A strong and stable economy

Rebalancing the UK economy

1.1 Over the pre-crisis decade, developments in the UK economy were driven by unsustainable levels of private sector debt and rising public sector debt. Indeed, it has been estimated that the UK became the most indebted country in the world.¹

1.2 Chart 1.1 highlights the rise in private sector debt in the UK. Households took on rising levels of mortgage debt to buy increasingly expensive housing, while by 2008 the debt of non-financial companies reached 110 per cent of GDP. Within the financial sector, the accumulation of debt was even greater. By 2007, the UK financial system had become the most highly leveraged of any major economy. The level of public sector net debt as a share of GDP steadily rose from 2001-02, as the government ran a persistent structural deficit, despite continued economic growth.

1.3 Public and private sector borrowing relied on finance from abroad. The UK’s current account went from near balance in 1997 to a deficit of more than 3 per cent of GDP by 2006, which was, in absolute terms, the third largest in the world.

1.4 Increasing reliance on the financial sector and borrowing in the private and public sectors drove growing imbalances in the UK economy:

- Chart 1.2 shows that from 2001 onwards public spending grew steadily as a share of the economy and a structural deficit began to emerge. According to the OECD, by 2007 the UK had the largest structural deficit of any G7 economy. Moreover, the spending plans set out in the 2007 Comprehensive Spending Review were based on unsustainable revenue streams from the property boom and the financial sector. As tax receipts fell away during the crisis, the persistent gap between spending and revenue widened, with total public spending rising to around 47½ per cent of GDP by 2009-10; and

- higher public borrowing was used to finance increased public spending, driving up the price of public services, so that the proportion of the economy made up by government rose in the pre-crisis decade. By contrast, business investment as a percentage of GDP fell, leaving its share in the UK among the lowest in advanced economies.

1.5 Economic growth was unbalanced across the UK, concentrated in the South East, with some other parts of the country increasingly reliant on jobs funded by public spending. Growth relied on a limited number of sectors. Financial services’ share of GDP rose from 6½ per cent in 1997 to 8½ per cent in 2007, while manufacturing’s share nearly halved over the same period, from over 20 per cent to 12½ per cent.

¹ Debt and deleveraging: The global credit bubble and its economic consequences, McKinsey Global Institute, January 2010.
1.6 This model of growth proved to be unsustainable. More than a quarter of the GDP per capita growth in the pre-crisis decade to 2007 was reversed during the financial crisis and recession of 2008 and 2009. As the OECD concluded in its March 2011 Economic Survey of the UK:

“The global financial crisis and the associated recession ended a 15-year period of continuous growth, rising employment and stable inflation. Significant imbalances had developed, however, in terms of public and external deficits, an excessively leveraged financial sector, high house prices and low household savings. The imbalances exacerbated the downturn during the global recession and contributed to a more pronounced fall in GDP, a larger fiscal deficit and higher inflation than in most of the OECD.”

1.7 The level of UK economic activity in current prices (money GDP) is estimated to be around 10 per cent lower in 2010-11 than it was forecast to be at Budget 2008. In other words, the economy is now around 10 per cent smaller than it was forecast to be only three years ago, reducing the resources available for government spending.

The Government’s strategy

1.8 The Government’s economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries. Creating lasting prosperity requires the economy to change and to rebalance: from unsustainable public spending toward net trade and investment, which will support the UK’s long-term economic potential and help to create new jobs.

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Government policy has an important role to play in supporting the necessary rebalancing toward sustainable, private sector-led growth and minimising risks to the recovery. The Government has set out a strategic policy response to the UK’s exceptional economic and fiscal challenges:

- fiscal policy will bring the public finances back under control over the medium-term, addressing the largest budget deficit in the UK’s post-war history. It is essential to mitigate downside risks from rising public debt, promote stability and provide businesses with the confidence they need to invest;
- monetary policy will ensure price stability, and thereby support wider economic stability;
- reform of financial sector regulation will help to prevent the build-up of systemic risks and ensure financial stability, a pre-requisite for sustainable growth; and
- microeconomic policies will drive growth and position the UK at the forefront of the global economy, to meet the Government’s ambitions to: create the most competitive tax system in the G20; make the UK the best place in Europe to start, finance and grow a business; encourage investment and exports as a route to a more balanced economy; and create a more educated workforce that is the most flexible in Europe.

Fiscal policy

The current historically high level of public borrowing risks undermining fairness, growth and economic stability in the UK. Tackling the deficit is essential as it will:

- reduce the UK’s vulnerability to further shocks or a loss of market confidence, which could force a much sharper correction;
- underpin private sector confidence, supporting growth and job creation over the medium term;
- help keep long-term interest rates down, helping families and businesses through the lower costs of loans and mortgages;
- keep debt and debt interest paid by the Government – and ultimately the taxpayer – lower than would otherwise have been the case; and
- avoid accumulating substantial debts to fund spending that benefits today’s generation at the expense of tomorrow’s, which would be irresponsible and unfair.

June Budget 2010 set out comprehensive policies to bring the public finances back under control, demonstrating the Government’s determination to reduce public sector borrowing and debt and promote confidence in the sustainability of the public finances. The Government:

- set fiscal plans to restore the public finances to a sustainable position;
- created the new Office for Budget Responsibility (OBR), introducing independence, greater transparency and credibility to the economic and fiscal forecast on which fiscal policy is based; and
- announced a clear, forward-looking fiscal mandate to guide fiscal policy decisions over the medium term.
Fiscal consolidation plan

1.12 The Government’s fiscal consolidation plans have been designed with growth and fairness in mind, as far as possible:

- protecting the most productive public investment expenditure;
- avoiding punitive increases in tax rates on capital and labour; and
- reforming the welfare system to reward work.

1.13 As set out in Table 1.1, the Government plans a total consolidation of £126 billion a year by 2015-16, consisting of total reductions in spending of £95 billion and a net increase in taxes of £30 billion. Implementation of these plans is now underway. Under the plans that this Government inherited, £14 billion of spending cuts were planned in 2011-12, compared with 2010-11. This Government’s spending cuts amount to £16 billion over the same period.

1.14 Taking the consolidation as a whole, 73 per cent of the total will be delivered by lower spending in 2014-15, rising to 76 per cent in 2015-16. This is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that largely rely on spending restraint promote growth.3

Table 1.1: Total consolidation plans over the forecast period

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<td></td>
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<td>88</td>
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<td>126</td>
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<tr>
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<td>53</td>
<td>62</td>
<td>67</td>
<td>73</td>
<td>76</td>
</tr>
</tbody>
</table>

1 Spending consolidation is attributable to three factors. Reductions in DEL are calculated by assessing the latest nominal DEL totals (set out in Table 2.4) against a counterfactual of growing DELs in line with general inflation in the economy, as set out in Table 4.8 of the OBR’s pre-Budget forecast (June 2010). The reduction in AME is the net effect of AME policy changes announced since June Budget 2010. Finally, the spending reduction also includes estimated debt interest savings now updated for Budget 2011 debt interest forecast assumptions.

2 The spending share of the consolidation is lower across the forecast period than that set out in Table 1.1 of June Budget 2010. This is largely the result of updating the total consolidation savings attributable to AME policies in line with the OBR’s Budget 2011 AME forecast and the revision to the capital envelope at Spending Review 2010. (See Table 2.2 for updated costings of policy measures announced in Spending Review 2010 or earlier, but still to be implemented).

3 The Government has not set DELs for 2015-16. Figures shown above are based on the assumption that Total Managed Expenditure between 2014-15 and 2015-16 grows in line with inflation. (See Table 2.3 for the breakdown of Total Managed Expenditure across the forecast period).

4 The tax consolidation figure includes an updated costing for the pensions tax relief measure (see Table 2.2) and tax measures from the scorecard (see Table 2.1).

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1.15 Chart 1.2 shows that, as a result of these plans, public spending is projected by the OBR to fall from around 47½ per cent of GDP in 2009-10 to around 40 per cent of GDP by 2015-16, while tax receipts are projected to rise from 36½ to around 38½ per cent of GDP over the same period, addressing the imbalances in the public finances.

Source: Office for Budget Responsibility and Office for National Statistics.
Box 1.A: International consensus on fiscal consolidation

There is a broad international consensus that advanced economies should put in place and begin implementing credible medium-term fiscal consolidation plans this year, in order to underpin market confidence, promote private-sector recovery, and create space for fiscal policy in the face of future economic shocks. In February 2011, the G20 Finance Ministers and Central Bank Governors concluded that their “main priority actions include implementing medium term fiscal consolidation plans”, while in June 2010 they agreed “that consolidation will need to begin in advanced economies in 2011, and earlier for countries experiencing significant fiscal challenges.”

The IMF has noted the risk that “any renewed turbulence in sovereign debt markets could trigger an adverse feedback loop between sovereign debt markets and the financial sector, inflicting major damage on the recovery.”

In 2010, the UK had one of the highest budget deficits in the world; higher than in Greece, Portugal or Spain. The IMF has stated that “the initial state of public finances in the immediate aftermath of the crisis is a key determinant of the pace of consolidation.” As the chart below shows, the pace of fiscal consolidation in the UK this year is in line with that of other countries facing serious fiscal challenges. The US, in a unique position because of the role of the US dollar as the major reserve currency, plans to begin tightening in 2012, and at a faster pace than the UK based on IMF forecasts.

The IMF has endorsed the UK Government’s action as “essential” to ensure debt sustainability and concluded that it will help rebalance the economy. Similarly, the OECD’s view is that “the announcement and initial implementation of the fiscal consolidation programme strikes the right balance between addressing fiscal sustainability and thereby reducing tail-risks on the one hand, and preserving short-term growth on the other.”

Note: Based on the general government cyclically-adjusted overall balance. The most recent forecast by the IMF (January 2011) is used where possible. For those countries not included in this IMF publication, the IMF’s November forecast is used. The data points of G7 countries are marked in black. Data in calendar years.


2G20 Toronto Summit declaration, June 2010.
3World Economic Outlook, IMF, October 2010.
4IMF Fiscal Monitor, November 2010.
5IMF UK Article IV statement, September 2010.
Implementation of fiscal consolidation

1.16 Implementation of the Government’s fiscal plans is underway. The Government is on course to deliver the £6.2 billion of savings announced in May 2010.

1.17 Spending Review 2010 set firm and fixed departmental budgets for four years from 2011-12 to 2014-15, as well as announcing reforms to Annually Managed Expenditure (AME), including welfare and public service pensions. The Government protected spending on the NHS and overseas aid and also made choices to: prioritise fairness and social mobility; focus on spending that promotes long-term economic growth; and reform public services, to shift power away from central government to the local level and improve value for money.

1.18 The Government is implementing plans and reforms announced in the Spending Review. Legislation has been introduced to Parliament where necessary, including the Welfare Reform and Pensions and Savings Bills. Detailed funding settlements have also been announced, including for local government, schools and science.

1.19 The Government is committed to ensuring the spending consolidation is delivered. The Public Expenditure Cabinet Committee will oversee departments’ implementation of their Spending Review plans, holding them to account on their progress. Business plans for each department, setting out information on key reform programmes and performance data on public services, are being finalised this spring. The public will be able to monitor progress on plans through monthly reports and a quarterly performance scorecard for each department.

1.20 The Government has implemented the tax plans for 2011-12 announced or confirmed in June Budget 2010, including the increase in the standard rate of VAT to 20 per cent on 4 January 2011.

The fiscal policy framework

The Office for Budget Responsibility

1.21 The creation of the independent OBR has significantly enhanced the credibility of the UK’s fiscal policy. The IMF has welcomed the OBR as “addressing deficiencies in the previous Government’s fiscal framework” and “complementing the Government’s commitment to fiscal discipline”,4 while the OECD concluded “This is clearly an important initiative in terms of strengthening government management of public spending and improving public confidence in the government’s fiscal policy”.5

1.22 The OBR is now being placed on a permanent, statutory footing through the Budget Responsibility and National Audit Act 2011, which received Royal Assent on 22 March. The OBR has produced all the official forecasts of the economy and public finances since the General Election, independently of Ministers.

Fiscal objectives

1.23 To promote transparent fiscal policy-making, the new fiscal policy framework introduces a requirement for the Government to set out its fiscal policy objectives and fiscal mandate before Parliament in the Charter for Budget Responsibility. The Government published the Charter in draft on 22 November 2010. The Government’s fiscal policy objectives, presented in the Charter, are to:

- ensure sustainable public finances that support confidence in the economy, promote intergenerational fairness, and ensure the effectiveness of wider Government policy; and

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4 IMF UK Article IV Report, November 2010.
• support and improve the effectiveness of monetary policy in stabilising economic fluctuations.

The fiscal mandate and supplementary target for debt

1.24 The Government has set a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. At this Budget, the end of the forecast period is 2015-16.

1.25 The fiscal mandate is based on:

• the current balance, to protect the most productive public investment expenditure; and

• a cyclically-adjusted aggregate, to allow some fiscal flexibility at a time of economic uncertainty.

1.26 June Budget 2010 also announced a supplementary target for debt. This requires public sector net debt (PSND) as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are restored to a sustainable path.

1.27 The Government has asked the OBR independently to judge whether fiscal policy is consistent with: a greater than 50 per cent chance of meeting the mandate; and with a greater than 50 per cent chance of meeting the target for debt.

1.28 The choices of a five-year rolling forecast period for the fiscal mandate, supplemented by the fixed date for the debt target, reflect the exceptional environment in which the Government must address the fiscal challenge. They are designed to ensure that fiscal consolidation is delivered over a realistic and credible timescale. Once the public finances are closer to balance the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR’s assessment of the long-term sustainability of the public finances.

Monetary policy framework

1.29 In this Budget, the Government reaffirms the inflation target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times. The Monetary Policy Committee (MPC) of the Bank of England has full operational independence to set policy to meet the inflation target. The MPC has maintained Bank Rate at 0.5 per cent since March 2009, and undertaken a programme of asset purchases, through the Asset Purchase Facility, financed by the issuance of central bank reserves totalling £200 billion. The Government confirms in Budget 2011 that the Asset Purchase Facility will remain in place for the financial year 2011-12.

Financial regulation framework

1.30 The Government is implementing its plans to overhaul the tripartite system of financial regulation, by meeting its commitment to provide the Bank of England with:

• control of macro-prudential regulation, which relates to system-wide risks. The Government will legislate to create a Financial Policy Committee (FPC) within the Bank of England, with a clear macro-prudential remit to identify the risks that build up across the system as a whole and the power to ensure that action is taken to address those risks before they can threaten wider stability. An interim FPC was established in February 2011; and

• oversight of micro-prudential regulation, which focuses on risks within individual financial institutions. The Government will establish the Prudential Regulation Authority (PRA) as
a subsidiary of the Bank. The PRA will promote the safety and soundness of the financial institutions it regulates, minimising the wider economic impact should a firm fail.

1.31 The Government intends to introduce primary legislation in 2011 to implement these reforms.

Microeconomic policy to support growth

1.32 *The Plan for Growth,* published alongside this Budget, contains four overarching ambitions that will ensure progress is made towards achieving strong, sustainable and balanced growth. The ambitions are to:

- create the most competitive tax system in the G20;
- make the UK the best place in Europe to start, finance and grow a business;
- encourage investment and exports as a route to a more balanced economy; and
- create a more educated workforce that is the most flexible in Europe.

1.33 Each ambition is supported by a number of measurable benchmarks against which the Government expects to be judged. The Government will constantly benchmark the UK against best practice around the world.

Recent economic developments

1.34 Global developments, the legacy of the past economic imbalances that built up over recent years, and the action that the Government is taking to address them provides the backdrop to UK economic developments since June Budget 2010.

Global developments

1.35 The world economy returned to growth in 2010, with world GDP rising by 5 per cent over the year. However, this masks divergences across regions. In the major emerging markets, GDP and credit growth have rebounded rapidly. In advanced economies, such as the US and core euro area, recoveries have been more moderate and unemployment remains high. Growth in the euro area periphery has been hampered by sovereign debt crises. The UK is supporting Ireland through EU, IMF and bilateral packages. The G20 continue to work towards policy that delivers “strong, sustainable and balanced growth”.

1.36 Global financial markets have continued to experience volatility and heightened uncertainty in recent months, as a series of shocks have hit the global economy. Commodity prices have risen sharply, with dollar oil prices around 50 per cent higher than June last year, as shown in Chart 1.1, in part reflecting instability in the Middle East and North Africa. Stock markets gradually improved through the course of 2010, as the recovery in the world economy strengthened. In more recent weeks, markets have seen sharp falls following the devastating earthquake and tsunami in Japan. In response to volatility in the yen exchange rate associated with the events in Japan, the UK along with other G7 countries took part in a co-ordinated foreign currency intervention on 18 March 2011.

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6 *The Plan for Growth,* HM Treasury and Department for Business, Innovation and Skills, March 2011.
7 *World Economic Outlook update,* IMF, January 2011.
UK activity and rebalancing

1.37 In 2010, the UK economy grew by 1.3 per cent, but in line with previous recoveries, quarterly GDP growth has been choppy. Inflation has risen sharply, lifted by temporary factors such as a surge in global commodity prices and the effect of the 2008 depreciation of sterling on import prices. The labour market has shown signs of recovery with private sector employment growing by 428,000 over the course of 2010.

1.38 After four consecutive quarters of growth, the latest estimate from the Office for National Statistics (ONS) suggests GDP fell by 0.6 per cent in the final quarter of 2010. The estimated decline largely reflects the temporary effect of bad weather in December, although the ONS estimate of the underlying strength of the economy was still weaker than expected. The bad weather adds to the significant uncertainty in assessing the underlying strength of the economy.

1.39 The rebalancing of the economy appears to be underway:

- manufacturing output continues to expand rapidly. In 2010, manufacturing output grew by 3.6 per cent, its fastest rate since 1994;
- the value of UK goods exports rose by 17 per cent in 2010, supported by growth to emerging markets: exports of goods to China rose by more than 40 per cent over the year. Recent surveys point toward continued export growth in the coming months, with both the Confederation of British Industry (CBI) and the Chartered Institute of Purchasing and Supply (CIPS) measures of export orders above their long-run averages; and
- business investment fell very sharply through the recession, but has started to recover and at an earlier stage than in previous recoveries. According to the latest estimate from the ONS, business investment has grown by nearly 7 per cent since the third quarter of 2009. Survey measures of investment intentions have strengthened, as shown in Chart 1.4. The reductions in the rate of corporation tax and healthy financial position of UK companies in aggregate should help support further investment growth.

All data from the Office for National Statistics unless otherwise stated.
Output in the services sector, which constitutes around three quarters of the economy, rose by 1.1 per cent in 2010. Construction output rose by 5.6 per cent in 2010, although quarterly output data, which can be volatile, has been uneven. Both the construction and services sectors were affected by the bad weather in December, but survey measures point to recovery at the start of this year.

Credit conditions have shown signs of stabilisation. Reports from the Bank of England Agents suggest credit availability for larger companies has improved and the cost of credit has decreased. However, credit conditions for smaller firms remain tight. According to the latest Bank of England Credit Conditions Survey, the availability of secured credit to households remained broadly unchanged over the second half of 2010. Net secured lending to households has remained stable, albeit at low levels.

In February 2011, the five largest banks operating in the UK (Barclays, HSBC, Lloyds Banking Group, The Royal Bank of Scotland and Santander) agreed to make £190 billion of new credit available to businesses this year. Of this total, £76 billion will be made available to small and medium-sized enterprises (SMEs), £10 billion more than the banks lent to SMEs in 2010.

**Labour market**

Employment has started to recover, in line with the rise in activity. While public sector employment began to fall from December 2009, and was down by 132,000 in the year to December 2010, private sector employment rose by 428,000. Consistent with this, redundancies have fallen to their lowest level since August 2008. The ILO unemployment rate rose slightly in the three months to January, to 8.0 per cent. The claimant count fell in February 2011 and is down by almost 130,000 on a year earlier.
1.44 Excluding the effect of bonus payments, whole economy earnings growth picked up progressively through 2010, but remains subdued by historical standards.

Inflation

1.45 Recent months have seen a large and unexpected surge in commodity prices. Since the summer of 2010, world agricultural commodity prices have risen by over 50 per cent,\(^{10}\) while sterling oil prices have increased by around 40 per cent. These global developments along with other temporary factors, including the lagged effects of the 2008 depreciation of sterling, helped to push up inflation over the past year. CPI inflation was 4.4 per cent in February 2011. In its latest Inflation Report,\(^{11}\) the Bank of England estimated that, excluding the contribution of these temporary factors, prices of other goods and services have on average increased at a rate below the inflation target in 2010 and that import prices, energy prices, and the increases in the standard rate of VAT together could be adding between 2 to 4 percentage points to CPI inflation in the final quarter of 2010.

Budget decisions

A fiscally neutral budget

1.46 Fiscal consolidation is necessary to reduce risks in the short term, restore private-sector confidence and underpin sustainable economic growth. Budget 2011 takes place against a backdrop of ongoing global economic uncertainty in the wake of the financial crisis, including from ongoing sovereign debt concerns, most apparent in the euro area periphery, and continued adjustment in the global financial sector. This uncertainty reinforces the case for stability in the Government’s plans for fiscal consolidation:

- as Box 1.B sets out, delivering the Government’s fiscal consolidation plan is essential to reduce the risks of a costly loss of market confidence in UK fiscal sustainability. There is evidence that the Government’s fiscal plans are delivering improved market confidence;

- a consistent approach from Government in tackling the UK’s large structural deficit provides much needed stability and certainty for businesses making hiring and investment decisions; and

- in the current context, stepping back from the Government’s commitment to fiscal consolidation would, other things equal, risk prompting an offsetting monetary tightening such that overall there would be little, if any, net support to economic activity even in the short-term.

1.47 Previous UK and international experience demonstrates that fiscal consolidation can be achieved alongside continued economic growth. The evidence from the fiscal tightening currently underway in the UK supports this conclusion. Table 1.3 shows Treasury estimates, based on the OBR’s forecast, of the cyclically-adjusted primary balance, a measure that excludes the effects of the cycle and debt interest payments on the deficit and so illustrates the underlying fiscal position. This measure tightened by 2.3 per cent of GDP in 2010-11, compared with a year earlier, while the economy returned to growth of 1.3 per cent in 2010. In 2011-12, the projected tightening in the cyclically-adjusted primary balance is of an equivalent scale, at 2.2 per cent of GDP, and the economy is forecast to grow by 1.7 per cent in 2011.

1.48 The OBR forecasts public sector net borrowing to fall from its post-war peak of 11.1 per cent of GDP in 2009-10 to 9.9 per cent of GDP in 2010-11. This fall is largely as a result of the implementation of consolidation measures, including in-year reductions in spending and increases in VAT. The OBR forecasts borrowing to fall further to 7.9 per cent of GDP in 2011-12, which is still above the previous post-war peaks seen in the early 1990s and mid-1970s.

\(^{10}\) As of mid March, according to the S&P GSCI Agricultural Index.

Over the medium term, while the OBR forecasts for borrowing and debt are slightly higher than in June Budget 2010, their estimate of the path of the cyclically-adjusted current balance is broadly unchanged. This unchanged outlook for the underlying fiscal position, combined with the significant ongoing uncertainty in the outlook, demonstrates the need to stay the course of planned structural consolidation in the public finances.

1.49 **Budget 2011 discretionary policy decisions have a neutral impact on the public finances.** The costs of policy decisions announced in this Budget are broadly offset in each year by measures to raise revenue. This balanced judgement reinforces the fiscal consolidation plans announced at June Budget 2010 and Spending Review 2010. Further detail is provided in the Growth and Fairness sections of this chapter, and in Chapter 2.

**Debt and reserves management**

1.50 The *Debt and Reserves Management Report 2011-12,* published alongside the Budget, sets out details of the Government’s financing plans for 2011-12, which are also summarised in Annex B. The projection for the Net Financing Requirement (NFR) in 2011-12 is £167.4 billion. This will be met by gross gilt sales of £169.0 billion and a reduction in the Treasury bill stock of £1.6 billion. Financing for 2011-12 will provide £6.0 billion of financing for the Official Reserves. The Government envisages sterling financing for the Official Reserves being held at a similar level on average over the three years up to, and including, 2014-15. This sterling financing will be sufficient to meet potential calls on the Official Reserves from the IMF and ensure the level of foreign currency reserves is sufficient. The Government retains the option of issuing foreign currency denominated securities. Following any such issuance, sterling financing for the reserves would be adjusted accordingly.

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Box 1.B: Market confidence in fiscal sustainability

Events in the euro area periphery illustrate the problems that can be caused by heightened market concerns regarding fiscal sustainability. A key lesson from recent events is that once market sentiment turns against a sovereign issuer, it is extremely difficult to regain. Retaining fiscal credibility is therefore critical. The IMF has said that “The vulnerability of sovereigns emphasizes the urgency of moving toward more sustainable fiscal paths—not just by countries in the euro area periphery, but also by major advanced economies.”

While there are many factors that affect relative bond yields across countries, one of these is markets’ assessment of fiscal risk. Over the past year, the premium paid on some countries’ government debt has risen sharply. This is indicated by a widening of the spread of their bond yields over German bunds. For example, between 3 May 2010 and 22 March 2011, Spain’s spread increased by around 100 basis points.

By contrast, there is evidence that the Government’s fiscal plans have improved market confidence in the UK. As the chart below shows, the spread of UK gilt rates to German bunds has fallen since May 2010. As a result, while in May 2010 the spread of UK gilts to German bunds was around the same level as that of Spain and Italy, the UK’s spread is now significantly lower than those countries’. Following the October Spending Review 2010, the credit rating agency Standard and Poor’s restored the UK’s AAA rating to a stable outlook. Maintaining a low risk premium on UK gilts will benefit the wider economy through lower interest rates faced by households and businesses than would otherwise be the case.

Note: Spread to bunds is the difference between the ten-year German bund yield and the ten-year benchmark bond yield in basis points.
Source: Bloomberg.
*a World Economic Outlook update, IMF, January 2011.*
Reform of the spending framework

1.51 Delivering the Government’s spending plans will require a more robust framework for spending control, given the scale of the challenge. The current framework splits expenditure into Departmental Expenditure Limits (DEL), which are fixed departmental budgets, and Annually Managed Expenditure (AME), which is not subject to such firm control. The Government is therefore considering options for strengthening control over AME by increasing the amount of spending that is managed within fixed budgets. This will improve incentives to manage AME, in particular social security spending which is the most significant component. Further detail will be set out by the summer.

1.52 This Budget announces that a new Budget Exchange system will be introduced in 2011-12, to replace the End-Year Flexibility system. Further details are set out in Chapter 2. In addition, the Government is introducing a new framework to manage DECC’s levy-funded spending, in order to cap the total impact of these policies on energy bills.

Action to address long-term fiscal pressures

1.53 The Budget also announces action to address longer-term fiscal pressures, in particular those arising from an ageing population. The Government has already taken significant action to address future fiscal pressures arising from demographic change, including bringing forward the rise in the State Pension Age (SPA) from 65 to 66 to 2020 from 2026.

1.54 This Budget announces further measures to address long-term spending pressures, setting out the Government’s initial response to the final report of the Independent Public Service Pensions Commission, and announcing that the Government will bring forward proposals to manage future increases in the State Pension Age more automatically in response to increases in longevity, including through a regular independent review of the implications of longevity changes.

1.55 The decisions the Government is taking to strengthen the tax system – including the increase in VAT announced at June Budget 2010, the move to CPI indexation of the benefit and direct tax system, and the introduction of the carbon price floor announced at this Budget – will also help to support the long-term sustainability of the public finances. More detail is provided in the Growth and Fairness sections of this chapter, and in Chapter 2.

1.56 The OBR will publish its first fiscal sustainability report in July, which will provide a full analysis of the long-term sustainability of the UK’s public finances.

Economic and fiscal forecast

1.57 Table 1.2 provides a summary of the OBR’s central economic forecast. Annex C reproduces key tables from the OBR’s economic and fiscal forecast. Further information is provided in the OBR’s March 2011 Economic and fiscal outlook, published alongside this Budget.13

Economic prospects

1.58 The OBR forecast is for a gradual recovery, as the legacy of unbalanced growth and excessive levels of debt continue to weigh on the economic outlook. The economy is forecast to grow by 1.7 per cent in 2011, lower than forecast in the June Budget. This mainly reflects higher-than-expected inflation this year, as a result of recent global commodity prices shocks, and the weak, weather-affected final quarter of 2010. GDP growth is then forecast to strengthen, with growth peaking at 2.9 per cent in 2013. Table 1.2 shows the forecast for GDP and contributions to growth.

13 Economic and fiscal outlook, OBR, March 2011.
### Table 1.2: Summary of OBR’s central economic forecast

<table>
<thead>
<tr>
<th></th>
<th>Pre-crisis decade average contribution</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross domestic product</strong></td>
<td>2.9</td>
<td>1.3</td>
<td>1.7</td>
<td>2.5</td>
<td>2.9</td>
<td>2.9</td>
<td>2.8</td>
</tr>
<tr>
<td><strong>Main contributions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private consumption</td>
<td>2.1</td>
<td>0.5</td>
<td>0.4</td>
<td>0.8</td>
<td>1.2</td>
<td>1.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Business investment</td>
<td>0.6</td>
<td>0.2</td>
<td>0.6</td>
<td>0.8</td>
<td>1.1</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Dwellings investment</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Government</td>
<td>0.6</td>
<td>0.4</td>
<td>-0.2</td>
<td>-0.5</td>
<td>-0.5</td>
<td>-0.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>Change in inventories</td>
<td>0.0</td>
<td>1.4</td>
<td>0.2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Net trade</td>
<td>-0.6</td>
<td>-0.9</td>
<td>0.7</td>
<td>1.0</td>
<td>0.7</td>
<td>0.6</td>
<td>0.5</td>
</tr>
<tr>
<td>CPI inflation (Q4)</td>
<td>3.4</td>
<td>3.9</td>
<td>2.2</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
</tr>
</tbody>
</table>

1. See OBR’s March 2011 Economic and Fiscal Outlook for further details. All figures in this table are rounded to the nearest 1 decimal place. This is not intended to convey a degree of unwarranted accuracy. Components may not sum to total due to rounding, omission of transfer costs of land and existing buildings, and the statistical discrepancy.

2. The average contribution to real GDP growth between 1997 and 2007. In 2006, private consumption accounted for 64 per cent of GDP, business investment for 10 per cent, dwellings investment for 6 per cent, Government for 23 per cent and change in inventories for less than 1 per cent. As explained in paragraph 1.6, more than a quarter of the GDP per capita growth in the pre-crisis decade to 2007 was reversed during the financial crisis and recession of 2008 and 2009.

3. The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.

4. The sum of government consumption and general government investment.

**Source:** Office for Budget Responsibility and Office for National Statistics.

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### Rebalancing the economy

1.59 As set out earlier in the chapter, significant imbalances in the UK economy built up during the pre-crisis decade. The OBR are forecasting the economy to rebalance, away from private and government consumption towards net trade and investment. As Table 1.2 shows:

- the contribution of private consumption to growth is lower over the forecast period than in the pre-crisis decade. The contribution of government consumption is also forecast to be lower;

- business investment is forecast to grow by between 6½ to 11 per cent in each year over the forecast, and as a result its contribution to growth picks up to over 1 percentage point per year. However, business investment does not return to its pre-recession peak until the third quarter of 2013. This is almost a year later than whole economy output (GDP), and in line with previous recoveries; and

- having made a negative contribution on average through the pre-crisis decade, net trade is forecast to make a significant positive contribution to growth throughout the forecast period, with UK exporters continuing to gain market share into 2013.

1.60 Chart 1.5 shows that as a result of these trends the share of private consumption and government consumption in the economy is forecast to fall and the share of net trade and total investment to rise.
Trend output

1.61 The OBR’s assessment of trend output growth, including the assumption of a constant structural unemployment rate of around 5¼ per cent, remains unchanged. The OBR’s judgement is that the trend rate of growth is projected to be 2.35 per cent, falling back to 2.10 per cent from 2014 as demographic changes reduce the growth of potential labour supply. Based on the latest evidence from cyclical indicators, the output gap is judged to have been around -3 per cent in the third quarter of 2010.
Fiscal prospects

1.62 Table 1.3 provides a summary of the OBR’s central forecast for the public finances.

Table 1.3: Overview of OBR central fiscal forecast

<table>
<thead>
<tr>
<th></th>
<th>Per cent of GDP</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deficit</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public sector net borrowing</td>
<td>11.1</td>
<td>9.9</td>
<td>7.9</td>
<td>6.2</td>
<td>4.1</td>
<td>2.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Surplus on current budget</td>
<td>-7.6</td>
<td>-7.1</td>
<td>-5.8</td>
<td>-4.5</td>
<td>-2.7</td>
<td>-1.2</td>
<td>-0.2</td>
</tr>
<tr>
<td>Primary balance</td>
<td>-9.2</td>
<td>-7.1</td>
<td>-5.0</td>
<td>-3.5</td>
<td>-1.3</td>
<td>0.3</td>
<td>1.3</td>
</tr>
<tr>
<td>Cyclically-adjusted net borrowing</td>
<td>8.9</td>
<td>7.4</td>
<td>5.3</td>
<td>3.7</td>
<td>2.0</td>
<td>1.0</td>
<td>0.5</td>
</tr>
<tr>
<td>Cyclically-adjusted surplus on current budget</td>
<td>-5.3</td>
<td>-4.6</td>
<td>-3.2</td>
<td>-2.0</td>
<td>-0.6</td>
<td>0.4</td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Total policy decisions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Treaty Deficit²</td>
<td>11.4</td>
<td>9.8</td>
<td>7.9</td>
<td>6.2</td>
<td>4.1</td>
<td>2.6</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public sector net debt³</td>
<td>52.7</td>
<td>60.3</td>
<td>66.1</td>
<td>69.7</td>
<td>70.9</td>
<td>70.5</td>
<td>69.1</td>
</tr>
<tr>
<td>Treaty Debt ratio⁴</td>
<td>71.2</td>
<td>78.7</td>
<td>84.1</td>
<td>87.0</td>
<td>87.2</td>
<td>85.7</td>
<td>83.5</td>
</tr>
<tr>
<td><strong>Output Gap</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>-4.2</td>
<td>-3.4</td>
<td>-3.9</td>
<td>-3.5</td>
<td>-2.8</td>
<td>-2.0</td>
<td>-1.3</td>
</tr>
<tr>
<td><strong>Memo: HMT estimate of cyclically-adjusted primary balance</strong></td>
<td></td>
<td>-6.9</td>
<td>-4.6</td>
<td>-2.4</td>
<td>-0.9</td>
<td>0.8</td>
<td>1.9</td>
</tr>
</tbody>
</table>

1 Equivalent to the ‘Total policy decisions’ line in Table 2.1.
2 General government net borrowing on a Maastricht basis.
3 Debt at end March; GDP centred on end March.
4 General government gross debt on a Maastricht basis.
5 This is a Treasury estimate of the cyclically-adjusted primary balance. It has been calculated by applying the cyclical-adjustment methodology set out in Public finances and the cycle: Treasury Economic Working Paper No.5 (November 2008), which the OBR also use for their forecast of cyclically-adjusted aggregates.

Source: Office for National Statistics, Office for Budget Responsibility, and HM Treasury

1.63 Taking account of the policy measures announced by the Government, the OBR projects that:

- public sector net borrowing will decline from its peak of 11.1 per cent of GDP in 2009-10 to 7.9 per cent of GDP in 2011-12, still higher than its peak in the 1990s recession, and then to 1.5 per cent of GDP in 2015-16;
- the cyclically-adjusted or ‘structural’ current deficit will be eliminated by 2014-15, with a projected surplus of 0.4 per cent of GDP in that year, rising to 0.8 per cent of GDP in 2015-16; and
- public sector net debt will peak at 70.9 per cent of GDP in 2013-14, before declining to 70.5 per cent of GDP in 2014-15 and 69.1 per cent of GDP in 2015-16.

1.64 The OBR’s latest forecast shows that the outlook for the public finances is broadly unchanged since June Budget 2010. Public sector net borrowing this year is slightly lower than forecast in June and November, largely as a result of lower than expected public spending. The forecast for public sector net borrowing is slightly higher over the medium term, by 0.5 per cent of GDP in 2015-16, compared with the June Budget. This reflects the OBR’s higher forecast for inflation, which results in higher projected AME expenditure on debt interest and social security payments, and also a slightly weaker short-term outlook for economic growth compared with June Budget 2010. However, the OBR’s judgement is that this increased borrowing is largely temporary, cyclical borrowing that will reduce automatically as the economy returns to trend.
This means that the forecast for the structural position of the public finances, as measured by the cyclically-adjusted current balance, is broadly unchanged since the June Budget 2010, although slightly lower than estimated in November.

**Performance against the mandate**

1.65 Charts 1.6 and 1.7 show performance against the Government’s fiscal mandate and the supplementary debt target.

1.66 As set out in the OBR’s March 2011 *Economic and fiscal outlook* the OBR’s judgement is that the policies set out in this Budget are consistent with a greater than 50 per cent chance of achieving the Government’s fiscal mandate. Based on past forecasting performance and their central forecast, the OBR estimates that there is a roughly 70 per cent probability that the Government’s fiscal mandate will be met.

1.67 It is also the OBR’s assessment that the Government’s policies have a greater than 50 per cent chance of meeting the target for debt in 2015-16.

1.68 As the OBR has highlighted, all forecasts are subject to uncertainty, but this applies in particular to fiscal forecasts at the present time. Recognising this, the Government has set policy to achieve a surplus on the cyclically-adjusted current budget, so that moderate shocks can be absorbed should they arise. The OBR’s central Budget forecast is for the fiscal mandate to be achieved in 2014-15, a year early. The forecast also shows the debt target being achieved a year early in 2014-15.

**Performance against EU obligations**

1.69 Following the measures the Government has taken, the path set for fiscal policy is now consistent with the UK meeting the European Union’s Excessive Deficit Procedure recommendation to reduce the Treaty deficit below 3 per cent of GDP in 2014-15. The OBR projects that the Treaty deficit will fall from 11.4 per cent of GDP in 2009-10 to 2.6 per cent of GDP in 2014-15, and that the Treaty debt ratio will be restored to a downward path from 2014-15.
Chart 1.6: Consolidation in the cyclically adjusted current budget

Note: The OBR pre-Budget forecast 2010 contained projections to 2014-15. The March Budget 2010 assumed further consolidation to 2016-17 based on the average change in the cyclically-adjusted current balance between 2009-10 and 2014-15. This Budget forecasts to 2015-16.

Source: Office for Budget Responsibility, HM Treasury and Office for National Statistics.

Chart 1.7: Public sector net debt

Source: Office for Budget Responsibility and Office for National Statistics.
Growth

1.70 This section sets out the policy actions that the Government is taking to support balanced economic growth and job creation. The Government has already taken decisive action to reduce the deficit and restore economic stability, the essential foundation for rebalancing the UK economy. Building on this earlier action, The Plan for Growth announces measures to achieve four overarching ambitions for the British economy:\(^{14}\)

- to create the most competitive tax system in the G20;
- to make the UK the best place in Europe to start, finance and grow a business;
- to encourage investment and exports as a route to a more balanced economy; and
- to create a more educated workforce that is the most flexible in Europe.

To create the most competitive tax system in the G20

1.71 The Government is committed to creating a tax system that is more efficient and supportive of growth; more certain and predictable; simpler and easier to comply with; fairer with greater reward for work and aspiration; and with stronger incentives for investment and enterprise.

1.72 During 2010, the Government consulted on improvements to tax policy making. As part of this, draft clauses of Finance Bill 2011 were published for consultation in autumn 2010 and the Government’s final approach to these clauses is confirmed in this Budget. The tax policy changes in this Budget are consistent with this improved approach.

Tax competitiveness

1.73 The Government has published its Corporate Tax Road Map in support of its aim to create the most competitive tax system in the G20.\(^{15}\) This includes the four annual 1 per cent reductions in the main rate of corporation tax and the decrease in the rate applicable to small profits from 21 per cent to 20 per cent announced at the June Budget 2010.

1.74 This Budget announces that the Government will reduce the main rate of corporation tax by a further 1 per cent. From April 2011, the rate will be reduced from 28 per cent to 26 per cent and, by 2014, it will reach 23 per cent. This will promote higher levels of business investment. It will help the UK maintain the lowest rate in the G7. To offset the benefits to banks from the further cut in corporation tax, the rate of the Bank Levy will increase to 0.078 per cent from 1 January 2012.

1.75 In addition, this Budget confirms that the Government will:

- introduce new Controlled Foreign Company (CFC) rules in Finance Bill 2012 to allow groups based in the UK to compete more effectively with those based overseas, while protecting against the artificial diversion of UK profits. A further consultation document will be published in May 2011, followed by draft legislation in autumn 2011. The new rules will include a finance company partial exemption that, in broad terms, results in an effective UK tax rate of one quarter of the main rate on profits derived from overseas group financing arrangements (equivalent to 5.75 per cent by 2014). This will be preceded by interim improvements to the current CFC rules in Finance Bill 2011 for accounting periods beginning on or after 1 January 2011 to make the rules easier to operate ahead of full reform;

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\(^{14}\) The Plan for Growth, HM Treasury and Department for Business, Innovation and Skills, March 2011.

\(^{15}\) Corporate Tax Reform: delivering a more competitive system, HM Treasury, November 2010.
• publish further consultation on the introduction of a patent box in May 2011 setting out details on how the regime will operate, followed by draft legislation in autumn 2011. The Patent Box will provide a reduced 10 per cent corporate tax rate for profits from patents, which will encourage UK businesses to retain high-value jobs associated with commercialisation of patents and to invest further in innovation; and

• introduce an opt-in exemption from corporation tax on the profits of foreign branches of UK companies in Finance Bill 2011. This will contribute to the Government’s aim of a more territorial corporate tax system and help make the UK a more competitive location for international businesses.

Tax simplification

1.76 The Government announces measures to address complexity in the tax system aimed at easing the burden of tax compliance for businesses and individuals. Based on the recommendations of the Office of Tax Simplification’s (OTS) review of tax reliefs, and continuing work by HMRC, the Government intends to abolish 43 tax reliefs whose rationale is no longer valid (see Chapter 2 for a full list). This will help to reduce complexity and will mean the removal of over 100 pages of tax legislation.

1.77 The Government believes that integrating the operation of income tax and National Insurance Contributions (NICs) can remove distortions, reduce burdens on business and improve fairness. However, it recognises that any change will be complex and involve a wide range of policy and implementation issues. The Government will consult this year on the options, stages and timing of reform. It will maintain the contributory principle and will reflect this in any changes it brings forward. In addition, the Government will not extend NICs to individuals above State Pension Age or to other forms of income such as pensions, savings and dividends.

1.78 Following publication of the OTS review of small business tax,16 the Government commits to making clear improvements in the way IR35 is administered (see Chapter 2 for detail).17 The Government has decided to retain IR35 as abolition would put substantial revenue at risk.

1.79 As part of the second stage of the OTS review of small business tax, the OTS will look at improving tax administration for small business, with recommendations to the Government for Budget 2012. Further detail on this work, the Government’s response to OTS reviews, and future work of the OTS will be announced before summer 2011.

1.80 The Government also recognises the importance of having an effective system for administering personal taxes. To complement its investment in real time information for the PAYE system, the Government will consult in 2011 on modernising the administration of the personal tax system to make it more transparent and accessible to individual taxpayers.

To make the UK the best place in Europe to start, finance and grow a business

Deregulation

1.81 The Government has taken action to reduce the disproportionate cost of business regulations including through introducing a ‘One-in-One-out’ system, but recognises there is

16 Small business tax review, Office of Tax Simplification, March 2011.
17 The intermediaries legislation, known by the original press release number “IR35”, came into force on 6 April 2000. The objective of the legislation is to ensure that, where an individual provides services to an end user through an intermediary and the circumstances are such that he or she would have been viewed as an employee of the end user if he or she had been engaged directly, the income received is subject to tax and NICs as employment income.
more to be done. To address this, alongside a substantial package of sectoral deregulation, the Government will:

- **drop existing proposals for specific regulations which would have cost business over £350 million a year to implement.** This includes not extending the right to request time to train to businesses with less than 250 employees and not bringing forward the dual discrimination rules;

- **introduce a moratorium exempting micro-businesses and start-ups from new domestic regulation for three years from 1 April 2011;**

- **implement the proposals from Lord Young’s review of Health and Safety; and**

- **launch a public thematic review to reduce the stock of regulation.** The presumption will be that all regulations identified as burdensome would be removed unless good reasons are given for them to stay.

**Planning reform**

1.82 The planning system has held back investment and created distortions in the way that businesses compete, deterring development and growth. To address this, the Government will:

- **introduce a new presumption in favour of sustainable development, so that the default answer to development is ‘yes’;**

- **localise choice about the use of previously developed land, removing nationally imposed targets while retaining existing controls on greenbelt land;**

- **pilot a land auction model, starting with public sector land;**

- **introduce a number of measures to streamline the planning applications and related consents regimes removing bureaucracy from the system and speeding it up. This will include a 12 month guarantee for the processing of all planning applications, including any appeals;**

- **ensure a fast-track planning process for major infrastructure applications through the Major Infrastructure Planning system; and**

- **consult on proposals to make it easier to convert commercial premises to residential.**

1.83 To accelerate the release of public sector land to support homes and jobs, the Government will work with local authorities to expedite planning decisions for surplus military land and other public sites suitable for housing, also testing ‘build now, pay later’ techniques to quicken delivery. Together with the new presumption in favour of sustainable development, these proposals will potentially allow the Ministry of Defence to realise up to £350 million of estate disposals and enable delivery of up to 20,000 new homes by 2014-15.

**Start-up finance and business growth**

1.84 To encourage investment in businesses with high growth potential, the Government announces reform of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts, subject to State aid approval, including raising the rate of EIS income tax relief to 30 per cent from April 2011. From April 2012, the limits on the size of qualifying companies and on the amounts companies can receive and individuals can invest will increase, and the schemes will be refocused to better target risk. The Government will also bring forward proposals to provide further support for seed investment. Further details are set out in Chapter 2.

1.85 Effective from 6 April 2011, the lifetime limit on capital gains qualifying for Entrepreneurs’ Relief (where eligible gains are taxed at a 10 per cent rate of Capital
Gains Tax) will be doubled to £10 million. This will encourage serial entrepreneurs who want to expand their business and reinvest gains, helping to make the UK a more attractive location for entrepreneurs.

1.86 Business rates can be a significant cost, particularly for smaller businesses. The Government announces that the small business rate relief holiday will be extended by one year from 1 October 2011.

1.87 The Government will reduce the Low Value Consignment Relief (LVCR) threshold from £18 to £15 from November 2011. In addition, the Government will explore options with the European Commission to limit the scope of the relief so that it can no longer be exploited for a purpose it was not intended for. The Government will also revisit the level of the LVCR in Budget 2012, if discussions with the European Commission do not produce a workable solution to the problem of exploitation of the relief.

Banking

1.88 In February 2011, the five largest banks operating in the UK (Barclays, HSBC, Lloyds Banking Group (LBG), The Royal Bank of Scotland (RBS) and Santander) agreed to make £190 billion of new credit available to businesses this year. Of this total, £76 billion will be made available to SMEs, £10 billion more than the banks lent to SMEs in 2010. This Budget announces that both LBG and RBS met their Year Two commitments for business and mortgage lending (see Chapter 2 for detail).

1.89 Following discussions between Government and the banks, the aggregate 2010 bonus pool for the UK-based staff of Barclays, HSBC, LBG and RBS will be lower than it was in 2009. These banks have also committed to world-leading pay disclosure arrangements which, when taken together with the FSA’s sector-wide regime, make the UK’s disclosure arrangements the most transparent of any major financial centre. The Government intends to consult on a proposal to extend these disclosure arrangements to all large banks from 2012 onwards.

1.90 From January 2012, the Government will increase the rate of the Bank Levy, a permanent tax on banks’ balance sheets which, with the increase announced previously for 2011, is now expected to raise £10 billion over the lifetime of this Parliament. The increase in the rate from January 2012 offsets the further reduction in the rate of corporation tax announced in this Budget. This change will ensure that banks continue to make a fair contribution while also ensuring that they continue to be encouraged to move to less risky funding models. The Bank Levy will raise over £2.5 billion each year, as compared with the one-off net yield of £2.3 billion from the bank payroll tax.

1.91 The Code of Practice on Taxation for Banks ensures that banks follow the spirit as well as the letter of the law and encourages banks to moderate their tax planning. Two hundred banks have now adopted the Code, including the top 15 banks operating in the UK.

Innovation

1.92 As well as introducing the Patent Box, the Government reaffirms its commitment to research and development (R&D) tax credits. Following consultation, the Government announces:

- an increase in the SME rate of R&D tax credit to 200 per cent from April 2011, and 225 per cent from April 2012, subject to State aid approval; and

- simplification of the R&D tax credit schemes (see Chapter 2 for detail).

1.93 The Government will invest an additional £100 million in 2011-12 in science capital development to provide facilities for the commercialisation of research, accommodation for innovative SMEs and new research capabilities.
The Government will launch the first Technology and Innovation Centre in high value manufacturing which will integrate the activities of a number of existing high performing centres in Rotherham, Coventry, Strathclyde, Sedgefield, Redcar and Bristol.

To encourage investment and exports as a route to a more balanced economy

Investment

To encourage investment in plant and machinery, the Government announces that, from April 2011, the limit on the capital allowances short life assets election will be extended from four to eight years, more closely aligning tax and economic depreciation. It will also extend the Business Premises Renovation Allowance for a further five years from 2012, providing relief on renovation of business premises in assisted areas.

Infrastructure

Over the next four years, the Government will invest over £30 billion in transport projects, which is more than was invested during the past four years. This Budget announces £200 million of new funding for rail projects.

The Government announces £100 million of funding for local authorities to repair potholes caused by the exceptionally cold winter, funded from within existing budgets. This is in addition to the £100 million announced in February 2011.

To give industry the confidence to invest in economic infrastructure, the Government will publish the UK’s long-term forward view of projects and programmes in autumn 2011 as part of the National Infrastructure Plan. The Government will also enable building contractors to respond more effectively to emerging market opportunities by publishing quarterly, from autumn 2011, a rolling two-year forward programme of infrastructure and construction projects where public funding has been agreed.

Trade and inward investment

UK Trade and Investment (UKTI) will make better use of private sector expertise and talent with a clear focus on winning business for the UK, led by the Minister for Trade and Investment. The Government will provide a bespoke service to major inward investors giving them direct access to UK Ministers and speedy resolution of bureaucratic obstacles to investment.

The Government will make permanent two facilities for exporters introduced in response to the financial crisis: the Export Credits Guarantee Department’s (ECGD) Letter of Credit Guarantee Scheme and a facility that allows ECGD’s guarantees to be used to raise long-term finance in capital markets for UK exports.

Growth in all parts of the UK

The Government announces the location of ten new urban Enterprise Zones within the following Local Enterprise Partnership (LEP) areas: Birmingham and Solihull; Leeds City Region; Sheffield City Region; Liverpool City Region; Greater Manchester; West of England; Tees Valley; North Eastern; the Black Country; and Derby, Derbyshire, Nottingham and Nottinghamshire.

In addition, London will have an Enterprise Zone and be able to choose its site. This reflects the Mayor of London’s unique economic development responsibilities.

The Government will also launch a competitive process for interested LEPs to establish ten more Enterprise Zones.

The Government will make a range of policy tools available to all 21 zones:
• a 100 per cent business rate discount worth up to £275,000 over a five year period for businesses that move into an Enterprise Zone during the course of this Parliament;

• all business rates growth within the zone for a period of at least 25 years will be retained and shared by the local authorities in the LEP area to support their economic priorities;

• Government and local authority help to develop radically simplified planning approaches in the zone; and

• Government support to ensure superfast broadband is rolled out in the zone. This will be achieved through guaranteeing the most supportive planning environment and, if necessary, public funding.

1.105 In addition, the Government will work with individual LEPs to consider:

• the scope for introducing enhanced capital allowances to support zones in assisted areas where there is a strong focus on high value manufacturing;

• the use of Tax Incremental Finance to support the long-term viability of the zone, in tandem with the Local Government Resource Review; and

• UKTI support on inward investment and trade opportunities.

1.106 The Government will work with the devolved administrations to explore opportunities for employing the new Enterprise Zone model across the UK.

1.107 The Regional Growth Fund was set up to support private sector growth in the areas most dependent on the public sector. The Government will confirm all successful bids shortly and will launch the second round in April 2011.

1.108 Following a thorough review, the Government is approving a revised Sheffield retail quarter regeneration scheme. The Government is also announcing approval of an important, and re-designed, element of the Milton Keynes residential quarter scheme.

1.109 On 24 March 2011, the Government will publish a consultation paper on rebalancing the Northern Ireland economy, including looking at mechanisms for devolving the rate of corporation tax to Northern Ireland.

Environment

1.110 The Government is committed to being the greenest Government ever. A simple, efficient and cost effective policy framework will meet environmental objectives while supporting growth and maintaining a sound fiscal position. Market-based solutions to price carbon are at the heart of this approach, achieving objectives at the lowest possible cost.

1.111 The Government will increase the proportion of tax revenue accounted for by environmental taxes. Tax policy will be developed in the context of wider Government levers (such as voluntary agreements and regulation) and overlap of policy instruments will be avoided. The Government announces that:

• following consultation, a carbon price floor for electricity generation will be introduced from 1 April 2013. The carbon price floor will start at around £16 per tonne of carbon dioxide and follow a linear path to £30 per tonne in 2020 to drive investment in the low-carbon power sector. The carbon price support rates for 2013-14 will be equivalent to £4.94 per tonne of carbon dioxide.
• Climate Change Agreements (CCAs) will be extended to 2023. The climate change levy discount on electricity for CCA participants will be increased from 65 to 80 per cent from April 2013 to continue to support energy intensive businesses exposed to international competition. A consultation on proposals to simplify the agreements will be published by summer 2011; and

• it remains committed to providing public funding for four Carbon Capture and Storage (CCS) demonstration plants. However, consistent with its objectives for tax simplification, it will not proceed with the CCS levy. It will instead fund its commitments to CCS demonstrations from general taxation.

1.112 The Government is committed to ensuring that the Green Investment Bank (GIB) has the resources to help the UK to move towards a low-carbon economy. The Government announces that the initial capitalisation of the GIB will be £3 billion and that the GIB will begin operation in 2012-13, a year earlier than previously anticipated. Government investment alongside private finance should mean that there is in the region of an additional £18 billion of investment in green infrastructure by 2014-15 as a result of the GIB. The Spending Review allocated £1 billion for the GIB and the Government is aiming for the remaining £2 billion to be funded from the sale of assets. This will include the £775 million net proceeds already received from the sale of High Speed I, ensuring that funding is in place to allow GIB investments from 2012-13. The Government will enable the GIB to have borrowing powers from 2015-16 and once the target for debt to be falling as a percentage of GDP has been met.

1.113 The Government is committed to the success of the Green Deal and will act to encourage and incentivise take-up so that the Green Deal will appeal to households, businesses and prospective providers alike, before it is introduced in 2012.

To create a more educated workforce that is the most flexible in Europe

Skills and youth employment

1.114 Youth unemployment rose by 100,000 between 2004 and 2008, and has risen by a further 250,000 since the start of the recession. While participation in learning by 16 to 18 year olds has continued to rise, currently 9.4 per cent of all 16 to 24 year olds are unemployed and not in education.18

1.115 The Government is already investing £7.6 billion in 2011-12 in education and training for 16 to 19 year olds in addition to the £1.4 billion apprenticeship programme. The Government will also give young people earlier access to the Work Programme, benefiting up to 100,000 young people in 2011-12.

1.116 The Government will fund an additional 80,000 work experience places for young people, ensuring up to 100,000 places will be available over the next two years.

1.117 The Government also announces £180 million for up to 50,000 additional apprenticeship places over the next four years. 40,000 places will provide additional capacity to support young unemployed people, in particular through progression from the work experience programme. To address the specific barriers faced by SMEs in accessing apprenticeships, the Government will support business consortia to set up and maintain advanced and higher apprenticeships schemes, supported by grants, creating a further 10,000 apprenticeships.

1.118 The Government will expand the University Technical Colleges programme to establish at least 24 new colleges by 2014. Formed through partnerships between universities, colleges and businesses, University Technical Colleges will provide technical training opportunities for 11 to 19 year olds. The sponsors will help set curricula to match the needs of the local economy and of their sectors, provide high quality work placements, and allow the colleges to use their specialist facilities.

Housing

1.119 The affordable supply of new homes in the right places helps to create a dynamic economy and a flexible labour force. Housing supply is constrained by the lack of viable land for development. As set out above, the Government is announcing reforms to the planning system which will increase the amount of land brought forward and improve incentives for local communities to support development.

1.120 Over the long term, increased macroeconomic and financial stability will create a favourable environment for house-building. Stability in the labour market and the availability of mortgage finance will support sustainable demand for housing. The associated increase in certainty for the construction sector will aid the supply of new homes.

1.121 The Budget provides help for homeowners and new buyers, and supports the capacity of the house-building industry to ensure a more efficient housing market:

- the Government will help homeowners facing difficulties by extending for a further year temporary changes to the Support for Mortgage Interest (SMI) scheme. The 13-week waiting period and £200,000 limit on eligible mortgage capital will now remain in force for new working age SMI claimants until January 2013;

- the Government will provide £250 million to support first time buyers to purchase a new-build property. The FirstBuy programme will assist over 10,000 households with equity investments jointly funded with house-builders; and

- the Government will strengthen demand for residential property by reforming the stamp duty land tax rules applied to bulk purchases. This will reduce a barrier to investment in residential property, promoting private rented housing supply.

1.122 The Government will announce the outcome of its review of the stamp duty land tax relief for first time buyers in autumn 2011.

1.123 The Government will make Real Estate Investment Trusts easier to set up and more accessible to investors. This will encourage investment in the private rented sector over the longer term.

Fairness

1.124 Fairness is integral to the Government’s fiscal strategy and to sustainable growth. Tackling the deficit will ensure that future generations are not burdened with unsustainable debt and will underpin private sector confidence, supporting growth and job creation over the medium term.

1.125 This Budget sets out the next steps in realising the Government’s vision of a fair, simple and efficient tax, benefit and pensions system which rewards work, saving and personal responsibility. This supports the Government’s strategy to increase social mobility in the UK.
Personal tax

1.126 The Government’s objective is to support lower and middle income earners by raising the personal allowance to £10,000, with real terms progress towards that goal every year.

1.127 From April, the personal allowance for under 65s increases by £1,000 to £7,475. This Budget announces that the personal allowance for under 65s will increase by a further £630 to £8,105 in 2012-13, with an equivalent £630 reduction in the basic rate limit to leave the higher rate threshold unchanged. As a result, this Budget does not create any additional higher rate taxpayers. In combination the increases in the personal allowances announced by this Government will benefit 25 million individuals, taking 1.1 million out of income tax altogether. This year’s increase occurs alongside the switch to using the CPI as the basis for indexation of the employee and self-employed National Insurance threshold.

1.128 As announced in the June Budget 2010, the Government has reviewed how the CPI can be used for the indexation of taxes and duties while protecting revenues. Consistent with this, the default indexation assumption for direct taxes will be the CPI from April 2012. To ensure employers and older people do not lose out, for the duration of this Parliament the annual increases in the employer NICs threshold, and the age related allowance and other thresholds for older people, will be over-indexed compared to the CPI, and will increase by the equivalent of the RPI. The Government will review the use of the CPI for indirect taxes once its fiscal consolidation plans have been implemented and the duty increases it inherited from the previous Government have come to an end.

Pensions

1.129 The Government will simplify the state pension system so that it is fair and supports personal responsibility, and so that costs are sustainable, both today and for future generations.

1.130 The state pension system is complex. It is not clear to working-age individuals what they might receive from the state, in particular from the State Second Pension, making it difficult to plan retirement saving. The Government will look to reform the state pension for future pensioners so that it provides simple, contributory, flat-rate support above the level of the means-tested Guarantee Credit. DWP will shortly publish a Green Paper to consult on options for reform, which will include a proposal for a single tier pension, currently estimated to be worth around £140 a week. Moving to single tier provision would end contracting out for defined benefit pension schemes. In itself, this could bring significant simplification of the personal tax system. However, the Government will investigate the potential impact on employees and schemes in both the private and public sectors. The Government will honour contributions to the current system. Given longer-term pressures on the public finances, these reforms will be designed so as not to increase public spending dedicated to state pensions. Final proposals are subject to confirmation, including on affordability, and will reflect the projections set out in the Office for Budget Responsibility’s forthcoming Fiscal Sustainability Report.

1.131 The Government has already decided to bring forward the increase in State Pension Age to 66 to April 2020. Given the continuing increases in life expectancy the Government will bring forward proposals to manage future changes in the State Pension Age more automatically, including the option of a regular independent review of longevity changes. This should ensure the costs arising from increased longevity are spread more fairly between generations, with cost savings and improved economic growth helping to ensure sustainable public finances in the future. The Government has also established a commission, chaired by Andrew Dilnot, to make recommendations by July for a sustainable social care system, and the Government will set out its plans for reform in due course.
The final report of Lord Hutton’s Independent Public Service Pensions Commission was published on 10 March 2011. The Government accepts Lord Hutton’s recommendations as a basis for consultation with public sector workers, trades unions and others, recognising that the position of the uniformed services will require particularly careful consideration. The Government will set out proposals in the autumn that are affordable, sustainable and fair to both the public sector workforce and the taxpayer.

Residence and domicile

At Budget last year, the Government confirmed that it would review the taxation of non-domiciled individuals. The Government recognises that non-domiciled individuals make a valuable contribution to the UK economy and the current tax rules can discourage them from investing their foreign income and gains in the UK. However there must be a balance to ensure that non-domiciled individuals, especially those who have been resident in the UK for many years, make a fair tax contribution in return.

The Government will therefore reform the taxation of non-domiciled individuals by:

- increasing the existing £30,000 annual charge to £50,000 for non-domiciled individuals who have been UK resident for twelve or more years and who wish to retain access to the remittance basis of taxation. The £30,000 charge will be retained for those who have been resident for at least seven years but less than twelve years;
- removing the tax charge when non-domiciled individuals remit foreign income or capital gains to the UK for the purpose of commercial investment in UK businesses; and
- making technical simplifications to some aspects of the current rules to remove undue administrative burdens for non-domiciled individuals.


The current rules that determine tax residence for individuals are unclear and complex. The Government will consult in June on the introduction of a statutory definition of residence to provide greater certainty for taxpayers.

The Government intends to implement the reforms to non-domicile taxation and the statutory definition of residence from April 2012. There will be no other substantive changes to these rules for the remainder of this Parliament.

Charitable giving

The Government wants to encourage charitable giving and philanthropy and to support the voluntary sector.

Building on the 10 point action plan for philanthropy, the Government will encourage giving by the wealthiest by:

- reducing the rate of inheritance tax by 10 per cent for those estates leaving 10 per cent or more to charity, from a rate of 40 per cent to 36 per cent. This will reduce

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20Culture Secretary announces plan to boost philanthropy, Department for Culture, Media and Sport, December 2010.
the cost of giving to charity through bequests. The relief is designed so that the benefit of the tax saving is reflected in the bequests received by charities and not in payments to other beneficiaries;

- increasing the Gift Aid benefit limit from £500 to £2,500 from April 2011 to enable charities to give ‘thank you’ gifts, to recognise the generosity of significant donors; and

- consulting on proposals to encourage donations of pre-eminent works of art or historical objects to the nation in return for a tax reduction.

1.139 Building on the Giving Green Paper,21 this Budget will support the voluntary sector by:

- reducing bureaucracy for charities through the introduction of a new system of online filing which will bring Gift Aid into the 21st century; and

- introducing a Gift Aid small donations scheme. This will allow charities to claim Gift Aid on up to £5,000 of small donations per year without the need for Gift Aid declarations.

1.140 The Government will also explore how to increase the take up of Payroll Giving, which allows individuals to give through their pay and reduce their income tax bills.

### Tax avoidance

1.141 The Government is determined to reduce tax avoidance in order to protect the Exchequer and maintain fairness for the taxpayer. The Government is introducing measures which will raise around £4 billion over the current Parliament, balancing long-term improvements to the anti-avoidance framework with targeted measures to prevent particular schemes spreading.

1.142 Building on the commitments made last year, the Government has today published *Tackling Tax Avoidance*, which:

- initiates reviews of legislation which have been subject to repeated attempts at tax avoidance;

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• outlines proposals to counter the continued use and marketing of highly aggressive and artificial tax avoidance schemes; and

• sets the criteria for deciding whether to announce a change to tax law that has immediate effect.

1.143 This Budget also includes measures which target specific avoidance schemes. This includes new measures to address the abuse of stamp duty land tax rules (effective from 24 March 2011); to amend the sale of lessors anti-avoidance legislation (effective from today); and to clarify the degrouping charge rules affecting corporate gains (effective from today).

Duties and North Sea oil and gas

1.144 The Government is committed to fair duties and taxes which contribute to deficit reduction while supporting households and businesses. Recognising the impact of record pump prices, the Government announces a £1.9 billion package to ease the burden on motorists.

Motoring

1.145 In recognition of high current oil prices, fuel duty will be cut by 1 penny per litre from 6pm today.

1.146 The Government will abolish the fuel duty escalator and replace it with a fair fuel stabiliser. When oil prices are high, as now, fuel duty will increase by inflation only. UK oil and gas production is more profitable at such times, so it is fair that companies should contribute more. The Supplementary Charge on oil and gas production will therefore increase to 32 per cent from midnight tonight.

1.147 In addition, to ease the burden on motorists, the 2011-12 inflation-only increase in fuel duty will be deferred to 1 January 2012. The 2012-13 increase in fuel duty will be implemented on 1 August 2012.

1.148 In future years, if the oil price falls below a set trigger price on a sustained basis, the Government will reduce the Supplementary Charge back towards 20 per cent on a staged and affordable basis while prices remain low. Fuel duty will increase by RPI plus 1 penny per litre in each such year. The Government believes that a trigger price of $75 per barrel would be appropriate, and will set a final level and mechanism after seeking the views of oil and gas companies, and motoring groups.

1.149 As the increased rate of Supplementary Charge will only apply when prices are high, the Government will restrict tax relief for decommissioning expenditure to the 20 per cent rate to avoid incentivising accelerated decommissioning. There will be no restrictions to decommissioning relief below this level over the course of this Parliament, and the Government will work with the industry with the aim of announcing further, longer-term certainty on decommissioning at Budget 2012. Recognising the importance of continued investment in the North Sea, including in marginal gas fields, the Government will also consider with the industry the case for introducing a new category of field that would qualify for field allowance.

1.150 This Budget announces three further steps to support motorists:

• vehicle excise duty rates will increase by RPI indexation only in 2011-12, and rates for Heavy Goods Vehicles will be frozen;

• for motorists who are required to use their own vehicle for work, the Approved Mileage Allowance Payments (AMAPs) rate will rise to 45 pence per mile for
the first 10,000 miles and 25 pence per mile thereafter. In addition to claiming AMAPs rates, an allowance for passenger payments currently in place for business employees, at 5 pence per passenger per mile, will be extended to volunteers; and

- the Government has today formally submitted a derogation request to the European Commission for a rural fuel duty rebate pilot scheme. This is intended to deliver a 5 pence per litre duty discount on petrol and diesel across the Inner and Outer Hebrides, the Northern Isles, the islands in the Clyde and the Isles of Scilly.

1.151 To encourage businesses to use ultra low carbon cars, the Government will freeze Company Car Tax for cars emitting less than 95g/km from April 2013. The Government will increase Company Car Tax for all vehicles with carbon dioxide emissions between 95g/km and 219g/km by 1 percentage point from the same date.

Air Passenger Duty

1.152 In the June Budget 2010, the Government undertook to explore changes to the aviation tax system, including switching from a per-passenger to a per-plane duty. The UK’s international obligations in this area include Air Service Agreements with over 150 different countries and the 1944 Chicago Convention. The Government will not introduce a per-plane duty at the present time, given concerns over the legality and feasibility of this approach. The Government will start a programme of intensive work with our international partners to build consensus for a per-plane duty in the future.

1.153 Today the Government is launching a consultation on reform of Air Passenger Duty. The Government wants a simple tax system for air transport services which does not hamper growth, which ensures a fair contribution toward the public finances and which will support the reduction of global emissions. The consultation includes plans to extend the tax system to flights taken aboard business jets for the first time. The Government will also freeze Air Passenger Duty rates for 2011-12, with the RPI increase assumed in the forecast deferred to April 2012.

Tobacco and alcohol

1.154 The Government is committed to fair excise duties on tobacco and alcohol which contribute to deficit reduction whilst supporting health objectives. In addition to the duty increases that the Government inherited, it is restructuring cigarette duty and increasing duty on hand-rolling tobacco by a further 10 per cent.

1.155 From 1 October 2011, the Government will introduce an additional duty on high-strength beers, and a reduced rate of duty on lower-strength beers to encourage their production and consumption. This will reduce the health and social harms resulting from problem drinking, and is designed to avoid unfairly penalising responsible drinkers.

Water

1.156 The Government is committed to supporting households who face water affordability pressures and households in areas with particularly high water bills, such as the South West. The Government will consult shortly on proposals to address water affordability. This will include reforms to the existing WaterSure scheme, the approach to Company Social Tariffs and options for additional Government spending to provide further support.
Social mobility and child poverty

1.157 The Government is developing a broad strategy to tackle the causes of poverty and to ensure that children born in low income families realise their full potential.

1.158 This Budget confirms that the Government’s modelled tax and welfare reforms, including the measures announced today, could reduce child poverty by up to 50,000 over the next two years.\(^2\) However, such estimates are uncertain and may be on the edge of statistical significance. The way that child poverty is currently measured means that, perversely, reducing the income tax paid by millions of lower earners, or providing additional support to low income pensioners, could push the poverty line up. This would increase the number of children calculated as being in poverty.

1.159 Drawing on the recommendations in Frank Field MP’s *Independent Review on Poverty and Life Chances* and the first report of Graham Allen MP’s review of early intervention,\(^2\) the Government will therefore develop improved ways to measure poverty which better capture the reality of living in poverty and reflect the Government’s commitment to increase social mobility.

\(^2\)Estimates calculated using HM Treasury tax and benefit microsimulation model.