



BUILDING A STRONGER, FAIRER BRITAIN IN AN UNCERTAIN WORLD

Pre-Budget Report
November 2001

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by Command of Her Majesty
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This Pre-Budget Report, *Building a Stronger, Fairer Britain in an Uncertain World*, is an integral part of the Government's annual Budget process. It reports on how the Government's policies are contributing towards the achievement of its long-term economic goals for Britain. In particular, the Pre-Budget Report:

- provides a progress report on what the Government has achieved so far;
- sets out updated forecasts for the economy and public finances; and
- details the next stage of reforms that the Government is considering in the run up to Budget 2002 and on which it will be consulting in the months ahead.

INTRODUCTION

1.1 Global economic conditions pose significant challenges for policy-makers around the world. The world economy has slowed more sharply this year than at any time over the past two decades. For the first time since the mid-1970s growth has slowed significantly in almost every region of the world. The events of 11 September in the US have further weakened demand, delayed the global recovery and intensified the risks to global growth.

1.2 Over the past four and a half years, the Government has laid the foundations for long-term economic stability. Extensive reforms to the frameworks for monetary and fiscal policy have established a platform of stability with low inflation, low interest rates, low unemployment and sound and sustainable public finances. This platform of stability has allowed the Government to devote more resources to the nation's priorities – promoting enterprise, innovation and investment across Britain; extending employment opportunity to all; tackling poverty for families, children and pensioners; and building high quality public services.

1.3 In an integrated global economy, no country can fully insulate itself from international economic events. But as a result of the steps the Government has taken, and the platform of stability it has created, the UK economy is now better placed than on previous occasions to continue to steer a course of economic stability.

1.4 In an uncertain global environment, countries need to build greater economic strength. Building on the steps taken over the last Parliament, the Government has set a series of ambitious ten-year goals to build a stronger and fairer Britain. In these testing economic times, the Government remains determined to advance its long-term goals to:

- deliver long-term economic stability, ensuring that the fiscal rules are met, inflation remains low, and the UK has faster productivity growth than its main competitors;
- sustain a higher proportion of people in employment than ever before, seeking to ensure full employment in every UK region;
- eradicate child poverty and tackle pensioner poverty, extending opportunity for all children and providing security for all pensioners;
- establish world-class public services, delivering investment to raise standards in education, improve national healthcare for all, modernise Britain's transport and tackle crime; and
- tackle global poverty and climate change, delivering the UK's commitments under the Kyoto Protocol and helping to achieve the Millennium Development Goals by 2015.

1.5 The Pre-Budget Report describes the next steps in the Government's strategy for meeting its long-term goals – combining a stronger, more enterprising, economy with a fairer, more just, society. The principal elements of the Government's strategy, as set out in this Pre-Budget Report, are:

- maintaining macroeconomic stability;
- meeting the productivity challenge;
- increasing employment opportunity for all;
- ensuring fairness for families and communities;
- delivering high quality public services; and
- protecting the environment.

1.6 Each element of the strategy is covered separately in subsequent chapters of this report. The Government's updated forecasts for the economy and the public finances are set out in Annexes A and B respectively.

MAINTAINING MACROECONOMIC STABILITY

1.7 The Government's economic goal is to deliver long-term economic stability, ensuring that the fiscal rules are met and inflation remains low. Chapter 2 describes how the Government is working to achieve this goal, maintaining stability in testing economic times.

The policy framework

1.8 In the last Parliament, the Government acted swiftly to introduce new frameworks for monetary and fiscal policy based on the principles of transparency, responsibility and accountability, and designed to deliver long-term economic stability. The Bank of England was given operational independence to set interest rates to deliver the Government's inflation target, while a new fiscal policy framework was introduced to improve fiscal management and deliver sound public finances. These policies work together in a coordinated way to deliver economic stability.

1.9 While no country can fully insulate itself from the slowdown in the world economy, the macroeconomic framework the Government has put in place has allowed monetary policy to respond pro-actively to the downturn while enabling fiscal policy to support monetary policy, this year and next, in limiting the impact on the UK economy. As a result, the UK is now well positioned to respond appropriately to the global slowdown and to preserve stability in the face of uncertain external events.

The economy

1.10 Even before the terrorist attacks on America, world economic conditions were deteriorating more sharply than forecast in Budget 2001. Growth has slowed in almost all regions of the world, accompanied by sharp declines in world trade growth, investment, industrial production and stock markets. In the Pre-Budget Report forecast:

- **G7 GDP** is now expected to increase by 1 per cent in 2001, compared with 2 per cent forecast in Budget 2001;
- growth in **world trade** is expected to slow to 1¹/₄ per cent in 2001, compared with 6³/₄ per cent forecast in Budget 2001 and 11¹/₂ per cent recorded for 2000; and
- growth in **UK export markets** is expected to slow significantly to 1 per cent in 2001, compared with 6 per cent forecast in Budget 2001 and 11¹/₄ per cent in 2000.

1.11 Despite a weaker external environment, strong economic fundamentals and preemptive macroeconomic policy action have helped cushion the impact on the UK economy in 2001. The key features of the Pre-Budget Report forecast are that:

- **GDP** is expected to increase by $2\frac{1}{4}$ per cent in 2001, in line with the lower end of the Budget 2001 forecast range;
- as the global recovery gathers pace from the middle of 2002, **UK GDP** is expected to become stronger and more balanced, growing by between 2 and $2\frac{1}{2}$ per cent in 2002 and by between $2\frac{3}{4}$ and $3\frac{1}{4}$ per cent in 2003; and
- the economy is continuing to experience its longest period of sustained low inflation since the 1960s. **RPIX inflation** is expected to remain close to the Government's $2\frac{1}{2}$ per cent target over the forecast period.

1.12 Prospects for the world economy have become more uncertain in the aftermath of 11 September and are a continued source of risk. The impact of the terrorist attacks on confidence has reinforced the downward momentum in activity and is expected to delay the economic recovery across the G7. A deeper or more protracted global slowdown, prompted by a further deterioration in consumer and business confidence, is a downside risk to the Pre-Budget Report forecast. However, the deterioration in economic conditions could also prove relatively short-lived. If the impact of the terrorist attacks on confidence proves less severe than anticipated, then recent decisive policy action in the world's major economies could stimulate a recovery which is stronger, or begins earlier, than expected. With sound public finances and low inflation in the UK, macroeconomic policy is currently well placed to respond to either eventuality.

The public finances

1.13 The public finance projections published in the Pre-Budget Report, and summarised in Tables 2.5 and 2.6, provide an interim forecast update. They do not necessarily represent the fiscal outcome the Government is seeking and have a different status from those published at the time of the Budget which include all the effects of Budget policy measures. In line with the *Code for Fiscal Stability*, the updated fiscal projections include the effects of all firm decisions announced in the Pre-Budget Report.

1.14 The fiscal projections continue to be based on the prudent and cautious assumption of $2\frac{1}{4}$ per cent trend growth. This is one of a number of assumptions set out in Box B1 that underpin the public finance projections and are audited by the National Audit Office (NAO) under the three-year rolling review to ensure they remain reasonable and cautious.

1.15 Tough decisions on taxation and spending taken by the Government over the course of the last Parliament have put the public finances on a sustainable footing. Public sector net debt has been brought down from 44 per cent of GDP in 1997 to close to 30 per cent at present. UK debt ratios are now the lowest in the G7. The fiscal position is therefore sound and better able than in the past to deal with instability in the global economy. Fiscal policy is able to support monetary policy this year and next in maintaining economic stability as the economy moves temporarily below trend.

1.16 The current budget surplus in 2001-02 was $\text{£}2\frac{3}{4}$ billion higher than forecast in the Budget, while repayments on net borrowing exceeded the Budget projection by $\text{£}3\frac{3}{4}$. The slowdown in the world economy since Budget 2001 means that receipts are now expected to be lower than forecast in the short-term. Much of the reduction in receipts is attributed to the economic cycle and the impact of the cautious, audited assumptions, including lower equity prices. Financial companies' profits have been hit by the downturn in international capital markets, leading to a significant temporary reduction in tax revenues from this source.

1.17 A current budget surplus of £10¹/₄ billion is now expected in 2001–02, compared with £16 billion at the time of the Budget. The surplus is expected to fall further to £3 billion in 2002–03 before returning towards the Budget profile from 2003–04 as global economic conditions improve and financial companies' profits move back towards a cautious view of their long-term trend. The forecast demonstrates that fiscal policy is supporting monetary policy this year and next in maintaining stability.

1.18 The updated forecast takes into account firm policy decisions taken in the Pre-Budget Report, including a comprehensive package of further support for pensioners, worth £2³/₄ billion a year by 2004–05. In line with the *Code for Fiscal Stability*, the forecast does not take into account measures proposed in the Pre-Budget Report for consultation or where final decisions have yet to be taken. Decisions on these measures will be taken in the Budget. Changes to the forecast for AME programmes in the Pre-Budget Report have been offset in the AME margin in the usual way.

The fiscal rules **1.19** Taking into account non-discretionary changes to receipts and spending as a result of the slowdown in the world economy and the prudent use of cautious assumptions, and after releasing new resources for measures announced in the Pre-Budget Report, the Government remains on track to meet its fiscal rules over the cycle, including in the cautious case.

1.20 As shown in Table 1.1, the current budget is projected to remain in surplus throughout the forecast period, including when adjusted for the effects of the economic cycle. Public sector net debt is expected to remain close to 31 per cent of GDP in each year of the forecast – comfortably below the 40 per cent guideline set by the sustainable investment rule.

Table 1.1: Meeting the fiscal rules

	Per cent of GDP							
	Outturn			Projections				
	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Golden rule								
Surplus on current budget	2.3	2.6	1.0	0.3	0.4	0.6	0.7	0.7
Average surplus since 1999–2000	2.3	2.5	2.0	1.6	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	2.0	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Sustainable investment rule								
Public sector net debt	36.4	31.2	30.7	30.6	31.0	31.1	31.1	31.1

MEETING THE PRODUCTIVITY CHALLENGE

1.21 Productivity growth, alongside higher levels of employment, is a key route to delivering greater economic prosperity. The productivity performance of the UK economy has historically been weak, creating a substantial productivity gap between the UK and other advanced industrial economies. In difficult economic times, it is more important than ever that reforms are introduced to close the productivity gap. The Government is therefore continuing to take action to achieve its long-term economic goal of raising Britain's productivity performance to deliver rising living standards for all.

Measures so far **1.22** The Government's strategy for raising productivity is described in detail in Chapter 3 and focuses on five priority areas for action – the five drivers of productivity performance. Significant reforms have been introduced in each of these areas, including:

- **competition:** through the Competition Act 1998 which strengthened the powers of the Office of Fair Trading and modernised the overall UK competition regime; as well as detailed investigations into competition in particular markets, including banking and the professions;
- **enterprise and innovation:** with major reforms to capital gains tax; a new All-Employee Share Ownership Plan (the Share Incentive Plan) and Enterprise Management Incentives to help smaller companies recruit and retain highly skilled people; a research and development (R&D) tax credit for SMEs; and wide-ranging consultations on two new tax credits to encourage private investment in disadvantaged areas and to stimulate R&D by larger companies;
- **investment:** through reduced corporation tax rates, including a new 10 pence starting rate for smaller companies; a comprehensive review of institutional investment in the UK; and spending plans that will double net public sector investment by 2003–04;
- **skills:** by providing extra resources for education to raise standards in primary and secondary schools and additional funding for places in higher education; and
- **public sector productivity:** with a stronger focus on outcomes for public service delivery through Public Service Agreements (PSAs), Departmental Investment Strategies (DISs) to improve public sector investment, and a new Office of Government Commerce to deliver more efficient procurement within government.

Next steps 1.23 The Government is committed to working with all stakeholders to support business and the manufacturing sector during the current global slowdown. In this context, it welcomes the success of the CBI–TUC productivity campaign in identifying and addressing key areas for action. To support further the drivers of productivity growth in every community and region, the Government is now:

- planning to introduce a **volume-based research and development (R&D) tax credit for large companies** in Budget 2002;
- taking further steps to build a **modern and pro-enterprise business tax system**, by improving the capital gains tax business assets taper, and publishing draft legislation for an exemption for capital gains and losses on substantial shareholdings and a new regime for providing relief for the costs of intellectual property, goodwill and other intangible assets;
- **piloting new measures to improve access to training** and enable employees to attain basic and level 2 skills, recognising that employers, individuals and the Government have shared responsibilities to deliver a highly-skilled, high productivity economy;
- **publishing a Green Paper on planning reform** next month, setting out proposals to improve the flexibility, speed and responsiveness of the land use planning system;
- introducing a **package of measures to support small business**, improving access to finance, reducing the administrative burden of VAT and publishing a review of payroll administration;

- taking further steps to support enterprise and investment in Britain's disadvantaged communities by **introducing a stamp duty exemption for all property transfers up to £150,000 in disadvantaged areas** and announcing further decisions on the new Community Investment Tax Credit;
- confirming a radical programme of **further enhancements to the UK's competition regime**;
- **enhancing Enterprise Management Incentives**, by doubling the gross asset limit for companies which can qualify to £30 million; and
- **publishing a new analysis of Britain's regional productivity challenge**.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.24 To build a stronger economy and a fairer society, employment opportunity must be extended to all groups and areas in the country. Worklessness, particularly on a long-term basis, is a waste of human resources and a source of misery and degradation for those affected. It is also an important cause of child poverty and a determinant of future pensioner poverty. The Government is determined to advance its long-term economic goal of having a higher proportion of people in work than ever before by the end of the decade. This means continuing to help people move off welfare and into work, easing the transition to work, and making work pay. In times of economic uncertainty it also requires flexible working practices and responsive employment policies to ensure that people remain attached to the labour market.

Measures so far **1.25** The Government's strategy for achieving its long-term goal is described in Chapter 4. To extend employment opportunity and deliver higher levels of employment, the Government has introduced a range of reforms, including:

- **welfare to work**: reducing structural unemployment with the help of the New Deal programmes for young people and the long-term unemployed, and addressing concentrations of inactivity through the New Deal programmes for lone parents and people with disabilities. Starting in 49 pathfinder areas, the Government is delivering an active, "employment first", service to all working age benefit recipients through Jobcentre Plus, with rights and responsibilities balanced at every stage. Action Teams are tackling the problems of worklessness in many disadvantaged areas and the Job Transition Service provides security and assistance to those in areas affected by large-scale redundancies;
- **making work pay**: with reforms to the tax and benefit system underpinned by the National Minimum Wage, including reform of national insurance contributions (NICs), extension of the new 10 pence starting rate of income tax, and a reduction in the basic rate of income tax to 22 pence; and by introducing the Working Families' Tax Credit (WFTC) and the Disabled Persons' Tax Credit (DPTC); and
- **easing the return to work**: through the new Job Grant, simplified extended payments in Housing Benefit, and by providing more childcare places through the National Childcare Strategy.

Next steps 1.26 The Government is taking further steps to promote work, targeting those groups that have in the past been allowed to fall behind the rest of society. In addition to measures already announced, the Government is now taking steps to:

- **introduce a new Working Tax Credit** to extend in-work support to those on low incomes without children. The rates and thresholds for the new tax credit will be set in Budget 2002;
- provide additional help with re-skilling and jobsearch for people affected by large-scale redundancies, especially in deprived areas, by **strengthening the Job Transition Service**; and
- provide further help to communities with concentrations of long-term unemployment, **by piloting transitional employment opportunities for hard to help groups in deprived areas.**

FAIRNESS FOR FAMILIES AND COMMUNITIES

1.27 A strong and productive economy must be underpinned by fairness and inclusion so that every individual can contribute to, and share in, rising national prosperity. The Government is determined to meet its long-term goal of eradicating child poverty and tackling pensioner poverty, extending opportunity for all children and providing security for all pensioners. In seeking to build social inclusion, the Government is rewarding saving, working to create stronger communities and establishing a fair and efficient tax system. It is also playing a leading role in international efforts to tackle global poverty and help to achieve the Millenium Development Goals by 2015.

Measures so far 1.28 As described in Chapter 5, the Government has already taken action on a range of fronts to address these priorities:

- **support for families and children:** lifting children out of poverty through the introduction of the WFTC and the Children's Tax Credit; targeted help for low-income parents under the Sure Start Maternity Grant; a new Children's Fund to provide improved support for children, young people and their families; and increases in the level of Child Benefit, the children's allowances in Income Support and the JobSeekers' Allowance, and the flat rate of Statutory Maternity Pay;
- **fairness for pensioners:** through the introduction of the Minimum Income Guarantee (MIG) uprated by earnings for the poorest pensioners; increases in the basic state pension; an annual winter fuel payment for every household containing someone aged 60 or over; concessionary TV licences for those aged 75 or over; and the Budget 2001 commitment to raise the age-related income tax personal allowances at at least in line with earnings in 2003-04 and for the remainder of the Parliament; and
- **supporting saving:** by introducing Individual Savings Accounts (ISAs) and retaining the £7,000 annual contribution limit (and the associated £3,000 cash limit) until April 2006; through the introduction of Stakeholder Pensions to help people provide for financial security in old age; and by increasing the 10 pence income tax band by more than indexation from April 2001.

Next steps 1.29 Building on this comprehensive programme of reform, the Government is now taking additional steps to create a fairer and more inclusive society by:

- **introducing a further package of support to raise living standards for pensioners, including:**
 - **a guaranteed increase in the annual basic state pension** of £100 for single pensioners and £160 for pensioner couples in 2003-04. Subsequently, the basic state pension will rise each year by 2½ per cent or the increase in the September Retail Price Index – whichever is higher;
 - **maintaining the winter fuel payment at £200 a year for the remainder of this Parliament;** and
 - **introducing a new Pension Credit from 2003** to tackle the unfairness and complexities of the existing system and ensure that pensioners on low and modest incomes are rewarded, rather than penalised, for their savings.
- **announcing the next steps in introducing a new Child Tax Credit for families with children.** The rates and thresholds for the new tax credit will be set in Budget 2002;
- **taking further steps to extend the benefits of saving and asset-ownership by commencing Saving Gateway pilot schemes and launching further consultation on the Saving Gateway and Child Trust Fund;** and
- **announcing further steps to promote a modern and fair tax system by continuing to crack down on smuggling and fraud,** and replacing the current pools betting duty with a **new tax on pools companies' gross profits.**

DELIVERING HIGH QUALITY PUBLIC SERVICES

1.30 The Government's long-term goal is to establish world-class public services through significant and sustained increases in investment and reforms to ensure that taxpayers receive real value for money. Strong and dependable services are vital to extend opportunity, tackle social exclusion and improve people's quality of life. They are also fundamental in laying the foundations for a high productivity economy. High and stable levels of growth and employment provide the platform from which the Government is working to deliver lasting improvements in Britain's public services.

Measures so far 1.31 As described in Chapter 6, the Government has already taken important steps to improve Britain's public services, including:

- **introducing a new framework for controlling public spending** that provides greater certainty for long-term planning, removes past discrimination against investment, and delivers a sharper focus on the quality and outcome of public service provision;

- **allocating substantial increases in resources over three years in the 2000 Spending Review**, including average annual real growth of 5.6 per cent for education and 5.7 per cent for health and a doubling of public sector net investment. Departmental spending on services will be £50 billion higher in 2003–04 than it was in 2000–01; and
- **extending the principle of outcome-focused public service delivery to local government** by establishing stretching new targets with local authorities in return for greater freedoms, flexibilities and financial rewards if they succeed.

Next steps 1.32 By maintaining economic stability in difficult economic times, and ensuring that the fiscal rules are met, the Government is now laying the foundations for further, sustained increases in investment in Britain's public services to ensure that they deliver high standards throughout the country. The Government is now:

- publishing **Derek Wanless' interim report on the trends affecting the UK health service over the next two decades**. A consultation process will now seek views from patients and those who work in the service. The review will report to the Chancellor next year on the resources required for the health service over the next 20 years;
- **providing an additional £1 billion to the National Health Service in the UK in 2002–03** by reallocating resources from lower debt interest payments;
- **conducting a Spending Review, to be completed next year**, to determine how departments' programmes can most effectively deliver investment and modernisation in priority services and to establish new departmental annual spending plans up to and including 2005–06. The Pre-Budget Report describes the Government's priorities for the Review; and
- **publishing shortly a White Paper on modernising local government**, setting out steps to strengthen the delivery of high-quality, cost-effective local public services throughout the country.

PROTECTING THE ENVIRONMENT

1.33 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. But growth must not come at the expense of the environment or social progress. The Government is pursuing a far-reaching strategy to deliver its long-term goal of tackling climate change, and fulfilling its commitments under the Kyoto Protocol. To meet the challenge of sustainable development, it is also taking wider action to improve air quality, regenerate Britain's towns and cities and protect Britain's countryside.

Measures so far 1.34 Chapter 7 describes the Government's strategy for protecting and, where possible, enhancing the environment. In addition to environmental appraisal and evaluation of Budget policy measures, the Government has introduced significant policy measures to deliver its environmental objectives, including:

- **tackling climate change and air quality**: through the introduction of the climate change levy in April 2001 which is encouraging business to become more energy-efficient; significant reforms to car vehicle excise duty (VED) and to company car tax; a range of tax incentives to promote the use of greener fuels; launching the world's first economy-wide greenhouse gas emissions trading scheme in April 2002; and the launch of a Green Technology Challenge to encourage investment in certain environmentally-friendly technologies and products;

- **regenerating Britain's towns and cities:** with a major package of fiscal measures to support sustainable regeneration of urban areas, including targeted VAT reliefs and tax incentives for cleaning up contaminated land; and
- **protecting the countryside:** with continued annual increases in the standard rate of landfill tax, a new aggregates levy from April 2002 to tackle the environmental costs of quarrying, and continuing work to reduce the environmental impact of the use of pesticides.

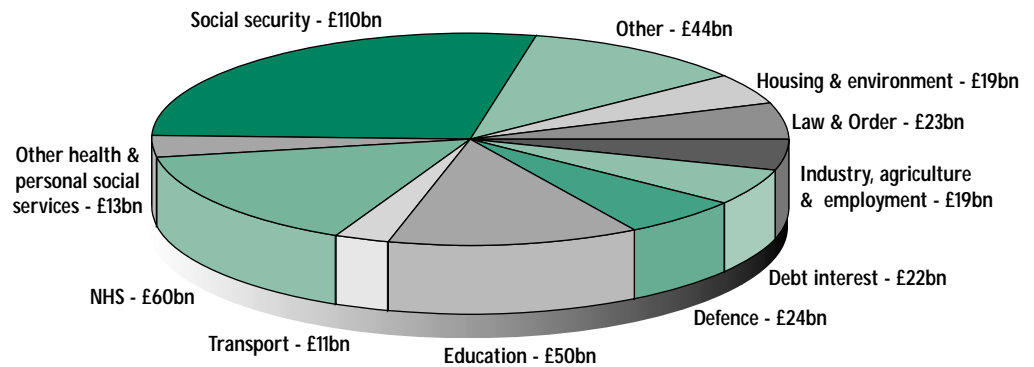
Next steps 1.35 The Pre-Budget Report sets out the next steps in the Government's strategy to protect and improve the environment. These include:

- responding to business through the Green Technology Challenge by announcing the next steps in **extending Enhanced Capital Allowances (ECAs) to encourage investment targeted at wider environmental objectives**, including energy-saving, cleaner vehicles and fuels, and water;
- **consulting on options for modernising road haulage taxation**, to ensure that hauliers contribute fairly to reducing the environmental impact of freight transport, irrespective of nationality, while ensuring that the UK haulage industry does not pay more as a result;
- continuing to pursue environmental reforms of vehicle taxation by **consulting on further measures, including changes to motorcycle VED and reforms to encourage cleaner vans**;
- launching shortly a proposed strategy for **promoting future road vehicles and fuels** by encouraging innovative and ground-breaking new low-carbon technologies; and
- following the Green Fuel Challenge, announcing support through **fuel duty concessions for three research projects into environmentally-friendly alternative road transport fuels**.

GOVERNMENT SPENDING AND REVENUES

Chart 1.1: Government spending by function

Total managed expenditure: £394 billion

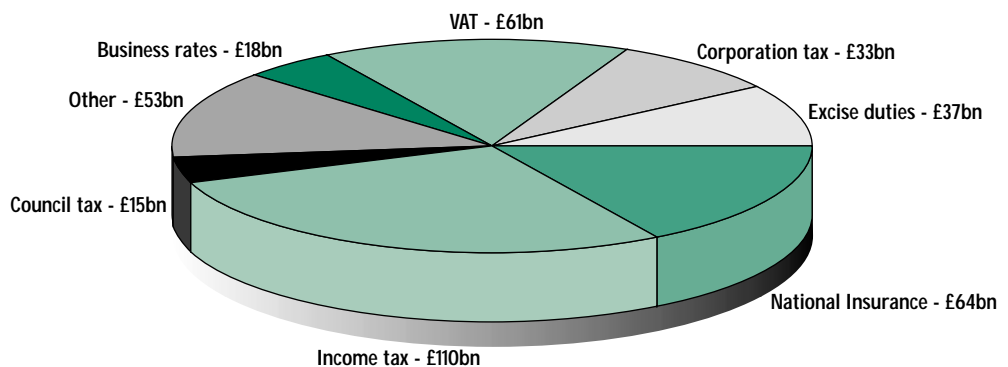


Source: HM Treasury, 2001–02 figures. Other expenditure includes spending on central administration, culture, media and sport, international cooperation and development and public service pensions, plus spending yet to be allocated and some accounting adjustments.

1.36 Chart 1.1 presents public spending by main function. Total public spending (Total Managed Expenditure – TME) is expected to be around £394 billion in the current financial year, 2001–02. TME is divided into Departmental Expenditure Limits (DEL), shown in Table B15, and Annually Managed Expenditure (AME), shown in Table B13. A number of DELs, especially those of the devolved administrations, contribute to spending on more than one function. Chart 1.1 also includes spending by local authorities, rather than the grants they receive from central government, which are included in Tables B13 and B15 in Annex B.

Chart 1.2: Government receipts

Total receipts: £391 billion



Source: HM Treasury, 2001–02 figures. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts (eg. interest and dividends).

1.37 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £391 billion in 2001–02. Table B11 provides a more detailed breakdown of receipts consistent with this chart.

