

Budget 2005

Investing for our future: Fairness and opportunity for Britain's hard-working families

Economic and Fiscal Strategy Report and Financial Statement and Budget Report

March 2005

Return to an Order of the House of Commons dated 16 March 2005

*Copy of Economic and Fiscal Strategy Report and Financial Statement and Budget Report – March 2005
as laid before the House of Commons by the Chancellor of the Exchequer when opening the Budget.*

Stephen Timms
Her Majesty's Treasury
16 March 2005

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

CONTENTS

	Page	
Economic and Fiscal Strategy Report		
Chapter 1	Overview	1
Chapter 2	Maintaining macroeconomic stability	15
Chapter 3	Meeting the productivity challenge	41
Chapter 4	Increasing employment opportunity for all	79
Chapter 5	Building a fairer society	101
Chapter 6	Delivering high quality public services	133
Chapter 7	Protecting the environment	151
Annex A	Illustrative long-term fiscal projections	175
 Financial Statement and Budget Report		
Chapter A	Budget policy decisions	185
Chapter B	The economy	213
Chapter C	The public finances	239
 List of abbreviations		283
List of tables		288
List of charts		290

Economic and Fiscal Strategy Report

OVERVIEW

The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Budget 2005, *Investing for our future: Fairness and opportunity for Britain's hard-working families*, presents updated assessments and forecasts of the economy and public finances, and reports on how the Government's policies are helping to deliver its long-term goals. The Budget:

- shows that the economy is growing strongly and that the Government is meeting its strict fiscal rules for the public finances;
- announces a long-term programme of investment to deliver twenty-first century facilities in primary schools, along with further support for ICT in schools and funding to help schools deliver extended services;
- sets out further measures to help young people develop skills, including improving financial support for 16 to 19 year olds in learning; and piloting a new allowance for 16 to 17 year olds not in education, employment or training;
- sets out radical reforms to reduce the regulatory burden on business, through implementing the recommendations of the Hampton Review of regulatory inspection and enforcement; the recommendations of the Better Regulation Task Force report on controlling the stock and flow of regulations; and applying the principles of better regulation in Europe;
- announces free local bus travel for people over the age of 60 and disabled people from April 2006, and an additional payment guaranteeing that council tax paying households with someone over 65 will receive £200 towards the cost of council tax;
- announces further measures to help families, including a commitment to increase the child element of the Child Tax Credit in line with average earnings up to 2007-08;
- takes further steps to extend employment opportunity for all, through measures which focus help and support on those who face the greatest barriers to work;
- doubles the starting threshold of stamp duty land tax to £120,000 for all residential property transactions;
- provides a further £340 million for the special reserve in 2004-05 and £400 million in 2005-06 for military operations in Iraq and the UK's other international obligations;
- announces a new better targeted Local Enterprise Growth Initiative to drive forward local business-led regeneration, following the end of time-limited relief on commercial property purchases in disadvantaged areas;
- introduces a range of measures to modernise the tax system, and to tackle tax fraud and avoidance; and
- defers the inflation-based increase in main road fuel duties to 1 September 2005, in response to sustained volatility in oil prices.

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

1.2 The long-term decisions the Government has taken – giving independence to the Bank of England, new fiscal rules and a reduction in debt – have created a strong platform of economic stability. Over the past four years, many industrialised countries have suffered economic downturns, including the US and much of the euro area. More recently, the international economy has been affected by geopolitical uncertainty, rising oil prices, and large current account imbalances and shifting exchange rates between Europe, Asia and the

US. In the UK, with low and stable inflation, interest rates set by the Monetary Policy Committee to meet the Government's symmetric inflation target, and fiscal policy supporting monetary policy over the cycle, the economy has grown continuously throughout this period. The UK economy continues its longest unbroken expansion on record, with GDP now having grown for 50 consecutive quarters.

1.3 Economic stability provides the platform for building prosperity, achieving social justice with security and opportunity for all, and maintaining investment in public services. Stability allows business, individuals and the Government to plan more effectively for the long term, improving the quantity and quality of investment and helping to raise productivity. The Government is committed to locking in stability and investing in the UK's future, enabling it to meet the challenges and rise to the opportunity of the rapidly evolving global economy.

Meeting long-term global challenges

1.4 The international economy is becoming increasingly integrated through greater cross-border trade and investment, driven in part by rapid advances in technology. Production processes are becoming increasingly flexible, dispersed across continents and with an increasing level of specialisation. Emerging market economies are growing strongly, particularly China and India, and are developing skilled workforces. China and India already each produce around 2 million graduates a year, compared with around 250,000 in the UK. Within the next twenty years, half the world's manufactured exports could come from developing countries.

1.5 These developments are both a great opportunity and a great challenge for the UK and the global economy. The Government is committed to taking the long-term decisions to ensure the UK meets these challenges, by entrenching stability and building a flexible, enterprising economy with a highly-skilled, high-productivity workforce and a strong science and innovation sector. This requires investment by the Government and the public and private sectors working together to meet the challenges faced by the UK economy. This Budget includes radical reforms to reduce the regulatory burden on business, ensuring regulation can promote competition and drive up standards, without imposing unnecessary costs on business. It also sets out further plans to boost the UK science and innovation sector.

1.6 Fairness must go alongside flexibility, providing security and support for those that need it and ensuring that everyone has the opportunity to fulfil their potential. The reforms of the welfare state introduced since 1997 reflect the Government's aims of eradicating child poverty, supporting families to balance their work and family life, promoting saving and ensuring security for all in old age. The Government is also committed to a modern and fair tax system which encourages work and saving and ensures that everyone pays their fair share of tax. The Budget announces further measures to help families and pensioners, and to promote employment opportunity for all.

Investing in education and skills

1.7 High levels of education and skills will allow the UK to harness technological improvements and become more productive, and are key to the Government's ambition of creating a flexible, enterprising and innovative economy. For an individual, education and skills provide security and opportunity, enhance personal fulfilment and enable people to contribute to their communities. The Budget sets out a programme of long-term investment in schools and colleges, and further measures to enhance the development of skills, to ensure that everyone has the opportunity to make the most of their talents.

1.8 The Budget describes the next steps the Government is taking to enhance its long-term goals of:

- **maintaining macroeconomic stability**, ensuring the fiscal rules are met and that inflation remains low;

- **raising the sustainable rate of productivity growth**, through reforms that promote enterprise and competition, enhance flexibility and promote science, innovation and skills;
- **providing employment opportunity for all**, by promoting a flexible labour market which sustains a higher proportion of people in employment than ever before;
- **ensuring fairness**, by providing security for people when they need it, tackling child and pensioner poverty, providing opportunity for all children and young people and delivering security for all in retirement;
- **delivering world-class public services**, with extra investment alongside efficiency, reform and results, including long-term plans for investment in education; and
- **addressing environmental challenges**, such as climate change, poor air quality and environmental degradation in urban and rural areas.

MAINTAINING MACROECONOMIC STABILITY

1.9 The Government's long-term economic goal is to maintain macroeconomic stability, ensuring the fiscal rules are met at all times and that inflation remains low. Chapter 2 describes how the Government is working to achieve this goal and summarises prospects for the UK economy and public finances, full details of which are set out in Chapters B and C of the *Financial Statement and Budget Report (FSBR)*.

The policy framework **1.10** The Government's macroeconomic framework is based on the principles of transparency, responsibility and accountability, and is designed to ensure lasting stability so that businesses, individuals and the Government can plan effectively for the long term. The Bank of England has operational independence to meet the Government's symmetrical inflation target. Fiscal policy is underpinned by clear objectives and two strict rules which ensure sound public finances over the medium term. The fiscal rules underpin the Government's public spending framework which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes.

1.11 The UK economy is currently experiencing its longest unbroken expansion on record, with GDP now having grown for 50 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the global economic challenges and opportunities of the next decade.

Economic prospects **1.12** World growth in 2004 recovered to its strongest rate for nearly three decades and it remains robust. For 2004 as a whole, UK GDP rose by 3.1 per cent, its fastest rate of growth for four years, consistent with the 3 to 3½ per cent forecast range that the Government maintained since the 2002 Pre-Budget Report. Growth has also been more balanced as business investment accelerated in 2004 and private consumption continued to grow at sustainable rates. As world growth retains much of its momentum and with UK business and consumer confidence strong, GDP is expected to grow by 3 to 3½ per cent in 2005 as the remaining slack in the economy is absorbed and the output gap is closed around the end of the year. Growth is then expected to return to between 2½ and 3 per cent in 2006, in line with the economy's trend rate.

The public finances **I.13** The Budget 2005 projections for the public finances are broadly in line with the 2004 Pre-Budget Report and show that the Government is meeting its strict fiscal rules:

- the current budget shows an average surplus as a percentage of GDP over the current economic cycle, even using cautious assumptions, ensuring the Government is meeting the golden rule. Beyond the end of the current cycle, the current budget moves clearly into surplus including, by the end of the projection period, the cyclically-adjusted current budget in the cautious case; and
- public sector net debt is projected to remain low and stable over the forecast period, stabilising at a level well below the 40 per cent ceiling in the sustainable investment rule.

Table I.1: Meeting the fiscal rules

	Outturn 2003-04	Estimate 2004-05	Per cent of GDP Projections				
			2005-06	2006-07	2007-08	2008-09	2009-10
Golden rule							
Surplus on current budget	-1.8	-1.4	-0.5	0.0	0.3	0.6	0.8
Average surplus since 1999-2000	0.5	0.1	0.1	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	-1.0	-0.8	-0.3	0.1	0.3	0.6	0.8
Sustainable investment rule							
Public sector net debt	32.8	34.4	35.5	36.2	36.8	37.1	37.1

Budget policy decisions **I.14** Against this backdrop, and building on steps already taken, Budget 2005 announces further decisions to lock in stability and invest in the UK's future, including :

- a long-term programme of investment to deliver twenty-first century facilities in primary schools, and new measures to boost the development of skills in young people;
- a commitment to increase the child element of the Child Tax Credit in line with average earnings up to 2007-08;
- free local area bus travel for all people over the age of 60 and disabled people from April 2006, and an additional payment guaranteeing that council tax paying households with someone over 65 will receive £200 towards the cost of council tax;
- a doubling of the stamp duty land tax zero-rate threshold from £60,000 to £120,000 for all residential property transactions;
- a range of measures to tackle tax fraud and avoidance; and modernise the tax system;
- deferral of the inflation-based increase in main road fuel duties to 1 September 2005, in response to sustained volatility in oil prices; and
- a further £340 million for the special reserve in 2004-05 and £400 million in 2005-06 for military operations in Iraq and the UK's other international obligations.

Long-term fiscal sustainability **I.15** Consistent with the requirements of the *Code for fiscal stability*, the updated public finance projections in Budget 2005 take into account the fiscal effects of these and all other firm decisions announced in the Budget. The fiscal impact of Budget policy decisions is set out in Table 1.2. Full details are provided in Chapter A of the FSBR.

I.16 An updated analysis of long-term fiscal sustainability was published alongside the 2004 Pre-Budget Report in the *2004 Long-term public finance report*, and is updated in Annex A of the Economic and Fiscal Strategy Report. Using a range of sustainability indicators, this shows that the public finances are sustainable in the longer term, and that the UK is in a strong position relative to many other countries to meet the challenges of an ageing population.

MEETING THE PRODUCTIVITY CHALLENGE

I.17 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance in the global economy. In the increasingly knowledge-driven global economy, science, innovation and creativity are important drivers of productivity growth, backed up by a highly-skilled workforce and a competitive and enterprising economy. The UK has historically experienced comparatively low rates of productivity growth. However, in recent years, UK performance has improved in relation to other major economies. The Government's long-term goal is for the UK to continue to close the productivity gap by achieving a faster rate of growth than its main competitors.

- Action so far I.18** The Government's strategy focuses on five key drivers of productivity performance:
- **improving competition** which promotes flexible markets and increases business efficiency and consumer choice;
 - **promoting enterprise**, including through reducing the regulatory burden on business, to ensure that UK firms are well-placed to respond to opportunities in a rapidly changing global market;
 - **supporting science and innovation** which is central to success in the international economy, as global restructuring focuses developed economies toward knowledge-based and high value-added sectors;
 - **raising UK skills** to create a more flexible and productive workforce, and to meet the long-term challenge of rising skills levels in emerging markets; and
 - **encouraging investment** to increase the stock of physical capital supported by stronger, more efficient capital markets. In the global economy, attracting international capital and investment will require macroeconomic stability and a robust and efficient investment environment.

- Next steps I.19** Building on the reforms and initiatives already introduced, Budget 2005 sets out the next steps the Government is taking to strengthen the drivers of productivity growth and meet the long-term challenges of the global economy, including:
- **a package of radical reforms to tackle the burden of regulation on business**, while maintaining standards of protection for the public, consumers and employees, through:
 - building on the success of the Panel for Regulatory Accountability (PRA) by ensuring that regulation is only used where necessary, that it is not 'goldplated' if it originates from EU law, and that all Whitehall departments strengthen their focus on removing outdated and unnecessary regulations as recommended by the Better Regulation Task Force (BRTF) report;
 - adopting a risk-based approach to inspection and enforcement, streamlining regulatory structures and increasing accountability in order to reduce the costs to business of administering regulation, as

recommended by the Hampton Review, and setting new targets to reduce the administrative burden over time;

- applying the principles of better regulation in Europe through the six presidencies initiative;
- consistent with the Hampton principles, a strategy to meet stretching new targets **to reduce the administrative burden of the tax system for small businesses**, including in the short-term cutting the tax return for 500,000 of the smallest businesses and rolling out new options for paying and managing VAT online;
- **taking forward the ten-year Science and Innovation Investment Framework**, including a UK Stem Cell Initiative, chaired by Sir John Pattison, to formulate a ten-year vision for stem cell research, creating a platform for co-ordinated public and private research funding; a mandatory requirement that at least 2.5 per cent of public sector extra-mural R&D spending will be with Small and Medium Enterprises (SMEs) and engaging with business to ensure that the R&D tax credit better supports UK businesses with high potential to become major innovative firms of the future;
- **to support the Government's major new investment in education and skills**, plans to enhance workforce skills including continued support of £65 million for the Employer Training Pilots and funding to support a new Union Academy;
- **further support for enterprise**, through a new Local Enterprise Growth Initiative worth £150 million per year by 2008-9, to boost enterprise in the most deprived areas of England, following the end of the time-limited commercial stamp duty land tax disadvantaged areas relief in this Budget; and Regional Development Agencies' (RDAs) plans for the development of business coaching focused on businesses with high growth prospects;
- **a package of measures to increase the contribution of creativity to productivity growth**, including: a review led by George Cox, on how best to use the UK's world class creative industries and universities to support and develop the creativity of SMEs; and action by the RDAs to support the integration of design into corporate strategy, product and market development, including through the Design Council's Design Immersion Programme; and £12 million to the Arts Council England to promote better management and leadership within the cultural sector; and
- as a further step in reforming the investment chain, **taking forward the Morris Review recommendations** to promote greater competition in actuarial services and in advice to pension funds on investment issues, including asset allocation and fund manager selection, and to strengthen the regulation of the actuarial profession.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.20 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. To achieve this, each individual who wants and is able to work should be provided with the support to enable them to find work and develop skills. The Government is

also determined to build a flexible labour market which allows the economy to respond quickly and efficiently to economic change, driven for example by shifting patterns of international production and trade.

Action so far 1.21 The Government's strategy for extending employment opportunity to all builds on the strong performance of the UK labour market over recent years. UK unemployment has fallen to 4.7 per cent, the second lowest of the G7 economies, while the working age employment rate has reached 74.9 per cent. Chapter 4 describes the successful action the Government has already taken to increase employment opportunity, through:

- **delivering employment opportunity to all**, to provide everyone who is able to work with the support they need to move into work as quickly as possible;
- **extending employment opportunity** to those groups and regions which have faced the greatest barriers to work;
- **enhancing skills and mobility**, to ensure that everyone can fulfil their potential in the labour market and that business has access to the skilled workforce they need to compete in the global economy; and
- **making work pay**, through the National Minimum Wage and tax credits which create a system of support that provides greater rewards from work, improving incentives for individuals to participate in the labour market;

Next steps 1.22 Budget 2005 describes the further steps the Government is taking to build on this success and further strengthen the labour market, with a long-term vision for extending support to the inactive and those who face particular barriers to work. The Budget announces:

- **improvements to incapacity benefits linking rules**, including an automatic guarantee of entitlement to the rules on a move into employment; a single, extended linking rules period of 104 weeks; and immediate re-qualification for the rules on a return to benefit;
- following the Low Pay Commission's recommendations, **the adult rate of the National Minimum Wage will rise to £5.05 per hour from October 2005 and £5.35 from October 2006**;
- **examining the scope for improving Jobseeker's Allowance sanctions and the potential for a fixed fines system**, to maintain an effective balance between rights and responsibilities by improving the capacity to respond swiftly and effectively in cases of non-compliance;
- **supporting young people not in education, employment or training**, details are set out in Chapter 5;
- **accepting the recommendations of the National Employment Panel's report on measures to promote employment and small business growth for ethnic and faith minorities. The Government will develop proposals for implementing these recommendations, including the establishment of Centres of Vocational Excellence in Entrepreneurship**;
- **a package of measures to help simplify and improve Housing and Council Tax Benefit** by making further improvements in administration; and
- **improving IT links between local authorities and the Department for Work and Pensions** to allow faster and more accurate processing of Housing Benefit claims.

BUILDING A FAIRER SOCIETY

1.23 The Government's long-term economic goal is to combine flexibility with fairness. Policies that ensure fairness minimise the short-term costs that can be associated with the changes that are needed in flexible outward-looking economies. Fairness provides security and support for those that need it and ensures that everyone has the opportunity to fulfil their potential in the global economy, now and in the future. The Government is also at the forefront of global efforts to achieve the Millennium Development Goals for global poverty, and to reduce debt in the poorest countries.

Action so far 1.24 Chapter 5 describes the range of reforms the Government has undertaken to achieve its goals in these areas, including:

- **support for families and children** to lift children out of poverty and so ensure they have the opportunity to fulfil their potential;
- **support for pensioners** to tackle poverty and ensure security in retirement for all pensioners, with extra help for those who need it most and rewards for those who have saved modest amounts;
- **steps to encourage saving**, including through the introduction of the Child Trust Fund, stakeholder pensions and Individual Savings Accounts; and
- **measures and reforms to improve the tax system**, and to ensure that everyone pays their fair share toward extra investment in public services.

Next steps 1.25 Building on these reforms, the Government is committed to taking the long-term decisions to promote opportunity and fairness. The Budget announces:

- building on previous increases in financial support for families, **a commitment to increase the child element of the Child Tax Credit at least in line with average earnings up to and including 2007-8**;
- **enhancing the development of young people's skills**, through measures to improve financial support for 16 to 19 year olds in learning, including through extending Child Benefit and Child Tax Credit from April 2006; and piloting a new Activity Agreement and Allowance for 16 to 17 year olds not in education, employment or training from April 2006;
- to support parents and improve children's learning, **an additional £35 million in 2006-07 and 2007-08 for the Parenting Fund and to improve early learning help for families**;
- **free off-peak local area bus travel for all people over the age of 60 and disabled people in England from April 2006**;
- **an additional payment guaranteeing council tax paying households with someone over 65 will receive £200 towards the cost of council tax**;
- **extending the existing higher Individual Savings Accounts limits to April 2010**, to promote further saving;
- **consulting on payments at secondary school age in the Child Trust Fund**;
- **investing up to £100 million over the next three years, to deliver the Government's response to the Russell Commission report on youth volunteering**, including a matched volunteering opportunities fund rising to

£40 million in 2007-08, conditional on private sector support;

- **doubling the zero-rate threshold for stamp duty land tax to £120,000 for residential property transactions**, exempting an extra 300,000 home buyers from stamp duty every year;
- **increasing the threshold for inheritance tax** to £275,000 in 2005-06, £285,000 in 2006-07 and £300,000 in 2007-08; and
- further reforms to **modernise the tax system**, including better aligning North Sea corporation tax payments with payments for petroleum revenue tax, and a number of measures to clamp down on **tax fraud and avoidance**.

DELIVERING HIGH QUALITY PUBLIC SERVICES

I.26 The Government's goal is to establish world class public services, with extra investment tied to reform and results. Investment in key public services provides the foundation on which the UK will be able to meet long-term economic challenges. A healthy and skilled workforce, modern and reliable transport networks, and an adequate supply of affordable housing will promote productivity and flexibility, and also help to ensure opportunity and security for all, both now and in future generations. The Government's strategy is to deliver improvements in public services through sustained investment and reform to ensure that taxpayers receive value for money.

Action so far I.27 Chapter 6 sets out the steps the Government has taken to deliver lasting improvements in the delivery of public services, including:

- **a new framework for managing public spending** that strengthens incentives for departments to plan for the long term;
- **significant extra resources for public services**, consistent with the strict fiscal rules. The 2004 Spending Review set departmental spending plans for the three years to 2007-08, locking in previous increases in investment, while providing for further investment in priority areas of the public services. Current spending will increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08; and
- **challenging efficiency targets for all departments**, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

Next steps I.28 The Government's long-term goal is to deliver world class public services through investment and reform, while ensuring efficiency and value for money. The Budget announcements include:

- **a further update on the progress departments have made toward meeting the challenging efficiency targets for all departments;**
- **proposals to rationalise the inspection and regulation of public services, building on the approach of the Hampton Review;**
- **a long-term programme of investment to deliver twenty-first century facilities in primary schools**, along with further support for ICT in schools, funding to help schools deliver extended services, and measures to ensure that every 16-18 year old has access to education and training; and

- **an additional £340 million for the special reserve in 2004-05 and £400 million in 2005-06** for military operations in Iraq and the UK's other international obligations.

PROTECTING THE ENVIRONMENT

1.29 The Government's goal is to deliver sustainable growth and a better environment, by addressing the challenges of climate change, poor air quality and environmental degradation in urban and rural areas. Sustainable development is vital to ensure a better quality of life for everyone, today and for generations to come. Economic growth is key to rising national prosperity. However, growth must not come at the expense of the environment or social progress. Continued growth in the developed world, combined with the rapidly growing and highly populated economies of China and India, will place increasing demands on the world's resources and environment over the coming decade. Meeting this long-term challenge requires action at a local and national level, but crucially also through international cooperation.

Action so far 1.30 Chapter 7 describes the steps the Government has taken to deliver its environmental objectives, including:

- **tackling climate change**, and reducing emissions of greenhouse gases in line with domestic as well as international targets;
- **improving air quality** to ensure that air pollutants are maintained below levels that could pose a risk to human health;
- **improving waste management**, so that resources are used more efficiently and waste is re-used or recycled to deliver economic value; and
- **protecting the UK's countryside and natural resources**, to ensure they are sustainable economically, socially and physically.

Next steps 1.31 The Government is using a range of economic instruments to address the challenges posed by sustainable development, while taking into account other social and economic factors. This Budget describes the next steps in the Government's strategy, including:

- in support of the UK's leadership role in tackling climate change, including through its EU and G8 Presidencies, **a package of new measures to support further action on the abatement of greenhouse gas emissions, including new fiscal incentives, an energy services summit, and a new energy efficiency theme as part of the Government's Invest to Save Budget**;
- **the publication of an independent evaluation of the climate change levy**, which concludes that this measure will deliver annual savings of over 3.5 million tonnes of carbon in 2010, well above the originally forecast savings;
- **two new reduced rates of VAT for the installation of low carbon technologies, and an extension of the Landlord's Energy Savings Allowance** to cover solid wall insulation;
- **the deferral to 1 September 2005, of the inflation-only increase of main road fuel duties, reflecting sustained volatility in oil prices, and of a 1.22 pence per litre increase in duty on rebated fuels**, which will support the strategy to tackle oils fraud;
- **a freeze in the threshold for the minimum percentage charge rate of company car tax** at 140g per kilometre for 2007-08, and simplifications to the company car tax system;

- a freeze of the vehicle excise duty (VED) rates for the lowest four bands of graduated VED for cars, and the standard increase of £5 for the two most polluting bands and for the over 1549cc band for pre-March 2001 vehicles;
- progress on work to assess the feasibility of a biofuels obligation as part of a package of measures to support the development of biofuels;
- a freeze in the rate of the aggregates levy, and the rates of climate change levy and air passenger duty; and
- an increase in line with inflation of the landfill tax credit scheme.

BUDGET MEASURES AND THEIR IMPACT ON HOUSEHOLDS

I.32 The measures introduced in this and previous Budgets support the Government's objectives of promoting enterprise, skills and science, creating employment opportunity, tackling child and pensioner poverty, and protecting the environment. Consistent with the requirements of the *Code for fiscal stability*, the updated public finance projections in Budget 2005 take into account the fiscal effects of all firm decisions announced in the Budget. The fiscal impact of Budget policy decisions is set out in Table 1.2. Full details are provided in Chapter A of the FSR.

I.33 As a result of personal tax and benefit measures coming into effect in 2005-06, by October 2005, in real terms:¹

- families with children will be, on average, £20 a year better off, while those in the poorest fifth of the population will be, on average, £45 a year better off;
- a single earner couple with 2 children, with earnings up to the median for full time workers – £23,400 per year – will be at least £150 a week better off; and
- a lone parent with 2 children, working 16 hours a week at the National Minimum Wage,² will be at least £150 per year better off.

I.34 As a result of personal tax and benefit measures introduced since 1997, by October 2005, in real terms:³

- households will be, on average, £900 a year better off;
- families with children will be, on average, £1,400 a year better off; and
- families with children in the poorest fifth of the population will be, on average, £3,200 a year better off.

I.35 As a result of personal tax and benefit measures introduced since 1997, in 2005-06:³

- pensioner households will be £1,500 a year better off in real terms; and
- the poorest third of pensioner households will have gained £2,000 a year in real terms.

¹ Compared to the 2004-05 system of taxes and benefits, indexed to 2005-06 prices.

² The National Minimum Wage will be £5.05 for adults from October 2005.

³ Compared to the 1997-98 system of taxes and benefits, indexed to 2005-06 prices.

Table I.2: Budget 2005 policy decisions

	(+ve is an Exchequer yield)			£ million
	2005-06 indexed	2006-07 indexed	2007-08 indexed	2005-06 non-indexed
MEETING THE PRODUCTIVITY CHALLENGE				
1 Tonnage tax: adjustments	*	-5	-5	*
2 VAT: revalorise registration and deregistration thresholds	0	0	0	-5
3 Film tax reform	*	-50	*	*
4 Local Enterprise Growth Initiative	-15	-65	-125	-15
5 Stamp duty land tax: ending commercial disadvantaged areas relief	+340	+350	+370	+340
6 Enterprise and creativity	0	-5	-10	0
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
7 Housing benefit and council tax benefit: simplification	-5	-5	-5	-5
8 Incapacity benefit: linking rules	0	-10	-20	0
BUILDING A FAIRER SOCIETY				
Supporting families and communities				
9 Income tax: indexation of starting and basic rate limits	0	0	0	-700
10 Child Tax Credit: uprating child element in line with earnings until 2007-08	0	-260	-480	0
11 Stamp duty land tax: increase threshold to £120,000	-250	-240	-220	-250
12 ISAs: extension of higher investment limits until April 2010	0	-35	-100	0
13 Free local off-peak bus travel for pensioners and disabled people	0	-420	-440	0
14 Abolition of hospital downrating	0	-65	-65	0
15 Payment for the over 65s	-800	0	0	-800
16 Supporting youth volunteering	-10	-30	-80	-10
17 Increasing capital limits for IS/JSA from £8,000 to £16,000	0	-5	-5	0
Protecting tax revenues				
18 Preventing avoidance of tax on capital gains	*	+70	+105	*
19 Stamp duty land tax: avoidance	+20	+20	+15	+20
20 Financial products avoidance	+280	+430	+430	+280
21 Double tax relief: anti-avoidance rule	+130	+200	+200	+130
22 Intangible assets: closing loopholes	+15	+25	+25	+15
23 Counteracting avoidance through arbitrage	+130	+200	+200	+130
24 Red diesel: supporting the UK oils fraud strategy	+40	+70	+70	+45
25 VAT: partial exemption loopholes	+25	+30	+25	+25
26 VAT: warehousing avoidance	+20	+25	+25	+20
Duties and other tax changes				
27 Inheritance tax: increase of threshold	-20	-60	-130	-90
28 Alcohol duties: revalorise beer and wine duties and freeze other rates	-10	-10	-10	+150
29 Tobacco: revalorise rates	0	0	0	+20
30 North Sea corporation tax: aligning payments with PRT	+1,100	+210	+170	+1,100
31 VAT: supplies promoting the welfare of vulnerable people	-5	-5	-5	-5
32 VAT: extension of listed places of worship scheme	0	-10	-10	0
33 VAT: construction and repair of memorials by charities	-5	-5	-5	-5
PROTECTING THE ENVIRONMENT				
Environment				
34 Climate change levy: freeze	-20	-20	-20	0
35 Aggregates levy: freeze	-10	-10	-10	0
36 VAT: reduced rate on micro-CHP boilers	*	-5	-5	*

Table I.2: Budget 2005 policy decisions

	(+ve is an Exchequer yield)			£ million
	2005-06 indexed	2006-07 indexed	2007-08 indexed	2005-06 non-indexed
PROTECTING THE ENVIRONMENT				
Transport				
37 VAT: revalorise fuel scale charges	0	0	0	+10
38 Fuel duties: revalorise rates from 1 September 2005	-235	0	0	+330
39 Fuel duties: narrowing the differential of road fuel gases until 2007	*	0	+5	*
40 Fuel duties: differentials for biodiesel and bioethanol until 2007	*	0	+5	*
41 Incentivising the use of biomass	0	-5	-5	0
42 Air passenger duty: freeze rates	-10	-25	-30	0
43 Changes to Vehicle Excise Duty	-40	-45	-50	+85
OTHER POLICY DECISIONS				
44 Education and skills measures	0	-300	-400	0
45 Special reserve allocation ¹	-400	0	0	-400
TOTAL POLICY DECISIONS	+265	-65	-590	+415
*negligible				
MEMO ITEMS				
Resetting of the AME margin	+1,880	+370	-260	
Direct taxes compliance package ²	0	+25	+355	

¹This is in addition to the Budget 2005 decision to allocate £340 million to the special reserve for 2004-05.

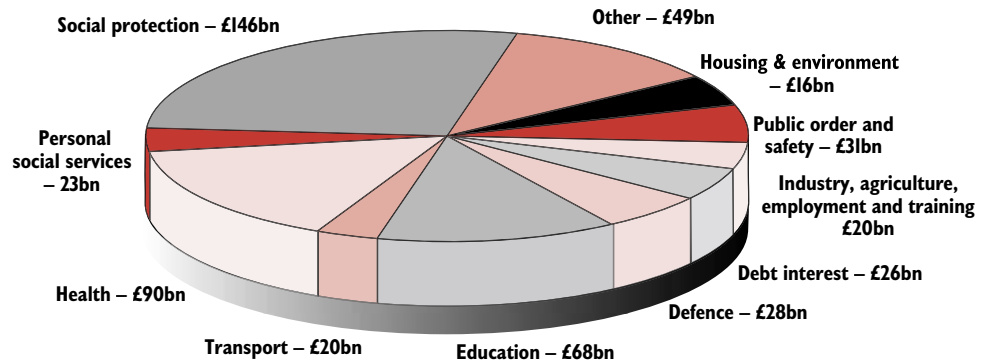
²Net of additional resources allocated to Inland Revenue.

GOVERNMENT SPENDING AND REVENUE

I.36 Chart 1.1 presents public spending by main function. Total managed expenditure (TME) is expected to be around £519 billion in 2005-06. TME is divided into Departmental Expenditure Limits (DEL), shown in Table C13 of the FSBR, and Annually Managed Expenditure (AME), shown in Table C11 of the FSBR.

Chart I.1: Government spending by function

Total managed expenditure: £519 billion

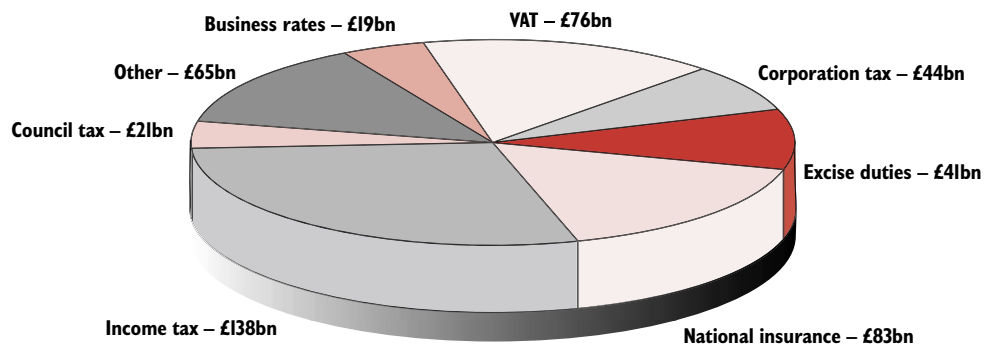


Source: HM Treasury, 2005-06 near-cash projections. Spending re-classified to functions compared to previous presentations and is now using methods specified in international standards. Other expenditure includes spending on general public services; recreation, culture, media and sport; international cooperation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments. Social protection includes tax credit payments in excess of an individual's tax liability, which are now counted in AME, in line with OECD guidelines. Figures may not sum to total due to rounding.

I.37 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £487 billion in 2005-06. Table C8 of the FSRB provides a more detailed breakdown of receipts consistent with this chart.

Chart I.2: Government receipts

Total receipts: £487 billion



Source: HM Treasury, 2005-06 projections. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts – for example, interest and dividends. Figures may not sum to total due to rounding.

The UK economy is currently experiencing its longest unbroken expansion on record, with GDP now having grown for 50 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the global economic challenges of the next decade.

World growth in 2004 recovered to its strongest rate for nearly 30 years and remains robust. For 2004 as a whole, UK GDP rose by 3.1 per cent, its fastest rate of growth for four years, consistent with the 3 to 3½ per cent forecast range that the Government maintained since the 2002 Pre-Budget Report. Growth has also been more balanced as business investment accelerated in 2004 and private consumption continued to grow at sustainable rates. As world growth retains much of its momentum and with UK business and consumer confidence strong, GDP is expected to grow by 3 to 3½ per cent in 2005 as the remaining slack in the economy is absorbed and the output gap is closed around the end of the year. Growth is then expected to be 2½ to 3 per cent in 2006, in line with the economy's trend rate.

The Budget 2005 projections for the public finances are broadly in line with the 2004 Pre-Budget Report and show that the Government is meeting its strict fiscal rules:

- the current budget shows an average surplus as a percentage of GDP over the current economic cycle, even using cautious assumptions, ensuring the Government is meeting the golden rule. Beyond the end of the current cycle, the current budget moves clearly into surplus including, by the end of the projection period, the cyclically-adjusted current budget in the cautious case; and
- public sector net debt is projected to remain low and stable over the forecast period, stabilising at a level well below the 40 per cent ceiling in the sustainable investment rule.

THE MACROECONOMIC FRAMEWORK

2.1 The UK economy is currently experiencing its longest unbroken expansion since quarterly national accounts data began, with GDP now having grown for 50 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the global economic challenges of the next decade.

2.2 The Government's macroeconomic framework is designed to maintain long-term economic stability. Large fluctuations in output, employment and inflation add to uncertainty for firms, consumers and the public sector, and can reduce the economy's long-term growth potential. Stability allows businesses, individuals and the Government to plan more effectively for the long term, improving the quality and quantity of investment in physical and human capital and helping to raise productivity.

2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability.¹ The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term while allowing fiscal policy to support

¹ Further details can be found in *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002.

monetary policy over the economic cycle. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

Monetary policy framework

2.4 Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target and allowed the Bank of England's Monetary Policy Committee (MPC) to mitigate the impact of global events on the UK economy. The framework is based on four key principles:

- clear and precise objectives. While the primary objective of monetary policy is to deliver price stability, the adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's target. **The Government reaffirms in Budget 2005 the target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI),** which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC.

2.5 These arrangements have removed the risk that short-term political factors can influence monetary policy and ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target.

Fiscal policy framework

2.6 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*² – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

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

² *Code for fiscal stability*, HM Treasury, 1998.

2.7 These objectives are implemented through two strict fiscal rules, against which the performance of fiscal policy can be judged. The fiscal rules are:

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

2.8 The fiscal rules ensure sound public finances in the medium term while allowing flexibility in two key respects:

- the rules are set over the economic cycle. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and
- the rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

Public spending framework

2.9 The fiscal rules underpin the Government's public spending framework. The golden rule increases the efficiency of public spending by ensuring that public investment is not sacrificed to meet short-term current spending pressures. Departments are now given separate allocations for resource and capital spending to help ensure adherence to the rule. The sustainable investment rule sets the context for the Government's public investment targets and ensures that borrowing for investment is conducted in a responsible way. Further details of the public spending framework are set out in Chapter 6.

Financial stability framework

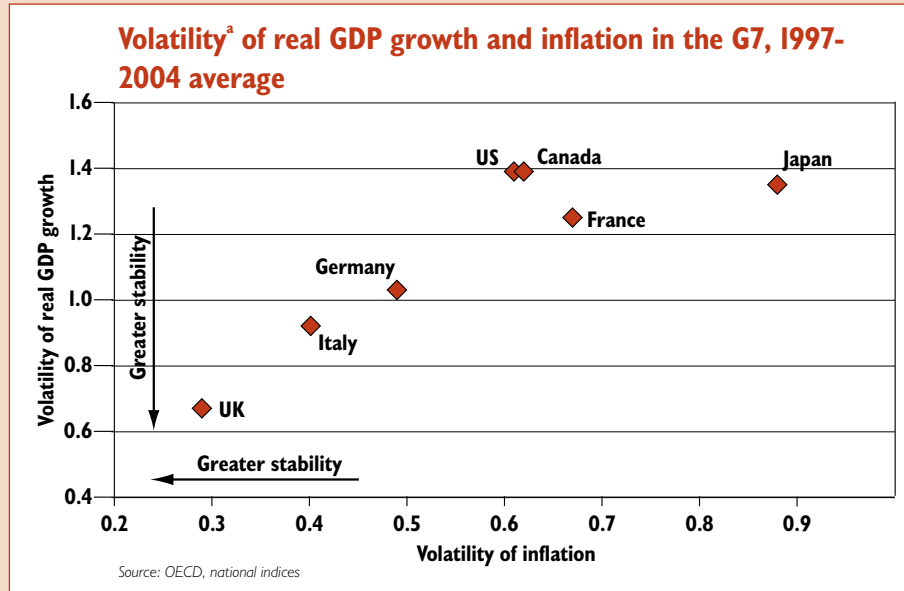
2.10 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding³ in 1997 established a framework for co-operation between these three bodies on financial stability. The Bank of England is responsible for the stability of the financial system as a whole, including the payments infrastructure. The FSA is responsible for the authorisation and supervision of financial institutions including banks, for supervising financial markets and securities clearing and settlement systems, and for regulatory policy. The Treasury has responsibility for the overall institutional structure of regulation and the legislation that governs it.

2.11 A Standing Committee, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss financial stability, focusing on risks deemed to have systemic consequences. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and coordinates the three authorities' contingency plans. In the event of a crisis, it would meet at short notice and co-ordinate any necessary action by the authorities.

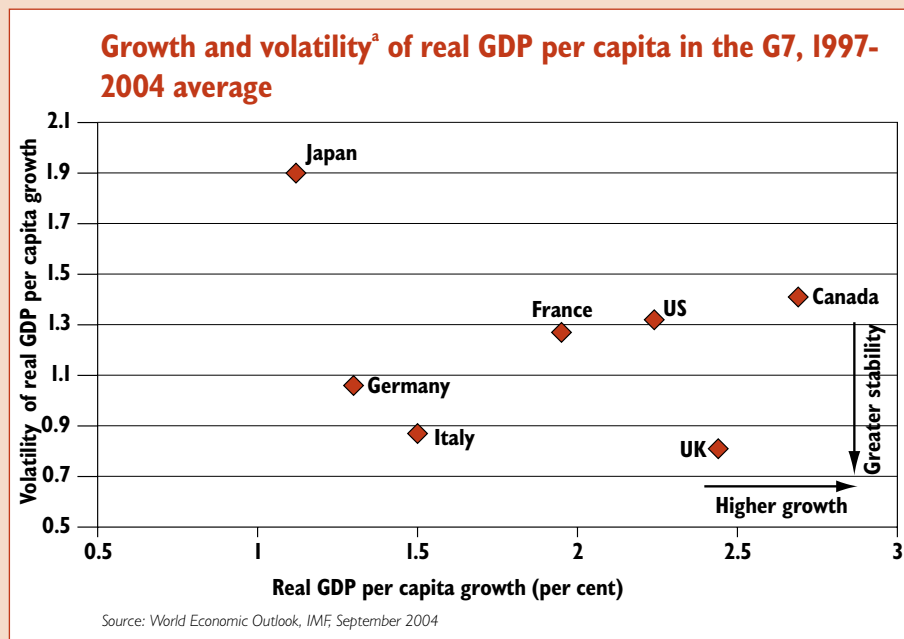
³ Full text available at www.hm-treasury.gov.uk.

Box 2.1: Macroeconomic stability in the UK

The UK has experienced unprecedented macroeconomic stability since the introduction of the new macroeconomic framework in 1997, with the volatility of real GDP growth and inflation now at their lowest sustained levels since quarterly national accounts data began. The UK has been the most stable of all G7 economies since 1997, with volatility in real GDP growth and inflation around half that of the average of the other economies in the G7. From being one of the most volatile economies in the G7, the UK is now the most stable.



This domestic stability has been achieved alongside strong economic growth, with the UK real GDP per capita growth rate over a third higher than the average of the other G7 economies since 1997. As the International Monetary Fund has noted: “Macroeconomic performance in the United Kingdom during the past decade has been strong and steady. Standing out among G7 countries, the United Kingdom has enjoyed relatively rapid and stable per capita growth.”^b



^a Volatility is measured by the standard deviation.

^b IMF UK Article IV Report, March 2005.

PERFORMANCE OF THE FRAMEWORK

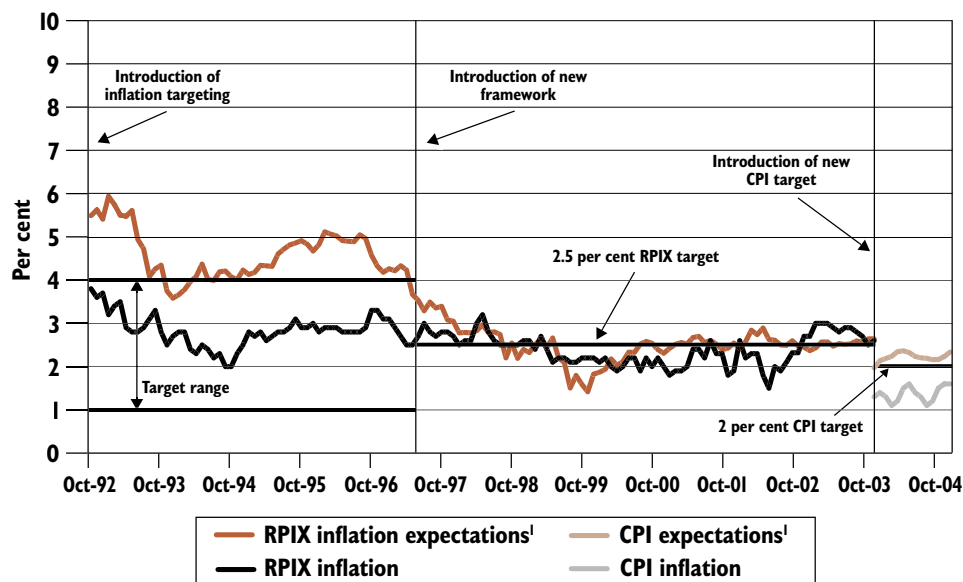
2.12 The frameworks for monetary policy, fiscal policy and public spending provide a coherent strategy for maintaining high and stable levels of growth and employment, and for minimising the adverse impact of external events.

Monetary policy 2.13 The monetary policy framework has improved the credibility of policy making and continues to deliver clear benefits. Since the new framework was introduced:

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target value of 2½ per cent, the longest period of sustained low inflation for the last 30 years; and
- inflation expectations have remained close to target following the switch from a 2½ per cent RPIX target to a 2 per cent CPI target. CPI inflation has been within 1 percentage point of its target since its inception in December 2003.⁴

2.14 The monetary policy framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3½ per cent. This helped to keep output relatively close to its trend level, while ensuring that inflation remained close to target. Consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation, as growth strengthened, the MPC raised interest rates on five occasions between November 2003 and August 2004 to reach 4¾ per cent.

Chart 2.1: Inflation performance and expectations



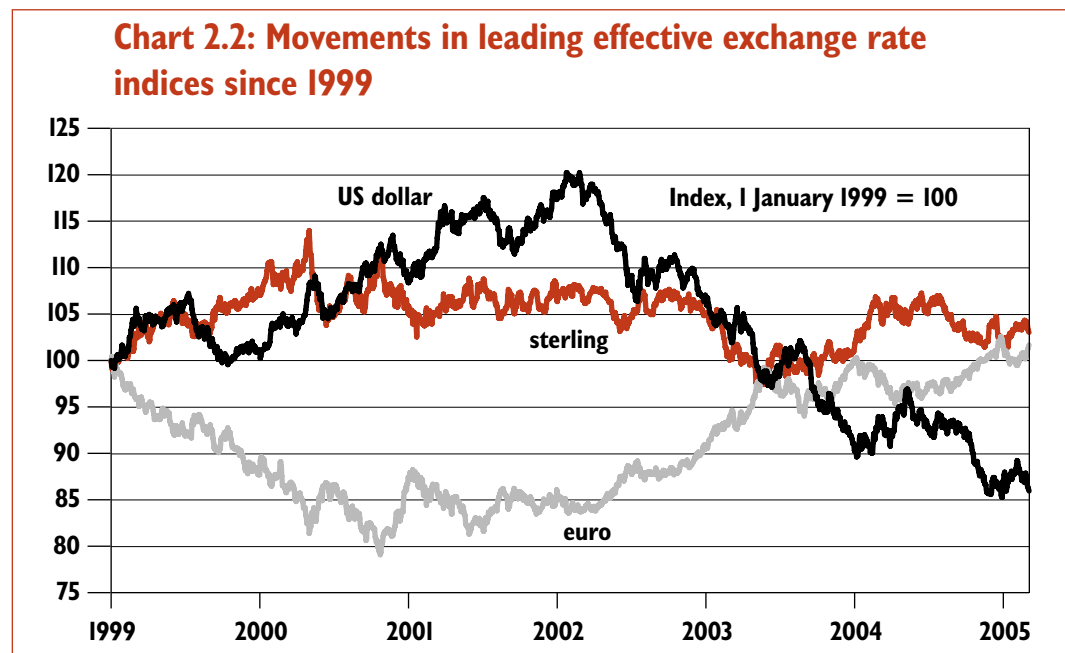
¹ Implied expectations of average RPI inflation ten years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI expectations and stylised assumptions about expected differences between RPI and CPI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

2.15 Low inflation expectations and a period of entrenched macroeconomic stability have helped long-term spot interest rates remain at historically low levels, averaging 4.8 per cent over the last year. Over the current economic cycle, provisionally judged to have begun in mid-1999, long-term spot interest rates have averaged just under 5 per cent, compared with

⁴ In January 2005, the difference between RPIX and CPI inflation fell to 0.5 per cent. This narrowing of the difference between the two measures is broadly as was expected when the new inflation target was introduced in December 2003.

an average of over 9 per cent in the cycle running from mid-1986 to mid-1997. Low long-term interest rates reduce the Government's debt interest payments, free up resources for public services and help to promote investment throughout the economy. Ten-year forward rates, which abstract from cyclical influences, remain at or below those in the US and the euro area.⁵ Ten-year forward rates have fallen slightly in the UK over the year from 4.8 per cent in March 2004 to 4.5 per cent. This compares with a rate of 8 per cent in April 1997 before the introduction of the new macroeconomic framework.

2.16 The sterling effective exchange rate remains close to levels at Budget 2004. Alongside the UK's macroeconomic stability in recent years, the effective exchange rate has also been relatively stable, as seen in Chart 2.2. Indeed, since the introduction of the euro in 1999, the volatility of sterling's effective exchange rate has been under half that of the euro and around a third that of the US dollar.



Fiscal policy 2.17 The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by around 4 per cent of GDP, supporting monetary policy during a period when the economy was generally above trend. In more recent years, fiscal policy has supported monetary policy as the economy has been below trend: between 2000-01 and 2003-04, the fiscal stance eased by around 3 per cent of GDP. Public sector net debt was also reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.3 and Box 2.6 show, since 1997 the UK's public finances have compared favourably with other countries and they remain in a fundamentally sound long-term position.

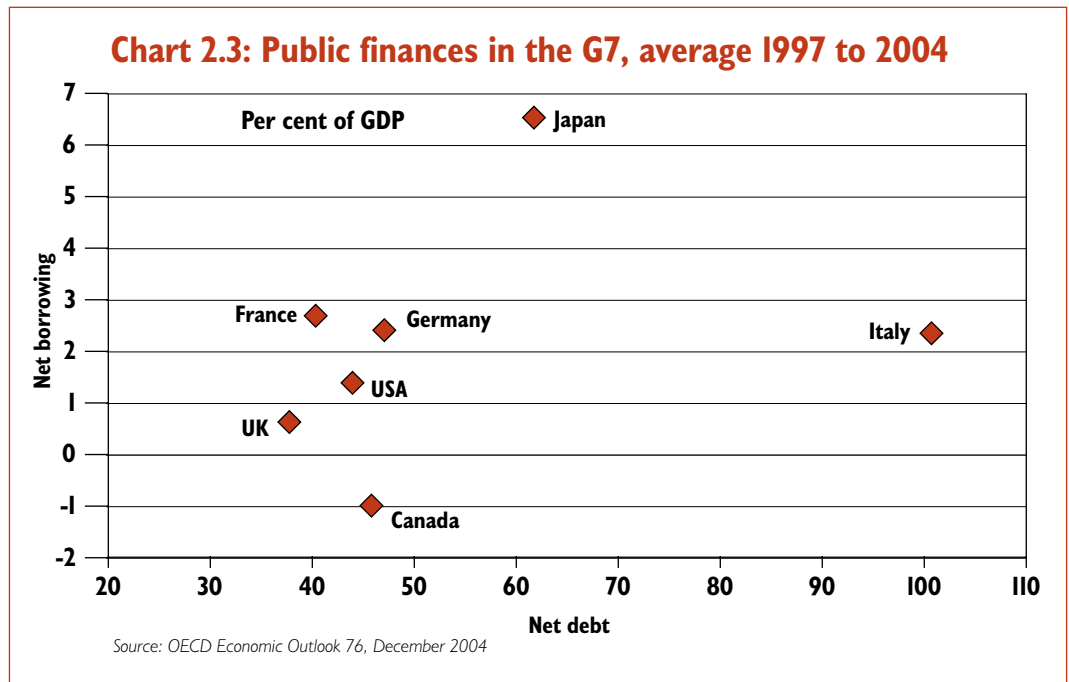
2.18 The 2004 Spending Review set spending plans for the years 2005-06 to 2007-08, locking in the increased investment of previous spending reviews while providing for further investment in the most crucial areas of the public services. These plans provide for:

- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;

⁵ Ten year forward rates are market expectations, formed today, of short rates in ten years' time. They are less affected by short-term factors, such as the current cyclical position of the economy, than spot rates and are therefore a better basis for making international comparisons when cyclical conditions differ.

- public sector net investment to rise from 2 per cent of GDP to 2½ per cent by 2007-08, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

2.19 The overall spending limits set in Budget 2004 and confirmed in the 2004 Spending Review remain sustainable and fully consistent with the fiscal rules.



Box 2.2: Government policy on EMU

The Government's policy on membership of the single currency was set out by the Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor is the national economic interest and whether, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous.

An assessment of the five economic tests was published in June 2003. This concluded that: "since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area." The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment. The Budget reports on progress, including:

- the introduction in December 2003 of a symmetric inflation target as measured by the Consumer Prices Index (CPI). CPI inflation has been within 1 percentage point of its target since its inception;
- reforms to address both supply and demand in the housing market through implementing a programme of change to increase supply and responsiveness of the housing market as recommended in the Barker review and action taken in response to the Miles review on the mortgage market, described further in Chapter 3; and
- reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. Chapters 3 and 4 provide further detail.

The Government also publishes twice-yearly reports on euro preparations. The *Report on euro preparations, December 2004*, sets out the progress that has been made across the economy since the last report in April 2004. On the Stability and Growth Pact, the Government continues to emphasise the need for a more prudent interpretation of the Pact as described in Box 2.4 and *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004. The Government also remains committed to the EU's Lisbon strategy on economic reform, launched in March 2000, and will continue to work with Member States and the EU institutions to build on progress so far and to accelerate the pace of reform in order to meet the Lisbon challenge. In December 2004, the Chancellor and the Finance and Economics Ministers of Ireland, the Netherlands, Luxembourg, Austria and Finland launched a joint initiative, *Advancing Regulatory Reform in Europe*, establishing regulatory reform as a key priority of the six EU Presidencies through to the end of 2006.

In his statement to the House of Commons on 9 June 2003, the Chancellor committed the Government to an annual review of progress. The Government does not propose a euro assessment to be initiated at the time of this Budget. The Treasury will again review the situation at Budget time next year as required by the Chancellor's June 2003 statement.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments **2.20** The Government's macroeconomic framework allowed the UK economy to remain resilient in the face of the challenges and uncertainties that affected the world economy between 2001 and 2003. The UK is the only major economy not to have experienced a single quarter of negative GDP growth during this period.

2.21 As expected the global economy gathered pace last year. World output growth in 2004 was at its strongest for nearly three decades as a result of improved economic developments in most advanced economies as well as a number of major emerging economies. Strong G7 growth in 2004 was driven principally by robust growth in the US, Canada and UK. There was also a solid contribution to growth from Japan in 2004 and some improvement in the euro area, although growth in these countries remains low relative to that of many other advanced economies, and Japan, Germany and Italy, all saw output fall in the latter part of the year. Nevertheless strong growth in a number of advanced and emerging economies means world growth has retained much of its momentum going into 2005.

Table 2.1: Summary of world forecast

	Percentage change on a year earlier unless otherwise stated			
	2004	Forecasts		
		2005	2006	2007
<i>Major 7 countries¹</i>				
Real GDP	3¼	2½	2½	2½
Consumer price inflation ²	2½	2¼	1¾	1¾
<i>Euro area</i>				
Real GDP	1¾	1½	2¼	2¼
World trade in goods and services	8¾	8¼	7¾	7¼
UK export markets ³	7½	7½	7	6¾

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

² Per cent, Q4.

³ Other countries' imports of goods and services weighted according to their importance in UK exports.

2.22 UK GDP has now grown for 50 consecutive quarters, the longest unbroken expansion on record. UK GDP is currently estimated to have risen by 3.1 per cent in 2004 as a whole, the fastest for four years and consistent with the 3 to 3½ per cent forecast range that the Government maintained unchanged from the 2002 Pre-Budget Report. Growth dipped to slightly below its assumed trend rate in the third quarter, strengthening in the final quarter of the year.

2.23 Stronger expansion at the end of 2004 has been accompanied by recent rises in manufacturing output, and supported by both the continued momentum of domestic demand, in particular business investment, and increasing signs of strong external demand translating into more vigorous export growth. Private sector business survey indicators in recent months have generally supported the view that robust growth of UK output and activity is expected to continue into 2005.

Box 2.3: UK Presidencies of the G7/8 and EU

Far-reaching and fundamental changes in technology, production and trading patterns are shifting the balance of global economic activity, and supporting the rise of the large emerging economies. These changes bring with them challenges and opportunities for all economies. The UK sees its leadership of the G7/8 and EU this year as an opportunity to address the key challenges of international poverty reduction; structural economic reform; fairer trade; and climate change.

G7 Finance Ministers and Central Bank Governors met in London on 4-5 February 2005. In response to these challenges, they discussed the importance of all countries playing their part to achieve balanced and sustainable growth; agreed proposals to improve the operation of the oil market; and set out plans to help developing countries achieve the Millennium Development Goals by 2015. Further information is set out in Chapter 5 and at www.g7.gov.uk. Further, recognising the need for greater and wider partnerships, the G7 held an informal meeting with key emerging economies and continued its productive dialogue with the Chinese authorities. As G7 and G20 Presidencies, the UK and China will continue to work closely together.

Long-term global economic challenges and opportunities for Europe, published alongside Budget 2005, examines the implications for Europe of the far-reaching changes likely to affect the global economy over the coming decade, and sets out the associated policy challenges. Meeting these will require sustained action over the long term. The UK will aim to use its EU Presidency in the second half of 2005 to develop a consensus on the need for a more Global Europe which, by becoming more outward-looking and embracing greater flexibility in labour, product and capital markets, delivers high employment for its citizens; and steps up to its global responsibilities. In particular, working closely with EU institutions and Member States, the UK will seek to:

- foster enterprise and innovation in Europe – driving forward the regulatory reform agenda to improve the quality of Commission impact assessments and to simplify and reduce burdens in the existing stock of regulation;
- establish a more dynamic single market – working to achieve progress on a single market in services, and towards a future strategy on financial services which focuses more on implementation and enforcement of existing legislation and use of non-legislative alternatives such as proactive competition policy;
- promote high employment across Europe – encouraging further action by Member States to develop and implement active labour market strategies to help the unemployed and inactive find work and policies to raise skills levels and improve adaptability among the workforce;
- create a more outward-looking Europe – encouraging the EU to show leadership on fairer trade to work towards an ambitious and pro-poor agreement in the Doha Development Agenda WTO negotiations; and strengthening bilateral economic relations, particularly with the US, through a new EU-US economic cooperation partnership; and
- encourage Europe to play a leadership role in meeting global challenges – increasing resources to help meet the Millennium Development Goals, and tackling climate change.

Economic prospects 2.24 Recent economic developments are broadly as envisaged in the 2004 Pre-Budget Report and so the Budget 2005 forecast is very similar. With the world economy still expanding strongly, and business and consumer confidence having regained strength, the recent momentum of UK GDP growth is expected to carry through into 2005. Renewed growth at above trend rates is therefore expected for much of 2005, as robust domestic demand growth is bolstered by continued strong growth in external demand for UK output. However, with the output gap narrowing further and monetary policy having undergone a tightening of 125 basis points since November 2003, growth is expected gradually to ease back to its trend rate later in the year, with the current economic cycle coming to a close around the end of 2005. Fiscal policy should continue to support monetary policy with the overall impact of fiscal policy moving back towards a more neutral position as the economy returns to trend.

2.25 Going forward, CPI inflation is expected to rise gradually during 2005 from its current level of 1.6 per cent as strong global growth feeds through in further upward pressure on import prices. The credibility of the Government's monetary policy framework, through its effect in anchoring inflation expectations, is also expected to contribute in returning inflation to target.

Table 2.2: Summary of UK forecast¹

	2004	Forecast		
		2005	2006	2007
GDP growth (per cent)	3	3 to 3½	2½ to 3	2¼ to 2¾
CPI inflation (per cent, Q4)	1¼	1¼	2	2

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

Composition of UK growth 2.26 In recent years, GDP growth has become more balanced, with the composition having shifted away from private consumption, and investment and export growth picking up.

2.27 Real private consumption growth in 2004, at just over 3 per cent, was stronger than in 2003. This largely reflects a particularly strong rise of over 1 per cent in the first quarter – in contrast to an unusually weak beginning to the previous year. In the remainder of 2004, private consumption growth progressed at a little below its long-run average. The position of household balance sheets and recent increases in interest rates are expected to keep consumer spending growth at rates close to that of incomes over the forecast horizon. Therefore private consumption is expected to continue growing at sustainable rates, rising by 2¼ to 2¾ per cent this year and by 2 to 2½ per cent in 2006, slightly below forecast rates of GDP growth.

2.28 Investment growth has strengthened significantly during the past two years, as corporate sentiment has risen on the back of improved global demand. In 2004, business investment grew by just under 5½ per cent, its strongest performance for six years. Investment growth in 2004 was stronger than expected either at the time of the 2003 Pre-Budget Report or Budget 2004. Going forward, business investment is expected to continue growing at robust rates, but at a slightly slower pace than in 2004, as companies, with relatively supportive balance sheets, continue to respond to strong demand growth. High levels of profitability are expected to offer further support to expanding capital outlays. Business investment is therefore forecast to rise by 4¼ to 4¾ per cent in 2005 and by 3½ to 4¼ per cent in 2006.

2.29 Export growth strengthened in 2004. Following a fall in the first quarter which coincided with a sharp drop in UK export market growth, export volume growth in the final three quarters of 2004 averaged $1\frac{3}{4}$ per cent a quarter. The recent momentum of export growth is expected to carry through into 2005, supported by further robust demand in the world economy. Export volumes of goods and services are forecast to rise by 6 to $6\frac{1}{2}$ per cent this year and by $6\frac{1}{4}$ to $6\frac{3}{4}$ per cent in 2006, implying rates of underlying growth close to those already seen in recent quarters and similar to the 2004 Pre-Budget Report projections. Import growth is also expected to follow a similar path to that set out in the Pre-Budget Report, growing a little more slowly than exports. The trade balance is expected to remain broadly flat over the forecast horizon, with net trade making a broadly neutral contribution to GDP growth.

Risks 2.30 On balance there has been a reduction in the risks surrounding the forecast since the Pre-Budget Report. The global outlook remains a key influence on UK prospects. The risks to the global outlook of higher oil prices have diminished since the time of the Pre-Budget Report given the robustness of growth in the face of high prices in 2004, with increasing recognition that high oil prices have been driven primarily by strong demand. The risks relating to exchange rates and a disorderly adjustment to the world's current account imbalances remain unchanged since the Pre-Budget Report. In the medium term, structural reform would help to rebalance growth and facilitate the unwinding of imbalances.

2.31 UK house prices continue to pose risks in both directions, although increasingly the evidence since the Pre-Budget Report points to an orderly moderation in house price inflation and recent signs of some emerging revival in sentiment suggest that the downside risks are smaller than at the time of the Pre-Budget Report.

2.32 The forecast also continues to face upside risks from investment. For example, growth of business investment could exceed expectations going forward given current robust rates of demand growth and with supportive corporate financial conditions.

The economic cycle 2.33 On the basis of the Government's provisional judgement on the dating of the current and past economic cycles, the economy completed a full, though short, cycle between the first half of 1997 and mid-1999. The current economic cycle began in mid-1999 when actual output moved above its trend level. In the second half of 2001, the economy moved below trend with actual output remaining below its trend level since then. The economy is expected to return to trend around the end of 2005, in line with the forecast in the 2004 Pre-Budget Report.

Caution and the public finances 2.34 A number of key assumptions that underpin the public finance projections are independently audited by the Comptroller and Auditor General to ensure that they remain reasonable and cautious. A complete list of these assumptions is set out in Chapter C of the *Financial Statement and Budget Report*. This prudent approach to fiscal policy builds an important safety margin into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending.

2.35 For Budget 2005, the Comptroller and Auditor General has audited the assumption relating to unemployment. The review concluded that the assumption was reasonable and cautious.

2.36 The public finances continue to be based on a deliberately cautious assumption for trend output growth that is a $\frac{1}{4}$ percentage point lower than the Government's neutral view. The Comptroller and Auditor General will be invited to audit this assumption once the current cycle has ended, currently projected to be around the end of 2005, around which time information relating to an additional on-trend point will be available.

RECENT FISCAL TRENDS AND OUTLOOK

2.37 Budget 2005 presents the Government's annual fiscal forecast and updates the 2004 Pre-Budget Report interim projections.⁶

2.38 The Budget 2005 projections are broadly in line with the 2004 Pre-Budget Report interim projections, locking in the Government's prudent fiscal stance. Underpinned by a strong and stable economy, receipts growth has strengthened through the year, with estimated growth in tax receipts in 2004-05 as projected in the Pre-Budget Report. Growth in corporation tax receipts has exceeded expectations. Where there are changes to the Pre-Budget Report projections, these are modest and are primarily explained by timing effects relating to expenditure; the projections in the medium term are broadly unchanged.

2.39 The estimated 2004-05 outturn for public sector net borrowing is £34.4 billion, compared with £34.2 billion projected in the 2004 Pre-Budget Report and £32.9 billion projected in Budget 2004. For the public sector current budget, the estimated 2004-05 outturn shows a deficit of £16.1 billion compared with projected deficits of £12.5 billion and £10.5 billion in the 2004 Pre-Budget Report and Budget 2004 respectively. This is significantly lower than the deficit on the public sector current budget of £20.4 billion in 2003-04 as the impact of the strengthening economy has fed through to receipts. On the basis of cautious, audited assumptions, the Government is meeting its strict fiscal rules over the economic cycle.

2.40 Table 2.3 shows projections for public sector net borrowing compared with those presented in the 2004 Pre-Budget Report. It disaggregates the differences into those relating to net taxes and national insurance contributions and other forecasting effects. It also includes the impact of discretionary measures. In this Budget, the Government provides a further £340 million for the special reserve in 2004-05 and £400 million for the special reserve in 2005-06, continuing to make prudent provision for the costs of the military conflict in Iraq and its other international obligations.

Non-discretionary changes in receipts

2.41 Net taxes and national insurance contributions have strengthened through 2004-05, and are estimated to have grown at 7.3 per cent on the previous year, as forecast in the Pre-Budget Report. Income tax receipts have grown in line with expectations, with robust growth in the financial sector reflected in higher bonus payments. Improving corporate profitability and higher oil prices have boosted corporation tax receipts, which have strengthened since the Pre-Budget Report. VAT receipts have been lower than expected, in part due to slower growth in nominal consumers' expenditure.

2.42 With the economy retaining its momentum as it moves back to trend, the public finances are expected to strengthen further in 2005-06. In addition to strong underlying growth in corporation tax receipts, NAO-audited assumptions for oil prices and equity prices contribute to expected continued growth in tax receipts.

⁶ The Budget 2005 fiscal projections take account of the February outturns for receipts, spending and borrowing. The Office for National Statistics/HM Treasury Public Sector Finances Release with provisional estimates of the public finances for February 2005 will be issued on 18 March 2005. Further details are provided in Chapter C of the *Financial Statement and Budget Report*.

Table 2.3: Public sector net borrowing compared with the 2004 Pre-Budget Report

£ billion	Estimate		Projections			
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
PBR 2004	34.2	33	29	28	24	22
Net taxes and national insurance contributions	-0.1	1	0	-1½	-½	0
Other forecasting effects	-0.1	-2	0	½	1	-½
Total before discretionary measures¹	34.1	32	29	27	24	22
Discretionary measures²	0.3	-½	0	½	-½	½
Budget 2005	34.4	32	29	27	24	22

¹ Totals may not sum due to rounding.

² Discretionary measures include tax compliance and anti-avoidance measures announced in Budget 2005.

Non-discretionary changes in spending

2.43 Other forecasting effects include offsetting impacts of higher current expenditure and lower than expected net investment in 2004-05. While the estimated outturn for Total Managed Expenditure (TME) in 2004-05 is £1.1 billion lower than projected in the 2004 Pre-Budget Report, the estimated outturn for 2004-05 Resource Departmental Expenditure Limits (DEL) is £269 billion, £2.0 billion higher than projected in the 2004 Pre-Budget Report, including the further £340 million for the special reserve in 2004-05.

2.44 Higher current expenditure in 2004-05 is in part due to a timing effect relating to net payments to the EU, with higher than expected payments in 2004-05 being offset by lower expected payments in 2005-06. There has been additional expenditure in 2004-05 to meet the UK's international commitments as well as use by departments of end-year flexibility to meet the Government's priorities including health and education. Use of end-year flexibility has enabled departments to smooth their expenditure for 2004-05, the year with the lowest overall planned spending growth of the 2002 Spending Review period.

BUDGET DECISIONS

2.45 The Budget is the definitive statement of the Government's desired fiscal policy settings. In making its Budget decisions the Government has considered:

- the need to ensure that, over the economic cycle, the Government will continue to meet its strict fiscal rules;
- its fiscal policy objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- how fiscal policy can best support monetary policy over the economic cycle.

2.46 Against this backdrop, and building on steps already taken, Budget 2005 announces further decisions to lock in stability and invest in the UK's future, including:

- a long-term programme of investment to deliver twenty-first century facilities in primary schools, and new measures to boost the development of skills in young people;
- a commitment to increase the child element of the Child Tax Credit in line with average earnings up to 2007-08;

- free local area bus travel for all people over the age of 60 and disabled people from April 2006, and an additional payment guaranteeing that council tax paying households with someone over 65 will receive £200 towards the cost of council tax;
- a doubling of the stamp duty land tax zero-rate threshold from £60,000 to £120,000 for all residential property transactions;
- further reforms to modernise the tax system, including better aligning North Sea corporation tax payments with payments for petroleum revenue tax; and a number of measures to tackle tax fraud and avoidance;
- deferral of the inflation-based increase in main fuel duties to 1 September 2005, in response to sustained volatility in oil prices; and
- a further £340 million for the special reserve in 2004-05 and £400 million in 2005-06 for military operations in Iraq and the UK's other international obligations.

2.47 Table 1.2 lists the key Budget policy decisions and their impact on the public finances, including resetting the AME margin. Further details are set out in Chapter A of the *Financial Statement and Budget Report*.

MEDIUM-TERM FISCAL PROJECTIONS

2.48 Table 2.4 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2004 and in the 2004 Pre-Budget Report. Changes in the fiscal balances are disaggregated into those attributable to revisions or forecasting changes and discretionary measures. It includes the impact of all Budget decisions in accordance with the *Code for fiscal stability*. Further detail is provided in Chapter C of the *Financial Statement and Budget Report*.

2.49 The revised outturn for 2003-04 shows the deficit on the current budget to be £0.9 billion lower than in Budget 2004, and £0.7 billion lower than in the 2004 Pre-Budget Report. The outturn for 2003-04 for net borrowing is £2.1 billion lower than shown in Budget 2004, and £0.6 billion higher than in the 2004 Pre-Budget Report.

Table 2.4: Fiscal balances compared with Budget 2004 and the 2004 Pre-Budget Report

	Outturn ¹	Estimate ²	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Surplus on current budget (£ billion)							
Budget 2004	-21.3	-10.5	-5	0	4	9	
Effect of revisions and forecasting changes:	0.2	-1.2	-1	1	0	-1	
Receipts ³	-2.8	-3.5	-3	-2	-1	-1	
Current expenditure ⁴	3.0	2.3	2	3	1	1	
Effect of discretionary changes	0.0	-0.8	0	0	0	0	
PBR 2004	-21.1	-12.5	-7	1	4	9	12
Effect of revisions and forecasting changes:	0.8	-3.2	1	0	1	0	1
Receipts ³	0.2	-1.3	-2	-1	0	-1	0
Current expenditure ⁴	0.5	-1.9	3	1	1	1	1
Effect of discretionary changes	0.0	-0.3	0	0	0	0	0
Budget 2005	-20.4	-16.1	-6	1	4	9	12
Net borrowing (£ billion)							
Budget 2004	37.5	32.9	31	27	27	23	
Changes to current budget	-0.2	2.0	1	-1	1	1	
Forecasting changes to net investment	-2.5	-0.6	1	2	0	0	
Discretionary changes to net investment	0.0	-0.1	0	0	0	0	
PBR 2004	34.8	34.2	33	29	28	24	22
Changes to current budget	-0.8	3.6	-1	0	-1	0	0
Forecasting changes to net investment	1.4	-3.4	0	0	0	0	0
Discretionary changes to net investment	0.0	0.0	0	0	0	0	0
Budget 2005	35.4	34.4	32	29	27	24	22
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2004	-1.0	-0.2	-0.2	0.0	0.3	0.7	
PBR 2004	-1.0	-0.4	-0.4	0.1	0.3	0.6	0.8
Budget 2005	-1.0	-0.8	-0.3	0.1	0.3	0.6	0.8
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2004	2.4	2.1	2.3	2.1	1.9	1.6	
PBR 2004	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Budget 2005	2.3	2.4	2.4	2.2	2.0	1.6	1.5
Net debt (per cent of GDP)							
Budget 2004	33.2	34.4	35.3	35.9	36.3	36.4	
PBR 2004	32.9	34.3	35.4	36.2	36.8	37.0	37.1
Budget 2005	32.8	34.4	35.5	36.2	36.8	37.1	37.1

Totals may not sum due to rounding.

¹ The 2003-04 figures were estimates in Budget 2004.

² The 2004-05 figures were projections in Budget 2004.

³ Further details given in table C7.

⁴ Includes depreciation.

2.50 The estimated surplus on the current budget in 2004-05 is lower compared with the 2004 Pre-Budget Report, reflecting higher current expenditure than previously projected, as discussed above. As receipts strengthen over the projection period, the surplus on the current budget rises in line with projections in the 2004 Pre-Budget Report. The estimated net borrowing in 2004-05 and later years is broadly unchanged compared with the 2004 Pre-Budget Report.

2.51 Table 2.4 also sets out the underlying structural position of the fiscal balances, adjusted for the impact of the economic cycle on the public finances.⁷ Cyclically-adjusted, the deficit on the current budget and net borrowing are a little higher in 2004-05 compared with the 2004 Pre-Budget Report and Budget 2004 projections. After 2004-05, they return to levels in line with projections in the 2004 Pre-Budget Report and Budget 2004. At 1.5 per cent of GDP by the end of the projection period, cyclically-adjusted net borrowing is consistent with net debt stabilising at 37 per cent of GDP.

⁷ Details of the Treasury's approach to cyclical adjustment can be found in Annex A of the 2003 *End of year fiscal report*.

Box 2.4: The Stability and Growth Pact

There has been significant discussion recently of issues surrounding macroeconomic frameworks in Europe, particularly of the Stability and Growth Pact (SGP). The introduction of the SGP in the late 1990s represented a major step forward in recognising the importance of long-term budgetary discipline and as a framework for coordination by Member States of their fiscal policies. The UK has supported the principle of a strong SGP, recognising that fiscal sustainability is a prerequisite for macroeconomic stability, and that collective fiscal co-ordination is desirable within an integrated economic community, and essential for a successful monetary union. However the operation of the SGP has highlighted a number of issues that need to be addressed. The slowdown in the global and European economies in recent years tested its effectiveness in supporting both stability and growth, and the implementation of the SGP's Excessive Deficit Procedure (EDP) for a number of countries highlighted problems surrounding its operation and design.

As set out in *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004, the UK Government has consistently argued for reform to promote a prudent interpretation of the SGP. A prudent interpretation would take into account:

- the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy, so providing the flexibility to take the right decisions over the cycle;
- sustainability – taking into account that low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations, such as that set out in Annex A and in the *2004 Long-term public finance report*; and
- public investment – recognising that public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.

Proposals for reform are being discussed in Europe. These proposals are an important step forward, with increased attention to the economic cycle, debt levels, and country specific circumstances. However, much will depend on implementation. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

ADHERING TO PRINCIPLES

2.52 Table 2.5 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. The table indicates that, after allowing for non-discretionary changes to receipts and spending and taking into account the Budget decisions, the Government is meeting both its fiscal rules.

Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate ¹	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Fairness and prudence							
Surplus on current budget	-1.8	-1.4	-0.5	0.0	0.3	0.6	0.8
Average surplus since 1999-2000	0.5	0.1	0.1	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	-1.0	-0.8	-0.3	0.1	0.3	0.6	0.8
Long-term sustainability							
Public sector net debt ¹	32.8	34.4	35.5	36.2	36.8	37.1	37.1
Core debt ¹	31.6	32.8	33.8	34.5	35.2	35.6	35.7
Net worth ²	24.7	22.1	19.9	18.9	18.2	18.4	18.0
Primary balance	-1.5	-1.3	-0.9	-0.5	-0.2	0.1	0.3
Economic impact							
Net investment	1.3	1.6	2.1	2.3	2.3	2.3	2.3
Public sector net borrowing (PSNB)	3.2	2.9	2.6	2.2	2.0	1.6	1.5
Cyclically-adjusted PSNB	2.3	2.4	2.4	2.2	2.0	1.6	1.5
Financing							
Central government net cash requirement	3.5	3.7	3.2	2.6	2.3	2.1	2.2
Public sector net cash requirement	3.5	3.2	2.8	2.4	2.1	1.8	1.8
European commitments							
Treaty deficit ³	3.2	2.9	2.6	2.2	2.0	1.7	1.6
Cyclically-adjusted Treaty deficit ³	2.3	2.3	2.4	2.2	2.0	1.7	1.6
Treaty debt ratio ⁴	39.5	41.0	42.0	42.4	42.8	42.9	42.9
<i>Memo: Output gap</i>	-1.2	-0.7	-0.1	0.0	0.0	0.0	0.0

¹ At end March; GDP centred on end March.

² At end December; GDP centred on end December.

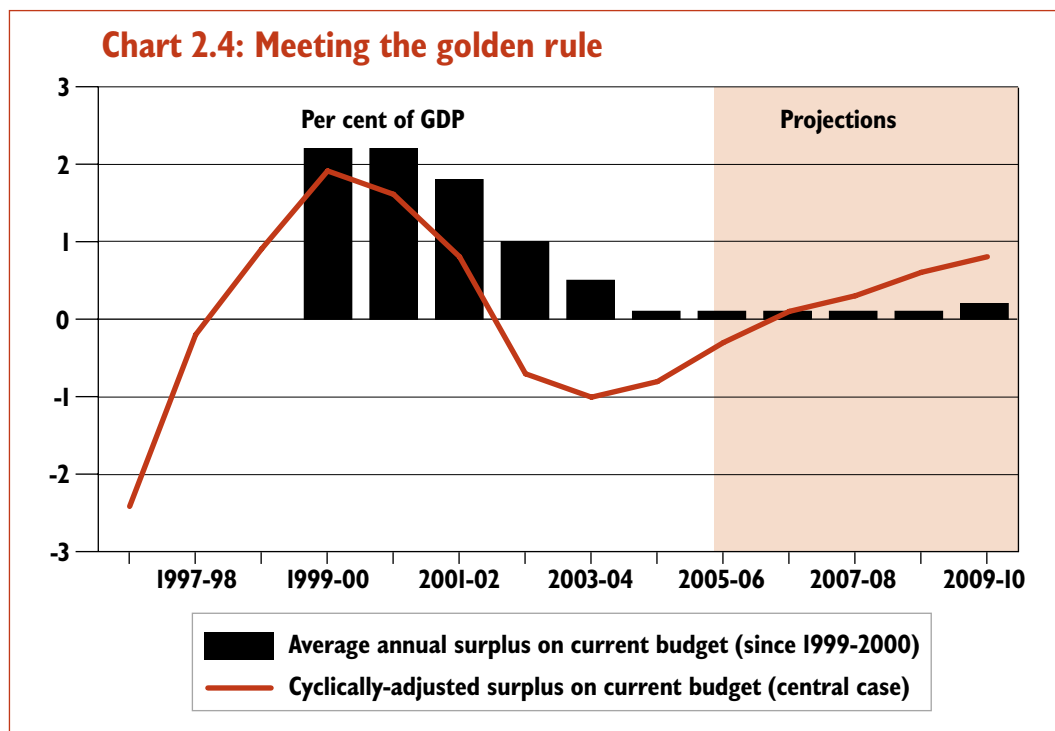
³ General government net borrowing on a Maastricht basis.

⁴ General government gross debt on a Maastricht basis.

Golden rule 2.53 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and is therefore an important indicator of intergenerational fairness. The current budget strengthens through the projection period, returning to surplus in 2006-07 and showing a surplus of 0.8 per cent of GDP by 2009-10.

2.54 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.

2.55 The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year of the projection period. The economy is projected to return to trend during 2005-06, meaning that over the whole cycle the average annual surplus on the current budget would be 0.1 per cent of GDP, unchanged since Budget 2004. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £6 billion in this cycle, including the AME margin.



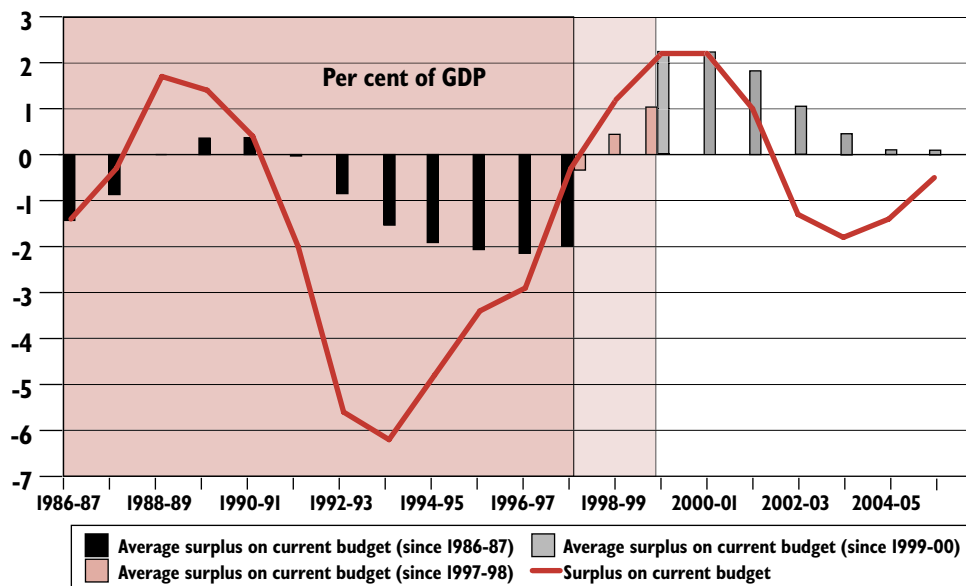
2.56 The economy is projected to return to trend around the end of 2005. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus on the current budget over the period 2005-06 to 2009-10 is over a $\frac{1}{4}$ per cent of GDP. Based on cautious assumptions, the Government is therefore on course to meet the golden rule from 2005-06 to the end of the projection period.

Box 2.5: The current budget in past and current cycles

The current budget represents the difference between current receipts and current expenditure including depreciation. The golden rule is met if the average annual surplus on the current budget expressed as a ratio to GDP is in balance or surplus over the economic cycle.^a

Since the mid-1980s, there have been three economic cycles: the first running from mid-1986 to the first half of 1997; a short cycle which began in the first half of 1997 and, on the basis of the Government's provisional judgement, is estimated to have ended in mid-1999; and the current economic cycle beginning in mid-1999 and currently projected to end in 2005-06. The chart shows that the golden rule was met in the short cycle between the first half of 1997 and mid-1999, and is being met in the current cycle. The golden rule would not have been met in the cycle running from mid-1986 to the first half of 1997, during which period there was an average annual deficit on the current budget of nearly 2 per cent of GDP.

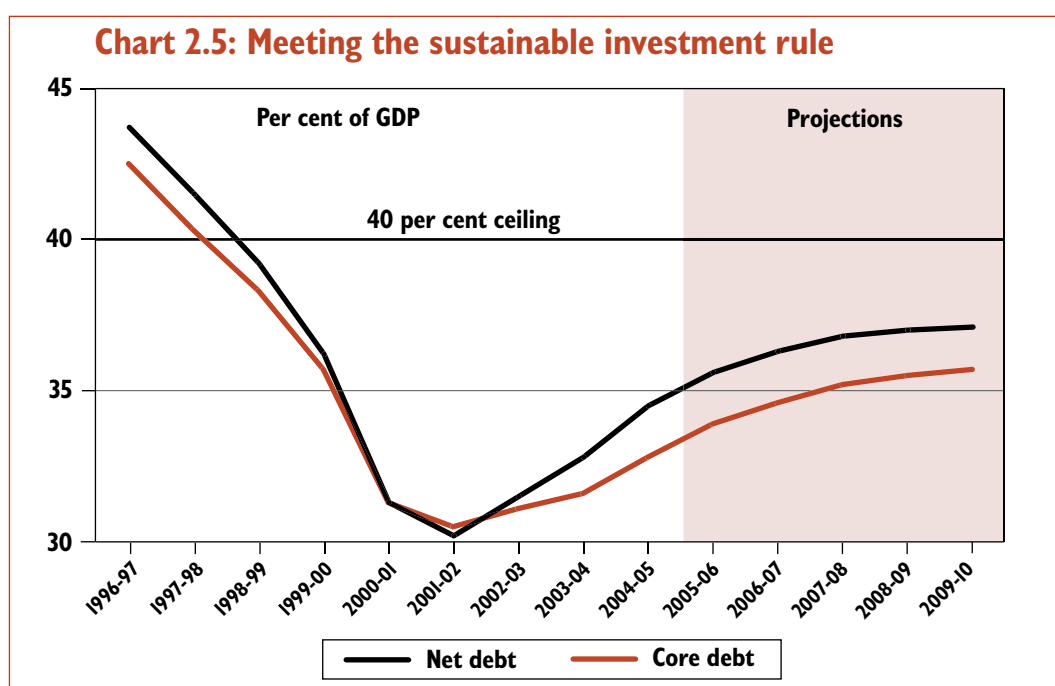
Current budget 1986-87 to 2005-06



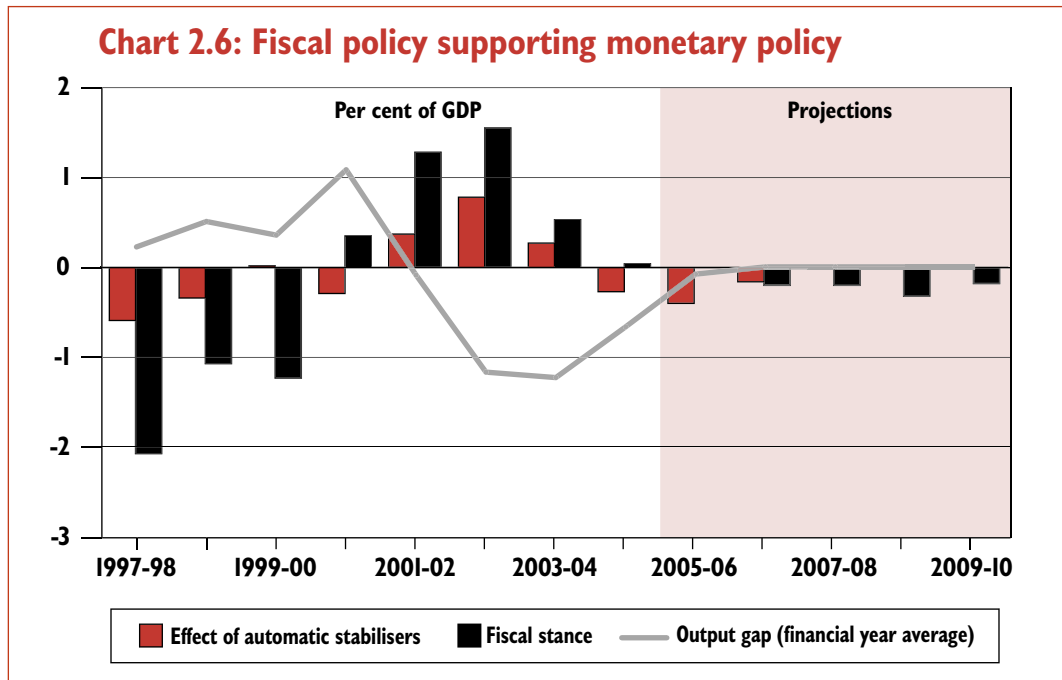
^a The rationale for the Government's fiscal rules and their measurement is discussed in detail in Chapter 9 of *Reforming Britain's Economic and Financial Policy*, Balls and O'Donnell (eds.), 2002.

Sustainable investment rule 2.57 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector net debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

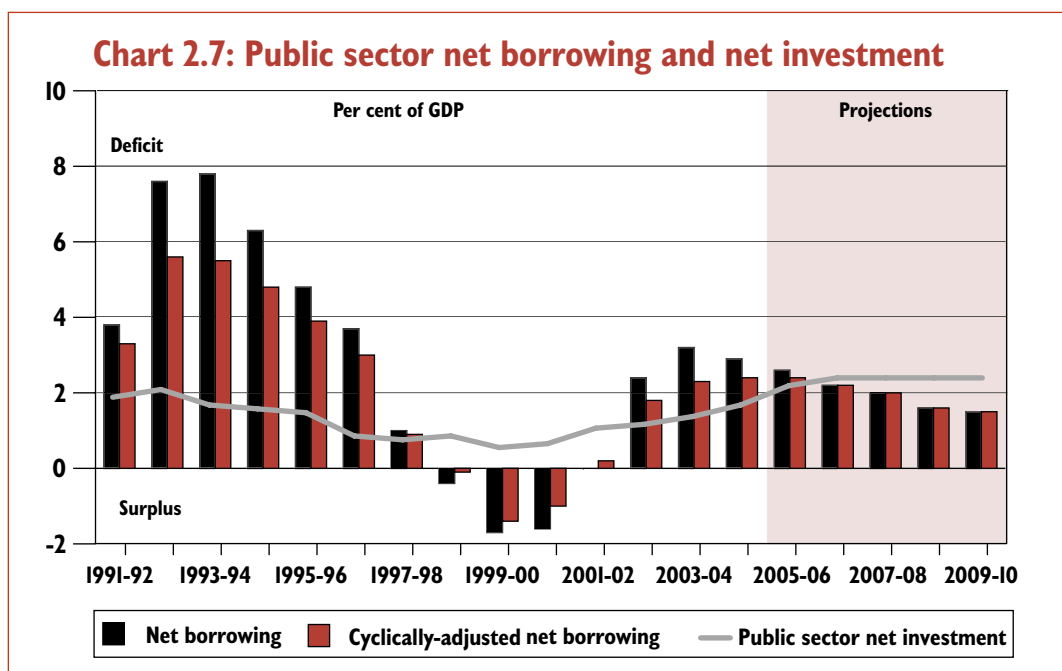
2.58 Chart 2.5 shows that, despite a sustained period of weakness in the world economy between 2001 and 2003, net debt is expected to remain low and stable, stabilising at 37 per cent of GDP by the end of the projection period, well below the 40 per cent level. Therefore, the Government comfortably meets its sustainable investment rule. Chart 2.5 also illustrates projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt is projected to rise to 35½ per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key objective of intergenerational fairness that underpins the fiscal framework.



Economic impact 2.59 While the primary objective of fiscal policy is to ensure sound public finances, it also affects the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.6 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.



2.60 During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy moved below trend, fiscal policy continued to support monetary policy in helping to deliver economic stability, through the automatic stabilisers and an easing of the fiscal stance. Subsequently as the economy returns to trend the fiscal stance moves back to a more neutral position, locking in the fiscal stance projected in Budget 2004 and the 2004 Pre-Budget Report. This is the appropriate stance for this stage of the economic cycle, when the economy is just below or at trend. This allows moderate borrowing for sustained public investment, to address the UK's historical under-investment in front-line public services, while maintaining debt at a low and sustainable level. Cyclically-adjusted net borrowing is projected to fall gradually by nearly 1 per cent of GDP by the end of the projection period. A significant loosening of the fiscal stance in the near term, such as through a large discretionary fiscal stimulus, would be inappropriate given the current cyclical position of the economy and could undermine the UK's recent economic stability.



2.61 The overall impact of fiscal policy on the economy is made up of changes in:

- the fiscal stance - that part of the change in PSNB resulting from changes in cyclically-adjusted PSNB; and
- the automatic stabilisers - that part of the change in PSNB resulting from cyclical movements in the economy.

2.62 Between Budgets and Pre-Budget Reports, the fiscal stance can change as a result of a discretionary measure to:

- achieve a desired change in the fiscal stance; or
- accommodate or offset the impact of non-discretionary factors (non-cyclical or structural changes to tax receipts or public spending).

2.63 Table 2.6 explains how these concepts relate to the projections in the Budget. It shows the changes in both the fiscal stance and the overall fiscal impact between Budget 2004 and the 2004 Pre-Budget Report, and the changes since the Pre-Budget Report. Budget 2005 locks in the fiscal stance over the medium term, with a modest tightening in 2005-06.

Table 2.6: The overall fiscal impact¹

	Per cent of GDP						
	Outturn ²	Estimate ³	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Change from Budget 2004 to PBR 2004							
Post Budget and PBR policy decisions	0.0	0.1	0.0	0.0	0.0	0.0	–
+							
non-discretionary factors	–0.3	0.1	0.2	0.1	0.0	0.1	–
=							
CHANGE IN FISCAL STANCE	–0.3	0.1	0.2	0.1	0.1	0.0	–
+							
automatic stabilisers	0.0	0.0	0.0	0.0	0.0	0.0	–
=							
OVERALL FISCAL IMPACT	–0.2	0.1	0.2	0.1	0.1	0.0	–
Change from PBR 2004 to Budget 2005							
Budget measures	0.0	0.0	0.0	0.0	0.1	0.0	0.0
+							
non-discretionary factors	0.1	0.1	–0.1	0.0	–0.1	0.0	0.0
=							
CHANGE IN FISCAL STANCE	0.1	0.1	–0.1	0.0	0.0	0.0	0.0
+							
automatic stabilisers	–0.1	–0.1	0.0	0.0	0.0	0.0	0.0
=							
OVERALL FISCAL IMPACT	0.0	0.0	–0.1	0.0	0.0	0.0	0.0

¹ All numbers represent the impact of changes on public sector net borrowing. A negative number represents fiscal tightening.

² The 2003-04 figures were estimates in Budget 2004.

³ The 2004-05 figures were projections in Budget 2004.

Financing 2.64 The forecast for the central government net cash requirement (CGNCR) for 2004-05 is £42.9 billion, an increase of £3.2 billion from the 2004 Pre-Budget Report forecast. Allowing for a £0.1 billion increase in financing due to the Debt Management Office's (DMO) secondary market purchases of gilts means that the net financing requirement for 2004-05 is now expected to be £55.7 billion, an increase of £3.3 billion from the 2004 Pre-Budget Report forecast. This increased financing requirement is being met by a £2.0 billion increase in the forecast stock of Treasury's bills, resulting in a £1.3 billion reduction in the forecast level of DMO's short-term cash position at end-March 2005.

2.65 The forecast for the CGNCR for 2005-06 is £40.2 billion. With redemptions of £14.5 billion, and an estimated forecast net contribution of £3.5 billion from National Savings & Investments, the forecast net financing requirement for 2005-06 is £51.2 billion. The financing requirement will be met by:

- gross gilts issuance of £53.5 billion; and
- a reduction in the Treasury bill stock of £1.0 billion by end March 2006; and
- £1.3 billion increase in the DMO's short-term cash position by end March 2006.

2.66 Full details and a revised financing table can be found in Chapter C. Further details can be found in the *Debt and Reserves Management Report 2005-06* which has been published today.

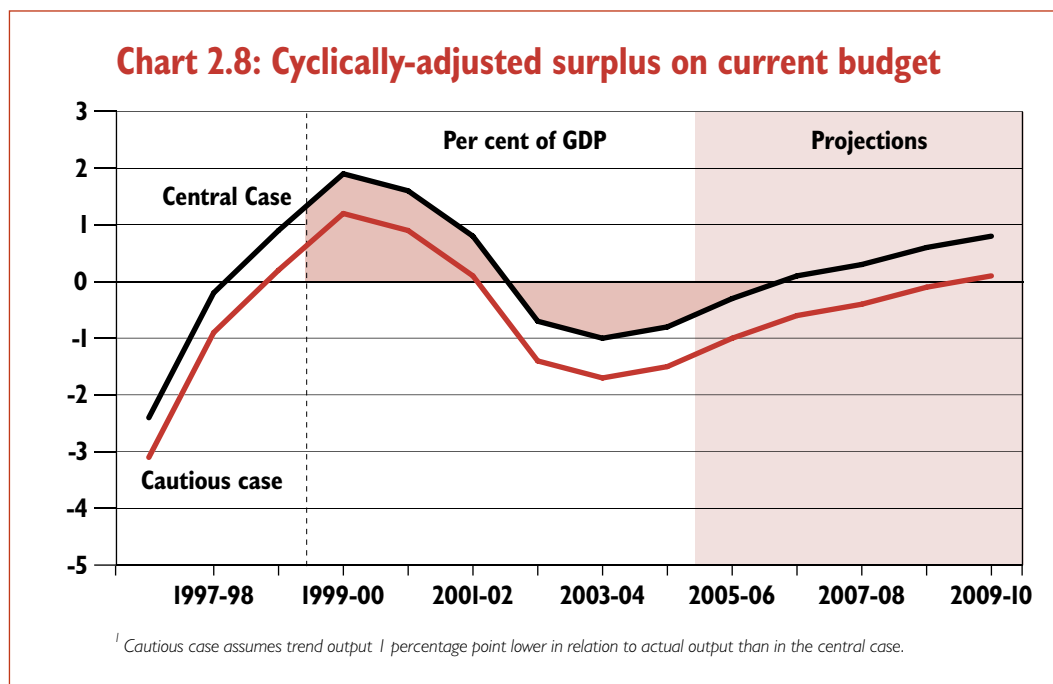
European commitments 2.67 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box 2.4 and *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in Budget 2005, which show the Government is meeting its fiscal rules over the cycle, low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with the prudent interpretation of the Pact.

Dealing with uncertainty 2.68 Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The use of cautious assumptions audited by the NAO builds a safety margin into the public finance projections to guard against unexpected events. The degree of caution in the assumptions underpinning the public finance projections increases over the projection period. For example, to accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is a $\frac{1}{4}$ percentage point lower than its neutral view. This implies that the level of GDP used in the public finance forecast is 1.3 per cent below the neutral view by 2009-10.

2.69 A second important source of potential error results from misjudging the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.8 illustrates the projections for this cautious case.

2.70 The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. This was combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt. This has allowed the Government to safeguard the increase in investment in priority public services, allow the automatic stabilisers to work in full during the period of global economic uncertainty that began in 2000 and meet in full the UK's international commitments, while continuing to meet the fiscal rules.

2.71 The Government is, on the basis of cautious, independently audited assumptions, meeting the golden rule in the central case. In the cautious case, the projections show that this safety margin is being rebuilt by the end of the projection period as the current budget moves into surplus and the cyclically-adjusted surplus in the cautious case also moves back into surplus. In the meantime, the Government will remain vigilant to the risks and continue to base projections of the public finances on cautious assumptions.



LONG-TERM FISCAL SUSTAINABILITY

2.72 While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability*.

2.73 An analysis of long-term fiscal sustainability is presented in Annex A. The analysis shows that given the projected profile for tax revenues and transfers, current public consumption can grow at around the same rate as that assumed for GDP after the medium term while meeting the Government's golden rule. Public sector net investment can also grow broadly in line with the economy without jeopardising the sustainable investment rule.

2.74 These illustrative long-term fiscal projections yield similar conclusions to those presented in the Government's 2004 *Long-term public finance report*, published alongside the 2004 Pre-Budget Report. The report demonstrates that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries to face the challenges ahead.

Box 2.6: Public Finances in the G7

The table below compares the projections presented in Budget 2005 with those for other G7 countries, as forecast by the OECD. While care needs to be taken when comparing numbers internationally, the UK performs well, with debt and deficits among the lowest in the G7, and below the average for the G7 as a whole. Over the medium term, low and falling deficits in the UK contrast with high and persistent deficits in a number of our major industrialised competitors. This relatively favourable fiscal position, alongside a higher potential growth rate than some of our major competitors, means the UK is well placed to respond to the global economic challenges of the next decade.

Public finances in the G7

Per cent of GDP	Estimate	Projections	
	2004-05	2005-06	2006-07
United Kingdom			
Public sector net borrowing (PSNB)	2.9	2.6	2.2
Cyclically-adjusted PSNB	2.4	2.4	2.2
Net debt	34.4	35.5	36.2
Public sector net investment	1.6	2.1	2.3
	2004	2005	2006
France			
Net borrowing	3.7	3.1	2.9
Cyclically-adjusted net borrowing	3.1	2.5	2.4
Net debt	46.1	47.6	48.7
Germany			
Net borrowing	3.9	3.5	2.7
Cyclically-adjusted net borrowing	2.6	2.3	1.9
Net debt	54.7	57.1	58.0
Italy			
Net borrowing	2.9	3.1	3.6
Cyclically-adjusted net borrowing	2.7	3.0	3.7
Net debt	96.2	95.8	95.5
Canada			
Net borrowing	-1.1	-1.2	-1.0
Cyclically-adjusted net borrowing	-1.2	-1.1	-1.0
Net debt	31.1	28.1	25.7
Japan			
Net borrowing	6.5	6.4	6.3
Cyclically-adjusted net borrowing	6.3	6.4	6.6
Net debt	84.4	90.1	94.7
USA			
Net borrowing	4.4	4.1	4.2
Cyclically-adjusted net borrowing	4.2	4.0	4.2
Net debt	44.3	45.7	47.6
G7 average¹			
Net borrowing	3.3	3.1	3.0
Cyclically-adjusted net borrowing	2.9	2.8	2.9
Net debt	55.9	57.1	58.1

Source: For comparability, data for countries excluding UK from OECD Economic Outlook 76 (December 2004). Net borrowing refers to general government financial balances, net debt refers to general government net financial liabilities.

¹ Unweighted average (financial year figures used for UK).

Productivity growth underpins strong economic performance and sustained increases in living standards. The Government's long-term goal is for the UK to achieve a faster rate of productivity growth than its major competitors. Budget 2005 sets out the next steps that the Government is taking to strengthen the drivers of productivity growth, including:

- **a package of radical reforms to tackle the burden of regulation on business**, while maintaining standards of protection for the public, consumers and employees, through:
 - building on the success of the Panel for Regulatory Accountability (PRA) by ensuring that regulation is only used where necessary, that it is not 'goldplated' if it originates from EU law, and that all Whitehall departments strengthen their focus on removing outdated and unnecessary regulations as recommended by the Better Regulation Task Force (BRTF) report;
 - adopting a risk-based approach to inspection and enforcement, streamlining regulatory structures and increasing accountability in order to reduce the costs to business of administering regulation, as recommended by the Hampton Review, and setting new targets to reduce the administrative burden over time;
 - applying the principles of better regulation in Europe through the six presidencies initiative;
- consistent with the Hampton principles, a strategy to meet stretching new targets **to reduce the administrative burden of the tax system for small businesses**, including in the short-term cutting the tax return for 500,000 of the smallest businesses and rolling out new options for paying and managing VAT online;
- **taking forward the ten-year Science and Innovation Investment Framework**, including a UK Stem Cell Initiative, chaired by Sir John Pattison, to formulate a ten-year vision for stem cell research, creating a platform for co-ordinated public and private research funding; a mandatory requirement that at least 2.5 per cent of public sector extra-mural R&D spending will be with Small and Medium Enterprises (SMEs) and engaging with business to ensure that the R&D tax credit better supports UK businesses with high potential to become major innovative firms of the future;
- **to support the Government's major new investment in education and skills**, plans to enhance workforce skills including continued support of £65 million for the Employer Training Pilots and funding to support a new Union Academy;
- **further support for enterprise**, through a new Local Enterprise Growth Initiative worth £150 million per year by 2008-9, to boost enterprise in the most deprived areas of England, following the end of the time-limited commercial stamp duty land tax disadvantaged areas relief in this Budget; and Regional Development Agencies' (RDAs) plans for the development of business coaching focused on businesses with high growth prospects;
- **a package of measures to increase the contribution of creativity to productivity growth**, including a review: led by George Cox, on how best to use the UK's world class creative industries and universities to support and develop the creativity of SMEs; and action by the RDAs to support the integration of design into corporate strategy, product and market development, including through the Design Council's Design Immersion Programme; and £12 million to the Arts Council England to promote better management and leadership within the cultural sector; and
- as a further step in reforming the investment chain, **taking forward the Morris Review recommendations** to promote greater competition in actuarial services and in advice to pension funds on investment issues, including asset allocation and fund manager selection, and to strengthen the regulation of the actuarial profession.

3.1 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. The UK has historically experienced low rates of productivity growth compared with other major economies. In recent years, however, the UK's performance has been improving. As set out in Box 3.1, the UK now has output per worker similar to Germany, and has narrowed the gap with France. However, despite some progress, there remains a significant gap with the US. The Government's long-term goal is for the UK to continue to close the productivity gap by achieving a faster rate of growth than its main competitors.

The Government's strategy

3.2 The Government's strategy for closing the productivity gap in this environment has two broad strands: maintaining macroeconomic stability to help businesses and individuals plan for the future; and implementing microeconomic reforms to remove the barriers that prevent markets from functioning efficiently and flexibly. Effective and well-focused regulation can play a vital role in correcting market failures, promoting fairness and competition, and driving up standards. However, inefficient regulation can impose a significant burden on business. This Budget sets out a radical set of reforms to reduce the burden of regulation on business, and so promote enterprise and competition. As the global economy restructures, the success of developed countries will depend on building a flexible economy with a highly-skilled workforce, which can respond quickly to change and that focuses increasingly on high value-added sectors. Building on the new long-term plans to deliver twenty-first century facilities in primary schools and significant investment in Further Education colleges set out in Chapter 6, this chapter also sets out further plans to enhance workforce skills in the UK economy.

The five drivers of productivity

3.3 These reforms are described in the context of the five key drivers of productivity performance:

- improving *competition*, which is the lifeblood of strong and effective markets. Competition puts downward pressure on costs and prices, driving innovation and business efficiency, and delivering a better deal for consumers;
- promoting *enterprise*, by removing barriers to entrepreneurship, promoting an enterprise culture, and delivering a new and radical approach for improving the way that regulations are made and enforced across the public sector to deliver genuine reductions in the burdens on business;
- supporting *science and innovation*, to promote the development of new technologies and more efficient ways of working. Increasing rewards to innovation mean that the UK will increasingly depend on its ability to create new knowledge and translate it into innovative goods and services;
- raising *skills* levels, to create a more flexible and productive workforce, which can adopt innovative technologies and enable individuals to move into new areas of work; and
- encouraging *investment*, to increase the stock of physical capital, including through stronger, more efficient capital markets.

Productivity and the global economy

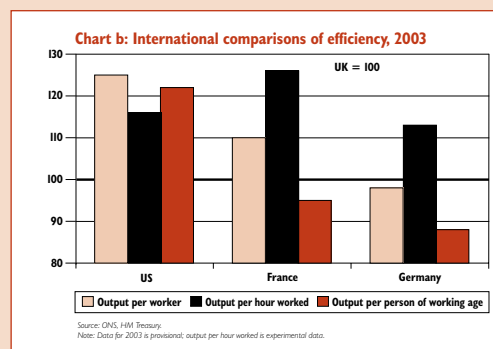
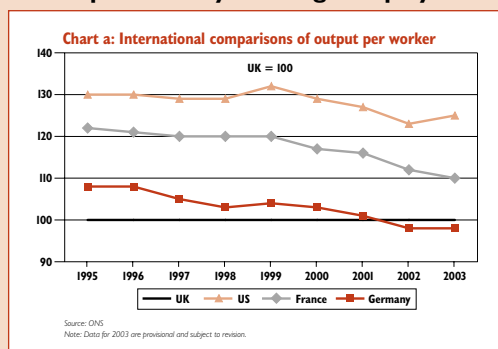
3.4 Continuing productivity growth will be key to long-term success in an increasingly integrated global economy. *Long term global economic challenges and opportunities for the UK*, published alongside the 2004 Pre-Budget Report, set out the challenges over the next ten years for the UK economy. The global economy is undergoing a profound transformation, with far-reaching and fundamental changes in technology, production and trading patterns. The rapid growth of large emerging markets, in particular China and India, is shifting the balance of global economic activity. Global markets can deliver significant benefits for

economic growth and productivity and enhance living standards by providing new opportunities for UK businesses to trade. The Government has prioritised making progress on multilateral trade liberalisation and is seeking to strengthen economic co-operation with major partners such as the US.

Box 3.1: UK productivity performance

Historically, UK productivity has been lower than in other major economies. However, recent data show clear signs that the UK is catching up on both of the key measures of labour productivity – output per worker and output per hour worked. The UK has narrowed the output per worker gap with France to 10 per cent from 22 per cent in 1995. Despite a slight widening in 2003, the gap with the US has narrowed to 25 per cent from 30 per cent over the same period, and the productivity gap with Germany closed in 2001. On an output per hour basis the UK has further to catch-up, although steady progress is being made.

The UK performs relatively well in terms of output per person of working age, a measure which reflects both employment and productivity performance. This measure is closely related to prosperity and indicates how effectively an economy is using all of its potential labour resources. On this measure, UK performance is over 12 per cent higher than Germany and similar to France. However, the UK lags behind the US, which combines high labour productivity with high employment.



Between 1997 and 2001, the trend rate of underlying productivity growth (on an output per hour basis) is estimated to have grown by 2.7 per cent a year in the UK. This compares favourably with the previous economic cycle of just over 2.2 per cent a year. This improvement is encouraging, although it is too early to say definitively whether it will be sustained.^a

It is important to sustain recent progress on productivity growth to ensure that the UK is equipped to meet the long-term challenges of the global economy. The Government will continue to implement a programme of microeconomic reforms with the ambition of raising the productivity of British workers to a level comparable with the best in the world. A new set of productivity indicators^b launched in 2004 allows the Government to monitor progress towards its productivity target, highlights how the UK is performing against its major competitors on key dimensions of each of the five productivity drivers and provides early warning of where more policy action may be needed.

a: Chapter B sets out the trend productivity and trend growth projections.

b: HM Treasury and DTI Productivity Indicators, available at www.dti.gov.uk/economics.

Global challenges for Europe 3.5 *Long-term global economic challenges and opportunities for Europe*, published alongside this Budget, examines the implications for Europe's policymakers of changes in the global economy over the coming decade. As outlined in Chapter 2, through its Presidency of the EU in the second half of 2005, the UK will aim to develop a consensus on the need for a more global Europe, which by becoming more outward looking and embracing greater

flexibility in labour, product and capital markets, delivers higher growth and employment for its citizens. To improve the pace and focus of structural economic reform in Europe, the 2004 spring European Council launched a Mid-Term Review of the Lisbon strategy¹ and invited Wim Kok, former Prime Minister of the Netherlands, to report on this issue ahead of the 2005 spring European Council. The Government agrees with the central recommendation of Wim Kok's High-Level Group,² reiterated in the European Commission's February 2005 communication to the European Council,³ that the EU should focus its actions on raising growth and employment and will continue to work closely with other Member States and EU institutions to advance structural economic reform in Europe.

Productivity in the regions

3.6 The Government is committed to boosting productivity across all countries, regions and localities of the UK. Its goal is to make sustainable improvements in the economic performance of all UK regions and reduce the persistent gap in growth rates between the regions in the long-term. The Government believes that the best way to improve the productivity of the regions and to overcome regional disparities in economic performance is to allow each area the freedom and flexibility to exploit local sources of growth. The Regional Development Agencies (RDAs), as strategic leaders of economic development in the regions, working with local authorities and other partner organisations, have a good understanding of the opportunities and restrictions that they face in their efforts to enhance regional and local economic performance.

3.7 In recognition of this, the RDAs were asked to contribute to the development of Budget 2005 in a number of key policy areas: enterprise; skills; the development of science cities; aligning regional budgets; sustainable development; and the role of the voluntary and community sector in economic development. Budget 2005 announces measures developed with and building on the RDAs' input. These are detailed in this chapter and include a new framework for intensive business support developed by the East Midlands Development Agency which will be adopted by all RDAs; the designation of further science cities; a package of measures to ensure that small and medium enterprises (SMEs) maximise design and creativity in their businesses; a programme to allow SMEs to compete more successfully for public sector procurement contracts; a consultation document on developing a new devolved Local Enterprise Growth Initiative to promote enterprise in deprived areas; and an update on the development of Regional Skills Partnerships.

¹ *Brussels European Council: Presidency conclusions*, March 2000.

² *Facing the challenge: The Lisbon strategy for growth and employment*, High Level Group chaired by Wim Kok, November 2004.

³ *Working together for growth and jobs: A new start for the Lisbon Strategy*, Communication to the Spring European Council, COM (2005) 24, Brussels, February 2005.

Inter-regional growth strategies **3.8** The three northern RDAs, along with other regional partners, published the Northern Way Growth Strategy Report in September 2004.⁴ At the Sustainable Communities Summit in January 2005, the Northern Way published a progress report,⁵ which included updates on the strategy's plans for enterprise education, building up research capacity, raising the level of skills and promoting inward investment into the North. The report also included the Government's response to the strategy, welcoming the proposal for a Northern Transport Compact to help identify strategic priorities for transport investment in the north to support long-term economic growth, and agreeing that the Northern Way's additional £10 million investment to enhance the Pathways to Work pilots in the North should inform future decisions about the national scheme. Budget 2005 provides further support to the Northern Way through national initiatives including the National Employer Training Programme and the new Local Enterprise Growth Initiative, and welcomes the RDAs' establishment of a Northern Design Centre in Newcastle/Gateshead to strengthen creative industries. The Northern Way Action Plan will be published in April 2005. Both the Midlands and the South West also published strategies at the Sustainable Communities Summit as responses to the Sustainable Communities Plan.⁶

COMPETITION

3.9 Competition is essential to an efficient economy and is strongly correlated with productivity performance. A strong competition framework drives productivity by putting downward pressure on prices, increasing the diversity and quality of products available to consumers, and driving innovation. It will also prepare the UK to respond to the challenges of the global economy where international markets are becoming increasingly competitive as their geographical scope and accessibility expand.

3.10 Radical reform of the institutional framework of the competition regime has been central to the Government's strategy for promoting competition. The reforms have made the competition authorities stronger, more pro-active, and responsible for making decisions on specific cases independently from Government. The Government has also introduced structural reforms to promote competition in specific markets. The latest international peer review of competition regimes ranked the UK regime third globally, and described the UK competition authorities as having all the necessary powers to develop a world-class competition regime.⁷

Competition in specific markets

3.11 Using its powers under the Enterprise Act 2002, the Office of Fair Trading (OFT) keeps markets under review to ensure that they are working well for consumers. Current and recently completed studies include the markets for ticket agents, care homes and property searches. The OFT has also completed an initial study on an economic framework against which to assess the types of and delivery methods for government subsidies, their impact on competition and how such impacts might be minimised. The OFT is currently working to develop more specific recommendations. The Government also believes that the pro-active enforcement of competition policy is key to increasing productivity in EU markets. In February 2005, the European Commission's Communication to the Spring European Council promised that "*sectoral screenings of the barriers to competition will be launched in sectors*

⁴ *Moving Forward: the Northern Way – First Growth Strategy Report*. Available at www.thenorthernway.co.uk.

⁵ *Moving Forward: the Northern Way – Progress Report*. Available at www.thenorthernway.co.uk.

⁶ *SMART Growth: The Midlands Way*. Available at www.emda.org.uk/midlandsway. *The Way Ahead: Delivering Sustainable Communities in the South West*. Available at www.southwestrda.org.uk

⁷ *Peer Review of Competition Policy*, KPMG and the Department for Trade and Industry, May 2004. Available at www.dti.gov.uk.

such as energy, telecoms and financial services". The Government strongly supports this action.

Payment systems 3.12 Payment systems play a crucial role in the economy. The Government continues to believe that improved competition and efficiency in these systems would deliver significant benefits to the UK. Innovation, price inefficiency, access and governance are key issues related to improving competition and efficiency in these systems. The Government welcomes the plans of the Payment Systems Task Force, chaired by the OFT, to examine these issues across all payment schemes in the UK. If successful in resolving the outstanding issues, the Government believes that the Task Force will improve competition in payment systems while being more flexible and less costly than legislation.

3.13 The Government looks forward to the conclusion of the Task Force's work on faster electronic payments in April 2005. The Government notes that progress has been made in some aspects of this work and looks forward to further progress on some outstanding issues. The Government also notes that the industry has agreed to form an implementation group that will decide by the end of 2005 how to implement the Task Force's recommendations. Unless the Task Force, and subsequent action by the industry, leads to significant improvements in competition and efficiency, the Government will legislate to tackle these issues. The Government will consider the forthcoming conclusions of the Task Force on faster electronic payments, and the work of the implementation group, in this context.

Home credit 3.14 Following its analysis of a super-complaint submitted by the National Consumer Council, the OFT has referred the supply of home credit to the Competition Commission for further investigation. The Competition Commission is also currently investigating the markets for liquefied petroleum gas (LPG) and store card credit services.

Competition in the supply of goods and services to Government

3.15 The Government is committed to achieving greater value for money through improved competition in the supply of goods and services to the public sector and helping business to maximise the opportunities offered by public sector procurement. The Office of Government Commerce (OGC) is implementing the recommendations of Sir Christopher Kelly's report⁸ on increasing competition and improving capacity in public sector procurement. Work on the first market selected by the Kelly Review – construction – is near completion and a briefing event will set out, in April, a strategic approach to construction procurement reflecting both demand and supply, which together with improved industry consultation should lead to greater predictability of the project pipeline. The programme will focus on a second market – waste management.

Improving access to public sector markets in Europe 3.16 Alan Wood's report on EU public procurement⁹ identified significant obstacles to competition in EU public procurement markets, and made fifteen recommendations to achieve improvements, including the promotion of best procurement practice and the use of competition tools to open markets in sectors relevant to public procurement. The Government is working with the European Commission and other Member States to implement the report's recommendations, particularly by implementing a new action plan to drive up use of new techniques such as e-procurement, developing new indicators to enable better measurement of performance, and actively promoting best practice in public

⁸ *Increasing competition and improving long-term capacity planning in the Government market place*, Office of Government Commerce, December 2003.

⁹ *Investigating UK business experiences of competing for public contracts in other EU countries*, Office of Government Commerce, November 2004.

procurement through networks of procurement agencies. The Commission has also made clear that stricter enforcement of procurement rules will be one of its top priorities in improving the functioning of the Single Market.

ENTERPRISE

3.17 Enterprise is a key driver of a modern, dynamic economy and is crucial in ensuring that the UK is well-placed to prosper in increasingly globalised markets. A vibrant small business sector creates wealth and employment, generates competitive pressure that drives innovative activity and improves the range, quality and prices of goods and services for consumers. There are 4 million SMEs in the UK, accounting for more than 50 per cent of business employment and 52 per cent of business turnover.¹⁰ Rates of entrepreneurial activity in the UK compare favourably with those of other European economies, but lag behind those in the US.

3.18 The Government is committed to improving the UK business environment and tackling barriers to business growth to allow the UK to fulfil its potential in the global economy. The Government's strategy has focused on five areas: regulatory reform; modernising and simplifying the business tax system; improving access to finance for small business; improving business support services and encouraging enterprise in disadvantaged areas; and promoting an enterprise culture.

Leading regulatory reform

3.19 Effective and well-focused regulation can play a vital role in correcting market failures, promoting fairness and increasing competition. Society expects the Government to provide protection for the general public, consumers and employees consistent with the best international standards, and these expectations grow over time. However, the Government believes that inefficient regulation can impose a significant burden on business, and has pursued a programme of reforms to deliver better regulation against five principles: proportionality, accountability, consistency, transparency and targeting.¹¹ The Government's approach focuses upon:

- ensuring that regulation is used only where necessary, that it is not 'goldplated' if it originates from the EU law, that it is only used to achieve policy outcomes for which there is a clear rationale and where alternatives to regulation are not feasible;
- minimising the administrative burdens upon business of understanding regulations and complying with them, including the costs of paperwork, undergoing inspection and complying with enforcement activity; and
- pursuing an agenda of regulatory reform in Europe, because around half of all significant new regulations affecting UK businesses originate in the EU.

3.20 This Budget outlines the next steps in the Government's agenda to deliver better regulatory outcomes while driving down the costs to businesses of complying with regulations, especially for smaller businesses. It builds upon the reforms already made, and sets out the steps needed to ensure that regulations, and the ways in which they are administered, are proportionate to the risks that they seek to address. It also outlines the Government's approach to working with other European nations and applying in Europe the principles of better regulation that it applies at home.

¹⁰ *Statistical Press Release*, Small Business Service and Office of National Statistics, August 2004.

¹¹ *Principles of Good Regulation*, Better Regulation Task Force, January 1998.

Regulating only where necessary

3.21 Since 1997, the Government has built a robust process for designing and scrutinising regulatory proposals, to ensure both that new regulations are introduced only if they are absolutely necessary and that they are proportionate to the problems that they are designed to tackle. The Government has now implemented more than 400 of the measures identified for reform in its Regulatory Reform Action Plan published in December 2003, and has laid 28 Regulatory Reform Orders before Parliament, 21 of which are now on the statute book.

Rigorous regulatory accountability

3.22 As announced in Budget 2004, the Prime Minister's Panel for Regulatory Accountability (PRA) has been established to hold departments to account for their regulatory performance. It scrutinises all new regulatory proposals that impose a significant cost upon business. In doing so it provides a rigorous mechanism through which the flow of new regulations is reduced, and through which the quality of the regulations that it approves is enhanced. The PRA continues to reject and delay a significant proportion of regulatory proposals, where departments have not properly justified extra burdens on business. It is delivering significant benefits for business, including commitments from the Department for the Environment, Food and Rural Affairs (DEFRA) to reduce the costs to business of complying with its regulations by 25 per cent, and from the Department of Trade and Industry (DTI) similarly to reduce the costs it imposes by £1 billion, both as part of their departmental five-year plans.

3.23 All government departments have to complete Regulatory Impact Assessments (RIAs) for new regulatory proposals. The 2004 Pre-Budget Report announced a strengthening of this system and said that regulations should also be reviewed after they are implemented to ensure that they are having the intended effect. Departments will have to set out how the regulations for which they are responsible are going to be monitored using post-implementation reviews before they are introduced.

Removing unnecessary regulations

3.24 The Government wants to increase the emphasis at the heart of the regulatory process upon the simplification and removal of regulations. The Prime Minister therefore asked the Better Regulation Task Force (BRTF) to produce a report, which is published alongside the Budget and summarised below in Box 3.3. The report recommends that the Government adopt an approach to new regulation that forces departments to prioritise between new regulations, and remove unnecessary regulations. In accordance with the Government's acceptance of the BRTF's recommendations, as set out below, the Budget announces that the Government is committing to:

- **always explore options for removing unnecessary and outdated regulations as part of the RIA process when new regulations are being proposed.** The PRA will expect to scrutinise proposals for simplifications alongside new regulations, and may reject proposed regulations unless the scope for off-setting simplifications has been addressed;
- **always respond, in detail and within 90 days, to suggestions made to government by businesses and business groups for regulatory simplifications;** and
- **include from April 2005 appropriate objectives on better regulation and reducing bureaucracy in the personal objectives of civil servants** and, as set out in the 2004 Pre-Budget Report, take part in a new award for civil servants who deliver innovative and deregulatory solutions to policy problems.

EU regulation: 3.25 The Government has to make decisions about how to apply, administer and enforce in the least burdensome way new regulations emerging from the EU. **The Government is publishing alongside the Budget new guidelines for the transposition of European legislation into UK law.**¹² These will ensure that the UK implements EU laws in the clearest and least burdensome way possible, so that they can be administered in accordance with the principles of good regulatory practice set out by the Hampton Review. The guidance establishes the principle that transposed UK laws should mirror as closely as possible the wording of the original EU directive and the need to work with other Member States to understand different approaches to transposition and share best practice, so that the relative burdens of the different approaches are understood. The guidelines also put in place new procedures for ensuring that Parliament and the public are better able to understand the implications of transposed legislation and identify any proposed over-implementation. The guidance also sets out new checks, through the PRA, to ensure that the negotiation and transposition of European legislation is properly scrutinised. Any proposed over-implementation of EU law will also need specific approval from the PRA.

Box 3.2 Deregulation in financial services markets

Following the Government's review last year of the **Financial Services and Markets Act 2000 (FSMA)**, the Government is taking forward the following initiatives to enhance further the regulatory environment for the financial services sector in the UK:

- considering the case for introducing a more effective and simplified financial promotions regime, in line with EU requirements;
- making the regulated activities regime easier to follow, and making requirements on the disclosure of shareholdings more market-focused;
- simplifying and lightening the FSMA controllers regime, under which individuals must notify the Financial Services Authority (FSA) when they hold any of a range of controlling relationships over regulated persons;
- reducing some of the burdens and restrictions placed by FSMA on the FSA, enhancing the FSA's efficiency and enabling it to reduce compliance burdens; and
- applying common commencement dates to statutory instruments made under FSMA, wherever possible and practical.

Reducing the administrative burden of regulation

3.26 As well as pursuing better and more proportionate regulation overall, the Government believes that the costs to businesses of administering regulations should be as low as they possibly can be without jeopardising regulatory outcomes. The time and expense incurred by businesses when trying to comprehend regulations, fill in paperwork and deal with inspections, is time that could otherwise be productively deployed in the running of the business. As such, the Government has worked to make regulations more transparent to understand, easier to comply with and created consolidated regulatory bodies such as Ofcom and the Financial Service Authority to rationalise regulatory structures in some sectors.

¹² Available at www.cabinetoffice.gov.uk

3.27 The Budget builds upon the measures outlined in the Pre-Budget Report by helping business to comprehend the regulations with which they need to comply by:

- extending the use of common commencement dates for new regulation, not only to new sectors as announced in the 2004 Pre-Budget Report, but also wherever possible **using common commencement dates for the commencement of the new simplification measures** that will be outlined in the plans that departments present to PRA; and
- **rolling out ‘Regulation Updates’ guidance for all new or significantly changed regulations.** Designed for SMEs, businesses can see at a glance what is being introduced, whether it applies to them, and what they have to do about it.

Reducing administrative costs

3.28 The BRTF was asked by the Prime Minister in 2004 to examine the merits of an approach taken in the Netherlands, where the Government has pursued targeted reductions for the costs to business of administering regulations. It was also asked to examine the merits of a ‘one-in, one-out’ approach to making regulations. Box 3.3 describes the findings of the BRTF report.

Box 3.3: BRTF Report: Less is more. Reducing burdens, improving outcomes

The BRTF’s report to the Prime Minister argues that the regulatory burden upon British business could be reduced if the Government adopted an approach similar to one applied since 2002 in the Netherlands. This involves first measuring the administrative costs to business of complying with regulations – i.e. those costs of familiarisation, form-filling and enforcement not directly attributable to the policy goal being pursued – and then setting a target to reduce them over time. The report also says that the Government should pursue a number of measures to force departments to prioritise between creating new regulations, and simplifying and removing existing regulations. It makes eight recommendations to the Government on ways in which it could introduce a greater focus upon regulatory simplification into the regulation-making process, through:

- adopting the Dutch method of measuring the administrative burden of regulation, and setting an independently monitored target for reducing the burden;
- establishing a system for businesses to suggest regulatory simplifications to government;
- developing, for each department, rolling simplification programmes to deliver regulatory simplifications on a consistent and systematic basis;
- being obliged always to explore regulatory simplification measures as part of the RIA process when new regulations are being proposed;
- reviewing the effectiveness of the Regulatory Reform Act and use of Regulatory Reform Orders where they can be used to simplify regulations;
- making parliamentary time for a Deregulation Bill where primary legislation is required to simplify regulations;
- extending the use of Common Commencements Dates, including to the commencement of regulatory simplification measures; and
- beginning to develop a methodology to measure the cumulative cost of regulatory proposals and reassess the merits of introducing ‘regulatory budgets’.

3.29 The Government welcomes the BRTF's report, and accepts its recommendations. It commits itself to a process of assessing the existing costs to business of administering regulations, including the time needed to comply with regulations and other costs including form-filling, inspections, data retention requirements, comprehension costs and, where relevant, the costs of license or permit applications. It will undertake this process using a common methodology on a departmental basis for all departments responsible for regulating business activity.

3.30 All departments responsible for aspects of business regulation will present to the PRA, by the 2006 Pre-Budget Report, their assessments of these costs and their plans for delivering reductions in the administrative burden of their regulations over time. Departments will achieve these reductions through their implementation of the recommendations of the Hampton Review, as outlined below. The PRA, based on this information, supported by the new Better Regulation Executive described below, will set a stretching but achievable target or targets and ensure their delivery.

Lowering the burden of compliance **3.31** In Budget 2004, the Chancellor asked Philip Hampton to lead a review into the burden on business of regulatory inspection and enforcement with a view to reducing the burden on business of complying with regulations to the minimum level necessary with maintaining the UK's excellent regulatory outcomes. The interim report of the Hampton Review was published alongside the 2004 Pre-Budget Report, and identified a range of possible reforms, centred around the application of risk-based regulatory enforcement, that could spread best practice across all regulatory bodies. The Review has consulted with businesses, regulators and other stakeholders upon these proposals and, as outlined in Box 3.4, Philip Hampton publishes his final report alongside the Budget.

Box 3.4: The Hampton Review. Reducing administrative burdens: effective inspection and enforcement

The final report of the Hampton Review finds that the administrative burden upon business from regulatory inspection and enforcement is significant. The 63 national regulators within the scope of the Review perform at least 600,000 inspections and send out 2½ million forms to businesses each year. In addition, local authorities conduct at least 2½ million inspections.

The final report outlines a balanced package of reforms that will reduce the costs to businesses of complying with regulations. It sets out a number of common principles that it recommends all regulators should follow and which, once implemented, will result in a step change in their culture and management:

- regulators should take a risk-based approach across all of their enforcement activities, so there should be no inspection of businesses without a reason, and regulators' resources and inspection activity should consequently be strengthened in the areas where the risks are greatest;
- information requirements should also be based on risk based assessment to reduce the number of forms and requests for information. The number of forms that businesses have to fill in should be reduced, through greater sharing of data between regulators;
- all new forms sent to businesses by regulatory bodies should have US-style 'time to complete' statements on them, and business reference groups should vet all forms for their business-friendliness before they are introduced;
- the penalty regime should be based on managing the risk of re-offending, and the impact of the offence, but there will be tougher penalties for 'rogue businesses' that persistently break the rules;
- there should be a greater focus upon giving advice and support to businesses on how to comply with regulations and regulators should provide advice on regulatory compliance to any business that asks for it;
- all regulators should set out standards for service delivery, and publish an annual report setting out their performance against them; and
- new policies should be made with a view to using, wherever possible, existing regulators' inspections, forms and enforcement mechanisms.

The Hampton Review identified a total of 674 different bodies at local and national level that administer regulations upon business. This current structure is fragmented and diffuse with little coordination between different bodies, causing overlap and duplication in many areas. The review believes that a confusing and complex regulatory structure imposes potentially avoidable administrative burdens on business, and that a more joined-up approach would improve regulatory outcomes overall. It therefore recommends a significant consolidation of existing regulatory bodies, with 31 existing national regulators being absorbed into seven thematic bodies over the next four years. The Review also recommends reforms to improve the coordination of local and national regulatory services to deliver greater consistency for businesses.

The Hampton Review's recommendations represent a far-reaching programme through which regulatory burdens upon businesses will be reduced. To manage the implementation of its advocated reforms, and to ensure a consistency of approach across the public sector, the review recommends that a stronger, and more accountable regulatory framework is needed at the heart of government.

3.32 The Government welcomes the final report of the Hampton Review and accepts its recommendations in full and will bring forward early legislation to implement them. The Government has asked Philip Hampton to work with it to ensure effective implementation of his recommendations. The Government believes that a risk-based approach should be applied by all regulatory bodies in all aspects of their work, including when making data requests from businesses, when shortening forms, when applying penalty regimes and when applying systems of inspection and enforcement. The benefits of a risk-based approach are that it focuses regulators' resources in those areas where the risks to society are greatest, ensuring inspections of riskier businesses that may not otherwise take place, delivering better regulatory outcomes overall and substantially reducing the costs incurred by the majority of low-risk businesses. Many regulators within the scope of the review operate in Wales, Scotland and Northern Ireland, and the recommendations on these bodies will need to be implemented following discussion between the Government and the Devolved Administrations.

Helping businesses comply **3.33** At the same time, regulators should focus greater resources upon providing comprehensive advice to businesses and do more to help them understand and comply with regulations easily and cheaply. As a result of the consolidation of national regulators, businesses should have to deal with many fewer regulatory bodies than before and be able to get clear helpful advice on how they can comply with regulations. The acceptance of the Hampton Review's recommendations will also mean that in the future forms will be shorter, simpler, written in plain English, and designed around business practices. The implementation of these recommendations will be the way in which departments deliver against the targets set by the PRA for the reduction in the administrative burden to business.

Strengthened regulatory scrutiny

3.34 The final report of the Hampton Review, and the report of the BRTF, recommend that stronger and more independent structures of regulatory accountability are needed at the centre of government to deliver effective implementation of their recommendations. Enhanced accountability will not interfere in individual regulatory decisions or regulators' independence, but should hold regulators to account for their delivery against their own performance indicators for reducing the burden to business of administering regulation and help to spread best practice between regulatory bodies.

3.35 The Government intends to deliver the ambitious regulatory reforms set out in the Budget by establishing a new Better Regulation Executive (BRE) in the Cabinet Office. The BRE will take on the work carried out by the existing Regulatory Impact Unit; drive delivery across Whitehall of the Hampton-led reductions in the administrative burden of regulation upon business against the targets recommended in the BRTF's report, and support the PRA in holding departments and regulators to account.

3.36 The BRE will be led by a person recruited from outside central Government, with a management board including several non-executive members recruited from the private sector. The BRE will bring greater weight to the delivery of regulatory policy across Government and will be responsible amongst other things for:

- driving departmental implementation of the recommendations of the Hampton Review;
- leading the work on reducing administrative burdens and the process towards setting targets for the reduction of the administrative burden of regulation;
- providing a secretariat function to the PRA, holding departments to account for the delivery of better regulation;

- holding regulators to account for their performance against the principles of good regulation set out by the Hampton Review;
- providing robust advice to Government on better regulatory policy, both in the UK and at the European level; and
- challenging departments on their RIAs and on their delivery plans for meeting their administrative burden targets.

3.37 The Government will set out plans to transform the BRTF into a new Better Regulation Commission (BRC) to sit alongside the BRE and provide independent advice to government from business and other stakeholders about new regulatory proposals, and about the Government's overall regulatory performance. It will continue the work of the BRTF and take on new responsibilities for monitoring the ambitious reforms set out in this Budget, including vetting departmental plans for administrative burden reduction. The Government also expects the BRC to work with business organisations and others to make proposals to government for regulatory simplification.

3.38 Finally, it is important that the performance of departments and regulators in implementing these changes is independently monitored. The BRC are well placed to do this on an ongoing basis, but there also need to be rigorous retrospective reviews of performance. The NAO should therefore be invited to take an enhanced role in overseeing the technical evaluation of departments and regulators in reducing the burden to business of administering regulation by reporting to Parliament on:

- departments' performance against their targets for the reduction of the administrative burden of regulations and, where relevant, their performance in establishing the new regulators recommended by Hampton; and
- regulators' performance against the Hampton Review's recommendations and principles.

3.39 These new arrangements represent a rigorous and transparent framework within which the Government's performance will be scrutinised. This strengthened institutional framework will support departments' efforts to progress regulatory reform, and hold government to account for the delivery of the radical changes that it is committing itself to make.

Regulatory reform in Europe

Regulating only where necessary in the EU

3.40 About half of all significant new regulations affecting UK businesses originate in EU law. The Government is therefore committed to promoting comprehensive reform of the EU regulatory framework and will found its approach to European regulation on the same risk-based principles recommended by the Hampton Review. Building on the progress of the Four Presidencies' initiative, in December 2004 the Finance and Economics Ministers of Ireland, the Netherlands, Luxembourg, the UK, Austria and Finland launched an updated and extended initiative, *Advancing Regulatory Reform in Europe*,¹³ establishing regulatory reform as a priority of the six EU Presidencies through to the end of 2006. The initiative presented a series of concrete proposals for ongoing reform of the regulatory regime in Europe, including to further develop the competitiveness testing of all new regulations, exercise stronger and more effective control over the administrative burdens associated with EU regulation, make faster progress in simplifying the existing stock of EU laws, and improve business input into the regulatory reform process.

¹³ *Advancing regulatory reform in Europe*. A joint statement of the Irish, Dutch, Luxembourg, UK, Austrian and Finnish Presidencies of the European Union, 7 December 2004.

Box 3.5: European regulatory reform

In the past year significant progress has been achieved in reforming the regulatory framework in Europe. The Commission's communication to the spring European Council, noted that “[better regulation] will be the cornerstone for decision making at all levels of the Union”. Since the launch of the Four Presidencies' Statement in January 2004^a the initiative has been extended to six Presidencies, and:

- agreement has been reached on the principal elements of competitiveness testing, to ensure that all new regulatory proposals are properly scrutinised for their impact on jobs and competitiveness;
- as of 2005, the Commission is submitting all legislation set out in its legislative and work programme, as well as the most important cross-cutting non-legislative proposals, to an impact assessment;
- fifteen priority areas of regulation have been identified by the Council for simplification, marking an important step towards reducing burdens in the stock of existing EU legislation; and
- work is now underway to develop a methodology for measuring the size of administrative burdens imposed by new and existing regulations, so that such assessments may be included in all future impact assessments.

In addition, a number of concrete steps have been taken to reduce the regulatory burden of EU legislation:

- consultation with business, as part of an extended impact assessment of the European Commission's proposal for the registration, evaluation, and authorization of chemicals (REACH) directive, has resulted in at least £6 billion savings to business;
- in negotiating the end of life vehicles legislation, the cost to business was reduced from £100-£150 per car to around £25 per car through a focus on a light touch regulatory approach. This reduced overall costs from £200 million to £40 – 80 million a year while retaining the environmental objectives of the directive; and
- as a result of an extended impact assessment^b involving extensive consultation with business, the Commission chose not to impose a single standard for digital interactive television services, which would have had a negative impact on the UK digital television industry. Instead they have opted to allow the market to develop freely.

a: *Joint Initiative on Regulatory Reform*, An initiative of the Irish, Dutch, Luxembourg and UK Presidencies of the European Union, 26 January 2004.

b: Brussels, 30.7.2004, SEC (2004) 1028.

Simplifying tax administration for small business

3.41 The Government is committed to a modern, fair and efficient business tax system that can contribute to enterprise by encouraging investment and keeping pace with changes in business practice and the global economy. The Government has already introduced a number of reforms to business taxes since 1997, including cutting the main rate of corporation tax by 3 percentage points to 30 per cent and the small business rate by 4 percentage points to 19 per cent – the lowest levels ever – and reducing capital gains tax.

3.42 The tax authorities were not within the remit of the Hampton Review or the BRTF report, in recognition of the different nature of the enforcement of the tax system from the inspection and enforcement of other government regulations. However, many of the principles set out by the review apply equally to the activities of the tax authorities. In keeping

with the principles set out by both the Hampton Review and the BRTF report, the Government has already acted to simplify the business tax system, minimise administrative burdens on business and remove unnecessary barriers to innovation, for example by introducing measures to reduce the administrative burden of VAT.

3.43 Inland Revenue and HM Customs and Excise have today published *Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system on small business*. **This sets out how, consistent with the recommendations of the Hampton Review, the Government will realise the benefits to small business of the integration of the Inland Revenue and HM Customs and Excise.**¹⁴ It describes a number of near-term reforms, including cutting the tax return for 500,000 of the smallest businesses from sixteen pages to four, as well as rolling out new ways of paying and managing VAT online. The paper also seeks views from smaller businesses and their advisers on what the priorities for the new department should be in order to improve their relationship. In particular, it describes how in future small business customers can expect to:

- provide information only once, with information, where possible, flowing seamlessly from business systems to those of the new department without the need for forms or returns;
- benefit from a range of modern flexible payment options that suit their business needs;
- spend less time dealing with inspections, with no inspection without a reason and all enforcement activity informed by more sophisticated risk assessment;
- enjoy a single point of contact with the new department for all their tax affairs, either on-line or by phone. This will give them or their adviser access to the details of their tax account – the same details the department’s staff will see; and
- benefit from co-ordinated, clear and helpful support and education that will help them comply with their tax obligations at key stages in the development of their business.

Targets for reducing compliance costs

3.44 To benchmark and monitor progress in delivering real reductions in the administrative burden imposed on compliant small businesses by the tax system, both departments are already developing stretching targets that will be consistent with the new department’s objective to ensure that the tax system is fair for all business. They will be published and progress against them monitored.

Operational Impact Assessments

3.45 **The new department will publish impact assessments of all changes to a form, or changes to a business practice that could have a significant impact on businesses.** These Operational Impact Assessments will complement existing Regulatory Impact Assessments already carried out on new laws and regulations and will mean that for the first time any change that could have a significant impact on business will be assessed, with the results made public. The first such assessment – on the new short Self Assessment return – has been published today.¹⁵ This shows that the change will mean overall savings of £20 million for all taxpayers, including £5 million for business.

¹⁴The Commissioners for Revenue and Customs Bill which provides the legislative framework for integration has nearly completed its parliamentary passage and the Government expects the new department to be launched shortly.

¹⁵ Available on the Inland Revenue website: <http://newinternet.inrev.gov.uk/menus/consult.htm>.

Tax credits: 3.46 Following consultation with representatives of employers and other interested parties, **the Government will phase out the payment of Working Tax Credit via employer payment via employers (PVE) between November 2005 and April 2006.** 1.2 million small businesses stand to benefit from this reform and the new tax department and employers will be issuing targeted publicity to make employees aware of the changes that will result from the phasing out.

VAT and small business 3.47 The Government has introduced simplified schemes to reduce the administrative burden of accounting for VAT. The Flat Rate Scheme, under which the requirement to account for every VAT transaction is replaced by one flat rate payment which can reduce a firm's costs by up to £600, has been extremely successful. Take-up has risen from under 17,000 to around 73,000 over the last 18 months. However, there are 600,000 eligible firms in total, and so **the new tax department will work together with the British Chambers of Commerce on a take-up campaign to ensure that more firms understand the benefits of the scheme.**

Further modernisation of the business tax system

VAT registration threshold 3.48 From 1 April 2005 the Government will increase the VAT registration threshold in line with inflation from £58,000 to £60,000, maintaining the highest threshold in Europe and helping to keep up to a further 5,000 of the smallest businesses out of the VAT system.

Corporation tax reform 3.49 A Corporation Tax Reform Technical Note¹⁶ was issued at the 2004 Pre-Budget Report. A number of constructive consultation meetings have been held on the issues raised in the Technical Note and on the wider international context in which the UK corporation tax system operates. The Government is grateful for businesses' contributions to this debate and for written comments received, which will help ensure that the Government can take forward reform with a clearer understanding of businesses' priorities.

Film tax reform 3.50 In the 2004 Pre-Budget Report the Government announced a review of the tax relief for large budget films, to ensure that it remains effective at delivering Government objectives for supporting a sustainable UK film industry. The Government has concluded that the current structure of the relief is no longer effective for this purpose and **intends to replace it next year with a structure that is similar to the new tax relief model that has been proposed for low budget films.** The Government will therefore conduct a formal consultation on draft legislation and retain the existing relief until an orderly transition to its replacement can be effected.

3.51 Details of the new tax relief for low budget films were launched in an Inland Revenue Technical Note in September 2004.¹⁷ The Government is committed to the principles and terms of the proposed new relief but understands that the industry has concerns, in the short term, about its practical operation. **The Government has therefore decided to extend the current relief for low budget films.** This will enable the formal consultation on draft legislation to consider issues across the entire film sector and will ensure that tax reliefs for low and large budget film production are provided on a coherent and consistent basis. The transition from the current to the new film tax reliefs will then be effected next year, subject to state aids clearance.

¹⁶ *Corporation Tax reform: Technical Note*, Inland Revenue, December 2004.

¹⁷ *Tax Relief for the Production of Low Budget British Films*, Inland Revenue, September 2004.

Promoting enterprise in the regions and in disadvantaged areas

3.52 The Government is committed to economic and business development across all the regions of the UK and believes that regions themselves should play a key role in determining their priorities. Raising levels of enterprise and economic activity is essential to sustainable regeneration in the UK's most disadvantaged communities. Since 1997, the Government has acted to improve the delivery of business support services to small businesses and enterprise through a programme of regionalisation, including devolving the control of Business Links to RDAs. It has also designated 1,997 Enterprise Areas in the most deprived wards in the UK, in which a number of specific policies to boost enterprise have been focused, including the Community Investment Tax Relief and the Phoenix Development Fund.

3.53 The Government wants to empower local areas with the freedom and flexibility to develop local approaches to enterprise and growth in disadvantaged areas, which respond to local needs. Therefore, the Government is introducing a new **Local Enterprise Growth Initiative (LEGI)**, worth £50 million in 2006-07 and rising to £150 million by 2008-09 (subject to confirmation in the next Spending Review), which will operate through local area agreements to support locally developed proposals to promote and remove barriers to enterprise in the most deprived areas of England. A consultation document is being issued today to determine the final details of the LEGI, described further in Box 3.6.

Box 3.6: A Local Enterprise Growth Initiative

The Local Enterprise Growth Initiative (LEGI) will provide significant and flexible investment in the most disadvantaged areas of England – determined by the Neighbourhood Renewal Fund areas – to support locally developed proposals that promote economic activity and growth through enterprise development – thereby boosting local incomes and employment opportunities. It will focus on helping local communities to achieve long-term changes in the business environment in deprived areas, building indigenous strength and making them more attractive places to do business. As a result of this investment, the Government wants to see more businesses starting-up; fewer businesses failing; stronger growth from locally-owned business; more businesses locating in these areas; and more jobs for local people.

The LEGI will support proposals for long-term enterprise growth in around 30 disadvantaged local areas. Local authorities that are designated as Neighbourhood Renewal Fund areas will be able to apply to the Government Offices for financial support from the LEGI to implement long-term local proposals for enterprise growth. £10 million will be provided in 2005-06 to pump-prime the development of local enterprise and growth proposals by local authorities, in partnership with their local business communities and Regional Development Agencies. The resources to support these proposals will be channelled through Local Area Agreements wherever possible, providing local authorities with the flexibility and freedom to determine what the local priorities should be, and how to pursue them effectively.

The details of the LEGI are being consulted on from now until summer 2005, with key questions outlined in *Enterprise and economic opportunity in deprived areas: A consultation on proposals for a Local Enterprise Growth Initiative*, published alongside this Budget.

3.54 In addition, Budget 2005 announces additional funding over 3 years to:

- **boost the capacity of the New Entrepreneur Scholarships beyond the existing funding levels over the next 3 years;** and
- **provide long term support for business incubation,** building on existing feasibility studies, which are currently funded through the Phoenix Fund and the Business Incubation Fund.

3.55 Business Improvement Districts (BIDs) also provide new opportunities for improvements in local services and activities. BIDs allow local authorities and businesses to work together on agreed projects to improve their local areas through a fund raised by an additional levy on local business rates. They can be used to fund a wide range of projects such as the appointment of ‘community rangers’ to deter anti-social behaviour. As BIDs are rolled out the Government will review progress to identify any barriers to their establishment, especially in deprived areas.

3.56 The LEGI will **follow the time-limited commercial stamp duty land tax disadvantaged areas relief, which will end on 16 March 2005,** and will better target support to drive forward local enterprise development and business regeneration.

Business premises renovation allowance **3.57** Following consultation launched in the 2004 Pre-Budget Report, **the Government will legislate in the Finance Bill for the introduction of the business premises renovation allowance.** This will provide 100 per cent capital allowances in Enterprise Areas for the costs of renovating business properties that have been vacant for at least a year. The scheme will be brought into effect subject to state aids approval.

Local Authority Business Growth Incentive scheme **3.58** To create a direct financial incentive for local authorities to promote local business growth the Government is **introducing the Local Authority Business Growth Incentive (LABGI) scheme, starting in April 2005,** originally announced in the 2002 Pre-Budget Report. Under the scheme, this financial year local authorities will receive a proportion of increases in local business rate revenues to spend on their own priorities. The Government estimates that local authorities in England and Wales could gain up to £1 billion over the three years to 2007-08.

Better support and advice for small businesses

High Growth Business Coaching **3.59** The 2004 Pre-Budget Report announced that Bryan Jackson, the new Chairman of the East Midlands Development Agency, would lead the development of a framework for intensive business support for business and pre-start-ups with the potential for rapid growth. **The Government welcomes the publication today of the RDAs’ Framework for High Growth Business Coaching,**¹⁸ which sets out how they will develop and deliver in every region focused coaching for new and existing businesses with high growth prospects and for high-potential entrepreneurs in the pre-start-up phase. This new service will help entrepreneurs to meet the challenges of rapid growth, particularly in the areas of investment readiness and access to finance, developing markets, skills, innovation and technology transfer. In parallel with a range of measures to increase the contribution of creativity to productivity growth described later in this chapter, it will also assist entrepreneurs to harness creativity and design for the success of their businesses. Work over the next year will address the institutional arrangements to support coaching, and the Government welcomes plans for the RDAs and Learning and Skills Council (LSC) regions to develop the skills support component as part of their wider arrangements to identify joint priorities and plans to deliver more demand-led skills provision.

¹⁸ *High Growth Business Coaching - Executive Summary*, Regional Development Agencies, March 2005.

3.60 The Government continues to aim to improve the coherence and quality of its services through alignment of business support services. Good progress has been made on pilot projects in the North East and East Midlands to coordinate services, with the aim of making it easier for businesses to access the support they need. A pathfinder project will be launched in the East Midlands in April this year and the Small Business Service (SBS) is working with other RDAs to identify further possible pilots.

Women's Enterprise **3.61** Building on the Strategic Framework for Women's Enterprise published in May 2003¹⁹, the Government welcomes the action plan recommended by the national Women's Enterprise Panel to increase significantly the proportion of UK businesses owned and run by women. The Government will work with RDAs and other stakeholders to take these recommendations forward including that the RDAs consider proposals for Regional Women's Enterprise Units, and discussions with the banks on joint action to ensure the provision of better information for women on routes to financing their business. The Government published an analysis of the economic benefits of promoting women's enterprise earlier this month.

National Employment Panel Report **3.62** At the time of the 2004 Pre-Budget Report, the National Employment Panel was asked by the Chancellor to recommend measures to encourage employment, self-employment and the growth of small businesses for ethnic minorities and faith minority groups. Chapter 4 sets out the Panel's findings and recommendations for action.

Improving access to finance for small business

3.63 The Government is committed to addressing market failures in the supply of risk capital and improving access to finance for small business by enhancing incentives to invest in SMEs. Over £6 billion of private capital has been raised through the Enterprise Investment Scheme and Venture Capital Trusts. The Regional Venture Capital Funds, the UK High Technology Fund and the Early Growth Funding programme will collectively invest around £400 million in businesses otherwise affected by the equity gap. The Government has also introduced specific measures to improve access to finance in the UK's least prosperous communities, including the Phoenix Fund and Community Investment Tax Relief, and has supported the Bridges Community Development Venture Fund.

Enterprise Capital Funds **3.64** The Government is waiting for European state aids clearance before launching the pathfinder round of Enterprise Capital Funds (ECFs). Announced in the 2003 Pre-Budget Report, ECFs will be commercially-managed entities investing a mixture of public and private capital in potentially high-growth small businesses affected by the equity gap. The Government has published draft bidding guidance for fund managers interested in applying to establish an ECF, which will be finalised ahead of the formal launch of the programme. As announced in the 2004 Pre-Budget Report, the Government is establishing a panel to provide expert advice on the implementation of the pathfinder round of ECFs and taking forward the Graham Review recommendations for the Small Firms Loan Guarantee. If the pathfinder round of ECFs demonstrates the viability of a long-term ECF programme, the Government would seek to establish an arm's length delivery company that would take over the role of the advisory panel. Further, the Government believes that such a company should also manage the on-going delivery of all its risk-capital interventions for SMEs.

¹⁹ *A Strategic Framework for Women's Enterprise - Sharing the vision: a collaborative approach to increasing female entrepreneurship*, Small Business Service, May 2003.

Improving access to public sector procurement for small business

3.65 The Government is also committed to improving access to public sector procurement for SMEs. SME involvement improves competition and drives innovation, and thus improves value for money in the delivery of public services. As described below, the Government is introducing a mandatory requirement that at least 2.5 per cent of public sector extra-mural R&D will be with SMEs. The SBS has today published further details of how this goal will be met,²⁰ including:

- with the involvement of RDAs, OGC and SBS will roll out measures nationwide to improve SMEs' ability to tender effectively for public sector contracts, building on the success of pilot projects in the West Midlands and Haringey which involved 1,600 businesses, increasing the number of SMEs competing for public sector projects and increasing the overall success rates of SMEs, including ethnic minority-owned businesses. In the West Midlands pilot, 14 per cent of SMEs had won government projects at the project start – by the end, SMEs had won 26 per cent of contracts awarded through the pilot portal, improving competition and innovation;
- the OGC and the SBS will launch a national portal for low-value contracts in the summer, making it easier for SMEs to compete for business;
- to improve the coverage and quality of information available on SMEs' participation in procurement opportunities, the SBS will publish an annual review of departments' spending, and explore how to extend this to local government. Furthermore, the SBS, OGC and others will review SME and other procurement information gathering across government to investigate opportunities for efficiencies and more robust data;
- the first phase of research commissioned by the SBS,²¹ providing evidence on the costs and benefits of SME involvement in public sector markets; and
- in response to particular concerns from SMEs on the public sector's use of third party assessment providers to pre-qualify suppliers, the OGC and SBS will research the effect this has on potential suppliers and identify options to reduce any barriers to SMEs' participation.

Enterprise culture

3.66 Creating a climate in which entrepreneurial achievement is valued underpins a strong business sector. The Government believes that anyone with the initiative, drive and talent to succeed in business should be able to do so, and continues to promote enterprise culture in the UK through number of initiatives, including:

- from September this year, £60 million will be available to schools to develop enterprise education at Key Stage 4. Over the last year, Enterprise Advisers have been working in the 1,000 most disadvantaged schools to embed enterprise education. The Government is announcing **an extension of funding for Enterprise Advisers** for an additional year until July 2006 to ensure that schools are able to continue this work during the national rollout of **Davies Review implementation**;

²⁰ Available at www.supplyinggovernment.gov.uk

²¹ Available at www.supplyinggovernment.gov.uk

- in February 2005, the Chancellor announced that Sherwood Energy Village was the winner of the first Enterprising Britain competition. The Government has been working with the European Commission to develop a proposal to launch a European Centres of Enterprise competition during the UK Presidency of the EU; and
- the Chancellor hosted *Advanced Enterprise: Enterprise in Global Markets*, attended by business leaders, entrepreneurs and Government representatives in February 2005. This conference addressed the challenges and opportunities posed by growth in rapidly growing emerging markets, including China and India, to large and small businesses in the UK.

SCIENCE AND INNOVATION

3.67 *Long-term global economic challenges and opportunities for the UK*, published alongside the 2004 Pre-Budget Report, emphasised the importance of science and innovation in ensuring the UK's long-term competitiveness in an increasingly knowledge-driven global economy. In all countries, economic activity is shifting towards innovation and knowledge-driven industries, with emerging economies moving up the value chain and challenging the predominance of the advanced economies. In this environment, the UK needs to build on its historical strength in scientific research to exploit new technology driven and high value-added areas and secure its long-term prosperity.

3.68 The UK science base is the most productive within the G7.²² However, the UK's national investment in R&D has been low compared with other major developed countries, with total public and private investment in R&D at 1.9 per cent of GDP in 2002, compared with 2.2 per cent in France, 2.5 per cent in Germany, and 2.7 per cent in the US.²³ In addition, the UK has not been fully effective at realising the commercial potential of research.

3.69 The Government's strategy for promoting science focuses on increasing public investment in the science base and boosting the teaching and learning of science, engineering and technology skills, while simultaneously tackling market failures that prevent firms from investing more in R&D and developing innovative products and services. Key steps under this strategy include increasing public investment in science and technology, introducing R&D tax credits for business and encouraging greater collaboration between business and academic institutions to further links between research and its commercial exploitation. To take this strategy forward, the Government published a *Ten-year Science and Innovation Investment Framework* in 2004, which set out the Government's ambition for the UK's public and private investment in R&D to reach 2.5 per cent of GDP by 2014 and the long-term policy framework to achieve this goal.

UK Stem Cell Initiative

3.70 Over £2.5 billion in the three years up to 2008 has been allocated for biotechnology, including stem cell research. To safeguard the UK's long-term excellence in the field of stem cell research and to shape the transformation of research into patient benefit and commercial opportunities, **the Government is launching a UK Stem Cell Initiative (UKSCI), in collaboration with the Wellcome Trust, the Medical Research Council, the Biotechnology and Biological Sciences Research Council, the DTI, the Department of Health and the proposed private-sector led UK Stem Cell Foundation.** This will take the form of a high-level review, led by Sir John Pattison, to formulate a ten-year vision for UK stem cell research,

²² Data from Evidence Ltd. PSA Target Metrics for the UK Research Base 2004. Available at www.ost.gov.uk

²³ Science and Innovation Investment Framework 2004-2014, p. 7. Available at www.hm-treasury.gov.uk

creating a platform for coordinated public and private funding of research. UKSCI will report back to the Government with its recommendations by the time of the 2005 Pre-Budget Report.

Business R&D

3.71 Business investment in R&D rose by 2 per cent in real terms in 2003, broadly in line with the economy as a whole, but it will need to rise faster than trend growth if the UK is to catch up with competitors. The Government's focus has been on working with business to encourage greater investment in R&D and innovation, and to promote closer collaboration between industry and the science base.

Analysis of UK business R&D **3.72** On 15 March 2005, the Treasury and the DTI published an in-depth analysis of UK business R&D and innovation performance, outlined in Box 3.7, fulfilling the commitment made in the 2004 Pre-Budget Report. The paper will inform the first meeting of the UK Science Forum, as well as the first annual progress report on the ten-year framework, due in Summer 2005.

R&D tax credits **3.73** Building on the continued success of R&D tax credits, the Inland Revenue has embarked on a programme to ensure greater consistency in the treatment of claims and a better understanding of the credit system amongst tax advisers. In conjunction with the SBS, it has developed **new guidance for small companies claiming the R&D tax credit, providing plain-English assistance to claimant companies and a template to help small companies determine their qualifying expenditure. The SBS will pilot the new guidance with small businesses soon after the Budget.**

3.74 The Government is continuing to evaluate the impact of the credits and to gather evidence on R&D activity in UK firms. In light of this, it is examining how the R&D tax credit can better support those growing firms with the potential to develop into highly-innovative companies in the future, and how it can help retain and grow current world-leading R&D intensive companies and make the UK an even more attractive location for R&D investment. **The Government will consult with business on this issue and will publish a discussion paper in summer 2005.**

Box 3.7: Analysis of UK business R&D performance

The DTI-HM Treasury paper on UK business R&D performance presents an in-depth analysis of UK business R&D performance, focusing in particular on differences between sectors and a comparison of global trends. The material presented is work in progress, and innovatively brings together several data sources for the first time. The key findings with implications for policy are:

- in sectors where UK firms do undertake R&D, there is some evidence to suggest they undertake less than their overseas competitors;
- however, outside a few sectors – notably pharmaceutical, aerospace, and healthcare – large UK firms tend to be concentrated in low R&D sectors. A survey of the top 600 European companies^a shows that, compared with the UK, French firms generate 14 per cent more of their value-added in the top ten R&D intensive sectors, while German firms generate 40 per cent more; and
- outside a few sectors, large foreign-owned firms are more likely to get their R&D from overseas.

The paper's analysis therefore supports a number of the policy priorities for business investment highlighted in the ten-year framework, in particular: maintaining or growing R&D in sectors where the UK is strong; attracting R&D investment into the UK from multi-nationals; increasing the R&D intensity of firms or sectors that are lagging behind their peers; and, developing new R&D intensive sectors through the creation and growth of R&D-intensive SMEs. These will be the central themes of future analytical and policy work in pursuit of the objectives set out in the ten-year framework.

a: DTI estimates based on DTI Value Added scoreboard 2004 and DTI R&D scoreboard 2004.

UK Science Forum **3.75** As announced in the 2004 Pre-Budget Report, the new UK Science Forum will meet in the summer to discuss progress in implementing the ten-year framework, trends in UK business R&D as outlined in the DTI-HM Treasury Paper, and science and technology education. The Forum will be chaired by Sir Tom McKillop of AstraZeneca and will bring together business leaders, scientists and representatives of government to discuss science investment and to inform future decisions on public and private funding of UK R&D.

Guaranteeing SMEs' involvement in public sector R&D **3.76** SMEs undertake some of the UK's most innovative R&D, and can make an important contribution to meeting the public sector's R&D needs. Some SMEs have faced obstacles in offering their services to public sector R&D purchasers. The Small Business Research Initiative (SBRI) has, since 2000, addressed these issues through departments and agencies adopting voluntary targets for minimum levels of R&D contracts with SMEs. **Recognising the potential for a greater positive impact on SME innovation and growth, the Government now intends to adopt a mandatory requirement, through the SBRI, that at least 2.5 per cent of the value of departments' and agencies' extra-mural R&D contracts will be placed with SMEs.** This requirement will further encourage SMEs to enter bids for public sector work, while maintaining value for money and quality of procurement.

3.77 The economic spillover benefits of R&D spending add an extra dimension to procurement judgements, and this is reflected in the exclusion of certain R&D services from EU procurement directives. Departments and agencies will use this limited facility to ensure that their efforts to meet SBRI obligations are successful while remaining within the overall policy and legal framework for public procurement and the EC Treaty generally. SBS will work with OGC and HM Treasury to deliver the new SBRI regime.

Investment in science and innovation

UK Research Councils 3.78 On 7 March 2005, the Director-General of the Research Councils announced the detailed allocation of the science budget up to 2008. This provides a major boost to UK science and fulfils the commitments made in the 2004 Spending Review. Substantial funding increases have been awarded to a number of strategic priorities, including:

- investment of over £1 billion over the period to ensure the sustainability of university research and infrastructure, including £440 million to enable Research Councils and Learned Societies to pay a greater proportion of the full economic cost of research;
- over £300 million to support knowledge transfer and business-university collaboration;
- £60 million to underpin the health of key disciplines such as engineering, and to attract the best researchers from around the world; and
- additional funding of £25 million for clinical research, as part of the Medical Research Council's £1.5 billion budget allocation over the period. This will take the combined budget for medical R&D to over £1.2 billion per annum by 2007-08, meeting the commitment made at Budget 2004.

Energy R&D 3.79 The Government is committed to supporting research and development into sustainable energy technologies, as part of its response to climate change. Funding for energy R&D from the Science Budget will rise from a current level of £40 million per year to £70 million per year by 2007-08, with additional support for business via the DTI Technology Programme and The Carbon Trust. **To underpin this investment, the Government will establish a UK Energy Research Partnership, bringing together public and private funders of energy research to enhance opportunities for collaboration and identify shared priorities for research.**

Science cities 3.80 At the time of the 2004 Pre-Budget Report, the Government welcomed the commitment by the three Northern RDAs to designate three 'science cities', and asked the RDAs to come forward with further proposals on how to develop science cities by Budget 2005. The RDAs have recognised science cities as a valuable model for targeting investment in science and technology in cities which have particular potential to benefit from higher growth in this area. **In partnership with the RDAs, the Government welcomes the announcement today by the RDAs that three further science cities will be developed in Bristol, Birmingham and Nottingham.**

Box 3.8: Science cities

'Science cities' are those with strong science-based assets – such as a major university or centre of research excellence – which have particular potential to use these assets as the basis for generating business success. Developing science cities requires a range of complementary policies to address the specific needs of research and development, to support university-business collaboration, and to influence a wider spectrum of factors that contribute to the growth of knowledge-intensive industries, such as skills, transport, finance and infrastructure. By bringing these factors together in a concentrated space, science cities can attract a critical mass of innovative businesses and become drivers of regional growth.

While cities will need to tailor their strategies to their individual circumstances, successful science cities will typically emerge where world-class research capacity combines with successful knowledge-based industries in an environment with the physical infrastructure and supply of higher level skills to support significant further investment. Strong local and regional leadership, in partnership with business, is also an essential factor for the growth of science cities.

The 2004 Pre-Budget Report announced an initial set of science cities in Manchester, Newcastle and York, as part of the Northern Way initiative. These cities are currently developing their strategies and will provide details in their city-regional development plans in May 2005.

Regional science and innovation

3.81 The Government is working to ensure that national funding streams for science and innovation better reflect regional priorities. It is currently developing an allocations procedure for the third round of the Higher Education Innovation Fund, supporting universities' collaboration with business, and will consult with stakeholders on how funding for knowledge transfer can best be aligned with regional priorities. The next round of the Science Research Infrastructure Fund, which provides capital funding of £500 million per annum to renew university infrastructure, will require universities to develop their implementation strategies in light of regional priorities, and make research facilities more accessible to businesses as well as academic users.

Scientific research organisations

3.82 Budget 2004 announced proposals to refine the tax treatment of scientific research organisations (SROs) bringing the definition of R&D into line with that used in the rest of the tax system and modernising the monitoring process. These changes will be included in the Finance Bill. The Government will consult with SROs and their representatives on the statutory framework necessary to underpin the new monitoring regime.

University spin-offs

3.83 As announced at the 2004 Pre-Budget Report, the Government will bring forward legislation to remove the tax uncertainty surrounding the formation of spin-off companies from universities and public sector research establishments (PSREs). This will take into account responses to the Technical Note published alongside the 2004 Pre-Budget Report.²⁴

A full Regulatory Impact Assessment on the new legislation and summary of consultation responses is published today.

Creativity in industry

3.84 UK creative industries represent around 8 per cent of UK GDP, and lead the world in many areas including music, design, fashion, digital media and the arts. However, there is evidence that, beyond the success of the creative industries, businesses in other sectors of the economy do not recognise the potential to raise performance and productivity by investing in creativity and incorporating innovative design ideas into their products, as described in Box 3.9.

²⁴ *New Tax measures to help researchers acquiring shares in spinout companies created with universities and research establishments*, Inland Revenue, December 2004.

Box 3.9: Creativity and business performance

Creativity is a key ingredient in the success of businesses right across the UK economy. By applying a range of creative skills, businesses transform goods and services from commodities to differentiated products which can be marketed on the strength of their unique characteristics. This can reflect a range of creative contributions, from the impact of product innovation and design, to innovation in delivery through digital media, and influences from the arts and diverse cultures. By increasing the distinctiveness of products and services, creativity allows large and small firms to compete in global markets on the basis of the added value of their unique appeal to consumers. Research for the Design Council and the DTI's Innovation Review^a bears this out, showing that:

- design-intensive companies outperformed the FTSE 100 by more than 200 per cent over a ten-year period;
- rapidly growing businesses attach much greater weight to the importance of creativity than the average firm – ranking design as the second most important factor, after marketing, in their success, compared with seventh for the average UK firm;
- growing businesses are more than twice as likely to use creativity to improve quality than static businesses; and
- 70 per cent of businesses where design is integral to strategy say that design has increased the quality of their products and services.

The UK has a world-leading creative sector, directly contributing 8 per cent to UK GDP and employing more than 1.3 million people. It has a major creative cluster around London, but is also spread across the nations and regions, with 60 per cent of creative sector employment outside London. The UK's artistic and cultural diversity, and its trading and cultural connections across the world, contribute to the economy's creative strength.

The challenge is to ensure that businesses – especially SMEs and modern manufacturers – are aware of the potential for improving their profitability and productivity by applying creativity; and know how to go about it. The success of the creative industries notwithstanding, there is evidence that UK business is not realising the full potential of applying creativity more widely:

- on average, UK businesses expected a return on investment of 50 per cent on their most successful design project last year, but actually secured a return of more than 75 per cent;
- many companies suffer the consequences of under investing in creativity: for example, 45 per cent of businesses which do not use design are driven to compete mainly on price, whereas this is true of only 21 per cent of design-intensive firms;
- significant innovative breakthroughs remain scarce for UK businesses. Only one in ten firms have come up with new products, services or processes based on major innovation in the last 3 years;

The measures announced in this Budget seek to match the UK's world-class creative talents with untapped potential for enhancing business performance.

a: The Impact of Design on Stock Market Performance (Design Index), Design Council, 2004; *National Survey of Firms*, Public and Corporate Economic Consultants, 2004; *Competing in the global economy, the innovation challenge*, DTI, 2003.

3.85 For many businesses, effective use of creative inputs to their goods, services and business processes can improve their value-added, and provide a means of competing globally – not just on cost but on the quality, value and distinctiveness of their products and services. This is particularly important for SMEs and in modern manufacturing, where cost competition is intensifying in a globalised economy, making it critical that producers are able to differentiate their products by adding value.

3.86 This Budget announces measures to increase the contribution of creativity to productivity growth. In particular, it takes steps to improve access for firms to the substantial capability in the creative sector's institutions and businesses:

- **the Chancellor has asked George Cox, Chair of the Design Council, to review how best to ensure that SMEs are able to apply creativity and innovation to improve their performance and productivity.** The review will consider how to raise awareness of the potential benefits for SMEs, including in modern manufacturing, and the steps needed to ensure that SMEs are able to draw on the UK's world-leading creative skills in areas such as digital media, product and industrial design, the arts and culture, graphics, branding and advertising, publishing, packaging, interior and retail design. It will also examine how links can be improved between universities and colleges, SMEs and creative skills in businesses and other institutions;
- **the Government welcomes the initiative of the Design Council in devising and piloting the Design Immersion Programme** with the RDAs in the West Midlands and London to provide mentoring for business chief executives to support them in integrating design into corporate strategy, product and market development. Building on this initiative, and similar plans in Yorkshire and the Humber, and the North East, the Government is encouraging the RDAs to consider how best to build design, including the Design Immersion Programme, into their plans;
- as part of the Northern Way, **the RDAs for the North East, North West, Yorkshire and the Humber will launch a modern Design Centre in Newcastle/Gateshead** to ensure that businesses across northern England are able to access creative talent and design skills;
- to help to improve the business impact of cultural creativity, **the Government will provide £12 million over 2 years from 2006-07 to the Arts Council England and others to promote excellence in management and leadership within the cultural sector.** This will ensure that a larger number of talented high-flyers in cultural organisations will be able to develop commercial and business leadership skills, encourage the leadership talents of leading ethnic minority figures in the arts, and create new opportunities for business-arts collaboration; and
- **the DTI will launch a study of the value and productivity impact of creativity and design in businesses,** helping firms to identify how creativity can improve their performance.

SKILLS

Skills in the global economy **3.87** *Skills in the global economy*, published alongside the 2004 Pre-Budget Report, highlighted the increasing importance of skills to the UK economy. As described in Chapter 4, UK employment is now at a record high. However, while the proportion of people in the UK with high skills compares well internationally, the share of the workforce with intermediate skills is relatively low and, despite improvements over the last few years, there is still a large stock of workers with no or low skills. There is strong evidence that investment in training is lower than optimal because of market failures, especially for those with lower level qualifications or no qualifications at all.

3.88 Chapter 6 sets out in detail the Government's major new investment in education, including plans for investment to deliver twenty-first century facilities in primary schools, further support for ICT in schools, and significant investment in Further Education colleges.

3.89 Alongside this, the Government is introducing a major package of reforms to ensure that, for the first time, every young person will be able to benefit from education and training between the ages of 16 and 18. Chapters 5 and 6 set out reforms to improve financial support for 16-19 year olds and raise levels of participation in education and training post-16. This includes a pilot scheme offering 16 and 17 year olds who are not in education, training or employment financial support in return for a commitment to progress towards formal learning, and a further pilot scheme targeted at 16 and 17 year-olds in work with no training, offering financial support in return for a commitment to further study.

Leitch Review **3.90** The 2004 Pre-Budget Report announced that the Government had established an independent review to examine the future skills needs and priorities for the UK economy, led by Lord Leitch, Chairman of the National Employment Panel.²⁵ The Review will report in spring 2006 on what skills profile the UK should aim to achieve in 2020 to support productivity and growth over the longer term. In addition to the economic case, the Review will also consider the benefits to society of improving workforce skills. The Review will work with a wide range of stakeholders to build an evidence base upon which the Government can set its skills ambitions for 2020 and will consider the implications for skills policy.

Developing the skills of young people

3.91 The Government has introduced a number of measures to encourage all young people to take part in some form of education or training up to the age of 19. These include reform to the financial support system for 16-19 year olds through the introduction of Education Maintenance Allowances, which have been rolled out nationally from September 2004, and the extension of Child Benefit and Child Tax Credit to unwaged trainees, described in Chapter 5. In addition, the continued development of Apprenticeships allows young people to combine vocational training with valuable work experience.

14-19 education **3.92** Building on progress to date and reforms set out in the five-year skills strategy, the Government recently published a White Paper setting out the detail of the reform programme for 14-19 education, building on the work of Sir Mike Tomlinson's Working Group on 14-19 education reform. The White Paper describes the Government's long-term vision for an education system that provides every young person with a route to success in life through work and dedication. This includes an increased focus on securing basic skills, reform of vocational qualifications, greater stretch and differentiation between students, and measures

²⁵ www.hm-treasury.gov.uk/leitch

to tackle disengagement. The reforms will deliver a system which is more tailored to the talents and aspirations of individual young people, with greater flexibility about what and where to study and when to take qualifications.

3.93 The Government has set an ambitious participation target for higher education to ensure that more young people than ever before will have the opportunity to progress to higher skill levels. The expansion of Foundation Degrees aims to facilitate young people and adults moving on to higher education by strengthening the choice and routes for progression. These vocational qualifications are designed and developed with employers and provide students with the skills and knowledge employers are looking for, typically taking two years to complete but with the opportunity, after further study, to gain a full honours degree.

Workforce development

3.94 The Government is committed to enabling all adults to continue training and developing skills during their working lives. The Government's skills strategy in 2003, and the New Deal for Skills in 2004, introduced a number of measures including: an entitlement to free training to NVQ level 2 and in basic literacy, numeracy and ICT skills; a more flexible qualification and curriculum structure; improved adult information and guidance services; improved services from training providers; and a new network of Sector Skills Councils to provide a forum for employers and employees to tackle skills needs in each major sector of the economy.

Skills White Paper **3.95** The Government will shortly publish a Skills White Paper setting out the next phase of reform to make this country a world leader in skills. It aims to do this by putting employers' needs centre stage in the design and delivery of training, supporting individuals to gain the skills and qualifications they need to achieve at all levels, from basic skills in literacy and language, through to Foundation Degrees, and delivering this in partnership with the Skills Alliance. Together with the White Paper on 14-19 education this represents a clear and determined strategy to tackle the long-standing weaknesses in the UK's education and training system for young people and adults.

Employer Training Pilots **3.96** The Government has taken action to address market failures that restrict business and individuals from investing in skills training. Employer Training Pilots (ETPs), introduced in September 2002, now have over 17,000 employers and 120,000 learners participating. Most employees involved left school at or before age 16 and half have no qualifications at all. 70 per cent of participating firms employ less than 50 people. The first evaluation of the scheme shows that it has been successful. After involvement with ETPs, 63 per cent of learners were more positive about the likelihood of progressing to further training. 93 per cent of ETP employers felt the training would result in improved quality of service and production.²⁶ Building on this success the Government will ensure that the pilots are funded to continue to meet employer demand, by providing an additional £65 million in 2005-06.

National Employer Training Programme **3.97** As announced in the 2004 Pre-Budget Report, the Government will rollout a National Employer Training Programme from 2006-07 to cover the whole country by 2007-08. This will build on the success of the ETPs and guarantee that, where employers are prepared to offer their low-skilled employees paid time to train up to level 2 qualifications, the costs of this training will be fully subsidised. It will also include support from brokers to assess, design and source training needs for employers and employees. There is mixed evidence on the impact of wage compensation, offered in all but one pilot to help employers meet the costs of giving staff paid time off to train. However, some early evidence suggests that it may be important in initially engaging those employers who would not usually provide training. The Government will continue to consider this issue and look to further evaluation before making a final decision on the inclusion of wage compensation within the national programme.

²⁶ ETP second year evaluation, DfES, forthcoming - to be published alongside Skills White Paper on 22 March 2005. [Check reference to forthcoming document with DFES]

Regional Skills Partnerships 3.98 Evidence shows variations in the skill levels of different regions are a key factor in explaining differences in economic performance. Regional Skills Partnerships (RSPs) were announced in July 2003 to bring together the work of a number of bodies, including the RDAs, on skills, training and business support. In the 2004 Pre-Budget Report, the RSPs, the RDAs and the LSC were asked for an update of progress in each region on aligning regional priorities for adult skills provision.

3.99 Overall progress is encouraging, although some regions and RSPs are further advanced than others. Detailed work is underway in some regions on 'dual key' arrangements for planning and funding adult skills, which will enable RDAs and Regional LSC Directors better to align regional skills budgets with regional economic strategies. The Government expects all RSPs to agree skills priorities, and reflect these in adult skills provision over the 2004 Spending Review period. The Government also remains committed to removing obstacles, where regional partners identify them, to further integration.

Union Academy 3.100 In the skills strategy the Government made a commitment to a new social partnership for skills – bringing together key economic and delivery partners to drive forward reform. As part of this partnership, the TUC and trade unions have made a significant contribution in helping union members with low or no qualifications to take advantage of learning opportunities offered by government initiatives such as Skills for Life, ETPs and online learning. Drawing together the strands of existing union learning activity, the TUC plan to launch a Union Academy to increase the capacity of unions to help members recognise the value of learning and training opportunities and drive a step change in the level of learning and development delivered through unions. The unions are committing significant resources of their own to the development of the academy and the Government will provide additional funding to implement the proposal.

3.101 The Government opened a discussion in 2003 on the role tax incentives can play in encouraging workforce development. Since then, it has been discussing ideas with interested parties, alongside the development of the skills strategy. The Government recognises the case for reform and will continue to work with key groups to develop its plans for the future.

Migration 3.102 As the global economy integrates, labour markets are becoming increasingly international. To remain competitive it is important that the UK continues to attract and retain talent. The Government's Five-Year Strategy for Asylum and Immigration, published in February 2005, will deliver a flexible points-based system to ensure that the UK attracts the migrants needed by economy and businesses. **The Government will also provide the opportunity for young Chinese graduates to develop a greater understanding of the UK by establishing a China Youth Exchange Scheme, to allow a year-long working stay in the UK.**

INVESTMENT

3.103 Capital investment is a key driver of productivity. Evidence suggests that the UK has a significantly lower level of capital per worker than the USA, France and Germany, and that this capital gap contributes to the labour productivity gap with those economies.²⁷ The UK economy has historically experienced among the lowest overall levels of investment relative to GDP in the OECD, in particular owing to low levels of investment by government and households.

²⁷ Britain's Relative Productivity Performance: Updates to 1999, National Institute of Economic and Social Research, O'Mahony and de Boer, 2002.

3.104 The Government is committed to enhancing the economic environment within which businesses make their investment decisions. Central to this is providing a platform of macroeconomic stability to enable firms and households to plan for the long term. The Government is also implementing microeconomic reforms to remove the barriers that prevent capital markets from functioning efficiently and flexibly, so removing barriers to innovation and investment. A report on progress to promote product and capital market flexibility is provided in Box 3.11. The Government recognises that foreign direct investment brings a range of economic benefits. It is refocusing the resources of UK Trade and Investment towards strengthening inward investment services and promoting FDI, building on the UK's excellent record in attracting FDI. As described in Chapter 6, the Government has also taken action to address historic under-investment in the public sector, which plays a key role in driving productivity.

Investment in transport **3.105** There is a clear consensus on the importance of appropriate investment in transport for productivity and economic growth. The Government's White Paper *The Future of Transport: a Network for 2030*, published in 2004, set out a strategy for long-term increased investment by both public and private sectors, combined with smarter choices on travel. This also set out, as a result of the 2004 Spending Review, increased transport funding over the ten-year period through to 2015 with the introduction of a new Transport Innovation Fund to support the development of innovative transport measures that can benefit national productivity. Total public sector investment over this period will be over £79 billion in today's prices. Recognising the need to take a sustainable longer term view, and building on the 30-year strategy, it is necessary to bring together the right investment plans and the right framework for prioritising and delivering new infrastructure. **The Secretary of State for Transport and the Chancellor have asked Rod Eddington, outgoing Chief Executive of British Airways PLC, to work with the Department for Transport and HM Treasury to advise on the long-term impact of transport decisions on the UK's productivity, stability and growth.**

The investment chain

3.106 UK institutional investors manage almost half of UK equities, investing a large part of the wealth of UK savers and exerting indirect control and influence over much of UK industry. This ownership is intermediated through an 'investment chain' of relationships connecting ultimate owners with their investment in companies. Ensuring this chain works efficiently is of vital economic importance for productivity and long term growth, because the chain is a critical mechanism for ensuring that investment is efficiently allocated. The Government has taken action to improve the functioning of the investment chain, identifying under-performing links in this chain and implementing solutions, including:

- addressing the problem of distorted investment decision-making by institutions through the original Myners Review.²⁸ The Government endorsed Paul Myners' recommendation that trustees of occupational pension funds voluntarily adopt, on a 'comply or explain' basis, a set of principles codifying best practice for investment decision-making. Building on this, Sir Derek Morris' Review, described below, makes recommendations for increasing competition in the market for actuarial services and strengthening the regulatory framework for the actuarial profession;

²⁸ *Institutional investment in the UK: a review*, Paul Myners, March 2001.

²⁹ *Medium and long-term retail savings in the UK: a review*, Ron Sandler, July 2002.

- rectifying, following the Sandler Review²⁹, the failure of the retail savings industry to serve medium to long term savers optimally, by working with the FSA to develop simplified and more transparent savings products and to enhance disclosure of the cost of advice;
- improving the UK corporate governance regime following Sir Derek Higgs' Review³⁰ into the role of non-executive directors. The Financial Reporting Council has issued a revised Combined Code on Corporate Governance. As a result of the Smith Review³¹ and the work of the Co-ordinating Group on Audit and Accounting, measures have been implemented to improve the independence and transparency of audit and the quality of financial reporting; and
- to promote more active engagement by shareholders with companies, welcoming in October 2002 the Institutional Shareholder Committee (ISC) principles and the commitment to reflect these in fund management mandates. The ISC will shortly conclude its review of the impact of the principles on engagement and the government will take account of the ISC's conclusions when finalising its own review.

Myners principles: review of progress **3.107** Addressing the problem of distorted investment decision-making by institutions is central to improving the functioning of the investment chain. In December 2004, the Government published a review of progress against the Myners principles. This shows that, while behaviour is beginning to change, progress is lagging in key areas. The Government has therefore proposed changes to the principles designed to: strengthen trustee expertise; ensure more effective use is made of advisers; improve the quality of asset allocation activity and the resources devoted to it; and provide greater clarity on funds' investment time horizons. In addition, the Government will work with key stakeholders to improve the quality of the commentary trustees make on how they are implementing the principles. The Government is consulting on its proposals.

Morris Review **3.108** The Government asked Sir Derek Morris to conduct a wide-ranging independent review of the actuarial profession following Lord Penrose' Inquiry into the Equitable Life³² and as part of the Government's wider programme of reform to improve the efficiency of the investment chain. The provision of high-quality actuarial advice is a key element of the investment chain – actuaries advise pension funds on strategic investment issues, including asset allocation and fund manager selection. Sir Derek Morris has today published his final report and has made a number of recommendations, described further in Box 3.10, to increase competition in the market for actuarial services; to strengthen the regulatory framework for the actuarial profession and on the future role and institutional status of the Government Actuary and his Department.

²⁹ *Review of the role and effectiveness of non-executive directors*, Derek Higgs, January 2003.

³¹ *Audit committees: Combined Code guidance*, Financial Reporting Council appointed group chaired by Sir Robert Smith.

³² *Report of the Equitable Life inquiry*, The Right Honourable Lord Penrose, March 2004.

Box 3.10: Morris Review Recommendations

The central recommendation of the Morris Review is that regulation of the actuarial profession should be subject to independent oversight by the Financial Reporting Council (FRC.) The FRC should:

- create an Actuarial Standards Board as a new operating body of the FRC to set actuarial professional standards and oversee the regulatory and other activities of the actuarial professional bodies – including their role in: setting ethical standards; administering education and CPD; monitoring of compliance with professional standards; and in administering disciplinary procedures.

In order to promote an open and competitive market for actuarial services the review recommends that it is best practice for pension scheme trustees to:

- invite tenders separately for actuarial advice, strategic investment advice and fund manager selection advice, as proposed by the Government in its recent revision to the Myners' principles.
- (i) informally evaluate their actuarial advisers on an annual basis, (ii) undertake a more formal evaluation every three years and (iii) undertake a formal market test of their actuarial advisers no less frequently than every six years.

In relation to the Government Actuary's Department the review recommends that:

- the Government should increase choice and competition for users of actuarial advice to public service pension schemes and should transfer a limited number of functions to other government departments in order to achieve more effective integration of the services provided; the Government Actuary should continue to report to Ministers and Parliament on the National Insurance Fund; and the Government should consider converting the Government Actuary's Department into a trading fund.

3.109 The Government welcomes the report of the Morris review and, in principle, accepts its recommendations, and looks forward to working with the actuarial profession and other stakeholders on implementation. The Government believes that the report's recommendations provide a blueprint for practical and effective reform of the actuarial profession and clarify the ongoing role of the Government Actuary and the Government Actuary's Department. **The Government urges all stakeholders – the actuarial profession and its users, the Pensions Regulator, the Financial Reporting Council, and the Financial Services Authority – to support the report's recommendations and work with the Government to see how they can be implemented in practice.**

Investment in housing and property

3.110 A stable and flexible housing market is essential to a productive economy. Housing market imbalances between supply and demand are a potential brake on economic development, as the cost and availability of housing influences the geographical distribution and mobility of the labour force and may affect capacity levels in local labour markets.

Implementing the Barker Review

3.111 Kate Barker's independent review of housing supply,³³ published alongside Budget 2004, set out the long-term lack of supply and responsiveness of housing in the UK. It identified problems of affordability for new households, wealth redistribution from those outside the housing market to those inside the market, and significant regional price differentials and expectations, reducing labour mobility and constraining productivity. It recommended a step change in housing supply and a programme of wide-ranging reform to

³³ *Delivering Stability: Securing Our Future Housing Needs*, Kate Barker, March 2004

deliver better balanced housing markets, including a proposal for a Planning-gain Supplement to help fund additional investment in infrastructure and social housing and to give local authorities stronger incentives to deliver housing growth.

3.II2 The Government is making significant progress in implementing the Barker Review's recommendations on investment planning reform and affordability. The 2004 Spending Review announced a 50 per cent increase in new social house building by 2007-08 compared with 2004-05 – an additional 10,000 homes a year. It also established a new Community Infrastructure Fund (CIF) of £150 million by 2007-08 to support the transport infrastructure costs required to enable faster housing development in the four growth areas. An announcement on the projects that have been provisionally approved for funding through the CIF will be made imminently.

3.II3 Following recent consultation, the Government is considering how best to merge Regional Housing Boards (RHBs) and Regional Planning Bodies (RPBs) to create integrated bodies responsible for managing regional housing markets. It will also establish an independent advice unit to strengthen the evidence and analysis on improving housing market affordability available to regional bodies throughout the regional planning process.

3.II4 Ahead of a full response on Barker Review implementation later this year, the Government will consult in the summer on other aspects of the Barker Review package, including introducing a long term national goal for affordability in the housing market and on increasing the planning system's responsiveness to housing market signals by reforming Planning Policy Guidance on Housing (PPG3). The Government will also consider by the summer progress made by the house building industry to improve service quality and customer satisfaction ratings and to increase investment in skills and innovation.

Planning reform 3.II5 A transparent and flexible planning system is central to delivery of the Government's economic, social and environmental objectives, and plays a vital role in driving up productivity. In addition to the implementation of the Barker Review recommendations, the Government has taken steps to make the planning system work more quickly and predictably. The 2004 Planning and Compulsory Purchase Act introduced a simplified planning structure with strengthened Regional Spatial Strategies and flexible local development frameworks. **The Government will shortly publish its revised policy statement on town centres (PPS6) in England. This will set out the Government's objectives for promoting the growth and development of town centres to strengthen their vitality and viability, enhance consumer choice and tackle social exclusion.**

Implementing the Miles Review 3.II6 Professor David Miles published the final report of his review of supply and demand side factors limiting the development of the UK longer-term fixed-rate mortgage market alongside Budget 2004.³⁴ Good progress has been made in taking the recommendations forward:

- information and advice to borrowers – the new FSA regulatory regime for mortgages covered a number of elements of the review's recommendations on disclosure and advice, including the introduction of an improved mortgage information leaflet and consumer fact-sheet on switching mortgages. The FSA will launch a review of the effectiveness of the current regime by end of 2005 and will consider further recommended changes on advice and disclosure as part of that review. The Financial Capability Steering Group's borrowing group will also include work on understanding the risks of mortgage borrowing as part of its broader work on risk messages;

³⁴ *The UK mortgage market: taking a longer-term view*, David Miles, March 2004.

- the structure of pricing of mortgages – the FSA will consider the review’s recommendations on cross-subsidy within the mortgage market, possibly in the context of their ongoing work on Treating Customers Fairly;
- the funding of fixed-rate mortgages – the Treasury introduced legislation in December 2004 to remove a constraint on building societies’ ability to securitise assets as a source of funding. As recommended by Miles, the Government has considered whether the funding limit for building societies should be changed. In light of the greater flexibility provided by the legislation, and following consultation, no further action will be taken at this time, but the position will be kept under review. The lack of symmetric mark-to-market charges and stand-alone interest rate cap products at present means that it is not possible to assess their potential tax treatments. However, the Treasury and the Inland Revenue will engage with lenders considering developing such products in future; and
- the Debt and Reserves Management Report 2005-06, published today, responds to the recommendation that it consider the potential costs and benefits of issuing interest rate derivatives. A substantial degree of uncertainty remains over the balance of advantage to the Government and the case for issuing these instruments from the perspective of debt management policy has not yet been made. Accordingly the Government does not propose to issue any such instruments at this time.

Real Estate Investment Trusts **3.117** Alongside Budget 2004, the Government launched a consultation to consider the introduction of Real Estate Investment Trusts (REITs)³⁵ with the aim of promoting greater efficiency in the UK property investment market, supporting the Government’s wider objective of raising UK productivity. **The Government is today publishing *UK Real Estate Investment Trusts: a discussion paper, along with a summary of responses to the Budget 2004 consultation.***

3.118 The Government is committed in principle to reforming the taxation of property investment. The consultation has enabled the Government to better define the key features of a potential UK-REIT model that allows for market flexibility. These features are set out in the discussion paper. The paper also raises some challenging issues in designing the tax treatment for a model that meets both the needs of the UK property investment market and the Government’s objectives for a UK-REIT. The Government will therefore engage in further dialogue with industry representatives. **Subject to finding a workable solution that meets the stated objectives, including reform at no overall cost to the Exchequer, the Government aims to legislate for a UK-REIT in Finance Bill 2006.**

Flexibility of commercial property leases **3.119** The Government has been considering the outcome of a consultation by the Office of the Deputy Prime Minister (ODPM) on legislative remedies for the prevalence in commercial property leases of upward-only rent review clauses.³⁶ A recent report into flexibility in the property market, published in February 2004,³⁷ showed that while there is encouraging evidence that parts of the market are becoming more flexible, there is also evidence of much less progress in a number of important respects. Since 2001, the Government has been working with the commercial property industry to promote a voluntary code of practice to improve the flexibility of commercial lease terms for businesses. While the Government welcomes the recent trend towards greater market flexibility, it believes much more can be done to strengthen the impact of the code of practice on the market. It will continue to work with the industry on strengthening the code, but remains willing to pursue legislation if further movements towards greater market flexibility are not forthcoming.

³⁵ *Promoting more flexible investment in property: a consultation*, HM Treasury and Inland Revenue, March 2004.

³⁶ *Commercial property leases: Options for deterring or banning the use of upward only rent review clauses*, ODPM, 2004.

³⁷ *Monitoring the 2002 Code of Practice for Commercial Leases*, ODPM and Reading University, 2005.

Box 3.1 I: Product and capital market flexibility – report on progress

Flexible product and capital markets stimulate enterprise and innovation, and create jobs and growth. Product market flexibility that promotes competition and encourages innovation and research enables firms to respond quickly to changing market conditions, allowing them to exploit new opportunities and deal with potential challenges. Capital market flexibility ensures that capital is allocated efficiently, so that business and entrepreneurs have ready access to the funds they need to develop their ideas. It also enables financial risks to be shared across firms and individuals, so reducing the economy's vulnerability to economic shocks.

The assessment of the five economic tests for UK membership of Economic and Monetary Union (EMU) in June 2003 examined the flexibility of UK product and capital markets. It noted that a decision to join EMU would highlight the need for rapid price and factor movements, and for firms to sharpen their ability to respond effectively to shocks and competitive opportunities. It concluded that the UK has a reasonable degree of price flexibility and generally exhibits a competitive business environment, but that the degree of competition and market flexibility falls short of what might be achievable. The assessment also concluded that capital markets can play an important role in stabilising the impact of shocks, but that risk-sharing is not significant in the EU at present and greater integration could bolster its role as an adjustment mechanism. This box and chapter report on trends and progress in product and capital markets. Key new measures introduced since Budget 2004 to promote capital and product market flexibility include:

Modernising the business tax system: the Government is establishing a new integrated tax department, and taking immediate steps to deliver benefits for business. Further proposals for the reform of corporation tax have been published for consultation.

Regulatory reforms to ease the burden on business: including the Government's acceptance of the recommendations of the Hampton Review of regulatory inspection and enforcement and the recommendations from the Better Regulation Task Force, and a continuing commitment to regulatory reform in Europe as a priority of the six EU Presidencies until the end of 2006.

Promoting competition: through reviews into, and action on, competition in a variety of markets including legal services, payment systems, subsidies, ticket agents, home credit, liquefied petroleum gas and store card credit services; an Office of Fair Trading (OFT) review of how public sector procurement affects competition; an audit of public sector radio spectrum use; and an OFT review of the impact on competition of the Financial Services and Markets Act 2000.

Planning reform: including the Planning and Compulsory Purchase Act 2004 which introduces a simplified planning structure with strengthened regional spatial strategies; updating national planning guidance on housing, town centres and retail, and economic development; and increased resources for the planning system. Significant progress has been made in implementing the planning reform recommendations of the Barker Review, published alongside Budget 2004.

Improving access to finance for SMEs and individuals: including the final report of the Graham Review of the Small Firms Loan Guarantee Scheme and action to implement its recommendations by end 2005, and deregulatory changes to the financial promotions regime.

Capital market integration: together with the FSA and Bank of England, the Government has set out a strategic approach to developing the Single Market in financial services following the EU Financial Services Action Plan. The Government has taken action to improve the functioning of the investment chain, identifying under-performing links in this chain and implementing solutions.

4

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

The Government's long-term goal is employment opportunity for all – the modern definition of full employment. Delivering this requires that everyone should be provided with the support they need to enable them to find employment and develop skills. This chapter describes the further steps the Government is taking to move towards its aim of employment opportunity for all, including:

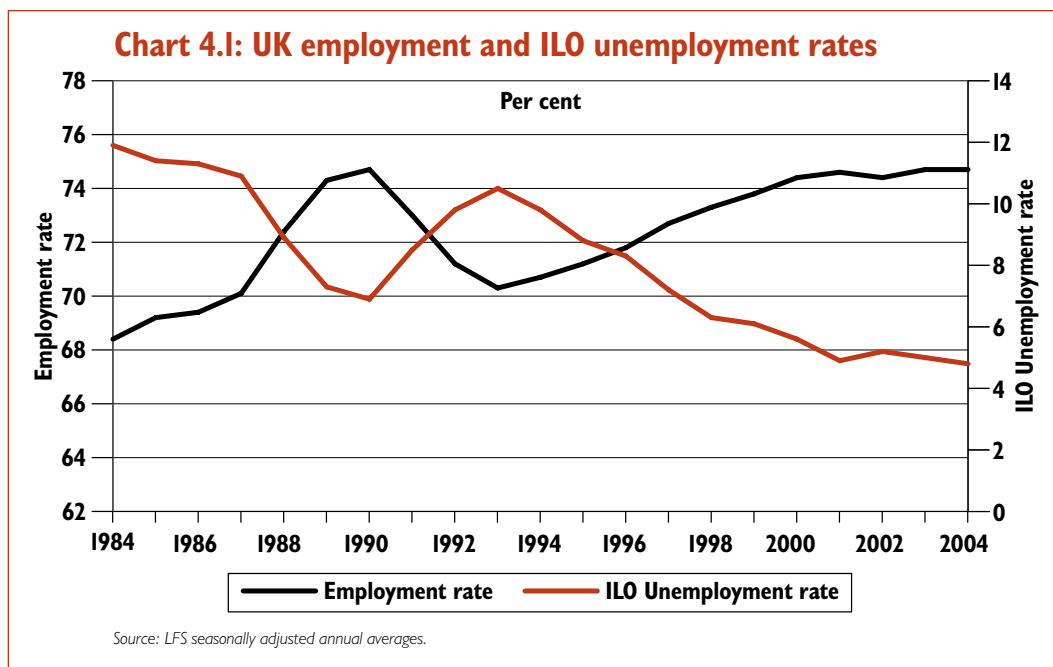
- **improvements to incapacity benefits linking rules**, including an automatic guarantee of entitlement to the rules on a move into employment; a single, extended linking rules period of 104 weeks; and immediate re-qualification for the rules on a return to benefit;
- following the Low Pay Commission's recommendations, **the adult rate of the National Minimum Wage will rise to £5.05 per hour from October 2005 and £5.35 from October 2006;**
- **examining the scope for improving Jobseeker's Allowance sanctions and the potential for a fixed fines system**, to maintain an effective balance between rights and responsibilities by improving the capacity to respond swiftly and effectively in cases of non-compliance;
- **supporting young people not in education, employment or training**, details are set out in Chapter 5;
- **accepting the recommendations of the National Employment Panel's report on measures to promote employment and small business growth for ethnic and faith minorities. The Government will develop proposals for implementing these recommendations, including the establishment of Centres of Vocational Excellence in Entrepreneurship;**
- **a package of measures to help simplify and improve Housing and Council Tax Benefit** by making further improvements in administration; and
- **improving IT links between local authorities and the Department for Work and Pensions** to allow faster and more accurate processing of Housing Benefit claims.

4.1 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. The strong labour market performance of recent years has helped deliver this, with many of the previously most disadvantaged groups and regions demonstrating the most significant improvements. This Budget sets out action to build on this strength and tackle the long-term challenges of increasing flexibility, reducing inactivity and helping those groups in society facing particular barriers to work and skills development.

Labour market challenges

4.2 The unemployment rate peaked at almost 12 per cent in the 1980s and again at nearly 11 per cent in the early 1990s, with over 3 million unemployed on both occasions. By the mid 1990s, as Chart 4.1 shows, unemployment had begun to fall. However, this headline improvement masked a set of structural changes in the labour market which were producing very unequal outcomes for working age households. Unemployment, although falling, had become much more concentrated, with some people experiencing much longer periods unemployed. Employment was falling for lone parents and couple mothers with a partner not in work, but rising for couple mothers with a working partner. Employment rates were low

among people with a health condition or disability, and ethnic minority groups. These trends contributed to an increasingly polarised distribution of work across households. The proportion of couple households with a single earner declined sharply, while the proportion of both workless households, and households in which both adults were in work, increased.



Recent labour market performance

4.3 The Government's labour market policies have contributed to ongoing improvements in headline employment and falls in unemployment, while also addressing the underlying weaknesses and inequalities within the labour market described above. As Chart 4.1 shows, UK unemployment, on the International Labour Organisation (ILO) definition, fell in the three months to December 2004 to 4.7 per cent – the lowest rate since summer 1975. The number of people in employment totalled a record 28.5 million, while the working age employment rate reached 74.9 per cent. On a comparable basis (people aged 15-64) the employment rate in the UK, at 71.7 per cent, is higher than that of both the EU (64.7 per cent for the EU15, or 63.2 per cent for the enlarged EU) and the US (71.3 per cent). Success at the national level has been reflected in progress in extending employment opportunity across all groups and regions. Employment rates have risen for lone parents, older workers, ethnic minorities, and people with a health condition or a disability, as well as in disadvantaged areas.

4.4 The Government is determined to build further on this strong performance. The Department for Work and Pensions (DWP) recently published a Five Year Strategy¹ setting out the Government's long term aspiration of an 80 per cent employment rate. As Box 4.1 describes, this is an ambitious aspiration which reflects the importance of a rising employment rate both to support an ageing society and to extend employment opportunity to all disadvantaged groups and areas.

¹ Department for Work and Pensions Five Year Strategy – Opportunity and security throughout life, Department for Work and Pensions, February 2005.

Box 4.1: Looking to the long term – an aspiration of an 80 per cent employment rate

The Government is committed to delivering employment opportunity for all. This is a challenging and ambitious objective, reinforced in the DWP's Five-Year Strategy which sets out a long-term aspiration of achieving and sustaining an 80 per cent employment rate.

The rise in employment over the past decade has reflected primarily a move out of unemployment into work. As is also clear, falling unemployment has not been a product of people moving from unemployment into inactivity. The inactivity rate, broadly stable over the decade, has declined by 0.3 percentage points since 1997. Given that the number of full time students has been rising (one of several compositional changes in inactivity, including a recent decline in the number registered as inactive due to illness or disability after strong increases in the 1980s and early 1990s), the fall in inactivity excluding students has been a more marked 0.9 percentage points.

Inactive individuals tend to be more detached from work than their unemployed counterparts. This does not, however, mean that they do not want to work. Offered appropriate tailored support, many who wish to work, find work, as demonstrated by rising employment rates among lone parents, older workers and people with health conditions and disabilities.

Reducing inactivity and raising employment is important on both economic and social grounds: in promoting a growing and enterprising economy; in reducing regional disparities in economic performance; in tackling poverty; in supporting those unable to work; in enabling everyone to fulfil their potential; and in meeting the challenge of an ageing society. An 80 per cent employment rate would virtually offset the projected rise in the UK dependency ratio (the ratio of non-workers to workers) between now and 2050; of benefit to future, as well as current, generations.

Realising this long-term aspiration will be achieved only on a platform of ongoing macroeconomic stability, and by building on the success of the welfare and education reforms already delivered. This will include extending the support offered by Jobcentre Plus and the New Deal; ensuring that no-one, whoever they are and wherever they live, is excluded from the labour market through disadvantage; bringing down still further, financial and other barriers to work; taking forward the child poverty agenda; and equipping people – both at school, and throughout their adult lives – with the skills they need to find, remain and progress in work.

The policy framework 4.5 The strong labour market performance of recent years has been based on a foundation of macroeconomic stability. Stability alone, however, cannot ensure employment opportunity for all. This also requires microeconomic reforms to improve the functioning and flexibility of the labour market, tackle structural unemployment, improve work incentives, and address the specific problems faced by particular groups or areas. The Government's policy framework underpinning its welfare to work agenda comprises:

- active labour market policies – tailored and appropriate help for those without work, to prevent long term detachment from the labour market;
- policies that make work pay – improved incentives through reform of the tax and benefit system, and the introduction of the National Minimum Wage; and

- policies that reduce barriers to work – including education, skills, childcare and training policies to create an adaptive, flexible and productive workforce.

Flexibility and fairness

4.6 Flexibility allows workers and businesses to adapt quickly and effectively to change and to seize opportunities in the global economy. In an increasingly open and integrated global economy, the countries that will prosper are those with flexible and outward-looking economies, which can react effectively to changing economic circumstances. Box 4.2 summarises the trends and progress in UK labour market flexibility since Budget 2004.

Box 4.2: Labour market flexibility – report on progress

A flexible and efficient labour market that creates jobs and raises productivity is central to economic growth in increasingly integrated global markets where investment and production can move quickly between countries. Labour market flexibility is, therefore, a key element of a globally competitive economy and central to the overall performance of the UK economy. If the UK were to join Economic Monetary Union (EMU), labour market flexibility would become even more important, as the adjustment burden on factor and price movements in response to addressing country-specific shocks would be much greater. Key new measures introduced since Budget 2004 to promote labour market flexibility include:

Developing skills: giving employers the opportunity to access free and flexibly delivered training for their low-skilled employees through a National Employer Training Programme; the New Deal for skills, with skills counselling in jobcentres, and a Learning Allowance to help benefit claimants access training; and continued reform of the financial support given to 16-19 year olds, including the introduction of a Child Benefit Bill which includes measures aimed at increasing the number of 19 year olds who are equipped with the skills they need to succeed.

Enhancing wage flexibility: ensuring Government evidence to the Pay Review Bodies referred to the sector's local recruitment and retention situation and examined the case for more geographically differentiated pay; and ensuring civil service departments explored the potential benefits of more local pay differentiation in the context of their relocation plans and as part of their pay and workforce strategies and pay remit business cases.

Improving labour market opportunities: to support more incapacity benefits claimants into work, an extension of the Government's Pathways to Work pilots to an additional 14 Jobcentre Plus districts, covering a third of the country; and to improve labour market opportunities for lone parents, an extension of the In-Work Credit pilots and extra support to improve the quality and affordability of childcare.

Promoting geographic mobility and economic migration: structural reform and administrative improvements to ensure Housing Benefit does not constrain the ability of the unemployed to find or take up work; and launching a five-year strategy for asylum and immigration, including a flexible points-based system to ensure that the UK attracts the migrants needed for the economy.

4.7 The Government believes that flexibility must go hand-in-hand with fairness. Its policies are designed to provide the security and support necessary to ensure that people are able to meet the challenges of economic change. Active labour market policies support people back into work, whether after a period of unemployment or of economic inactivity. The tax and benefit system, described in this chapter and in Chapter 5, provides security through financial

support for those who need it most, when they need it most. *Tax credits: reforming financial support for families*, published alongside the Budget, sets out the principles which underpin the Government's ongoing modernisation of the tax and benefit system, transforming it to promote a fair and inclusive society better able to rise to the opportunities and challenges of economic change. Flexible delivery is important in tackling specific barriers to work faced by local areas and individuals. It is important that national standards of service provision are upheld. However, the Government is committed to ensuring that service providers are given the flexibility to tailor policies to the specific needs of their communities.

4.8 This Budget builds on the steps the Government has previously taken by setting out new action and direction to make further progress towards the twin goals of greater flexibility and fairness. This chapter focuses on the challenge of reducing inactivity and helping those groups in society that face particular barriers to work.

DELIVERING EMPLOYMENT OPPORTUNITY TO ALL

4.9 The Government's active labour market strategy aims to provide everyone who is able to work with the support and skills they need to move into work as quickly as possible. The New Deal and other programmes provide intensive support to address barriers to work and to prevent the demoralisation and attrition of skills that often accompany long-term unemployment.

The New Deal 4.10 The New Deal has been fundamental to the success of the Government's labour market policies. Since its launch in 1998, over £3.6 billion has been invested in New Deal programmes. This has helped over 1.2 million people into work, including 535,000 young people and 200,000 unemployed adults. The New Deal has contributed to a fall in long-term unemployment of over three quarters since 1997, providing strong social, economic and fiscal benefits. The Government now spends £5 billion a year less on unemployment related benefits than in 1997. The New Deal has been particularly successful in tackling long term and youth unemployment. As Chart 4.2 shows, long-term youth unemployment fell to 39,100 in January 2005, despite the number of 16-24 year olds increasing by nearly half a million since 1997. The proportion of young people not in full-time education or employment has fallen from 17.8 per cent to 16.5 per cent. Chapter 5 sets out proposals for piloting a new Activity Agreement and Allowance for 16 to 17 year olds not in education, employment or training.

4.11 Studies have shown the New Deal's positive effect both in encouraging the longer-term unemployed to return to education, and in promoting work.² In 2000, the National Institute of Economic and Social Research (NIESR) concluded that, without the New Deal for young people (NDYP), the level of long-term unemployment would have been twice as high.³ More recent studies show that NDYP has significantly boosted exit rates from unemployment in all regions;⁴ that overall youth unemployment has been reduced by between 30,000 and 40,000;⁵ that young men are now 20 per cent more likely to find work as a result of the New Deal, and that the social benefits of NDYP outweigh the costs.⁶

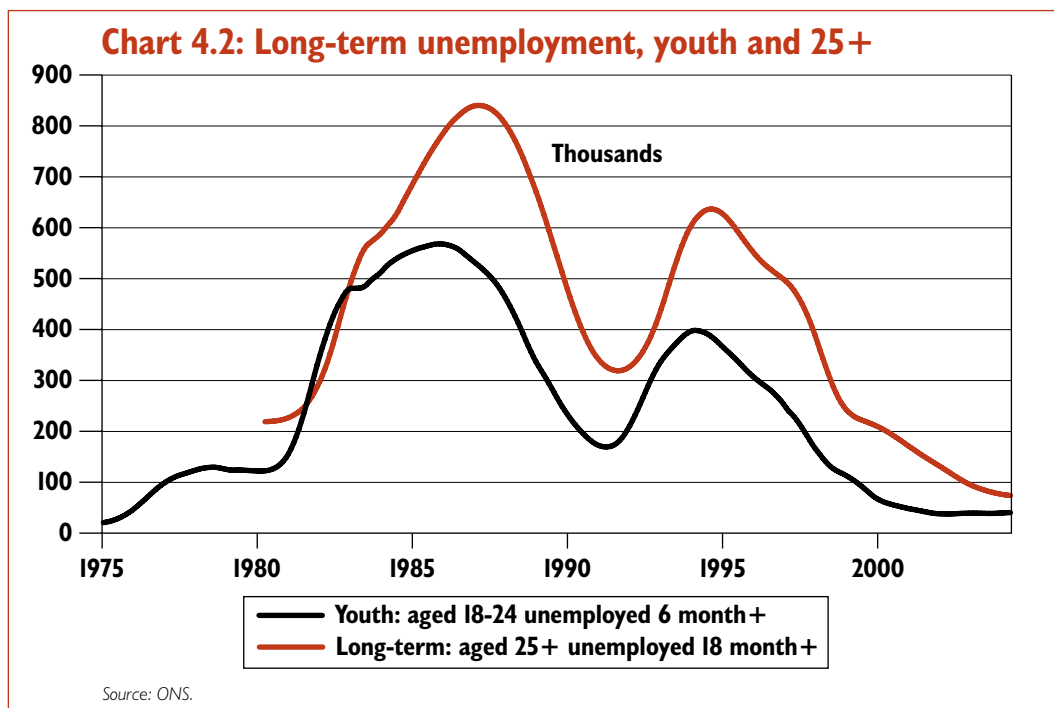
² *Into Jobs or into the Classroom: The UK New Deal for Young People*, McVicar, D and Podivinsky, J. Northern Ireland Economic Research Centre, April 2003.

³ *The New Deal for Young People: implications for employment and the public finances*. NIESR, December 2000.

⁴ *How well has the New Deal for Young People worked in the UK?*, McVicar, D. and Podivinsky, J. Northern Ireland Economic Research Centre, April 2003.

⁵ *New Deal for Young People: evaluation of unemployment flows*, Wilkinson, D., Policy Studies Institute, 2003.

⁶ *Active labour market policies and the British New Deal for unemployed youth in context*, Van Reenen, J., in *Seeking a premier league economy*, Blundell, R., Card, D. and Freeman, R. (eds), University of Chicago Press. June 2004.



Building on New Deal 4.12 The Government is committed to building on the success of the New Deal, and to using its investment in staff, processes and information systems to enable the development of more locally-diverse labour market support. *Building on New Deal: Local solutions meeting individual needs*, published by the DWP in June 2004, outlines proposals to give greater empowerment to local Jobcentre Plus staff, enhancing their ability to respond effectively to the needs of individuals and to challenges in their area.

Jobcentre Plus 4.13 Jobcentre Plus was launched in April 2002, delivering, for the first time, an active, work-focused service to all benefit claimants of working age, helping unemployed and economically inactive people move closer to the labour market and search effectively for work. The nationwide rollout of this new business model – due to be completed in 2006 – represents a £2.2 billion investment in improved service and efficiency.

EXTENDING EMPLOYMENT OPPORTUNITY TO ALL

4.14 In recent years, rising employment and falling worklessness have been seen across the UK labour market, including among those groups and regions which have generally been the most disadvantaged in labour market terms. This section sets out progress – and the challenges remaining – in extending employment opportunity to everyone, whatever their circumstances and wherever they live.

People with a health condition or disability

4.15 In the last decades of the twentieth century, many people in the UK were adversely affected by the changing structure of economic activity and macroeconomic instability. A significant number ended up needlessly on sickness and disability benefits where – rather than being supported by the welfare system back into work – they were, in many cases, effectively consigned to a lifetime on benefits. The number of incapacity benefits claimants in the UK reached 2.6 million in the mid-1990s.⁷

⁷Incapacity benefits include Incapacity Benefit, Income Support on the grounds of incapacity and Severe Disablement Allowance.

The Government's vision **4.16** A failure to tackle the barriers to work faced by incapacity benefits claimants – barriers which are not necessarily related to their health condition or disability – is a missed opportunity for the individuals themselves, their family and community, and the economy as a whole. The Government's vision is to deliver a fundamental change in the way that people with a health condition or disability, who want and are able to work, are given the support to find, remain and progress in employment. The Government believes that everyone who wants and is able to work should be helped and enabled to do so, maintaining a balance between rights and responsibilities. The Government has put in place support to ensure that more people with a health condition or disability are able to move into employment. In particular:

- Jobcentre Plus is providing early and ongoing support and, for the first time, new incapacity benefits claimants are required to attend a Work Focused Interview (WFI);
- the New Deal for disabled people (NDDP) is providing improved employment support and advice and has helped almost 55,000 disabled people into work since July 2001. In total, the Government's New Deal programmes have helped over 200,000 disabled people into work;
- the Working Tax Credit (WTC), together with the National Minimum Wage, is helping to ensure that work pays; and
- the Government has extended the scope and coverage of the Disability Discrimination Act to tackle discrimination in the workplace and beyond.

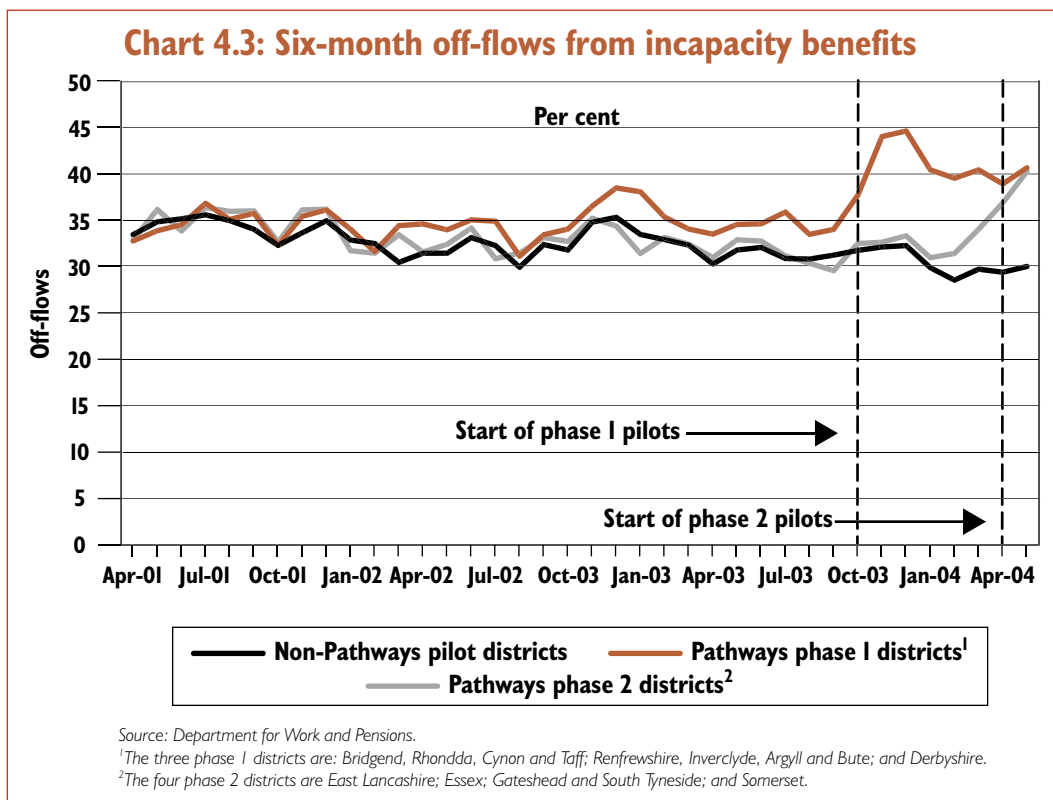
4.17 As a result of these and wider reforms, and in the context of a stable economy, more than half of disabled people in the UK are, for the first time, in employment, and the annual inflow to incapacity benefits has fallen by one-third since the mid 1990s. The overall number of incapacity benefits claimants has now stabilised, and the most recent data has shown a small fall.

Pathways to Work **4.18** Building on its investment in Jobcentre Plus and the New Deal, the Government is now testing a new system of support and advice – combining Jobcentre Plus, the health service and the voluntary and private sector – that has not previously been available to incapacity benefits claimants. These Pathways to Work pilots are testing a structured ongoing intervention regime. Early evidence from the pilots shows that the Pathways approach is significantly improving the work prospects of incapacity benefits claimants, in particular:

- there has been an increase of between 8 and 10 percentage points in off-flows from incapacity benefits after six months of a claim. This is illustrated in Chart 4.3,⁸ which shows the percentage of new claimants in a particular month who have left the benefit six months later;
- there have been over 10,700 Jobcentre Plus job entries through Pathways to Work up to December 2004 and the number of recorded job entries for people with a health condition or disability has almost doubled compared with the same period last year; and

⁸ The off-flow rates presented are produced from the Working Age Statistical Database (WASD). WASD does not include a proportion of short-term Incapacity Benefit claims; therefore the off-flows presented will be lower than actual rates. However, trends over time will be consistent.

- following the initial Work Focused Interview (WFI) at 8 weeks, over 20 per cent of claimants have taken up elements of the Choices package,⁹ with around 10 per cent of claimants joining NDDP. This compares with 4 per cent of claimants joining NDDP in Jobcentre Plus Pathfinder offices and 2 per cent nationally.



4.19 Around 10 per cent of participants in the pilots are longer-term claimants who have volunteered to take part after hearing about the support on offer. In February 2005, the Government improved the help available in the pilot districts by extending the mandatory work focused support at Jobcentre Plus to some existing claimants. This will be piloted alongside a new Job Preparation Premium – a payment of £20 per week to encourage steps towards finding work. Subject to evidence from this pilot, the Government will seek to broaden this approach to a further proportion of existing claimants, from April 2006 onwards.

4.20 In the light of the positive evidence from the pilots to date, the 2004 Pre-Budget Report announced that the Pathways to Work pilots would be expanded to a further 14 Jobcentre Plus districts. This extends this groundbreaking approach to the 30 Local Authority Districts with the highest concentrations of incapacity benefit claimants, covering one-third of the country and 900,000 incapacity benefits claimants in total.¹⁰

Incapacity benefit reform

4.21 In combination with the employment and health support offered through Pathways to Work, and in the context of a society that recognises the importance of ensuring that people with a health condition or disability are enabled to continue working, the next stage is to reform the structure of incapacity benefit.

⁹The Choices package is a range of provision aimed at improving labour market readiness and opportunities. This includes NDDP and the Condition Management Programmes.

¹⁰The expansion will be carried out in three phases so that support will be available from: October 2005 in Cumbria; Glasgow; Lancashire West; and Tees Valley; April 2006 in Barnsley, Rotherham and Doncaster; Sunderland; County Durham; Lanarkshire and East Dunbartonshire; Liverpool and the Wirral; Manchester and Salford; Swansea and West Wales; and October 2006 in Eastern Valleys; Greater Mersey; and Staffordshire.

4.22 Alongside Pathways to Work, the Government has proposed a new model which would include a new 'Rehabilitation and Support Allowance' for people with potentially more manageable conditions. These claimants would receive a higher rate of benefit than the current long-term rate in return for engagement in Work Focused Interviews and for fulfilment of an action plan agreed at the interview. People with the most severe health conditions or disabilities would receive a 'Disability and Sickness Allowance' and will also receive further support to reflect the increased risk of poverty that they face. The Government recognises the important contribution that external stakeholders have made to the development and delivery of the Pathways to Work pilots and intends to continue to work closely with interested parties to develop these proposals.

Linking rules 4.23 For many incapacity benefits claimants, moving into employment after a spell on benefit can be a daunting experience due to the uncertainty involved and the fear of losing higher rates of benefit if work does not go as planned. Incapacity benefits linking rules, which allow claimants who move into employment to reclaim any higher rates of benefit on the same terms as their previous claim, provide reassurance during the transition from benefits to work. **In this Budget, the Government announces that it will simplify and improve the operation of the linking rules from October 2006, through:**

- **automatic application – claimants who have to return to benefit from work because of incapacity will be able to establish their entitlement to the previous higher rate of benefit at the point of reclaiming;**
- **an extended linking rule period – there will be a single linking rule period of 104 weeks for all people leaving a higher rate of incapacity benefits for work; and**
- **immediate re-qualification for the linking rules on a return to benefit – claimants who move back onto benefit from work via the linking rules will be able to re-qualify immediately for the linking rules if they successfully return to work, rather than first having to spend 28 weeks on benefit.**

4.24 The Government will re-launch the linking rules with new material for claimants and ensure that the new arrangements form a central part of discussions between Personal Advisers and claimants.

4.25 Fundamental change can only happen effectively if backed by a collective effort from all stakeholders – the Government, GPs and other healthcare professionals, people with a health condition or disability and their representatives. Employers also have an important role and it is essential that they deal with an individual's absence from work in an effective way, as discussed in Box 4.3.

Box 4.3: Helping people with disabilities stay in work

Poor health or a disability does not always begin when somebody starts to claim incapacity benefits; many new claimants will have already had their sickness absence managed by their employer. Job retention rates are lower for disabled people than the population as a whole, and around 200,000 people move from employment to incapacity benefits each year.

Evidence shows that many employers without experience of managing health problems lack information about how best to support their workers. For example, in one study,¹ while 50 per cent of employers thought it would be difficult to retain someone who became disabled, almost three quarters of those who had actually made adjustments to retain disabled workers had found it relatively straightforward. In addition, some employers may lack information on the best ways to manage sickness absence.²

The Government is committed to working with, and supporting, employers in helping their employees to stay in and return to work when a health condition arises. Access to Work provides support to overcome work-related obstacles resulting from a disability. The information available to employers is also being improved; the Health and Safety Executive for example, produces guidance and standards for employers advising them about managing sickness absence. In 2004 the Government published a Framework for Vocational Rehabilitation, as a first step towards building a new approach in the UK. These changes are supported by statutory requirements under the Disability Discrimination Act, requiring employers to make reasonable adjustments for disabled workers.

Despite this, the Government recognises that there is more to do. Statutory Sick Pay (SSP) ensures that employees who are off work due to illness receive a minimum income paid by their employer for up to 28 weeks. The DWP Five Year Strategy announced that the Government would review SSP to ensure it provides the right incentives to employers to rehabilitate people and get them back to work quickly. It will also consider how best to support business in the management of sickness absence for people on SSP, and ensure consistency with the reformed system of incapacity benefits.

¹ *Disability in the workplace: employers' and service providers' responses to the DDA in 2003 and preparation for 2004 changes*, DWP Research Report 202, 2004.

² *Ibid.*

Lone parents

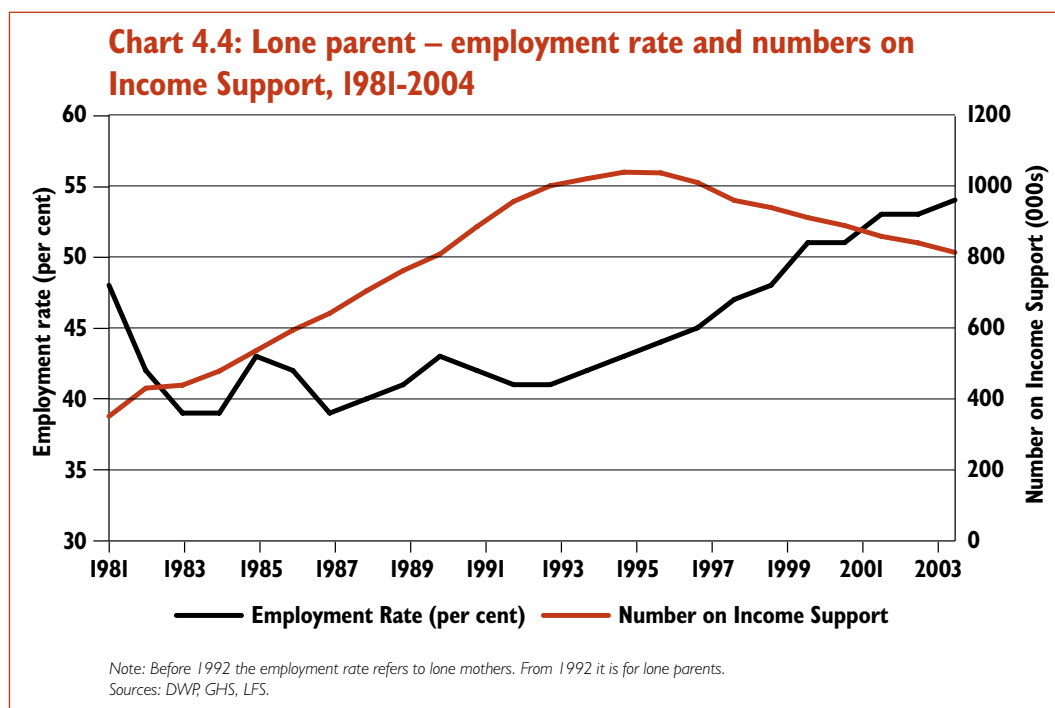
4.26 Between the early 1980s and mid 1990s, the number of lone parents on Income Support trebled and the employment rate of lone parents fell from around 50 per cent to 40 per cent. These trends reflected, in part, demographic factors and changes in the composition of the lone parent population, but were also a consequence of insufficient active support for lone parents on benefit, poor incentives to enter and progress in work, and a shortage of affordable childcare.

4.27 The Government's target is to ensure that 70 per cent of lone parents are in employment by 2010. The lone parent employment rate now stands at over 55 per cent¹¹ – the highest rate on record. There are now almost one million lone parents in work and, in the last year alone, more than 55,000 lone parents have moved into employment. Moreover, since 1997 the number of lone parents claiming Income Support has fallen by more than 200,000. Chart 4.4 shows the evolution of lone parent employment since the early 1980s.

¹¹ Autumn 2004 data, Labour Force Survey.

4.28 Evaluation evidence¹² suggests that the support introduced since 1997 has been a significant reason for this improvement, with Government policies accounting for about half of the gains. In particular:

- 550,000 lone parents have joined the New Deal for lone parents (NDLP), of which nearly 300,000 have been helped into work. Independent evaluation suggests that NDLP doubles the employment chances of lone parents;¹³
- Work Focused Interviews (WFIs) delivered through Jobcentre Plus by skilled Personal Advisers ensure that lone parents are aware of the help available to them. Independent evaluation shows take-up of the NDLP rises by more than 14 percentage points among lone parents required to attend a WFI;
- the Working Tax Credit ensures that work pays. The childcare element of the credit is received by more than 220,000 lone parents, compared to just 40,000 on Family Credit at its peak;
- the Government has invested heavily in improving the affordability, quality and availability of childcare provision. Described further in Chapter 5, the Government's ten-year strategy for childcare, published alongside the 2004 Pre-Budget Report, sets out the Government's long-term vision so that parents have more choice about how to balance work and family life;¹⁴ and
- employers are becoming increasingly aware of the business benefits of allowing their staff to work flexible hours. By 2004, 205,000 lone parents with dependent children were benefiting from flexible working arrangements – a 40 per cent increase from 1997 levels.



¹² *Welfare Reform and Lone Parents Employment in the UK*, CMPO working paper no. 72, Gregg and Harkness, 2003.

¹³ *New Deal for Lone Parents: Second Synthesis Report of the National Evaluation*, DWP, June 2003.

¹⁴ *Choice for parents, the best start for children; a ten year strategy for childcare*, HM Treasury, Department for Education and Skills, Department for Work and Pensions, Department of Trade and Industry, December 2004.

4.29 Despite these successes, the Government recognises that more needs to be done. Lone parent employment remains below that of mothers in couples in the UK and of lone parents in most other OECD countries. Further progress is essential in order for the Government to continue to reduce the number of workless households and eradicate child poverty. The Government is building on the reforms to date by developing and testing new and innovative approaches to supporting lone parents into employment:

- to encourage lone parents to engage in work search activities, the Government is piloting a £20 a week Work Search Premium in eight areas across the country, available to lone parents who have been claiming Income Support for more than a year who choose to look for work; and
- to support lone parents during the transition into employment and improve financial incentives, the Government is piloting a new In-Work Credit – a payment of £40 per week for the first 12 months back in work for lone parents who have been on Income Support for one year or more.

4.30 The DWP Five-Year Strategy sets out the Government's intention to pilot these measures as part of an integrated package of support for lone parents in five areas of the country¹⁵ from 2005.

Women returners **4.31** The 2004 Pre-Budget Report announced that three Regional Development Agencies will pilot new approaches for engaging with non-working mothers, including lone parents, in low income families and facilitating a return to work. **The London Development Agency will begin piloting two support packages in June 2005, across six London boroughs.** The pilots will run for 11 months and there will be an in-depth qualitative evaluation to determine which approaches are most effective.

Partners

4.32 Over the past two decades there has been a significant change in the way that households organise their work, leading to a polarisation of work into 'work rich' dual-earning households and 'work poor' households who are more likely to live in poverty. Historically, the benefits system has focused support on the main claimant, treating partners of benefit claimants as 'adult dependents' with virtually no rights or responsibilities, and thereby contributing to the increase in workless households and pensioner and child poverty.

4.33 In response, the Government has improved the labour market support available to partners. In April 2004, the Government introduced WFIs for benefit claimants, and to date, over 32,000 partners have attended an interview. The Government also relaunched the New Deal for partners (NDP), which in October 2004 became available to partners within families receiving the WTC who are either not working or working less than 16 hours a week. Over 1,650 job entries have been recorded for partners who have either attended a WFI or joined NDP since April 2004.

Older workers

4.34 The Government is committed to ensuring that older people have the opportunity to extend their working lives, should they choose to do so. Opening up these opportunities enhances the ability to save for retirement, for those who wish to. Evidence also suggests that remaining in work can increase social inclusion and improve health.

¹⁵ The five pilot areas are Leicestershire, Bradford, London South East, North London and Dudley and Sandwell.

4.35 The Government has improved the back to work support available to older people through Jobcentre Plus, and through the New Deal for people aged 50 and over, which is estimated to have supported around 150,000 job starts. The Government has also improved the financial incentive to work through the Working Tax Credit, which includes additional support for people over 50. As discussed in more detail in Chapter 5, pension reforms are also providing greater choice and flexibility for people over when, and how, they move from work to retirement.

4.36 These measures have, in the context of a strong and stable economy, delivered impressive results. Since May 1997, the employment rate of people aged between 50 and State Pension Age has increased from less than 65 per cent to over 70 per cent. Furthermore, there are now over 1 million people over State Pension Age in employment, with the employment rate for this group increasing by 1.5 percentage points to over 9 per cent.

4.37 In 2006, in line with the European Employment Directive, the Government will introduce legislation that outlaws age discrimination in employment and vocational training. Following consultation, the Government has concluded that the legislation should provide for a national default retirement age of 65. As announced in Budget 2004, a campaign to support the recruitment, retention and training of older workers will start in May 2005.

The unemployed

4.38 The Jobseeker's Allowance (JSA) regime prevents long-term detachment from the labour market by enforcing, supporting, and monitoring claimants' responsibilities to look for work, with more intensive support for the minority who fail to return quickly to work or who have a high risk of prolonged unemployment. Around 80 per cent now leave JSA within 6 months, compared with 75 per cent in 1997, directly contributing to the fall in JSA claimant numbers to just over 800,000 in January 2005.

4.39 The 2004 Pre-Budget Report set out the Government's intention to build on this success by looking at ways of improving the efficiency of the JSA regime and strengthening the focus on rights and responsibilities. This included testing the effectiveness of a revised and strengthened Jobseeker's Agreement that enables more robust checking of job search steps undertaken. It also set out innovative signing regimes for the first 13 weeks of a claim, including requiring jobseekers to attend Jobcentre Plus irregularly and at short notice.

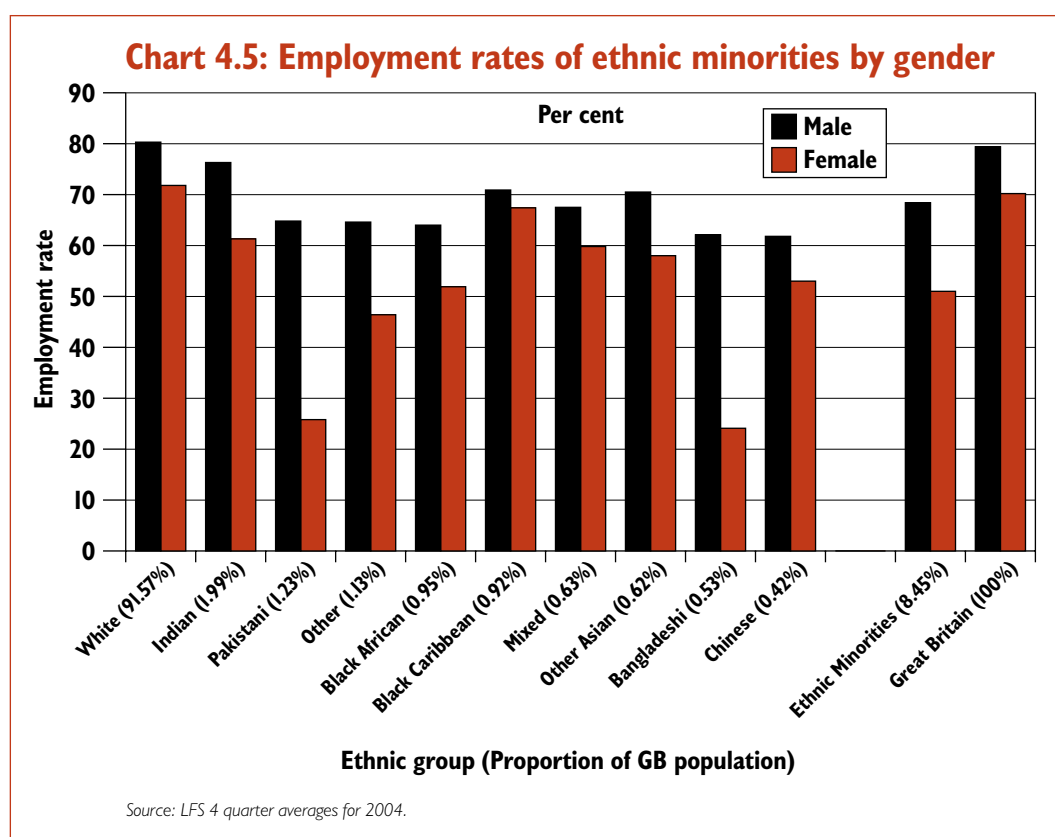
4.40 An effective balance between rights and responsibilities also requires effective penalties for failure to carry out responsibilities. The current sanctions regime can be heavy-handed, with lengthy processes and sanctions imposed long after the instance of non-compliance. There is scope for improving the capacity to respond swiftly and effectively by making identification and referral of instances of non-compliance more automatic, so removing the burden of decision-making from Jobcentre Plus advisers, and speeding up the sanctions process. **The Government will therefore examine the scope for improving Jobseeker's Allowance sanctions and the potential for a fixed fines system.**

4.41 As announced in the 2003 Pre-Budget Report, the Government will build on the support offered to the small minority of JSA claimants who have not moved back into work after six months by intensifying the activity they are expected to undertake as a condition of benefit. In October 2005, Jobseeker Mandatory Activity pilots will be introduced in twelve pilot areas. All claimants aged 25 or over who reach six months of unemployment will be required to participate in a new three day work-focused course delivered by expert providers contracted to Jobcentre Plus. Providers will create a personal action plan to form the basis of subsequent personal activity, and Personal Advisers will monitor whether the action plan has been carried out in a series of three mandatory follow-up interviews.

Ethnic minorities

4.42 While the employment rate for ethnic minorities is rising, and the gap between the ethnic minority employment rate and the overall rate is narrowing, ethnic minorities are twice as likely as the overall population to be unemployed. Around one third of the ethnic minority working age population is economically inactive, compared with just over one fifth of the working age population overall.

4.43 Within the ethnic minority population the experiences of people from different ethnic groups can vary considerably, as Chart 4.5 shows. The Government's overall strategy for raising employment rates for ethnic minorities recognises the need to tackle the specific issues of different groups, and not treat ethnic minorities as a homogenous group. The Ethnic Minority Employment Taskforce is co-ordinating delivery of the cross-cutting recommendations of the Prime Minister's Strategy Unit report in these areas.¹⁶



4.44 People from ethnic minorities who are claiming out of work benefits have access to the full range of mainstream programmes, such as the New Deal, the JSA intervention regime, and the range of programmes and pilots aimed at tackling inactivity. In addition, the Government has established a number of programmes in areas with high ethnic minority populations, to reinforce mainstream support at the local level, including outreach projects; specialist advisers; funding for innovative local projects; and 'Fair Cities Boards' in three major cities, to work with local employers and stakeholders on city-wide strategies to tackle ethnic minority worklessness.

4.45 There are early signs that these policies are contributing to improved labour market outcomes for ethnic minorities. The employment rate has risen by nearly 2 percentage points over the last 12 months to almost 60 per cent. Further improvement across all ethnic minority and faith groups is, however, important.

¹⁶ *Ethnic Minorities and the labour market*, Prime Minister's Strategy Unit, 2003, www.number-10.gov.uk/su/ethnic%20minorities/report/index.htm.

National Employment Panel Report **4.46** In the 2004 Pre-Budget Report, the Chancellor asked the National Employment Panel (NEP), working with the Ethnic Minority Business Forum, to explore further measures to encourage employment, self-employment and growth of small businesses for ethnic and faith minority groups. The NEP has submitted recommendations to the Chancellor that are published today alongside the Budget. The analysis that underpins the recommendations will be published shortly. Box 4.4 lists the main findings.

Box 4.4: Ethnic minority employment and business growth

Since the 2004 Pre-Budget Report, the National Employment Panel, working with the Ethnic Minority Business Forum, has been examining how to increase the employment, self-employment and business growth of ethnic minorities and faith groups in the UK. The Panel has consulted with a wide range of stakeholders – employers, community and faith groups, and academics – to identify reasons for continued disadvantage and to explore ways of building on current services.

The Panel has proposed a range of policy and operational measures. It has recommended that, in order to achieve the greatest impact, most of these measures should be focused on the five cities which together have more than two thirds of the ethnic minority population: London, Birmingham, Manchester, Bradford/Leeds, and Leicester. The Panel also calls for stronger political and business leadership to tackle discrimination and improve race equality within the public and private sectors. The Panel's recommendations include:

- the Department for Work and Pensions and the Department for Education and Skills should ensure mainstream and discretionary resources are sufficiently targeted on the designated cities;
- outreach support for employability, skills development and job access should be focused on people who are not in work, not on benefit and may have been traditionally excluded from the labour market;
- an integrated, employer-led employment and skills framework should be established in each of the designated five cities to increase the number and quality of jobs for ethnic minorities and disadvantaged residents;
- Regional Development Agencies should assess the needs of ethnic minority businesses as part of their Regional Economic Strategies;
- new Centres of Vocational Excellence (CoVEs) for Entrepreneurship should be established in the designated cities;
- the Small Business Service should work with banks and financial intermediaries to review the availability and accessibility of finance in the designated major cities;
- the Government should promote the incorporation of race equality into public procurement within current legal and policy frameworks;
- the public sector should become an example of best practice in promoting race equality and diversity, and fulfil its public duty through improved targets, measurement and evaluation, with departments reviewing their use of Race Equality Impact Assessments;
- a commission of business leaders should be charged with advising on increasing employment of ethnic minorities and faith groups in the private sector by 2010, including indicators by which the private sector can measure progress; and
- the Government should ensure, at Cabinet Committee level, that ethnic and faith minorities participate and share equally in this country's continued economic success.

4.47 Ethnic minority communities are key to future productivity and economic growth. The NEP recommendations set out a challenge to key government and business institutions to make a real change to the way that they operate for ethnic minority people and to realise the aspiration of eradicating disadvantage based on someone's ethnicity or faith. **The Government welcomes the report and accepts the recommendations, and will develop proposals for taking them forward.** In recognition of the important role self-employment and entrepreneurship can play in helping young people from ethnic and faith minorities contribute to economic growth and tackling social inclusion **the Government will begin by piloting Centres of Vocational Excellence in Entrepreneurship in two of the designated cities.**

SKILLS AND MOBILITY

Enhancing skills in the labour market

4.48 Enabling people to acquire skills is central to helping them find, and progress in, employment, and to ensuring that businesses have access to the skilled workforce they need. Education and skills are central to the Government's ambition of promoting a high-skilled, high-productivity workforce which will ensure the UK can prosper in the increasingly competitive global economy. The Budget sets out a programme of long-term investment in education, described further in Chapter 6, and further measures to enhance the development of skills, to ensure that everyone has the opportunity to fulfil their potential. This section focuses on measures to help people on benefits develop the skills they need to re-enter the labour market. The Government's approach to enhancing workforce skills levels is set out in Chapter 3, while measures to support 16-19 year olds in education and training are set out in Chapter 5.

Skills to enter and progress in work

4.49 To provide co-ordinated and seamless access to a broad range of support, the New Deal for skills will offer skills coaches in jobcentres to identify skill gaps, direct people to appropriate training opportunities, and ensure a seamless transition from training on benefit to training in work. The 2004 Pre-Budget Report set out proposals for further developing the New Deal for skills by testing the impact of a 'Learning Option' that would enable benefit claimants for whom lack of skills is a primary barrier to work to participate in full-time training.

Enhancing choice and mobility

4.50 As described in Box 4.2, flexibility is central to ensuring a smoothly functioning labour market capable of adapting to economic change. The ease with which people are able to move location or commute is a key determinant of labour market flexibility, allowing workers to take advantage of a broad range of employment opportunities, and contributing to the Government's goal of full employment in every region.

Housing Benefit

4.51 The structure and delivery of Housing Benefit has a large part to play in ensuring labour mobility. Housing Benefit provides help to over 3.8 million low-income tenants, both in and out of work. However, Housing Benefit can be complex both for claimants to understand and for local authorities to deliver. The Government's Housing Benefit reform programme is therefore addressing administrative improvements; structural reform; and the streamlining and alignment of benefits.

4.52 Government support to help local authorities improve their administration of Housing Benefit has already led to significant improvements. By the second quarter of 2004-05, the average time to process a new claim had improved by 10 days compared to the second quarter of 2002-03. Over the same period, the 60 worst performing authorities reduced their average clearance times for new Housing Benefit claims by 25 days. The average time taken to make a decision on a change of circumstances has also improved, from 19 days in the second quarter of 2002-03 to 13 days in the second quarter of 2004-05. The Performance Standards Fund will continue to provide resources to support administrative improvements until March 2006. **In addition, from 2006, the Government intends to introduce improved IT links between local authorities and the DWP to provide faster and more accurate processing of Housing and Council Tax Benefit.**

Local Housing Allowances

4.53 The Government is also making good progress with structural reform of the Housing Benefit system. The flat-rate Local Housing Allowance (LHA) has been successfully implemented in nine Pathfinder areas,¹⁷ with over 35,000 private sector tenants now receiving it. The Government intends to roll out the flat-rate system throughout the country by March 2008, informed by the evaluation of the Pathfinders. In preparation for full national roll-out of the private sector LHA system, the Government will introduce a second round of nine Pathfinders from April 2005.¹⁸ These will help develop best practice before the system is introduced nationally.

4.54 Tenants in the social sector are entitled to the same standards of service and the same opportunity to exercise choice as those tenants in the private sector. Consequently, the Government is also committed to developing pilots of the flat-rate LHA in the social rented sector, based on the principles underlying the LHA system, to encourage choice, responsibility and fairness. As announced in the 2004 Pre-Budget Report, the Government will introduce a £180 million Housing Benefit Reform Fund from April 2006 to March 2008 to help the DWP to roll out flat-rate allowances and to continue to improve the administration and structure of Housing Benefit.

4.55 The Government is also continuing to simplify the Housing Benefit and Council Tax Benefit system to make further improvements in administration. This Budget announces that:

- **from April 2005, the Government will align the rules in Housing Benefit and Council Tax Benefit with those in other income-related benefits so that all claims will be taken from the date of first contact as long as a written claim is made within four weeks;**
- **from April 2006, the Government will protect student households from Council Tax liability if a non-student receiving an income-related benefit joins the household; and**
- **from April 2006 the Government will also introduce a number of other changes in Housing and Council Tax Benefit that have been requested by local authorities to simplify the claiming and administration of Housing and Council Tax Benefit.**

¹⁷ The nine existing LHA pathfinders are in Blackpool; Coventry; Lewisham; Brighton and Hove; Edinburgh; North East Lincolnshire; Conwy; Leeds; and Teignbridge.

¹⁸ The second round of LHA pilots will be in Argyll-Bute; East Riding of Yorkshire; Guildford; Norwich; Pembrokeshire; Salford; South Norfolk; St Helens; and Wandsworth.

MAKING WORK PAY

4.56 The Government believes that work is the best route out of poverty and is committed to making work pay, by improving incentives to participate and progress in the labour market. Through the Working Tax Credit and the National Minimum Wage, the Government has boosted in-work incomes, improving financial incentives to work and tackling poverty among working people.

The National Minimum Wage **4.57** The National Minimum Wage guarantees a fair minimum income from work. In February 2005, **the Government accepted the Low Pay Commission's recommendations to increase the adult rate to £5.05 an hour from October 2005 and, subject to the Low Pay Commission's review early next year, to £5.35 from October 2006. The youth rate, for workers aged between 18 and 21, will also rise, to £4.25 from October 2005 and to £4.45 from October 2006.**

The Working Tax Credit **4.58** The Working Tax Credit provides financial support on top of earnings for households with low incomes. By December 2004, 2.2 million working families and over 250,000 low-income working households without children were benefiting from the Working Tax Credit. Some 87,000 households were benefiting from the disabled worker element of the Working Tax Credit, more than double the number who received support through its predecessor, the Disabled Person's Tax Credit. **The Government announced in the 2004 Pre-Budget Report that it would increase the income threshold above which Working Tax Credit is tapered away in line with inflation in April 2005 to £5,220 per year.**

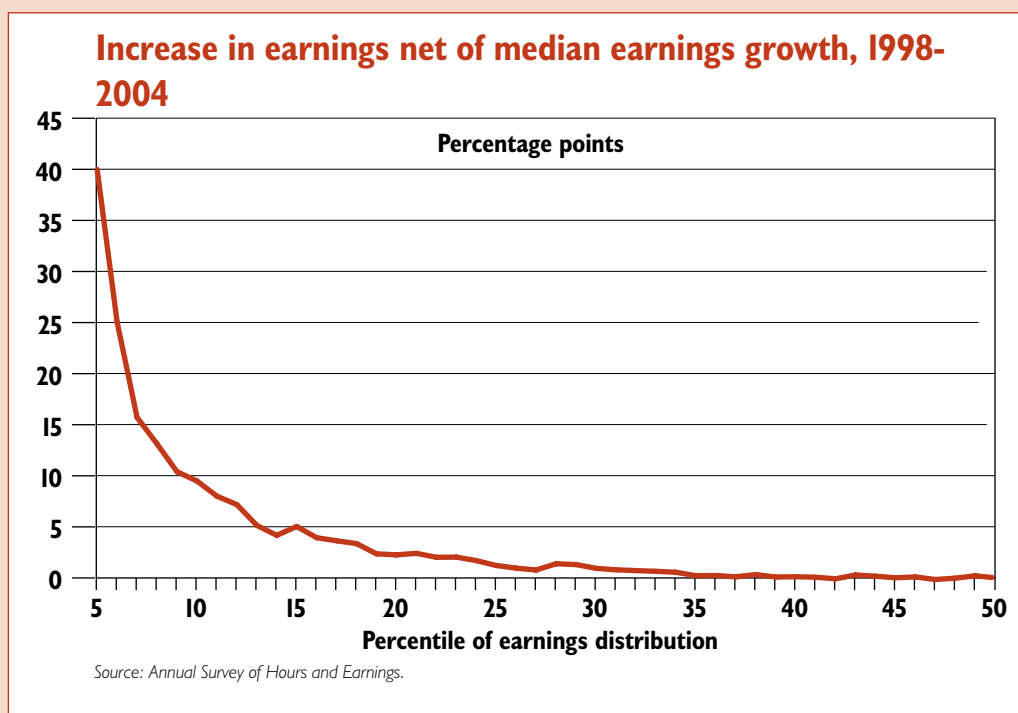
4.59 Tax credits have reduced the burden of tax for low-income households and for workers with a disability. This is discussed in more detail in *Tax Credits: reforming financial support for families* which is published alongside Budget 2005 and is described in Box 5.1. The Government will consider carefully what changes can be made to tax credits to complement the reforms to incapacity benefits discussed earlier in this chapter.

4.60 The 2004 Pre-Budget Report set out improvements to the childcare element of the Working Tax Credit. These reforms will make childcare more affordable for working families on low or moderate incomes; significantly increasing the financial gains to work for families with eligible childcare costs. Some 330,000 families stand to benefit by, on average, £400 per year as a result of the increase in the maximum proportion of costs covered from 70 to 80 percent in April 2006. Financial support for childcare is discussed in more detail in Chapter 5.

Box 4.5: Measuring the impact of the National Minimum Wage

The standard measure of the impact of the National Minimum Wage (NMW) has been the 'expected number of beneficiaries', the number of workers whose pay would otherwise be expected to be paid below the new NMW rate. However, this measure does not reflect the impact of the minimum wage on the wage distribution more generally. For example, many firms increase their lowest pay levels to ensure that they remain slightly above the NMW rate. These low-paid workers, who are benefiting indirectly from the increases in the NMW, are not captured by the expected number of beneficiaries measure.

The NMW has helped to increase significantly the earnings of the lowest paid workers. The chart below shows the total increase in hourly pay across the bottom half of the earnings distribution between 1998 and 2004. The increase in median pay over that period of 25 per cent has been netted off, so that the chart highlights movements above the median. The lowest paid workers have benefited from above-average increases in pay in recent years – pay at the 10th percentile of the distribution has risen by nearly 10 per cent above median pay growth.



Tackling the unemployment trap 4.61 The unemployment trap occurs when those without work find the difference between in-work and out-of-work incomes too small to provide an incentive to enter the labour market. Table 4.1 shows that, since the introduction of the National Minimum Wage in April 1999, the Government has increased the minimum income that people can expect when moving into work, thereby reducing the unemployment trap.

Table 4.1: Weekly minimum income guarantees

	April 1999	October 2005	Percentage increase in real terms ²
Family ¹ 1 child, full-time work	£182	£260	22%
Family ¹ 1 child, part-time work	£136	£202	27%
Single person, no children, 25 or over, full-time work	£113	£169	28%
Couple, no children, 25 or over, full-time work	£117	£200	46%
Single disabled person in full-time work	£139	£211	29%
Single disabled person in part-time work	£109	£153	20%

Note: assumes a single earner household, the prevailing rate of the National Minimum Wage and that the family is eligible for the Working Families' Tax Credit or Disabled Person's Tax Credit and the Working Tax Credit/Child Tax Credit. Full-time work is assumed to be 35 hours. Part-time work is assumed to be 16 hours.

¹ Applies to one parent families and couples with children alike.

² RPI growth for 2005 is taken from the HM Treasury economic forecast.

Tackling the poverty trap

4.62 The poverty trap occurs when those in work have limited incentives to move up the earnings ladder because it may leave them little better off. Marginal deduction rates (MDRs) measure the extent of the poverty trap by showing how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefits or tax credits.

4.63 The Government's reforms are ensuring that workers have improved incentives to progress in work. Table 4.2 shows that, as a result of these reforms, around half a million fewer low-income households now face MDRs in excess of 70 per cent than in April 1997. The increase in the number of households facing MDRs of between 60 and 70 per cent is primarily due to the introduction of tax credits, which have extended financial support so that far more families benefit.

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

Marginal deduction rate ¹	Before Budget 1998	2005-06 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	30,000
Over 80 per cent	300,000	165,000
Over 70 per cent	740,000	235,000
Over 60 per cent	760,000	1,730,000

¹ Marginal deduction rates are for working households in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week, and the head of the household is not a disabled person.

Note: Figures are cumulative. Before Budget 1998 based on 1997-98 estimated caseload and take-up rates; the 2005-06 system of tax and benefits is based on 2003-04 caseload and take-up rates.

FUNDING FOR WELFARE TO WORK

4.64 The Department for Work and Pensions delivers the Welfare to Work programme. Originally funded from the one-off Windfall Tax on the excess profits of the privatised utilities, the programme is now funded from resources allocated in the 2002 Spending Review. Table 4.3 sets out that element of the Welfare to Work programme, and other programmes, funded from the Windfall Tax.

Table 4.3: Allocation of the Windfall Tax

£ million	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04 ²	2004-05 ³	2005-06 ³	TOTAL
Spending by programme¹										
New Deal for young people ⁴	50	200	310	300	240	260	170	0	0	1,530
New Deal for 25 plus	0	10	90	110	200	210	150	0	0	770
New Deal for over 50s	0	0	5	20	10	10	10	0	0	60
New Deal for lone parents	0	20	40	40	40	80	60	0	0	280
New Deal for disabled people ⁵	0	5	20	10	10	30	30	0	0	100
New Deal for partners	0	0	5	10	10	10	10	0	0	40
Childcare ⁶	0	20	10	5	0	0	0	0	0	35
University for Industry ⁷	0	5	0	0	0	0	0	0	0	5
Workforce development ⁸	0	0	0	0	0	40	50	150	80	320
ONE pilots ⁹	0	0	0	5	5	0	0	0	0	10
Action Teams	0	0	0	10	40	50	50	0	0	150
Enterprise development	0	0	0	10	20	10	0	0	0	40
Modernising the Employment Service	0	0	0	40	0	0	0	0	0	40
Total Resource Expenditure	50	260	480	560	570	700	530	150	80	3,380
Capital Expenditure¹⁰	90	270	260	750	450	0	0	0	0	1,820
Windfall Tax receipts	2,600	2,600								5,200

¹ In year figures rounded to the nearest £10 million, (except where expenditure is less than £5 million). Constituent elements may not sum to totals because of rounding.

² Windfall Tax expenditure on welfare to work programmes is reduced from 2003-04 onwards as Windfall Tax resources are exhausted. Remaining in-year expenditure will be topped up with general Government revenues.

³ Figures are provisional for the years from 2004-05 to 2005-06.

⁴ Includes funding for the Innovation Fund.

⁵ Includes £10 million in 1999-2000, an element of the November 1998 announcements on welfare reform.

⁶ Includes £30 million for out-of-school childcare. The costs of the 1997 Budget improvements in childcare through Family Credit are included from April 1998 to October 1999, after which the measure was incorporated within the Working Families' Tax Credit.

⁷ Start up and development costs. Other costs of the University for Industry are funded from within Departmental Expenditure Limits.

⁸ Includes £219 million funding for Employer Training Pilots.

⁹ Funding for repeat interviews. Other funding is from the Invest to Save Budget.

¹⁰ Includes capital spending on renewal of school infrastructure, to help raise standards.

5

BUILDING A FAIRER SOCIETY

The Government is committed to promoting fairness alongside flexibility and enterprise to ensure that everyone can take advantage of opportunities to fulfil their potential. The Government's reforms of the welfare state reflect its aims of eradicating child poverty, supporting families to balance their work and family life, promoting saving and ensuring security for all in old age. This Budget sets out the next steps the Government is taking to support these aims, including:

- building on previous increases in financial support for families, a **commitment to increase the child element of the Child Tax Credit at least in line with average earnings up to and including 2007-8;**
- **enhancing the development of young people's skills**, through measures to improve financial support for 16 to 19 year olds in learning, including through extending Child Benefit and Child Tax Credit from April 2006; and piloting a new Activity Agreement and Allowance for 16 to 17 year olds not in education, employment or training from April 2006;
- to support parents and improve children's learning, **an additional £35 million in 2006-07 and 2007-08 for the Parenting Fund and to improve early learning help for families;**
- **free off-peak local area bus travel for all people over the age of 60 and disabled people in England from April 2006;**
- **an additional payment guaranteeing council tax paying households with someone over 65 will receive £200 towards the cost of council tax;**
- **extending the existing higher Individual Savings Accounts limits to April 2010, to promote further saving;**
- **consulting on payments at secondary school age in the Child Trust Fund;**
- **investing up to £100 million over the next three years, to deliver the Government's response to the Russell Commission report on youth volunteering**, including a matched volunteering opportunities fund rising to £40 million in 2007-08, conditional on private sector support;
- **doubling the zero-rate threshold for stamp duty land tax to £120,000 for residential property transactions**, exempting an extra 300,000 home buyers from stamp duty every year;
- **increasing the threshold for inheritance tax to £275,000 in 2005-06, £285,000 in 2006-07 and £300,000 in 2007-08; and**
- further reforms to **modernise the tax system**, including better aligning North Sea corporation tax payments with payments for petroleum revenue tax, and a number of measures to clamp down on **tax fraud and avoidance.**

5.1 The Government's aim is to promote a fair and inclusive society where everyone shares in rising national prosperity and no one is held back from achieving their potential through disadvantage or lack of opportunity. The Government is committed to ensuring that flexibility and fairness are advanced together, so everyone can achieve their full potential in a modern, dynamic economy. Education and skills are central to this ambition. A high-skilled, high-productivity workforce will ensure the UK can prosper in the global economy. For an

individual, education and skills provide security and opportunity, enhance personal fulfilment and can enable people to contribute better to their communities. The Budget sets out a programme of long-term investment in education, and further measures to enhance the development of skills, to ensure that everyone has the opportunity to fulfil their potential.

Tax and benefit reform 5.2 Published alongside this Budget and summarised in Box 5.1, *Tax credits: reforming financial support for families*, sets out the reforms the Government has made to achieve a more inclusive society, reduce the tax burden on the low paid, ensure that financial support is targeted on those who need it most, provide dignity in retirement for all pensioners and guarantee minimum levels of income for the most vulnerable in society.¹ In the past, the tax and benefit system had failed to address the challenges of rising worklessness and poverty among families and pensioners that emerged from the early 1980s. To tackle this problem, the Government's reforms are based on the principle that, for those who can, work provides the best platform of security and independence.

Box 5.1: Reforming the tax and benefit system

Tax credits: reforming financial support for families sets out how, in the past, the tax and benefit system failed to address the challenges of rising worklessness and poverty among families and pensioners that emerged from the early 1980s. It sets out the Government's reforms since 1997, the principles that underpin them and the evidence of their impact so far. The document also explains how future policies will be guided by the principles for modernising the tax and benefit system.

In particular, *Tax credits: reforming financial support for families* explains how the Child and Working Tax Credits have helped to support families, tackle child poverty and make work pay. Tax credits provide flexible support tailored to a family's circumstances, and around 10 million children in 5.9 million families are benefiting from tax credits.

The introduction of tax credits has created a system of financial support where families can actually receive a net tax payment. While the personal allowance can only reduce a household's tax bill to zero, tax credits can go further, reducing the net tax rate faced by a family to below zero. *Tax credits: reforming financial support for families* shows that:

- around 4 in 10 families in Britain pay no net tax as a result of tax credits, and the number of families paying no net tax has risen by around 500,000 since 1997;
- tax credits offer a number of advantages over increasing the personal allowance as a means of targeting support on low and middle income families. Raising the personal allowance also provides greatest benefit to higher-rate taxpayers. The personal allowance can cut a family's tax bill to zero, but it cannot make payments to them, and neither can the personal allowance provide support tailored to a family's circumstances, such as the number of children the family has or whether it cares for a disabled child; and
- as a result of tax credits, a single earner two child family on half male mean earnings receives a net tax payment of £2,200 a year in 2005-06. This means their net tax rate in 2004-05 was minus 15 per cent, compared to 4 per cent in 1977-78 when Child Benefit was introduced and 9 per cent in 1997-98.

Chart 5.1 provides more information on how the net tax rate faced by a family changes with income and the number of children in a family.

5.3 The Government's approach to promoting employment opportunity for all is set out in Chapter 4. Alongside this, the Government is reforming the tax and benefit system to ensure security and opportunity for the most vulnerable in society. This chapter sets out the

¹ *Tax credits: reforming financial support for families – The modernisation of Britain's tax and benefit system*, Number Eleven, HM Treasury, March 2005.

progress the Government has made in tackling child poverty, improving childcare, promoting saving and asset ownership, and ensuring security for all in old age. The Government is also committed to creating a modern and fair tax system, which adapts to changes in business and the global economy and ensures everyone pays their fair share toward building world class public services.

5.4 This chapter also sets out how the Government is using the UK's Presidencies of the G7/G8 and the EU in 2005 to make progress on finance for international development, including through taking forward the recommendations of the Commission for Africa, and with measures for a new deal between developed and developing countries as bold as the Marshall Plan of the 1940s.

SUPPORT FOR FAMILIES AND CHILDREN

5.5 Child poverty increased dramatically in the last two decades of the twentieth century. By 1998, the UK had the highest child poverty rate in the EU. Around a quarter of children lived in relative low-income households before taking account of housing costs and around a third lived in relative low-income households after housing costs. A number of factors contributed to the high level of poverty, including the failure of the tax and benefit system to address the challenges of rising worklessness and poverty among families. Fundamental reform of Britain's tax and benefit system was needed if the Government was to meet its long-term goal of eradicating child poverty by 2020.

Financial support for families with children

5.6 The Government's programme of tax and benefit reform is described in more detail in *Tax credits: reforming financial support for families*. Reforms aimed at providing more support for families include:

- increasing the value of Child Benefit, benefiting all families with children. Since 1997, the value of Child Benefit for the first child has been increased by 25 per cent in real terms; and
- introducing the Child and Working Tax Credits from April 2003. Tax credits are benefiting 5.9 million families and 10 million children, including those families receiving their child allowances through their benefits. The Child Tax Credit is part of the Government's progressive universalist approach, providing more support for all families and the greatest support to those who need it most, including those with low incomes, families with children under one and those with disabled children.

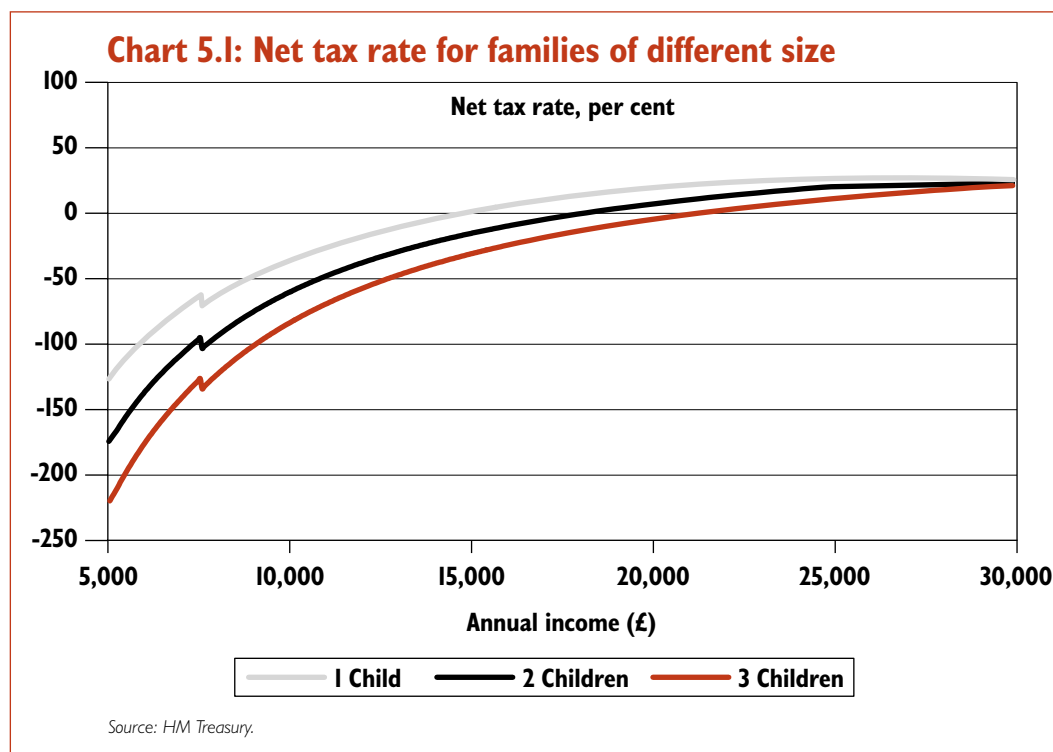
Increased support for families **5.7** The 2004 Pre-Budget Report announced that **from April 2005, the child element of Child Tax Credit will be raised to £1,690 a year**, representing a total increase of £245 since its introduction in April 2003. A family with two young children and a full-time earner on £15,500 per year – around half male average earnings – will receive over £103 per week in Child Tax Credit and Child Benefit from April 2005. This represents a real terms increase of 85 per cent since 1997-98. Table 5.1 shows the levels of support that Child Tax Credit and Child Benefit will provide for families from April 2005. Since the introduction of Child Tax Credit in April 2003, the Government has kept and exceeded its commitment to increase the child element in line with average earnings. **Budget 2005 announces that the Government will continue to increase the child element of the Child Tax Credit at least in line with average earnings up to and including 2007-08.**

Table 5.1: Annual levels of support for families from April 2005

Family income (£ a year)	less than £13,910	less than £50,000	all families
<i>Per cent of families</i>	30	82	100
1 child	£3,125	£1,430	£880
2 children	£5,410	£2,020	£1,475
3 children	£7,695	£2,615	£2,065

5.8 As set out in *Tax credits: reforming financial support for families*, tax credits such as the Child and Working Tax Credit ensure that financial support is provided fairly, responding both to family income and circumstances. This means some families will receive enough tax credits and Child Benefit to cancel out their income tax liabilities and national insurance contributions, and will in effect be paying no net tax. Other families will receive net tax payments and have a negative net tax rate.

5.9 Chart 5.1 shows the net tax rate for single earner families. Those with one child do not start to pay net tax until income reaches £15,400. For a family with two children the level is £18,700 and with three children £21,900.²



5.10 Tax credits are far more flexible and are fairer than traditional methods of altering the burden of tax. For example, increasing the personal allowance in income tax provides a tax reduction for a higher rate taxpayer four times greater than for an individual with a much lower income, paying the 10 pence starting rate of tax. Additionally, adjusting the personal allowance cannot reduce the tax burden below zero, nor can it respond flexibly to family circumstances, for example the number of children or the presence of a disabled child in a family.

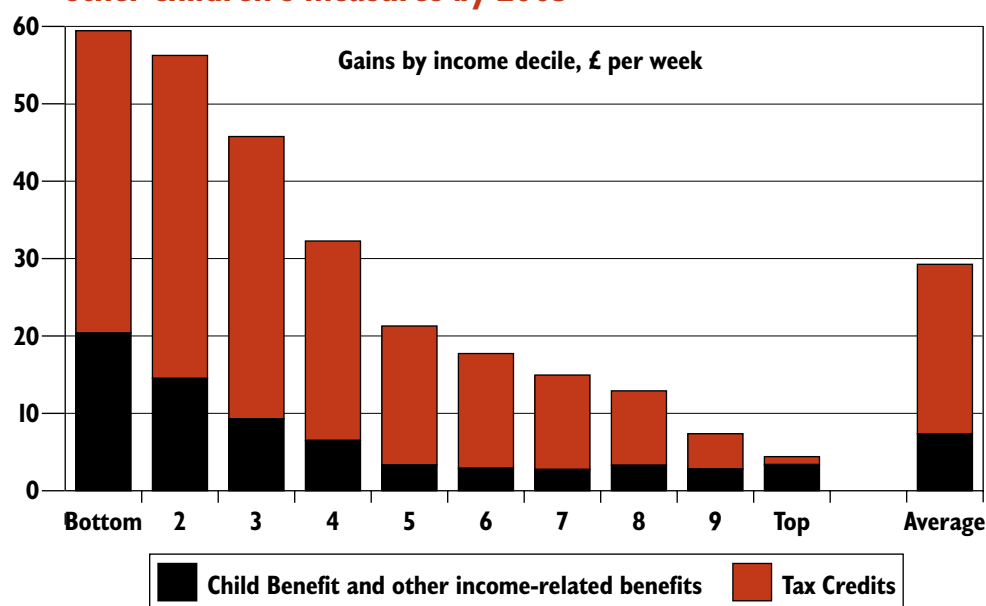
² The definition of tax liability and the tax rate would depend on whether NICs were included. For some purposes it would be appropriate to include NICs but in other cases it may not be because they finance pension entitlements and health services through the National Insurance Fund, and are therefore distinct from general taxation.

5.11 With tax credits, the support people receive from the tax system is not limited by their tax liability. Instead, they can receive tax credit payments from the Inland Revenue even where they could receive no benefit from an increase in the personal allowance. All single earner households pay no tax on their first £4,895 of income. For a two child family, Child Benefit cancels out their income tax until they earn around £12,700 and tax credits mean they pay no net income tax until they earn £21,200. Increasing the personal allowance by £500 would raise the point at which this family's income tax liability was cancelled out by Child Benefit to £13,200, an increase of £500, but putting the same money into the Child Tax Credit would raise the point at which they start to pay net income tax to £22,500, an increase of around £1,300. So tax credits help more people to pay no net tax.

Making families better off **5.12** Chart 5.2 shows the impact by income decile on families with children of the Government's reforms to the tax and benefit system since 1997. As a result, by October this year, in real terms:

- families with children will be, on average, £1,400 a year better off, while those in the poorest fifth of the population will be, on average, £3,200 a year better off;
- a single-earner family on half average male earnings with two children will be £3,700 a year better off; and
- a single-earner family on average male earnings with two young children will be £205 a year better off.

Chart 5.2: Gains for families as a result of tax credits and other children's measures by 2005



Source: HM Treasury.

Eradicating child poverty

Progress to date **5.13** As the first milestone towards meeting its long-term goal of eradicating child poverty by 2020, the Government is on track to reduce the number of children in relative low-income households by a quarter between 1998-99 and 2004-05. The most recent data show that by 2002-03, the numbers of children in relative low-income households had fallen by 0.5 million before housing costs and by 0.6 million after housing costs, from 3.1 million and 4.2 million respectively.³

³ Data from *Households Below Average Income: An analysis of the income distribution 1994/95 – 2002/03*, Department for Work and Pensions, 2004. Data for 2003-04 will be published on 30 March 2005 and final outturn data against the 2004-05 target will be available in early 2006.

New target for 2010-II 5.14 As the next milestone towards the eradication of child poverty, the Government is committed to halving the number of children in relative low-income households between 1998-99 and 2010-11.⁴ The Government will set an additional target in the next Spending Review to halve by 2010-11 the number of children suffering from both material deprivation and relative low-income.

Implementing the Child Poverty Review 5.15 As well as ensuring work for those who can and providing financial support for families, the Government's strategy for reducing child poverty involves tackling material deprivation and ensuring public services contribute to improving poor children's life chances. The *Child Poverty Review* set out the next steps necessary to move towards halving child poverty by 2010.⁵ The Government is committed to working closely with partner organisations, including local authorities, to make progress across the range of policy areas covered by the Review. Key developments since the Review include:

- *work for those who can and financial support for families.* To encourage lone parents who have been out of work for a year or more back into employment, the Government is piloting an In-Work Credit in areas where the cost of living is highest;⁶
- *tackling material deprivation.* To improve the quality of accommodation for families with children, the Housing Act 2004 included measures aimed at helping those families most at risk from poor conditions. The Government also set out measures to tackle financial exclusion, which reduces household income available to spend on children, described in more detail later in this chapter; and
- *improving poor children's life chances.* To ensure that every child gets the best possible start in life, the Government has committed to delivering 3,500 Children's Centres by 2010, which will provide integrated services for families in every community by 2010. The Public Health White Paper and its delivery plan set out the next steps for tackling health inequalities and supporting children and families to make healthy choices.⁷ To break cycles of poverty and criminality, the Government has committed to increasing the coverage of early intervention programmes by 50 per cent by 2008.

Childcare and work-life balance

5.16 The Government is committed to investing in early years and childcare to help expand the range of choices available to families with children. The Government's vision is to ensure that every child gets the best start in life and to give parents more choice about how to balance work and family life. Steps taken have included increasing the duration and the level of maternity leave and pay, introducing paternity and adoption pay and leave and establishing the right to request flexible working. Since 1997, the Government has put in place 524 Sure Start local programmes, free part-time early education for every three and four year old, and 529,000 more childcare places.

⁴ In line with international practice, low income will be measured on a before housing cost basis. The Government continues to monitor progress against a range of other indicators, including income measured on an after housing cost basis and data on regional variations in child poverty.

⁵ *Child Poverty Review*, HM Treasury, July 2004.

⁶ In-Work Credit for lone parents will be extended from October 2005 to Surrey and Sussex; Essex; Kent; Berkshire, Buckinghamshire and Oxfordshire; Bedfordshire and Hertfordshire; and Hampshire and Isle of Wight.

⁷ *Choosing Health: making healthier choices easier*, Department of Health, November 2004 and *Delivering choosing health*, Department of Health, March 2005.

- Ten year strategy for childcare** **5.17** However, the Government acknowledges that more needs to be done. Many parents still find it difficult to find affordable childcare that meets their circumstances and is of the quality they want for their children. *Choice for parents, the best start for children: a ten year strategy for childcare*, published alongside the 2004 Pre-Budget Report, sets out an ambitious agenda of reform and investment to create a childcare sector fit for the 21st century.⁸
- 5.18** The strategy sets out the Government's aim of a childcare place available for all families who want it by 2010, for all children aged 3-14 between the hours of 8am and 6pm each weekday. The number of free hours of early education for three and four year olds will begin to be extended to 15 hours from 2007, with a goal of 20 hours a week. To improve the quality of childcare and boost parents' confidence in how their child is looked after, all full daycare centres will be professionally led. A £125 million Transformation Fund each year will be available in 2006-07 and 2007-08 to support high quality, sustainable, affordable care.
- 5.19** The strategy also introduces measures to improve childcare affordability, including an increase in the eligible cost limits of the childcare element of Working Tax Credit to £300 a week (£175 for one child) from April 2005, and an increase in the maximum proportion of costs that can be claimed from 70 to 80 per cent from April 2006. Significant progress has already been made on many of the commitments announced in the ten year strategy.
- Consultation with parents and other stakeholders** **5.20** The ten year childcare strategy invited responses from parents and other stakeholders. Over 75 written responses have been received, with contributions from a range of groups including parents, local authorities, representative bodies and businesses. The Government has also proactively engaged with parents through a series of structured parent forums across the country and held a range of meetings with key stakeholders and experts in the sector. Initial results from the consultation process have been positive, with strong support for the Government's commitment to build a highly skilled childcare and early years workforce. A summary of responses is published alongside this Budget.⁹
- Parenting and early learning support** **5.21** The analysis in the ten year strategy for childcare demonstrated the importance of children's early learning to their readiness to learn at school. This analysis also showed that a child's home learning environment is vital to his or her development. **The Government is therefore allocating an additional £25 million in 2006-07 and 2007-08 for early learning partnerships with parents, working with Sure Start Local Programmes, Children's Centres and other pre-school providers. In addition, an extra £10 million is allocated in 2006-07 and 2007-08 for the Parenting Fund to support parenting programmes provided by the voluntary and community sectors.**
- Affordability in London** **5.22** The ten year strategy announced a contribution of £5 million a year from April 2006 for a pilot to work with the Greater London Authority and London Development Agency to address childcare affordability issues in London. The pilots, which will test a range of approaches aimed at improving the accessibility and affordability of good quality childcare for lower-income parents, are planned to come on stream in autumn 2005.
- VAT and childcare** **5.23** Local authorities have a key role in delivering the Government's vision for childcare. They will be given a new duty to secure sufficient supply of affordable, high-quality childcare to meet the needs of local children and families. Local authorities will also play a critical role in delivering on the Government's ambitious plans for a Children's Centre in every community.

⁸ *Choice for parents, the best start for children: a ten year strategy for childcare*, HM Treasury, Department for Education and Skills, Department for Work and Pensions, Department of Trade and Industry, December 2004.

⁹ A summary of responses to the childcare strategy is available at: www.hm-treasury.gov.uk/childcare

5.24 To ensure that VAT does not obstruct the delivery of the Government's vision for childcare, and in recognition of the role that local authorities play in delivering the strategy, **the Government will refund local authorities all of the VAT that they incur in the provision of welfare services, such as childcare and Children's Centres.** The Government intends to legislate on this, in due course, but in the interim will use existing powers to operate this administratively. The Government will also explore whether there are any further VAT changes that might be made to enable local authorities to play their part in ensuring local delivery of childcare.

Work-life balance 5.25 In order to support child development and parents' choices during the crucial first year of a child's life, the ten year strategy sets out the aim for a year of paid maternity leave by 2010. Further details on work-life balance proposals announced in the ten year childcare strategy were published in *Work and Families: Choice and Flexibility* in February 2005.¹⁰ These measures include: the extension of maternity pay to 39 weeks; the introduction of a new right for a mother to transfer a proportion of her pay and leave to the father; the extension of flexible working to carers of sick and disabled relatives and parents of older children; and the case for transferring responsibility for the administration of Statutory Maternity Pay, Statutory Paternity Pay, Maternity Allowance and Statutory Adoption Pay to the Inland Revenue. The consultation period ends on 25 May 2005.

SUPPORTING YOUNG PEOPLE

5.26 The Government is committed to enhancing skills and has a long-term aspiration to increase the UK's rates of post-16 participation in education and training to match the best in the OECD. For an individual, education and skills provide security and opportunity, enhance personal fulfilment and can enable people to better contribute to their communities. As described in Chapter 6, this Budget sets out new long-term plans for investment in education and skills, which are central to the Government's aim of creating a high-skilled, high-productivity workforce which will ensure the UK can prosper in the increasingly competitive global economy.

Review of financial support for 16-19s 5.27 The review of financial support for 16-19 year olds aims to remove the financial barriers to learning for all young people, including the most vulnerable. The success of the Education Maintenance Allowance (EMA) pilots demonstrates the important role of financial incentives in delivering higher staying-on rates. EMA was rolled-out nationally in September 2004 for 16 year olds continuing in full-time education, introducing a framework of rights and responsibilities based on a learning agreement signed by each recipient.

5.28 Building on this milestone, *Supporting young people to achieve*, published alongside Budget 2004, launched a consultation on the Government's long-term vision of a single, coherent system of financial support, focused on encouraging and supporting all young people to participate in education or training.¹¹ This system would include young people engaged in different activities and respond to their individual circumstances, simplifying administration and improving accessibility. It would provide support that encourages young people to progress and ensures smooth transitions as they move between different activities, for example as they move into formal learning. The consultation clearly demonstrated that there is a strong consensus in favour of the Government's proposals. The Government is publishing a full response to the consultation alongside this Budget.¹²

¹⁰ *Work and Families: Choice and Flexibility, A Consultation Document*, Department of Trade and Industry, February 2005.

¹¹ *Supporting young people to achieve: towards a new deal for skills*, HM Treasury, DfES and DWP, March 2004.

¹² The Government's response to the *Supporting young people to achieve* consultation is available at www.hm-treasury.gov.uk/financialsupport

Improving financial support for 16-19s in learning **5.29** As an important step towards this long-term vision, a Child Benefit Bill is currently being considered by Parliament. **The Government can confirm its intention to extend entitlement to Child Benefit, Child Tax Credit and Income Support from April 2006 to 19 year olds completing a course of non-advanced education or training which they started before their 19th birthday, up to a limit of age 20.** Benefiting around 80,000 individuals a year, this change will ensure that more young people achieve their qualifications rather than dropping out at 19 due to financial pressures.

5.30 Furthermore, **the Government can confirm its intention to extend entitlement to Child Benefit and Child Tax Credit from April 2006 to unwaged trainees on work-based learning programmes arranged by the Government.** The courses covered by the new rules are set out in the draft Child Benefit regulations published on 10 January 2005.¹³ There are around 100,000 unwaged training places a year provided through these programmes, which help young people to progress to a waged apprenticeship, further education or skilled employment.

5.31 These reforms will improve the financial support available to these learners and, with the extension of EMA in England, deliver parity in financial support for education and unwaged training. This will give individuals genuine choice, enabling them to select the learning route most appropriate for their needs and aspirations, rather than basing their decision on the amount of financial support available. The Child Benefit Bill will also provide the flexibility to extend support to other groups of young people in the future. For example, the Government will consider the Russell Commission's recommendations on financial support for young people participating in the new framework for youth action and engagement, described later in this chapter.

Engaging inactive young people **5.32** Despite significant increases in the numbers of young people who continue in learning after the end of compulsory schooling, at any one time around 150,000 UK 16 and 17 year olds are not in education, employment or training. Evidence suggests that it is detrimental to their long-term opportunities for young people to spend prolonged periods unemployed or inactive when they could be gaining further skills and qualifications. The Government's ambition is to ensure no teenager faces long-term unemployment or inactivity, by providing every young person with the opportunities and financial support to continue in education or training. As the next step towards a single, coherent system of financial support, the Government intends to extend the successful framework of rights and responsibilities which underpins EMAs for example to the hardest to help 16-17 year olds. The consultation strongly endorsed the extension of conditional financial support, which would set a clear expectation for young people to progress into learning and reach their potential. To inform this next stage of reform, **the Government will allocate £60 million over two years to pilot Activity Agreements and an Activity Allowance for 16 to 17 year olds not in employment or learning in eight areas of England from April 2006.** The Activity Agreement will form a personally negotiated contract with the young person, identifying specific steps they should take to move into education or training, in return for access to financial support. For disadvantaged young people who need more help to prepare for formal learning, the Activity Allowance would support them to undertake basic skills training, including courses provided by the voluntary and community sector. The pilots will test different options for the Activity Agreement and Allowance, to help identify which model would be most effective in a national roll-out. Chapter 6 sets out the Government's plans for piloting a Learning Agreement to engage young people who are in low-skilled work without training, to ensure they are also encouraged to continue developing skills.

¹³ Available at www.hm-treasury.gov.uk/

5.33 To improve accessibility to the financial support system for vulnerable young people who are unable to live in the family home, the Government has been consulting with the voluntary sector on ways of simplifying and improving the processing of benefits claims for 16-17 year olds under the estrangement criteria. This consultation will feed into revised guidance and training for Jobcentre Plus advisers to be rolled out nationally in April 2006. The Government is also considering further simplification of the benefits structure for 16-17 year olds.

FAIRNESS FOR DISABLED PEOPLE

5.34 The Government is committed to advancing the civil rights of disabled people, and to ensuring they are able to participate fully in society. Reforms introduced to support people with a health condition or disability into work, as set out in Chapter 4, must go hand in hand with action to tackle discrimination and to give disabled people more choice. The Government is tackling the barriers that can prevent disabled people from participating fully in society, including by widening the scope of the Disability Discrimination Act and establishing the Disability Rights Commission.

Improving the life chances of disabled people

5.35 In January 2005, the Government published *Improving the life chances of disabled people*, which set out the Government's vision for improving the life chances of disabled people over the next 20 years.¹⁴ The recommendations made in the report are designed to increase disabled people's ability to live independently; enable disabled children and their families to enjoy a good quality of life; support young disabled people effectively as they become adults; and improve the support available to disabled people to help them remain in contact with the labour market. A new Office for Disability Issues will be established to coordinate disability policy across Government.

PROMOTING SAVING, ASSET OWNERSHIP AND INCLUSION

5.36 Assets and savings provide people with opportunity and independence throughout life, flexibility to adjust to unforeseen events and financial security in retirement. Broad asset ownership contributes to social cohesion, giving more people a stake in the economy and society. Building on the platform of macroeconomic stability set out in Chapter 2, which aids long-term planning, the Government seeks to support saving and asset building for all from childhood, through working life and into retirement. People save in a range of assets, from deposit accounts, shares and pensions, to homes and businesses. Traditional measures of aggregate saving, such as the household saving ratio, are therefore only part of the story.¹⁵

5.37 Household net wealth has grown by around 50 per cent in real terms since 1997. Total household assets, including savings, pensions, life insurance and housing, are over £6 trillion. The debt taken on by households in aggregate is primarily as they accumulate assets, rather than borrowing to fund current consumption.¹⁶ Nevertheless, the Government recognises that some households face debt problems and set out in July 2004 its strategy for tackling over-indebtedness.¹⁷

¹⁴ *Improving the life chances of disabled people*, Prime Minister's Strategy Unit, January 2005.

¹⁵ See for example, *Bank of England Quarterly Bulletin*, Spring 2001.

¹⁶ 'Household Secured Debt,' *Bank of England Quarterly Bulletin*, Autumn 2004.

¹⁷ *Tackling Over-Indebtedness: Action Plan 2004*, Department of Trade and Industry, July 2004.

Promoting saving and asset ownership

5.38 The Government's policies provide over £2 billion a year in tax relief on savings, and promote saving through the benefit system, improved regulation, public spending and education. As set out in the 2004 Pre-Budget Report, the Government's plans to promote further saving and asset ownership focus on three areas:

- *Individual Savings Accounts* – tax-free saving opportunities for all adults;
- *the Saving Gateway* – piloting the provision of a Government cash contribution to 'match' individual savings for those on low incomes; and
- *Stakeholder savings and investment products* – simple and risk-controlled, with a charge cap to protect consumers from high charges.

Individual Savings Accounts

5.39 Individual Savings Accounts (ISAs) were introduced in 1999. Over 16 million people now have an ISA, with over £160 billion subscribed. ISAs have a higher take-up among both low-income groups and the young compared to Tax Exempt Special Savings Accounts (TESSAs) or Personal Equity Plans (PEPs), which they replaced. These savings are supported by around £1.6 billion in tax relief every year. When introduced, ISAs were guaranteed to run for an initial ten years to 2009 and the overall annual investment limit was set at £5,000, with a maximum of £1,000 in cash. A higher limit of £7,000, with a maximum of £3,000 in cash, was set for the first year to encourage new saving. In 2000, these higher limits were extended to April 2006. **In response to the consultation announced in the 2004 Pre-Budget Report, the Government will extend further the existing higher ISA limits, not only to 2009 but now to April 2010.**

5.40 As announced in the 2003 Pre-Budget Report, **from April 2005, Stakeholder medium-term investment products and existing life insurance products will be available through stocks and shares ISAs.** This will improve flexibility and increase the tax relief available by allowing investment of £4,000 in stocks and shares mini-ISAs. In response to changes introduced by the FSA, **the Government will extend the list of qualifying investments for ISAs to include all FSA-authorised retail investment schemes.**¹⁸ Taking these decisions together, it is estimated that by 2010 the Government will provide around an additional £350 million a year in tax relief on ISAs.

5.41 Responses to the consultation on ISA limits, and a wider debate among industry bodies, providers and consumer groups contain interesting ideas on how to continue and build on the success of ISAs. Their flexible structure allows them to be updated easily in response to regulatory and financial market developments. The Government is keen to play its part in facilitating the transferability of savings between different vehicles in order to give savers more flexibility over their lifetime and to link short, medium, and long-term savings.

Matching and the Saving Gateway

5.42 In addition to tax relief, the Government is using the Saving Gateway to explore how matching and carefully tailored information can help promote saving among those who do not usually save. This provides a more understandable, transparent and equitable framework of support for savers, and greater incentives for those on low incomes who benefit less, or not at all, from tax relief. In the initial Saving Gateway pilot established in 2002, the Government matched individuals' savings pound-for-pound up to a limit, and provided tailored financial information and education to participants. The final evaluation report, published alongside this Budget, confirms that matching can encourage genuinely new savers and new saving.¹⁹ The evidence shows that participants doubled their saving with minimal substitution from existing savings.

¹⁸ *ISA and Child Trust Funds: All FSA authorised or regulated retail investment schemes will be qualifying investments*, Inland Revenue, March 2005.

¹⁹ *Incentives to save: Encouraging saving among low-income households*, University of Bristol, Personal Finance Research Centre, March 2005.

5.43 The 2004 Pre-Budget Report announced a new, larger, £15 million Saving Gateway pilot. The accounts will run for 18 months and the first are already open. Halifax bank is providing banking facilities in six areas: Cambridgeshire; Cumbria and North Lancashire; East Yorkshire; Manchester; East London; and South Yorkshire. The pilot will test alternative match rates, different monthly contribution limits, the effect of an initial endowment, and the support of a wider range of community financial education bodies.²⁰ It will also be made available to a wider range of income groups than the first pilot. The pilot will inform the development of matching as a central pillar in the Government's strategy for promoting saving and asset ownership.

Stakeholder savings and investment products **5.44** Following the Sandler Review of the retail savings industry, the Government will introduce a new 'Stakeholder' suite of simple, low cost, risk-controlled savings and investment products in April 2005.²¹ The suite will include a deposit account and a medium-term investment product – both of which will be available within ISAs – as well as a Child Trust Fund account and a revised Stakeholder pension. There is also a new advice regime, Basic Advice, which the FSA finalised in November 2004.²² Following consultation, **the launch of the Stakeholder Suite will be supported by a £4 million programme to inform consumers.**

Treatment of capital limits **5.45** The Government is committed to ensuring the benefit system encourages households to save appropriately, particularly those on lower incomes. As announced in Budget 2004, **from April 2006 the threshold above which savings begin to reduce eligibility for Income Support, Jobseeker's Allowance, Housing Benefit and Council Tax Benefit will be raised from £3,000 to £6,000.** In addition, in this Budget **the Government announces that it will raise the upper capital thresholds for Income Support and Jobseeker's Allowance from £8,000 to £16,000 from April 2006.**

Child Trust Fund **5.46** The Government launched the Child Trust Fund in January 2005. The Child Trust Fund is at the heart of the Government's asset-based welfare strategy. It will promote saving and ensure all children have a financial asset at age 18, regardless of their family background. It will also provide children with practical financial education. All children born since September 2002 will receive at least £250 to invest in a long-term savings or investment account and children from families with lower incomes will receive £500. Children, parents, family and friends will together be able to contribute up to £1,200 a year to each account and there will be no tax for them to pay on any interest or gains made on this money. There are now over 90 official providers and distributors of Child Trust Funds, including institutions across the financial services industry and numerous high street retailers. 1.6 million vouchers are being sent to families in the first few months of this year, accompanied by a major information campaign. Child Trust Fund accounts will become fully operational on 6 April 2005.

5.47 As announced in the 2004 Pre-Budget Report, the Government is consulting on a universal payment at age seven of £250, with children from low-income families receiving £500 more. This will link in with financial education in primary schools, by providing a relevant and practical example of saving. **The Government now invites views on what further payments should be made into Child Trust Fund accounts at secondary school age.** Details of the consultation can be found on the HM Treasury website.

5.48 Building on the success of the ISA model, the Government has designed the rules for Child Trust Fund accounts to allow a range of investment options, including Stakeholder accounts, ethical accounts and Shari'a compliant accounts. As it is doing for ISAs, the Government will extend the list of qualifying investments for Child Trust Fund accounts to include all FSA-authorised retail investment schemes. Credit unions can already make

²⁰ MORI and the Institute of Fiscal Studies will evaluate the pilot scheme.

²¹ *Medium and Long-Term Retail Savings In The UK: A Review*, Ron Sandler, July 2002.

²² *A basic advice regime for the sale of Stakeholder products*, Financial Services Authority, November 2004.

available Stakeholder accounts and in addition **the Government will enable credit unions to offer Child Trust Fund cash accounts, providing that depositors are afforded the same level of protection they would have had, had they invested with any other provider.**

Financial capability 5.49 The Government is supporting efforts to improve financial capability, to help people make financial decisions with confidence throughout their lives. The importance of financial education is recognised in the Government's recent White Paper on the national curriculum.²³ Financial education is also a key part of the Child Trust Fund and the Saving Gateway. The Government actively supports the FSA in coordinating a national financial capability strategy, in conjunction with the Government, financial services firms, consumer organisations and others.²⁴

Saving through pooled investments 5.50 Around £2 trillion of household assets are held in pooled investments, which combine funds to diversify risk and provide professional asset management.²⁵ These schemes form an important part of the investment chain, as discussed in Chapter 3. The Government recognises the potential benefits of simplifying and modernising the taxation of pooled investments and continues to invite views on whether radical reform similar to that underway for pensions is viable. The aim is a simpler regime for both savers and investment intermediaries and a more efficient channel for businesses to raise capital.

5.51 Details of changes to the taxation of authorised investment funds (AIFs) and further consultation on potential changes are announced alongside the Budget.²⁶ These are designed to facilitate a more flexible approach to investment strategies following the FSA's changes to the regulatory regime in 2004. However, as the flexibility of the new Qualified Investor Scheme (QIS) offers greater scope for exploitation of the AIF tax regime, Finance Bill 2005 will introduce a power to make regulations to apply different tax rules to investors holding a substantial portion of a QIS. The Government will continue to work with those affected to ensure that the benefits of the regime are properly focused.

Promoting financial inclusion

5.52 Access to mainstream financial services is restricted for many people on low incomes. This imposes costs on those who can least afford them and can prevent people from getting started on the savings ladder. *Promoting Financial Inclusion*, published alongside the 2004 Pre-Budget Report, set out the Government's strategy for tackling financial exclusion, outlining policy measures in three key areas: access to banking; access to affordable credit; and access to money advice. It established a Financial Inclusion Fund of £120 million over three years to support these measures, and a Financial Inclusion Taskforce, launched in February 2005, to oversee progress.

Access to banking 5.53 In 2002-03, there were around 2.8 million adults in households without access to a bank account. In December 2004, the banks and the Government agreed to work together towards the goal of halving the number of adults in households without a bank account, and of demonstrating significant progress in that direction within two years.

Access to affordable credit 5.54 Many low-income households rely on the 'alternative credit market', where typical products have Annual Percentage Rates of over 100 per cent. Through the Consumer Credit Bill, the Government aims to increase transparency and fairness in the market and improve consumers' access to redress mechanisms. To reduce the costs and risks of lending to vulnerable groups, and following consultation, **the Government will work towards a scheme where, under certain circumstances, lenders could apply for repayment through deduction from benefits, where normal repayment arrangements have broken down.**

²³ *14-19 Education and Skills*, Department for Education and Skills, February 2005.

²⁴ *Building financial capability in the UK*, Financial Services Authority, May 2004.

²⁵ Investment Management Association. Pooled investment schemes can include authorised investment funds, life insurance products, private and occupational pension funds and other collective investment vehicles that pool investors' funds.

²⁶ *Reform of Taxation of Collective Investment Schemes*, Inland Revenue, March 2005.

5.55 ‘Third sector’ lenders, such as credit unions and community development finance institutions (CDFIs), have a key role to play in providing affordable credit to those on low incomes. The Government will set up a growth fund for third sector lenders, from within the Financial Inclusion Fund, to boost the coverage, capacity and sustainability of the sector in providing an affordable source of credit for the financially excluded. **The Government is today publishing a consultation document on the costs and benefits of raising the cap on interest that credit unions can charge on loans to members**, to establish what impact, if any, this would have on the ability of credit unions to offer loans to low-income consumers.²⁷ **The Government will also shortly consult on the case for, and practicalities of, extending Community Investment Tax Relief to investments in CDFIs’ personal lending activities.**

5.56 The Social Fund provides a safety net of grants and loans for the most vulnerable in times of crisis, supporting those without a stock of savings and assets to fall back on. As announced in the 2004 Pre-Budget Report, **the Government will introduce reforms to the Social Fund Budgeting Loans scheme in April 2006.** These measures will increase funding for the Social Fund by £210 million over three years and improve its transparency and effectiveness. Further reforms will be considered in the context of the Government’s commitment to promoting financial inclusion.

Access to money advice

5.57 The Government recognises that free face-to-face money advice provision is a particularly effective mechanism in tackling over-indebtedness for more vulnerable consumers. The Financial Inclusion Fund will support an increase in the capacity of the face-to-face money advice sector. The Government will also pilot models of money advice provision to reach those who do not normally go to debt advisors.

FAIRNESS FOR PENSIONERS

5.58 In the past, the tax and benefit system failed to deliver security for the poorest pensioners, while providing inadequate support for low-income households who were saving for retirement. A fair society guarantees security in old age and ensures that all pensioners can share in rising national prosperity. *Principles for reform: The national pensions debate* set out the extent of pensioner poverty in 1997 and the inadequate framework for the working-age population, especially for those on low and moderate earnings, to plan for retirement.²⁸

5.59 *Tax credits: reforming financial support for families* sets out the policies the Government has introduced aimed at guaranteeing security in old age and ensuring that all pensioners can share in rising prosperity. The introduction of the programme for Informed Choice, accompanying radical reform of the taxation of pensions, the introduction of the State Second Pension and the development of simple, low cost savings products, are enabling all individuals and families to build up retirement incomes that meet their aspirations. The Government’s measures will continue to be guided by the principles set out in *Principles for reform*.

Fairness for today’s pensioners

5.60 Building on the foundation of support for retirement provided by the basic and additional state pensions, the Government continues to focus resources on the poorest pensioners. In 1997, the poorest single pensioners lived on £69 a week; in 2005-06, all single persons aged 60 or over are entitled to a minimum of £109.45 a week.

²⁷ *The credit union interest rate cap: a consultation document*, HM Treasury, March 2004.

²⁸ *Principles for reform: The national pensions debate*, Department for Work and Pensions, February 2005.

Pension Credit 5.61 Key to this success has been the Pension Credit, which further extends support to the poorest pensioners and rewards those who have built up small savings for retirement. By December 2004, 2.65 million pensioner households (over 3.2 million individuals) were receiving the Pension Credit with 2.08 million households receiving the guarantee credit element. Current estimates suggest that take-up of the Pension Credit guarantee by the poorest pensioners is over 80 per cent. The Pension Service has a take-up target of 3 million pensioner households by 2006, rising to 3.2 million by 2008, and is working with local authorities and the voluntary sector to achieve this. Pension Credit also rewards 1.9 million pensioners who have saved for their own retirement, and has ended the unfair penalty on many savers of a 100 per cent marginal deduction rate on their savings. Women pensioners, many of whom have not been able to build up an entitlement to a full basic state pension in their own right in the past, have been among those to benefit the most from Pension Credit. Twice as many women as men receive Pension Credit.

5.62 To ensure that Pension Credit continues to take and keep pensioners out of poverty, in the 2004 Pre-Budget Report the Government committed to increasing the guarantee element of Pension Credit by earnings until 2008. On current forecasts, it will be worth £119 a week by March 2008. This means that the Pension Credit guarantee will rise to £109.45 for single pensioners and £167.05 for couples from April 2005; and the Pension Credit savings credit reward will rise to a maximum of £16.44 a week for single pensioners and £21.51 for couples from April 2005.

Support for all pensioners 5.63 The Government has guaranteed that the annual April increase in the basic state pension will be in line with the Retail Prices Index for the previous September or 2.5 per cent (whichever is higher). This will mean that from April 2005 the basic state pension will rise to £82.05 for single pensioners and £131.20 for couples. The Government is also providing free television licences for the over 75s, and free prescriptions and free eye tests for those aged 60 and over. Moreover, Winter Fuel Payments of £200 to all households with someone aged 60 or more, rising to £300 for households with someone aged over 80, will benefit over 11 million people by the end of 2005.

5.64 The Government is continuing to ensure that all pensioners can share in rising national prosperity. Since 1997, it has done this through directly increasing the incomes of older people and by indirectly reducing the cost of key public services to older people.

5.65 Budget 2005 continues this policy by **announcing free off peak local area bus travel for those aged over 60 and disabled people in England from April 2006**. Not only will this reduce the cost of travel for approximately 11 million people aged over 60 and approximately 2 million disabled people, it should also help approximately 54 per cent of pensioner households who do not have a car to travel freely in their local area.

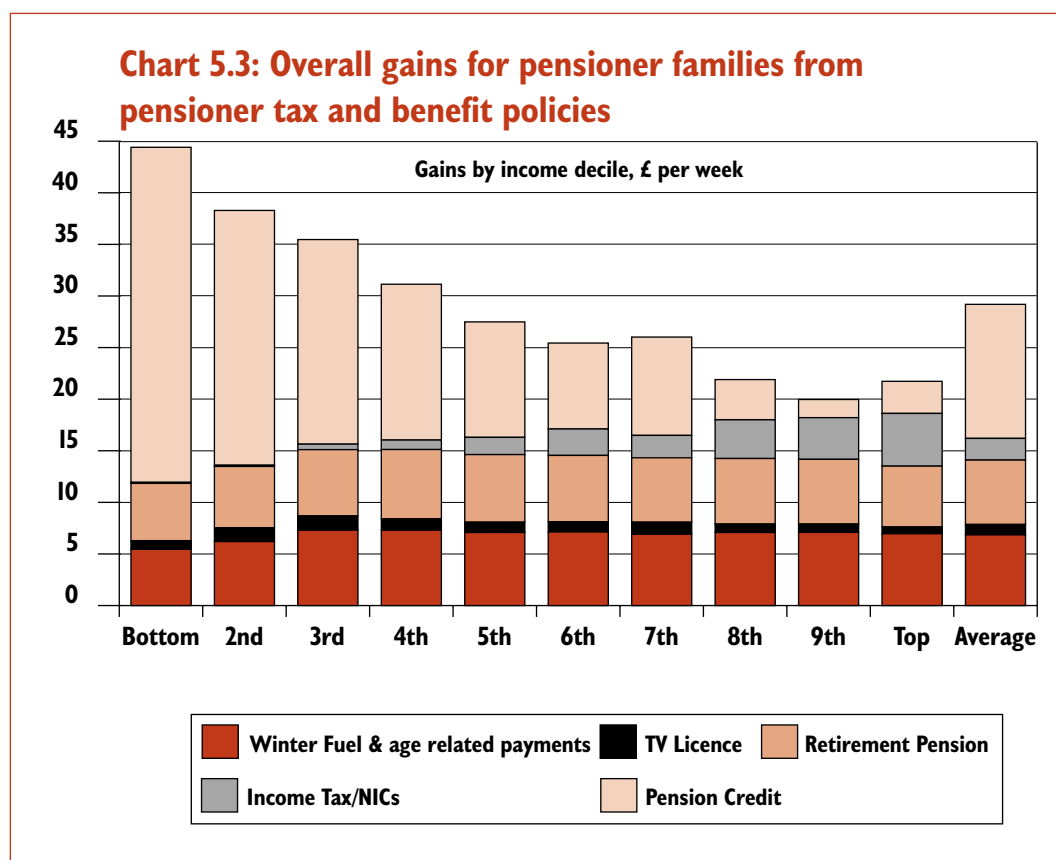
5.66 The Government understands the position of older people on fixed incomes facing pressures such as council tax bills. Alongside Council Tax Benefit for the poorest pensioners, the Government believes that it is right to help elderly households with their council tax. **This Budget announces an additional payment to all council tax paying households with someone over 65**. Together with payments, in addition to the Winter Fuel Payment announced in the 2004 Pre-Budget Report, this will mean some 4.7 million council tax paying households with someone over 65 will receive £200. These payments will be made at the same time as the 2005 Winter Fuel Payment.

5.67 Budget 2003 announced that all pensioners in hospital would continue to receive their state pension entitlement for stays of up to 52 weeks. Budget 2005 announces that this will now be extended so that **all those entering hospital from April 2005 will continue to**

receive their full state pension and their full entitlement to Incapacity Benefit, Severe Disablement Allowance and Income Support for the entire duration of their stay in hospital from April 2006. Those already in hospital will have their benefits increased from April 2006 if they have then been in hospital for 52 weeks or more. This is in recognition of the fact that individuals have many on-going fixed commitments such as housing costs and utility bills while they are in hospital.

Support for pensioners who pay tax **5.68** The Government is committed to supporting pensioners who pay income tax. Around half of all pensioners pay no tax on their income, but for those who do the Government has committed to increasing age-related tax allowances in line with earnings for this Parliament which means that the age-related allowances for 2005-06 will increase to £7,090 for people aged between 65 and 74 and to £7,220 for those aged 75 and over. This will mean that no person aged 65 or over need pay tax on an income of less than £136 a week.

Effects of measures to support pensioners **5.69** As a result of measures implemented since 1997, the Government is spending around £11 billion a year more on pensioners – around £8 billion a year more than if it had simply linked the basic state pension to earnings over the same period. The Government's strategy is not only more generous overall, but has also focused support on those who need it most. If the extra £11 billion had been spent on raising the basic state pension, the poorest 10 per cent would on average be £24 a week worse off than they are now. As a result of tax and benefit measures the Government has introduced, the poorest 10 per cent of pensioner households will be on average £2,300 a year, or around £44 a week better off; and pensioner households will be on average £1,500 a year better off, or around £29 extra a week. Chart 5.3 shows the distributional impact of the Government's measures to support pensioners.



Fairness for tomorrow's pensioners

5.70 The Government is committed to providing a clear and sustainable framework for retirement provision within which individuals can make informed choices about how much to save and when to retire, as set out in the Pensions Green Paper in 2002. Since then, the measures in the Green Paper have been taken forward through legislation and the Government documents, *Informed Choices for Working and Saving* and *Principles for reform: The national pensions debate*.²⁹ The Government's policies aim to deliver:

- *a guarantee of a decent minimum income in retirement* – provided by the state, and below which no pensioner need live;
- *transparency* – the Informed Choice programme is helping people to make informed and effective choices about working and saving for their retirement;
- *simplicity* – simplifying the tax regime for pensions, and ensuring that people have access to simple and flexible savings products;
- *security* – the Pension Protection Fund (PPF) and a new pro-active regulator will improve protection for members of occupational pension schemes, while the Financial Assistance Scheme will provide support covering the period before the PPF becomes operational; and
- *opportunities for extended working lives* – combating age discrimination and providing people with greater opportunity and reward for working longer, if they wish to do so.

Pensions Commission 5.71 In 2002, the Government invited the Pensions Commission to examine the regime for private pensions and long-term saving and consider whether the level of compulsion within the UK pensions and retirement system is appropriate. An interim report was published in autumn 2004 and a final report will be published later this year.³⁰ The Government's policies will continue to be guided by the imperative of maintaining long-term fiscal sustainability.

Decent minimum income in retirement 5.72 The Government is committed to providing a decent minimum income to pensioners in the future as well as those today. As set out above, the guarantee element of the Pension Credit will be uprated by earnings until 2008. The Government reformed the State Earnings Related Pension (SERPS) by introducing the State Second Pension in April 2002 to strengthen the foundation in retirement for 14.6 million working age people on low and moderate earnings. For example, someone on around half median earnings, £12,000, will be able to accrue a weekly State Second Pension of around £70 in 2050, in today's earnings terms; roughly double what would have been built up under SERPS. A further innovation of the State Second Pension is that over 4 million of those making non-remunerated contributions to society, such as carers and the disabled, are for the first time able to build up rights to an additional pension. Of the 18.7 million in total gaining from the 2002 reform, around 55 per cent are women.

Transparency 5.73 Beyond the foundation provided by the state, individuals and families make decisions as to what income they wish to receive in retirement. The Government is playing its role in assisting people to make informed choices about working and saving, issuing over 4.5 million pension forecasts in 2004-05 and developing a web-based retirement planner for launch in 2006. Currently, around 4.7 million individuals have access to an occupational scheme but are not members of it. *Informed Choices for working and saving* set out a number of options for

²⁹ *Simplicity, security and choice: Informed choices for working and saving*, Department for Work and Pensions, February 2004; *Principles for reform: The national pensions debate*, Department for Work and Pensions, February 2005.

³⁰ *Pensions: Challenges and Choices*, Pensions Commission, October 2004.

maximising employee participation in these schemes. Both the CBI and the Employer Task Force have recommended that firms adopt automatic enrolment in order to increase employee participation.³¹ The Government is keen to discuss with employers how to increase the number of schemes that operate this joining mechanism.

Simplification 5.74 To make informed choices, individuals need clarity around the tax treatment of their pension saving. The numerous existing taxation regimes, each with its own set of rules, create complexity. The Finance Act 2004 legislated for a single universal regime for tax-privileged pension savings, to come into effect in April 2006. As well as providing individuals with greater flexibility and choice over their retirement savings, tax simplification will also benefit employers and pension providers through a reduction in administrative costs. In response to representations made on the legislation, the Government will **introduce a package of supplementary measures, which will come into effect from April 2006, to provide additional flexibility for schemes and individuals, clarify aspects of the legislation, smooth the transition from the current to the new regime, and introduce further anti-abuse and compliance rules.**

5.75 Individuals need access to simple, good value products. The introduction of Stakeholder pensions has ensured that value-for-money, flexible private pension arrangements are accessible to all. These products form part of the Stakeholder suite of products described earlier in this chapter.

Pension Protection Fund 5.76 The Pensions Act 2004 legislated for the Pension Protection Fund (PPF), which will come into being from April 2005. This is the UK's first scheme for ensuring that individuals in defined benefit pension schemes receive a meaningful proportion of their expected pension income if their sponsoring employer becomes insolvent. The Government will legislate to ensure that the PPF has the same tax privileges as the pension schemes that it protects – so that if the PPF takes over a scheme there will be no adverse tax consequences for members of that scheme. Employers who fund the statutory levies payable to the PPF will be able to claim tax relief on those payments. The Government is also establishing a Financial Assistance Scheme to provide support covering the period before the PPF becomes operational.

Enabling longer working lives 5.77 The Pensions Commission analysis confirmed that enabling longer working lives will be an important part of the response to increased life expectancy. Chapter 4 sets out the Government's employment strategy, which contains measures to further improve employment opportunities for older workers. The Government does not believe it is right to force people to work longer and has no plans for a crude increase in the state pension age, but it is providing greater choice and flexibility for those who wish to do so. From April 2005, those who choose to defer taking their state pension will be better rewarded, including the option of a taxable lump sum. From April 2006 it will be possible to draw an occupational pension while remaining with the same employer; and in the same year the Government will also implement the age discrimination strand of the European Employment Directive. Legislation coming into force in autumn 2006 will provide for a national default retirement age of 65. Employees who wish to continue to work will have to have their request considered seriously by their employer.

SUPPORTING COMMUNITIES, CHARITIES AND GIVING

5.78 The third sector plays a key role in creating a fair and enterprising society with a culture of volunteering and giving. To create a framework in which voluntary and community activity can flourish, the Government is providing support for charitable giving, support to

³¹ *Securing our future: developing sustainable pension provision in the UK*, CBI, July 2004; *Report to the Secretary of State for Work and Pensions*, The Employer Task Force on Pensions, December 2004.

charities through the tax system and other provisions, and support for community programmes and involvement. Tax reliefs and other measures are now worth more than £2.4 billion a year to charities. Following the success of the Giving Campaign, the Government will continue to work with the sector to identify new ways to promote charitable giving.

Modernising tax administration for charities 5.79 The integration of HM Customs and Excise and the Inland Revenue into Her Majesty's Revenue and Customs (HMRC) provides an opportunity to deliver significant improvements for charities in the administration of the tax system.³² It will take sustained effort to ensure that the new department meets the diverse needs of charities and their donors. The first key steps by the new department include:

- setting up a single unit for all activity with respect to charitable organisations and charitable donations, including repaying tax to charities and ensuring that charitable reliefs are sufficiently protected against abuse;
- researching the experience and needs of the sector and inviting representatives onto an advisory group to contribute on the initial development of the unit; and
- creating a one-stop shop for charities, including improved website guidance and enhanced dedicated helpline support covering direct and indirect taxation.

Gift Aid 5.80 Gift Aid has provided a significant boost to donations to charities. Around 56,000 charities reclaimed tax of £586 million on Gift Aid donations in 2003-04, including around 6,000 claiming for the first time. Charities using Gift Aid range from the largest to the very smallest and tax has been claimed on donations of all sizes, demonstrating that taxpayers of all income levels can use the scheme.

Tsunami Appeal 5.81 The Tsunami Appeal highlighted the generosity of the British public and demonstrated increasing awareness of tax-effective ways to give. The Disasters Emergency Committee (DEC) raised £300 million and estimates from charities and others involved in the appeal suggest that 60 per cent of donors used Gift Aid, which is twice normal take up rates. Tax reclaimed could add over £50 million to donations. In light of the unprecedented generosity of the UK public, the Government announced in January 2005 that a special one-off donation would be made to DEC equivalent to the VAT collected on charity concerts, charity records and other fundraising activities for tsunami relief.

Payroll Giving 5.82 The Government is keen to encourage greater use of Payroll Giving, which enables employees to make regular, tax effective, donations to charity. In January 2005, the Home Office launched the Government's £8.3 million scheme to improve access to Payroll Giving and encourage more of the UK's 12 million employees in small and medium sized enterprises to give to charity. The scheme, administered and promoted by the Institute of Fundraising and Business in the Community (BITC), offers a cash incentive to employers who set up a scheme and matches employee donations. Initial take-up has been encouraging. Through BITC, its regional networks and its key corporate members, the scheme will be promoted to 500,000 small and medium sized enterprises. In addition, over 20,000 copies of the Government's *Guide to Tax Incentives for Corporate Giving*, launched in January, are being disseminated to businesses and charities.

Gift Aid admissions 5.83 In the 2004 Pre-Budget Report, the Government announced changes to the special exemption in relation to Gift Aid and admission charges. Charities have been consulted on how the broader scope of the exemption will be applied and on draft legislation, which reflects their comments. Legislation will be introduced in the next Finance Bill and changes will take effect from April 2006.

³²The Commissioners for Revenue and Customs Bill which provides the legislative framework for integration has nearly completed its parliamentary passage and the Government expects the new department to be launched shortly.

- Support for charities** **5.84** In addition to encouraging charitable giving, the Government is committed to supporting the role the third sector plays in the reform of public services, as outlined in Chapter 6. **Building on this the Government will introduce a new reduced rate of VAT for certain supplies of advice or information connected with or intended to promote the welfare of elderly or disabled people or children.**
- 5.85** The Government recognises that charities increasingly want to enter into joint trading ventures but that the existing rules on company Gift Aid may be a barrier to such arrangements. **The Inland Revenue will examine with the sector whether an approach can be found to allow companies owned by more than one charity to donate their profits to the parent charities using Gift Aid.**
- Unclaimed assets** **5.86** The Government continues to believe that it is right in principle that more should be done to reunite assets with their owners. Where assets and their owners cannot be reunited, the Government believes that the assets should be reinvested in society, as long as the original owners' entitlements to reclaim are preserved. Therefore in Budget 2004, the Government asked the industry to expand the scope of voluntary action to achieve this beyond investment banking into retail banking and the wider financial sector.
- 5.87** The Government is engaged in constructive discussions with the industry to take this forward. Looking ahead, the Government expects to agree with industry a common definition of an unclaimed asset, and for the industry to search their records and to set out the full value of their assets so defined, by the time of the 2005 Pre-Budget Report. The Government also expects the industry to explore what more could be done to reunite owners and assets, including the possibility of a National Register, and to set out how they will achieve this by the time of the 2005 Pre-Budget Report.
- VAT grant scheme for memorials** **5.88** The Government recognises the social value of memorials as a means of commemoration, especially this year, which marks the sixtieth anniversary of the end of the Second World War. It will therefore seek agreement at European level on a reduced rate of VAT for the construction, renovation and maintenance of memorials. In the meantime, **an interim grant scheme will be introduced to cover the VAT costs incurred by charities in the construction, renovation and maintenance of memorials.** This scheme will apply alongside the existing VAT relief for memorial buildings.
- Listed places of worship** **5.89** The Government is also seeking agreement at European level on a reduced rate of VAT for repairs and maintenance to listed places of worship. **The Government remains committed to this objective and, in the meantime, will extend the period for which funding will be available for the listed places of worship scheme for three years until 2007-08 unless a permanent reduced rate is achieved earlier.**
- Queen Mother memorial** **5.90** HM Queen Elizabeth the Queen Mother passed away in 2002. To create a fitting memorial to celebrate her life and her contribution to the nation the **Government will make available up to £2 million from sales of a commemorative coin to be issued to celebrate HM the Queen's eightieth birthday,** to be allocated in accordance with the wishes of HM the Queen and HRH Prince of Wales.

Volunteering 5.91 Recognising the important role of voluntary action in developing social capital and creating strong and cohesive communities, 2005 is the Year of the Volunteer.³³ Working with Volunteering England and Community Service Volunteers, the Government is leading a programme to celebrate the work volunteers do and encourage more people to volunteer. The Home Office will invest an extra £4.8 million in the Year of the Volunteer to expand Volunteer Centres to increase opportunities for public sector employees to volunteer; raise awareness of volunteering through voluntary sector partners; and support the Volunteer Films unit to promote volunteering in their joint work with the media industry. This brings total Government investment in the Year of the Volunteer to £6.8 million.

Youth volunteering 5.92 The Russell Commission has shown that there is a large number of young people who are prepared to volunteer their time to serve their communities. **In response to the Russell Commission report, the recommendations of which are set out in Box 5.2, the Government is investing up to £100 million over the next three years in a new national framework for youth action and engagement.** This will include a volunteering opportunities fund rising to £40 million by 2007-08. The Government is making this fund available to match contributions from business. The framework will ensure young people have a choice of a range of opportunities from introductory 'tasters' to a more sustained commitment, covering diverse activities in fields such as health, heritage and culture, community safety, sport, conservation and education. The Heritage Lottery Fund has pledged £5 million through their Young Roots programme in 2005-06 and Sport England has pledged £1 million a year from their programme for young people to volunteer in sports activities.

5.93 The private sector will lead the creation of a new body which will be a partnership between the voluntary and community sector, young people and the private sector working with the Government to achieve the shared ambition of a million new young volunteers within five years. Using the latest technologies, the new body will set up a portal to improve information and advice on volunteering, spearheading a step change in choice and quality of opportunities available to young volunteers while ensuring the needs and goals of individual young volunteers are at the heart of what it does. Furthermore, to ensure a greater diversity of young people volunteering, the framework will include a discretionary hardship fund to support full-time volunteering opportunities and the Government will consider extending the same entitlements to full-time volunteers aged 16 to 19 as those in education and training, as outlined earlier in this chapter. The Government will also publish a rulebook to set out existing rules on volunteering and the benefits system; will assess the interaction between volunteering and Housing Benefit within the context of the ongoing programme of reform; and will examine the issue of national insurance credits for volunteering.

³³For more information please see: www.yearofthevolunteer.org

Box 5.2: Achieving a step change in youth action and engagement – the findings of the Russell Commission

The Russell Commission, led by Ian Russell, Chief Executive of Scottish Power, was established by the Chancellor and the Home Secretary in May 2004. Its recommendations are a response to the demand from young people to volunteer in their communities, and to the goodwill that exists in the private and voluntary and community sectors to support volunteering.

Published today, the report of the Russell Commission sets out recommendations for a national framework to deliver a step change in the diversity, quality and quantity of young people's volunteering. The Commission calls for a shared purpose in making the framework happen – the voluntary and community sector, business, government and young people themselves all have an essential part to play. The Commission recommends:

- **an ambition of attracting 1 million more young volunteers** – more than half of 16 to 25 year olds should participate, with significant increases in short-term opportunities and part-time roles, and a high profile national programme of full-time youth volunteering, including a weekly allowance;
- **an implementation body, youth led and independent from government** – to provide an accessible portal for young people to get information and advice about volunteering, and maintain a nationwide database of volunteering opportunities;
- **consistently better quality opportunities** - a kitemark guarantee of standards, with young people able to choose between short-term volunteering (such as taster sessions); part-time volunteering (from a few hours to one or two days per week); and full-time programmes;
- **all young people should have the opportunity to volunteer, regardless of background** – a discretionary fund should be created for young people experiencing hardship who wish to undertake full-time volunteering opportunities, and a rulebook should be published on volunteering and the benefits system;
- **recognition of the positive achievements of young volunteers** – accreditation and links to vocational qualifications to amplify the importance of volunteering to personal and skills development, particularly to educational institutions and employers; and
- **measurable community impact** – volunteering should become a common, fun and popular pursuit for young people, establishing a pattern of lifelong engagement.

Almost 6,000 responses were received to the Commission's consultation and key results were announced as part of the Chancellor and the Home Secretary's Volunteering Conference in January 2005. The full report is available at: www.russellcommission.org.

Mentoring 5.94 The new Mentoring and Befriending Foundation, backed by the Government, will support the growth and development of mentoring and befriending within local communities. The Government will work with the Foundation to identify where mentoring can add most value to service delivery, develop an evidence base on the impact of mentoring and encourage more businesses to get involved in mentoring. New regional organisations, working with Volunteering England, Timebank and local partners will run a targeted campaign in June to encourage more people to become mentors and befrienders.

DELIVERING A MODERN AND FAIR TAX SYSTEM

5.95 A modern and fair tax system encourages work and saving, keeps pace with business practices and the global economy and provides the foundation for building world-class public services. The creation of Her Majesty's Revenue and Customs (HMRC) will introduce greater efficiency, effectiveness and better customer focus into this system. Chapter 3 sets out some of the benefits that the new department will bring to business, consistent with the recommendations of the Hampton Review.

Protecting tax revenues

Improving compliance **5.96** For the tax system to be effective, everyone needs to pay their fair share of taxes and receive the tax credits they are entitled to. Tax avoidance and tax or tax credit fraud undermine the ability of the tax system to deliver its objectives, imposing significant costs on society. The Government has always made clear its determination to ensure that the tax system is fair and is seen to be fair.

5.97 The Government has taken a series of steps to prevent abuse of the tax system. These have included structural reforms that make the system less vulnerable, closing loopholes in the law and improving the way HM Customs and Excise and Inland Revenue deliver their compliance functions. Continued vigilance at both a domestic and international level is essential to ensure that action is taken against those who attempt to gain an unfair advantage by avoiding or evading their obligations.

Tackling avoidance schemes **5.98** In Budget 2004, the Government introduced disclosure rules to tackle tax avoidance schemes for both direct taxes and VAT. These rules allow earlier, targeted action against avoidance schemes. To build on this success, the Government is now expanding the rules to include **stamp duty land tax on commercial property** and **two more listed VAT schemes and an additional VAT hallmark**.

Direct tax compliance measures **5.99** The Government is determined to ensure all employers and employees pay the proper amount of tax and national insurance contributions (NICs). Budget 2005 reiterates the Government's intention, announced alongside the 2004 Pre-Budget Report, to close down the ever more complex and contrived attempts at tax and NICs avoidance. Should further arrangements emerge that frustrate this intention, the Government will legislate to close them down where necessary from 2 December 2004.

5.100 The disclosure rules have revealed a number of areas of the tax system at risk from high levels of tax avoidance. International transactions have emerged as a particular concern, with increasing globalisation presenting new opportunities for those attempting to avoid their obligations. Building on the action taken in the 2004 Pre-Budget Report, the Government is introducing two new anti-avoidance rules which will allow the Inland Revenue to issue a notice to counter a tax advantage in specific circumstances where a UK tax avoidance motive is present. These new measures will tackle **arbitrage, where companies seek to gain a tax advantage by exploiting differences within and between tax codes** and **excessive claims for double taxation relief**.

5.101 The Government is providing additional resources to the Inland Revenue to improve compliance in high-risk areas, and will take action, with immediate effect, to close specific loopholes that are currently being exploited. These measures include:

- **preventing arrangements that enable individuals and trustees to avoid tax on capital gains;**

- preventing avoidance by companies and individuals using financial product based schemes;
- blocking a marketed avoidance scheme for the corporate intangible assets regime; and
- closing loopholes in the stamp duty land tax rules.

Film tax avoidance 5.102 As announced in the 2004 Pre-Budget Report and alongside the film tax reform described in Chapter 3, the Government is legislating in the Finance Bill to close a number of avoidance schemes that exploit the tax reliefs for UK film production.

VAT compliance measures 5.103 The Government is continuing to see the benefits of the VAT compliance strategy launched in April 2003. Further measures announced today include:

- tackling a specific avoidance scheme exploiting Customs warehousing rules;
- measures to address VAT losses from partly exempt businesses in relation to their VAT recovery; and
- extending the unjust enrichment provisions so that no business can unfairly benefit from charging too much VAT.

Tackling tobacco smuggling 5.104 Tobacco smuggling involves serious widespread criminality, and costs over £2.5 billion a year in lost tax revenue. Since the launch of the tobacco strategy in 2000, the illicit cigarette market share has fallen to 15 per cent, down by more than a quarter from its peak.³⁴ The Government will continue to take steps to reduce the smuggled market share still further.

5.105 As part of this effort, the Government will continue to target the increasing numbers of counterfeit cigarettes now being sold by smugglers. More than half of the smuggled cigarettes now being seized are counterfeit, many of which are contaminated with cadmium and arsenic and may pose additional risks to smokers. **The Government is considering further action to tackle the smuggling of hand-rolling tobacco with a view to announcing a package of further measures later in 2005.**

Combating alcohol fraud 5.106 The Government is committed to taking action to tackle alcohol fraud that is both tough and proportionate. The 2004 Pre-Budget Report announced details of the duty stamps scheme to be introduced in 2006. The Government's objective is to tackle spirits fraud while minimising compliance costs. Following close consultation with the industry, the Government has decided:

- that the benefits of duty stamps can be delivered without attaching financial liability to the stamps;
- to provide targeted exemptions from the duty stamps regime for mobile operators and duty-free shops and for spirits of less than 30 per cent alcohol by volume
- not to include a class exemption for liqueurs; and
- to adopt the industry proposal to allow stamps to be incorporated into the bottle labels and to do so in a way that allows them to be printed by the industry's own label printers. Businesses will have the option to use free-standing duty stamps.

³⁴ *Tackling tobacco smuggling*, HM Customs and Excise, March 2000.

5.107 Compliance costs for the industry will be less than the estimates published at the 2004 Pre-Budget Report, without compromising the effectiveness of the scheme which remains central to the strategy for tackling spirits fraud.

Oils fraud 5.108 The UK Oils Fraud Strategy was announced in Budget 2002 and is targeted specifically at the misuse of rebated oils. Oils fraud cost the Exchequer around £850 million in 2003 in Great Britain alone. The strategy is a combination of new regulatory regimes and enhanced law enforcement activity. It is designed to tackle oils fraud by making it harder to commit the crime successfully, increasing the likelihood of getting caught and increasing penalties.

5.109 At the 2004 Pre-Budget Report the Government increased rebated oils duty rates by 1 penny per litre, narrowing the differential in duty rates between these oils and main road fuels. This helped to reduce incentives for fraud as even a small narrowing can dent fraudsters' profits significantly. As described in Chapter 7, to further support this strategy, and to maintain the differential with main fuel duties, **the Government today announces an increase in duty of 1.22 pence for rebated oils**, to take effect from 1 September 2005.

Modernising information powers 5.110 The Government will shortly begin consulting on the powers that will be available to the new tax department and the appeal rights and other safeguards for taxpayers. This will be a key element in creating a modern organisation with modern tools. The aim will be to provide a framework of law and practices that supports the Government's objectives of a tax system that is fair and better adapted to the needs of customers. The consultation will consider the scope for aligning and rationalising the different powers that currently apply to different taxes to make it easier for taxpayers to comply; and how best to obtain the information needed for better risk assessment and better targeted compliance activities. A key aspect of this process will be a consultative committee to ensure its outcomes fully reflect the priorities of a wide range of stakeholders.

Protecting the UK tax base 5.111 The Government is determined to continue to defend robustly the corporation tax system against legal challenges under EU law. The Government will continue to monitor the impact of international accounting standards on the corporation tax base.

Modernising the tax system

Stamp duty land tax thresholds 5.112 Budget 2003 set out details of a major reform of stamp duty on property to modernise administration and enforcement and remove distortions. To reduce the number of first-time and low-income house buyers paying stamp duty land tax and to improve the efficiency of the housing market, **the Government will double the zero-rate threshold to £120,000 for all residential property transactions with effect from 17 March 2005**. This puts the threshold above the £115,000 median price paid by first-time buyers and will exempt an extra 300,000 home buyers from stamp duty every year. To increase home ownership in deprived areas, the threshold in the 2,000 Enterprise Areas will remain at the higher level of £150,000. As a result, 650,000 residential property transactions will be exempt from stamp duty each year. Over 50 per cent of first-time buyers and 47 per cent of all residential buyers will not now pay stamp duty land tax.

Inheritance tax 5.113 To provide a fair and targeted inheritance tax system, with certainty for families, **the Government will increase the threshold by more than the statutory indexation in each of the next three years to £275,000 in 2005-06, £285,000 in 2006-07 and £300,000 in 2007-08**.

- Capital gains tax** **5.II4** The Government is indexing the capital gains tax annual exempt amount in line with prices. It will therefore increase to £8,500. Gains arising on disposal of a principal private residence will continue to be exempt from capital gains tax.
- Modernising the tax system for trusts** **5.II5** The Government has consulted widely on the modernisation proposals in *Modernising the tax system for trusts* and continues to work with the industry to secure consensus on the best way to simplify trusts taxation further to help people manage their affairs, whilst ensuring that trusts are not used to achieve an unfair tax advantage.³⁵ The Government will fulfil commitments made in Budget 2004 by introducing:
- **new rules so that tax for certain trusts with vulnerable beneficiaries is charged as if the vulnerable person were receiving the income and gains directly. This will apply from 6 April 2004; and**
 - **a standard rate band of £500 which will mean that 25,000 trustees that consistently receive taxed income under this amount will no longer have to submit a self-assessment tax return every year. This will apply from 6 April 2005.**
- Residence and domicile** **5.II6** The Government is continuing to review the residence and domicile rules as they affect the taxation of individuals and will proceed on the basis of evidence and in keeping with its principles. It would welcome further contributions to the debate, which will then be taken forward by the publication of a consultation paper setting out possible approaches to reform.
- Shari'a compliant financial products** **5.II7** The Government is committed to fair tax treatment for Shari'a compliant financial products. Following consultation announced in the 2004 Pre-Budget Report, **legislation will be included in the Finance Bill to amend the tax rules so that the mark-up on a Murabaha transaction and the profit-share on a Mudaraba arrangement are taxed on a level playing field with equivalent banking products.** Stamp duty land tax reliefs for Islamic house purchase schemes will be extended to include a new Shari'a compliant product.
- Stamp duty intermediary relief** **5.II8** **Legislation will be introduced to enable the Government to designate new forms of multilateral trading facilities as 'recognised exchanges'.** This will enable intermediaries operating through those facilities to continue to qualify for intermediary relief. This will give operators more flexibility and will support competition.
- Small businesses** **5.II9** The Government believes that small businesses' decisions on which legal form to use should be made for commercial reasons. *Small companies, the self-employed and the tax system* began a dialogue with small firms and their advisers on the strategic issues associated with these decisions. Final responses are welcome by 29 April 2005.³⁶
- Construction industry** **5.II20** There are also issues with legal forms in the construction industry which means there is no clear dividing line between employment and self-employment. The Government is presently discussing with the industry a range of practical options to help clarify this dividing line, and so reduce tax avoidance and resolve any employment rights issues.
- North Sea corporation tax: aligning payments more closely with PRT** **5.II21** To bring the corporation tax payment profile for companies operating within the North Sea ring-fence more into line with the profile for payments of petroleum revenue tax, **the payment dates for instalments of North Sea corporation tax for these companies will be amended so that the bulk of tax is paid within an accounting period or soon after the end of each period.**

³⁵ *Modernising the tax system for trusts*, Inland Revenue, August 2004.

³⁶ *Small companies, the self-employed and the tax system: a discussion paper*, HM Treasury, December 2004.

Tobacco duties 5.122 Smoking remains the greatest cause of preventable illness and premature death in the UK. Maintaining high levels of tax helps to reduce overall tobacco consumption. **Budget 2005 therefore announces that from 6pm on Budget day tobacco duties will increase in line with inflation, adding 7 pence to the price of a packet of cigarettes.**

Alcohol duties 5.123 The Government is committed to creating a fairer balance of taxation falling on different alcoholic drinks. Budget 2004 announced a spirits duty freeze for the remainder of this Parliament. This means spirits duty has now been frozen for 8 successive Budgets so that by 2005-06 the total tax on a standard bottle will be £1.32 lower than if duty had risen in line with inflation since 1997. In addition, Budget 2005 announces from midnight on 20 March 2005 the following duty changes:

- **duties on beer and wine will increase in line with inflation, adding 1 penny to a pint of beer and 4 pence to a standard 75cl bottle of wine; and**
- **duties on cider and sparkling wine will be frozen.**

Travellers' allowances 5.124 The Government supports the freedom to shop across international borders and is against excessive restrictions being applied to travellers who bring goods into the country for their own use. Travellers may currently bring goods (excluding wine, spirits, tobacco and perfume) up to a total value of £145 from outside the EU into the UK, without being required to pay tax or duty on arrival. This limit is set in EU law and would require unanimous agreement among Member States in order to be changed. The travellers' allowance was last revised by the EU in 1994 and is now out-of-date. The Government believes that the £145 limit should be raised significantly, **and has proposed to the European Commission and other Member States that it now be set at £1,000.**

TACKLING GLOBAL POVERTY

5.125 The UK is committed to eliminating global poverty in the long-term and achieving the internationally agreed Millennium Development Goals (MDGs), which include halving poverty, combating diseases and achieving primary education for every child by 2015. The UN has warned that, although progress is being made globally on reducing poverty, most developing countries are not expected to meet more than three of the seven MDGs by 2015. 2005 is the target year for the first MDG of eliminating gender disparity in primary and secondary education, but this target will be missed.

Priorities for 2005 5.126 2005 represents a unique opportunity for the UK to drive the international development agenda. Box 5.3 sets out the key opportunities for the UK to pursue this agenda. The UK will use its presidencies of the G7/G8 and the EU in the second half of the year to press for real action on aid, trade, debt relief, governance and peace and security for all developing countries, with action on Africa based on the Report of the Commission for Africa:

- more and better aid, with more countries declaring a timetable towards 0.7 per cent of Gross National Income (GNI) in overseas development assistance, a new International Finance Facility (IFF) and consideration of international taxation proposals as possible sources of financing for development;
- deeper and broader debt relief, matching 100 per cent bilateral debt relief with 100 per cent multilateral debt relief; and
- an ambitious outcome to the Doha round of trade negotiations that delivers substantial benefits to poor countries, and allows them to carefully design and sequence their trade policy reforms to take account of broader development and poverty reduction objectives and not be forced to liberalise as a result of external pressure. It will be important to help developing countries build up

the capacity they need to trade, including more funds for infrastructure, so that as rich countries open up markets, developing countries can take advantage of new opportunities.

Box 5.3: 2005 - Key events for international development.

February – G7 Finance Ministers held their first meeting under the UK Presidency in London. They agreed a series of progressive ‘conclusions on development,’ reaffirming their commitment to help developing countries achieve the MDGs and setting out the steps they plan to take:

- to provide on a case by case basis as much as 100 per cent multilateral debt relief for heavily indebted poor countries;
- a work programme on the IFF and other financing measures for decisions at the G8 Summit in Gleneagles;
- to improve the effectiveness of aid by harmonising operational procedures and aligning aid behind country-owned priorities;
- to ensure that the Doha Round of trade negotiations delivers substantial benefits to developing countries and to ask the IFIs to develop proposals to ease adjustment in these economies, consistent with debt sustainability and country-owned development strategies; and
- a reaffirmed commitment to the Global HIV Vaccine Enterprise to coordinate research on an HIV vaccine; to consider how to increase public research; and to explore the use of advance purchase commitments to drive private sector investment.

The UK Government will press for further action to tackle global poverty at the remaining key events this year:

April – The G7 Finance Ministers will meet for the second time under the UK’s presidency. The Spring meetings of the IMF and World Bank will also take place in April.

June – The G8 Finance Ministers pre-summit meeting will be held in advance of Gleneagles.

July – The G8 Summit in Gleneagles and the EU Finance Ministers meeting on development will take place. July also marks the start of the UK’s Presidency of the EU.

September – The UN Millennium Declaration Review Summit. The summit will be an opportunity for the world to take stock of the scale of the effort that is needed if the MDGs are to be achieved. Also taking place in September: the third G7 Finance Ministers meeting under the UK’s presidency and the annual meetings of the IMF and World Bank.

December – WTO trade negotiations in Hong Kong and the end of the UK Presidency of the G7/8 and EU.

Africa 5.127 On current trends, Sub-Saharan Africa will not meet any of the MDGs by 2015. Therefore, Africa is one of the Government’s two priorities for its G8 presidency this year, along with climate change. The Commission for Africa was established by the Prime Minister in February last year to determine which policies have been effective and where more can be done to support Africa’s development. The final report, summarised in Box 5.4, was published on 11 March 2005. The report of the Commission for Africa sets out a comprehensive plan of action for the African continent. It demonstrates that with bold concerted action Africa can be set back on track to meet the MDGs. The report contains detailed recommendations for African countries, individual donors, and for the international community. **The Government accepts the detailed recommendations of the Commission for Africa and will work through the UK’s G8 and EU presidencies to secure their implementation.**

Box 5.4: The Commission for Africa

The Commission for Africa published its findings in March 2005. Commissioners from across Africa and the world are saying that a comprehensive package of action is required if Africa is to meet the MDGs by 2015. The Commission for Africa's recommendations are informed by the work of the African Union and the New Partnership for Africa's Development. The key recommendations are:

- **finance** – an immediate doubling of aid to Africa raised through the International Finance Facility (IFF) providing \$25 billion per annum immediately and increasing as rich countries make progress towards spending 0.7 per cent of their annual income on aid. This will provide a substantial increase in resource flows to education, infrastructure and health for the most vulnerable, with strategies for delivery and monitoring, including a global agreement on tackling HIV/AIDs;
- **trade** – improving Africa's capacity to trade, improving access to markets and transitional support from developed countries to help Africa respond to new trade regimes, and ensuring that the EU's Economic Partnership Agreements (EPAs) contributes to growth, poverty reduction and regional integration in poor countries – Africa, the Caribbean and Pacific;
- **debt** – 100 per cent multilateral debt relief for low-income countries and a new compact on debt relief to provide up to 100 per cent cancellation of debt service and debt stock on bilateral and multilateral debt for all low-income countries in Africa;
- **governance** – investment in capacity building, increased accountability and transparency and a call for renewed political will from African governments in tackling corruption; and stronger measures on the repatriation of Africa's stolen assets and on the transparency of payments in natural resource and other industries and greater transparency in export credit industries; and
- **peace and security** – building capacity to prevent and resolve conflict, improved co-ordination of post-conflict peacebuilding and making aid more effective at reducing conflict.

Aid 5.128 The UK has set a timetable for achieving the UN target for overseas aid of 0.7 per cent of Gross National Investment (GNI). The 2004 Spending Review announced that by 2007-8, total UK aid will rise to nearly £6.5 billion a year, representing 0.47 per cent of GNI, a real terms increase of 140 per cent since 1997. The Government aims to sustain the rate of growth it achieves in 2007-8, which would mean that total UK overseas development assistance would reach 0.7 per cent of GNI by 2013. If the proposal for the IFF is agreed, the equivalent of 0.7 per cent of GNI could be achieved in 2008-9.

5.129 Increasing the volume of aid is vital to achieving the MDGs, but action is also needed to ensure that international aid is provided in the most effective way. The UK will continue to work with other donors to encourage long-term and predictable aid which is: targeted to the poorest countries; harmonised around country-owned poverty reduction strategies; delivered in a way which imposes the minimum burden on developing country systems; and is untied. The UK has also set out a new approach to aid conditionality.³⁷ While it is important to ensure aid is used for its intended purpose and not lost to corruption, the Government aims to support poor countries in the policy choices that they make themselves.

³⁷ *Partnerships for Poverty Reduction: Rethinking Conditionality*, UK Policy Paper, March 2005.

Box 5.5: IFF and IFFIm

It is estimated that an additional \$50 billion per year is needed ahead of 2015 if the MDGs are to be met. The International Finance Facility (IFF) would frontload donors' existing long-term aid commitments through bond issuances on the international markets to deliver immediately the additional, predictable funding needed to achieve the MDGs. With the IFF, the UK could reach the equivalent of 0.7 per cent as early as 2008-09.

The IMF and World Bank have confirmed that the IFF is the most advanced proposal for raising additional development finance and that it is technically feasible. The IFF now has the support of almost fifty countries.

As the first step, the UK, together with France and Sweden, is finalising a \$4 billion IFF for immunisation (IFFIm), which could save the lives of 5 million children ahead of 2015 and a further 5 million lives after 2015. This would make a substantial contribution to the MDGs and demonstrate the significant benefits of frontloading resources. The UK has proposed to provide one-third of the resources required, and it is expected that the IFFIm will be launched in the first half of 2005.

International taxation proposals are complementary to both the IFF and the IFFIm, and the UK is considering these proposals in further detail and will be working with others to take forward technical discussions.

Tsunami 5.130 The UK responded to the devastating impact of the tsunami in the Indian Ocean with £75 million towards the emergency humanitarian relief effort. The G7, chaired by the UK, agreed in February to defer debt payments during 2005 for tsunami affected countries which request it. Indonesia and Sri Lanka requested such a moratorium, which was agreed by the Paris Club group of creditor countries on 10 March 2005. The Government recognises the need for coordinated long-term reconstruction and will consider additional contributions to the international reconstruction effort once the IMF/World Bank needs assessments have been finalised with affected countries.

Debt relief 5.131 The experience of the last five years of the Heavily Indebted Poor Countries (HIPC) Initiative has shown that debt relief can be an extremely effective tool in support of poverty reduction. The debt burden of the world's poorest countries is being reduced by some US\$70 billion dollars over time, allowing the savings from debt relief to fund country-owned strategies aimed at reducing poverty. Poverty reducing expenditures in HIPCs have on average increased from 6.4 percent of GDP in 1999 to 7.9 percent of GDP in 2003, a level about three times that spent on debt service.³⁸ For example, debt relief has helped Tanzania increase the number of children in primary schools by over 50 per cent and build 1,000 new schools.

³⁸ *Heavily Indebted Poor Countries (HIPC) Initiative: Status of Implementation*, IMF and World Bank, August 2004.

5.132 However, the achievements of the HIPC Initiative must be set against the greater challenges that remain. The UK announced in September 2004 that it will pay its share of the debt service from eligible countries to the World Bank and African Development Bank's concessional financing arms on behalf of eligible countries until 2015. The Secretary of State for International Development has now signed and funded debt relief agreements with 14 countries. The UK has started paying service relief on its share (10 per cent) of World Bank and African Development Bank debt for the eligible countries. This will free up \$49 million of additional resources for poverty reducing expenditure such as on health and education, in 2005. Canada has joined this initiative, which if fully financed will provide up to \$20 billion of additional financing over the next ten years. The UK is urging G7 and other partners to provide additional resources to finance World Bank and African Development Bank debt relief. The Government continues to call for a revaluation or off-market sale of further IMF gold to fund the IMF's share of further multilateral debt relief.

Trade 5.133 International trade is key to economic growth and poverty reduction. However, in addition to market access for developing countries, more needs to be done to help poor countries build up the capacity to trade. It is also important that developing countries have the policy space to carefully design and sequence trade policy reform to fit in with their broader objectives on development and poverty reduction and are not forced to liberalise through external pressure. The UK believes that the current round of trade negotiations, the Doha Development Agenda, must deliver substantial benefits for poor countries. Agreement must be reached to phase out agricultural protectionism in developed countries, including Europe's Common Agricultural Policy, and improve preference schemes including through reforming rules of origin so that poor countries can maximise their opportunities for improved access to developed market countries, not just in theory but in reality. At the same time, it is important to ensure that product standards, tariff peaks and tariff escalation do not act as barriers to developing country exports.

5.134 The role of aid will be key in helping developing countries realise the benefits of trade. They often lack the basic building blocks to enable growth, trade and private investment such as a healthy and well-skilled population, electricity, transport and communications, as well as the institutions that are needed to manage trade and economic growth. The Commission for Africa has recommended that increasing economic growth in Africa requires scaling up investment in infrastructure, support for local enterprise, and a stronger role for the business community. The UK believes that developed countries must stand ready, through increased aid, to help countries put in place these building blocks for growth, as well as assist with the costs associated with the transition to more open markets. This will be a key priority for additional aid targeted for agreement in 2005.

Health 5.135 The health MDGs on infant mortality, maternal mortality, HIV and AIDS and Malaria are unlikely to be met, especially in many Sub-Saharan African countries. Good health is vital to achieving other MDGs, for example on primary education and to enable a robust economy that is capable of sustaining growth. Underlying this is the need to support the development of health systems that are responsive to the needs of poor people, particularly women and young people, as well as tackling diseases that have a disproportionate impact on poor people. This requires allocations to health systems from within national budgets, supplemented by predictable donor flows.

5.136 Malaria kills one million people a year and AIDS kills three million a year, with significant impacts on the economy and service delivery in developing countries. The UK believes a three-step approach is needed to develop vaccines for malaria and HIV. First, research needs to be coordinated better. Second, publicly funded research needs to increase. This will be an early priority for spending through the IFF as an example of an area where the returns to investment are potentially very high. Third, the UK is already working with international partners to enter into contracts to buy a fixed quantity of vaccines at an agreed

price. Such advance purchase agreements, which are only binding if the vaccines are successfully developed, will encourage pharmaceutical companies to invest in research with confidence that there will be a market for their products and can ensure that the vaccines will be affordable.

Peacekeeping 5.137 The Government will continue to support African-led peacekeeping operations, especially efforts to end the current conflict in Darfur, where the UK has provided more than £14 million to the African Union force. Since September 2003, the Government has committed £62.5 million in humanitarian assistance in response to the crisis in Darfur. Outside Darfur, the UK is supporting humanitarian efforts across Sudan, as well as building up a development programme, in conjunction with other donors. Current plans focus on delivery of basic services at the local level, rule of law and access to justice, and reform of the security sector. The Government is leading a group to ensure Sudan's debt is lifted, once progress has been made to end the conflict in Darfur.

Support for reconstruction of Iraq 5.138 The UK continues to work alongside its international partners to support the reconstruction of Iraq. In this context, the UK supported the agreement in September 2004 of a \$436 million IMF Emergency Post-Conflict Assistance programme for Iraq. The UK's objective of a fair and sustainable solution to Iraq's external debt problems was achieved in November 2004, when the Paris Club of creditor countries agreed to forgive 80 per cent of Iraq's external debts. The debt reduction will be implemented in stages linked to progress in delivering the economic reforms Iraq agrees with the IMF. The UK's share of this debt relief, once fully implemented, will amount to approximately £960 million. The UK is working to strengthen the capacity of Iraqi government institutions, including fiscal and economic policy-making capacity within the Ministry of Finance.

6

DELIVERING HIGH QUALITY PUBLIC SERVICES

The Government's aim is to deliver world-class public services through sustained investment and ongoing reform. The 2004 Spending Review set outcome-focused targets and spending plans to 2007-08 that locked in the increased resources delivered in previous spending reviews. It agreed efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line services.

Budget 2005 sets out a long-term investment programme for education. To ensure that rising educational standards are locked in and to address future challenges, the Budget announces:

- a long-term programme of investment rising by an additional £500 million in 2009-10 to deliver twenty-first century facilities in primary schools, rebuilding or radically refurbishing more than 50 per cent over around 15 years;
- increases in direct payments to headteachers of £100 million and £150 million in 2006-07 and 2007-08 to help schools deliver extended services;
- £50 million over 2006-07 and 2007-08 to support ICT in schools to help the most disadvantaged pupils;
- an additional £350 million of capital investment over 2008-09 to 2009-10 to support the transformation of the further education sector; and
- pilot programmes to ensure that every 16 to 18 year old has access to education and training.

The Government is taking its agenda for public service reform further, and announces proposals to rationalise the inspection and regulation of public services, building on the approach of the Hampton Review discussed in Chapter 3. The Government will merge the eleven main public service inspectorates currently operating into four bodies, reducing costs and the burden on front-line public services, while safeguarding the interests of public service users.

The Budget also provides an additional £340 million for the special reserve in 2004-05 and £400 million in 2005-06 for military operations in Iraq and the UK's other international obligations.

6.1 The Government's goal is to deliver world-class public services – including high quality education and training, a modern and reliable transport network, a modern criminal justice system and an effective health service – through sustained investment and reform. World-class public services are central to delivering the Government's objective of building a flexible economy and a fair society, which is well placed to prosper in the increasingly competitive global economy.

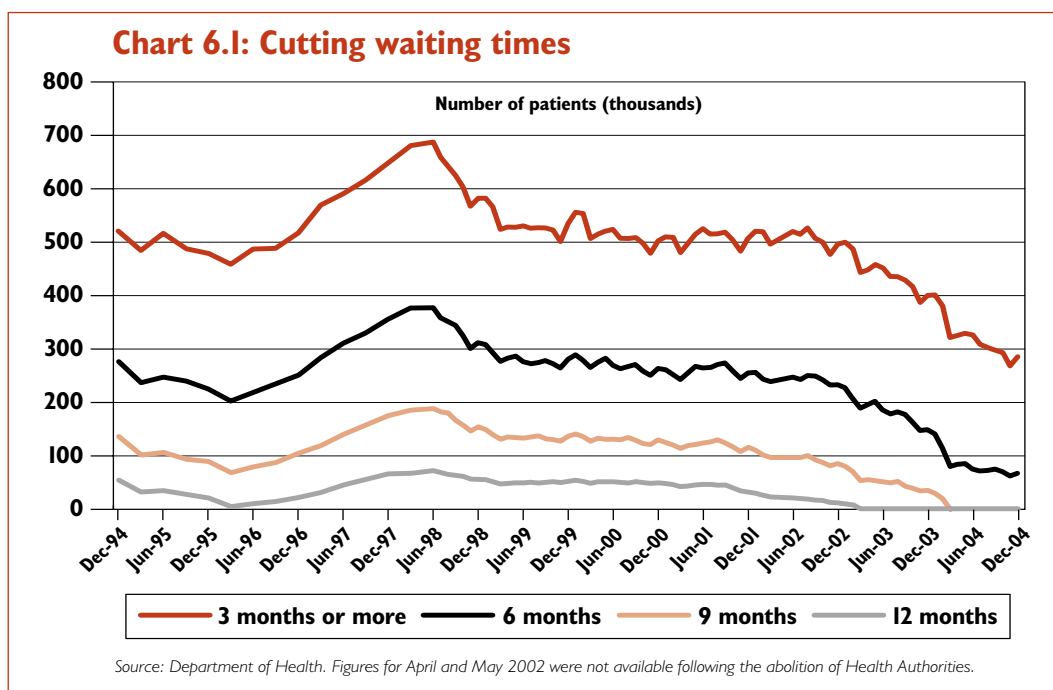
6.2 The Government has established an ambitious programme to improve public services. Its objectives are to:

- *improve outcomes*, including achieving higher standards, reduced inequalities and greater user satisfaction, by delivering excellent, equitable and more personalised public services;
- *ensure value for money*, to fulfil the Government's obligation to taxpayers and service users to employ resources efficiently and effectively; and
- *strengthen accountability*, by ensuring that those delivering public services are responsive to the needs and preferences of the individuals and communities they serve.

Improvements in public services

6.3 Significant progress is being made toward achieving these objectives for public service delivery. Recent years have seen improvements in the outputs and outcomes being delivered by public services, and in particular in the Government's key priorities:

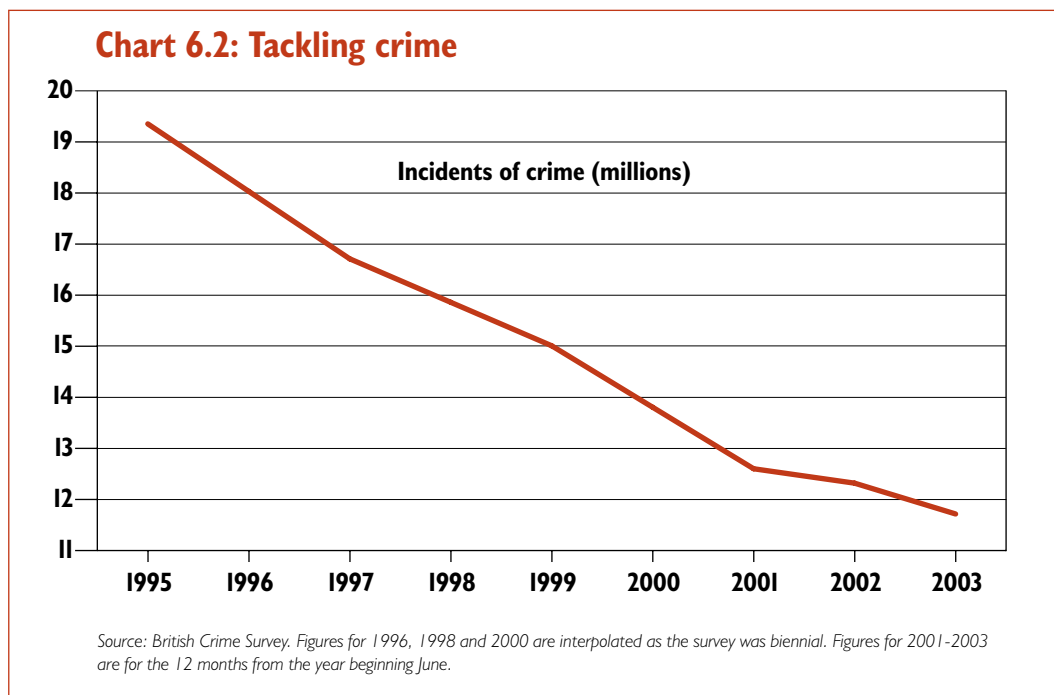
- *in health* increased resources have led to 200,000 fewer patients waiting for treatment than 10 years ago. Maximum waiting times for an operation halved from 18 months in 1997 to nine months in April 2004, and at the same time health outcomes have improved, with premature deaths from heart disease and cancer reduced by 27 per cent and 12 per cent respectively, building on earlier improving trends;
- *in education* there have been consistent improvements in attainment at all levels. The 2004 GCSE results showed that the fastest improvements are being made in areas of significant deprivation and historic low achievement. Progress is also being made towards closing gaps in attainment between different groups – Pakistani, Bangladeshi, and black pupils made the greatest progress in GCSE results last year; and
- *in criminal justice*. Crime, measured by the British Crime Survey, rose substantially in the 1980s and early 1990s and peaked in 1995 with over 19 million incidents. In 1997 there were almost 17 million incidents. By 2003-04 overall crime had fallen by a further 30 per cent, and the most recent data shows continued falls. The risk of being a victim of crime is now the lowest recorded by the British Crime Survey since it began in 1981.



A strategy of investment and reform

6.4 The Government aims to build on these successes. To help deliver its objectives, the Government will continue to take forward a public service strategy based on:

- *investing in public services*, with stable public finances and a reformed fiscal and budgetary framework as the basis for sustained increases in resources and investment in public assets; and
- *reforming public services*, securing efficiency improvements in the way they are delivered, setting clear goals and establishing national standards for performance, implementing devolved decision-making to increase front line operational freedoms and local accountability, and increasing personalisation and a focus on users.



Investing in education and skills

6.5 Education and skills are key to the Government's ambition of creating a flexible, skilled, enterprising and innovative economy. They provide security and opportunity for individuals, enhance personal fulfilment and enable people to contribute better to their communities. Prudent management of the economy and the public finances within a strict fiscal framework has allowed the Government to deliver significant increases in investment in its priorities, including education. The Budget sets out a programme of long-term investment in schools and colleges, and measures to enhance the development of skills, to ensure that everyone has the chance to make the most of their talents.

DELIVERING RESOURCES TO THE FRONT LINE

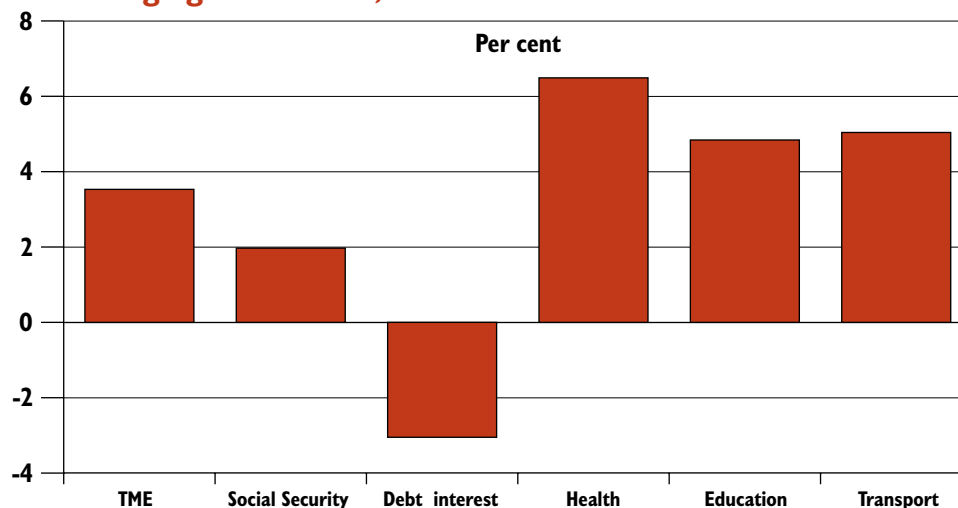
6.6 The Government has introduced a new public spending framework to ensure stable public finances can support continued investment and the right incentives are in place to deliver value for money. The Government's fiscal rules, described fully in Chapter 2, are the basis of this framework, and underlie a budgeting regime which removes past disincentives to investment and supports the prudent and efficient planning of expenditure over the medium term. Large, potentially volatile, and demand-led expenditure items are classed as Annually Managed Expenditure (AME) and subject to tough scrutiny twice a year as part of the Budget and Pre-Budget Report process. Departments are allocated firm three-year Departmental Expenditure Limits (DELs), separated into resource and capital to remove the previous bias against investment. The provision of End Year Flexibility (EYF) allows departments to carry forward unspent resources for use in future years, helping to avoid wasteful end-year spending surges.

Resources for priorities

6.7 Prudent management of the economy and the public finances within a reformed fiscal and budgetary framework has allowed the Government to deliver significant increases in investment in priorities. These increases in provision are affordable within the fiscal rules, as low debt and debt interest payments and the containment of growth in social security payments have freed up resources to be allocated to front-line public services. Chart 6.3 illustrates this, showing real growth in total spending and in spending on health, education, transport, social security payments and debt interest since 1997. By the end of the 2004 Spending Review period, compared with 1997:

- public spending on the National Health Service (NHS) will be around 90 per cent higher in real terms;
- total spending on schools will be around 60 per cent higher in real terms; and
- the share of social security and debt interest in total spending will have fallen by 8.1 percentage points.

Chart 6.3: Releasing resources for priorities – real annual average growth rates, 1997-98 to 2007-08



Source: HM Treasury.

Public infrastructure

6.8 As part of improving outcomes from public services, the Government has sought to address the legacy of under-investment in public service assets. In the 1990s, net investment in the public sector asset base fell from a high of 2.0 per cent of GDP in 1992-93 to 0.5 per cent in 1999-2000. Since then it has increased steadily, and is set to reach 2 $\frac{1}{4}$ per cent of GDP by 2007-08. This increased Government investment is delivering improved buildings and equipment. In health, this includes 49 new hospitals which have been built and are operational since 1997, with another 33 developments under construction. New and replacement equipment for the NHS since April 2000 includes 90 linear accelerators, 184 CT scanners, 87 MRI scanners and 730 items of breast screening equipment. In schools, the Government has made a long-term commitment to provide twenty-first century facilities for all secondary pupils through Building Schools for the Future.

2004 Spending Review

6.9 Building on these increases in resources, the 2004 Spending Review provided for:

- current spending to grow by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;
- public sector net investment to grow to 2 $\frac{1}{4}$ per cent of GDP in 2007-08; and
- agreed efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line services.

Special reserve

6.10 In the 2004 Pre-Budget Report, the Government continued to make prudent provision for the costs of the military conflict in Iraq and its other international obligations, adding £520 million to the special reserve for 2004-05. **In this Budget, the Government provides a further £340 million for the special reserve in 2004-05 and £400 million for the special reserve in 2005-06.** Costs and provision will be reviewed again in time for the 2005 Pre-Budget Report.

Asset management **6.11** Alongside its major capital investment programme, the Government is putting in place a framework for taking forward better asset management across the whole of the public sector, ensuring the most effective management of renewed public sector infrastructure. Following the guidance provided in Sir Michael Lyons' report *Towards Better Management of Public Sector Assets*,¹ all departments have been asked to develop asset management strategies that are driven by their business plans, are the responsibility of finance directors, and are considered and approved at board level. Departments will ensure that there are sufficient incentives at business unit level to manage and, where they are no longer necessary for business planning, to dispose of assets.

6.12 The Government has set an objective of £30 billion of asset disposals by 2010, described as realistic but challenging by Sir Michael Lyons. Good early progress is already planned for the 2004 Spending Review period, with estimated local government asset disposals of about £12 billion by March 2008. In addition, central government departments have already identified asset disposals of some £2 billion in the same period, and improved asset management and planning will release further resources during the 2004 Spending Review and beyond. The Government is considering what further steps to take in implementing Sir Michael Lyons' recommendations.

REFORMING PUBLIC SERVICES

Programme of reform **6.13** The Government's public service reform programme, which is designed to help achieve the Government's objectives for public services, is based on four main elements:

- *setting clear goals and establishing national standards*, through the Public Service Agreement (PSA) framework, and improved inspection, regulation and information to drive up standards and increase accountability;
- *implementing devolved decision-making*, by increasing front-line operational freedoms and local accountability to deliver more responsive services, including through local government reform and provision of more autonomy to police and schools;
- *increasing personalisation* to deliver user-focused services. This includes providing greater choice in the services available and more opportunities for users to participate in their design, delivery and governance, equipping public service professionals to deliver more personalised services, and drawing on the voluntary and community sector's expertise in meeting diverse user needs; and
- *securing efficiency improvements* in the way public services are delivered, through progress in implementing the 2004 Spending Review efficiency targets.

Efficiency

6.14 Building on the Government's existing value for money targets, the 2004 Spending Review set stretching new efficiency targets across the public sector, in the light of Sir Peter Gershon's July 2004 review, *Releasing Resources for the Front Line*. The Government is ahead of schedule in meeting these targets. Against a total target of £20 billion annual efficiency gains by 2008, £2 billion of savings have already been made – even before the programme gets

¹ *Toward Better Management of Public Sector Assets*, Sir Michael Lyons, December 2004.

fully underway in April 2005. These savings are additional to the £2 billion of savings against current value for money targets announced in the Pre-Budget Report. Detailed examples are in Box 6.1.

Workforce and relocation 6.15 The Government is making good progress towards its planned gross reduction of 84,000 civil service posts by 2008. Reductions in posts will total over 12,500 by the end of 2004-05, about 3,500 more than the expected number of 9,000 announced at the 2004 Pre-Budget Report. These include:

- another 2,250 reductions from the Department of Work and Pensions (DWP) in addition to its 2004 Pre-Budget Report announcement;
- more than 400 additional posts from the Inland Revenue and HM Customs and Excise bringing their total reduction by the end of 2004-05 to around 1,250;
- the Department of the Environment, Food and Rural Affairs (Defra) is delivering more than 200 further reductions in addition to their forecast of 120 at the Pre-Budget Report; and
- as a result of early delivery against its target, the Department of Trade and Industry (DTI) will have achieved a total reduction by the end of 2004-05 of 560 posts.

6.16 The 2004 Spending Review established a target of 20,000 relocations of civil service posts out of London and the South East by 2010. The 2004 Pre-Budget Report set out the Government's aim to relocate 10,000 of those posts by the end of 2008 and the delivery of the first 4,000 by the end of 2004-05. The Budget announces that over 4,300 posts overall will already have been moved out of London and the South East by the end of 2004-05 and that Departments have agreed relocation plans for a further 3,500 posts, meaning that over 7,800 relocations have already been confirmed. In particular:

- the Department of Health (DoH) is relocating 500 posts, with at least 300 going to Yorkshire;
- the Department of Culture, Media and Sport (DCMS) is relocating 600 posts, including 200 for the Gambling Commission to Birmingham and 200 from the Big Lottery Fund going to Newcastle and Birmingham;
- Defra is moving over 300 posts, the majority of which are expected to be to Yorkshire; and
- the Foreign and Commonwealth Office is moving 450 posts to Milton Keynes.

Sickness absence 6.17 The Health, Safety and Productivity Ministerial Task Force has drawn up a detailed plan to deliver a 30 per cent reduction in sickness absence across the public sector, drawing on the experience of the Health and Safety Executive. This includes a number of initiatives which will be piloted in the civil service, including greater use of occupational health services, systematic checks for persistent short-term absence and tougher sanctions for those deemed to be abusing the system. Permanent Secretaries will report on the absence records of their departments as part of their performance partnership agreements with the Cabinet Secretary.

Box 6.1: Departmental progress on efficiency

The **Home Office** has made £600 million of efficiency gains during 2004-05. These include savings from better use of police time, smarter procurement and greater collaboration between police forces, improvements in the **National Offender Management Service**, and a substantial reduction in the cost of asylum. **Her Majesty's Courts Service** will be operational from April 2005, meaning that for the first time all magistrates, Crown, and County courts will operate together creating a more effective organisation which will deliver £14 million of efficiencies in 2005-06.

The **NHS** has negotiated a better deal for licensing of its desktop products, saving £112 million over the next three years and in excess of £330 million over the length of the contract. **DoH** has signed a joint venture to use centralised corporate service centres, saving over £220 million over the next ten years.

The **Ministry of Defence (MoD)** has already achieved £300 million of efficiency gains through improved defence logistics in the first year of its transformation programme. **Whole Fleet Management** will deliver over £17 million of efficiency gains in 2004-05, primarily through a reduction in stocks and spares as a result of the introduction of a new asset management system. The **MoD's Procurement Reform Programme** is delivering £30 million of efficiency gains in 2004-05 on items such as IT, general stores, and vehicle, ship and aircraft spares repair.

DWP is paying the benefits and pensions of 90 per cent of its customers directly into their bank accounts. The move to direct payment will save the taxpayer in excess of £1 billion over the next five years.

The **Office of the Deputy Prime Minister (ODPM)** will deliver efficiency gains of £274 million in social housing in 2005-06. The gains will be delivered in four areas: new supply, capital works, commodity procurement and management and maintenance. Money saved will be used to provide more social housing and ensure higher standards throughout the sector. **Fire and Rescue Authorities** will benefit from £105 million efficiency gains by 2007-08. For example, by April 2005 all authorities will have introduced **Integrated Risk Management Planning** action plans, providing greater flexibility and more productive use of time and resources. These plans are aimed at saving more lives by re-investing efficiency savings. **Local authorities** have reported efficiency gains in 2004-05 of £123 million.

In 2004-05, **Defra** made efficiency gains of £41 million. This includes better contract management, procurement and corporate services in the **Environment Agency**; improved e-transactions in the **Rural Payments Agency**; and efficiencies resulting from the reorganisation of the **Rural Development Service**.

The **Department for Education and Skills (DfES)**, through its lead agency for information and communication technology (ICT), has negotiated a software licensing deal which will deliver £50 million of efficiency gains over the next three years. Framework contracts have led to greater price visibility and competition, bringing down prices and saving schools and **Local Education Authorities (LEAs)** £14 million in 2004-05 on laptops and interactive whiteboards.

Through smarter procurement **Inland Revenue** and **HM Customs and Excise** have delivered efficiency gains of £12.7 million in 2004-05. **Transport for London** will deliver £107 million of efficiency gains in 2004-05 from better procurement, improved communications infrastructure and shared services in finance and human resources.

Atkinson Review 6.18 Robust, independent National Accounts measures of government output and productivity are important both as a major component of GDP and for assessing the performance of public services. They complement more disaggregated and wide ranging performance measures, such as those used to assess progress against efficiency and PSA targets. In December 2003, Sir Tony Atkinson was asked by the National Statistician to conduct an independent review of the measurement of government output and productivity for the National Accounts. Sir Tony Atkinson's final report was published at the end of January this year.

6.19 The National Statistician has broadly welcomed the report, and has announced he is setting up a new UK Centre for the Measurement of Government Activity, within the Office for National Statistics (ONS), to carry out this work. The Government fully supports the work of the Atkinson Review. The initial work enabled the ONS to publish new health output data in the National Accounts Blue Book in June 2004 and an article examining health productivity in October 2004. The National Statistician has indicated that he intends to consider nine of Sir Tony Atkinson's recommendations for refinements to existing National Accounts methodology for possible inclusion in the 2005 Blue Book, and to publish an article examining education productivity later this year.

Clear goals and national standards

6.20 The Government is committed to setting transparent long-term goals in order to drive public service improvements. PSAs are fundamental to the Government's approach, combining national goals with unprecedented levels of transparency. As set out in the 2004 Spending Review PSA White Paper, PSAs will continue to focus on the Government's highest priority outcomes, within which service providers are given maximum freedom to decide how outcomes are delivered. As those outcomes are achieved PSA targets will, where appropriate, become national standards. Building on successful public involvement in setting PSA targets, future policy on the performance management framework will actively promote an emphasis on user participation, to ensure that targets reflect citizens' priorities.

Inspection and regulation 6.21 The Government remains committed to ensuring that the monitoring of performance against these objectives through the regulation and inspection of public services provides assurance to the public, leads to real service improvements, and – because it is proportionate to risk – is not burdensome to the front line. The Hampton Review, published today and described in full in Chapter 3, makes a number of recommendations to rationalise the regulation that the public sector imposes on the private and voluntary and community sectors, including moving to a risk-based approach to reduce the burden of inspection. **Building on this approach, the Government can announce further proposals to rationalise the inspection and regulation of public services.**

Box 6.2: Public services inspection strategy

The main elements of the strategy are to:

- **refocus** inspection on what is relevant to the people who use public services, the way that they use them and the outcomes that they experience;
- **rationalise**, in order to simplify and manage better the complex pattern of multiple scrutiny that service providers experience; and
- **reduce** the amount of inspection activity and burden generated, and the variety of approaches that is a feature of having many bodies performing similar tasks.

Over time, having fewer inspectorates will enable better co-ordination and reduced duplication; better and wider identification and promulgation of best practice, including taking a risk-based, proportionate approach; a much greater ability to track the experience of users across service and institutional boundaries, and to comment on these pathways; and the ability to reprioritise work within larger bodies to focus on emerging concerns. The strategy builds on previous developments in joint-working across the inspectorates and their recognition of the need for more risk-based approaches.

Inspection 6.22 The Government's proposals build on the principles of public service inspection which were published by the Government in July 2003,² and on the implementation strategy that has since been developed (described in Box 6.2). They involve a long-term rationalisation of national public services' inspectorates from eleven to four to enable a significant reduction in, and refocusing of, inspection activity. The new bodies will be expected to develop common approaches, based on the agreed principles of government inspection endorsed by the Hampton Review. In particular their work will need to be clearly proportionate to risk, take account of the user's perspective, focus on outcomes and improvement, and provide value for money. Ultimately, they should give the best performers as much freedom as possible, help good performers improve, and help ensure appropriate and swift action and intervention takes place when performance is below standard or unacceptable.

6.23 As part of the implementation of these proposals, stakeholders will be fully consulted on the arrangements for and governance of the new bodies, including the co-ordination of inspection work within and across their jurisdictions:

- a consultation paper will shortly be published with a view to establishing a single justice and community safety inspectorate from 2007, bringing together Her Majesty's Inspectorate of Constabulary, Her Majesty's Crown Prosecution Services Inspectorate, Her Majesty's Inspectorate of Court Administration, Her Majesty's Inspectorate of Prisons and Her Majesty's Inspectorate of Probation;
- the Secretaries of State for Education and Health will shortly announce plans to bring together by 2008 the inspection of children's services, which is currently carried out by the Commission for Social Care Inspection (CSCI), into the Office for Standards in Education (Ofsted). In addition the Government will consult with employers on the future of the Adult Learning Inspectorate, with the expectation that by 2008 it will also be part of this single inspectorate for education, children's services, and skills;

² *Inspecting for improvement: developing a customer focused approach*, Office of Public Service Reform, July 2003.

- the Secretary of State for Health has agreed in principle to come forward with plans to merge CSCI and the Healthcare Commission into a single body by 2008, reflecting the increasing joint work between adult social care and health on the ground, and as part of a wider review of regulation in social care and health; and
- the Deputy Prime Minister will shortly publish a further discussion document on the performance framework for local government as part of the development of his *local:vision* strategy. It will include plans to establish a single inspectorate of local services, merging the Audit Commission's and the Benefit Fraud Inspectorate's inspection functions in relation to English local authorities. It will consider the issues involved in implementing the new inspectorate, including how it will ensure a co-ordinated approach to inspection is taken across local government services.

Regulation 6.24 As well as acting on inspection, the Government will continue to review the scope elsewhere for rationalisation and reduction in the regulation of the front-line providers of public services, to free good and excellent providers from bureaucratic burdens. Progress is already being made. The DoH is implementing its arm's length body review, which will see a 50 per cent reduction in the number of arm's length bodies and a 25 per cent reduction in posts. Defra and its sponsored bodies are implementing the recommendations from the Haskins review, which will rationalise many of their policy formulation, funding and regulatory activities.

Devolving decision-making

6.25 The Government is clear that robust national standards work best as part of an overall framework of devolution and local accountability. A devolved approach to public service delivery can help deliver excellent and equitable public services that are better suited to different local and regional needs and individual circumstances. For example:

- recently announced police reform proposals will reduce bureaucracy and shift police resources to the front-line to enable them to be more responsive and accountable to their local communities and neighbourhoods; and
- the Government will increase autonomy for schools by providing them with three-year financial settlements and establishing a New Relationship with Schools, freeing secondary schools from unnecessary bureaucracy through a single point of contact.

Local government reform 6.26 Building a coherent relationship between central, regional and local government is at the heart of the Government's commitment to delivering high quality public services and improving the effectiveness of local government in their leadership and delivery of services to all communities. Performance, measured through the Comprehensive Performance Assessment, improved substantially between 2002 and 2004, with two-thirds of county and single tier councils as well as around half of district councils now rated excellent or good across the full range of services.

6.27 In addition, the Government has worked closely with local government and its local partners, including the voluntary and community sector, to develop Local Area Agreements. The Government has announced that a further 40 Local Area Agreements will be in place by April 2006 following the successful negotiation of the initial pilots. The negotiation of local PSAs will be integrated with Local Area Agreements, providing rewards in return for greater performance in locally agreed areas for improvement.

Box 6.3: Supporting local government

This Budget introduces further measures to put local authorities at the centre of delivering improved local services. Specific measures include:

- new funding to enable every local authority to provide free off-peak local area bus travel for those aged over 60 and disabled people in England from April 2006;
- a new Local Enterprise Growth Initiative, described in full in Chapter 3, worth £150 million per year by 2008-09, subject to confirmation in the next Spending Review, to boost enterprise in the most deprived areas of England;
- in recognition of the role that local authorities play in delivering its childcare strategy, the Government will refund local authorities all of the VAT that they incur in the provision of welfare services such as childcare and Children's Centres, as described in Chapter 5;
- a single inspectorate of local services, ensuring a co-ordinated approach to inspection across local government services, and clearer delineation of responsibilities for private sector regulation; and
- the Government will work with public sector bodies and third sector organisations, through the National Procurement Strategy for Local Government, to develop better procurement practices, in accordance with the new Compact Code of Good Practice on Funding and Procurement.

Funding local services 6.28 The Government is committed to achieving stability and sustainability in the funding of local authorities, so that they can play a full part in delivering high quality public services. The 2004 Pre-Budget Report announced a package to reduce financial pressures on local government by £1 billion. Recent independent analysis³ suggests average council tax increases in England will be 4 per cent in 2005-06, the lowest increase for eleven years. The Government is also committed to introducing three-year settlements from 2006-07, following the recent consultation. For the longer term, the independent inquiry into local government finance, headed by Sir Michael Lyons, will report by the end of 2005.

Regional funding allocations 6.29 In the 2004 Pre-Budget Report, the Government launched a consultation on proposals to establish regional funding allocations for regional transport, housing and economic development. This included establishing regional transport funding allocations for the first time and providing guidance on long-term planning assumptions for regional transport, housing and economic development beyond the spending review period. These proposals will give regions a more realistic basis on which to plan, and the opportunity to have a stronger voice in the next and subsequent spending reviews, leading to decisions that better reflect regional priorities. The Government has held consultation events with stakeholders across the English regions, received 107 written responses by the consultation deadline of 10 March, and is currently considering this feedback. The Government will set out how it intends to proceed in due course.

Regional governance 6.30 Budget 2005 announces two new measures to strengthen devolution and performance management in the Regional Development Agencies (RDAs). First, **an independent assessment, conducted by the National Audit Office, based on last year's Initial Performance Assessment (IPA) of the London Development Agency (LDA) will be introduced for the RDAs on a rolling basis during 2005-06**, as part of a more transparent, efficient and less bureaucratic system resulting in a net reduction of the audit burden. Second, **the Government intends to increase flexibilities for the LDA and strengthen the LDA's accountability to the London Mayor** in the way it offers financial assistance, recognising the LDA's 'good' rating in its IPA.

³Published online by the Chartered Institute of Public Finance & Accountancy (CIPFA), February 2005, at <http://www.cipfa.org.uk/press>

6.31 The 2004 Pre-Budget Report announced that HM Treasury would work with ODPM and other departments to review ways of improving the efficiency and effectiveness of the Government Office (GO) network. The emerging proposals are set out in Box 6.4.

Box 6.4: Review of Government Offices

The Review of Government Offices (GOs) has engaged a wide range of stakeholders from GOs themselves, local government, other regional institutions and across Whitehall. In line with the GOs' new lead role in Local Area Agreements and the proposed lead role in the Local Enterprise Growth Initiative, the Review has found broad support for a more strategic role for the GOs, with the recognition that they need key changes to add greatest value. The Review's emerging proposals include:

- a more focused role for the GOs in working with local authorities and other local partners on performance, and on the oversight of regional strategies, while looking over time to transfer grant administration functions to other agencies;
- new freedoms and flexibilities for the GOs to enable them to join up their activities more effectively across departmental boundaries;
- a transformed and more strategic network, including a higher proportion of staff with professional skills and delivery experience;
- a challenge to departments to decentralise activity from Whitehall to the regions and to integrate this activity into the GOs where this can improve delivery;
- stronger links between GO Regional Directors and departments on policy development, with a particular emphasis on policy implementation;
- a strong performance management framework to underpin these new flexibilities driven by a small corporate centre with a strong focus on improving performance; and
- building on the challenging efficiency agenda for the GO network set in the 2004 Spending Review, a smaller, more focused network in the years to come.

The Review's final report will be published this summer. It will include full details of the Government's plans to transform the GOs to fulfil their new strategic role.

Increasing personalisation and user focus

6.32 To improve public service outcomes, including improving user satisfaction, both the people who use public services and the public service employees who provide them have to be fully engaged in their design and delivery. The outcomes which public services deliver, in health, education and elsewhere, are as dependent on the actions of the public themselves as they are on the work of public service professionals. Improved outcomes from the NHS require not only a world-class health service, but also changes in the behaviour of individuals to protect their own health. Similarly, educational achievement is dependent on pupils and parents as well as teachers. As users' behaviour has a significant influence on many public service outcomes, they are in effect co-producers of services alongside public service staff.

Personalised services **6.33** In recognition of this, the Government is committed to delivering more personalised services that are responsive to the needs and experience of users, as well as those of front-line professionals. Achieving more personalised services in practice requires providing more opportunities for users to participate in the design, delivery and governance of public services. It requires the building and harnessing of a 'new professionalism' amongst front-line public service providers to improve service delivery and design. Achieving more personalised

public services often requires working more effectively in partnership with voluntary and community sector organisations, and the wider third sector, to maximise the added value they can contribute.

6.34 Personalisation is already an important theme in the Government's public service reform programme. For example:

- the Pathways to Work pilots – which include support from skilled Jobcentre Plus Personal Advisers as well as new rehabilitation services – are improving labour market opportunities for claimants of incapacity benefits;
- in education, the Assessment for Learning initiative encourages pupils and teachers to agree learning objectives in each subject and develop a plan to achieve those goals, using data to help flag up and monitor areas for development;
- the NHS Improvement Plan sets out how the NHS is offering more flexible access to services, empowering patients through more choice and shared decision-making and providing better access to information and support; and
- recent reforms provide for police to be more visible, responsive and engaged with their local communities and neighbourhoods. Greater transparency and stronger accountability will enable communities to have greater involvement in what their local police do.

User participation 6.35 Building on this, the Government aims to involve users more closely in the design, delivery and governance of public services, recognising their critical role as co-producers. Expanding opportunities for people to participate in the governance of their local services is also a key dimension of the Government's devolving decision-making agenda. The Government will examine the role of user participation in public services, drawing on existing examples where users have been successfully consulted, and then look to identify those services where it may be feasible and affordable to extend its scope.

New professionalism 6.36 The Government believes strongly in the importance of the public service ethic that motivates front-line staff to deliver, and is committed to supporting them to develop their high standards of professionalism. The Government has taken steps to foster stronger local leadership (for example setting up the National College for School Leadership, and providing funding for the Local Government Leadership Centre); to enable front-line professionals to learn from each other, encouraging greater collaboration and the spread of best practice across local government, the NHS and schools; and to reduce the burden of inspection.

Consulting frontline professionals 6.37 Engaging the knowledge and experience of public service professionals in the design of public services has the potential to make services more efficient and tailored to users' needs. In developing future public service reforms, the Government will examine the way in which employees' and professionals' input is used in the design of policy and the provision of services, ensuring a constant flow of information and ideas between policy-makers and the front line.

The third sector 6.38 Third sector organisations, including voluntary and community organisations, social enterprises and mutuals, are well-placed to put service users at the heart of their activity. The Government is committed to supporting the development of the sector's infrastructure and capacity, for example through the £80 million ChangeUp programme, the £125 million Futurebuilders fund and the *Invest to Save – Inclusive Communities* fund, described below. Achieving strong local partnerships is key to the next stage of reform. Building on two successive reviews and the recent Third Sector Summit, the Government will:

- update *Guidance to Funders*, with a focus on implementing the principle of full cost recovery to improve funding relationships for third sector organisations;
- review the impact of controls or charges applied by funders over publicly funded assets, to identify how grant conditions can enable funders to retain a reasonable and proportionate charge or interest over the asset, while at the same time supporting the role of third sector organisations in service delivery; and
- work with local government, third sector bodies and with procurement practitioners, to communicate through a series of workshops the benefits of working with the sector at a local level (see above, Box 6.3).

Carter Review of funding for sport **6.39** Drawing on Lord Carter's recommendations, the Government will set up a new national sports foundation. DCMS will provide funding of £27.5 million over the period to 2007-08 as match-funding. The Government will consider further how it can support the co-ordination of public, private and voluntary sector investment – as well as local authorities and regional bodies – in order to improve local sporting facilities.

Invest to Save Budget **6.40** The *Invest to Save – Inclusive Communities* fund was launched in the 2004 Spending Review to encourage new and joined-up ways of working that strengthen local communities. The Government is announcing the allocation of £37 million from the fund to 37 innovative projects, from health and social care for older people to integration for refugees and migrants. The fund continues to promote partnerships involving the voluntary and community sector in the delivery of public services, with 17 of the successful partnerships led from the sector. A number of partnerships plan to make use of volunteers and mentors to improve services for the most needy and vulnerable. In the year of the volunteer, *Invest to Save – Inclusive Communities* will fund some 5,000 volunteering opportunities.

PUBLIC SERVICE DELIVERY AND REFORM

Health **6.41** The NHS Improvement Plan published in 2004⁴ sets out the future priorities for the increased resources delivered to healthcare in Budget 2002, which announced a real increase in expenditure on the NHS of 7.2 per cent a year on average up to 2008. The plan aims to build on improvements already made, ensuring that NHS services are responsive, convenient and personalised for all patients. For hospital services this means that there will be a much greater choice for patients about how, when and where they are treated, and for the millions of people who have chronic illnesses, such as diabetes or asthma, it will mean much closer personal attention and support in the community and at home, and fewer unplanned admissions to hospital.

Criminal justice **6.42** The 2004 Spending Review built on the significant progress the Government has made in delivering its aims for the criminal justice system, providing for an increase in spending on crime, justice and communities of £3.5 billion in 2007-08 compared to 2004-05. It also set stretching new targets for the Home Office, Department of Constitutional Affairs and Crown Prosecution Service to sustain progress and reform, and build public confidence in the criminal justice system. These include a 15 per cent reduction in crime, increasing neighbourhood policing, including providing 25,000 Community Support Officers and Neighbourhood Wardens by 2008, and an increase in the number of crimes for which an offender is brought to justice to 1.25 million by 2007-08.

⁴The NHS Improvement Plan: Putting people at the heart of public services, Department of Health, July 2004.

Tackling crime 6.43 The Government is committed to combating criminals operating at the local, regional or national level. The new Serious Organised Crime Agency will bring a new impetus to the fight against serious international organised crime, such as drugs and immigration crime, and individual police forces are achieving increasingly good results at the local level. There is however a need to build capacity to tackle regional criminal enterprises which operate across force boundaries, and **the Government will allocate £20 million to address this gap and to support collaboration between police forces.**

6.44 The Government knows that children and young people that offend are far more likely to become persistent offenders later in life. The Government recognises the need to do more to protect the most vulnerable children from having their life chances wrecked by crime and anti-social behaviour, even before they reach their teenage years. **To build on the progress made in the *Child Poverty Review*, the Government will make an additional allocation of £15 million to fund targeted early intervention programmes to improve outcomes for those most at risk.**

Housing 6.45 In January 2005, the Deputy Prime Minister set out five-year plans for delivering sustainable communities and meeting housing needs, including testing out more radical approaches to transforming some of the most deprived areas in the country. **This Budget announces a trebling in the number of mixed community demonstration projects** (see Box 6.5). ODPM's five-year plan also set out proposals for extending low cost home-ownership opportunities for 80,000 households, while negotiations with the Council of Mortgage Lenders suggest it may be possible to extend assistance to at least a further 20,000. Up to 300,000 social housing tenants will also gain the chance to buy a share in their home, although only a proportion of these will take up the offer in any one year. The Deputy Prime Minister will be publishing a consultation paper with further details on all of the Government's low cost home-ownership options later this month. Measures to help first-time buyers and improve the efficiency of the housing market are set out in Chapter 3.

Box 6.5: Mixed communities

The Government is committed to the vision that no person should be seriously disadvantaged by where they live. The National Strategy for Neighbourhood Renewal sets out a far-reaching programme to achieve this vision that is intended to narrow the gap between the most deprived areas and the rest of the country, ensuring minimum standards everywhere in jobs, health, education, housing and in tackling crime.

Delivering this vision in areas with the severest concentrations of deprivation and worklessness may, however, require a much more radical and intensive approach. Such concentrations have additional detrimental effects on individuals' aspirations, opportunities and outcomes – particularly for children. Overcoming these 'area effects' will require the transformation of these neighbourhoods from mono-tenure social housing estates into communities containing a much broader socio-economic mix of households.

Such transformation will require fundamental changes to the mix of housing types and tenures in the community and improved local services and amenities, in order to attract and retain a wider range of households and incomes within the area. Achieving this could require: substantial remodelling of existing properties and surrounding areas; tenure modification through mixed development, sensitive allocations policies, and incentives (such as first-time buyer assistance); and assisting existing social tenants who want more housing choice through locating to more economically diverse communities.

In the 2004 Pre-Budget Report the Chancellor announced the Government's intention to test out approaches to transforming some of the most deprived areas in the country. The first demonstration projects will be in Harpurhey (Manchester), Gipton (Leeds) and Canning Town (Newham), and a further six areas will also be invited to participate. The Government will draw on the lessons from these projects in reshaping its approach to transforming the most disadvantaged neighbourhoods everywhere.

6.46 The Government has also provided for a 50 per cent increase in the rate of delivery of new social homes through a combination of increased investment and greater efficiencies in procurement. Provision of new social housing is now being opened up to a wider range of potential suppliers in both the private and public sectors in order to encourage competition and greater value for money. From 2006-07, the whole of the Housing Corporation's social housing grant, currently around £1.6 billion a year, will be open to competition from new suppliers as well as housing associations. While housing associations are regarded as 'Bodies Governed by Public Law' and thus subject to EC public procurement rules, they remain private sector bodies for public expenditure purposes.

INVESTING IN THE FUTURE

6.47 In the increasingly integrated global economy, success will depend on building a flexible economy with a highly-skilled workforce, which can respond quickly to change and which focuses increasingly on high value-added sectors. Education and skills are key to the Government's ambition of creating a flexible, skilled, enterprising and innovative economy. Education and skills provide security and opportunity for individuals, enhance personal fulfilment and can enable people to better contribute to their communities.

6.48 The Government has committed record levels of investment to education, and expenditure on UK education is projected to rise to 5.6 per cent of GDP by 2008. Overall capital investment in schools will rise to £6.3 billion by 2008. This unprecedented level of investment in schools buildings has already enabled the Government to commit to providing every secondary school pupil with twenty-first century facilities through Building Schools for the Future, a long-term, strategic programme of rebuilding and refurbishment.

Investment in primary schools

6.49 The Government is now announcing plans to extend this transformational approach to primary schools. **Budget 2005 announces a long-term commitment to deliver 21st century learning facilities in primary schools**, to deliver quality school environments which facilitate personalised learning and which will ensure that primary schools can play a lead role at the heart of their communities.

6.50 The capital strategy previously announced for 2005-06 to 2007-08 should enable overall Government support for investment in the primary estate to rise to an estimated £1.8 billion in 2007-08. **Budget 2005 announces that additional funding of £150 million will be available in 2008-09, rising to £500 million when the full scale programme begins one year later.** Together with funds for strategic investment already in the system, the Government estimates that this additional funding will, over around 15 years, provide for a wide-ranging programme of rebuilding, refurbishing and upgrading covering at least 50 per cent of primary schools in England. Those primary schools not benefiting directly from the programme will continue to receive support for their maintenance and smaller scale capital needs. The certainty that this programme gives about future investment levels will facilitate strategic investment in primary schools which will help them to deliver high standards and contribute to the Every Child Matters agenda by providing integrated services to children. It will mean that every child and family will have access to a primary school in their locality which is a focus for local services, offers ICT facilities after hours, provides parenting support, adult education and where appropriate healthcare, and provides childcare 8am to 6pm. Every school will provide first class ICT facilities so pupils can study in a way that suits them, facilities of some scale that equip them to play a part in the Every Child Matters agenda, and quality learning environments that enhance teachers' flexibility.

Extended services 6.51 The Government's aim is for every school to offer some extended services, and for every secondary school to be open from 8am to 6pm year round by 2010. Many of these schools will deliver comprehensive services ranging from parenting support and adult learning to access to healthcare. The long-term investment in primary and secondary schools described above will deliver major improvements to school facilities to help them deliver these services

6.52 To help schools meet the challenges that provision of extended services involves in the shorter-term, **Budget 2005 announces an increase in the grant paid directly to every primary and secondary headteacher in England in 2006-07** bringing the payment in that year for a typical primary school up to around £34,000 and for the typical secondary school up to around £109,000.¹ A further increase the following year will bring the payment for a typical primary school up to around £36,000 in 2007-08, and for the typical secondary school to around £115,000.

Investing in further education 6.53 The Government wants to transform the further education sector to create world-class vocational establishments, supporting increased post-16 and adult participation in education and training and enhancing the reputation of the vocational and apprenticeship route. Reform needs to support development of the vocational reform plans set out in the 14 to 19 Education and Skills White Paper², and the growth of apprenticeships, with an extra 40,000 apprenticeships in training by 2010 and an additional 10,000 employers offering apprenticeship places. It must also support higher skill levels in the workforce to help address the UK's productivity gap.

6.54 Building on the Government's long-term commitment to investment in primary and secondary schools, **Budget 2005 announces a step change in capital investment in the Further Education (FE) sector.** This will allow transformation towards a more dynamic sector providing a diverse and specialised offer to employers and learners, supported by high quality management and teaching. It will also allow world class training infrastructure which gives employers confidence to invest in training, and a more responsive sector able to adapt to the rapidly changing needs of employers and learners.

6.55 Existing plans should enable overall Government support for investment in the FE estate to rise to an estimated £250 million in 2007-08. **Budget 2005 announces that an additional £350m of capital investment will be made over 2008-09 to 2009-10 to support the longer-term transformation of the further education sector.** Budget 2005 also sets a challenge to employers to significantly raise their investment in the sector to £100 million by 2015 and take a more active role in design and delivery of training.

Education and ICT 6.56 ICT plays an essential role in the modern classroom and is central to delivering personalised learning that meets the needs of all pupils. The Government's investment in ICT in recent years means that, while in 2000 there was on average one computer for every eight pupils in secondary schools, there is now one for every five. The Government already plans to invest £1.62 billion in ICT capital between 2005-06 and 2007-08. To help overcome the 'digital divide' which can prevent young people from disadvantaged backgrounds from enjoying the benefits that access to ICT can bring, **Budget 2005 announces that a further £25 million per annum will be available in 2006-07 and 2007-08** for schools in deprived areas to invest in home access to ICT for their neediest pupils. **Budget 2005 also announces that DfES will double their contribution to the e-Learning Foundation to £600,000 a year from 2005-06, to**

¹ These figures are an approximation based on the existing formula allocation system for School Standards Grant. As set out in the Government's recent consultation document on schools funding arrangements, however, the Government intends to revise this formula which will mean that increases in allocations to schools will be distributed differently to the current formula. These figures should therefore be taken as a broad indication only.

² 14-19 Education and Skills, DfES, February 2005³ The National Minimum Wage will be £4.50 for adults from October 2003.

allow the Foundation to increase their support for schemes which enable schools to lease laptops to pupils.

Teach first 6.57 The Government aims to improve the quality and diversity of the school workforce to help deliver the personalised learning environment that pupils and parents deserve. Teach First gives opportunities for outstanding graduates to work in London schools and gain experience teaching students from challenging backgrounds. The Government has already announced the expansion of the Teach First scheme to Manchester from 2006, and **Budget 2005 gives additional funding to support the roll out of the scheme across four further cities from 2007.**

Improving participation 6.58 The UK has one of the lowest levels of post-16 participation in education and training in the OECD. The Government aims to improve the participation rate at 17 from 75 per cent of young people today to 90 per cent over the next ten years, and has announced its aim to transform secondary education so that it becomes the norm for all young people to continue in learning until at least 18.

6.59 Part of this transformation involves changes to the secondary curriculum. The Government has recently published a White Paper setting³ out the detail of the reform programme for the 14-19 phase, building on the work of Sir Mike Tomlinson and his Working Group. The White Paper describes the Government's long-term vision for an education system that provides every young person with a route to success including an increased focus on securing basic skills, reform of vocational qualifications, and measures to tackle disengagement. **Budget 2005 announces new measures to give young people the best possible opportunity to benefit from education and training between the ages of 16 and 18.**

6.60 At any one time around 150,000 16 and 17 year olds in the UK are in employment with no training. To increase access to training options for this group, **the Government is allocating £80 million over two years to pilot a negotiated Learning Agreement for 16 and 17 year olds in work with no training in eight areas of the country from April 2006.** This initiative builds on the existing statutory right to paid time off to study or train for this group. Learning undertaken as part of the activity agreement could include an apprenticeship or study towards a qualification unrelated to the young person's current job. The pilots will test the effectiveness of a range of financial incentives in encouraging employers and employees to take up this offer and in supporting apprenticeships as a key route for 16-17 year olds in the labour market.

6.61 As set out in Chapter 5, the Government will also introduce a pilot scheme offering 16 and 17 year olds who are not in education, training or employment financial support in return for a commitment to progress towards formal learning.

6.62 These initiatives to provide better support to 16-19 year olds outside education and training will be complemented by better opportunities for 14-16 year olds to experience different learning styles and settings. Improving the offer for 14-16s should raise motivation and attainment by 16, increasing post-16 participation and reducing the need for subsequent intervention. **The Government will therefore make available £20m over two years in pilot areas to boost employer and work based learning pre-16.** This will offer an extra 20,000 opportunities across the pilot areas for 14-16 year olds to benefit from better vocational learning either in colleges or with employers.

³ 14-19 Education and Skills, DfES, February.

The Government is committed to delivering sustainable growth and a better environment and to tackling the global challenge of climate change. It has used a range of economic and other instruments to achieve these aims, while taking into account social and economic factors. The Budget provides an assessment of the key environmental taxes, which indicates the success of these measures, and describes the next steps in the Government's strategy, including:

- in support of the UK's leadership role in tackling climate change, including through its EU and G8 Presidencies, a **package of new measures to support further action on the abatement of greenhouse gas emissions, including new fiscal incentives, an energy services summit, and a new energy efficiency theme as part of the Government's Invest to Save Budget;**
- **the publication of an independent evaluation of the climate change levy, which concludes that this measure will deliver annual savings of over 3.5 million tonnes of carbon in 2010, well above the originally forecast savings;**
- **two new reduced rates of VAT for the installation of low carbon technologies, and an extension of the Landlord's Energy Savings Allowance to cover solid wall insulation;**
- **the deferral to 1 September 2005, of the inflation-only increase of main road fuel duties, reflecting sustained volatility in oil prices, and of a 1.22 pence per litre increase in duty on rebated fuels, which will support the strategy to tackle oils fraud;**
- **a freeze in the threshold for the minimum percentage charge rate of company car tax at 140g per kilometre for 2007-08, and simplifications to the company car tax system;**
- **a freeze of the vehicle excise duty (VED) rates for the lowest four bands of graduated VED for cars, and the standard increase of £5 for the two most polluting bands and for the over 1549cc band for pre-March 2001 vehicles;**
- **progress on work to assess the feasibility of a biofuels obligation as part of a package of measures to support the development of biofuels;**
- **a freeze in the rate of the aggregates levy, and the rates of climate change levy and air passenger duty; and**
- **an increase in line with inflation of the landfill tax credit scheme.**

7.1 If modern economies are to flourish, the Government recognises that they must be built on a platform not only of high and stable levels of growth and employment but also high levels of environmental care. In putting sustainable development at the heart of policy making the Government recognises that economic, social and environmental objectives must be met together. Since 1997, the Government has made significant progress in delivering environmental improvements. Its environmental strategies have made an innovative use of a range of measures, including fiscal instruments, regulatory and voluntary approaches and spending programmes. Consistent with the Government's goal of promoting a productive and flexible economy, a key feature of the Government's approach has been the use of economic and other market-based mechanisms, such as the climate change levy and negotiated agreements, UK and EU Emissions Trading Schemes, the Renewables Obligation, Energy Efficiency Commitment, company car tax reform and fuel duty differentials. These

promote cost-effective responses which minimise compliance costs for households and business, and help to stimulate technological innovation.

7.2 The evidence suggests that these instruments are achieving their policy goals. However, as recognised in the recent UK Sustainable Development Strategy there is more to do. The Strategy sets out the UK's sustainable development priorities and proposes a strengthened role for the Sustainable Development Commission. In addition, to ensure the UK continues to make progress in reducing carbon dioxide emissions, the Review of the Climate Change Programme is evaluating the Government's full range of existing policy measures and appraising options for future action.

7.3 In many areas, such as climate change, international co-operation is vital to achieve environmental goals – action only at the domestic level is not enough. This is why the UK is making climate change one of its key priorities as part of its G8 and EU Presidencies. To lead this international debate, the Government recognises that the UK must take action domestically and demonstrate that good environmental policy can promote, rather than stifle, enterprise and innovation, while not damaging UK business competitiveness. The rest of this chapter sets out the key environmental challenges the UK faces, the strategies for tackling these and progress against them. It then describes the developments in the key measures, and assesses the success of some of the most important economic instruments. The impact of the full range of environmental measures introduced by this Government is set out in Tables 7.1 and 7.2 at the end of this chapter.

THE ENVIRONMENTAL CHALLENGE - STRATEGY AND PROGRESS

7.4 The key environmental challenges for the Government are:

- *tackling climate change*, and reducing emissions of greenhouse gases in line with domestic as well as international targets;
- *improving air quality*, to ensure that air pollutants are maintained below levels that could pose a risk to human health;
- *improving waste management*, so that resources are used more efficiently and waste is reused or recycled to deliver economic value; and
- *protecting the UK's countryside and natural resources*, to ensure they are sustainable economically, socially and physically.

A strategy for the use of economic instruments

7.5 To meet these environmental challenges, the Government is committed to using a range of policy measures to ensure that policy-making reflects the integrated goals of sustainable development. This chapter provides an assessment of three of the key economic instruments (climate change levy and agreements, landfill tax and aggregates levy) and their success in delivering environmental improvements. The Government continues to learn from its use of economic instruments and other policy measures and to develop its approach accordingly.¹

¹ This approach was described in *Tax and the environment: using economic instruments*, HM Treasury, November 2002, which describes the framework by which decisions on economic tools are made.

Tackling the global challenge of climate change

7.6 Climate change is one of the most serious risks facing the world and a major challenge for all countries. Global atmospheric temperatures have risen by about 0.6°C over the last 100 years, with about 0.4°C of this warming occurring since the 1970s. Depending on the amount of greenhouse gases emitted and the sensitivity of the climate system, it is predicted that global average temperatures could rise by between 1.4 and 5.8°C over the next 100 years and that annual average temperatures in the UK may rise by between 2 and 3.5°C by the 2080s. The Government's 'Avoiding Dangerous Climate Change' conference² in February 2005 brought together world experts to advance scientific understanding of the long-term implications of climate change, the relevance of stabilisation goals and options to reach goals. It concluded that there was now greater clarity about the impacts of climate change than at the time of the Intergovernmental Panel on Climate Change Third Assessment Report in 2001. In many cases, the risks are more serious than previously thought and a number of new and significant impacts were identified. For example, recent changes in the acidity of the oceans may reduce their capacity to remove carbon dioxide from the atmosphere and affect the entire marine food chain.

The cost of climate change

7.7 The impact of climate change will be experienced globally, and is of particular concern for fragile ecosystems, low-lying coastal countries and the poorest nations, which have the least capacity to adapt. These changes are likely to have far-reaching effects on environment, economy and society, and in some cases they are already being felt. Claims for storm and flood damages in the UK have doubled to over £6 billion over the period 1998-2003, compared with the previous five years, with a prospect of a further tripling by 2050. Swiss Re, the world's second largest insurer, has said that the economic costs of global warming could double to \$150 billion per year in 10 years, hitting insurers with \$30-40 billion in claims, annually. Without effective action, climate-related risks and damages will increase – the cost of doing nothing is substantial. One of the most widely used estimates of the cost of climate change is produced by the Intergovernmental Panel on Climate Change. This found that the indicative global economic costs of an increase in average global temperature of 2.5°C would be between 1.5 and 2 per cent of global GDP per annum, with a wide variation between world regions.

The Government's climate change strategy

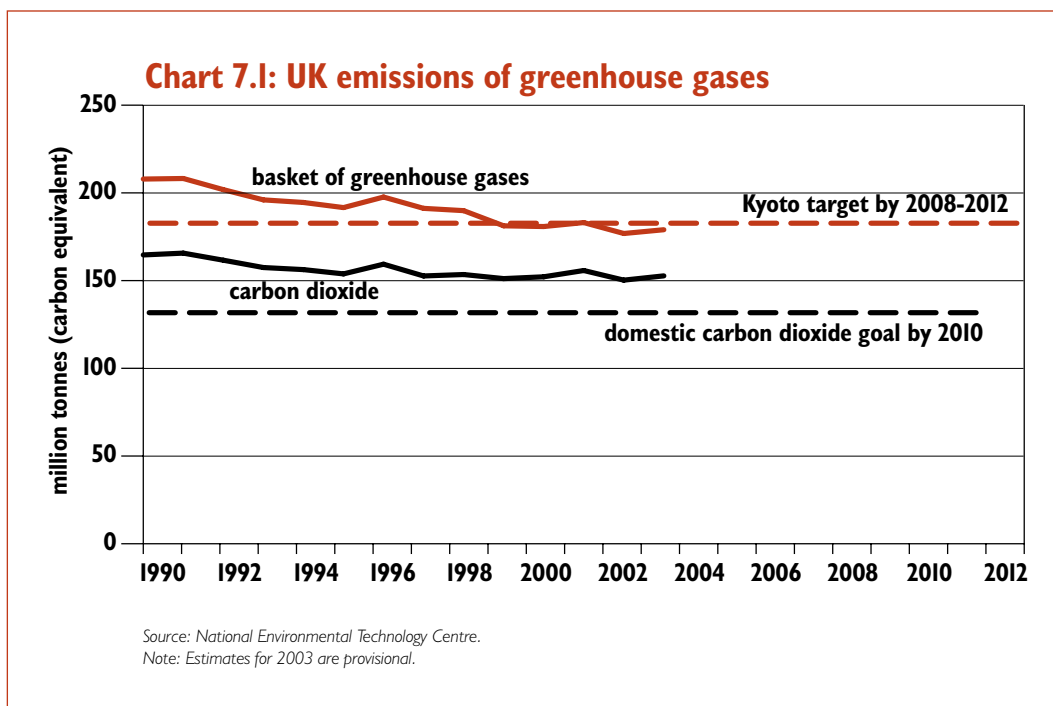
7.8 The Government has used a range of fiscal measures, such as the climate change levy, reforms to company car tax, and incentives for energy efficiency, to tackle climate change. They have worked in tandem with other economic instruments, for example the Renewables Obligation and the climate change agreements and also more traditional regulation and spending programmes. The EU Emissions Trading Scheme (EU ETS) is now also in operation and the Government expects it to be influential in delivering substantial carbon reductions. The next steps in the Government's strategy for tackling climate change are described later in this chapter.

7.9 These measures have been successful in reducing greenhouse gas emissions. UK greenhouse gas emissions are provisionally estimated to have fallen by 14 per cent between 1990 and 2003, and carbon dioxide emissions by 7 per cent, as shown in Chart 7.1. Over the same period, the economy grew by around 35 per cent – showing that reductions in emissions can be achieved alongside economic growth. Emissions increased by a provisional 1.5 per cent between 2002 and 2003, largely due to increased coal burn for electricity generation, but the downward trend is projected to resume in future years.

² International 'Avoiding Dangerous Climate Change' conference, Hadley Centre, Exeter, February 2005.

³ www.dti.gov.uk

7.10 The latest available projections show that with current policies, UK carbon dioxide emissions will be about 14 per cent below the 1990 level, and that emissions of all greenhouse gases will be around 20 per cent below 1990 levels by 2010. The UK is therefore well on track not just to meet but exceed its Kyoto commitment to reduce greenhouse gas emissions by 12.5 per cent between 2008 and 2012. However, the projections show the UK falling short of the domestic goal of moving towards a 20 per cent reduction in carbon dioxide emissions by 2010. The Government has therefore launched a review of the UK Climate Change Programme to examine the success of existing policies and consider the scope for further emission reductions.



Improving air quality

The Government's Air Quality Strategy

7.11 The Government's and the Devolved Administrations' policies on improving air quality are set out in the Air Quality Strategy for England, Scotland, Wales and Northern Ireland and its first addendum.⁴ These strategies set health-based air quality standards for nine key air pollutants and target dates for their achievement across the UK between 2003 and 2010.

7.12 There have already been significant reductions in the key pollutants, such as emissions of particulates, nitrous oxide and lead, as a result of stringent vehicle emission standards, control of pollution from fixed sources and local air quality management plans. Further significant reductions in all air pollutants are projected. However, on the basis of current policy measures, it is unlikely that targets for nitrogen dioxide and particulates will be met in all parts of the country, particularly in some urban areas. To tackle these pollution hotspots and achieve further public health benefits and air quality improvements, the Government is assessing the need for additional cost-effective measures in the current review of the Air Quality Strategy. Public consultation will take place during the summer and the Review will be published towards the end of 2005.

⁴ Available at www.defra.gov.uk/environment/airquality

Improved waste management

7.13 Efficient use of resources and the effective management of waste are essential features of an environmentally sustainable economy. The Government is committed to minimising the amount of waste produced and getting as much value as possible out of what is left, by re-use, recycling or composting and the recovery of energy, while also protecting human health.

7.14 Since the introduction of the landfill tax, waste sent to landfill has fallen by almost 20 per cent. In 2003-04, the volume of active waste from households and industry fell by over 4 per cent and Defra has announced that England exceeded its 2003-04 target to compost or recycle 17 per cent of household waste. This year the Government is conducting the first of three five-year reviews of Waste Strategy 2000 to evaluate progress and inform future policy decisions. Further measures are set out later in this chapter.

Protecting the UK's countryside and natural resources

7.15 The Government is committed to ensuring that the UK's natural resources are managed prudently. It aims to achieve positive trends in its headline indicators of sustainable development, which include indicators of river water quality, biodiversity and land use. The UK also has a number of international objectives for conservation and water quality. The most prominent is the Water Framework Directive, which requires good chemical and ecological status in UK surface waters by 2015.

7.16 The Government is tackling these challenges in a variety of ways, and good progress has been made in most areas. The Government has introduced measures such as the aggregates levy and contaminated land tax credit to encourage efficient use of land and other resources. Since 1990, there has been a significant improvement in the biological and chemical quality of UK waterways. However, recognising that the pace of improvement is slowing, the Government is continuing to work closely with stakeholders to develop policy measures to help achieve the necessary changes. The next steps in the Government's strategy in this area are described later in this chapter.

CLIMATE CHANGE: POLICY MEASURES

7.17 The UK recognises that climate change is a global phenomenon and is using its Presidencies of the G8 and EU to promote a high level global debate in tackling this problem, as set out in Box 7.1. Over the last five years, the Government has pursued a wide range of measures to reduce greenhouse gas emissions.

Review of the Climate Change Programme

7.18 The UK Climate Change Programme (CCP), published in 2000, set out policies to meet the UK's Kyoto target, and the domestic goal of moving towards a 20 per cent reduction in carbon dioxide emissions by 2010. It included a commitment to review the Programme. The Review of the CCP, launched in September 2004, is evaluating and consulting on the efficacy and cost-effectiveness of existing policy measures, and appraising options for future action, to ensure the UK continues to make progress in reducing carbon dioxide emissions. The Government's aim is to introduce a revised CCP in the first half of 2005.

Climate change levy

7.19 The climate change levy (CCL), alongside associated measures such as negotiated agreements and exemptions for new renewables, seeks to encourage businesses to use energy more efficiently and to reduce emissions of carbon dioxide. As part of its continuing review of environmental taxation, the Government is today publishing a report commissioned from

Cambridge Econometrics⁵ that evaluates the environmental impact of the levy. Described further in Box 7.2, this shows that the CCL is expected to deliver carbon dioxide savings of over 3.5 million tonnes of carbon (MtC) by 2010, well above the estimates made at the time of the levy's introduction. Given business success in delivering climate change objectives, the advent of the EU ETS and the recent movement in energy prices, **Budget 2005 announces a freeze in the rates of the CCL for 2005-06.**

Climate change agreements

7.20 As described in Box 7.2, climate change agreements (CCAs) allow energy-intensive sectors to obtain 80 per cent relief from the CCL if they agree to increase energy efficiency and reduce emissions. Audited findings from the sectors that signed CCAs suggest absolute savings against baselines of 4.5 MtC in the first target period of 2001-02. Following consultation, Budget 2004 announced new eligibility criteria to widen the entitlement to relief, to be introduced once EU state aid approval is obtained. In the meantime, negotiations are continuing with several sectors of business that have applied for agreements under the new arrangements.

Box 7.1: EU, G8 and climate change

To enable progress at an international level, the Government has made climate change a central theme of its G8 and EU Presidencies in 2005, as set out in Chapter 2. The UK's objective is for G8 partners – who account for over 65 per cent of global GDP and 47 per cent of global carbon dioxide emissions – to work together on international action to address the problem of climate change. The Government believes that all G8 countries, as large emitters of greenhouse gases, must pull their weight in reducing greenhouse gas emissions. The Government aims to build on the science of climate change and reach agreement on a process to speed up the science and technology needed to meet the threat.

Central to these aims is engaging countries outside the G8 that have growing energy needs. On 15-16 March 2005, the Government is hosting an international Round Table for Energy and Environment Ministers from around 20 countries including the G8, China, India, Brazil and South Africa, to consider the scale of energy demand over the next 50 years and how far these needs can be met through investment in lower-carbon energy systems. In addition, the March 2005 G8 Environment and Development Ministerial will focus on the impacts of climate change for Africa, taking into account new research commissioned by the Government and the conclusions of the Commission for Africa, described further in Chapter 5.

The UK will also be focusing on climate change during the EU Presidency in 2005. In addition to meeting its Kyoto targets, now that the Kyoto Protocol has entered into force, the EU should consider establishing longer-term greenhouse gas emission reduction targets. Acknowledging the increasing impact that aviation emissions are making towards total greenhouse gas emissions the UK will also seek the inclusion of EU aviation into the EU Emissions Trading Scheme (EU ETS).

EU Emissions Trading Scheme

7.21 In January 2005, the world's first internationally-traded carbon permit system started in the EU. The EU ETS sets a quota for carbon emissions at around 1200 installations in the UK, and many thousands of sites throughout the 25 EU Member States. Phase One of the EU ETS should help Member States move towards their legally-binding Kyoto targets; it is important that Phase Two, due to start in 2008, helps to ensure that these targets are met. In the first phase, the amended UK emissions cap represents a reduction in business-as-usual emissions projections equivalent to around 5 per cent, and will be a major factor in taking the UK beyond its Kyoto commitment. The Government has now announced it will issue

⁵ *Modelling the initial effects of the climate change levy*, Cambridge Economics, available at www.hmce.gov.uk

allowances to operators of UK installations based on the initial totals which the European Commission has approved, so they can participate in the EU ETS at the earliest possible time. Simultaneously, the UK will initiate legal proceedings against the Commission for their failure to consider the UK's amendment to its plan, and to help ensure that the Commission follows a fair, transparent and legally robust process which will be important for Phase Two of the EU ETS. It is envisaged that the final allocation work will be completed in late April or early May this year.

Renewable energy **7.22** In January 2000, the Government announced a target for renewable sources to supply 10 per cent of UK electricity by 2010, subject to the costs being acceptable to the consumer. The key policy mechanism to meet this target is the Renewables Obligation, which requires all licensed electricity suppliers to supply a specific and growing proportion of their electricity from certified renewable sources each year. The Government recently commenced a Review of the Renewables Obligation to ensure that the Obligation continues to stimulate the use of renewable electricity, while maximising value for money for consumers. The Department of Trade and Industry (DTI) will publish a preliminary consultation on the Review in March 2005.

7.23 The Government is committed to supporting research and development (R&D) into sustainable energy technologies, as part of its response to climate change (as described in Chapter 3). Funding for energy R&D from the science budget will rise from a current level of £40 million per year to £70 million per year by 2007-08, with additional support for business via the DTI Technology Programme and the Carbon Trust. **To underpin this investment, the Government will establish a UK Energy Research Partnership, bringing together public and private funders of energy research to enhance opportunities for collaboration.**

7.24 Carbon capture and storage (CCS) is a process by which the carbon in fossil fuels is captured as carbon dioxide and committed to long-term storage in geological formations. It has the potential to significantly reduce carbon emissions from fossil fuel power generation. It is likely to prove a critical technology in global carbon reduction strategies, particularly for countries with fast growing economies and rapidly growing fossil fuel consumption. **The Government is therefore examining how it might support the development of CCS in the Climate Change Programme Review, including the potential for new economic incentives.**

Investment in energy-saving technologies **7.25** In 2001 the Government announced an enhanced capital allowances (ECAs) scheme to reward investments in the most innovative energy-saving technologies. This list currently covers more than 8,000 approved products and is administered by the Carbon Trust, an independent not-for-profit company funded principally from recycled CCL revenues. The Government is committed to the development of the scheme and continues to consider the case for additional technologies. It plans to take forward a formal evaluation of the scheme in 2005 with the aim of reporting next year. As announced in the 2004 Pre-Budget Report, the Government will also help focus the growing public and private investment by investing £20 million from 2005-06 through to 2007-08 in a new partnership to accelerate energy-efficient technology, run by the Carbon Trust.

Energy efficiency **7.26** Improving energy efficiency is the most cost-effective way of reducing greenhouse gas emissions and reducing the costs of fuel bills. Energy efficiency measures can pay for themselves over just a few years. However, upfront costs often prevent more investment in energy efficiency measures across all sectors of the economy. The Government has set up the Carbon Trust and Energy Saving Trust to help business and domestic sectors tackle this.

7.27 The joint HM Treasury-Defra Energy Efficiency Innovation Review announced in the 2004 Pre-Budget Report has identified a significant market failure in the UK in the provision of 'energy services'. An energy services approach shifts the focus away from the sale of units of energy to a focus on the services derived from the use of energy, for example the lowest cost methods of keeping warm and providing lighting. The Government believes that there is clear scope for the development of such a market to domestic, business and public sector customers. **The Treasury will host a summit later this year to explore how Government and the business community can encourage, and remove barriers to, the development of energy services markets in the UK.**

**Household
energy efficiency**

7.28 Households have an important role to play in helping the UK to meet its environmental targets, as they account for nearly 30 per cent of energy consumption and around a quarter of total UK emissions. To encourage investment in domestic energy-efficiency, the Government has introduced a broad range of measures including the use of economic instruments, such as reduced VAT rates for micro-renewable energy and energy saving materials. Building on the progress made to date and recognising the environmental benefits, **Budget 2005 announces a reduced rate for the installation of micro-combined heat and power (micro-CHP) and also extends the reduced rates to air source heat pumps.** In addition, the Government will continue to negotiate with European partners to extend the categories of permitted reduced VAT rates to include energy-saving materials for DIY installations and energy-efficient products.

7.29 The Government is committed to measures to support investment in energy efficiency in the private rented sector. The Landlord's Energy Savings Allowance (LESA) was introduced in 2004 to encourage investment in cavity wall and loft insulation, and **Budget 2005 announces the extension of the LESA scheme to cover solid wall insulation.** As part of its consideration of a Green Landlord Scheme, the Government will explore how other tax deductions and reliefs, including the existing Wear and Tear Allowance, might be developed to encourage and reward landlords who improve the energy efficiency and quality of their property. Discussions with stakeholders will take place over the summer.

7.30 The Energy Efficiency Commitment (EEC) requires energy suppliers to achieve targets for installing energy efficiency measures in the household sector. The Government has set a target for the next phase of the EEC, over 2005-08, roughly to double activity and deliver savings of around 0.7 million tonnes of carbon a year by 2010. This target also includes incentives for energy services and support for the development of innovative products, such as micro-CHP. In October 2004, the Government announced an additional £3 million for the Energy Saving Trust information campaign to support the EEC. The Warm Front Programme also provides for the improvement of energy efficiency of homes as part of the Government's commitment to ending fuel poverty for vulnerable households by 2010.

**Public sector
energy efficiency**

7.31 Improving energy efficiency is a particular challenge for the public sector. The 2002 Framework for Sustainable Development on the Government Estate set targets for central government to reduce its overall carbon emissions, improve energy efficiency and increase energy from renewable sources and good quality combined heat and power (CHP). A best value energy efficiency indicator is in place for local authorities. To help invigorate improved energy performance, the Government will include a theme under the 2005-06 round of the Invest to Save Budget (ISB), which will make money available for good energy efficiency projects across the public sector. The Government, drawing upon the experience of the ISB, will also consider the case for a rolling-fund which could invest in similar projects. Through such a mechanism, savings from reduced energy use would be recouped and reinvested in the fund, so tackling the upfront investment barrier cost-effectively.

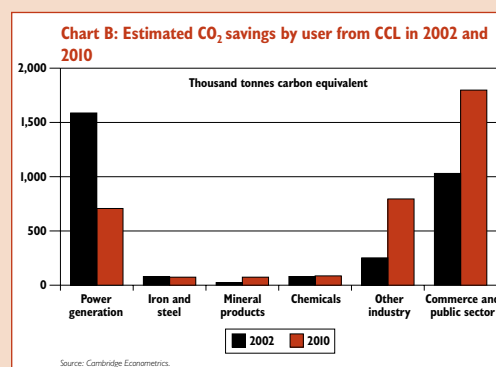
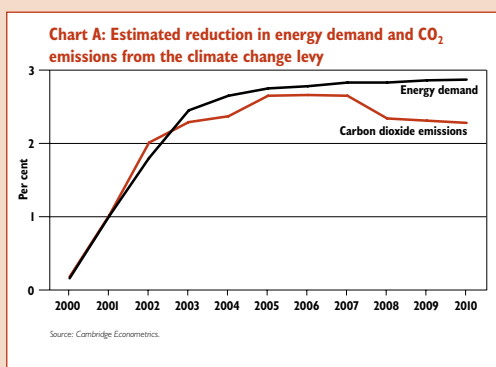
Energy Products Directive 7.32 The Energy Products Directive (EPD) came into force on 1 January 2004 and provides an EU framework for taxation on energy products. The minimum rates in the EPD do not affect any of the UK's existing rates or exemptions for hydrocarbon oils duty or CCL, but will require increases to rates in some other Member States, which will provide environmental benefits across the EU. In February 2005, the Government successfully secured a derogation from the Directive to continue the UK's policy of exempting low value solid fuel from CCL on environmental grounds.

Box 7.2: Assessment of the climate change levy package

The climate change levy (CCL) is part of a package of measures to tackle climate change, including climate change agreements (CCAs), enhanced capital allowances for energy-saving technologies, and support for business energy efficiency and renewable energy technology through the Carbon Trust. An independent evaluation by Cambridge Econometrics has examined the effect of the levy since its announcement in Budget 1999 and introduction in April 2001. The main conclusions are that:

- CCL should deliver estimated annual carbon dioxide savings of over 3.5 million tonnes of carbon (MtC) in 2010 – well above the 2 MtC figure forecast at the time of its introduction;
- the announcement of CCL in Budget 1999 is estimated to have reduced energy demand by 1.2 per cent in 2000 in the commerce and public sector. This reduction in energy demand is estimated to grow to 13.8 per cent in 2003 and 14.6 per cent in 2010 in combination with price effects; and
- CCL is estimated to increase good quality combined heat and power capacity by 1.2 gigawatts of electricity by 2010, and to encourage renewable energy sources, because generation from these sources is exempt from the levy.

Chart A illustrates how modelled energy demand and carbon dioxide emissions are reduced through to 2010. Chart B shows carbon dioxide savings from the CCL by fuel user. The biggest saving is in the commerce and public sector. Savings from CCL are lower in the industrial sectors, which generally benefit from the discounts from CCAs.



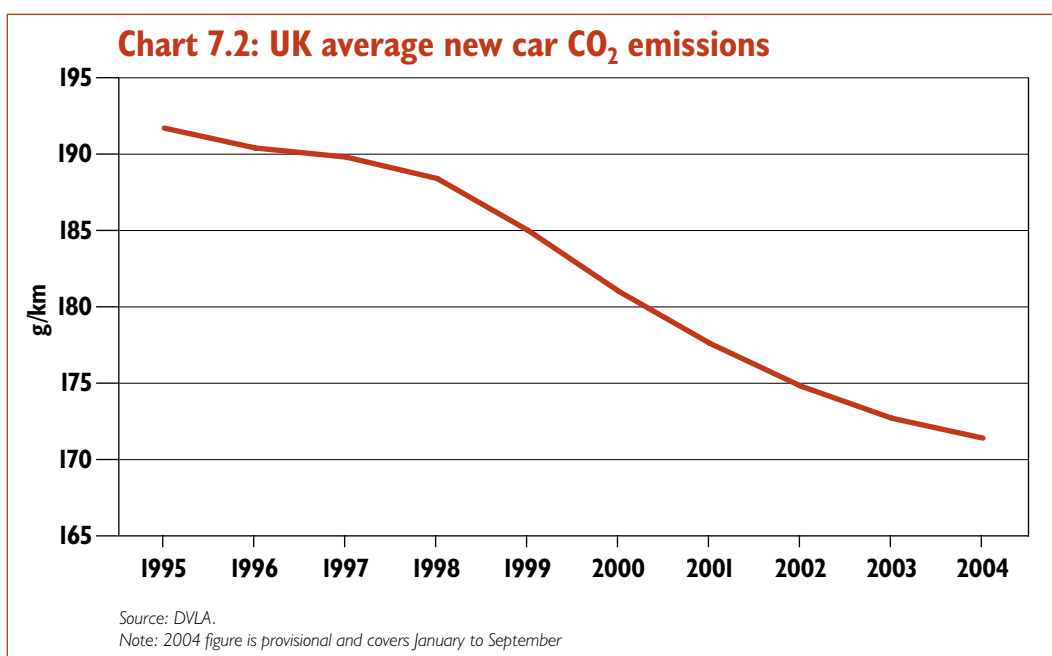
Introduced as part of the CCL package, CCAs allow 80 per cent discounts on the CCL for energy-intensive sectors that agree to make energy saving improvements. Cambridge Econometrics estimates that a further 0.5 MtC per year would be saved in 2010 if the levy were applied at the full rate across all business sectors. In contrast, audited findings from the sectors that signed CCAs suggest that the absolute saving against baselines was 4.5 MtC for the first target period of 2001 to 2002.^a This shows that CCAs have been effective, yielding greater savings than through simply applying the full rate CCL to all business sectors.

^a Climate change agreements results of the first period assessment, Future Energy Solutions, April 2003 (revised July 2004). Available at www.defra.gov.uk

A CLEAN AND EFFICIENT TRANSPORT SYSTEM

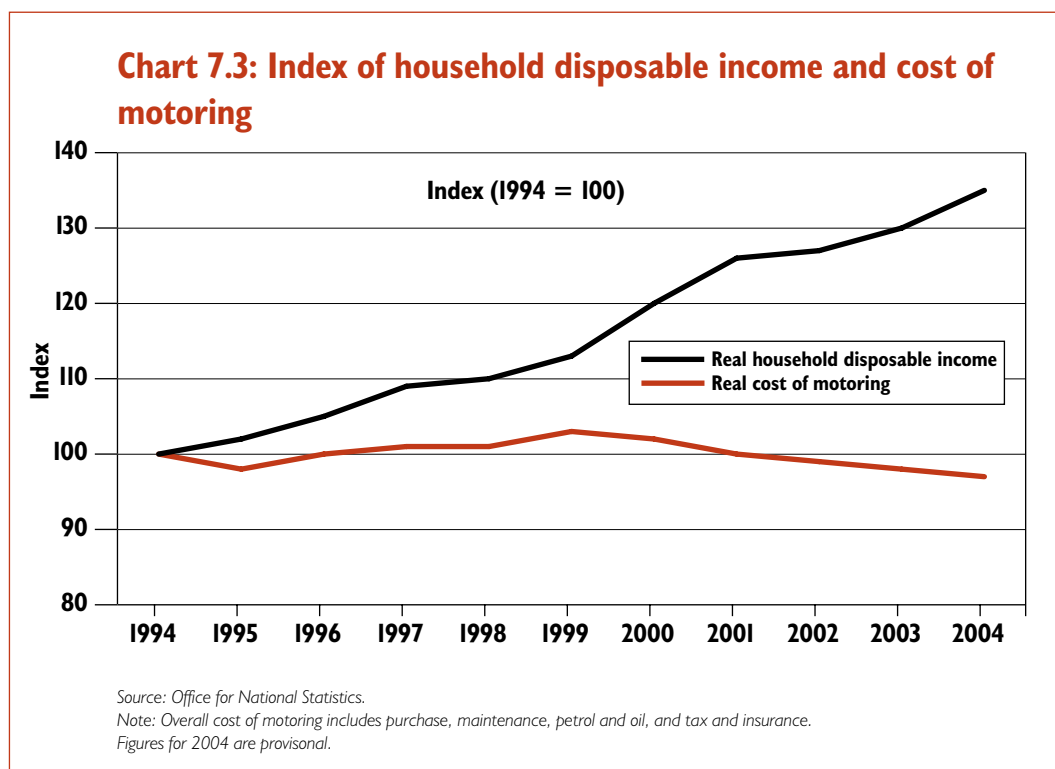
7.33 A safe, clean and efficient transport system is key to sustainable economic growth. The Government recognises the importance of an efficient transport network in boosting productivity, extending mobility and helping to create a more inclusive society. However, transport is the second largest source of carbon dioxide emissions in the UK, and also contributes towards local air pollution. The challenge is to combine an effective transport network to promote UK economic strength and mobility, with reduced emissions from transport over time, to support climate change, air quality and low-carbon transport objectives.

7.34 As shown in Chart 7.2, average carbon dioxide emissions from new cars are falling year on year. This is supported both by the voluntary agreement between the European Commission and car manufacturers to reduce new car emissions, and by the measures Government has taken (such as reforms to vehicle taxation) to encourage consumers to choose less polluting vehicles.



Costs of motoring 7.35 The cost of motoring has remained broadly constant over the past decade as shown in Chart 7.3. Over the same period, household disposable income has steadily increased, with average motoring costs therefore accounting for a smaller share of disposable income.

Fuel duty 7.36 Since 2000, duty on main road fuels used in the UK has fallen in real terms by nearly 12 per cent, a saving equivalent to nearly 6 pence per litre for motorists, while the cost of motoring overall has also fallen to below 1990 levels, in part owing to increasing fuel efficiency. It is the Government's policy that fuel duty should rise at least in line with inflation as the Government seeks to meet its targets of reducing polluting emissions and funding public services. **The Government today announces an inflation-based increase of 1.22 pence per litre for main fuel duties. Owing to the sustained volatility in the oil market, the changes in rates will be deferred to 1 September 2005.**



7.37 The Government recognises that sulphur-free fuels offer local air quality benefits, as well as helping the latest vehicle engines work more efficiently. It will discuss with industry the most effective way of ensuring these fuels are made available.

Rebated oils 7.38 Oils fraud cost the Exchequer around £850 million in 2003 in Great Britain alone. To support the UK Oils Fraud Strategy, described in Chapter 5, **the Government today announces an increase in duty of 1.22 pence for rebated oils, to take effect from 1 September**, maintaining the duty differential between rebated oils and main fuels. This will also apply to heavy fuel oil, reflecting the polluting nature of the fuel.

7.39 The Government supports the use of lower-sulphur gas oil where this can deliver significant health and local environmental benefits, and continues to keep under review whether any changes to the structure or administration of excise duty are required to ensure the availability of lower-sulphur gas oil for use in off-road machines.

Alternative fuels 7.40 In the 2003 Pre-Budget Report, the Government published its Alternative Fuels Framework. The framework includes a commitment to a three-year rolling guarantee on the fuel duty differentials for all alternative fuels, in recognition of investors' need for long-term certainty in the market. The Government continues to use this structured approach to promote further investment in this growing sector – which it expects to make a significant contribution to future carbon reductions from transport and help provide security of the fuel supply.

Biofuels 7.41 The Government considers that biofuels can offer significant and cost-effective environmental benefits through reduced emissions of greenhouse gases from road transport and local air quality improvements, and in the future potentially contribute to the security of the fuel supply. To encourage development of the biofuels market, the Government introduced a 20 pence per litre duty differential for biodiesel in 2002 and, from 1 January 2005, for bioethanol. In line with the Alternative Fuels Framework, **the Budget confirms that the 20 pence per litre duty differentials for both biodiesel and bioethanol will continue until 2007-08**, providing further certainty and stability for development.

7.42 As announced in the 2004 Pre-Budget Report, the Government is undertaking a feasibility study and consultative process on a possible Renewable Transport Fuels Obligation (RTFO). The RTFO would require a specified proportion of aggregate fuel sales to come from a renewable source and would draw on the experience of the Obligation for renewable electricity. A cross-Government group has been set up and is currently holding a series of stakeholder workshops to discuss specific aspects of how an RTFO could work in practice. Detailed work will continue over the coming months with a view to informing decisions later in the year. The 2004 Pre-Budget Report also announced that the Government will undertake a pilot project to examine the potential for using fuel duty incentives for inputs-based production of road fuel as a means of encouraging the use of biomass in conventional fuel production. **The tendering process will be launched in the coming months, and the Government intends that the project should begin from 2006, subject to Commission approval.** A factsheet on this measure can be found at www.hmce.gov.uk.

7.43 The Government has been holding discussions with the biofuels industry on the merits of an enhanced capital allowance scheme for the cleanest biofuels processing plants. **The Government considers that this would be a useful additional measure of support to the UK biofuels industry, subject to state aid approval and further work on the detail of the scheme.**

Road fuel gases **7.44** Liquefied petroleum gas (LPG) has a significant duty differential and benefited from the wider fuel duty freeze in 2004. The Government intends to reduce the differential towards a level more commensurate with its environmental benefits. Budget 2005 announces that the **duty differential for LPG will narrow against conventional road fuels by the equivalent of one penny per litre each year until 2007-08. The duty increase in 2005-06 will take effect from 1 September.** The current duty differential for natural gas against conventional road fuels will be maintained for the next three years until the end of 2007-08, a continuation of the policy announced at Budget 2004.

Company car tax **7.45** In April 2002, the company car tax system was reformed to reflect vehicle carbon dioxide emissions, to encourage the take-up of more environmentally-friendly cars. In April 2004, the Inland Revenue published an evaluation of the scheme⁶, which showed that it has been successful in reducing business mileage and lowering carbon dioxide emissions, as described further in Box 7.3. The Inland Revenue will continue to evaluate the scheme to ensure that it meets the Government's environmental aims. **The Government today announces that the threshold for the minimum percentage charge rate will be frozen at 140g per kilometre for 2007-08.**

7.46 Following the commitment in the 2004 Pre-Budget Report, **the Budget announces simplifications of the company car tax system relating to bi-fuel and hybrid electric cars.** The discount system for these cars will be simplified from April 2006, to replace the existing provisions with a 1 per cent increase in the basic percentage discounts.

Capital allowances for cars **7.47** In the 2004 Pre-Budget Report, the Government announced that it would consider options for modernising the capital allowance rules for business cars, including those that would fit with its wider environmental objectives, by potentially basing car allowances on carbon dioxide emissions. The Government will now assess the responses to that consultation before deciding on the next stage of the process.

⁶ *Report on the evaluation of company car tax reform*, Inland Revenue, April 2004, available at www.inlandrevenue.gov.uk

Box 7.3: Assessment of transport taxation against environmental objectives

The Government has set transport and other taxes to encourage the reduction of greenhouse gases and improve air quality. Analysis suggests that the following measures have been successful against these aims:

- reform of company car tax, which is initially estimated to have reduced business travel in company cars by between 300 and 400 million miles, saving around 0.15 to 0.2 MtC in 2003 and 0.5 to 1 MtC by 2010. Over half of all employers who run company car fleets are encouraging their employees to switch to cars with lower carbon dioxide emissions;
- biodiesel can reduce carbon dioxide emissions by up to 54 per cent and the Government has introduced a 20 pence per litre duty differential in its favour. Since 2002, 43 million litres of biodiesel have been sold. A similar duty differential for bioethanol was introduced in January 2005 and early indications suggest sales of around 60 million litres a year;
- the shift to ultra-low sulphur petrol (ULSP) from ordinary unleaded petrol as a result of a duty differential introduced by the Government in 2000, which is estimated to have reduced nitrogen oxide emissions by 1 per cent, carbon monoxide emissions by 4 per cent and volatile organic compounds emissions by 1 per cent in each year between 2001 and 2004;
- a differential for ultra-low sulphur diesel (ULSD) was first introduced in 1997 and has been widened since then. This incentive encouraged the entire market to switch to ULSD by 2000. This is estimated to have reduced emissions of particulates by 8 per cent and nitrogen oxides by up to 1 per cent in each year between 2001 and 2004; and
- liquefied petroleum gas and natural gas are the two types of gas currently used as road fuel in the UK. The growth in road fuel gases encouraged by the Government's duty differential has reduced emissions of particulates and nitrogen oxides, which has helped to improve local air quality, and brought about a cumulative carbon dioxide emissions saving of 0.1 MtC.

Company car fuel 7.48 The company car fuel benefit charge was reformed in 2003 to bring it into line with the carbon emissions basis of the company car tax system. Company car fuel benefit is calculated by multiplying the relevant company car tax percentage band for the vehicle in question to a set figure, which since April 2003 has been set at £14,400. **This Budget announces that the calculation figure will be frozen at £14,400 in 2005-06.** The Government also intends, subject to Commission approval and informal discussions with businesses, to reform the VAT fuel scale charge to a carbon dioxide emissions basis.

Vehicle excise duty 7.49 The Government reformed vehicle excise duty (VED) in 2001 to reflect vehicle carbon dioxide emissions and provide motorists with an incentive to choose more environmentally-friendly vehicles. **The Government announces that the six VED bands will be re-named A-F, from the current lettering of AAA to D,** while retaining their current carbon dioxide emission levels. This will align VED lettering with the new energy efficiency labelling scheme to be introduced by industry into car showrooms later this year, ahead of EU proposals for such labels. This will help consumers to make fully-informed vehicle choices.

7.50 Following the freeze in VED in Budget 2004, and to underline VED's environmental focus, **VED rates will be frozen for the four least polluting carbon dioxide bands and increased by the standard £5 for the two most polluting bands, as well as for cars and light goods vehicles of over 1549cc registered before 1 March 2001. Changes take effect for licences commencing 1 April.**

Vehicle emission standards **7.51** The European Commission is currently considering new Euro V vehicle emission standards for cars and small vans, and a proposal is expected later this year. The Government supports the development and introduction of new vehicle standards, where these can deliver air quality improvements cost-effectively, and will consider its response once the proposal has been issued.

Lorry road-user charge **7.52** Road haulage plays an important role in a productive economy. The Government is committed to ensuring that all lorries using UK roads contribute on a fair and equal basis towards the costs that they impose. The Government is therefore progressing its plans for a Lorry Road-User Charge (LRUC), accompanied by offsetting tax cuts. It is due to be phased in from 2007-08. The LRUC programme is now well into its procurement phase, and HM Customs and Excise have started detailed discussions about their requirements with the bidders who have been short-listed to receive a Final Invitation to Negotiate (FITN). **The Government will publish draft legislation later this year, which will outline a framework for the charge and the fuel duty repayment scheme.**

National road user charging **7.53** Congestion is a serious and growing problem in the UK. Unpredictable and rising journey times raise costs for individuals and businesses, and have an adverse effect on UK productivity and economic growth. Congestion also creates localised air-quality hotspots, often in highly populated urban areas. While there is a case for increased investment and better management of the road network, it will not be possible to build a way out of congestion and the problems that it will cause. The feasibility study into road pricing, published by DfT in July 2004⁷, concluded that a carefully-designed national road pricing scheme could reduce congestion by up to a half, as well as delivering environmental benefits. In the Future of Transport White Paper, the Government welcomed the feasibility study and committed to taking a number of actions in response to its recommendations.⁸ It also recognised that establishing a number of congestion charging schemes at the local level would be an important part of any trajectory towards a national road pricing system.

Aviation **7.54** The UK Air Transport White Paper⁹ recognised that greenhouse gas emissions from aviation make a significant and growing contribution to climate change. Forecasts suggest that the UK's combined domestic and international aviation emissions could account for up to a quarter of the UK's total contributions to climate change emissions by 2030. The Government believes that the challenge of tackling aviation emissions is best met through concerted international action. A well-designed emissions trading scheme is potentially the most cost-effective way of ensuring that aviation contributes to global climate stabilisation. The Government is committed to aviation joining the EU ETS from 2008, or as soon as possible thereafter, and advancing this objective is a priority for the UK Presidency of the EU. The Government will also continue to explore the role of other economic instruments. **The Government today announces a freeze on air passenger duty (APD) rates for the year ahead.**

IMPROVING WASTE MANAGEMENT

7.55 The Government has introduced a number of measures, such as landfill tax, landfill allowance trading scheme and spending programmes designed to improve the efficient use of resources, encourage the effective management of waste and meet the commitment to reduce the volume of household waste sent to landfill.

⁷ *Feasibility Study of road pricing in the UK*, DfT, July 2004, available at www.dft.gov.uk

⁸ *Future of Transport White Paper*, DfT, July 2004, available at www.dft.gov.uk

⁹ *Air Transport White Paper*, DfT, 2003.

Landfill tax 7.56 The total volume of waste disposed to landfill has fallen by almost 20 per cent since the introduction of the tax. As confirmed in Budget 2003, from 1 April 2005 the standard rate (for active waste) will be increased by £3 a tonne to £18 a tonne. The rate will also increase by at least £3 a tonne in the following years to a rate of £35 a tonne in the medium-to longer-term. As described in Box 7.4, these announced increases appear to be having a positive effect, with waste being disposed to landfill falling and greater investment in alternative waste management options.

Recycling landfill tax revenue 7.57 Budget 2003 announced that future increases in the standard rate of landfill tax would be introduced in a way that is revenue neutral to business as a whole and to local government. In line with this commitment, the 2004 Spending Review announced that a new spending programme for England – the Business Resource Efficiency and Waste (BREW) programme – worth £284 million over three years, would be used to support businesses in improving resource efficiency and minimising waste outputs. The programme will be rolled out in April 2005.

7.58 The Government has consulted stakeholders on the potential for a new enhanced capital allowance for waste and associated resource efficiency technologies. It is clear that there is support for a scheme and the Government will therefore continue to consult, focusing on supporting the introduction of new technologies, such as mechanical and biological treatment, and report on its findings at the 2005 Pre-Budget Report.

Landfill tax credit scheme 7.59 The Government recognises the important contribution made by the landfill tax credit scheme to local communities and has received positive representations from stakeholders on the value of projects funded by the scheme. Since the start of the scheme it has spent £566 million delivering over 17,500 projects, including improvements to parks, playing fields, nature reserves, places of worship and improvements to wildlife habitats to support biodiversity. **This Budget announces that it will increase the value of the scheme in line with inflation to £49.7 million.** The Government will carry on working with stakeholders to build on the improvements made and will continue to consider representations on the level of the scheme.

Improving local waste management 7.60 In December 2004, Defra announced the allocation of £45 million to local authorities in 2005-06 from the reform of the Waste Minimisation and Challenge Fund. The funding will be used to support local authorities to introduce more sustainable waste management practices and to help deliver the £299 million of efficiency gains on waste services announced in the 2004 Spending Review. £5 million of the grant will focus specifically on local authority incentives for households to recycle and reduce waste. To help ensure the planning system assists delivery of the required disposal facilities, Defra and the Office of the Deputy Prime Minister issued a joint consultation on revised policy guidance in December 2004 to facilitate strategic and spatial planning for waste management.

PROTECTING THE UK'S COUNTRYSIDE AND NATURAL RESOURCES

7.61 To protect the UK's countryside and natural resources the Government seeks to implement measures that balance economic growth with the need to encourage a sustainable approach, particularly in sectors with a significant direct impact, such as agriculture and aggregate extraction.

Aggregates levy 7.62 Introduced in April 2002, the aggregates levy aims to reduce the amount of primary aggregate being extracted from quarries and to encourage the use of alternatives. Revenue from the aggregates levy is recycled to businesses through a 0.1 percentage point cut in employer national insurance contributions and through the aggregates levy sustainability

fund. As set out in Box 7.5, the Government's initial assessment is that the levy is achieving its primary objectives. Sales of primary aggregate in Great Britain fell by 8 per cent and the estimated production of recycled aggregates increased by 3.1 million tonnes between 2001 and 2003. **The Government today announces that in 2005-06 the rate of the levy will be frozen at £1.60 a tonne.** From 1 April 2004, the Government extended the scope and duration of the relief that applied to aggregate used in processed products in Northern Ireland, so that it now covers primary aggregates as well. To benefit from the extended relief, aggregate businesses in Northern Ireland have to agree to implement stringent environmental improvements to their operations.

Diffuse water pollution from agriculture

7.63 Over 75 per cent of land in the UK is used for agricultural purposes and so farming practices have a significant impact on the UK's environment, including water pollution from the use of fertilisers and pesticides. In December 2004, the UK completed the first assessment of the status of all UK water bodies against the environmental requirements of the EU Water Framework Directive. The supportive approaches that the Government is pursuing and the Common Agricultural Policy (CAP) reform will lead to reductions in diffuse water pollution from agriculture, but further action is likely to be needed. The UK has taken a lead role in helping to establish a strategic programme within the EU for addressing the linkages between the Water Framework directive and the CAP, and a new EU strategic steering group is being set up to co-ordinate this work. Defra and the Devolved Administrations are working with stakeholders to develop policy measures to help achieve the necessary changes in farm practice, including supportive and awareness-raising measures on the ground. The Government will consider using other measures to tackle diffuse water pollution.

Pesticides

7.64 An industry voluntary initiative (VI) on measures to reduce the environmental damage caused by the agricultural use of pesticides has been in place since April 2001. The Government continues to believe that, if fully implemented, this will be the most effective way of reducing the environmental pollution associated with pesticides. There has already been good progress made against the current targets, for example, with 777,000 hectares covered by crop protection management plans in 2004 – three times the initial target level. Targets that are related directly to their environmental and biodiversity impact allow the success of the initiative to be demonstrated. The Government is continuing to have discussions with the VI steering group on the strengthening of targets, including proposals for a 50 per cent reduction by 2006 in the frequency of pesticide detection above the 0.1 part per billion threshold. To cover the possibility that the VI might fail to deliver the required environmental benefits within a reasonable time, the Government continues to keep options for a tax or economic instrument under review. Work has also been taken forward in consultation with stakeholders on developing a national plan for pesticides, of which the VI will be a central element.

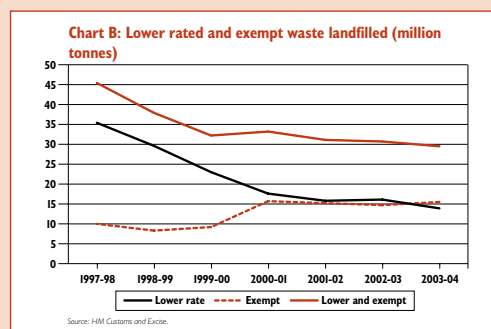
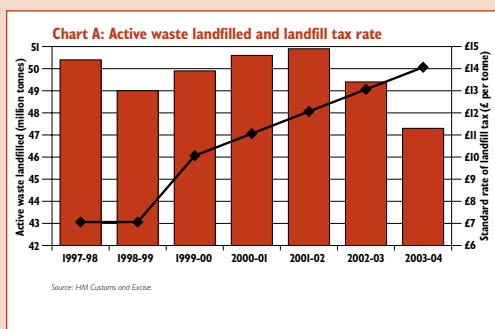
Sustainable land use

7.65 The Government's strategy for housing places key housing, planning and regeneration policies in the context of wider requirements for sustainable communities. The Barker Review, described further in Chapter 3, also recognised the need for housing policy to balance the environmental implications of housing development against the risks to macroeconomic stability and long-term affordability of not delivering a substantial increase in the housing supply. The Government has already taken a number of steps to improve the energy efficiency of housing, including amending Building Regulations from 2005 onwards so that new homes must be at least 25 per cent more efficient in their use of energy; and incentivising improvements in new and existing social housing – with all existing social homes being brought up to the Decent Homes standard by 2010.

Box 7.4: Assessment of the landfill tax

The landfill tax was introduced in October 1996. In Budget 2003, to reduce reliance on landfill further, the Government announced that landfill tax on active waste would increase annually by at least £3 a tonne from April 2005 on the way to a medium- to long-term rate of £35 a tonne.

The total volume of waste disposed to landfill fell by almost 20 per cent between 1997-98 and 2003-04. As shown in Chart A, since the Government's announcement of increases to the landfill tax on active waste, the volume of such waste has fallen by over 4 per cent. The quantity of inactive or inert waste disposed to landfill fell by 60 per cent between 1997-98 and 2003-04. Even allowing for the fact that some of this material may have been reclassified as exempt, there is still an overall reduction in inert or exempt material of 16 million tonnes (35 per cent) over the period, as shown in Chart B.



It is too early to reach a conclusive view on the changes in waste management investment since April 2003. However, initial analysis of waste management planning decisions suggests that there has been a shift away from landfill towards investment in alternative waste management options, although landfill remains an important means of waste disposal. In England, approved planning decisions (i.e. where planning permission has been granted) for landfill sites fell by 14 per cent between 2002-03 and 2003-04. Over the same period, approved decisions for waste treatment sites rose by 52 per cent and for composting facilities increased by 55 per cent. The greatest number of decisions in 2003-04 was for treatment (28 per cent of all approved decisions) followed by landfill (22 per cent of all approved decisions). However the Government recognises that further investment in alternatives to landfill is still required.

The landfill tax has been effective in diverting waste from landfill. Increasing the rate on active waste is one of a number of measures to help put the UK on course to achieve the target of reducing biodegradable municipal waste landfilled in 2010 to 75 per cent of that landfilled in 1995.

Sustainable housing 7.66 The Government is developing, in consultation with the building industry, a voluntary Code for Sustainable Buildings, which will set new standards for resource efficiency in the built environment, focusing initially on new housing. Demonstrations of the Code will be in place by the end of 2005, followed by national rollout in 2006.

Contaminated land tax credit 7.67 The Government continues to examine options to extend the contaminated land tax credit (CLTC) to long-term derelict land in an efficient way. Research into the effectiveness of the CLTC is under way and, depending on the outcome of that research, the Government will consult later this year on extension.

Box 7.5: Assessment of the aggregates levy

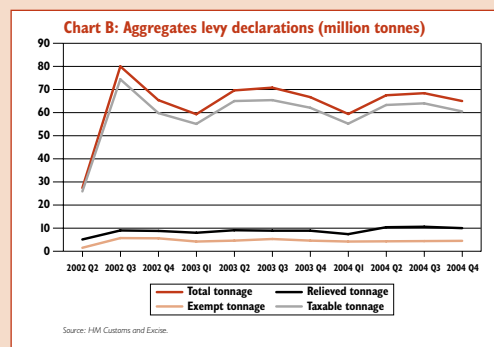
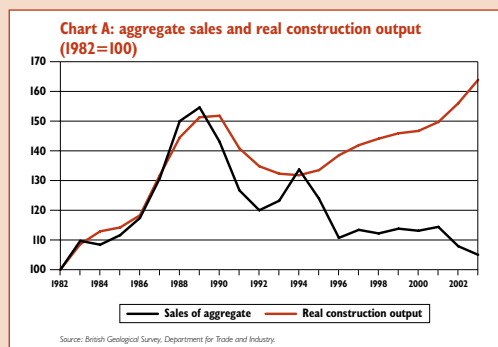
The aggregates levy aims to reduce the amount of primary aggregate being extracted from quarries and to encourage the use of alternatives. Early indications suggest the aggregates levy has been effective in achieving its objectives:

- sales of primary aggregate in Great Britain fell by 8 per cent between 2001 and 2003, to their lowest level since 1982. The falls are against a backdrop of buoyant construction activity, including higher levels of road building since 2000, and GDP growth;
- in England, the estimated production of recycled aggregates increased by 3.1 million tonnes between 2001 and 2003;
- when surveyed, expanding recycled aggregate businesses gave the levy as the most frequent reason for growth since 2001; and
- there was a marked increase in the volume of china clay waste and slate waste sold as aggregate as a result of the economic incentive presented by the aggregates levy exemptions granted to these products. Between 2001 and 2004 china clay waste sold as aggregate in the UK increased by 14 per cent to 2.5 million tonnes.^a National sales of slate for 'fill and other' uses increased by 65 per cent in 2003, compared with the pre-levy year 2001.

Chart A shows aggregate sales and construction output over time. The series are closely matched throughout the 1980s and early 1990s. However, in the mid 1990s aggregate sales fell while construction output continued to rise. There are reasons for this in addition to the introduction of the landfill tax, including changes in construction processes, and a decrease in road building between 1994 and 2000. Over the period 1997 to 2001, sales of aggregates remained flat before falling sharply after 2001 with the introduction of the aggregates levy. This is against a background of a sharp increase in construction output from 2001, including higher levels of road building from 2000 (which is aggregate intensive).

Chart B indicates that aggregates levy declarations show a seasonal effect, attributed to lower demand from the building sector in the winter months. Declarations of relieved aggregate have increased by around 3 million tonnes per quarter since the quarter beginning April 2004. The most likely explanation is the extension of the Northern Ireland relief scheme from 1 April 2004.

The Government will continue to evaluate the levy, and in particular consider evidence from industry about its impact.



^a Kaolin and Bael Clay Association

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

7.68 This chapter includes assessments of the Government's experience to date of using environmental taxes, which show that they are meeting their objectives, for example:

- the climate change levy should deliver savings of 3.7 million tonnes of carbon (MtC) by 2010;
- sales of primary aggregate in Great Britain fell by 8 per cent between 2001 and 2003;
- the amount of waste going to landfill is falling; and
- evidence suggests that reform of company car tax has reduced carbon dioxide emissions with savings of 0.5 to 1 MtC in 2010 and led to a reduction of 300-400 million business miles.

7.69 Table 7.1 shows how Budget measures sit alongside other policies as part of the Government's approach to the environmental elements of sustainable development. Table 7.2 sets out the environmental impact of the measures the Government has taken since the Statement of Intent in 1997 that have had a significant effect on the environment or which serve an environmental purpose. To increase transparency and public reporting of key performance indicators, the environmental appraisal tables are also available on the Treasury website.¹⁰ The tables will be updated to reflect continuing monitoring of environmental indicators and further evaluation of specific schemes.

¹⁰ www.hm-treasury.gov.uk

Table 7.1: The Government's policy objectives and measures

Sustainable Development Indicator ¹ and recent trend data	Recent Government Measures
Tackling Climate Change	
<p>Targets Joint Defra/DfT/DfT PSA target – reduce greenhouse gas emissions to 12.5 per cent below 1990 levels in line with Kyoto commitment and move towards a 20 per cent reduction in carbon dioxide emissions below 1990 levels by 2010.</p> <p>Progress UK greenhouse gas emissions were 13.9 per cent below 1990 levels in 2003.² Carbon dioxide emissions fell by 7.2 per cent during this period.</p>	<ul style="list-style-type: none"> • Climate Change Programme, DETR, November 2000. • UK Emissions Trading Scheme, Defra, August 2001. • Energy Efficiency Commitment, Defra, April 2002 and April 2004. • Renewables Obligation, Defra, April 2002 and December 2003. • Energy White Paper, DTI 2003. • Energy Efficiency – the Government's plan for Action, Defra, April 2004. • EU ETS 2005. • Package of fiscal measures, including climate change levy (see Table 7.2).
Air Quality	
<p>Targets Air Quality Strategy for England, Scotland, Wales and Northern Ireland set health-based air quality standards for nine key air pollutants and target dates for their achievement across the UK between 2003 and 2010.</p> <p>Progress The number of days with moderate or higher air pollution decreased from 50 to 22 in urban areas and from 61 to 41 in rural areas between 2003 and 2004.³</p>	<ul style="list-style-type: none"> • Air Quality Strategy DETR January 2000 and Addendum, Defra February 2003, and Review, Defra 2004-05. • Implementation of Integrated Pollution, Prevention Control regime, Defra 2002-2007. • Continued support for local air quality management system. • Negotiation and implementation of EU air quality directives and international agreements 2004-05. • Ten Year Plan for Transport, DETR July 2000, and Future of Transport White Paper, July 2004. • Review of the Transport Energy Grant Programmes, DfT 2004. • Air Transport White Paper, DfT, December 2003. • Fiscal measures including fuel differentials for less polluting fuels (see Table 7.2).
Improving Waste Management	
<p>Targets Defra PSA target – enable at least 25 per cent of household waste to be composted or recycled in 2005-06. Landfill Directive target to reduce the volumes of biodegradable municipal waste disposed of at landfill to 75 per cent of 1995 levels by 2010, 50 per cent by 2013, and 35 per cent by 2020.</p> <p>Progress Composting / recycling rate of 17.7 per cent for England in 2003-04. Active waste disposed to landfill has fallen from 50.4 million tonnes in 1997-98 to 47.3 million tonnes in 2003-04.</p>	<ul style="list-style-type: none"> • Waste Strategy 2000, DETR, May 2000. • Waste Implementation Programme, Defra, 2002. • Reform of the Waste Minimisation and recycling challenge fund. • Landfill allowance (trading) schemes enacted by the Waste and Emissions Trading (WET) Act 2003. • Defra are reviewing their Waste Strategy in 2005. • Waste Implementation Programme Defra 2002. • Business resource and efficiency waste programme (BREW) 2004. • Landfill tax and related measures (see Table 7.2).
Regenerating the UK's towns and cities	
<p>Targets ODPM PSA 5: 60 per cent of housing development to be on previously developed land. ODPM PSA 1: Promote better policy integration and work with departments to help meet PSA floor targets for neighbourhood renewal and social inclusion.</p> <p>Progress In 2003, 67 per cent of new housing was on previously developed land, increasing from around 54 per cent in 1990. 2004 data shows the gap between the most deprived areas and the rest of the country on several key indicators, including education at GCSE, burglary and unemployment has narrowed. Salford and Blackpool Urban Regeneration Companies launched in February 2005, bringing total to 18.</p>	<ul style="list-style-type: none"> • Sustainable Communities: "building for the future" launched in February 2003. • National Nuisance Vehicle Strategy launched in November 2004. • Feb 2005, Planning Policy Statement 1 launched, placing sustainability for the first time as a core principle of the planning system. • Feb 2005 English Partnerships launch pilot programme with 12 local authorities to tackle England's legacy of derelict and brownfield land, to bring 66,000 hectares of brownfield land into beneficial use. • SR04 rolled forward £525 million Neighbourhood Renewal Fund for neighbourhood renewal in 88 most deprived areas and maintained commitment to New Deal For Communities programmes. • Package of fiscal measures including contaminated land tax credit (see Table 7.2).
Protecting the UK's countryside and natural resources	
<p>Targets Defra PSA target – positive trends in the Government's headline indicators of sustainable development (includes wildlife, river water quality, land use). Water Framework Directive – requires achievement of good chemical and ecological status in surface water by 2015.</p> <p>Progress</p> <ul style="list-style-type: none"> • Farmland birds almost halved between 1977 and 1993. However, declines have reduced in recent years and 2003 populations were virtually unchanged from 1993. • Woodland birds fell by about 30 per cent between 1975 and 1992. Since then, however, populations have remained broadly constant. • In 2003 about 95 per cent of rivers in the UK were rated as having good or fair chemical quality and approximately 96 per cent of UK rivers were of good or fair biological quality. 	<ul style="list-style-type: none"> • Regulations transposing the Water Framework Directive came into force 2 January 2004. • Rural White Paper, DETR, November 2000. • Strategy for Sustainable Farming and Food, Defra, December 2002. • Developing measures to promote catchment-sensitive farming (Defra-HMT consultation), June 2004. • Defra consulting on pesticides strategy. • Aggregates levy and aggregates levy sustainability fund (see table 7.2).

¹ Achieving a better quality of life - Review of progress towards sustainable development, Defra, March 2004 - latest data from www.sustainable-development.gov.uk

² The six main greenhouse gases are: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride (provisional figure).

³ Air quality headline indicator for sustainable development: Defra, 2004 (provisional figures).

Table 7.2: The environmental impacts of Budget measures

Budget measure	Environmental impact ¹
Climate Change and Air Quality	
Climate change levy package: <ul style="list-style-type: none"> • Climate change levy; • Climate change agreements; • Green Technology Challenge (GTC); • Exemptions for new renewables and combined heat and power (CHP); • UK Emissions Trading Scheme. 	CCL is estimated to deliver annual CO ₂ savings of over 3.5 million tonnes of carbon (MtC) in 2010 – well above the 2 MtC figure forecast at the time of the levy's introduction. ² CCAS are estimated to have saved 4.5MtC in the first target period 2001-03. GTC is expected to save up to 0.5MtC by 2010. The UK ETS is estimated to have saved 1.4MtC in 2004.
Landlord's Energy Saving Allowance (LESA);	Small reduction of CO ₂ emissions.
VAT reduction. Budget 2005 extended reduced rates of VAT to air source heat pumps and micro CHP. VAT reduction for energy saving materials and domestic installation of renewable energy technologies.	Small reduction of CO ₂ emissions.
Reduced rate of VAT on domestic fuel and power.	Estimated to increase CO ₂ by 0.2 million tonnes by 2010.
Road fuel duty escalator. In 1997 the level increased from 5 per cent to 6 per cent and remained at that level until 1999.	Between 1997 and 1999, the fuel duty escalator is forecast to have reduced emissions between 0.1 MtC and 0.2 MtC per year by 2010.
Road fuel duty and differentials ³ Budget announces, from 1 September, an inflation-based increase in main road fuel duties. Since 1997, the Government has used a series of duty differentials to promote the manufacture and take-up of less polluting road fuels. Key changes include: –Introduction of duty differentials to facilitate a market switch: <ul style="list-style-type: none"> • From leaded to unleaded; • From low sulphur to ultra-low sulphur diesel (ULSD); • From low sulphur to ultra-low sulphur petrol (ULSP). –Introduction of duty differentials to encourage growth in the use of more environmentally-friendly fuels: <ul style="list-style-type: none"> • For liquefied petroleum gas and natural gas; • 20 pence per litre (ppl) differential for biodiesel in 2002; • 20 ppl differential for bioethanol in 2005. 	Not increasing fuel duties in line with inflation from Budget day is expected to result in higher carbon emissions than would otherwise have been the case, although this is expected to be partially offset by higher oil prices. The shift to ULSP from ordinary unleaded is estimated to have reduced emissions of nitrogen oxide by 1 per cent, carbon monoxide by 4 per cent and volatile organic compounds by 1 per cent per year between 2001 and 2004. The shift to ULSD from ordinary diesel is estimated to have reduced emissions of particulates by 8 per cent and nitrogen oxides by up to 1 per cent per year between 2001 and 2004. The increased use of biodiesel and bioethanol will reduce CO ₂ emissions overall by up to 54 per cent per litre of biofuel used. It is estimated that the biodiesel differential could save up to 0.2 MtC per year by 2010 ⁴ . The road fuel gas differential has reduced emissions of particulates and nitrogen oxides, which has helped to improve local air quality, and brought about a cumulative carbon saving of 0.1 MtC.
Rebated fuels Budget 2005 announces from 1 September, a 1.22ppl increase in duty rates for rebated oils. As part of the Oil Fraud Strategy, the gap between duty on rebated oils and main road duty rates was narrowed in 2004.	Maintaining the differential with main road fuels will reduce levels of fraud, which will deliver small CO ₂ and local air pollution benefits through increased use of less polluting fuels and less use of rebated fuels which are more polluting.

¹ Estimates of the environmental impacts of measures are difficult as they depend on the behavioural impact and savings from new technologies so are often subject to a wide margin of error.

² *Modelling the initial effects of the climate change levy*, Cambridge Econometrics, available at www.hmce.gov.uk

³ Using NETCEN emissions models - further detail on the methodology used is provided in NETCEN's January 2000 report, *UK Road Transport Emissions Projections*.

⁴ DfT modelling.

Table 7.2: The environmental impacts of Budget measures (continued)

Budget measure	Environmental impact ¹
<p>Reforms to vehicle excise duty (VED)</p> <p>Budget 2005 announces VED rates will be frozen for the four least polluting CO₂ bands and increased by £5 for the two most polluting bands and for cars and light goods vehicles and for vehicles with engines bigger than 1549 cc registered before 1 March 2001.</p> <p>Bands are relettered from A-F</p> <p>VED has been reformed over the years to more closely reflect environmental impacts: VED for cars and light goods vehicles registered on or after 1 March 2001 based on CO₂ emissions.</p>	<p>Currently small reductions in CO₂ emissions and local air pollutants. Numbers of vehicles in 3 lowest CO₂ emission graduated VED bands forecasted to grow significantly by 2006-07,¹ in part due to reforms to VED bands.</p>
<p>Enhanced capital allowances (ECAs)</p> <p>Since 2002, businesses of all sizes can claim 100 per cent first-year allowances on capital expenditure on electric cars or cars with CO₂ emissions of 120g per km fewer.</p>	<p>Small reductions in emissions of CO₂ and local air pollutants.</p>
<p>ECAs for hydrogen and compressed natural gas refuelling equipment.</p>	<p>Reduction in emissions of CO₂ and local air pollutants.</p>
<p>Green travel plans.</p> <p>In Budget 2001, Government announced a series of measures to promote environmentally friendly travel including a reduced rate of VAT for cycle helmets, increasing the income tax and NICs free mileage rate employers can pay, and a passenger rate of 5 pence per mile to encourage car sharing on business trips.</p>	<p>Very small CO₂ reductions and reductions in road traffic and congestion.</p>
<p>Company car tax system (CCT).</p> <p>Budget 2005 announces a freeze of CCT bands and simplification of the discounts relating to bi-fuel and hybrid electric cars.</p> <p>A graduated scheme was introduced in 2002 to provide a lower charge to cars that emit less CO₂ and a higher charge to those with large CO₂ emissions.</p>	<p>Freezing CCT bands leads to a small increase in CO₂ and local air pollutants, compared with the position had the lowest band been reduced by 5g/km.</p> <p>Estimated CO₂ emissions savings of 0.15 to 0.2 MtC in 2004. In the long run it is forecast that CO₂ savings will be between 0.5 and 1 MtC in 2010.⁶</p>
<p>Company car fuel benefit charge.</p> <p>Budget 2005 announces a freeze of the charge at £14,400.</p> <p>Budget 1998 announced a five-year programme of annual increases to discourage the giving/receiving of free fuel for private use in a company car. In 2003 the Charge was restructured to relate it to CO₂ emissions and to include the same discounts and premiums as in the company car tax system.</p>	<p>The programme of increases over five years in the fuel scale charge between 1997-98 and 2002-03 is estimated to have reduced the number of drivers in receipt of free fuel by around 300,000.⁷</p> <p>It is expected that the programme has reduced CO₂ and local air pollutant emissions due to fewer private miles travelled.</p> <p>Restructure of the fuel scale charge in 2003 will have produced further reductions in carbon emissions.</p>
<p>VAT fuel scale charge reform.</p> <p>The VAT fuel scale charge is planned to be aligned with the Inland Revenue fuel charge system, based on the CO₂ emissions of the vehicle.</p>	<p>Expected to deliver small reduction CO₂ and local air pollutant emissions.</p>
<p>Employer-provided van benefit.</p> <p>The reform of the employer provided vans rules, to take effect from April 2005, will remove the incentive to drive older, more polluting vans.</p>	<p>Small reduction in CO₂ and local air pollutants.</p>
<p>Haulage modernisation fund.</p>	<p>1 per cent reduction in particulate emissions per year by 2004, reductions in carbon emissions of around 0.1 MtC per year by 2004, and reductions in nitrogen oxides.</p>
<p>Air passenger duty (APD).</p> <p>Budget announces a freeze on the rate of APD.</p> <p>APD was introduced in 1994, and reformed in 2001.</p>	<p>Freezing the APD rates will lead to a small increase in emissions of CO₂ and local air pollutants compared with, for example, increase in line with inflation.</p> <p>Levying APD has meant a reduction in emissions of CO₂ and local air pollutants from aviation.</p>

⁶ Inland Revenue modelling.

⁷ Inland Revenue modelling.

Table 7.2: The environmental impacts of Budget measures (continued)

Budget measure	Environmental impact ¹
Improving Waste Management	
<p>Landfill tax.</p> <p>In 1999 the standard rate increased by £3 a tonne and annually by £1.</p> <p>Budget 2003 announced that standard rate of landfill tax would increase by £3 a tonne in 2005-06 and by at least £3 a tonne in following years to reach a medium-long term rate of £35 a tonne.</p>	<p>Encourages waste producers and the waste management industry to switch away from landfill disposal towards waste minimisation, re-use, and other waste management options. Planning applications for alternatives to landfill have risen significantly.</p>
<p>Landfill tax credit scheme (LTCS).</p> <p>Budget 2005 has increased the value of the scheme in line with inflation to £49.7 million.</p> <p>In 2003 the scheme was amended and sustainable waste management projects were removed.</p>	<p>A scheme supporting local community and environmental projects in the vicinity of landfill sites.</p> <p>The LTCS has provided £566 million for projects since its introduction.</p>
Regenerating the UK's towns and cities	
Contaminated land tax credit.	Bringing forward remediation of contaminated land.
Capital allowances for flats over shops.	Bringing empty space over shops back into the residential market, while reducing the pressure for new greenfield development.
Reforms to VAT on conversion and renovation.	Reduced pressure on greenfield site development.
Protecting the UK's countryside and natural resources	
<p>Aggregates levy and aggregates levy sustainability fund.</p> <p>Budget 2005 freezes the aggregates levy at £1.60 a tonne.</p> <p>In Northern Ireland a relief scheme was introduced in April 2002 and was extended in scope and duration in April 2004.</p>	<p>Reductions in noise and vibration, dust and other emissions to air, visual intrusion, loss of amenity and damage to wildlife habitats.</p> <p>An 8 per cent reduction in aggregates between 2001 and 2003.</p>
Enhanced capital allowances for water efficiency technologies.	Reductions in energy and water use by business.

To safeguard long-term economic growth and ensure intergenerational fairness it is important that Budget decisions are consistent with the long-term sustainability of the public finances. The illustrative long-term fiscal projections presented in this annex provide an assessment of the long-term sustainability of the Government's fiscal policies over the period up to 2034-35, in line with the requirements of the *Code for fiscal stability*. The key points are:

- the UK remains well-placed to deal with potential future spending pressures due to ageing and other factors;
- given the projected profile for tax revenue and transfers, current public consumption can grow at around assumed GDP growth after the medium term while meeting the Government's golden rule; and
- public sector net investment can grow more or less in line with the economy without jeopardising the sustainable investment rule.

This conclusion concurs with the findings of the *2004 Long-term public finance report*, which provides a more detailed examination of the long-term public finances. The report finds that on a range of assumptions and using a number of techniques, the UK's fiscal position is sustainable in the long term on the basis of current policies, and that the UK is in a strong position relative to many other developed countries to face the challenges ahead. However, the Government remains vigilant to future risks and is not complacent about the long-term challenges posed by an ageing population. It will continue to update and report on assessments of long-term fiscal sustainability.

Illustrative long-term fiscal projections

A.1 The Government's fiscal policy framework, as set out in the *Code for fiscal stability*,¹ is designed to ensure transparent, long-term decision-making. Fiscal policy is set to ensure sustainable public finances, with consideration to the short, medium and long term. Long-term fiscal sustainability helps to promote long-term economic growth by ensuring that financial burdens are not shifted to future generations.

A.2 To assess the sustainability and inter-generational impact of fiscal policy, the *Code* requires the Government to publish illustrative long-term fiscal projections covering a period of at least 10 years. In practice, a 30-year horizon has been adopted. The projections published in previous Budgets showed that the UK's long-term fiscal position was relatively favourable and that the Government will meet its two fiscal rules – the golden rule and the sustainable investment rule – over the long term.

A.3 To complement and enhance the illustrative projections, the Government has published the *Long-term public finance report* each year since 2002, most recently alongside the 2004 Pre-Budget Report.² The 2004 report examined long-term challenges to the public finances and provided a comprehensive assessment of the sustainability of the public finances. It also updated the illustrative long-term fiscal projections in Budget 2004. The projections in this annex provide a further update, incorporating the Budget 2005 medium-term spending and revenue projections. The underlying assumptions and methodology remain broadly unchanged from previous years.

¹ *Code for fiscal stability*, HM Treasury, March 1998.

² *2004 Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004.

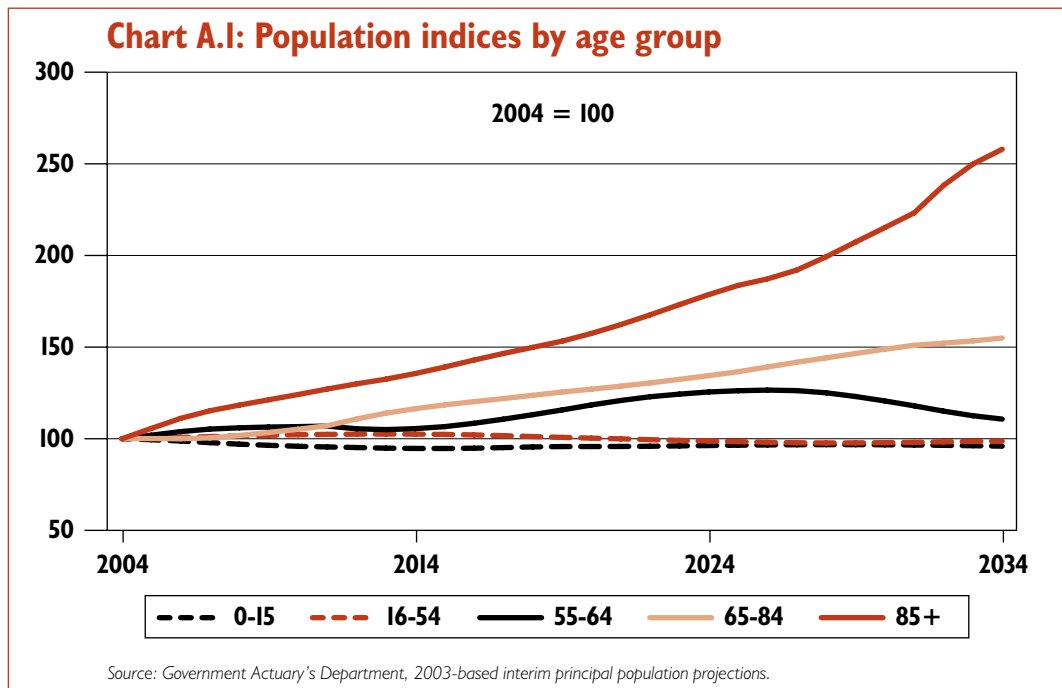
LONG-TERM SOCIO-ECONOMIC TRENDS

Population ageing

A.4 Declining fertility rates and improvements in life expectancy over past decades have led to a general ageing of the population in the UK, and throughout most of the developed world. Since Budget 2004, the Government Actuary's Department (GAD), which is the official producer of population projections in the UK, has published a new set of projections, based on the Office for National Statistics' mid-year 2003 population estimate.³ The new population projections differ from their predecessor only in their assumption regarding long-term annual net migration, with the latest projections assuming net migration of 130,000 per year – 30,000 more than previously. The assumptions regarding the fertility rate (the average number of children per woman) and life expectancy have remained unchanged at 1.74, and 80.6 years (males) and 84.6 years (females), respectively.⁴

A.5 However, the new population projections are based on a substantially higher life expectancy assumption than the 2001-based new projections.⁵ This reflects a constantly evolving understanding of future demographic trends in general, and of the future evolution of life expectancy in particular. As future population projections may look very different from today's, it is important to update long-term fiscal projections and to assess the sustainability of the public finances on a regular basis.

A.6 Based on the latest principal projections, the UK's population will increase from nearly 60 million today to around 66 million by the mid 2030s, before stabilising. The population structure is also projected to change substantially. Chart A.1 shows the wide variations between the projected change in size of different age groups, with the older age groups projected to increase substantially in absolute size over the next 30 years. According to the projections, the number of people aged 65-84 years will increase by more than 50 per cent, while the number of people aged 85 years and over will increase by around 250 per cent. The latter trend is also projected to continue beyond 2034, with four times as many people in this age group in 2050 than there are now.



³ Available at www.gad.gov.uk.

⁴ Life expectancy at birth in 2027.

⁵ For a comparative table, see 2004 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004.

A.7 The composition of the population will change as a result. Whereas those aged between 16 and 64 years make up nearly two-thirds of the total population now, their share is projected to fall to 58 per cent by 2034. At the same time the share of people aged 65 years and over in the total population is projected to rise from 16 per cent to nearly a quarter by 2034, with the share of those aged 85 years and over more than doubling from 1.8 per cent to 4.3 per cent. By contrast the share of children (those aged up to 15 years) in the total population is projected to fall by 2½ percentage points over the same period.

A high degree of uncertainty **A.8** Any long-term projection is subject to a high degree of uncertainty. To deal with this uncertainty, the GAD produces high and low variants around the principal projections. These projections differ in their assumptions regarding the fertility rate, life expectancy at birth and annual net migration flows. For example, the high fertility variant assumes that the average number of children per woman is 1.94, while the high longevity variant assumes life expectancy at birth in 2027 of 82.5 years for males and 85.9 years for females. The variants differ markedly from the principal projections in terms of future overall size and composition of the population. Other approaches to dealing with this uncertainty have been developed. For example, the National Institute for Economic and Social Research (NIESR) has generated a set of stochastic population projections, which produces a larger range of outcomes than the GAD's projections.^{6,7}

Other long-term trends **A.9** Over the last few years, many studies have analysed the potential effects of an ageing population on the public finances.⁸ However, there are other trends that could affect the UK's economy and public finances over the long term. For example, it is reasonable to assume that an older population will have a greater demand for health services than a younger population. However, future demand (and so spending needs) will also depend on factors such as health status, technological progress and changes in social preferences.⁹ The sustainability of the public finances will also be affected by future trend economic growth, which depends on labour market developments and productivity growth. Some commentators have suggested that an ageing population could lead to slower productivity growth. While there is no consensus on this issue,¹⁰ a cautious approach to assessing the long-term sustainability of the public finances would allow for this possibility and is the approach taken below. The expected continued integration of the world economy is also likely to affect the UK economy over the coming decades, including through changes to capital flows and the location of business activity.

METHODOLOGY AND ASSUMPTIONS

A.10 The methodology for producing the long-term fiscal projections presented in this annex determines the rate at which current public consumption can grow while the Government meets its fiscal rules. This is achieved by projecting the evolution of tax receipts, transfer payments (such as pensions) and capital consumption (depreciation) over the

⁶ Available at www.niesr.ac.uk.

⁷ See *World Economic Outlook September 2004: The Global Demographic Transition*, International Monetary Fund, September 2004, pages 144-145 for a more detailed discussion of uncertainty.

⁸ See the European Union's Economic Policy Committee's study on the budgetary cost of ageing populations at www.europa.eu.int for an example.

⁹ See *Securing our Future Health: Taking a Long-Term View*, Derek Wanless, 2002, *2004 Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004, *Intergenerational Report 2002-03*, Department of the Treasury of Australia, May 2002 and www.europa.eu.int.

¹⁰ For example, the Department of Trade and Industry finds that: "There is no evidence to support the view that older workers are inherently less productive than younger workers, except in a limited range of jobs requiring rapid reactions or physical strength, and people tend to move out of these as they become harder for them", *Retirement ages in the UK: a review of the literature*, Department of Trade and Industry, 2003, page vii.

coming decades. Subtracting transfers and capital consumption from tax revenues provides a measure of the financial resources available for current public consumption.¹¹

A.II The projections are based on prudent and cautious economic assumptions, and on existing policies. They are based on the fiscal forecasts and assumptions presented in Chapter C of the *Financial Statement and Budget Report* (FSBR), up to and including 2009-10, the end of the medium-term forecast period. Unless stated otherwise, the Government is assumed to leave these policies unchanged in 2010-11 and future years. The projections cannot, and do not, attempt to pre-empt future policy decisions.

Economic assumptions

A.I2 Table A.1 sets out the economic assumptions that underlie the long-term fiscal projections after 2009-10, which are broadly unchanged from those used in Budget 2004. The greater degree of uncertainty involved in projecting long-term trends means that the assumptions used in this exercise are particularly cautious. Productivity is assumed to grow by 2 per cent a year between 2010-11 and 2014-15, and then by 1³/₄ per cent a year between 2015-16 and 2034-35, which is ¹/₄ per cent lower than the neutral view of productivity growth. The assumption of a slower rate of productivity growth in later years reflects the greater use of caution. The 2004 *Long-term public finance report* provides sensitivity analysis on the use of different productivity growth assumptions.

A.I3 By assumption, employment is driven entirely by demographic trends. Specifically, with the overall employment rate assumed to remain constant from 2009-10 onwards, changes in employment levels reflect changes in the working-age population. As in previous years, this includes the impact of the increase in the female state pension age from 60 years in 2010 to 65 years by 2020, which will increase the working-age population. The assumed growth rates for productivity and employment generate the growth rates for GDP from 2010-11 onwards.

Table A.1: Real GDP growth and its components

Year	2010-11 to 2014-15	2015-16 to 2024-25	2025-26 to 2034-35
Productivity	2	1 ³ / ₄	1 ³ / ₄
Employment	¹ / ₄	¹ / ₄	- ¹ / ₄
Real GDP	2 ¹ / ₄	2	1 ¹ / ₂

Source: HM Treasury.

¹¹See *Budget 2000: Prudent for a Purpose: Working for a Stronger and Fairer Britain*, HM Treasury, March 2000 for a discussion of the methodology.

Box A.1: Projecting future employment trends

The illustrative long-term fiscal projections presented in this annex are based on the assumption that the total employment rate of the working-age population will remain constant in the future. This approach has the advantage that it is transparent and consistent with previous projection exercises, which have been based on the same assumption. One of the disadvantages is that it does not capture the impact of an ageing workforce on the total employment rate.

However, there are other approaches to projecting future employment trends. The dynamic cohort approach, for example, describes the effect of current young cohorts gradually replacing current older cohorts.^a By doing so, it explicitly takes into account that individuals belonging to any given generation or cohort have their own specific level of participation. For example, younger females today are much more likely to participate in the labour market than females of the same age, say, 20 or 30 years ago. It is reasonable to expect that the current generation of young females will participate in the labour market more over their entire working lives than their predecessors. Using gender and age-specific data, the cohort approach also captures the impact of an ageing workforce and the (assumed) effect of the increase in the female state pension age on total participation rates. The 2004 *Long-term public finance report* uses both modelling approaches to project employment trends and finds that, despite their differences, the overall projections are very similar.^b

^aSee *Coping with Ageing: A Dynamic Approach to Quantify the Impact of Alternative Policy Options on Future Labour Supply in OECD Countries*, OECD, June 2004.

^b2004 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004.

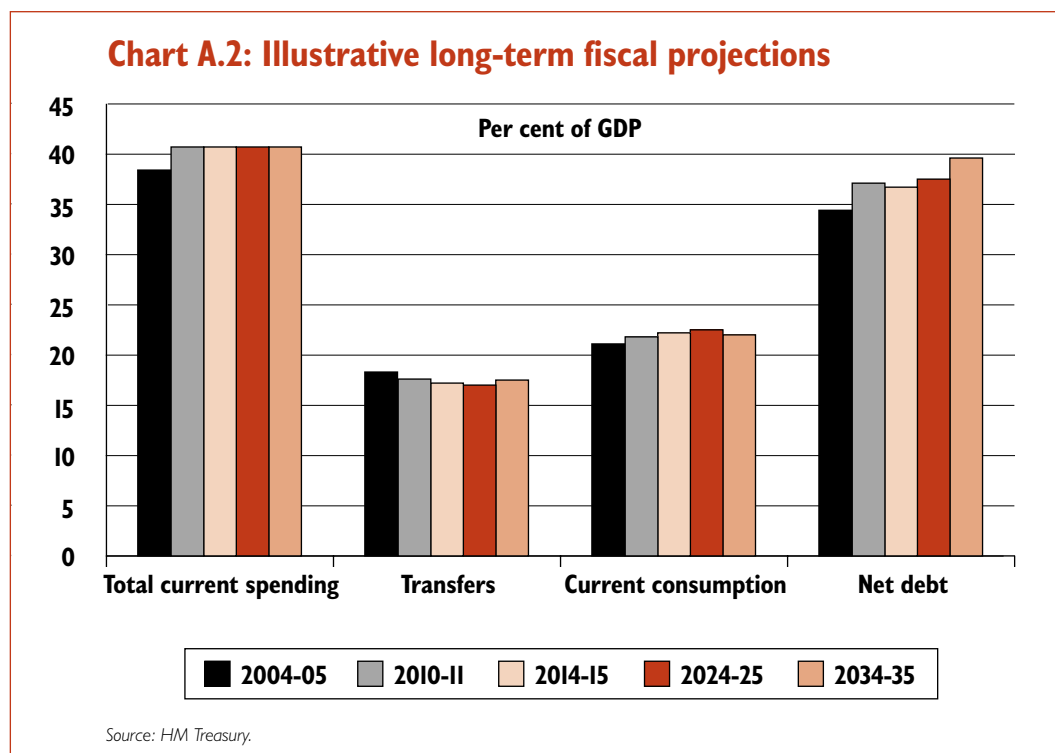
Taxation and spending assumptions **A.14** For the period up to and including 2009-10, the illustrative long-term fiscal projections are based on the forecasts and assumptions presented in Chapter C of the FSBR. Unless stated otherwise, policy settings in 2009-10 are then assumed to continue throughout the rest of the projection period. For example, the Government is assumed to raise the same amount of revenue as a proportion of GDP as in 2009-10, offsetting possible changes in tax bases by changing policy in a revenue neutral way. Tax revenues are also assumed to be equal to total current spending from 2010-11 onwards. This implies that, by assumption, the golden rule is met, with the current budget in balance at all times.

A.15 Current public consumption is calculated as the difference between tax revenues and other current spending, which comprises transfers and capital consumption. Transfers mainly consist of social security spending (e.g. the basic state pension) and debt interest payments. The latter are calculated using the projected debt stock and a long-term interest rate, which is assumed to equal the implicit interest rate in 2009-10; the last year of the medium-term forecast. Under the assumption that the current budget is in balance, the growth of public sector net debt reflects growth in public sector net investment. As in previous long-term fiscal projections, the share of public sector net investment in GDP is reset at 1.8 per cent beyond the medium term.

ILLUSTRATIVE PROJECTIONS

A.16 Chart A.2 shows the projected evolution of total current spending, transfers, current (public) consumption and net debt as a share of GDP between 2004-05 and 2034-35, given the assumptions stated above. Total current spending is projected to increase between 2004-05 and 2009-10, and then remain stable by assumption. Transfers are projected to fall from 18.3 per cent in 2004-05 to 17 per cent by the mid 2020s before rising again gradually, while current

consumption is projected to be more or less the same in 2034-35 as in 2010-11. Hence current consumption can grow at around the same annual rate as GDP, after the medium term, while still meeting the fiscal rules. Starting from just over 37 per cent in 2010-11, net debt is projected to fall initially before rising again, reaching 39.6 per cent by 2034-35, consistent with the sustainable investment rule. The projected changes in net debt emphasise the importance of ensuring sound public finances in the medium term to prepare for future developments.



A.17 Transfers are projected to fall as a share of GDP until the mid 2020s mainly because most social security transfers are projected to rise less rapidly than nominal GDP. However, on current projections, this trend will be reversed in the second half of the 2020s as pension spending (as a share of GDP) will increase as the baby-boom generation reaches retirement age.

A.18 The illustrative long-term fiscal projections presented here yield similar conclusions to those presented in the 2004 *Long-term public finance report*, which uses a broader range of techniques, assumptions and modelling approaches to assess long-term sustainability. The report demonstrates that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries to face the challenges ahead. In addition to an overall assessment of long-term fiscal sustainability, the 2004 *Long-term public finance report* also identifies individual spending trends: health spending is likely to increase the most as a share of GDP over the coming decades, while spending on education is projected to remain relatively stable.

Sensitivity analysis

A.19 Long-term projections of any type are inevitably subject to a high degree of uncertainty. The outcome of any projection exercise depends on the underlying assumptions. These include population projections and assumptions regarding productivity, revenue, labour market participation and social security spending. It is important to determine the sensitivity of baseline projections to changes in the assumptions. The 2004 *Long-term public finance report* illustrates the effect of different assumptions of productivity, interest rates and future labour market and health trends.¹²

¹² The 2003 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003, analysed the effects of different fertility, longevity and migration assumptions on spending projections.

INTERNATIONAL COMPARISONS

Population ageing: a global phenomenon

A.20 The UK is not the only developed country with an ageing population. In fact, the populations of many developed countries are projected to age more rapidly than the UK's. One of the best ways to capture the ageing process is through the evolution of the old-age dependency ratio. This ratio is calculated as the number of people aged 65 years and over relative to the number of people aged 16 to 64 years. Based on the GAD's latest principal population projections, the old-age dependency ratio will rise in the UK from around 25 per cent today to just above 40 per cent in the early 2030s and then further to around 45 per cent by the middle of the century.

A.21 By contrast, the ratio is projected to exceed 45 per cent on average in the EU15 by the mid 2030s and to reach 50 per cent by the 2050s. The picture is similar in the new Member States. The most marked increase is projected in Japan though, where the ratio is projected to reach more than 70 per cent by the 2050s. However, the ageing trend is not limited to the developed world: many emerging markets are also projected to age. For example, in China and India, the two most populous countries in the world, the ratio is projected to increase, respectively, from 10 to 37 per cent and from 8 to 22 per cent over the same period.¹³

Ageing and trend growth

A.22 Demographic changes, and in particular changes in the working-age population, are likely to affect the long-term growth potential of an economy. All else being equal, the slower the expansion of the working-age population, the lower will be trend growth. Combined with other long-term trends, differing population trends across countries and regions could therefore have profound effects on the balance of global economic activity in the decades to come.¹⁴

A.23 The US is ageing slowly by comparison with other developed countries. Nonetheless fiscal imbalances are projected to arise in the US over the coming decades. The US Congressional Budget Office (CBO) regularly publishes long-term analysis covering a wide range of topics, including future social security and health spending. The CBO projects that spending on social security will increase from 4.4 per cent of GDP in 2003 to 6.2 per cent by 2050, while spending on Medicare and Medicaid (the two principal public health care schemes) is projected (in an 'intermediate spending path scenario') to rise from just under 4 per cent of GDP in 2003 to 11½ per cent by 2050, due to a combination of demographic and non-demographic factors.¹⁵ The CBO also acknowledges the wide degree of uncertainty in these projections, particularly in the area of health care, with a 'low spending path scenario' projecting a modest increase in Medicare and Medicaid spending to 6.4 per cent of GDP, while the share would rise to 21.3 per cent in a 'high spending path scenario'.

EU A.24 Many EU countries face significant challenges from ageing populations. In October 2003, the EU's Economic Policy Committee (EPC) published detailed findings on the impact of ageing populations on the public finances.¹⁶ The EPC found that age-related spending will rise substantially in many Member States over the coming decades if policies remain unchanged but also noted that projected age-related spending increases are not necessarily highest in those countries with the most rapidly ageing population.¹⁷ Despite recent efforts in

¹³ With the exception of the GAD-generated UK-specific projections, the figures presented are based on United Nations' projections. See United Nations, *World Population Prospects: The 2002 Revision*. Also see *Budget 2004: Prudence for a purpose: A Britain of stability and strength*, HM Treasury, March 2004.

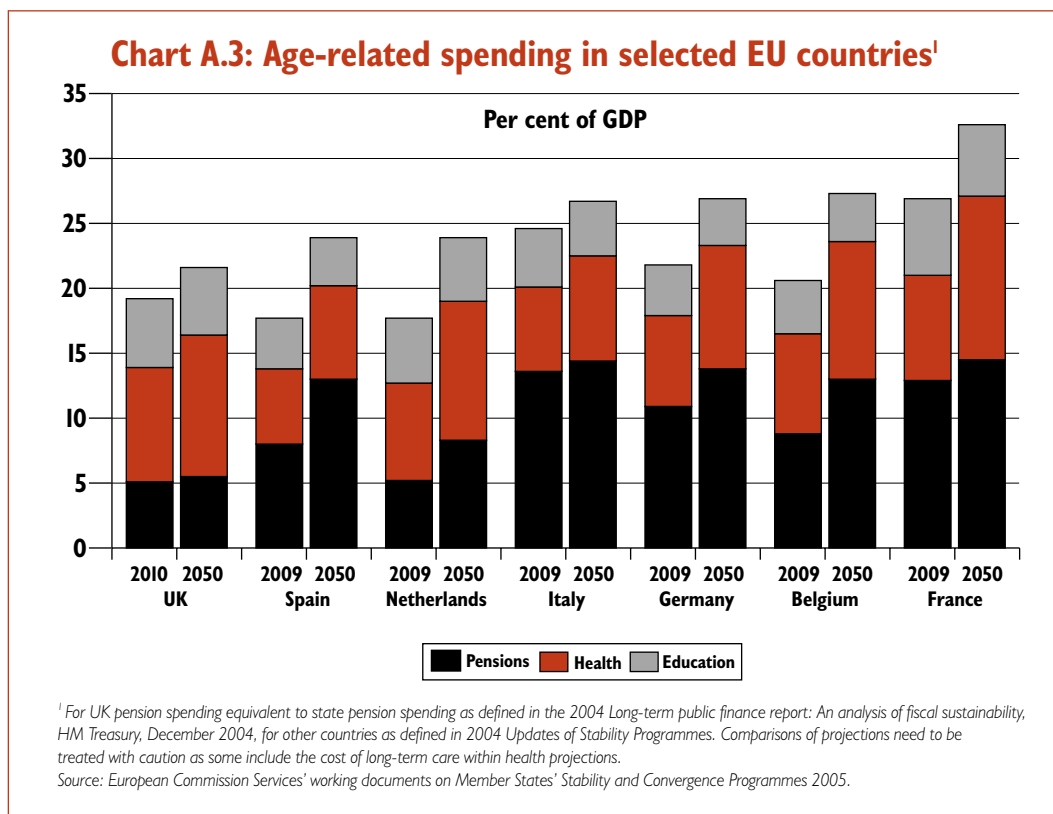
¹⁴ See *Long-term global economic challenges and opportunities for Europe*, HM Treasury, March 2005 for more details.

¹⁵ *The Long-Term Budget Outlook*, Congressional Budget Office, December 2003. Also see *The Economic Costs of Long-Term Federal Obligations*, Congressional Budget Office, February 2005.

¹⁶ *The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme*, Economic Policy Committee, October 2003.

¹⁷ The CBO and EPC health projections are not directly comparable as the former include non-demographic drivers, whereas the latter are based on demographic changes only.

a number of EU Member States to control future spending increases, the latest projections continue to confirm the EPC findings. Chart A.3 shows the projected evolution of age-related spending over the coming decades in the seven largest EU countries.¹⁸ It shows that age-related spending in the UK is projected to rise only moderately over the next five decades to reach a relatively low level by 2050. This contrasts with substantial projected increases in some other countries.



A.25 In 2002, the Council of European Finance Ministers (ECOFIN) asked the EPC to provide a new set of long-term fiscal projections in 2005. Key objectives of the exercise are to widen the projections to cover the ten new Member States that joined in May 2004, to incorporate recent policy developments in EU Member States, to use updated and refined assumptions and modelling techniques, and to raise the degree of cross-country comparability of the projections.

A.26 Other developed countries will also have to deal with the fiscal challenges arising from an ageing population. Due to its rapidly ageing population, these challenges are particularly marked in Japan. The Japanese Ministry of Health, Labour and Welfare, which manages social security spending, including health and pensions, estimates that the funds necessary to finance the current social security system will need to rise from 16 per cent of GDP in 2002 to nearly 25 per cent by 2025.¹⁹ The Australian Treasury projected that the deficit on the primary balance could reach around 5 per cent of GDP by 2041-42, mainly as a result of substantially higher projected health spending.²⁰ The Australian Treasury intends to update its findings every few years. Canada provides another interesting example of a developed country that is preparing for the fiscal impact of an ageing population. Mainly as a result of rapid population ageing, the Canadian Department of Finance projects that health spending

¹⁸ In terms of purchasing power parity adjusted GDP in 2004. See <http://www.europa.eu.int>.

¹⁹ 'Assessing the long-term fiscal position of Japan', International Monetary Fund, 2003, in: *Japan: Selected Issues*.

²⁰ The Australian Treasury found that non-demographic factors are likely to be the main driver of future health spending increases. See *Intergenerational Report 2002-03*, Department of the Treasury of Australia, May 2002.

will increase from 7.1 per cent of GDP in 2004 to 11.2 per cent by 2050. The ageing process will also put substantial pressure on the country's social security programmes. To meet this challenge, the Canadian government set itself the objective in 2004 to reduce the federal debt to GDP ratio to 25 per cent within ten years.²¹

CONCLUSIONS

A.27 The fiscal projections presented in this annex show that the UK's public finances are broadly sustainable over the long term, confirming the detailed findings presented in the 2004 *Long-term public finance report*. Current public consumption can grow at around the same rate as GDP beyond the medium term, ensuring that resources are available to meet potential future spending pressures. The golden rule and the sustainable investment rule are both met throughout the projection period, with net debt projected to be below 40 per cent of GDP in the long run. Public sector net investment can grow more or less in line with the economy without jeopardising the sustainable investment rule. The UK is also in a strong position to face future challenges relative to other developed countries.

A.28 However, notwithstanding the use of prudent and cautious assumptions, a wide range of unforeseen developments and spending pressures could arise over the projection period. The Government will therefore continue to update and report on its assessments of long-term fiscal sustainability, both through regular publication of the *Long-term public finance report* alongside the Pre-Budget Report and through the illustrative long-term fiscal projections presented with each Budget, so as to ensure that all fiscal policy decisions are set within a sustainable long-term framework.

²¹ *The Budget Plan 2005: Delivering on Commitments*, Department of Finance Canada, February 2005.

Financial Statement and Budget Report

A

BUDGET POLICY DECISIONS

A1 The Economic and Fiscal Strategy Report (EFSR) explains how the measures and other decisions announced in Budget 2005 build on those already introduced to advance the Government's long-term goals. This chapter of the Financial Statement and Budget Report (FSBR) brings together in summary form all the measures and decisions that affect the Budget arithmetic, announced in Budget 2005 and since Budget 2004, including in the 2004 Pre-Budget Report, giving their estimated effect on government revenues and spending to 2007-08.¹

A2 The chapter sets out how the Budget 2005 measures affect the tax and benefit system and government spending. This includes a summary of the main rates and allowances for the personal tax and benefit system, the business tax system, Value Added Tax (VAT), environmental taxes, and other indirect taxes.

A3 The appendices to this chapter provide additional information on Budget measures:

- Appendix A1 provides details of tax changes and other policy decisions which were announced in Budget 2004 or earlier, but which take effect from or after April 2005;
- Appendix A2 explains in detail how the effects of the Budget measures on government revenues are calculated; and
- Appendix A3 provides estimates of the costs to the Government of some of the main tax allowances and reliefs.

BUDGET POLICY DECISIONS

A4 Table A.1 summarises the Budget 2005 measures and their effects on government revenues and spending. These include tax measures, national insurance contributions (NICs) measures, measures that affect Annually Managed Expenditure (AME), and additions to Departmental Expenditure Limits (DEL). Measures that are financed from existing DEL provisions are not included.

¹ The contents of the brackets after each measure in this chapter refer to the line in Tables A.1 and A.2 where its costs or yield is shown. The symbol '-' indicates that the proposal has no Exchequer effect. The symbol '*' indicates that the effect is negligible, amounting to less than £3 million a year.

Table A1: Budget 2005 policy decisions

	(+ve is an Exchequer yield)			£ million
	2005-06 indexed	2006-07 indexed	2007-08 indexed	2005-06 non-indexed
MEETING THE PRODUCTIVITY CHALLENGE				
1 Tonnage tax: adjustments	*	-5	-5	*
2 VAT: revalorise registration and deregistration thresholds	0	0	0	-5
3 Film tax reform	*	-50	*	*
4 Local Enterprise Growth Initiative	-15	-65	-125	-15
5 Stamp duty land tax: ending commercial disadvantaged areas relief	+340	+350	+370	+340
6 Enterprise and creativity	0	-5	-10	0
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
7 Housing benefit and council tax benefit: simplification	-5	-5	-5	-5
8 Incapacity benefit: linking rules	0	-10	-20	0
BUILDING A FAIRER SOCIETY				
Supporting families and communities				
9 Income tax: indexation of starting and basic rate limits	0	0	0	-700
10 Child Tax Credit: uprating child element in line with earnings until 2007-08	0	-260	-480	0
11 Stamp duty land tax: increase threshold to £120,000	-250	-240	-220	-250
12 ISAs: extension of higher investment limits until April 2010	0	-35	-100	0
13 Free local off-peak bus travel for pensioners and disabled people	0	-420	-440	0
14 Abolition of hospital downrating	0	-65	-65	0
15 Payment for the over 65s	-800	0	0	-800
16 Supporting youth volunteering	-10	-30	-80	-10
17 Increasing capital limits for IS/JSA from £8,000 to £16,000	0	-5	-5	0
Protecting tax revenues				
18 Preventing avoidance of tax on capital gains	*	+70	+105	*
19 Stamp duty land tax: avoidance	+20	+20	+15	+20
20 Financial products avoidance	+280	+430	+430	+280
21 Double tax relief: anti-avoidance rule	+130	+200	+200	+130
22 Intangible assets: closing loopholes	+15	+25	+25	+15
23 Counteracting avoidance through arbitrage	+130	+200	+200	+130
24 Red diesel: supporting the UK oils fraud strategy	+40	+70	+70	+45
25 VAT: partial exemption loopholes	+25	+30	+25	+25
26 VAT: warehousing avoidance	+20	+25	+25	+20
Duties and other tax changes				
27 Inheritance tax: increase of threshold	-20	-60	-130	-90
28 Alcohol duties: revalorise beer and wine duties and freeze other rates	-10	-10	-10	+150
29 Tobacco: revalorise rates	0	0	0	+20
30 Modernising North Sea corporation tax	+1,100	+210	+170	+1,100
31 VAT: supplies promoting the welfare of vulnerable people	-5	-5	-5	-5
32 VAT: extension of listed places of worship scheme	0	-10	-10	0
33 VAT: construction and repair of memorials by charities	-5	-5	-5	-5
PROTECTING THE ENVIRONMENT				
Environment				
34 Climate change levy: freeze	-20	-20	-20	0
35 Aggregates levy: freeze	-10	-10	-10	0
36 VAT: reduced rate on micro-CHP boilers	*	-5	-5	*

Table AI: Budget 2005 policy decisions

	(+ve is an Exchequer yield)			£ million
	2005-06 indexed	2006-07 indexed	2007-08 indexed	2005-06 non-indexed
PROTECTING THE ENVIRONMENT				
Transport				
37 VAT: revalorise fuel scale charges	0	0	0	+10
38 Fuel duties: revalorise rates from 1 September 2005	-235	0	0	+330
39 Fuel duties: narrowing the differential of road fuel gases until 2007	*	0	+5	*
40 Fuel duties: differentials for biodiesel and bioethanol until 2007	*	0	+5	*
41 Incentivising the use of biomass	0	-5	-5	0
42 Air passenger duty: freeze rates	-10	-25	-30	0
43 Changes to Vehicle Excise Duty	-40	-45	-50	+85
OTHER POLICY DECISIONS				
44 Education and skills measures	0	-300	-400	0
45 Special reserve allocation ¹	-400	0	0	-400
TOTAL POLICY DECISIONS	+265	-65	-590	+415
*negligible				
MEMO ITEMS				
Resetting of the AME margin	+1,880	+370	-260	
Direct taxes compliance package ²	0	+25	+355	

¹This is in addition to the Budget 2005 decision to allocate £340 million to the special reserve for 2004-05.

²Net of additional resources allocated to Inland Revenue.

A5 Table A.2 summarises the impact on government revenues and spending of other measures introduced since Budget 2004, including those measures announced in the 2004 Pre-Budget Report.

Table A2: Other measures announced since Budget 2004

	(+ve is an Exchequer yield)			£ million
	2005-06 indexed	2006-07 indexed	2007-08 indexed	2005-06 non-indexed
MEETING THE PRODUCTIVITY CHALLENGE				
a † National Employer Training Programme	0	-80	-160	0
b † New Deal for Skills	-10	-10	-25	-10
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
c † Incapacity benefit: additional Pathways to Work	*	-60	-65	*
d † Increasing Working Tax Credit thresholds	-140	-140	-140	-140
BUILDING A FAIRER SOCIETY				
e † Indexation of income tax allowances	0	0	0	-830
f † Indexation of national insurance rates and limits	0	0	0	-460
g † Indexation of Working Tax Credit	0	0	0	-200
h † Social Fund reform	0	-5	-5	0
i † £50 payment for the over 70s	-250	0	0	-250
j † Indexation of the pension earnings cap	0	0	0	-5
k Improving support to 16-19 year olds in learning	0	-135	-155	0
l † Tax consequences of the Civil Partnerships Act	*	-5	-5	*
m † VAT: grant to Band Aid 20	-5	*	*	-5
n VAT: grant to the Tsunami Appeal	-5	0	0	-5
o † Modernising the taxation of leasing	0	+65	+170	0
10 year Childcare Strategy				
p † Working Tax Credit: increase childcare element to 80%	0	-130	-130	0
q † Working Tax Credit: increase childcare limits to £175/£300 per week	-30	-30	-30	-30
r † Extension of paid maternity leave to 9 months	0	0	-345	0
s † Improving childcare quality and sustainability	0	-240	-155	0
Protecting revenues				
t † Capital gains options avoidance	+50	+80	+80	+50
u † Remuneration based avoidance	+500	+500	+500	+500
v † Films: reform and avoidance	+90	+110	+120	+90
w † Life insurance companies avoidance	+40	+60	+60	+40
x † Abuse of Controlled Foreign Companies regime	+30	+50	+80	+30
y † Abuse of double tax relief	+145	+200	+200	+145
z † VAT: abuse of input tax rules	+45	+45	+50	+45
aa † Loans and financial instruments avoidance	+115	+150	+150	+115
ab Rent factoring for plant and machinery	+5	+5	+5	+5
ac Businesses financed by a related party	+5	+10	+20	+5
PROTECTING THE ENVIRONMENT				
ad † Company car tax: reform of diesel supplement	0	+40	+100	0
ae † Fuel duties: freeze of main rates	-665	-685	-710	0
af † Rebated oils: narrowing of the differential	-105	-110	-110	-110
OTHER POLICY DECISIONS				
ag † Addition to local authorities	-150	0	0	-150
TOTAL POLICY DECISIONS	-335	-315	-500	-1,170

* negligible

† Announced in the 2004 Pre-Budget Report

Note: As required by the Code for Fiscal Stability, the 2004 Pre-Budget Report economic and fiscal projections were based on and included the impact of all Government decisions and all other circumstances where the impact of these decisions and circumstances could be quantified with reasonable accuracy by the day the projections were finalised.

PERSONAL TAXES AND SPENDING MEASURES

Income Tax

Bands, rates and personal allowances **A6** As announced in the 2004 Pre-Budget Report, the income tax personal allowances for those aged 65 or over will increase in line with earnings to £7,090 for those aged 65-74, and for those aged 75 or over to £7,220. Other allowances, including the personal allowance for those aged under 65, will be increased by statutory indexation. (e)

A7 The starting and basic rate limits are increased with statutory indexation and there are no changes to the income tax rates. (9)

A8 The maximum earnings for which pension provision may be made with income tax relief is increased in line with statutory indexation. The final remuneration for calculating pension benefits from Occupational Pension Schemes will be aligned with the earnings cap with effect from 6 April 2005. (j)

Table A3: Bands of taxable income 2005-06

2004-05	£ a year	2005-06	£ a year
Starting rate 10 per cent	0 – 2,020	Starting rate 10 per cent	0 – 2,090
Basic rate ^{1,2} 22 per cent	2,021 – 31,400	Basic rate ^{1,2} 22 per cent	2,091 – 32,400
Higher rate ² 40 per cent	over 31,400	Higher rate ² 40 per cent	over 32,400

¹ The rate of tax applicable to savings income in Section 1A ICTA 1988 remains at 20 per cent for income between the starting and basic rate limits.

² The rates applicable to dividends are 10 per cent for income up to the basic rate limit and 32.5 per cent above that.

Table A4: Income tax allowances 2005-06

	2004-05	£ a year 2005-06	Increase
Personal allowance			
age under 65	4,745	4,895	150
age 65-74	6,830	7,090	260
age 75 and over	6,950	7,220	270
Married couple's allowance ¹			
aged less than 75 and born before 6th April 1935	5,725	5,905	180
age 75 and over	5,795	5,975	180
minimum amount ²	2,210	2,280	70
Income limit for age-related allowances	18,900	19,500	600
Blind person's allowance	1,560	1,610	50

¹ Tax relief for this allowance is restricted to 10 per cent.

² This is also the maximum relief for maintenance payments where at least one of the parties is born before 6 April 1935.

Effects on the Scottish Parliament's tax varying powers – statement regarding Section 76 of the Scotland Act 1998

A9 A one penny change in the Scottish variable rate in 2005-06 could be worth approximately plus or minus £280 million, and is broadly unaffected by these changes. In the Treasury's view, an amendment to the Scottish Parliament's tax-varying powers is not required as a result of these changes.

National Insurance contributions

A10 As announced in the 2004 Pre-Budget Report, the national insurance contributions (NICs) thresholds and limits will increase in line with inflation. There will be no change in NICs rates for employers and employees, or the profit-related NICs paid by the self-employed. (f)

A11 Other NICs rates for 2005-06 will increase in line with inflation; for the self-employed the rate of Class 2 contributions will be £2.10, the special rate of Class 2 contributions for share fishermen will be £2.75, the rate of Class 3 voluntary contributions will be £7.35 and the special rate of Class 2 contributions for volunteer development workers will be £4.10. (f)

Table A5: Class 1 national insurance contribution rates 2005-06

Earnings ¹	Employee (primary) NICs rate ²	Employer (secondary) NICs rate ³
£ per week	per cent	per cent
Below £82 (LEL)	0	0
£82 to £94 (PT/ST)	0 ⁴	0
£94 to £630 (UEL)	11	12.8
Above £630	1	12.8

¹ The limits are defined as LEL – lower earnings limit; PT – primary threshold; ST – secondary threshold; and UEL – upper earnings limit.

² The contracted-out rebate for primary contributions in 2005–06 is 1.6 per cent of earnings between the LEL and UEL for contracted-out salary-related schemes (COSRS) and contracted-out money purchase schemes (COMPS).

³ The contracted-out rebate for secondary contributions is 3.5 per cent of earnings between the LEL and UEL for COSRS and 1.0 per cent for COMPS. For COMPS, an additional age-related rebate is paid direct to the scheme following the end of the tax year. For approved personal pensions, the employee and employer pay NICs at the standard, not contracted-out rate. An age and earnings related rebate is paid direct to the personal pension provider following the end of the tax year.

⁴ No NICs are actually payable but a notional primary Class 1 NIC will be deemed to have been paid in respect of earnings between LEL and PT to protect benefit entitlement.

Table A6: Self-employed national insurance contribution rates 2005–06

Profits ¹	Self employed NICs	
	Class 2 £ per week	Class 4 per cent
£ per year		
Below £4,345 (SEE)	0 ²	0
£4,345 to £4,895 (LPL)	£2.10	0
£4,895 to £32,760 (UPL)		8
Above £32,760		1

¹ The limits are defined as LPL – lower profits limit and UPL – upper profits limit.

² The self-employed may apply for exemption from paying Class 2 contributions if their earnings are less than, or expected to be less than, the level of the Small Earnings Exception (SEE).

Other personal taxes and spending measures

- Child Tax Credit A12** As announced in the 2004 Pre-Budget Report, the child element of the Child Tax Credit will be raised to £1,690 a year. This Budget announces that the child element of the Child Tax Credit will rise at least in line with earnings in 2006-07 and 2007-08. (10).
- Working Tax Credit A13** As announced in the 2004 Pre-Budget Report, the limits on the costs of eligible childcare within the childcare element of the Working Tax Credit will rise to £175 per week for one child and £300 per week for two or more children from 6 April 2005. (q)
- A14** As announced in the 2004 Pre-Budget Report the maximum proportion of childcare costs that can be claimed within the childcare element of Working Tax Credit will increase from 70 per cent to 80 per cent from 6 April 2006. (p)
- A15** As announced in the 2004 Pre-Budget Report, the income threshold above which the Working Tax Credit is tapered will increase in line with inflation to £5,220 in 2005-06. (g) From 6 April 2005 the Government will change the way in which income from tax credits is taken into account in Housing Benefit and Council Tax Benefit. (d)
- Payment via employer A16** The Inland Revenue will be issuing targeted publicity to make employees aware of the changes to the way their Working Tax Credit is paid. Employers will be required to send one targeted letter to individual employees shortly before the phasing out begins to explain the changes. Inland Revenue will be consulting employers' representatives about the arrangements for phasing out payments via employers and will be refining the regulatory impact assessment to be published with the regulations. (-)
- VAT and child care A17** From 1 April 2005, where local authorities are under a statutory obligation to ensure adequate welfare provision, the Government will refund them all of the VAT that they incur in the provision of these services, such as childcare and Children's Centres. (*)
- Childcare vouchers A18** As announced in the 2004 Pre-Budget Report, from 6 April 2005, the £50 a week tax and national insurance contributions exemption on childcare vouchers will apply to the face value of the childcare vouchers, and associated administration costs and service charges will also be exempt from tax and NICs. (*)
- Childcare Transformation Fund A19** As announced in the 2004 Pre-Budget Report, the Government will create a Transformation Fund worth £125 million each year from April 2006 to invest in childcare provision. (s)
- Child Trust Fund A20** The Government will extend the list of qualifying investments for Child Trust Fund accounts to include all Financial Services Authority-authorized retail investment schemes. Credit Unions will be allowed to offer Child Trust Fund cash accounts in addition to Stakeholder accounts. (*)
- Individual Savings Accounts A21** Following consultation, the Government will extend further the existing higher ISA limits to April 2010. (12)
- A22** The Government will extend the list of qualifying investments for ISAs to include all Financial Services Authority-authorized retail investment schemes. (*)
- Stakeholder products A23** As announced in July 2004, following the Sandler Review of the retail savings industry, the Government will introduce a new 'Stakeholder' suite of savings and investment products in April 2005. This Budget announces £4 million to inform consumers of the Stakeholder suite in 2005-06.

- Pension lump sum** **A24** As announced in the 2004 Pre-Budget Report, with effect from 6 April 2005, pensioners choosing to defer their state pension for at least a year will be able to have their marginal rate of tax deducted from the lump sum. (*)
- Pensions tax simplification** **A25** In addition to the measures legislated for in Finance Act 2004, a further series of measures will be introduced, taking effect from 6 April 2006. These will provide additional flexibility for schemes and individuals, smooth the transition from the old to the new regime, and introduce further anti-abuse and compliance rules. (*)
- A26** These new measures will build on the transitional rule announced in the 2004 Pre-Budget Report to allow certain funeral expenses currently paid by occupational schemes to continue to be paid tax-free. As announced on 1 November 2004, a measure taking forward online service will be introduced with effect from 6 April 2006. (-)
- Pension Protection Fund** **A27** A measure will be introduced to give the Pension Protection Fund the same tax privileges and treatment as an approved or registered pension scheme with effect from 6 April 2005. (-)
- Armed Forces pensions and compensation** **A28** A measure will be introduced, effective from 6 April 2005, to ensure that recipients of benefits payable under new Armed Forces pension and compensation schemes operational from that date will be in the same tax position as those receiving pension and attributable benefits under the existing Armed Forces Pension Scheme. It will also exempt in-service injury awards paid to service personnel from tax. (*)
- Loaned computer and bicycle exemption** **A29** As announced on 21 February 2005, with effect from 6 April 2005, the rules for calculating the value of the benefit in kind that arises where an employee purchases a computer or bicycle that has previously been loaned to an employee by the employer will be simplified. (*)
- Outplacement counselling** **A30** A measure will be introduced, with effect from 6 April 2005, to extend the tax-free provision of outplacement counselling and retraining exemptions to part-time employees. (*)
- EU Mutual Assistance Directive** **A31** As announced on 2 December 2004, with effect from 1 January 2005, the UK tax authorities may send documents to a UK-resident taxpayer at the request of another EU Member State that relate to a tax liability of the taxpayer in the other Member State. (-)
- Civil Partnerships** **A32** As announced on 31 March 2004, for tax purposes civil partners will be treated the same as married couples. This will be effective from the start of the civil partnership scheme on 5 December 2005. (l)
- Thalidomide Trust** **A33** As announced on 15 July 2004, with effect from 5 August 2004, payments from the Thalidomide Trust to victims of Thalidomide are not counted as income for the purposes of calculating the victims' income tax liabilities and their entitlement to tax credits. (*)

Table A7: Child and Working Tax Credits rates and thresholds

	2005-06 £ a year
Working Tax Credit	
Basic element	1,620
Couples' and lone parent element	1,595
30 hour element	660
Disabled worker element	2,165
Severe disability element	920
50+ Return to work payment (16-29 hours)	1,110
50+ Return to work payment (30+ hours)	1,660
Childcare element of the Working Tax Credit	
Maximum eligible cost for one child	£175 per week
Maximum eligible cost for two or more children	£300 per week
Per cent of eligible costs covered	70 per cent
Child Tax Credit	
Family element	545
Family element, baby addition	545
Child element	1,690
Disabled child element	2,285
Severely disabled child element	920
Income thresholds and withdrawal rates	
First income threshold	5,220
First withdrawal rate (per cent)	37 per cent
Second income threshold	50,000
Second withdrawal rate (per cent)	6.67 per cent
First threshold for those entitled to Child Tax Credit only	13,910
Income disregard	2,500

BENEFITS

Free local bus travel **A34** This Budget announces that free local area bus travel in England will be extended to all people aged 60 or over and disabled people during off peak hours with effect from April 2006. (13)

Pension Credit **A35** As announced in the 2004 Pre-Budget Report, the guarantee element of Pension Credit will increase by earnings until 2008.

Hospital downrating **A36** This Budget announces that hospital downrating of the basic state pensions will be abolished from April 2006. (14)

Helping pensioners **A37** This Budget announces additional payments to all council tax paying households with someone aged over 65 which, when combined with payments announced at the 2004 Pre-Budget Report, will mean such households receive £200, to be paid alongside the 2005 Winter Fuel Payments. (15) (i).

Extending financial support for 16 – 19s in learning **A38** Entitlement to Child Benefit, Child Tax Credit and Income Support will be extended in respect of 19 year olds completing a course of non-advanced education or training. Child Benefit and Child Tax Credit will be extended to the parents of unwaged trainees aged 16-19 on Government-arranged training programmes. Corresponding changes will be made to Income Support and, in England, to the Education Maintenance Allowance. Subject to Parliamentary approval of the Child Benefit Bill, these changes will take effect from 10 April 2006. (k)

- In-Work Credit A39** As announced in the 2004 Pre-Budget Report, there will be an extension of the £40 per week In-Work Credit for lone parents to six further pilot areas.
- Learning Allowance A40** As announced in the 2004 Pre-Budget Report, from April 2006, the Government will pilot the approach of allowing the longer-term unemployed benefit claimants to take up free, full-time training.
- Linking rules A41** This Budget announces an improvement to the incapacity benefits linking rules to better support claimants during the transition from benefits to work. (8)
- Pathways to work A42** As announced in the 2004 Pre-Budget Report, the Pathways to Work pilots will be expanded to a further 14 Jobcentre Plus districts. (c)
- Housing Benefit A43** As announced in the 2004 Pre-Budget Report, a Housing Benefit Reform Fund worth £180 million will be launched during 2006-08 to help DWP roll out flat-rate allowances and to improve the administration and structure of the Housing Benefit system.
- A44** This Budget announces that the date of claim rules for Housing Benefit and Council Tax Benefit will be aligned with other income related benefits from April 2005. From April 2006, the Government will also introduce a number of other changes in Housing and Council Tax Benefit to simplify the claiming and administration of Housing and Council Tax Benefit. (7)
- A45** From 2006, the Government intends to introduce improved IT links between Local Authorities and the Department for Work and Pensions to provide faster and more accurate processing of Housing and Council Tax Benefit.
- Social Fund reform A46** As announced in the 2004 Pre-Budget Report, reforms to the Social Fund, amounting to an increase in funding for the Social Fund of £210 million over the three years to 2008-09, will be implemented in April 2006. (h)
- Treatment of capital limits A47** From April 2006, the Government will raise the upper capital thresholds for Income Support and Jobseeker's Allowance from £8,000 to £16,000. (17)
- Paid maternity leave A48** As announced in the 2004 Pre-Budget Report, paid maternity leave will be extended to 9 months from April 2007, and there will be an increase in the flat rate of Statutory Maternity Pay, Maternity Allowance and Statutory Adoption Pay, and Statutory Paternity Pay to £106 a week from April 2005. (r)

CHARITIES AND COMMUNITIES

- Youth volunteering A49** Up to £100 million will be made available over the next three years to take forward the recommendations of the Russell Commission. (16)
- Queen Mother memorial A50** The Government will make available up to £2 million from the sale of a commemorative coin in order to create a memorial to HM Queen Elizabeth, the Queen Mother.
- Gift Aid and Admissions A51** As announced in 2004 Pre-Budget Report, the statutory exemption in relation to Gift Aid and admission charges will be changed from April 2006. (*)
- VAT and the Tsunami A52** The Government will make a special donation in 2005-06 to the Disasters Emergency Committee equivalent to the VAT collected from the fund-raising activities. (n)
- VAT and Band Aid A53** The Government will make a special donation in 2005-06 to the Band Aid Charitable Trust to cover the cost of the VAT collected on the Band Aid 20 single and Live Aid DVD. Further donations will be made to cover sales up to financial year 2009-10. (m)

- VAT and Memorials A54** An interim grant scheme to cover VAT costs incurred by charities in the construction, renovation and maintenance of memorials will be introduced whilst the Government negotiates at the European level for a permanent reduced rate. (33)
- VAT: listed places of worship A55** The Government will extend the listed places of worship scheme so that funding will be available three years to 2007-08, whilst the Government negotiates at the European level for a permanent reduced rate. (32)
- VAT: reduced rate A56** The Government will introduce a new reduced rate of VAT for certain supplies of advice or information connected with or intended to promote the welfare of elderly or disabled people, or children. (31)

TAXES ON CHARGEABLE GAINS, INHERITANCE TAX AND STAMP TAXES

- Capital gains tax A57** The capital gains tax annual exempt amount is increased in line with statutory indexation to £8,500. (-)
- Inheritance tax A58** The inheritance tax threshold will increase above statutory indexation from £263,000 to £275,000 for new tax charges arising on or after 6 April 2005. The threshold will increase again to £285,000 for new tax charges arising on or after 6 April 2006, and again to £300,000 for new tax charges arising on or after 6 April 2007. (27)

Stamp taxes

- Stamp duty land tax thresholds A59** From 17 March 2005, the zero-rate threshold for stamp duty land tax will increase from £60,000 to £120,000 for residential property transactions. The zero-rate threshold for residential property transactions within the Enterprise Areas remains at £150,000. (11)
- Disadvantaged areas relief A60** With effect from 17 March 2005, the commercial stamp duty land tax disadvantaged areas relief will end. Temporary state aids clearance for this relief was granted from 2003 until the end of 2006. (5)
- Stamp duty land tax relief A61** As announced on 2 July 2004, a change to the charities relief for stamp duty land tax was introduced with effect from 22 July 2004. (*)
- Technical changes A62** A measure will be introduced, with effect from Royal Assent, to ensure that the Valuation Office Agency in Great Britain, and the Valuation and Lands Agency in Northern Ireland, have access to information on stamp duty land tax returns. (*)
- E-conveyancing A63** A further measure will be introduced, with effect from Royal Assent, to provide powers to make regulations to facilitate electronic conveyancing. (*)
- Stamp duty reserve tax A64** A measure will be introduced, with effect from Royal Assent, to extend the relief for intermediaries and for repurchases and stock lending to members of a Multilateral Trading Facility (MTF), as defined by the EU Markets in Financial Instruments Directive. (-)
- A65** In addition, a further measure will be introduced, with effect from Royal Assent, to amend the relief for demutualisation of insurance companies. (-)

BUSINESS TAXES AND SPENDING MEASURES

Tax on business profits

- Corporation tax A66** The main rate of corporation tax will be set at 30 per cent for financial year 2006-07. The small companies rate and the starting rate are unchanged at 19 per cent and zero per cent respectively for the financial year 2005-06. The non-corporate distribution rate is also unchanged at 19 per cent for the financial year 2005-06. (–)
- Leasing A67** As announced in the 2004 Pre-Budget Report, the Government will align the tax treatment of leasing with that of other forms of finance. Legislation on these proposals will be included in Finance Bill 2006. (o)
- European Company Statute A68** A package of measures will be introduced, with effect from 1 April 2005, to allow European companies based in the UK to be taxed on a similar basis to UK companies. (*)
- Parent Subsidiary Directive A69** As announced on 31 January 2005, measures were introduced to change the Parent Subsidiary Directive in relation to dividends paid on or after 1 January 2005. (*)
- International Accounting Standards A70** As announced in the 2004 Pre-Budget Report, a package of measures was introduced to address specific technical issues, to defer the impact of certain transitional adjustments and to allow UK accounting standards to be used for one additional year by certain companies used to raise funds by the securitisation of assets with effect from 1 January 2005. In addition, as announced on 14 December 2004, a measure was introduced to prevent forestalling of the transitional rules. It applies to transactions occurring on or after 14 December 2004. (*)
- A71** In addition, measures were introduced to extend the class of securitisation companies covered by the one-year deferral and to enable a new tax regime for securitisation companies to be introduced. This also applies from 1 January 2005. (*)
- Lloyd's regulations A72** Legislation will be introduced in Finance Bill 2005 amending the powers for making regulations relating to the taxation of Lloyd's underwriters with effect from Royal Assent. (–)
- Deemed transfers of assets by companies A73** A measure will be introduced in Finance Bill 2005, with effect from 16 March 2005, covering deemed transfers of assets between group members prior to disposal where the transferee is not UK-resident but trades in the UK through a permanent establishment. (–)
- Tonnage tax A74** A package of measures will be introduced giving companies a new opportunity to elect in to tonnage tax and to extend activities which qualify under the scheme. Changes will be made to bring the scheme into line with revised EU guidelines on state aid for maritime transport. (1)
- North Sea taxation A75** For companies operating within the North Sea ring fence, the instalment payment arrangements for North Sea corporation tax will be amended for accounting periods ending after 30 June 2005. (30)
- Authorised Investment Funds A76** Measures will be introduced to change the taxation of AIFs, which will include powers to make further changes in regulations designed to facilitate a more flexible approach to investment strategies. Legislation will be included in Finance Bill 2005. (*)

Shari'a compliant financial products **A77** Legislation will be included in Finance Bill 2005 to amend the tax rules so that the mark-up on a Murabaha transaction and the profit-share on a Mudaraba arrangement are taxed on a level playing field with equivalent banking products. Stamp duty land tax reliefs for Islamic house purchase schemes will be extended to include a new Shari'a compliant product. (–)

VAT: small businesses **A78** From 1 April 2005, the VAT registration threshold will increase from £58,000 to £60,000, and the deregistration threshold from £56,000 to £58,000. (2)

Incentives for businesses and employees

National Employer Training Programme **A79** As announced in the 2004 Pre-Budget Report, the Government will roll out a National Employer Training Programme from 2006-07 that will cover the whole country by 2007-08. (a)

Education exemption **A80** A measure will be introduced, with effect from 1 September 2005, simplifying the rules which will allow employers to make scholarship payments of up to £15,000 tax and NICs free in an academic year to an employee for periods of attendance on a full time educational course at a University or technical college. (*)

New Deal for Skills **A81** As announced in the 2004 Pre-Budget Report, from April 2005 'skills coaches' will be piloted in eight Jobcentre Plus districts. (b)

University spin-offs **A82** As announced in the 2004 Pre-Budget Report, legislation will be introduced to remove the tax uncertainty for researchers involved in university spin-off companies with effect from 2 December 2004. (*)

Higher education finance **A83** As announced in the 2004 Pre-Budget Report, the Government will trial a three year matched funding scheme to support the Higher Education sector to build its capacity to increase the voluntary giving it receives. (44)

Film tax relief **A84** The current tax relief for low budget films, which is due to expire on 1 July 2005, will be extended to 31 March 2006 or a later appointed date. (3) The current tax relief for large budget films will be replaced with a new relief with a similar structure to that previously announced to replace the current relief for low budget films.

Energy Act consequentials **A85** Measures will be introduced consequential to changes in the Energy Act 2004 and the Health Protection Agency Act 2004, to remove exemptions, with effect from 1 April 2005 for the United Kingdom Atomic Energy Authority and after 1 April 2005 for the National Radiological Protection Board. (*)

Northern Ireland Water Service **A86** A measure will be introduced, with effect from Royal Assent to provide the powers to make tax provisions in Treasury regulations in relation to the Northern Ireland Water Service. This will allow the appropriate tax provisions to be made to deal with the consequences of the reorganisation of the Northern Ireland Water Service. (*)

ENVIRONMENTAL AND TRANSPORT TAXES

Aggregates levy **A87** The rate of aggregates levy is frozen at £1.60 per tonne in Budget 2005. (35)

Climate change levy **A88** The rates of the climate change levy for 2005-06 are frozen. (34)

- Household energy efficiency** **A89** The Landlord's Energy Saving Allowance (LESA) will be extended to cover solid wall insulation with effect from 7 April 2005. (*)
- VAT: reduced rates** **A90** A reduced rate of VAT of 5 per cent will apply to air source heat pumps (*); and micro combined heat and power (micro-CHP) boilers with effect from 6 April 2005. (36).
- VAT: car fuel scale charges** **A91** From 1 May 2005, the VAT fuel scale charges, which provide a simplified method for taxing the private use of road fuel bought by VAT registered businesses, will be adjusted in line with the average price of fuel. The Government also intends, subject to European Commission approval and informal discussions with business, to reform the charge to a CO₂ basis. (37)
- Fuel duties** **A92** The Government today announces an RPI-based increase in duty rates of 1.22 pence per litre for main road fuels. Due to the sustained volatility in the oil market, the changes in rates will be deferred to 1 September 2005. (38)
- Road fuel gases** **A93** The Government today announces, with effect from 1 September 2005, a narrowing of the duty differential for liquefied petroleum gas by one penny in 2005-06, and again in 2006-07 and 2007-08. The duty differential between natural gas and main road fuels will remain the same for the next three years. (39)
- Biofuels** **A94** The 20 pence duty differential for biodiesel and bioethanol will be guaranteed until at least 2007-08. (40)
- A95** Government will undertake a pilot project to examine the potential for encouraging the use of biomass in conventional fuel production. (41)
- Rebated oils** **A96** To support the UK oils fraud strategy, the Government today announces an increase in duty for rebated oils of 1.22 pence per litre. This increase will also be applied to heavy fuel oil, reflecting the polluting nature of the fuel, and will take effect from 1 September 2005. (24)
- Company car tax** **A97** The Government today announces that the threshold for the minimum percentage charge rate will remain frozen at 140g per kilometre for 2007-08. (-)
- A98** The discount system for bi-fuel and hybrid electric cars will be simplified to replace the existing provisions with a 1 per cent increase in the basic percentage discounts. These changes will take effect from 6 April 2006. (*)
- Company car tax – diesel supplement** **A99** As announced in the 2004 Pre-Budget Report, from 6 April 2006 the waiver of the 3 per cent diesel supplement for diesel cars that meet Euro IV emissions standards will cease for cars registered on or after 1 January 2006. (ad)
- Company car fuel** **AI00** The company car fuel calculation figure will be frozen at £14,400 in 2005-06. (-)
- Air passenger duty** **AI01** The Government today announces a freeze on air passenger duty (APD) rates. (42)
- Vehicle excise duty** **AI02** VED rates will be frozen for the four least polluting carbon dioxide bands and increased by £5 for the two most polluting bands, as well as for private and light goods vehicles of over 1549cc registered before 1 March 2001. Changes take effect for licences commencing 1 April 2005. (43)

Table A8a: VED bands and rates for private vehicles registered on or after 1 March 2001 (graduated VED)

VED band	CO ₂ emissions (g/km)	Cars using alternative fuels	VED rate (£)	
			Petrol car	Diesel car
A	100 and below	55	65	75
B	101 to 120	65	75	85
C	121 to 150	95	105	115
D	151 to 165	115	125	135
E	166 to 185	140	150	160
F	186 and above	160	165	170

Table A8b: VED bands and rates for private and light goods vehicles registered before 1 March 2001 (pre-graduated VED)

Engine size	VED rate (£)
1549cc and below	110
Above 1549cc	170

OTHER INDIRECT TAXES AND DUTIES

Tobacco duties AI03 From 6pm on Budget Day 2005, tobacco duty rates will rise in line with inflation to maintain the real price of tobacco. (29)

Table A9: Changes to tobacco duties

	Effect of tax ¹ on typical item (increase in pence)	Unit
Cigarettes	7	packet of 20
Cigars	3	packet of 5
Hand-rolling tobacco	8	25g
Pipe tobacco	5	25g

¹ Tax refers to duty plus VAT.

Alcohol duties AI04 Excise duty rates on cider and sparkling wine are frozen, while the rates on beer and wine are increased in line with inflation from midnight on 20 March 2005. As announced in Budget 2004, excise duty rates on spirits are frozen. (28)

Table A10: Changes to alcohol duties

	Effect of tax ¹ on typical item (increase in pence)	Unit
Beer	1	Pint of beer @ 4.2% abv
Wine	1	175ml glass typical strength
Wine	4	75cl bottle typical strength
Sparkling Wine	0	75cl bottle typical strength
Spirits	0	70cl bottle @ 37.5% abv
Spirits-based RTDs	0	275ml bottle @ 5.4% abv
Cider	0	Pint of cider typical strength
Sparkling cider	0	175ml typical strength

¹ Tax refers to duty plus VAT.

Betting and gaming duties **AI05** Gaming duty bandings will rise in line with inflation for accounting periods starting on or after 1 April 2005. (–)

AI06 Amusement machine licence fees are frozen at their current levels in Budget 2005. (*)

PROTECTING TAX REVENUES

Tackling avoidance schemes **AI07** A measure will be introduced, with effect from 1 July 2005, requiring promoters or users to disclose the details of certain schemes and arrangements involving stamp duty land tax on commercial property that might be expected to give a tax advantage.

AI08 Following Royal Assent, two additions will be made to the list of VAT avoidance schemes that must be notified to Customs and Excise by businesses with an annual turnover over £600,000. Following Royal Assent, an addition will also be made to the hallmarks used to identify those VAT avoidance schemes that must be notified by businesses with annual turnover exceeding £10 million. A new rule will also be added to ensure that obtaining a tax advantage includes reducing irrecoverable VAT.

Avoidance through arbitrage **AI09** A measure will be introduced, with effect from 16 March 2005, to counter the exploitation by companies of differences within and between tax codes in order to obtain a UK tax advantage. (23)

Double taxation relief **AI10** Measures will be introduced, with effect from 16 March 2005, to allow the Inland Revenue to cancel the effect of tax avoidance schemes that produce excessive DTR claims and to take action against known DTR avoidance schemes. In addition, as announced on 10 February 2005 measures were introduced to counter the acquisition of foreign tax credits for tax avoidance purposes with effect from that date. (21)

AI11 As announced in the 2004 Pre-Budget Report, existing DTR rules for trade receipts will be reinforced with effect from 16 March 2005. Targeted action against specific avoidance schemes involving DTR was introduced with effect from 2 December 2004. (y)

Controlled Foreign Company rules **AI12** As announced in the 2004 Pre-Budget Report, with effect from 2 December 2004, a package of measures was introduced to stop a number of avoidance schemes that allowed the artificial diversion of profits from the UK. In addition one of the exemption rules has been strengthened to prevent its use in avoidance schemes and will take effect from 31 March 2005. (x)

Employment related securities **AI13** As announced in the 2004 Pre-Budget Report, with effect from 2 December 2004, legislation will be introduced to tackle avoidance schemes using employment-related securities disclosed to the Inland Revenue under the new avoidance disclosure rules. (u)

Businesses financed by a related party **AI14** As announced on 4 March 2005, changes to transfer pricing and loan relationship rules will be included in Finance Bill 2005, to prevent businesses from avoiding tax by restructuring their finances. The changes will have effect from 4 March 2005. (ac)

Capital gains **AI15** As announced in the 2004 Pre-Budget Report, a measure was introduced, with effect from 2 December 2004, to counter certain avoidance schemes involving options to acquire or dispose of assets where options are exercised at uncommercial prices to avoid tax on chargeable gains or to create or augment losses. (t)

AI16 Measures will be introduced, with effect from 16 March 2005, to counter avoidance of tax on capital gains. The measures ensure that the interaction between residence rules and double taxation agreements cannot be exploited to avoid UK tax on capital gains. With effect from 16 March 2005, the range of assets which are treated as located in the UK for the purposes of tax on capital gains is being expanded. (18)

- Partnerships: restrictions on loss relief** **AI17** On 26 March 2004, measures were announced with effect from that date to prevent certain partners in a film partnership from claiming loss relief against other income and gains. (–)
- Financial product avoidance** **AI18** A package of measures will be introduced, with effect from 16 March 2005, to prevent a variety of income, corporation and capital gains taxation avoidance. The measures prevent avoidance by companies and individuals using financial product based schemes and build on announcements made in the 2004 Pre-Budget Report and on 10 February 2005. (20) (aa)
- Rent factoring** **AI19** As announced on 2 July 2004, a measure was introduced with effect from that date to counter avoidance whereby businesses could sell rental streams from leases of plant or machinery for a sum that was not brought into charge as income. (ab)
- Life companies** **AI20** As announced in the 2004 Pre-Budget Report, measures were introduced to prevent tax avoidance in connection with transfers of business between life insurance companies with effect from 2 December 2004. (–)
- AI21** As announced in the 2004 Pre-Budget Report, measures were introduced to enable the apportionment rules governing the distribution of income and gains between the various categories of life assurance business to be improved. Additional measures reflecting changes to the regulatory accounting rules for life insurance companies will also be introduced, effective for accounting periods starting on or after 1 January 2005. (w)
- Intangible fixed assets** **AI22** A package of measures will be introduced, with effect from 16 March 2005, to ensure intangible fixed assets transferred between related parties do not benefit from unintended tax relief. (22)
- Stamp duty land tax** **AI23** A package of measure will be introduced, with effect from 17 March 2005, to counter avoidance of stamp duty land tax, including measures to ensure that group relief rules work as intended. (19)
- Film and partnership tax relief** **AI24** As announced in the 2004 Pre-Budget Report, with effect from 2 December 2004, a package of measures was introduced to end the abuse of tax reliefs for UK film production and of trading loss relief for partners in a partnership. (v)
- Gifts of shares and securities to charities** **AI25** As announced on 2 July 2004, with effect from that date, a measure was introduced to prevent individuals from obtaining income tax relief on an amount in excess of the benefit received by a charity from the donation of shares and securities. (*)
- VAT: Customs' warehouses** **AI26** Following Royal Assent, legislation will enable HM Customs and Excise to make regulations requiring certain types of supplies of goods in Customs' warehouses to be taxed according to the normal domestic VAT rules to ensure the correct amount of VAT is accounted for. (26)
- VAT: partial exemption** **AI27** With effect from 1 April 2005, changes will be introduced to address weaknesses in partial exemption methods and ensure the amount of VAT on the costs that businesses can recover is fair. (25)
- VAT: unjust enrichment** **AI28** From 23 March 2005, the use of unjust enrichment defence by HM Customs and Excise will be extended to cover all claims by businesses for refunds of overcharged and over accounted for VAT, irrespective of whether they are in a payment or repayment position on individual VAT returns. (*)
- VAT: value of supplies** **AI29** From 17 March 2005, a special valuation provision will ensure that the value of supplies of natural gas and electricity from an overseas supplier, in cases where the customer is liable to account for the VAT, is derived from the full consideration payable to the supplier. (*)

VAT: financial and insurance supplies **AI30** As announced in the 2004 Pre-Budget Report, since 3 December 2004 businesses that incur VAT on costs used to make a supply of shares (or other incidental financial supply) are required to apportion the VAT based on the use to which the costs are put. (z)

AI31 As announced in the 2004 Pre-Budget Report, legislation has been put in place to stop unregistered non-EU businesses reclaiming UK VAT incurred since 3 December 2004 in the course of making exempt financial and insurance supplies to customers outside the EU. (*)

ADDITIONAL SPENDING AND DEBT MANAGEMENT DECISIONS

Local Authorities **AI32** As announced in the 2004 Pre-Budget Report, direct grant to local government will be increased by more than £600 million above the grant set for 2005-06 in the 2002 Spending Review settlement. To fund this increase, Departments have reallocated £512 million of existing funding from central programmes to local authorities. An additional £150 million in new funding has also been allocated to local government.

Local Enterprise Growth Initiative **AI33** The Government will introduce a Local Enterprise Growth Initiative (LEGI), worth £50 million in 2006-07, rising to £150 million per year in 2008-09 (subject to confirmation in the 2006 Spending Review). (4)

AI34 In addition, Enterprise Areas will be supported by £5 million over three years for the new Entrepreneur Scholarship and £5 million over three years for long-term support for business incubation. (*)

NS&I Ombudsman **AI35** National Savings and Investments (NS&I) will join the jurisdiction of the Financial Ombudsman Service. The post of the Parliamentary Adjudicator, responsible for NS&I's previously separate arbitration system, will be abolished. New complaints will be handled by the Financial Ombudsman Service from the first calendar day of the second month after Royal Assent. (-)

Annually Managed Expenditure **AI36** In line with usual practice, this Budget sets the Annually Managed Expenditure (AME) margin to £1 billion in 2005-06, £2 billion in 2006-07 and £3 billion in 2007-08.

Special reserve **AI37** In the 2004 Pre-Budget Report, the Government added £520 million to the special reserve for 2004-05. In this Budget, the Government provides a further £340 million for the special reserve in 2004-05 and £400 million for the special reserve in 2005-06, reflecting the continuing costs of the military conflict in Iraq and its other international obligations. (45)

Departmental Expenditure Limits **AI38** This Budget allocates an addition to the Department for Education and Skills from within total Departmental Expenditure Limits for a package of education and skills measures as described in the EFSR. (44)

AI39 An addition will be made to Inland Revenue DEL between 2005-06 and 2007-08 to implement measures announced in this Budget to improve direct tax and NICs compliance.

AI40 From April 2006, the Arts Council England will have increased capacity for programmes related to management and leadership within the cultural sector. (6)

BUDGET POLICY DECISIONS: APPENDICES

APPENDIX AI: MEASURES ANNOUNCED IN BUDGET 2004 OR EARLIER

AI41 This appendix sets out a number of tax, benefit and other changes which were announced in Budget 2004 or earlier and which will take effect from April 2005 or later. The revenue effects of these measures have been taken into account in previous economic and fiscal projections.

Table AI.1: Measures announced in Budget 2004 or earlier which take effect from April 2005 or later

	(+ve is an Exchequer yield)			£ million
	2005-06 indexed	2006-07 indexed	2007-08 indexed	2005-06 non-indexed
<i>a</i> Business premises renovation allowance	-10	-35	-30	-10
<i>b</i> Local Authority Business Growth Incentives	-240	-320	-375	-240
<i>c</i> Housing Benefit: private sector second round pathfinders	-15	-15	-15	-15
<i>d</i> Housing Benefit: align rules with those of tax credits	-35	-35	-35	-35
<i>e</i> Bringing medium term stakeholder products into ISAs	-20	-40	-50	-20
<i>f</i> Pension tax simplification	0	-25	-70	0
<i>g</i> Employer supported childcare	-20	-25	-40	-20
<i>h</i> Modernising trusts	0	-5	-5	0
<i>i</i> Reform of the Construction Industry Scheme	+40	+80	+110	+40
<i>j</i> Tackling alcohol fraud	+10	+30	+85	+10
<i>k</i> Pre-owned assets	+50	+50	+50	+50
<i>l</i> Increase capital limits within means tested benefits	0	-15	-15	0
<i>m</i> State pension: deferral, lump sum and increments	-10	-25	-60	-10
<i>n</i> E-filing incentives for payroll	-200	-275	-200	-200
<i>o</i> Company vans: reform	-30	-30	*	-30
<i>p</i> Changes to Climate Change Agreement criteria	-25	-25	-25	-25
<i>q</i> Aggregates levy: extension of Northern Ireland credit scheme	-20	-25	-30	-20
<i>r</i> Company car tax: emissions level for minimum charge	+80	+70	+60	+80
<i>s</i> Landfill tax: £3 increases from 2005-06	+125	+245	+360	+125
<i>t</i> Enhanced Capital Allowances for energy saving technologies	-10	-20	-20	-10
TOTAL POLICY DECISIONS	-330	-440	-305	-330

*Negligible.

Individual Savings Accounts AI42 As announced in the 2003 Pre-Budget Report, from 6 April 2005, Stakeholder medium-term investment products and existing life insurance products will be available through stocks and shares Individual Savings Accounts (ISAs). (*e*)

Employer-supported childcare AI43 As announced in the 2003 Pre-Budget Report, from 6 April 2005 employer-contracted childcare and employer-provided childcare vouchers up to £50 a week will be exempt from tax and national insurance. (*g*)

Pensions AI44 As announced in Budget 2004, a package of measures will be introduced, with effect from 6 April 2006, to simplify radically the current pension tax regime. The existing eight regimes will be replaced with a single universal regime for all tax privileged pension savings. (*f*)

- AI45** As announced in the 2003 Pre-Budget Report, those choosing to defer their state pension for at least one year from April 2005 will be able to take a taxable lump sum. (*m*)
- Housing Benefit AI46** As announced in Budget 2004, a second set of Local Housing Allowance Pathfinders will be introduced in the private rented sector from 2005. (*c*)
- AI47** As announced in Budget 2004, a package of measures will be introduced, taking effect from April 2005, to simplify the rules surrounding entitlement and take-up of Housing Benefit, and how the rules align with those for other support, such as tax credits and Pension Credit. (*d*)
- Capital limits AI48** As announced in Budget 2004, from April 2006, the threshold above which savings begin to reduce eligibility for Income Support, Jobseeker's Allowance, Housing Benefit and Council Tax Benefit will be raised from £3,000 to £6,000. (*l*)
- Company vans AI49** From 6 April 2005, the benefit an employee derives from private use of a company van will be revised. There will be a nil charge for vans where the van has to be taken home, but otherwise no private use is allowed. Transitionally, the current rates will remain until 2007 when there will be a single scale charge of £3,000 and an additional charge of £500 for fuel provided for private use. (*o*)
- Business premises renovation allowance AI50** As announced in the 2003 Pre-Budget Report, the Government will introduce, subject to state aid approval, a business premises renovation allowance scheme in 2005, providing 100 per cent capital allowances for the costs of renovating business properties in Enterprise Areas that have been vacant for at least a year. (*a*)
- Payroll services AI51** As announced in Budget 2002, incentives for small employers to switch to electronic filing will be introduced. (*n*)
- Scientific Research Organisations AI52** As announced in Budget 2004 the tax exemption for scientific research organisations will be updated, to bring it into line with the definition of research and development used in the rest of the tax system and to transfer the responsibility for their regulation from the DTI to the Inland Revenue. These changes will be included in Finance Bill 2005. (*)
- Local Authority Business Growth Incentives AI53** As announced in the 2003 Pre-Budget Report, a Local Authority Business Growth Incentives Scheme will be introduced from April 2005 to allow local authorities to retain a proportion of growth in local National Non-Domestic Rates revenues. (*b*)
- Construction Industry Scheme AI54** As announced in Budget 2004, the Government will introduce a revised Construction Industry Scheme from April 2006. It will replace the present cards, certificates and vouchers with an Inland Revenue verification service and monthly returns. (*i*)
- Climate change agreements AI55** Budget 2004 announced new eligibility criteria to widen the entitlement to relief from the climate change levy through climate change agreements, to be introduced once EU state aids approval is obtained. (*p*)
- Northern Ireland relief scheme AI56** Budget 2004 announced that the Northern Ireland relief scheme will be extended for businesses prepared to sign agreements committing them to make environmental improvements to the way they operate. (*q*)
- Company car tax AI57** The level of carbon dioxide emissions qualifying for the minimum company car tax petrol percentage (15 per cent) will reduce from 6 April 2005 by 5 grams per kilometre from 145 grams per kilometre to 140 grams per kilometre for 2005-06 and 2006-07. (*r*)
- Landfill tax AI58** As announced in the 2002 Pre-Budget Report, the standard rate of landfill tax will increase from £15 to £18 per tonne in 2005-06. (*s*)

- Energy saving technologies** **AI59** As announced in Budget 2004, the designated energy-saving and water-efficient technologies qualifying for 100 per cent enhanced first-year capital allowances (ECA) will be expanded. (*t*)
- Tackling alcohol fraud** **AI60** As announced in Budget 2004, legislation will be implemented early in 2006-07 which requires producer of spirits to apply a UK paid tax duty stamp to certain of their products. (*j*)
- Modernising the taxation of trusts** **AI61** As announced at Budget 2004, a special regime for certain trusts with vulnerable beneficiaries (backdated to 6 April 2004) will be introduced together with a standard rate band (with effect from 6 April 2005) for all trusts that pay tax at the rate applicable to trusts. (*h*)
- AI62** As announced in the 2003 Pre-Budget Report, a measure will have effect from 6 April 2005, to charge income tax on people who benefit from free or low-cost enjoyment of assets they formerly owned. (*k*)

APPENDIX A2: EXPLAINING THE COSTING

AI63 This appendix explains how the Exchequer effects of the Budget measures are calculated. In the context of these calculations, the net Exchequer effects for measures may include amounts for taxes, national insurance contributions, social security benefits and other charges to the Exchequer, including penalties.

Calculating the costings

AI64 The net Exchequer effect of a Budget measure is generally calculated as the difference between applying the pre-Budget and post-Budget tax and benefit regimes to the levels of total income and spending at factor cost expected after the Budget. The estimates do not therefore include any effect the tax changes themselves have on overall levels of income and spending. However, they do take account of other effects on behaviour where they are likely to have a significant and quantifiable effect on the yield and any consequential changes in revenue from related taxes and benefits. These include estimated changes in the composition or timing of income, spending or other tax determinants. For example, the estimated yield from increasing the excise duty on spirits would include the change in the yield of VAT and other excise duties resulting from the new pattern of spending. The calculation of the expected effect of changes in duty rates on consumer demand for excise goods assumes that any change in duty is passed on in full to consumers. Where the effect of one tax change is affected by implementation of others, the measures are generally costed in the order in which they appear in Tables A1, A2 and A1.1.

AI65 The non-indexed base columns in Tables A1, A2 and A1.1 show the revenue effect of changes in allowances, thresholds and rates of duty including the effect of any measures previously announced but not yet implemented from their pre-Budget level. The indexed base columns strip out the effects of inflation by increasing the allowances, thresholds and rates of duty in line with prices in this and future Budgets.

AI66 A policy which has been previously announced but not yet implemented is also stripped out of the indexed numbers. Measures announced in this Budget are assumed to be indexed in the same way for future Budgets. The indexed base has been calculated on the assumption that, each year:

- income tax and NIC allowances and thresholds and the single person, couple, lone parent and disabled worker elements of the Working Tax Credit increase in line with the Retail Price Index (RPI) to the September prior to the Budget;

- the child element of the Child Tax Credit rises in line with the annual increase in average earnings until 2007-08;
- air passenger duty, climate change levy, aggregates levy, vehicle excise duty and fuel, tobacco and alcohol duties all rise in line with the projected annual increase in the RPI to the September following the Budget; and
- VAT thresholds and gaming duty bands rise in line with the increase in the RPI to the December prior to the Budget.

AI67 Implementation dates are assumed to be: Budget day for fuel and tobacco duties; 10 days after Budget day for alcohol duties; May for amusement machine licence duty; July for insurance premium tax; November for air passenger duty; and April for all other taxes, duties and tax credits.

AI68 The yields of measures that close tax avoidance loopholes represent the estimated direct Exchequer effect of the measures with the existing level of activity.

AI69 These costings are shown on a National Accounts basis. The National Accounts basis aims to recognise tax when the tax liability accrues irrespective of when the tax is received by the Exchequer. However, some taxes are scored on a receipt basis, principally due to the difficulty in assessing the period to which the tax liability relates. Examples of such taxes are corporation tax, self-assessment income tax, inheritance tax and capital gains tax. This approach is consistent with other Government publications.

Notes on individual Budget measures

Company car tax AI70 The yield from the reform of the diesel supplement is expected to increase to £170 million by 2009-10.

Leasing AI71 The yield is expected to increase to £225 million by 2009-10.

Individual Savings Accounts AI72 The cost is expected to increase to £280 million by 2009-10.

APPENDIX A3: TAX ALLOWANCES AND RELIEFS

AI73 This appendix provides estimates of the revenue cost of some of the main tax allowances and reliefs.

AI74 Tax reliefs can serve a number of purposes. In some cases they may be used to assist or encourage particular individuals, activities or products, and so may be an alternative to public expenditure. In this case they are often termed 'tax expenditures'. There may, for example, be a choice between giving tax relief as an allowance or deduction against tax, or by an offsetting cash payment.

AI75 Many allowances and reliefs can reasonably be regarded (or partly regarded) as an integral part of the tax structure – called 'structural reliefs'. Some do no more than recognise the expense incurred in obtaining income. Others reflect a more general concept of 'taxable capacity'. The personal allowances are a good example: to the extent that income tax is based on ability to pay, it does not seek to collect tax from those with the smallest incomes. However, even with structural reliefs of the latter kind, the Government has some discretion about the level at which they are set. Many other reliefs combine both structural and discretionary components. Capital allowances, for example, provide relief for depreciation at a commercial rate as well as an element of accelerated relief. It is the latter element which represents additional help provided to business by the Government and is a 'tax expenditure'.

A176 The loss of revenue associated with tax reliefs and allowances cannot be directly observed, and estimates have to be made. This involves calculating the amount of tax that individuals or firms would have had to pay if there were no exemptions or deductions for certain categories of income or expenditure, and comparing it with the actual amount of tax due. The Government regularly publishes estimates of tax expenditures and reliefs. Largely because of the difficulties of estimation, the published tables are not comprehensive but do cover the major reliefs and allowances.

A177 The estimates in Table A3.1 below show the total cost of each relief. The classification of reliefs as tax expenditures, structural reliefs and those elements combining both is broad-brush and the distinction between the expenditures and structural reliefs is not always straightforward. In many cases the estimated costs are extremely tentative and based on simplifying assumptions. The figures make no allowance for the fact that changes in tax reliefs may cause people to change their behaviour. This means that figures in Table A3.1 are not directly comparable with those of the main Budget measures.

A178 Estimation of behavioural effects is difficult. The sizes of behavioural changes will obviously depend on the measure examined and possible alternative behaviours. For example, removing the tax privileges of a form of saving may just lead people to switch to another tax privileged form of saving.

A179 Table A3.1 also gives details relating to VAT. It shows the estimated yield forgone by not applying the standard rate of VAT (17.5 per cent) to goods and services which are currently zero-rated, reduced-rated, exempt or outside the scope of VAT. Estimates of the scale of structural reliefs for local authorities and equivalent bodies are also shown. Again, the figures are estimates and must be treated with caution - in line with the other taxes, they make no allowance for changes in behaviour.

A180 The estimated costs of reliefs and allowances given in Table A3.1 are costed separately and cannot be added up to give a meaningful total. The combined yield of withdrawing two related allowances could differ significantly from the sum of individual costs. Similarly the sum of the costs of component parts of reliefs may differ from the total shown.

A181 More details on individual tax allowances and reliefs can be found in the HM Treasury publication, *Tax ready reckoner and tax reliefs*, published alongside the 2004 Pre-Budget Report.

Table A3.1: Estimated costs of principal tax expenditures and structural reliefs

	£ million	
	2003-04	2004-05
TAX EXPENDITURES		
Income tax		
Relief for:		
Approved pension schemes	11,400	12,900
Share Incentive Plan	160	180
Approved savings-related share option schemes	140	160
Enterprise Management Incentives	50	60
Personal Equity Plans	625	425
Individual Savings Accounts	1,000	1,200
Venture Capital Trusts	30	130
Enterprise Investment Scheme	180	180
Professional subscriptions	70	70
Rent a room	90	90
Exemption of:		
First £30,000 of payments on termination of employment	800	800
Interest of National Savings Certificates including index-linked certificates	120	120
Tax Exempt Special Savings Account interest	50	0
Premium Bond prizes	100	150
Income of charities	950	950
Foreign service allowance paid to Crown servants abroad	90	100
First £8,000 of reimbursed relocation packages provided by employers	300	300
Tax credits:		
Life assurance premiums (for contracts made prior to 14 March 1984)	80	55
Child Tax Credit	2,800	3,000
Working Tax Credit	1,200	1,100
Income tax and corporation tax		
Film tax relief	140	70
Corporation tax		
R&D Tax Credits	430	450
National insurance contributions		
Relief for:		
Share Incentive Plan	110	120
Approved savings-related share option schemes	110	120
Employer contributions to approved pension schemes	5,800	6,600
Capital gains tax		
Exemption of gains arising on disposal of only or main residence	10,500	13,000

Table A3.1: Estimated costs of principal tax expenditures and structural reliefs

	£ million	
	2003-04	2004-05
Inheritance tax		
Relief for:		
Agricultural property	190	200
Business property	170	180
Exemption of transfers to charities on death	340	390
Value added tax		
Zero-rating of:		
Food	10,050	10,450
Construction of new dwellings (includes refunds to DIY builders)	6,300	6,700
Domestic passenger transport	2,000	2,100
International passenger transport (UK portion)	150	150
Books, newspapers and magazines	1,650	1,650
Children's clothing	1,150	1,200
Water and sewerage services	1,000	1,000
Drugs and supplies on prescription	1,100	1,150
Supplies to charities	200	200
Ships and aircraft above a certain size	450	500
Vehicles and other supplies to disabled people	400	400
Reduced rate for:		
Domestic fuel and power	1,800	1,800
Certain residential conversions and renovations	150	150
Energy saving materials	50	50
Women's sanitary products	50	50
STRUCTURAL RELIEFS		
Income tax		
Personal allowance	36,500	38,000
Income tax and corporation tax		
Double taxation relief	7,000	7,000
Corporation tax		
Life companies reduced rate of corporation tax on policy holders' fraction of profit	550	750
National insurance contributions		
Contracted-out rebate occupational schemes:		
Rebates deducted at source by employers	6,900	7,200
Rebates paid by the Contributions Agency direct to the scheme	300	300
Personal pensions	3,400	3,500

Table A3.1: Estimated costs of principal tax expenditures and structural reliefs

	£ million	
	2003-04	2004-05
Value added tax		
Refunds to:		
Northern Ireland Government bodies of VAT incurred on non-business purchases under the Section 99 refund scheme	250	300
Local Authority-type bodies of VAT incurred on non-business purchases under the section 33 refund scheme (includes national museums and galleries under section 33a refund scheme)	6,000	6,650
Central Government, Health Authorities and NHS Trusts of VAT incurred on contracted-out services under the Section 41 (3) refund scheme	3,650	3,650
RELIEFS WITH TAX EXPENDITURE AND STRUCTURAL COMPONENTS		
Income tax		
Age-related allowances	2,000	2,100
Exemption of:		
British Government securities where owner not ordinarily resident in the United Kingdom	850	850
Child Benefit (including one parent benefit)	1,030	1,070
Long-term incapacity benefit	250	260
Industrial disablement benefits	60	60
Attendance allowance	80	80
Disability living allowance	300	310
War disablement benefits	90	90
War widows' pensions	70	70
Corporation tax		
Small companies' reduced rate corporation rate	2,300	2,500
Starting rate of corporation tax	350	240
Exemption of gains on substantial shareholdings	260	260
Income tax and corporation tax		
Capital allowances	17,920	18,610
Of which:		
First year allowances for SMEs	350	370
First year allowances for small enterprises for information and communication technology	160	0
Enhanced capital allowances for energy saving technology	180	180
Accelerated capital allowances for Enterprise Zones	370	190
Capital gains tax		
Indexation allowance and rebasing to March 1982	330	320
Taper relief	2,750	3,750
Exemption of:		
Annual exempt amount (half of the individual's exemption for trustees)	1,050	1,400
Gains accrued but unrealised at death	600	650

Table A3.1: Estimated costs of principal tax expenditures and structural reliefs

	£ million	
	2003-04	2004-05
Petroleum revenue tax		
Uplift of qualifying expenditure	180	130
Oil allowance	530	510
Safeguard: a protection for return on capital cost	220	120
Tariff receipts allowance	30	30
Exemption for gas sold to British Gas under pre-July 1975 contracts	80	100
Inheritance tax		
Nil rate band for chargeable transfers not exceeding the threshold	8,700	9,400
Exemption of transfers on death to surviving spouses	1,400	1,600
Stamp duty land tax		
Exemption of transfers of land and property where the consideration does not exceed the £60,000 threshold and from December 2003 non-residential land and property where the consideration does not exceed £150,000	140	160
Exemption of residential transfers in designated disadvantaged wards where the consideration exceeds £60,000 but does not exceed £150,000 and exemption of all non-residential transfers	530	1,000
Transfers to charities	40	70
Transfers between associated companies	610	700
Transfers to registered social landlords	160	70
National insurance contributions		
Reduced contributions for self-employed not attributable to reduced benefit eligibility (constant cost basis)	1,600	1,900
Value added tax		
Exemption of:		
Rent on domestic dwellings	2,550	2,700
Rent on commercial properties	100	100
Private education	250	250
Health services	700	750
Postal services	400	400
Burial and cremation	100	100
Finance and insurance	2,400	2,550
Betting, gaming and lottery duties	1,150	1,200
Small traders	450	450
Vehicle Excise Duty		
Exemption for disabled motorists	140	140
Exemption for classic cars	50	50

World growth in 2004 was at its strongest for nearly three decades and remains robust, although G7 growth has moderated slightly since the 2004 Pre-Budget Report, principally because of weaker than expected growth in the euro area and Japan. However, US growth remains strong and emerging markets, especially China, continue to grow at a rapid pace.

UK GDP expanded by over 3 per cent in 2004, above its assumed trend rate and the fastest for four years, despite growth dipping to slightly below its trend rate during the third quarter of the year. Growth has already become more balanced. With businesses more confident about global economic conditions, investment accelerated further in 2004, having already picked up in 2003. There are also increasing signs of stronger external demand translating into more robust UK export growth. At the same time, private consumption continues to grow at sustainable rates.

With world growth maintaining much of its recent momentum and UK business and consumer confidence having strengthened in recent months, both external and domestic demand are forecast to continue growing robustly in the short term. The UK economy is judged still to be carrying a modest degree of slack, allowing further growth at above trend rates in 2005 without generating domestic inflationary pressures. However, growth is expected gradually to ease back to trend rates around the end of 2005 as the output gap closes and the economic cycle ends. The Budget forecast is broadly the same as that in the 2004 Pre-Budget Report:

- GDP is expected to grow by 3 to 3½ per cent in 2005, with renewed growth at just above trend rates for much of the year, and 2½ to 3 per cent in 2006; and
- Consumer Prices Index (CPI) inflation is expected to rise gradually back to its 2 per cent target by mid-2006 under upward pressure from import prices, and helped by monetary policy anchoring inflation expectations.

Global risks will continue to have a key bearing on UK economic prospects, and challenging judgements will continue to be faced in setting monetary and fiscal policy.

INTRODUCTION^{1,2}

BI This chapter discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2007. It begins with an overview of developments and prospects in the world economy. It then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

¹The UK forecast is consistent with output, income and expenditure data to the fourth quarter of 2004 released by the Office for National Statistics (ONS) on 25 February 2005. This release also contained revisions to earlier quarters of 2004 which the Treasury has carried through to certain other national accounts series that the ONS have not yet revised, in particular sectoral saving and borrowing. A fully consistent national accounts dataset for 2004 will be published by the ONS on 23 March. A detailed 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 (020 7270 4558).

² The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

THE WORLD ECONOMY

Overview

B2 World output growth in 2004 is estimated at around 5 per cent, the strongest rate for three decades and around twice the rate at its latest trough in 2001. The pick-up in world economic growth during 2003 and 2004 was the result of improved economic developments in most advanced economies as well as a number of major emerging economies.

B3 G7 GDP is estimated to have increased by $3\frac{1}{4}$ per cent in 2004, principally driven by the US. Euro area growth weakened in the second half of 2004, after an encouraging start to the year, but growth is expected to pick up again in 2005, moving back towards trend rates by 2006. Japan's growth was revised down significantly in late 2004, as a result of improved national accounting methodology, and the latest data indicate that the economy slipped back into a mild recession in the middle of 2004. Weaker growth in the euro area and Japan towards the end of last year feeds through into the 2005 G7 projection, resulting in a moderation of growth to $2\frac{1}{2}$ per cent, but growth is expected to improve a little in these economies in 2006, and will be reinforced by ongoing solid growth in the US, the UK and Canada.

Table B1: The world economy

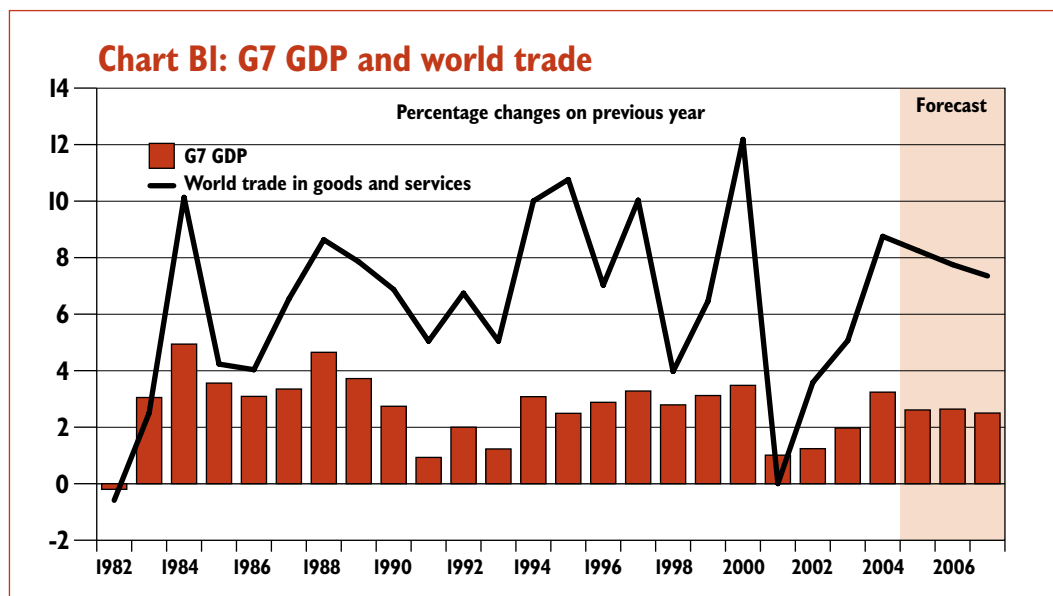
	Percentage changes on a year earlier unless otherwise stated			
	2004	Forecast		
		2005	2006	2007
<i>Major 7 countries¹</i>				
Real GDP	$3\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$
Consumer price inflation ²	$2\frac{1}{2}$	$2\frac{1}{4}$	$1\frac{3}{4}$	$1\frac{3}{4}$
<i>Euro area</i>				
Real GDP	$1\frac{3}{4}$	$1\frac{1}{2}$	$2\frac{1}{4}$	$2\frac{1}{4}$
World trade in goods and services	$8\frac{3}{4}$	$8\frac{1}{4}$	$7\frac{3}{4}$	$7\frac{1}{4}$
UK export markets ³	$7\frac{1}{2}$	$7\frac{1}{2}$	7	$6\frac{3}{4}$

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

² Per cent, Q4.

³ Other countries' imports of goods and services weighted according to their importance in UK exports.

B4 There has been a marked contrast in the growth profiles of advanced economies. Some countries, such as the US, the UK and to a lesser extent Canada, have experienced strong domestic demand associated with rising household wealth, while others, such as Japan and Germany, have had more dependence on exports, with a correspondingly higher exposure to external factors and exchange rate fluctuations. Growth in the former group has tended to be the stronger of the two.



B5 The strength of world output growth, together with increasing regional integration, particularly in Asia, buoyed the rate of world trade growth to around 8% per cent in 2004, significantly stronger than in recent years, but below the 30-year high reached in 2000. UK export markets expanded at slightly slower rates than world trade in 2004 because of weaker growth in the euro area, the UK's biggest export market. Growth for the euro area as a whole has been export orientated, with domestic demand remaining relatively subdued.

B6 Global economic growth has remained resilient despite high and volatile oil prices. This is because oil price rises have largely reflected strong demand for oil, particularly from China and other rapidly expanding emerging economies, rather than the predominantly supply-side influences that have driven previous episodes of high prices. In addition, energy intensity in the advanced economies has been in long-term decline. Nevertheless, the tight market for oil has resulted in prices being more sensitive to perceived supply risks, low stocks and capacity constraints. Prices rose rapidly from early 2004 and peaked in October at new record nominal highs. Prices have fluctuated since then, but recently reached another historical high in nominal terms.

B7 Non-fuel commodity prices also rose sharply during 2004 due to stronger than expected demand, but became more stable in the latter stages of 2004. Price increases were particularly strong for metals and other industrial inputs, due to the rapid expansion in China, India and other Asian emerging markets, on top of strong growth in some advanced economies.

B8 Despite declining spare capacity and the rise in commodity prices feeding through to headline rates of inflation in advanced economies, core inflation has remained relatively stable, allowing monetary tightening to be gradual, principally in the US, but also in the UK, Canada and some other advanced economies. Consequently, financing conditions continue to be supportive of growth.

B9 On balance there has been a reduction in the risks surrounding the forecast since the Pre-Budget Report. The risks to the global outlook of higher oil prices have diminished since the time of the Pre-Budget Report given the robustness of growth in face of high prices in 2004, with increasing recognition that high oil prices have been driven primarily by strong demand. The risks relating to exchange rates and a disorderly adjustment to the world's current account imbalances remain unchanged since the Pre-Budget Report. In the medium term, structural reform would help to rebalance growth and facilitate the unwinding of imbalances.

G7 activity

B10 Following the sharp downturn of the preceding two years or so, momentum in the G7 economies built during 2003 and 2004, with GDP growth rising to 3¹/₄ per cent last year, but is expected gradually to moderate towards 2¹/₂ per cent going forward. The recovery was led by robust growth in the US, Canada and the UK. There was also a relatively solid contribution to growth from Japan in 2004 as a whole and some improvement in the euro area, although growth in these countries remains low relative to that of many other advanced economies, and Japan, Germany and Italy all saw output fall at stages during the second half of 2004. Domestic demand has been important in driving growth of the US, UK and to a lesser extent Canada, while export growth has been more dominant in Japan and Germany. French growth has been more consumption orientated than the other major euro area economies.

United States B11 The US recovery gained considerable pace during 2003 and 2004 after weak growth in 2001, when the US was hit by accounting scandals, equity price declines and the terrorist attacks of 11 September. The recovery has been predominantly consumption led, with increases in household wealth, low interest rates and tax cuts boosting consumption. Over the past two years, corporate profits have risen to historic highs, and this is now feeding through to strong business investment, which is also supporting GDP growth. The depreciation of the US dollar should begin to be reflected in some recovery in export growth going forward. However, the strength of consumption has led to rising imports and expanding trade and current account deficits. Consequently, net imports have been an increasing drag on GDP growth, and are expected to remain so in the short to medium term.

B12 Productivity growth has been particularly strong over the past three years, rising from around 2¹/₂ per cent in the late 1990s to around 4¹/₄ per cent over the past two years. While this has boosted growth and profit margins, it has been accompanied by relatively subdued employment and aggregate wage growth. Productivity growth is expected to remain solid, but at a slower rate of around 2¹/₂ per cent, with firmer growth in employment and wages. In addition, the household saving ratio is not expected to rise significantly, with household wealth remaining relatively stable. These factors should ensure private consumption remains buoyant.

Euro area B13 The euro area grew at a modest pace in 2004, below the rates achieved by the G7 and other advanced economies although stronger than in recent years. After strong growth in the first half of 2004, momentum faded as the year progressed. This deceleration reflected continued weakness in private consumption and less buoyant net exports, in contrast to the first half of the year which was driven by a strong contribution from external demand. There were considerable variations across Member States. In France and Spain, robust growth was supported by strength in private consumption, while in Germany weak domestic demand growth contrasted with significant net export growth. Looking forward, external demand growth, although moderating, should continue to support activity in the euro area before a more widespread revival in investment and consumption materialises.

Japan B14 In late 2004, Japan moved from a fixed-base to a chain-linked national accounting system, which led to revisions to GDP growth, mainly downward, back to 1995. The revisions were particularly marked in 2003 and 2004, and for some quarters led to negative growth estimates. Despite a particularly strong performance in the first quarter of last year, when annualised growth rose to 6 per cent, its fastest in over a decade, latest estimates show Japan was in mild recession through the middle of 2004, with output contracting by a cumulative ¹/₂ per cent, which impacts on the 2005 growth forecast.

B15 However, while these revisions have lowered estimated GDP growth, they have not had a significant effect on the underlying composition, with net exports and business investment still shown to have underpinned the recent recovery in growth, while private consumption has remained weak. Moreover, despite the downward revisions, Japan's growth has still shown improvement over the past two years, compared with the 1990s and earlier this decade. Short-term indicators in early 2005 also point to some improvement compared with much of last year, including strong export growth to China continuing to support growth, corporate profitability continuing to rise and labour markets showing further modest improvement.

Emerging markets and developing economies

B16 Emerging market economies continued to register high rates of growth in 2004. In particular, Asian and Latin American economies benefited from buoyant US consumption, which drove demand for their exports. In some countries this generated a knock-on stimulus to domestic demand. Strong activity in Asia has been underpinned by continued rapid growth in China, which grew by an estimated 9½ per cent in 2004. Asian prospects continue to depend, in part, on the Chinese authorities' ability to moderate overheating in certain sectors of the economy, although fears of a hard-landing have receded in recent months. India's growth, at around 6½ per cent in 2004, has been driven by expansion in the manufacturing and services sectors. Growth in the Middle East and Former Soviet Union has remained robust on the back of high oil prices. Similarly, growth in Latin America has been supported by increases in commodity prices.

B17 The external financing environment for emerging markets remains generally very favourable, with bond spreads at near record lows. This is thought to reflect considerable liquidity in this asset class plus a general improvement in the structure of emerging market debt. Furthermore, high levels of foreign exchange reserves among many Asian countries reduces their external vulnerability. In mid-2004, uncertainties relating to the expected pace of monetary tightening in the US briefly caused bond spreads to widen, but as concerns about a more rapid adjustment receded spreads returned to historically low levels. Nevertheless, it is possible that financing conditions could deteriorate going forward if equity markets and bond spreads are unsettled by a potentially more rapid or disorderly adjustment of exchange rates.

World trade

B18 Growth in world trade picked up significantly in the second half of 2003 and during 2004, supported by robust US demand and strong gains in worldwide industrial production. World trade grew by around 8¾ per cent in 2004, its fastest for four years and a significant pick-up from the trough in 2001, when growth for the year was close to zero. Increasing regional integration of production processes, reflecting the differing cost advantages of countries at different stages of the production chain, together with rising consumption, have also contributed to greater intra-regional trade in Asia and wider Europe. Specifically, increasing comparative advantage in producing cheaper manufactures means that Asia is now a significant driver of world trade growth, underpinned by strong growth of final demand in North America and some European countries.

UK export markets B19 UK export markets have grown a little slower than world trade, but have still seen a significant strengthening over the past four years. The continued improvement in UK export market growth into 2004 was largely due to the improvement in growth in wider Europe, the UK's major export market. Although GDP growth in the euro area lost momentum in the second half of 2004, for the year as a whole it remained stronger than in recent years. Moreover, some of the faster growing, but smaller, economies are key UK export markets. Stronger growth in some other key UK export markets, such as North America, Australasia, Africa and the Middle East, provided further support to the pick-up in UK export market growth, which is expected to remain strong in 2005.

Oil and commodity prices

B20 Oil prices rose sharply during 2004, reaching record highs in nominal terms. The price of Brent crude oil, a global bench-mark, rose from a low of \$10 per barrel in 1999 to over \$53 a barrel in recent weeks, though the average price so far in 2005 has been significantly lower. In sterling terms oil prices have also risen, but due to the depreciation of the US dollar price rises have been less pronounced. Nevertheless, prices are trading near nominal highs at around £27 a barrel. Futures prices have tended to fluctuate in line with spot prices, but to show a downward time path. Nominal oil prices are expected to remain high by historical standards and to continue to be sensitive to demand increases and supply disruptions. Over the medium term, prices are expected to moderate somewhat, as supply responds to higher prices and adjusts to meet demand.

B21 The impact of strong demand from China and other rapidly growing emerging economies has been a key driver of the marked pick-up in oil prices from mid-2004. Although China's demand has been rising for a number of years, in 2004 it coincided with stronger demand from advanced economies, low stocks and spare capacity, some uncertainty over supplies, and imbalances between the demand and supply of different grade crude oils. This combination of factors meant that small changes had a disproportionate effect on prices.

B22 Recent oil price rises have, so far, not had the detrimental economic impact that has been associated with rapid oil price rises in the past. Three factors explain this. First, high oil prices have stemmed largely from strong world demand. Second, in real terms oil prices have remained comfortably below historic peaks. Third, the energy intensity of production in advanced economies has continued to decline. Moreover, the impact on developing economies has been less than might have been expected, despite their higher energy intensity of production and greater exposure to foreign currency liabilities, because of relatively supportive international financial conditions, improvements in external debt positions and larger holdings of foreign exchange reserves.

B23 Non-fuel commodity prices also rose sharply during 2004, principally due to stronger than expected demand, but became more stable towards the end of the year. Price increases were particularly strong for metals and other industrial inputs, reflecting the rapid economic expansion in China, India and other Asian emerging markets, on top of strong growth in some advanced economies. Markets for other commodities such as most food items have been much less tight, holding down prices.

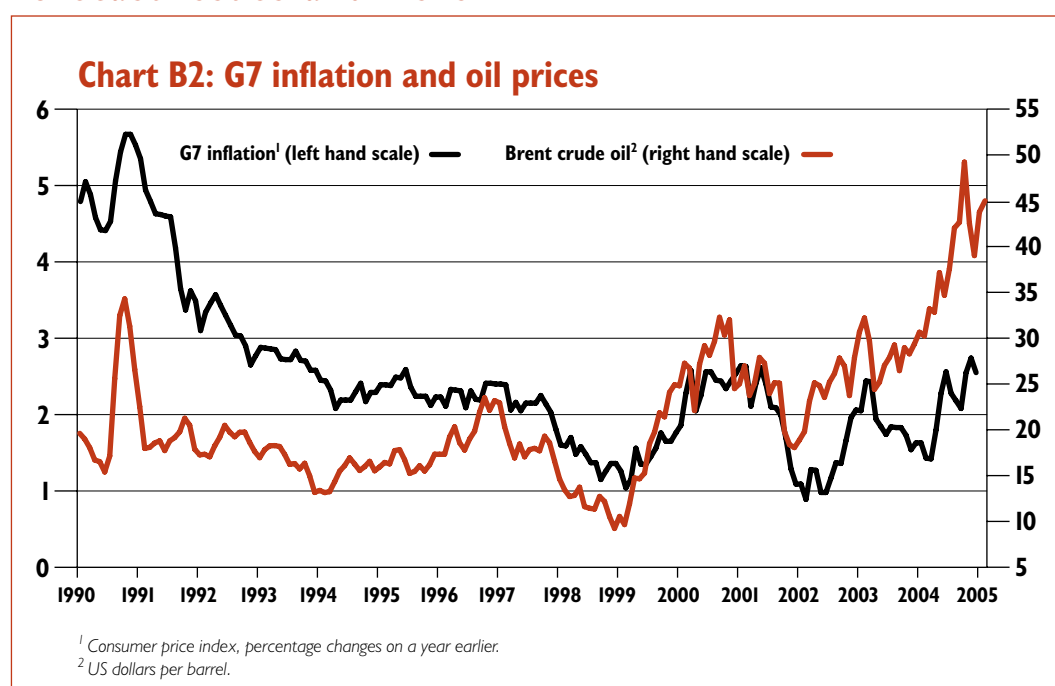
G7 inflation

B24 Overall inflationary pressures in the G7 have been rising gradually, with headline inflation picking up from 1½ per cent in 2003 to 2½ per cent in 2004. However, there remain some exceptions, notably Japan, where deflation continues and shows little sign of abating in the near term. As global growth has strengthened over the past two years, capacity utilisation

has risen, particularly in the US, and allowed some inflationary pressures to build. While core inflation remains stable and relatively low, headline inflation has picked up as oil and other input prices have risen. Rising employment in some G7 labour markets should give rise to higher wages and a consequent narrowing of profit margins, suggesting that more cost increases will tend to feed through to consumer prices and therefore core inflation.

B25 Although input prices have been rising during 2004, leading to rising headline inflation, central banks have generally been successful in anchoring inflation expectations, and core inflation is expected to rise only gradually. Beyond the near term, commodity, and therefore input, prices are expected to begin to moderate, and with subdued price pressures in the euro area and Japan, G7 headline inflation is forecast to ease gradually over the forecast horizon.

Forecast issues and risks



B26 Prospects for G7 economic growth and world trade have changed little since the 2004 Pre-Budget Report, though Japan's national accounting revisions have slightly reduced G7 growth estimates across the years. However, with world trade buoyed by emerging markets, particularly Asia, it has been less affected by the slight adjustment to G7 growth.

B27 On balance there has been a reduction in the risks surrounding the forecast since the Pre-Budget Report, with financial conditions remaining supportive of growth and some of the uncertainties of 2003 and 2004 lifting. The risks to the global outlook of higher oil prices have diminished since the time of the Pre-Budget Report given the robustness of growth in face of high prices in 2004, with increasing recognition that high oil prices have been driven primarily by strong demand. The risks relating to exchange rates and a disorderly adjustment to the world's current account imbalances remain unchanged since the Pre-Budget Report. In the medium term, structural reform would help to rebalance growth and facilitate the unwinding of imbalances

UK ECONOMY

Overview of recent developments

B28 The Government's macroeconomic framework allowed the UK economy to remain resilient in the face of the challenges and uncertainties that affected the world economy between 2001 and early 2003. Most of the world's major economies experienced recession during this period – conventionally defined as two consecutive quarters in which GDP contracted. The UK was the only G7 economy to avoid at least one quarter of negative GDP growth throughout.

B29 As global developments improved from around the middle of 2003 and growth of world trade and GDP strengthened, sustained domestic stability enabled the UK to benefit significantly from stronger international conditions. UK GDP has now grown for 50 consecutive quarters, the longest unbroken expansion on quarterly national accounts records.

B30 As both the world economy and UK domestic demand strengthened, the independent Monetary Policy Committee (MPC) of the Bank of England raised repo rates on five occasions between November 2003 and August 2004, consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation at the target rate of 2 per cent. Since August 2004, the MPC has held rates unchanged at 4³/₄ per cent.

B31 During the second half of 2004, GDP growth dipped to slightly below its assumed trend rate, with growth in the third quarter estimated at 0.5 per cent and official data indicating a fall in manufacturing output. Since the Pre-Budget Report, UK economic developments have evolved broadly as expected. GDP growth strengthened to 0.7 per cent in the final quarter of 2004, with growth of 2.9 per cent on a year earlier, slightly above the economy's assumed trend rate of growth. In 2004 as a whole, UK GDP is currently estimated to have risen by 3.1 per cent – consistent with the 3 to 3¹/₂ per cent forecast range that the Government maintained unchanged from the 2002 Pre-Budget Report. This is the second year running that GDP growth has turned out in line with the Government's previous forecasts.

B32 Stronger expansion since last autumn's dip in growth has been accompanied by recent rises in manufacturing output, and supported by both the continued momentum of domestic demand, in particular business investment, and increasing signs of strong external demand translating into more vigorous export growth. Private sector business survey indicators in recent months have generally supported the view that robust growth of UK output and activity is expected to continue into 2005. For example, the British Chambers of Commerce (BCC) survey for the final quarter of 2004 suggested both external and domestic demand were growing at rates above their respective long-run averages, while the Chartered Institute of Purchasing and Supply (CIPS) Reports on both manufacturing and services suggest continued growth going into 2005. Regional and National Purchasing Managers' Indices (PMIs) from the Royal Bank of Scotland suggest growth has been particularly strong in London, the South East and the North West in the past year. Moreover, recently business survey confidence indicators have regained strength, while consumer confidence has reached its highest level for over two years, bolstered by strong growth of output, robust labour market outcomes, and low inflation and interest rates.

The labour market B33 The UK labour market continues to perform strongly, as the Government's supply-side reforms, described in full in Chapter 4, help create a more dynamic and flexible labour market. The employment rate eased and the inactivity rate rose slightly between the early months of 2004 and the summer, but these developments have subsequently been reversed. Employment picked up from the middle of 2004, and rose strongly by 300,000 – or 1 per cent – in the year to the fourth quarter. This is entirely accounted for by rising full-time employment, tending to boost average hours worked. Employment growth over the past year has been fairly evenly split between the private and public sectors. The employment rate in the fourth quarter stood just below 75 per cent, 0.3 percentage points up on a year earlier, and only exceeded over the past 30 years or so around cyclical peaks.

B34 Unemployment has continued to trend down over the past year, declining by almost 60,000 in the year to the fourth quarter of 2004, with the unemployment rate falling by 0.2 percentage points to 4.7 per cent – the second lowest in the G7. The claimant count has also continued to fall, reaching a new 30 year low of 2.6 per cent in January 2005, down relatively sharply by 0.4 percentage points on a year earlier. Almost all countries and regions of the UK have seen employment rise and unemployment fall, with employment growing particularly strongly in Northern Ireland, the West Midlands and Scotland. Nevertheless, labour market inactivity has remained high, though, as explained in Chapter 4 of the Economic and Fiscal Strategy Report (EFSR), the annual inflow to incapacity benefits has fallen by one-third since the mid-1990s.

B35 Despite strong employment growth, productivity has risen strongly over the recent past, buoyed by robust gains in output, although it has eased back compared with latest peaks. In the second and third quarters of 2004, output per hour averaged over 3 per cent up on a year earlier, comfortably above its estimated trend rate of 2 $\frac{1}{4}$ per cent.

Trend growth and the output gap

B36 The Treasury's neutral estimate of the economy's trend output growth rate for Budget 2005 remains at 2 $\frac{3}{4}$ per cent to the end of 2006. Between the end of 2006 and 2010, projections by the Government Actuary's Department (GAD) show that demographic effects are expected to depress growth in the working-age population, and hence trend output growth, by $\frac{1}{4}$ percentage point a year, reflecting post-War baby-boom women reaching retirement age. The Treasury reassesses its estimates of trend growth around the time each cycle is judged to have ended. One of the important considerations that will bear on the next assessment is discussed in Box B1.

B37 Table B2 presents historical estimates of trend output growth and its decomposition between the estimated on-trend points in 1997 and 2001, and for the preceding cycle, as well as the forward-looking assumptions for trend growth based on projections of its components for the current cycle and beyond.

Table B2: Contributions to trend output growth¹

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked ^{2,3}		Trend	Trend	Population	Trend
	Underlying	Actual	average hours	employment	of working	output
	(1)	(2)	worked ³	rate ³	age ⁴	(6)
1986Q2 to 1997H1	2.22	2.04	-0.11	0.36	0.24	2.55
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	-0.37	0.36	0.66	2.63
Budget 2003	2.35	2.14	-0.47	0.43	0.50	2.61
PBR 2003 and Budget 2004	2.65	2.44	-0.47	0.42	0.54	2.94
PBR 2004	2.70	2.50	-0.43	0.41	0.58	3.06
Budget 2005	2.70	2.50	-0.43	0.41	0.58	3.06
Projection⁵						
2001Q4 to 2006Q4						
Budget 2002	2.10	2.00	-0.1	0.2	0.6	2³/₄
Budget 2003/PBR 2003/ Budget 2004/PBR 2004	2.35	2.25	-0.1	0.2	0.5	2³/₄
Budget 2005 ⁶	2.35	2.25	-0.1	0.2	0.5	2³/₄
2006Q4 onwards						
PBR 2004	2.35	2.25	-0.1	0.2	0.3	2¹/₂
Budget 2005 ⁶	2.35	2.25	-0.1	0.2	0.3	2¹/₂

¹ Treasury analysis based on judgement that 1986Q2, 1997H1 and 2001Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward.

Columns (2) + (3) + (4) + (5) = (6).

Full data definitions and sources are set out in Annex A of 'Trend Growth: Recent Developments and Prospects', HM Treasury, April 2002.

² The underlying trend rate is the actual trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant.

Column (1) = column (2) + (1-a).column (4), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.

³ The decomposition makes allowance for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that hours lag output by just one quarter, though this lag is hard to support by econometric evidence. Hours worked and the employment rate are measured on a working-age basis.

⁴ UK household basis.

⁵ Neutral case assumptions for trend from 2001Q3.

⁶ Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2004Q4 are anchored.

BOX B1: GOVERNMENT OUTPUT, THE OUTPUT GAP AND IMPLICATIONS OF THE ATKINSON REVIEW

The final report of the Atkinson Review, described in Chapter 6 of the EFSR, was published on 31 January 2005, and implementation of the recommendations is likely in due course to lead to further improvements in measuring government output, and hence GDP. Ideally changes to the way government output is measured ought not to change estimates of the output gap.^a

The output gap, because it measures fluctuations in output arising from the business cycle, should be determined by factors affecting the cyclical behaviour of the private or market sector of the economy rather than the rate of utilisation within the government or non-market sector:

- changes in government output (and employment) can be expected to influence the gap by affecting the resources available to the private sector and the demand for output produced by the private sector;
- variation in government output is more structural than cyclical, and hence not part of the output gap, despite affecting it; and
- revisions to government output data reflecting improvements in the way it is measured should not affect capacity pressures in the private sector or the whole economy.

However, in practice output gap estimates based on current estimation methods used by the Treasury and others may inadvertently be affected by government output changes or revisions to the data. This could happen if, for example:

- a changing government share of total employment were to affect whole economy productivity growth. This possibility was noted in the 2002 'Trend Growth' paper,^b but to date Treasury trend growth projections have not explicitly taken account of such factors; or
- revisions to government output data were to lead to unequal effects on whole economy actual and trend output estimates.

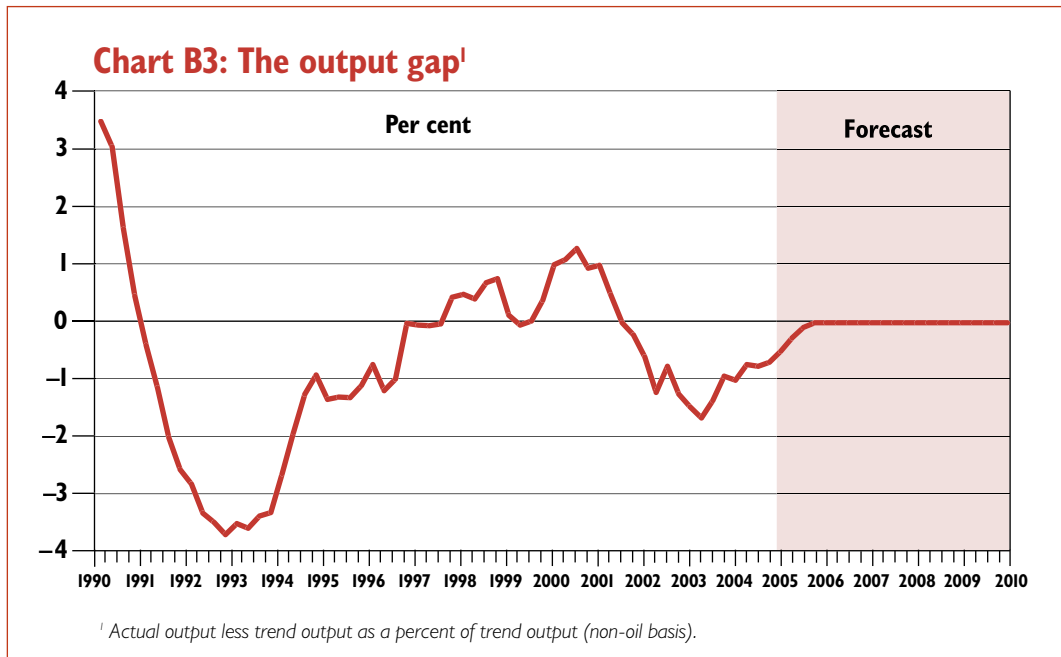
Treasury (and other) methods of estimating the output gap will require refinement to ensure that the estimates are properly insulated from prospective revisions to the way government output is measured. It will be necessary for the implications of changes in government output or employment, including those solely due to measurement changes, to be properly reflected in the projection for whole economy trend output.

Consideration will be given to introducing such refinement in time for future output gap assessments once prospective Atkinson Review related improvements start to feed through into revisions to GDP.

^aHM Treasury trend output and output gap estimates are measured in terms of non-oil Gross Value Added (GVA) at basic prices.

^b*Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002 (paragraph 3.11).

B38 The judgement on the size of the output gap has not changed compared to the 2004 Pre-Budget Report, though the composition implied by latest data is different. Since the 2004 Pre-Budget Report, cumulative growth in non-oil output from the start of 2003 has been revised up by around $\frac{1}{4}$ percentage points, as a result of methodological improvements in accounting for increased VAT compliance over the past couple of years. On its own this would have tended to narrow the estimate of the output gap implied by the $2\frac{3}{4}$ per cent trend growth assumption, compared to Pre-Budget Report time. However, growth over the second half of 2004 is now estimated to have been slightly below the Pre-Budget Report projection. These two developments offset, meaning that the implied output gap at the end of 2004 is the same as was forecast in the 2004 Pre-Budget Report, at around $\frac{3}{4}$ per cent of non-oil output.



B39 Consistent with the decomposition of trend output growth, the output gap can be broken down into components by comparing productivity (output per hour), average hours worked and the employment rate against their assumed trend levels that make up the overall trend output projection. Recent data, mainly on average hours worked, give rise to a different composition of the implied output gap at the end of 2004 compared to that projected at the time of the Pre-Budget Report:

- the accelerated decline in average hours from spring 2002 slowed in the year leading up to the 2004 Pre-Budget Report, and data released subsequently show a marked increase in average hours worked. It is still too early to be sure that the rise is not simply due to erratic data, but it is consistent with the cyclical recovery foreshadowed in previous assessments, as discussed further in Box B2. Therefore, although average hours still make an implied negative contribution to the output gap, it is much less pronounced than at the time of the 2004 Pre-Budget Report;
- the recent pick-up in average hours is balanced by slower growth in productivity measured on an output per hour basis. Productivity is now estimated to make a negative contribution to the output gap, in contrast with the Pre-Budget Report assessment which implied productivity close to its assumed trend; and
- the employment rate was estimated to have made a small negative contribution to the output gap at the time of the Pre-Budget Report. However, it grew at above its assumed trend rate in the second half of 2004 and, as a result, it is now estimated to be close to trend.

B40 Direct evidence on the output gap is provided by a variety of economic indicators, including business survey measures of capacity utilisation and recruitment difficulties. While indicators of capacity utilisation mainly reflect the output per hour and average hours components of the output gap, recruitment indicators are more likely to reflect the employment component.

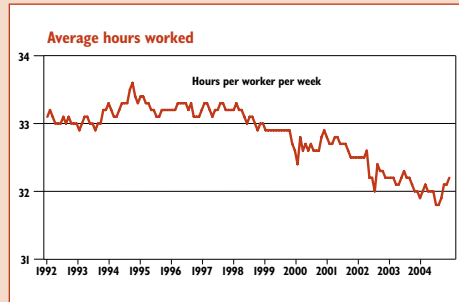
B41 Survey indicators of capacity utilisation in the service sector rose between the third and fourth quarters of last year, while indicators of capacity utilisation in manufacturing fell slightly. Given the relative size of the service sector in the economy, this is consistent with an overall narrowing of the output gap. Survey indicators of general recruitment difficulties showed less slack in the labour market towards the end of 2004, though when asked about difficulties in recruiting specific kinds of labour, firms' responses were more ambiguous about whether the labour market had tightened further in the final quarter of the year.

B42 Wage and price data still show little evidence of unsustainable inflationary pressures emerging. Underlying average earnings growth has remained below the rate judged consistent with trend productivity growth and the inflation target in the medium term. Moreover unit wage cost growth, estimated at around 2 per cent in the year to the fourth quarter of 2004, has been even further below sustainable rates. At the same time, CPI inflation has remained below the Bank of England's 2 per cent target.

B43 As discussed in the 2004 Pre-Budget Report, output gap estimates are subject to a range of unavoidable uncertainties, though the Treasury's approach yields estimates that have been less susceptible to revision than some alternative approaches. Nevertheless, since the estimated on-trend point in mid-1999, when the current cycle is judged to have started, output has so far grown at an annualised average rate of 2.8 per cent, consistent with the 2½ per cent neutral view of trend growth. This confirms that the assumption of 2½ per cent trend growth used in the public finance projections has to date proved reasonable and cautious. The public finance projections contained in Budget 2005 continue to be based on this cautious view of prospects.

BOX B2: AVERAGE HOURS WORKED

Growth in average hours worked is one of the key determinants of the trend rate of economic growth. Therefore, deviations in average hours away from their assumed trend are one factor that can account for the emergence of positive or negative output gaps in the economy. Average hours worked have trended downwards in recent decades, and the Treasury's current estimates of potential growth embody a trend decrease in average hours of 0.1 per cent a year from the third quarter of 2001 onwards.



Between the start of the current economic cycle in mid-1999 and the latest estimated on-trend point in the third quarter of 2001, there does not appear to have been a significant trend in average hours worked. Subsequently average hours generally fell, as global economic weakness affected UK output growth and gave rise to a negative output gap. More recently, the rate of decrease in average hours worked

slowed and the final quarter of 2004 saw a significant bounce back, taking levels of average hours worked back to where they last were in mid-2003. This is consistent with the economy being below trend from 2001Q3, but with the size of the negative output gap diminishing recently as the economy has expanded at above trend rates. It also matches partly with full-time jobs entirely accounting for the increase in employment over the past year, and some recent reduction back towards trend in part-timers who would prefer full-time work. Overall, the recent rise in average hours worked appears consistent with a cyclical unwinding. However, average hours data can be volatile, and it would be premature to conclude with certainty that the recent increase can be attributed to a shift back towards trend until further data offer support for this interpretation.

In assessing the cyclical component of recent movements in average hours, the potential effect of structural influences needs to be carefully assessed. Factors such as trend changes in the part-time share of employment, the implementation of the EU Working Time Directive and changes to the composition of employment across sectors could all have affected underlying levels of average hours worked in recent years. However, it is hard to offer convincing evidence in support of the view that movements in average hours since 2002 have been predominantly structural. The Treasury's judgement remains that average hours are still making a contribution, albeit modest and declining, to a negative output gap.

B44 With output at the end of 2004 still assessed to be modestly below potential, growth is forecast to be above its trend rate until the current cycle completes, which is judged to occur around the end of 2005.

Summary of prospects

Table B3: Summary of forecast¹

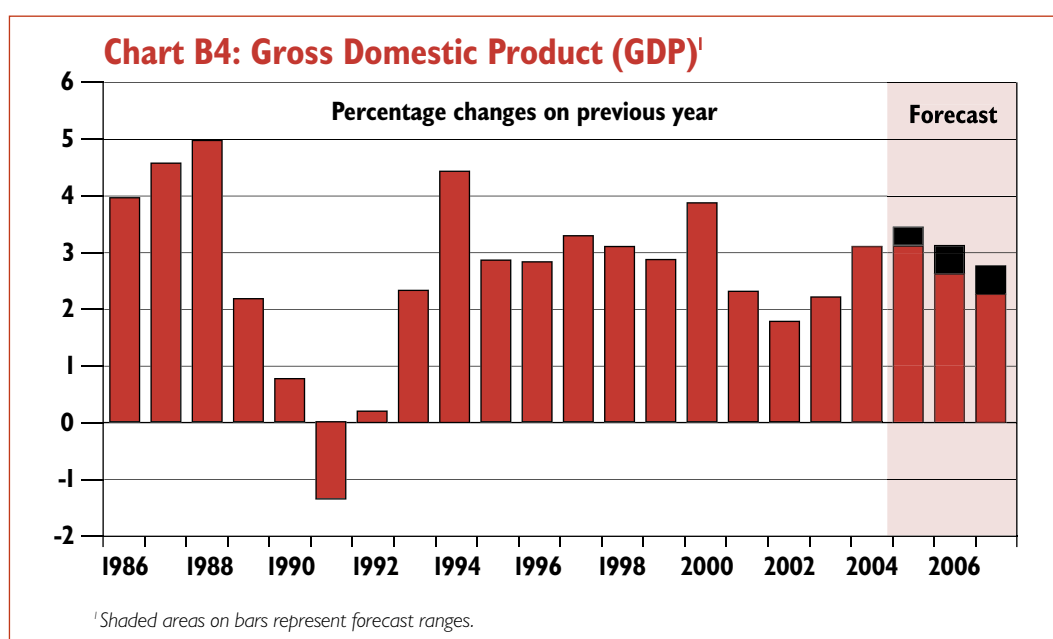
	2004	Forecast		
		2005	2006	2007
GDP growth (per cent)	3	3 to 3½	2½ to 3	2¼ to 2¾
CPI inflation (per cent, Q4)	1¼	1¾	2	2

¹ See footnote to table B9 for explanation of forecast ranges.

GDP B45 The Budget 2005 forecast is very similar to that of the 2004 Pre-Budget Report. Offsetting effects of new data and revisions have left the estimated output gap at the end of 2004 unchanged, and more generally economic developments have continued to evolve as expected. With the world economy still expanding briskly, and business and consumer confidence having lately regained strength, the recent momentum of UK GDP growth is expected to carry through into 2005. Renewed growth at just above trend rates is therefore expected for much of 2005, as robust domestic demand growth is bolstered by a further pick-up in external demand for UK output. However, with the output gap narrowing further and monetary policy having undergone a tightening of 125 basis points since November 2003, growth is expected gradually to ease back to its trend rate later in the year. Fiscal policy should continue to support monetary policy with the overall impact of fiscal policy moving back towards a more neutral position.

B46 So the Budget forecast implies that the current economic cycle will come to a close around the end of 2005, in line with the Pre-Budget Report forecast. GDP is expected to grow by 3 to 3½ per cent in 2005 and 2½ to 3 per cent in 2006. This is the same forecast that has been maintained since Budget 2003, consistent with GDP growth in 2003 and 2004 turning out in line with the Budget (and subsequent) forecasts.

Inflation B47 CPI inflation is expected to rise gradually during the course of 2005 as further upward pressure from import prices, reflecting strong global growth, feeds through to inflation. The credibility of the Government's monetary policy framework, through its effect in anchoring inflation expectations, is also expected to contribute in returning inflation to target by mid-2006.



UK DEVELOPMENTS AND PROSPECTS IN DETAIL

Demand

B48 In recent years GDP growth has become more balanced, with the composition having shifted away from private consumption and, more recently, investment and export growth picking up.

Private consumption B49 In 2004, nominal private consumption continued to drift down a little as a share of GDP, reaching its lowest level since 1998. This reflects the impact of continuing competitive pressure on consumer prices, with the private consumption deflator recently registering its weakest rate of growth since mid-2000. Real private consumption growth in 2004, at just over 3 per cent, was stronger than in 2003. This largely reflects a particularly strong rise of over 1 per cent in the first quarter – in contrast to an unusually weak beginning to the previous year. In the remainder of 2004, private consumption growth progressed at a little below its long-run average. Broadly in line with this, retail sales growth has eased back in recent months, following a string of particularly buoyant readings earlier in 2004.

B50 Levels of household debt and recent interest rate increases are expected to keep consumer spending growth at rates close to that of incomes over the forecast horizon. Thus private consumption is expected to continue growing relatively slowly, rising by $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent this year and by 2 to $2\frac{1}{2}$ per cent in 2006, below forecast rates of GDP growth.

Government consumption B51 Real government consumption grew at relatively robust rates in 2004, rising by just over $4\frac{3}{4}$ per cent compared with 2003. Real government consumption growth is programmed to slow progressively over the 2004 Spending Review period.

Investment B52 Investment growth has strengthened significantly during the past two years, as corporate sentiment has risen on the back of improved global demand. Buoyant profitability and stronger company balance sheets have also acted to underpin renewed growth in capital spending. Business investment has now grown by an average rate of $1\frac{1}{4}$ per cent a quarter over the past five quarters. In the final quarter of 2004 it stood around $9\frac{1}{2}$ per cent higher than at its latest trough in early 2003. In 2004 as a whole, business investment grew by just under $5\frac{1}{2}$ per cent, its strongest performance for six years. Stronger private sector capital expenditure has also coincided with still strong growth of government investment, with whole economy gross fixed capital formation rising by just under 6 per cent in 2004 as a whole.

B53 Going forward, business investment is expected to continue growing at robust rates, albeit at a slightly slower pace than in 2004, as companies, with relatively supportive balance sheets, continue to respond to strong demand growth in the UK and abroad. High levels of profitability are expected to offer further support to expanding capital outlays. At the same time, growth in gross fixed capital formation for the economy as a whole is expected to be supported by continued strong growth in government investment into this year, reflecting the Government's spending plans. Whole economy gross fixed capital formation, building on growth of 6 per cent in 2004, is thus expected to rise by 6 to $6\frac{1}{4}$ per cent this year and by 4 to $4\frac{1}{2}$ per cent next year.

Exports B54 Export growth strengthened in 2004. While growth in goods and services export volumes for the year as a whole averaged just over $2\frac{1}{2}$ per cent, this masked much stronger growth after the early months. Over the final three quarters of 2004 export volume growth averaged $1\frac{3}{4}$ per cent a quarter, following a fall in the first quarter which coincided with a sharp drop in UK export market growth. Strong UK domestic demand has also underpinned

robust import growth over the recent past, with volumes rising by over 5 per cent last year, up from 1¾ per cent growth in 2003.

B55 The recent momentum of export growth is expected to carry through into 2005, supported by further robust demand in the world economy. Export volumes of goods and services are forecast to rise by 6 to 6½ per cent this year and by 6¼ to 6¾ per cent in 2006, similar to the 2004 Pre-Budget Report projections. The exports forecast for 2005 implies quarterly growth averaging marginally less than over the final three quarters of 2004. Import growth is also expected to follow a similar path to that set out in the Pre-Budget Report, growing a little more slowly than exports.

Table B4: Contributions to GDP growth^{1,2}

	Percentage points, unless otherwise stated			
	2004	Forecast		
		2005	2006	2007
Private consumption	2	1¾	1½	1½
Business investment	½	½	½	¼
Government	1	1	¾	¾
Change in inventories	-¼	¼	0	0
Net trade	-1	-¼	0	0
GDP growth, per cent	3	3¼	2¾	2½

¹ Components may not sum to total due to rounding and omission of private residential investment, transfer costs of land and existing buildings and the statistical discrepancy. Rounding contributes over half of the difference in 2004.

² Based on central case. For the purpose of public finance projections, forecasts are based on the bottom of the forecast GDP range.

Balance of growth B56 The forecast thus implies a further rebalancing of growth away from private consumption, reinforcing the pattern established over the past few years.

Output

Manufacturing B57 Recent data revisions now reveal that manufacturing output grew more strongly over the recent past than previously estimated. Manufacturing production now appears to have grown by 0.7 per cent in the three months to January on the previous three months, having increased for three consecutive months. In 2004 as a whole, it rose by 1.4 per cent, slightly higher than forecast in the 2004 Pre-Budget Report and representing the sharpest increase for four years, following a relatively sharp decline in industrial activity throughout almost all advanced economies over much of the intervening period.

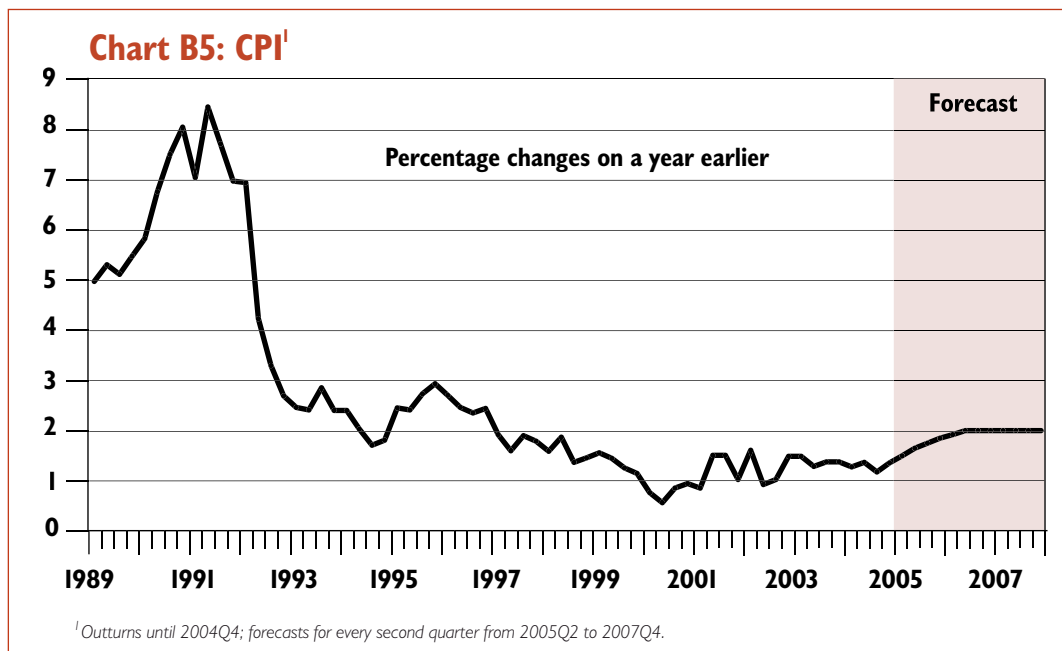
B58 As a result, official data are now more closely aligned with private sector business surveys over the recent past: prior to these revisions, surveys such as the CIPS Report on manufacturing and the BCC quarterly had portrayed a much stronger picture of manufacturing output than official estimates. Nonetheless, upward revisions have not fully reconciled official manufacturing data with the rather stronger signals coming from private surveys.

B59 Going forward, the pick-up in manufacturing output growth is expected to gather further momentum into 2005. Further strong export growth arising from robust global growth, coupled with still strong domestic investment expenditure, should together serve to spur further manufacturing output growth over the forecast horizon. Manufacturing output is thus forecast to rise by 1½ to 2 per cent this year and by 1¾ to 2¼ per cent next.

Services B60 Service sector output grew strongly throughout 2004, growing by 4 per cent in the year as a whole, its fastest rate for four years, with latest data showing a rise of almost 1 per cent between the third and fourth quarters of the year. Within services, business services and finance and transport storage and communications have seen particularly robust growth of late.

Inflation

CPI B61 Inflation has picked up a little since the time of the Pre-Budget Report, although underlying inflationary pressures remain firmly under control. CPI inflation averaged 1.3 per cent in 2004, marginally lower than in 2003, and a little below its 2 per cent target.



B62 In both December 2004 and January 2005, CPI inflation stood at 1.6 per cent, up from its recent low of 1.1 per cent in September and the highest rate for six months. Electricity and gas prices have been one important factor lately exerting upward effects as pre-announced increases in tariffs continue to be phased in. Petrol prices, however, have tended to have a downward impact in recent months. Overall, some of the recent uplift in the CPI measure of inflation is likely to have been due to erratic price movements within the basket, and any pick-up in underlying inflation is likely to be at a much more gradual pace than recent CPI outturns have suggested.

B63 Until recently, the wedge between CPI and RPIX inflation had remained relatively flat, at just under 1 percentage point. However, in January it fell sharply to just 0.5 percentage points, its lowest level for around eight and a half years. The marked narrowing between the two indices partly reflected shifting weights as part of the regular annual updating. Housing costs, as measured by the depreciation component of the RPI, continue to be the biggest source of the remaining difference between the indices, although the magnitude of the wedge attributable to housing is considerably smaller than in 2002 and 2003.

House price inflation B64 House price inflation eased significantly through the second half of 2004, and prices have been broadly flat in recent months. Both Halifax and the Nationwide reported annual house price inflation of around 10 per cent in the year to February 2005, down from around 20 per cent last summer, while monthly house price inflation has averaged very close to zero since the autumn. Other housing market indicators have also pointed to more subdued housing market activity over this period, but repossessions remain close to a record low, and latest indicators point to an emerging gradual pick-up in activity. House price inflation has eased in almost all parts of the UK in the past year, although there remain differences in the rates at which house values have been growing in different parts of the UK.

Producer prices B65 Producer input and output price inflation both picked up through 2004. This partly reflected the effects of higher oil prices, with both input and output prices for petroleum products rising by over 10 per cent in the final quarter. However, there are also some signs of a gradual pick-up in other categories, with core manufacturers' output prices – which exclude petroleum and certain other erratic product groups – rising at their fastest rate for just under nine years in the final quarter of last year. Import prices also appear to have been given a lift as a result of strong world growth and past increases in commodity prices, with goods import prices in the year to the final quarter of 2004 rising at their fastest rate for around two and a half years.

B66 Business surveys have also shown some pick-up in underlying price growth of late. The CBI Industrial Trends Survey has shown that more manufacturers expect to raise prices in coming months than cut them, for the first time in six years. Moreover, the CIPS Report on services has recently shown both input costs and prices charged rising at above their long-run averages. Nevertheless, the ONS's experimental corporate services price index has indicated falling inflationary pressures, with the rate of inflation easing back by around $\frac{3}{4}$ percentage points over the past year to just above 2 per cent in the fourth quarter of 2004.

Average earnings B67 The 12-month growth rates of both whole economy and private sector average earnings, either including or excluding bonuses, have fluctuated mainly within the range of 4 to $4\frac{1}{2}$ per cent since last spring, with no clear trend. Thus earnings growth has remained below thresholds at which it would be judged to begin posing a risk to inflation. Moreover, with productivity growth solid, unit wage costs have been growing well below sustainable rates over the recent past.

Prospects B68 The outlook for CPI inflation remains much as it was in the 2004 Pre-Budget Report forecast, despite slightly higher than expected outturns since that time. As 2005 unfolds, the absorption of the remaining slack in the economy is expected to remove one recent source of downward pressure on prices. At the same time, the effects of strong global growth and its ongoing boost to UK external demand are expected to continue to feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

The household sector

B69 Developments in household spending and finances since the 2004 Pre-Budget Report do not materially change the assessment made at that time. With house prices remaining broadly flat since last autumn and some emerging signs of a gradual pick-up in housing market activity, associated downside risks would appear to have receded a little.

Private consumption B70 2004 saw the third consecutive year of decline in nominal private consumption as a share of money GDP, for the first time in around 25 years, with the share falling to its lowest level since 1998. Nominal private consumption has recently been growing at its slowest rate for well over 50 years. This has been associated with fiercely competitive pricing in retail and other outlets supporting continued growth in real consumption volumes. Relative consumer prices have fallen in six of the past seven years, and more steeply since 2001.

B71 In real terms, average private consumption growth has been marginally below the growth in real GDP in recent quarters. Private consumption rose by 0.4 per cent in the fourth quarter, compared with a 0.6 per cent rise in the previous quarter, and stood 2.8 per cent higher than a year earlier. For 2004 as a whole, real private consumption grew by 3.1 per cent, the same rate of growth as that of GDP. This remains comfortably below the rates in the late 1990s and 2000, lending further weight to the Pre-Budget Report judgement that recent consumer spending growth has been sustainable. Underlying retail sales growth has also eased back, rising by around 4¼ per cent in the 3 months to January on a year earlier although, as is always the case, results covering the month around the busy Christmas trading period may have been affected by seasonal adjustment difficulties.

Household debt B72 Growth in household debt has continued to ease back, suggesting that households are adjusting to the effects of previously strong rises in their borrowing commitments. The total stock of household debt rose at its slowest rate for almost three years between the third and fourth quarters of 2004, with growth of both secured lending and consumer credit having slowed.

Consumer confidence B73 Nonetheless, consumer confidence has risen in recent months, reaching its highest level for two years, reflecting both improved sentiment in households' own finances and a more confident view of the outlook for the economy as a whole.

Prospects B74 Strong confidence, underpinned by the UK's continued domestic macroeconomic stability and sound fundamentals, should continue to ensure that private consumption grows at moderate rates going forward, although the Budget judgement remains for it to rise somewhat more slowly than real GDP over the forecast horizon. Private consumption is forecast to rise by 2¼ to 2¾ per cent this year and by 2 to 2½ per cent next. The saving ratio is expected to edge up in 2005 and to be broadly stable over the forecast horizon at just above its average over recent years.

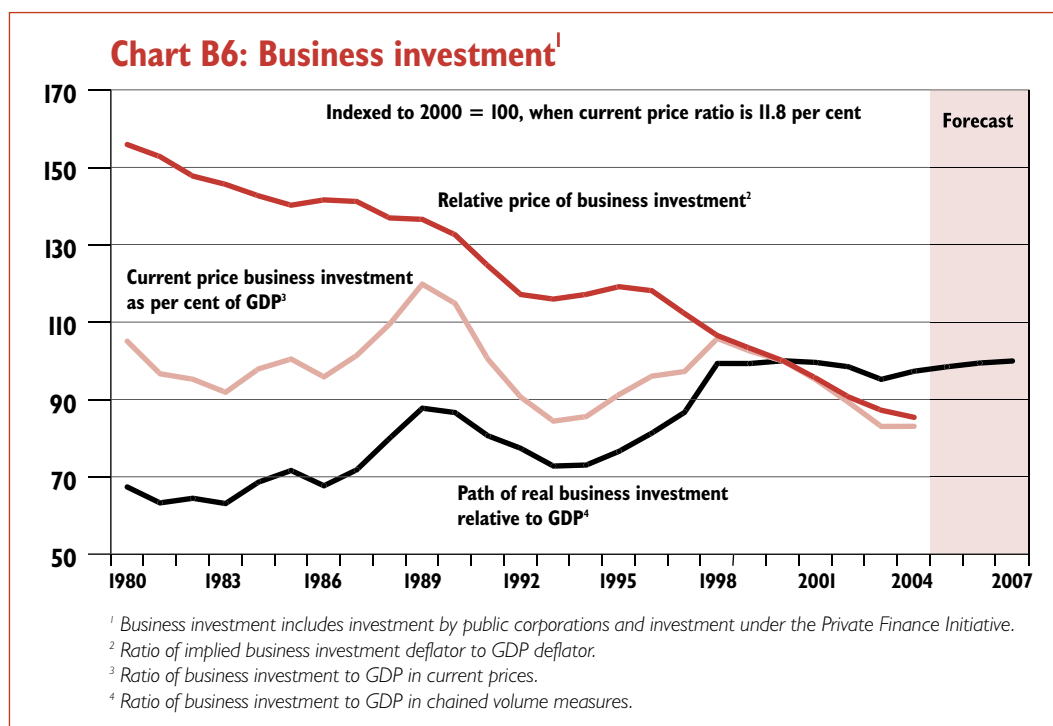
Table B5: Household sector¹ expenditure and income

	Percentage changes on previous year unless otherwise stated			
	2004	Forecast		
		2005	2006	2007
Household consumption ²	3¼	2¼ to 2¾	2 to 2½	2 to 2½
Real household disposable income	3	2¼ to 2½	1¾ to 2¼	1¾ to 2¼
Saving ratio (level, per cent)	5½	5¾	5¾	5¾

¹ Including non-profit institutions serving households.

² Chained volume measure.

Companies and investment



B75 As a result of improved corporate profitability and higher business confidence, business investment growth has picked up convincingly and at slightly stronger rates than had been assumed at the time of the 2003 Pre-Budget Report and 2004 Budget. Corporate profitability has risen sharply since early 2003, and in the past it has proved a good leading indicator of business investment growth. Business investment has now risen for seven consecutive quarters, and by an average rate of around 1½ per cent a quarter for the past five quarters, rising by almost 5½ per cent in 2004 as a whole, the fastest rate for six years. Moreover, the pick-up in business investment is relatively broad-based, with both manufacturing and service sector companies stepping up capital spending. Indeed, manufacturing investment is now over 10 per cent higher than its latest trough. Government investment also rose strongly in 2004, with whole economy gross fixed capital formation growing by almost 6 per cent compared with 2003.

B76 Partly reflecting stronger profitability, private non-financial corporations (PNFCs) have now been net lenders for 10 consecutive quarters. PNFCs appear to have taken steps to build up liquidity and secure their balance sheets. With respect to company pension fund deficits, recent developments give little reason to change the Budget 2004 assessment implying that the process of adjustment is likely to be gradual, with a relatively muted impact on business investment prospects.

Prospects B77 Going forward, business investment is expected to make further solid gains over the forecast horizon. On balance, evidence from forward-looking business surveys clearly points to further increases in the pipeline, though indications of buoyant investment intentions from some surveys are tempered by weaker signals from others. At the regional level, the BCC survey for the fourth quarter of 2004 showed investment intentions were particularly strong in Wales, Yorkshire and the Humber and the South West. Only Scottish, North Eastern and Eastern service companies reported plans to lower levels of investment spending in coming months. Key fundamentals remain sound, and further strong demand growth allied with the marked increase in corporate profitability and sound corporate finances are expected to

continue motivating companies to build on existing levels of capital expenditure. Nevertheless, the shallower downturn in business investment in the earlier phases of the current cycle suggests that the present upturn may be less strong than seen in past cycles. Business investment is therefore forecast to rise by $4\frac{1}{4}$ to $4\frac{3}{4}$ per cent in 2005 and by $3\frac{1}{2}$ to $4\frac{1}{4}$ in 2006.

Table B6: Gross fixed capital formation

	Percentage changes on previous year			
	2004	Forecast		
		2005	2006	2007
Whole economy ¹	6	6 to $6\frac{1}{4}$	4 to $4\frac{1}{2}$	$2\frac{3}{4}$ to $3\frac{1}{4}$
of which:				
Business ^{2,3}	$5\frac{1}{4}$	$4\frac{1}{4}$ to $4\frac{3}{4}$	$3\frac{1}{2}$ to $4\frac{1}{4}$	$2\frac{1}{2}$ to $3\frac{1}{4}$
Private dwellings ³	$8\frac{3}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$1\frac{1}{4}$ to $1\frac{3}{4}$	$1\frac{1}{2}$ to 2
General government ³	$3\frac{3}{4}$	$22\frac{3}{4}$	11 $\frac{1}{2}$	$5\frac{1}{4}$

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

² Private sector and public corporations' non-residential investment. Includes investment under the Private Finance Initiative.

³ Excludes purchases less sales of land and existing buildings.

Trade and the balance of payments

Trade in goods and services³ B78 UK export growth picked up in 2004, following a prolonged period where weak global demand kept UK exports subdued. In the fourth quarter, goods exports were up by 4 per cent on a year earlier, despite falling in the first quarter. Growth to non-EU markets remains significantly above that to EU destinations, broadly reflecting relative GDP growth rates over the recent past.

B79 Underlying growth of services exports has remained somewhat stronger than that of goods, despite falling back in the third quarter, rising by around $4\frac{3}{4}$ per cent in 2004 as a whole. As a result, the UK's surplus on services trade has continued to increase, and reached another record high in 2004, at a little over £18 billion.

B80 As a result of strong growth in UK domestic demand, imports have also grown relatively briskly over recent quarters. With import growth outstripping that of exports, the trade deficit has continued to widen gradually, although for 2004 as a whole the overall deficit turned out in line with the 2004 Pre-Budget Report projection.

³Based on the output, income and expenditure data released by the ONS on 25 February 2005. The ONS released revisions to trade in goods data on 9 March 2005 that will carry through to revisions in the national accounts release scheduled for 23 March 2005.

Table B7: Trade in goods and services

	Percentage changes on previous year					£ billion Goods and services balance
	Volumes		Prices ¹		Terms of trade ²	
	Exports	Imports	Exports	Imports		
2004	2½	5	-½	-¾	¼	-39½
<i>Forecast</i>						
2005	6 to 6½	6 to 6½	1	1	0	-42
2006	6¼ to 6¾	5½ to 6	2¼	2	¼	-41¾
2007	6¼ to 6¾	5¼ to 5¾	1½	1½	0	-41¾

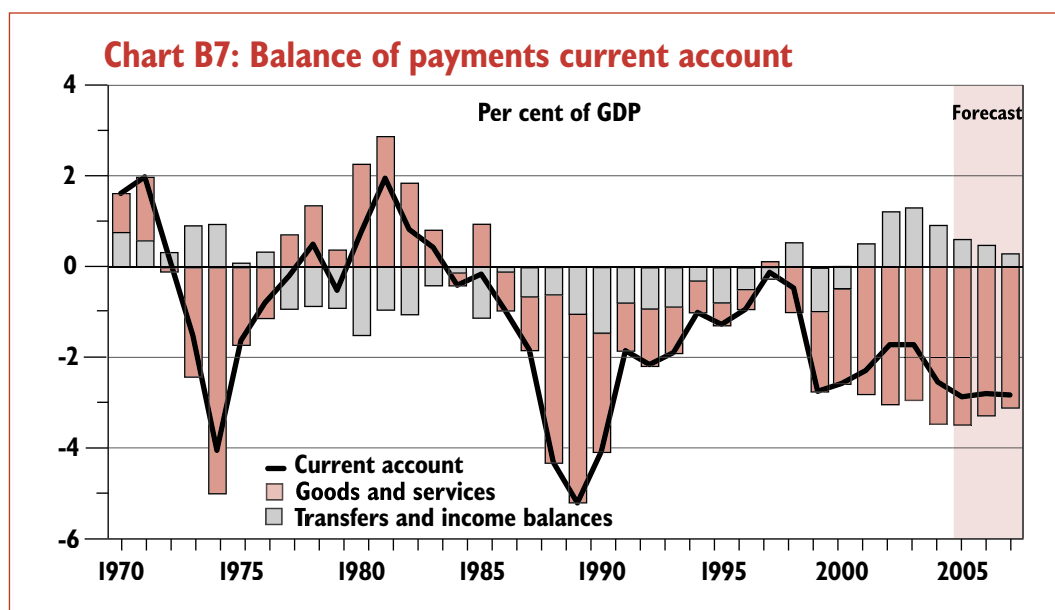
¹ Average value indices.

² Ratio of export to import prices.

Current account B81 The current account deficit widened over the first three quarters of 2004, mainly reflecting the widening in the trade in goods deficit. The income surplus has narrowed a little from 2003's record high, although still remains at very high levels relative to historical experience. The sterling Exchange Rate Index (ERI) has recently been close to levels prevailing a year or so ago. However, this masks a little softening in the exchange rate against the euro, broadly offset by some rise in sterling's value against the US dollar since spring 2004.

Prospects B82 In the Budget forecast, the recent momentum of export growth is expected to continue in 2005 as the effects of a further period of strong global demand feed through, implying a significant strengthening of export growth for the year as a whole compared to 2004. With export growth somewhat firmer than that of imports over the forecast horizon, the trade balance is expected to remain broadly flat.

B83 The income surplus is expected to moderate further from recent high levels as temporary factors that have been boosting it unwind. So the current account deficit is forecast to widen a little this year to around 2¾ per cent of GDP and to be stable at about that level thereafter.



Independent forecasts

B84 The average of independent forecasts for GDP growth in 2005 rose marginally in March, to 2.6 per cent. The shortfall of around ½ percentage point or more against the Budget forecast range of 3 to 3½ per cent largely reflects the relative weakness of the consensus forecast for investment growth in 2005.

B85 This is not the first time in recent years that Treasury forecasts have diverged from those of outside commentators. For example, the Treasury’s forecast for 2004 growth of 3 to 3½ per cent first made in the 2002 Pre-Budget Report was maintained unchanged thereafter. By contrast, independent forecasters were originally projecting 2004 growth to be just 2.6 per cent, and only moved within the 3 to 3½ per cent range last August. Latest ONS data show GDP grew by 3.1 per cent in 2004.

Table B8: Budget and independent¹ forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2005			2006		
	March Budget	Independent Average	Independent Range	March Budget	Independent Average	Independent Range
Gross domestic product	3 to 3½	2.6	1.5 to 3.2	2½ to 3	2.3	0.3 to 2.9
CPI (Q4)	1¾	1.8	1.4 to 3.0	2	1.9	1.5 to 3.2
Current account (£ billion)	-34½	-29.1	-38.4 to -20.0	-35¾	-28.9	-43.7 to -12.5

¹ 'Forecasts for the UK Economy: A Comparison of Independent Forecasts', March 2005.

B86 For 2006, the latest independent average for GDP growth of 2.3 per cent is only marginally below the lower end of the Budget forecast range of 2½ to 3 per cent.

Forecast risks

B87 On balance, the risks surrounding the economic forecast have diminished a little since the time of the 2004 Pre-Budget Report. The global outlook remains a key influence on UK prospects, and challenging judgements will continue to be faced in setting monetary and fiscal policy. Risks to the world outlook have become more focussed on exchange rates and the potential for a disorderly adjustment to the world’s current account imbalances. In the medium term, structural reform is needed to rebalance growth and to facilitate the unwinding of imbalances. With high nominal oil prices now perceived to pose less of a threat, global prospects have become a little more secure.

B88 UK house prices continue to pose risks in both directions, although increasing evidence since Pre-Budget Report time of an orderly moderation of price inflation, and recent signs of some emerging revival in sentiment, suggest that the downside risk has become slightly less prominent.

B89 The forecast also continues to face upside risks. For example, growth of business investment in 2004 was faster than had been expected at the time of either the 2004 Budget or 2003 Pre-Budget Report, and could hold further potential for upside surprise going forward given current robust rates of demand growth with supportive corporate financial conditions. There may be also be headroom for stronger consumer spending without household finances getting stretched.

Table B9: Summary of economic prospects¹

	Percentage changes on a year earlier unless otherwise stated					
	2004	2005	Forecast ^{2,3,4}		Average errors from past forecasts ⁵	
			2006	2007	2005	2006
Output at constant market prices						
Gross domestic product (GDP)	3	3 to 3½	2½ to 3	2¼ to 2¾	½	½
Manufacturing output	1½	1½ to 2	1¾ to 2¼	1¾ to 2¼	1	1¾
Expenditure components of GDP at constant market prices⁶						
Domestic demand	3¾	3¼ to 3½	2½ to 3	2¼ to 2¾	½	¾
Household consumption ⁷	3¼	2¼ to 2¾	2 to 2½	2 to 2½	½	1
General government consumption	4¾	3¾	3	2¾	1	¾
Fixed investment	6	6 to 6¼	4 to 4½	2¾ to 3¼	2	1¾
Change in inventories ⁸	-¼	¼	0	0	¼	¼
Exports of goods and services	2½	6 to 6½	6¼ to 6¾	6¼ to 6¾	2¼	3¾
Imports of goods and services	5	6 to 6½	5½ to 6	5¼ to 5¾	2¼	2¾
Balance of payments current account						
£ billion	-29	-34½	-35¾	-37¾	7	8¼
per cent of GDP	-2½	-2¾	-2¾	-2¾	½	¾
Inflation						
CPI (Q4)	1¼	1¾	2	2	-	-
Producer output prices (Q4) ⁹	3½	2½	2	2	1	1½
GDP deflator at market prices	2	2½	2¾	2¾	½	½
Money GDP at market prices						
£ billion	1158	1223 to 1227	1288 to 1299	1353 to 1370	7	7
percentage change	5¼	5½ to 6	5¼ to 5¾	5 to 5½	½	½

¹ The forecast is consistent with output, income and expenditure data to the fourth quarter of 2004, released by the Office for National Statistics on 25 February 2005. See also footnote 1 on the first page of this chapter.

² All growth rates in tables throughout this chapter are rounded to the nearest ¼ percentage point.

³ As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2¾ per cent to the end of 2006 and 2½ per cent thereafter. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances which is ¼ percentage point below the neutral assumption.

⁴ The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

⁵ Average absolute errors for current year and year-ahead projections made in spring forecasts over the past 10 years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2005 and 2006.

⁶ Further detail on the expenditure components of GDP is given in Table B10.

⁷ Includes households and non-profit institutions serving households.

⁸ Contribution to GDP growth, percentage points.

⁹ Excluding excise duties.

Table B10: Gross domestic product and its components

£ billion chained volume measures at market prices, seasonally adjusted											
	Household consumption ¹	General government consumption	Fixed investment	Change in inventories	Domestic demand ²	Exports of goods and services	Total final expenditure	Less imports of goods and services	Plus statistical discrepancy ³	GDP at market prices	
2004	719.1	213.1	184.0	0.5	1116.6	282.2	1398.9	333.9	1.2	1066.1	
2005	735.8 to 738.0	220.1	195.0 to 195.6	1.9 to 2.6	1152.8 to 1156.3	299.4 to 300.3	1452.2 to 1456.6	354.3 to 355.4	1.4	1099.3 to 1102.6	
2006	751.2 to 757.2	226.5	202.9 to 204.5	1.3 to 3.1	1181.9 to 1191.3	318.1 to 320.6	1500.0 to 1512.0	373.4 to 376.4	1.4	1128.0 to 1137.0	
2007	766.0 to 775.9	232.6	208.3 to 211.0	0.5 to 3.5	1207.4 to 1223.0	337.7 to 342.0	1545.1 to 1565.0	393.0 to 398.1	1.4	1153.5 to 1168.3	
2004	1st half	357.5	105.5	90.9	0.1	554.0	138.9	692.9	164.0	0.5	529.4
	2nd half	361.6	107.6	93.1	0.4	562.6	143.4	706.0	169.9	0.7	536.7
2005	1st half	365.8 to 366.5	109.3	95.3 to 95.5	1.8 to 2.0	572.2 to 573.2	147.4 to 147.7	719.6 to 720.9	174.8 to 175.2	0.7	545.5 to 546.5
	2nd half	370.0 to 371.6	110.8	99.7 to 100.1	0.1 to 0.6	580.6 to 583.1	152.0 to 152.6	732.6 to 735.7	179.5 to 180.2	0.7	553.8 to 556.2
2006	1st half	373.7 to 376.2	112.5	99.9 to 100.6	1.5 to 2.2	587.6 to 591.6	156.6 to 157.7	744.3 to 749.3	184.3 to 185.5	0.7	560.7 to 564.4
	2nd half	377.5 to 380.9	114.0	103.0 to 103.9	-0.2 to 0.9	594.3 to 599.8	161.4 to 162.9	755.8 to 762.7	189.1 to 190.8	0.7	567.4 to 572.6
2007	1st half	381.2 to 385.6	115.6	102.9 to 104.1	0.9 to 2.3	600.6 to 607.6	166.3 to 168.3	767.0 to 775.9	194.0 to 196.3	0.7	573.7 to 580.3
	2nd half	384.9 to 390.3	117.0	105.4 to 106.9	-0.5 to 1.2	606.8 to 615.4	171.4 to 173.8	778.2 to 789.2	199.0 to 201.8	0.7	579.8 to 588.0
Percentage changes on previous year ^{4,5}											
2004	3¼	4¾	6	-¼	3¾	2½	3½	5	¼	3	
2005	2¼ to 2¾	3¼	6 to 6¼	¼	3¼ to 3½	6 to 6½	3¾ to 4¼	6 to 6½	0	3 to 3½	
2006	2 to 2½	3	4 to 4½	0	2½ to 3	6¼ to 6¾	3¼ to 3¾	5½ to 6	0	2½ to 3	
2007	2 to 2½	2¾	2¾ to 3¼	0	2¼ to 2¾	6¼ to 6¾	3 to 3½	5¼ to 5¾	0	2¼ to 2¾	

¹ Includes households and non-profit institutions serving households.

² Also includes acquisitions less disposals of valuables.

³ Expenditure adjustment.

⁴ For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.

⁵ Growth ranges for GDP components do not necessarily sum to the ¼ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

INTRODUCTION

The Budget 2005 projections for the public finances are broadly in line with the 2004 Pre-Budget Report and show that the Government is meeting its strict fiscal rules:

- the current budget shows an average surplus of 0.1 per cent of GDP over the current economic cycle, even using cautious assumptions, ensuring the Government is meeting the golden rule. The average current surplus from 2005-06 to the end of the forecast period is 0.3 per cent of GDP; and
- public sector net debt is projected to remain low and stable over the forecast period, stabilising at 37 per cent of GDP, well below the 40 per cent ceiling in the sustainable investment rule.

C1 Chapter 2 describes the Government's fiscal policy framework and shows how the projections of the public finances are consistent with meeting the fiscal rules. This chapter explains the latest outturns and the fiscal projections in more detail. It includes:

- five-year projections of the current budget and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule, respectively;
- projections of public sector net borrowing, the fiscal aggregate relevant to assessing the impact of fiscal policy on the economy;
- projections of the cyclically-adjusted fiscal balances; and
- detailed analyses of the outlook for government receipts and expenditure.

C2 The fiscal projections continue to be based on deliberately cautious key assumptions audited by the National Audit Office (NAO).

MEETING THE FISCAL RULES

C3 Table C1 shows five-year projections for the current budget and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule respectively. Outturns and projections for other important measures of the public finances, including net borrowing and cyclically-adjusted fiscal balances, are also shown.

C4 As explained in Chapter 2, the Government's provisional view is that the current economic cycle began in mid-1999. The economy is expected to return to trend around the end of 2005, in line with the forecast in the 2004 Pre-Budget Report.

Table CI: Summary of public sector finances

	Per cent of GDP							
	Outturns		Estimate	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Fairness and prudence								
Surplus on current budget	-1.3	-1.8	-1.4	-0.5	0.0	0.3	0.6	0.8
Average surplus since 1999-2000	1.0	0.5	0.1	0.1	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	-0.7	-1.0	-0.8	-0.3	0.1	0.3	0.6	0.8
Long-term sustainability								
Public sector net debt ¹	31.5	32.8	34.4	35.5	36.2	36.8	37.1	37.1
Core debt ¹	31.1	31.6	32.8	33.8	34.5	35.2	35.6	35.7
Net worth ²	23.8	24.7	22.1	19.9	18.9	18.2	18.4	18.0
Primary balance	-0.8	-1.5	-1.3	-0.9	-0.5	-0.2	0.1	0.3
Economic impact								
Net investment	1.1	1.3	1.6	2.1	2.3	2.3	2.3	2.3
Public sector net borrowing (PSNB)	2.4	3.2	2.9	2.6	2.2	2.0	1.6	1.5
Cyclically-adjusted PSNB	1.8	2.3	2.4	2.4	2.2	2.0	1.6	1.5
Financing								
Central government net cash requirement	2.1	3.5	3.7	3.2	2.6	2.3	2.1	2.2
Public sector net cash requirement	2.3	3.5	3.2	2.8	2.4	2.1	1.8	1.8
European commitments								
Treaty deficit ³	2.2	3.2	2.9	2.6	2.2	2.0	1.7	1.6
Cyclically-adjusted Treaty deficit ³	1.6	2.3	2.3	2.4	2.2	2.0	1.7	1.6
Treaty debt ratio ⁴	37.7	39.5	41.0	42.0	42.4	42.8	42.9	42.9
Memo: Output gap	-1.2	-1.2	-0.7	-0.1	0.0	0.0	0.0	0.0

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

² Net worth at end December; GDP centred on end December.

³ General government net borrowing on a Maastricht basis.

⁴ General government gross debt measured on a Maastricht basis.

The golden rule C5 The projections show that the Government is meeting the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over this economic cycle of 0.1 per cent of Gross Domestic Product (GDP). On this basis, and based on cautious assumptions, there is a margin against the golden rule of £6 billion in this cycle, including the Annual Managed Expenditure (AME) margin.

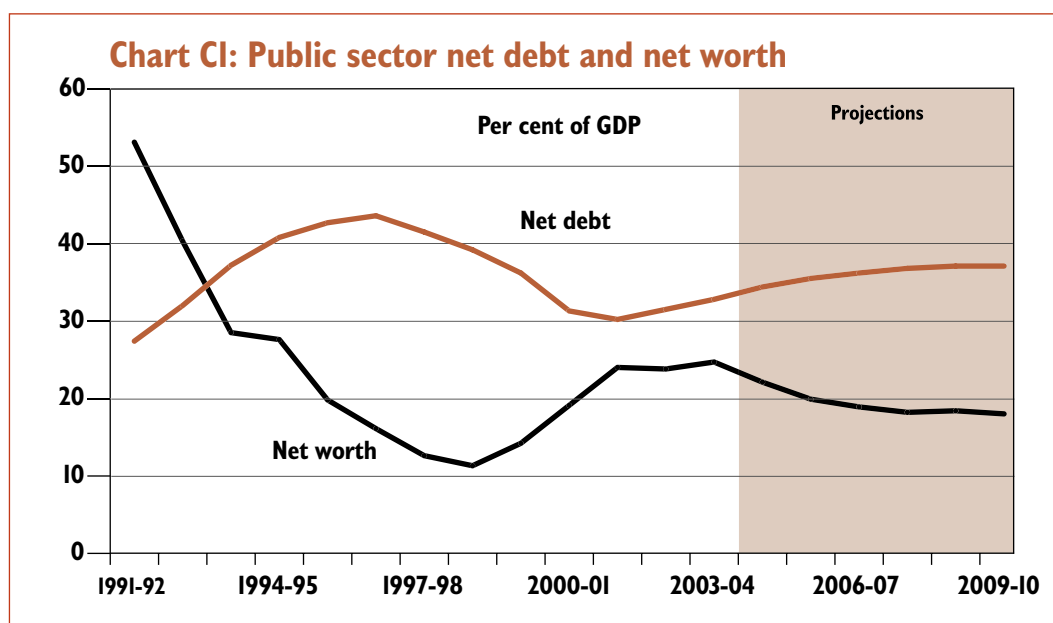
C6 Recent economic developments have been consistent with the current economic cycle drawing to a close around the end of 2005. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus on the current budget over the period 2005-06 to 2009-10 is a $\frac{1}{4}$ per cent of GDP. Based on cautious assumptions, the Government is therefore on course to meet the golden rule from 2005-06 to the end of the projection period.

The sustainable investment rule C7 The sustainable investment rule is also met over the economic cycle. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and expenditure taken by the Government, including the decision to use the proceeds from the auction of spectrum licenses to repay debt, reduced debt to around 30 per cent of GDP by the end of 2001-02. It is now projected to rise slowly, as the Government borrows modestly to fund increased investment in public services, reaching 35½ per cent of GDP by the end of this economic cycle, £57 billion below the 40 per cent level, and stabilising at around 37 per cent

of GDP by the end of the projection period. The projections for core debt, which exclude the estimated impact of the economic cycle on public sector net debt, rise to 35½ per cent of GDP by the end of the projection period. This is consistent with the fiscal rules, and with the key objective of intergenerational fairness that underpins the fiscal framework.

Net worth C8 Net worth is the approximate stock counterpart of the current budget. Modest falls in net worth are expected for the remainder of the projection period from the high level of 25 per cent of GDP in 2001-02. At present, net worth is not used as a key indicator of the public finances, mainly as a result of the difficulties involved in accurately measuring many government assets and liabilities.

C9 Chart C1 shows public sector net debt and net worth as a per cent of GDP from 1991-92 to 2009-10



Net investment C10 As a result of decisions taken in the 2004 Spending Review, public sector net investment is projected to rise to 2¼ per cent of GDP by 2007-08. This increase is sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level over the cycle, well below 40 per cent of GDP.

Net borrowing C11 This increase in net investment, together with the new projections for the current budget, mean that public sector net borrowing is expected to be just under 3 per cent of GDP in 2004-05 and then fall steadily to around 1½ per cent of GDP in 2009-10. Cyclically-adjusted net borrowing in 2004-05 is around 2½ per cent of GDP.

Financing C12 The central government net cash requirement was 3.5 per cent of GDP in 2003-04. It is projected to increase to 3.7 per cent in 2004-05, and decrease to 2.2 per cent of GDP by 2009-10.

European commitments C13 Table C1 shows the Treaty measures of debt and deficit used for the purposes of the Stability and Growth Pact under Article 104 of the Treaty.

CHANGES TO THE FISCAL BALANCES

CI4 Table C2 compares the latest estimates for the main fiscal balances with those in the 2004 Pre-Budget Report and in Budget 2004.

Table C2: Fiscal balances compared with Budget 2004 and the 2004 Pre-Budget Report

	Outturn ¹ Estimate ²		Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Surplus on current budget (£ billion)							
Budget 2004	-21.3	-10.5	-5	0	4	9	
Effect of revisions and forecasting changes:	0.2	-1.2	-1	1	-1/2	-1	
Effect of discretionary changes	0.0	-0.8	-1/2	0	-1/2	0	
PBR 2004	-21.1	-12.5	-7	1	4	9	12
Effect of revisions and forecasting changes:	0.8	-3.2	1	0	1	-1/2	1/2
Effect of discretionary changes	0.0	0.3	1/2	0	-1/2	1/2	-1/2
Budget 2005	-20.4	-16.1	-6	1	4	9	12
Net borrowing (£ billion)							
Budget 2004	37.5	32.9	31	27	27	23	
Changes to current budget	-0.2	2.0	1/2	-1/2	1/2	1/2	
Forecasting changes to net investment	-2.5	-0.7	1/2	2	1/2	0	
PBR 2004	34.8	34.2	33	29	28	24	22
Changes to current budget	-0.8	3.6	-1	0	-1/2	0	-1/2
Forecasting changes to net investment	1.4	-3.4	-1/2	0	0	0	0
Budget 2005	35.4	34.4	32	29	27	24	22
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2004	-1.0	-0.2	-0.2	0.0	0.3	0.7	
PBR 2004	-1.0	-0.4	-0.4	0.1	0.3	0.6	0.8
Budget 2005	-1.0	-0.8	-0.3	0.1	0.3	0.6	0.8
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2004	2.4	2.1	2.3	2.1	1.9	1.6	
PBR 2004	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Budget 2005	2.3	2.4	2.4	2.2	2.0	1.6	1.5
Net debt (per cent of GDP)							
Budget 2004	33.2	34.4	35.3	35.9	36.3	36.4	
PBR 2004	32.9	34.3	35.4	36.2	36.8	37.0	37.1
Budget 2005	32.8	34.4	35.5	36.2	36.8	37.1	37.1

¹ The 2003-04 figures were estimates in Budget 2004.

² The 2004-05 figures were projections in Budget 2004

Changes between Budget 2004 and the Pre-Budget Report

CI5 In the 2004 Pre-Budget Report, the current budget was revised down in 2004-05 and 2005-06 because of forecasting changes, mainly to receipts, with corporation tax showing the largest changes.

CI6 Discretionary changes, led to further small reductions in the current budget, with a continuation of the freeze of the Budget 2004 increase on road fuel duties, the ten year strategy for childcare and a further addition to the special reserve to meet the costs of the military conflict in Iraq and the UK's other international commitments. These factors offset action taken to combat tax fraud and avoidance.

Changes between the Pre-Budget Report and Budget 2005

CI7 For the public sector current budget the estimated 2004-05 outturn shows a deficit of £16.1 billion around £3½ billion higher than the deficit of £12.5 billion projected in the 2004 Pre-Budget Report. This is largely as a result of higher than expected current expenditure, in part due to a timing effect relating to net payments to the EU, with higher than expected payments in 2004-05 being offset by lower payments in 2005-06. There has been additional expenditure in 2004-05 to meet the UK's international commitments, including a further increase in the special reserve, as well as use by departments of end-year flexibility to meet the Government's priorities including health and education. Use of end-year flexibility has enabled departments to smooth their expenditure for 2004-05, the year with the lowest overall planned spending growth of the

2002 Spending Review period. Underpinned by a strong and stable economy, receipts growth has strengthened through the year, with estimated growth in tax receipts in 2004-05 as projected in the Pre-Budget Report. Growth in corporation tax receipts has exceeded expectations. Non-tax receipts are expected to be around £1 billion lower.

C18 Forecasting changes lead to a small improvement in the 2005-06 current surplus since the 2004 Pre-Budget Report. Receipts are expected to be lower by around £2 billion but current spending in 2005-06 is also expected to be about £2½ billion lower than in the 2004 Pre-Budget Report, partly because of the timing change relating to net payments to the EU and partly because of the resetting of the AME margin. There are also fiscally neutral changes, which reduce both current receipts and spending by around £¾ billion. In subsequent years forecasting changes have little effect on overall current receipts and expenditure.

C19 Discretionary measures announced in this Budget include a commitment to increase the child element of the Child Tax Credit in line with average earnings up to 2007-08, an additional payment guaranteeing that council tax paying households with someone over 65 will receive £200 towards the cost of council tax and further reforms to modernise the tax system. Full details are set out in Chapter A. Overall these changes have only a small effect on the current budget.

C20 Public sector net borrowing in 2004-05 is broadly unchanged compared with the 2004 Pre-Budget Report, due to offsetting impacts of higher current expenditure and lower than expected net investment. This reflects monthly outturns to date.

FORECAST DIFFERENCES AND RISKS

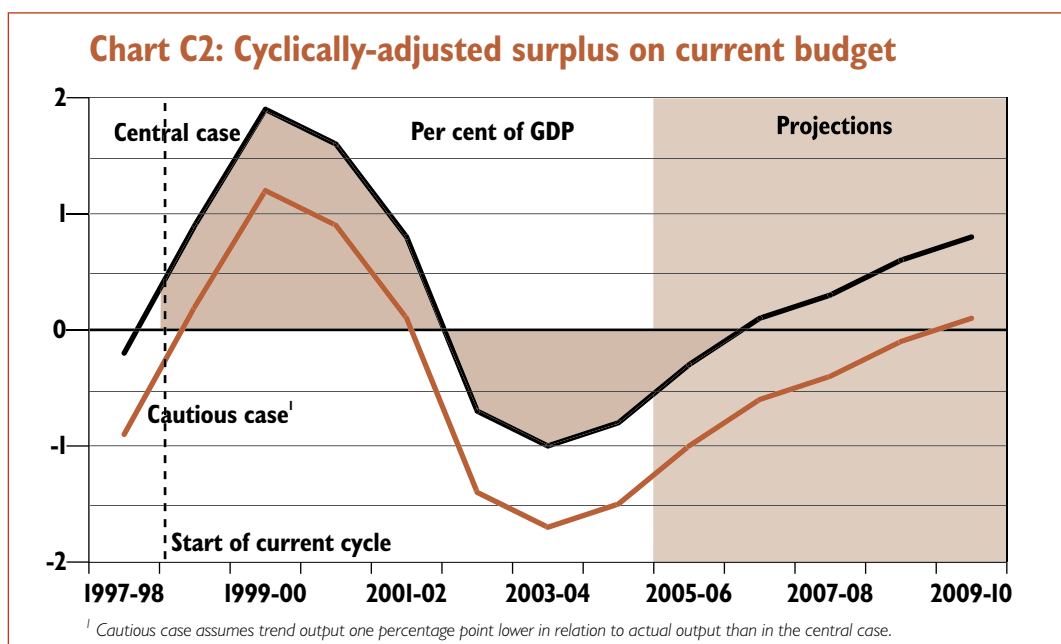
C21 The fiscal balances represent the difference between two large aggregates of expenditure and receipts, and forecasts are inevitably subject to a considerable degree of uncertainty. Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been around 1 per cent of GDP. This difference tends to grow as the forecast horizon lengthens. A full account of differences between the year-ahead projections made in Budget 2003 and Budget 2004, and the subsequent outturns is provided in the *End of year fiscal report*, published alongside the 2004 Pre-Budget Report.

C22 As explained in Chapter B, UK GDP expanded by over 3 per cent in 2004, above its assumed trend rate. With world growth maintaining much of its momentum from 2004 and UK business and consumer confidence strong, both external and domestic demand are forecast to grow robustly in the short term. GDP is expected to grow by 3 to 3½ per cent in 2005 as the remaining slack in the economy is absorbed and the output gap is closed around the end of the year. Growth is then expected to be 2½ to 3 per cent in 2006, in line with the economy's trend rate.

C23 The global outlook remains a key influence on UK economic prospects. The risks to the global outlook of higher oil prices have diminished since the Pre-Budget Report given the robustness of growth in the face of higher prices in 2004. The risks relating to exchange rates and the potential for a disorderly adjustment to the world's current account imbalances remain unchanged since the Pre-Budget Report. UK house prices continue to pose risks in both directions, although increasingly the evidence since the Pre-Budget Report points to an orderly moderation in house price inflation and recent signs of some emerging revival in sentiment suggest that the downside risks are smaller than at the time of the Pre-Budget Report. The forecast also continues to face upside risks from investment. For example, growth of business investment could exceed expectations going forward given current robust rates of demand growth and with supportive corporate financial conditions.

C24 The use of cautious assumptions audited by the NAO builds a safety margin into the public finance projections to guard against unexpected events. One of the key audited assumptions is that for trend output growth, which is assumed to be $\frac{1}{4}$ per cent below the neutral view. This means that the rate of economic growth used to forecast the public finances is the bottom end of the projection range. For example, in this Budget, the forecast for economic growth used in the public finances projections over the period 2005-06 averages under $2\frac{1}{2}$ per cent, $\frac{1}{4}$ per cent below the central case. This implies that the level of GDP used in the public finances forecast is 1.3 per cent below the central view by 2009-10.

C25 Another source of potential errors results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart C2 illustrates the Budget projection for this cautious case.



C26 The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. This was combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt. This has allowed the Government to safeguard the increase in investment in priority public services, allow the automatic stabilisers to work in full during the period of global economic uncertainty in the early part of the decade and meet in full the UK's international commitments, while continuing to meet the fiscal rules.

ASSUMPTIONS

C27 The fiscal projections are based on the following assumptions:

- the economy follows the path described in Chapter B. In the interests of caution, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend output growth of $2\frac{1}{2}$ per cent up to 2006-07, $\frac{1}{4}$ percentage point lower than the Government's neutral view. The Government's neutral view of trend output is reduced to $2\frac{1}{2}$ per cent between 2007-08 and 2009-10, and so, to maintain a cautious approach, an assumption of $2\frac{1}{4}$ per cent is used in the public finances projections, still $\frac{1}{4}$ percentage point lower than the Government's neutral view;

- there are no tax or spending policy changes beyond those announced in or before this Budget, and the indexation of rates and allowances;
- firm Departmental Expenditure Limits (DEL) as set out in the 2004 Spending Review up to 2007-08, but adjusted for the impact of policy decisions and reclassifications;
- total AME programmes through to 2005-06 have been reviewed. The total has been adjusted for DEL/AME reclassifications, and for the estimated costs of spending measures announced in this Budget. In accordance with usual practice, the Government has decided to reset the AME margin to zero in 2004-05, £1 billion in 2005-06, £2 billion in 2006-07 and £3 billion in 2007-08;
- as is normal, the Treasury is setting out its assumption for public sector current expenditure for the period beyond the next Spending Review. Public sector current expenditure in 2008-09 is assumed to grow by 1.9 per cent in real terms, in line with the assumed growth rate in the 2004 Pre-Budget Report, and by the same rate in 2009-10. Taken together, these assumptions imply public sector current expenditure grows on average in line with the cautious view of trend GDP growth used in the public finance projections for the three year period starting in 2007-08; and
- Net investment is assumed to remain at 2¼ per cent of GDP in 2008-09 and 2009-10.

Table C3: Economic assumptions for the public finance projections

	Percentage changes on previous year						
	Outturn	Estimate	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Output (GDP)	2½	3¼	3	2½	2¼	2¼	2¼
Prices							
CPI	1¼	1½	1¾	2	2	2	2
GDP deflator	3	2	2½	2¾	2¾	2¾	2¾
RPI ¹ (September)	3	3	2¾	2½	2¾	2¾	2¾
Rossi ² (September)	2	1¼	2	2½	2¼	2¼	2¼
Money GDP ³ (£ billion)	1,118	1,174	1,240	1,305	1,369	1,437	1,507

¹ Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.

² RPI excluding housing costs, used for uprating certain social security benefits.

³ Not seasonally adjusted.

C28 Consistent with the *Code for fiscal stability*, the forecast does not take account of measures proposed in this Budget for consultation or other proposals where final decisions have yet to be taken such as the rollout of the local housing allowance to the private and social rented sectors, further extensions to paid maternity leave or increasing Child Trust Fund Payments, or others where the impact cannot yet be quantified, such as the Pension Protection Fund. The Government is also awaiting the judgement from the Law Lords on a recent case regarding state pensions for pensioners living outside the EU;

C29 The outturn figures are based on series published in the monthly Public Sector Finance release (the latest outturns covering January 2005 were published on 18th February 2005). The figures are also adjusted to take account of the changes announced by the Office for National Statistics (ONS), where the size of the change has also been publicly announced. This includes the revisions concerning roads maintenance expenditure detailed in ONS's Technical Explanatory Note published on 28 February 2005.

C30 The projections for 2004-05 also are based on all data available within the Treasury and other departments involved in producing tax and spending forecasts where the projections were finalised. This includes details of February central government receipts and spending which will form the basis of the February outturn numbers to be published by ONS and HM Treasury on 18 March 2005.

C31 The key assumptions underlying the fiscal projections are audited by the National Audit Office (NAO) under the three-year rolling review process. Details of the audited assumptions are given in Box C1.

Box C1: Key assumptions audited by the NAO^a

<ul style="list-style-type: none"> • Privatisation proceeds 	<p>Credit is taken only for proceeds from sales that have been announced.</p>
<ul style="list-style-type: none"> • Trend GDP growth 	<p>2½ per cent a year to 2006-07 and 2¼ per cent in subsequent years.</p>
<ul style="list-style-type: none"> • UK claimant recent unemployment^d 	<p>Rising slowly to 0.89 million in 2007-08, from recent levels of 0.82 million.</p>
<ul style="list-style-type: none"> • Interest rates 	<p>3-month market rates change in line with market expectations (as of 7 March).</p>
<ul style="list-style-type: none"> • Equity prices^b 	<p>FTSE All-share index rises from 2523 (close 7 March) in line with money GDP.</p>
<ul style="list-style-type: none"> • VAT^{b,c} 	<p>The VAT gap will rise by 0.5 percentage points per year from a level that is at least as high as the estimated outturn for the current year.</p>
<ul style="list-style-type: none"> • Consistency of price indices^b 	<p>Projections of price indices used to project the public finances are consistent with CPI.</p>
<ul style="list-style-type: none"> • Composition of GDP^c 	<p>Shares of labour income and profits in national income are broadly constant in the medium term.</p>
<ul style="list-style-type: none"> • Funding^c 	<p>Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.</p>
<ul style="list-style-type: none"> • Oil prices 	<p>\$40.6 a barrel in 2005, the average of independent forecasts, and then constant in real terms.</p>
<ul style="list-style-type: none"> • Tobacco 	<p>The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For Budget 2005, a share of 14.5 per cent is used for 2005-06 onwards.</p>

^aFor details of all NAO audits before the 2003 Pre-Budget Report, see Budget 2003, 9 April 2003 (HC500).

^bAudit of Assumptions for the 2003 Pre-Budget Report, 10 December 2003 (HC35).

^cAudit of Assumptions for the 2004 Budget, 17 March 2004 (HC434)

^dAudit of Assumptions for the 2005 Budget, 16 March 2005 (HC452)

The audited assumptions

C32 For this Budget, the Comptroller and Auditor General audited the assumption on UK claimant unemployment, under the three year rolling review process. The review concluded that the assumption was reasonable and cautious. The public finances continue to be based

on a deliberately cautious assumption for trend output growth that is a $\frac{1}{4}$ percentage point lower than the Government's neutral view. The Comptroller and Auditor General will be invited to audit this assumption once the current cycle has ended, currently projected to be around the end of 2005, around which time information relating to an additional on-trend point will be available.

FISCAL AGGREGATES

C33 Tables C4 and C5 provide more detail on the projections for the current and capital budgets.

Table C4: Current and capital budgets

	£billion						
	Outturn	Estimate	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Current budget							
Current receipts	418.9	449.7	487	520	553	582	612
Current expenditure	425.3	451.1	477	503	531	555	581
Depreciation	14.0	14.6	15	16	17	18	19
Surplus on current budget	-20.4	-16.1	-6	1	4	9	12
Capital budget							
Gross investment	35.7	38.8	47	51	53	56	58
Less asset sales	-6.7	-5.8	-5	-5	-5	-5	-4
Less depreciation	-14.0	-14.6	-15	-16	-17	-18	-19
Net investment	15.0	18.3	26	29	31	32	34
Net borrowing	35.4	34.4	32	29	27	24	22
Public sector net debt- end year	375.5	415.0	452	484	517	546	573
Memos:							
Treaty deficit ¹	35.4	34.1	32	29	27	24	24
Treaty debt ²	441.2	481.5	521	554	587	617	647

¹General government net borrowing on a Maastricht basis.

²General government gross debt on a Maastricht basis.

Table C5: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Current budget							
Current receipts	37.5	38.3	39.3	39.9	40.4	40.5	40.6
Current expenditure	38.1	38.4	38.5	38.6	38.8	38.6	38.5
Depreciation	1.3	1.2	1.2	1.3	1.3	1.3	1.3
Surplus on current budget	-1.8	-1.4	-0.5	0.0	0.3	0.6	0.8
Capital budget							
Gross investment	3.2	3.3	3.8	3.9	3.9	3.9	3.9
Less asset sales	-0.6	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3
Less depreciation	-1.3	-1.2	-1.2	-1.3	-1.3	-1.3	-1.3
Net investment	1.3	1.6	2.1	2.3	2.3	2.3	2.3
Net borrowing	3.2	2.9	2.6	2.2	2.0	1.6	1.5
Public sector net debt- end year	32.8	34.4	35.5	36.2	36.8	37.1	37.1
Memos:							
Treaty deficit ¹	3.2	2.9	2.6	2.2	2.0	1.7	1.6
Treaty debt ratio ²	39.5	41.0	42.0	42.4	42.8	42.9	42.9

¹General government net borrowing on a Maastricht basis.

²General government gross debt on a Maastricht basis.

C34 Following a current budget deficit of 3 per cent of GDP in 1996-97, current budget surpluses of more than 2 per cent were recorded in 1999-2000 and 2000-01. These surpluses allowed the Government to use fiscal policy to support monetary policy during the economic slowdown in 2001 and 2002, and as a result the current budget moved into deficit. The current budget is expected to move back into surplus in 2006-07, with increasingly larger surpluses in later years, reaching 0.8 per cent in 2009-10.

C35 The current budget surplus is equal to public sector current receipts minus public sector current expenditure and depreciation. Underlying the projections of the current budget are steady increases in the ratio of current receipts to GDP. This partly reflects measures taken to protect revenues. The other reasons behind this are explained in later sections.

C36 Table C4 also shows that net investment is projected to increase from £15 billion in 2003-04 to £31 billion in 2007-08, as the Government seeks to rectify historical under-investment in public infrastructure. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, as debt is being held at 37 per cent of GDP or less throughout the projection period, well within the 40 per cent limit set by the sustainable investment rule.

RECEIPTS

C37 This section looks in detail at the projections for public sector tax receipts. It begins by looking at the main determinants of changes in the overall projections since the 2004 Pre-Budget Report, before looking in detail at changes in the projections of individual tax receipts. Finally, it provides updated projections for the tax-GDP ratios.

Changes in total receipts since the 2004 Pre-Budget Report

C38 Table C6 provides a detailed breakdown of the main factors that have led to the changes in the overall projections since the 2004 Pre-Budget Report.

Table C6: Changes in current receipts since the 2004 Pre-Budget Report

	£ billion					
	Estimate		Projections			
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Effect on receipts of non-discretionary changes in:						
Assumptions audited by the NAO	0	1	2	2	2	2
Other economic determinants	-1	-1	-1	0	½	½
Fiscal forecasting changes	-½	-2	-2	-2	-3	-2
Total before discretionary changes¹	-1½	-2	-1	0	-1	0
Discretionary changes ²	0	1½	1	1½	1	½
Total change¹	-1½	-½	½	1	0	½

¹ Totals may not sum due to rounding.

² Includes measures announced since the 2004 Pre-Budget Report.

Economic determinants audited by the NAO

C39 Changes in economic determinants audited by the NAO increase public sector current receipts by around £1 billion in 2005-06 and by a little under £2 billion over the rest of the forecast period. Higher profiles for dollar oil prices, equity prices and interest rates all contribute to higher receipts. The average of independent forecasts for 2005 has risen from \$38.2 a barrel used in the 2004 Pre-Budget Report to \$40.6 a barrel. The impact on North Sea revenues is limited due to the appreciation of sterling against the dollar, which means the increase in sterling terms is more modest. The impact of the exchange rate is included in other economic determinants.

C40 Compared to the 2004 Pre-Budget Report, equity prices are around 4 per cent higher throughout the forecast period. This adds around £½–£1 billion to receipts from corporation tax revenues from life assurance companies, stamp duty receipts and capital taxes. Income tax on interest income is higher because of the NAO assumption on interest rates.

Other economic determinants C41 Changes in other economic determinants subtract around £1 billion in 2004-05. This in part reflects lower than expected estimates of wages and salaries in 2004 based on provisional data, although PAYE and National Insurance contributions for 2004-05 are estimated to be in line with their 2004 Pre-Budget Report estimate. It also reflects slower growth in the GDP components that are used to project the VAT tax base, including modestly lower growth in nominal consumers' expenditure. In later years, the impact of these factors diminishes and there is a boost from higher estimates of North Sea oil production.

Fiscal forecasting changes C42 Fiscal forecasting changes account for around £½ billion of the reduction in receipts in 2004-05 and around £1-2 billion in subsequent years. The 2004-05 reduction represents the combined effects of many different changes, largely reflecting outturns for the year to date. In subsequent years, the change is larger partly reflecting the effect of fiscally neutral changes, which reduce both receipts and spending by about £½ billion in 2005-06 and 2006-07 and by about £1 billion a year in subsequent years. They also reflect lower non-tax receipts, particularly from public corporations.

Tax-by-tax analysis

C43 Table C7 shows the changes to the projections of individual taxes since Budget 2004 and the 2004 Pre-Budget Report for 2004-05 and 2005-06. The table shows that overall net taxes and national insurance contributions are as forecast in the Pre-Budget Report. Table C8 contains updated projections for the main components of public sector receipts for 2003-04, 2004-05 and 2005-06.

Table C7: Changes in current receipts by tax since Budget 2004 and the 2004 Pre-Budget Report

	£ billion			
	Budget 2004		PBR 2004	
	2004-05	2005-06	2004-05	2005-06
Income tax (gross of tax credits)	-1.0	0.7	-0.6	0.3
National Insurance Contributions	0.2	0.4	0.1	0.3
Non-North Sea corporation tax ¹	-2.1	-1.2	1.0	1.2
Less tax credits ²	-0.5	-0.3	-0.4	-0.2
North Sea revenues	1.6	3.4	-0.1	1.1
Capital taxes ³	0.9	1.2	0.3	0.3
Stamp duty	-0.5	-0.8	0.1	0.1
Value added tax	-0.8	-1.1	-1.2	-1.0
Excise duties ⁴	-0.7	-1.0	-0.1	-0.2
Other taxes and royalties ⁵	-1.0	-3.0	0.7	-1.3
Net taxes and National Insurance contributions	-3.8	-1.7	0.1	0.7
Other receipts and accounting adjustments	-1.2	-1.4	-1.4	-1.1
Current receipts	-5.0	-3.1	-1.3	-0.3

¹ National accounts measure: gross of enhanced and payable tax credits.

² Includes enhanced company tax credits that offset tax liability.

³ Capital gains tax and inheritance tax.

⁴ Fuel, alcohol and tobacco duties.

⁵ Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.

Table C8: Current receipts

	£ billion		
	Outturn 2003-04	Estimate 2004-05	Projection 2005-06
<i>Inland Revenue</i>			
Income tax (gross of tax credits)	118.4	126.8	138.1
Income tax credits	-4.5	-4.1	-3.9
National Insurance Contributions	72.5	77.9	82.6
Corporation tax ¹	28.6	34.1	43.7
Corporation tax credits ²	-0.5	-0.5	-0.5
Petroleum revenue tax	1.2	1.3	1.5
Capital gains tax	2.2	2.3	3.0
Inheritance tax	2.5	2.9	3.4
Stamp duties	7.5	8.9	9.7
Total Inland Revenue (net of tax credits)	228.0	249.6	277.5
<i>Customs and Excise</i>			
Value added tax	69.1	72.3	76.3
Fuel duties	22.8	23.5	24.6
Tobacco duties	8.1	8.1	8.4
Spirits duties	2.4	2.4	2.5
Wine duties	2.0	2.2	2.3
Beer and cider duties	3.2	3.3	3.4
Betting and gaming duties	1.3	1.4	1.4
Air passenger duty	0.8	0.9	1.0
Insurance premium tax	2.3	2.4	2.6
Landfill tax	0.6	0.7	0.7
Climate change levy	0.8	0.8	0.8
Aggregates levy	0.3	0.3	0.3
Customs duties and levies	1.9	2.2	2.2
Total Customs and Excise	115.7	120.4	126.5
Vehicle excise duties	4.8	4.8	5.1
Oil royalties	0.0	0.0	0.0
Business rates ³	18.3	19.0	19.4
Council tax ⁴	18.8	19.8	20.9
Other taxes and royalties ⁵	11.2	12.0	12.4
Net taxes and National Insurance contributions⁶	396.8	425.6	461.9
Accruals adjustments on taxes	3.2	2.3	0.9
Less own resources contribution to European Communities (EC) budget	-4.6	-4.0	-3.9
Less PC corporation tax payments	-0.1	-0.1	-0.1
Tax credits adjustment ⁷	0.5	0.6	0.6
Interest and dividends	4.4	5.0	4.9
Other receipts ⁸	18.5	20.2	22.4
Current receipts	418.9	449.7	486.7
<i>Memo:</i>			
North Sea revenues ⁹	4.3	5.2	7.1

¹ National accounts measure: gross of enhanced and payable tax credits.

² Includes enhanced company tax credits.

³ Includes district council rates in Northern Ireland paid by business.

⁴ Cash numbers. The increase in accrued council tax in 2005-06 is based on the latest available estimates released by the Chartered Institute for Public Finance and Accountancy (CIPFA) and the increases for later years on the increases in council tax from 1993-94 onwards.

⁵ Includes VAT refunds and money paid into the National Lottery Distribution Fund.

⁶ Includes VAT and 'traditional own resources' contributions to EC budget.

⁷ Tax credits which are scored as negative tax in the calculation of NTNIC but expenditure in the national accounts.

⁸ Includes gross operating surplus and rent; net of oil royalties and business rate payments by Local Authorities.

⁹ Consists of North Sea corporation tax, petroleum revenue tax and royalties.

Income tax and national insurance contributions **C44** Accrued income tax and NICs for 2004-05 is only slightly below the 2004 Pre-Budget Report projection. The 2004 Pre-Budget Report forecast for 2004-05 was based on growth in cash receipts of income tax, national insurance contributions and capital gains tax increasing from 7.1 per cent for April-October 2004 to 7.8 per cent for 2004-05 as a whole. Cash receipts to the end of January were running ahead of this showing growth of 8.8 per cent on the same period in 2003-04. However, this largely reflected a timing shift, as a larger proportion of self-assessment receipts due on 31 January are expected to score in January in 2005 than in 2004, because the due date was a Monday in 2005 and a Saturday in 2004. Self assessment receipts for the year as a whole are expected to be around £½ billion lower than in the 2004 Pre-Budget Report. There is a larger shortfall on the income tax and national insurance contributions (NIC) elements of self-assessment, because the capital gains tax element is expected to be slightly higher.

C45 In contrast, receipts from Pay As You Earn (PAYE) income tax and Class 1 NICs are in line with their 2004 Pre-Budget Report estimate, which was based on a further recovery in bonus payments, particularly in the financial sector. Budget 2005 reiterates the Government's intention, announced alongside the 2004 Pre-Budget Report, to close down permanently the ever more complex and contrived attempts at tax and NICs avoidance, particularly in relation to financial sector bonuses. Other income tax components, such as tax on interest income have grown more quickly than expected since the 2004 Pre-Budget Report. Receipts from income tax and NICs are expected to be a little stronger in 2005-06. This chiefly reflects the economic determinants including higher revenues from the interest rate assumption audited by the NAO.

Non-North Sea corporation tax **C46** In the 2004 Pre-Budget Report, year on year growth of total corporation tax receipts was expected to increase from 12.5 per cent for the April to October period to 15.3 per cent for the year as a whole. Since the 2004 Pre-Budget Report, receipts have grown more quickly than expected, with year on year growth from April to January of 17.4 per cent. With North Sea corporation tax in line with expectations in January, the higher than anticipated growth is due to non-North Sea companies. Total receipts for non North Sea corporation tax in 2004-05 are now estimated to be just over £1 billion higher than in the Pre-Budget Report. Receipts were stronger than expected from both industrial and financial companies.

C47 Further above trend growth is expected in 2005, as the remaining slack in the economy is absorbed. This should continue to boost receipts through 2005-06. Receipts growth in 2005-06 should also benefit from financial company taxable profits returning towards trend, the impact of higher equity prices on receipts from life assurance companies and the impact from of anti-avoidance measures announced in the 2005 Budget and in earlier Budgets and Pre-Budget Reports.

North Sea revenues **C48** The 2004 Pre-Budget Report noted that the full impact of higher oil prices on North Sea revenues would not be reflected in receipts until towards the end of 2004-05, because of lags built into the tax system. For North Sea corporation tax, the full effect would not be seen until the instalment payments in January and April 2005. North Sea corporation tax receipts were, as expected, much higher in January 2005 than in January 2004 and overall North Sea receipts in 2004-05 are expected to be close to their Pre-Budget Report estimate.

C49 The forecast for North Sea revenues uses the NAO audited assumption on oil prices. Oil prices are expected to average \$40.6 a barrel in 2005, in line with the average of independent forecasts. This is substantially below the oil price level in the first quarter of 2005. Compared with the 2004 Pre-Budget Report, oil prices are expected to be \$2.4 a barrel higher in 2005, although the appreciation in sterling against the dollar means that the rise in sterling terms is less marked. The Budget 2005 changes to the payment profile of North Sea corporation tax bring the average lag before tax is due more into line with the PRT lag and add around £1.1 billion to overall revenues in 2005-06, whilst the stronger oil price projection, coupled with upward revisions estimates of oil production result in higher North Sea revenue projections from 2005-06 onwards. The scoring of the payment changes is consistent with Eurostat guidance on permanent changes in due for payment dates¹.

Capital gains tax and inheritance tax C50 Initial analysis of the self-assessment returns suggests capital gains tax in 2004-05 is likely to be around £300 million higher than expected in the 2004 Pre-Budget Report. The maturing of the business asset taper in 2002-03 led to larger than expected disposals of business assets, which boosted receipts in 2003-04. The continuation of this trend is likely to be one factor behind the higher than anticipated receipts for 2004-05. Higher equity prices will push up receipts of capital gains tax and inheritance tax combined by around £1/2 billion, although tax payment lags mean that most of this effect will only be observed from 2006-07 onwards.

Stamp duties C51 The 2004 Pre-Budget Report forecast for stamp duties assumed weaker growth in receipts in the final part of 2004-05 than earlier in the financial year, reflecting the moderation in house price inflation and less buoyant housing market activity. Total receipts for 2004-05 are close to their 2004 Pre-Budget Report estimate. The projection for stamp duty receipts in 2005-06 reflects a more subdued housing market and the impact from the measures to raise the stamp duty threshold to £120,000 and the reform of disadvantaged area relief. A higher equity price projection leads to higher receipts from stamp duty on shares.

VAT receipts C52 VAT receipts on a cash basis in 2004-05 are estimated to be around £1.2 billion below the 2004 Pre-Budget Report projection. Part of the explanation is likely to be slower growth in the GDP components that are used to project the VAT tax base, particularly lower growth in nominal consumers' expenditure. The slower growth in VAT receipts in recent months is consistent with the easing in the growth of nominal retail sales, after a period of greater buoyancy earlier in the year.

Excise duties C53 Higher pump prices, the result of the continued high oil price, has reduced the demand for fuel and lowers revenues from fuel duties, which are charged on a per litre basis. With the oil price expected to remain higher than in the 2004 Pre-Budget Report forecast, fuel duties are likely to be affected further in 2005-06. The decision to delay the revalorisation of fuel duties until September 2005 will also reduce revenues in 2005-06. The 2004 Pre-Budget Report forecast had assumed, in line with convention, that fuel duty rates would rise in line with inflation on the day of the Budget. In contrast, revenues from tobacco duties in 2004-05 are close to the 2004 Pre-Budget Report estimate, whilst alcohol duties have been stronger than expected. This is primarily due to stronger sales of wine.

Council tax C54 Council tax increases are determined annually by local authorities, not by the Government, and the council tax figures for 2005-06 onward are projections based on stylised assumptions, not government forecasts. The methodology used to derive these assumptions is the same as in Budget 2004. The projected increase in 2005-06 is based on the latest available estimates released by the Chartered Institute for Public Finance and Accountancy

¹ ESA95 Manual of Government deficit and debt, Section 111.2 (Eurostat 2002).

(CIPFA)² and the increases for later years on the average increases in council tax from 1993-94 onwards. These increases are lower than those assumed in the 2004 Pre-Budget Report, with council tax around £½ billion lower in 2005-06 and around £1¼ billion lower by 2009-10. However, changes to council tax are broadly balanced by changes to locally financed expenditure and have no material effect on the current balance or net borrowing.

Other taxes and royalties C55 The main change in the 'other taxes' component in 2004-05 is higher than anticipated VAT refunds, which also affect spending estimates. In 2005-06, projections for business rates and vehicle excise duty are lower, whilst VAT refunds are expected to move back in line with the Pre-Budget Report forecast.

Other receipts C56 Non-tax receipts are now expected to be about £1½ billion lower in 2004-05, and about £1 billion a year lower in subsequent years largely because of a reduction in gross operating surpluses. Under national accounts rules, current receipts include gross operating surpluses for all sectors. For non-market bodies, such as most of central government, this is imputed and equals depreciation. For market bodies, such as public corporations, gross operating surplus is derived by adding back depreciation to the net operating surplus. Almost £1/2 billion of the change each year reflects the changes to the treatment of roads maintenance expenditure (see the Assumptions section above), but this change also reduces current spending (accounting adjustments in AME, see the DEL and AME section below) and depreciation itself. It therefore has no effect on net borrowing but has an upward overall impact on the current budget balance. Most of the remainder of the change since the Pre-Budget Report reflects a reduction in public corporation gross (and net) operating surplus, which does impact on the current budget. Very little in-year data is available in the public corporations sector, which includes some 350 different corporations. The data is subject to considerable revision, and will not be finalised until final accounts are available after the end of the financial year.

Tax-GDP ratio

C57 Table C9 shows projections of receipts from major taxes as a per cent of GDP, and Table C10 sets out current and previous projections of the overall tax-GDP ratio.

C58 The tax-GDP ratio is expected to have risen to 36.3 per cent in 2004-05 from 35.6 per cent in 2003-04. This is primarily due to the strong receipts growth in both income tax and non-North Sea corporation tax. Table C7 shows that net taxes and national insurance contributions is little changed from the 2004 Pre-Budget Report, at £425.6 billion. The 0.1 percentage point rise in the tax-GDP ratio mainly reflects lower nominal GDP. The reductions in money GDP also affect later years and explain part of the increases in the tax-GDP ratio since the 2004 Pre-Budget Report. Discretionary changes, mainly those designed to combat tax avoidance and fraud, also impact on the ratio.

C59 The increase in the ratio from 2005-06 onwards is largely driven by rises in the income tax and corporation tax to GDP ratios. The income tax to GDP ratio is driven by the normal fiscal forecasting convention for the treatment of fiscal drag. The rise in the non-North Sea corporation tax to GDP ratio reflects the recovery in receipts from financial company profits, the impact of higher equity prices on receipts from life assurance companies and the anti-avoidance measures announced in this Budget and in previous Budgets and Pre-Budget Reports.

²Published on-line by the Chartered Institute of Public Finance and Accountancy (CIPFA), February 2005, at <http://www.cipfa.org.uk>.

Table C9: Current receipts as a proportion of GDP

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Income tax (gross of tax credits)	10.6	10.8	11.1	11.3	11.5	11.7	11.9
National insurance contributions	6.5	6.6	6.7	6.7	6.8	6.8	6.8
Non-North Sea corporation tax ¹	2.3	2.6	3.1	3.4	3.5	3.5	3.5
Tax credits ²	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3
North Sea revenues ³	0.4	0.4	0.6	0.5	0.6	0.5	0.4
Value added tax	6.2	6.2	6.2	6.1	6.1	6.1	6.1
Excise duties ⁴	3.4	3.4	3.3	3.3	3.2	3.2	3.1
Other taxes and royalties ⁵	6.7	6.7	6.7	6.8	6.9	7.0	7.0
Net taxes and national insurance contributions⁶	35.6	36.3	37.3	37.9	38.3	38.5	38.5
Accruals adjustments on taxes	0.3	0.3	0.1	0.1	0.2	0.1	0.1
Less EC transfers	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2
Tax credits ⁷	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Other receipts ⁸	1.9	2.1	2.1	2.1	2.1	2.2	2.2
Current receipts	37.5	38.3	39.3	39.9	40.4	40.5	40.6

¹ Gross of enhanced and payable tax credits.

² Tax credits scored as negative tax in net taxes and national insurance contributions.

³ Includes oil royalties, petroleum revenue tax and North Sea corporation tax.

⁴ Fuel, alcohol and tobacco duties.

⁵ Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.

⁶ Includes VAT and 'own resources' contributions to EU budget. Cash basis.

⁷ Tax credits scored as negative tax in net taxes and national insurance contributions but expenditure in the national accounts.

⁸ Mainly gross operating surplus and rent, excluding oil royalties. Net of Local Authority business rate payments.

Table C10: Net taxes and national insurance contributions¹

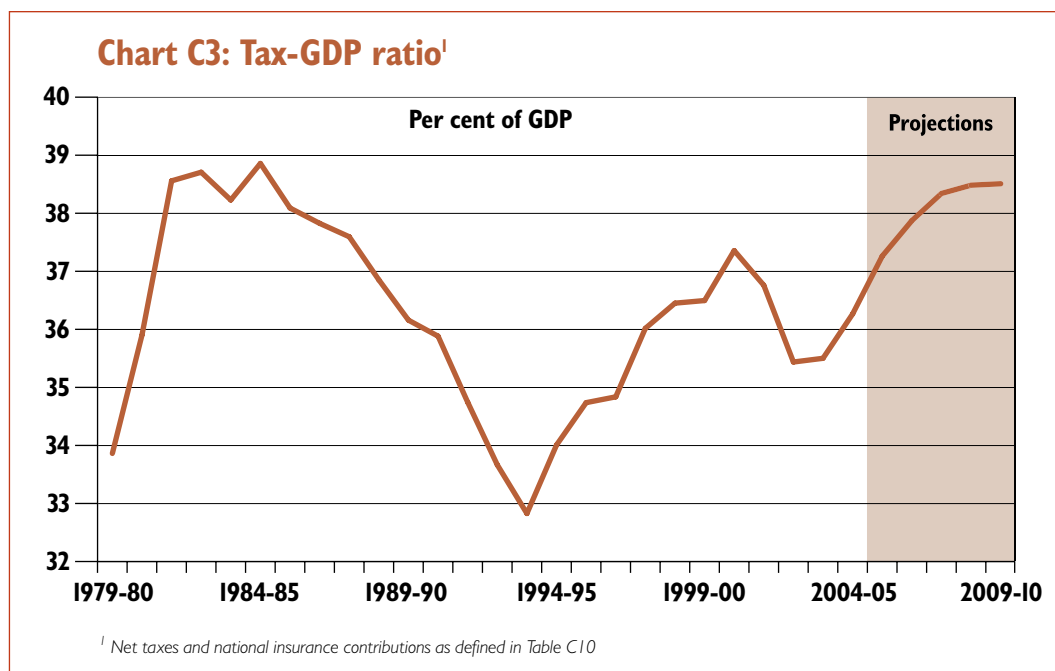
	Per cent of GDP						
	Outturn ²	Estimate ³	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Budget 2004	35.7	36.5	37.3	37.8	38.1	38.3	
PBR 2004	35.6	36.2	37.1	37.7	38.1	38.3	38.4
Budget 2005	35.6	36.3	37.3	37.9	38.3	38.5	38.5

¹ Cash basis. Uses OECD definition of negative tax credits.

² The 2003-04 figures were estimates in Budget 2004.

³ The 2004-05 figures were projections in Budget 2004.

C60 Chart C3 shows the tax-GDP ratio from 1978-79 to 2009-10.



PUBLIC EXPENDITURE

C60 This section looks in detail at the projections for public expenditure. The spending projections cover the whole of the public sector, using the national accounts aggregate Total Managed Expenditure (TME).

C61 For fiscal aggregates purposes, TME is split into national accounts components covering public sector current expenditure, public sector net investment and depreciation. For budgeting and other purposes, TME is split into Departmental Expenditure Limits (DEL) – firm three year limits for department's programme expenditure – and Annually Managed Expenditure (AME) – expenditure which is not easily subject to firm multi-year limits.

Changes in TME since 2004 Pre-Budget Report

C62 Forecasting changes have led to lower TME in each year. These changes are described in detail below. Discretionary changes to TME include scorecard measures on pensioners as described in Chapter A and increase spending by about £1 to £1½ billion a year from 2005-06 to 2007-08. Overall, TME is slightly lower in 2004-05 and 2005-06 but unchanged in later years.

C63 Although, as expected in the 2004 Pre-Budget Report, expenditure growth has slowed in the last few months of 2004-05, total current expenditure in 2004-05 is now expected to be about £2½ billion higher, partly due to a timing effect relating to net payments to the EU, with higher than expected payments in 2004-05 being offset by lower expected payments in 2005-06. There has been additional expenditure in 2004-05 to meet the UK's international commitments including special reserve as well as use by departments of end-year flexibility to meet the Government's priorities including health and education. Use of end-year flexibility has enabled departments to smooth their expenditure for 2004-05, the year with the lowest overall planned spending growth of the 2002 Spending Review period. Outturns to date suggest that capital expenditure will be lower than expected in 2004-05, and this change more than offsets the effect of higher current spending, leading to a fall in TME of about £1 billion.

C64 Current spending in 2005-06 is expected to be about £2½ billion lower than in the 2004 Pre-Budget Report. About £2 billion of the change is due to resetting of the AME margin. In the 2004 Pre-Budget Report lower forecasts of AME components and the normal practice of absorbing these changes within set AME total meant that the AME margin rose to almost £3 billion. This has now been reset to £1 billion. The forecasts for AME components has fallen since the 2004 Pre-Budget Report, changes to the timing of net contributions to the EU and lower net spending on public sector pensions national accounts spending offsetting modest increases in other components. Current spending including discretionary changes is little changed from the 2004 Pre-Budget Report after 2005-06.

C65 Public sector current expenditure is increased in 2004-05, but reduced in subsequent years. ONS revisions to the treatment of road maintenance and repair expenditure eliminate the double-count reducing the forecast by £0.4bn in each year. This change also reduces the depreciation forecast and increases public sector net investment by £0.4bn in each year. Other changes are described in detail below.

Table CII: Total Managed Expenditure 2003–04 to 2007–08

	£ billion				
	Outturn 2003-04	Estimate 2004-05	Projections		
			2005-06	2006-07	2007-08
Departmental Expenditure Limits					
Resource Budget	251.9	268.7	286.9	304.8	320.6
Capital Budget	23.2	23.8	28.8	32.0	35.2
Less depreciation	-9.4	-11.3	-11.8	-12.1	-11.8
Total Departmental Expenditure Limits	266.0	281.2	303.9	324.7	344.0
Annually Managed Expenditure					
Social security benefits ¹	112.7	121.4	127.3	131.6	138.6
Tax credits ¹	14.8	15.2	14.6	14.0	13.9
Common Agricultural Policy	2.9	3.2	3.3	3.2	3.2
Net public service pensions ²	2.0	1.0	0.7	0.3	0.3
National Lottery	1.9	1.8	1.7	1.5	1.3
Non-cash items in AME	5.2	3.4	2.2	3.9	4.5
Other departmental expenditure	1.5	4.2	5.2	3.6	3.4
Net payments to EU institutions ³	2.4	3.7	3.1	2.8	4.5
Locally-financed expenditure	21.2	24.3	25.4	27.1	28.8
Central government gross debt interest	22.2	23.8	25.6	27.0	28.8
Public corporations' own-financed capital expenditure	2.5	2.2	2.3	2.3	2.5
AME margin	0.0	0.0	1.0	2.0	3.0
Accounting adjustments ⁴	-0.9	-1.2	2.3	5.1	3.6
Annually Managed Expenditure	188.4	202.9	214.7	224.5	236.0
Total Managed Expenditure	454.3	484.1	518.6	549.2	580.0
of which:					
Public sector current expenditure	425.3	451.1	476.9	503.4	531.5
Public sector net investment	15.0	18.3	26.2	29.4	31.1
Public sector depreciation	14.0	14.6	15.5	16.4	17.4

¹ For 2003-04 to 2006-07, child allowances in Income Support and Jobseekers' Allowance, which, from 2003-04, are paid as part of the Child Tax Credit, have been included in the tax credits line and excluded from the social security benefits line. This is in order to give figures a consistent definition over the forecast period.

² Net public service pensions expenditure is reported on a national accounts basis.

³ Net payments to EU Institutions exclude the UK's contribution to the cost of EU aid to non-Member States (which is attributed to the aid programme).

Net payments therefore differ from the UK's net contribution to the EU Budget, latest estimates for which are (in £ billion):

	2004-05	2005-06	2006-07	2007-08
	4.3	3.8	3.4	5.2

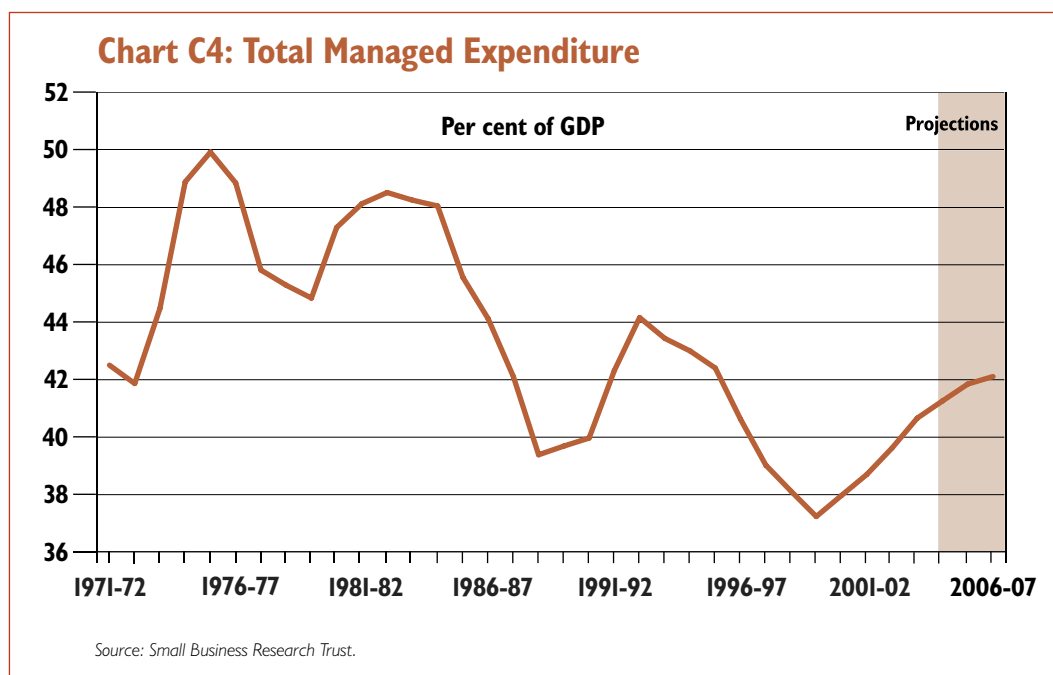
⁴ Excludes depreciation.

Table CI2: Changes to Total Managed Expenditure since the 2004 Pre-Budget Report

	£ billion				
	Outturn 2003-04	Estimate 2004-05	Projections		
			2005-06	2006-07	2007-08
Departmental Expenditure Limits					
Resource Budget	1.4	2.0	0.4	0.6	0.9
Capital Budget	0.2	-2.4	-0.4	0.5	0.3
Less depreciation	-0.3	-0.3	-0.1	0.0	0.0
Total Departmental Expenditure Limits	1.4	-0.7	-0.1	1.1	1.3
Annually Managed Expenditure					
Social security benefits	-4.3	0.2	0.9	0.4	0.1
Tax credits	1.5	0.3	0.3	0.3	0.7
Common Agricultural Policy	0.1	0.1	0.2	0.1	0.1
Net public sector pensions ¹	-0.3	-0.8	-0.3	-0.7	-0.9
National Lottery	0.0	0.0	0.0	0.0	0.0
Non-cash items in AME	0.1	-0.2	-0.6	0.4	0.9
Other departmental expenditure	-0.3	0.7	1.3	0.2	0.0
Net payments to EU institutions	0.0	1.7	0.1	-1.4	0.0
Locally-financed expenditure	-0.7	0.3	-0.2	-0.5	-0.9
Central government gross debt interest	0.0	0.0	0.4	0.4	0.6
Public corporations' own-financed capital expenditure	0.0	-0.1	0.0	0.2	0.2
AME margin	0.0	-1.0	-1.9	-0.4	0.3
Accounting adjustments ²	3.4	-1.7	-2.1	0.3	-1.6
Annually Managed Expenditure	-0.5	-0.4	-1.8	-0.8	-0.7
Total Managed Expenditure	0.9	-1.1	-1.9	0.3	0.6
<i>of which:</i>					
Public sector current expenditure	-0.2	2.5	-1.2	0.6	0.9
Public sector net investment	1.4	-3.4	-0.2	0.0	0.0
Public sector depreciation	-0.3	-0.3	-0.3	-0.3	-0.2

¹ Net public service pensions expenditure is reported on a national accounts basis.

² Accounting adjustments are net of depreciation and exclude FRS17 pension related items.



DEL and AME analysis

C66 Table C11 sets out projected spending on DEL and the main components of AME to the end of the 2004 Spending Review period in 2007-08. Table C12 shows change since the 2004 Pre-Budget Report.

DEL C67 As set out in Chapter 2, resource DEL spending for 2004-05 is higher than planned spending set out in the 2004 Pre-Budget Report, due to higher than expected expenditure to meet the UK's international commitments as well as use by departments of EYF to deliver key public service priorities, including health and education. Prior to 2004-05, drawdown of EYF has generally been more than offset by underspending. Higher spending on public services in 2004-05 reflects exceptional factors, including that planned expenditure growth in 2004-05 was lower than in both 2003-04 and 2005-06 and the use of EYF has enabled departments to smooth spending across the 2002 Spending Review period. Looking forward, planned expenditure growth slows after 2005-06 and departments therefore have an interest in maintaining reasonable contingency levels of EYF entitlements to allow sensible management of expenditure in the 2004 Spending Review period.

C68 The increase of £1.4 billion in resource DEL in 2003-04 since the 2004 Pre-Budget Report reflects the reclassification of expenditure on the Supporting People programme from AME to DEL. Apart from Budget policy decisions, the only overall changes to DEL for 2005-06 to 2007-08 since the 2004 Pre-Budget Report are reclassifications between DEL and AME, and some switches between resource and capital DEL. The changes include:

- switches of £0.2 billion in 2005-06 and 2006-07, and £0.1 billion in 2007-08 from resource to capital in ODPM DEL for realignment between direct investment and capital grants;
- a switch from Scottish Executive capital to resource DEL in 2005-06 of £0.2 billion and a switch of £0.1 billion from resource into capital in 2006-07 for realignment between direct investment and capital grants;
- switches of around £0.2 billion each year from ODPM AME to capital DEL for the funding of the Arms Length Management Organisation; and
- a switch of £0.5 billion from the Department of Health's DEL to their AME in 2005-06 for the capital spending of foundation hospitals.

C69 The detailed allocations of DELs are shown in Table C13. In line with previous practice, resource and capital DEL for 2004-05 includes an allowance for shortfall reflecting likely underspends against departmental provision.

AME C70 The main economic assumptions underpinning the AME projections are set out in Box C1 and Table C3. In particular it is assumed that the UK claimant count unemployment rises slowly to 0.89 million in 2007-08, from recent levels of 0.82 million. The AME total is also affected by the reclassifications described at the beginning of this section.

C71 Outturn for 2003-04 social security expenditure has decreased since the 2004 Pre-Budget Report by £4.3 billion. This is due to the reclassification of expenditure on the Supporting People programme as DEL, transferring £2.1 billion into the resource DEL total in this year. An additional £1.2 billion of the change is caused by revised estimates for child allowances in Income Support and Jobseeker's Allowance, which, from 2003-04, are paid as part of the Child Tax Credit and have been included in the tax credits line and excluded from the social security benefits line in order to give figures on a consistent definition over the forecast period. Forecasting changes in 2004-05, 2005-06 and 2007-08 have made only small differences since the 2004 Pre-Budget Report. Discretionary measures have increased the forecast by £0.8 billion in 2005-06, £0.2 billion in 2006-07 and £0.2 billion in 2007-08, as outlined in Chapter A.

C72 Forecast spending on the Child and Working Tax Credits differs from the 2004 Pre-Budget Report. Forecast costs have changed because of higher take up of the disabled elements of Child Tax Credit & Working Tax Credit and because of re-profiling of payment schedules. There have also been increases in tax credit payments scored as negative tax (see Table 7). Discretionary measures to increase the forecast by £0.3 billion in 2006-07 and £0.5 billion in 2007-08, as described in Chapter A.

C73 Forecast expenditure on the Common Agricultural Policy (CAP) has increased since the Pre-Budget Report. This is primarily because of revisions to the exchange rate assumption. However, in the national accounts, CAP payments are treated as a transaction between the EU and farmers and hence do not score in UK government expenditure – they are now removed in the accounting adjustments, and have no impact on Total Managed Expenditure (TME).

C74 Net public service pensions figures are reported on a national accounts basis. This spending is now expected to be lower than in the 2004 Pre-Budget Report. Current spending is lower by £0.8 billion in 2004-05, £0.3 billion in 2005-06, £0.7 billion in 2006-07 and £0.9 billion in 2007-08. This mainly reflects revisions to forecasts for the NHS pension scheme, in line with future workforce plans. There is increased capital spending of £0.2 billion in 2005-06.

Table CI3: Departmental Expenditure Limits – resource and capital budgets

	£ billion				
	Outturn 2003-04	Estimate 2004-05	Plans 2005-06	2006-07	2007-08
Resource Budget					
Education and Skills	23.1	24.6	26.3	28.1	29.6
Health	62.7	69.1	75.1	81.9	89.3
of which: NHS	60.9	66.9	72.8	79.9	87.3
Transport	7.8	8.3	8.8	10.8	9.9
Office of the Deputy Prime Minister	6.0	6.2	6.4	6.6	7.1
Local Government	40.9	43.4	46.2	48.8	51.3
Home Office	11.7	12.3	12.8	13.3	14.0
Departments for Constitutional Affairs	3.2	3.4	3.7	3.8	3.8
Attorney General's Departments	0.6	0.7	0.7	0.7	0.7
Defence	31.3	32.6	32.7	32.7	33.0
Foreign and Commonwealth Office	1.6	1.8	1.8	1.7	1.7
International Development	3.8	3.9	4.5	5.0	5.3
Trade and Industry	4.4	5.3	5.9	6.3	6.4
Environment, Food and Rural Affairs	2.7	3.2	3.1	3.3	3.4
Culture, Media and Sport	1.3	1.5	1.5	1.6	1.7
Work and Pensions	8.3	8.4	8.4	8.2	8.2
Scotland ¹	18.8	20.0	21.4	22.8	24.1
Wales ¹	9.8	10.7	11.3	12.1	12.8
Northern Ireland Executive ¹	6.4	7.0	7.3	7.7	8.0
Northern Ireland Office	1.0	1.2	1.2	1.1	1.1
Chancellor's Departments	4.5	5.0	5.2	5.2	5.2
Cabinet Office	1.9	2.0	2.0	2.0	2.1
Invest to Save Budget	0.0	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	0.4	1.3	1.7
Unallocated special reserve ²	0.0	0.0	0.3	0.0	0.0
Allowance for shortfall ³	0.0	-1.8	0.0	0.0	2.0
Total Resource Budget DEL	251.9	268.7	286.9	304.8	320.6
Capital Budget					
Education and Skills	3.2	3.7	4.4	4.9	5.6
Health	2.5	3.1	3.8	5.3	6.3
of which: NHS	2.5	3.0	3.7	5.2	6.1
Transport	3.0	3.3	3.3	4.1	4.2
Office of the Deputy Prime Minister	2.6	2.9	3.0	2.9	2.9
Local Government	0.2	0.3	0.3	0.2	0.2
Home Office	0.9	1.1	1.2	1.2	1.3
Departments for Constitutional Affairs	0.1	0.2	0.1	0.1	0.1
Attorney General's Departments	0.0	0.0	0.0	0.0	0.0
Defence	6.1	6.6	6.9	7.0	7.6
Foreign and Commonwealth Office	0.0	0.1	0.1	0.1	0.1
International Development	0.0	0.0	0.0	0.0	0.0
Trade and Industry	0.6	0.2	0.3	0.5	0.5
Environment, Food and Rural Affairs	0.4	0.3	0.3	0.3	0.3
Culture, Media and Sport	0.1	0.2	0.1	0.1	0.1
Work and Pensions	0.2	0.3	0.3	0.2	0.1
Scotland ¹	1.4	2.0	1.9	2.1	2.2
Wales ¹	0.8	0.9	0.9	1.1	1.2
Northern Ireland Executive ¹	0.4	0.4	0.4	0.5	0.5
Northern Ireland Office	0.1	0.1	0.1	0.1	0.1
Chancellor's Departments	0.3	0.4	0.3	0.4	0.5
Cabinet Office	0.5	0.3	0.2	0.2	0.3
Invest to Save Budget	0.0	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	0.5	0.6	1.1
Allowance for shortfall ³	0.0	-2.6	0.0	0.0	0.0
Total Capital Budget DEL	23.5	23.8	28.8	32.0	35.2
Depreciation	-9.4	-11.3	-11.8	-12.1	-11.8
Total Departmental Expenditure Limits	266.0	281.2	303.9	324.7	344.0
Total education spending	59.3	64.5	68.2	72.6	77.2

¹ For Scotland, Wales and Northern Ireland, the split between current and capital budgets is indicative and reflects the consequential of the application of the Barnett formula to planned changes in UK departments spending.

² This represents provision for the costs of military operations in Iraq and the UK's other international obligations. The figure for 2004-05 is after the further addition of £340 million announced in this Budget.

³ The allowance for shortfall reflects likely underspends in departmental forecasts.

AME C75 Changes to non-cash items in AME reflect revisions to the notional interest cost arising from unwinding the discount on public service pensions schemes liabilities, due to a change in the discount rate. The change to the discount rate reflects the requirements of FRS17 accounting treatment for pensions. Like all non-cash items, this does not score in TME and is removed in the accounting adjustments. Therefore these changes have no impact on TME.

C76 Other departmental expenditure has increased in 2004-05, 2005-06 and 2006-07. This reflects increased estimates for Department of Health PFI pilot projects and departmental lending to public corporations. Both of these items are classified as financial transactions and are removed from TME in the accounting adjustments. In 2005-06, there is also an increase associated with the NNDR outturn adjustment and with capital spending of NHS foundation trusts. The latter is a switch into AME from DEL as described at the beginning of this section, so again has no impact on TME.

C77 The net payments to EU institutions forecast reflects revised estimates of EU receipts. It also takes account of more recent information on the EU Budget than was available at the time of the 2004 Pre-Budget Report and of changes in the timing of certain payments to the EU Budget. As described above, Common Agricultural Policy (CAP) payments are treated as a transaction between the EU and farmers and hence do not score in UK government expenditure. Therefore the EU receipts associated with this expenditure are now also removed in the accounting adjustments and do not score in TME. The overall effect of changes to net payments to the EU on the current budget since the 2004 Pre-Budget Report is to reduce the current budget by about £1 billion in 2004-05 and increase it by around £1 billion in 2005-06, mainly because of changes to the timing of Structural Funds receipts. There are only small changes in later years.

C78 Changes to local authority self-financed expenditure (LASFE) reflect the revision of the forecasting assumption made for increases in Council Tax. This is outlined in more detail in the Tax-by-tax analysis sub-section. In 2006-07 and 2007-08 payments are higher mainly because of the cumulative effects of higher cash requirement.

C79 Central government debt interest payments for 2005-06 are higher than at the 2004 Pre-Budget Report, largely as a result of the impact of higher Retail Price Index (RPI) on index linked gilt payments.

C80 The main accounting adjustments, which reconcile the DEL and AME measures of spending with the national accounts measure, are shown in Table C14. Changes to the accounting adjustments since the last forecast are mainly due to:

- reductions in depreciation due to the revised recording of road maintenance and repair expenditure; and
- the removal of CAP expenditure and the associated receipts from the EC.

Table C14: Accounting adjustments

	£ billion				
	Outturn	Estimate	Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08
Tax credits for individuals	0.1	0.0	0.0	0.0	0.0
European Union contributions	-4.7	-4.0	-3.9	-4.0	-4.0
Other central government programmes	0.9	0.9	0.8	0.8	0.7
VAT refunds	9.1	10.0	10.7	11.8	12.6
Central government non-trading capital consumption	5.3	5.5	5.9	6.3	6.7
Non-cash items in resource budgets and not in TME	-12.3	-10.5	-10.1	-12.6	-14.3
Expenditure financed by revenue receipts	0.2	0.3	0.3	0.3	0.3
Local authorities	4.5	3.1	5.0	6.3	6.3
General government consolidation	-5.2	-5.0	-5.0	-5.1	-5.3
Public corporations	0.1	0.2	0.2	0.3	0.3
Financial transactions	0.8	-1.0	0.1	0.4	0.4
Other accounting adjustments	0.1	-0.7	-1.7	0.9	-0.2
Total accounting adjustments	-1.3	-1.2	2.3	5.1	3.6

C81 Table C15 shows public sector capital expenditure from 2003-04 to 2007-08.

Table C15: Public sector capital expenditure

	£ billion				
	Outturn	Estimate	Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08
Capital Budget DEL	23.5	23.8	28.8	32.0	35.2
Locally-financed expenditure	-0.6	2.1	2.2	2.3	2.4
National Lottery	1.2	0.9	0.9	0.8	0.7
Public corporations' own-financed capital expenditure	2.5	2.2	2.3	2.3	2.5
Other capital spending in AME	2.5	3.9	7.5	8.1	7.5
AME margin	0.0	0.0	0.1	0.2	0.3
Public sector gross investment¹	29.0	33.0	41.7	45.8	48.6
Less depreciation	14.0	14.6	15.5	16.4	17.4
Public sector net investment	15.0	18.3	26.2	29.4	31.1
Proceeds from the sale of fixed assets ²	6.7	5.8	5.2	5.0	4.9

¹ This and previous lines are all net of sales of fixed assets.

² Projections of total receipts from the sale of fixed assets by public sector.

C82 Table C16 shows estimated receipts from loans and sales of assets from 2003-04 to 2007-08.

Table CI6: Loans and sales of assets

	£ billion				
	Outturn	Estimate	Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08
Sales of fixed assets					
Central government	1.1	1.0	1.0	1.0	1.0
Local authorities	5.6	4.8	4.2	4.0	3.9
Total sales of fixed assets	6.7	5.8	5.2	5.0	4.9
Total loans and sales of financial assets	-2.1	-2.2	-2.4	-2.7	-3.4
Total loans and sales of assets	4.6	3.7	2.8	2.3	1.5

PRIVATE FINANCE INITIATIVE

C83 Under the Private Finance Initiative (PFI) the public sector contracts to purchase services on a long-term basis so as to take advantage of private sector management skills incentivised by having private finance at risk. The private sector has always been involved in the building and maintenance of public infrastructure, but PFI ensures that contractors are bound into long-term maintenance contracts and shoulder responsibility for the quality of the work they do. With PFI, the public sector defines what is required to meet public needs and ensures delivery of the outputs through the contract. Consequently, the private sector can be harnessed to deliver investment in better quality public services whilst frontline services are retained within the public sector.

C84 The Government only uses PFI where it is appropriate and where it expects it to deliver value for money. This is based on an assessment of the lifetime costs of both providing and maintaining the underlying asset, and of the running costs of delivering the required level of service. In assessing where PFI is appropriate, the Government's approach is based on its commitment to efficiency, equity and accountability, and on the Prime Minister's principles of public service reform. PFI is only used where it can meet these requirements, and where the value for money it offers is not at the expense of the terms and conditions of staff. The Government is committed to securing the best value for its investment programme by ensuring that there is no inherent bias in favour of one procurement option over another.

C85 Table C17 shows a breakdown by department of the estimated capital investment in public services resulting from signed PFI contracts. Table C18 shows the estimated total capital value of contracts that are at preferred bidder stage and are expected to reach financial close within the next three years. Under PFI, the public sector contracts for services, including the availability and management of facilities, and not assets. Capital investment is only one of the activities undertaken by the private sector in order to supply these services. The figures in Tables C17 and C18 report the capital value of projects in order to show investment on a basis comparable with conventional capital procurement.

C86 Table C19 shows a forecast of the estimated payments for services flowing from signed PFI projects. Actual expenditure will depend on the details of the payment mechanism for each contract. Payments may be lower than those estimated as a result of deductions that can be applied if the supplier fails to meet required performance standards. Variances may also occur as a result of agreed changes to the service requirements that are made during the course of the contract, or because of contractual arrangements that trigger compensation on termination. The fact that capital investment only represents one element of the overall contract means that the figures presented in this table should not be taken to be directly comparable with a public sector debt liability.

Table C17: Departmental estimate of capital spending by the private sector (signed deals)^{1,2}

	£ million		
	Projections		
	2005-06	2006-07	2007-08
Education and Skills ³			
Health	848	560	334
Transport ⁴	1494	1343	1202
Office of the Deputy Prime Minister	71	53	14
Home Office	45	0	0
Constitutional Affairs	27	18	0
Defence	458	304	181
Foreign and Commonwealth Office	5	5	0
Trade and Industry	8	1	0
Environment, Food and Rural Affairs	47	28	27
Work and Pensions			
Scotland	109	32	
Wales	23	0	0
Northern Ireland Executive	40	24	0
Chancellor's Departments	41	36	37
Cabinet Office			
Culture, Media and Sports	13	9	0
Total	3229	2413	1795

¹Investment in assets scored on the public sector balance sheet also score as public sector net investment.

²PFI activity in local authority projects is included under the sponsoring central government department.

³Excludes private finance activity in educational institutions classified to the private sector.

⁴Includes estimates of the capital expenditure for the London Underground Limited Public Private Partnership PFI Contracts in the years that investments are expected to take place.

Table CI8: Estimated aggregated capital value of projects at preferred bidder stage

	£ million		
	Projections		
	2005-06	2006-07	2007-08
Education and Skills	290	0	0
Health	3039	0	0
Transport	248	0	0
Office of the Deputy Prime Minister	135	0	0
Home Office	0	0	0
Constitutional Affairs	0	0	0
Defence	1418	0	0
Foreign and Commonwealth Office	0	0	0
Trade and Industry	0	0	0
Environment, Food and Rural Affairs	0	0	0
Work and Pensions	0	0	0
Scotland	150	0	0
Wales	93	0	0
Northern Ireland Executive	51	0	0
Chancellor's Departments	0	0	0
Cabinet Office	0	0	0
Culture, Media and Sport	42	0	0
Total	5280	0	0

¹ The figures reported in this table reflect the fact that, at the time of collection, all projects that are at preferred bidder are expected to reach financial close before the end of 2005-06.

Table CI9: Estimated payments under PFI contracts – March 2005 (signed deals)¹

	£ billion			
	Projections			
2005-06	6.4	2018-19	4.3	
2006-07	6.8	2019-20	4.3	
2007-08	6.9	2020-21	4.4	
2008-09	6.8	2021-22	4.1	
2009-10	6.9	2022-23	4.1	
2010-11	6.9	2023-24	4.1	
2011-12	6.9	2024-25	4.1	
2012-13	6.9	2025-26	4.1	
2013-14	7	2026-27	3.8	
2014-15	7	2027-28	3.6	
2015-16	7	2028-29	3.3	
2016-17	7.1	2029-30	3	
2017-18	6.5	2030-31	2.1	

¹ The figures between 2004-05 and 2017-18 include estimated payments for the LUL PPP contracts. These contracts contain periodic reviews each 7.5 years and therefore the service payments are not fixed after 2009-10.

FINANCING REQUIREMENT

C87 Table C20 presents projections of the net cash requirement by sector, giving details of financial transactions that do not affect net borrowing (the change in the sector's net financial indebtedness) but do affect its financing requirement.

C88 Although public sector net borrowing is slightly lower in 2005-06 than in the PBR, the cash requirement has increased because of higher net lending to the private sector and higher accruals adjustments, largely reflecting changes to the timing of cash receipts from the EU.

Table C20: Public sector net cash requirement

	£ billion							
	2004-05				2005-06			
	General government		Public corporations	Public sector	General government		Public corporations	Public sector
Central government	Local authorities	Central government			Local authorities			
Net borrowing	37.0	-2.8	0.2	34.4	34.2	-2.2	-0.1	31.9
<i>Financial transactions</i>								
Net lending to private sector and abroad	2.0	0.1	0.0	2.1	2.3	0.1	0.0	2.4
Cash expenditure on company securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Accounts receivable/payable	4.0	0.0	-0.9	3.1	3.9	0.0	-0.7	3.1
Adjustment for interest on gilts	-2.4	0.0	0.0	-2.4	-2.6	0.0	0.0	-2.6
Miscellaneous financial transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Own account net cash requirement	40.7	-2.7	-0.7	37.3	37.7	-2.1	-0.9	34.8
Net lending within the public sector	2.1	-1.6	-0.5	0.0	2.4	-1.5	-0.9	0.0
Net cash requirement¹	42.9	-4.3	-1.3	37.3	40.2	-3.6	-1.8	34.8

¹ Market and overseas borrowing for local government and public corporation sectors.

C89 Table C21 updates the financing arithmetic for both 2004-05 and 2005-06 in line with the new public finances forecast. The forecast for the central government net cash requirement (CGNCR) for 2004-05 is £42.9 billion, an increase of £3.2 billion from the 2004 Pre-Budget Report forecast of £39.7 billion. Allowing for a £0.1 billion increase in financing due to the Debt Management Office's (DMO's) secondary market purchases of gilts means that the net financing requirement for 2004-05 is now expected to be £55.7 billion, an increase of £3.3 billion from the 2004 Pre-Budget Report forecast of £52.4 billion. This increased financing requirement is being met by a £2.0 billion increase in the forecast stock of Treasury bills, resulting in a £1.3 billion reduction in the forecast level of DMO's short-term cash position at end March 2005.

C90 The forecast for the CGNCR for 2005-06 is £40.2 billion. Gross gilt redemptions are £14.5 billion and National Savings & Investments net contribution to financing is estimated to be £3.5 billion. This means that the net financing requirement for 2005-06 is forecast to be £51.2 billion. The DMO will aim to meet the net financing requirement by:

- gross gilts issuance of £53.5 billion;
- a reduction in the Treasury bill stock of £1.0 billion by end March 2006; and
- a £1.3 billion reduction in the DMO's short-term cash position by end March 2006.

C91 At the Pre-Budget Report 2004, the Government instructed the DMO formally to consult the market about possible issuance of ultra-long (circa 50-year maturity) conventional and index-linked gilts, perhaps in the alternative format of fixed-term annuities. A full summary of the responses to the consultation is available on the DMO's website at www.dmo.gov.uk.

C92 The key conclusions from the consultation are that:

- from 2005-06, the DMO may issue conventional and index-linked gilts with maturities of up to approximately 50-years; and
- the DMO will not issue conventional or index-linked gilts in annuity format in 2005-06.

C93 Full details of the DMO's financing remit including the structure of gilts issuance and the gilt auction calendar for 2005-06 can be found in the Debt and Reserves Management Report 2005-06 which is published today.

Table C21: Financing requirement forecast

	£ billion			
	2004-05		2005-06	
	April 2004	December 2004	March 2005	March 2005
	Revised Remit ¹	Pre-Budget Report	Budget	Budget
Central Government net cash requirement	35.6	39.7	42.9	40.2
Gilt Redemptions	14.7	14.7	14.7	14.5
Net financing of the Official Reserves	0.0	0.0	0.0	0.0
Debt buy-backs	0.0	0.0	0.1	0.0
Gross financing requirement	50.3	54.4	57.7	54.7
Less assumed net contribution from National Savings & Investments	2.0	2.0	2.0	3.5
Net financing requirement	48.3	52.4	55.7	51.2
<i>Financed by:</i>				
1. Debt Issuance by the DMO				
a) Change in the Treasury bill stock	-1.8	-0.8	1.2	-1.0
b) Gross gilt sales	47.1	50.3	50.3	53.5
2. Planned changes in Government's short-term cash position²	2.9	2.9	4.2	-1.3
3. Unanticipated changes in short-term debt	-	-	-1.3	-

Note: Figures may not sum due to rounding.

¹Budget 2004 financing arithmetic was revised on 22 April 2004 to reflect outturn data for 2003-04.

²Including changes in the DMO's cash deposit at the Bank of England.

ANALYSIS BY SUBSECTOR AND ECONOMIC CATEGORY

C94 Table C22 shows a breakdown of general government transactions by economic category for 2003-04 to 2006-07. Table C23 shows a more detailed breakdown for public sector transactions by sub-sector and economic category for each of these years.

C95 The allocation of public sector transactions between sub-sectors has changed since the 2004 Pre-Budget Report, largely because of better data on the split of TME. This has the effect of substantially increasing central government net borrowing, and hence the cash requirement, and reducing Local Authority counterparts.

Table C22: General government transactions by economic category

	£ billion				
	Estimate	Projections			
	2003-04	2004-05	2005-06	2006-07	2007-08
<i>Current receipts</i>					
Taxes on income and wealth	145.7	163.4	183.9	200.6	215.4
Taxes on production and imports	148.7	155.9	163.7	172.4	180.9
Other current taxes	23.3	24.0	25.4	27.2	29.2
Taxes on capital	2.5	2.9	3.4	3.6	3.8
National insurance contributions	75.1	78.3	83.1	87.7	93.4
Gross operating surplus	10.1	10.7	11.6	12.5	13.4
Rent and other current transfers	1.6	1.6	1.6	1.7	1.7
Interest and dividends from private sector and abroad	3.8	4.4	4.3	4.5	4.6
Interest and dividends from public sector	5.8	6.3	6.9	7.4	7.6
Total current receipts	416.6	447.4	483.8	517.6	550.1
<i>Current expenditure</i>					
Current expenditure on goods and services	233.0	247.9	261.9	279.9	297.1
Subsidies	7.2	6.2	6.3	7.0	6.7
Net social benefits	135.1	143.2	150.0	151.1	158.1
Net current grants abroad	-0.9	0.0	0.7	0.3	-0.3
Other current grants	28.1	29.3	30.9	35.4	37.9
Interest and dividends paid	22.6	24.3	25.9	27.6	28.9
AME margin	0.0	0.0	0.9	1.8	2.7
Total current expenditure	425.1	450.9	476.7	503.1	531.1
Depreciation	10.1	10.7	11.6	12.5	13.4
Surplus on current budget	-18.7	-14.2	-4.4	2.0	5.5
<i>Capital expenditure</i>					
Gross domestic fixed capital formation	18.0	20.1	26.7	30.9	33.4
Less depreciation	-10.1	-10.7	-11.6	-12.5	-13.4
Increase in inventories	0.0	0.3	0.2	0.2	0.1
Capital grants (net) within public sector	1.2	0.7	0.9	0.4	0.4
Capital grants to private sector	8.9	11.1	13.4	13.6	13.5
Capital grants from private sector	-1.3	-1.6	-2.0	-2.0	-1.9
AME margin	0.0	0.0	0.1	0.2	0.3
Net investment	16.7	20.0	27.6	30.7	32.3
Net borrowing¹	35.4	34.2	32.0	28.7	26.8
<i>of which:</i>					
Central government net borrowing	37.3	37.0	34.2	29.5	27.9
Local authority net borrowing	-2.0	-2.8	-2.1	-0.8	-1.1
Gross debt (Maastricht basis)					
Central government	387.9	432.5	475.4	510.4	545.8
Local government	53.3	49.0	45.5	43.4	40.8

¹ Although this is based on the ESA95 definition of general government net borrowing (GGNB), the projections are identical to GGNB calculated on a Maastricht definition.

Table C23: Public sector transactions by sub-sector and economic category

	£ billion			
	2003-04			
	General government			Public sector
	Central government	Local authorities	Public corporations	
<i>Current receipts</i>				
Taxes on income and wealth	145.7	0.0	-0.1	145.6
Taxes on production and imports	148.6	0.1	0.0	148.7
Other current taxes	5.1	18.2	0.0	23.2
Taxes on capital	2.5	0.0	0.0	2.5
National insurance contributions	75.1	0.0	0.0	75.1
Gross operating surplus	5.3	4.9	7.6	17.8
Rent and other current transfers	1.6	0.0	0.0	1.6
Interest and dividends from private sector and abroad	3.1	0.7	0.6	4.4
Interest and dividends from public sector	4.8	1.0	-5.8	0.0
Total current receipts	391.6	24.9	2.4	418.9
<i>Current expenditure</i>				
Current expenditure on goods and services	141.4	91.6	0.0	233.0
Subsidies	6.0	1.2	0.0	7.2
Net social benefits	121.7	13.4	0.0	135.1
Net current grants abroad	-0.9	0.0	0.0	-0.9
Current grants (net) within public sector	86.8	-86.8	0.0	0.0
Other current grants	28.1	0.0	0.0	28.1
Interest and dividends paid	22.2	0.4	0.2	22.8
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	405.4	19.7	0.2	425.3
Depreciation	5.3	4.9	3.9	14.0
Surplus on current budget	-19.0	0.3	-1.8	-20.4
<i>Capital expenditure</i>				
Gross domestic fixed capital formation	8.9	9.0	3.1	21.0
Less depreciation	-5.3	-4.9	-3.9	-14.0
Increase in inventories	0.0	0.0	0.0	0.1
Capital grants (net) within public sector	7.2	-6.0	-1.2	0.0
Capital grants to private sector	7.8	1.1	0.3	9.2
Capital grants from private sector	-0.4	-0.9	0.0	-1.3
AME margin	0.0	0.0	0.0	0.0
Net investment	18.4	-1.6	-1.7	15.0
Net borrowing	37.3	-2.0	0.0	35.4

Table C23: Public sector transactions by sub-sector and economic category

£ billion				
2004-05				
	General government			Public sector
	Central government	Local authorities	Public corporations	
<i>Current receipts</i>				
Taxes on income and wealth	163.4	0.0	-0.1	163.3
Taxes on production and imports	155.7	0.2	0.0	155.9
Other current taxes	5.1	19.0	0.0	24.0
Taxes on capital	2.9	0.0	0.0	2.9
National insurance contributions	78.3	0.0	0.0	78.3
Gross operating surplus	5.5	5.2	8.0	18.7
Rent and other current transfers	1.6	0.0	0.0	1.6
Interest and dividends from private sector and abroad	3.5	0.9	0.6	5.0
Interest and dividends from public sector	3.6	2.7	-6.3	0.0
Total current receipts	419.5	27.9	2.3	449.7
<i>Current expenditure</i>				
Current expenditure on goods and services	150.7	97.3	0.0	247.9
Subsidies	4.9	1.3	0.0	6.2
Net social benefits	128.1	15.1	0.0	143.2
Net current grants abroad	0.0	0.0	0.0	0.0
Current grants (net) within public sector	93.1	-93.1	0.0	0.0
Other current grants	29.2	0.0	0.0	29.3
Interest and dividends paid	23.8	0.4	0.2	24.4
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	430.0	21.0	0.2	451.1
Depreciation	5.5	5.2	4.0	14.6
Surplus on current budget	-16.0	1.7	-1.8	-16.1
<i>Capital expenditure</i>				
Gross domestic fixed capital formation	9.3	10.8	2.7	22.8
Less depreciation	-5.5	-5.2	-4.0	-14.6
Increase in inventories	0.3	0.0	0.0	0.3
Capital grants (net) within public sector	7.8	-7.0	-0.7	0.0
Capital grants to private sector	10.0	1.2	0.3	11.4
Capital grants from private sector	-0.7	-0.9	0.0	-1.6
AME margin	0.0	0.0	0.0	0.0
Net investment	21.0	-1.1	-1.7	18.3
Net borrowing	37.0	-2.8	0.2	34.4

Table C23: Public sector transactions by sub-sector and economic category

	£ billion			
	2005-06			
	General government			Public sector
	Central government	Local authorities	Public corporations	
<i>Current receipts</i>				
Taxes on income and wealth	183.9	0.0	-0.1	183.8
Taxes on production and imports	163.5	0.2	0.0	163.7
Other current taxes	5.4	20.0	0.0	25.4
Taxes on capital	3.4	0.0	0.0	3.4
National insurance contributions	83.1	0.0	0.0	83.1
Gross operating surplus	5.9	5.7	9.1	20.7
Rent and other current transfers	1.6	0.0	0.0	1.6
Interest and dividends from private sector and abroad	3.6	0.7	0.6	4.9
Interest and dividends from public sector	3.2	3.7	-6.9	0.0
Total current receipts	453.6	30.2	2.8	486.7
<i>Current expenditure</i>				
Current expenditure on goods and services	159.2	102.8	0.0	261.9
Subsidies	4.9	1.4	0.0	6.3
Net social benefits	134.1	15.9	0.0	150.0
Net current grants abroad	0.7	0.0	0.0	0.7
Current grants (net) within public sector	98.1	-98.1	0.0	0.0
Other current grants	30.9	0.0	0.0	30.9
Interest and dividends paid	25.6	0.4	0.2	26.2
AME margin	0.9	0.0	0.0	0.9
Total current expenditure	454.3	22.3	0.2	476.9
Depreciation	5.9	5.7	3.9	15.5
Surplus on current budget	-6.6	2.2	-1.3	-5.7
<i>Capital expenditure</i>				
Gross domestic fixed capital formation	12.0	14.7	3.0	29.7
Less depreciation	-5.9	-5.7	-3.9	-15.5
Increase in inventories	0.2	0.0	0.0	0.2
Capital grants (net) within public sector	10.2	-9.3	-0.9	0.0
Capital grants to private sector	11.8	1.6	0.3	13.7
Capital grants from private sector	-0.9	-1.2	0.0	-2.0
AME margin	0.1	0.0	0.0	0.1
Net investment	27.6	0.0	-1.4	26.2
Net borrowing	34.2	-2.1	-0.1	31.9

Table C24: Historical series of public sector balances, receipts and debt

	Per cent of GDP								
	Public sector current budget	Cyclically-adjusted surplus on current budget	Public sector net borrowing	Cyclically-adjusted public sector net borrowing	Public sector net cash requirement	Net taxes and social security contributions	Public sector current receipts	Public sector net debt ¹	Public sector net worth ²
1970-71	6.7		-0.6		1.2		43.3		
1971-72	4.2		1.1		1.4		41.4		
1972-73	2.0	2.5	2.8	2.3	3.6		39.0		
1973-74	0.3	-0.8	4.9	6.0	5.9		39.6		
1974-75	-1.1	-2.4	6.6	7.9	9.0		42.3	52.1	
1975-76	-1.6	-1.5	7.0	7.0	9.3		42.9	53.8	
1976-77	-1.2	-0.3	5.5	4.6	6.4		43.3	52.3	
1977-78	-1.4	-1.0	4.3	3.8	3.7		41.5	49.0	
1978-79	-2.6	-2.5	5.0	4.9	5.2	33.5	40.2	47.1	
1979-80	-1.9	-1.8	4.1	4.0	4.7	33.9	40.7	43.9	
1980-81	-3.0	-1.6	4.9	3.4	5.2	35.9	42.4	46.0	
1981-82	-1.4	2.4	2.3	-1.5	3.3	38.6	45.8	46.2	
1982-83	-1.5	2.8	3.0	-1.3	3.2	38.7	45.5	44.8	
1983-84	-2.0	1.7	3.8	0.1	3.2	38.2	44.4	45.1	
1984-85	-2.2	0.8	3.7	0.7	3.1	38.9	44.3	45.3	
1985-86	-1.2	0.6	2.4	0.6	1.6	38.1	43.2	43.5	
1986-87	-1.4	-1.2	2.1	1.9	0.9	37.8	42.0	41.0	
1987-88	-0.3	-1.6	1.0	2.2	-0.7	37.6	41.1	36.8	74.1
1988-89	1.7	-0.9	-1.3	1.3	-3.0	36.9	40.7	30.5	79.1
1989-90	1.4	-1.4	-0.2	2.6	-1.3	36.2	39.9	27.7	70.9
1990-91	0.4	-1.2	1.0	2.6	-0.1	35.9	38.9	26.2	60.4
1991-92	-2.0	-1.5	3.8	3.3	2.3	34.7	38.5	27.4	53.1
1992-93	-5.6	-3.6	7.6	5.6	5.9	33.7	36.6	32.0	40.3
1993-94	-6.2	-4.0	7.8	5.5	7.1	32.8	35.6	37.2	28.5
1994-95	-4.8	-3.4	6.3	4.8	5.3	34.0	36.7	40.8	27.6
1995-96	-3.4	-2.6	4.8	4.0	4.3	34.7	37.6	42.7	19.8
1996-97	-2.8	-2.3	3.5	3.0	2.9	34.8	37.1	43.6	16.1
1997-98	-0.2	-0.1	0.8	0.7	0.2	36.0	38.2	41.6	12.6
1998-99	1.2	0.8	-0.4	-0.1	-0.8	36.5	38.5	39.1	11.3
1999-00	2.2	1.8	-1.7	-1.4	-0.9	36.5	38.8	36.3	14.2
2000-01	2.2	1.6	-1.6	-1.0	-3.9	37.4	39.5	31.3	19.1
2001-02	1.0	0.7	0.0	0.2	0.3	36.8	38.6	30.2	24.0
2002-03	-1.3	-0.7	2.4	1.8	2.3	35.4	37.1	31.5	23.8
2003-04	-1.8	-1.0	3.2	2.3	3.5	35.6	37.5	32.8	24.7

¹ At end-March; GDP centred on end-March.

² At end-December; GDP centred on end-December.

Table C25: Historical series of government expenditure

	£ billion (2003–04 prices)				Per cent of GDP			
	Public sector current expenditure	Public sector net investment	Public sector gross investment ¹	Total managed expenditure	Public sector current expenditure	Public sector net investment	Public sector gross investment ¹	Total managed expenditure
1970-71	170.2	31.9	52.3	222.5	32.6	6.1	10.0	42.7
1971-72	178.2	28.2	49.1	227.3	33.3	5.3	9.2	42.5
1972-73	185.9	27.1	48.9	234.9	33.1	4.8	8.7	41.9
1973-74	204.1	30.4	54.9	258.9	35.1	5.2	9.4	44.5
1974-75	226.3	32.2	58.5	284.8	38.8	5.5	10.0	48.9
1975-76	231.4	31.6	58.2	289.5	39.9	5.5	10.0	49.9
1976-77	238.2	25.9	53.3	291.6	39.9	4.3	8.9	48.8
1977-78	234.6	17.5	45.0	279.7	38.4	2.9	7.4	45.8
1978-79	241.7	15.3	43.4	285.0	38.4	2.4	6.9	45.3
1979-80	247.7	14.2	42.7	290.4	38.2	2.2	6.6	44.8
1980-81	255.0	11.4	40.2	295.2	40.8	1.8	6.4	47.3
1981-82	266.6	5.8	34.5	301.1	42.6	0.9	5.5	48.1
1982-83	272.4	9.6	37.4	309.8	42.7	1.5	5.9	48.5
1983-84	280.8	11.8	39.5	320.3	42.3	1.8	5.9	48.2
1984-85	288.6	10.4	36.7	325.2	42.6	1.5	5.4	48.0
1985-86	288.5	8.8	32.2	320.7	41.0	1.2	4.6	45.6
1986-87	293.3	5.2	29.0	322.3	40.1	0.7	4.0	44.1
1987-88	296.5	5.1	27.0	323.5	38.6	0.7	3.5	42.1
1988-89	289.4	2.9	25.5	314.9	36.2	0.4	3.2	39.4
1989-90	291.8	9.8	32.6	324.4	35.7	1.2	4.0	39.7
1990-91	293.3	11.8	31.6	324.9	36.1	1.4	3.9	40.0
1991-92	310.6	14.9	31.7	342.4	38.4	1.8	3.9	42.3
1992-93	325.8	16.2	32.0	357.7	40.2	2.0	3.9	44.2
1993-94	335.2	13.1	28.7	363.8	40.0	1.6	3.4	43.4
1994-95	346.1	12.7	28.9	375.1	39.7	1.5	3.3	43.0
1995-96	351.1	12.2	28.6	379.7	39.2	1.4	3.2	42.4
1996-97	352.3	6.6	21.2	373.5	38.3	0.7	2.3	40.6
1997-98	352.0	6.0	20.3	372.2	36.9	0.6	2.1	39.0
1998-99	351.0	7.7	21.6	373.1	35.9	0.8	2.2	38.1
1999-00	357.2	5.4	19.7	377.4	35.2	0.5	1.9	37.2
2000-01	377.3	6.1	20.4	398.1	36.0	0.6	1.9	38.0
2001-02	387.6	10.9	25.2	413.2	36.3	1.0	2.4	38.7
2002-03	403.5	12.0	26.2	430.2	37.1	1.1	2.4	39.6
2003-04	425.3	15.0	29.0	454.7	38.1	1.3	2.6	40.7

¹ Net of sales of fixed assets.

CONVENTIONS USED IN PRESENTING THE PUBLIC FINANCES

FORMAT FOR THE PUBLIC FINANCES

The June 1998 Economic and Fiscal Strategy Report (EFSR), set out a new format for presenting the public finances that corresponded more closely to the two fiscal rules. The three principal measures are:

- the surplus on the current budget (relevant to the golden rule);
- public sector net borrowing; and
- the public sector net debt ratio (relevant to the sustainable investment rule).

These measures are based on the national accounts and are consistent with the European System of Accounts 1995 (ESA95). Estimates and forecasts of the public sector net cash requirement (formerly called the public sector borrowing requirement) are still shown in the FSBR, but they are given less prominence.

The fiscal rules are similar to the criteria for deficits and debt laid down in the Treaty but there are important definitional differences:

- UK fiscal rules cover the whole public sector, whereas the Treaty deficit and debt only includes general (i.e. central and local) government;
- The fiscal rules apply over the whole economic cycle, not year to year;
- The current budget excludes capital spending, which is included in the Treaty deficit measure; and
- The UK debt measure is net of liquid assets, whereas the Treaty measure uses gross debt.

From February 2000 the Treaty deficit moved to being reported on an ESA95 basis.

NATIONAL ACCOUNTS

The **national accounts** record most transactions, including most taxes (although not corporation tax, self-assessment income tax and some other Inland Revenue taxes which, because of practical difficulties, are scored on a cash basis) on an accruals basis, and impute the value of some transactions where no money changes hands (for example, non-trading capital consumption).

Full details of the sources for each table are included in the Budget 2005 technical annex: data sources, economy forecasts and charts, available on the Treasury's internet site and on request from the Treasury's Public Enquiry Unit (020 7270 4558).

The **outturn** figures are based on series published in the monthly Public Sector Finance release (last published in February 2005). The figures are also adjusted to take account of the changes announced by ONS, where the size of the change has also been publicly announced. This includes the reviews concerning roads maintenance expenditure detailed in ONS's Technical Explanatory Note published on 28 February 2005.

The principal measures drawn from the national accounts are described below.

FISCAL AGGREGATES

The **current budget** (formerly known as the current balance) measures the balance of current account revenue over current expenditure (including depreciation). The definition of the current budget presented in this chapter is very similar to the National Accounts concept of net saving. It differs only in that it includes taxes on capital (mainly inheritance tax) in current rather than capital receipts. The current budget is used to measure progress against the golden rule. The actual measure is the average surplus on the current budget expressed as a ratio to GDP over the economic cycle.

Public sector **net borrowing** (formerly known as the financial deficit in the UK National Accounts) is the balance between expenditure and income in the consolidated current and capital accounts. It differs from the public sector net cash requirement in that it is measured on an accruals basis and because certain fiscal transactions (notable net lending and net acquisition of other financial assets, which affect the level of borrowing but not the public sector's net financial indebtedness) are excluded from public sector net borrowing but included in the public sector net cash requirement.

Public sector net debt is approximately the stock analogue of the public sector net cash requirement. It measures the public sector's financial liabilities to the private sector and abroad, net of short-term financial assets such as bank deposits and foreign exchange reserves.

General government gross debt, the Treaty debt ratio, is the measure of debt used in the European Union's Excessive Deficit Procedure. As a general government measure, it excludes the debt of public corporations. It measures general government's total financial liabilities before netting off short-term financial assets.

Public sector net worth represents the public sector's overall net balance sheet position. It is equal to the sum of the public sector's financial and non-financial assets less its total financial liabilities. The estimates of tangible assets are subject to wide margins of error, because they depend on broad assumptions, for example about asset lives, which may not be appropriate in all cases. The introduction of resource accounting for central government departments will lead in time to an improvement in data quality, as audited information compiled from detailed asset registers becomes available.

PUBLIC SECTOR RECEIPTS

Net taxes and national insurance contributions (NTNIC) is a measure of net cash payments made to UK government and differs in several respects from the national accounts measure of total public sector current receipts (PSCR). A reconciliation between the two aggregates is given in the lower half of Table C8. The main adjustments are:

- accruals adjustments, mainly on income tax, national insurance contributions and VAT, are added to change the basis of figures from cash to national accounts accruals;
- some tax payments that are collected by the Government, but then paid to the EU, are subtracted as they do not score as government receipts in the national accounts;
- tax paid by public corporations is also subtracted, as it has no impact on overall public sector receipts;

- an adjustment is made for tax credits. In NTNIC, all tax credits are scored as negative tax to the extent that they are less equal to the tax liability of the household, and as public expenditure where they exceed the liability, in line with the Organisation for Economic Cooperation and Development (OECD) Revenue Statistics guidelines. Although the ONS have adopted this treatment for the Working Tax Credit and Child Tax Credit, which were introduced in April 2003, they have continued to treat the Working Families' Tax Credit (WFTC), the Disabled Person's Tax Credit (DPTC) and enhanced and payable company tax credits entirely as public expenditure in the national accounts. Those parts of WFTC, DPTC and company tax credits that offset tax liability in NTNIC are added back into current receipts in Table C8;
- interest and other non-tax receipts, which are excluded from NTNIC, are added. This excludes oil royalties, as they are already included in NTNIC, even though the national accounts treat them as non-tax receipts; and
- business rates paid by local authorities are included in the calculation of NTNIC but not PSCR. These are therefore deducted from NTNIC before arriving at PSCR.

TOTAL MANAGED EXPENDITURE

Public expenditure is measured across the whole of the public sector using the aggregate **Total Managed Expenditure (TME)**. TME is the sum of the public sector current expenditure, public sector net investment and public sector depreciation. These aggregates are based on National Accounts definitions defined under ESA95.

Public sector current expenditure is the sum of expenditure on pay and related costs, plus spending on goods and services, and current grants made to the private sector. Current expenditure is net of receipts from sales of goods and services.

Public sector capital expenditure is shown in Table C15. It includes:

- gross domestic fixed capital formation (i.e. expenditure on fixed assets such as schools and hospitals, roads, computers, plant and machinery and intangible assets) net of receipts from sales of fixed assets (e.g. council houses and surplus land);
- grants in support of capital expenditure in the private sector; and
- the value of the physical increase in stocks (for central government, primarily agricultural commodity stocks).

Public sector net investment: in Table C1 nets off depreciation of the public sector's stock of fixed assets.

Public sector depreciation: is the annual charge that is made in relation to the reduction in value of the public sector's capital assets over a particular financial year.

For budgeting purposes, TME is further split into Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME):

Departmental Expenditure Limits (DEL) are firm three-year spending limits for departments. In general DEL will cover all running costs and all programme expenditure except that spending that is included in departmental Annually Managed Expenditure due to it not being reasonably subject to close control over the three year period. DEL has distinct resource and capital budgets, as shown in Table C13.

Annually Managed Expenditure (AME) is spending that cannot be reasonably subject to firm multi-year limits. AME components are shown in Table C11 and are defined as follows.

Social security benefits in AME expenditure covers contributory, non-contributory and income-related benefits for children, people of working age and pensioners. Broadly, benefits are paid in respect of retirement, unemployment, incapacity, or disability, caring responsibilities and bereavement, as well as housing costs for all groups with effect from Budget 2004. Some expenditure on housing-related benefits is, however, covered by the locally financed expenditure category.

Tax credits for individuals scored as expenditure includes that element of the Working Tax Credit and the Child Tax Credit that is classified as public expenditure under national accounts definitions.

Common Agriculture Policy expenditure comprises direct payments to farmers and market price supports (intervention purchases and export refunds). In the national accounts this is treated as a transaction between the EU and the farmers, so it is removed in the accounting adjustments and does not score in TME.

Net public service pensions expenditure is reported on national accounts basis and reflects the difference between the cash paid out during the year and any contributions received for the main unfunded public service pension schemes.

National Lottery expenditures relate to the distribution of the money received from the National Lottery for good causes. Funds are drawn down by Distributor Bodies and directed towards Lottery funded projects.

Non-cash items in AME. Under the current resource budgeting regime, a department's spending budget includes certain items that do not have a cash component at the time when the expense is recorded. Examples include depreciation, cost of capital charges and provisions.

Other departmental expenditure aggregates all other expenditure made by departments that is not separately identified in the AME table.

Net payments to European Union (EU) institutions is the balance between the UK's gross contribution to the EU Budget minus the UK abatement and public sector receipts from the EU Budget (net contribution to EU budget). For domestic public expenditure planning purposes part of the UK's contribution to the EU budget is attributed to the overseas aid programme and excluded from the net payments to EU institutions figures. In the national accounts, Common Agriculture Policy expenditure is treated as a transaction between the EU and farmers, so the associated receipts from the EU are removed in the accounting adjustments and do not score in TME.

Locally financed expenditure consists of local authority self-financed expenditure (LASFE) and Scottish spending financed by local taxation (non-domestic rates and, if and when levied, the Scottish variable rate of income tax), LASFE is the difference between total local authority expenditure, including most gross debt but net of capital receipts, and central government support to local authorities (i.e. Aggregate External Finance (AEF), specific grants and credit approvals).

Central government debt interest is shown gross – only interest paid within the public sector is netted off. All other receipts of interest and dividends are included in current receipts. The capital uplift on index-linked gilts is also scored here as interest at the time it accrues as is the amortisation of discounts on gilts at issue.

Public corporations' own-financed capital expenditure. This is the amount of capital expenditure by public corporations that is not financed by general government.

AME margin is an unallocated margin on total AME spending and is included as a measure of caution against AME expenditure exceeding its forecast levels.

The **accounting adjustments** reconcile the DEL and AME framework of departmental budgets to the national accounts measure of TME, and are shown in Table C14.

Tax credits adds in spending on individuals' tax credits which is scored as negative tax in net taxes and national insurance contributions but as public expenditure in National Accounts. As explained in the public sector current receipts section this mainly includes elements of WFTC and DPTC, which were replaced by new tax credits in 2003-04.

European Community contributions deduct traditional own resources (i.e. payments of customs duties and agricultural and sugar levies) and VAT contributions to the EC, which are included in the net payments to EC institutions line in AME but excluded from TME.

Other central government programmes covers various items which relate to central government programme expenditure and where budgeting and national accounts treatment differ, for example the depreciation costs of NHS trusts and tax credits for companies.

Vat refunds adds back refunds obtained by central government departments, local authorities and certain public corporations. DEL and AME programme expenditure are measured net of these refunds, while TME is recorded with VAT paid.

Central government non-trading capital consumption (i.e. depreciation) as measured by ONS for national accounts is added.

Non-cash items in resource budgets and not in TME includes cost of capital charge, write-offs, notional audit fee, take-up, movements in the value, and release of provisions, the subsidy and bad debt element of student loans, and movement in stocks.

Expenditure financed by revenue receipts adds in certain receipts which are deducted from departmental budgets but which are not treated as negative expenditure in TME.

Local authorities adds in local authority depreciation and subsidies paid to local authority trading bodies, and deducts capital grants from local authorities to public corporations, local authority receipts of investment grants from private sector developers and certain license fees collected by local authorities.

General government consolidation adjusts for the fact that payments of certain taxes, grants and interest that are within the public sector do not score in TME, as TME is a consolidated public sector concept.

Public corporations adds receipts from public corporations of interest, dividends and equity withdrawals that are netted-off in budgets, interest paid by public corporations to the private sector and abroad (as property income paid by the public sector to the rest of the economy is in TME, but not in departmental budgets) and deducts the profit/loss of the Forestry enterprise.

Financial transactions deducts net lending, acquisition of securities and profit/loss on sale of financial assets.

Other accounting adjustments deducts depreciation and impairments in AME, removes expenditure on the CAP and the associated receipts from the EU and reconciles to national accounts outturn.

LIST OF ABBREVIATIONS

AEI	Average earnings index
AHC	After housing costs
AIF	Authorised investment funds
ALMPs	Active labour market policies
AME	Annually Managed Expenditure
APD	Air passenger duty
AU	African Union
BCC	British Chamber of Commerce
BHC	Before housing costs
BoE	Bank of England
BRE	Better Regulation Executive
BREW	Business Resource Efficiency and Waste
BRTF	Better Regulation Task Force
CAP	Common Agricultural Policy
CBI	Confederation of British Industry
CBO	Congressional Budget Office
CCAs	Climate change agreements
CCL	Climate change levy
CCP	Climate change programme
CCS	Climate capture and storage
CDFIs	Community development finance institutions
CGAA	Coordinating Group for Accounting and Audit
CEO	Chief Executive Officer
CFL	Compact fluorescent lamps
CGNCR	Central government net cash requirement
CGT	Capital gains tax
CHAI	Commission for Healthcare Audit and Improvement
CHD	Coronary heart disease
CHP	Combined heat and power
CIPFA	Chartered Institute of Public Finance and Accountancy
CIS	Construction Industry Scheme
CLTC	Contaminated land tax credit
COMPS	Contracted out money purchase schemes
COSRS	Contracted out salary related schemes
CPA	Comprehensive Performance Assessment
CPI	Consumer Prices Index
CSO	Community Support Officers
CSV	Community Service Volunteers
CTB	Council Tax Benefit
CTC	Child Tax Credit
CTF	Child Trust Fund
DCA	Department of Constitutional Affairs
DCMS	Department of Culture, Media and Sports
DDA	Disability Discrimination Act
DEC	Disasters Emergency Committee
DEFRA	Department for Environment, Food and Rural Affairs
DEL	Departmental Expenditure Limit

DfES	Department for Education and Skills
DfID	Department for International Development
DfT	Department for Transport
DH	Department of Health
DME	Departmental Managed Expenditure
DPTC	Disabled Person's Tax Credit
DTI	Department of Trade and Industry
DTR	Double taxation relief
DVLA	Driver and Vehicle Licensing Agency
DWP	Department for Work and Pensions
ECA	Enhanced capital allowance
ECA	Energy saving technologies
ECF	Enterprise Capital Fund
ECOFIN	Council of European Finance Ministers
EEC	Energy Efficiency Commitment
EFSR	Economic and Fiscal Strategy Report
EIS	Enterprise Investment Scheme
ELCI	Employers' liability compulsory insurance
EMA	Educational Maintenance Allowance
EMU	Economic and Monetary Union
EPC	Economic Policy Committee
EPCS	Environment, Protective and Cultural Services
EPD	Energy Products Directive
ESM	Energy saving materials
ESRC	Economic and Social Research Council
ETPs	Employer Training Pilots
ETS	Emissions Trading Scheme
EU	European Union
EU ETS	EU Emissions Trading Scheme
EYF	End-year flexibility
FCO	Foreign and Commonwealth Office
FDI	Foreign Direct Investment
FE	Further Education
FITN	Final Invitation to Negotiate
FOS	Financial Ombudsman Service
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSBR	Financial Statement and Budget Report
FSMA	Financial Services and Markets Act
G7	Group of Seven. A group of seven major industrial nations: Canada, France, Germany, Italy, Japan, UK and US.
G8	The G8 is an informal group of eight countries: Canada, France, Germany, Italy, Japan, Russia, the UK and the US.
GAD	Government Actuary's Department
GCSE	General Certificate of Secondary Education
GDP	Gross Domestic Product
GGNB	General government net borrowing
GNI	Gross National Income
GNP	Gross National Product

GP	General Practitioner
GSS	Government Statistical Service
GVA	Gross Value Added
HB	Housing Benefit
HEIF	Higher Education Innovation Fund
HGVs	Heavy Goods Vehicles
HIPC	Heavily Indebted Poor Countries
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
ICT	Information and Communications Technology
IFF	International Finance Facility
IHT	Inheritance Tax
ILO	International Labour Organisation
IMF	International Monetary Fund
IMFC	International Monetary Fund Conference
ISA	Individual Savings Account
ISB	Invest to Save Budget
ISC	Institutional Shareholders Committee
IT	Information Technology
JSA	Jobseeker's Allowance
LA	Local Authority
LABGI	Local Authority Business Growth Incentive
LEA	Local Education Authority
LEGI	Local Enterprise Group Initiative
LESA	London's Energy Savings Allowance
LFS	Labour Force Survey
LGA	Local Government Association
LHA	Local Housing Allowance
LIFT	Local Improvement Finance Trust
LMI	Labour market information
LPC	Low Pay Commission
LPG	Liquefied petroleum gas
LPL	Lower profit limit
LRUC	Lorry Road-User Charge
LSC	Learning and Skills Council
MA	Modern Apprenticeship
MDGs	Millennium Development Goals
MDRs	Marginal Reduction Rates
MIG	Minimum Income Guarantee
MPC	Monetary Policy Committee
MtC	Million tonnes of carbon
MTIC	Missing Trader Intra-Community
NAO	National Audit Office
NDDP	New Deal for disabled people
NDLP	New Deal for lone parents
NDP	New Deal for partners

NDYP	New Deal for young people
NEPAD	New Partnership for Africa's Development
NETA	New Electricity Trading Agreement
NETCEN	National Environmental Technology Centre
NGO	Non-Governmental Organisation
NHS	National Health Service
NI	Northern Ireland
NICs	National Insurance Contributions
NICE	National Institute for Clinical Excellence
NIESR	National Institute of Economic and Social Research
NMW	National Minimum Wage
NSFs	National Service Frameworks
NS&I	National Savings and Investments
NVQ	National Vocational Qualification
ODA	Overseas Development Assistance
OECD	Organisation for Economic Cooperation and Development
OFT	Office of Fair Trading
OFWAT	Office of the Water Services
OGC	Office of Government Commerce
ONS	Office of National Statistics
OPEC	Organisation of Petroleum Exporting Countries
PCT	Primary Care Trust
PEP	Personal Equity Plan
PRA	Panel for Regulatory Accountability
PPAF	Police Performance and Assessment Framework
PPF	Pension Protection Fund
PPG3	Planning Policy Guidance on Housing
PPS	Public Private Partnerships
PRS	Private rented sector
PSA	Public Service Agreement
PSNB	Public sector net borrowing
PSNI	Public sector net investment
PSRE	Public Sector Research Establishments
QC	Queen's Counsel
R&D	Research and Development
RDA	Regional Development Agency
REITs	Real Estate Investment Trusts
RHBs	Regional Housing Boards
RIA	Regulatory Impact Assessments
RO	Renewables Obligation
RPBs	Regional Planning bodies
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
RROs	Regulatory Reform Orders
RRS	Rapid Response Service
RSPs	Regional Skills Partnerships
RTFO	Renewable Transport Fuels Obligation
SARS	Severe Acute Respiratory Syndrome

SBS	Small Business Service
SDAs	Service Delivery Agreements
SDLT	Stamp duty land tax
SEE	Small Earnings Exception
SERPs	State Earnings Related Pensions
SFLG	Small Firms Loan Guarantee
SITF	Social Investment Task Force
SME	Small and medium-sized enterprise
SMP	Statutory Maternity Pay
SRIF	Science Research Infrastructure Fund
SRO	Science Research Organisation
SSP	Statutory Sick Pay
SVR	Standard Variable Rates
TESSA	Tax Exempt Special Savings Account
TIF	Transport Innovation Fund
TME	Total Managed Expenditure
TUC	Trade Union Council
TUPE	Transfer of Undertakings (Protection of Employment)
UK GAAP	UK Generally Accepted Accounting Practises
UN	United Nations
UPL	Upper profits limit
USD	United States Dollar
ULSD	Ultra-low sulphur diesel
ULSP	Ultra-low sulphur petrol
VAT	Value Added Tax
VCS	Voluntary community sector
VCT	Venture Capital Trust
VED	Vehicle excise duty
VI	Voluntary initiative
WFI	Work Focused Interview
WFTC	Working Families' Tax Credit
WTC	Working Tax Credit
WTO	World Trade Organisation

LIST OF TABLES

Economic and Fiscal Strategy Report

- 1.1 Meeting the fiscal rules
- 1.2 Budget 2005 policy decisions

- 2.1 Summary of world forecast
- 2.2 Summary of UK forecast
- 2.3 Public sector net borrowing compared with the 2004 Pre-Budget Report
- 2.4 Fiscal balances compared with Budget 2004 and the 2004 Pre-Budget Report
- 2.5 Summary of public sector finances
- 2.6 The overall fiscal impact

- 4.1 Weekly minimum income guarantees
- 4.2 The effect of the Government's reforms on high marginal deduction rates
- 4.3 Allocation of the Windfall Tax

- 5.1 Annual levels of support for families from April 2005

- 7.1 The Government's policy objective and measures
- 7.2 The environmental impacts of Budget measures

- A.1 Real GDP growth and its components

Financial Statement and Budget Report

- A1 Budget 2005 policy decisions
- A2 Other measures announced since Budget 2004
- A3 Bands of taxable income 2005-06
- A4 Income tax allowances 2005-06
- A5 Class 1 national insurance contribution rates 2005-06
- A6 Self-employed national insurance contribution rates 2005-06
- A7 Child and Working Tax Credits rates and thresholds
- A8a VED bands and rates for private vehicles registered on or after 1 March 2001 (graduated VED)
- A8b VED bands and rates for private and light goods vehicles registered before 1 March 2001 (pre-graduated VED)
- A9 Changes to tobacco duties
- A10 Changes to alcohol duties
- A1.1 Measures announced in Budget 2004 or earlier which take effect from April 2005 or later
- A3.1 Estimated costs of principle tax expenditure and structural reliefs

- B1 The world economy
- B2 Contributions to trend output growth
- B3 Summary of forecast
- B4 Contributions to GDP growth
- B5 Household sector expenditure and income
- B6 Gross fixed capital formation
- B7 Trade in goods and services
- B8 Budget and independent forecasts

B9	Summary of economic prospects
B10	Gross domestic product and its components
C1	Summary of public sector finances
C2	Fiscal balances compared with Budget 2004 and the 2004 Pre-Budget Report
C3	Economic assumptions for the public finance projections
C4	Current and capital budgets
C5	Current and capital budgets (per cent of GDP)
C6	Changes in current receipts since the 2004 Pre-Budget Report
C7	Changes in current receipts by tax since Budget 2004 and the 2004 Pre-Budget Report
C8	Current receipts
C9	Current receipts as a proportion of GDP
C10	Net taxes and national insurance contributors
C11	Total Managed Expenditure 2003-04 to 2007-08
C12	Changes to Total Managed Expenditure since the 2004 Pre-Budget Report
C13	Departmental Expenditure Limits – resource and capital budgets
C14	Accounting adjustments
C15	Public sector capital expenditure
C16	Loans and sales of assets
C17	Departmental estimate of capital spending by the private sector (signed deals)
C18	Estimated aggregate capital value of projects at preferred bidder stage
C19	Estimated payments under PFI contracts – March 2005 (signed deals)
C20	Public sector net cash requirement
C21	Financing requirement forecast
C22	General government transactions by economic category
C23	Public sector transactions by sub-sector and economic category
C24	Historical series of public sector balances, receipts and debt
C25	Historical series of government expenditure

LIST OF CHARTS

Economic and Fiscal Strategy Report

- 1.1 Government spending by function
- 1.2 Government receipts

- 2.1 Inflation performance and expectations
- 2.2 Movements in leading effective exchange rate indices since 1999
- 2.3 Public finances in the G7, average 1997 to 2004
- 2.4 Meeting the golden rule
- 2.5 Meeting the sustainable investment rule
- 2.6 Fiscal policy supporting monetary policy
- 2.7 Public sector net borrowing and net investment
- 2.8 Cyclically-adjusted surplus on current budget

- 4.1 UK employment and ILO unemployment rates
- 4.2 Long-term unemployment, youth and 25+
- 4.3 Six-month off-flows from incapacity benefits
- 4.4 Lone parent– employment rate and numbers on Income Support, 1981-2004
- 4.5 Employment rates by ethnic minorities and gender

- 5.1 Net tax rate for families of different size
- 5.2 Gains for families as a result of tax credits and other children’s measures by 2005
- 5.3 Overall gains for pensioner families from pensioner tax and benefit policies

- 6.1 Cutting waiting times
- 6.2 Tackling crime
- 6.3 Releasing resources for priorities-real annual average growth rates, 1997-98 to 2007-08

- 7.1 UK emissions of greenhouse gases
- 7.2 UK average new car CO₂ emissions
- 7.3 Index of household disposable income and cost of motoring

- A.1 Population indices by age group
- A.2 Illustrative long-term fiscal projections
- A.3 Age related spending in selected EU countries

Financial Statement and Budget Report

B1	G7 GDP and world trade
B2	G7 inflation and oil prices
B3	The output gap
B4	Gross Domestic Product (GDP)
B5	CPI
B6	Business investment
B7	Balance of payments current account
C1	Public sector net debt and net worth
C2	Cyclically-adjusted surplus on current budget
C3	Tax-GDP ratio
C4	Total Managed Expenditure

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