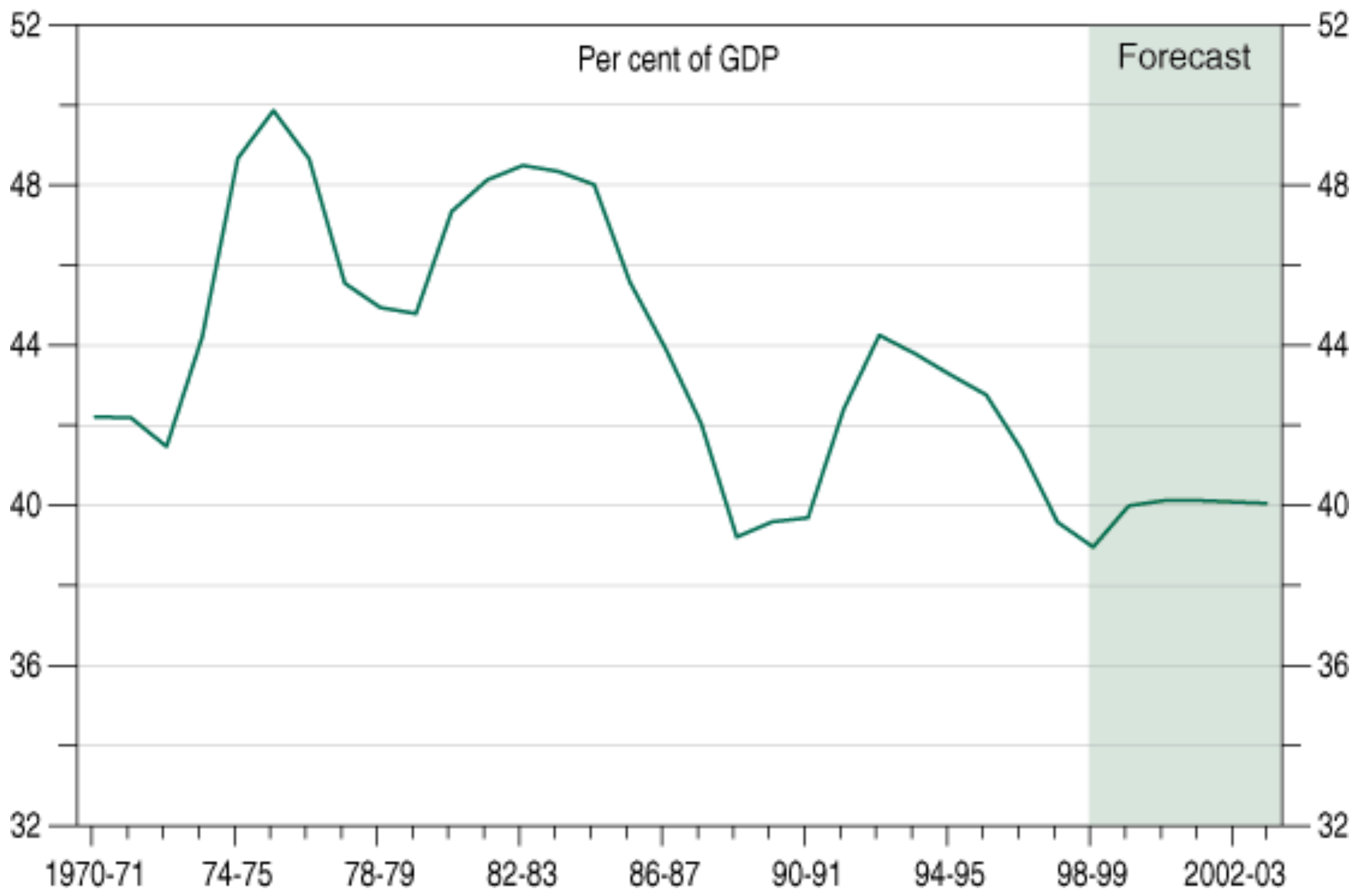


Chart B4: Tax/GDP ratio [1]
42
40
38
36
34
32
Forecast
1978-79
1981-82
1984-85
1987-88
1990-91
1993-94
1996-97
1999-00
2002-03
[1] Net taxes and social security contributions as defined in T able B10


Per cent of GDP
Forecast
52
48
44
40
36
32
1970-71
74-75
78-79
82-83
86-87
90-91
94-95
98-99
2002-03

B19. Over the three-year planning period from 1999-2000, DEL is essentially unchanged from the CSR. However the forecasts AME have been updated. The biggest change since the CSR is a downward revision to the forecast of social security expenditure lower outturns for the current year. Debt interest is higher and accounting adjustments are lower - but these changes mainly refle reclassifications. The net result of all the changes is to reduce the forecast sum of AME components by £2¼ to £3¾ billion acros decision has been taken to reflect this reduction in forecast expenditure in a higher AME Margin - a provision for uncertainty for AME components rather than a lower TME total (and hence higher current budget surplus). It is a deliberately cautious policy, ir Report, to stick to the total provision for public spending published in the CSR. The figures will be reviewed again at the time of

**Table B12: Total Managed Expenditure 1997**-98 to 2001-02

| | 1997-98 | 1998-99 | 199 |
|---|---|---|---|
| | | £ billion | |
| **Departmental Expenditure Limits** | **162·7** | **169·2** | **179** |
| **Annually Managed Expenditure** | | | |
| Social Security Benefits | 91·0 | 94·0 | 98·' |
| Housing Revenue Account subsidies | 4·0 | 3·7 | 3·5 |
| Common Agricultural Policy | 2·4 | 2·6 | 2·6 |
| Export Credits Guarantee Department | 0·0 | 0·1 | 0·1 |
| Net Payment to EC Institutions**1** | 2·0 | 3·4 | 2·8 |
| Self-financing Public Corporations | -0·3 | -0·2 | -0·2 |
| Locally Financed Expenditure | 15·0 | 15·8 | 16·' |
| Net Public Service Pensions | 5·3 | 5·7 | 6·1 |
| National Lottery | 0·8 | 1·4 | 2·6 |
| Central Government Gross Debt Interest | 29·8 | 29·5 | 28·: |
| Accounting and other adjustments | 9·2 | 7·8 | 9·9 |
| AME Margin | 0·0 | 0·0 | 3·0 |
| **Annually Managed Expenditure** | **159·3** | **163·8** | **174** |
| **Total Managed Expenditure** | **322·1** | **333·0** | **353** |
| of which: | | | |
| *Current expenditure* | *304·1* | *314·1* | *332* |
| *Net Investment* | *3·9* | *4·3* | *6·2* |
| *Depreciation* | *14·1* | *14·5* | *14·* |

| | 1998-99 | 199 |
|---|---|---|
| [1] *Net payments to EC institutions exclude the UK*'s contribution to the cost of EC aid to non-Member States (which is attributed to the aid programme). Net payments therefore differ from the UK's net contribution to the EC Budget, latest estimates for which are (in £ billion): | *1998*-99 | *199* |
| *Figures from 1999*-2000 are trend estimates. | *3·9* | *3·3* |

Chart B6

B20. Current expenditure for 1999-2000 is at the same level as shown in the CSR (after adjusting for classification changes), bu 99 is greater because of this year's estimated under-spend. As shown in the CSR, the ratio of net investment to GDP doubles betw 02. The levels of net investment are lower than shown in the CSR, but this wholly reflects ESA95 classification changes, which l increased the estimated level of depreciation.

B21. The CSR plans extend only to 2001-02. The spending totals for the last two years of the projection period are illustrative. '

current expenditure grows by 2¼ per cent a year, in line with the estimated trend growth of the economy, and net investment rem
of GDP.

B22. Chart B5 shows the ratio of TME to GDP. The ratio rises very slightly over the next three years, reflecting the higher level

**Risks and error margins**

B23. These projections should be placed within realistic error margins. The average absolute error (ie the average error irrespect errors have been positive or negative) for one-year ahead forecasts of net borrowing has been over 1 per cent of GDP. The error i projections further ahead. Much of this error arises from errors in the forecasts of GDP.

**Table B13: Average errors in Budget forecasts of public sector net borrowing[1]**

| | Per cent of GDP |
|---|---|
| **One-year ahead** | 1·2 (1·0) |
| **Two-years ahead** | 2·0 (1·4) |
| **Three-years ahead** | 3·0 (2·0) |
| **Four-years ahead** | 4·1 (2·4) |

[1]Average absolute errors over the period 1985-86 to 1997-98.

Figures in brackets are adjusted for the estimated effect of errors in the GDP forecast.

B24. The precise cyclical path of the economy is inevitably uncertain. If the profile of growth were to differ from that assumed, for the public finances would be affected. If GDP growth were 1 per cent higher or lower over the coming financial year, net borr or higher by around 0.4 per cent of GDP, equivalent to £3½ billion, in the first year, and by a further 0.3 per cent, equivalent to £ second year. (See 'Fiscal policy: public finances and the cycle', a forthcoming Treasury Pre-Budget Report Paper.)

B25. Chart B6 illustrates the pessimistic case described in Chapter 2: that the current output gap is a further 1 per cent higher tha average, between 1997-98 and 2003-04, the cyclically-adjusted current balance is close to balance. Throughout the period, cyclic borrowing is higher than in the central case by around ¾ per cent of GDP.

# CHANGES IN CLASSIFICATION AND PRESENTATION

**The new European System of National Accounts (ESA95)**

B26. Since 24 September, the Office for National Statistics (ONS) has published the public finance statistics in the national acc with the 1995 European System of Accounts (ESA95). ESA95 is being introduced throughout the European Union. It is consiste System of National Accounts (SNA93), which is supported by all the major international organisations and is being adopted wor introduction of ESA95 will make international comparison easier. The Financial Statement and Budget Report (page 137) stated publications would move onto an ESA95 basis immediately after ONS publications had done so. The basic concepts have remain of the underlying data series are unchanged. But the main aggregates have all been affected to some extent by classification chan out the main changes. Fuller descriptions are given in the ONS' publication National Accounts Concepts, Sources and Methods (

B27. There have been two main changes to the statistics for net borrowing. First the transactions of notionally funded public sec (such as those for teachers and NHS staff) now score 'above the line' as current income and expenditure. Previously, the differen contributions received by such schemes and the pensions they paid out scored 'below the line' as a financial transaction. Because exceed receipts, this change has the effect of raising recorded net borrowing. Secondly, any difference between the issue and red is now recorded as debt interest, spread over the life of the gilt. Under the old guidelines, discounts and premia did not score as i or when the gilt was redeemed. Together, the two changes raise recorded net borrowing by £1·8 billion in 1997-98.

B28. The statistics for the current budget surplus are affected by the two changes above, and also by changes in the statistics for depreciation. Some expenditure that was previously classified as current - chiefly dual-use military equipment, computer softwar corporations' expenditure on entertainment, literary and artistic originals - has been redefined as capital. Estimates of depreciatio to take account of this wider definition of capital. These estimates also now include depreciation on roads and bridges, which we under the old guidelines. Finally, most expenditure financed by grants from the European Union is no longer scored as public ex direct payment from the EU to the final recipient. That has no effect on net borrowing, since the grants from the EU are also no l receipts of government. But it does worsen the surplus on current budget as all receipts had been treated as current, while some c been capital. The net effect of all these changes is to reduce the recorded current budget surplus by £3·5 billion in 1997-98.

**Table B14: Effects of ESA changes, 1997**-98 (£ billion)

| | |
|---|---|
| **Net borrowing (old basis)** | **3·9** |
| plus: | Pension scheme deficits |
| plus: | Gilts discount accrual |
| equals: | **Net borrowing (ESA 95)** |
| **Current budget surplus (old basis)** | |
| less: | Change to net borrowing |
| less: | Depreciation on roads and bridges |
| plus: | Effects of wider definition of capital |
| less: | ERDF & Agricultural Guidance Fund grants |
| equals: | **Current budget surplus (ESA 95)** |

B29. The statistics for public sector net debt and the net cash requirement are unaffected by any of the above changes. A reclass deposits in Government accounts (at the Office of HM Paymaster General and the National Investment and Loans Office) increa requirement in some periods, but reduces it in others.

B30. The statistics for general government net borrowing and general government gross debt reported under the Excessive Defi Maastricht Treaty are not immediately affected by the changes. They will remain on an ESA79 basis until February 2000, when the new ESA95 definitions.

B31. There are large number of effects on the statistics for total managed expenditure (TME), which tend to be largely cancellin increased by the higher estimates of depreciation, the new treatment of unfunded pension schemes, and the additional debt intere inclusion of discounts on gilts. TME is also increased by the reclassification of the Bank of England Issue Department from cent central bank sector (payments of interest on government securities held by the Issue Department were previously consolidated w government; they are now payments to the central bank sector and so add to government expenditure), and by the reclassificatio credits (such as MIRAS) wholly to government expenditure. On the other hand, the statistics for both public expenditure and rec reduced by a change in the treatment of EU contributions. Under the terms of ESA95 the contributions from VAT and from 'tradi (agricultural levies and customs duties) are no longer treated as taxes collected by the UK government and used to finance the U EU budget; rather, they are required to be scored as taxes paid directly by the UK to the EU.

B32. These are purely accounting changes, and the financial transactions between the UK and the Community remain unaltered continue to present figures for the UK's net contributions to the European Community Budget in the annual Departmental Repor the Exchequer's Departments on the same basis as in earlier years, and the ONS will publish similar information on the UK's net 'Blue Book'. Thus the consequences for the UK of our membership of the EU will continue to be available on a basis which is er past publications.

B33. The changes to the definitions of capital and current expenditure feed through into new figures for public sector current ex sector net investment.

B34. Public sector current expenditure (PSCE) has also been redefined to exclude depreciation. PSCE continues to include non- consumption as an element of final consumption expenditure by government. The definition of Total Managed Expenditure (TM now be presented as PSCE plus public sector net investment plus depreciation.

B35. Where it makes administrative sense to do so, the ESA95 changes to TME have been taken through to the control aggrega

- ESA95 has led to few changes to the Control Total.
- The capital and current expenditure provisions within Departmental Expenditure Limits (DEL) have been restated onto Table B17).
- Annually Managed Expenditure (AME) reflects the new treatment of pensions in a new line for net public service pensi level of central government debt interest payments is altered by ESA95. The presentation of net payments to EC Institu unaltered, and the changes required by ESA95 for this item, tax credits, and depreciation are taken through the accounti adjustments.

**Table B15: Impact of ESA95 on expenditure aggregates, 1997-98 (£ billion)**

| |
|---|
| Public sector current expenditure |

EU Contributions

Tax credits

Debt interest

Pension transactions

Non-trading capital consumption

Reclassification to capital of dual-use military equipment & in-house developer software

ERDF & Agricultural Guidance Fund grants no longer netted off current expenditure

Other

**Total**

Public sector net investment

Depreciation

Reclassification of public corporations' entertainment, literary & artistic originals

Reclassification from current of dual-use military equipment & in-house developer software

Expenditure financed by ERDF & Agricultural Guidance Fund grants

Other

**Total**

Depreciation

**Total Managed Expenditure (TME)**

B36. The statistics for current receipts, like those for public expenditure, are subject to largely offsetting changes. They are incr estimates of depreciation (which increase the non-trading capital consumption imputed to receipts in the national accounts), the r Issue Department (the profit from the note issue is now treated as a central government receipt) and the reclassification of certair public expenditure. They are reduced by the reclassification of EU contributions. The series for net taxes and social security con Table B10 and Chart B4 is not a national accounts concept and is unaffected by these changes. EU contributions from VAT, dutie included and income tax credits are netted off. (These two items are included in 'other receipts and accounting adjustments' in or receipts on the new national accounts definitions.)

# FINANCING POLICY

B37. The 1998-99 Debt Management Report, published in March, set out how the Government intended to finance its net cash r Revisions to those plans were announced on 11 June, with the Economic and Fiscal Strategy Report. The updated forecast in the Strategy Report reduced the financing requirement to £12.1 billion, compared to the original figure of £15.2 billion published in updates the financing arithmetic to allow for the latest forecast of the central government net cash requirement (formerly the CG

B38. The further reduction to the forecast of the net cash requirement now reduces the financing requirement to £6.5 billion. Th met predominantly from gilt sales, with a £0.1 billion net contribution from National Savings.

B39. Gilt sales to end-October are already £6.5 billion, of which index-linked issuance is £0.9 billion. The Government announ Management Report that to ensure the medium-term viability of the index-linked auction programme the authorities remained co gross supply of £2.5 billion of index-linked stocks in 1998-99 and for the forseeable future. The Government proposes to meet th proceeding with the two index-linked auctions scheduled for 25 November and 27 January. To support the transition to index-lin Government also undertook to supply up to a further £0.5 billion index-linked gilts through taps in the second half of this year, i relieve any overall market shortages. The revised gilt sales target of £8.1-8.6 billion accordingly provides some flexibility. The C plan to auction further conventional gilts in 1998-99. Should gilt sales exceed the financing requirement, there will be an offsetti government short-term borrowing in-year.

**Table B16: Financing requirement for 1998-99**

| | | | £ billion |
|---|---|---|---|
| | March 1998 | EFSR 98 | Nover |
| | Original Remit | Update | Pre-Bu |
| Central government net cash requirement | 3·7 | 3·5 | -2·1 |
| Net change in official reserves | 0·0 | 0·0 | 0·0 |
| Expected gilt redemptions | 16·7 | 16·8 | 16·8 |
| Plus gilt sales residual from previous financial year | -5·1 | -8·2 | -8·2 |
| **Financing requirement** | **15·2** | **12·1** | **6·5** |
| Less net National Savings inflow | 1·0 | 0·5 | 0·1 |
| Less other funding | 0·0 | 0·0 | 0·0 |
| **Gross gilts sales requirement** | **14·2** | **11·6** | **6·4** |
| Gilt sales to date (April-October 1998) | | | 6·5 |
| of which: | | | |
| Medium conventionals | | | 2·5 |
| Long conventionals | | | 3·1 |
| Index-linked | | | 0·9 |
| Further planned gilt sales (index-linked) | | | 1·6-2· |
| **Total planned gilt sales** | | | **8·1-8·** |

# PUBLIC EXPENDITURE TABLES

B40. Table B17 sets out current and capital budgets for each department and Table B18 gives more details of the plans for publi correspond to Tables A4 and A5 of the Comprehensive Spending Review, but have been adjusted to take account of changes to t and capital spending resulting from the introduction of ESA95.

**Table B17: Department Expenditure LimitsóCurrent and Capital budgets 1996**-97 to 2001-02

| | | | | £ billion | |
|---|---|---|---|---|---|
| | 1996-97 | 1997-98 | 1998-99 | 1999-00 | 20 |
| **Current budget** | | | | | |
| Education and Employment | 13·4 | 14·0 | 13·4 | 14·4 | 15· |
| Health | 33·4 | 35·1 | 36·9 | 39·9 | 42· |
| of which: NHS | 32·8 | 34·5 | 36·3 | 39·3 | 42· |
| DETR-Main programmes | 4·2 | 4·2 | 4·0 | 4·2 | 4·5 |
| DETR-Local Government and Regional Policy | 31·2 | 31·1 | 32·4 | 34·0 | 35· |
| Home Office | 5·9 | 6·2 | 6·5 | 7·3 | 7·4 |
| Legal Departments[1] | 2·5 | 2·6 | 2·6 | 2·7 | 2·7 |
| Defence | 20·7 | 20·1 | 20·7 | 20·8 | 21· |
| Foreign and Commonwealth Office | 1·0 | 1·0 | 1·0 | 1·0 | 1·0 |
| International Development | 2·1 | 2·0 | 2·0 | 2·1 | 2·6 |
| Trade and Industry[2] | 2·9 | 2·8 | 2·8 | 3·0 | 3·3 |
| Agriculture, Fisheries and Food[3] | 1·8 | 1·4 | 1·2 | 1·1 | 1·0 |
| Culture, Media and Sport | 0·9 | 0·8 | 0·8 | 0·9 | 0·9 |
| Social Security (administration) | 3·4 | 3·3 | 3·2 | 3·2 | 3·2 |
| Scotland[1] | 11·4 | 11·5 | 11·6 | 12·2 | 12· |
| Wales | 5·5 | 5·6 | 5·8 | 6·2 | 6·5 |

| | | | | | |
|---|---|---|---|---|---|
| Northern Ireland | 4·9 | 5·0 | 5·1 | 5·4 | 5·5 |
| Chancellor's Departments | 2·7 | 2·7 | 2·7 | 3·0 | 3·1 |
| Cabinet Office | 1·0 | 0·7 | 1·1 | 1·1 | 1·1 |
| Welfare to Work | | 0·0 | 0·8 | 1·0 | 1·0 |
| Invest to Save Budget | | | | 0·0 | 0·0 |
| Capital Modernisation Fund | | | | | 0.0 |
| Reserve[4] | | | 1·3 | 1·4 | 1·8 |
| **Total current budget** | **148·9** | **150·2** | **156·0** | **164·9** | **17** |
| **Capital budget** | | | | | |
| Education and Employment | 0·8 | 0·7 | 0·8 | 1·1 | 1·6 |
| Health | 0·4 | 0·2 | 0·3 | 0·3 | 0·4 |
| of which: NHS | 0·2 | 0·2 | 0·2 | 0·3 | 0·4 |
| DETRóMain programmes | 5·5 | 5·5 | 5·5 | 5·5 | 6·1 |
| DETRóLocal Government and Regional Policy | 0·1 | 0·3 | 0·4 | 0·3 | 0·1 |
| Home Office | 0·5 | 0·5 | 0·4 | 0·4 | 0·4 |
| Legal Departments[1] | 0·1 | 0·1 | 0·1 | 0·1 | 0·1 |
| Defence | 0·7 | 0·9 | 1·5 | 1·5 | 1·5 |
| Foreign and Commonwealth Office | 0·1 | 0·1 | 0·1 | 0·1 | 0·1 |
| International Development | 0·2 | 0·2 | 0·3 | 0·3 | 0·3 |
| Trade and Industry[2] | 0·6 | 0·4 | 0·3 | 0·4 | 0·4 |
| Agriculture, Fisheries and Food[3] | 0·3 | 0·3 | 0·2 | 0·2 | 0·2 |
| Culture, Media and Sport | 0·1 | 0·1 | 0·1 | 0·1 | 0·1 |
| Social Security (administration) | 0·1 | 0·0 | -0·3 | 0·1 | 0·1 |
| Scotland[1] | 1·5 | 1·4 | 1·5 | 1·6 | 1·7 |
| Wales | 1·0 | 0·8 | 0·8 | 0·9 | 0·9 |
| Northern Ireland | 0·5 | 0·5 | 0·6 | 0·6 | 0·7 |
| Chancellor's Departments | 0·2 | 0·2 | 0·1 | 0·2 | 0·0 |
| Cabinet Office | 0·2 | 0·2 | 0·2 | 0·3 | 0·2 |
| Welfare to Work | | 0·1 | 0·3 | 0·3 | 0·3 |
| Invest to Save Budget | | | | 0·0 | 0·0 |
| Capital Modernisation Fund | | | | | 1·0 |
| Reserve[4] | | | 0·2 | 0·2 | 0·2 |
| **Total capital budget** | **12·9** | **12·5** | **13·2** | **14·2** | **16** |
| **Departmental Expenditure Limits** | **161·8** | **162·7** | **169·2** | **179·2** | **19** |
| Total education spending[5] | 36·3 | 37·2 | 38·2 | 41·2 | 44 |

[1]The Crown Office is included in the Legal Departments' figures up to 1998-99, and in the Scotland figures from 1999-2000, ref
government change. See Chapter 22 of the CSR White Paper for further details.

[2]Includes the capital expenditure of the Export Credits Guarantee Department.

[3]Includes spending on BSE-related programmes.

[4]Reserve has been arbitrarily apportioned between current and capital, with 10% allocated to capital. Figures for 1998-99 repres
against planned spending in DEL consistent with forecast Control Total underspend of £1·25 billion. Because expenditure in 19
controlled under the existing regime, these figures have no operational significance.

[5]Central government spending on education falling within DEL plus locally-financed education spending (in AME).

**Table B18: Public sector capital expenditure** 1998-99 to 2001-02

| | | | £ billion |
|---|---|---|---|
| | 1998-99 | 1999-00 | 2000-01 |
| CG spending and LA support in DEL | 11·1 | 12·3 | 14·5 |
| Locally-financed spending | 0·7 | 0·7 | 0·8 |
| National Lottery | 1·2 | 2·2 | 2·3 |
| Public Corporations[1] | 4·7 | 4·8 | 4·8 |
| Other capital spending in AME | 1·0 | 0·7 | 1·0 |
| Allocation of Reserve and AME Margin | 0·2 | 0·2 | 0·2 |
| **Public sector gross investment**[2] | **18·8** | **21·0** | **23·6** |
| Less depreciation | -14·5 | -14·8 | -15·2 |
| **Public sector net investment**[2] | **4·3** | **6·2** | **8·3** |
| Proceeds from the sale of fixed assets[3] | 3·7 | 3·8 | 3·8 |

[1]Public Corporations' capital expenditure is partly within DEL and partly within AME.

[2]This and previous lines are all net of sales of fixed assets.

[3]Projections of total receipts from the sale of fixed assets by public sector. These receipts are taken into account in arriving at pu
net investment which are net of sales of fixed assets.

# HISTORICAL TABLES

B41. Table B19 sets out historical data for the main fiscal aggregates.

**Table B19: Historical series of deficits, receipts and public expenditure**

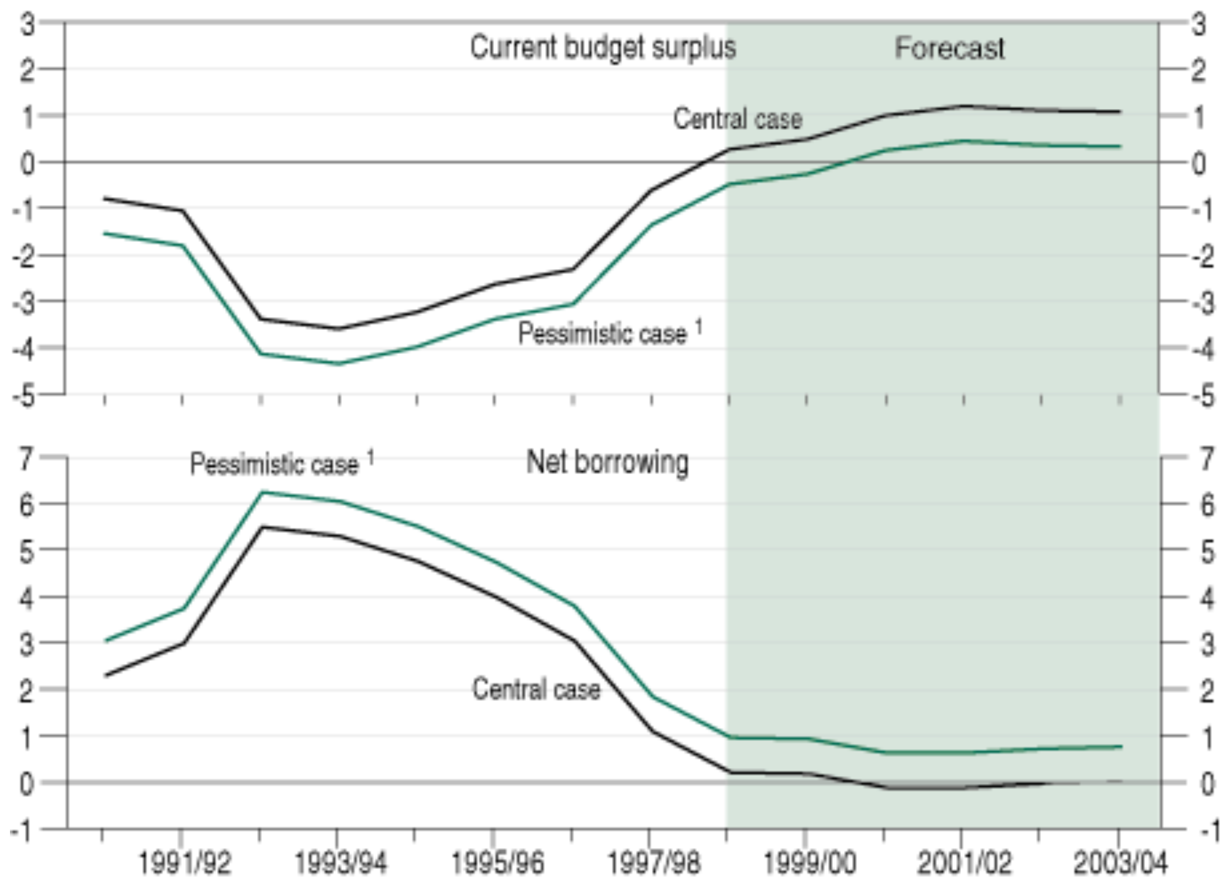
| | | | | | Per cent of GDP | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Public sector current budget1 | Public sector net borrowing1 | Public sector net cash requirement1 | General government net borrowing2 | Net taxes and social security contributions | Public sector current receipts | Public sector current expenditure | Public sector net capital expenditure | Gene gove expe |
| 1970-71 | 7·0 | -0·6 | 1·2 | -2·0 | 36·7 | 42·8 | 32·1 | 6·5 | 41·0 |
| 1971-72 | 4·5 | 1·0 | 1·5 | -0·7 | 35·1 | 41·2 | 32·9 | 5·5 | 41·4 |
| 1972-73 | 2·2 | 2·9 | 3·7 | 2·2 | 32·7 | 38·6 | 32·7 | 5·1 | 40·8 |
| 1973-74 | 1·0 | 4·5 | 5·7 | 4·1 | 33·5 | 39·7 | 34·7 | 5·5 | 42·4 |
| 1974-75 | -0·6 | 6·4 | 8·8 | 4·0 | 35·9 | 42·3 | 38·6 | 5·8 | 47·8 |
| 1975-76 | -1·3 | 7·1 | 9·1 | 4·8 | 36·3 | 42·8 | 39·8 | 5·8 | 48·2 |
| 1976-77 | -1·0 | 5·6 | 6·4 | 4·2 | 35·8 | 43·0 | 39·7 | 4·6 | 45·6 |
| 1977- | -1·1 | 4·3 | 3·8 | 3·6 | 34·6 | 41·3 | 38·1 | 3·1 | 42·4 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 78 | | | | | | | | | |
| 1978-79 | -2·1 | 4·8 | 5·1 | 4·0 | 33·8 | 40·2 | 38·0 | 2·7 | 43·1 |
| 1979-80 | -1·4 | 3·9 | 4·8 | 2·8 | 34·9 | 40·9 | 38·2 | 2·5 | 43·1 |
| 1980-81 | -2·6 | 4·6 | 5·2 | 3·6 | 36·2 | 42·7 | 40·9 | 2·0 | 46·1 |
| 1981-82 | -1·0 | 2·1 | 3·4 | 3·1 | 39·0 | 46·0 | 42·6 | 1·1 | 46·7 |
| 1982-83 | -1·3 | 3·0 | 3·2 | 3·1 | 38·5 | 45·5 | 42·6 | 1·7 | 46·6 |
| 1983-84 | -1·8 | 3·8 | 3·2 | 3·8 | 38·2 | 44·6 | 42·4 | 1·9 | 45·6 |
| 1984-85 | -2·5 | 4·2 | 3·1 | 3·8 | 38·4 | 43·9 | 42·5 | 1·7 | 45·5 |
| 1985-86 | -1·0 | 2·3 | 1·6 | 2·6 | 38·0 | 43·3 | 41·0 | 1·3 | 43·5 |
| 1986-87 | -1·3 | 2·1 | 0·9 | 2·6 | 37·6 | 41·8 | 39·9 | 0·8 | 41·6 |
| 1987-88 | -0·2 | 0·9 | -0·8 | 1·3 | 37·3 | 41·1 | 38·5 | 0·8 | 39·8 |
| 1988-89 | 1·9 | -1·5 | -3·0 | -1·0 | 36·8 | 40·7 | 36·0 | 0·4 | 37·2 |
| 1989-90 | 1·7 | -0·4 | -1·4 | -0·1 | 36·7 | 40·0 | 35·6 | 1·3 | 38·3 |
| 1990-91 | 0·8 | 0·7 | -0·1 | 1·5 | 36·3 | 39·0 | 35·8 | 1·5 | 38·5 |
| 1991-92 | -1·7 | 3·6 | 2·3 | 3·1 | 35·5 | 38·8 | 38·4 | 1·9 | 40·8 |
| 1992-93 | -5·7 | 7·8 | 5·9 | 7·3 | 33·8 | 36·5 | 40·2 | 2·1 | 42·8 |
| 1993-94 | -6·2 | 7·9 | 7·1 | 7·8 | 33·4 | 35·9 | 40·3 | 1·7 | 42·9 |
| 1994-95 | -4·8 | 6·3 | 5·3 | 6·1 | 34·4 | 36·9 | 40·0 | 1·5 | 42·2 |
| 1995-96 | -3·5 | 4·9 | 4·4 | 5·0 | 35·4 | 37·9 | 39·6 | 1·3 | 42·1 |
| 1996-97 | -3·0 | 3·7 | 3·0 | 3·9 | 35·4 | 37·7 | 38·9 | 0·7 | 40·4 |
| 1997-98 | -0·5 | 1·0 | 0·4 | 0·6 | 36·4 | 38·9 | 37·4 | 0·5 | 39·0 |
| 1998-99 | 0·6 | -0·2 | -0·3 | -0·8 | 37·2 | 39·3 | 36·8 | 0·5 | 38·7 |

[1]Excluding windfall tax receipts and associated spending.

[2]On UK national accounts definition prior to 1991-92 and a Maastricht basis thereafter.

Chart B6: Cyclically -adjusted budget balances [1]




[1] Pessimistic case assumes output 1 per cent higher in relation to trend than in the central case