Budget 2004

March 2004

Prudence for a purpose:

A Britain of stability and strength

HM TREASURY

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Budget 2004

Prudence for a purpose:

A Britain of stability and strength

Economic and Fiscal Strategy Report and Financial Statement and Budget Report

March 2004

Return to an Order of the House of Commons dated 17 March 2004

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Ruth Kelly
Her Majesty's Treasury
17 March 2004

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

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OVERVIEW

The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. With the global economy strengthening, Budget 2004 describes the steps the Government is taking to ensure long-term stability, growth and prosperity.

Budget 2004, *Prudence for a purpose: A Britain of stability and strength*, presents updated assessments and forecasts of the economy and public finances, reports on how the Government's policies are helping to deliver its long-term goals and describes the further steps the Government is now taking. The Budget:

- **shows that the economy continues to grow steadily and that the Government is on track to meet its strict fiscal rules for the public finances;**
- **sets out plans for public service efficiency savings of up to 2.5 per cent a year by 2007-08, and the envelope for the 2004 Spending Review;**
- **announces that education spending in England will grow by an annual average of 4.4 per cent in real terms across the 2004 Spending Review period, and by 2007-08 education spending will be £7.4 billion higher in England than in 2005-06 and £8.5 billion higher for the UK on top of the uplift for 2005-06 already in spending plans. By 2007-08, education spending in the UK will be 5.6 per cent of GDP, up from 5.4 per cent in 2004-05;**
- **introduces plans to boost long-term productivity and growth, through a New Deal for skills, and a ten-year framework for investing in the UK's science and innovation base;**
- **announces a £100 payment to pensioner households with someone aged 70 or over, to help with their council tax bills;**
- **takes further steps to extend employment opportunity for all, through measures which focus help and support on those who face particular barriers to work;**
- **promotes fairness in the tax system by ensuring that everyone contributes to the extra investment in public services; and**
- **introduces a range of measures to improve the environment, including proposals to tackle climate change, improve air quality and reduce waste.**

INTRODUCTION

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

1.2 The long-term decisions the Government has taken – giving independence to the Bank of England, new fiscal rules, and a reduction in debt – have created a strong platform of economic stability. The UK economy grew continuously throughout the global downturn that began in 2001, while many of the world's major economies experienced recession. The UK is now experiencing the longest period of sustained low inflation for over thirty years and unemployment is the lowest of the G7 major industrialised economies.

1.3 Economic stability provides the platform for building prosperity, achieving social justice with security and opportunity for all, and maintaining investment in public services. With the world economy now strengthening, the challenge is to lock in the UK's stability and strength, and equip the UK to continue to succeed over the long term in a more competitive global economy.

1.4 In an increasingly knowledge-driven global economy, success lies in a flexible economy with a strong science and innovation base, and a highly skilled and educated workforce. The Budget sets out a programme of long-term investment in schools, colleges and universities, to give every young person the chance to make the most of their talents. It also sets out plans for new investments in science and innovation, and in a highly skilled workforce through apprenticeships and a New Deal for skills.

1.5 The Government is determined that continued progress towards a flexible and highly productive economy is matched with reforms which promote fairness. This Budget continues the action the Government is taking to create a fairer, more inclusive society with opportunity and security for all.

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

- maintaining macroeconomic stability, ensuring the fiscal rules are met and that inflation remains low;
- raising the sustainable rate of productivity growth, through reforms that promote enterprise across the whole economy, enhance flexibility and promote, science, innovation and skills;
- providing employment opportunity for all, by promoting a flexible labour market which sustains a higher proportion of people in employment than ever before;
- combining flexibility with fairness, by tackling child and pensioner poverty, providing opportunity for all children, effective choices for parents and delivering security for all in retirement;
- establishing world-class public services, with extra investment tied to reform and results, including plans for long-term investment in education; and
- addressing the challenges of climate change, poor air quality and environmental degradation in urban and rural areas.

MAINTAINING MACROECONOMIC STABILITY

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

The policy framework

1.8 The Government's macroeconomic framework is based on the principles of transparency, responsibility and accountability, and is designed to ensure lasting stability so that businesses, individuals and the Government can plan effectively for the long term. The Bank of England has operational independence to meet the Government's symmetrical inflation target. In the 2003 Pre-Budget Report, the Chancellor announced that the operational target for monetary policy would switch with immediate effect to a target based on the Consumer Prices Index (CPI). Budget 2004 reaffirms the target of 2 per cent for the 12-month increase in the CPI. Fiscal policy is underpinned by clear objectives and two strict rules which ensure sound public finances over the medium term. The fiscal rules underpin the Government's public spending framework which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes.

Economic prospects

1.9 The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges in the world economy over recent years. The UK economy grew continuously throughout the global downturn that began in 2001, while many of the world's major economies experienced recession.

1.10 As geo-political and other international uncertainties have receded, global demand has strengthened and most major international financial markets have seen valuations rise back to around the levels of spring or summer 2002. In the UK, business and consumer confidence has risen further since the time of the 2003 Pre-Budget Report, and improved sentiment has underpinned a significant pick-up in domestic demand growth since early 2003. Moreover, tentative signs have also emerged of improved international prospects feeding through to higher external demand. Following growth of 0.8 per cent in the third quarter, UK GDP rose by 0.9 per cent in the final quarter of 2003, above trend rates and the fastest rate of quarter-on-quarter growth for over three and a half years.

1.11 As in the 2003 Pre-Budget Report, the recent pick-up in activity seen over the latter half of 2003 is expected to be consolidated through 2004 and into 2005. The Budget 2004 forecast is that:

- UK **GDP** is expected to grow by 3 to $3^{1}/_{2}$ per cent in both 2004 and 2005, unchanged from both the Budget 2003 and the 2003 Pre-Budget Report forecasts. By 2006, with slack in the economy absorbed, and the output gap closed, growth is expected to return to its trend rate of $2^{1}/_{2}$ to 3 per cent; and
- CPI **inflation** is expected to rise through the course of this year to reach its 2 per cent target by mid-2005, as the lagged effects of sterling's depreciation against the euro since 2002, combined with the effects of the strengthening recovery in the world economy, feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute to returning inflation to target through anchoring inflation expectations.

The public finances

1.12 Budget 2004 presents the Government's annual fiscal forecast. The 2003 Pre-Budget Report interim projections showed weaker receipts as a result of lower than expected growth in certain GDP components and higher than expected spending, including that arising from the UK's international commitments. The Budget 2004 public finance projections show little change compared with the Pre-Budget Report, as receipts and spending have turned out largely as expected.

1.13 The estimated 2003-04 outturn for the public sector current budget shows a deficit of £21.3 billion compared with projected deficits of £19.3 billion and £8.4 billion in the 2003 Pre-Budget Report and Budget 2003 respectively. For public sector net borrowing, the estimated 2003-04 outturn is £37.5 billion, compared with £37.4 billion projected in the 2003 Pre-Budget Report and £27.3 billion projected in Budget 2003.

Budget policy decisions

1.14 Against this backdrop, and building on steps already taken, Budget 2004 announces further decisions to lock in stability and invest in Britain's future, including:

- a package of measures to encourage enterprise, and boost science and skills;
- further steps to boost employment opportunity for all, including extending the support offered to lone parents and sick and disabled people who want to return to work;

- action to protect tax revenues for the benefit of all taxpayers, tackling tax fraud and avoidance;

1.15 Budget 2004 sets firm overall spending limits for the 2004 Spending Review period, allowing:

- current spending to increase by an average of 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumption for trend economic growth and consistent with the nominal growth rates set out in Budget 2003 and the 2003 Pre-Budget Report. Final plans for Departmental Expenditure Limits and Annually Managed Expenditure will be set in the Spending Review; and
- public sector net investment to rise from 2 per cent of GDP to 2¼ per cent of GDP by 2007-08 to continue to address historic under-investment in Britain's infrastructure while remaining consistent with the sustainable investment rule.

1.16 The growth rate of both overall spending and departmental spending will be lower in the 2004 Spending Review than in the 2002 Spending Review. However, building on the progress made in correcting historic under-investment, and with administration costs frozen in nominal terms and planned efficiency gains, the Government expects to match the pace of growth in front line public services achieved in the last Spending Review.

The fiscal rules

1.17 Table 1.2 lists the key Budget policy decisions and their impact on the public finances. Further details are set out in Chapter A of the FSBR.

1.18 The Government remains on track to meet its strict fiscal rules over the economic cycle. As shown in Table 1.1, the current budget since the start of the current economic cycle in 1999-2000 shows an average annual surplus up to 2005-06 of 0.1 per cent of GDP and the Government is therefore on track to meet the golden rule on the basis of cautious assumptions. There is a margin against the golden rule of £11 billion in this cycle, including the AME margin. With the economy assumed to be on trend from 2005-06 onwards, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2008-09 is 0.1 per cent of GDP. At this early stage, the Government is therefore on track to continue to meet the golden rule after the end of this economic cycle. Public sector net debt is projected to remain low and stable over the next five years, stabilising at just under 36½ per cent of GDP – £53 billion below the 40 per cent ceiling set in the sustainable investment rule.

Table 1.1: Meeting the fiscal rules

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Golden rule							
Surplus on current budget	–1.2	–1.9	–0.9	–0.4	0.0	0.3	0.7
Average surplus since 1999-2000	1.0	0.4	0.2	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–0.6	–1.0	–0.2	–0.2	0.0	0.3	0.7
Sustainable investment rule							
Public sector net debt	30.8	33.2	34.4	35.3	35.9	36.3	36.4

1.19 Budget 2004 decisions are consistent with the long-term sustainability of public finances. Consistent with the requirements of the *Code for fiscal stability*, an analysis of long-term fiscal sustainability is presented in Annex A of the *Economic and Fiscal Strategy Report*. This shows that given the projected profile for tax revenue and transfers, current consumption can grow at around assumed GDP growth after the medium term while meeting the golden rule. Public sector investment can also grow broadly in line with the economy without jeopardising the sustainable investment rule. The UK is also in a strong position to face future challenges relative to many other developed countries.

MEETING THE PRODUCTIVITY CHALLENGE

1.20 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. As a result of macroeconomic instability and market failures, the UK has historically experienced low rates of productivity growth compared to other major economies. In recent years, UK performance has improved in relation to its main competitors. Recent data indicate that, on an output per worker basis, the UK now has higher productivity than Germany and is closing the gap with France. The Government's long-term goal is for the UK to continue to close the productivity gap by achieving a faster rate of growth than its main competitors. To do this it aims to promote productivity across all regions and countries of the UK. In the increasingly knowledge-driven global economy, a strong science and innovation sector is an important driver of productivity growth, backed up by a highly-skilled workforce and a competitive and enterprising economy.

Action so far

1.21 Chapter 3 sets out the reforms the Government is taking to promote productivity, focusing on five key drivers of productivity performance:

- improving **competition** which promotes flexible markets and increases business efficiency and consumer choice. The Government has worked to ensure the UK competition regime ranks among the best in the world;
- promoting **enterprise** through measures aimed at increasing flexibility by removing barriers to entrepreneurship and developing an enterprise culture. Reforms to the business tax regime and measures designed to increase access to finance have helped small and growing businesses;
- supporting **science and innovation** through increases in funding for science and for promoting stronger collaboration between business and universities. Improvements to R&D tax credits have enabled more businesses to claim a wider range of relief;
- raising UK **skills** levels to create a more flexible and productive workforce. Increased resources have been made available to improve standards in schools and the further education sector. The Government has launched Employer Training Pilots and packages of training support for small businesses; and
- encouraging **investment** to increase the stock of physical capital supported by stronger, more efficient capital markets. The Government has taken steps to increase flexibility in the housing market and to improve the planning regime. It has also taken action to promote greater flexibility in capital markets.

Next steps **1.22** Budget 2004 introduces further measures to promote productivity growth, including:

- the publication of **a consultation document to inform the preparation of a ten-year investment framework for science and innovation,** as part of the 2004 Spending Review, committing to grow public investment in the science base faster than the trend rate of GDP growth over the next Spending Review period;
- **a commitment to increase NHS funding for R&D by £100 million by 2008,** to underpin the creation of a new UK Clinical Research Collaboration for the effective and efficient translation of scientific advances into patient care;
- **a New Deal for skills** to ensure that individuals are helped to develop the skills they need for employment and employers can develop the skilled workforce needed for the success of their business, and extending Employer Training Pilots to six new areas;
- **reforms to reduce the regulatory burden on businesses,** including consulting on the implementation of phasing out payment via employers for Working Tax Credit, strengthened Government scrutiny of regulatory proposals, and changing the structure of the UK's tax administration;
- **devolving delivery of regional and local Business Link services** from the Department of Trade and Industry to the Regional Development Agencies;
- **full details of the Local Authority Business Growth Incentives scheme,** which will boost the role of local authorities in promoting enterprise and economic growth;
- the Barker Review of housing supply, published today, concludes that house building must rise substantially to reduce house price inflation and increase the number of affordable homes. The Government agrees with the need for a signficant increase in housing development over time. It intends to **implement a programme of reform to planning and delivery of development as recommended in the Review and consider a package of measures to increase housing supply,** including social housing investment, alongside a Planning-gain Supplement by the end of 2005;
- **a new entitlement for graduates of the world's top 50 business schools to come to the UK** to seek employment; and
- seeking views on how **property investment funds** (a UK version of the successful US Real Estate Investment Trusts) should be structured, to encourage more efficient investment in commercial and residential property.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.23 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. To achieve this, each individual who wants and is able to work should be provided with the support to enable them to find work and develop skills. The Government recognises that each person will face different barriers to work. Delivering full employment requires a personalised approach, with services tailored to the needs of the individual and local circumstances.

Action so far **1.24** The Government's strategy for extending employment opportunity for all builds on the strong performance of the UK labour market over recent years. UK unemployment has fallen to 5.0 per cent, the lowest of the G7 economies, while the working age employment rate has reached 74.8 per cent. Chapter 4 describes the successful action the Government has already taken through:

- **extending employment opportunity** and equipping people to take advantage of employment opportunities. Labour market policies such as the New Deals provide effective support to help people into work. Further measures aim to promote diverse forms of employment, facilitate labour market mobility and raise skills;
- **making work pay**, through the National Minimum Wage and tax credits which create a system of support that provides greater rewards from work, improving incentives for individuals to participate in the labour market; and
- **ensuring responsive and flexible delivery**, so that providers are able to tailor policies to suit the specific needs of the community they serve.

Next steps **1.25** Budget 2004 describes the further steps the Government is taking to strengthen the labour market, and to extend support to those who face particular barriers to work, including through:

- **the piloting of a mandatory work-focused interview regime for some existing claimants of incapacity-related benefits** in the Pathways to Work pilot areas;
- **the piloting of a job preparation premium of £20 per week** in the Pathways to Work pilot areas, for existing claimants of incapacity-related benefits who undertake relevant activity that supports a return to work;
- **the introduction of a worksearch premium of £20 per week,** available to those in a family in receipt of the Working Tax Credit who are not working, in six pilot areas with high levels of worklessness;
- **the introduction of a second set of Local Housing Allowance Pathfinders in the private rented sector from April 2005;**
- **a package of measures to simplify the rules around Housing Benefit;**
- **from October 2004, an increase in the adult and youth rates of the National Minimum Wage** to £4.85 and £4.10 respectively, and the **introduction of a National Minimum Wage for 16 and 17 year old workers** of £3.00 an hour; together with the Learning and Skills Council and employers, the Government will work to acheive minimum pay levels for apprentices in England of £70 to £80 per week;
- **an extension of measures for lone parents** in six cities with large lone parent populations, including access to NVQ level 3 training; and
- **'Fair Cities' initiatives,** to be established in three areas later this year, to improve employment outcomes for people from disadvantaged ethnic minority groups.

BUILDING A FAIRER SOCIETY

1.26 The Government is committed to combining flexibility with fairness, by tackling child and pensioner poverty, providing opportunity for all children, effective choices for parents and delivering security for all in retirement. The tax and benefit system puts into practice the Government's principles of progressive universalism, with support for all, and more help for those who need it most, when they need it most. The Government is also committed to a modern and fair tax system, in which everyone pays their fair share. It is also at the forefront of global efforts to achieve the Millennium Development Goals for global poverty.

Action so far **1.27** Chapter 5 describes the range of reforms the Government has undertaken to achieve its goals in these areas, including:

- **support for families and children** to lift children out of poverty and so ensure they have the opportunity to make the choices they need to fulfil their potential. The Government has increased financial support through the tax and benefit system, with significant rises in Child Benefit and the introduction of the Child Tax Credit (CTC). The 2003 Pre-Budget Report announced a significant rise in the CTC, which will enable the Government to meet or exceed its target of reducing by a quarter the number of children in low-income households by 2004-05 on a before housing costs basis;
- **support for pensioners** to tackle poverty and ensure security in retirement for all pensioners, with extra help for those who need it most. The Government has increased financial support for pensioners through the basic state pension and has introduced the Pension Credit which rewards saving by pensioners on low and modest incomes; and
- **steps to encourage saving**, including through the introduction of the Child Trust Fund, stakeholder pensions and Individual Savings Accounts. The Child Trust Fund will provide an endowment for every child, with more for children in the poorest third of families, and will strengthen the saving habit of future generations.

Next steps **1.28** This Budget sets out the next steps the Government is taking to support these aims, including:

- **reforming financial support for 16 to 19 year olds,** to increase the proportion of young people who reach the age of 19 equipped with the skills they need to succeed in a modern global economy;
- **additional funding for Sure Start, early years and childcare of £669 million in 2007-08** compared with 2004-05, an average annual real growth rate of 17.3 per cent;
- **a Children's Centre in all of the 20 per cent most disadvantaged wards in England by 2008,** moving towards the goal of a Children's Centre for every community;
- **a £100 payment to pensioner households with someone aged 70 or over to help with their council tax bills;**
- **simplifying the taxation of pensions,** replacing the complexity of eight existing regimes with a single, simplified regime with a lifetime allowance for tax-privileged pension saving;

- **promoting financial inclusion,** focusing on helping households access affordable banking and credit;
- **taking action to protect tax revenues and modernise the tax system,** including measures to combat tax fraud and avoidance; and
- **implementing the O'Donnell review recommendations to establish a new customer-focused tax service,** integrating the Inland Revenue and HM Customs and Excise.

DELIVERING HIGH QUALITY PUBLIC SERVICES

1.29 The Government's goal is to establish world class public services, with extra investment tied to reform and results. This is central to achieving a stronger, more flexible economy and a fairer society. A healthy and educated workforce, modern and reliable transport network, and adequate supply of affordable housing promote productivity and flexibility and help to ensure opportunity and security for all. The Government's strategy is to deliver improvements in public services through sustained investment and reform to ensure that taxpayers receive value for money.

Action so far

1.30 Chapter 6 sets out the steps the Government has taken to deliver lasting improvements in the delivery of public services, including:

- **a new framework for managing public spending** that strengthens incentives for departments to plan for the long term, ensures that resources are used as effectively and efficiently as possible and gives departments the flexibility they need to ensure improvements in public service delivery; and
- **significant extra resources for public services,** consistent with the fiscal rules. The 2002 Spending Review delivered substantial extra investment in key public service priorities, with more than 75 per cent of planned additional spending allocated to the key priorities of health, education, criminal justice, housing and transport.

Next steps

1.31 The 2004 Spending Review will set spending plans for 2006-07 and 2007-08 and will confirm the plans set for 2005-06 in the 2002 Spending Review. In doing so it will consolidate and build on the step change in funding for key public services achieved in previous spending reviews. In Budget 2004, the Government announces:

- **education spending in England will grow by an annual average of 4.4 per cent in real terms across the 2004 Spending Review period**, and by 2007-08 education spending will be £7.4 billion higher in England than in 2005-06 and £8.5 billion higher for the UK on top of the uplift for 2005-06 already in spending plans. By 2007-08, education spending in the UK will be 5.6 per cent of GDP, up from 5.4 per cent in 2004-05;
- **reforms including resources for Children's Centres in all of the 20 per cent most disadvantaged wards, and a transformation of all secondary schools to twenty-first century standards in the next 10 to 15 years**; and
- that the growth rate of both overall public spending and departmental spending will be lower in the 2004 Spending Review than in the 2002 Spending Review. However, building on the progress made in correcting historic under-investment and with administration costs cut in real terms and planned efficiency gains equivalent to £20 billion a year by 2007-08, the Government's objective is to match the pace of growth in front line public services achieved in the last Spending Review.

PROTECTING THE ENVIRONMENT

1.32 Sustainable development is vital to ensure a better quality of life for everyone, today and for generations to come. Economic growth is key to rising national prosperity. However, growth must not come at the expense of the environment or social progress. The Government's goal is to deliver sustainable growth and a better environment, by addressing the challenges of climate change, poor air quality and environmental degradation in urban and rural areas.

Action so far **1.33** Chapter 7 describes the steps the Government has taken to deliver its environmental objectives, including:

- **tackling climate change and improving air quality**, ensuring that the UK meets its international commitments under the Kyoto Protocol. The Government's aim is to put the UK on the path to a 60 per cent reduction in greenhouse gas emissions from current levels by 2050;
- **promoting a clean and efficient transport system**, including support for the take-up of the most efficient fuels and vehicles, and promotion of the development of greener forms of transport and fuels;
- **improving waste management**, so that resources are re-used or recycled to deliver economic value. The landfill tax and targeted strategic waste management programmes are central to these aims; and
- **protecting the UK's countryside and natural resources**, to ensure they are sustainable economically, socially and physically. The aggregates levy is helping to tackle the environmental costs of quarrying, and action has been taken to limit the environmentally damaging impact of agriculture.

Next steps **1.34** Budget 2004 describes the next steps in the Government's environmental strategy, including:

- **new eligibility criteria for climate change agreements**, which will increase the number of businesses which can participate in the scheme, and **a freeze in the rates of the climate change levy;**
- **a package of measures to promote household energy efficiency** including a reduced rate of VAT for ground source heat pumps, and possibly for micro-combined heat and power units from 2005, and incentives for the private rented sector to invest in energy efficiency;
- **duty rates for sulphur-free fuels raised in line with inflation from 1 September 2004, the duty for ultra-low sulphur fuels set at 0.5 pence per litre above this level from the same date, an increase in rebated fuels rates, and three-year certainty for duty rates on biofuels and road fuel gases;**
- **reforms to the tax treatment of company vans and emergency vehicles,** taking 85 per cent of drivers of company vans out of the system altogether;
- **publication of the third progress report on the lorry road-user charging scheme,** which now moves the scheme into the procurement phase, and sets out decisions on key aspects of the scheme's design; and
- **reform of the aggregates levy relief scheme in Northern Ireland.**

BUDGET MEASURES AND THEIR IMPACT ON HOUSEHOLDS

1.35 The measures introduced in this and previous Budgets support the Government's objectives of promoting enterprise, skills and science, creating employment opportunity, and tackling child and pensioner poverty. Table 1.2 lists the key Budget policy decisions and their impact on the public finances. Further details are provided in Chapter A of the FSBR.

1.36 The increase in CTC announced in the 2003 Pre-Budget Report builds on the success of Working and Child Tax Credits, which were introduced in April 2003. As a result of the personal tax and benefit measures that come into effect in 2004-05, by October 2004, in real terms:[1]

- families with children will be, on average, £175 a year better off, while those in the poorest fifth of the population will be, on average, £425 a year better off;
- a single earner couple with two children, with earnings up to the median for full time workers – £22,000 per year – will be at least £4.20 a week better off; and
- a lone parent with two children, working 16 hours per week at the National Minimum Wage, will be at least £16.00 per week better off.

1.37 As a result of all personal tax and benefit measures introduced since 1997, by October 2004, in real terms:[2,3]

- households will be, on average, £850 a year better off;
- families with children will be, on average, £1,350 a year better off; and
- families with children in the poorest third of the population will be, on average, £3,000 a year better off.

1.38 As a result of all personal tax and benefit reforms introduced to help pensioners, including the Pension Credit, in 2004-05:[2]

- pensioner households will be, on average, £1,350 a year better off; and
- the poorest third of pensioner households will be, on average, £1,750 a year better off.[2]

[1] Compared to the 2003-04 system of taxes and benefits, indexed to 2004-05 prices.
[2] Compared to the 1997-98 system of taxes and benefits, indexed to 2004-05 prices.
[3] The National Minimum Wage will be £4.85 for adults from October 2004.

Table 1.2: Budget 2004 policy decisions

	(+ve is an Exchequer yield)			£ million
	2004-05 indexed	2005-06 indexed	2006-07 indexed	2004-05 non-indexed
MEETING THE PRODUCTIVITY CHALLENGE				
1 Venture capital schemes: improvements	0	–55	–60	0
2 VAT: revalorise registration and deregistration thresholds	0	0	0	–10
3 Business Premises Renovation Allowance	0	–10	–35	0
4 Capital Allowances: one year increase for small enterprises	*	–55	+15	*
5 Local Authority Business Growth Incentives	0	–150	–300	0
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
6 Housing Benefit: align rules with tax credits	–5	–35	–35	–5
7 Housing Benefit and Council Tax Benefit: backdating for up to 12 months	–10	–15	–10	–10
8 Housing Benefit: private sector second round Pathfinders	0	–15	–15	–15
BUILDING A FAIRER SOCIETY				
Supporting families and pensioners				
9 Income tax: index starting and basic rate limits	0	0	0	–610
10 Pensions tax simplification	0	0	–25	0
11 £100 payment to over 70s	–475	0	0	–475
12 Pension Credit backdating for up to 12 months	–5	–15	–15	–5
13 Pension schemes earnings cap: indexation	0	0	0	–5
14 Modernising Trusts	0	0	–5	0
15 Payroll Giving: grant scheme for SMEs	–5	–5	0	–5
Protecting tax revenues				
16 Finance leasing: closing loopholes	+75	+110	+110	+75
17 Life companies	+5	+10	+10	+5
18 Red diesel: supporting the UK oils fraud strategy	+80	+180	+190	+90
19 VAT: transfers of going concern	+155	+140	+125	+155
20 VAT: demonstrator cars	*	+5	+5	*
21 Distributed profits: minimum rate[1]	+10	+340	+490	+10
22 Customs: allocation for alcohol strategy	0	–15	–10	0
Duties and other tax changes				
23 Inheritance tax: index threshold	0	0	0	–55
24 Tobacco duties: revalorise rates	0	0	0	–15
25 Alcohol duties: freeze spirits duty until end of this Parliament	–35	–70	–70	0
26 Alcohol duties: revalorise beer and wine duties and freeze other rates	–5	–5	–5	+155
27 Small breweries' relief: extension	–5	–5	–5	–5

Table 1.2: Budget 2004 policy decisions

	(+ve is an Exchequer yield)			£ million
	2004-05 indexed	**2005-06 indexed**	**2006-07 indexed**	**2004-05 non-indexed**
PROTECTING THE ENVIRONMENT				
Environment				
28 Enhanced capital allowances for additional energy saving technologies	*	–5	–10	*
29 Landlords' energy saving allowance	*	–10	–10	*
30 Changes to Climate Change Agreement eligibility criteria	–5	–25	–25	–5
31 Climate change levy: freeze	–25	–25	–25	0
32 Aggregates levy: freeze	–10	–10	–10	0
33 Aggregates levy: extension of Northern Ireland credit scheme	–15	–20	–25	–15
34 Recycling of landfill tax revenues	0	0	–245	0
Transport				
35 Fuel duties: revalorise rates from 1 September 2004 and introduce differential between sulphur free and other main road fuels	–300	0	0	+345
36 Fuel duties: increase road fuel gases by 1p over next three years	+5	+10	+10	+5
37 Fuel duties: differentials for bioethanol and biodiesel at 20p until 2007	*	+5	+10	*
38 Company vans: reform	*	–30	–30	*
39 Air passenger duties: freeze rates	–25	–30	–30	0
40 VED: freeze rates	–130	–130	–135	0
TOTAL BUDGET MEASURES	**–725**	**+65**	**–170**	**–395**
* *negligible*				
MEMO ITEMS				
Enforcement and compliance[2]				
Direct taxes compliance package[3]	+155	+465	+925	
Resetting of the AME margin	–1,000	–2,000		

[1] *Alongside the revenue raised by this meaure, tax revenue has been reduced as a result of an increase in the number of self-employed individuals incorporating their business to reduce tax (see Chapter 5). Estimates of the impact of the measure, and of the estimated reduction in tax payments by small businesses incorporated for tax reasons since the last Budget are set out below:*

2003-04	*2004-05*	*2005-06*	*2006-07*
–250	*–420*	*–50*	*+80*

[2] *Forecast impact if operational measures to enhance compliance, or to enhance the powers available to the Revenue Departments.*

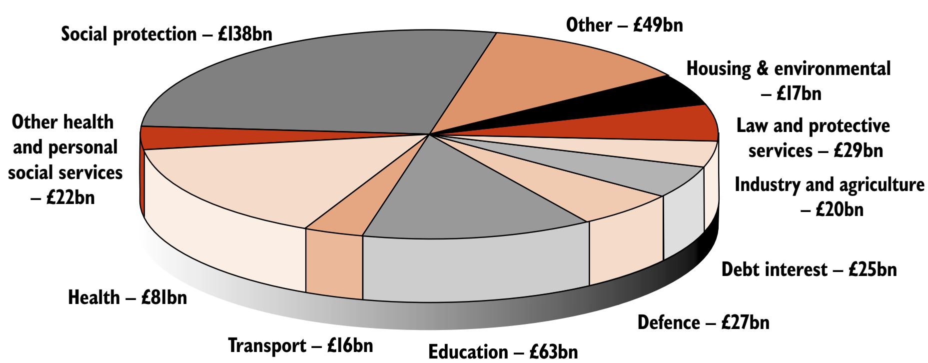
[3] *Net of additional resources allocated to the Inland Revenue.*

GOVERNMENT SPENDING AND REVENUE

1.39 Chart 1.1 presents public spending by main function. Total Managed Expenditure (TME) is expected to be around £488 billion in 2004-05. TME is divided into Departmental Expenditure Limits (DEL), shown in Table C14 of the FSBR, and Annually Managed Expenditure (AME), shown in Table C12 of the FSBR.

Chart 1.1: Government spending by function

Total managed expenditure: £488 billion

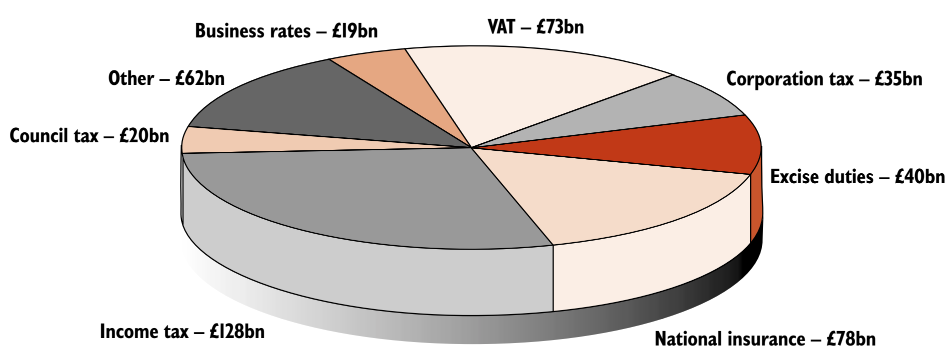


Source: HM Treasury, 2004-05 near-cash projections. Spending re-classified to functions compared to previous presentations and is now using methods specified in international standards. Other expenditure includes spending on general public services; recreation, culture and religion; international cooperation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments. Social protection includes tax credit payments in excess of an individual's tax liability, which are now counted in AME, in line with OECD guidelines. Figures may not sum to total due to rounding.

1.40 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £455 billion in 2003-04. Table C8 of the FSBR provides a more detailed breakdown of receipts consistent with this chart.

Chart 1.2: Government receipts

Total receipts: £455 billion



Source: HM Treasury, 2004-05 projections. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts – for example, interest and dividends. Figures may not sum to total due to rounding.

2 MAINTAINING MACROECONOMIC STABILITY

The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges that have faced the world economy over recent years. While many of the world's major economies have experienced recession, the UK grew continuously throughout the global downturn that began in 2001. The UK is the only G7 economy not to have experienced at least one quarterly contraction in output over the last three years, with GDP now having grown for 46 consecutive quarters, which, on the basis of quarterly national accounts' data, is the longest sustained expansion on record.

UK GDP rose 0.9 per cent in the fourth quarter of 2003, the fastest rate for over three and a half years. For 2003 as a whole, GDP rose by 2.3 per cent, consistent with the Budget 2003 forecast of 2 to 2½ per cent and slightly above the 2003 Pre-Budget Report estimate of 2.1 per cent. GDP is expected to grow by 3 to 3½ per cent in both 2004 and 2005 before returning to a trend of 2½ to 3 per cent in 2006.

The Budget 2004 projections for the public finances are little changed from the 2003 Pre-Budget Report, and show that the Government is on track to meet its strict fiscal rules:

- **the current budget since the start of the current economic cycle in 1999-2000 shows an average annual surplus up to 2005-06 of 0.1 per cent of GDP and the Government is therefore on track to meet the golden rule on the basis of cautious assumptions. There is a margin against the golden rule of £11 billion in this cycle, including the Annually Managed Expenditure (AME) margin. The current budget returns to balance by 2006-07, and the cyclically-adjusted current budget in the cautious case moves back to balance by the end of the projection period; and**
- **public sector net debt is projected to remain low and stable over the next five years, stabilising at just under 36½ per cent of GDP – £53 billion below the 40 per cent ceiling set in the sustainable investment rule.**

Budget 2004 sets firm overall spending limits for the 2004 Spending Review period, allowing:

- **current spending to increase by an average 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumption for trend economic growth and consistent with the nominal growth rates set out in Budget 2003 and the 2003 Pre-Budget Report. Final plans for Department Expenditure Limits (DEL) and AME will be set in the Spending Review; and**
- **public sector net investment to rise from 2 per cent of GDP to 2¼ per cent of GDP by 2007-08 to continue to address historic under-investment in Britain's infrastructure.**

The growth rate of both overall spending and departmental spending will be lower in the 2004 Spending Review than in the 2002 Spending Review. However, building on the progress made in correcting historic under-investment, and with administration costs frozen in nominal terms and planned efficiency gains, the Government expects to match the pace of growth in front line public services achieved in the last Spending Review.

THE MACROECONOMIC FRAMEWORK

2.1 The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges that have faced the world economy over recent years. While many of the world's major economies have experienced recession, the UK grew continuously throughout the global downturn that began in 2001. The UK is the only G7 economy not to have experienced at least one quarterly contraction in output over the last three years, with GDP now having grown for forty-six consecutive quarters – the longest unbroken expansion since quarterly records began five decades ago.

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

2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability.[1] The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term while allowing fiscal policy to support monetary policy over the economic cycle. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

Monetary policy framework

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

- clear and precise objectives. While the primary objective of monetary policy is to deliver price stability, the adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's inflation target. **The Government reaffirms in Budget 2004 the target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI),** which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC

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

proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC.

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

Box 2.1: The new inflation target

On 10 December 2003, the Pre-Budget Report confirmed that the inflation target would with immediate effect switch to a measure based on the harmonised index of consumer prices, which the National Statistician named the Consumer Prices Index (CPI) for the UK. This improves the quality of the UK inflation target and also helps ensure inflation expectations in the UK remain in line with those in the euro area.

The new inflation target is 2 per cent for the 12-month increase in the CPI. The rate for the new target is ½ a percentage point lower than the previous target of 2½ per cent for the 12-month increase in Retail Prices Index excluding mortgage interest payments (RPIX) because of differences in the way that CPI and RPIX inflation are measured. The level of the new target was set to be consistent with the old target in two years' time, the typical forecast horizon for monetary policy purposes, and broadly in line with the expected long-run difference between the CPI and RPIX measures arising from differences between their formulae.

The move to a target for inflation based on the CPI measure of inflation has a number of distinct advantages over the RPIX measure for monetary policy purposes.[a] In particular, the CPI:

- **better allows for the substitution of cheaper for more expensive goods and services within expenditure categories when relative prices change and so may be considered a more realistic depiction of consumer behaviour;**
- **has a wider population coverage and is more consistent with national accounts principles of consumer expenditure, so it shares a coherence with other economic statistics and gives a better picture of spending patterns in the UK; and**
- **is a more comparable measure of inflation internationally and represents international best practice. The CPI measure of inflation is also consistent with the Harmonised Index of Consumer Prices (HICP) which is the European Central Bank's (ECB) preferred measure of inflation and the measure used to judge whether the ECB has met its objective of achieving price stability. The adoption of the CPI will therefore enable a more direct comparison between inflation rates in the United Kingdom and the euro area.**

[a] Further detail can be found in the ONS article 'The New Inflation Target: The Statistical Perspective', Economic Trends, January 2004

Fiscal policy framework

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

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and

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

- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

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

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

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

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

2.9 The fiscal policy framework also takes account of uncertainty that is inherent in projections of the public finances. The fiscal projections are based on cautious assumptions for key economic variables, including the trend rate of growth, oil prices and the level of unemployment. This cautious approach builds a safety margin into the public finances and minimises the need for unexpected changes in taxation or spending. The assumptions are audited by the Comptroller and Auditor General as part of a three-year rolling review to ensure that they remain reasonable and cautious.

Public spending framework

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

Box 2.2: Government policy on EMU

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

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

- **switching the symmetric inflation target to one measured by the Consumer Prices Index (CPI). This will improve the quality of the UK inflation target and will help ensure inflation expectations in the UK remain in line with those in the euro area. Further detail is provided in Box 2.1;**
- **the publication of the draft euro referendum bill on 10 December 2003. The draft bill allows for consultation over the details of a referendum if one were to be held;**
- **reforms to address both supply and demand in the housing market and macroeconomic stabilisation by implementing a programme of change to increase supply and responsiveness of the housing market as recommended in the Barker review and, on the demand side, responding to the Miles review on the mortgage market. Further detail is provided in Box 2.9; and**
- **reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. Boxes 3.2 and 4.1 provide further detail. The Government is committed to publishing six-monthly reports on trends and progress in increasing flexibility in the UK economy. The second flexibility report is published alongside the Budget today.**

The Government issues six-monthly reports on euro preparations. The seventh report in November 2003 set out the progress that has been made across the economy since June 2003. In addition, the Government is continuing to discuss the proposals set out in the discussion paper *Fiscal Stabilisation and EMU*. On the Stability and Growth Pact, the Government continues to emphasise the need for a more prudent interpretation of the Pact as described in Box 2.6 and is today publishing *The Stability and Growth Pact: A Discussion Paper,* which assesses the performance of the Pact against the principles of credibility, flexibility and legitimacy and considers how a prudent interpretation helps the Pact better to achieve its objectives. The Government also remains committed to the EU's Lisbon strategy on economic reform, launched in March 2000, and will continue to work with Member States and the EU institutions to build on progress so far and to accelerate the pace of reform in order to meet the Lisbon challenge.

While the Government does not propose a euro assessment be initiated at the time of this Budget, the Treasury will again review the situation at Budget time next year.

Financial stability framework

2.11 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding[3] in 1997 established a framework for co-operation between these three bodies on financial stability. The Bank of England is responsible for the stability of the financial system as a whole, including the payments infrastructure. The FSA is responsible for the authorisation and supervision of financial institutions including banks, for supervising financial markets and securities clearing and settlement systems, and for regulatory policy. The Treasury has responsibility for the overall institutional structure of regulation and the legislation that governs it.

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

THE PERFORMANCE OF THE FRAMEWORK

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

Monetary policy

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

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target value of $2^1/_2$ per cent; and

- inflation expectations have been close to target – market expectations are that CPI inflation will be close to the 2 per cent target.

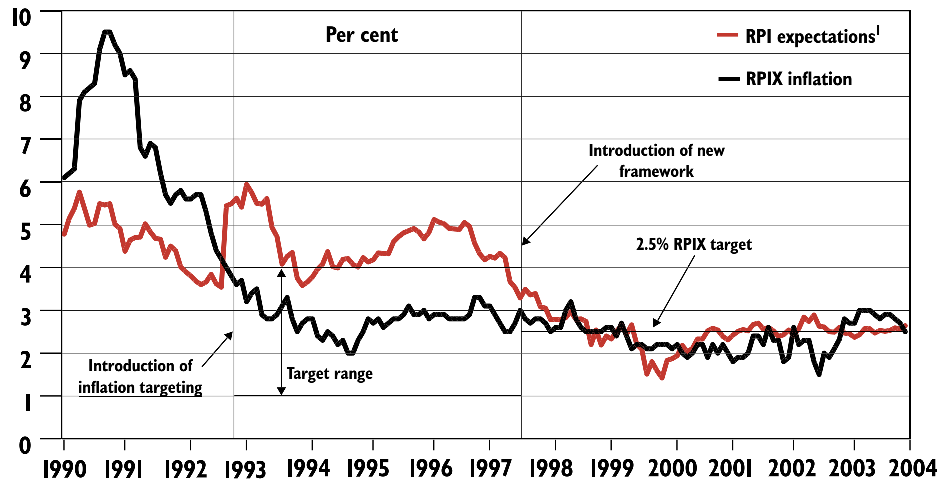
2.15 The framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped to keep output relatively close to its trend level, while ensuring that inflation remained close to target. Consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation as growth strengthens the MPC has raised interest rates twice in recent months by $^1/_4$ percentage point in November 2003 and February 2004.

2.16 Despite increasing during the year, the average long-term, ten-year interest rate in the UK was around $4^1/_2$ per cent in 2003, the lowest average annual rate in over 40 years. Low long-term rates reduce the Government's debt interest payments, free up resources for public services and help to promote investment throughout the economy. UK long-term, ten-year forward interest rates[4] remain below the equivalent rates in the euro area and the US, as they have done for the past five years.

[3] Full text available at on the Treasury website www.hm-treasury.gov.uk.

[4] Source: www.bankofengland.co.uk and Bank of England.

Chart 2.1: Inflation performance and expectations



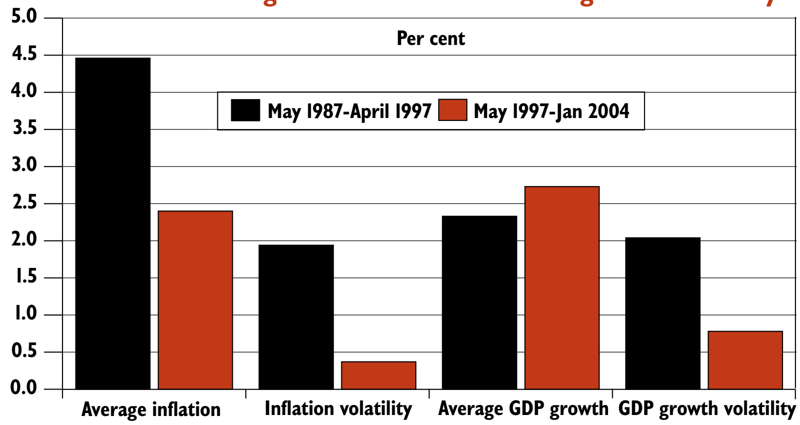
[1] *Ten year ahead market inflation expectations.*

Fiscal policy **2.17** The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by more than 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. Public sector net debt was also reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.2 shows, in 2003 the UK's net debt was the lowest in the G7.

Box 2.3: The benefits of inflation targeting with central bank independence

In May 1997, the Chancellor gave the Bank of England full operational independence with the Monetary Policy Committee being set a single, symmetrical, point inflation target.

Chart a: UK GDP growth and inflation: averages and volatility[a]

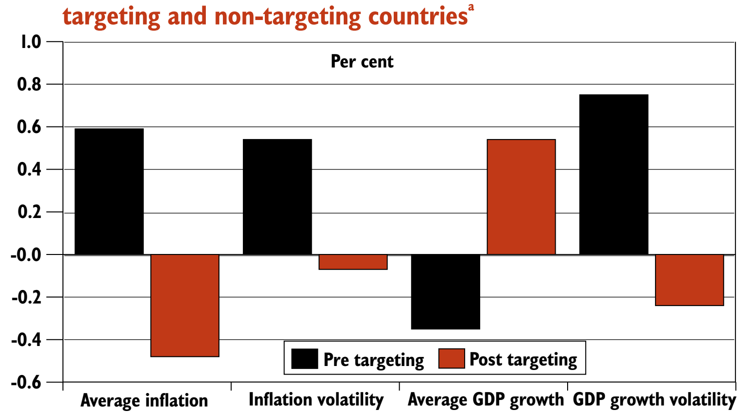


[a] Inflation is measured on the RPIX basis. Inflation and GDP growth volatility are measured by standard deviations.

The arrangements for monetary policy introduced in 1997 were designed to enhance credibility. The chart above shows that since May 1997, average inflation, the volatility of inflation and the volatility of output growth have all fallen in the UK relative to the previous 10 years, without any adverse effects on output growth. Furthermore since May 1997, the UK has had the lowest volatility of inflation and output growth of all the G7 countries.

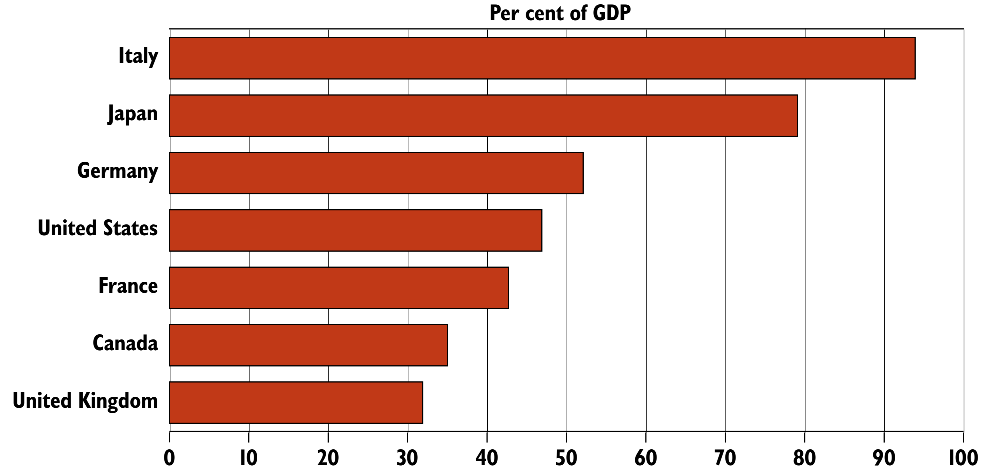
Other OECD countries that have adopted explicit inflation targets with independent central banks have also shown an improved performance. The chart below shows that before inflation targeting these countries had experienced relatively high average inflation, high inflation volatility, high output growth volatility and low output growth. After these changes, performance improved, not only compared to their past histories, but also with respect to the group of countries that have not adopted inflation targets. However, in many of the inflation-targeting countries, including the UK, the monetary policy reforms were also accompanied by reforms in other areas such as fiscal policy and so the improvements could partly reflect these wider reforms.

Chart b: Difference in performance between inflation targeting and non-targeting countries[a]



[a] Inflation and GDP growth volatility are measured by standard deviations.
Note: The inflation targeters are the UK, New Zealand, Australia and Sweden. The non-targeters are the US, Japan, France, Germany, Italy, the Netherlands, Portugal, Ireland, Austria, Belgium, Denmark and Greece. For the inflation targeters, the pre targeting period is the ten year period before inflation targets were implemented. For the countries that do not target inflation, the pre targetting period reflects the median date of the change in monetary policy regimes in the inflation targeters.

Chart 2.2: Net financial liabilities in the G7 in 2003



Source: OECD Economic Outlook 74. December 2003.

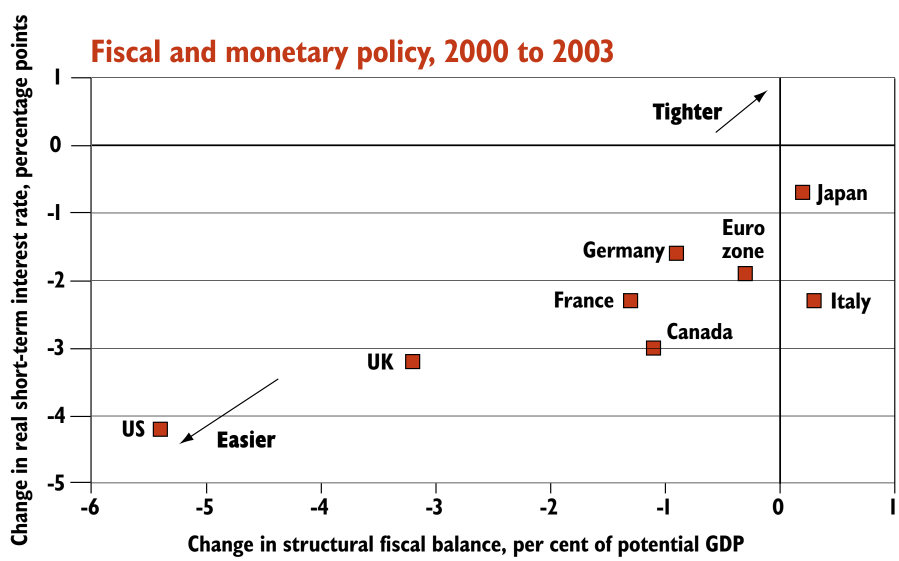
2002 Spending Review

2.18 The 2002 Spending Review set spending plans for the years 2003-04 to 2005-06 for the public services other than the NHS, for which spending plans to 2007-08 were fixed in the 2002 Budget. Continuing the trend set in previous Spending Reviews, these spending plans allowed for significant increases in investment for the key public services, with resources focused on health, education, transport, criminal justice and housing. The overall spending limits set in Budget 2002 and confirmed in the 2002 Spending Review remain sustainable and fully consistent with the fiscal rules.

Box 2.4: Global downturn – the response of monetary and fiscal policy in G7 economies

While world economic growth is now strengthening, the global slowdown that began in 2001 resulted in many of the world's major economies, including the US, Japan, Italy and Germany, moving into recession. In the UK, the Bank of England's Monetary Policy Committee took decisive action to cut short-term interest rates, while inflation expectations remained close to target. At the same time, fiscal policy was able to support monetary policy, underpinned by strong and sustainable public finances. The UK experienced unbroken growth throughout this period. The chart shows how fiscal policy supported monetary policy in the US and UK from 2000 to 2003, while monetary and fiscal policy were less responsive in many other countries.

Fiscal and monetary policy, 2000 to 2003



Source: Calculated from OECD Economic Outlook No 74 December 2003.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.19 The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges that have faced the world economy over recent years. As described in Box 2.4, while many of the world's major economies have experienced recession, the UK grew continuously throughout the global downturn that began in 2001. Indeed, the UK is the only G7 economy not to have experienced at least one quarterly contraction in output over the past three years, with GDP now having grown for 46 consecutive quarters which, on the basis of quarterly national accounts' data, is the longest sustained expansion on record.

2.20 In early 2003, geo-political and other uncertainties weighed heavily on international growth prospects, and global activity remained weak. However, growth in several major economies had already picked up by the middle of last year and, as expected at the time of the Pre-Budget Report, activity has continued to strengthen across the world's major economies. As geo-political and other uncertainties have receded, global demand has strengthened and most major international financial markets have seen valuations rise back to around the levels of spring or summer 2002.

Table 2.1: The world economy

	Percentage change on a year earlier unless otherwise stated			
		Forecasts		
	2003	2004	2005	2006
Major 7 countries[1]				
Real GDP	2¼	3¼	3	2¾
Consumer price inflation[2]	1½	1½	1¾	1¾
Euro-area				
Real GDP	½	1¾	2¾	2½
World trade in goods and services	4¼	7¾	8	7¼
UK export markets[3]	3¾	6¼	7¼	6¾

[1] *G7: US, Japan, Germany, France, UK, Italy and Canada.*
[2] *Per cent, Q4.*
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

2.21 UK GDP rose 0.9 per cent in the fourth quarter of 2003, the fastest rate for over three and a half years and following growth of 0.8 per cent in the third quarter. For 2003 as a whole, GDP rose by 2.3 per cent, consistent with the Budget 2003 forecast of 2 to 2½ per cent and a little above the 2003 Pre-Budget Report estimate of 2.1 per cent.

Economic prospects

2.22 Economic developments and prospects remain much as envisaged in the 2003 Pre-Budget Report. As at that time, the recent pick-up in activity seen over the latter half of 2003 is expected to be consolidated through 2004 and into 2005. As demand continues to accelerate into 2004, GDP is forecast to grow by 3 to 3½ per cent both this year and in 2005. The output gap is forecast to close by early 2006 and GDP growth is forecast to moderate thereafter, with the economy projected to remain at trend. The 2004 Budget forecast for GDP growth is therefore the same as in the 2003 Budget and Pre-Budget Reports in every year of the current projection period.

Table 2.2: Summary of UK forecast

		Forecast		
	2003	2004	2005	2006
GDP growth (per cent)	2¼	3 to 3½	3 to 3½	2½ to 3
CPI inflation (per cent, Q4)	1½	1¾	2	2

2.23 The forecast for CPI inflation is also broadly unchanged compared with the 2003 Pre-Budget Report. Inflation is expected to remain a little below its symmetrical 2 per cent target in 2004 as existing slack in the economy continues to subdue domestically generated pricing pressures. However, inflation is expected to return to target by mid-2005 as the lagged effects of sterling's depreciation against the euro since 2002, combined with the effects – already evident in commodity prices – of the strengthening synchronised recovery in the world economy, feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

2.24 Business investment shows signs of having increased in recent months, following a prolonged period of weakness during which global uncertainty reduced companies' appetite to undertake capital expenditure. Survey evidence indicates investment intentions have risen sharply in recent months, and business investment is forecast to pick up through this year as the global recovery gathers pace.

2.25 Tentative signs of improved international prospects feeding through to higher external demand have also emerged. Although the sterling exchange rate index has strengthened a little since last December's Pre-Budget Report, this mainly reflects further rises in sterling's exchange rate with the US dollar. Sterling has been relatively more stable against the euro, but remains significantly weaker in relation to it than for most of the first four years of the euro's existence. Recent exchange rate developments are discussed in more detail in Box B6.

2.26 Export growth is expected to pick up more significantly through 2004 and 2005 as external demand continues to accelerate. The weakening of sterling against the euro should provide a boost to export volumes as euro area GDP growth picks up and the lags between exchange rates and trade flows work through.

2.27 At the same time, private consumption growth is forecast to moderate and remain comfortably below the rates seen for much of the period since the mid-1990s. As investment and exports pick up, the composition of demand is projected to become more balanced than in recent years.

Risks

2.28 Risks, both on the upside and downside, have changed little since the time of the 2003 Pre-Budget Report. A number of ongoing risks and uncertainties to the world economy would, if realised, influence the UK economy. In particular, the US dollar has continued to decline against some other major currencies in recent months. So far, this has been an orderly depreciation, accompanied by improving financial conditions and strengthening growth, but given continued large global imbalances, much sharper movements in major exchange rates cannot be ruled out. This highlights the urgent need for policy makers to push ahead with the structural reforms that will ensure a more broadly-based and sustainable global recovery over the medium term, minimising the risk of a disorderly unwinding of global trade positions.

2.29 A further downside risk comes from the potential rebuilding of balance sheets. Significant progress has been made in rebuilding household and corporate balance sheets across several major economies since the recession of 2001. However, this process may not be complete and could resume once the stimulus from policy begins to fade. Another downside risk comes from the continued threat of international terrorism.

2.30 In the UK, downside risks continue to be associated with the outlook for consumer spending. While the forecast allows for a moderation in the growth of private consumption, expenditure could undergo a sharper than expected correction if, for example, house prices were to decline significantly or the world economy were to suffer a negative shock. On the upside, the pick-up in growth seen since early 2003 could prove stronger than expected in the short-term. In particular, business investment has, in the past, tended to surprise on the upside once into an upswing, and private sector capital expenditure could once more prove stronger than forecast over the projection period. Similarly, private consumption could again prove to have more near-term momentum than envisaged in the Budget forecast, although this would raise the risk of a sharp correction in the opposite direction further out.

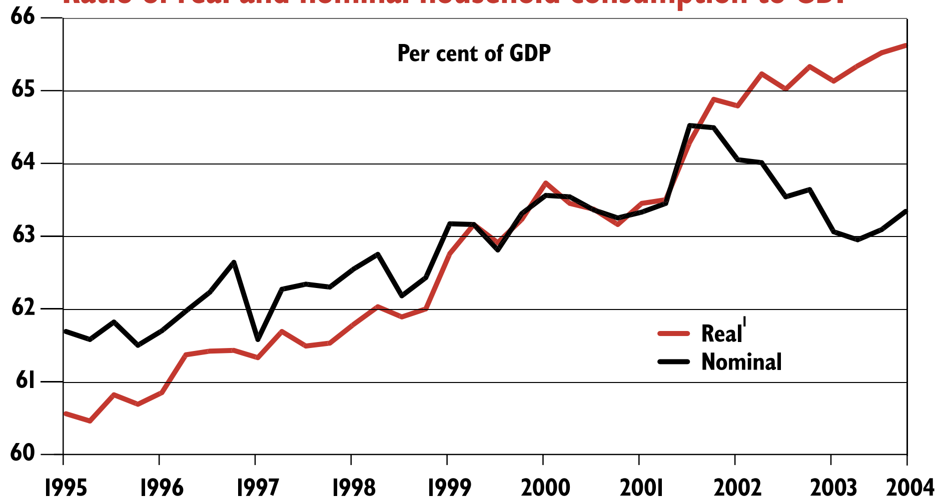
The economic cycle

2.31 On the basis of the Government's provisional judgement on the dating of the current and past economic cycles, the economy completed a full, though short, cycle between the first half of 1997 and mid-1999. The current economic cycle began in mid-1999 when actual output moved above the trend level. In the second half of 2001, the economy moved below trend with actual output remaining below the trend level since then. The economy is expected to return to trend by early 2006 as forecast in the 2003 Pre-Budget Report.

Box 2.5: The sustainability of household consumption

Growth of real household consumption moderated in 2003, increasing by 2.8 per cent, its slowest annual rate since 1995. Moreover, much of the growth in household consumption volumes over the past year appears to have been spurred by strong competition exerting downward pressures on prices in parts of the retail and service sectors: in nominal terms, private consumption in 2003 grew by 4.4 per cent, its slowest since 1949, and its share in GDP fell by more than in any year since 1977. This further supports the evidence set out in the 2003 Pre-Budget Report that since the mid-1990s the data in nominal terms indicate growth in private consumption has been more sustainable than the real measures suggest. However, it also suggests that, independent of the temporary effects of the global uncertainties prevailing earlier in 2003, households' expenditure patterns have gradually begun to adjust to relatively high levels of indebtedness and weaker growth in real incomes compared with recent years.

Ratio of real and nominal household consumption to GDP



[1] *Ratio of household consumption to GDP in chained volume measures.*

Nonetheless, as international uncertainties have receded, growth in real consumer spending has picked up from its low in early 2003 and revealed more momentum than previously expected, with growth of 1 per cent or more in each of the past three quarters. This unexpected momentum has been accompanied by continued growth in household borrowing at historically high rates. In the three months to January 2004, the stock of household debt was up by just over 13 per cent on a year earlier.

Although the ratio of household debt to income has climbed to historically high levels, this needs to be viewed alongside developments in household assets. The ratio of household debt to total net wealth is currently estimated to be no higher than it was in 1995. Moreover, more than three quarters of the increase in household mortgage debt since early 2000 has been matched by the build-up of household holdings of money and deposits. This is consistent both with the view that much of mortgage equity withdrawal (MEW) over this period has been saved rather than used to finance spending, and with the relatively stable saving ratio in recent years. It also suggests that the risk of a moderation in house price inflation and sharply lower MEW leading to faltering consumer spending growth should not be overstated. In any case, despite strong increases in MEW, households' equity in housing has continued to build up. Equity is estimated recently to have risen to almost four fifths of house values, which is high by historical standards. This reduces the likelihood of MEW coming rapidly to an end.

NAO audited assumptions

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

2.33 Under the rolling review, for Budget 2003 the Comptroller and Auditor General has audited the assumptions relating to factor income shares and government financing. In both cases the review concluded that the assumptions were reasonable and continue to be so for the future.

2.34 As described in Chapter 5, Budget 2004 announces a new compliance and enforcement package for direct taxes and national insurance contributions. Consistent with previous practice, the estimates of the extra revenue delivered by the package include the direct and preventive effects of the package and made no allowances for indirect effects. Therefore, while the package is expected to produce an additional £2 billion in revenue over the next three years, in line with the Government's cautious approach to the public finances, a lower figure of £1.7 billion has been included in the public finances projections. The Comptroller and Auditor General has audited the approach adopted to estimate the revenue benefits of the package and concluded that, though there are uncertainties in the estimates of the benefits, it is reasonable and incorporates caution.

2.35 As explained in Chapter C, in the light of the volatility in the observed ratio of VAT to consumption, a new approach to project VAT receipts has been used for the projections in Budget 2004. This is a more comprehensive approach to model the tax base than the old one, and uses an assumption on the VAT gap. The Comptroller and Auditor General has also completed the audit of the assumption on the VAT gap used to project VAT receipts. In his report, the Comptroller and Auditor General has concluded that the assumption has features that introduce caution in the projections for VAT and is reasonable.

RECENT FISCAL TRENDS AND OUTLOOK

2.36 Budget 2004 presents the Government's annual fiscal forecast and updates the 2003 Pre-Budget Report interim projections.

2.37 The Pre-Budget Report interim projections showed weaker receipts as a result of lower than expected growth in certain GDP components and higher than expected spending, including that arising from the UK's international commitments. The Budget 2004 public finance projections show little change compared with the Pre-Budget Report as trends in receipts and spending have turned out largely as expected.

2.38 The estimated 2003-04 outturn for the public sector current budget shows a deficit of £21.3 billion compared with projected deficits of £19.3 billion and £8.4 billion in the 2003 Pre-Budget Report and Budget 2003 respectively. For public sector net borrowing, the estimated 2003-04 outturn is £37.5 billion, compared with £37.4 billion projected in the 2003 Pre-Budget Report and £27.3 billion projected in Budget 2003. On the basis of cautious, audited assumptions, the Government remains on course to meet its fiscal rules over the economic cycle.

2.39 Table 2.3 shows projections for public sector net borrowing compared with those presented in the 2003 Pre-Budget Report. It disaggregates the difference into those relating to the assumptions audited by the NAO, changes in GDP components and other forecasting effects. It also shows the discretionary measures, including the decision to reset the Annually

Managed Expenditure (AME) margin. If the Government had not decided to rebuild this cautious safety margin in AME, medium-term projections for net borrowing would have been lower and the surplus on the current budget higher than shown in the 2003 Pre-Budget Report.

Table 2.3: Public sector net borrowing compared with the 2003 Pre-Budget Report

£ billion	Estimate[1]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
PBR 2003	**37.4**	**31**	**30**	**27**	**27**	**24**
Assumptions audited by the NAO	**–0.2**	**–1**	**–1½**	**–2**	**–2**	**–1½**
of which:						
VAT forecasting assumption	0.0	½	0	–½	–1	–1
equity prices	0.0	–½	–1	–1	–1	–1
GDP components	**0.3**	**–½**	**–1**	**–1**	**–1**	**–½**
of which:						
consumers expenditure	0.0	–½	–½	–½	–½	0
Other forecasting effects	**0.0**	**2**	**2½**	**2½**	**2**	**½**
of which:						
receipts	0.6	1½	2	2	2	2
expenditure	–0.7	½	½	0	–½	–1½
Total before discretionary measures	**37.5**	**32**	**30**	**27**	**26**	**22**
Discretionary measures[2]	0.0	1½	1	½	½	½
of which:						
resetting the AME margin	0.3	1	2	2	2	2
Inland Revenue compliance package	0.0	0	–½	–1	–1	–1
Budget 2004	**37.5**	**33**	**31**	**27**	**27**	**23**

Note: Figures may not sum due to rounding.
[1] *The 2003-04 figures were estimates in PBR 2003.*
[2] *Includes measures announced since the 2003 Pre-Budget Report.*

2.40 Changes associated with assumptions audited by the NAO have reduced net borrowing. The new approach for forecasting VAT, which is based on a more detailed model of the VAT base and an audited assumption on the VAT gap, which the NAO have concluded incorporates caution, has increased projected receipts by up to £1½ billion. In addition, higher equity prices are expected to increase receipts from corporation tax, capital taxes and stamp duty.

2.41 Differences between the 2003 Pre-Budget Report and Budget 2004 projections for individual components of GDP have reduced net borrowing. This is mainly due to higher levels of consumers' expenditure, which increases projections for VAT receipts, related to information from the latest national accounts' data for 2003. Other forecasting effects for receipts are the result of revisions to NHS gross operating surpluses, though this is matched by changes in receipts and therefore is fiscally neutral; lower than projected receipts of council tax, which is also fiscally neutral; and recent trends in incorporations. The expenditure forecasting effects are mainly related to AME, discussed below, and the revenue neutral switch with NHS gross operating surplus.

Non-discretionary changes in receipts

2.42 Table 2.4 shows how projections for specific receipts and spending items have affected net borrowing since the 2003 Pre-Budget Report. Projections for receipts from income tax, national insurance contributions and non-north sea corporation tax taken together are lower in 2003-04, a result of temporarily higher capital allowances and corporation tax repayments, but over the medium term, are broadly unchanged from the 2003 Pre-Budget Report. Recent data show that underlying receipts are increasing in line with the 2003 Pre-Budget Report projections, with financial companies' profits and income tax receipts from bonuses both increasing as expected.

2.43 Receipts from VAT are greater than expected this year, and in future years are increased by higher consumers' expenditure and the new audited assumption. Projections for excise duties and vehicle excise duty (VED) are lower as a result of a lower projection for RPI inflation and a lower estimated outturn this year respectively.

Non-discretionary changes in spending

2.44 The estimated outturn for Total Managed Expenditure (TME) in 2003-04 is £0.5 billion higher than projected in the 2003 Pre-Budget Report. The estimated outturn for 2003-04 Departmental Expenditure Limits (DEL) is £1 billion lower than projected in the 2003 Pre-Budget Report.

2.45 Projections for AME are, as shown in Table 2.4, higher in the short term compared to the 2003 Pre-Budget Report projections, though they remain broadly unchanged over the medium term. In the short term, the effect of a re-profiling of Child and Working Tax Credit payment schedules has increased expenditure. In addition, there is higher spending in the early years from changes in the timing of payments of the UK's contributions to the EU. AME is also affected by changes to local authority self-financed expenditure, which are fiscally neutral and related to lower council tax receipts discussed above.

Table 2.4: Changes in projections of public sector net borrowing since the 2003 Pre-Budget Report

£ billion	Estimate[1]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
PBR 2003	**37.4**	**31**	**30**	**27**	**27**	**24**
Changes before discretionary measures	**0.1**	½	–½	–½	–1	–1½
of which:						
Income tax, NICs and non-North Sea CT	0.6	1½	½	0	½	0
VAT	–0.7	–½	–1	–1½	–2	–2
Excise duties and VED	0.1	½	½	½	½	½
AME[2]	0.9	½	0	0	0	0
Other	–0.7	–1½	0	½	½	0
Total before discretionary measures	**37.5**	**32**	**30**	**27**	**26**	**22**
Discretionary measures[3]	0.0	1½	1	½	½	½
of which:						
resetting the AME Margin	0.3	1	2	2	2	2
Inland Revenue compliance package	0.0	0	–½	–1	–1	–1
Budget 2004	**37.5**	**33**	**31**	**27**	**27**	**23**

Note: Figures may not sum due to rounding.
[1] *The 2003-04 figures were estimates in PBR 2003.*
[2] *Resource AME.*
[3] *Includes measures announced since the 2003 Pre-Budget Report.*

BUDGET DECISIONS

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

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

2.47 Within this disciplined framework, Budget 2004 shows the Government can meet its public spending commitments and announces further decisions to create a Britain of stability and strength, including:

- a £100 payment to pensioner households with someone aged 70 or over to help with their council tax bills;
- a package of measures to help protect tax revenues for the benefit of all taxpayers. The Inland Revenue has been provided with additional resources to support a new compliance and enforcement package as described in Chapter 5;
- Budget 2004 sets firm overall spending limits for the 2004 Spending Review period, allowing:
  - current spending to increase by an average 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumption for trend economic growth and consistent with the nominal growth rates set out in Budget 2003 and the 2003 Pre-Budget Report. Final plans for DEL and AME will be set in the Spending Review;
  - public sector net investment to rise from 2 per cent of GDP to $2^1/_4$ per cent of GDP by 2007-08 to continue to address historic under-investment in Britain's infrastructure; and
- the growth rate of both overall spending (TME) and departmental spending (DEL) will be lower in the 2004 Spending Review than in the 2002 Spending Review. However, building on the progress made in correcting historic under-investment, and with administration costs frozen in nominal terms and planned efficiency gains, the Government expects to match the pace of growth in front line public services achieved in the last Spending Review.

2.48 Table 1.2 lists the key Budget policy decisions and their impact on the public finances. Further details are set out in Chapter A of the FSBR.

2.49 The Government has also decided to reset the AME margin to £1 billion and £2 billion for the years 2004-05 and 2005-06, in accordance with usual practice. This increases projections for TME by the same amount, and ensures that the public spending projections include a prudent and cautious safety margin against unexpected events. The resetting of the AME margin transfers around £3 billion to an explicit public spending safety margin and maintains the same overall caution in the projections as a whole.

MEDIUM-TERM FISCAL PROJECTIONS

2.50 Table 2.5 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2003 and in the 2003 Pre-Budget Report. Changes in the fiscal balances are disaggregated into those attributable to revisions or forecasting changes and discretionary measures. It includes the impact of all Budget decisions in accordance with the *Code for fiscal stability.* Consistent with the presentation in the Pre-Budget Report, the table includes the impact of the windfall tax and associated spending. Further detail is provided in Chapter C of the FSBR.

2.51 The revised outturn for 2002-03 shows the deficit on the current budget to be £0.5 billion higher than in Budget 2003, and £0.4 billion higher than in the 2003 Pre-Budget Report. The outturn for net borrowing is £1.1 billion lower than shown in Budget 2003, and £0.4 billion higher than in the 2003 Pre-Budget Report.

Table 2.5: Fiscal balances compared with Budget 2003 and the 2003 Pre-Budget Report

	Outturn[1]	Estimate[2]	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Surplus on current budget (£ billion)							
Budget 2003	**–11.7**	**–8.4**	**–1**	**2**	**6**	**9**	**–**
Effect of forecasting changes:							
Receipts[3]	–0.5	–5.5	–4	–4	–3	–1	–
Current expenditure[4]	0.4	–2.9	–2	–2	–3	–3	–
Effect of discretionary changes[5]	0.0	–2.5	–1	–1	0	0	–
PBR 2003	**–11.8**	**–19.3**	**–8**	**–5**	**0**	**4**	**8**
Effect of revisions and forecasting changes:							
Receipts[3]	–0.4	–1.3	–2	–1	0	0	1
Current expenditure[4]	–0.1	–0.6	1	1	1	1	1
Effect of discretionary changes[5]	0.0	0.0	–1	–1	–1	–1	0
Budget 2004	**–12.3**	**–21.3**	**–11**	**–5**	**0**	**4**	**9**
Net borrowing (£ billion)							
Budget 2003	**24.0**	**27.3**	**24**	**23**	**22**	**22**	**–**
Changes to current budget	0.1	10.9	7	7	6	4	–
Forecasting changes in net investment	–1.5	-0.9	0	0	0	0	–
Discretionary changes to net investment	0	0	0	0	0	0	–
PBR 2003	**22.5**	**37.4**	**31**	**30**	**27**	**27**	**24**
Changes to current budget	0.5	1.9	2	1	0	0	–1
Forecasting changes in net investment	–0.1	–1.8	0	0	0	0	0
Discretionary changes to net investment	0.0	0.0	0	0	0	0	0
Budget 2004	**22.9**	**37.5**	**33**	**31**	**27**	**27**	**23**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2003	–0.5	0.2	0.5	0.4	0.4	0.6	–
PBR 2003	–0.6	–0.8	–0.1	–0.1	0.0	0.3	0.6
Budget 2004	**–0.6**	**–1.0**	**–0.2**	**–0.2**	**0.0**	**0.3**	**0.7**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2003	1.7	1.5	1.5	1.7	1.7	1.6	–
PBR 2003	1.6	2.4	2.0	2.2	2.0	1.9	1.7
Budget 2004	**1.6**	**2.4**	**2.1**	**2.3**	**2.1**	**1.9**	**1.6**
Net debt (per cent of GDP)							
Budget 2003	30.9	32.2	32.7	33.2	33.5	33.8	–
PBR 2003	30.9	32.8	33.8	34.6	35.1	35.4	35.5
Budget 2004	**30.8**	**33.2**	**34.4**	**35.3**	**35.9**	**36.3**	**36.4**

[1] *The 2002-03 figures were estimates in Budget 2003.*
[2] *The 2003-04 figures were projections in Budget 2003.*
[3] *Further details given in table C7.*
[4] *Includes depreciation.*
[5] *Includes measures announced since the 2003 Pre-Budget Report.*

2.52 Short-term projections for the surplus on the current budget are slightly lower, and net borrowing slightly higher compared to the 2003 Pre-Budget Report reflecting lower receipts and a reprofiling of expenditure. As receipts strengthen over the projection period, so the main fiscal aggregates return to the levels projected in the 2003 Pre-Budget Report. Debt is forecast to rise to just under 36½ per cent of GDP by the end of the projection period. The revision to debt also includes the impact of fully reflecting the Blue Book 2003 changes to the classification of business rates, which increases the public sector net cash requirement by around £1 billion a year.

2.53 Table 2.5 also sets out the underlying structural position of the fiscal balances, adjusted for the impact of the economic cycle on the public finances.[5] Cyclically-adjusted, the current budget and net borrowing are little changed from the 2003 Pre-Budget Report projections. Compared to Budget 2003, cyclically-adjusted net borrowing is higher, and the surplus on the current budget lower, in the near term. Towards the end of the projection period, they return towards the levels shown in Budget 2003.

Box 2.6: The Stability and Growth Pact

The Stability and Growth Pact is intended to ensure that EU Member States maintain sound public finances. Fiscal sustainability is a prerequisite for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy coordination.

The Government supports a prudent interpretation of the Pact that builds on the Code of Conduct, agreed by Member States in June 2001[a] and the March 2003 ECOFIN conclusions agreed by Finance Ministers on strengthening budgetary coordination. A prudent interpretation would lock in long-term fiscal discipline and sustainability, enhancing credibility across the economic cycle, while allowing the automatic stabilisers to smooth fluctuations in output, and allow appropriate increases in investment in public services. Specifically, it would take into account:

- **the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy;**
- **sustainability – low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations, such as that set out in Annex A and in the 2003 *Long-term public finance report*; and**
- **public investment – public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.**

The Government is today publishing *The Stability and Growth Pact: A Discussion Paper.* This assesses the performance of the Pact against the principles of credibilty, flexibility and legitimacy and considers how a prudent interpretation helps the Pact better to achieve its objectives. The issue is not one of fundamental overhaul or Treaty change, but evolution. There are signs that the implementation of the Pact is evolving towards a more prudent interpretation. Over the past two years the Council has approved: a greater focus on cyclical adjustment; a recognition that the automatic stabilisers should be allowed to operate symmetrically over the cycle; a greater focus on long-run sustainability, including the impact of ageing populations; a greater emphasis on debt reduction in highly indebted countries; and greater attention to the quality of public finances.

[a] The Code of Conduct on the content and format of Stability and Convergence Programmes was agreed as an EFC Opinion, endorsed by ECOFIN in October 1998 and revised in June 2001. Available at www.europa.eu.int

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

ADHERING TO PRINCIPLES

2.54 Table 2.6 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. The table indicates that, after allowing for non-discretionary changes to receipts and spending and taking into account the Budget decisions, the Government remains on track to meet both fiscal rules.

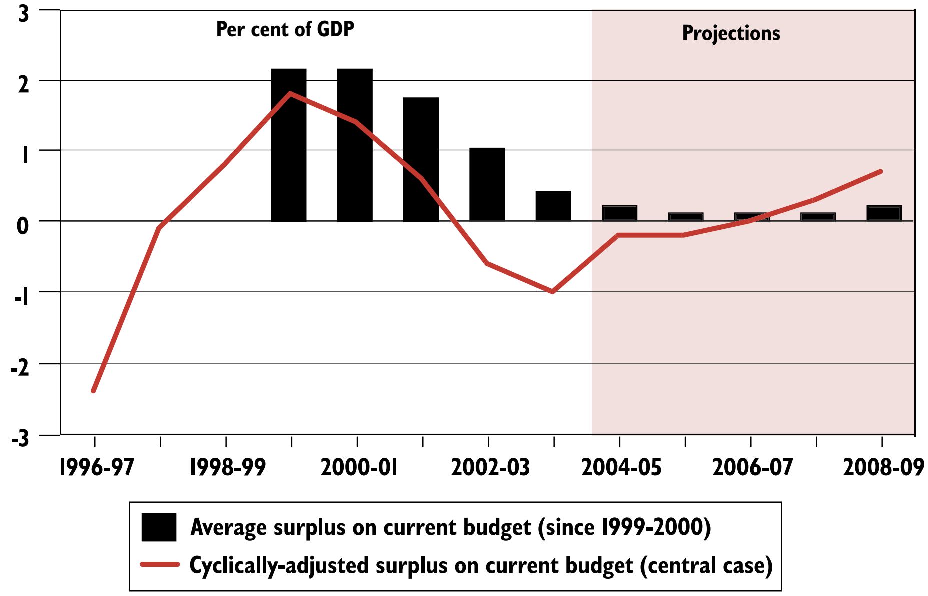
Table 2.6: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate[1]	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Fairness and prudence							
Surplus on current budget	–1.2	–1.9	–0.9	–0.4	0.0	0.3	0.7
Average surplus since 1999-2000	1.0	0.4	0.2	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–0.6	–1.0	–0.2	–0.2	0.0	0.3	0.7
Long-term sustainability							
Public sector net debt[1]	30.8	33.2	34.4	35.3	35.9	36.3	36.4
Core debt[1]	30.8	32.2	32.9	33.7	34.3	34.8	34.9
Net worth[2]	24.3	22.0	19.6	17.1	16.5	15.4	15.5
Primary balance	–0.6	–1.7	–1.1	–0.8	–0.5	–0.2	–0.1
Economic impact							
Net investment	1.0	1.5	1.9	2.0	2.1	2.2	2.2
Public sector net borrowing (PSNB)	2.2	3.4	2.8	2.5	2.1	1.9	1.6
Cyclically-adjusted PSNB	1.6	2.4	2.1	2.3	2.1	1.9	1.6
Financing							
Central government net cash requirement	2.1	3.8	3.0	2.6	2.4	1.9	1.6
Public sector net cash requirement	2.1	3.9	2.9	2.5	2.3	1.9	1.6
European commitments							
Treaty deficit[3]	2.1	3.2	2.6	2.4	2.0	1.9	1.6
Cyclically-adjusted Treaty deficit[3]	1.5	2.3	1.9	2.2	2.0	1.9	1.6
Treaty debt ratio[4]	37.9	39.8	40.9	41.5	41.9	42.2	42.1
Memo: Output gap	–1.2	–1.4	–0.8	–0.1	0.0	0.0	0.0

[1] *At end March; GDP centred on end March.*
[2] *At end December; GDP centred on end December.*
[3] *General government net borrowing on a Maastricht basis.*
[4] *General government gross debt measures on a Maastricht basis.*

Golden rule

2.55 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and is therefore an important indicator of inter-generational fairness. Lower receipts and additional spending in the short term means that the deficit on the current budget is forecast to be 1.9 per cent of GDP this year, falling to 0.9 per cent next year and moving back to balance in 2006-07, and showing a surplus of 0.6 per cent of GDP by the end of the projection period.



2.56 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.[6] The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year of the projection period. The economy is projected to return to trend by early 2006, meaning that over the whole cycle the average surplus on the current budget would be around an annual 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is on track to meet the golden rule and there is a margin against the golden rule of £11 billion in this cycle, including the AME margin. If the economic cycle were assumed to have started in 1997-98, the average surplus on the current budget up to 2005-06 would be 0.2 per cent of GDP.

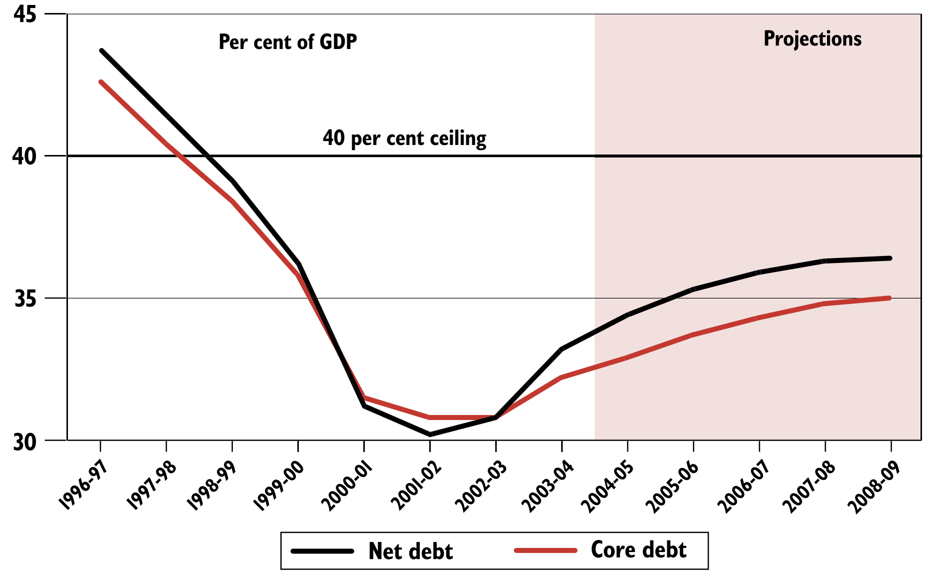
2.57 The economy is projected to return to trend by early 2006. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2008-09 is 0.1 per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on track to continue to meet the golden rule after the end of this economic cycle.

Sustainable investment rule

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

[6] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002 and performance over past cycles is described in Budget 2000.

Chart 2.4: Meeting the sustainable investment rule



2.59 Chart 2.4 shows that, despite sustained weakness in the world economy, net debt is expected to remain low and stable, rising from 31 per cent to stabilise at just under 36½ per cent at the end of the projection period – £53 billion below the 40 per cent level. Therefore, the Government comfortably meets its sustainable investment rule. Chart 2.4 also illustrates the Pre-Budget Report projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt is projected to rise to around 35 per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key objective of inter-generational fairness that underpins the fiscal framework.

Box 2.7: Public finances in the G7

The table below compares the projections presented in Budget 2004 with those for other G7 countries, as forecast by the European Commission or the OECD. While care needs to be taken when comparing numbers internationally, the UK performs well: gross debt is the lowest in the G7 and the deficit is below the average for the G7 as a whole.

Public finances in the G7

Per cent of GDP	Estimate[a]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
United Kingdom						
Treaty deficit	3.2	2.6	2.4	2.0	1.9	1.6
Cyclically-adjusted Treaty deficit	2.3	1.9	2.2	2.0	1.9	1.6
Treaty debt	39.8	40.9	41.5	41.9	42.2	42.1
Public sector net investment	1.5	1.9	2.0	2.1	2.2	2.2
	2003	**2004**	**2005**			
France						
Treaty deficit	4.2	3.8	3.6			
Cyclically-adjusted Treaty deficit	3.9	3.3	3.2			
Treaty debt	62.6	64.3	65.6			
Germany						
Treaty deficit	4.2	3.9	3.4			
Cyclically-adjusted Treaty deficit	3.5	3.3	3.0			
Treaty debt	63.8	65.0	65.8			
Italy						
Treaty deficit	2.6	2.8	3.5			
Cyclically-adjusted Treaty deficit	2.1	2.3	3.2			
Treaty debt	106.4	106.1	106.1			
Canada						
Deficit	–1.0	–0.7	–0.8			
Cyclically-adjusted deficit	–1.1	–0.6	–0.7			
Gross debt	75.6	73.6	70.8			
Japan						
Deficit	7.4	6.8	6.9			
Cyclically-adjusted deficit	6.9	6.5	6.6			
Gross debt	154.6	161.2	167.2			
USA						
Deficit	4.9	5.1	4.9			
Cyclically-adjusted deficit	4.5	5.1	5.0			
Gross debt	63.4	66.0	68.5			
G7 average[b]						
Deficit	3.7	3.5	3.4			
Cyclically-adjusted deficit	3.2	3.1	3.2			
Gross debt	80.9	82.5	83.7			

Source: data for EU countries excluding UK from European Commission autumn forecasts; non-EU countries from OECD Economic Outlook 74 (December 2003). The fiscal aggregates forecast by the OECD are slightly different from those forecast by the European Commission, deficit refers to deficit on general government financial balance, gross debt to general government gross financial liabilities.

[a] The 2003-04 figures were estimates in Budget 2003.

[b] Unweighted average (financial year figures used for UK)

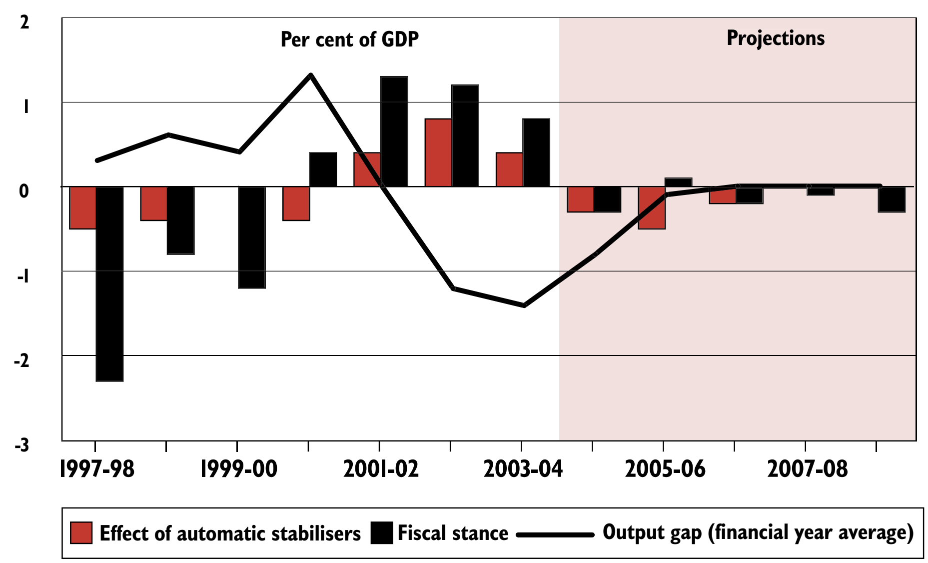
Economic impact **2.60** While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB).

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

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

2.62 Chart 2.5 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy. During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy has moved below trend so the fiscal stance has eased, helping to maintain economic stability. Over the next few years, as the economy returns to trend, fiscal policy moves towards a more neutral stance.

Chart 2.5: Fiscal policy supporting monetary policy



2.63 Between Budgets, the fiscal stance can change as a result of a discretionary measure to:

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

2.64 Table 2.7 explains how these concepts relate to the projections in the Budget. It shows the changes in both the fiscal stance and the overall fiscal impact between Budget 2003 and the 2003 Pre-Budget Report, and the changes since the Pre-Budget Report.

Table 2.7: The overall fiscal impact

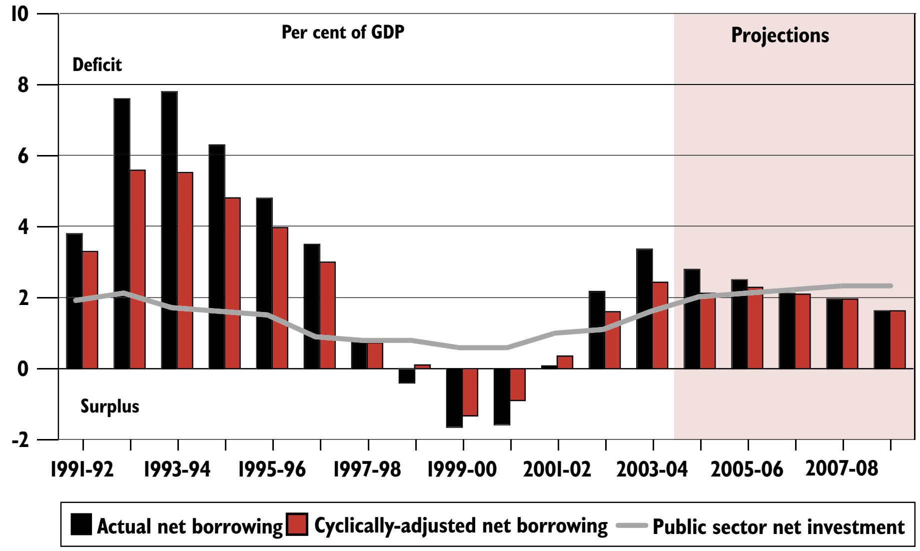
	Percentage points of GDP						
	Outurn	Estimate[1]	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Change from Budget 2003 to PBR 2003							
Post Budget and PBR policy decisions	0.0	0.0	0.0	0.0	0.0	0.0	–
+							
non-discretionary factors	–0.1	0.9	0.6	0.5	0.4	0.3	–
=							
CHANGE IN FISCAL STANCE	–0.1	0.9	0.6	0.5	0.4	0.3	–
+							
automatic stabilisers	–0.1	0.0	0.0	0.1	0.0	0.0	–
=							
OVERALL FISCAL IMPACT	–0.1	0.9	0.6	0.5	0.4	0.3	–
Change from PBR 2003 to Budget 2004							
Budget measures	0.0	0.0	0.1	0.1	0.0	0.1	0.0
+							
non-discretionary factors	0.0	0.0	0.0	0.0	0.0	–0.1	–0.1
=							
CHANGE IN FISCAL STANCE	0.0	0.0	0.1	0.1	0.0	0.0	–0.1
+							
automatic stabilisers	0.0	0.0	0.0	0.0	0.0	0.0	0.0
=							
OVERALL FISCAL IMPACT	0.0	0.0	0.2	0.0	0.0	0.0	–0.1

[1] *The 2003-04 figures were projections in Budget 2003.*

2.65 With the path of the output gap little different from Budget 2003 and the 2003 Pre-Budget Report, the Treasury's methodology for cyclical adjustment attributes almost all of the change in the net borrowing to non-discretionary factors. Table 2.7 therefore shows that, relative to Budget 2003, the fiscal stance has eased. Relative to the 2003 Pre-Budget Report, the fiscal stance is broadly unchanged. However, the degree of caution in the assumptions underpinning the public finance projections increases over the projection period, and the actual outcomes and the effects on the economy may not necessarily be reflected in the projections, especially in later years.

2.66 Modest levels of borrowing over the forecast period reflect sustained capital investment in public services, as shown in Chart 2.6, and is fully consistent with meeting the Government's firm fiscal rules.

Chart 2.6: Public sector net borrowing and net investment



Financing

2.67 The forecast for the central government net cash requirement (CGNCR) for 2003-04 is £42.3 billion, an increase of £1.8 billion from the 2003 Pre-Budget Report forecast. Allowing for a £0.2 billion increase in the sterling offset from the issuance of foreign currency debt for the financing of the Official Reserves and a £0.7 billion increase in the forecast net contribution from National Savings & Investments (NS&I) means that the net financing requirement for 2003-04 is now expected to be £58.0 billion, an increase of £0.9 billion from the 2003 Pre-Budget Report forecast. The increased financing requirement is being met by a £0.1 billion revision to the forecast level of gilt sales and a £0.8 billion increase in the forecast level of short-term debt at end March 2004.

2.68 The forecast for the CGNCR for 2004-05 is £35.6 billion. With gilt redemptions of £14.7 billion, and an estimated forecast net contribution from NS&I of £2.0 billion, the forecast net financing requirement for 2004-05 is £48.3 billion. The financing requirement will be met by:

- gross gilts issuance of £48.0 billion; and
- a £0.3 billion increase in the net short-term debt position.

2.69 Full details and a revised financing table can be found in Chapter C. Further details can be found in the *Debt and Reserves Management Report 2004-05,* which is published alongside Budget 2004.

European commitments

2.70 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box 2.6 and *The Stability and Growth Pact: A Discussion Paper,* published alongside Budget 2004. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in this Budget, which show the Government on track to meet its fiscal rules over the cycle, low debt and sustainable public finances, combined with sustainable increases in public sector net investment, are fully consistent with the prudent interpretation of the Pact.

Dealing with uncertainty

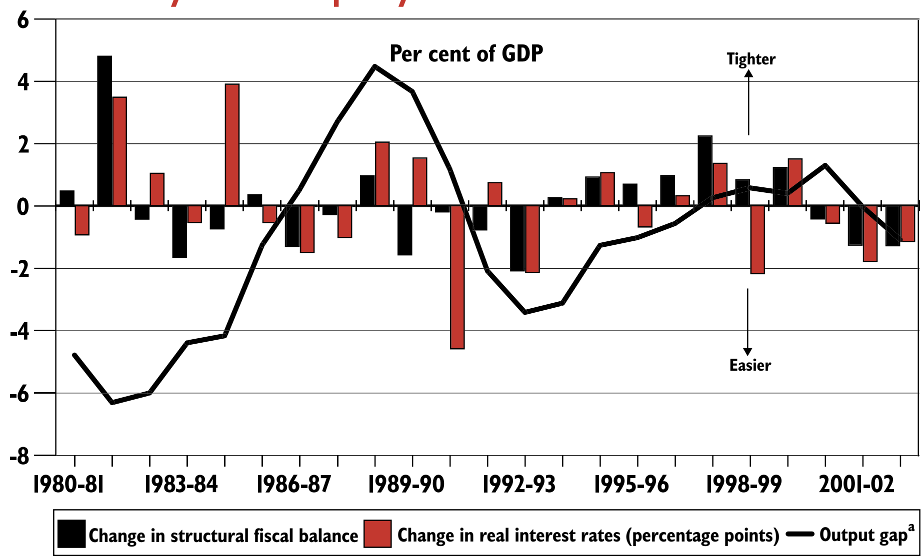
2.71 Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The use of cautious assumptions audited by the NAO builds a margin into the public finance projections to guard against unexpected events. To accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is $^1/_4$ percentage point lower than its neutral view.

Box 2.8: Fiscal policy and monetary policy in the UK

The UK's macroeconomic framework is designed to promote economic stability. In recent years fiscal and monetary policy have worked together to support economic growth during a period of economic uncertainty. From the top of the economic cycle in 2000-01 to 2002-03, when the economy was below trend, real interest rates fell by around 3 percentage points and fiscal policy eased by around 2.5 per cent of GDP.

The chart below shows how the fiscal stance and monetary policy have moved in relation to the output gap over time. Since the late 1990s, both fiscal and monetary policy have tended to be counter-cyclical and forward looking. The chart also shows, however, that monetary and fiscal policy have not always worked in such a coherent, counter-cyclical

Monetary and fiscal policy since 1980

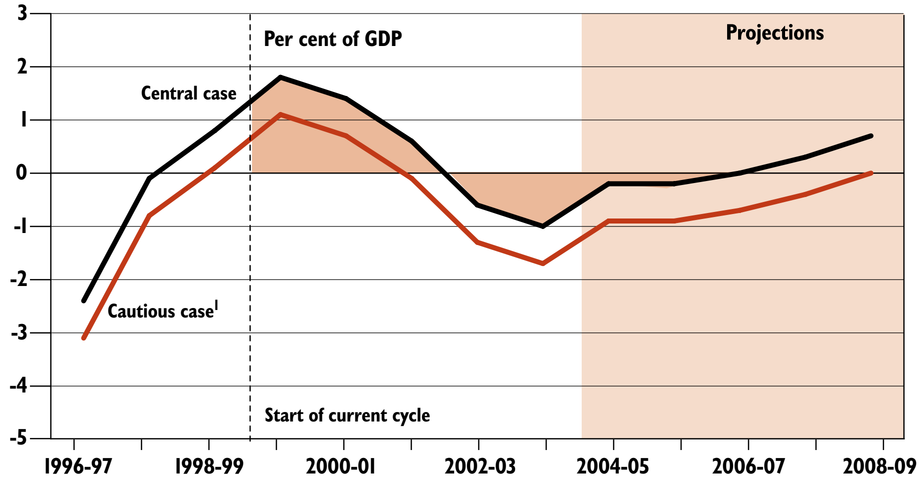


[a] *Financial year average.*

2.72 A second important source of potential error results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.7 illustrates the Pre-Budget Report projection for this cautious case.

2.73 The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. Combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, the Government can now draw on this margin to safeguard the increase in investment in priority public services, reset the AME margin to ensure that the public spending projections include a cautious safety margin, and allow the automatic stabilisers to work in full following a period of global economic uncertainty, while remaining on track to meet the fiscal rules.

Chart 2.7: Cyclically-adjusted surplus on current budget



[1] *Cautious case assumes trend output 1 percentage point lower in relation to actual output than in the central case.*

2.74 The Government is, on the basis of cautious, independently audited assumptions, on track to meet the golden rule in the central case. However, in the cautious case, the average surplus on the current budget in the cautious case is no longer positive as the Government draws on its safety margin against unexpected events. The projections show that this margin is being rebuilt at the end of the projection period as the current budget moves into surplus and the cyclically-adjusted surplus in the cautious case moves back to balance. In the meantime, the Government will remain vigilant to the risks and continue to base projections of the public finances on cautious assumptions.

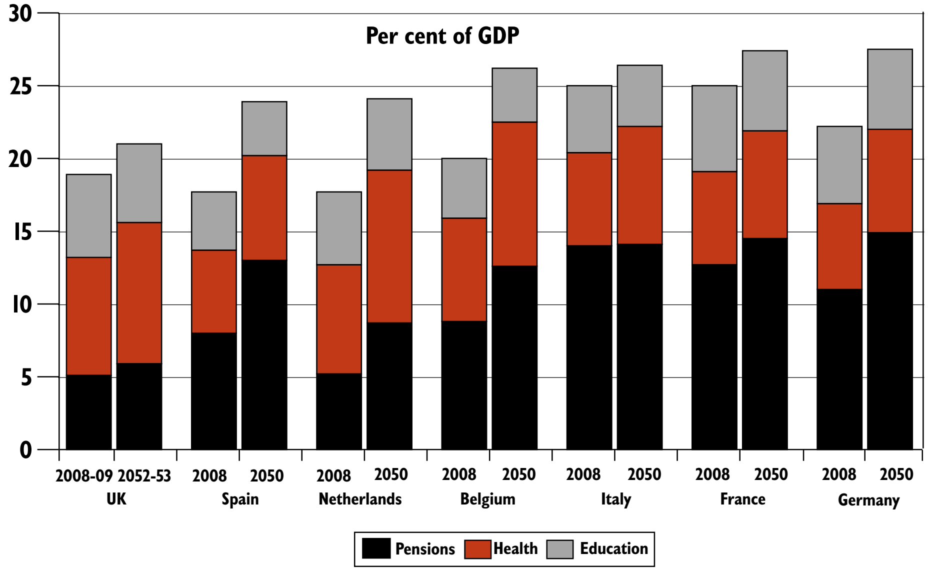
LONG-TERM FISCAL SUSTAINABILITY

2.75 To safeguard long-term economic growth and ensure inter-generational fairness it is important that Budget decisions are consistent with long-term sustainability of the public finances. Failure to do so would be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability*.

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

2.77 These illustrative long-term fiscal projections yield similar conclusions to those presented in the Government's 2003 *Long-term public finance report,* published alongside the 2003 Pre-Budget Report. The report demonstrates that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries to face the challenges ahead. Chart 2.8 shows the projected development of age-related spending over the coming decades in selected EU countries. It shows that age-related spending in the UK is projected to rise only moderately over the next five decades, even when including the latest projections on state pension spending.

Chart 2.8: Age-related spending in selected EU countries



[1] For UK spending in 2008-09 and 2052-53 based on health and education projections presented in 2003 Long-term public finance report and latest pension projections, for other countries spending in 2008 and 2050 based on national and EPC projections. Comparisons of projections need to be treated with caution as some include the cost of long-term care within health projections, and may not fully reflect latest policy changes.

Sources: HM Treasury 2003, Department for Work and Pensions 2004 and European Commission's assessments of Member States' Stability and Convergence Programmes 2004.

2.78 Alternative projections can be generated on a wide range of assumptions and policy scenarios, including uprating pension increases in line with earnings growth rather than inflation. For example, based on GAD projections[7], it can be calculated that spending on the basic state pension, state earnings related pension scheme and the state second pension would rise to around 7 per cent of GDP by 2050 with earnings uprating, around 3 percentage points higher than under current policy.

2.79 However, notwithstanding the use of prudent and cautious assumptions, a wide range of unforeseen developments could arise over the projection period. The Government will therefore continue to update and report on its assessments of long-term fiscal sustainability, both through regular publication of the *Long-term public finance report* alongside the Pre-Budget Report and through the illustrative long-term fiscal projections presented with each Budget, to ensure that all fiscal policy decisions are set within a sustainable, long-term framework.

MACROECONOMIC STABILITY AND THE HOUSING MARKET

2.80 The housing market in the UK has often been associated with instability in the economy as a whole. Pronounced cycles in the housing market have been a notable feature of the UK economy over the past three decades and have affected the wider economy through private consumption. Housing is a key asset for households and household spending is closely associated with changes in housing wealth. Reducing volatility in the housing market will therefore help promote macroeconomic stability.

[7] Based on data from the *Quinquennial Review of the National Insurance Fund*, Government Actuary's Department, 2003.

2.81 A number of structural features may contribute to the high levels of housing market volatility in the UK compared to other European countries, and could explain the strong link to consumption:

- the low responsiveness of housing supply to demand in the UK, which has contributed to the strong rise in real house prices in the UK and tends to increase house price volatility;
- the dominance of variable rate mortgages and high level of mortgage debt combine to explain both households' sensitivity to interest rate changes and the strong link between the housing market and consumption in the UK; and
- high levels of owner occupation, as compared to renting, and the ability of households to withdraw equity from housing adds to the impact of changes in housing wealth on consumption.

2.82 The unique characteristics of the housing market expose households to many inter-related risks. Demand for housing changes over people's lifetimes but trading up or down is costly and the timing of moves involves price risk. Since houses are also usually bought with mortgage finance, this entails interest rate risk. Furthermore, the ability to service interest payments, cover the costs of moving and meet maintenance costs depend on the households' future income stream, which is also uncertain. Importantly, the risks associated with house prices, interest rates and incomes have tended to be positively related, compounding the potential impact of shocks on consumption.

Box 2.9: Stability, the housing market and EMU

The Government is committed to a comprehensive programme to improve the functioning of the housing market. Building on the reforms to deliver a step change in planning policy, the Government is undertaking further significant changes in the planning system, supply of housing and housing finance to tackle market failures, increase the responsiveness of supply to demand and reduce national and regional price volatility. These measures are beneficial in their own right to improve the stability and flexibility of the UK housing market and wider economy, but will also help to increase the housing market's compatibility with the euro area, encouraging greater convergence over time.

The June 2003 assessment of the five economic tests for UK membership of EMU concluded that distinct supply and demand features of the UK housing market mean that both the relationship between house prices and household consumption, and the underlying rate of real house price growth, are stronger in the UK than in the euro area. The structure of the UK mortgage market is such that UK households are more sensitive to interest rates, which has implications for the transmission of monetary policy.

The Government is implementing quickly and decisively past reforms to housing supply and going further to address both supply and demand in the housing market and macroeconomic stabilisation more generally. In particular:

- **Kate Barker's final report on the factors affecting housing supply published today sets out a challenging set of reforms to improve the functioning of the housing market to increase housing supply. The Government accepts the need for a substantial increase in development over time, and the need for reform, and intends to implement a programme of change as recommended in the review to the planning system and to the delivery of development. Chapter 3 sets out how it intends to take this forward; and**
- **the Government commissioned David Miles to review the mortgage market to consider why, unlike in many other developed economies, very little mortgage debt in the UK is at longer-term fixed interest rates. David Miles' final report on the UK mortgage market, published on 12 March 2004, makes recommendations on how the market can be helped to work better for consumers in a number of areas. A summary of the report and the Government's response is set out below.**

2.83 The Government has recognised that reforms in the housing market are needed to reduce volatility and promote stability in the wider economy. At the time of Budget 2003, the Chancellor asked David Miles to review the mortgage market in the UK, to consider why, unlike in many other developed economies, very little mortgage debt in the UK is at longer-term fixed interest rates. The final report was published on 12 March 2004 and is summarised in Box 2.10.

2.84 The Government welcomes David Miles' analysis of the strengths of the UK mortgage market, the areas for reform and his recommendations for action. The Government endorses his conclusion that urgent reform is desirable to make the market work better for consumers in a number of areas. A number of his recommendations are addressed to the Government and it will consider and consult on them as proposed by the Review. A number of recommendations are addressed to the FSA, which has in train reforms in the mortgage market, which will move to statutory regulation on 31 October 2004. The Chancellor has asked the FSA to consider and report on the further reforms proposed by David Miles.

2.85 At the time of Budget 2003, the Chancellor, with the Deputy Prime Minister, also commissioned Kate Barker to analyse the issues surrounding housing supply in the UK. Details of the final report of the Barker Review are presented in Chapter 3.

Box 2.10: The Miles Review of the UK mortgage market

The interim report of the Miles Review, published in December 2003, found that while many borrowers can benefit from longer-term fixed-rate mortgages, few choose these products – overwhelmingly, mortgages in the UK are either at variable rates or at rates fixed for around two years. The interim report presented evidence on the key factors limiting the take-up of mortgages at longer-term rates of interest:

- when choosing between mortgages, many borrowers attach great weight to the level of initial monthly repayments. Consideration of where interest rates might move in the future, and what this implies for affordability, seems to play a far smaller role. Many households find it difficult to assess these risks and the type of advice and information they receive does not help them as much as it could;
- the structure of mortgage pricing generates cross-subsidisation from many existing borrowers, a significant proportion of whom are paying standard variable rates, to new borrowers taking out discounted variable and short-term fixed-rate mortgages. This creates unfairness and makes the market less transparent than it could be. It plays to a tendency of many borrowers to focus on the initial monthly payments on a mortgage and it makes medium-term and longer-term fixed-rate mortgages appear expensive; and
- there are also a number of potential legislative and regulatory barriers that might affect the cost effective funding of longer-term fixed-rate lending and the way in which early redemption charges are structured.

The Review's final report, published on 12 March 2004, makes recommendations to the FSA and associated bodies, and to the Government on how the mortgage market in the UK can be helped to work better. The recommendations are based on evidence presented both in the interim report and the final report and fall broadly into two groups: those that are aimed at improving the advice and information that borrowers receive and at creating a fairer and more transparent pricing structure, and those that are aimed at helping lenders fund mortgages and handle risk in the most cost effective way. The recommendations include measures to:

- improve the information and advice available to consumers so they can make well-informed decisions about mortgage products;
- make the pricing of mortgages in the UK more transparent, fairer and sustainable, including the recommendation that lenders make their full range of mortgage products available to all borrowers;
- remove obstacles to the development of alternative forms of protection from nominal payment uncertainty; and
- enable cost-effective long-term lending, including recommendations to consider changes that would affect the wholesale markets.

The report concludes that, although there are great strengths in the UK housing finance system, if acted upon the recommendations have the potential to change the UK mortgage market and make it work better. This will be to the benefit of borrowers, lenders, other financial intermediaries and the savers whose funds are channelled through the market.

3 MEETING THE PRODUCTIVITY CHALLENGE

Productivity growth underpins strong economic performance and sustained increases in living standards. The Government's long-term goal is for the UK to achieve a faster rate of productivity growth than its main competitors. Recent data show that the UK is making some progress in closing the productivity gap with Germany and France. Budget 2004 sets out the next steps the Government is taking to build on this success and further strengthen the drivers of productivity growth, including:

- the publication of **a consultation document to inform the preparation of a ten-year investment framework for science and innovation**, as part of the 2004 Spending Review, committing to grow public investment in the science base faster than the trend rate of GDP growth over the next Spending Review period;
- **a commitment to increase NHS funding for R&D by £100 million by 2008**, to underpin the creation of a new UK Clinical Research Collaboration for the effective and efficient translation of scientific advances into patient care;
- a **New Deal for skills** to ensure that individuals are helped to develop the skills they need for employment and employers can develop the skilled workforce needed for the success of their business, and extending Employer Training Pilots to six new areas;
- **reforms to reduce the regulatory burden on businesses**, including consulting on the implementation of phasing out payment via employers for Working Tax Credit, strengthened Government scrutiny of regulatory proposals, and changing the structure of the UK's tax administration;
- **devolving delivery of regional and local Business Link services** from the Department of Trade and Industry to the Regional Development Agencies;
- **full details of the Local Authority Business Growth Incentives scheme**, which will boost the role of local authorities in promoting enterprise and economic growth;
- the Barker Review of housing supply, published today, concludes that house building must rise substantially to reduce house price inflation and increase the number of affordable homes. The Government agrees with the need for a signficant increase in housing development over time. It intends to **implement a programme of reform to planning and delivery of development as recommended in the Review and consider a package of measures to increase housing supply**, including social housing investment, alongside a Planning-gain Supplement by the end of 2005;
- **a new entitlement for graduates of the world's top 50 business schools to come to the UK** to seek employment; and
- seeking views on how **property investment funds** (a UK version of the successful US Real Estate Investment Trusts) should be structured, to encourage more efficient investment in commercial and residential property.

RAISING PRODUCTIVITY IN A FAIR ECONOMY

3.1 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. As a result of macroeconomic instability and market failures, the UK has historically experienced low rates of productivity growth compared to other major economies. In recent years, however, the UK's performance has improved. Box 3.1 explains that the UK now has similar output per worker to Germany and is narrowing the gap with France. However, there remains a sizeable productivity gap with the US and (on an output per hour measure) with France. The Government's long-term goal is for the UK to continue to close the productivity gap by achieving a faster rate of growth than its main competitors.

3.2 Productivity growth requires a flexible economy in which individuals and firms can adapt rapidly to changing conditions, allowing them to exploit new opportunities and to deal with potential challenges effectively. Box 3.2 summarises trends and progress in product and capital market flexibility since the time of Budget 2003.

3.3 This chapter describes the steps the Government is taking to raise productivity across all regions and countries of the UK. It focuses on the five key drivers of productivity performance:

- improving *competition*, which promotes flexible markets and increases business efficiency and consumer choice;
- promoting *enterprise*, by removing barriers to entrepreneurship and developing an enterprise culture;
- supporting *science and innovation*, to promote the development of new technologies and more efficient ways of working;
- raising *skills* levels, to create a more flexible and productive workforce; and
- encouraging *investment*, to increase the stock of physical capital, including through stronger, more efficient capital markets.

Monitoring the five drivers of productivity

3.4 These five drivers provide a framework both for analysis and for organising policies designed to improve productivity. HM Treasury and the Department of Trade and Industry (DTI) recently published a consultation document[1] setting out a potential set of indicators, grouped around the five drivers, to monitor progress and signal areas where further policy action may be needed. The paper also considers using a similar set of productivity indicators to monitor progress towards the Government's regional performance target.

Productivity and flexibility in the regions

3.5 The Government is committed to ensuring that the benefits of improved productivity are spread throughout the country. Its goal is to make sustainable improvements in the economic performance of all UK regions and, over the long run, reduce the persistent gap in growth rates between the regions. The Government believes that the best way to improve the productivity of all the regions and to overcome regional disparities in economic performance is to allow each area of the UK the freedom and flexibility to exploit indigenous sources of growth. Since 1997, it has pursued a number of important developments driving forward devolution. These developments include the establishment of devolved administrations in Scotland, Wales and Northern Ireland and the setting up of nine Regional Development Agencies (RDAs) in the English regions.

3.6 The next phase requires an evolution in the relationship between central government, local government, regional organisations and the front line. Central government needs to maintain a strategic role, ensuring national standards are met and maintained, but allowing greater scope locally to determine other priorities and to decide how best to deliver national outcomes. The RDAs, as strategic leaders of economic development in the regions, have a good understanding of the opportunities and restrictions that they and their partner organisations face in their efforts to enhance regional economic performance.

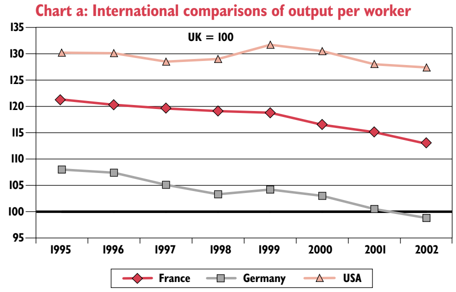
[1] *Productivity in the UK 5: Benchmarking UK productivity performance*, HM Treasury and Department of Trade and Industry, March 2004.

Box 3.1: UK productivity performance

Historically, UK productivity has been lower than in other major economies. Evidence suggests the UK has been less productive than the US since the early twentieth century and was overtaken by France and Germany in the post-war period.[a]

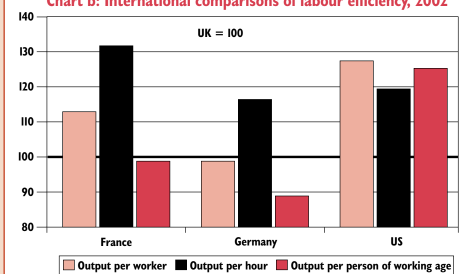
New data shown in Chart (a) suggest that since 1997, UK productivity has grown faster than its main competitors. As a result, UK workers on average produce as much as German workers, and the productivity gap with France has fallen by seven percentage points. However, workers in the US are still just under 30 per cent more productive than UK workers. Between 1997 and 2001, UK trend productivity (on an output per hour basis) is estimated to have grown by almost two and a half per cent annually, compared to a figure of just over two per cent between 1986 and 1997.[b] This higher rate of productivity growth suggests that the UK has also seen an increase in its trend rate of hourly productivity growth.

Chart a: International comparisons of output per worker



Source: ONS
Note: 2002 data is provisional

Chart b: International comparisons of labour efficiency, 2002



Sources: Output per worker and output per hour measures based on OECD/ONS data.
Output per person of working age: HMT estimate based on OECD data.
Note: Data for output per worker and output per hour is provisional.

This improvement has been achieved despite sustained employment growth in the UK over recent years, which has made the aim of raising productivity growth more challenging because new workers tend to have lower productivity than experienced workers. New workers take time to learn job-specific skills, which may result in lower productivity growth than would otherwise have been the case in a growing economy. A comparison of output per person of working age shows the benefits of the UK's record of strong growth and high employment, as shown in Chart (b). This measure indicates how effectively an economy includes all of its potential workers in productive employment. It shows that UK performance is significantly better than Germany, at a similar level to France, and around 25 per cent behind the US.

It is important to sustain recent improvements and to build on them. The Government will continue to implement a programme of microeconomic reforms with the ambition of raising the productivity of British workers to a level comparable with the best in the world.

[a] *Britain's relative economic performance, 1870-1999*, Nick Crafts, April 2002.
[b] This is shown in Table B2 in Chapter B.

Box 3.2: UK product and capital market flexibility – report on progress

The assessment of the five economic tests for UK membership of Economic and Monetary Union (EMU) in June 2003 examined the flexibility of UK product and capital markets. It noted that a decision to join EMU would increase the need for rapid price and factor movements and make it necessary for firms to be able to respond effectively to shocks and adapt to the competitive opportunities that the single currency would bring. It concluded that the UK has a reasonable degree of price flexibility and generally exhibits a competitive business environment, but that the degree of competition and market flexibility falls short of what might be achievable. The assessment also concluded that capital markets play an important role in stabilising the impact of shocks between regions in the US, and greater financial market integration could enhance the scope for risk-sharing across the EU.

Details of trends, measures and progress on the flexibility of product and capital markets are set out in *Flexibility in the UK economy*, published alongside this Budget, and new measures introduced in the Budget are set out in this chapter. Measures include:

<u>Modernising the corporation tax system:</u> following consultation the Government has introduced reforms to the corporation tax system, and is committed to further reforms in a number of areas. Detailed legislative proposals will be published later in the year.

<u>A package of regulatory reforms to ease the burden on small business:</u> including consulting on implementation of phasing out payments via employers of Working Tax Credit; and any regulatory proposal likely to impose a major new burden on business will require clearance from the Panel for Regulatory Accountability chaired by the Prime Minister, based on a thorough impact assessment of the proposal agreed by the Cabinet Office Regulatory Impact Unit.

<u>Promoting competition:</u> through reviews into, and action on, competition in a number of specific markets, including legal services, financial services and energy markets; an Office of Fair Trading (OFT) review into how public sector procurement affects competition; encouragement for the OFT to review Government regulations and consider their impact on competition; and the roll-out from summer 2004 of a consumer help-line, *Consumer Direct*, across four pathfinder regions.

<u>Planning reform:</u> through reforms including the first Planning Bill for more than a decade; the creation of Regional Spatial Strategies to guide the pattern of development at regional level; and follow up of the recommendations of the Barker Review of housing supply in the UK, published today.

<u>Improving access to finance for SMEs and individuals:</u> through enhanced tax relief for investments in Venture Capital Trusts and incentives to invest under the Enterprise Investment Scheme; the independent Graham Review into the effectiveness of the Small Firms Loan Guarantee scheme; and follow up of the recommendations of the Sandler Review into medium- and long-term savings in the UK.

<u>Capital market integration:</u> through initial preparations for implementation in the UK of the wholesale financial services directives most recently passed under the EU's Financial Services Action Plan.

3.7 The RDAs were asked to identify the top ten institutional barriers that hinder effective coordination in the regions, as part of the Devolving Decision-Making Review, which the Chancellor announced in Budget 2003. The Government is publishing two reports resulting from this review alongside this Budget. *Devolving decision-making 1 – Delivering better public services: refining targets and performance management* looks at how refining the approach to targets and performance management can help improve the efficiency and responsiveness of public services. Further detail is provided in Chapter 6. In the second report, *Devolving decision-making: 2 – Meeting the regional economic challenge: increasing regional and local flexibility,* the Government responds to the RDAs' top ten barriers and provides an update on its analysis of the drivers of regional economic growth. The principles emerging from the review are reflected in the devolution of regional and local Business Link services, outlined later in this chapter.

3.8 Ahead of Budget 2004, HM Treasury also asked the RDAs to provide advice on specific regional productivity challenges. Among the issues raised were proposals to overcome barriers to business start-ups, improve the provision of services to small businesses, enhance access to finance for small and medium-sized enterprises (SMEs) create flexibility at a regional level to meet employers' skills needs, and increase the level of knowledge transfer between businesses and universities. Budget 2004 announces further measures which respond to the RDAs' recommendations.

Productivity in the EU

3.9 In March 2000, at the Lisbon European Council, Europe's leaders committed themselves to a ten-year programme of far-reaching economic reform designed to make the EU "*the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.*"[2] Structural reform of Europe's labour, product and capital markets, and increased flexibility were seen as the key to economic success in a global economy – success that is vital for ensuring social justice and high standards of environmental protection. Increasing productivity is central to improving Europe's growth potential.

3.10 Action at the European level since 2000 has included inter-institutional agreement on the need for better regulation and modernisation of EU competition policy. The EU has also adopted a new Action Plan for R&D, with plans on enterprise and innovation forthcoming. Over the past year, action by Member States has included French and Spanish reforms to promote enterprise, German reforms to enhance innovation and research in R&D and the establishment of a new Innovation Council in the Netherlands. Looking ahead, the immediate priorities for reform are strengthening competition in the Single Market, regulatory reform to minimise unintended burdens on business, and advancing enterprise and innovation to increase flexibility.

International trade and productivity

3.11 Openness to international trade raises productivity by reallocating resources to the most efficient producers, increasing competition, facilitating technology transfers and raising innovation levels. The Government believes that the goals of more open global markets and domestic structural reform should be pursued vigorously and in tandem. Key to this strategy are success in the current multilateral trade negotiations, discussed further in Chapter 5, and the reduction of barriers to trade and investment between the EU and US. The UK will also take part in a joint productivity forum with the US later in the year.

[2] *Presidency conclusions Lisbon European Council*, 23-24 March 2000.

COMPETITION

3.12 Competition promotes efficiency, puts downward pressure on prices and increases choice for consumers. The Enterprise Act 2002 built on earlier reforms to create a world-class competition regime in the UK. The latest international survey shows that the UK competition regime is joint second in the world behind the US.[3] The DTI has commissioned KPMG to carry out a further peer review of the UK competition framework, which will report in April 2004. The Government also continues to encourage the OFT to review existing Government regulations and to consider their impact on competition and consumers.

Competition in specific markets

Legal Services

3.13 David Clementi is leading an independent review into a regulatory framework for legal services, and will make recommendations by the end of 2004. The review published a consultation paper on 8 March 2004, which sets out the key questions on matters such as regulatory models and complaints. It also covers alternative business structures, including legal disciplinary practices (bringing lawyers together from different professional bodies) and multi-disciplinary practices (practices between lawyers and other professionals).

Payment systems

3.14 The Government welcomes the recent announcement by the OFT on the creation of a Payment Systems Task Force, and the commitment by industry to participate. This Task Force will identify and seek to resolve competition, efficiency and incentive issues relating to payment systems. It will operate initially for a four-year period. The Government will then review competition in the industry and will legislate unless there has been a significant improvement. The Government considers it vital that this important market is efficient and open to real competition, and urges the industry to engage constructively with the Task Force on issues of mutual concern.

Financial services

3.15 As part of a review of the Financial Services and Markets Act 2000, the OFT is scrutinising the impact of the Act on competition in financial services markets. A report setting out how the OFT will approach the competition scrutiny is available on its website.[4]

Energy markets

3.16 Liberalisation in energy markets has boosted competition, delivered lower gas and electricity prices, and reduced the need for regulation. The Energy Bill, currently before Parliament, will establish a single framework for electricity transmission and trading arrangements across Great Britain. By April 2005, Scottish consumers will receive the competitive benefits enjoyed by those in England and Wales, while generators will have fair and open access to the market.

Consumers

3.17 The Government is committed to putting empowered consumers at the heart of an effective competition regime. Empowered consumers know their consumer rights and demand high quality goods and services, encouraging higher standards and innovation. The DTI is currently reviewing the UK consumer framework, and will publish a consultation paper later this year drawing on the comparative benchmarking report published in October 2003.

3.18 From summer 2004 a new consumer helpline, *Consumer Direct*, will provide consumers with information on their rights and practical advice on resolving problems and information on their rights. The service will initially launch pathfinders in Yorkshire and the Humber, Wales, Scotland and the South West of England, with national roll-out continuing over the next two years.

[3] *Rating enforcement*, Global Competition Review, 2003.

[4] www.oft.gov.uk/Market+studies/Studies/fsma2.htm.

3.19 HM Treasury and the DTI are undertaking a joint project on consumer representation in regulated industries. In spring 2004, the project will publish a report that will make recommendations to improve the operation of the current system in the medium term. This report will draw upon the results of a benchmarking study undertaken by PriceWaterhouseCoopers, jointly commissioned by the DTI and the National Audit Office.

Competition in the supply of goods and services to Government

3.20 The Government is committed to achieving greater value for money through better procurement and is considering ways of strengthening the public sector procurement infrastructure – further details are provided in Chapter 6. It is also taking steps to improve competition in the supply of goods and services to the Government:

- the Office of Government Commerce is taking forward the recommendations of a recent report on this issue[5] through discussions with industry and the wider public sector, and is developing a pilot market for testing capacity planning techniques. The pilot market will be launched by September 2004 prior to a wider roll-out in 2005; and
- the OFT has launched a review into how public sector procurement affects competition. This research is expected to be completed by July 2004.

3.21 Effective competition in public procurement is essential to the proper functioning of the EU, and the Government welcomes the recent revision of European procurement rules. To help ensure that these rules are translated into practice, Alan Wood, Chief Executive of Siemens in the UK, is undertaking a review of UK businesses' experiences of accessing public contracts in the EU. Firms involved in tendering for public contracts in other EU Member States have been invited to report on their experiences through the review's website.[6] The review will report in summer 2004.

Competition in the EU

3.22 The UK supports a strong and proactive European competition policy. It believes that investigations of markets and sectors have a key role to play in ensuring that barriers to competition can be tackled flexibly. In January 2004, the UK, France and Germany called for further action to develop this strategic dimension through a clear statement of the European Commission's approach. The Commission has made a number of welcome recent steps in this direction, including investigations of competition in specific markets and sectors.

ENTERPRISE

3.23 A modern dynamic economy needs a strong entrepreneurial base. There are 3.75 million SMEs in the UK, accounting for over 55 per cent of business employment and 52 per cent of business turnover. A vibrant small business sector creates wealth and employment, generates competitive pressure that drives innovative activity and improves the range, quality and prices of goods and services for consumers.

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

[6] www.woodreview.org.

Enterprise culture

3.24 The Government believes that a culture of entrepreneurship should be encouraged and valued so that anyone who has the potential to succeed in business has the opportunity and support to do so. Latest data from the Global Entrepreneurship Monitor show that levels of entrepreneurial activity in the UK have risen to 6.4 per cent of the adult population, from 5.4 per cent in 2002.[7] The Government wants the UK to be the best environment in the world for starting and growing a business. In January 2004, the Chancellor hosted a conference in London, *Advancing Enterprise: Britain in a Global Economy*, attended by many business leaders and Government representatives. The conference covered a range of different themes related to enterprise including creating an enterprise culture, technology and innovation, and tackling the skills gap.

Promoting an enterprise culture

3.25 The implementation of the Davies Review[8] into economy and enterprise in education is critical to ensuring that young people develop the entrepreneurial skills and attitudes necessary for success in their working lives. The interim report of the Tomlinson Review[9] of the 14-19 curriculum identifies a core set of employability skills, of which enterprise skills are an important subset. Integrating enterprise education fully within the 14-19 curriculum will strengthen the UK's enterprise culture.

3.26 The Government has also introduced a number of specific measures to promote an enterprise culture, including:

- Enterprise Insight's campaign to create a step change in the enterprise culture of the UK, which will be launched in June 2004, leading to Enterprise Week in November;
- the £1 million Enterprise Promotion Fund, announced in Budget 2003, which has made awards to more than 20 organisations. As part of the UK-US Enterprise Agreement, students from the New Entrepreneur Scholarship programme will study in the US, and the first US-UK forum to share best practice in enterprise education will be held in June 2004;
- the launch of a new competition to identify European Centres of Enterprise – local centres of excellence in enterprise policy; and
- an online summit of experts from the US, UK and Canada to be held in April 2004 on women's entrepreneurship. This is the start of a trilateral alliance, which aims to increase the percentage of businesses owned by women.

National Council for Graduate Entrepreneurship

3.27 In the 2003 Pre-Budget Report, the Government announced the establishment of a new National Council for Graduate Entrepreneurship. **Six members of the Council have been appointed with David Frost, British Chambers of Commerce, acting as interim chairman and Karan Bilimoria, founder of Cobra Beer, as the Council's Graduate Champion**.

[7] *UK Report*, Global Entrepreneurship Monitor, 2003.

[8] *A review of enterprise and the economy in education*, Howard Davies, February 2002.

[9] *14-19 curriculum and qualifications reform,* Interim report of the working group on 14-19 reform, February 2004.

Training, education and advice

3.28 Small businesses that access external training and advice are more likely to grow and to succeed. In Budget 2003, the Government asked a working group chaired by Sue Brownson to oversee the development of a training and support package for SMEs. The new online training directory developed by the group, and which will be promoted in partnership with the main high-street banks, has been successfully launched at www.businesslink.gov.uk/training. The site offers a range of online courses and a directory of 750,000 other courses across the UK that can help businesses to succeed. It is just one element of the new businesslink.gov.uk online advisory service to be launched at the end of April. The website will be a one-stop shop where businesses can access advice on starting-up, regulatory requirements, exporting, accessing finance for growth, and other information.

Business Links

3.29 The 2002 Spending Review launched a pilot programme of devolved RDA-led Business Link services in the North West, East Midlands and West Midlands. The Government intends to roll out the programme nationwide and devolve delivery of regional and local Business Link services to RDA control. **From April 2005 all RDAs will be granted responsibility for flexibly managing Business Link services in their areas to tailor delivery to the needs of their region**. A national framework will maintain core service standards and will sustain the performance improvements Business Link achieved last year. Further details will be set out in the 2004 Spending Review.

Promoting enterprise in the regions and in disadvantaged areas

Local Authority Business Growth Incentives

3.30 To create a direct financial incentive for local authorities to promote local business growth, the Government is introducing the Local Authority Business Growth Incentives scheme. This will allow local authorities to retain a proportion of increases in local business rate revenues to spend on their own priorities. No business will pay more under the scheme.

3.31 The 2003 Pre-Budget Report announced the results of a public consultation, and initial decisions on the model to be used for setting local baselines. **The Office of the Deputy Prime Minister (ODPM) is today publishing full details of the baselines for individual local authorities,** alongside further proposals on the method to be used to calculate ceilings on the amount of revenue that each local authority can retain.

3.32 Details of other technical factors, including local authority floors, scaling factors, and the division of revenues between the different tiers of local government, will be published in the coming months. Following consultation last year, the Government is proposing a medium floor and ceiling factor so that most authorities can benefit from the scheme, and the calculation of ceilings based on a modified Formula Spending Share approach. The ODPM will work with a number of local authorities to test the administration of the scheme, and will publish a further consultation document alongside the draft secondary legislation in summer 2004. The scheme will then begin operating for all authorities in April 2005. In total, the Government expects local authorities across England and Wales to retain around £150 million of revenues in 2005-06, rising to £450 million by 2007-08. To ensure that the scheme is achieving its objectives, and that baselines and incentives remain fair, the Government will commission an evaluation of the scheme, and will review baselines and floors after three years. The Welsh Assembly Government has also finished consultation on a similar scheme.

Enterprise Areas

3.33 The Government believes that raising levels of enterprise and economic activity is essential to sustainable regeneration in the UK's most disadvantaged communities. The 2002 Pre-Budget Report designated 2,000 Enterprise Areas in which measures to boost enterprise are being focused. The Government has been working with the RDAs and the Local Government Association and has held a series of Open Space events in partnership with RBS/Natwest and local communities. These are being used to inform policy developments and are shedding light on how local stakeholders and RDAs can tailor measures in Enterprise Areas to meet specific development challenges.

3.34 Research by the Social Exclusion Unit in ODPM has found that 75 per cent of the streets with the highest rates of worklessness in England are in Enterprise Areas. The Government is considering measures to tackle barriers to employability in Enterprise Areas.

Business Premises Renovation Allowance

3.35 In the 2003 Pre-Budget Report, the Government announced details of a Business Premises Renovation Allowance scheme, providing 100 per cent capital allowances in Enterprise Areas for the costs of renovating business properties that have been vacant for at least a year. **Subject to state aid approval, the scheme will be introduced in 2005, and draft legislation will be published shortly for consultation.**

Finance for small businesses

Small Firms Loan Guarantee

3.36 The 2003 Pre-Budget Report announced that Teresa Graham would conduct a review of the Small Firms Loan Guarantee (SFLG). In February 2004, the Review published a discussion document which asked for submissions from interested parties.[10] The Review intends to publish its initial findings on the state of the market and the trends in SFLG usage in the spring, and to make recommendations in summer 2004 on the appropriateness of the scheme's structure and rules to its effective operation, and whether SFLG is sufficient to tackle the barriers faced by start-ups and small businesses in the current debt finance market.

Enterprise Capital Funds

3.37 In the 2003 Pre-Budget Report, the Government announced the introduction of a pathfinder round of Enterprise Capital Funds (ECFs) to explore the scope for a longer term ECF programme. ECFs will be commercially-managed entities investing a mixture of public and private capital in potentially high-growth small businesses affected by the equity gap. The Government is discussing the details of the pathfinder round with interested stakeholders and, subject to satisfactory progress in the state aids clearance process, intends to publish, within the next three months, draft details of what pathfinder ECFs might look like and how the funds will be selected. Full details will be published once EU state aids clearance has been achieved.

Venture Capital Trusts and Enterprise Investment Schemes

3.38 The 2003 Pre-Budget Report also announced proposals to target structural factors that have contributed to volatility in fundraising for Venture Capital Trusts (VCTs) and to improve the incentives to invest under the Enterprise Investment Scheme (EIS). The Government now intends to proceed with its proposals, including:

- **doubling the annual investment limit for VCTs for both the relief for new shares and shares in issue to £200,000;**
- **raising, also to £200,000, the annual limit on the size of investment eligible for income tax relief under the EIS;**
- **withdrawing capital gains tax deferral relief for investments in VCTs in favour, in the long term, of an enhancement of equivalent value to the incentives to invest through income tax relief for new subscriptions to VCT shares;** and
- **in the short term, to provide a temporary additional stimulus to investment in VCTs for a period of only two years, by increasing the effective rate of income tax relief from 20 per cent to 40 per cent.**

[10] www.hm-treasury.gov.uk/graham.

3.39 Following discussions with industry, and having explored alternative delivery options, the Government has decided to deliver this additional stimulus through a straightforward increase to 40 per cent in the rate of income tax relief paid to investors.

Financial intermediation

3.40 Budget 2003 announced that Michael Snyder would chair a working group to consider how intermediaries, such as accountants, could do more to advise small firms seeking to raise finance for growth. The Institute of Chartered Accountants in England and Wales and the Association of Chartered Certified Accountants have indicated through the group that, with the help of the Small Business Service (SBS), they will **work to establish a self-accreditation programme for accountants and other business advisers who are able to provide advice to small businesses seeking finance**. **Business Link will promote accredited advisers to businesses seeking advice.**

3.41 The Small Business Investment Taskforce (SBIT) has reported its findings on potential barriers in the UK market for intermediation between small firms seeking equity finance and investors, including business angels. Their initial view is that there is no widespread lack of intermediation provision in the UK, although there are problems for SMEs seeking start up and early stage risk capital. **The Government will ask the SBIT to build upon their initial work by focusing on the broader demand issues, and in particular the problems faced by start up and early stage firms.**

3.42 In January 2004, the Government launched a consultation on potential changes to the regulation of financial promotion to make it easier for small firms to raise finance from business angels.[11] The consultation seeks views by April 2004 on how best to ensure that financial regulation in this area strikes the right balance between allowing small firms to raise capital, and the appropriate level of protection for investors. The Government will continue to examine the appropriate balance in other areas of financial regulation, and will, in implementing the Prospectus Directive, assess whether the costs of issuing equity for small firms can be properly lowered.

Business transfer

3.43 Effective transition of business ownership has the potential to drive productivity benefits through improved innovation, investment and skills. However, ensuring a smooth succession of ownership can be especially challenging for smaller businesses who may not know how to get appropriate advice, and who may face barriers in raising finance to fund the transition. The Small Business Council has asked the Government to examine the barriers that might constrain business transfer. Martin Wyn Griffith, the Chief Executive of the Small Business Service, will lead a cross-departmental review of the hurdles that businesses face when their ownership changes, and what more could be done to ease the process.

Modernising the business tax system

3.44 The Government proposes a number of steps in this Budget to reform the tax system for business; promoting investment and productivity, while modernising the relationship between business and the tax system. As set out in Chapter 5, the Government today published the report of the Review of the Revenue Departments and has accepted its recommendations. A particular focus of the review was how costs to businesses that currently interact with two separate revenue departments might be reduced. The Review recommends that a new single tax department should be created, integrating HM Customs and Excise and the Inland Revenue. The new department will be able to focus more effectively on its customers, helping to reduce costs for compliant taxpayers. It will also help to create a more coherent approach to tax administration and support policy making.

[11] *Informal capital raising and high net worth and sophisticated investors: a consultation on proposed changes to the Financial Promotion Order*, HM Treasury, January 2004.

3.45 Chapter 5 also includes a number of measures to protect revenues, including proposals to prevent business competitiveness being undermined by tax avoidance schemes, which distort competition and disadvantage the majority of businesses without access to sophisticated tax planning schemes and arrangements. Following the announcement of the Government's intentions in the 2003 Pre-Budget Report, Chapter 5 also sets out the steps the Government is taking to address a trend to tax-induced incorporation by the self employed, and to ensure low rates of corporation tax are focused on those businesses adopting the corporate legal form in order to invest in, and grow their business, including through a 19 per cent minimum rate of Corporation Tax levied on distributed profits.

Enhancing capital allowances

3.46 The Government recognises that small businesses make a vital contribution to the productivity of the UK economy and it remains committed to encouraging investment, as a key driver of productivity and growth. In response to representations from a number of bodies, the Government has been considering the case for further expansion of the capital allowances available to small businesses. 40 per cent first year capital allowances for SMEs were made permanent in Budget 2000 and extended in the 2003 Pre-Budget Report to a wider definition of enterprises. Budget 2004 announces an extension to the enhanced capital allowances available to incorporated and unincorporated small businesses investing in plant and machinery. **For expenditure in the year from April 2004, the first year allowance will be set at a new rate of 50 per cent.** This measure will assist small businesses' cashflow and provide enhanced funding for new investment.

Corporation tax reform

3.47 The Government is committed to a modern, fair and competitive corporation tax system that reflects the increasingly flexible and global business environment. Box 3.3 sets out further details of the Government's approach. Following the August 2003 consultation on corporation tax reform,[12] two specific issues are being taken forward from 1 April 2004, as announced in the 2003 Pre-Budget Report:

- relief for the expenses of managing investments will be available to companies with investment business, whether or not they qualify as investment companies; and
- transfer pricing will apply to transactions within the UK as well as cross-border. Concerns raised during consultation will be addressed through exemptions for SMEs, with a two-year relaxation of the penalty regime, new guidance on record-keeping and enquiries, **an exemption for existing dormant companies and a number of technical measures designed to accommodate various commercial financing transactions and structures.**

3.48 The Government is committed to reform in other areas of the corporation tax system, including the schedular system, the capital/income divide, and the tax differences between trading and investment companies. Detailed legislative proposals will be published later this year, focusing on those areas where the system may create unjustified barriers to modern commercial activity. Having considered a range of proposals for reform of the tax treatment of capital investment, the Government has concluded against alignment with accounts depreciation. Respondents to the consultation made it clear that capital allowances were a valuable part of the tax system. The Government will therefore consider further whether the current capital allowances regime can be modernised to reflect more closely the relative economic value of different forms of investment, and will consider possible changes to the way that leasing transactions are taxed in the light of this decision.

3.49 The Government will also continue the wider-ranging dialogue on international issues that was begun during the August 2003 consultation, with a view to maintaining the competitiveness and fairness of the UK corporation tax regime and ensuring that it remains robust.

[12] *Corporation tax reform: a consultation document*, HM Treasury and Inland Revenue, August 2003.

Modernising VAT

3.50 The Government has introduced a series of measures designed to help reduce the administrative burden on small businesses and to ease their cash flow. Budget 2004 announces further measures to help small and newly-registered businesses reduce their VAT compliance costs, including from 1 April:

- **raising the VAT registration threshold in line with inflation from £56,000 to £58,000**, helping to keep a further 5,000 of the smallest businesses out of the VAT system; and
- **increasing the turnover ceiling for businesses wishing to use the VAT annual accounting and cash accounting schemes from £600,000 to £660,000**.

3.51 Budget 2004 also announces **a consultation to enable VAT to be applied more fairly to land and property used by charities**.

Box 3.3: Corporation tax, globalisation and the changing nature of business activity

Two interrelated trends are reshaping corporate activity and pose both opportunities and challenges for corporation tax systems:

- the growth and global integration of multinational companies; and
- new forms of business activity, such as the proliferation of diverse corporate structures and financing arrangements and the growth of intangible inputs and products.

Sovereign governments need the freedom to respond to these challenges, reflecting different choices over the level and types of social provision and the size and nature of their public sector. Inflexible systems, including those that could arise from harmonisation, will increasingly become barriers to growth. A modern corporate tax system must also avoid creating barriers to innovation or commercial activity, while ensuring that businesses contribute their fair share to the provision of public goods and services. Unjustified distortions in the treatment of different types of assets, barriers to entrepreneurship and risk-taking, and outdated distinctions between different forms of commercial activity will therefore continue to be addressed as part of reform and modernisation of UK corporation tax. The Government will therefore continue to ensure that the UK is able to exploit the benefits of economic integration, while embracing fair competition and resisting tax harmonisation at the European level and beyond.

In addition, the Government will continue to support effective international cooperation to ensure that national tax systems help deliver the benefits of global integration. For example:

- the UK's extensive network of bilateral tax treaties removes significant barriers to cross-border investment by alleviating double taxation;
- the UK is an active participant in the Organisation for Economic Co-operation and Development's work to develop international standards for transparency and exchange of information in national tax systems, which help counter cross-border tax evasion and avoidance; and
- the UK has played a lead role in the Code of Conduct on business taxation in the European Union, a voluntary process of peer review to facilitate the removal of harmful tax measures and ensure fair tax competition.

Reforming and reducing regulation

3.52 Effective and well-focused regulation can play a vital role in correcting market failures, promoting fairness and competition and driving up standards. However, unnecessary or poorly implemented regulation can be an obstacle to flexibility, restricting employment growth and competitiveness, particularly for smaller firms, without actually improving regulatory outcomes. The Government is committed to delivering targeted deregulatory changes to relieve burdens on business as well as strengthening policy-making processes at UK and EU level to improve the quality of regulation.

Tax credits: payment via employers

3.53 Payment via employers has helped reinforce the principle that tax credits are a reward for work, reducing the stigma associated with claiming. Tax credits are now firmly established as the fair approach to providing financial support to working families. Further, at the end of January 2004, six million families were benefiting from the new tax credits exceeding the Government's ambitious expectations. The Government accepts the case, in principle, that the benefits to business justify moving to direct payment of the Working Tax Credit, reducing the cost of payroll administration and addressing a key area of business concern. The reform will be particularly valuable to the 1.2 million small businesses that stand to benefit. The Government will consult with employers on the detail of implementation.

Better policy-making in the UK

3.54 Significant and lasting improvements in the regulatory environment for business will only be delivered through the continuous improvement in policy-making at both UK and EU level. The Government has already strengthened its approach to reducing the overall regulatory burden on business, improving the quality of regulations, and enhancing regulatory stability. For the first time, Government departments are this year reporting on their regulatory performance – **and the independent Better Regulation Task Force (BRTF) will publish its own analysis of these reports**. Departments' regulatory performance will be taken into account in the 2004 Spending Review. The Government has also accepted all the recommendations in a recent BRTF report[13] and is now promoting the use of alternatives to regulation across Whitehall and the wider public sector.

3.55 Building on this, the Government is introducing further changes to ensure that reducing the flow and improving the quality of regulation at UK level is a central part of the policy-making process. **In future, any regulatory proposal likely to impose a major new burden on business will require clearance from the Panel for Regulatory Accountability, chaired by the Prime Minister, based on a thorough impact assessment of the proposal agreed by the Cabinet Office Regulatory Impact Unit, before the proposal is put to wider Ministerial approval.** The Panel will consider all such proposals in the context of Departments' previous regulatory performance and the overall burden of regulation across key business sectors. Where appropriate emergency legislation will be exempt from these new processes, and the new requirements will not change the long-standing arrangements through which tax matters are considered by the Chancellor in the course of normal Budget processes.

Better policy-making at EU level

3.56 Around half of all new regulation with a significant impact on UK businesses originates in EU law. Further reform is therefore essential at the European level. In January 2004, the Chancellor and the Finance Ministers of Ireland, the Netherlands and Luxembourg set out proposals for regulatory reform. These proposals include improved tests to ensure that new legislative proposals do not damage the European economy, clear commitments to reduce the burden of existing EU legislation, and greater use of alternatives to regulation. **EU Finance Ministers have supported these proposals and called for a clear programme of action covering the next two years. The Government will press for agreement on this at the Spring European Council**. Further, the Government is submitting to the European Commission a list of priority areas for regulatory simplification, reflecting those suggested by business in the recent BRTF consultation.

[13] *Imaginative thinking for better regulation*, Better Regulation Task Force, September 2003.

Better regulation

3.57 The enforcement activity of regulatory bodies is a significant driver of business compliance costs. As the BRTF recognised in their 2003 report *Independent regulators,*[14] well targeted inspection programmes are vital, not only to deliver the outcomes society demands, but also to minimise the costs borne by compliant firms. Regulators understand these challenges and some are making progress. Enforcement strategy is a theme of a document recently published by the Health and Safety Executive,[15] and the Environment Agency's consultation *Delivering for the Environment.*[16] Building on this work, the Government has asked Philip Hampton, former finance director of LloydsTSB, BT and British Gas, to consider, with business, regulators, and in consultation with the BRTF, the scope for promoting more efficient approaches to regulatory inspection and enforcement while continuing to deliver excellent regulatory outcomes.

Greater regulatory certainty

3.58 In Budget 2003 the Government committed to making changes to employment regulation on only two dates each year, unless European obligations require otherwise. This approach, providing greater certainty about changes to the regulatory environment, has been welcomed by business. **The Government will consult formally with businesses next month on the feasibility of extending common commencement dates to other areas of regulation and tax. In parallel, the Department for Environment, Food and Rural Affairs will study the feasibility of extending the approach to environmental regulation.**

Tackling regulations across key sectors

3.59 Alongside the strengthened central scrutiny of new regulatory proposals outlined above, Government Departments will continue to engage directly with businesses to tackle unnecessary regulations across key sectors. The sectoral reviews announced in Budget 2003 are progressing well:

- **for the construction, chemicals and retail sectors, the Government will establish new industry/cross-government forums on policy and regulatory development**, to give early warning of, and allow industry to express its views on, emerging policy and regulatory proposals; and

- following concerns expressed by the construction industry on unreasonable delays in payment, **the Government will review the operation of the adjudication and payment provisions in the Housing Grants, Construction and Regeneration Act 1996** to identify what improvement can be made.

3.60 The two-year review of the Financial Services and Markets Act 2000 proposes making it easier for Citizens Advice Bureaux and similar organisations to advise their clients without being subject to Financial Services Authority regulation. Similar steps are proposed in relation to employers advising employees on pensions.

Enterprise in Europe

3.61 The Government is also working with its European partners to promote enterprise in Europe. The Finance and Industry Ministers of the UK, France and Germany recently submitted joint proposals to the European Commission and other Member States setting out the priority actions to boost enterprise in Europe.[17] The Government believes these proposals, alongside those to improve the quality of regulation in Europe and a new European Centre of Enterprise competition, provide a concrete framework for further action. This work will be taken forward as part of the Commission's Action Plan on Entrepreneurship.

[14] *Independent regulators*, Better Regulation Task Force, October 2003.

[15] *A strategy for workplace health and safety in Great Britain to 2010 and beyond,* Health and Safety Commission, February 2004.

[16] *Delivering for the environment*, Environment Agency, October 2003.

[17] *Towards an enterprising Europe,* A paper by the French, German and UK Governments, January 2004.

SCIENCE AND INNOVATION

3.62 Science and innovation lie at the heart of the UK's prosperity and quality of life. Scientific and technological advances are necessary to help tackle many of the UK's national challenges, particularly in health and environmental protection. In an increasingly knowledge-driven global economy, a high-quality science base and a strong supply of science, engineering and technology skills are also critical for the UK's innovation performance and long-term competitiveness.

Ten-year investment framework for science and innovation

3.63 The Government will publish a ten-year investment framework for science and innovation alongside the 2004 Spending Review. The framework (detailed in Box 3.4) will set out the Government's ambition for UK science and innovation over the next decade. In drawing up this framework, the Government is consulting key stakeholders including the scientific community, businesses, charities, and regional and devolved bodies. The Government published a consultation document on 16 March 2004.[18]

3.64 **To maintain the momentum of recent reforms, funding and improved outcomes from the science base, the Government will ensure that the level of public investment here will grow faster than the trend rate of GDP growth over the Spending Review period 2005-06 through to 2007-08**. Further, in order to ensure that this growth in spending is well matched to the needs of the economy as a whole, the Government hopes to see parallel commitment from major business, charity and public sector funders of UK R&D to their own engagement in the future of British science over the next ten years. The strength of this response from others will be a crucial factor in the scale of the Government's commitment and the success of this strategy for the UK.

Box 3.4: The ten-year investment framework for science and innovation

In January 2004, the Chancellor announced that the Government would develop, as part of the 2004 Spending Review, a ten-year investment framework for public and private investment in science and innovation to provide a medium-term platform for innovation and productivity growth.

The framework will set out the attributes and funding arrangements of a research system capable of delivering the Government's key aims:

- **world-class research at the UK's strongest centres of excellence;**
- **sustainable and financially robust universities and public laboratories across the UK;**
- **a continuing step change in the responsiveness of the research base to the needs of the economy and public services;**
- **increased business investment in R&D, and increased business engagement with the UK science base when seeking ideas and talent;**
- **a supply of science, technology, engineering and mathematics skills more responsive to the needs of the economy, and greater flexibility within schools and universities to attract the skills they need; and**
- **confidence across UK society in scientific research and innovative applications.**

The consultation document sets out the Government's considerations and key questions in these areas.

[18] *Science and innovation: working towards a ten-year investment framework*, Department for Education and Skills, Department of Trade and Industry and HM Treasury, March 2004.

3.65 A key focus of the investment framework will be the contribution of science and innovation to the Government's public service priorities, particularly in supporting the Government's health modernisation agenda, and delivering better, more personalised healthcare services to patients. Following reports by the Bioscience Innovation and Growth Team and the Academy of Medical Sciences, the Government will work with the NHS, industry and the medical charities to strengthen clinical research in the UK. The ten-year investment framework will also consider what more could be done to ensure that clinical research plays its full role in generating health and economic benefits in the UK. To support this work, **the Department of Health will increase the NHS funding for R&D by £100 million by 2008**. This will provide a stronger platform for growth in Government investment in medical research, including through the Medical Research Council, and will complement business and charity-funded clinical research efforts. This should allow the combined budget for medical research and for R&D within the NHS to rise to around £1.2 billion a year by 2007-08.

Box 3.5: Partnerships in medical research: the UK Clinical Research Collaboration

Four years ago, the Government recognised the advantages of developing research partnerships to help tackle major diseases. As a first step it set up the National Cancer Research Institute (NCRI). This has been a great success, and works closely with the National Cancer Institute in the US. The Government now wishes to extend partnership working to cover a much wider range of medicine, and has therefore decided to create a new UK Clinical Research Collaboration (UKCRC) involving the Medical Research Council, the Wellcome Trust and other medical charities, the NHS, industry and patients themselves. Its purpose will be to achieve effective and efficient translation of scientific advances into patient care, thereby improving national health and contributing to national wealth.

The first major initiative of the NCRI was to create cancer research networks, which succeeded in doubling the number of patients involved in clinical trials of new anti-cancer drugs within two years, such that overall numbers are now similar to those in the USA. This idea will now be extended to other disease areas covered by the UKCRC, with funding and research efforts targeted on diseases that place a high burden on the nation.

DTI Innovation Report

3.66 The DTI Innovation Report, published in December 2003,[19] highlights the UK's excellent science base and record of accomplishment in invention, but explains that more needs to be done, including in the service sector, to ensure the successful exploitation of new ideas and secure our future prosperity in an increasingly global world. Proposals in the Report now being implemented include:

- a £150 million National Technology Strategy to provide a framework for policy priorities and focus support on innovation;
- new procurement guidelines to make government a more intelligent customer and encourage innovation through its supply chain; and
- an increased role for the Small Business Service in promoting innovation and knowledge transfer.

[19] *Competing in the global economy: the innovation challenge*, Department for Trade and Industry, December 2003.

3.67 The Secretary of State for Trade and Industry is chairing a Ministerial team to lead the innovation agenda across the whole of government and to drive forward the action plan of the Report.

Lambert Review of business-university collaboration

3.68 The final report of the Lambert Review, an independent review of business-university collaboration, was published in December 2003 and made a series of recommendations aimed at improving the links between the UK's strong science base and the business community.[20] The Government recognises the importance of this policy agenda and is strongly supportive of the analysis in the report.

3.69 The Government's ten-year investment framework on science and innovation requires linkage at national, regional and international levels. Within this framework of national-regional partnership, the Government intends to develop the main strands of policy reform put forward by the Lambert Review, including:

- **building the Higher Education Innovation Fund as a permanent third stream of funding** for universities in England to further build the university sector's capacity for knowledge transfer;
- **working with universities and businesses to develop a set of model collaboration contracts and to undertake further work on the development of an intellectual property protocol;**
- **enhancing the role of the English RDAs in strengthening business-university links**. The Government believes that the RDAs are well placed to promote business-university collaboration, but recognises that they need the capacity and links to national innovation programmes to do this most effectively. The Government will continue to explore with the RDAs and other stakeholders the best mechanisms for fostering business-university collaboration;[21] and
- **working with the Funding Councils and other agencies to explore further whether a workable lighter-touch approach to risk-based regulation of the university sector can be developed**.

3.70 Full details are set out in the Government's science and innovation consultation document and comments on the Government's initial proposed response to the Lambert Review are invited. The Government's final response will be published this summer as part of the ten-year investment framework.

R&D tax credits

3.71 Improvements to the R&D tax credits scheme were announced in the 2003 Pre-Budget Report. The new definition of R&D published by the DTI has been welcomed by business as easy to use and clear, and will come into effect from 1 April 2004. An extension to the range of qualifying costs was also announced at the 2003 Pre Budget Report. Expenditure on software, power, water and fuel will all qualify for the tax credit, providing £35 million of additional support. The definition of materials consumed during the R&D process will also be revised.

3.72 With these further extensions and clarifications the tax credit will provide an even greater incentive for companies to invest in R&D. **The Inland Revenue will produce new guidance in support of the R&D tax credit in advance of the 2004 Pre-Budget Report. It will also embark upon a programme to improve delivery of the credit so that companies get the most benefit from the reliefs and funds available.**

[20] *Lambert review of business-university collaboration: final report*, Richard Lambert, December 2003.

[21] The devolved administrations have primary responsibility for working with their own development agencies to improve business innovation and economic performance in their respective countries, including through strengthening business-university collaboration.

Science Research Organisations

3.73 The 2003 Pre-Budget Report announced that proposals would be brought forward in Budget 2004 to refine the treatment of Scientific Research Organisations (SROs). The Government proposes:

- **updating the tax exemption for SROs and bringing it in line with the new definition of R&D used for tax credits purposes;** and
- **reducing compliance costs by replacing the current DTI-administered clearance system with a new monitoring procedure operated by the Inland Revenue.**

3.74 The Government will work with SROs and their representatives to ensure that the new legislation puts the original aims of the tax exemption in a modern context, while deregulating the sector wherever possible. To enable a managed transition, the required legislative changes will be brought forward in Finance Bill 2005.

Innovation in Europe

3.75 The innovation performance of the EU remains poor relative to some of its major international competitors'. In April 2003, EU leaders endorsed an Action Plan to try and raise public and private expenditure on R&D to approaching 3 per cent of GDP by 2010. The Government welcomes this initiative, but believes that additional investment must be backed by wider action to tackle the structural barriers to innovation itself. To address this challenge, the Finance and Industry Ministers of the UK, France and Germany recently submitted joint proposals[22] to the European Commission and other Member States setting out a range of priority actions to strengthen innovation in Europe. The Government hopes that these proposals will be fully reflected in the Commission's forthcoming Action Plan on Innovation.

SKILLS

3.76 A dynamic and flexible economy needs skilled workers, better equipped to adapt effectively to change. *Flexibility in the UK economy*, published alongside this Budget, sets out the need for a flexible economy, and the role that workforce skills have to play in that. Chapter 4 describes the next steps in the Government's strategy for promoting employment opportunity for all.

3.77 UK unemployment is now the lowest of the G7 economies and employment is at a record high. However, while the proportion of people in the UK with high skills compares well internationally, the share of the workforce with intermediate skills is relatively low and, despite improvements over the last few years, there is still a large stock of low-skilled workers.

3.78 Tackling the number of people with no or low skills is therefore a key priority for the Government. More than one-third of the workforce has qualifications below level 2 (equivalent to five GCSE passes at grade C or above). Seven million have basic skills needs in literacy or numeracy.[23] The case for helping individuals acquire level 2 skills is strong. They are important in their own right and provide an essential platform for improving employability and progression to higher skills. However, it is at these lower skill levels that market failures appear to be most significant – those with lower level qualifications, or none at all, are much less likely to receive training. This is where the challenge is greatest.

[22] *Towards an innovative Europe*, A paper by the French, German and UK Governments, February 2004.

[23] *The Skills for Life Survey: A national needs and impact survey of literacy, numeracy and ICT skills*, Department for Education and Skills, October 2003.

3.79 The White Paper *21st century skills*[24] sets out a national skills strategy to ensure employers have the right skills to support the success of their business, and individuals have the skills they need to be employable and personally fulfilled. The Government is determined to build on this foundation, by tackling the barriers to skills acquisition and training for the low skilled, to help them gain qualifications to move into sustainable and productive work and, through work, progress to higher skills levels and better paid jobs. This is a challenging goal which cannot be achieved by the Government alone. Building on the Skills Strategy, and in following the National Employment Panel's report,[25] the next stage in tackling the low skills problem is to set out clear rights and responsibilities of individuals and employers with respect to skills, and the steps which the Government must take to ensure appropriate support, extend choice, secure an efficient consumer driven system, and provide an informed and effective lead. This compact is the Government's New Deal for skills.

New Deal for skills

3.80 Building on the Skills Strategy, the New Deal for skills will be a major step forward in ensuring that each individual is helped to develop the skills he or she needs to be employable and each employer - whether in the private, public or voluntary sector - can develop the skilled workforce needed for the success of his or her business. To realise this aim, high quality training must be accessible for every individual and employer requiring additional skills, to improve their employment prospects and the success of their business. Box 3.6 summarises the New Deal for skills.

3.81 To deliver these aspirations the Government will ensure that its skills and employment services:

- are restructured around the consumer rather than the producer, giving a stronger voice for employers, particularly through the work of Sector Skills Councils;
- clearly set out rights and responsibilities for individuals and employers in return for government help; and
- support clear pathways for progression beyond subsidised training towards higher skill levels.

Welfare, work and learning

3.82 There is good evidence that the longer someone spends on benefits, the harder it is to move into work. The Government's primary aim is therefore to get people into work as early as possible. In most cases, entering work provides the best foundation for remaining and progressing in work. However, accessing appropriate training can be difficult for some while in work, and for others appropriate training may be a prerequisite to getting sustainable and productive work in the first place. Benefit claimants currently have access to a wide range of skills assistance:

- work-based learning for adults provides occupational training, basic skills, and employability training;
- the New Deals provide several training options, from full time education to short, job-focused occupational training;
- the Employment Retention and Advancement pilots offer a package of support to help low wage workers advance in the workplace, including an in-work training bonus; and
- large numbers of benefit claimants also take up Learning and Skills Council (LSC) funded education or training part-time.

[24] *21st century skills: Realising our potential*, Department for Education and Skills, July 2003.

[25] *Welfare to workforce development*, National Employment Panel, February 2004.

Box 3.6: New Deal for skills

It is in the common interest of individuals, employers and the wider economy that every adult has the NVQ level 2 skills, which are the platform for further training and future job prospects in a modern economy. The Government's aim, through the New Deal for skills, will be to offer:

- **all individuals the opportunity to check the benefits they could receive from further training; to understand how they can get that training might be obtained and what support they can expect from the Government or their employer; and a clear and straightforward access point to comprehensive consumer-focused skills advice;**
- **all individuals with low skills – employed or unemployed – a local skills advice point, through which they can get access to free comprehensive information and advice;**
- **for all those in work, free high-quality and flexible training leading to a first full level 2 qualification, focused on the skills they need for employment;**
- **for those without work, improved access to high-quality advice and training; and**
- **for all employers better advice and more flexible support to meet the skills needs of their business and the training needs of their workforce, including free and flexibly-delivered training for their low-skilled workers.**

The New Deal for skills will build on the New Deal for work and the policies already in place, or that are planned under the Skills Strategy, including:

- **free training in basic literacy, numeracy and ICT skills including help in English, where needed, for speakers of other languages;**
- **free training to a first full NVQ level 2 qualification (focused on work-based learning providing occupational training, basic skills and employability training) with piloting of this entitlement due to commence later this year;**
- **improved adult information, advice and guidance services;**
- **a redesigned, more flexible qualification and curriculum structure; and**
- **a higher quality and more flexible service from training providers.**

To help the Government achieve its aims the New Deal for skills introduces more measures to help people move from low to higher skilled work. They include:

- **measures and pilots to improve the incentives and help available to those out of work to gain new skills, move into work and then get on at work. These are set out in more detail in Chapter 4;**
- **better joint working between Jobcentre Plus offices and Information Advice and Guidance (IAG) partnerships to offer a more integrated skills service in Jobcentre Plus offices;**
- **development of a 'skills passport' to help individuals to make the move from welfare into sustainable work, to build a record of skills and competences gained and to transfer skills between jobs; and**
- **a further extension of Employer Training Pilots (ETPs) to cover over one third of England.**

3.83 As part of its employment strategy, set out in Chapter 4, the Government is increasing the support and training people can access to develop their skills while claiming benefits, as a basis for helping them move into sustainable and productive work. With the New Deal for skills, when people move into employment, the Government will expect and encourage their training to continue.

Information, Advice and Guidance

3.84 **As part of the New Deal for skills, Jobcentre Plus will work with IAG Partnerships to ensure skills counselling is available in Jobcentres**. Better joint working will help focus training on qualifications that best support employability. These skills counsellors will be located in and integrated with the work of Jobcentre Plus offices, as well as linking closely to local colleges and training providers. Jobcentre Plus will ensure that its customers are able to access *Learndirect* and other relevant websites. Further detail is provided in Box 3.7.

Box 3.7: Information, Advice and Guidance services

There is clear evidence that access to IAG services increases the likelihood that individuals will enter learning, and that they will achieve a qualification from their study.

The Government wants to ensure that individuals have the advice and support they need to make decisions about training based on a full understanding of how it is likely to enhance their employability. To this end some IAG local services are working together with Jobcentre Plus to ensure advice is available in Jobcentre Plus offices. The Government's aim is to build on this approach, so that skills counsellors can make personal assessments of the skills people need to progress into sustainable and productive work, and to improve their earnings and career prospects. Counsellors will also be able to explain their entitlements to learning and support and to guide them towards the training and qualifications that will best develop their skills. This will make services easier to access, more personalised and clearly linked to enhancing employability

The Skills Strategy recognised that there is currently a lack of consistency in the range of IAG services being delivered, depending on geographical location. As a step towards better coherence, the Strategy committed to the integration of *Learndirect*, which provides a national information and advice service, with the work of local IAG services. The new National Policy Framework for IAG has set out a minimum standard for access to core services including:

- 24 hour access to the website to submit e-mail requests;
- freephone access to the integrated IAG service through a national Entry Point;
- centres for information available at least five days a week;
- appointments for advice available outside normal working hours; and
- outreach provision.

This core service is to be launched in August 2004. It will be accompanied by a strategy to raise awareness and visibility of IAG services.

Provision of comprehensive advice, guidance and support direct to employers particularly for SMEs is also important. The new on-line training directory, described earlier, will help ensure SMEs have access to a range of online courses and a directory of other available courses that can help these businesses to succeed.

Skills passports

3.85 **As part of the New Deal for skills, the Department for Education and Skills will look into developing the concept of 'skills passports'** informed by similar schemes such as the e-Skills UK passport and the Small Firms Development Account. Such a scheme could help make the move from welfare into sustainable employment easier, enable participants to build a record of skills and competences and help them transfer skills between jobs. This could link to the sector-based passports that have been developed through Sector Skills Agreements. These passports already allow learners to compile records of training and skills gained, structured according to the employers' needs for skills and accumulating over time to secure recognition through qualifications. Further detail is provided in Box 3.8.

Box 3.8: Skills passport

The Skills Strategy sets out how the principles of Individual Learning Accounts have been integrated into a broader strategy, based around a series of entitlements to free training. As part of the Government's ambition to engage those with low or no skills in learning, and take forward principles from the ILA scheme, evidence is emerging from sector pilots of the benefits of using skills passports.

The Construction Skills Certification Scheme (CSCS)[a] aims to register every competent construction operative within the UK not currently on a skills registration scheme. Operatives will get an individual registration card which lasts for three or five years. The CSCS card also provides evidence that the holder has undergone health and safety awareness training or testing.

CSCS is owned and managed by CSCS Limited, controlled by a management board whose members are from The Construction Confederation, Federation of Master Builders, GMB Trade Union, National Specialist Contractors Council, Transport and General Workers Union and Union of Construction Allied Trades and Technicians.

Observer members include the Department for Education and Skills, the Department for Environment, Food and Rural Affairs, the Department for Transport, the Health and Safety Executive and the Confederation of Construction Clients.

[a] More information is available at www.cscs.uk.com.

Developing the skills of young people

Improving post-16 participation

3.86 Raising the participation rate of young people in education and training is central to meeting the demand for skills in a dynamic, modern economy. The Government is committed to ensuring that all young people reach the age of 19 ready for higher education or skilled employment. To deliver this, the Government is:

- reforming the financial support system for this age group to support choice and progress, with the right to support conditional on a responsibility to engage in learning. The report on the review of financial support for 16 to 19 year olds, published alongside this Budget and summarised in Chapter 5, sets out a short-term programme of improvements to the current system and a longer-term vision for a radically simplified financial support system for 16 to 19 year olds;

- reforming the curriculum to improve vocational pathways and more flexible programmes of learning for all young people. To inform the Government's thinking on long-term strategy, the Working Group on 14 to 19 Reform, led by Mike Tomlinson, published its interim report in February 2004 proposing a flexible multi-level diploma system.[26] The group will present its final recommendations in the Autumn;

- expanding the quality and quantity of training supplied through stronger accountability and incentives for further education providers and through the expansion of the Modern Apprenticeship (MA) programme. With 255,000 young people now engaged in MAs, the Government is on track to meet its 2004 PSA that 28 per cent of young people start an MA; and

[26] *14 -19 curriculum and qualifications reform*, Interim Report of the Working Group on 14 - 19 Reform, February 2004.

- reforming the advice, guidance and support structures better to fit need. This will include both the role of schools and colleges and the personal adviser model developed by Connexions. It will also look to ensure that parents have access to relevant advice and information, which will inform the support they offer their children when they make their learning decision.

Improving workforce learning

Raising skills through professional bodies

3.87 *Delivering an incentive to membership bodies to provide workforce development,*[27] published alongside the 2003 Pre-Budget Report, outlined the principles that the Government believes should underpin any reform of the current tax relief for fees and subscriptions to membership-based organisations. The paper has prompted a range of responses, which the Government is evaluating. The Government will continue to discuss with interested parties how the relief can be better targeted, in order to promote training and skills opportunities across the workforce and will bring forward proposals.

Employer Training Pilots

3.88 The Government is currently testing ETPs to help employers stimulate demand and train their low skilled staff. As announced in the 2003 Pre-Budget Report, the Government is extending ETPs for a third year to cover over a third of England. **New pilots will operate from September 2004 in the North East region, Lancashire, the Black Country, West Yorkshire, Cambridgeshire, and Devon and Cornwall,** helping to strengthen evaluation of the scheme.

3.89 The pilots offer a package of support to help low-skilled people in work gain basic skills or their first level two qualification, and provide an option for those out of work to move into supported employment. Employers who offer their low-skilled staff paid time off to train are provided with compensation for wage costs (varying by firm size and pilot area). Training is free or heavily subsidised. A key element of the scheme is that employers are offered skills audits to ensure that the training meets their business needs and the needs of their staff. Training is flexibly provided to ensure minimum disruption to the business and their employees. The training package is developed with the support of brokers who can help design and source the training to ensure that it is delivered in a way that meets the employer's needs. Early evidence suggests that the pilots are proving successful at engaging low-skilled employees in training. By March 2004, over 7,000 employers had signed up to the pilots and approximately 39,000 employees had committed to improving basic skills or gaining a first NVQ level 2. Over 70 per cent of employers involved have less than 50 employees and 40 per cent have not had any previous contact with Government agencies.

Regional Skills Partnerships

3.90 Following the Skills Strategy White Paper, the RDAs have been working in partnership with the SBS, local LSCs, Jobcentre Plus, the Sector Skills Development Agency and other regional stakeholders to develop Regional Skills Partnerships. The first of these will be in place by April 2004. The Government is committed to tackling any institutional barriers identified by the Regional Skills Partnerships to creating an effective and integrated approach to regional skills delivery, taking into account the balance with national policy. Further details are provided in *Devolving decision-making: 2 – Meeting the regional economic challenge*, published alongside this Budget.

[27] *Delivering an incentive for membership bodies to provide workforce development: a discussion paper*, HM Treasury and Inland Revenue, December 2003.

Migration

3.91 Migration helps to raise productivity and boost economic growth by increasing labour supply and reducing domestic skills shortages. The UK benefits from free movement of labour within the EU, and to maximise these benefits, the Home Secretary has recently announced that workers from accession states will be allowed to access the UK labour market from 1 May 2004, subject to a worker registration scheme.

3.92 The Government is also committed to promoting schemes to attract unique talent to the UK, recognising in particular the potential of international students, and will therefore:

- introduce over the coming months **a new entitlement for graduates of the world's top 50 business schools to work in the UK for up to 12 months on completing MBAs;** and
- build on pilot measures announced last month by the Scottish Executive to establish a new Relocation Advisory Service streamlining the services involved in migration, and allow graduates from Scottish universities to remain in Scotland for up to two years to live and seek work. If successful, an extended scheme could provide greater freedom for other parts of the UK to attract migrants. This will benefit regional economies and communities.

INVESTMENT

3.93 Alongside a skilled labour force, greater investment in physical capital, both public and private, is essential to support a productive economy. The Government is taking steps to improve the environment for private investment and investment decision-making by providing a platform of macroeconomic stability, promoting flexibility in capital markets, and addressing specific market failures in planning and the housing market.

Non-residential planning

3.94 A simpler, more flexible and transparent planning system is an important element in raising productivity and delivering the Government's economic, social and environmental objectives. Reforms to the system are being delivered through new legislation, with the first Planning Bill for more than a decade currently before Parliament. Investment in the Planning Delivery Grant has been increased; and the Government is undertaking wide-ranging revision to national planning guidance. It has recently completed the public consultation process for its revised planning policy statement on town centres in England, which aims plan for growth in town centres, expand the boundaries of town centres where this will facilitate further development, promote consumer choice and promote social inclusion.

3.95 The Planning Bill introduces significant reform to planning system. Its measures include:

- the creation of Regional Spatial Strategies, which will link closely with economic, housing and transport strategies;
- the introduction of a more flexible system based on local development plans;
- statutory timetables for ministerial casework;
- reform to the compulsory purchase system;
- the introduction of Business Planning Zones; and
- reform to Planning Obligations.

Delivering stability: securing our future housing needs

3.96 The Government welcomes Kate Barker's review of housing supply *Delivering stability: securing our future housing needs,* published today. A summary of the Review's recommendations is set out in Box 3.9. The Review has fulfilled its remit to consider the weak responsiveness of new housing supply to rising house prices in the UK and the consequences this has in terms of macroeconomic volatility and the diminishing affordability of housing to individuals.

Box 3.9: The Barker Review of housing supply

The Barker Review's final report states that the UK has experienced a long-term upward trend in real house prices, 2.4 per cent per annum over the last 30 years. To improve macroeconomic stability and deliver greater affordability for individuals a lower trend in house prices is desirable:

- **in order to deliver a trend in real house prices of 1.8 per cent an additional 70,000 houses in England might be required;**
- **to bring the real price trend in line with the EU average of 1.1 per cent an extra 120,000 houses might be required; and**
- **the Review's scenarios also call for additional social housing new build of between 17,000 and 23,000 units a year.**

The Review sets out a number of recommendations for improving the functioning of the housing market:

- **a long-term goal for improved market affordability should be set;**
- **investment in social housing should be increased over time building up to an additional £1.2 to £1.6 billion per annum;**
- **Regional Planning Bodies and Regional Housing Boards should be merged to create a single body responsible for managing regional housing markets supported by independent advice on the steps required to achieve affordability goals;**
- **the introduction of a Planning-gain Supplement to capture some of the development gains that landowners benefit from, and as a fair means of releasing resources to increase housing supply;**
- **the establishment of a Community Infrastructure Fund to help to unlock some of the barriers to development; and**
- **that local authorities should be allowed to 'keep' the council tax receipts from new housing developments for a period of time to provide incentives for growth and to meet transitional costs associated with development.**

Housing supply

3.97 The Government's objectives for the housing market are to promote stability, sustainability, flexibility and fairness. Locking in economic stability means being more vigilant in matching supply and demand. The Barker Review shows that in order to deliver long-term stability, the current level of housebuilding will not suffice and a substantial increase in housing supply is required. A failure to increase supply risks increasing excess demand for housing and the threat of further volatility in the wider economy. A failure to increase supply also means diminishing affordability of housing in the private sector. The Barker Review also shows how house price inflation has made home ownership in the private sector increasingly unaffordable for many groups in the population, particularly for first-time buyers, with knock-on impacts on rent levels in the private sector and on demand for social housing, which already outstrips supply. The Government is concerned about the impact of this diminishing 'market affordability' on social exclusion and on the opportunities available to young people and others.

3.98 The Review sets out a challenging analysis of future housing needs. The scenarios it presents suggests that current levels of house building – 160,000 homes a year in England plus a total of 200,000 in the four Growth Areas by 2016 – are insufficient and would need to increase by between 70,000 and 120,000 units per annum to improve affordability trends and to as much as 200,000 units per annum to deliver stable house prices in real terms.

3.99 The Government needs to balance the economic and social case for development against its environmental and wider implications, and ensure that development is sustainable and protects valuable countryside. The Review recognises the steps the Government has taken through the Sustainable Communities Plan to increase housing supply in a sustainable way in the wider South East, by requiring the efficient use of land through density targets, and to avoid exacerbating problems of low demand and abandonment in parts of the North and Midlands. However, the Review argues that the Government needs to build on that momentum and increase housing supply levels further if it is to meet its economic and social aims. As the Review itself points out, increasing development by 200,000 units a year might put at risk this sustainability and endanger our environmental objectives. Equally, however, the Review states that current supply levels are not sufficient. The Review recommends that to deliver improved affordability, levels of house building would need to rise by over 70,000 units and towards 120,000 units per annum.

3.100 The Government agrees that to deliver its commitment to stability and affordability a significant increase in development over time is needed. The Government will need to consider the scale of such development and how it can be delivered both in high demand areas and in areas suffering problems of low demand. **The Government will establish a long-term goal for affordability in the housing market incorporated within the PSA process as recommended by the Barker Review.** This goal will need to be reflected at a regional level through regional targets as part of the process of setting regional housing numbers. The Government will consult on the consequences of such development and how this should be reflected at the regional level over the course of the next 18 months.

Planning

3.101 The Barker Review sets out challenging reform proposals to deliver increased supply to central, regional and local government, and the development industry. **The Government accepts the need for reform and intends to implement a programme of change as recommended in the Review.** The Government will therefore consult with stakeholders to:

- consider how Regional Planning Bodies and Regional Housing Boards can be merged to create a single body responsible for managing regional housing markets and making recommendations to the Government on the distribution of the single housing pot in their regions and how they can be supported by stronger independent advice on the steps required to achieve affordability goals. The Government will come forward with proposals by the summer with a view to implementing them in 2005. Such a structure could also provide the model for planning and housing within elected Regional Assemblies, though this will be for the Assemblies to decide;

- improve the delivery and responsiveness of the planning system by allocating land in a way that provides developers with sufficient land to ensure the delivery of agreed housing numbers and more choice as to which sites to develop. This incorporates market-based triggers to ensure additional land is released where this is needed to balance local housing markets. Government will issue guidance on how these proposals should be reflected in Local Development Frameworks;

- revise planning policy and guidance and consult on it this year, including guidance on determining the scale and allocation of housing at the regional level and the application of market information and signals, a presumption in favour of brownfield development, and the scope for taking account of the relative value society places on different land uses;
- issue planning guidance on the interpretation of the presumption in favour of granting planning permissions which conform to local plans and the realistic availability of sites. The Government will also provide a clearer basis for Regional Spatial Strategies to reflect regional circumstances which justify departure from national policy;
- publish further guidance on the composition of Regional Planning Bodies and the need for a full range of regional stakeholders to be represented on these bodies;
- set out the choice of routes available to housing developers through the planning system, including clarifying the distinction between outline and detailed planning permission and the greater use of design codes backed by Local Development Orders;
- speed-up planning decisions. The Deputy Prime Minister has announced £130 million for 2004-05 in Planning Delivery Grant (PDG) allocations to reward good planning performance, including housing delivery in growth areas and performance on appeals to drive strategic plan making. Allocations of the £170 million PDG for 2005-06 will include a link to housing delivery more generally, to enable and incentivise authorities to deliver improved housing outcomes and to promote progress on e-planning; and
- look to assist local authorities to focus on key development through considering the coverage of Permitted Development Rights and help deliver large-scale sites including through best practice and assistance from the Planning Advisory Service and English Partnerships.

Delivering development

3.102 **The Government also accepts the need for reforms to more effectively deliver housing development,** through:

- agreeing to the need to provide incentives to support infrastructure to enable housing development, as suggested in the Community Infrastructure Fund, and will consider how to start to undertake this as part of the 2004 Spending Review;
- building on the Local Authority Business Growth Incentive scheme to consult on ways to give incentives to local authorities to deliver housing growth. The Government can see the case for such an incentive scheme and will come forward with proposals for consultation;
- considering how Government policy and allocation decisions for infrastructure across all relevant departments take account of planned housing, employment and population growth alongside other priorities, including the potential for developer contributions. The Government will also consider how the Highways Agency and utilities are involved in developing regional and local strategies and have clear remits to work to minimise delays to development;
- asking English Partnerships to take a lead role in assembling complex sites for development, including the use of Public Private Partnerships, surplus public sector land, and joint ventures where necessary and within a set of principles defining where and when it should intervene in the market; and

- regularly reviewing the need for special purpose vehicles in consultation with regional and local planners, including where housing undersupply remains a persistent problem.

Industry

3.103 Delivering increased housing supply requires a housebuilding industry with the capacity and skills to deliver supply in the most cost effective manner and to time. The Government and the industry must work in partnership to deliver this with all sides playing their part. The Barker Review sets out a series of challenging reform proposals to the industry to increase customer satisfaction, tackle skills shortages, increase the flow of new houses onto the market, reduce the time taken to build out new sites, and improve design and use of modern methods of construction. The Review considered the case for an investigation of the industry by the OFT but suggests this is not yet necessary. It is for the industry, in partnership with Government, to respond to these recommendations, together with the recommendations from the forthcoming review of skills by Sir John Egan. **The Government will consider the progress made by summer 2005.**

Monitoring development

3.104 As recommended by the Barker Review, the Government will establish an independent review of the housing market in no more than three years' time and actively look to improve the evidence base for housing policy and data availability drawing on expertise from the relevant sectors. The Government has also asked Kate Barker to undertake a continued role in monitoring delivery of the whole reform programme.

Economic incentives

3.105 The Barker Review's analysis has considered the need for incentives and additional resources to facilitate delivery. The Review assesses whether fiscal measures coupled with targeted spending could deliver long-term stability and affordability through an increase in the housing supply. The Review recommends that as housing supply increases the number of social houses needs to rise to meet society's needs. It concludes that investment in social housing must increase and the efficiency of the sector must improve to deliver this supply. The Government accepts that there is a case for increased investment in social housing. It will begin to address this in the 2004 Spending Review. The Government accepts that there are limits to what is achievable within the current fiscal framework and accepts the need for incentives to deliver a long-term solution.

Taxation of land

3.106 The Barker Review considers the efficient taxation of land and of development on that land. The Review concludes that increased revenues are needed to support greater expenditure on social housing, the infrastructure needed to complement new housing, and to provide the right incentives for local authorities to expand housing provision. These revenues can and should be provided out of the increase in land values associated with new residential development.

3.107 When agricultural land is sold for development very large gains are often realised that arise mainly because planning permission has been granted. This is known as 'betterment'. The Barker Review has looked at two principal options for a charge based on this increase in land values, in order to provide the resources to fund the Review's other recommendations. These options are:

- *VAT on new housing on greenfield land* – the Review has looked closely at this tax and concluded that VAT on new greenfield housing would have several disadvantages. VAT is a national tax covered by EU legislation, which sets significant constraints on how flexibly it can be levied, and may mean that it is difficult in practice to target VAT at betterment without an adverse impact on incentives to develop new housing; and

- *Planning-gain Supplement* – the Review also looked at the option of supplementary contributions to the Exchequer based on increases in land values and linked to the granting of planning permission. It concluded that this provides a better-targeted and more flexible charge. It could, for example, have lower rates for brownfield development, and thus provide a fair share of the gain in land values to support expansion in housing supply, while incentivising growth in the right areas. The Review concluded that such a charge would have no material effect on either the price paid by householders or on the incentive to develop new housing.

3.108 The Barker Review concludes that a Planning-gain Supplement is likely to be more effective than VAT in providing an appropriate and efficient source to release resources to help in the expansion of housing supply providing it can be successfully designed and implemented. The Supplement would be levied on the increase in land values at the stage of planning permission, as a fair means of releasing resources. This would be accompanied by the scaling back of section 106 agreements linked with Local Authorities receiving a share of the development gain generated by this measure. As well as expanding housing supply and locking in macroeconomic stability, this package of measures would alter the balance of incentives between greenfield and brownfield development, helping to encourage a more efficient use of land including an added incentive for brownfield land use.

3.109 There are a range of other measures considered by the Review, including Property Investment Funds (PIFs), a UK version of the successful US Real Estate Investment Trusts, and a Derelict Land Tax Credit. The Government agrees with these suggestions and is consulting on the introduction and structure of PIFs, as discussed below, to improve the efficiency of the property investment market and encourage an expansion of the private rented sector. The Government also aims to introduce, following further evaluation, a Derelict Land Tax Credit that could provide a tax incentive for the development of derelict brownfield land, as discussed in Chapter 7.

Delivering the Barker package

3.110 The Government accepts that, in order to meet the key objectives of stability and improved market affordabiity, there is a good case for additional social housing investment, incentives to local authorities to deliver housing growth, support for infrastructure to complement new developments, and potentially support to the industry to train their employees to deliver this challenging agenda, all of which would require additional investment. The Government agrees that it is in principle fair to fund this proposed package of measures out of the uplift in land values experienced during the development process.

3.111 Delivering long-term stability will require the delivery of all the elements within this overall package. The Government will work with stakeholders to ensure that the necessary conditions are in place for the Barker Review's proposals to succeed. Therefore, in considering a package of reforms to follow the Barker Review, the Government will need to be sure that:

- planning reforms are underway and the system is delivering a coherent and efficient service;
- there is a positive impact on supply from the introduction of these incentives;
- the industry is responding to the Review's recommendations and is capable of rising to the challenge;
- the 2004 Spending Review has begun to put in place increased investment for social housing; and
- the design of the proposed Planning-gain Supplement is effective and workable.

3.112 **The Government will review progress against these objectives by the end of 2005**. If the Government is satisfied that they are all on track, it will bring forward this package of measures to deliver economic stability and improved market affordability address housing needs.

An efficient property investment market

3.113 **The Government has today launched a consultation document, *Promoting more flexible investment in property***, seeking views on how PIFs should be structured to meet the Government's objectives of further enhancing the liquidity of property investment, providing greater access to retail investors and encouraging expansion in the private rented sector. In addition, **consultation will continue on the introduction of legislation to facilitate the removal of tax barriers to the development of a market in property-based derivatives**. This will complement and encourage more efficient investment in property.

North Sea oil and gas

3.114 The Government is committed to working with industry to maximise economic recovery of UK oil and gas reserves by encouraging new investment to ensure all economically viable reserves are developed. The 2003 Pre-Budget Report announced a new Exploration Expenditure Supplement to help new entrant North Sea companies that do not receive the full benefit of current 100 per cent exploration and appraisal (E&A) capital allowances. The supplement will apply to all expenditure on E&A on or after 1 January 2004.

Investing in British films

3.115 The Government has discussed with the film industry and others extending support to the industry through the tax system beyond 2005, with the aim of simplifying and targeting support more effectively. Budget 2004 announces that **Section 48 relief for low-budget British qualifying films, which is due to expire on 1 July 2005, will be replaced by a new relief for production expenditure**. The relief will go direct to the film-maker and not to any third party. it will typically cover 20 per cent of the production costs of British films, compared with the 15 per cent typically provided by the current Section 48 relief. The Government is currently reviewing the treatment of co-productions with a view to creating a tighter definition of British Qualifying Status. The Government will also consider the scope for the new relief to increase the proportion of British films that get distribution. Full details of the new relief will be published in summer 2004, following further discussions with the industry and others.

Flexibility in capital markets

Institutional investment

3.116 A key feature of the UK economy is that owners are separated from company management by a complex chain of intermediaries, including pension trustees, insurance companies, investment consultants, fund managers and brokers. Substantial analysis has shown that many elements along the investment chain have poor incentives to act in the interests of owners and that companies are not interacting with shareholders as effectively as they could. The Government has already taken a series of steps to tackle these issues, particularly by promoting greater accountability and transparency in the links between investors and companies. These steps include the Myners review of institutional investment, published in March 2001, and the Higgs review of the role and effectiveness of non-executive directors, published in January 2003. Following on from Myners, in October 2002 the Institutional Shareholders Committee (ISC) issued best practice principles for shareholder engagement with companies, and its members committed to incorporating the principles into fund management mandates.

3.117 The Pensions Bill introduced in February 2004 implements two of the Myners Review's[28] recommendations: the legal requirement for trustees to have appropriate knowledge of investment matters, and the replacement of the Minimum Funding Requirement with scheme-specific funding standards. The Government is also conducting a review of progress after two years by pension scheme trustees against the set of investment principles recommended by Myners. Qualitative research was published in November 2003 as the first part of this review. It showed that while some progress has been made, particularly by larger schemes, further progress is necessary against many of the Myners principles.

3.118 The Government will undertake discussions with the industry on the potential for further progress in a number of key areas of Myners. It will consider the need for further actions to improve the functioning of the institutional investment chain in the light of these discussions and the findings of the next part of the review, which is nearing completion.

3.119 In addition, later in 2004, the Government will examine the extent to which the ISC's principles have delivered change. The Government also welcomes Paul Myners' recent report to the Shareholder Voting Working Group on the obstacles to voting UK shares,[29] which addressed the practical steps which all parties involved in shareholder voting should take to improve the voting process.

Government response to Equitable Life Inquiry

3.120 The Government announced an independent review of the actuarial profession and the Government Actuary's Department (GAD) in response to Lord Penrose's Inquiry into Equitable Life.[30] The review, which will build on the work of the Myners review of institutional investment, will be led by Sir Derek Morris and has a wide-ranging remit to examine the profession and GAD, to consider how to modernise the profession and to promote an open and competitive market in actuarial advice in the UK. The review will report by spring 2005.

3.121 The Government also announced a review led by Paul Myners into the corporate governance arrangements applicable to mutual life offices. The review will consider the governance framework for mutual life offices in comparison with that for similar companies (and, where relevant, for listed companies). Where appropriate, the review will bring forward recommendations to ensure that boards of mutual life offices are as accountable to their members as boards of comparable companies are to their shareholders. The review will report by the end of 2004.

[28] *Institutional investment in the United Kingdom: a review*, Paul Myners, March 2001.

[29] *Review of the impediments to voting UK shares*, Report by Paul Myners to the Shareholder Voting Working Group, January 2004.

[30] *Report of the Equitable Life Inquiry*, Rt Hon Lord Penrose, March 2004.

4 INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. To achieve this, individuals who want and are able to work should be provided with the support they need to enable them to find employment and develop skills. The Government recognises that each individual will face different barriers to work. Delivering full employment therefore requires a personalised approach, with services tailored to the needs of the individual and local circumstances. This chapter describes the further steps the Government is taking to move towards its aim of employment opportunity for all, including:

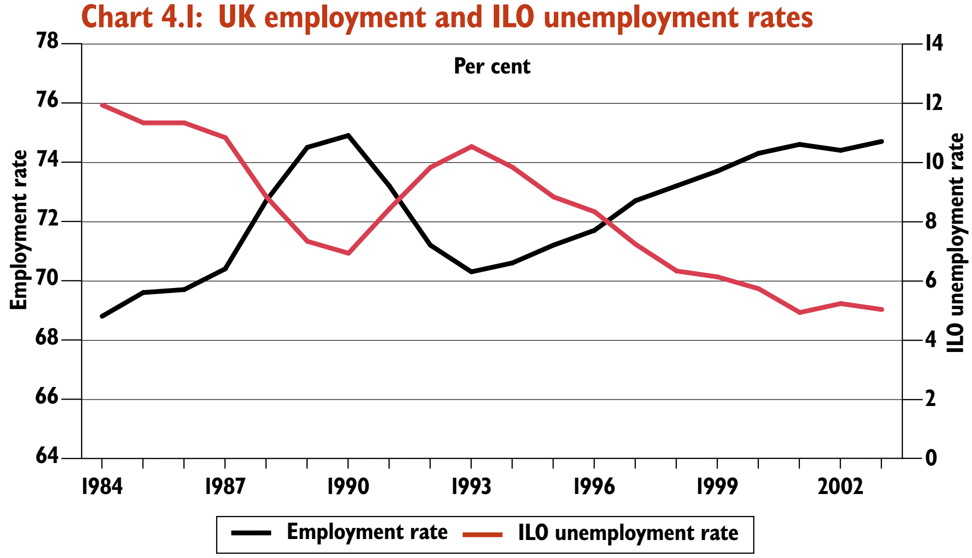
- **the piloting of a mandatory work-focused interview regime for some existing claimants of incapacity-related benefits** in the Pathways to Work pilot areas;
- **the piloting of a job preparation premium of £20 per week** in the Pathways to Work pilot areas, for existing claimants of incapacity-related benefits who undertake relevant activity that supports a return to work;
- **the introduction of a worksearch premium of £20 per week**, available to those in a family in receipt of the Working Tax Credit who are not working, in six pilot areas with high levels of worklessness;
- **the introduction of a second set of Local Housing Allowance Pathfinders in the private rented sector from April 2005**;
- **a package of measures to simplify the rules around Housing Benefit;**
- **from October 2004, an increase in the adult and youth rates of the National Minimum Wage** to £4.85 and £4.10 respectively, and the **introduction of a National Minimum Wage for 16 and 17 year old workers** of £3.00 an hour; together with the Learning and Skills Council and employers, the Government will work to acheive minimum pay levels for apprentices in England of £70 to £80 per week;
- **an extension of measures for lone parents** in six cities with large lone parent populations, including access to NVQ level 3 training; and
- **'Fair Cities' initiatives,** to be established in three areas later this year, to improve employment outcomes for people from disadvantaged ethnic minority groups.

INTRODUCTION

4.1 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. The Government believes that everyone who is able and wants to work should have the opportunity to do so, and should be given support appropriate to their individual needs. Along with extending the right to support, the Government is also increasing the responsibilities placed on each person to take steps to improve their own chances of moving from welfare to work. Only by extending rights and responsibilities together can the welfare system be made more fair and efficient.

4.2 The Government's strategy for extending employment opportunity builds on the strong performance of the UK labour market over recent years. UK unemployment, on the International Labour Organisation (ILO) definition, fell in the last quarter of 2003 to 4.9 per cent, the lowest of the G7 economies, while the working age employment rate reached 74.5 per cent. The employment level has risen by nearly 1.7 million since spring 1997, while claimant count unemployment has fallen by more than 700,000 since 1997 and has remained consistently below one million since February 2001. Chart 4.1 shows UK labour market performance since 1984.

Chart 4.1: UK employment and ILO unemployment rates



Source: Office for National Statistics (ONS).

Regional employment

4.3 The Government is determined to ensure that the labour market works effectively for everyone in all parts of the country. In the last few years, employment has risen and unemployment fallen in every region of the UK, and there has been a narrowing of previously wide differences between regions. At the same time, however, this progress has not been felt by all groups or across all areas to a sufficient extent. The Government set out its strategy for tackling regional and local variations in employment in *Full employment in every region,* published alongside the 2003 Pre-Budget Report. *Devolving decision making: 2 – meeting the regional economic challenge; increasing regional and local flexibility,* published today alongside the Budget, sets out the Government's approach to achieving the responsive regional and local services necessary to address the economic disparities that still exist between regions.

Flexibility and fairness in the labour market

4.4 The UK's strong employment performance is based on a foundation of macroeconomic stability and reforms that have enhanced flexibility in labour, product and capital markets. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high employment, low inflation, low unemployment and continued growth in real incomes. To achieve flexibility in the labour market requires an institutional environment that encourages labour force participation, equips people to adapt rapidly to change and provides support for those without employment. Box 4.1 summarises trends and progress in UK labour market flexibility since Budget 2003.

[1] *The consequences of 'in work' benefit reform in Britain: new evidence from panel data,* Francesconi, M. and Van der Klaauw, W., University of Essex, 2004.

4.5 The Government's labour market policies ensure that flexibility and fairness go hand in hand. The tax and benefit system, described in this chapter and in Chapter 5, provides financial support for those who need it most, when they need it most. Recent research[1] shows the positive impact of the Government's policies in this area with, for example, a 7 per cent increase in the proportion of lone parents working 16 or more hours per week resulting from the introduction of the Working Families' Tax Credit (WFTC). Policies to promote the development of employment services, such as the introduction of the New Deals and Jobcentre Plus, provide the help and support that enable people to enter the labour market rapidly. Policies to raise skills levels will help to ensure that workers have the skills that employers need and are able to respond more flexibly to changes in the demand for labour.

Box 4.1: Labour market flexibility – report on progress

An efficient and flexible labour market that creates jobs and raises productivity is essential to the UK. However, were the UK to join Economic and Monetary Union (EMU), a flexible labour market would be particularly important. Inside EMU, the loss of national monetary policy and the nominal sterling-euro exchange rate as adjustment mechanisms would place a greater burden of adjustment on factor and price movements in response to a country-specific shock. The 2003 assessment of the five economic tests for UK membership of EMU concluded that, since 1997, UK labour market flexibility has improved markedly. However, important challenges remain in the UK to reduce inactivity and repeated spells of worklessness and to enhance skills levels and improve mobility. More progress on labour market reform would enhance flexibility in the UK and advance the Government's long-term goal of employment opportunities for all. In the context of EMU, greater flexibility in the UK and throughout the euro area would minimise output and employment instability, helping to ensure convergence was durable and that the potential benefits of EMU could be fully realised.

Details of trends, measures and progress on the flexibility of labour markets are set out in the report *Flexibility in the UK economy* published alongside the Budget, and new measures introduced in the Budget are set out in Chapters 3 and 4. Measures include:

<u>Developing skills:</u> through a New Deal for skills which sets out a vision for closing the skills gap with the UK's international competitors; reform of financial support for 16-19 year olds, to increase the proportion who reach the age of 19 equipped with the skills they need to succeed; and the addition of six new areas that will take part in Employer Training Pilots from September 2004.

<u>Enhancing wage flexibility:</u> by amending the remits for the Pay Review Bodies to include a stronger local and regional dimension, and working with the rest of the public sector to increase the focus on respecting local pay conditions, side by side with UK-wide guarantees of a National Minimum Wage and tax credit support for low paid workers, to make work pay.

<u>Improving labour market opportunities:</u> through a range of measures to extend the support available to lone parents, people with health conditions and disabilities and others who would like to work; the introduction of practical guidance to support the recruitment, retention and training of older workers; and through increased discretionary powers and funding available to local Jobcentre Plus staff. The Government will consider the case for extending further flexibility to respond to the needs of individual clients and local areas.

<u>Promoting geographic mobility and economic migration:</u> through new measures to ensure that Housing Benefit does not constrain the ability of the unemployed to find or take up work; following up the recommendations of the Barker Review of the constraints on housing supply; and improvements in and extension of the Highly Skilled Migrant Programme.

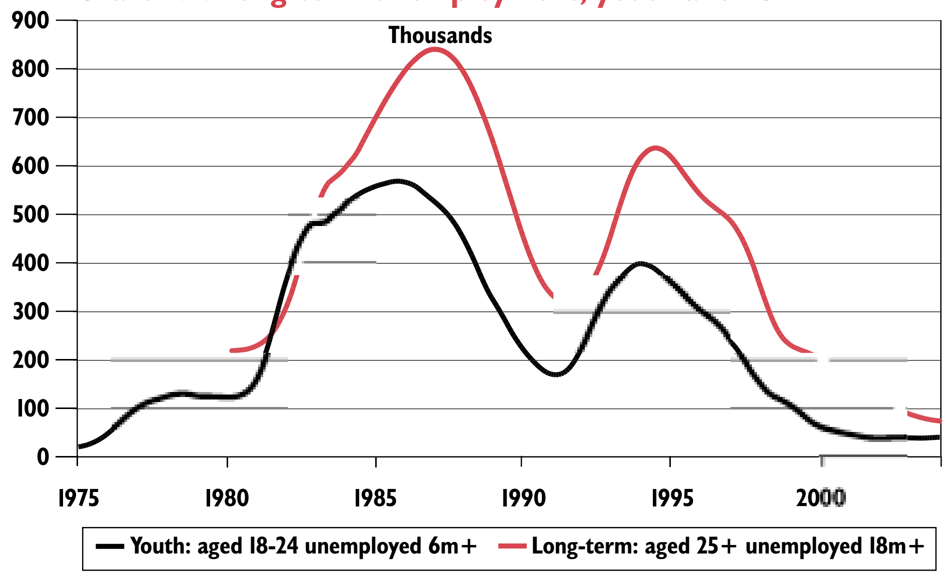
The New Deals

4.6 The New Deals have been integral to the success of the Government's labour market policy over recent years. Since its launch in 1998, the New Deal for young people (NDYP) has helped nearly 480,000 people between the ages of 18 and 24 to move into employment, while the New Deal for those aged 25 and over (ND25+) has helped over 170,000 people get back to work. New Deal programmes have contributed to a fall in long-term unemployment of over three-quarters since 1997, including a fall in long-term youth unemployment from 177,500 in spring 1997 to only 41,500 in January 2004. Both the NDYP and the ND25+ provide personal adviser support and opportunities to improve basic skills and training and participate in subsidised employment.

4.7 In 2000, the National Institute of Economic and Social Research (NIESR) concluded that, without the NDYP, the level of long-term youth unemployment would have been twice as high.[2] More recent studies show that the NDYP has reduced overall youth unemployment by between 30,000 and 40,000;[3] that young unemployed men are now 20 per cent more likely to find work as a result of the New Deal; and, more generally, that the social benefits of the NDYP outweigh the costs.[4]

4.8 The New Deal for lone parents (NDLP) has also proved successful. Of the 541,000 lone parents who have joined the NDLP, over 247,000 have been helped into employment, contributing to a rise in the lone parent employment rate from around 47 per cent when the NDLP was introduced, to 53.4 per cent in spring 2003. Independent evaluation for the Department for Work and Pensions (DWP) suggests that, "*the programme doubles the employment chances of participants; 50 per cent of participants entering work compared to 26 per cent of non-participants – an additional impact of 24 percentage points*".[5]

Chart 4.2: Long-term unemployment, youth and 25+



Source: ONS.

[2] *The New Deal for young people: implications for employment and the public finances,* NIESR, December 2000.
[3] *New Deal for young people: evaluation of unemployment flows,* Wilkinson, D., Policy Studies Institute, 2003.
[4] *Active labor market policies and the British New Deal for unemployed youth in context,* Van Reenen, J., in *Seeking a premier league economy*, Blundell, R., Card, D. and Freeman, R. (eds), University of Chicago Press (awaiting publication).
[5] *New Deal for lone parents: second synthesis report of the national evaluation,* Centre for Analysis of Social Policy, University of Bath (Evans, Eyre, Millar, Sarre), June 2003.

Skills **4.9** The Government's employment policies are succeeding in getting people into work. However, intervention is also needed to support people in gaining the skills they need to progress and move from low to high skilled work. A highly skilled workforce is a key part of a flexible economy, while for the individual, acquiring and developing skills helps support sustained employment. The Government is determined to help people enter, remain, and progress in work by ensuring that they have the skills they need to reach their full potential.

4.10 Benefit claimants currently have access to a wide range of skills provision, including through the New Deals, Work Based Learning for Adults and Basic Skills training. Chapter 3 sets out the Government's New Deal for skills, which will assist those in work to move from low to high skilled employment, and will give those out of work improved access to the high quality skills advice and training they need to find sustainable employment. As part of the New Deal for skills, Jobcentre Plus will work with Information Advice and Guidance Partnerships to ensure that skills counsellors are co-located and integrated with the work of Jobcentre Plus offices, and Jobcentre Plus will ensure that its customers are able to access Learndirect and other relevant websites.

Next steps **4.11** Having achieved significant falls in unemployment, the Government is determined to do even more for those who face the most difficult barriers to work. This requires a personalised approach where service providers are given sufficient flexibility to deliver solutions appropriate to local areas and individuals. This Budget sets out the next stages of the Government's employment strategy, focusing on providing increased support for those groups that continue to face barriers to work, including people with health conditions or disabilities, lone parents and ethnic minorities. Through its proposals the Government aims to:

- ensure that barriers to work are tackled, particularly for those people that have not been given sufficient opportunities to access work-focused support in the past, such as claimants of incapacity-related benefits; and

- ensure that people are better able to make personal choices to overcome their own barriers to work.

EXTENDING EMPLOYMENT OPPORTUNITY TO ALL

4.12 The Government is committed to extending employment opportunity to all, ensuring that support is available to help everyone fulfil their potential. All those who are able to work should be given the opportunity to participate in a flexible and buoyant labour market, and should be helped to develop the skills necessary for them to sustain and progress in employment. Not only does this benefit individuals, giving them and their families the best chance of avoiding poverty and enjoying financial security later in life, but it also promotes a growing and enterprising economy, capable of supporting those people who are unable to work.

Effective job search

Helping the unemployed move into work

4.13 The Government's Welfare to Work strategy ensures that the unemployed are given the support and skills they need to move back into work as quickly as possible, with more intensive support provided through the New Deals for those who are unsuccessful in the earlier stages of their benefit claim.

4.14 Delivered through Jobcentre Plus, the Jobseeker's Allowance (JSA) regime provides individuals who are out of work and actively seeking employment with the advice and support they need to find jobs. JSA has been effective in maintaining low unemployment and reducing the risk of long-term detachment from the labour market. Most people move rapidly off JSA, with 60 per cent leaving JSA within 13 weeks and over 75 per cent within six months. The Government has introduced a number of measures to build on this success, including:

- from April 2004, as announced in Budget 2003, **the minimum number of steps that JSA claimants are required to take to search for jobs will increase, as will the number of interventions in the first six months;** and
- as announced in the 2003 Pre-Budget Report, **from June 2005, the Government will pilot in ten areas a mandatory short intensive work-focused course for all JSA claimants, aged 25 or over, at the six-month stage, followed by three mandatory personal adviser interviews.**

Sick and disabled people

4.15 Sick and disabled people make up the largest group on out-of-work benefits. There are currently over 2.7 million people of working age claiming incapacity benefits, a number which until recently was rising strongly. Many of the people on these benefits are capable of and want to work, but too often in the past were denied the support necessary to enable them to do so.

4.16 In recent years, economic success and the extra help and support that the Government has introduced have made a difference. The number of people moving onto incapacity-related benefits has fallen by around one-third since 1995, and the growth in the incapacity benefits caseload has slowed considerably. Between spring 1998 and spring 2003, the employment rate of disabled people increased from 43.5 per cent to 49 per cent. However, it remains significantly below that of the overall working age population. The Government is committed to providing further employment support to enable people with health conditions or disabilities to realise their aspiration of moving into work.

4.17 Support is available for disabled people moving into work through programmes such as Access to Work and Work Preparation. The Government also recognises the additional costs faced by disabled people participating in the labour market. The Working Tax Credit (WTC) has addressed this and, together with the National Minimum Wage, has increased the guaranteed minimum income for a single disabled person working 35 hours a week from £173 in April 2002 to £204 a week from October 2004. The New Deal for disabled people (NDDP) provides support and encouragement for people on incapacity-related benefits seeking to work. The NDDP, which has helped over 25,000 people into employment since its national launch in July 2001, has been improved and extended to March 2006.

4.18 Recognising that some people with health conditions or disabilities may not be ready to move immediately to the provisions provided by the NDDP, **the 2003 Pre-Budget Report announced extra support from April 2004 to enable Jobcentre Plus personal advisers to help those on incapacity benefits who want to move into work.**

4.19 Creating a wider framework of support within which to deliver provision such as the NDDP more effectively, the Government launched its Pathways to Work pilots in three areas in October 2003. The Organisation for Economic Co-operation and Development (OECD) recently described the pilots as a *"radically new approach to dealing with those on incapacity benefits"*.[6] The pilots aim to reshape the culture and expectations of being on an incapacity benefit, placing a stronger focus on returning to work particularly in the critical early stages of a claim. The pilots will test the effectiveness of more skilled adviser support; more intensive mandatory work-focused interviews; engagement of key stakeholders such as employers and General Practitioners; and improved and more visible financial incentives through a Return to Work Credit. A further four pilot areas will commence from April 2004.[7]

4.20 Contact with personal advisers can raise individuals' knowledge of local labour market opportunities and the employment and financial support available to them. The Pathways to Work pilots are testing a new mandatory work-focused interview regime within Jobcentre Plus for new claimants of incapacity benefits, early and sustained support that will reduce the likelihood of people becoming long-term claimants. The Government noted during the Pathways to Work consultation that it would consider whether it would be sensible and feasible to extend the work-focused interview regime to some of the existing claimants of incapacity benefits in the pilot areas once the effectiveness of the new arrangements became clear. The pilots have bedded in well, and **Budget 2004 now announces an extension to the support available in the seven Pathways to Work pilot areas with:**

- **the piloting of a mandatory work-focused interview regime for some existing claimants of incapacity-related benefits.** Most people who started a claim in the two years prior to the launch of the Pathways to Work pilots will be required to take part in three additional work-focused interviews.[8] This extra support will provide these claimants with an informed choice and encourage them to realise the aspirations many still have of a return to work; and
- **the piloting of a job preparation premium of £20 per week, available to existing claimants of incapacity-related benefits who undertake relevant activity that supports a return to work.** The premium will be payable for a maximum of 26 weeks where the claimant completes an action plan detailing a return to work, and undertakes approved activities in support of that plan.[9]

4.21 This provision ensures that both responsibilities and rights are extended together, and the Government will look to roll out these measures from January 2005 in the first three Pathways to Work pilot areas and from April 2005 in the remaining four locations. The DWP will discuss these new proposals with external stakeholders before they are implemented to ensure that they are introduced in such a way as to best encourage a return to work. The Pathways to Work pilots, including this new provision, will be evaluated robustly and rigorously to assess what interventions are most effective and to shape the scope for rollout to other areas.

[6] *Economic survey of the UK*, OECD, 2004.

[7] These will be in East Lancashire; Essex; Gateshead and South Tyneside; and Somerset.

[8] As with the existing arrangements for new claimants, people who have a severe health condition or disability (as defined through the exempt categories for the Personal Capability Assessment) will not be required to take part in the mandatory regime. They will, however, be able to access the support on a voluntary basis.

[9] The activities include Work Based Learning for Adults, Programme Centres, Work Preparation, Condition Management Programmes, the NDDP, the New Deal for those aged 50 and over (ND50+) and Jobcentre Plus personal adviser caseloading.

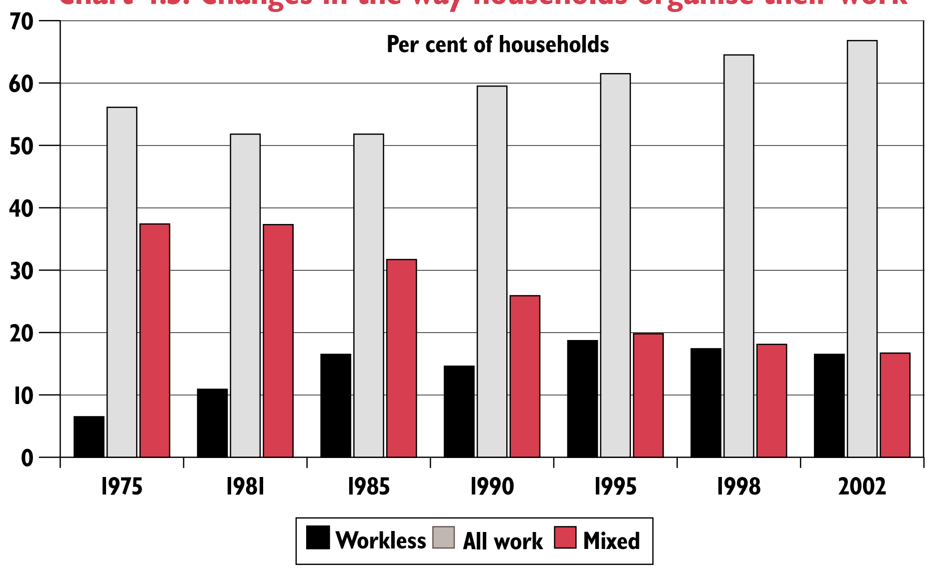
4.22 Underpinning the Government's initiatives is the legislative framework set out in the Disability Discrimination Act (DDA). The employment provisions of the DDA ensure that disabled people are not treated less favourably with respect to recruitment, retention, training and promotion. The DDA is discussed in more detail in Chapter 5.

Partners **4.23** Since the mid 1980s there have been significant changes in the way that households organise their work, related to a steady increase in the employment rate among women from 59 per cent in 1984 to 70 per cent today. Chart 4.3 shows how work is polarised between 'work-rich' and 'work-poor' households. It illustrates the importance of providing work-focused support to every adult in a household who is without work, and not just to the main claimant of benefits, if the Government is to meet its goals of extending employment opportunity to all and tackling child poverty.

4.24 In order to address this problem of workless households and the consequences for child and pensioner poverty, the Government has sought to:

- ensure that information reaches partners who otherwise would not engage with any active labour market policies, through the work-focused interview regime;
- provide access to voluntary programmes, with parity between the New Deal for partners (NDP) and the NDLP;
- introduce joint claims, starting with younger couples without children and eventually ending the outmoded concept of adult dependence; and
- improve gains to work for second earners working part-time, compared with previous systems of financial support.

Chart 4.3: Changes in the way households organise their work



Source: Labour Force Survey and Family Expenditure Survey, updating Gregg, P., Hansen, K. and Wadsworth, J. (1999) The Rise of the Workless Household, in Gregg, P. and Wadsworth, J. (1999) The State of Working Britain, Manchester University Press.

4.25 There are still over 4.2 million people of working age and almost 1.8 million children living in workless households. The Government believes that every workless adult should have access to the work-focused support provided by Jobcentre Plus, and that the nature of this support should reflect each individual's circumstances.

4.26 As announced in the 2002 Pre-Budget Report, **the Government intends to introduce compulsory work-focused interviews for partners of all new and existing benefits claimants from April 2004, over and above those having joint claim status for JSA.**

4.27 Building on the success of the voluntary NDLP, the NDP offers tailored, personalised advice and support to partners of benefit claimants in households in which both partners are workless. As announced in Budget 2003, **the NDP will be enhanced from April 2004 to provide the same package of support as is currently available to lone parents. Partners will also be eligible for the enhanced Job Grant from October 2004.**

4.28 Around 800,000 children live in couple single-earner families with low incomes. Tackling child poverty requires the provision of work-focused support for non-working partners in these families. As announced in the 2003 Pre-Budget Report, **the Government will extend eligibility for the NDP to those in a family in receipt of the WTC who are either not working or are working less than 16 hours a week from October 2004.** This will help to ensure that those who are workless can benefit from work-focused help, regardless of the status of their partner.

4.29 The Government recognises that the costs of looking for work may act as a disincentive to non-working partners in single-earner families. **Budget 2004 therefore announces that:**

- **from October 2005 a new worksearch premium of £20 per week will be available to those in a family in receipt of the WTC who are not working, who agree to join the enhanced NDP and voluntarily choose to search actively for a job, in six pilot areas with high levels of worklessness.**

4.30 This will address the inactivity of partners of those in lower paid employment, and has the added advantage of addressing the lower employment rates of some ethnic minority groups.

4.31 The Government has already taken steps to extend the rights and responsibilities of JSA claimants on an equal basis. Since October 2002, childless partners of the unemployed, where at least one partner was born after 1957, have also become joint JSA claimants. The Government's long-term aim is to extend rights and responsibilities in the benefit system so that everyone has access to appropriate help and support, by introducing joint claims for all partners of JSA claimants, and for partners of those claiming Income Support. This long-term aim constitutes a significant reform that would mean that every partner in a couple becomes eligible for work-focused support that is appropriate to their individual circumstances. However, the Government recognises that there is further to go in modernising the benefit system to reflect today's society. The system of joint claims means that couples can nominate the partner to whom benefit should be paid, and the Government believes there is a strong case in principle for extending an individual's right to payment, as and when this is practical.

Lone parents

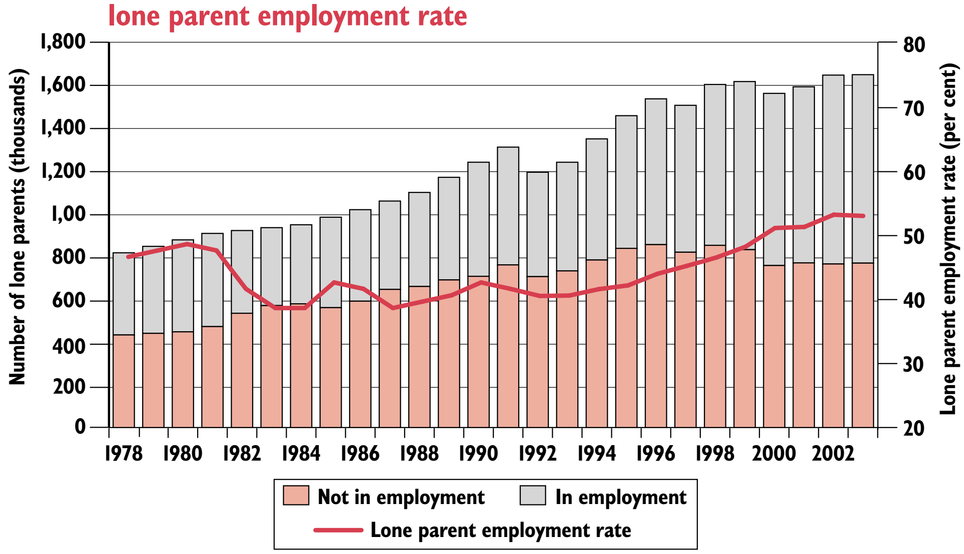
4.32 Most of the 1.7 million lone parents in this country want to work. However, lone parents are less likely than mothers in couples to be in employment and more likely to be in poverty. Giving lone parents the opportunity to exercise informed choice over their decision to work, and the support they need to move into employment if they wish to do so, is key to the Government's aim of increasing employment opportunity for all and tackling child poverty. The Government's target is for 70 per cent of lone parents to be in work by 2010. Its strategy to achieve this target includes:

- work-focused interviews to ensure all lone parents are aware of the support available to them;
- tailored help and support through the NDLP for those who choose to look for work; and
- measures to ensure that moving into work pays, such as the WTC including help with childcare costs.

4.33 In part as a result of the NDLP and other measures, employment among lone parents has risen substantially in recent years, as Chart 4.4 shows, to 53.4 per cent in spring 2003. The NDLP offers lone parents who choose to look for work a comprehensive package of support, including access to a personal adviser for all lone parents who are either not working or who are working fewer than 16 hours a week. Independent evaluation for the DWP concludes: *"NDLP is cost effective and interim analysis suggests an economic gain to society of £4,400 per additional job and a net exchequer saving of just under £1,600 per additional job, and a substantial social benefit".*[10]

4.34 Work-focused interviews ensure that lone parents are aware of the help and support available to them, and independent evaluation[11] shows that they have significantly increased participation in the NDLP while maintaining the rate at which participants find jobs. Since their introduction in April 2001, work-focused interviews have increased entry to the NDLP, with average monthly caseloads up by 15 percentage points and a 1 percentage point net impact on Income Support off-flows for stock claimants who have been on benefit for one year or more. The Government is continuing to roll out work-focused interviews to ensure that all lone parents are able to make informed choices about their labour market participation. The programme the Government has already announced will be fully rolled out in April 2006.

Chart 4.4: Lone parent population in and out of work and lone parent employment rate



Source: General Household Survey for 1978-1991 data; Labour Force Survey, Spring 2003 data set, for 1992-2003 data.

[10] *New Deal for lone parents: second synthesis report of the national evaluation*, Centre for Analysis of Social Policy, University of Bath (Evans, Eyre, Millar, Sarre), June 2003.

[11] *Integrated findings from the evaluation of the first 18 months of lone parent work-focused interviews*, DWP, March 2004.

Box 4.2: The Government's approach to helping lone parents

The NDLP is one of the most flexible and generous of all programmes, and at the heart of it is a highly personalised approach, individually tailored to meet a lone parent's needs to move into work. Evaluation evidence shows that this approach is very effective.

Moving into employment is dependent upon three factors: good information; addressing barriers to employment; and job search.

Job information is provided to lone parents through: compulsory work-focused interviews to ensure lone parents have the right information about what is available; a communications strategy which ensures that there are positive messages for lone parents about the benefits of work and for employers about this group of potential employees; mentoring targeted at lone parents furthest from the labour market; and Discovery Weeks, designed to boost soft skills such as the confidence of lone parents, and promote contact with local employers.

Lone parents who decide to join the NDLP have access to support from specially trained personal advisers in Jobcentre Plus in order to help them address their barriers to employment. The aim of the support is to develop a relationship based on knowledge of personal circumstances, building up lone parents' confidence in their ability to work.

This key relationship allows a tailored suite of measures to be developed. The type of help available may include: working towards job readiness through mentoring, confidence building and personal support; building skills through training (including a grant of £15 per week); access to NVQ level 2, and in some areas level 3; and in-work training through the Employment Retention and Advancement Demonstration (ERAD) project; childcare, including expert advice on local provision; childcare tasters; childcare while at interviews and on training; childcare in the week before starting work; extended schools pilots; and assistance with costs through the Adviser Discretionary Fund (ADF); financial assistance, for example through the 'better off in work' calculation; help claiming tax credits; the In-Work Emergencies Fund (in certain areas); ERAD (in certain areas); access to the ADF; debt advice; and from October 2004, access to the Job Grant; and first weeks in work assistance, for 28 days in all areas and more than 60 days in some areas; ERAD assistance for up to 2 years (in certain areas).

Job search assistance is provided through measures including a worksearch premium of £20 per week (in certain areas); a full range of Jobcentre Plus worksearch assistance; and employer engagement, especially to encourage the use of flexible working.

4.35 The Government is determined to build on the success of its strategy to date. The New Deal for skills will particularly benefit lone parents. Furthermore, the Government is working with employers to implement a range of measures in six cities[12] with high lone parent populations, in recognition of the key role that employers play in helping lone parents into work.

[12] Birmingham, Glasgow, Leeds/Bradford, Liverpool, London and Manchester. See *Work Works – final report of the National Employment Panel's steering group on lone parents,* National Employment Panel and British Telecommunications, April 2003.

4.36 As announced in Budget 2003, these measures include 'Discovery Weeks' designed to boost soft skills, such as confidence, and promote contact with local employers. The first Discovery Weeks successfully took place in London in November 2003 and the rest will be rolled out to the other five cities from April 2004. In addition, the Government now announces that **a further 15 Discovery Weeks will be introduced in London. Budget 2003 also announced that childcare tasters would be piloted in the six cities from April 2004.** These will allow lone parents on the NDLP to access formal childcare for up to one week, to test whether it suits their needs.

4.37 The Government is reviewing the implementation of these measures and is building on early positive feedback by announcing further steps in the six cities. These will continue to develop the strategy of ensuring lone parents are informed about the opportunities available to them and have the support they require to maximise their potential in the labour market, and ensuring that local employers are fully engaged in this activity. **The new measures, to be introduced from October 2004, include:**

- **a new communications strategy** to ensure that lone parents in these areas are aware of the opportunities that work offers and of the full range of support available to them, and that employers have positive local examples of employing lone parents and adopting flexible working practices;
- **access to NVQ level 3 training in these areas,** in sectors where local employers identify a demand for skills and where routes into work may not have been traditionally accessed by lone parents, possibly including, for example, scientific and technical services. In addition NVQ level 3 training in childcare will be available to lone parents, as this is an area where there is an acute skills shortage that is critical to addressing barriers to work; and
- **enhanced support for the first two months that lone parents in these areas move into work,** including contact with personal advisers and access to funding, via the In-Work Emergencies Fund, to overcome barriers that might otherwise make it difficult to remain in work.

4.38 In the 2003 Pre-Budget Report the Government announced the creation of extended school pilots in three areas. **The Government now announces its intention to seek a further four areas in which to establish extended school pilots from October 2004.** In these areas, with this improved childcare, worksearch premiums and in-work credits will also be available.

Ethnic minorities

4.39 People from ethnic minority groups continue to face barriers to accessing and realising opportunities in the labour market, though there is significant variation in the labour market position of different ethnic groups. The Ethnic Minority Taskforce is taking forward the recommendations of the Prime Minister's Strategy Unit report on the position of ethnic minorities in the labour market. In addition, Budget 2003 announced:

- **from April 2004, the introduction of specialist advisers in Jobcentre Plus districts with high ethnic minority populations;** and
- **a new policy fund of £8 million over two years** to help Jobcentre Plus managers provide local innovative solutions to helping people from ethnic minorities back into work.

4.40 In recognition of the important role that employers play in enabling people from disadvantaged ethnic minority groups to overcome barriers to their participation in the labour market, the National Employment Panel 'Fair Cities' project has been investigating the scope for employer-led initiatives that could complement Government policies in this area.

Budget 2004 announces that 'Fair Cities' initiatives will be established in three areas later this year, to work with employers and other local stakeholders in order to develop strategies to improve employment outcomes for people from disadvantaged ethnic minority groups.

Older workers **4.41** The Government is determined to increase employment opportunities for people aged 50 and over and has introduced a number of measures to help older people remain in or return to work. The New Deal for those aged 50 and over (ND50+) has improved back to work help and has helped to raise the employment rate of those aged between 50 and state pension age to 70 per cent. The Government is committed to opening up individual choice and is encouraging age positive employment practices and flexible approaches to retirement, to be backed by legislation from late 2006. **Budget 2004 announces a new high profile national guidance campaign to raise employers' awareness of, and ability to adopt, flexible employment and retirement opportunities in order to increase the recruitment, training and retention of older workers.**

Diverse patterns of employment

4.42 Each person seeking work can offer different skills and experience and has different requirements from work (for example, the need to fit working hours around family and care commitments). If employment opportunity is to be maximised, it is therefore essential to ensure that a diverse range of work is available. Greater flexibility around employment choices and the creation of a diverse workforce will help to ensure that the needs of both employers and employees are met, and that the labour market as a whole can adjust efficiently to changing economic conditions. The UK labour market shows a high degree of flexibility, demonstrated by, for example, a wide distribution of hours worked and a high incidence of part-time work.

Self-employment **4.43** The Government offers a wide range of support to people moving from benefits into self-employment, including business advice, financial support through tax credits, and a 'test trading' period for those eligible for the New Deals or Work Based Learning for Adults. To ensure that all workless people are able to take full advantage of this support, the 2003 Pre-Budget Report announced **a review of the routes off benefits into self-employment to be carried out by the Small Business Service.** Interim findings will be available in the spring. The findings will inform the steps Jobcentre Plus and Business Link operators are taking to ensure that all workless people are able to take full advantage of the support available to them. These include, as announced in the 2003 Pre-Budget Report, **producing a leaflet signposting the support available,** and **developing arrangements for Business Link operators to market their services, and specialist support services, directly to Jobcentre Plus clients.**

Labour mobility

4.44 The ease with which people are able to move within and between regions is a key indicator of the flexibility of the labour market. High geographic mobility implies that the workforce is able to respond quickly and easily to labour demand, contributing to achieving the Government's goal of full employment in every region. A highly mobile workforce improves the UK's ability to respond at a regional level to economic shocks which might otherwise lead to individuals' detachment from the labour market and increased long-term unemployment. The UK exhibits relatively low levels of geographic mobility, in part due to the way in which assistance with housing costs is provided. **The Government is therefore taking steps to improve the administrative interface between Jobcentre Plus and Local Authority housing departments, to facilitate moves from one area to another.**

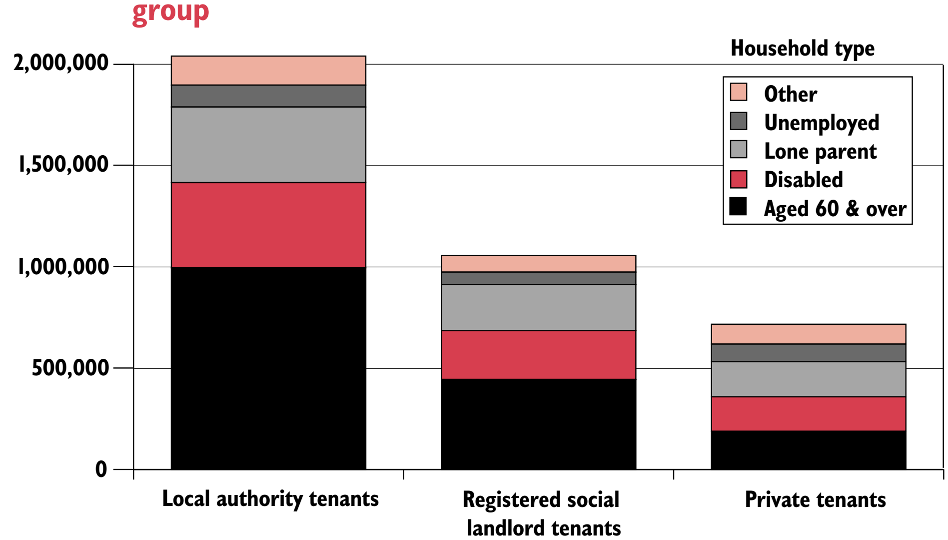
Reform of Housing Benefit

4.45 Housing Benefit provides help with rent to over 3.8 million low-income tenants, both in and out of work. Chart 4.5 shows the distribution of tenants by tenure type and client group. The current system of administration can be complex, both for claimants to understand their entitlement and how changing circumstances will affect the level of Housing Benefit they will receive, and for Local Authorities to deliver. The Housing Benefit reform programme is now well underway. It represents the most radical structural change to Housing Benefit since 1988 and comprises the following elements:

- streamlining and alignment of benefits to make claiming, changes of circumstance and means tests more transparent and closer to those for other forms of support;
- administrative improvement through the £200 million Performance Standards Fund;
- Pathfinders for flat-rate Local Housing Allowances (LHAs) in the private rented sector, leading to national roll-out; and
- development of pilots of flat-rate LHAs in the social rented sector.

4.46 The Government is determined to build on the measures already introduced in Budget 2003 and the 2003 Pre-Budget Report to reduce the complexity surrounding the Housing Benefit system. Enabling Housing Benefit claimants to move more easily between locations will lead to greater choice for the individual over their accommodation and place of work. It will also promote increased flexibility and efficiency in the labour market as a whole, contributing towards the Government's objectives of increasing employment opportunity, reducing child poverty and tackling concentrations of deprivation.

Chart 4.5: Housing Benefit caseload by tenure type and client group



Source: Housing Benefit and Council Tax Benefit statistics, May 2002, Department for Work and Pensions.

4.47 In administering Housing Benefit, Local Authorities can face overly complex rules, which frequently lead to delays in claimants receiving their payment and to varying levels of service across the country. To address the latter the Government already has in place the £200 million Performance Standards Fund; the average time to process a new claim has improved in just one year by around 5 per cent, compared to 2002-03. **The Government will introduce, from April 2005, a package of measures that will assist, for example, vulnerable students and children in pensioner households, as a first step in an overall programme designed to simplify the rules surrounding entitlement and take-up of Housing Benefit, and the way in which the rules align with those for other support such as tax credits and Pension Credit.** The measures will take account of the changes to Pension Credit backdating, described fully in Chapter 5.

4.48 The Government has already made good progress towards simplification of the Housing Benefit system. Budget 2003 announced that the Government would introduce a LHA in nine Pathfinder areas for tenants in the private sector. All nine of the Pathfinders have now been rolled out, and potential barriers to implementation successfully overcome in each case. Initial evidence suggests that they have a high level of acceptance from tenants and local landlords and that they are already enabling tenants to exercise choice over their housing options. Subject to the evaluation evidence, the Government intends to roll out the flat-rate system throughout the country.

4.49 In preparation for full national roll out of the private sector LHA system, **the Government intends to introduce a second round of Pathfinders from April 2005.** This will test the scope for rationalising the extent of the local areas to which various LHAs will apply, and will provide a further opportunity to adopt best practice in implementation before the system is introduced nationally.

4.50 The 2003 Pre-Budget Report also announced that the Government will develop pilots of flat-rate LHAs in the social rented sector. These would give tenants more flexibility over where they live, enabling them to make economically rational choices to occupy properties which best suit their needs. Conditions in the social sector are different from those in the private sector: the pattern of rents is uneven, although rent reform is already addressing this; there is more limited choice available until choice-based letting is in place; and there are far more vulnerable tenants. The Government is considering all these factors carefully, and will continue to develop suitable pilots for the social rented sector.

RESPONSIVE AND FLEXIBLE DELIVERY

4.51 While it is important that national standards of service provision are upheld, the Government recognises that specific barriers to work differ between local areas and individuals and may not easily be tackled with a 'one size fits all' approach. The Government wants to ensure that service providers are given sufficient flexibility and discretion to tailor policies to suit the specific needs of the community they serve. For people with multiple barriers to work or in concentrated areas of worklessness, in particular, there is a need to maximise local autonomy and accountability wherever possible.

Service provision

Jobcentre Plus

4.52 Jobcentre Plus was launched in April 2002, bringing together the Employment Service and those parts of the Benefits Agency dealing with working age people. Jobcentre Plus promotes work as the best form of welfare, helping unemployed and economically inactive people of working age move closer to the labour market and compete effectively for work. The nationwide rollout of this new business model represents a £2.2 billion investment in improved service and efficiency, taking Jobcentre Plus from around 1,500 local outlets to around 1,000 sites, supported by a new network of call centres. **The Government aims to complete the nationwide roll out in 2006.** Through this new network of offices Jobcentre Plus aims to offer a high quality, integrated, and accessible service to all its working age clients. Furthermore, and as Chapter 6 describes, new efficiencies over the period to 2008 will help deliver both a reduction in back room processing staff, and an increase in the number of front line personal advisers, thereby helping more people from welfare to work.

Building on success

4.53 The Government intends to build upon the success of the New Deal by learning from the best of current provision and strengthening the New Deal's ability to help people who face particular difficulties in moving into employment. The Government will examine the range and availability of provision and the support needs of both unemployed and economically inactive people, integrating services within the New Deal to ensure that the full range of effective help is in place.

4.54 The Government will consider the case for extending further flexibility to respond to the needs of individual clients and local areas, subject to the maintenance of high national standards, and in the context of the overall framework of rights and responsibilities of the national benefit system. The Government will also consider the scope for simplifying current processes to make systems easier for employers, clients, advisers and providers.

Local responsiveness

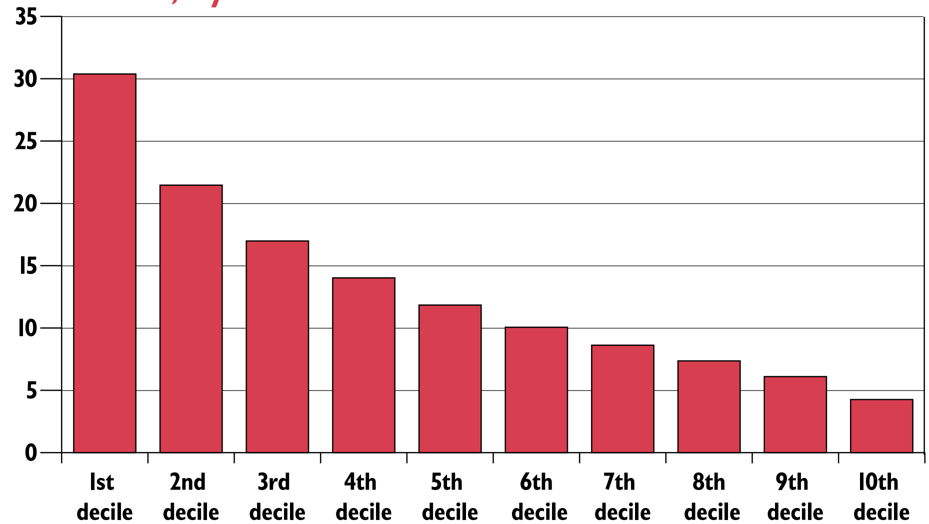
4.55 Despite the success of Government policy in raising the overall employment rate, local concentrations of unemployment and inactivity persist. As Chart 4.6 shows, more than 30 per cent of the population claim out of work benefits in the first decile of local authority wards, compared to under 5 per cent of the population in the tenth decile of wards. It is important that policy is delivered in such a way as to effectively address the problems of these areas, and help local and regional economies adjust to change.

4.56 As noted earlier, the Government set out its strategy for tackling areas of disadvantage and concentrations of worklessness in *Full employment in every region,* published alongside the 2003 Pre-Budget Report. *Devolving decision making: 2 – meeting the regional economic challenge; increasing regional and local flexibility,* published alongside the Budget, sets out the rationale for devolving more responsibility to regional and local levels in order to tackle geographical variations in economic growth, and describes delivery of the Government's labour market policy in the context of devolved decision-making more generally.

Concentrations of worklessness

4.57 Recognising the importance of flexible regional and local employment programmes, the Government announced in the 2002 Pre-Budget Report **the introduction from April 2004 of Working Neighbourhoods pilots, to provide a programme of intensive support in 12 neighbourhoods with very high concentrations of worklessness, helping local residents access jobs which may often be within travelling distance of where they live.** The pilots will test new approaches, combining earlier and more intensive intervention, community-based delivery and additional resources to help overcome barriers to employment. The help provided by each pilot will be determined locally, in consultation with local partners, to reflect local needs.

Chart 4.6: Percentage of people claiming working age benefits,[1] by ward



[1] *Working age benefits defined as Jobseeker's Allowance, Income Support, Incapacity Benefit, Severe Disablement Allowance or Invalid Care Allowance.*
Source: Department for Work and Pensions, August 2001.

Action Teams

4.58 Action Teams for Jobs focus on the long-term unemployed and inactive, using innovative methods to address specific local barriers to work in 63 disadvantaged areas of the UK, many of which contain large ethnic minority communities. Action Teams have helped almost 97,000 people into work. The 2003 Pre-Budget Report announced that, **from April 2004, the 63 existing Action Teams will be extended to 2006 with two additional Action Teams introduced in Wear Valley and Barrow-in-Furness, and Jobcentre Plus District Managers and Action Team contractors will have greater discretion to direct resources towards the most disadvantaged people in their area.**

Employment Zones

4.59 Employment Zones, which provide personal advisers with complete discretion over funds to overcome individual barriers to work, have already helped over 44,000 long-term unemployed people aged 25 and over back into work in 15 areas of England, Scotland and Wales. Budget 2003 announced further steps to build on this success, including:

- **from April 2004, replacing the NDLP in the five London Employment Zones and for lone parents returning for a second or subsequent work-focused interview in the other Zones;** and
- to make the most effective use of resources through the use of multiple providers, **from April 2004, multiple providers will be introduced in the five London Zones, as well as in Birmingham, Liverpool and Glasgow.**

MAKING WORK PAY

4.60 Through the National Minimum Wage and tax credits, the Government has created a system of in-work support that provides greater rewards from work. The Government's strategy to make work pay has improved incentives for individuals to participate and compete in the labour market, making it more flexible and dynamic. Making work pay tackles two key problems:

- the unemployment trap, when those without work find the difference between in-work and out-of-work income too small to provide an incentive to enter the labour market; and
- the poverty trap, when those in work have limited incentives to increase their hours or to move up the earnings ladder because it may leave them little better off.

The National Minimum Wage

4.61 The National Minimum Wage guarantees a fair minimum income from work. In October 2003, the rate for adult workers aged 22 or over was increased to £4.50 an hour; the youth and development rate, for workers aged between 18 and 21 or in approved training, rose to £3.80.

4.62 On 15 March 2004 the Government published the Low Pay Commission's (LPC) 2004 Report, in which the LPC reviewed the recommendation made last year to increase the adult and youth rates to £4.85 and £4.10 respectively from October 2004. The LPC found that the economic outlook had improved since the time of its Fourth Report and noted that *"the labour market remains remarkably robust"*.

4.63 In the light of the LPC's evidence that the National Minimum Wage has had no discernible negative impact on overall employment, inflation or the wider economy, the Government has accepted the LPC's recommendation. **From October 2004, the adult rate of the National Minimum Wage will therefore rise to £4.85 and the youth and development rate will rise to £4.10.** The ONS estimates that between 1.6 and 1.9 million low-paid workers will benefit from the new rates of the National Minimum Wage.

4.64 In July 2003, the Government asked the LPC to consider the case for a minimum wage for 16 and 17 year olds, in the context of education and training objectives. The Government believes that it is wrong to allow 16 and 17 year olds in employment to be exploited through low wages. The LPC has presented strong evidence that a cautious minimum wage rate would prevent the worst exploitation of young people, without discouraging participation in education or training. **The Government has therefore accepted the LPC's recommendation that 16 and 17 year olds should be covered by a new National Minimum Wage of £3.00 an hour, from October 2004.** The existing exemption from the minimum wage of apprentices aged under 19 will be retained. The review of financial support for 16 to 19 year olds is covered in detail in Chapter 5.

The Working Tax Credit

4.65 The WTC provides support on top of the earnings guaranteed by the National Minimum Wage, tackling poor work incentives and persistent poverty among working people. By January 2004, 2.3 million families and low-income working households were benefiting from the WTC. There were 70,000 families benefiting from the disabled worker element of the WTC, 87 per cent higher than the number who received support through the Disabled Person's Tax Credit (DPTC). The number of families benefiting from the childcare element of the WTC had reached 300,000 by January 2004, 67 per cent higher than the 180,000 families who benefited from the childcare component of the WFTC.

4.66 Table 4.1 shows that, since the introduction of the National Minimum Wage in April 1999 and the WFTC in October 1999, the Government has increased the minimum income that people can expect when in work, thereby reducing the unemployment trap.

Table 4.1: Weekly minimum income guarantees

	April 1999	October 1999	October 2004
Family[1] 1 child, full-time work (35 hours)	£182	£200	£252
Family[1] 1 child, part-time work (16 hours)	£136	£144	£195
Single person, no children, 25 or over, full-time work (35 hours)	£113	£113	£164
Couple, no children, 25 or over, full-time work (35 hours)	£117	£117	£193
Disabled person (single), working full-time (35 hours)	£139	£155	£204
Disabled person (single), working part-time (16 hours)	£109	£112	£148

Note: assumes a single earner household, the prevailing rate of the National Minimum Wage and that the family is eligible for the Working Families' Tax Credit or Disabled Person's Tax Credit and the Working Tax Credit/Child Tax Credit.

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

4.67 The Government's reforms are also tackling the poverty trap, ensuring that workers have improved incentives to move up the earnings ladder. Marginal deduction rates (MDRs) measure the extent of the poverty trap by showing how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefit or tax credits.

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

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

Marginal deduction rate[1]	Before Budget 1998	2004-05 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	40,000
Over 80 per cent	300,000	190,000
Over 70 per cent	740,000	265,000
Over 60 per cent	760,000	1,700,000

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

Note: Figures are cumulative. Before Budget 1998 based on 1997-98 estimated caseload and take-up rates; the 2004-05 system of tax and benefits is based on 2002-03 caseload and take-up rates, and projected caseload estimates of Working Tax Credit and Child Tax Credit in 2004-05 are based on October 2003 administrative data.

4.69 Table 4.2 does not take into account the effect of the disregard, for the current year's award, of the first £2,500 of an income rise compared with the previous tax year. The disregard ensures that families do not see their tax credit awards reduced until their income increases by more than £2,500, so the effective MDR in any one year is reduced. However, the system responds in full to falls in income as soon as they are identified, ensuring that extra support is provided to families when they need it most.

FUNDING FOR WELFARE TO WORK

4.70 The DWP delivers the majority of the Welfare to Work programme, which is funded by the one-off Windfall Tax on the excess profits of the privatised utilities together with resources allocated in the 2002 Spending Review. The DWP annual report sets out expenditure plans and outturn information. Table 4.3 sets out that element of the Welfare to Work programme funded by the Windfall Tax.

Table 4.3: Allocation of the Windfall Tax

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

[1] *In year figures rounded to the nearest £10 million, except where expenditure is less than £5 million. Constituent elements may not sum to totals because of rounding.*
[2] *Figures are provisional for the years from 2003-04 to 2005-06.*
[3] *Windfall Tax expenditure on welfare to work programmes is reduced from 2003-04 onwards as Windfall Tax resources are exhausted. Remaining in-year expenditure will be topped up with general Government revenues.*
[4] *Includes funding for the Innovation Fund.*
[5] *Includes £10 million in 1999-2000, an element of the November 1998 announcements on welfare reform.*
[6] *Includes £30 million for out-of-school childcare. The costs of the 1997 Budget improvements in childcare through Family Credit are included from April 1998 to October 1999, after which the measure was incorporated within the Working Families' Tax Credit.*
[7] *Start up and development costs. Other costs of the University for Industry are funded from within Departmental Expenditure Limits.*
[8] *Includes £290 million funding for Employer Training Pilots.*
[9] *Funding for repeat interviews. Other funding is from the Invest to Save Budget.*
[10] *Includes capital spending on renewal of school infrastructure, to help raise standards.*

5 BUILDING A FAIRER SOCIETY

The Government is committed to promoting fairness alongside flexibility and enterprise so that everyone can take advantage of opportunities to achieve their full potential in a modern, flexible economy. The reforms of the welfare state introduced by this Government reflect its aims of eradicating child poverty, work for those who can and ensuring security for all in old age. The Government is also committed to a modern and fair tax and benefit system which encourages work and saving and ensures that everyone pays their fair share of tax. This Budget sets out the next steps the Government is taking to support these aims, including:

- **reforming financial support for 16 to 19 year olds**, to increase the proportion of young people who reach the age of 19 equipped with the skills they need to succeed in a modern global economy;
- **additional funding for Sure Start, early years and childcare of £669 million in 2007-08** compared with 2004-05, an average annual real growth rate of 17.3 per cent;
- **a Children's Centre in all of the 20 per cent most disadvantaged wards in England by 2008,** moving towards the goal of a Children's Centre for every community;
- **a £100 payment to pensioner households with someone aged 70 or over to help with their council tax bills;**
- **simplifying the taxation of pensions**, replacing the complexity of eight existing regimes with a single, simplified regime with a lifetime allowance for tax-privileged pension saving;
- **promoting financial inclusion**, focusing on helping households access affordable banking and credit;
- **taking action to protect tax revenues and modernise the tax system,** including measures to combat tax fraud and avoidance; and
- **implementing the O'Donnell review recommendations to establish a new customer-focused tax service,** integrating the Inland Revenue and HM Customs and Excise.

INTRODUCTION

5.1 The Government's aim is to build a strong economy and a fair society, where there is opportunity and security for all. The Government is committed to ensuring flexibility and fairness are advanced together, so that everyone can achieve their full potential in a modern, dynamic economy.

5.2 The Government's strategy for delivering strong and stable growth centres on a robust macroeconomic framework and reforms which promote a flexible economy with a skilled workforce and high levels of employment. The principles of opportunity, responsibility and security underpin the welfare state. Ensuring employment opportunity for all, set out in Chapter 4, is central to avoiding poverty and provides the best platform from which to save for security in retirement. This chapter describes the action the Government is taking to put into practice the principle of progressive universalism, providing security through support for all and more help for those who need it most, when they need it most.

5.3 The chapter sets out the steps the Government is taking to tackle child and pensioner poverty, promote saving and ensure security for all in old age. It describes the action the Government is taking to promote a modern and fair tax system, to close tax loopholes and to tackle fraud. The chapter also sets out the Government's strategy for achieving the Millennium Development Goals to reduce global poverty.

SUPPORT FOR FAMILIES AND CHILDREN

Tackling child poverty

5.4 Every child deserves the best start in life, with opportunities to develop their full potential and lead fulfilling lives. In the mid to late 1990s, the UK suffered higher child poverty than nearly all other industrialised nations. Over a period of 20 years, the proportion of children in relative low-income households had more than doubled. The Government therefore set an ambitious long-term goal to halve child poverty by 2010 and eradicate it by 2020.

5.5 Poverty is not just about income. The Government's strategy for tackling child poverty involves a broad range of measures to improve children's lives in the short term and, over the long term, to break cycles of deprivation. The strategy comprises: ensuring decent family incomes, with work for those who can and support for those who cannot; supporting parents in their parenting role; delivering high quality public services; and working with the voluntary and community sectors.

Progress to date

5.6 The first step towards the Government's long-term goal is the Public Service Agreement (PSA) target to reduce by a quarter the number of children in low-income[1] households between 1998-99 and 2004-05. The most recent data show that, between 1998-99 and 2001-02, the numbers of children in relative low-income households fell by 0.5 million before housing costs (BHC) and by 0.4 million after housing costs (AHC), from 3.1 million and 4.2 million respectively.[2] The Government has therefore succeeded in arresting and reversing the long-term trend of rising child poverty and is making steady progress towards the 2004-05 PSA target. In addition, between 1998-99 and 2001-02, the number of children in absolute low-income households fell from 2.8 million to 1.6 million BHC and from 4.0 million to 2.5 million AHC.

Meeting the child poverty target

5.7 These data do not reflect the increased support for families with children provided through the introduction of new tax credits in April 2003, nor the £180 a year increase in the child element of the Child Tax Credit (CTC) announced in the 2003 Pre-Budget Report. This additional investment of almost £1 billion, on top of uprating by inflation, will benefit 7.2 million children in 3.7 million families. The investment in financial support for families, combined with continued progress against the Government's employment targets, means that the Government is on track to meet or exceed its PSA target on a BHC basis. Achieving the target is less certain on an AHC basis. The nature of the target means there are uncertainties either way. Analysis by the Institute for Fiscal Studies suggests that the Government is on course to meet the target comfortably on a BHC basis and to just meet the target on an AHC basis.[3] The IFS acknowledges the uncertainties in making these forecasts.

[1] Low-income is defined as less than 60 per cent of contemporary median income. Income is defined as household disposable income, adjusted for household size and composition. The target is measured on both a before housing costs and after housing costs basis to take into account variations in housing costs that do not correspond to comparable variations in housing quality.

[2] Data from *Households Below Average Income 1994-95 to 2001-02*, Department for Work and Pensions, March 2003. Data for 2002-03 will be published on 30 March 2004.

[3] *Will the Government hit its child poverty target in 2004-05?*, M. Brewer, Institute for Fiscal Studies, Briefing Note No.47, March 2004.

Long-term measure of child poverty

5.8 As the Government moves towards its long-term goal of eradicating child poverty, it is important that the way child poverty is measured helps target policies effectively and enables the public to hold the Government to account. In December 2003, the Department for Work and Pensions published the new long-term measure of child poverty,[4] which consists of three tiers:

- absolute low income – to measure whether the poorest families are seeing their incomes rise in real terms;
- relative low income – to measure whether the poorest families are keeping pace with the growth of incomes in the economy as a whole; and
- material deprivation and low income combined – to provide a wider measure of people's living standards.

5.9 This measure provides the right balance between clarity and comprehensiveness. Using this measure, poverty is falling when all three indicators are moving in the right direction. Applying the new measure, the Government will continue to judge progress towards halving child poverty by 2010 against relative low income alongside the new measures on material deprivation and absolute low income. The specific PSA targets to achieve this will be set as part of future Spending Reviews.

The Child Poverty Review

5.10 The Government remains determined to make progress beyond 2004-05 and recognises that further investment and reform are needed to meet the goals of halving and then eradicating child poverty. The Child Poverty Review, announced in Budget 2003, is addressing this. It is discussed further in Box 5.1. The results of the review will feed into the 2004 Spending Review and beyond.

Financial support for children

5.11 The Government's approach to financial support for children is based on the principle of progressive universalism, with help for all families and more help for those who need it most. Support is delivered through the combination of universal Child Benefit and progressive Child Tax Credit (CTC). The CTC provides an integrated system of income-related support for families which is independent of the parents' work status, bridging the gap between welfare and work.

5.12 By the end of January 2004, the new tax credits were benefiting six million families, including those receiving support through the child allowances in their benefits, meeting the Government's ambitious expectations for the number of beneficiaries in 2003-04 after just ten months. The tax credits are reaching far more low and moderate-income families than any previous system of income-related financial support.

5.13 By 2004-05, financial support for children through tax credits, Child Benefit and other benefits will have increased by £10.4 billion in real terms from its 1997 level, a rise of 72 per cent. The 2003 Pre-Budget Report announced **a significant rise in the child element of Child Tax Credit – up £180 to £1,625 a year from April 2004**. Table 5.1 shows the levels of support that the CTC and Child Benefit will provide for families from April 2004. The amount a family receives depends on its income and circumstances. For example, a family with a disabled child or eligible childcare costs receives more support for a given level of income.

[4] *Measuring child poverty*, Department for Work and Pensions, December 2003.

Table 5.1: Levels of support for families from April 2004

Family income (£ a year)	less than £13,480	less than £50,000	all families
Per cent of families	*30*	*85*	*100*
1 child	£3,030	£1,405	£855
2 children	£5,235	£1,980	£1,430
3 children	£7,435	£2,550	£2,005

Box 5.1 Child Poverty Review

The Child Poverty Review was announced in Budget 2003 to feed into policy development for the 2004 Spending Review and beyond. The Child Poverty Review will set out the further welfare reform and public service changes required to halve child poverty by 2010 and to eradicate it by 2020.

During a series of 16 seminars in autumn 2003, the Government consulted extensively with the research community and those delivering front line services in this field, including the voluntary and community sectors, and representatives from primary care trusts, the criminal justice system, local authorities and trade unions. Approximately 220 organisations contributed to the seminar programme, with many organisations also participating in the seminars.

The seminars covered a wide range of issues relating to child poverty: deprived areas; ethnicity; childcare and early years; housing; disabled children; parenting; child crime and anti-social behaviour; education; health outcomes; debt, access to credit and financial inclusion; adult risk factors; transport; employment, particularly of disabled parents; and sharing best practice across the four nations.

Emerging themes include:

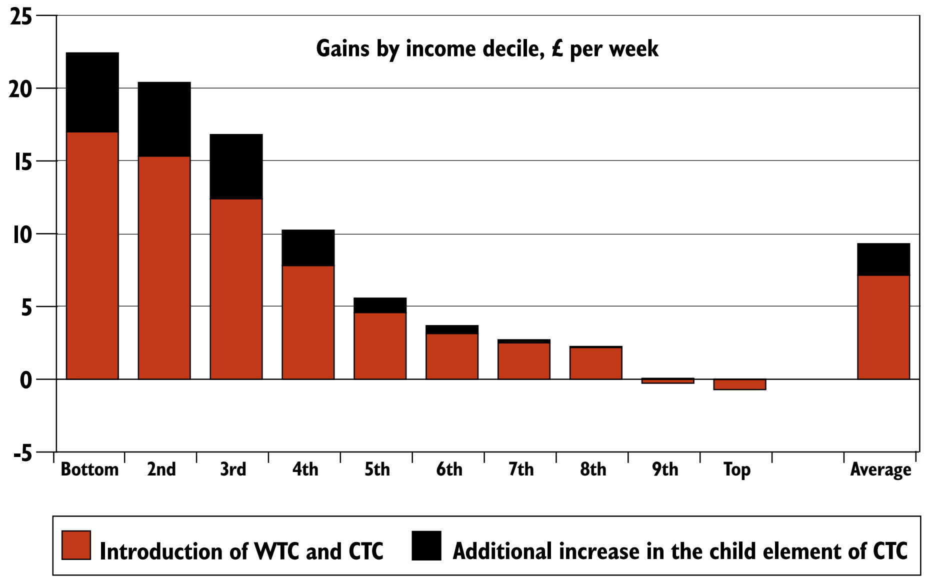
- **the importance of providing appropriate, responsive support as children pass through different stages of development;**
- **the need for additional support for certain groups such as ethnic minority families and families with disabled children;**
- **the need for policy to work across traditional boundaries; and**
- **the vital role played by local authorities and the voluntary and community sectors.**

The seminars, written submissions and further research have contributed to an extensive list of suggested policy reforms, which are being considered in the context of the Spending Review. The Child Poverty Review's findings have already influenced the direction of policy. The Government's work to develop a strategy to tackle financial exclusion, referred to later in this chapter, has been developed in conjunction with the Child Poverty Review. Chapter 6 announces new investment plans for the Department for Education and Skills (DfES). The Review has worked with the Childcare Review and the DfES to develop further measures to help achieve equal opportunities for disadvantaged children. Early years and childcare measures are outlined in paragraph 5.24. In addition, more challenging floor targets for schools and a target to narrow the gap in childcare provision between the 20 per cent most disadvantaged wards and other areas will contribute to tackling child poverty.

5.14 Chart 5.1 shows the average gains for families as a result of the introduction of the Working Tax Credit and the CTC and previously announced upratings, and identifies the additional increase in the CTC as announced in the 2003 Pre-Budget Report. Chart 5.2 shows the impact by income decile of the Government's reforms to the tax and benefits system, since 1997, on families with children. As a result of reforms since 1997, including measures due to take effect in 2004-05, by October 2004, in real terms:

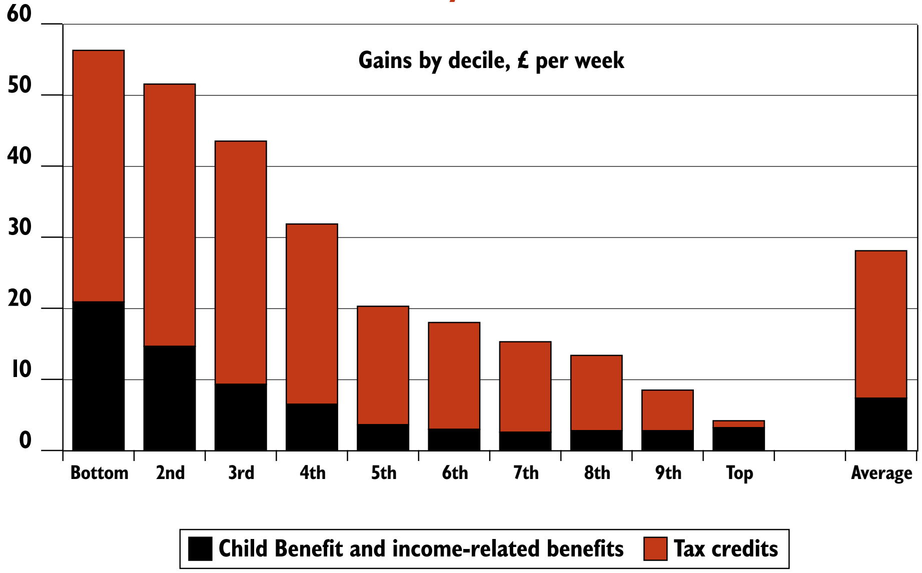
- families with children will be, on average, £1,350 per year better off, while those in the poorest fifth of the population will be, on average, £3,000 per year better off;
- a single-earner family on half average earnings with two young children will be £3,790 a year better off; and
- a single-earner family on average earnings with two young children will be £285 a year better off.

Chart 5.1: Average gains for families as a result of Working and Child Tax Credit



Source: HM Treasury

Chart 5.2: Gains for families as a result of tax credits and other children's measures by 2004



Source: HM Treasury

Supporting young people

Review of financial support for 16-19 year olds

5.15 Building on the success of Education Maintenance Allowances and in response to the Low Pay Commission's (LPC) request to investigate a National Minimum Wage for 16 and 17 year olds, Budget 2003 announced a wider review of financial support for 16 to 19 year olds. The review examined the role of financial support in achieving the Government's skills objectives, alongside supporting families, independent young people and low paid workers. It also examined the case for rationalising the system of financial support for 16 to 19 year olds. The review's report[5] is published alongside this Budget.

5.16 The review has worked closely with the voluntary and community sectors, consulting young people and parents and gathering evidence from across government, including from the devolved administrations. The aim of the review was to ensure that all young people have the support and incentives they need to participate in education and training.

5.17 The report sets out the Government's vision that all young people should reach the age of 19 equipped for higher education or skilled employment. Alongside the vision of the Working Group on 14-19 Reform led by Mike Tomlinson for a radically reformed qualification structure culminating in a diploma, the Government has a long-term vision of a single, coherent system of financial support for 16-19 year olds.

5.18 As an initial step towards this vision, the Government will introduce a package of short-term measures to improve choice, deliver minimum income standards and offer a more individualised, professional service to young people. At the centre of this package is the intention to remove the current distinction in financial support between education and unwaged training and to support young people to finish their courses after their 19th birthday. The Government will consult on these reforms and on its long-term vision for financial support for 16-19 year olds.

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

National Minimum Wage for 16 and 17 year olds

5.19 As outlined in Chapter 4, the Government has accepted the LPC's recommendation that 16 and 17 year old workers should be covered by a new National Minimum Wage of £3.00 per hour from October 2004. The existing exemption from the minimum wage of apprentices aged under 19 will be retained. Employed trainees' wages are currently underpinned by the Minimum Training Allowance (MTA) at £40 a week in England. The MTA was introduced at £35 a week for 17 year olds in 1986, and was raised to £40 a week for 16 and 17 year olds in 1999. In the light of the LPC's recommendations and together with the Learning and Skills Council and employers, the Government would like to achieve minimum pay levels for apprentices in England of £70-£80 a week.

Supporting parents: balancing work and family life

5.20 The Government wants to support parents to balance their work and family life, to help them to fulfil their responsibilities to their children and to their employers. By increasing childcare provision and support, working with business to promote the benefits of flexible working and supporting fair working rights, the Government aims to increase choice and support for parents.

Childcare

5.21 The Government's vision is for every parent to have access to affordable, flexible, good quality childcare. This is key to achieving a range of Government objectives, supporting child development and removing barriers to parental employment. The Government has therefore invested heavily to support the creation of new childcare places and to extend financial support for childcare costs to more working parents. New childcare places for over 1.6 million children have been created since 1997, reaching the Government's target for 2004, and putting it on course to meet its target of new places for over two million children by 2006.

5.22 The significant investment in childcare has improved the position for many parents, but the Government recognises that more needs to be done. Budget 2003 announced a Childcare Review to consider whether the long-term projection for childcare and early years education is sufficient to meet the Government's aims; whether the expansion is proceeding quickly enough; and whether there are areas where more remains to be done.

5.23 The Childcare Review has drawn on a range of expertise from across Government and from key stakeholders in the sector. It has examined a number of issues, including the roll-out of Children's Centres and ensuring effective school-age provision. The Review has worked closely with the Child Poverty Review on the benefits of good quality early childhood education and care for disadvantaged children.

5.24 The Review's initial findings are reflected in the **Budget allocation for Sure Start, childcare and early years of £669 million additional funding by 2007-08** compared with 2004-05, an average annual real growth rate of 17.3 per cent. This will establish Children's Centres in all of the 20 per cent most disadvantaged wards in England by 2007-08, making Sure Start type services available to the 56 per cent of poor children who live in these disadvantaged areas. **This will mean 1,700 Children's Centres by March 2008**, providing services and linked childcare places, another significant step towards the Government's goal of a Children's Centre for every community. The settlement will also support **100,000 new childcare places, including in extended schools, and a pilot to extend a free part-time early education place to 6,000 two-year olds in disadvantaged areas**. Further details of the settlement for the Department for Education and Skills are set out in Chapter 6.

Financial support for childcare

5.25 The Government wants to ensure that childcare is affordable and within reach of all working parents, including those on low and moderate incomes. The childcare element of the Working Tax Credit provides support to working parents for good quality childcare. Following the introduction of new tax credits, help towards childcare costs is now reaching over 300,000 families, up from 180,000 in November 2002, and is worth over £700 million a year.

5.26 Employers can play an important role in helping employees balance their work and parenting responsibilities. As announced in Pre-Budget Report 2003, the Government is introducing new measures to improve the tax and National Insurance incentives for employer supported childcare, for implementation in April 2005. This introduces **a new tax exemption on up to £50 a week of provision of good quality formal childcare contracted by the employer or paid for with childcare vouchers provided by the employer**. With these new provisions there is no requirement for the employer to have management responsibility for the childcare provision, but where such schemes operate all employees should be able to benefit from them.

5.27 The Government is keen to extend the range of good quality childcare that is eligible for financial support, through tax credits or the new tax exemption. **Budget 2004 therefore announces a new light-touch voluntary scheme that will enable accreditation for financial support purposes of a broad range of childcare**. This will enable working parents to access financial support. The Government will bring forward proposals for consultation in early summer 2004, for implementation by April 2005. Before that, **from June 2004, parents using breakfast clubs run by schools and those paying for childcare provided by foster carers will be eligible for the childcare element of the Working Tax Credit**.

Pay and leave for parents

5.28 As part of the Government's policy to promote work-life balance, new rights have been introduced for working parents. Mothers now have a right to up to one year's maternity leave and Statutory Maternity Pay was increased to £100 a week for 26 weeks, up from £60.20 a week for 18 weeks in 2000. New fathers and adoptive parents now also have rights for pay and leave and, since April 2003, all parents of children under six have had the right to request flexible working. As announced in the 2003 Pre-Budget Report, **from April 2004, the Government will uprate Statutory Paternity Pay and Statutory Adoption Pay in line with Statutory Maternity Pay, to £102.80 a week from April 2004.**

5.29 The Government is taking further steps to help parents balance their work and family responsibilities. *Balancing work and family life: enhancing choice and support for parents*[6] set out the Government's strategy in this area and suggested possible reforms. The Government has already implemented some of these steps and is considering a number of options concerning leave for parents.

FAIRNESS FOR DISABLED PEOPLE

5.30 The Government is determined to ensure that disabled people have the opportunity to lead independent and fulfilling lives. Chapter 4 sets out the steps the Government is taking to increase employment and financial support for people with a disability who want to work.

5.31 The Government recognises that families with disabled children often need extra help. From April 2004, the disabled child element of the CTC will be worth over £42 a week on top of the child and family elements of the CTC or the child allowances of Income Support or Jobseeker's Allowance. 106,000 working families were benefiting from the disabled child element of the CTC in January 2004, over three times higher than the number who benefited from disabled child credits in the Working Families' Tax Credit and Disabled Person's Tax Credit.

5.32 Fairness for disabled people requires an end to discrimination in the workplace and beyond. The Disability Discrimination Act gives disabled people rights in a number of areas. Regulations, which come into force in October 2004, will extend the coverage of the employment provisions of the Act to employers of fewer than 15 employees and to most

[6] *Balancing work and family life: enhancing choice and support for parents*; HM Treasury and Department of Trade and Industry, January 2003.

currently excluded occupations, such as police officers and firefighters. In addition, the Government published a draft Disability Discrimination Bill in December 2003, which will increase opportunities for disabled people and give them a greater say in how services are run.

FAIRNESS FOR PENSIONERS

5.33 A fair society guarantees security in old age and ensures that all pensioners can share in rising national prosperity. Building on the foundation of support for retirement income provided by the basic and additional state pensions, the Government launched the Pension Credit in October 2003 to tackle pensioner poverty and reward savings. Tomorrow's pensioners, above this foundation, should be empowered to make their own decisions about their retirement, where possible supported by their employers, and plan their saving and work accordingly. Taking forward the pensions Green Paper, the Government has set out its strategy of informed choice, and is legislating to ensure the success of our voluntarist system, providing people with simplicity, security and choice in working and saving for retirement.

Security for today's pensioners

5.34 To ensure that today's pensioners have security in retirement, the Government has introduced a number of measures to improve the incomes of all pensioners. It has:

- increased the basic state pension by more than the level of inflation in each of the last three years. **In April 2004, the full basic state pension will increase further to £79.60 a week for single pensioners and to £127.25 a week for pensioner couples**, annual increases of more than £100 for single pensioners and nearly £180 for couples;
- guaranteed that the basic state pension will continue to rise each April by 2.5 per cent or the increase in the Retail Prices Index for the previous September, whichever is higher; and
- launched the Pension Credit in October 2003 to guarantee a minimum income and reward those with modest savings or other income.

5.35 In addition the Government has introduced a range of measures to help pensioners offset certain costs of living. These include:

- winter fuel payments worth £200 per household each year for the remainder of this Parliament, benefiting around 11 million people aged 60 or over. This was increased to £300 for households with someone aged 80 or over from winter 2003-04;
- free TV licences for households with someone aged 75 or over and free eye-tests and prescriptions for all those aged over 60; and
- abolished hospital downrating for stays up to 52 weeks, and introduced concessionary travel for those aged over 60.

Council tax payment for pensioners over 70

5.36 The Government understands the position of older people on fixed incomes facing pressures such as higher council tax bills and thus a reduction in their standard of living. Council tax consumes a greater proportion of the incomes of older pensioners – who have little or no opportunity to increase their incomes – than it does for other households. Alongside Council Tax Benefit **the Government believes that it is right to help older pensioner households with their council tax. Pensioner households with someone aged over 70 will therefore receive a £100 payment to help with their council tax bills.** Allowing also for the Winter Fuel Payment, households with someone aged 70 or over will this year receive at least £300. Households with someone aged 80 or over will benefit in total by £400.

Pension Credit

5.37 To tackle pensioner poverty and reward saving for retirement, the Government built on the Minimum Income Guarantee by introducing the Pension Credit in October 2003. From April 2004, the Pension Credit will guarantee an income of at least £105.45 a week for a single pensioner and £160.95 for pensioner couples. The guarantee element of the Pension Credit will be linked to earnings throughout this Parliament. Over 2.7 million pensioners now receive the Pension Credit.

5.38 Around half of all pensioner households stand to gain an additional £400 a year on average under the Pension Credit. As a result of the Pension Credit, the poorest third of pensioners will be around £600 a year better off on average than if the equivalent amount had been spent on raising the basic state pension. All eligible applications received before October 2004 will be backdated to the start of the Pension Credit in October 2003 or to the date of the entitlement if that is later. **Budget 2004 announces that for applications received after October 2004, the maximum period of backdating allowed will be extended from three months to 12 months**. To encourage and help people to claim their entitlements, the Pension Service is promoting a range of **measures to encourage claims and increase take up including a trial of targeted entitlement checks in one region during the summer for groups including the over 80s**.

Effects of measures to support pensioners

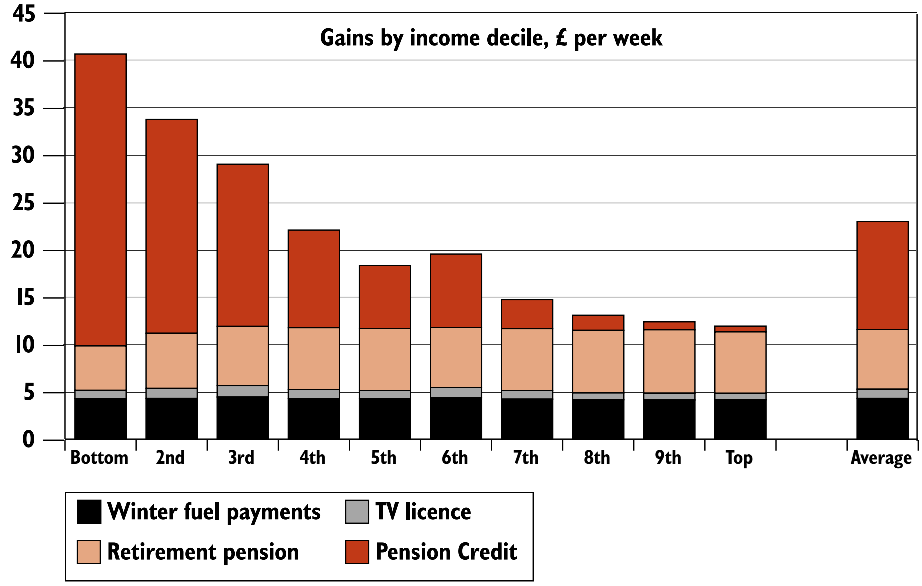
5.39 From 2004-05, as a result of measures introduced since 1997, including the Pension Credit, the Government will be spending around £10 billion more in real terms on pensioners. This is £6 billion more than the cost of indexing the basic state pension to earnings since 1998. Chart 5.3 shows the distributional impact, in current prices, of the Government's measures to support pensioners introduced before April 2004. As a result of personal tax and benefit measures introduced since 1997, in 2004-05:

- pensioner households will be, on average £1,350 a year better off in real terms, or around £26 extra a week; and
- the poorest third of pensioner households will be on average £1,750 a year better off in real terms.

Support for pensioners who pay tax

5.40 Almost half of pensioners pay no income tax, but for those who do, the **age-related personal allowances in 2004-05 will rise in line with earnings to £6,830 for people aged between 65 and 74 and to £6,950 for those aged 75 or over.** No pensioner aged 65 or over will pay tax on income of less than £131 a week in 2004-05. The age-related personal allowances will continue to rise at least in line with earnings rather than prices for the remainder of this Parliament.

Chart 5.3: Overall gains for pensioner families from pensioner policies



Source: Department for Work and Pensions.

Supporting tomorrow's pensioners

Taking forward the Pensions Green Paper

5.41 The December 2002 Green Paper[7] on pension reform set out the challenges in helping to ensure future pensioners are able to build up retirement incomes that meet their expectations. Following an extensive consultation, the measures in the Green Paper have been developed and taken forward through legislation, the publication of *Informed choices for working and saving*,[8] combatting age discrimination and promoting extended working lives. This radical programme of action is designed to ensure:

- *simplicity* – in addition to introducing a new simplified taxation regime for pensions, the Government is replacing the Minimum Funding Requirement with Scheme Specific Funding arrangements to give schemes greater flexibility over their funding strategy, simplifying contracting out arrangements, and ensuring people have access to simple and flexible savings products;
- *security* – under the Pensions Bill, a new pro-active regulator will be introduced to protect the interests of members of work-based pension schemes. The Pension Protection Fund will protect members of private sector defined-benefit schemes whose sponsoring employer becomes insolvent at a point in time when the scheme is under-funded; and
- *choice* – the Government is helping people make informed choices about their retirement, and removing barriers to working longer.

[7] *Simplicity, security and choice: Working and saving for retirement*, Department for Work and Pensions, HM Treasury and Inland Revenue, December 2002.

[8] *Simplicity, security and choice: Informed choices for working and saving*, Department for Work and Pensions, February 2004.

Pensions tax simplification

5.42 The Government provides generous tax relief to encourage people to save for their retirement. Private pensions are the most tax-favoured form of saving, receiving tax incentives worth £21 billion a year (£13 billion net after income tax paid by pensioners). National Insurance relief on employer contributions is worth a further £5 billion. However, the existing eight taxation regimes have complex rules that limit annual contributions to, and final benefits from, a pension scheme. This imposes unnecessary inflexibility and complication, drives up costs and discourages people from saving in a pension.

5.43 *Simplifying the taxation of pensions: the Government's proposals,*[9] published alongside the 2003 Pre-Budget Report, set out proposals to simplify radically the taxation of pensions, replacing the eight current regimes with a single lifetime allowance on the amount of pension savings that can benefit from tax relief. In the 2003 Pre-Budget Report, in response to concerns expressed during consultation, the Government asked the National Audit Office to consider:

- whether it is factually accurate that the £1.4 million lifetime allowance is, using a factor of 20:1 to calculate the capital value of a defined benefit pension, equivalent to the maximum pension available under the current occupational pensions regime which includes the earnings cap;
- whether it is reasonable for the Government to estimate that around 5,000 people will have pension funds in excess of £1.4 million at 5 April 2005; and
- whether it is reasonable for the Government to estimate that around 1,000 people a year may be affected by the lifetime allowance who would not have been affected by the earnings cap.

5.44 The National Audit Office reported before the Budget.[10] Its conclusions were:

- £1.4 million is broadly equivalent to the maximum pension allowable under the current occupational pensions regime, which includes the earnings cap;
- the estimate of 5,000 people is at the lower end of a range of reasonable estimates. Sensitivity testing and other evidence is consistent with an estimate of around 10,000. Other estimates of the numbers affected – up to 600,000 have been quoted – include large numbers of people already capped by the existing earnings cap, and so are not directly comparable; and
- there is no evidence to discredit the estimate of around 1,000 people a year for the next ten years.

5.45 The Government welcomes the report. The few thousand people with pension funds in excess of £1.4 million contrasts with the many millions of people who will gain from greater simplicity and flexibility. The response from the second consultation has been overwhelmingly positive, with almost all respondents favouring the new regime. **The Government is therefore proceeding with the proposals set out in the December 2003 document**, replacing the eight current regimes with a single lifetime allowance on the amount of tax-privileged pension saving. In response to concerns expressed in the consultation, the Government will:

- **legislate in Finance Bill 2004 to implement the simplified regime in April 2006,** allowing employers and providers sufficient time to fully implement the benefits of simplification;

[9] *Simplifying the taxation of pensions: the Government's proposals*, HM Treasury and Inland Revenue, December 2003.
[10] *The Government's estimates of the impact of the pensions lifetime allowance*, National Audit Office, 9 March 2004.

- **set the lifetime allowance on introduction at £1.5 million** to reflect an April 2006 implementation date;
- to provide certainty, **pre-announce the lifetime allowance for all years up to 2010 such that it increases steadily to £1.8 million in 2010**;[11] and
- **review the lifetime allowance level and indexation every 5 years**, with the first review in 2010.

Other responses to the consultation document are still being considered and may lead to minor changes, which will be announced in due course.

5.46 The simplified system will help people make informed choices about working and saving for retirement, by:

- providing more flexibility for everyone on when and how to save;
- allowing for a flexible retirement, where people in occupational schemes will, where their schemes allow it, be able to draw benefits from their pension while continuing to work for the same employer;
- removing complexity from pensions in payment with a single set of rules that sets the tax-free lump sum at up to 25 per cent of an individual's pension fund; and
- offering more flexible annuity rules that stimulate innovation by allowing for the provision of limited period annuities and value-protected annuities.

5.47 Under the current system, lump sum payments are currently made by many occupational pension schemes to the spouses of pension scheme members who die within five years of retirement. Under the simplified pensions regime, subject to the lifetime allowance, these lump sum payments will continue to be able to be made tax free, with the potential for many scheme providers to offer larger tax-free lump sum payments. Under the simplified regime, where a member dies before age 75, it will be possible for the scheme provider to arrange for a capital sum equal to any unused lifetime allowance to be paid tax-free along with unlimited dependants' pensions, instead of the current specific provision to allow schemes to pay a tax-free lump sum equal to the balance of five years' payments un-drawn at the time of the member's death.

Informed choices for working and saving

5.48 Empowering individuals to make informed choices about working and saving for retirement is fundamental to ensuring that future pensioners receive the income in retirement that they expect. *Informed choices for working and saving* sets out the Government's strategy, which is based on activation, education and information, and includes:

- issuing 1.6 million state pension forecasts to the self-employed by the end of 2003-04, and sending out 8 million automatic state pension forecasts in 2005-06;
- ensuring 6.3 million people receive combined pension forecasts. The 2004 Pensions Bill provides the Government with reserve powers to compel employers to provide these forecasts, should evidence show that they could make a significant difference to savings levels;

[11]The lifetime allowance will be: £1.50 million in 2006; £1.60 million in 2007; £1.65 million in 2008; £1.75 million in 2009; and £1.80 million in 2010. Similarly, the annual allowance will be: £215,000 in 2006; £225,000 in 2007; £235,000 in 2008; £245,000 in 2009; £255,000 in 2010.

- developing an on-line retirement planner so that people can see the impact of varying their savings levels or working longer than they currently plan to;
- acting to ensure that people have the tools to understand this information. The introduction of the Sandler suite of products and reforms to improve employment opportunities for older workers will mean that people have genuine choices available when it comes to working and saving; and
- making information and guidance available to employers to draw attention to the benefits to themselves and to the wider economy of employing older workers. Chapter 4 sets out other measures the Government is taking to extend employment opportunity to older workers.

5.49 To support employers who help their employees through these decisions, **the Government will exempt pensions information and advice from being a taxable benefit, subject to it being generally available to all employees and below a limit of £150 for each employee per year**.

Deferring the state pension

5.50 The employment rate of people aged between 50 years and state pension age has risen from 65 per cent in 1997 to 70 per cent now. Of those at or over state pension age, 9.2 per cent are in employment now compared with 7.7 per cent in 1997. The Government is providing people who wish to work longer more choice and flexibility to do so, by introducing, through the Pensions Bill, the option of taking a deferred state pension as a taxable lump sum instead of higher weekly pension payments.

5.51 Those choosing to defer their state pension for at least one year from April 2005 will be able to take a lump sum. **Interest will be payable on the deferred pension for those choosing the lump sum at Bank of England base rate plus 2 per cent.** The Government believes that this is a fair rate which rewards those who choose to defer their state pension. The lump sum will be taxed at the recipient's marginal rate on his or her other income to ensure that pensioners do not move into a higher tax bracket as a result of taking a lump sum. It will not affect pensioners' age-related income allowances, and **people who defer their state retirement pension and who may be eligible for Working and Child Tax Credits, Housing Benefit or Council Tax Benefit will have their notional state retirement pension disregarded for the purpose of assessing their entitlement while deferring**.

5.52 Alternatively, for people who defer and choose state pension increments from April 2005, their pensions will rise by 10.4 per cent a year instead of the current rate of just under 7.5 per cent a year. A person deferring a state pension of around £100 a week for five years could see their pension rise to around £152 a week – an increase of around £14.75 a week compared with the current system.

Pension statistics

5.53 Pension statistics are an important issue: the Pension Statistics Review Committee, comprising academics, industry experts and officials from various Government departments, is overseeing progress on implementing the pensions review action plan[12] which aims to improve the quality and range of data available on pensions. The most recent progress report[13] highlights changes which will lead to improved data flows during the next 12 to 15 months. The Committee is also developing priorities for further work on pensions statistics over the longer term.

5.54 In addition, the new Pensions Regulator, being introduced as part of the Pensions Bill, will collect data to support its own risk-based work and the work of the Pension Protection Fund. This will include information about the levels of funding of defined-benefit occupational pension schemes. The Pensions Regulator is likely to collect data from April 2005.

PROMOTING SAVING AND ASSET OWNERSHIP

5.55 The Government's strategy for promoting saving and asset accumulation is founded on its principles of opportunity, responsibility and security, which underpin the welfare state:

- opportunity – assets enable individuals to take advantage of opportunities throughout life and widen choice;
- responsibility – developing the saving habit to promote independence; and
- security – helping individuals accumulate a stock of financial assets for times of adversity.

The Child Trust Fund

5.56 The Government is committed to strengthening the saving habit of future generations and ensuring that all children have a stake in the wealth of the nation. The Child Trust Fund (CTF) will provide an endowment for every child at birth and at age seven, with those from the poorest families receiving the largest amounts, and will be underpinned by increased financial information and education for parents and children. The Government published its detailed proposals[14] for the CTF in October 2003 and draft regulations[15] in February 2004. The draft regulations announced that:

- charges for stakeholder CTF accounts will be capped at 1.5 per cent per year and that providers must accept contributions of £10 and above;
- no charges will apply to transfers between different types of accounts, including from stakeholder to non-stakeholder, and between providers; and
- the stakeholder CTF account must be diversified and lifestyled.

5.57 The Government's decision to set the charge cap at 1.5 per cent for the stakeholder CTF was based upon all available evidence, and it recognised that the CTF had certain key characteristics which were not typical of other products in the stakeholder suite, including stakeholder pensions. The 1.5 per cent cap is in the best interests of consumers, as it encourages as wide a selection of providers as possible to offer CTF accounts. A large number of providers will encourage competition and ensure the best value for consumers. The Government will continue to monitor the level of the charge cap to ensure it best meets the interests of consumers.

[12] *Review of Pension Contributions Statistics,* Office of National Statistics, September 2002.
[13] *Pension Statistics Review Progress Report*, Office of National Statistics, December 2003. Available at: www.statistics.gov.uk.
[14] *Detailed proposals for the Child Trust Fund*, HM Treasury and Inland Revenue, October 2003.
[15] *The draft Child Trust Fund regulations 2004*, February 2004. Available at www.ir.gov.uk

The Saving Gateway

5.58 The Saving Gateway is designed to be an ideal starting point for many low-income individuals who would otherwise have difficulty starting on the savings ladder. The aim of the Saving Gateway is to encourage saving by means of a Government-funded match of all money saved, up to a limit. The most recent evaluation of the Saving Gateway pilots is available on the HM Treasury website.[16] The indications are positive and the Government looks forward to further evaluation.

Individual Savings Accounts

5.59 Individual Savings Accounts (ISAs) are the Government's primary vehicle for tax-free saving outside pensions. Over 15 million people now have an ISA and over £130 billion has been subscribed to ISAs since their launch in 1999.

The Sandler review of retail savings

5.60 In July 2002, the Sandler review[17] made a series of recommendations, including the design of a simple product suite that could be marketed outside the Financial Services Authority's (FSA) Conduct of Business regulations. In response, the Government has been developing a suite of simple, low-cost, risk-controlled products. The stakeholder suite will be on the market from April 2005. HM Treasury has been working closely with the FSA in developing these products, and the Government is keen to take forward work on the sales regime and the product design together. The FSA aims to have completed its research by the end of May 2004. Once the FSA has reached a satisfactory conclusion, the Government will announce the charge cap for stakeholder products and consult on the regulations. It will also publish independent research undertaken by Deloitte on the effects on the stakeholder market of different charge structures.

5.61 In addition, the Government continues to examine the scope for simplifying and modernising the taxation of pooled investment schemes. This is a complex area and discussions with the industry representative bodies are taking place before any next steps are announced. The consultation on property investment funds, described in Chapter 3, will also provide an opportunity to discuss wider issues.

Treatment of capital limits

5.62 The Government will keep under review the treatment of capital in income-related working-age benefits. As a first step, **from April 2006, the threshold above which savings reduce eligibility for Income Support, Jobseeker's Allowance, Housing Benefit and Council Tax Benefit will be raised from £3,000 to £6,000**.

Promoting financial inclusion

5.63 Through the Child Trust Fund and the Saving Gateway pilots, the Government is exploring policies to encourage saving and asset-building. However, for many low income households the urgent need is access to affordable banking services and credit. In 1999, the Government published the Social Exclusion Unit's Policy Action Team report *Access to Financial Services*.[18] Most of the key recommendations are now in place but significant progress remains to be achieved in three key areas:

- access to banking services – around 3 million households in Great Britain[19] do not have a current account and therefore face higher costs in paying bills. Around 1.5 million households have no mainstream financial products at all. Despite the introduction of the Basic Bank Account in 1999 the number of households operating outside the financial mainstream – facing higher costs to cash cheques as well as pay bills - has not fallen significantly;
- access to affordable credit – problem debt hits low income families hardest – households with an income of less than £7,500 make up 57 per cent of all over-

[16] *Evaluation of the CFLI and Saving Gateway Pilots*, December 2003. Available at www.hm-treasury.gov.uk

[17] *Medium and Long-Term Retail Savings in the UK: A Review*, Ron Sandler, HM Treasury, July 2002.

[18] *Access to Financial Services*, Report of PAT14, HM Treasury, November 1999.

[19] *Family Resources Survey 2001-02*, Department for Work and Pensions, May 2003.

indebted households (where debt repayments are over 25 per cent of household income).[20] This group is most likely to use the 'alternative credit market', including sale and buyback shops, pay day loans and doorstep lenders. While some consumers value the convenience of these services, vulnerable consumers without alternatives must pay interest rates many times those of a standard overdraft; and

- access to free debt advice – the FSA has found that 6.1 million families reported some difficulties meeting their debt repayments[21] and Citizens Advice Bureaux have reported a substantial increase in new debt enquiries and are now dealing with well over a million new debt enquiries per year, two-thirds of which are related to consumer credit debts.

5.64 The Consumer Credit White Paper[22] contains proposals to improve transparency and fairness of credit markets and a strategy to tackle over-indebtedness. The problem of financial exclusion exacerbates the debt problems of the most vulnerable. Government will work in partnership both with the financial services sector and with voluntary and community bodies to achieve:

- dramatic reductions in the 3 million households without a current account and the 1.5 million households without an account of any kind;
- a significant increase in the availability of affordable credit for those on the lowest incomes; and
- a step change in the availability of free debt advice for those who need it.

5.65 The Government will work with the financial services industry to bring forward specific proposals in the summer.

The Social Fund

5.66 The Social Fund provides a safety net of grants and interest free loans for the most vulnerable in times of crisis. Budget 2003 announced an additional £90 million for the Discretionary Social Fund over the three years to 2005-06. The Government has also implemented some administrative changes to improve monitoring and ensure existing resources are being directed to those most in need.

SUPPORTING COMMUNITIES, CHARITIES AND GIVING

5.67 The Government believes that a thriving and active sense of citizenship – strengthened by an independent voluntary and community sector and a culture of volunteering and giving – is vital for fair and enterprising communities. The Government's support for the sector has been demonstrated by the wide range of tax and spending measures introduced since 1997, described in detail in Table 5.2 in the 2003 Pre-Budget Report.

Giving

5.68 The Giving Campaign, set up in 2001 as a three-year promotion to encourage payroll giving has been very successful. The Campaign will come to an end in 2004, but it has been a key catalyst in increasing the value of amounts donated from £37 million in 1999-2000 to £86 million in 2002-03. This success was supported by the removal of the cap on donations and the 10 per cent Payroll Giving Supplement, which was introduced in April 2000 initially for three years and extended in 2003 for a further and final year. A continuing legacy of the Giving Campaign is the successful Giving Nation, developed to fit National Curriculum activity in citizenship, and encourage more young people to give their time and money to help others.

[20] Over-indebtedness in Britain: a report to the Department of Trade and Industry, Elaine Kempson, 2002.

[21] Financial Risk Outlook, FSA, 2004.

[22] *Fair, clear and competitive: the consumer credit market in the 21st century*, Department of Trade and Indsutry, December 2003.

5.69 The Government remains committed to encouraging payroll giving and, in particular, wants to see more employers setting up schemes. To this end, **the Government is launching a Payroll Giving Grant for SMEs who agree to offer their staff the opportunity to give through the payroll**. Proposals for the scheme will be announced shortly. The Government will also work with the business community to provide a guide to tax incentives for corporate giving to charity, and explore the potential for an intensive data collection exercise on corporate giving.

Volunteering and mentoring

5.70 Giving time is as important as giving money. There is wide agreement that volunteering has benefits for the services volunteers work within, the volunteers themselves and our communities in building social cohesion. The Government is keen to promote measures that will help and encourage more people to volunteer, especially the young. The Government is therefore **establishing a Commission headed by Ian Russell of ScottishPower to report to the Government by the end of the year on the way forward for a National Youth Volunteering Strategy, building on existing expertise and experience**. In recognition of the Pre-Budget Report commitment, the Commission will be asked to consider how sport volunteering and mentoring opportunities can be more inclusive as part of a national call to service. The Commission will involve a wide range of stakeholders including VCS organisations who lead on working with young people, business and young people themselves in the consultation process. The Government realises the role mentoring can have in society and, building on existing initiatives is committed to developing a national and local infrastructure that offers mentoring opportunities in every area of the country.

CEF and Sport Relief

5.71 The Chancellor launched the Commonwealth Education Fund (CEF) in 2002 to mark the Queen's Golden Jubilee year. The CEF works in developing Commonwealth countries to support progress towards the education Millennium Development Goals, helping civil society to work strategically with governments to take forward national education plans. The Government provided an initial £10 million to the CEF and **will continue to match, for a further year until April 2005, any CEF donations raised, pound for pound up to £10 million. It will also provide money to Comic Relief's Sport Relief in July 2004 by matching pound for pound, up to £5 million, donations raised for that appeal to go towards education in developing Commonwealth countries**. Matched tax relief is included in both cases.

Unclaimed assets

5.72 The Government supports the efforts of the British Bankers' Association, the Building Societies' Association and National Savings & Investments in trying to reunite unclaimed assets and their owners. It is right in principle that more should be done. Where assets and owners cannot be reunited, it is also right that the assets be reinvested in society, as long as the original owners' entitlements to reclaim are preserved. Charitable and voluntary organisations would provide an effective route for this.

5.73 The Government welcomes the creation of the Balance Charitable Foundation for unclaimed assets, and the commitment made by two major investment banks to pass over some of their unclaimed assets to the Foundation. The proceeds of such transfers should be distributed fairly across the charitable and voluntary sector. Distributing organisations for these monies should be run in an open and consultative manner, in accordance with best governance practice and with the involvement of the financial services industry and the voluntary and community sectors.

5.74 The Government looks to the industry to build on current momentum, and expand the scope of voluntary action beyond investment banking into retail banking and the wider financial sector. The Government will assess and report on progress at the time of the 2004 Pre-Budget Report.

Museums and VAT

5.75 Every member of society has a right to access the UK's cultural heritage, made possible by public support for museums and galleries. The Government's committment to achieve free access to the main national museums and galleries has proved an outstanding success, with visitor numbers up 70 per cent since the policy was introduced. Building on that success, and on the recommendation of the Goodison review,[23] **the Government will consider the issue of extending the free access committment for the main national museums and galleries, and the VAT refund scheme that has helped to deliver it, to university museums in the context of the forthcoming Spending Review.**

Listed places of worship

5.76 The Government has been negotiating with its European partners on a review of the EU rules governing VAT reduced rates. It remains one of the Government's clear objectives to achieve a permanent reduced rate of VAT for repairs to listed places of worship, which would offer the permanence, simplicity and certainty that a grant scheme cannot. However, against a background of success, with around 4,500 listed places of worship having benefited from congregations spending over £140 million since 2001, the Government is keen to promote even greater take-up of the scheme to help tackle any backlog of repairs and promote the upkeep of Britain's historic places of worship. Therefore, for spending from 1 April 2004 until March 2006, unless a permanent VAT reduced rate is achieved earlier, **grants will be paid to cover all the VAT on the repair and maintenance of listed places of worship**.

Gift aid day memberships

5.77 The Government announced in the Pre-Budget Report that it would consult charities on an amendment to the special exemption in the Gift Aid rules which allows certain heritage and conservation charities to offer free admission in return for a donation which attracts Gift Aid. Gift Aid is designed to promote giving to charity by individuals but, by simply reclassifying admission fees as donations on which Gift Aid is then claimed, these schemes do not generate additional giving. The Government has received a number of representations from the charitable sector in response and recognises the concerns expressed. It will continue this consultation to determine a way forward that preserves the principles and intentions of Gift Aid while dealing sympathetically with the charities affected by the proposed change. It will work closely with the heritage and conservation sector to complete the consultation on developing a new definition of the special exemption. It aims to announce the results of the consultation around the time of the Spending Review giving charities the opportunity to take account of the changes in their financial planning, alongside the wider Government support for this sector which is now worth over £2 billion a year.

Football Supporters' Trusts

5.78 Under the review into the Inland Revenue treatment of Supporters' Trusts announced in the 2003 Pre-Budget Report, the Government is currently examining how best to assist Football Supporters' Trusts in their valuable work in local communities, by maximising the benefit they receive from the contributions of their members.

[23] *Goodison Review: Securing the best for our Museums : Private Giving and Government Support*, HM Treasury , January 2004.

DELIVERING A MODERN AND FAIR TAX SYSTEM

5.79 A modern and fair tax system encourages work and saving, keeps pace with developments in business practice and the global economy and raises sufficient revenue to fund the Government's objective to build world-class public services.

Revenue Departments Review

5.80 The Government today publishes the report of the Review of Revenue Departments,[24] led by Gus O'Donnell, the Permanent Secretary to the Treasury, and accepts its recommendations. The most important recommendation is that **a new single department should be established, integrating HM Customs and Excise and the Inland Revenue**. The creation of a single, customer-focused, department, which makes better use of the information that taxpayers provide, will improve tax collection from the non-compliant and reduce costs for the compliant, helping to improve the fairness of the tax system.

Protecting tax revenues

5.81 A tax system in which everyone pays or claims what is due forms the basis for the Government's objectives of stable public finances and world-class public services. Tax avoidance and evasion undermine these objectives, and also damage the integrity of the tax system, by undermining incentives and by shifting a greater burden of tax onto honest and compliant taxpayers. The Government is therefore determined to close down opportunities for avoidance and evasion.

New compliance package

5.82 To this end, the Inland Revenue will receive additional resources to support a new compliance and enforcement package for direct taxes and National Insurance contributions. The funding will provide for:

- additional resources, including specialist staff, to address tax at risk among large companies and those taxpayers who have complex tax affairs;
- better use of taxpayer information and additional staff to improve the focus of compliance activity; and
- greater use of publicity to support and encourage those currently outside the tax system to meet their tax obligations.

5.83 The package is expected to produce an additional £2 billion in revenue over the next three years. However, in line with the Government's cautious approach to the public finances, a lower figure of £1.7 billion has been audited by the NAO and is included in the public finances forecast.

Tackling tax avoidance

5.84 Schemes designed to avoid tax represent a significant threat to the integrity of the tax system. These sophisticated and aggressive avoidance schemes thrive on concealment and secrecy. Therefore, Budget 2004 introduces new measures to improve transparency in the tax system. The rules, aimed at those marketing and using certain tax avoidance schemes and arrangements, will allow early detection of such schemes and enable more effective targetting of avoiders. As a result of these measures:

- **promoters who market schemes and arrangements that meet certain criteria for direct taxes will be required to disclose details of these schemes to the Inland Revenue**; and
- **businesses with an annual turnover of £600,000 or more using VAT avoidance schemes that appear on a statutory list, and businesses with an annual turnover of £10 million or more using VAT arrangements that meet certain criteria, will be required to notify HM Customs and Excise**.

[24] *Financing Britain's future,* Review of the Revenue Departments, HM Treasury, March 2004.

5.85 In addition, the Government is taking action to close a number of loopholes currently being exploited to avoid tax, including:

- **preventing company profits being wrapped up in a partnership structure and extracted as untaxed or low-taxed capital receipts**;
- **stopping two avoidance schemes where users obtain a double relief for the cost of capital assets used in their business**;
- **countering avoidance by life companies using financial reinsurance**; and
- **further measures to prevent exploitation of loopholes in the VAT system.**

5.86 These and other measures are set out in more detail in Chapter A.

Modernising the tax system for trusts

5.87 Trusts have a positive role to play in helping people to manage their affairs, but the Government is determined that they should not be used to achieve unfair tax avoidance. The 2003 Pre-Budget Report therefore announced a series of measures designed to tackle complex tax avoidance schemes using trusts, and made clear the Government's intention to protect the most vulnerable.

5.88 The Government has been clear since the outset of consultation that the income tax charge on pre-owned assets, which takes effect from April 2005, would not affect legitimate transactions between family members. The Government therefore confirms that the charge:

- will not affect parents or grandparents who have helped their children or grandchildren onto the property ladder;
- will not affect transactions between married couples;
- will not apply where the benefit is incidental;
- will not apply if the assets still count as part of the taxpayer's estate for inheritance tax purposes;
- will not apply if a person who has used a contrived avoidance scheme to remove their property from the inheritance tax system opts to bring the property back into their estate for inheritance tax purposes; and
- is not retrospective as it will not take effect until April 2005.

5.89 The Government has also consulted on ways to make the system of trust taxation less burdensome for those not using trusts for tax avoidance purposes. The Government has today announced that it will:

- **bring in new rules so that trusts set up for the most vulnerable are taxed as if the vulnerable person was receiving the income and gains directly**, therefore ensuring that they enjoy the full benefit of their personal allowances and lower rate bands; and that
- **introduce a basic rate band for trusts**, which means that around 30,000 trusts that receive small amounts of taxed income will have no further liability and will no longer have to submit a self assessment return every year.

5.90 The Government will continue to discuss modernisation with the trust sector and will publish draft legislation alongside the 2004 Pre-Budget Report.

Small business tax incentives

5.91 The Government has introduced a range of tax measures to support small businesses, including reductions in both income tax and corporation tax, payable tax credits for research and development, and cuts in capital gains tax which mean the UK now has the most favourable regime for business capital gains amongst all major developed economies. Chapter 3 sets out further measures to support small firms, and to encourage them to innovate, invest and grow. This includes, in response to requests from a number of industry representative bodies, an **extension of first year capital allowances for small firms investing in plant and machinery to 50 per cent from 1 April 2004 for one year**, after which the measure will be reviewed.

5.92 As part of this strategy, the Government believes that transition to the corporate legal form can be an important step in the development of a business, and can assist small businesses in realising their growth potential by providing flexibility in access to external finance, improving governance and managing risk. The Government is committed to ensuring that the UK remains one of the easiest places to start and grow a business. As set out in the 2003 Pre-Budget Report, the Government is determined to ensure that the measures it has introduced provide support for firms taking on the opportunities and responsibilities involved in that transition, by encouraging them to reinvest their profits and grow their business.

5.93 The Government is therefore concerned about the increasing numbers of self-employed individuals adopting the corporate legal form where the change is made for tax reasons rather than as a step to growth, often as a result of marketed tax-avoidance schemes. Following the announcement in the 2003 Pre-Budget Report, the Government has reviewed options for more closely aligning the tax paid by these individuals with their economic characteristics. Having considered a range of options, the Government is determined to proceed in a way that protects the benefits of low tax rates for those investing in their businesses. **With effect from 1 April 2004, the Government will therefore introduce a 19 per cent minimum rate of corporation tax on distributed profits.** This measure will ensure that corporate tax rates lower than 19 per cent, including the zero rate of corporation tax introduced in April 2002, remain available to small companies as they re-invest in their business. Businesses re-investing their profits, or companies with taxable profits above £50,000, will be unaffected by this measure.

5.94 The Government will also take steps to reinforce compliance with the tax system by the smallest companies, while preventing compliant businesses from facing additional burdens. The Government will introduce two specific measures to address the compliance risks associated with those incorporating for tax reasons:

- **the Government will bring forward legislation in Finance Bill 2004 to ensure disclosure of basic tax information on incorporation,** by making the existing registration form for corporation tax compulsory; and
- **the Government will consider measures to strengthen anti-avoidance legislation on loans made to shareholder directors of close companies,** reinforcing existing legal obligations under Company Law.

5.95 The Government is determined to continue with a forward programme of targeted tax incentives, in support of its objectives for growth, enterprise and productivity. In some areas, the pursuit of these objectives through the tax system may be constrained by the ability to match definitions for tax purposes with underlying economic characteristics. The reform of the Construction Industry Scheme is an example where Government and the industry are discussing how to address these definitional issues as they relate to construction; in this case the dividing line between employment and self-employment earnings. Across many other sectors, the growth in small owner-managed businesses, as well as the changing nature of employment and contractual relationships, is creating challenges for the definitions and boundaries in the tax and national insurance systems between income from self-employment and the remuneration of owner-managers. The Government therefore proposes to consider the strategic issues raised by these developments, to ensure that the tax system reflects the realities of today's changing labour market and business environment. A discussion paper will be issued at the time of the 2004 Pre-Budget Report.

Alcohol fraud

5.96 The 2003 Pre-Budget Report set out proposals for an enhanced strategy to tackle alcohol fraud, against a backdrop of:

- success in taking tough action to tackle fraud across the other indirect tax regimes, with the previous trend of growing fraud now decisively reversed in the tobacco and oils regimes and indications of a sharp fall in levels of VAT missing trader fraud;
- success in reducing cross-channel passenger smuggling of alcohol, which fell by 90 per cent between 2000 and 2002; and
- estimates showing a significant and rising level of revenue losses through spirits fraud, costing £600 million in lost duty and VAT in 2001-02, despite the action taken by HM Customs and Excise and the alcohol industry.

5.97 As part of that strategy, the Government proposed to implement the Roques report recommendation to introduce tax stamps for spirits, in order to enable consumers, traders and Customs to distinguish fraudulent from duty-paid product and to reduce both the opportunities for and profitability of spirits diversion fraud. Recognising the potential impact on the legitimate trade, the Government also said that it would consider any alternative proposals the spirits industry put forward that would be as effective in tackling fraud as tax stamps, and that, if it had to proceed with tax stamps, it would consider measures to help offset and mitigate the compliance costs to the legitimate trade. The 2003 Pre-Budget Report also confirmed the introduction of new regulatory controls to support the fight against alcohol fraud, following consultation last summer.

5.98 Since the 2003 Pre-Budget Report, the Government and the industry have worked together closely and intensively to take forward the development of the alcohol strategy. The National Audit Office has examined the range of fraud estimates made by both Customs and the industry. The Government welcomes the constructive approach that has been taken by the trade, and the recognition by all parties that action must be taken to tackle fraud. The Government is grateful for the information the trade has provided to enable a better understanding of the likely costs, benefits and detailed design issues involved with tax stamps. It also welcomes the trade's alternative proposal, in the form of a package of proposed new controls on the alcohol supply chain. **Having considered the options carefully, the Government has concluded that this package would be significantly less effective in tackling fraud than tax stamps**. **The Finance Bill will therefore legislate to enable the introduction of tax stamps from 2006-07**. However, in order to minimise and offset the compliance costs to the legitimate trade, the Government will:

- **freeze the duty on spirits for the remainder of this Parliament** – the longest duty freeze since the 1950s, so that by 2005-06 the total tax on standard bottle of spirits will be £1.33 lower in real terms than if duty had risen in line with inflation since 1997 and 36p lower than now, helping to absorb the costs associated with tax stamps;

- **establish a £3 million fund to provide targeted grants to UK-based alcohol traders making capital investment in approved tax stamping equipment**, subject to further detailed consultation with the trade;

- **meet the ongoing printing and distribution costs of tax stamps in full** and further examine the scope for reducing security costs, as part of detailed implementation discussions; and

- subject to further detailed consideration and discussion with the trade, seek to **operate a system requiring no advance payment for tax stamps** in order to minimise adverse cash flow impact. If such an approach proves unworkable, HM Customs and Excise will further examine the scope for extended deferment arrangements to accompany a pre-payment system.

5.99 The Government will publish a full regulatory impact assessment, including its assessment of the trade's alternative proposals, alongside Finance Bill 2004.

Rebated oils

5.100 The UK Oils Fraud Strategy was announced in Budget 2002 and is targeted specifically at the misuse of rebated oils. It is a combination of new regulatory regimes and enhanced law enforcement activity which aims to deter oils fraud by making it harder to commit the crime successfully and increasing the likelihood of getting caught and being subject to tough penalties.

5.101 **Budget 2004 announces an increase of rebated oils duty by 2.42 pence per litre narrowing the differential with main fuel duties by one penny,** which will, when combined with the ongoing impact of other strategy measures, further reduce the potential for oils fraud and reinforce the approach to tackling it, assisting Customs in achieving the aim of an illicit oils market of no more than 2 per cent by 2006.

Modernising and simplifying the tax system

Self assessment

5.102 To simplify self assessment, over 400,000 people around the country will receive a simplified four page short self assessment tax return this April. This is a first step towards national rollout in April 2005, when around one and a half million taxpayers will benefit from the short tax return. The new form will be issued to people with simple tax affairs including employees, pensioners and small businesses. In addition, many more people are taking advantage of the Inland Revenue's electronic filing service. Of the 90.6 per cent of self assessment returns filed on time, over one million have been received electronically. At around 15 per cent of the total this represents a significant increase from the previous year.

Residence and domicile

5.103 The Government is continuing to review the residence and domicile rules as they affect the taxation of individuals, and is considering various aspects of this issue in the light of the responses to the paper[25] published at Budget 2003. The Government remains determined to proceed on the basis of evidence and in keeping with its key principles. It would welcome further contributions to the debate, which will then be taken forward by the publication of a consultation paper setting out possible approaches to reform.

[25] *Reviewing the Residence and domicile rules as they affect the taxation of individuals: a background paper*, HM Treasury, April 2003.

Stamp duty land tax

5.104 A modernised regime for stamp duty on property transactions was successfully introduced on 1 December 2003. However, certain transactions involving partnerships remained outside the new regime, creating ambiguity and opportunities for avoidance. Legislation will now be introduced from Royal Assent of Finance Bill 2004 to level the playing field between these partnerships transactions and transactions undertaken by individuals. No changes in stamp duty rates or thresholds are proposed in this Budget.

Inheritance tax

5.105 In keeping with its desire to make the tax system fairer and easier to operate, the Government will greatly simplify the inheritance tax system for around 30,000 estates each year. From later this year, they will be able to use the simplified reporting procedures that already exist for smaller estates. To deter abuse of the simpler process, changes are being made to the penalty regime for inheritance tax to bring it more into line with that for income tax and capital gains tax.

Accrued Income Scheme

5.106 *Options for reform of the Accrued Income Scheme*[26] published today, seeks views on how the Accrued Income Scheme (AIS) could be simplified while maintaining protection of revenues. The AIS prevents avoidance of income tax where interest bearing securities are bought or sold by individuals and trusts.

Offshore funds

5.107 Following consultation in 2002, the Government announced in the 2003 Pre-Budget Report that legislation would be brought forward in the 2004 Finance Bill to revise the rules for determining whether or not an offshore fund qualifies for 'distributor status'. Measures will therefore be introduced to:

- remove outdated rules from the UK Equivalent Profits test, so that an offshore fund can compare its distributions against a measure of its income that is more in line with the income of an equivalent UK fund;
- abolish restrictions on offshore funds' investments which have become out of line with the regulatory environment; and
- allow sub-funds of umbrella funds, and separate share classes of funds or sub-funds to qualify without affecting the other parts of the fund or umbrella.

Tobacco duties

5.108 Smoking remains the greatest cause of preventable illness and premature death in the UK. Maintaining high levels of tax helps to reduce overall tobacco consumption. Budget 2004 therefore announces that from 6pm on Budget day tobacco duties will be increased in line with inflation.

Alcohol duties

5.109 The Government is committed to delivering a fairer balance in the burden of taxation falling on different alcoholic drinks and different types of drink producer. To increase fairness in the alcohol duty regime, and in addition to the spirits duty freeze for the remainder of this Parliament to help offset the compliance costs of tax stamps, Budget 2004 announces from midnight on Sunday 21 March the following alcohol duty changes:

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

[26] *Options for the reform of Accrued Income Scheme*, HM Treasury and Inland Revenue, March 2004.

Small Breweries' Relief

5.110 In July 2003 the Government asked for evidence to help it assess the effectiveness of the Small Breweries' Relief scheme.[27] Responses indicate that the scheme has exceeded its objectives of helping the smallest breweries to invest in product development, compete better in the market and so maintain the diversity of products available to the consumer, with small brewers reporting significant growth in beer production. However, in response to concerns expressed about the effect of losing the relief on small breweries that outgrow the scheme, the Government today announces that, **from 1 June 2004 the relief will be extended, on a tapered basis, to breweries producing up to 60,000 hectolitres**, doubling the volume of beer production that is eligible for some relief.

Gambling

5.111 Following consultation, the Government has decided to defer any reform of Amusement Machine Licence Duty (AMLD), and any further major reform of other gambling taxes, to align with the Gambling Bill. Examination of the future of gambling taxation will include:

- consideration of whether a gross profits tax structure for the lottery would be more efficient and provide a better basis for generating money for the good causes while protecting tax revenues. Furthermore, the Government intends that the same principles that apply to the existing National Lottery would apply to any Olympic themed lottery games;
- development of the Government's work with the machines sector, following this year's consultation on AMLD, and in the context of Gambling Bill proposals;
- re-examination of the tax treatment of Fixed Odds Betting Terminals (FOBTs), in light of the potential competition and machine definition issues they raise in a developing UK gambling industry;
- continuing work with the industry to settle a fair and equitable tax treatment for betting exchanges and their clients; and
- consideration of the appropriate tax treatment of hedged bets.

TACKLING GLOBAL POVERTY

5.112 The Government is committed to reducing global poverty and the achievement of the Millennium Development Goals (MDGs), signed up to in 2000 by almost 190 countries. However, the international community is already not on track to meet these targets, most significantly in the commitment to reduce child mortality by two-thirds. More than 70 countries are unlikely to meet the target to achieve universal primary education by 2015 and while there has been a 10 per cent reduction of people living in extreme poverty in the last 10 years, such progress is very uneven with many countries failing to achieve the MDG of halving poverty by 2015. In the case of sub-Saharan Africa, poverty levels have actually risen.

5.113 One of the major reasons for this potential failure is lack of sustained resources needed to underpin all these targets for simultaneous investment in health, education, sanitation and economic development. It is estimated that the resources needed are at least $50 billion per annum greater than current flows of aid, even after essential further action to improve the effectiveness of current aid to achieve both value for money and improved outcomes. These additional resources are also an essential counterpart to providing opportunities for trade (see below) by ensuring that low-income countries have the capacity, with adequate human capital and physical infrastructure, to expand their trade and benefit from access to international market opportunities.

[27] *Small Breweries' Relief: A Call for Evidence*, HM Customs and Excise, July 2003.

UK aid commitment

5.114 The UK Government remains committed to the UN target for aid of 0.7 per cent of gross national income. As announced in the 2002 Spending Review, total UK aid in 2003-04 stands at 0.33 per cent of gross national income and will rise to 0.4 per cent by 2005-06, representing a near doubling of aid since 1997 and on course to exceed the EU target of 0.39 per cent by 2006.

5.115 However the scale of the challenge set out above shows that the gap in resources cannot be bridged in time to meet the MDGs by traditional funding and so the Chancellor has proposed that donor Governments while moving toward the agreed target of 0.7 per cent consider immediately setting up an International Finance Facility (see Box 5.2) which raised an additional $50 billion per annum to 2015 as a sustainable financing vehicle to underpin the MDGs, provide and sustain greater debt relief and ensure the capacity as well as the access to trade.

Box 5.2 International Finance Facility

The International Finance Facility (IFF) is designed to deliver the additional, predictable finance necessary to making progress on meeting the MDGs. Based on long-term commitments of $16 billion per annum pledged by donors in the Monterrey Consensus, the IFF would leverage in $50 billion per year from the international capital markets.

Recognising the pressing need to deliver additional resources, the international community has mandated the World Bank and International Monetary Fund to look at innovative financing mechanisms including the UK Government's proposal for an IFF. The institutions are due to present an interim report at the Spring Meetings in 2004 with a full report at the Annual Meetings in autumn 2004.

International support for the IFF continues to grow. To address issues such as the case for bringing forward investment and to heighten support for the IFF, more than 60 countries have been invited to a Financing for Development conference, co-hosted by the Chancellor and the French Finance Minister which will be held in Paris on 8 April 2004. HM Treasury recently hosted a conference, sponsored by Lord Carey of Clifton and Lord Griffiths of Fforestfach, on Making Globalisation Work for All which examined the challenges of delivering the Monterrey Consensus. At the conference, the coalition of non-governmental organisations, faith leaders and figures from the business world reached a consensus requiring urgent action in trade reform and increasing aid to achieve the MDGs.

The Global Alliance for Vaccines and Immunisation (GAVI) has approached the UK to explore whether the IFF's frontloading principles can be applied to GAVI so as to increase the resources available to meet the international community's child mortality targets. The World Health Organisation estimates that the lives of three million children a year can be saved if universal access can be provided to all vaccines which are currently or soon to be available. GAVI is collaborating with the French and UK Governments to take this initiative forward.

5.116 Sub-Saharan Africa in particular will not reach any of the MDGs by 2015 and on current trends is estimated not to achieve universal primary education until 2129, reduce child mortality by two-thirds before 2165 or halve the number of people living on less than $1 per day before 2147. The Prime Minister has therefore launched a Commission for Africa to report in April 2005 during the UK's Presidency of the G8. The Chancellor will chair the Economy and Financing section of the Commission and will consider, amongst other issues, actions that need to be taken to increase aid and reform trade to enable Africa to meet its challenges.

Debt relief **5.117** The Heavily Indebted Poor Countries (HIPC) Initiative is providing $70 billion in debt relief to 27 of the poorest countries in the world and has helped increase their poverty-reducing expenditure by over $2 billion a year since 1999. For example, debt relief has allowed Tanzania to abolish school fees in primary education and recruit 18,000 new primary school teachers. As a result of these measures enrolment rates have risen by 50 per cent and almost as many girls are now in school as boys reaching the 2005 target in the MDGs of gender equality in education.

5.118 However, as set out in the recent World Bank Report, half of HIPC countries risk not having a sustainable exit from their debt burden mainly as a result of dependency on exports of commodities whose prices have fallen. The UK believes, therefore, that the international community will have to provide more resources – either through topping up generally or by specific country initiatives – and will have to ensure that debt is kept sustainable in the future by providing more aid in the form of grants. This will need resources which are additional to existing aid flows and the UK has therefore proposed that disbursements from the IFF should be provided mainly in the form of grants or debt relief.

Trade **5.119** Trade is an essential engine of economic growth for both developed and developing countries. The World Bank has estimated that trade could lift an additional 140 million people out of poverty in developing countries. The Government remains fully committed to make the most of the Doha Development Agenda to improve developing countries' trading opportunities. Key to this agenda is securing ambitious reform of EU agriculture, discussed further in Box 5.3.

Box 5.3: Trade, agriculture and protectionism

Developing countries are heavily dependent on agriculture. Agriculture accounts for around 12 per cent of gross domestic product (GDP) in low- and middle-income countries, and in some African countries over 50 per cent of GDP, compared to less than 2 per cent in the EU. Despite this, while 900 million in farming families in developing countries struggle to survive on less than $1 a day, developed countries protect their agricultural sectors through high tariffs and subsidies worth nearly $900 million a day. This is greater than the combined income of sub-Saharan Africa and six times the amount that developing countries receive in aid. Agricultural protectionism also harms rich countries' own economies. The Common Agricultural Policy (CAP) is estimated to cost EU taxpayers and consumers around $100 billion a year through subsidies and high food prices. The poorest, who spend the greatest proportion of their income on food, are hit hardest by an implicit tax on food of around 26 per cent. Even after the benefits for farmers are taken into account, the cost to the UK economy has been estimated at some 0.5 per cent of GDP. Artificially high prices also tend to encourage over-intensive production and environmental damage.

Agriculture is not the only area of protectionism which harms poor countries – processed products also often face high tariff rates. This prevents developing countries from gaining maximum advantage from their resources. For example, in the EU and US cocoa beans enter tariff-free, but paste and chocolate face tariffs in excess of 15 per cent. A 2003 Oxfam investigation found that Vietnam – where 64 per cent of people live on less than $2 a day – pays more in US customs duties than the Netherlands, despite accounting for a far smaller share of imports.

The Government is a leading advocate of reform of agricultural and trade policies which work against the poor. Last year, the EU agreed to reforms of the CAP which decouple the link between subsidies and production for many important products, so reducing incentives to over-produce. However, further reform is necessary, both to extend decoupling to the remaining sectors and to improve market access for developing countries. The Government continues to press for reform, particularly of the sugar and cotton sectors.

Post-conflict support for Iraq

5.120 The UK, as co-sponsor with the US of United Nations Security Council Resolution 1483, is responsible for the administration of Iraq as an occupying power, acting through the Coalition Provisional Authority (CPA). Under the November 2003 agreement with the Iraqi Governing Council, and following the UN fact-finding report of February 2004, the CPA will transfer sovereignty to an Interim Iraqi Government in July 2004. The UK Government's economic objectives are to strengthen the capacity of Iraq's own institutions, putting in place robust frameworks for future economic reform under a sovereign Iraqi Government, and reintegrating Iraq with the international community. Working with the Iraqi Ministry of Finance and Central Bank of Iraq, the UK has contributed to the work of the CPA, which has:

- introduced new public sector salary and pension scales which pay a decent wage and pension;
- introduced a single and secure new currency to replace the two currencies previously in circulation;
- modernised budget preparation methods, resulting in a unified budget for the first time in Iraq; and
- liberalized trade and encouraged investment, with a post-war tariff holiday succeeded by the introduction of a simple reconstruction levy from March 2004.

5.121 The focus of the CPA's current economic work is to strengthen capacity at the Central Bank and Ministry of Finance to ensure that from July 2004 they can perform their core functions. At the same time, the Government continues to encourage the IMF and World Bank's efforts to provide technical assistance to Iraq, with a view to establishing a full programme and lending after July 2004.

5.122 At the International Donor's Conference in Madrid in October 2003, donors pledged a total of at least $32 billion to support Iraqi reconstruction, with the UK Government pledging a total of £544 million over the three years from 2003. In February, the Department for International Development published its Country Assistance Plan for Iraq and allocated an initial £65 million from the UK Madrid pledge to the International Reconstruction Fund Facility for Iraq, managed by the World Bank and the United Nations. The commitment announced at Madrid is in addition to the UK's significant contribution towards the costs of maintaining security. In addition, the UK's work on enforcing UN financial sanctions has led to the transfer of $326 million of frozen financial assets of the former Iraqi regime to the Development Fund for Iraq.

5.123 The Government is committed to a fair and sustainable solution to Iraq's debt problems and believes that creditors will need to write-off the vast majority of Iraq's debt. The UK actively supported the work of the US Presidential Envoy on Iraq Debt, Secretary James Baker, who has successfully brokered a G7 consensus that there should be substantial debt reduction for Iraq in the Paris Club in 2004. The Government will continue to work with international partners to broaden this emerging international consensus.

6 DELIVERING HIGH QUALITY PUBLIC SERVICES

The Government's goal is to deliver world class public services through sustained investment and outcome focused reforms to ensure that taxpayers receive value for money.

Budget 2004 sets out the main issues for the 2004 Spending Review, which will conclude this summer. The review will take further steps to strengthen the economy, build a fair society with opportunity and security for all, and deliver better public services. This chapter sets out the priorities for the next phase of the public services reform agenda, which will increasingly focus resources and decision-making on the front line.

The Government is committed to maximising efficiency within the public sector and reducing administration costs while continuing its ambitious programme of public service delivery. Greater efficiency will enable the Government to release significant extra resources for front line services such as schools and hospitals and deliver further improvements in the performance of key public services. Budget 2004 announces the Government's plans to cut administration costs in real terms and achieve efficiency gains across the public sector of 2.5 per cent a year over the three years of the 2004 Spending Review period.

The 2004 Spending Review will set spending plans for 2006-07 and 2007-08 and will confirm the plans set for 2005-06 in the last Spending Review. In doing so it will consolidate and build on the step change in funding for key public services achieved in previous spending reviews. The efficiency savings identified by the Government will ensure that the resources allocated in the 2004 Spending Review will make the greatest possible impact on front line public services.

Budget 2004 sets firm overall spending limits for the 2004 Spending Review period, allowing:

- **current spending to increase by an average of 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumption for trend economic growth and consistent with the nominal growth rates set out in Budget 2003 and the 2003 Pre-Budget Report. Final plans for DEL and AME spending will be set in the Spending Review; and**
- **public sector net investment to rise from 2 per cent of GDP to 2¼ per cent by 2007-08, to continue to address the historic under-investment in the UK's infrastructure while remaining consistent with the sustainable investment rule.**

The growth rate of both overall public spending and departmental spending will be lower in the 2004 Spending Review than in the 2002 Spending Review. However, building on the progress made in correcting historic under-investment and with administration costs cut in real terms and planned efficiency gains equivalent to £20 billion a year by 2007-08, the Government's objective is to match the pace of growth in front line public services achieved in the last Spending Review.

Budget 2004 sets out resources for skills, science and education. To ensure that recent progress in raising educational standards and attainment is locked in and that new challenges can be addressed over the coming years, Budget 2004 announces:

- **education spending in England will grow by an annual average of 4.4 per cent in real terms across the 2004 Spending Review period, and by 2007-08 education spending will be £7.4 billion higher in England than in 2005-06 and £8.5 billion higher for the UK on top of the uplift for 2005-06 already in spending plans. By 2007-08, education spending in the UK will be 5.6 per cent of GDP, up from 5.4 per cent in 2004-05;**
- **reforms including resources for Children's Centres in all of the 20 per cent most disadvantaged wards, and a transformation of all secondary schools to twenty-first century standards in the next 10 to 15 years; and**
- **by 2007, per pupil spending will rise to £5,500, more than twice that in 1997.**

INTRODUCTION

6.1 The Government's goal is to deliver world class public services through sustained investment and reforms which achieve the standards of services that the public expect and ensure that taxpayers receive value for money. World class public services are key to building a stronger, more flexible economy and a fairer society. A healthy and educated workforce, modern and reliable transport network, and adequate supply of housing promote productivity and flexibility and help to ensure opportunity and security for all.

6.2 Achieving this goal requires sustained investment in public services, used in the most efficient way to deliver the levels of services the public expects. The Government's fiscal framework and prudent management of the economy and the public finances have enabled it to deliver a step change in investment in key public service priorities in the three Spending Reviews since 1998. The 2004 Spending Review, which will conclude this summer, will lock in the step change in funding for key public services delivered in previous Spending Reviews while continuing the drive to increase the efficiency of public services and release resources for front line, non-administration services. Resources will be targeted on the front line, where they best deliver added value and better standards for the users of public services.

Delivering better and more efficient public services

6.3 The Government has made increasing investment in public services and improving delivery a top priority. There has been a significant increase in resources made available for public services in successive Spending Reviews, helping to address the underinvestment of previous decades. Alongside this additional investment, the Government has embarked on an ambitious reform agenda to deliver efficient, responsive public services with high standards achieved across the country. The key principles that have driven the reform agenda so far, as set out in Budget 2003, are:

- clear long-term outcome-focused goals set by the Government;
- devolution of responsibility to public service providers themselves, with maximum local flexibility and discretion to innovate and incentives to ensure that the needs of local communities are met;
- independent and effective arrangements for audit and inspection to improve accountability; and
- transparency about what is being achieved, with better information about performance both locally and nationally.

6.4 This agenda has been put into practice across the public services, and alongside increased investment, is continuing to deliver real progress in standards and outcomes. Public Service Agreements (PSAs) have been a key mechanism for driving improvement in the public services through providing focus and ambition. Since 1998, the PSA framework has been progressively improved, with the number of targets halved as they have been achieved, and refined with a stronger focus on the outcomes that matter most to the public. They are also providing a framework of long-term goals, within which departments and delivery agents are free to determine how best to deliver, and have been instrumental in the drive for better performance information, with regular web-based reporting of progress providing unprecedented transparency about the results that investment in public services is delivering.

6.5 Transparent and measurable national targets for delivery, which continue to be an essential framework for reforms, have resulted in measurable improvements in key priority areas, for example:

- there are 187,000 fewer patients waiting for treatment now than in 1997-98;
- almost 53 per cent of 16 year olds achieved five or more A* to C grade GCSEs in 2003 compared to 45 per cent in 1997; and
- overall crime fell by 28 per cent between 1997 and 2002.

6.6 Despite the successes of the reform programme so far, a lot remains to be done. Raising the productivity of the public sector is a key part of the Government's objective to ensure that resources and capacity are utilised with maximum effectiveness to deliver public services that are responsive and personalised to local and individual needs. As set out in the HM Treasury paper *Public Services: meeting the productivity challenge*, published alongside Budget 2003, productivity of the public sector raises productivity of the economy as a whole. It also helps ensure that the public receives the highest possible standards from the additional resources the Government has made available for public services. Reliable measures of public sector output are crucial in gaining an accurate sense of how productivity is changing and in informing policy decisions. The National Statistician has therefore asked Sir Tony Atkinson to undertake a review of the future development of measures of government output, productivity and associated price indices so as to advance methodologies.

ACHIEVING GREATER EFFICIENCY

6.7 The 2004 Spending Review will consolidate and build on progress so far, by setting out the priorities and next steps in the Government's continuous drive for improvement. Achieving greater efficiency in the public sector will enable the Government to deliver high and continuously improving standards within the public services by releasing extra resources for front line services. This means moving resources, as a result of more efficient procurement and streamlined back office functions, away from administration and closer to public service customers. The greater the scale of efficiencies that can be achieved within the public sector, the lower the increase in total expenditure that is required to achieve further improvements in the performance of key public services. Efficiency gains therefore also enable the Government to fulfil its responsibility to deliver value for money to taxpayers.

6.8 Efficiency in the public sector involves making best use of the significant investment in information and communications technology (ICT), workforce reform and the sharing of best practice agreed for the 2002 Spending Review period. Other investments and reforms designed to modernise and enhance the delivery of public services will build on this. The pursuit of efficiency also includes reducing bureaucracy, which both cuts headquarters' administration costs and frees up the time of front line professionals to respond better to the needs of their customers.

The public spending framework

6.9 Since 1997, the Government's commitment to improving standards in the public services has been matched by a focus on the efficiency of spending. Underpinned by the new fiscal framework and prudent management of the economy and the public finances, the Government has undertaken extensive reforms of the system for managing public expenditure. The elements of this new public spending framework that are already delivering greater efficiency are:

- firm three year plans for public spending, reviewed every two years, and full end-year flexibility (EYF), allowing departments to carry over unspent resources into future years and reducing wasteful end of year spending over time;

- PSAs, which provide an outcome focused contract for delivery and put the spotlight on efficiency and effectiveness in departmental programmes;
- the introduction of resource budgeting in line with best commercial practice and Departmental Investment Strategies, which have put a new emphasis on asset management and estate rationalisation in departments; and
- the introduction of administration cost limits for government departments, which translate the previous running cost controls to a resource budgeting basis and to better promote economical and efficient administration within central government.

Efficiency in the 2002 Spending Review

6.10 Specific measures have also been introduced over past Spending Reviews to increase the efficiency and effectiveness of particular aspects of public spending. The establishment of the Office of Government Commerce (OGC) in 2000, for example, has helped departments improve the efficiency of their procurement activities – saving over £1.6 billion in its first three years. In addition, significant investment in ICT by both central and local government in the 2002 Spending Review is streamlining the delivery of services to the public, cutting transaction costs and reducing paperwork. The Department for Work and Pensions (DWP), for example, now pays over 60 per cent of benefits directly into its customers' bank accounts, and is on track to deliver savings of £400 million a year by 2006.

The Efficiency Review

6.11 Building on these achievements, Budget 2003 announced a cross-cutting review of efficiency in the public sector to identify the scope for further efficiencies in public spending that would release resources for frontline priorities. As the head of this review, Sir Peter Gershon has drawn on his own extensive experience and consulted widely to identify opportunities for sustainable efficiencies in the use of resources within both central government and the wider public sector. Drawing on the evidence gathered by this review, the Government believes that there is scope for real efficiency gains in a number of areas:

- procurement savings can be achieved by greater use of shared purchasing strategies, use of electronic purchasing and improved supplier management. As indicated in the 2003 Pre-Budget Report, the Efficiency Review and the OGC are exploring options for radically reforming the approach to public sector procurement;
- the corporate back office, including IT, finance and human resource management services, can be streamlined by adopting existing best practice, for example by simplifying back office processes and procedures, plus standardising and sharing support functions; and
- transactional services, such as the payment of benefits and tax, can be made more cost-effective through maximising the benefits of investment in more efficient communication channels such as web interfaces and call centres.

6.12 There are also potential benefits from more long term reforms to the way government works and public money is spent, for example, how policy is set, funding provided and quality regulated for front line public service delivery organisations. Further efficiencies can also be achieved that will enable front line professionals to spend more time delivering services to the public.

The Government's forward efficiency programme

6.13 Recognising the varied cost and complexity of different efficiency measures, the Government envisages a comprehensive, continuous programme of efficiency improvements that will release resources for the front line from administration, and also enable the front line to make better use of the resources it has. These efficiencies will be delivered during the course of the 2004 Spending Review period and beyond.

6.14 Ambitious efficiency proposals have already been brought forward by a number of departments, particularly in relation to headquarters costs and back office rationalisation. Further details of these departments' proposals are given in Box 6.1. Building on these initial proposals in relation to central government administration costs, Budget 2004 announces:

- the administration costs of all departments will be capped at or below the 2005-06 nominal level for the remainder of the 2004 Spending Review period;
- in particular, core Departmental Expenditure Limits (DEL) for 2006-07 and 2007-08 for DWP, Inland Revenue, HM Customs and Excise and HM Treasury, almost entirely comprised of administration costs, will be held constant in nominal terms at 2005-06 levels, representing a real terms cut;
- within the overall DEL settlement for education announced in this Budget, the administration costs of the DfES will fall in nominal terms over the next Spending Review; and
- the devolved administrations will also set tough administration cost limits for the 2004 Spending Review period.

6.15 As a consequence of these measures, total central government administration costs will be capped at 2005-06 nominal levels in 2006-07 and 2007-08 – a real terms reduction – with the expectation that further savings should enable a cut in the nominal level. As Chart 6.1 illustrates, this will reduce administration costs to a planned 3.7 per cent of total spending, the lowest level since the running costs regime (the predecessor of the current administration costs regime) was introduced in 1986-87. These cash savings will be available for redistribution to priority public services in the 2004 Spending Review.

Box 6.1: Departmental efficiency programmes

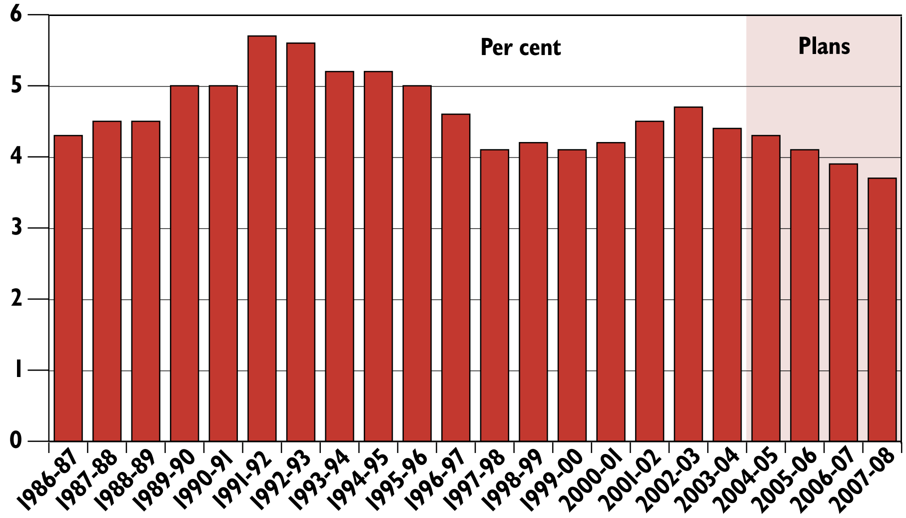
A number of departments are demonstrating their commitment to releasing resources for the front line and improving public service delivery by bringing forward early proposals as part of the efficiency review for savings in their headquarters and wider administrative costs:

- **DWP plans to make gross efficiency gains equivalent to 40,000 posts between now and 2008, and reinvest some of the savings in meeting significant increases in its own front line work load, such as additional work-focused interviews. On the basis of policy commitments and existing activities, this will result in a net reduction equivalent to 30,000 posts by 2008;**
- **following the Government's announcement that it accepts the recommendations of the review of the revenue departments, led by Gus O'Donnell, a new tax department will be created, offering a one-stop service to business and allowing tax flows to be managed more effectively. This integration of the Inland Revenue and HM Customs and Excise, along with existing plans and proposed efficiency reforms, could create scope for overall savings equivalent to up to 14,000 jobs by the end of of 2007-08. On the basis of policy commitments and existing spend-to-save packages, this would result in a net reduction equivalent to 10,500 posts by 2008;**

These announcements, affecting departments covering over 40 per cent of all civil servants and over 50 per cent of all administration costs, represent significant steps in the Government's efficiency programme.

- **the DfES has started a major restructuring process to streamline the department and its Non-Departmental Public Bodies (NDPBs). By 2008, the department will have reduced its workforce by 31 per cent (a reduction of 1460 jobs) alongside significant savings in the wider education and skills sector, and a reduction in the costs of OFSTED's inspection of schools. Together with planned 2.5 per cent a year efficiency gains, as set out later in this chapter, these reforms will enable the department to focus its resources on strategic leadership of the system and on ensuring effective delivery mechanisms for education and children's services; and**
- **the Department of Health has already started a process that will reduce the number of people working in the Department by 1,400, or 38 per cent, by October 2004. Together with the planned 2.5 per cent a year efficiency gains, these reforms will focus the Department's resources on those areas where it can add most value – providing the strategic, regulatory and funding framework within which the NHS operates.**

Chart 6.1: Administration costs as a proportion of total spending



Source: HM Treasury

6.16 In addition to administration cost savings, the Government believes there is also scope for further efficiencies in the way the wider public sector uses the resources it has available. This could be, for example, through back office rationalisation, improvements in procurement processes and streamlining of transaction services, as well as through freeing up more time for front line professionals to deliver services direct to the public. Sir Peter Gershon has identified the risk that an excessive target for efficiencies could affect delivery of the Government's objectives for the public services, as set out in PSA targets. The Government is determined to deliver the maximum level of efficiencies that are compatible with continuing its ambitious programme of improvements in public service outcomes. **On this basis, the Government is setting a stretching but realistic target for the whole public sector to deliver efficiencies of 2.5 per cent a year over the three years of the 2004 Spending Review period, which would deliver gains equivalent to £20 billion a year by 2007-08.**

Implementation and Monitoring

6.17 Delivering this ambitious efficiency programme will require departments and other public sector bodies to re-examine their existing spending programmes closely and prepare detailed efficiency proposals for consideration in the 2004 Spending Review. In order to drive through the Government's overall efficiency programme, Budget 2004 announces that John Oughton will become the new Chief Executive of the OGC and take on wider responsibility for the implementation of the Government's efficiency programme. He will:

- work closely with HM Treasury to monitor the progress of departments against their agreed efficiency programme, and identify further improvements in public sector efficiency that can be achieved through more radical reforms and process re-engineering within government; and
- build on the OGC's previous successes to deliver a further £3 billion of saving in central government civil procurement spend over the 2004 Spending Review period.

6.18 In securing these efficiency gains, there will be a strong emphasis on using normal staff turnover, and, for example, making the most of the opportunity for staff to be redeployed to posts out of London and the South East in the wake of the Lyons review. As part of this, the Government is examining options for strengthening the current arrangements for civil service staff to be redeployed across administrative boundaries.

6.19 As a result, the Government believes that in most cases the initial costs of departments' efficiency proposals will be met from within departments' existing expenditure limits. However, in some cases additional flexibilities may be required. Where departments can present a strong business case, HM Treasury will consider excluding some element of transitional costs from the departmental administration cost limits. Departments will also be able to bid in 2004-05 and 2005-06 for an element of match funding towards restructuring costs from a £300 million Efficiency Challenge Fund. Bids will be reviewed and then assessed against strict criteria.

6.20 Overall, the Government's ambitious efficiency programme will ensure that the 2004 Spending Review sustains continued improvements in front line public services, and delivers greater value for money for taxpayers, by releasing additional resources for investment in front line priorities and making better use of those already available.

DELIVERING RESOURCES

2002 Spending Review

6.21 Maintaining sound public finances that are sustainable over the economic cycle ensures economic stability, and has enabled the Government to deliver the investment in public services required to achieve value for money and the standards that the public expects.

6.22 The Government's fiscal rules are the foundation of the public spending framework, ensuring that the public finances are sustainable over the economic cycle and that spending and taxation impact fairly between generations. These rules remove the past discrimination against investment and ensure that borrowing for investment is conducted in a responsible way.

6.23 The 2002 Spending Review set spending plans for 2003-04 to 2005-06 for public services other than the NHS, for which spending plans to 2007-08 were fixed in Budget 2002. Building on previous Spending Reviews, these plans allow for significant increases in investment in key public services. The Government's spending plans are fully consistent with meeting its strict fiscal rules.

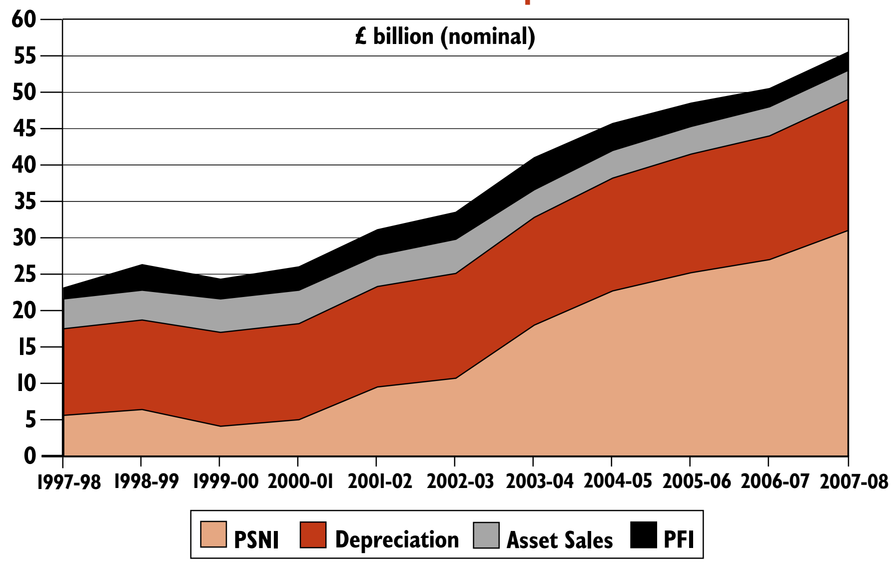
6.24 In Budget 2003, the Government made a special contingency provision of £3 billion to meet the costs of the military conflict in Iraq and of its international obligations. In the 2003 Pre-Budget Report, the Government carried forward £2 billion of the special reserve that had not been allocated in 2002-03 into 2003-04, and added a further £500 million, taking the total special reserve for 2003-04 to £2.5 billion. At the same time, a further £300 million was added to the special reserve in 2004-05 as a prudent allowance against continuing commitments.

6.25 The Government's fiscal framework and prudent management of the economy and the public finances, have enabled it to deliver a step change in investment in key public service priorities in the three spending reviews since 1998. After a period of relative stagnation in the mid-1990s, health and education have benefited from significant and sustained real increases in investment since the 1998 Comprehensive Spending Review. By 2006, public spending on education in the UK is set to be about 50 per cent higher in real terms than in 1997, and by 2008 spending on the NHS will be approximately 90 per cent higher in real terms than in 1997.

New spending plans: 2004 Spending Review

6.26 The 2004 Spending Review, which will conclude this summer, will set new spending plans for 2006-07 and 2007-08, and new PSA targets up to 2007-08 or beyond. Spending plans for 2005-06 that were set in the 2002 Spending Review will not be revisited. The new public spending plans build on those set in the 2000 and 2002 Spending Reviews, which increased the level of public spending by 20 per cent in real terms between 2000 and 2006. The new spending plans for 2006-07 and 2007-08 lock in public spending at these new higher levels. Greater efficiency will enable the Government to deliver high and continuously improving standards within the public services and release significant extra resources for front line services that address the public's highest priorities.

Chart 6.2: UK total investment in public services



Source: HM Treasury.

6.27 Budget 2004 sets firm overall spending limits for the 2004 Spending Review period, allowing:

- current spending to increase by an average of 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumptions for trend economic growth and consistent with the nominal growth rates set out in Budget 2003 and the 2003 Pre-Budget Report. Final plans for DEL and AME spending will be set in the Spending Review; and
- public sector net investment to rise from 2 per cent of GDP to $2^1/_4$ per cent by 2007-08, to continue to address the historic under-investment in the UK's infrastructure while remaining consistent with the sustainable investment rule. Chart 6.2 sets out the profile for total investment in public services that the Government is planning to deliver by 2007-08, consistent with existing plans and the Spending Review envelope, including all new public funding committed each year through additional investment, re-investing the proceeds of asset sales and estimated private sector investment in public service, through the Private Finance Initiative.

6.28 The growth rate of both overall public spending and departmental spending will be lower in the 2004 Spending Review than in the 2002 Spending Review. However, building on the progress made in correcting historic under-investment and with administration costs cut in real terms and planned efficiency gains equivalent to £20 billion a year by 2007-08, the Government's objective is to match the pace of growth in front line public services achieved in the last Spending Review.

PREPARING FOR THE 2004 SPENDING REVIEW

6.29 In the 2004 Spending Review additional funds allocated above existing baselines will be targeted at front line public service priorities based on a rigorous assessment of where new resources will have the greatest impact on outcomes at the front line. In particular, this year's Spending Review will take further steps to:

- strengthen the economy;
- build a fair society, with opportunity and security for all; and
- deliver better and more efficient public services.

Strengthening the economy

6.30 Budget 2004 announces early decisions on key economic areas that will be central to the 2004 Spending Review – science, skills, employment and education. The Spending Review will take further steps to tackle the historical barriers to stronger economic performance and higher productivity in the UK by investing in the science base, taking forward the Government's agenda to boost adult skills, reviewing financial support for 16 to 19 year olds continuing in education or vocational training, and investing further in the nation's infrastructure, as set out in earlier chapters of this Budget. The Spending Review will also help achieve more balanced growth across UK regions through these measures and also through support for urban renewal and regeneration, the rural economy, sustainable development and by developing further the framework to ensure that regional and local institutions have the flexibilities they need to achieve their ambitions.

Building a fair society

6.31 The Government is committed to tackling social exclusion and deprivation and promoting opportunity and security for all. The 2004 Spending Review will build on previous reviews with proposals to:

- increase the contribution of public services towards improving the life chances of children in low-income households and to improve services for children and their families living in deprived areas. The Child Poverty Review in particular will include recommendations to improve both the immediate material circumstances of children in low-income households and their long term life chances, as set out in more detail in Chapter 5;
- improve performance of public services accessed by those living in deprived areas and by disadvantaged population groups;
- respond to the recommendations of the Wanless Review to secure good health for the whole population, and tackle in particular the occurrence of avoidable ill health related to socio-economic deprivation;
- increase the supply of affordable housing, reduce homelessness and regenerate deprived city centres; and
- develop floor targets as part of PSAs to ensure standards of public services are raised across the board, especially in the most deprived areas, to meet minimum national standards.

6.32 The Review will also consider the resources available to reduce crime, strengthen the UK's defences and meet the UK's responsibilities in international development.

6.33 The Spending Review will also drive forward the next phase of the Government's reform agenda for the public sector. Key elements of this next stage of reform are contained in the reviews announced in Budget 2003, which aim to ensure that best use is made of the additional funding allocated in the 2002 Spending Review and to prepare the ground for the 2004 Spending Review.

6.34 Central to the aim of this next stage of public service reform is the Government's intention to deliver public services that are more responsive to local and personal needs. More efficient use of resources will help ensure public spending can be better targeted on regional and local priorities, and more personalised to the requirements of individual users. In addition to the action being taken to enhance efficiency:

- the Lyons Review of public sector relocation identified 20,000 posts for relocation from London and the South East;
- the Devolving Decision-Making Review is establishing a clear rationale for a more devolved approach to decision-making, alongside a framework of national targets, as the means of delivering more responsive regional and local public services;
- the review of the voluntary and community sector is exploring how best the Government can engage this sector to improve the responsiveness of public services to local and personal needs; and
- the Spending Review, in addition to the outcome of these reviews, will also set out further steps that will be taken to make the delivery of public services more personalised to individual needs.

6.35 The following section outlines progress made with each of these reviews and sets out further details of how the Government is taking forward its intention to make public service delivery more personalised. Progress on the Childcare and Child Poverty reviews is described in Chapter 5, along with the initial results of the review of financial support for 16 to 19 year olds. The results of the Wanless Review – *Securing good health for the whole population* – are set out in a later section in this chapter.

Spending Review 2004: Cross-cutting reviews – more responsive and personalised public services

Independent review of public sector relocation

6.36 The independent review of public sector relocation announced in Budget 2003, led by Sir Michael Lyons, is a key part of the Government's efficiency agenda. In his final report, *Well placed to deliver? – Shaping the pattern of Government service*, published on 15 March 2004, Sir Michael concluded that the current concentration of national public sector activity in and around London is inconsistent with Government objectives for efficiency and regional development, and that location needs to become an integral dimension of government business planning.

6.37 Sir Michael has identified 20,000 posts as candidates for dispersal from London and the South East as a first tranche, and has made ten recommendations for taking this forward. These are set out in Box 6.2 below. The Government welcomes Sir Michael's report and confirms that location will be an important theme of the 2004 Spending Review. Departments will be expected to reflect Sir Michael's recommendations in their submissions to the Spending Review, taking account of the read-across to efficiency. Departments will be able to make bids to the new efficiency challenge fund if their dispersal proposals meet strict efficiency criteria. The Government will come forward with detailed proposals for monitoring and implementing dispersal plans as part of the Spending Review.

Devolving Decision-Making Review

6.38 Consistent with the drive for efficiency, the Devolving Decision-Making Review, announced in Budget 2003, is considering how best to achieve decentralised delivery and responsive local and regional services in a way that is consistent with equity and efficiency, against a clear framework of national standards. The Review is today publishing two reports:

- *Devolving decision-making: 1 – Delivering better public services: refining targets and performance management,* published by HM Treasury and the Prime Minister's Delivery Unit, sets out how, as public services have improved, there is scope for greater local flexibility to determine local priorities and methods of delivering better services within a framework of clear national standards embedded in PSAs. This requires a reduction in the input controls set nationally, matched by stronger local accountability and incentives to improve public services. Improvements to performance data will be key to achieving these aims and increasing public engagement in service delivery. Local organisations also need to develop stronger performance management capacity to oversee reforms successfully; and

- *Devolving decision-making: 2 – Meeting the regional economic challenge: increasing regional and local flexibility* considers how a more devolved approach can enhance the economic policy making framework. It argues that to maximise economic performance in every country, region and locality in the UK, it is essential to increase the flexibilities of the Regional Development Agencies, local authorities and others to make decisions and use resources to increase local economic activity. More detail is set out in Chapter 3.

Box 6.2: Independent Review of Public Sector Relocation

The independent review of public sector relocation, led by Sir Michael Lyons, was announced in Budget 2003. The final report, *Well placed to deliver? – Shaping the pattern of Government service*, published on 15 March 2004, made the following findings and recommendations:

- departments have identified more than 27,000 jobs that could be taken out of London and the South East, including up to 20,000 jobs for dispersal as a first tranche. Plans for these dispersals should be taken forward urgently as part of the Government's forthcoming Spending Review;
- major dispersals are unlikely to offer a quick payback but incur considerable costs up front. The Government must be prepared to make the necessary investment. Equally, it needs to set sharper incentives to encourage departments to seek the benefits of locations outside London and to keep their presence in the capital to a necessary minimum;
- departments should implement their relocation plans alongside efforts to align their pay with local labour market conditions. The Review has demonstrated that failure to make progress on flexible pay, alongside relocation will limit the efficiency gains from dispersal, and could undermine the economic benefits for receiving locations;
- Whitehall headquarters should be radically slimmed down, reflecting a clearer understanding of what activity is really needed in London, and of the distinction between policy and delivery;
- a presumption against London and South East locations should be strongly enforced for new government bodies and activities; for functions such as back office work and call centres, which do not need to be in London; and for bodies and functions whose effectiveness or authority would stand to be enhanced by a location outside London;
- the Cabinet needs to give continuing political impetus to the location agenda. Leadership should be provided by a Cabinet Committee and, in the short term at least, a lead minister. These arrangements should be supported by a small, short life unit at the centre, to act as a ginger group, to monitor and report on progress with dispersals, and to ensure that best practice is disseminated and embedded;
- permanent secretaries and other public sector chiefs are responsible for managing their departments' resources, accounting to ministers and to Parliament. Locational considerations must be an integral part of these responsibilities. The aim should be to mainstream the locational aspect of business planning;
- the Government must take responsibility for the whole pattern of its locations, developing a strategic framework of guidance for departments and ensuring a mechanism for reviewing and, where necessary, challenging departments' locational preferences;
- the Government office portfolio must be much more tightly managed. In particular, relocations from London should be coordinated to ensure overall value for money and to strengthen individual business cases; and
- the civil service needs a more coordinated approach if it is to minimise the costs and the adverse impacts on staff associated with relocation and redundancy.

6.39 These two reports set out a clear rationale for taking a more devolved approach to decision-making. The Government believes this is an essential means of delivering both continuously improving public services and stronger economic performance throughout the UK. A devolved approach can help achieve these aims as it can:

- *improve efficiency,* providing an increased range of choices to users as local providers have the flexibility to tailor services to local needs based on better local information and knowledge;
- *improve internal management capacity* by empowering local leadership and frontline staff, thereby harnessing internal drivers of continuous improvement, leading to improved productivity; and
- *better engage local stakeholders* of public services and make local service providers more accountable to their users.

6.40 Both reports set out a vision for medium-term reform. First steps towards implementing the approach set out in the two reports will be made in the 2004 Spending Review, building on the progress that has been achieved so far.

Voluntary and community sector review

6.41 The 2004 Spending Review will also take further steps to improve the responsiveness of public services to local and personal needs. The review of the voluntary and community sector (VCS) aims to explore the practical ways in which Government can best engage the expertise, innovation and enthusiasm of the VCS in the delivery of world class public services. The VCS is sometimes better placed to provide highly responsive and personalised services at the local level, especially to some of the most disadvantaged people in society. The Government wants to support the work that VCS organisations do, recognise the contribution they make, and explore how to more closely involve voluntary and community organisations in the successful delivery of some of the Government's core public service objectives.

6.42 The review builds on the foundations laid in the 2002 cross-cutting review, *The role of the voluntary and community sector in service delivery,* by focusing on two key objectives:

- the practical steps Government can take to support an effective partnership at the local level between local voluntary and community organisations, local government and other local public sector agencies; and
- the potential for greater involvement of the VCS in the delivery of the core government objectives in the areas of services for older people, correctional services, adult and community learning, ethnic minority employment, homeless hostel provision and parenting support.

6.43 The Review is currently working with local government and the VCS to develop a joint strategy for building a powerful partnership at the local level. It is also working with departments as part of the Spending Review process to develop strategic and practical approaches for VCS involvement in the chosen areas over the coming few years. It is expected that the Review will report at the time of the 2004 Spending Review. Ahead of the Review's final report, Chapter 5 sets out other measures the Government is taking in this Budget to support the VCS.

Personalising delivery

6.44 Building on the Budget 2003 reviews, further steps will be taken to make the delivery of public services more personalised to individual needs:

- there is further scope for better use of IT to enhance data-driven real-time accountability of public service delivery. New technology has great potential to drive reform of public services and deliver a greater degree of personalisation of services;

- more user and community involvement in local public service delivery can help achieve services that are more responsive to local and personal needs. Therefore, a central feature of the next stage of reform must be to enable individuals to exercise much greater choice and control over the public services they receive. Greater user empowerment can also produce more effective services and better outcome; and
- public service professionals have a key role to play in delivering more personalised services. Front line staff that are free to innovate and to exercise their judgement are key to the delivery of public services that are more tailored to individual and local needs. The Government has already increased direct payments to headteachers and devolved 75 per cent of the NHS budget to Primary Care Trusts. The next stage of reform will further reduce centrally imposed controls and involve the front line to a greater degree in the redesign of services and the setting of targets. In the follow-up to the Gershon Review, work will focus on how greater flexibility and workforce reforms can enable professionals to make better use of their productive time.

Box 6.3: Personalisation in public services

Education

Personalised education is where teaching and learning respond to the needs of each pupil, where pupils own their learning, and where schools are engaging parents and communities in the learning process. Personalisation has been enhanced through the provision of 25,000 more teachers and over 80,000 extra support staff in schools, enabling more personal attention for each pupil and through widening curricular options through the increased flexibilities programme, 14 to 19 year olds pathfinders and the introduction of vocational GCSEs. Going forward, personalisation will be furthered in the following ways:

- development of Assessment for Learning in which pupils and teachers agree learning objectives in each subject and a plan for how to reach their goals using data as part of monitoring to enable better focus on areas for development. Workforce reform and ITC are also important;
- the interim Tomlinson report on 14 to 19 year olds education proposes a specialised diploma allowing a wider mix of subjects to engage pupils further and widen their learning and employment options; and
- more extended or full-service schools providing after school and breakfast clubs and childcare, as well as after-school opportunities in sports, arts and drama, and extra tuition.

Health

A more personalised health service is one that offers easier access and fits around the needs of the patient. It is a health service where patients are treated with dignity, have better information about the performance of NHS services and the treatment options open to them, and where they can have greater involvement in decisions about their care and treatment.

The Government has already improved personalisation through NHS Direct, providing 24 hour information and advice, and walk-in centres accessible 365 days a year without prior appointment, through speeding access to GP appointments and cutting waiting times for hospital treatment. It has committed to ensuring that all hospital appointments will be booked at a time and place convenient to the patient by 2005, is providing information and support for patients through hospital and Primary Case Trust (PCT) star ratings, a patient prospectus for every home, and Patient Advocacy and Liaisons Services in every hospital. Further steps to promote a personalised service include:

- every patient having their own electronic NHS ‘healthspace’ from this year, where they can record personal information about their health and preferences to share with NHS professionals, which will be linked in time to their electronic treatment record;
- by the end of 2004, all patients who have waited over six months for an operation will be offered a choice of an alternative hospital. Every patient will be offered choice at the point they are referred by their GP by 2005; and
- rolling out to every PCT the successful ‘expert patient’ schemes for chronic disease, enabling patients to take a much more active role in managing and taking informed decisions about treatment of their condition.

INVESTING IN THE FUTURE

6.45 Budget 2004 announces investment in key areas underpinning economic growth and flexibility now and for the future. This includes a framework for investment in science and innovation as set out in Chapter 3, further measures to boost employment as described in Chapter 4, and measures to improve the UK's education and skills base. To ensure that the key resources required for a strong and flexible economy and a fair society are in place, the Budget announces firm spending plans for education that will deliver the resources needed to underpin reforms and meet the requirements of the economy.

Education

New spending plans

6.46 The Government's aim is to achieve excellence in standards of education and levels of skills, and to give everyone the opportunity to develop their learning. To reflect this priority, ahead of the 2004 Spending Review the Budget announces firm spending plans for the DfES and for Local Authority Formula Spending Share on education and children's social services. DfES DEL spending from 2004-05 to 2007-08 is set to rise by an annual average real increase of 5.6 per cent. Education spending in England will grow by an annual average of 4.4 per cent in real terms across the Spending Review period, and by 2007-08 spending will be £7.4 billion higher than in 2005-06. By 2007-08 education spending in the UK will be 5.6 per cent of GDP, up from 5.4 per cent in 2004-05. Efficiency gains worth at least 2.5 per cent each year over the Spending Review period, delivered through reducing administrative costs, reforming procurement and unlocking productivity gains from technology and workforce improvements, will see resources freed up and cost pressures reduced for priority frontline programmes. Details of the exact education settlement and its breakdown are set out in Tables 6.1 and 6.2.

Table 6.1 New education and children spending plans

£ million	2005-06	2006-07	2007-08
Resource DEL budget	26,708	28,108	29,708
Capital DEL budget	4,445	4,845	5,445
Total Departmental Expenditure Limit[1]	31,105	32,905	35,105
Local Authority Formula Spending Share:			
Education	27,963	29,863	31,663
Children's Social Services[2]	4,016	4,316	4,516
Total education (England)[3]	56,529	60,122	63,910

Table 6.2 Education spending in the UK[4]

£ million	2004-05	2005-06	2006-07	2007-08
Total UK education and training	64,857	69,857	74,102	78,610
Total UK education	63,195	68,134	72,272	76,649
UK education as a proportion of GDP (per cent)	5.4%	5.5%	5.5%	5.6%

[1] *Full resource budgeting basis, net of depreciation.*

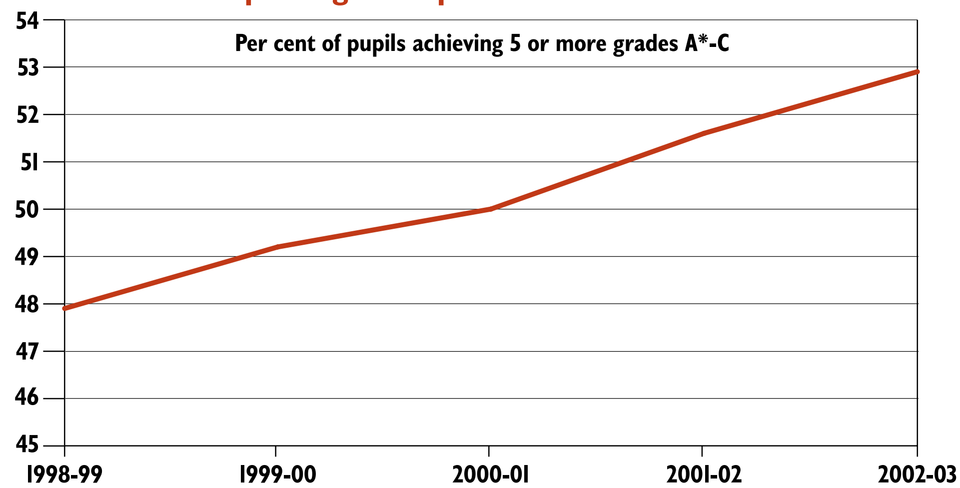
[2] *2005-06 still indicative at this stage.*

[3] *England education measured consistent with international definitions from the UN classifications of functions of government (COFOG). Actual outturns are subject to spending decisions by local authorities.*

[4] *UK education and UK education and training measured consistent with international definitions from the UN classifications of functions of government (COFOG). Actual outturns are subject to spending decisions by local authorities and devolved administrations.*

6.47 The sustained high investment in education since 1997 has resulted in a measurable improvement in standards. In particular, the proportion of 11 year olds achieving expected levels in reading and maths have risen by 12 per cent and 11 per cent respectively, and almost 53 per cent of 16 year olds achieved five or more A* to C grade GCSEs in 2003, compared to 45 per cent in 1997. The Government is on track to help 750,000 adults gain basic skills by 2004.

Chart 6.3: Improving GCSE performance



Source: Department for Education and Skills.

6.48 The investment allocated for education over the next three years will build on these improvements and tackle key future challenges. International comparisons show that the gap in attainment between children from higher and lower socio-economic groups in the UK is wider than that in almost every other OECD country. The UK has one of the lowest staying on rates after the age of 16, and has a particularly large number of adults with no and low skills. These weaknesses are a constraint on UK productivity and carry large social costs. The Government's long term ambitions are therefore to:

- improve opportunity for every child through extended schools, childcare and better integrated support for parents and children;
- deliver higher standards in schools, and narrow the attainment gap between the best and worst off;
- bring all school buildings up to twenty-first century standards in the next 10 to 15 years;
- improve the UK's post-16 staying on rates from being one of the lowest in the OECD to one of the highest;
- enable each individual to acquire the skills he or she needs to be employable and support employers to develop the skilled workforce needed for the success of their businesses; and
- support expansion of higher education to meet the UK's rising skill needs while reducing the social class gap between those that do and do not enter university studies.

Sure Start, Childcare and early years

6.49 In line with its commitment to ensure that every child has a sure start in life, the Government is announcing additional investment in childcare and services for disadvantaged children of £669 million by 2007-08 compared with 2004-05 as noted in Chapter 5. This funding will deliver a Children's Centre in all of the 20 per cent most disadvantaged wards in England by 2008, on the way towards achieving the Government's goal of a Children's Centre for every community.

Children

6.50 Children's Social Services will also receive a real terms increase, allowing them to make a leading contribution to delivering the vision of the Children's Green Paper: *Every child* *matters* (2003), to protect each child and help them achieve their potential. The Children's Fund will also be continued to 2008 to allow a smooth transition to new Children's Trusts, which will be focused on preventative work and developed and delivered with the full engagement of the voluntary sector.

Schools

6.51 The Government's primary and secondary schools strategies are the first stage in a process of reform, which aims to achieve excellence and to narrow the attainment gap between schools and between pupils within individual schools. In the next stage of schools reform, personalisation and devolving decision making will be central to the realisation of these objectives.

6.52 As part of the process of achieving excellent secondary education across all schools, direct payments to headteachers will ensure that schools have added flexibility to buy extra books, ICT and other items that complement teachers in developing a more personalised approach. Refined training will enable teachers better to identify the needs and pace of progress of every pupil across each subject. Up to one thousand more specialist schools and academies will be designated. All secondary school buildings will be transformed to twenty-first century standards in the next 10 to 15 years.

6.53 Pupils in both primary and secondary schools will benefit from more schools across the country offering extended services, bringing together education, health, children's social services and childcare. Such schools will open up the potential of schools to pupils, parents and the wider community in localities across the country. The concept of enterprise education within schools will be further developed, building on experience from the present pilots.

6.54 All schools will be empowered, particularly to take decisions about how to improve the way funding is used to help all pupils and to meet their particular objectives. Consistent with its commitment to devolving decision making, the Government is determined to ensure that the performance framework for schools reflects the circumstances of individual schools, with light touch regimes for the best and more intensive support for weaker schools. The performance framework will reinforce the focus on individuals, helping to reduce the significant scale of within-school variation in pupil performance which currently constrains school effectiveness. As part of this process, and to streamline funding, most specific grants will be paid as a single schools improvement grant. Targeting of excellence in urban and other deprived areas, as achieved via the excellence in cities and leadership incentive grants, will be sustained.

6.55 These reforms and investments will particularly help to support personalised learning and ensure that every pupil is able to realise his or her potential.

14-19 year olds and adult skills

6.56 The Government's vision is that all young people should reach age 19 ready for skilled employment or higher education. The new spending plans will support this ambition, through a coordinated reform strategy, as set out in Chapter 3. To improve outcomes among these most at risk of reaching age 19 with low skills, in the 2004 Spending Review the DfES will introduce a new PSA target to reduce the number of young people not in education, training or employment. Chapter 3 also sets out the New Deal for skills which includes the Government's aspirations and new measures for tackling the UK's large number of adults with low skills in the workforce.

Higher education

6.57 The further investment announced in this Budget will continue to advance progress towards the Government target to increase participation in higher education towards 50 per cent of 18 to 30 year olds by 2010. The Government will maintain per student spending levels in real terms over the 2004 Spending Review period.

Box 6.4: Department for Education and Skills new PSA targets

The Government is currently consulting with stakeholders on DfES's new PSA targets, which will drive up performance in each of the key areas of education and training, as well as reflecting the wider role of DfES in meeting the needs of children, including their social, emotional and physical well-being, and keep them from harm. Full details of the new PSA targets will be published at the end of the 2004 Spending Review. These PSAs will ensure increased resources match improved delivery and standards, while aiming to deliver a national minimum standard that all learners and institutions are entitled to, and expected, to achieve. The Government's key ambitions will be made a priority, through PSA targets to:

Improve life outcomes and general well-being of children and young people

- Improve children's learning and emotional development by increasing the proportion who are prepared for their education;
- As a contribution to reducing the proportion of children living in households where no one is working, increase the availability of childcare and narrow the gap in childcare provision between the 20 per cent most disadvantaged wards and other areas;
- Increase the number of schoolchildren spending a minimum of two hours each week on high quality PE and sport beyond the current commitment;
- Reduce the under-18 conception rate by 50 per cent by 2010

Raise standards and tackle the attainment gap in schools

- Increase the proportion of 11 year olds achieving level 4 or above in English and maths and close the gap in educational attainment by setting more challenging floor targets for schools;
- Increase the proportion of 14 year olds achieving level 5 or above in English, maths, ICT and science, and close the gap in educational attainment by setting more challenging floor targets for schools;
- Improve school attendance including reducing the level of unauthorised absence at school level;
- Narrow the gap in educational attainment between children in care and that of their peers, and improve the stability of their lives.

All young people to reach age 19 ready for skilled employment or higher education

- Increase the proportion of those aged 16 who achieve level 2 qualifications (equivalent to 5 GCSEs at grades A* to C) and close the gap in educational attainment by setting more challenging floor targets for schools;
- Increase the proportion of 19 year olds who achieve at least a level 2, as a step towards the Government's long term objective that all young people reach the age of 19 ready for higher education or skilled employment;
- Reduce the proportion of 16 to 18 year olds who are not in employment, education or training.

Tackle the adult skills gap

- Increase progress to reduce the number of low skilled adults, so that by 2007 1.5 million adults have improved their basic skills and by 2010 the number of adults in the workforce who lack NVQ 2 or equivalent qualifications is reduced by at least 40 per cent.

Raise and widen participation in higher Education

- by 2010 increase participation in Higher Education towards 50 per cent of those aged 18 to 30 and also make significant progress year on year towards fair access and bear down on rates of non-completions.

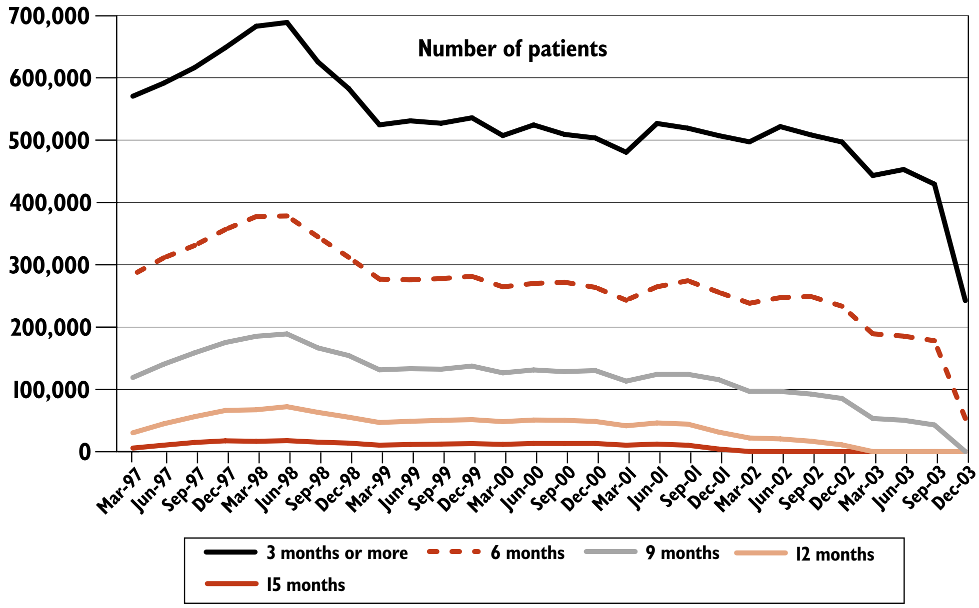
6.58 As described in Chapter 3, this Budget also puts in place the foundations for the Government's ten-year investment framework for science and innovation, and the implementation of the Lambert Review recommendations to strengthen business-university collaboration.

2004 SPENDING REVIEW: IMPLEMENTING REFORMS, DELIVERING RESULTS

6.59 The Government's agenda for public services reform is being put into practice by departments in the current Spending Review period and will be taken forward over the 2004 Spending Review period. Progress so far and concrete reform plans are set out by main public services delivery area in this section.

Health **6.60** The Government has introduced far-reaching reforms to deliver a world-class health service, which is available to all and free at the point of use, making best use of the record increase in funding of 7.2 per cent a year in real terms from 2003-04 to 2007-08. This is driving the considerable progress made against the health PSA targets to deliver the improvements in standards that the public expects. Compared to 1997-98, there are now 450,000 more NHS operations, 860,000 more elective admissions and 187,000 fewer patients waiting for treatment.

Chart 6.4: Cutting waiting times



Source: Department of Health.

6.61 However, while progress against PSA targets is generally excellent, further progress is still needed in some key areas. Work going forward includes:

- focusing a greater share of NHS resources on public health, developing a stronger evidence base and putting a greater emphasis on prevention, to help meet the 'fully-engaged' trajectory set out in the 2002 Wanless Report. A public health White Paper will be published in summer 2004 setting out the Government's response to the second Wanless Report, published last month, described in further detail in Box 6.5; and

- building on progress made in effective joint working between the NHS and social services, which has already resulted in the rate of delayed discharges from hospital falling by 50 per cent since 2001 and 20,000 more people supported to live independently at home through intensive homecare services since 1998-99.

6.62 To allow local health providers to address local needs and help to drive up NHS performance across the board, around 75 per cent of Department of Health funding is already devolved to PCT level. In addition, a Departmental Change Programme is re-focusing the Department on high level strategic issues, with day-to-day management decisions more fully devolved to those delivering front line service. Examples of how a more personalised health service that fits around the needs of the patient is being implemented are set out in Box 6.3 earlier in this chapter.

Securing good health for the whole population

6.63 In Budget 2003, the Government announced that Derek Wanless would provide an update on the long-term challenges in implementing the 'fully-engaged' scenario, which was identified in his 2002 report as the way to deliver the best health outcomes at least cost, with a particular focus on public health and health inequalities. His final report was published on 25 February 2004, and the key findings are set out in Box 6.5.

Box 6.5: Key findings of the Wanless Review – securing good health for the whole population

As set out in the Wanless report, achieving the goal of a population 'fully engaged' in improving its health is a major prize for the whole community. The step change in activity needed to achieve this will require strong leadership and organisation in public health delivery, access to high quality, personalised information, and increased support to help individuals take vital health and lifestyle decisions, as well as more evidence on the cost-effectiveness of public health interventions.

Individuals are primarily responsible for their own and their families' health, but the Government has a major role in the process by providing the necessary framework for success. Activity is needed on a wide front to help individuals take greater responsibility, with an enhanced role for schools, local authorities and other public sector agencies, employers, and private and voluntary sector providers in developing opportunities for individuals to play their part in securing better health.

The Wanless report makes more than twenty recommendations to Government on implementing cost-effective approaches to improving population health, prevention and reducing health inequalities consistent with the public health aspects of the 'fully engaged' scenario. The recommendations focus on improving public health policy making, improving the evidence base, engaging people in managing their own health, and the delivery structures required to achieve the 'fully engaged' scenario.

The report also recommends that the Government should set and monitor a consistent set of national objectives for the key risk factors such as smoking, physical inactivity and obesity. Primary Care Trusts and local authorities should then agree joint local targets based on the national objectives and their local needs, which should then be reinforced through the NHS and local government performance management and inspection systems and could mobilise other local groups to provide support.

Transport **6.64** The Government's aim is to provide the stable long-term framework needed to bring about real improvements to the UK transport system and reverse the legacy of under investment, stop-go funding and shifting policies. The 2000 Ten Year Plan for Transport sets out an £180 billion programme of transport investment. It represents an integrated approach to tackle the problems of congestion and pollution and to deliver improvements for passengers, motorists and businesses, while addressing concerns over safety and environment. In January 2004, the Secretary of State for Transport announced a review of the rail industry, which intends to publish proposals in summer 2004. The review will consider the structural and organisational changes needed for railways to operate more effectively and better respond to customers, with clear lines of accountability and responsibility.

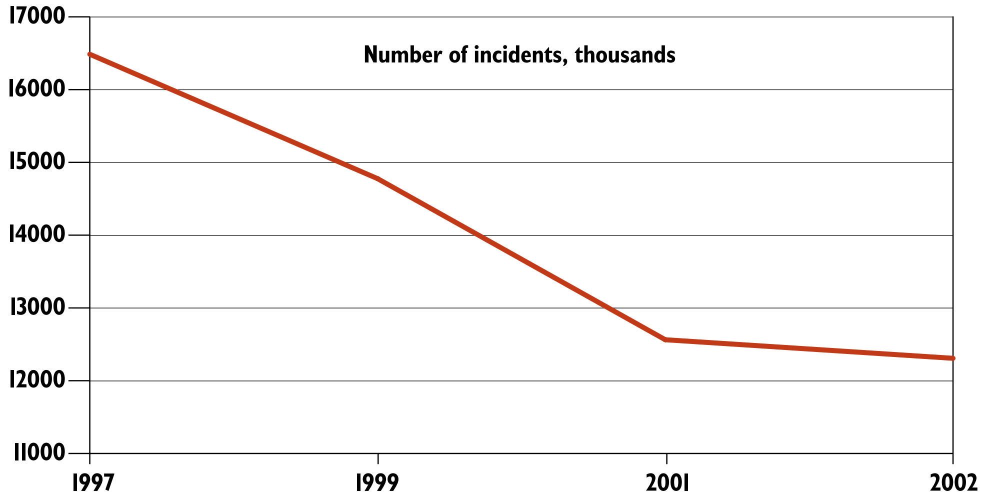
6.65 Further and challenging reforms are needed if the Government is to achieve its vision for transport. The 2004 Spending Review and the parallel strategic review of the Ten Year Plan will consider measures that include:

- an exploration with regional and local stakeholders of ways to improve regional planning and regional choice to bring transport investment choices closer to stakeholders and to deliver outcomes more effectively;
- better use of analytical tools and evidence base in appraising transport investment proposals and informing decisions; and
- the Bus Subsidy Review and road user charging, discussed further in Chapter 7.

Criminal Justice **6.66** The Government is determined to cut crime and the fear of crime. The Home Office, Department for Constitutional Affairs and Crown Prosecution Service are working together to bring more offenders to justice, increasing the public's confidence in the Criminal Justice System (CJS) and ensuring that it meets the needs of the people it serves. The Government will continue its reform programme, in particular it is:

- tackling serious and organised crime by establishing a new Serious and Organised Crime Agency;
- reducing re-offending rates and increasing rehabilitation through establishment of a new National Offender Management Service;
- improving the efficiency and effectiveness of the courts system by establishing a unified courts administration;
- increasing the number of offences brought to justice by the Crown Prosecution Service, which will now bring charges in all but routine cases; and
- introducing a new police reform consultation programme, which aims to increase transparency and accountability to the public by increasing community involvement in policing decisions.

Chart 6.5: Tackling crime



Source: British Crime Survey.

6.67 The British Crime Survey shows that the Government's strategy is delivering improved outcomes. Between 1997 and 2002, overall crime fell by 28 per cent, with a 34 per cent reduction in vehicle crime and a 41 per cent reduction in domestic burglary. Criminal Justice Boards have been established at both local and national level to be more responsive to CJS issues and to improve performance. The challenge for the 2004 Spending Review period is to continue to improve police performance, the effectiveness of the CJS and realise the benefits from improved partnership working.

Housing

6.68 The Government aims to offer everyone the opportunity of a decent home, and so promote social cohesion, well-being and self-dependence for all. By the end of this year the Office of the Deputy Prime Minister (ODPM) will have reduced the number of non-decent social homes by around a third compared to 2001, and will continue to work towards its aim to make all social housing decent by 2010.

6.69 In order to ensure greater responsiveness of housing policy to differing regional needs and housing market priorities, decisions need to be better aligned with regional planning and economic strategies, and ensure that investment decisions benefit from local knowledge. The Barker Review, into factors affecting the housing supply in the UK, which is described in Chapter 3, sets out proposals building on recent reforms by merging regional planning bodies and regional housing boards to create a single body supported by independent regional planning executives, responsible for managing regional housing markets. As part of the 2004 Spending Review, the Government will also consider whether to extend these bodies' strategic responsibilities to other housing related services as well.

6.70 This Government has accepted the need to increase investment in social housing in order to increase supply and will be making a start in the 2004 Spending Review. Greater investment needs to be accompanied by the delivery of higher and consistent standards in conditions, services and management across the social housing sector. Research undertaken by the Housing Inspectorate for the Treasury and ODPM, in conjunction with the Housing Corporation, has confirmed that there appear to be significant variations in management costs between housing association landlords even after accounting for issues such as stock location, size and management performance. The 2004 Spending Review will be considering appropriate measures to drive up efficiency and effectiveness within the sector, for the benefit of both tenants and the taxpayer.

Local Government

6.71 The Government's aim is to see vibrant, innovative and responsive local government delivering high quality public services for their communities. Central and local government are working together to ensure that local organisations, supported by appropriate performance frameworks and accountability arrangements, have sufficient flexibility to respond effectively to local needs.

6.72 From April 2004, the prudential regime for local authority borrowing will come into effect. Local Government will no longer need to seek permission to borrow for capital investment, and will be free to borrow subject to it being affordable as set out in the Prudential Code. Local authorities will also have new powers to trade, which will increase diversity and choice in the delivery of public services and support the development of a dynamic and entrepreneurial public sector. It will help to introduce new players to the market and encourage best value authorities to improve and extend the range of services they offer to local people. The wider issues of local government finance are being considered in the Balance of Funding Review, which is expected to report this summer.

6.73 Local PSAs encourage authorities to deliver service improvements above and beyond what would normally be expected in return for financial rewards. The first agreements of the second generation of local PSAs will run from April 2004. These will provide an increased focus on addressing local priorities and building more effective local partnerships.

6.74 These reforms are being matched by greater accountability. The Comprehensive Performance Assessment (CPA) brings together assessments of the individual services for which the authorities are responsible, with an overall assessment of the council's ability to lead the community, forge change and effect cross-service delivery improvements. In the second CPA for single-tier and county authorities, well over half were rated good or excellent and therefore benefit from increased freedoms and flexibilities over and above the general reforms. The Government is actively engaging with those authorities judged poor and one-third of those classified as poor or weak in 2002 moved up one category in 2003. CPA is now being extended to all lower-tier councils and refreshed scores for upper and single-tier authorities will be announced at the end of the year. The Audit Commission is consulting on a revised CPA for 2005 onwards, which will have a greater focus on local government's role in economic development and local priorities, including value for money, to continue to drive up standards across local government, delivering improvements in many of the services – including education, social services, waste management and housing – that matter most to people.

7 PROTECTING THE ENVIRONMENT

The Government is committed to delivering sustainable growth and a better environment. It is using a range of economic instruments to address the challenges posed by sustainable development, to tackle local environmental threats and to control and reduce emissions of the gases responsible for climate change and poor air quality. Budget 2004 describes the next steps in the Government's strategy, including:

- **new eligibility criteria for climate change agreements,** which will increase the number of businesses that can participate in the scheme, and **a freeze in the rates of the climate change levy;**
- **a package of measures to promote household energy efficiency** including a reduced rate of VAT for ground source heat pumps, and possibly for micro-combined heat and power units from 2005, and incentives for the private rented sector to invest in energy efficiency;
- **duty rates for sulphur-free fuels raised in line with inflation from 1 September 2004, the duty for ultra-low sulphur fuels set at 0.5 pence per litre above this level from the same date, an increase in rebated fuels rates, and three-year certainty for duty rates on biofuels and road fuel gases;**
- **reforms to the tax treatment of company vans and emergency vehicles,** taking 85 per cent of drivers of company vans out of the system altogether;
- **publication of the third progress report on the lorry road-user charging scheme,** which now moves the scheme into the procurement phase, and sets out decisions on key aspects of the scheme's design; and
- **reform of the aggregates levy relief scheme in Northern Ireland.**

INTRODUCTION

7.1 The Government is committed to promoting sustainable development, which is vital to ensure a better quality of life for everyone, today and for generations to come. To achieve sustainable development, strong and stable economic growth and social progress must be balanced with action to protect and improve the environment. The Government believes that economic instruments, alongside other policy levers, have an important role to play in securing this objective.

7.2 This approach is consistent with the Government's goal of promoting a productive, flexible economy. Individuals and businesses are able to choose how they respond to the incentives created by environmental taxes and economic instruments. This approach is also in accordance with the polluter pays principle, under which those that pollute more, pay more. As with all policy instruments, environmental economic instruments must be well designed to protect the international competitiveness of UK industry and take account of social objectives.

A strategy for environmental taxes

7.3 The Treasury's approach to environmental taxation was set out in the Statement of Intent on Environmental Taxation in 1997, and developed further in *Tax and the Environment: using economic instruments,* published alongside the 2002 Pre-Budget Report.[1] Sustainable development is now embodied in HM Treasury's aims and objectives, highlighting the greater weight being attached to quality of life and sustainable growth when developing policies.

7.4 The Government has made considerable progress against its environmental objectives, through the introduction of measures such as the climate change levy (CCL), the UK emissions trading scheme, and the aggregates levy, but recognises that there are more opportunities and challenges ahead. This chapter sets out the action the Government is taking to meet these challenges, by tackling climate change and improving air quality, encouraging a clean and efficient transport system, improving waste management and protecting the UK's countryside and natural resources.

TACKLING CLIMATE CHANGE AND IMPROVING AIR QUALITY

Climate change

7.5 There is strong evidence that global temperatures are rising. Average global temperatures have increased by 0.6ºC over the twentieth century and nine of the ten hottest years on record occurred between 1990 and 2003. Studies of temperature trends show that these increases are unlikely to be entirely natural in origin. Temperatures in the UK followed the twentieth century global trend, with annual average temperatures warming by about 1.0ºC. By the end of this century, models predict that average global temperatures will rise by a further 1.4ºC to 5.8ºC and UK temperatures by 2ºC to 3.5ºC. Sea levels are predicted to rise by between 9 and 88 centimetres.

7.6 The impacts of climate change could be wide-ranging and affect many parts of society. Some of the possible impacts of climate change in the UK include: increased weather variability causing damage to infrastructure and leading to transport disruption; reduced reliability of the energy supply; higher costs for building repairs and refurbishment; and increased flooding in many lowland areas due to more frequent river flooding and more severe storm surges.[2]

7.7 The Kyoto Protocol commits the UK to reduce its greenhouse gas emissions to, on average, 12.5 per cent below 1990 levels between 2008 and 2012. The Government also has a national goal to move towards a 20 per cent reduction in carbon dioxide emissions below 1990 levels by 2010. The Energy White Paper, *Our Energy Future – towards a low carbon economy,* sets out long-term strategies and shorter-term policies that aim to put the UK on the path to a reduction in carbon dioxide emissions of some 60 per cent by about 2050, as recommended by the Royal Commission for Environmental Pollution.[3]

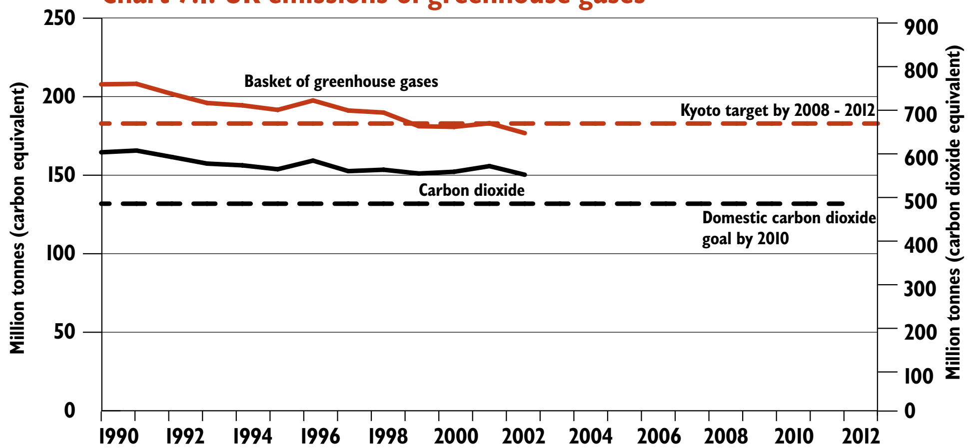
7.8 Chart 7.1 sets out progress against goals on greenhouse gas emissions. Provisional data for 2002 show that UK emissions of greenhouse gases fell by 14.9 per cent between 1990 and 2002, and carbon dioxide emissions fell by 8.7 per cent during this period.

[1] *Tax and the Environment: using economic instruments*, HM Treasury, November 2002.

[2] Full details available in the *UK Climate Change Impacts Programme* at www.ukcip.org.uk/scenarios.

[3] *Our Energy Future – towards a low carbon economy,* Department for Trade and Industry, February 2003.

Chart 7.1: UK emissions of greenhouse gases



Source: National Environmental Technology Centre (NETCEN)
Note: Figures for 2002 are provisional

Air quality

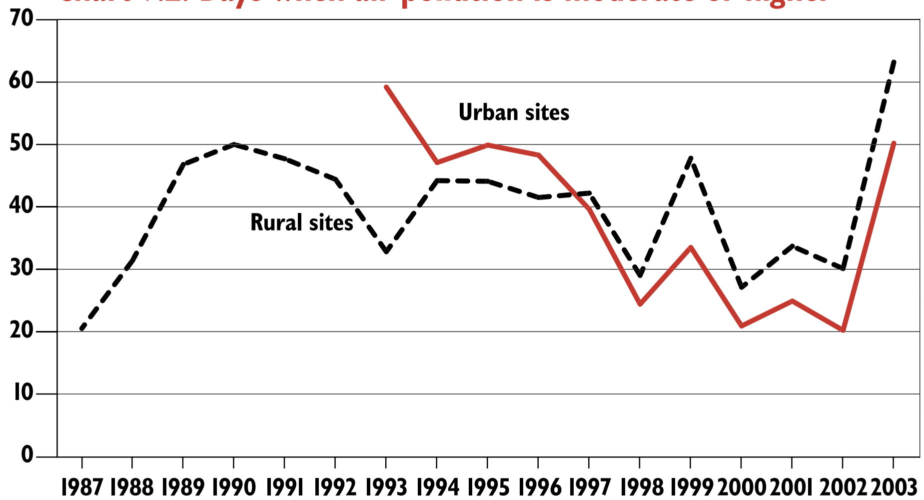
7.9 The Government's and the Devolved Administrations' policies on improving air quality are set out in the Air Quality Strategy for England, Scotland, Wales and Northern Ireland and its first addendum.[4] These strategies set health-based air quality standards for nine key air pollutants and target dates for their achievement across the UK between 2003 and 2010.

7.10 The sources of air pollution are many and varied, ranging from industrial and road transport emissions to domestic and natural sources. As part of the UK's sustainable development strategy, the Government publishes data that shows the number of days when any one of five air pollutants is moderate or higher, and provides a broad view of air quality in the UK. Significant fluctuations in yearly figures can occur, particularly because of differences in weather conditions. Provisional results for 2003 indicate that there were more than twice as many days when air pollution was moderate or higher than in 2002. This was primarily caused by high levels of ozone, produced during last year's hot, sunny summer weather conditions. Chart 7.2 shows the trends at urban and rural sites.

7.11 The Government has more specific targets on concentrations of particular air pollutants in the UK. Initial assessments show that in 2003 the UK achieved the first three objectives for carbon monoxide, benzene and 1,3-butadiene. The Government expects to see significant reductions in these pollutants. However, on the basis of current policy measures, it is unlikely that the Government will meet its targets for nitrogen dioxide and particulates in all parts of the country, particularly in some urban areas including parts of London. In order to tackle these pollution hotspots and achieve further general air quality improvements, the Government is reviewing measures in the Air Quality Strategy and the Ten Year Plan for Transport.

[4] Available at www.defra.gov.uk/environment/airquality.

Chart 7.2: Days when air pollution is moderate or higher



Source: NETCEN
Note: Figures for 2003 are provisional

Economic instruments to improve energy efficiency

7.12 The Energy White Paper placed energy efficiency at the heart of UK energy policy, identifying the efficient use of energy as the most cost-effective way to meet all four of the Government's energy goals – reducing carbon emissions, ensuring security of supply, maintaining competitiveness, and tackling fuel poverty. The Government is committed to putting the UK on a path towards a 60 per cent reduction in carbon dioxide emissions by the middle of the century. Economic instruments such as the CCL, and the forthcoming EU emissions trading scheme (EU ETS), have a key role in this area.

Energy Products Directive

7.13 The Energy Products Directive (EPD) came into force on 1 January 2004 and provides an EU framework for taxation on energy products, increasing the existing minimum rates of duty on hydrocarbon oils and introducing minimum rates of duty for the taxation of other energy products, including electricity, natural gas, coal and other solid fuels. The minimum rates in the EPD do not affect any of the UK's existing rates or exemptions, but will require increases in some other Member States, which will provide environmental benefits across the EU.

Climate change levy

7.14 The CCL and its associated measures seek to encourage businesses to use energy more efficiently and to reduce emissions of carbon dioxide. The levy package is expected to reduce emissions by the equivalent of at least 5 million tonnes of carbon by 2010. It is broadly revenue neutral for business and the service sector, with CCL revenues recycled back to business by means of a 0.3 percentage point reduction in employer national insurance contributions (NICs) introduced at the same time as the levy, and support for energy efficiency and low-carbon technologies via the Carbon Trust. Given business success in delivering on climate change objectives, **Budget 2004 again freezes the rates of the CCL.**

Energy products used to create energy

7.15 Energy products used to create other taxable energy products are generally exempt from the CCL, ensuring such products are not taxed twice. However, the scope of this exemption has fallen behind developments in new biofuels, such as biodiesel. **The Government is therefore extending the exemption to incorporate energy products used to create such new fuels.** Furthermore, to make it easy to provide similar exemptions in the future, provision will be made to enable such exemptions to be introduced by secondary legislation. **In addition, from 1 September 2004, fuel substitutes used in diesel engines to generate electricity will be exempt from hydrocarbon oil duty.**

Negotiated agreements

7.16 The 2003 Pre-Budget Report announced that, subject to further consultation with energy-intensive sectors and EU state aid approval, the Government would extend the current eligibility criteria for climate change agreements (CCAs). CCAs allow energy-intensive sectors to obtain 80 per cent relief from the CCL if they agree to increase energy efficiency and reduce emissions. CCAs have already delivered substantial carbon savings, almost three times more than the original target, and the Government believes that extending the eligibility criteria will deliver more.

7.17 Following consultation, **Budget 2004 announces new eligibility criteria, to be introduced once EU state aid approval is obtained.** Businesses currently eligible for CCAs will remain eligible but, in addition, the Government will extend CCAs to businesses in sectors that pass an energy intensity threshold, and can in some cases demonstrate the existence of international competition issues.

EU emissions trading scheme

7.18 The Government's preparations for the EU ETS, due to be introduced in 2005, are outlined in Box 7.1. The first phase of the EU ETS will regulate carbon dioxide emissions from installations across the EU and will include power generation, mineral oil refineries, offshore installations and other heavy industrial sectors. As announced in the 2003 Pre-Budget Report, sectors with CCAs that choose to opt in to the EU ETS instead will be allowed to retain the 80 per cent relief from CCL, without having to retain their current CCA.

Box 7.1: The EU emissions trading scheme

The first phase of EU ETS will run from 2005 to 2007. The scheme will set a cap on overall emissions from participating installations, which will be divided between these installations. Participants will then be able to buy and sell allowances to meet emissions reduction targets. In January 2004, the Government published for consultation its draft National Allocation Plan, setting out provisional allocations to participating installations over the first phase of the scheme. The Government is now considering responses to the consultation, with the aim of submitting its allocation plan to the European Commission by the end of March 2004.

In the National Allocation Plan, the Government has set an overall emissions cap in line with emission reductions projected from existing policy measures, plus an allowance of 1.5 million tonnes of carbon for the impact of the new EU ETS. On the basis of these projections, the allocation is currently consistent with an overall reduction in UK carbon dioxide emissions of 14 to 15 per cent by the end of the first phase of the EU ETS, and a 16.3 per cent reduction on 1990 levels by 2010. This approach is consistent with the UK's long-term emissions policy goals expressed in the Energy White Paper.

Investment in energy-saving technologies

7.19 Enhanced capital allowances (ECAs) for investments in approved energy-saving technologies were introduced in 2001 and currently cover more than 6,000 approved products. Administration of the ECA scheme is managed by the Carbon Trust, an independent not-for-profit company funded principally from revenues recycled from the CCL. **The Government is committed to the continued development of the scheme, and in 2004, subject to state aid approval, will introduce further ECAs for investments in energy-saving technologies.** Work to define the precise performance standards for these technologies is continuing. The addition of these groups will be worth £5 million during their first full year, 2005-06.

Household energy efficiency

7.20 The Government published a consultation document on economic instruments to promote household energy efficiency in summer 2003, as part of the Energy White Paper programme to promote more efficient use of energy.[5] The 2003 Pre-Budget Report confirmed the Government's view that there is a role for economic instruments to promote domestic energy efficiency, and that further detailed examination would be given to specific measures. Details of the Government's wider strategy for implementing the Energy White Paper is set out in Box 7.2.

Box 7.2: Implementation of the Energy White Paper targets for energy efficiency

The Government's Energy White Paper highlights the key contribution that energy efficiency can make to the Government's energy policy goals, including by reducing carbon emissions, tackling fuel poverty and ensuring security of supply. Meeting the Government's challenging goals requires improving energy efficiency twice as fast in the next twenty years as in the last two or three decades. More than half the emissions reductions needed to achieve the UK's domestic carbon emission targets – around 10 million tonnes of carbon per annum by 2010 – are expected to come from improvements in energy efficiency across the economy. The Government also believes that energy efficiency can contribute around half of the additional 15 to 25 million tonnes of carbon savings that are likely to be needed by 2020 to be on course for the long-term goal of reducing carbon dioxide emissions by some 60 per cent by around 2050.

The Government has introduced a package of policies designed to improve energy efficiency, and will publish an Energy Efficiency Implementation Plan in spring 2004. This will set out a delivery plan for the energy-efficiency strategy in the Energy White Paper. Key elements of this will include:

- **regulatory measures, such as revision of building regulations and an extension of the energy efficiency commitment;**
- **market-based mechanisms including the EU and UK emissions trading schemes;**
- **voluntary measures, including the climate change agreements and manufacturers' voluntary agreements on product standards;**
- **Government leadership on energy efficiency and procurement of energy-efficient buildings and products; and**
- **provision of information, advice and support such as that available from the Carbon and Energy Saving Trusts, and product and building energy labelling.**

7.21 Strong demand for energy-efficient products and services is often lacking, both from the household and business sectors. Economic instruments can provide useful signals, encouraging consumers to purchase such goods, and manufacturers to invest in their production. The Government will continue to negotiate with its European partners to extend the categories of permitted reduced VAT rates to include the purchase of energy-saving materials for DIY installation and energy-efficient products. In the short term these negotiations are unlikely to deliver an opportunity for VAT rates to be used to promote energy efficiency, beyond the existing provisions. However, the Government remains committed to making the fullest use of the reduced VAT rates available in EU law. To encourage the use of energy-saving technologies, **Budget 2004 introduces a reduced rate of VAT for the domestic installation of ground source heat pumps.** On micro-combined heat and power (CHP), the Government is ready to extend its support by introducing a reduced rate of VAT, taking account of the emerging findings of the field trials and will look to introduce this in 2005.

[5] *Economic Instruments to Improve Household Energy Efficiency: consultation document on specific measures,* HM Treasury, August 2003.

7.22 The Government believes that there is a strong case for providing incentives for the private rented sector to improve its energy efficiency, since landlords do not currently benefit from increasing the energy efficiency of their rented properties. **Budget 2004 announces a landlord's energy saving allowance, which provides individual private landlords with up-front relief on capital expenditure for installations of loft and cavity wall insulation in rented accommodation, including first-time installations.**

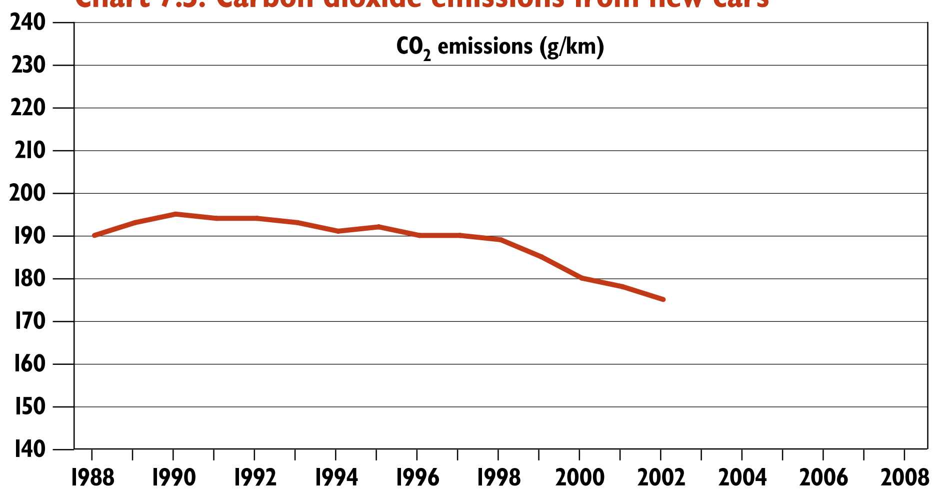
7.23 In addition, the Government will also consider the introduction of a 'green landlord scheme'. This would aim to incentivise landlords to invest, possibly through recognition of properties that achieve a sufficient level of energy efficiency.

A CLEAN AND EFFICIENT TRANSPORT SYSTEM

7.24 The Government believes that a safe, clean and efficient transport system is key to sustaining economic growth, generating higher productivity and safeguarding the environment. The significant increase over recent years in the demand for travel, a result of rising economic activity and incomes, is a challenge to the Government's transport and environmental objectives. The Government has therefore introduced a number of measures to improve the efficiency of the transport system, including support for the take-up of the most efficient fuels and vehicles, and promotion of the development of greener forms of transport and fuels.

7.25 The Government's long-term goal is to support the switch to a low-carbon economy, including zero-emissions transport. Chart 7.3 shows that average carbon dioxide emissions from new cars in the UK have fallen in recent years and are expected to fall further by 2008 with the continued impact of the voluntary agreement between the European Commission and car manufacturers, underpinned by environmentally-focused vehicle taxes.

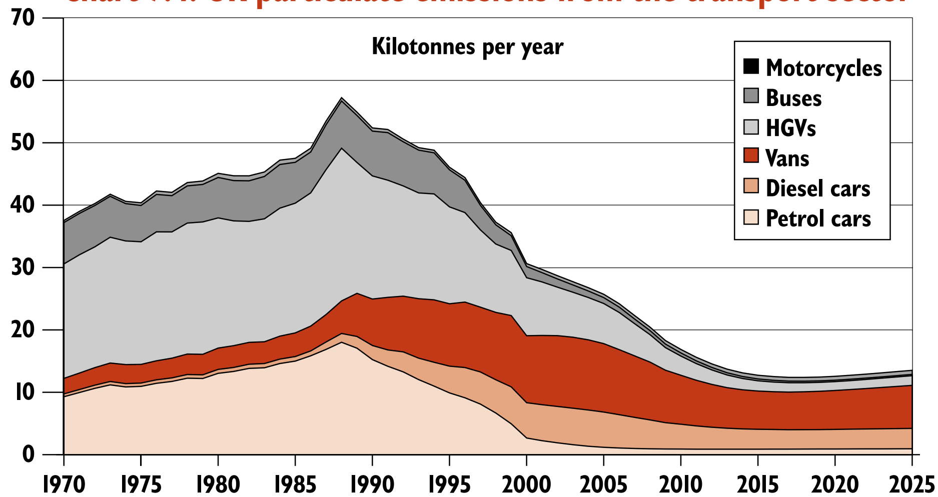
Chart 7.3: Carbon dioxide emissions from new cars



Source: Data from 1995 to 2001 based on DVLA monitoring. Data prior to 1995 estimated from average new car fuel consumption figures. The petrol average new car consumption data from Transport Statistics Great Britian. An equivalent diesel figure was calculated for 1994 at 22 per cent better than petrol fuel consumption. This figure was used for all previous years in this chart, in the absence of other data.

7.26 Progress in reducing the environmental effects of transport has been greatly aided by the introduction of progressively tighter EU standards for new vehicles and fuels, supported by the use of economic instruments and grant support such as the UK's Powershift and Clean-up programmes. Chart 7.4 shows that the combined effect of these policies has been a significant reduction in the overall emissions of key pollutants such as nitrous oxides and particulates. However, further efforts will be needed to ensure that national emissions do not start to rise again, and that further reductions are seen in urban pollution hotspots such as London.

Chart 7.4: UK particulate emissions from the transport sector



Source: NETCEN figures for the National Atmospheric Emissions Inventory (NAEI).
Note: Figures for 2001 onwards are provisional.

Road Transport

Road fuels **7.27** The Government has a long-standing and successful policy of using fuel duty differentials to encourage the take-up of less environmentally damaging fuels. Decisions on marginal fuel duty rates reflect the Government's concern with the environmental, economic and social consequences of increased use of road transport. Budget 2003 announced a deferment of the annual inflation increase of fuel duties in the light of the exceptional volatility of oil prices due to the military conflict in Iraq. The end of the conflict and the reduction in geo-political uncertainty meant that the revalorisation took place on 1 October 2003.

Fuel duties **7.28** The latest technologies for cleaner cars depend on the use of sulphur-free fuels to reduce emissions of carbon dioxide and improve local air quality. The Government has regularly demonstrated its commitment to the introduction of the cleanest road fuels through the use of duty incentives. Continuing this record, Budget 2004 confirms that sulphur-free petrol and diesel will benefit from a 0.5 pence per litre differential relative to the rates for ultra-low sulphur fuels. **Duty rates for sulphur-free fuels will therefore be raised in line with inflation (equivalent to 1.42 pence per litre) from 1 September 2004, with the duty for ultra-low sulphur fuels set at 0.5 pence per litre above this level from the same date.** The Government expects that this differential should lead to sulphur-free fuels becoming the standard specification for road fuels in the UK by the end of the year, well ahead of their mandatory introduction on 1 January 2009. This will bring significant improvements in air quality, and major savings in carbon dioxide, as the new direct-injection vehicle technology is introduced.

Alternative Fuels Framework **7.29** The Government published its *Alternative Fuels Framework* in the 2003 Pre-Budget Report. The framework sets out the rationale for Government support for alternative fuels, placing environmental benefit at its core. In recognition of the importance to investors of providing long-term certainty in the market, the framework also includes an unprecedented Government commitment to a three-year rolling guarantee on the fuel duty differentials for all alternative fuels. This structured approach to support in this area is intended to underpin further investment in the expanding area of alternative fuels.

Biofuels **7.30** Biofuels offer significant environmental benefits in terms of a reduction in the emissions of greenhouse gases and local air quality improvements. They also have the potential to contribute to security of supply and bring agricultural benefits. The introduction of the 20 pence per litre duty differential for biodiesel in July 2002 has led to expanded use of the fuel in the UK over the last two years. It now accounts for more than 25 million litres of fuel sold each year. Building on this, Budget 2004 confirms that:

- as a means of guaranteeing further stability for the sector, **the 20 pence per litre duty incentive in favour of biodiesel will be maintained until at least 2007;**
- as announced in Budget 2003, **a duty incentive of 20 pence per litre for bioethanol will be introduced from 1 January 2005.** In line with the commitment to provide rolling three-year certainty set out in the *Alternative Fuels Framework,* **the differential is also guaranteed to at least 2007;**
- the 2003 Pre-Budget Report announced that the Government was examining the use of input-based taxation to support cleaner fuels. To take this work forward, Budget 2004 announces that **the Government will be staging a series of stakeholder discussions over the summer to examine in detail the implications of input-based taxation for biofuels;** and
- to focus support further on the very best biofuels technologies, **the Government will be discussing with stakeholders the application of ECAs to support investment in the most environmentally beneficial biofuels processing plants, with a view to announcing the outcome at the 2004 Pre-Budget Report.**

7.31 The implications of these fiscal measures and other possible means of support will be included in the Government's draft Biofuels Directive implementation strategy, on which the Department for Transport (DfT) will consult shortly. The consultation will include options on complementary regulatory measures, including the option of a Biofuels Obligation for the transport sector, aimed at meeting the UK's targets for biofuels.

Road fuel gases **7.32** In the 2003 Pre-Budget Report, the Government announced a gradual reduction of the duty differential in favour of liquefied petroleum gas (LPG) over the next three years towards a level commensurate with the environmental benefits of the fuel. In line with its commitment to provide three-year rolling certainty for this and other alternative fuels, **Budget 2004 confirms that the differential for LPG will be reduced by 1 penny per litre in 2004-05, and by a further 1 penny per litre in both 2005-06 and 2006-07. The differential for natural gas (NG) will remain at its current rate, which is equivalent to 41 pence per litre, until 2007.** The Government expects that this high level of support will secure the investment in advanced NG vehicles needed to deliver the significant environmental benefits they produce compared with diesel vehicles.

7.33 The Energy Saving Trust recently reviewed its arrangements for Powershift funding for the next financial year and announced it would be limiting support to the very cleanest LPG vehicles. The Government fully supports this approach and in order to give further focus on the development of the market on those LPG and NG vehicles that offer the best environmental performance, the Government will be examining other means of incentivisation, including simplification of discounts for company car tax. Further details of these incentives will be announced at the 2004 Pre-Budget Report, with a view to implementation from Budget 2005. Box 7.3 provides details of the Government's recent consultation on future road fuel gases policy.

Box 7.3: Road fuel gases

In 1997, the Government increased the level of incentive for road fuel gases to encourage take-up of liquefied petroleum gas (LPG) and natural gas (NG) vehicles, which offer significant environmental benefits over conventional vehicles. The market has expanded rapidly since then, and more than 100,000 LPG vehicles and 1,400 LPG filling stations now operate in the UK. This has involved significant investment by industry, supported by the Government's use of economic instruments. The recent Government consultation on future road fuel gases policy acknowledged the success of the programme.[a] However, the sector still faces a number of challenges, including:

- **a tougher market for LPG, as competition from more efficient and cleaner conventional cars becomes more intense. For example, a 2005 diesel car will emit approximately 58 per cent less nitrogen oxide and 68 per cent less particulates than one built in 1997;**
- **poor quality conversions, which mean that a minority of LPG conversions on the road have poorer emissions than the original vehicle;**
- **delays in introducing the cleanest optimised mono-fuel vehicles onto the road. Motor manufacturers are already offering dedicated mono-fuel vehicles in other parts of the world, yet no vehicles are available in the UK despite a generous and long-standing duty incentive; and**
- **continued dependence of the market on excessive levels of Government subsidy, which are not commensurate with the environmental benefits. The UK will continue to have the highest level of fuel duty incentive for LPG in the world, and this will not be sustainable in the longer term.**

Both the LPG and NG sectors must meet these challenges if the fuels are to continue to provide cost-effective environmental advantages over conventional fuels and justify continuing government support. The UK's position as a leading centre of expertise in LPG engineering and growing consumer confidence in NG vehicles means it is well placed to do this. However, sustained effort from the industry will be needed to justify the Government's continuing commitment to the sector.

[a] *Road Fuel Gases and their Contribution to Clean Low-carbon Transport,* Department for Transport, HM Treasury and HM Customs and Excise, June 2003, available at www.dft.gov.uk.

Hydrogen

7.34 The Energy White Paper announced that the Government would undertake an assessment of the overall energy implications of a hydrogen economy and large-scale biomass-based fuels. This assessment is now in progress, and a website is in place to provide information and updates, and enable open access for comment and input into the assessment.[6] In addition, three first-generation hydrogen fuel-cell buses, which emit only pure water vapour, were introduced on a trial basis to the London bus network from January 2004. This pilot project, which also involves nine other European cities, will improve understanding of how the technology performs in urban settings.

Rebated oils

7.35 In July 2003, HM Customs and Excise published a consultation document, *Duty differentials for more environmentally friendly rebated oils,* which examines whether preferential duty rates for rebated oils with a lower sulphur content would deliver worthwhile environmental benefits.[7] Initial work suggested that there would be measurable environmental benefits from the introduction of low sulphur rebated oils in certain locations. Further discussion with the oil industry has highlighted the question of whether a differential alone would deliver these benefits or whether this should be coupled with regulatory

[6] Available at www.dti.gov.uk.

[7] *Duty differentials for more environmentally friendly rebated oils*, HM Customs and Excise, July 2003.

changes. The Government will therefore examine the measures that may be needed to deliver the potential environmental benefits offered by these fuels and to consider these in light of other policies, such as the UK Oils Strategy, with the intention of making an announcement about duty differentials in the 2004 Pre-Budget Report.

7.36 **Budget 2004 increases the duty on red diesel and fuel oil by 2.42 pence per litre from 1 September 2004.** This reduces the differential between rebated oils and the main road fuels by 1 penny per litre to 40.88 pence per litre, and supports the strategic approach for reducing oils fraud, described in Chapter 5.

Vehicle excise duty

7.37 The Government has introduced a series of reforms to vehicle excise duty (VED) to provide motorists with incentives to choose more environmentally-friendly vehicles and to continue the shift towards taxing vehicle usage rather than ownership. VED for cars first registered from March 2001 is based on the car's carbon dioxide emissions and fuel type. This has offered motorists the opportunity to reduce their VED by up to £95 a year by choosing less polluting cars. **Budget 2004 freezes the VED rates for all cars, vans, lorries and motorcycles.**

Company car tax

7.38 The Government continues to evaluate the carbon dioxide-based company car tax system, introduced in April 2002, to gauge its impact on consumer behaviour. The results of this initial evaluation show that the system has been successful in reducing business mileage and lower carbon dioxide emissions as a result of more fuel efficient cars, despite continued economic growth since its introduction. The initial evaluation report will be published shortly.

7.39 Following three years of increases in the rates, **the level of emissions qualifying for the minimum charge in 2006-7 will be frozen at 140 grams per kilometre.** This will give the Government further time for the behavioural impact of the system to be evaluated while providing motorists and company fleet managers with future certainty about rates.

Company car fuel

7.40 The tax system for company car fuel was reformed in April 2003 to follow the emissions basis of the company car tax system. The company car fuel benefit charge applies the same percentage as the company car charge against a set figure. In 2003-04 the figure was set at £14,400, and to allow the new system to settle, **Budget 2004 announces that this figure will be frozen for 2004-05.**

Company vans

7.41 Budget 2003 announced that the Government would consult on possible reform of the tax treatment of the private use of vans provided by employers. The consultation invited responses on simplification of shared van calculations and the use of environmentally-friendly vehicles, while taking into account fairness and modern working practices. **Budget 2004 announces a major deregulation of the employer-provided van tax rules – taking 85 per cent of those who currently pay a charge out of the system.** From 6 April 2005, a nil charge will apply to employees who have to take their van home and are not allowed other private use, and as a transitional measure, the benefit in kind charge of £500 (and £350 for older vans) will be continued for all vans where private use is unrestricted. From 6 April 2007, the scale charge for unrestricted use will be set at £3,000 with a £500 charge for employer-provided fuel. Under these new rules, basic rate tax-payers who choose to have unlimited private use of their vehicles will pay 22 per cent of £3,000, equal to £660 benefit in kind taxation from 2007. These changes do not apply to self-employed van drivers.

Emergency vehicles

7.42 Emergency service workers are often required to take their vehicles home at night so they can respond quickly to emergencies. The current rules on employees' home-to-work travel mean that there is a tax and NICs charge on this. **Budget 2004 announces that, with effect from 6 April, this charge will be removed where there is an operational requirement for emergency vehicles to be kept at home.**

Road haulage modernisation fund

7.43 The 2000 Pre-Budget Report and Budget 2002 announced a new three-year, £100 million road haulage modernisation fund (RHMF) as part of a package that included substantial reductions in VED for lorries and a freeze in fuel duties. In England, a programme of RHMF projects has been developed through the road haulage forum, and has helped industry to adopt best practice in safe and fuel-efficient driving and efficient operations, and to adapt vehicles to make them cleaner. The fund has also supported a training programme and other projects to address recruitment and retention issues. The devolved administrations undertook their own work on a fund. For example, a Scottish RHMF has been established and funded by the Scottish Executive. This has delivered grants to hauliers to enable them to make use of fuel-efficient technology and has helped fund the development and provision of training schemes aimed at tackling the skills shortage and recruitment problems faced by the Scottish haulage industry.

7.44 The three-year period of the fund has now elapsed. However, the Government is keen to allow worthwhile RHMF projects to continue, including the programme to promote safe and fuel-efficient driving, and the programme to encourage more fuel-efficient operations. The Department for Transport will be allocating a small budget to these in 2004-05, enabling more of the haulage industry to benefit from using the most up to date and efficient practices.

Lorry road-user charging

7.45 Road haulage plays an important role in a productive economy. The Government believes that all hauliers using UK roads should make a fair contribution towards the costs they impose, and significant steps have been made on the development of a distance-based lorry road-user charge. The Government recognises that some hauliers are already making a contribution to these costs, through VED and the purchase of fuel in the UK. To ensure that all hauliers pay towards the costs they impose on UK roads, the Government announced in the second progress report, published in May 2003, that it would be implementing a distance-based lorry road-user charge and that offsetting tax cuts would be made through a reduction in fuel duty.[8]

7.46 The Government has been working to refine the requirements of the charge. It is doing so in detailed discussions with the haulage sector and other industry representatives, and drawing on the experience of lorry road-user charging schemes in Switzerland, Austria and Germany. The Government has also taken account of and influenced developments in European legislation. **A third progress report is published today alongside the Budget.**[9] The report marks the move of the scheme into the procurement phase, and reaches the following conclusions on the technical workings of the scheme:

- that the fuel duty repayments should be via a repayment scheme that is linked to either fuel cards or a separate smart card to give protection against fraud;
- that beyond a certain mileage threshold it would be mandatory to install an electronic on-board unit;
- that the preferred approach to an occasional user scheme, for vehicles that do relatively few miles in the UK, is one that uses a low-specification electronic box rather than the paper-based ticketing system adopted in Germany; and
- that procurement is likely to be through three separate contracts, comprising central services and systems, on-board equipment and evidence, and capture and validation.

7.47 In determining the way forward on procurement and implementation, the experiences and lessons from other countries, including the recent problems in Germany, have been taken on board. The Government agrees with other stakeholders that the key determinant for planning should be successful implementation, rather than the fastest possible introduction. The

[8] *Modernising the Taxation of the Haulage Industry – lorry road-user charge: progress report two*, HM Treasury, May 2003.
[9] *Modernising the Taxation of the Haulage Industry – lorry road-user charge: progress report three*, HM Treasury, March 2004.

Government has therefore concluded that the project timetable must include a comprehensive testing phase with thorough monitoring of how the systems are operating and whether objectives are being met. These pilots will take place throughout 2006 and will mean that the roll out of technology occurs in 2007, with the charge coming into force in early 2008, and a phased introduction over two to three years, starting with the largest lorries. The Government will launch the procurement process with a Prior Indicative Notice in the next two months, formal advertising in the EU journal and a supplier open day in spring 2004. In taking forward procurement, the scheme will need to pass the final business case and Office for Government Commerce gateway reviews, and demonstrate that it is delivering value for money with robust delivery plans.

National road-user charging

7.48 The Department for Transport is currently leading a feasibility study into the practical options for the design and implementation of a new system to tackle congestion through road-user charging. The experience of the London Congestion Charge shows that a successful charging scheme can be implemented with a reduction in traffic level and congestion, and increased use of alternatives modes of transport. The Government's approach is underpinned by the key principles that any new charging system should:

- deliver a more efficient approach to the structure of transport pricing;
- be fair, respect privacy and promote social inclusion and accessibility;
- deliver higher economic growth and productivity for all regions of the UK; and
- deliver environmental benefits.

7.49 The study will consider whether a wider application of road charging to vehicles is practical and satisfies these four principles.

Bus subsidies

7.50 A review of bus subsidies was announced in Budget 2002 to consider how best to use the annual support for local bus services in England of over £1 billion, to achieve the Government's objectives of growth in bus use, a modal shift from cars to buses, and improved bus service quality, accessibility and reliability. The Government believes that buses have a crucial role to play in delivering its transport and environmental objectives. Improved bus services will also help to boost productivity by helping to tackle congestion, increase labour market flexibility and widen employment opportunities. The Government is undertaking this work as part of its wider review of transport, with the aim of ensuring that public funding delivers the best possible local bus services that meet the needs of local people and communities, and targets the Government's transport objectives as effectively as possible.

Aviation

Air Transport White Paper

7.51 UK air travel has increased fivefold over the last 30 years and is expected to continue growing over the next few years. The economic and social benefits of air travel come alongside significant costs to the environment. Reflecting this, the Government's Air Transport White Paper announced a number of new measures aimed at reducing the impact of aviation on the environment:

- increased use of scale charges for noise and local air quality;
- expanded noise compensation and mitigation schemes; and
- initiation of negotiations to include aviation in the European emissions trading scheme.[10]

[10] *The Future of Air Transport*, Department for Transport, December 2003.

7.52 Inclusion of aviation in the second phase of the EU ETS is one of the key priorities for the UK's European Presidency in 2005. Ahead of this, discussions have already been held with the European Commission and Member States. The UK will intensify these discussions over the coming months.

7.53 The Government will also continue to explore the role of further economic instruments. Discussions with stakeholders following publication in March 2003 of the Government's paper, *Aviation and the Environment: using economic instruments*, identified international legislation, particularly in the EU, as a key constraint in the design of effective economic instruments designed to improve the environmental performance of the aviation sector.[11] The Government will therefore discuss with the European Commission options for introducing greater flexibility in European legislation regarding the application of economic instruments to aviation.

Air passenger duty

7.54 Although there are positive signs of growth, the UK aviation sector is still recovering from the demand shocks of the events of 11 September 2001 and absorbing the cost of increased security measures. **Budget 2004 therefore freezes the rates for air passenger duty for this year.**

IMPROVING WASTE MANAGEMENT

7.55 Efficient use of resources and the effective management of waste are essential features of an environmentally sustainable economy. The most effective way of dealing with waste is by ensuring that less is created. The 2002 World Summit on Sustainable Development committed the international community to promote a 10-year framework in support of sustainable patterns of consumption and production. In September 2003, the Government announced its desire to break the link between economic growth and environmental pollution, by improving resource efficiency and examining the environmental life-cycle of a product.

7.56 The Government will shortly be publishing the independent review of the evidence on the health and environmental effects of waste management options, commissioned after the 2002 Pre-Budget Report. This review will to help inform policy development and the wider debate on waste management. In the meantime, the Government is encouraging a shift away from landfill through policies such as increases in the standard rate of landfill tax and the landfill allowance trading scheme, due to be introduced in 2005.

Landfill tax

7.57 The landfill tax encourages efforts to minimise the amount of waste generated and to develop more sustainable waste management techniques. It contributes to the achievement of the Government's waste strategy targets through the diversion of waste away from landfill. Total waste received at landfill sites registered for landfill tax fell by 16 per cent in the period from 1997-98 to 2002-03. In line with the five-year escalator announced in 1999, **the standard rate will increase by £1 per tonne to £15 per tonne on 1 April 2004.** As announced in Budget 2003, this rate will then be increased by £3 per tonne in 2005-06, and by at least £3 per tonne in the following years to reach a medium- to long-term rate of £35 per tonne. **The lower rate of landfill tax will remain at £2 per tonne.**

Recycling landfill tax to business

7.58 Budget 2003 announced that increases in the standard rate of landfill tax would be introduced in a way that is revenue neutral to business as a whole and to local government. Since the 2003 Pre-Budget Report, the Government has published research on the recycling options and has consulted stakeholders on these.[12] A number of options are now undergoing a more detailed examination, and consultations with stakeholders are continuing.

[11] *Aviation and the Environment: using economic instruments*, Department for Transport, March 2003.

[12] *An Assessment of Options for Recycling Landfill Tax Revenue*, HM Treasury, February 2004, available at www.hm-treasury.gov.uk.

Landfill tax credit scheme

7.59 The landfill tax credit scheme will be revalorised. **For 2004-05, this represents an increase to £48.3 million.** Since the reforms announced last year, further work on streamlining the scheme has been continuing, and will be completed shortly. These changes have allowed better monitoring and evaluation of the scheme, and improved its overall performance.

Improving local waste management

7.60 In August 2003, the Government announced that a new local authority Waste Management Performance Fund would be introduced in England in 2005-06. In its first year, the Performance Fund will run in parallel with the Waste Minimisation and Recycling Challenge Fund, and will have £45 million available to reward good management performance, rising to £90 million in 2006-07. This will provide incentives for local authorities to improve their waste management performance through high rates of recycling and composting of household waste. The Government launched its consultation on the detailed design of the Waste Management Performance Fund in January 2004. The consultation will end on 31 March 2004.

PROTECTING THE UK'S COUNTRYSIDE AND NATURAL RESOURCES

7.61 Sustainable development requires that economic growth is not pursued at the expense of the environment, but works to protect and preserve it, while supporting economically and socially stable communities. The Government is committed to ensuring that the UK's natural resources are used efficiently and responsibly.

Aggregate extraction

Aggregates levy

7.62 The extraction of aggregates imposes a range of environmental costs. Introduced in April 2002, the aggregates levy seeks to incorporate these costs into the price of virgin aggregate and encourages the use of alternative materials, such as wastes from construction and demolition that would otherwise be disposed of in landfill. It also promotes greater efficiency in the use of virgin aggregate. In the light of independent research, the levy was initially set at a rate of £1.60 per tonne on virgin aggregate commercially exploited in the UK. **Budget 2004 again freezes this rate.** Revenue from the aggregates levy is recycled to businesses through a cut in employer NICs, and through the aggregates levy sustainability fund, which supports projects seeking to minimise the impact of quarrying on local communities. As announced in the 2003 Pre-Budget Report, the sustainability fund will continue with its present level of funding for a further three years.

7.63 Early indications are that the levy is achieving its objectives. The production of virgin aggregate has decreased by 5.7 per cent between 2001 and 2002, with construction companies using more construction and demolition waste rather than sending it to waste disposal sites, and some substitution of primary aggregate with recycled or secondary aggregate products taking place. The Government continues to monitor the impact of the levy to ensure that it is achieving its objectives, and will continue to discuss with the aggregate and construction industries their concerns about the impact of the levy.

Northern Ireland relief scheme

7.64 It is now clear that in Northern Ireland the levy as currently structured is not achieving its environmental objectives. In order to enhance the environmental impact of the levy there, the Government is currently seeking EU state aid approval to extend the scope and length of the current relief that applies on aggregate used in processed products in the Province, so that it would cover virgin aggregates as well. It would be fixed at the current level of 80 per cent of the full rate until 31 March 2012. In order to benefit from the extended relief, aggregate businesses in Northern Ireland will have to agree to implement environmental improvements to their operations. These improvements will be regularly monitored and reviewed. **Following discussions with stakeholders, the Government is today publishing details of how the new relief scheme will operate, subject to EU state aid approval.**

Agriculture

7.65 Over 75 per cent of land in the UK is used for agricultural purposes, so farming practices have a significant impact on the UK's environmental performance. Good agricultural practice can help preserve and improve the natural environment. However, agriculture is also the potential source of a range of environmental problems, including water pollution from the use of fertilisers and pesticides and the impact of methane and carbon dioxide emissions on climate change.

7.66 The Government believes that the June 2003 reforms of the Common Agricultural Policy (CAP) could go some way to mitigating some of the negative environmental impacts associated with agriculture. Furthermore, the Government will be seeking EU approval for the entry level agri-environment scheme to be rolled out across England in 2005, following a positive assessment of the four pilots.

7.67 However, the Government believes that it may be necessary to do more to tackle the environmental impacts of agriculture. Recent improvements in the biological and chemical quality of the UK's rivers are showing signs of levelling off, and further action is needed to address the quality of the UK's rivers, lakes and groundwater. In particular, more action is required to address diffuse pollution from agriculture and other sources.

Diffuse water pollution

7.68 The Government has been considering the scope for using economic instruments to address the most pressing environmental issues associated with agriculture. In April 2003, the Department for Environment, Food and Rural Affairs (DEFRA) published a discussion paper on tackling diffuse water pollution.[13] As announced in the 2003 Pre-Budget Report, the Government will shortly consult on the use of policy instruments to reduce levels of diffuse water pollution, including consideration of the possible use of economic instruments in achieving this aim.

Pesticides

7.69 An industry voluntary initiative on measures to reduce the environmental damage caused by the agricultural use of pesticides has been in place since April 2001. This voluntary initiative has been developed through active participation by all the stakeholders, and is showing good progress against objectives, surpassing many of the initial key targets. To cover the potential case that the voluntary initiative might fail to deliver the required environmental benefits within a reasonable timescale, the Government has continued to keep the options for a tax or economic instrument under review and will publish further technical research on options.

7.70 The Government continues to believe that, if fully implemented, the voluntary initiative is the most effective way of reducing the environmental pollution associated with pesticides. The Government is keen to build on the good progress to date and ensure that the targets specified by the voluntary initiative are challenging and rigorous. The more that specific targets can be directly related to their environmental and biodiversity impact, the more the success of the initiative can be demonstrated. Work has also been taken forward in consultation with stakeholders on developing a national plan for pesticides, of which the voluntary initiative will be a central element.

Water

7.71 In 2003, the Government introduced 100 per cent first-year enhanced capital allowances (ECAs) for business investments in qualifying water efficiency technologies. The scheme currently supports five technologies. **The Government is committed to the continued development of the scheme, and will introduce further ECAs for rainwater harvesting equipment in 2004.**

[13] *Strategic Review of Diffuse Water Pollution from Agriculture: Discussion Document*, Department for Environment, Food and Rural Affairs, April 2003.

Sustainable land use

Sustainable housing

7.72 The Government's approach to creating and maintaining sustainable communities is discussed in Chapter 3. The Government's strategy places key housing, planning and regeneration policies in the context of wider requirements for sustainable communities including employment, quality public services, transport, a safe and healthy local environment, and sound local government.

7.73 The final report of the Barker Review of the factors affecting housing supply is published today and is discussed in Chapter 3. The Review recognises the need for housing policy to balance the environmental and social implications of housing development against the risks to macroeconomic stability and long-term affordability of not delivering a substantial increase in housing supply. The Review recommends a Planning-gain Supplement to fund a package of measures to boost housing supply, and also create a stronger incentive to re-use brownfield land relative to greenfield development. The Government accepts the need for reform to improve housing supply and intends to implement a programme of change as recommended in the Review.

Contaminated land tax credit

7.74 As part of a package of measures to promote urban regeneration, Budget 2001 introduced the contaminated land tax credit to provide business with incentives to clean up land rendered unusable. Early indications suggest that it is achieving its environmental goals. As announced in the 2003 Pre-Budget Report, the Government is looking to extend this credit to land that is long-term derelict, as recommended by the Barker Review. The Government continues to examine the effectiveness of this proposal, and will take into consideration the planned evaluation of the contaminated land tax credit.

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

7.75 The Government is committed to appraising the environmental impact of Budget measures, and aims to ensure that policy design, appraisal and evaluation take account of costs and benefits, the precautionary principle and the need to internalise costs by making the polluter pay. The Government constantly monitors the environmental impact of its policies to ensure they achieve their desired effect. In addition, this year formal evaluations will be carried out on the energy-saving ECA scheme, the contaminated land tax credit, and company car tax.

7.76 Table 7.1 shows how Budget measures sit alongside other policies as part of the Government's approach to the environmental elements of sustainable development. Table 7.2 sets out the environmental impact of measures introduced in recent Budgets that have a significant effect on the environment or which serve an environmental purpose. To increase transparency and public reporting of key performance indicators, the environmental appraisal tables are also available on the Treasury website. The tables will be updated regularly to reflect ongoing monitoring of environmental indicators and further evaluation of specific schemes.

Table 7.1: The Government's policy objectives and Budget measures

Policy objective	Sustainable development indicator and recent trend data[1]	Recent Government measures
Tackling climate change and improving air quality.	*Emissions of greenhouse gases* UK greenhouse gas emissions were provisionally 14.9 per cent below 1990 levels in 2002.[2] *Days when air pollution is moderate or higher* Provisional results show that the number of days with moderate or higher air pollution increased from 20 to 50 in urban areas and from 30 to 63 in rural areas between 2002 and 2003.[3] *Road traffic* Between 1998 and 2003, total motorised traffic volume rose by 7.2 per cent, however, road traffic intensity (vehicle kilometres per GDP) fell by 4.3 per cent between 1998 and 2003.[4]	*Government measures* • Climate change programme, DETR, November 2000. • UK emissions trading scheme, DEFRA, August 2001. • Energy efficiency commitment, DEFRA, April 2002. • Renewables Obligation, DEFRA, April 2002. • Air Quality Strategy, DETR, January 2000, and Addendum, DEFRA, February 2003, and review, DEFRA, 2003-04. • Implementation of Integrated Pollution, Prevention Control regime, DEFRA, 2002. • Continued support for local air quality management system. • Negotiation and implementation of EU air quality directives and international agreements, 2003-04. • Ten Year Plan for Transport, DETR, July 2000, and review, DfT, 2003-04. • Powering Future Vehicles, DfT et al, July 2002. • Air Transport White Paper DfT, December 2003. *Specific Budget measures* • Climate change levy (CCL) package. • Green Technology Challenge. • Road fuel duty and differentials. • Company car tax and fuel scale charge reform, and authorised mileage allowance payments. • Landlord's energy saving allowance.
Improving waste management.	*Household waste, all waste arisings and management* Household waste increased from 22.5 million tonnes in 1996-97 to 25.6 million tonnes in 2001-02. However, over the same period the proportion of household waste being recycled increased from 7.5 per cent to 12.4 per cent. The recycling rate for 2002-03 was 14.9 per cent.[5]	*Government measures* • Waste Strategy 2000, DETR, May 2000. • Waste Implementation Programme, DEFRA, 2002. • Waste Management Performance Fund. *Specific Budget measures* • Landfill tax and landfill tax credit scheme.
Regenerating Britain's towns and cities.	*New homes built on previously developed land* In 2002, 64 per cent of new housing was on previously developed land, increasing from around 54 per cent in the early 1990s.[6]	*Other Government measures* • Urban White Paper, DETR, November 2000. • Package of measures to tackle abandoned vehicles. *Specific Budget measures* • Capital allowances for flats over shops. • Contaminated land tax credit. • Stamp duty exemption for disadvantaged areas. • VAT relief for residential conversions.
Protecting the UK's countryside and natural resources.	*Populations of wild birds* The decline in farmland birds, the number of which has almost halved since 1977, levelled off in 1997. Since 1998, the number of farmland birds has increased by 5 per cent. In 2000, woodland birds increased to their highest level since 1990, but have since fallen, and are 3 per cent lower than in 1998. *Chemical river quality and biological river quality* In 2002, about 95 per cent of rivers in the UK were rated as having good or fair chemical quality and approximately 95 per cent of UK rivers were of good or fair biological quality.[7]	*Government measures* • Regulations transposing the Water Framework Directive came into force 2 January 2004. • Rural White Paper, DETR, November 2000. • Strategy for Sustainable Farming and Food, DEFRA, December 2002. *Specific Budget measures* • Aggregates levy and aggregates levy sustainability fund. • Pesticides voluntary initiative.

[1] *Achieving a Better Quality of Life, DEFRA, January 2002 – latest data from www.sustainable-development.gov.uk.*
[2] *The six main greenhouse gases are: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perflourocarbons and sulphur hexaflouride.*
[3] *Air quality headline indicator for sustainable development: 2003, DEFRA (provisional figures).*
[4] *Provisional data from DfT.*
[5] *Municipal Waste Management Survey, 2001-02, DEFRA, and DEFRA news release 18 December 2003. As the headline waste sustainable development indicator has not yet been updated this currently relates to the core indicator on household waste.*
[6] *The figure for 2002 is provisional.*
[7] *New measures of water quality will be needed under the EU Water Framework Directive; the Environment Agency is currently characterising water bodies to help establish these.*

Table 7.2: The environmental impacts of Budget measures

Budget measure	Environmental impact[1]
Climate change levy package.	Savings of at least 5 MtC per year by 2010.[2]
Landlord's energy saving allowance.	Reductions of carbon dioxide emissions.
Road fuel duty.[3]	Increases of 0.5 pence above inflation lead to a small reduction in carbon dioxide emissions and local air pollutants in the UK. Furthermore, the duty differential for sulphur-free fuels will lead to a significant reduction in local air pollutants and a medium term reduction in carbon dioxide emissions. The shift to ultra-low sulphur petrol from ordinary unleaded is estimated to have reduced nitrogen oxide emissions by 4 per cent and emissions of volatile organic compounds by 1 per cent per year between 2001 and 2004. The shift to ultra-low sulphur diesel from ordinary diesel is estimated to have reduced emissions of particulates by 8 per cent and nitrogen oxides by up to 1 per cent per year between 2001 and 2004. The increased use of biodiesel and bioethanol will help reduce carbon dioxide emissions. The road fuel gas differential results in a reduction in emissions of particulates and nitrogen oxides.
Company car tax reform.	Estimated carbon dioxide emissions savings of 0.15 to 0.2 MtC in 2003. In the long run it is forecast that carbon dioxide savings will be between 0.5 and 1 MtC per year.[4]
Employer-provided van benefit.	Simplification of legislation for shared vans will remove the incentive to drive older, more polluting, vans with resulting air quality benefits.
Fuel scale charges.	The programme of increases over five years in the fuel scale charge between 1997-98 and 2002-03 is estimated to have reduced the number of drivers in receipt of free fuel by around 300,000.[4] It is expected that the programme has reduced carbon dioxide and local air pollutant emissions due to fewer private miles travelled where fuel has been paid for by drivers and not their employers. Restructure of the fuel scale charge in 2003 to relate it to carbon dioxide emissions and to include the same discounts and premiums as in the company car tax system will further reduce emissions of carbon.
Air passenger duty (APD) rates.	The freeze in rates will lead to a small increase in emissions of carbon dioxide and local air pollutants.
Landfill tax.	Encourages waste producers and the waste management industry to switch away from landfill disposal towards waste minimisation, re-use and other waste management options.
Landfill tax credit scheme.	A scheme supporting local community and environmental projects in the vicinity of landfill sites.
Aggregates levy and aggregates levy sustainability fund.	Reductions in noise and vibration, dust and other emissions to air, visual intrusion, loss of amenity and damage to wildlife habitats.
Capital allowance for flats over shops.	Bringing empty space over shops back into the residential market, helping to create greater urban diversity while reducing the pressure for new greenfield development.
Contaminated land tax credit.	Bringing forward remediation of contaminated land.
Stamp duty exemption for disadvantaged areas.	Regeneration and improved functioning of property markets in the UK's most disadvantaged areas.
VAT relief for residential conversions.	Reduced pressure on greenfield site development due to the better use of existing buildings.

[1] *These estimates are subject to a wide margin of error.*
[2] *Based on the DTI energy model. There are a number of difficulties involved in estimating the emissions savings from the individual components of the climate change levy, including the need to avoid double counting. Of the 5 MtC (million tonnes of carbon) per year by 2010, the levy and exemptions account for 2.0 MtC, the negotiated agreements account for 2.5 MtC and energy efficiency measures account for 0.5 MtC. A related measure, the emissions trading scheme, involves 31 direct participants who have undertaken binding commitments to deliver emissions reductions of 1.1 MtC by 2006.*
[3] *Using NETCEN emissions models – further detail on the methodology used is provided in NETCEN's January 2000 report, UK Road Transport Emissions Projections.*
[4] *Based on Inland Revenue modelling.*

A ILLUSTRATIVE LONG-TERM FISCAL PROJECTIONS

To safeguard long-term economic growth and ensure inter-generational fairness it is important that Budget decisions are consistent with long-term sustainability of the public finances. The illustrative long-term fiscal projections presented in this annex provide an assessment of the long-term sustainability of the Government's fiscal policies over the period up to 2033-34, in line with the requirements of the *Code for fiscal stability*.[1] The key points are:

- **as a result of recent increases in life expectancy, the population is now projected to age more rapidly than previously;**
- **the Government remains well-placed to deal with potential future spending pressures due to ageing and other factors;**
- **given the projected profile for tax revenue and transfers, current public consumption can grow at around assumed GDP growth after the medium term while meeting the Government's golden rule; and**
- **public sector net investment can grow more or less in line with the economy without jeopardising the sustainable investment rule.**

This conclusion concurs with the findings of the 2003 *Long-term public finance report*,[2] which provides a more detailed examination of the long-term public finances. The report found that, on a range of assumptions and using a number of techniques, the UK's fiscal position is sustainable in the long term on the basis of current policies, and that the UK is in a strong position relative to many other developed countries to face the challenges ahead. However, the Government remains vigilant to future risks and is not complacent about the long-term challenges posed by an ageing population, and it will continue to update and report on its assessments of long-term fiscal sustainability.

INTRODUCTION

A.1 The Government's fiscal policy framework, as set out in the *Code for fiscal stability*, is designed to ensure transparent, long-term decision-making. Fiscal policy is set to ensure sustainable public finances, with consideration to the short, medium and long term. Long-term fiscal sustainability helps to promote long-term economic growth by ensuring that financial burdens are not shifted to future generations.

Illustrative long-term fiscal projections

A.2 To assess the sustainability and inter-generational impact of fiscal policy, the Code requires the Government to publish illustrative long-term fiscal projections covering a period of at least 10 years. In practice, a 30-year horizon has been adopted. The projections published in Budgets between 1999 and 2003 showed that the UK's long-term fiscal position was relatively favourable and that, as a result, current consumption could grow at a faster rate than projected economic growth without jeopardising the two fiscal rules – the golden rule and the sustainable investment rule.[3]

[1] *Code for fiscal stability*, HM Treasury, March 1998.

[2] 2003 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003.

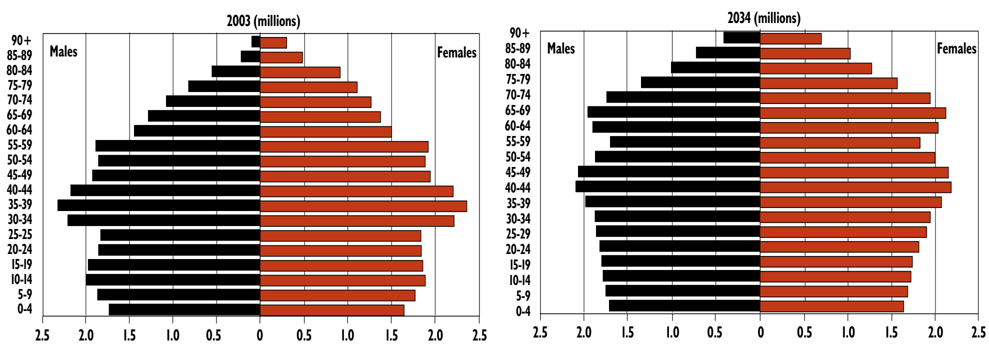
[3] See Chapter 2 for more details.

A.3 To complement and enhance the illustrative projections, an updated and refined *Long-term public finance report* was published alongside the 2003 Pre-Budget Report. The report examined a number of long-term challenges to the public finances and updated the illustrative long-term projections provided in Budget 2003. The projections set out in this annex provide a further update, incorporating the Budget 2004 medium-term spending and revenue projections. The underlying assumptions and the methodology used remain broadly unchanged from previous years.

DEMOGRAPHIC TRENDS

A.4 Declining fertility rates and improvements in life expectancy over the past decades have led to a general ageing of the population in the UK, and throughout the EU and Organisation for Economic Cooperation and Development (OECD) countries. Since the 2003 Pre-Budget Report the Government Actuary's Department (GAD) has published its latest set of population projections for the UK, based on the Office for National Statistics' mid-year 2002 population estimates. The new projections show a marked increase in the number of older people in the future compared to previous projections, primarily as a result of an increase in the life expectancy assumption. A male born in 2027 is now expected to live to just over 80 years, four years more than one born in 2002 and an increase of 1½ years over previous projections. A female born in 2027 can expect to live to just under 85 years, over four years more than one born in 2002 and an increase of 1.3 years over previous projections. The fertility and migration assumptions have remained broadly unchanged, with the long-term fertility rate assumed to be 1.74 children per woman and long-term annual net migration assumed to be 103,000. As a result, the number of children and the size of the working-age population are similar to those in previous projections. Chart A.1 shows the population pyramids for 2003 and 2034. The new population projections make it even more important that current policy takes into account the long-term sustainability of the public finances.

Chart A.1: UK population by age and sex

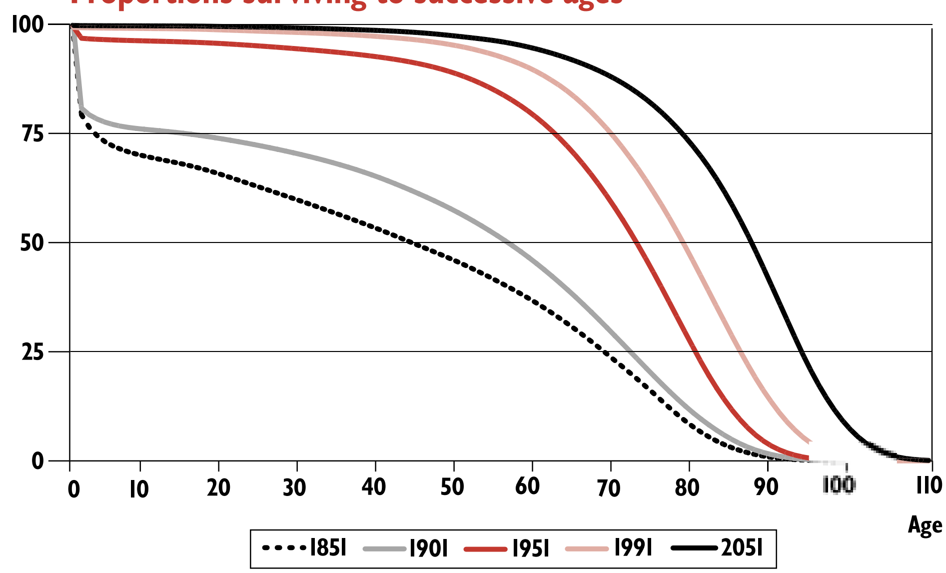


Source: Government Actuary's Department 2002-based principal population projections.

Box A.1: Increases in life expectancy

The ageing of the population can be illustrated by what is referred to as the 'rectangularisation of the life curve'. The chart shows the proportion of an age cohort surviving to successive ages. Of the generation born in 1851, around half survived until 50 years, while a quarter survived until 70 years. Between 1901 and 1951, life expectancy rose markedly, with around half of a cohort born in 1951 expected to reach 73 years. To a large extent the increase in life expectancy is due to the near elimination of infant mortality.

Proportions surviving to successive ages



Source: Office for National Statistics and Government Actuary's Department.

With infant mortality now down to very low rates, future gains in life expectancy are expected to come from higher life expectancy in old age. The Government Actuary's Department projects that half of those born in 1991 will survive to 78 years, while half those born in 2051 will survive to 87 years. The maximum age that people are predicted to reach is also projected to rise.

METHODOLOGY AND ASSUMPTIONS

A.5 The methodology for producing the long-term fiscal projections presented in this annex determines the rate at which current public consumption can grow while the Government meets its fiscal rules. This is achieved by projecting the evolution of tax receipts, transfer payments (such as pensions) and capital consumption (depreciation) over the coming decades. Subtracting transfers and capital consumption from tax revenues provides a measure of the financial resources available for current public consumption. This methodology is unchanged since Budget 1999 and was described in detail in Budget 2000.

A.6 The projections are based on prudent and cautious economic assumptions, and on existing policies. They are based on the fiscal forecasts and assumptions presented in Chapter C of the *Financial Statement and Budget Report* (FSBR), up to and including 2008-09, the end of the medium-term forecast period. Unless stated otherwise, the Government is assumed to leave these policies unchanged in 2009-10 and future years. The projections cannot, and do not, attempt to pre-empt future policy decisions.

Economic assumptions

A.7 Table A.1 sets out the economic assumptions that underlie the long-term fiscal projections after 2008-09, which are broadly unchanged from those used in Budget 2003. The greater degree of uncertainty involved in projecting long-term trends means that the assumptions used in this exercise are particularly cautious. Productivity is assumed to grow by 2 per cent a year between 2009-10 and 2013-14, and then by 1¾ per cent a year between 2014-15 and 2033-34, which is ¼ per cent lower than the neutral view of productivity growth. There is no indication that productivity growth will slow in the long run, and the Government is pursuing policies to improve the UK's productivity performance. However, the assumption of a slower rate of productivity growth in later years reflects this greater use of caution. The 2003 *Long-term public finance report* provides sensitivity analysis on the use of different productivity growth assumptions.

A.8 Employment assumptions are driven by demographic trends, as projected by GAD's 2002-based principal population projections. The overall employment rate is assumed to remain constant from 2008-09 onwards, so that changes in employment levels reflect changes in the working-age population. GAD's principal projection shows that the working-age population might increase from around 36½ million in 2002 to around 39½ million in 2020, before falling to just above 38 million by 2034. This includes the impact of the increase in the female state pension age from 60 years in 2010 to 65 years by 2020, which will increase the working-age population.

A.9 Given the assumed growth rates for productivity and employment, real GDP growth is derived from 2008-09 onwards, as shown in Table A.1. Nominal GDP growth depends on real GDP growth and the GDP deflator, which is assumed to increase at a rate of 2¾ per cent a year from 2008-09 onwards; the same as at the end of the medium-term horizon, as presented in Chapter C of the FSBR.

Table A.1: Real GDP growth and its components

Year	2009-10 to 2013-14	2014-15 to 2023-24	2024-25 to 2033-34
Productivity	2	1¾	1¾
Employment	½	¼	–¼
Real GDP	2½	2	1½

Taxation and spending assumptions

A.10 For the period up to and including 2008-09, the illustrative long-term fiscal projections are based on the forecasts and assumptions presented in Chapter C of the FSBR. Unless stated otherwise, policy settings in 2008-09 are then assumed to continue throughout the rest of the projection period. From 2008-09, total tax revenues therefore grow in line with GDP, so that the Government is assumed to raise the same amount of revenue as a proportion of GDP as in 2008-09, offsetting possible changes in tax bases by changing policy in a revenue neutral way. This does not represent a particular view about the appropriate tax to GDP ratio in the future, but rather in the absence of any planned changes it is the most reasonable assumption for the purposes of these illustrative long-term fiscal projections. Tax revenues are also assumed to be equal to total current spending from 2009-10 onwards. This implies that the golden rule is met with the current budget in balance at all times.

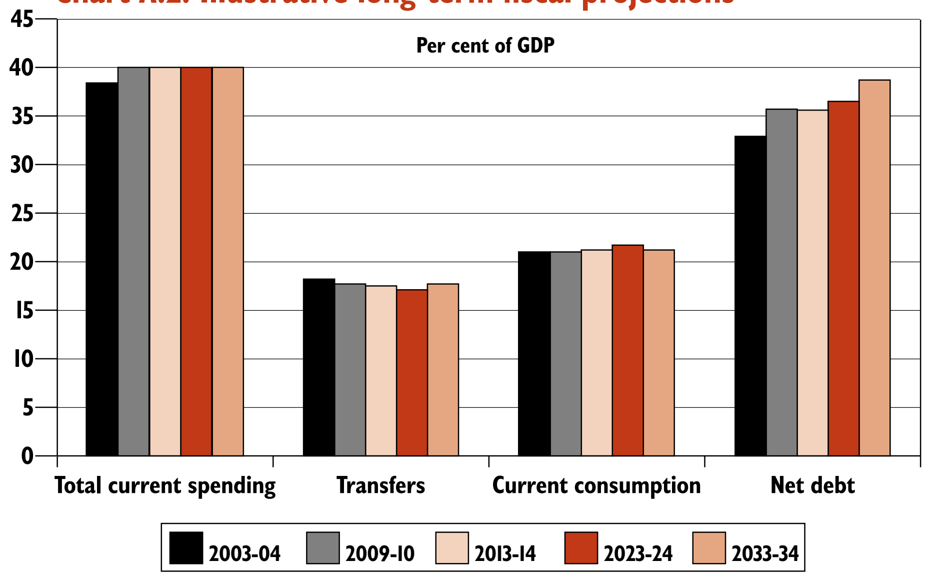
A.11 Current public consumption is calculated as the difference between tax revenues and other current spending, which comprises transfers and capital consumption. Transfers mainly consist of social security spending, grants and debt interest payments. Social security spending includes the basic state pension and the long-term costs of the Pension Credit. The calculation of interest payments is based on assumptions about interest rates and the evolution of debt. As in the medium-term public finance projections, interest rates are based on market expectations and the existing spread of financial assets to which those rates apply. Under the assumption that the current budget is in balance, the growth of public sector net debt reflects growth in public sector net investment. As in previous illustrative long-term fiscal projections, the share of public sector net investment in GDP is re-set at 1.8 per cent beyond the medium term.

A.12 The forward profile for investment shows additions to the capital stock, and is used to calculate capital consumption. Consumption of both the existing stock of assets and these new additions is then calculated on the assumption that future public-sector asset lives are broadly similar to those evident in the past. The profile shows that in the next 30 years the public sector capital stock will converge gradually towards the level of net debt. In the steady state (i.e. in the *very* long term) the entire stock of public debt will be backed by public sector capital.

ILLUSTRATIVE PROJECTIONS

A.13 Chart A.2 shows the projected evolution of total current spending, transfers, current consumption and net debt as a share of GDP between 2003-04 and 2033-34, given the stated assumptions. Total current spending is projected to increase between 2003-04 and 2008-09, and then stay stable. Transfers are projected to fall from just above 17½ per cent in 2008-09 to around 17 per cent by 2023-24 before gradually rising again, while current consumption is projected to be more or less the same as a share of GDP in 2033-34 as it was in 2008-09. Hence current consumption can grow at around the same annual rate as GDP, after the medium term, while still meeting the fiscal rules. Starting from just under 36½ per cent in 2008-09, net debt is projected to rise gradually, reaching 39.6 per cent by 2033-34, consistent with the sustainable investment rule. The projected changes in net debt emphasise the importance of ensuring sound public finances in the medium term to prepare for future developments.

Chart A.2: Illustrative long-term fiscal projections



Source: HM Treasury.

A.14 The main reason for the projected increase in transfer spending as a share of GDP after 2023-24 is that state pension spending is now projected to rise by slightly more than previously as a consequence of the higher life expectancy assumption used in GAD's 2002-based population projections. The Department for Work and Pensions has published detailed updated projections and analysis of the revisions.[4] The new pension projections will also be included in the next *Long-term public finance report*, due to be published at the time of the 2004 Pre-Budget Report. This projected increase in pension spending highlights the

[4] The publication by the Department for Work and Pensions is available at http://www.dwp.gov.uk/asd/asd4/expenditure.asp.

challenges of an ageing population, and demonstrates how important it is that current and future policies take into account the long-term sustainability of the public finances.

A.15 The increase in life expectancy and consequent rise in the number of older people (and in particular the number of those 80 years and older, see Chart A.1) is also likely to lead to additional spending on health care in the long term. Furthermore, non-demographic factors such as technological progress could also lead to an increase in health spending pressures.

Box A.2: Future health spending trends

Projections of future health spending trends were published in the 2003 *Long-term public finance report*. Taking account only of demographic changes beyond 2007-08, the report finds that public health spending could rise from around 6½ per cent of GDP currently, to around 8½ per cent by the early 2020s and then just under 10 per cent by the early 2050s. This excludes private sector health spending which is currently around 1.2 per cent of GDP.

More detailed projections of possible future health spending trends have been published in the first Wanless Review of the trends and resource needs that could affect the health service in the UK over the next 20 years.[a] The projections took into account both demographic and non-demographic trends, and modelled future health spending based on three different scenarios. These scenarios differed in terms of the efficient use of resources and responsiveness of the health service, and the level of public engagement in health issues. In the 'fully engaged' scenario, total health spending, which includes private health care, is projected to rise to 10.6 per cent of GDP by 2022-23, while spending would rise to 12½ per cent in the 'slow uptake' scenario. In February 2004, Derek Wanless presented the findings of his second review,[b] which examined how the public health aspects of the 'fully engaged' scenario could be realised. This highlighted the importance of prevention and the cost effectiveness of action that can be taken to improve the health of the whole population and to reduce health inequalities.[c]

[a] *Securing our Future Health: Taking a Long-Term View*, Derek Wanless, 2002.

[b] *Securing Good Health for the Whole Population*, Derek Wanless, 2004.

[c] For more details on the key findings of the second Wanless Review see Chapter 6 of the EFSR.

Long-term public finance report

A.16 The illustrative long-term fiscal projections presented here yield similar conclusions to those presented in the 2003 *Long-term public finance report,* which uses a broader range of techniques to assess long-term sustainability, including fiscal gap modelling, bottom-up projections and generational accounting. The report demonstrates that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries to face the challenges ahead. Furthermore, using a modelling approach refined since 2002, the report finds a relatively high degree of inter-generational fairness of current policies when compared to other developed countries.

Sensitivity analysis

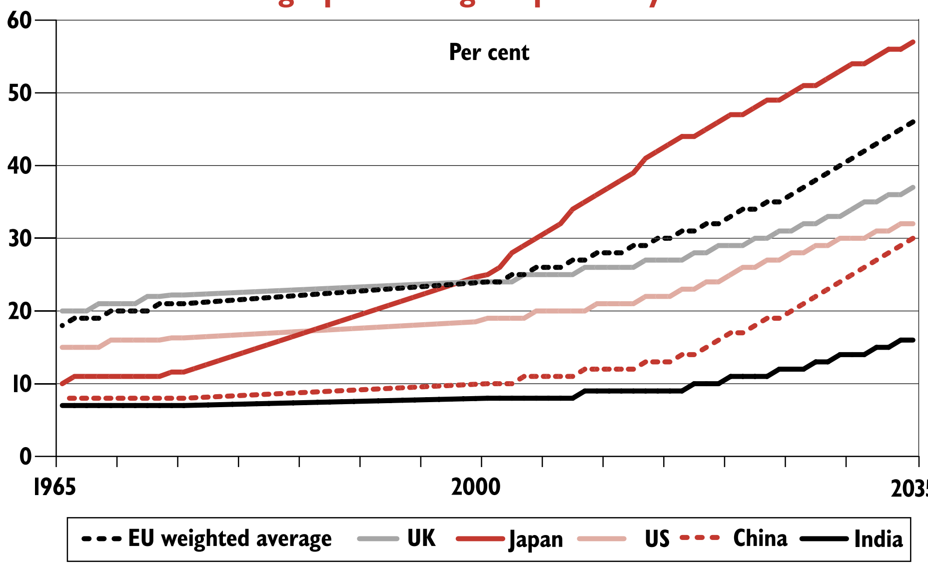
A.17 As with all economic projections, the results presented in this annex are dependent on the assumptions made. These include population projections, productivity and revenue assumptions, labour market participation rates and social security spending. It is important that projections are made under alternative assumptions, such as those listed above, to determine how sensitive the baseline projections are to changes in the assumptions. The 2003 *Long-term public finance report* illustrates the effect of different assumptions of fertility, longevity and migration on population estimates, and the implications for spending projections.

INTERNATIONAL COMPARISONS

Ageing is a global phenomenon

A.18 The UK is not the only country with an ageing population: ageing is a trend seen in most developed and some developing countries. In fact the populations of many developed countries are projected to age more rapidly than the UK's. Chart A.3 shows the historical and projected evolution of the demographic old-age dependency ratio between 1965 and 2035 in the EU, the UK, Japan and the US. In addition, Chart A.3 shows that the old-age dependency ratio is also projected to rise from a current low level over the coming decades in China and India, the two most populous countries in the world. These trends are predicted to continue beyond 2035, with the demographic old-age dependency ratio projected to reach over 70 per cent in Japan, over 50 per cent on average in the EU and 37 per cent in China, by 2050.

Chart A.3: Demographic old-age dependency ratios[1]



[1]Number of people aged 65 years and over as a share of number of people aged 16 to 64 years. EU weighted average based on the current 15 member states.
Source: United Nations, World Population Prospects: The 2002 Revision.

A.19 International comparisons also show that the UK's long-term fiscal position appears relatively strong compared with other developed countries, which face challenges from ageing populations, including the US and many EU countries. For example, a study by the Center for Strategic and International Studies and Watson Wyatt, a global consulting firm, concluded in 2003 that the UK public finances had a low degree of vulnerability with respect to rising old-age dependency costs.[5]

US

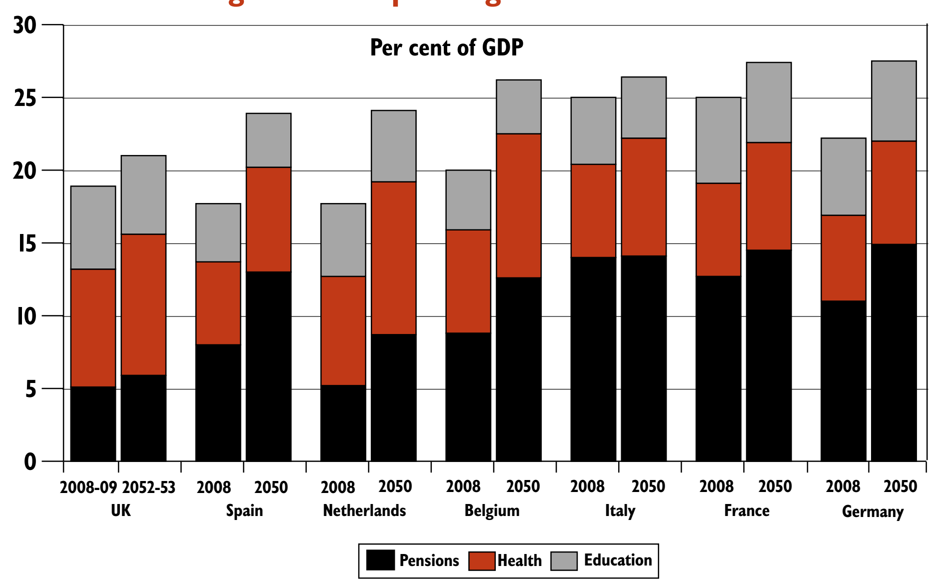
A.20 The US is ageing slowly by comparison with other developed countries. Nonetheless fiscal imbalances are projected to arise in the US over the coming decades. The US Congressional Budget Office (CBO) regularly publishes long-term analysis covering a wide range of topics, including future social security and defence spending. The CBO projects that spending on social security will increase from 4.2 per cent of GDP in 2003 to 6.2 per cent by 2050, while spending on Medicare and Medicaid (the two principal public health care schemes) is projected (in the 'middle-cost scenario') to rise from just under four per cent of GDP in 2003 to nearly 11½ per cent by 2050, due to a combination of demographic and non-

[5] The *2003 Aging Vulnerability Index: An Assessment of the Capacity of Twelve Developed Countries to Meet the Aging Challenge*, Richard Jackson and Neil Howe, Center for Strategic and International Studies and Watson Wyatt Worldwide, 2003.

demographic factors.[6] The CBO concludes that: *"unless taxation reaches levels that are unprecedented in the United States, current spending policies will probably be financially unsustainable over the next 50 years."*[7]

EU A.21 Many European countries face significant challenges from ageing populations, with the UK ageing less rapidly than most others. In October 2003, the EU's Economic Policy Committee (EPC) published detailed findings on the impact of ageing populations on the Member States' public finances.[8] It found that age-related spending, in particular on pensions, will rise substantially in many EU Member States over the coming decades if existing policies remain unchanged.[9] The EPC also found that projected age-related spending increases are not necessarily highest in those countries with the most rapidly ageing populations. Existing policy settings play a potentially even greater role. The latest Stability and Convergence Programmes submitted by EU Member States to the European Commission confirm the EPC findings. Chart A.4 shows the projected development of age-related spending over the coming decades in the seven largest EU countries.[10] It shows that age-related spending in the UK is projected to rise only moderately over the next five decades from a relatively low base, even when including the latest projections on state pension spending. This contrasts with substantial projected increases in some other countries. The UK's position would be less favourable if the basic state pension were indexed to earnings rather than prices, as set out in Chapter 2.

Chart A.4: Age-related spending in selected EU countries



[1] For UK spending in 2008-09 and 2052-53 based on health and education projections presented in 2003 Long-term public finance report and latest pension projections, for other countries spending in 2008 and 2050 based on national and EPC projections. Comparisons of projections need to be treated with caution as some include the cost of long-term care within health projections, and may not fully reflect latest policy changes.
Sources: HM Treasury 2003, Department for Work and Pensions 2004 and European Commission's assessments of Member States' Stability and Convergence Programmes 2004.

[6] *The Long-Term Budget Outlook*, Congressional Budget Office, December 2003.
[7] *The Long-Term Budget Outlook*, Congressional Budget Office, December 2003, executive summary.
[8] *The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme*, Economic Policy Committee, October 2003.
[9] The CBO and EPC health projections are not directly comparable as the former include non-demographic drivers, whereas the latter are based on demographic changes only.
[10] In terms of purchasing power parity adjusted GDP in 2003. See www.europa.eu.int.

A.22 In 2002, the Council of European Finance Ministers (ECOFIN) mandated the EPC to provide a new set of long-term fiscal projections by mid 2005. One of the key objectives of the exercise will be to incorporate recent policy developments in EU Member States and to use updated and refined assumptions and modelling techniques. The ten accession countries that will join the EU in May 2004 will also participate in this exercise. The need to develop and enhance the analysis of the long-term fiscal challenges in the EU is one that is strongly supported by the UK.[11]

Japan

A.23 Because the dependency ratio has already increased sharply in Japan, and is projected to reach very high levels, Japan is a particularly important country to study for the lesson it may demonstrate on the relationships between ageing, economic development and fiscal sustainability. Despite a rapidly ageing population, the OECD projects that state pension spending in Japan will rise only slightly over the coming five decades, from 7.9 per cent of GDP in 2000 to 8½ per cent by 2050. Furthermore, the OECD projections exclude the latest reform proposals, which aim to dampen future expenditure growth on pensions, for example by reducing generosity. Japanese law requires that reforms must be implemented if the quinquennial actuarial revaluation of the state pension scheme shows that it is on an unsustainable path. While these arrangements appear to be controlling public pension spending, overall age-related spending is nonetheless projected to rise markedly over the coming decades. For example, the Ministry of Health, Labour and Welfare, which manages social security spending, including health and pensions in Japan, estimates that the funds necessary to finance the current social security system will need to rise from 16 per cent of GDP in 2002 to nearly 25 per cent by 2025.[12]

CONCLUSIONS

A.24 The fiscal projections presented in this annex show that the UK's public finances are broadly sustainable over the long term, confirming the detailed findings presented in the 2003 *Long-term public finance report*. Current public consumption can grow at around the same rate as that assumed for GDP, after the medium term, ensuring that resources are available to meet potential future spending pressures. The golden rule and the sustainable investment rule are both met throughout the projection period, with net debt projected to remain below 40 per cent of GDP in the long run. Public sector net investment can grow more or less in line with the economy without jeopardising the sustainable investment rule. The UK is also in a strong position to face future challenges relative to many other developed countries.

A.25 However, notwithstanding the use of prudent and cautious assumptions, a wide range of unforeseen developments could arise over the projection period. The Government will therefore continue to update and report on its assessments of long-term fiscal sustainability, both through regular publication of the *Long-term public finance report* alongside the Pre-Budget Report and through the illustrative long-term fiscal projections presented with each Budget, so as to ensure that all fiscal policy decisions are set within a sustainable long-term framework.

[11] *The Stability and Growth Pact: A Discussion Paper*, HM Treasury, March 2004.

[12] *Assessing the long-term fiscal position of Japan*, International Monetary Fund, 2003, in: *Japan: Selected Issues*.

Financial Statement and Budget Report

A BUDGET POLICY DECISIONS

INTRODUCTION

The Economic and Fiscal Strategy Report (EFSR) explains how the measures and other decisions announced in Budget 2004 build on those already introduced to advance the Government's long-term goals. This chapter of the Financial Statement and Budget Report (FSBR) brings together in summary form all the measures and decisions announced in Budget 2004 that affect the Budget arithmetic, giving their estimated effect on government revenue or spending to 2006-07.[1] It also includes those measures announced since Budget 2003, including in the 2003 Pre-Budget Report.

The chapter also sets out how Budget 2004 measures affect the tax and benefit system and government spending. This includes a summary of the main rates and allowances for the personal tax and benefit system, the business tax system, Value Added Tax (VAT), environmental taxes, and other indirect taxes.

The appendices to this chapter provide additional information on Budget measures:

- Appendix A1 provides details of tax changes and other policy decisions which were announced in Budget 2003 or earlier, but which take effect from or after April 2004;
- Appendix A2 explains in detail how the effects of the Budget measures on government revenues are calculated; and
- Appendix A3 provides estimates of the costs to the Government of some of the main tax allowances and reliefs.

BUDGET POLICY DECISIONS

Table A1 summarises Budget 2004 measures and their effects on government revenue and spending. These include tax measures, national insurance contributions (NICs) measures, measures that affect Annually Managed Expenditure (AME), and additions to Departmental Expenditure Limits (DEL). Measures that are financed from existing DEL provisions are not included.

Table A2 summarises the impact on government revenues and spending of other measures introduced since Budget 2003, including those announced in the 2003 Pre-Budget Report.

[1] The contents of the brackets after each measure in this chapter refer to the line in Tables A.1 and A.2 where its costs or yield is shown. The symbol '-' indicates that the proposal has no Exchequer effect. The symbol '*' indicates that the effect is negligible, amounting to less than £3 million a year.

Table A1: Budget 2004 policy decisions

	(+ve is an Exchequer yield)			£ million
	2004-05 indexed	2005-06 indexed	2006-07 indexed	2004-05 non-indexed
MEETING THE PRODUCTIVITY CHALLENGE				
1 Venture capital schemes: improvements	0	–55	–60	0
2 VAT: revalorise registration and deregistration thresholds	0	0	0	–10
3 Business Premises Renovation Allowance	0	–10	–35	0
4 Capital Allowances: one year increase for small enterprises	*	–55	+15	*
5 Local Authority Business Growth Incentives	0	–150	–300	0
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
6 Housing Benefit: align rules with tax credits	–5	–35	–35	–5
7 Housing Benefit and Council Tax Benefit: backdating for up to 12 months	–10	–15	–10	–10
8 Housing Benefit: private sector second round Pathfinders	0	–15	–15	–15
BUILDING A FAIRER SOCIETY				
Supporting families and pensioners				
9 Income tax: index starting and basic rate limits	0	0	0	–610
10 Pensions tax simplification	0	0	–25	0
11 £100 payment to over 70s	–475	0	0	–475
12 Pension Credit backdating for up to 12 months	–5	–15	–15	–5
13 Pension schemes earnings cap: indexation	0	0	0	–5
14 Modernising Trusts	0	0	–5	0
15 Payroll Giving: grant scheme for SMEs	–5	–5	0	–5
Protecting tax revenues				
16 Finance leasing: closing loopholes	+75	+110	+110	+75
17 Life companies	+5	+10	+10	+5
18 Red diesel: supporting the UK oils fraud strategy	+80	+180	+190	+90
19 VAT: transfers of going concern	+155	+140	+125	+155
20 VAT: demonstrator cars	*	+5	+5	*
21 Distributed profits: minimum rate[1]	+10	+340	+490	+10
22 Customs: allocation for alcohol strategy	0	–15	–10	0
Duties and other tax changes				
23 Inheritance tax: index threshold	0	0	0	–55
24 Tobacco duties: revalorise rates	0	0	0	–15
25 Alcohol duties: freeze spirits duty until end of this Parliament	–35	–70	–70	0
26 Alcohol duties: revalorise beer and wine duties and freeze other rates	–5	–5	–5	+155
27 Small breweries' relief: extension	–5	–5	–5	–5

Table A1: Budget 2004 policy decisions

(+ve is an Exchequer yield)	2004-05 indexed	2005-06 indexed	2006-07 indexed	£ million 2004-05 non-indexed
PROTECTING THE ENVIRONMENT				
Environment				
28 Enhanced capital allowances for additional energy saving technologies	*	–5	–10	*
29 Landlords' energy saving allowance	*	–10	–10	*
30 Changes to Climate Change Agreement eligibility criteria	–5	–25	–25	–5
31 Climate change levy: freeze	–25	–25	–25	0
32 Aggregates levy: freeze	–10	–10	–10	0
33 Aggregates levy: extension of Northern Ireland credit scheme	–15	–20	–25	–15
34 Recycling of landfill tax revenues	0	0	–245	0
Transport				
35 Fuel duties: revalorise rates from 1 September 2004 and introduce differential between sulphur free and other main road fuels	–300	0	0	+345
36 Fuel duties: increase road fuel gases by 1p over next three years	+5	+10	+10	+5
37 Fuel duties: differentials for bioethanol and biodiesel at 20p until 2007	*	+5	+10	*
38 Company vans: reform	*	–30	–30	*
39 Air passenger duties: freeze rates	–25	–30	–30	0
40 VED: freeze rates	–130	–130	–135	0
TOTAL BUDGET MEASURES	**–725**	**+65**	**–170**	**–395**

* *negligible*

	2004-05	2005-06	2006-07
MEMO ITEMS			
Enforcement and compliance[2]			
Direct taxes compliance package[3]	+155	+465	+925
Resetting of the AME margin	–1,000	–2,000	

[1] Alongside the revenue raised by this meaure, tax revenue has been reduced as a result of an increase in the number of self-employed individuals incorporating their business to reduce tax (see Chapter 5). Estimates of the impact of the measure, and of the estimated reduction in tax payments by small businesses incorporated for tax reasons since the last Budget are set out below:

2003-04	2004-05	2005-06	2006-07
–250	–420	–50	+80

[2] Forecast impact if operational measures to enhance compliance, or to enhance the powers available to the Revenue Departments.

[3] Net of additional resources allocated to the Inland Revenue.

Table A2 summarises the impact on government revenue and spending of other measures introduced since Budget 2003, including those announced in the 2003 Pre-Budget Report.

Table A2: Other measures announced since Budget 2003

		(+ve is an Exchequer yield)			£ million
		2004-05 indexed	2005-06 indexed	2006-07 indexed	2004-05 non-indexed
	MEETING THE PRODUCTIVITY CHALLENGE				
a †	Improvements to the VAT flat-rate scheme	−10	−25	−30	−10
b †	Improvements to R&D tax credit schemes	−15	−25	−25	−15
c †	Capital allowances: increases in the thresholds defining SMEs	−100	−170	−125	−100
d †	Corporation tax reform: extension of relief for management expenses	−20	−35	−25	−20
e †	Corporation tax reform: transfer pricing and thin capitalisation	+25	+40	+25	+25
f	Interest and royalties directive	*	*	+5	*
	INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
g †	Extend Council Tax Benefit to Bands F, G and H	−10	−10	−10	−10
	BUILDING A FAIRER SOCIETY				
h †	Child Tax Credit: increase above earnings commitment	–885	–925	–955	–885
i †	Employer supported childcare	0	–20	–25	0
j †	Working Tax Credit: indexation of elements	0	0	0	–200
k †	Working Tax Credit for first time parents	−10	−10	−10	−10
l †	Income tax: indexation of allowances	0	0	0	–710
m †	National insurance: indexation of rates and limits	0	0	0	+305
n	Increase capital limits within means tested benefits	0	0	−15	0
o †	Bringing medium term products into ISAs	0	−20	–40	0
p	State pension: deferral, lump sum and increments	0	−10	–25	0
q	Modernising National Savings and Investments	0	+5	+5	0
r †	VAT: cultural bodies	–25	–25	–20	–25
s	VAT: exempting sub-contracted fund management services	–25	–25	–25	–25
	Protecting tax revenues				
t †	Foreign earnings deduction for seafarers (FED)	*	+20	+15	*
u †	Reform of the Construction Industry Scheme	+20	+40	+80	+20
v †	Modernising the taxation of trusts	+35	+150	+145	+35
w	Life policies: anti-avoidance	+30	+50	+40	+30
x †	VAT: abusive grouping	+50	+70	+65	+50
y †	VAT: partial exemption special methods	+50	+55	+50	+50
z †	VAT: assignment of bad debts	+20	+20	+20	+20
aa †	Tackling alcohol fraud	+5	+10	+175	+5
bb	Insurance premium tax: Changes to GAP insurance	+15	+15	+20	+15
	Additional policy decisions				
†	Total special reserve allocation	–300	0	0	
	TOTAL POLICY DECISIONS	**–1,150**	**–825**	**–685**	**–1,455**

** negligible*

† Announced in 2003 Pre-Budget Report

Note: As required by the Code for Fiscal Stability, the 2003 Pre-Budget Report economic and fiscal projections were based on, and included the impact of, all Government decisions and all other circumstances where the impact of these decisions could be quantified with reasonable accuracy by the day the projections were finalised.

PERSONAL TAXES AND SPENDING MEASURES

Income Tax

Bands, rates and personal allowances

The starting and basic rate limits are increased in line with statutory indexation and there are no changes to the income tax rates. (9)

As announced in the 2003 Pre-Budget Report, the personal allowance for those aged 65 and over will increase in line with earnings from 6 April 2004 to £6,830 for those aged 65-74, and for those aged 75 or over to £6,950. Other allowances, including the personal allowance for those under 65, will be increased by statutory indexation. (l)

The maximum earnings for which pension provision may be made with income tax relief (the "earnings cap") is increased in line with statutory indexation. (13)

Individual Savings Accounts

As announced in the 2003 Pre-Budget Report, all Sandler stakeholder medium-term products and life insurance products will be brought into the stocks and shares component of Individual Savings Accounts (ISAs) from 6 April 2005. (o)

National Savings and Investments

As announced on 24 January 2004, National Savings and Investments introduced a new account called the Easy Access Savings Account (EASA) available from 29 January 2004 to provide more flexible saving. Interest is taxable but paid gross. The EASA replaces the Ordinary Account, and savers have not been able to open new Ordinary Accounts since 28 January 2004. (q)

Lloyd's names

A measure will be introduced, with effect from 6 April 2004, to allow Lloyd's Names to qualify for relief for the carry forward of trading losses and deferral of capital gains on conversion to limited liability underwriting. (*)

ITEPA

A package of measures will be introduced to correct anomalies in the Income Tax (Employment and Pensions) Act 2003 (ITEPA). The measures affect both companies and individuals. For companies the majority of measures will be effective from 1 April 2004 but some will apply retrospectively from 1 April 2003. Similarly, for individuals the majority of the measures will be effective from 6 April 2004, but some will apply retrospectively from 6 April 2003. (-)

MPs' travel expenses

The tax exemption for the costs of travel of Members of Parliament to EU institutions and other EU parliaments will be extended to cover visits to regional assemblies with effect from 6 April 2004. (*)

Company vans

The benefit an employee derives from private use of a company van will be revised from 6 April 2005, there will be a nil charge for vans, where the van has to be taken home but otherwise no private use is allowed. Transitionally, the current rates will remain until 2007 when there will be a single scale charge of £3,000 and an additional charge of £500 for fuel provided for private use. (38)

Emergency service vehicles

A measure will be introduced, with effect from 6 April 2004, to remove the tax and NICs charge that arises when fire, police and ambulance emergency service workers have to take their emergency vehicles home at night when on call. (*)

Pensions tax simplification

A package of measures will be introduced, with effect from April 2006, to simplify radically the current pension tax regime. The existing eight regimes will be replaced with a single universal regime for all tax privileged pension savings. (10)

Offshore funds Measures will be introduced to change the rules that determine whether or not an offshore fund qualifies for "distributor" status, which in turn determines the tax treatment of UK residents' investment in offshore funds. The measures will be effective for accounting periods ending on or after Royal Assent. (*)

Company car fuel The figure on which company car fuel benefit is calculated will be frozen for 2004-05 at the 2003-04 level of £14,400. (-)

Long-term care A measure will be introduced to confirm current practice that payments for care under immediate needs annuity policies will not be included in the taxable income of the annuitant. (*)

Venture capital schemes A measure will be introduced to increase temporarily the level of income tax relief for venture capital trusts (VCTs) from 20 per cent to 40 per cent. This will apply from 6 April 2004 and cease on 5 April 2006.

In addition, several other measures will come into effect from 6 April 2004. Capital gains tax deferral relief for VCTs will be abolished and the annual limit for income tax relief will be increased to £200,000 for both the VCT scheme and the Enterprise Investment Scheme (EIS).

From 17 March 2004, the EIS and VCT scheme rules on qualifying companies with subsidiaries will be relaxed. This change also applies to the Corporate Venturing Scheme and Enterprise Management Incentives. The rules that relate to investment on the same day for EIS and the provisions that relate to emergency loans will also be relaxed. (1)

Loaned computer exemption A measure will be introduced, with effect from 6 April 2004, to extend the benefits tax exemption for computers lent to employees to cover cases where the benefit is treated as general earnings. (*)

Child and Working Tax Credits As announced in the 2003 Pre-Budget Report, with effect from 6 April 2004, the child element of the Child Tax Credit will be increased by £180 per year to £1,625 per year. In addition, the disabled child elements of the Child Tax Credit will be uprated in line with inflation for 2004-05. Elements of the Working Tax Credit will also rise in line with inflation for 2004-05 as will the rates of Child Benefit and Guardian's Allowance. (h,j)

Working Tax Credit From 6 April 2004 first-time parents who were working at least 16 hours a week before going on maternity, paternity or adoption leave will be able to claim Working Tax Credit from the date of birth or placement of adoption of their first child. (k)

Payment via employer Payment of Working Tax Credit by employers will be phased out, after a period of consultation with employer groups and business about the transition to direct payment. (-)

Employer-supported childcare As announced in the 2003 Pre-Budget Report, from April 2005 employer-contracted childcare and employer-provided childcare vouchers up to £50 a week will be exempt from tax and national insurance. The childcare used must be registered or approved and the benefit must be generally available to all employees where a childcare support scheme operates. (i)

Childcare support Tax credit legislation will be amended so that from June 2004 childcare provided by foster carers will be eligible for tax credit support, and will guarantee that parents using breakfast clubs run by schools will be able to claim support for their costs in England, Wales and Northern Ireland. (*)

Table A3: Bands of taxable income 2004-05

2003-04	£ a year	2004-05	£ a year
Starting rate 10 per cent	0 – 1,960	Starting rate 10 per cent	0 – 2,020
Basic rate[1,2] 22 per cent	1,961 – 30,500	Basic rate[1,2] 22 per cent	2,020 – 31,400
Higher rate[2] 40 per cent	over 30,500	Higher rate[2] 40 per cent	over 31,400

[1] *The rate of tax applicable to savings income in Section IA ICTA 1988 remains at 20 per cent for income between the starting and basic rate limits.*

[2] *The rates applicable to dividends are 10 per cent for income up to the basic rate limit and 32.5 per cent above that.*

Table A4: Income tax allowances 2004–05

		£ a year	
	2003-04	2004-05	Increase
Personal allowance			
age under 65	4,615	4,745	130
age 65–74	6,610	6,830	220
age 75 and over	6,720	6,950	230
Married couple's allowance[1]			
aged less than 75 and born before 6th April 1935	5,565	5,725	160
age 75 and over	5,635	5,795	160
minimum amount[2]	2,150	2,210	60
Income limit for age-related allowances	18,300	18,900	600
Blind person's allowance	1,510	1,560	50

[1] *Tax relief for this allowance is restricted to 10 per cent.*

[2] *This is also the maximum relief for maintenance payments where at least one of the parties is born before 6 April 1935.*

Table A5: Working and Child Tax Credit rates and thresholds

	2004-05 £ a year
Working Tax Credit	
Basic element	1,570
Couple and lone parent element	1,545
30 hour element	640
Disabled worker element	2,100
Severe disability element	890
50 plus element, 16–29 hours	1,075
50 plus element, 30+ hours	1,610
Childcare element	
– maximum eliglible cost for one child	*£135 per week*
– maximum eligible cost for two or more children	*£200 per week*
– *per cent of eligible costs covered*	*70*
Child Tax Credit	
Family element	545
Family element, baby addition	545
Child element	1,625
Disabled child element	2,215
Severely disabled child element	890
Income thresholds and withdrawal rates	
First income threshold	5,060
First withdrawal rate (per cent)	*37*
Second income threshold	50,000
Second withdrawal rate (per cent)	*6.67*
First threshold for those entitled to Child Tax Credit only	13,480
Income disregard	2,500

Effects on the Scottish Parliament's tax varying powers – statement regarding Section 76 of the Scotland Act 1998

A one penny change in the Scottish variable rate in 2004-05 could be worth approximately plus or minus £270 million, and is broadly unaffected by these changes. In the Treasury's view, an amendment to the Scottish Parliament's tax-varying powers is not required as a result of these changes.

National insurance contributions

As announced in the 2003 Pre-Budget Report, the national insurance contributions (NICs) threshold and limits will increase in line with inflation. There will be no change in NICs rates for employers and employees, or the profit-related NICs paid by the self-employed in 2004-05.

Other NICs rates for 2004-05 will increase in line with inflation; for the self-employed the rate of Class 2 contributions will be £2.05, the special rate of Class 2 contributions for share fisherman will be £2.70, the rate of Class 3 voluntary contributions will be £7.15 and the special rate of Class 2 contributions for volunteer development workers will be £3.95. (m)

National Insurance Contributions and Statutory Payments Bill

As announced on 27 October 2003, a package of measures will be introduced with effect from a date to be announced, to help employers decide how to meet their obligations for NICs on securities-based earnings and to align some aspects of debt recovery for Class 2 NICs with income tax.

In addition, further measures will be introduced, with effect from 6 April 2005, to align information powers for NICs with those for tax and to protect employees' rights to Statutory Sick and Maternity Pay by improving means of tackling non-compliance. (-)

Table A6: Class 1 national insurance contribution rates 2004-05

Weekly earnings[1]	Employee (primary) NIC rate[2] (per cent)	Employer (secondary) NIC rate[3] (per cent)
Below £79 (LEL)	0	0
£79 to £91 (PS/ST)	0[4]	0
£91 to £610 (UEL)	11	12.8
Above £610	1	12.8

[1] *The limits are defined as LEL – lower earnings limit; PT – primary threshold; ST – secondary threshold; and UEL – upper earnings limit.*

[2] *The contracted-out rebate for primary contributions in 2004-05 is 1.6 per cent of earnings between the LEL and UEL for contracted-out-salary-related schemes (COSRS) and contracted out money purchase schemes (COMPS).*

[3] *The contracted-out rebate for secondary contributions is 3.5 per cent of earnings between the LEL and UEL for COSRS and 1.0 per cent for COMPS. For COMPS, an additional age-related rebate is paid direct to the scheme following the end of the tax year. For appropriate personal pensions, the employee and employer pay NICs at the standard, not contracted-out rate. An age and earnings-rebate is paid direct to the personal pension provider following the end of the tax year.*

[4] *No NICs are actually payable but a notional Class 1 NIC will be deemed to have been paid in respect of earnings between the LEL and PT to protect benefit entitlement. Table A.7 Self-employed national insurance contribution rates 2004-05.*

Table A7: Self-employed national insurance contribution rates 2004-05

Annual profits[1]	Self employed NICs: Class 2	Class 4
below £4,215 (SEE)	0[2]	
£4,215 and above	£2.05	
£4,215 to £4,745 (LPL)		0
£4,745 to £31,720 (UPL)		8 per cent
above £31,720		1 per cent

[1] *The limits are defined as LPL – lower profits limit and UPL – upper profits limit.*

[2] *The self-employed may apply for exception from paying Class 2 contributions if their earnings are less than, or expected to be less than, the level of the small earnings exceptions (SEE).*

Inheritance Tax

Inheritance tax

The threshold will be increased from £255,000 to £263,000 for new tax charges arising on or after 6 April 2004. (23)

Simplifying the administration of inheritance tax

A measure will be introduced to extend the simplified inheritance tax reporting procedures to a further 30,000 estates per year. The necessary changes to secondary legislation will be made later this year. In addition, some of the inheritance tax penalty rules will be updated with effect from Royal Assent to bring them more into line with income and capital gains tax.(*)

Further personal tax measures are included in the Protecting Tax Revenues section of Chapter A.

Charities and giving

Payroll Giving The Government is launching a Payroll Giving grant scheme. SMEs with fewer than 500 employees who set up new Payroll Giving schemes from April 2004 will be able to apply for a one-off grant payment to assist with the cost of establishing their scheme. The grant will be available for two years. (15)

BENEFITS

From April 2006, the threshold above which savings reduce eligibility for Income Support, Jobseeker's Allowance, Housing Benefit and Council Tax Benefit will be raised from £3,000 to £6,000. (n)

Pensions Pension Credit will be strengthened by extending the backdating provision whereby those claiming beyond October 2004 will see, where eligible, their entitlements backdated by up to 12 months, where applicable. (12)

As announced in the 2003 Pre-Budget Report, those choosing to defer their state pension for at least one year from April 2005 will be able to take a lump sum. (p)

For those who defer their state pension their notional entitlement will be disregarded in calculation of Housing Benefit and Council Tax Benefit. For those who also work, their notional state pension will be disregarded when calculating Working and Child Tax Credits. (*)

More help for older pensioners Alongside Council Tax Benefit, the Government will help pensioner households with someone aged 70 or over with their living expenses with an extra £100 for 2004-05. (11)

Housing Benefit A second set of Local Housing Allowance Pathfinders will be introduced in the private rented sector from 2005. (8)

A package of measures will be introduced, taking effect from April 2005, to simplify the rules surrounding entitlement and take-up of Housing Benefit, and how the rules align with those for other support, such as tax credits and Pension Credit. (6)

Housing Benefit and Council Tax Benefit backdating for Pension Credit recipients will also continue to be extended to 12 months in line with Pension Credit. (7)

As announced in November 2003, the restriction limiting Council Tax Benefit to Band E will be lifted for properties in Bands F, G and H from April 2004. (g)

As announced in the 2003 Pre-Budget Report, help for tenants with high childcare costs claiming Housing Benefit will be improved from April 2004. (*)

Paternity and Adoption Pay From April 2004, the Government will uprate Statutory Paternity Pay and Statutory Adoption Pay in line with Statutory Maternity Pay to £102.80 a week. (*)

TAXES ON CHARGEABLE GAINS AND STAMP TAXES

Tax on chargeable gains

Annual exempt amount The capital gains tax annual exempt amount is increased in line with statutory indexation to £8,200. (-)

Taxation of trusts A package of measures will be introduced, with effect from 6 April 2005, to modernise the taxation of trusts. This will be achieved by establishing common trust definitions and tests across income tax and capital gains tax, and by introducing a basic rate band for small trusts. (14)

Stamp Taxes

Stamp Duty Land Tax A package of measures will be introduced to clarify and amend the current legislation. The majority of the measures will be effective from 17 March 2004 but some will apply from Royal Assent. (*)

In addition, a further package of measures will be introduced with effect from Royal Assent that will make permanent the temporary measures that were introduced by Treasury regulation on 5 November 2003 in relation to the new Stamp Duty Land Tax. (*)

Further measures concerning taxes on chargeable gains are included in the Protecting Tax Revenues section of Chapter A.

BUSINESS TAXES AND SPENDING MEASURES

Tax on business profits

International Accounting Standards As announced in the 2003 Pre-Budget Report, measures will be introduced to ensure that companies adopting International Accounting Standards (IAS) to draw up accounts from 1 January 2005 receive broadly equivalent tax treatment to those using UK Generally Accepted Accounting Practice (GAAP). (*)

North Sea taxation As announced in the 2003 Pre-Budget Report, a new Exploration Expenditure Supplement will be introduced to reduce barriers to entry for new North Sea companies not receiving the full benefit of current 100 per cent exploration and appraisal capital allowances. For expenditure on or after 1 January 2004, a company with no tax liability against which to use their allowances can enhance the value of that relief by 6 per cent per year for a maximum of 6 years. (*)

Corporation tax reform As announced in the 2003 Pre-Budget Report, entitlement to corporation tax relief for the expenses of managing investments will be extended. The requirement to qualify as an investment company will be lifted with effect from 1 April 2004. (d)

As also announced in the 2003 Pre-Budget Report, the transfer pricing rules will be extended to transactions between related entities in the UK from 1 April 2004. The change will be accompanied by measures to mitigate its effect, including exemptions for small and medium-sized businesses, a relaxation of the penalty regime for a transitional period of two years to give businesses time to adjust, and measures to ensure that the new rules will not result in double taxation. (e)

EU Interest and Royalties Directive A measure will be introduced, with effect from 1 January 2004, to implement the EU Interest and Royalties Directive (Council Directive 2003/49/EC) in the United Kingdom. This largely eliminates source state taxation of interest and royalty payments between associated companies situated in different EU Member States. (f)

NHS Foundation Trusts To ensure consistency with the principles that apply to NHS Trusts, a measure will be introduced with effect from Royal Assent of the Finance Bill to create a power that will be used as necessary to ensure that non-healthcare trading activities of NHS Foundation Trusts that are not carried on within companies are liable to tax. Companies will be taxed in the normal way. (-)

Tax on non-company distributions A measure will be introduced to ensure that companies and groups with profits chargeable to corporation tax are charged a minimum rate of corporation tax of 19 per cent on profits distributed to non-company shareholders. The measure will apply to distributions made on or after 1 April 2004. (21)

Community amateur sports clubs As announced in the 2003 Pre-Budget Report, a measure will be introduced, with effect from 1 April 2004, to double the corporation tax exemption thresholds for community amateur sports clubs (CASCs). Clubs with trading turnover of less than £30,000 and/or gross property income of less than £20,000 will pay no corporation tax on these sources. (*)

Increases to the SME thresholds As announced in the 2003 Pre-Budget Report, the thresholds for small and medium-sized companies have been increased to the maximum allowed under EU regulations. The measure was effective from 30 January 2004 and applies to financial years ending on or after that date. It doubles the amount of investment eligible for 40 per cent plant and machinery first year capital allowances. Businesses falling under the revised small business threshold are eligible for the 100 per cent first year capital allowance for spending on information and communication technology, until it expires on 31 March 2004 and for the increase to 50 per cent first year allowances announced below. (c)

Capital allowances for small enterprises A measure will be introduced to provide an increase in the rate of first year capital allowances for small businesses spending on most plant and machinery from 40 per cent to 50 per cent for one year. The increased allowances will apply to spending incurred on or after 1 April 2004 for businesses in the charge to corporation tax and on or after 6 April 2004 for businesses in the charge to income tax. (4)

Scientific Research Organisations The Government will work with Scientific Research Organisations (SROs) to update their tax exemption – bringing it into line with the new research and development (R&D) tax credits definition and reducing their compliance costs through a new monitoring procedure operated by the Inland Revenue. The legislative changes will be brought forward in Finance Bill 2005. (*)

Incentives for businesses and employees

Employee share schemes A measure will be introduced to provide income tax relief to employees who bear the employers' NIC liability due on post-acquisition earnings from employment-related awards of restricted shares and convertible shares, following the enactment of the National Insurance Contributions and Statutory Payments Bill. (*)

Research and Development tax credits As announced in the 2003 Pre-Budget Report, changes will be made to R&D tax credits. The definition of research and development will be simplified for tax purposes and the range of qualifying costs will be widened. Changes will take effect from 1 April 2004 for large companies and from a date to be announced for SMEs. (b)

Enterprise Capital Funds A measure will be introduced to set up Enterprise Capital Funds (ECF). It will apply from a date to be announced. (*)

Business Premises Renovation Allowance As announced in the 2003 Pre-Budget Report, the Government will introduce subject to state aid approval a Business Premises Renovation Allowance Scheme. The scheme will provide 100 per cent capital allowances for the costs of renovating business properties in Enterprise Areas that have been vacant for at least a year. The scheme will be introduced in 2005. (3)

Other measures

Local Authority Business Growth Incentives As announced in the 2003 Pre-Budget Report, a Local Authority Business Growth Incentives Scheme will be introduced from April 2005 to allow local authorities to retain a proportion of growth in local National Non-Domestic Rates revenues. Technical details of the scheme will be announced by the Office of the Deputy Prime Minister in a Press Notice on Budget Day. (5)

Recognised stock exchanges The present list of exchanges designated as recognised stock exchanges for certain tax purposes by the Inland Revenue will be reviewed to consider possible amendments, particularly in view of EU enlargement and changes to EC Directives.

European Company Statute The Government will conduct a consultation later in 2004 on the tax changes consequent on the European Company Statute.

Further business tax measures are included in the Protecting Tax Revenues section of Chapter A.

VALUE ADDED TAX (VAT)

Simplifying indirect taxes for small businesses Budget 2004 announces steps that the Government will take to help small and newly-registered business to reduce their compliance costs from 1 April 2004:

- revalorisation of the VAT registration and deregistration thresholds to £58,000 and £56,000 respectively; (2)
- increasing the turnover ceiling to £660,000 and easing the leaving rules for businesses using the cash accounting scheme; (-) and
- increasing the turnover ceiling to £660,000 for businesses using the annual accounting scheme. (-)

As announced in the 2003 Pre-Budget Report, from 1 January 2004 the Government revised the flat-rate scheme rates in the light of experience of the scheme, and introduced a new reduced rate to recognise the special circumstances of newly-registered businesses in their first year. (a)

Budget 2004 also announces, from 1 April 2004, an increase to £660,000 in the turnover ceiling beneath which bookmakers are eligible to make three-monthly betting duty returns. (-)

Modernising and simplifying VAT As announced in the 2003 Pre-Budget Report, certain cultural organisations, including theatres, galleries, zoos and museums, will be required to exempt admission charges from 1 June 2004. Affected organisations may reclaim VAT in respect of major building projects in progress at 1 June, where this is incurred before 31 May 2007. (r)

From 1 January 2005, the Government will amend the rules that determine the place of a supply of natural gas or electricity to ensure that the supplies are taxed either where the supplier is based or where the supplier consumes the product. (-)

Fund management services From 1 August 2003, the VAT exemption for the fund management of authorised unit trusts, trust-based schemes and open-ended investment companies (OEICs) was extended to fund management services provided by third party managers. (s)

Further VAT measures are included in the Protecting Tax Revenues section of Chapter A.

ENVIRONMENTAL AND TRANSPORT TAXES

Climate Change Levy Budget 2004 announces a freeze in the rates of Climate Change Levy (CCL). (31)

The eligibility criteria for climate change agreements (CCAs), which provide additional entitlement to 80 per cent discounts from CCL, will be extended following the receipt of state aid clearance. (30)

From Royal Assent, Budget 2004 announces legislation to prevent double taxation of energy products used to create biodiesel and bioblend. (*)

Landfill tax revenues As announced in the 2002 Pre-Budget Report, increases in the standard rates of landfill tax will be introduced in a way that is revenue neutral to business and local authorities (34)

Aggregates Levy The rate of aggregates levy is frozen at £1.60 a tonne in Budget 2004. (32)

On receipt of state aid approval, the Northern Ireland relief scheme will be extended for businesses prepared to sign agreements committing them to make environmental improvements to the way they operate. (33)

Domestic energy efficiency From 1 June 2004, the reduced VAT rate for domestic installations of energy-saving materials will be extended to include the domestic installation of ground source heat pumps. (*)

Landlords energy savings allowance From 6 April 2004, for a period of 5 years, individual landlords who invest in cavity wall insulation and loft insulation will be allowed to claim an in-year allowance of up to a maximum of £1,500 for the cost of that investment against their taxable profits, on the property in which the installation is made. (29)

Enhanced capital allowances The designated energy-saving and water-efficient technologies qualifying for 100 per cent enhanced first-year capital allowances (ECA) will be expanded during 2004, subject to agreement with the European Commission. (28)

VAT car fuel scale charges From 1 May 2004, the VAT scale charges are increased to reflect fuel price inflation. These are applied by businesses in order to calculate the amount of VAT due on the consumption of fuel for private motoring. (-)

Road fuel gases In line with the commitment in the 2003 Pre-Budget Report to offer three-year rolling certainty for alternative fuels, the duty differential for liquefied petroleum gas (LPG) will be 40.7p/l for 2004-05, 39.7p/l for 2005-06 and 38.7p/l for 2007-08. The differential for natural gas (NG) will be kept at 41p/l until 2007. (36)

Biodiesel and bioethanol The 20p per litre duty differential in favour of biodiesel and bioethanol (the latter to be introduced from 1 January 2005) is guaranteed until at least 2007. (37)

Fuel duties, ultra-low and sulphur-free fuels From 1 September 2004, duty on ultra-low sulphur petrol and diesel will increase by 1.92p per litre. From 1 September 2004, duty on sulphur-free petrol and diesel will increase in line with inflation. This will increase duty by 1.42p per litre. (35)

In order to encourage the supply and use of sulphur-free fuels, from Royal Assent, new relaxed rules will apply to the accounting provisions when road fuels attracting different duty rates are mixed in the same commercial tank. (-)

Red diesel, fuel oil and light oil From 1 September 2004, duty on rebated gas oil, (red diesel), fuel oil and light oil used as a furnace fuel will increase by 2.42p. (18)

Fuel substitutes used to generate electricity Legislation will be introduced later this year to exempt from fuel duty fuel substitutes used in diesel engines to generate electricity. (*)

Air passenger duty The rates of air passenger duty (APD) are frozen in Budget 2004. (39)

Vehicle excise duty The rates of vehicle excise duty (VED) are frozen for all vehicles. (40)

Table A8a: VED bands and rates for cars registered after 1 March 2002 (graduated VED)

VED band	CO_2 emissions (g/km)	Cars using alternative fuels	VED rate (£) Petrol car	VED rate (£) Diesel car
AAA	100 and below	55	65	75
AA	101 to 120	65	75	85
A	121 to 150	95	105	115
B	151 to 165	115	125	135
C	166 to 185	135	145	155
D	186 and above	155	160	165

Table A8b: VED bands and rates for cars and vans registered before 1 March 2002 (pre-graduated VED)

Engine size	VED rate (£)
1549cc and below	110
Above 1549cc	165

OTHER INDIRECT TAXES AND DUTIES

Tobacco duties

From 6pm on Budget Day 2004, tobacco duty rates will rise in line with inflation to maintain the real price of tobacco. (24)

Table A9: Changes to tobacco duties

	Effect of tax[1] on typical item (increase in pence)	Unit
Cigarettes	9.2	packet of 20
Cigars	3.3	packet of 5
Hand-rolling tobacco	9.0	25g
Pipe tobacco	5.5	25g

[1] *Tax refers to duty plus VAT.*

Alcohol duties

Excise duty rates on spirits, sparkling wine and cider are frozen, while the rates on beer and wine are increased in line with inflation from midnight on 21 March 2004. (25,26)

From 1 June 2004, the small breweries' duty relief scheme will be extended, on a tapered basis, to breweries producing between 30,000 and 60,000 hectolitres of beer a year. (27)

Table A10: Changes to alcohol duties

	Effect of tax[1] on typical item (increase in pence)	Unit
Beer	1	Pint of beer @ 4.2% abv
Wine	1	175ml glass typical strength
Wine	4	75cl bottle typical strength
Sparkling wine	0	75cl bottle typical strength
Spirits	0	70cl bottle 37.5% abv
Spirits-based RTDs	0	275ml bottle @ 5.4% abv
Cider	0	Pint of cider typical strength
Sparkling cider	0	175ml typical strength

[1] *Tax refers to duty plus VAT.*

Denatured alcohol

In order to modernise outdated legislation and reduce burdens for business, HM Customs and Excise will consult on new draft legislation – to be implemented in the summer – dealing with "denatured" alcohol. This is alcohol used for a variety of industrial and social purposes, and which is mixed with contaminants in order to make it unfit for drinking. (-)

The duty rates for general betting, pool betting, lottery and bingo are all frozen in Budget 2004. (-)

Betting and gaming duties

Gaming duty bandings will rise in line with inflation for accounting periods starting on or after 1 April 2004. (*)

Licence fees for machines in categories B, C, D and E of Amusement Machine Licence Duty (AMLD) will increase in line with inflation from 22 March 2004. The category A licence fees will be unchanged. (*)

For accounting periods ending on or after Royal Assent, any pool betting conducted or promoted in the UK, on horse or dog racing will fall within the scope of general betting duty. (-)

Customs' debts

Following Royal Assent, new rules will provide for the mutual sharing of information between the UK and Andorra, in order to assist with the recovery of customs' debts.(*)

Shipbuilders' relief

Following the Government's announcement on 12 January 2004, Budget 2004 confirms the repeal (including repeal having retrospective effect) of the shipbuilders' relief provisions in the 1966 Finance Act. (*)

Insurance Premium Tax

Following a policy review, HM Customs and Excise confirmed on 12 February 2004 that supplies of non-financial Guaranteed Asset Protection (GAP) insurance are liable to the higher rate of Insurance Premium Tax when sold through suppliers of motor vehicles or persons connected to them. This revised treatment takes effect from 1 April 2004. (bb)

Lorry road-user charge

Budget 2004 introduces legislation to assign responsibility for administering Lorry Road-User charge, once the tax is operational, to HM Customs and Excise.

Further indirect taxes and duties are included in the Protecting Tax Revenues section of the chapter.

PROTECTING TAX REVENUES

Jointly owned assets

A measure will be introduced, with effect from 6 April 2004, to tax distributions (including dividends) from shares in close companies jointly owned by a husband and wife, according to the actual proportions of ownership and entitlement to the income. (*)

Rate applicable to trusts

As announced in the 2003 Pre-Budget Report, the tax rate applicable to trusts will increase from 34 per cent to 40 per cent, and the corresponding dividend trust rate from 25 per cent to 32.5 per cent with effect from 6 April 2004. (v)

Pre-owned assets

As announced in the 2003 Pre-Budget Report, a measure will be introduced, with effect from 6 April 2005, to charge income tax on people who benefit from free or low-cost enjoyment of assets they formerly owned. (v)

Restriction of gift relief

As announced in the 2003 Pre-Budget Report, the capital gains tax rules were changed with effect from 10 December 2003 to prevent the exploitation of gift relief on disposals of assets to settlor-interested trusts. (v)

Private residence relief As announced in the 2003 Pre-Budget Report, the capital gains tax rules were changed with effect from 10 December 2003 to prevent the interaction between private residence relief and gifts relief being exploited. (v)

Inheritance tax life-time gifts A measure was introduced, with effect from 20 June 2003, to apply the gift with reservation rules to gifts made by a married person to a spouse via a trust. (-)

Life insurance As announced on 3 March 2004, a measure was introduced to prevent higher-rate taxpayers from using life insurance policies to avoid tax by manufacturing deficiency relief. The measure applies to new policies made on or after 3 March 2004 and to existing policies that are assigned, or become used as security for a debt, or into which policyholders choose to pay additional premiums on or after this date. (w)

UK equity repos As announced on 6 November 2003, a measure was introduced with effect from that date to prevent individuals avoiding income tax by entering into repo or stock lending transactions over UK equities. With effect from 17 March 2004, the measure will be extended to trusts and will apply to a capital gains development of the original scheme. (-)

Partnership avoidance As announced in the 2003 Pre-Budget Report, a charge to tax will be imposed where investors in film schemes attempt to avoid a charge to income tax on future income. The measures apply to disposals made on or after 10 December 2003.

As announced on 10 February 2004, partnership losses claimed against other income and gains by 'non-active' partners will be restricted to the amount actually contributed to the business; and disposals of future income streams by 'non-active' partners will be charged to income tax on disposal. The measures apply where losses arise on or after 10 February 2004.

A measure will be introduced to ensure that a charge to corporation tax will be made where a company shelters taxable profits in a realisation of its share of a partnership interest. This measure will apply to realisations of partnership interests which comprise untaxed profits arising on or after 17 March 2004. (-)

Gilt strips As announced on 15 January 2004, a measure was introduced with effect from that date to prevent artificial losses on strips of government bonds being set against other income so as to avoid tax. With effect from 17 March 2004 the measure will also prevent capital losses arising from such arrangements. (-)

Loan relationships A package of measures will be introduced to improve the effectiveness of, and close loopholes in, the loan relationship and derivative contracts regimes introduced in Finance Act 2002. These measures will be effective from various dates. (*)

Petroleum revenue tax Two petroleum revenue tax measures will be introduced, with effect from 17 March 2004, to prevent the generation of artificial costs through transactions with connected companies and to prevent the creation of unrelievable field losses through successive transfers of field interests close to decommissioning. (*)

Overpayment of tax As announced on 8 September 2003, a measure was introduced with immediate effect to ensure that, for direct taxes, the same time limits apply to common law actions for relief from the consequences of a mistake of law as apply for other actions to recover direct tax. (-)

Leasing avoidance A measure will be introduced, with effect from 17 March 2004, to counter avoidance involving the sale and leaseback or lease and leaseback of plant and machinery that allows businesses to continue to claim capital allowances on the asset but also to claim tax relief on all or most of the lease rentals paid to use the asset. (16)

Foreign earnings deduction As announced in the 2003 Pre-Budget Report, a measure will be introduced with effect from 6 April 2004 to re-define 'offshore installation' to ensure that the foreign earnings deduction is only available to genuine seafarers. (t)

Construction Industry Scheme The Government will introduce a revised Construction Industry Scheme from April 2006. This will reduce the regulatory burden on the industry, improve compliance, ensure that workers are correctly treated either as self-employed or employees and replace the present cards, certificates and vouchers with an Inland Revenue verification service and monthly returns. (u)

Payments by third parties As announced in the 2003 Pre-Budget Report, a measure was introduced with effect from 23 February 2004, to clarify that NICs are due where connected third parties, such as companies in the same group as an employer, make payments to employees. Tips paid to waiters and others in similar employment are not affected by this measure. (-)

Countering cross-border tax evasion by individuals As announced on 16 April 2003, UK paying agents will be required to report details of savings income paid to certain overseas residents. This enables the UK in particular to implement the European Savings Directive, which is designed to help combat cross-border tax evasion by individuals on their savings income. Reporting will not start before 1 January 2005. (-)

Life companies A package of measures will be introduced for life companies. One measure will counter avoidance using financial reinsurance. This will apply to account periods ending on or after 17 March 2004. In addition, the tax charge on assets retained by life companies following a transfer of business where the assets are retained to meet certain retained liabilities will be removed for transfers of business that take place on or after 17 March 2004.

Anomalies in section 444AD of the Income and Corporation Taxes Act (ICTA) 1988 and section 210A of the Taxation of Chargeable Gains Act 1992 will be corrected. The former applies to transfers of business that take place after 17 March 2004 and the latter applies for periods of account ending on or after 17 March 2004. Also a regulation making power will be introduced in relation to section 804B(7) ICTA 1988, which relates to double taxation relief for life insurance companies carrying on more than one category of business. This will apply from Royal Assent. (17)

Disclosure requirements New disclosure rules will be introduced that will require promoters who devise and market certain direct tax schemes to provide details of these schemes to the Inland Revenue, around the time the schemes are sold.

New rules will also require businesses with an annual turnover of £600,000 or more to notify HM Customs and Excise if they use an avoidance scheme listed in secondary legislation. Businesses with a turnover of £10 million or more will also be required to disclose schemes or arrangements bearing certain hallmarks of avoidance.

Details of when the rules will come into effect will be included with the Finance Bill.

Tackling VAT avoidance Following the granting of an EC derogation, new rules will counter the contrived arrangements that allow output tax to be avoided when demonstrator cars are made available to employees for their private use. (20)

From 1 August 2004, new eligibility rules will be introduced for corporate bodies wishing to join a VAT group. (x)

As announced in the 2003 Pre-Budget Report, new rules from 1 January 2004 prevent businesses from gaining the benefit of an unfair partial exemption method indefinitely. (y)

As announced in the 2003 Pre-Budget Report, from 11 December 2003 legislation was introduced to close VAT avoidance loophole where bad debts are assigned to associated businesses. (z)

From 18 March 2004, legislation will close a loophole used by avoiders to escape VAT on the purchase of commercial buildings. (19)

Tackling alcohol fraud

Budget 2004 introduces legislation, to be implemented early in 2006-07, requiring producers of spirits to apply a UK paid 'tax stamp' to certain of their products.

As announced in the 2003 Pre-Budget Report, the Government will introduce new regulatory controls during 2004 to help further tackle alcohol fraud. (aa)

ADDITIONAL SPENDING AND DEBT MANAGEMENT DECISIONS

Compliance package

A further package to fund additional compliance related activity by the Inland Revenue will be introduced. This package builds on the work begun last year and will further improve the ability of the Inland Revenue to tackle non-compliance and build for the future in key risk areas. The package is expected to yield £2 billion over three years.

2004 Spending Review

Budget 2004 sets firm overall spending limits for the 2004 Spending Review period. This allows current spending to increase by an average of 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumption for trend economic growth and consistent with the cash envelope set out in the 2003 and Pre-Budget Report. Final plans for DEL and AME spending will be set in the Spending Review. Budget 2004 announces that education spending in England will grow by an annual average of 4.4 per cent in real terms across the Spending Review period.

The capital expenditure of the 2004 Spending Review envelope is based on public sector net investment increasing from 2 per cent of GDP to $2^1/_4$ per cent of GDP by 2007-08. Net investment remains at $2^1/_4$ per cent of GDP in the spending projection of 2008-09.

Departmental Expenditure Limits

This Budget allocates an additional £80 to the Inland Revenue DEL as part of the new compliance package described in Chapter 5.

An allocation is made to HM Customs and Excise DEL of £12 million a year from 2005-06 for the implementation of an enhanced strategy to tackle alcohol fraud losses, including the implementation of tax stamps for spirits. A further allocation of £3 million is made in 2005-06 for a capital grants scheme to help mitigate the compliance costs to businesses of introducing tax stamps. The precise design and terms of the scheme are subject to further detailed discussions between HM Customs and Excise and the industry. (22)

Annually Managed Expenditure

In line with usual practice, this Budget sets the Annually Managed Expenditure (AME) margin to £1 billion in 2004-05, and £2 billion in 2005-06.

Euro preparations This measure, effective from Royal Assent, provides that the Debt Management Office (DMO) and National Savings and Investments (NS&I) may incur expenditure on preparations for the possible introduction of the single currency. (-)

APPENDIX A1: MEASURES ANNOUNCED IN BUDGET 2003 OR EARLIER

This appendix sets out a number of tax, benefit and other changes which were announced in Budget 2003 or earlier and which take effect from April 2004 or later. The revenue effects of these measures have been taken into account in previous economic and fiscal projections.

Table A1.1: Measures announced in Budget 2003 or earlier which take effect from April 2004 or later

		(+ve is an Exchequer yield)			£ million
		2004-05 indexed	2005-06 indexed	2006-07 indexed	2004-05 non-indexed
a	Electronic payment for large employers	+10	+10	+10	+10
b	E-filing incentives for payroll	0	–40	–110	0
c	Company car tax: emissions level for minimum charge	*	+100	+100	*
d	Stamp duty land tax: partnership transactions	+25	+60	+70	+25
e	Measures to encourage charitable giving	–30	–20	–10	–30
f	Fuel duties: new duty rate for bioethanol from January 2005	–5	–30	–40	–5
g	£1 per tonne increase in landfill tax from 2000 to 2004	+140	+145	+150	+115
h	Landfill tax: £3 increases from 2005-06	0	+125	+245	0
i	Housing benefit disregard	–45	–45	–45	–45
j	Transition to work package from October 2004	–10	–15	–15	–15
	TOTAL	**+85**	**+290**	**+355**	**+55**

* *negligible*

From April 2004, employers with 250 or more employees will be obliged to use electronic payment for PAYE and other statutory deductions to ensure they are paid promptly. (a)

Regulations made in September 2003 will offer incentives to small employers, and require larger employers, to e-file their PAYE end-of-year returns. This will be phased in over a number of years beginning for the year 2004-05 for business with 250 or more employees. Incentives for small employers to switch to electronic filing will be introduced beginning for 2004-05. (b)

The level of carbon dioxide emissions qualifying for the minimum company car tax petrol percentage (15 per cent) will reduce from 6 April 2005 by 5 grams per kilometre from 145 grams per kilometre to 140 grams per kilometre. (c)

The expected yield from all measures to reform stamp duty on land and buildings in the UK was published in Budget 2002. Details of the measures actually introduced under Stamp Duty Land Tax (SDLT) on 1 December 2003 and revised yields were published in Budget 2003. Following further consultation referred to in the Pre-Budget Report 2003, certain partnership transactions involving interests in land will be brought within the scope of SDLT from Royal Assent. (d)

From 6 April 2004, taxpayers completing a Self-Assessment return will be able to use the return to nominate a charity to receive all or a specified part of any tax repayment that arises. (e)

As announced in Budget 2003, a reduced rate of duty for bioethanol of 20 pence per litre below the rate for sulphur-free petrol will be introduced from 1 January 2005. (f)

In line with the Government's commitment in Budget 1999 to increase the standard rate of landfill tax by £1 per tonne each year until 2004, the rate increases from £14 to £15 per tonne on 1 April 2004. (g)

As announced in the 2002 Pre-Budget Report, the standard rate of landfill tax will increase from £15 to £18 per tonne in 2005-06. (h)

As announced in Budget 2003, from April 2004, the calculation of Housing Benefit will disregard £12.32 of earnings for all tenants who are claiming, or are entitled to claim, the Working Tax Credit, replacing the current 30 hour premium disregard.(i)

As announced in the 2002 Pre-Budget Report, from October 2004, the Job Grant will be available to those who move into work following six months on Jobseeker's Allowance, Incapacity Benefit or Income Support, including lone parents, and a new rate of £250 for households with children will be introduced. Partners of benefit claimants will also be eligible. These arrangements will replace the Back to Work Bonus and the lone parent Income Support run-on. (j)

As announced in the 2002 Pre-Budget Report, from April 2004 claimants of Incapacity Benefit or Severe Disablement Allowance will be treated in the same way as Jobseeker's Allowance and Income Support claimants when they return to work and will benefit from the Housing Benefit run-on. (j)

From 6 April 2004, the restrictions in the childcare element of the Working Tax Credit that prevent mothers on paid maternity leave receiving help with the costs of childcare for their new babies will be removed. (*)

APPENDIX A2: EXPLAINING THE COSTINGS

This appendix explains how the Exchequer effects of the Budget measures are calculated. In the context of these calculations, the net Exchequer effects for measures may include amounts for taxes, national insurance contributions, social security benefits and other charges to the Exchequer and, for HM Customs and Excise, penalties.

Calculating the costings

The net Exchequer effect of a Budget measure is generally calculated as the difference between applying the pre-Budget and post-Budget tax and benefit regimes to the levels of total income and spending at factor cost expected after the Budget. The estimates do not therefore include any effect the tax changes themselves have on overall levels of income and spending. However, they do take account of other effects on behaviour where they are likely to have a significant and quantifiable effect on the yield and any consequential changes in revenue from related taxes and benefits. These include estimated changes in the composition or timing of income, spending or other tax determinants. For example, the estimated yield from increasing the excise duty on petrol would include the change in the yield of VAT and other excise duties resulting from the new pattern of spending. The calculation of the expected effect of changes in duty rates on consumer demand for excise goods assumes that any change in duty is passed on in full to consumers. Where the effect of one tax change is affected by implementation of others, the measures are generally costed in the order in which they appear in Tables A1, A2 and A1.1.

The non-indexed base columns in Tables A1, A2 and A1.1 show the revenue effect of changes in allowances, thresholds and rates of duty including the effect of any measures previously announced but not yet implemented from their pre-Budget level. The indexed base columns strip out the effects of inflation by increasing the allowances, thresholds and rates of duty in line with prices in this and future Budgets.

A policy which has been previously announced but not yet implemented is also stripped out of the indexed numbers. Measures announced in this Budget are assumed to be indexed in the same way for future Budgets. The indexed base has been calculated on the assumption that, each year:

- income tax and NIC allowances and thresholds and the single person, couple, lone parent and disabled worker elements of the Working Tax Credit increase in line with the Retail Price Index (RPI) to the September prior to the Budget;
- the child element of the Child Tax Credit rises in line with the annual increase in average earnings for the lifetime of the Parliament;
- air passenger duty, climate change levy, aggregates levy, vehicle excise duty and fuel, tobacco and alcohol duties all rise in line with the projected annual increase in the RPI to the September following the Budget; and
- VAT thresholds and gaming duty bands rise in line with the increase in the RPI to the December prior to the Budget.

Implementation dates are assumed to be: Budget day for fuel and tobacco duties; 10 days after Budget day for alcohol duties; May for amusement machine licence duty; July for insurance premium tax; November for air passenger duty; and April for all other taxes, duties and tax credits.

The yields of measures that close tax avoidance loopholes represent the estimated direct Exchequer effect of the measures with the existing level of activity.

These costings are shown on a National Accounts basis. The National Accounts basis aims to recognise tax when the tax liability accrues irrespective of when the tax is received by the Exchequer. However, some taxes are scored on a receipt basis, principally due to the difficulty in assessing the period to which the tax liability relates. Examples of such taxes are corporation tax, self-assessment income tax, inheritance tax and capital gains tax. This approach is consistent with other Government publications.

Notes on individual Budget measures

Pensions tax simplification

The following notes provide further information on the costings for a small number of issues, to help explain the basis for costing the particular measure or give details of effects on government revenue in the longer term.

The costs include the likely impact of increased pensions savings from those who are constrained by the current rules, as well as the increased flexibility offered by the new regime, such as the ability for some to take a higher tax-free lump sum than under the current regime or for people in occupational schemes to draw benefit from their pension while continuing to work, where their schemes will allow it. It is estimated that the costs are likely to increase to around £250 million by 2009-10.

Increases to the SME thresholds The cost declines slowly after 2006-07 as profits are brought back into charge in later years due to the fact that tax relief on investment was accelerated in the first year.

Venture capital schemes The costs rise to 2006-07 as VCT investment is increased to take advantage of the enhanced income tax relief, and then in 2007-08 this switches to a net tax saving due to investment brought forward from 2006-07 to benefit from the enhanced relief. From 2008-09 onwards, the additional costs from raised income tax relief thresholds are approximately offset by the tax savings from abolishing capital gains tax deferral for VCT investment.

Corporation tax reform: transfer pricing and thin capitalisation After 3 years, the measure is expected to have an ongoing Exchequer cost. This is as the cost of the exemption for smaller businesses begins to outweigh the yield from UK-UK transfer pricing.

Employer supported childcare The cost is expected to increase to £60 million by 2009-10.

Company vans The cost from 2007-08 is expected to be negligible.

Capital allowances for small enterprises The yield in 2006-07 reflects the fact that profits will be brought back into charge from that year onwards due to the fact that tax relief on investment was accelerated in 2005-06. A small but declining yield continues after 2006-07.

APPENDIX A3: TAX ALLOWANCES AND RELIEFS

This appendix provides estimates of the revenue cost of some of the main tax allowances and reliefs.

Tax reliefs can serve a number of purposes. In some cases they may be used to assist or encourage particular individuals, activities or products, and so may be an alternative to public expenditure. In this case they are often termed 'tax expenditures'. There may, for example, be a choice between giving tax relief as an allowance or deduction against tax, or by an offsetting cash payment.

Many allowances and reliefs can reasonably be regarded (or partly regarded) as an integral part of the tax structure – called 'structural reliefs'. Some do no more than recognise the expense incurred in obtaining income. Others reflect a more general concept of 'taxable capacity'. The personal allowances are a good example: to the extent that income tax is based on ability to pay, it does not seek to collect tax from those with the smallest incomes. However, even with structural reliefs of the latter kind, the Government has some discretion about the level at which they are set.

Many other reliefs combine both structural and discretionary components. Capital allowances, for example, provide relief for depreciation at a commercial rate as well as an element of accelerated relief. It is the latter element which represents additional help provided to business by the Government and is a 'tax expenditure'.

The loss of revenue associated with tax reliefs and allowances cannot be directly observed, and estimates have to be made. This involves calculating the amount of tax that individuals or firms would have had to pay if there were no exemptions or deductions for certain categories of income or expenditure, and comparing it with the actual amount of tax due. The Government regularly publishes estimates of tax expenditures and reliefs for both HM Customs and Excise and Inland Revenue taxes. Largely because of the difficulties of estimation, the published tables are not comprehensive but do cover the major reliefs and allowances.

The estimates in Table A3.1 below show the total cost of each relief. The classification of reliefs as tax expenditures, structural reliefs and those elements combining both is broad-brush and the distinction between the expenditures and structural reliefs is not always straightforward. In many cases the estimated costs are extremely tentative and based on simplifying assumptions. The figures make no allowance for the fact that changes in tax reliefs may cause people to change their behaviour. This means that figures in Table A3.1 are not directly comparable with those of the main Budget measures.

Estimation of behavioural effects is difficult. The sizes of behavioural changes will obviously depend on the measure examined and possible alternative behaviours. For example, removing the tax privileges of a form of saving may just lead people to switch to another tax privileged form of saving.

Table A3.1 also gives details relating to VAT, which is collected by HM Customs and Excise. It shows the estimated yield forgone by not applying the standard rate of VAT (17.5 per cent) to goods and services which are currently zero-rated, reduced-rated, exempt or outside the scope of VAT. Estimates of the scale of structural reliefs for local authorities and equivalent bodies are also shown. Again, the figures are estimates and must be treated with caution. In line with the treatment of Inland Revenue taxes, they make no allowance for changes in behaviour.

The estimated costs of reliefs and allowances given in Table A3.1 cannot be added up to give a meaningful total. The combined yield of withdrawing two related allowances could differ significantly from the sum of individual costs. Similarly the sum of the costs of component parts of reliefs may differ from the total shown.

More details on individual tax allowances and reliefs can be found in the HM Treasury publication, Tax ready reckoner and tax reliefs, published alongside the 2003 Pre-Budget Report.

Table A3.1: Estimated costs of principal tax expenditures and structural reliefs

	£ million	
	2002-03	2003-04
TAX EXPENDITURES		
Income tax		
Relief for:		
Approved pension schemes	13,200	13,900
Approved profit sharing schemes	160	–
Share Incentive Plan	100	180
Approved savings-related share option schemes	170	160
Personal Equity Plans	625	575
Individual Savings Accounts	800	950
Enterprise Investment Scheme	190	180
Professional subscriptions	60	60
Rent-a-room	90	90
Exemption of:		
First £30,000 of payments on termination of employment	800	800
Interest of National Savings Certificates including index-linked certificates	140	120
Tax Exempt Special Savings Account interest	100	50
Premium Bond prizes	90	100
Income of charities	900	1,000
Foreign service allowance paid to Crown servants abroad	80	90
First £8,000 of reimbursed relocation packages provided by employers	300	300
Tax credits:		
Life assurance premiums (for contracts made prior to 14 March 1984)	75	65
Children's Tax Credit	2,300	500
Working Families' Tax Credit	750	10
Disabled Person's Tax Credit	40	*
Child Tax Credit	–	2,700
Working Tax Credit	–	700
Income tax and corporation tax		
Film tax relief	300	140
Corporation tax		
R&D Tax Credits	400	430
Relief for clearing contaminated land	75	75
National insurance contributions		
Relief for:		
Approved profit sharing schemes	110	–
Share Incentive Plan	60	110
Approved savings-related share option schemes	120	110
Employer contributions to approved pension schemes	5,100	6,300
Capital gains tax		
Exemption of gains arising on disposal of only or main residence	10,000	10,500

Table A3.1: Estimated costs of principal tax expenditures and structural reliefs

	£ million	
	2002-03	2003-04
Inheritance tax		
Relief for:		
Agricultural property	150	160
Business property	130	140
Exemption of transfers to charities on death	350	400
Value added tax		
Zero-rating of:		
Food	9,700	10,050
Construction of new dwellings (includes refunds to DIY builders)	4,300	4,450
Domestic passenger transport	1,850	1,950
International passenger transport (UK portion)	250	250
Books, newspapers and magazines	1,500	1,550
Children's clothing	1,100	1,150
Water and sewerage services	1,000	950
Drugs and supplies on prescription	850	900
Supplies to charities	200	200
Ships and aircraft above a certain size	550	600
Vehicles and other supplies to disabled people	350	400
Lower rate on domestic fuel and power	1,750	1,800
Lower rate for certain residential conversions	100	100
STRUCTURAL RELIEFS		
Income tax		
Personal allowance	35,000	36,200
Income tax and corporation tax		
Double taxation relief	8,000	8,000
Corporation tax		
Life companies reduced rate of corporation tax on policy holders' fraction of profit	450	400
National insurance contributions		
Contracted-out rebate occupational schemes:		
Rebates deducted at source by employers	7,420	7,550
Rebates paid by the Contributions Agency direct to the scheme	300	310
Personal pensions	3,630	3,770
Value added tax		
Refunds to:		
Northern Ireland Government bodies of VAT incurred on non-business purchases under the Section 99 refund scheme	250	300
Local Authority-type bodies of VAT incurred on non-business purchases under the Section 33 refund scheme	5,500	6,100
Central Government, Health Authorities and NHS Trusts of VAT incurred on contracted-out services under the Section 41 (3) refund scheme	3,000	3,500

Table A3.1: Estimated costs of principal tax expenditures and structural reliefs

	£ million	
	2002-03	2003-04
RELIEFS WITH TAX EXPENDITURE AND STRUCTURAL COMPONENTS		
Income tax		
Age-related allowances	1,600	2,000
Exemption of:		
British Government securities where owner not ordinarily resident in the United Kingdom	750	750
Child Benefit (including one parent benefit)	980	1,070
Long-term incapacity benefit	630	650
Industrial disablement benefits	90	80
Attendance allowance	250	310
Disability living allowance	500	570
War disablement benefits	110	110
War widow's pensions	70	70
Corporation tax		
Small companies' reduced rate corporation rate	2,150	2,350
Starting rate of corporation tax	300	350
Exemption of gains on substantial shareholdings	260	260
Income tax and corporation tax		
Capital allowances	18,200	18,500
Of which:		
First year allowances for SMEs	170	180
First year allowances for small enterprises for information and communication technology	170	160
Enhanced capital allowances for energy saving technology	150	180
Accelerated capital allowances for Enterprise Zones	170	540
Capital gains tax		
Indexation allowance and rebasing to March 1982	230	230
Taper relief	550	900
Exemption of:		
Annual exempt amount (half of the individual's exemption for trustees)	800	1,050
Gains accrued but unrealised at death	650	650
Petroleum revenue tax		
Uplift of qualifying expenditure	140	210
Oil allowance	440	520
Safeguard: a protection for return on capital cost	200	250
Tariff receipts allowance	50	40
Exemption for gas sold to British Gas under pre-July 1975 contracts	160	150
Inheritance tax		
Nil rate band for chargeable transfers not exceeding the threshold	7,500	8,200
Exemption of transfers on death to surviving spouses	1,500	1,800

Table A3.1: Estimated costs of principal tax expenditures and structural reliefs

	£ million	
	2002-03	**2003-04**
Stamp duties		
Exemption of transfers of land and property where the consideration does not exceed the £60,000 threshold (from December 2003 non-residential land and property threshold is £150,000)	140	110
Exemption of transfers of land and property in designated disadvantaged wards where the consideration does no exceed £150,000 and from April 2003 exemption of all non-residential transfers	70	400
National insurance contributions		
Reduced contributions for self-employed not attributable to reduced benefit eligibility (constant cost basis)	1,200	1,600
Value added tax		
Exemption of:		
Rent on domestic dwellings	2,750	2,900
Rent on commercial property	450	450
Private education	150	150
Health services	650	700
Postal services	400	400
Burial and cremation	100	100
Finance and insurance	2,350	2,500
Betting, gaming and lottery duties	900	950
Small traders	400	400

* *negligible*

B THE ECONOMY

Economic developments and prospects remain much as envisaged in the 2003 Pre-Budget Report. UK GDP has grown strongly in recent months, broadly in line with the 2003 Pre-Budget Report forecast. With the major uncertainties that dominated the international economic outlook in early 2003 receding, global demand continuing to pick up and UK macroeconomic fundamentals remaining sound, business and consumer confidence have strengthened. As a result, domestic demand growth rose significantly through last year as private consumption growth recovered from temporary lows and business investment started to rise. Moreover, tentative signs of improved international prospects feeding through to higher external demand have also emerged. UK GDP rose 0.9 per cent in the fourth quarter of 2003, the fastest rate for over three and a half years and following on from growth of 0.8 per cent in the third quarter. For 2003 as a whole GDP rose by 2.3 per cent, consistent with the Budget 2003 forecast of 2 to 2½ per cent and a little above the 2003 Pre-Budget Report estimate of 2.1 per cent.

As at Pre-Budget Report time, the pick-up in activity seen since spring 2003 is expected to be consolidated through 2004 and into 2005. Business survey evidence points to a considerable strengthening of investment intentions in recent months, suggesting further growth in private sector capital expenditure is in the pipeline. Rising world trade is also expected to underpin a renewed acceleration in exports through this year and into next. Although sterling has risen since last summer, this mainly reflects movement against the dollar. Sterling remains around 10 per cent weaker against the euro compared with rates prevailing two or so years ago, providing a boost to demand from the UK's largest export market. At the same time, private consumption growth is forecast to remain comfortably below the rates seen for much of the period since the mid-1990s. Therefore, as investment and exports pick up, the composition of demand is projected to become more balanced than in recent years.

The Budget 2004 economic assessment is that:

- **UK GDP is expected to grow by 3 to 3½ per cent in both 2004 and 2005, unchanged from both the Budget 2003 and Pre-Budget Report 2003 forecasts. By 2006, with slack in the economy absorbed and the output gap closed, growth is expected to return to its trend rate of 2½ to 3 per cent;**
- **Consumer Prices Index (CPI) inflation is expected to rise through the course of this year to reach its 2 per cent target by mid-2005 as the lagged effects of sterling's depreciation against the euro since 2002, combined with the effects of the strengthening synchronised recovery in the world economy, feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.**

However, while uncertainties have receded since early 2003, a number of downside and upside risks continue to surround the Budget forecast. Sudden, sharp movements in major exchange rates could potentially disrupt the ongoing recovery in the global economy. In the UK, there remains the risk that house price inflation will slow by more than expected, raising the possibility of a greater than forecast moderation in consumer spending. On the upside, the strengthening in both global and UK growth could reveal more short-term momentum than assumed in the forecast. In particular, business investment has, in the past, tended to accelerate markedly once a pick-up in growth gets underway. UK consumer spending growth could also continue to surprise on the upside, especially in the near term.

INTRODUCTION[1,2]

B1 This chapter discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2006. It begins with an overview of developments and prospects in the world economy. It then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

THE WORLD ECONOMY

Overview

B2 In early 2003, geo-political and other uncertainties weighed heavily on international growth prospects, and global activity remained weak. However, growth in several major economies had already picked up by the middle of last year and, as expected at the time of the 2003 Pre-Budget Report, activity has continued to strengthen across the world's major economies. While this improvement has been led by a sharp pick-up in growth in the United States (US) and rapid growth in Asia, there are now clearer signs that activity is strengthening elsewhere, suggesting that the global recovery is becoming more broadly based. Overall, leading indicators have continued to improve and financial conditions remain highly supportive, pointing to the prospect of a sustained recovery over the medium term.

B3 G7 GDP growth is expected to increase further in 2004, with the US economy expanding briskly and a gradual recovery taking shape in the euro area. Growth in Japan is also expected to remain robust, but to moderate slightly from its strong rate in 2003. Stronger global demand has fed a recovery in world industrial production and trade. As expected at the time of the Pre-Budget Report, world trade accelerated sharply during the second half of 2003, and is forecast to record further strong growth during 2004.

B4 Policy makers around the world have continued to support growth. In the US, monetary policy has remained highly accommodative and fiscal policy played a key role in prompting a pick-up in household spending during the second half of 2003. In the euro area and Japan interest rates remain low. Financial markets are now expecting the Federal Reserve and European Central Bank to keep short-term interest rates unchanged through much of this year, a slightly more accommodative stance than had been expected last December.

B5 Although some key uncertainties have diminished as the global recovery has gathered pace, significant risks still remain. The main downside risks come from global imbalances and exchange rate movements, generally weak labour markets, further balance sheet adjustment, high oil prices, ongoing geo-political concerns and the continued threat of international terrorism. On the other hand, pent-up demand and low inventory levels may prompt a faster recovery in GDP and world trade growth than currently expected.

[1] The UK forecast is consistent with output, income and expenditure data to the fourth quarter of 2003 released by the Office for National Statistics on 25 February 2004. This release also contained revisions to earlier quarters of 2003 which the Treasury has carried through to certain other national accounts series that the ONS have not yet revised, in particular sectoral saving and borrowing. A fully consistent national accounts dataset for 2003 will be published by ONS on 26 March. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk) and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

Table B1: The world economy

	Percentage changes on a year earlier unless otherwise stated			
		Forecast		
	2003	2004	2005	2006
Major 7 countries[1]				
Real GDP	2¼	3¼	3	2¾
Consumer price inflation[2]	1½	1½	1¾	1¾
Euro-area				
Real GDP	½	1¾	2¾	2½
World trade in goods and services	4¼	7¾	8	7¼
UK export markets[3]	3¾	6¼	7¼	6¾

[1] *G7: US, Japan, Germany, France, UK, Italy and Canada.*
[2] *Per cent, Q4.*
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

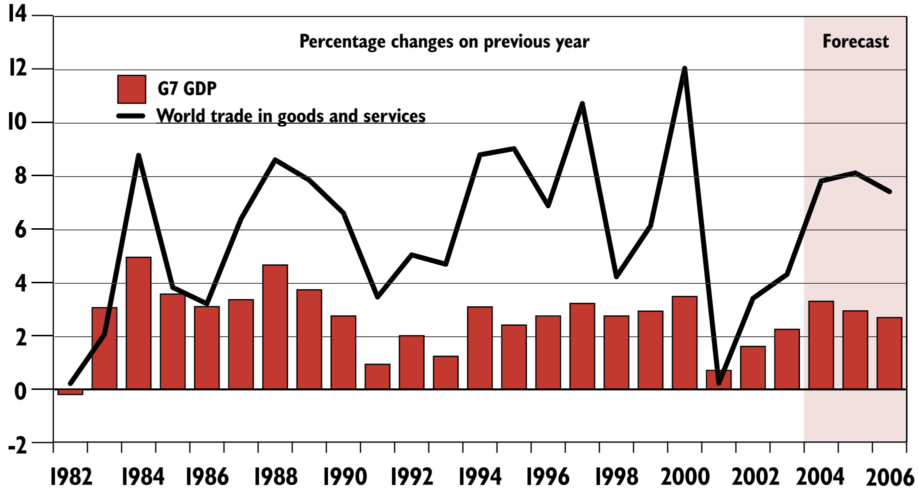
G7 activity

B6 After expanding by 2¼ per cent in 2003, G7 GDP is forecast to grow by 3¼ per cent in 2004, a little above the projection made in last December's Pre-Budget Report. This upward revision primarily reflects stronger than expected growth in the US and Japan. In the euro area, signs that a recovery is taking root have become more evident, and a gradual acceleration in GDP is expected through 2004.

B7 US GDP accelerated sharply during the second half of 2003. Reduced geo-political uncertainty, significant policy stimulus, and strengthening financial markets contributed to an improvement in business and consumer confidence, a pick-up in household spending and a recovery in business investment. For 2003 as a whole, the US recorded growth of 3.1 per cent, a little below most estimates of trend, but significantly higher than in 2001 and 2002. A key development in recent months has been the first significant evidence of a recovery in capital spending since the recession in 2001. Business investment turned up sharply during the second half of 2003, and leading indicators and financial conditions suggest this improvement should be sustained through 2004. Stock markets have rebounded significantly since their spring 2003 lows, long-term interest rates remain at low levels, corporate spreads have narrowed, and profitability has risen rapidly.

B8 The 2003 Pre-Budget Report noted several early signs of recovery in the euro area, and this has been confirmed with a return to positive growth in the second half of 2003. Nevertheless, GDP growth, of under ½ per cent for 2003 as a whole, was weak, and several economies, including Germany, Italy and the Netherlands, experienced short recessions. Spain and Greece were able to generate more robust growth, based on continued strength in domestic demand. The pace and strength of the upturn in euro area activity remains uncertain. Strong external demand should support trade, partly offsetting the effects of the recent appreciation of the euro. Investment appears to be strengthening in response to low financing costs, rising stock markets and growing confidence. Further out, household spending is expected to strengthen gradually as labour market conditions slowly improve although, in the short term, confidence in some of the larger economies may remain subdued. The main downside risks are further appreciation of the euro, and a failure of household confidence to improve on the back of a strengthening global economy.

Chart B1: G7 GDP and world trade



B9 Since the 2003 Pre-Budget Report, data have generally confirmed a pick-up in activity in Japan. Strong export demand from Asia, low inventory levels and restructuring among Japan's large manufacturers have boosted profitability and production. During 2003 this encouraged a recovery in business investment which looks set to continue, at least through the first half of 2004. The momentum in the export and manufacturing sectors has also fed an improvement in the labour market and rising consumer confidence. In conjunction with a falling saving ratio, private consumption is expected to strengthen during 2004, potentially leading to a more self-sustaining recovery. If the pace of structural reform can be lifted in the non-manufacturing and banking sectors, then the likelihood of more autonomous economic growth will increase. For the moment, however, the recovery remains vulnerable to developments overseas.

Emerging markets and developing economies

B10 Emerging market economies have rebounded strongly as the global recovery has gathered momentum. In particular, growth in emerging Asia bounced back significantly during the second half of 2003 as the temporary impact from Severe Acute Respiratory Syndrome (SARS) and geo-political uncertainties started to fade. Both exports and domestic demand have provided the impetus for this growth. China continues to play a pivotal role in the region, with official estimates of growth at just over 9 per cent. In a number of Latin American economies growth has also strengthened and prospects for 2004 have continued to improve. Although relatively resilient throughout the downturn, a rebound in Eastern Europe has been restrained by the sluggishness of domestic activity in the euro area. Prospects for the new EU Member States are discussed in Box B1. India's growth, at around 7 per cent in 2003, has been boosted significantly by a recovery in the agricultural sector. In the Middle East and Russia, growth has been supported by relatively high oil prices, and this is likely to continue in 2004. However, structural reform is still needed to ensure sustainable long-term growth. GDP growth in sub-Saharan Africa increased modestly in 2003 and is expected to strengthen further during 2004, reflecting a combination of improving macroeconomic fundamentals, higher commodity and energy prices, and improved political stability.

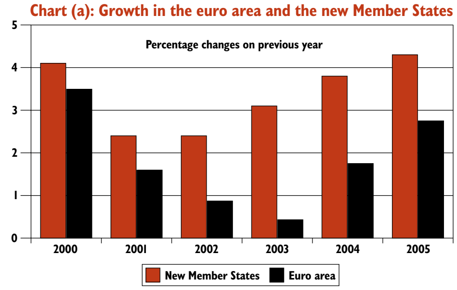
Box B1: EU enlargement

From 1 May 2004, membership of the EU will be expanded to include ten new Member States: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia. This will increase the size of the single market, in population terms, beyond that of the North American Free Trade Area.

The new Member States have undergone radical transformations since 1989, and have implemented substantial economic reforms in preparation for EU membership. These reforms have helped deliver significant improvements in economic performance. Average growth in the new Member States has been above 3 per cent in the past five years, with several of the smaller Member States experiencing growth rates above 4 per cent. This was despite an easing in growth during 2001 and 2002, in line with the global slowdown.

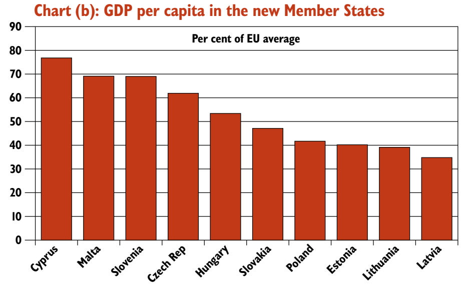
The expected recovery in the euro area should have a positive impact on the new Member States, as a large proportion of their trade is carried out with existing euro area economies. The European Commission estimates growth in the new Member States will be close to 4 per cent in both 2004 and 2005, as shown in Chart (a). Strong growth and continued reform is particularly important to raising living standards in the new Member States, which remain significantly below those in the EU15, as shown in Chart (b). Enlargement should offer new opportunities for the EU as a whole, by increasing supply-side competitive pressures and generating new demand for goods and services. Realising these benefits will require flexibility and continued reform to ensure countries can adapt quickly and efficiently to changes in competition and comparative advantage.

Chart (a): Growth in the euro area and the new Member States



Source: European Commission, (Autumn Forecast 2003) and HM Treasury.

Chart (b): GDP per capita in the new Member States



Source: Eurostat, Structural Indicators.

B11 Activity in many emerging markets has been supported by benign financing conditions, with bond spreads for many countries falling to new lows. However, looking ahead, higher global interest rates could pose a significant risk to emerging market financing conditions.

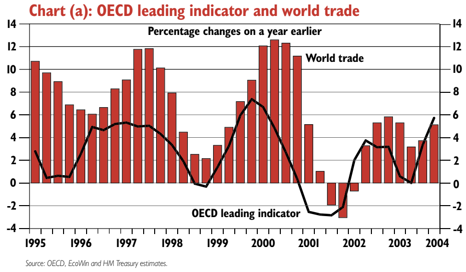
World trade

B12 World trade growth stalled during the second half of 2002, and dipped further in the early months of 2003 in response to weaker global activity. However, leading indicators of exports and industrial production improved rapidly during the final months of 2003, and as global demand has continued to strengthen, world trade appears to have gathered momentum. With the global recovery expected to continue and become more broadly based, trade should accelerate further. As in the 2003 Pre-Budget Report, world trade is forecast to grow by 7¾ per cent in 2004 and 8 per cent in 2005. Growth in UK export markets is likely to be somewhat weaker, reflecting domestic demand in the euro area remaining relatively subdued and these economies accounting for around 50 per cent of UK trade.

Box B2: The recovery in world trade

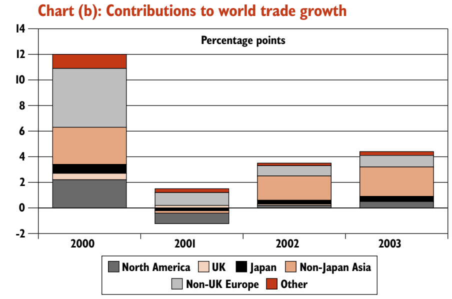
Recent data releases and a raft of leading indicators point to a sharp acceleration in world trade through 2004. For example, the OECD leading activity indicator, which has mapped movements in world trade fairly closely over the past, turned up sharply during 2003, as shown in Chart (a). Shipping freight indices, export orders and semi-conductor billings are also rising rapidly.

Chart (a): OECD leading indicator and world trade



Source: OECD, EcoWin and HM Treasury estimates.

Chart (b): Contributions to world trade growth



Source: HM Treasury estimates based on OECD data.

Chart (b) shows that while world trade growth slowed sharply in 2001, a recovery did take root in 2002 and 2003. However, even these relatively low world trade growth readings were heavily reliant on rapidly growing intra-regional trade in Asia. Trade activity across the G7 economies remained much more muted. Looking forward, the Budget 2004 forecast projects that global trade growth will become more broad-based, as economic activity becomes more balanced across the world's major economies.

To minimise the medium-term risks to the global economy and seize the opportunities from the recovery in economic activity and trade, it is vital that each country plays its part in addressing the causes of the current imbalances. This means every government should press ahead with reforms to labour, product and capital markets, making their economies more flexible and better able to adjust to the ongoing changes to the pattern of global growth. In the short term, imbalances may lead to greater calls for protectionist measures in some economies which, if accomodated, would pose a major threat to global development. Trade is a principal engine of global economic growth, and all countries can gain from the improving global prospects by further opening up their markets. It is therefore crucial that significant progress is made in the World Trade Organisation Doha Development Agenda negotiations as soon as possible. Balanced global growth will require the inclusion of all countries in the global economy, which is why the developed world needs to live up to its commitments to the developing world, including through innovative financing mechanisms and the removal of trade barriers.

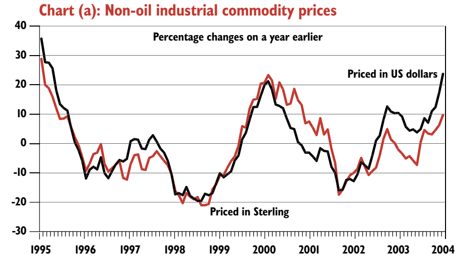
Oil and commodity prices

B13 Oil prices have remained in a range of $28 to $34 a barrel since the 2003 Pre-Budget Report, with low crude inventories, cold weather in the US and stronger global demand supporting prices. The depreciation in the US dollar has also pushed up prices, with recent rises much less pronounced in sterling terms. In the expectation of demand easing in the spring, OPEC recently decided to cut its production quotas from 1 April 2004. This decision has increased the risk that the market will remain tight through the spring. For the remainder of the year, prices are likely to stay significantly above their long-run average and, given low stock levels, remain vulnerable to shocks. Meanwhile, non-oil commodity prices have also continued to rise strongly in recent months. As with oil prices, these increases reflect strengthening global demand, rapid industrialisation in China, and the depreciation of the US dollar, as discussed further in Box B3.

Box B3: Recent developments in commodity prices

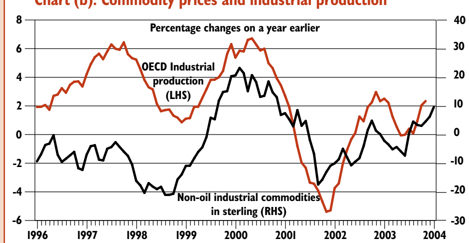
In recent months commodity price inflation has picked up sharply. In part this reflects the pricing of most major commodities in US dollars. With the US dollar exchange rate depreciating significantly since early 2002, international commodity producers have had an incentive to raise the US dollar price of their output in order to maintain their domestic profit margins. This is illustrated in Chart (a). Although non-oil industrial materials prices have risen by around 25 per cent over the past year, in sterling terms this increase is much less pronounced, at around 10 per cent.

Chart (a): Non-oil industrial commodity prices



Source: IMF and HM Treasury estimates.

Chart (b): Commodity prices and industrial production



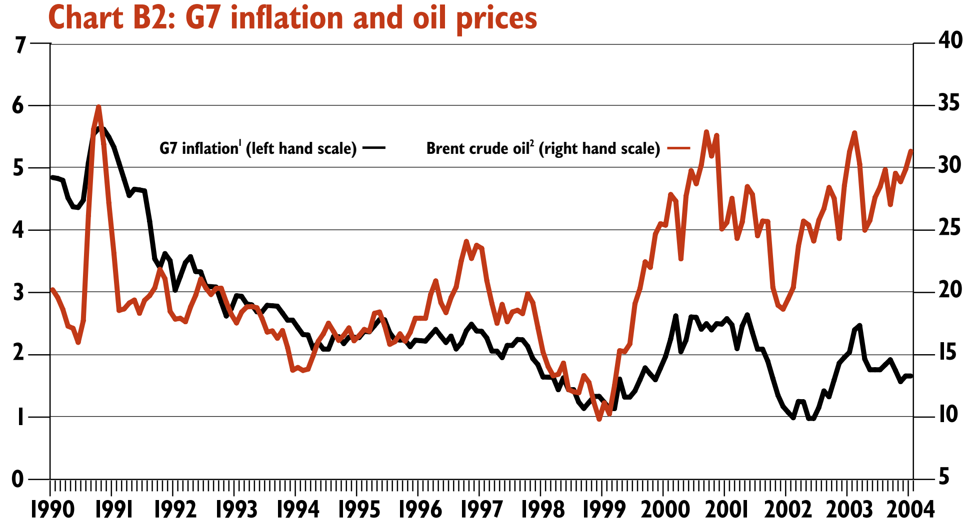
Source: IMF, OECD and HM Treasury estimates.

Movements in major exchange rates are not the only factor contributing to the pick-up in commodity prices. The cyclical improvement in global demand is also playing an important role. Chart (b) shows that the recent acceleration in prices is broadly consistent with the upturn in OECD industrial production. Economies outside the OECD are also having an important and growing impact. In particular, rapidly expanding industrial production in China is increasingly consuming large quantities of raw materials and metals. For example, industrial production in China is growing at an annual rate of over 20 per cent. There are also clear signs that demand from Asia is bidding up shipping freight costs. For example, the Baltic Freight Index is now around 300 per cent above its long-run average.

G7 inflation

B14 With output levels below potential in most major economies, inflationary pressures have remained very subdued. However, continued global recovery should reduce spare capacity, and rising commodity and goods prices are expected to push inflation higher. Consumer prices in the G7 are expected to rise by 1½ per cent in 2004 and 1¾ per cent in 2005.

Chart B2: G7 inflation and oil prices



[1] *Consumer price index, percentage change on a year earlier.*
[2] *US dollars per barrel.*

Forecast issues and risks

B15 As the global recovery has gathered pace, some key uncertainties have diminished. However, other risks remain. In recent months, the US dollar has continued to decline against some other major currencies. So far, this has been an orderly depreciation, accompanied by improving financial conditions and strengthening growth, but given continued large global imbalances, sharper movements in major exchange rates cannot be ruled out. This highlights the urgent need for policy makers to push ahead with structural reforms that will ensure a more broadly based and sustainable global recovery over the medium term, minimising the risk of a disorderly unwinding of global trade positions.

B16 A further downside risk comes from the potential rebuilding of balance sheets. Significant progress has been made in rebuilding household and corporate balance sheets across several major economies since the recession of 2001. However, this process may not be complete, and could resume once the stimulus from policy begins to fade. Further balance sheet adjustment might entail significantly weaker spending by households or the business sector, and could undermine the recovery. This is particularly a risk for the household sector when combined with weak labour markets: despite the acceleration in G7 GDP, employment growth has remained very subdued. Policy makers will also have to continue to be vigilant to a number of other downside risks, including remaining geo-political uncertainties, high oil prices, and viral epidemics, most recently avian flu.

B17 There are also a number of important upside risks. After several years of subdued activity, pent-up demand may prompt a sharper bounce in growth than currently assumed. The clearest example is capital spending, which has tended to pick up quickly in previous global upturns. Similarly, world trade may also accelerate more quickly than expected, given the continued strength in Asia and that the Budget 2004 projections entail growth rates well below those seen before the 2001 slowdown. Finally, with inventories at low levels across most major economies, a return to stock-building could provide a powerful short-term stimulus to growth.

UK ECONOMY

Trend growth

B18 The Treasury's neutral estimate of the economy's trend output growth rate for the 2004 Budget is and remains 2¾ per cent to the end of 2006. Business surveys and data reported since the 2003 Pre-Budget Report do not suggest any change in the Government's estimate of the growth potential of the economy.

B19 Table B2 presents the historical and forward-looking estimates of the composition of trend output growth. They are unchanged from the estimates in the 2003 Pre-Budget Report. The neutral trend projection from the economy's last adjudged on-trend point in the third quarter of 2001 provides the trend path around which the mid-points of the economic forecast ranges from the fourth quarter of 2003 are anchored.

B20 Blue Book 2003 introduced substantial revisions to the data underlying the Treasury's trend growth assumptions, and showed that both trend output and productivity growth over the recent past – between the estimated on-trend points in 1997H1 and 2001Q3 – had been stronger than previously thought. Trend output growth over this period is now estimated at 2.9 per cent. This further increased confidence that the 2¾ per cent trend growth assumption is consistent with the economy's potential. However, the Treasury continues to base the public finance projections on a deliberately cautious annual trend growth assumption that is ¼ percentage point below the neutral view.

Table B2: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]		Trend average hours worked[3]	Trend employment rate[3]	Population of working age[4]	**Trend output**
	Underlying (1)	Actual (2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1	2.22	2.05	–0.10	0.33	0.24	**2.54**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	–0.37	0.36	0.66	**2.63**
Budget 2003	2.35	2.14	–0.47	0.43	0.50	**2.61**
PBR 2003 and Budget 2004	2.65	2.44	–0.47	0.42	0.54	**2.94**
Projection[5]						
2001Q4 to 2006Q4						
Budget 2002	2.10	2.0	–0.1	0.2	0.6	**2¾**
Budget and PBR 2003	2.35	2.25	–0.1	0.2	0.5	**2¾**
Budget 2004[6]	2.35	2.25	–0.1	0.2	0.5	**2¾**

[1] *Treasury analysis based on judgement that 1986Q2, 1997H1, and 2001Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward. Columns (2)+(3)+(4)+(5)=(6). Full data definitions and sources are set out in Annex A of 'Trend Growth: Recent Developments and Prospects', HM Treasury, April 2002.*

[2] *The underlying trend rate is the actual trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant. Column (1)=column (2) + (1-a) column (4), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.*

[3] *The decomposition makes allowance for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that hours lag output by just one quarter, though this lag is hard to support by econometric evidence, not least because quarterly LFS data only extend as far back as 1992Q2. Hours worked and the employment rate are measured on a working-age basis.*

[4] *UK household basis.*

[5] *Neutral case assumptions for trend from 2001Q4.*

[6] *Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2003Q4 are anchored.*

Overview of recent developments and prospects

Recent developments

B21 The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges that have faced the world economy over recent years. Sound fundamentals allowed the independent Monetary Policy Committee of the Bank of England to cut interest rates nine times between February 2001 and July 2003, supporting private consumption during a protracted period of external weakness. Fiscal policy also helped maintain domestic demand, with sound public finances allowing counter-cyclical action through the operation of the automatic stabilisers. While many of the world's major economies have experienced recession, the UK grew continuously throughout the global downturn that began in 2001. Indeed, the UK is the only G7 economy not to have experienced at least one quarterly contraction in output over the past three years, with GDP now having grown for 46 consecutive quarters which, on the basis of quarterly national accounts data, is the longest sustained expansion on record.

Table B3: Summary of forecast[1]

		Forecast		
	2003	**2004**	**2005**	**2006**
GDP growth (per cent)	2¼	3 to 3½	3 to 3½	2½ to 3
CPI inflation (per cent, Q4)	1½	1¾	2	2

[1] *See footnote 3 to table B9 for explanation of forecast ranges.*

B22 Nonetheless, while macroeconomic stability, and the proactive policy action that it permitted, helped to support GDP, a highly open economy such as the UK cannot insulate itself completely from global developments. With geo-political and other international uncertainties weighing heavily on global economic prospects and underlying external demand remaining weak, UK GDP growth fell below trend rates in the course of 2001. With the exception of the post Jubilee 'bounce' in output in the third quarter of 2002, growth remained below trend through 2002 and into 2003.

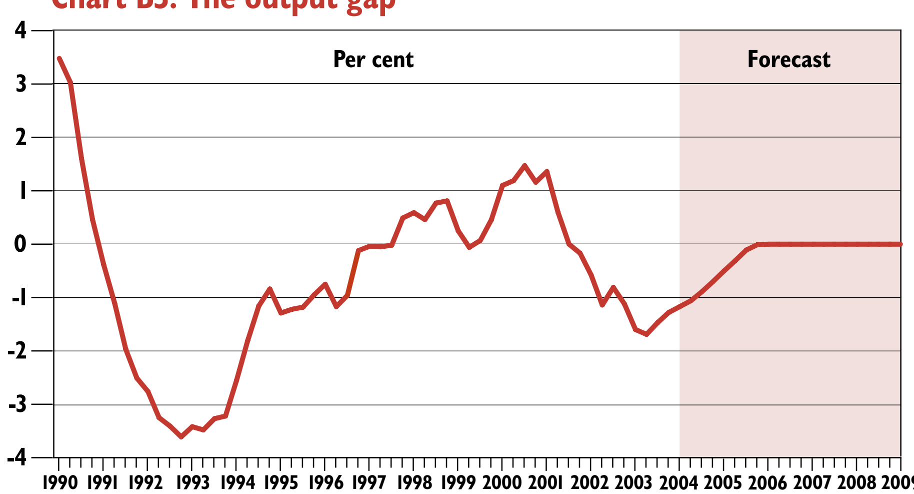
B23 Global economic prospects have strengthened significantly since early 2003. As geo-political and other uncertainties have receded, global demand has strengthened and most major international financial markets have seen valuations rise back to around the levels of spring or summer 2002. With the international outlook continuing to improve, UK business and consumer confidence have risen further since the time of the 2003 Pre-Budget Report. Moreover, improved sentiment has underpinned a significant pick-up in domestic demand growth since early last year. Following growth of 0.8 per cent in the third quarter, UK GDP rose 0.9 per cent in the final quarter of 2003, above trend rates and the fastest rate of quarter-on-quarter growth for over three and a half years. For 2003 as a whole, UK GDP rose by 2.3 per cent, fully in line with the 2003 Budget forecast of 2 to 2½ per cent and slightly above the 2003 Pre-Budget Report estimate of 2.1 per cent. As activity has strengthened, the Monetary Policy Committee has continued to adopt a proactive approach, with two pre-emptive ¼ percentage point increases in interest rates since November 2003, taking base rates to just a little above the 50 year lows that prevailed for most of 2003.

B24 Royal Bank of Scotland Purchasing Managers' Indices for the regions and devolved countries of the UK continue to offer evidence that the pick-up in activity has been geographically widespread. While London, the North West, the West Midlands and Northern Ireland reported the largest output gains in the three months to February 2004, all parts of the UK registered relatively sharp rates of growth compared with historical survey readings.

Output gap

B25 As GDP growth has picked up to above trend rates, the size of the negative output gap is judged to have narrowed a little. The gap is currently estimated to have stood at around 1¼ per cent in the final quarter of 2003, as expected in the 2003 Pre-Budget Report. Although GDP growth during 2003 has been revised up since the Pre-Budget Report, non-oil Gross Value Added (GVA), which is the basis for calculating the level of trend output and the output gap, has been subject to smaller revisions. Moreover, in six of the past seven quarters, GDP growth, measured at market prices, has been stronger than growth in non-oil GVA, which is measured at basic prices, with the wedge between the two reflecting movements in both the basic price adjustment and North Sea output.

Chart B3: The output gap[1]



[1] *Actual output less trend output as a percent of trend output (non-oil basis).*

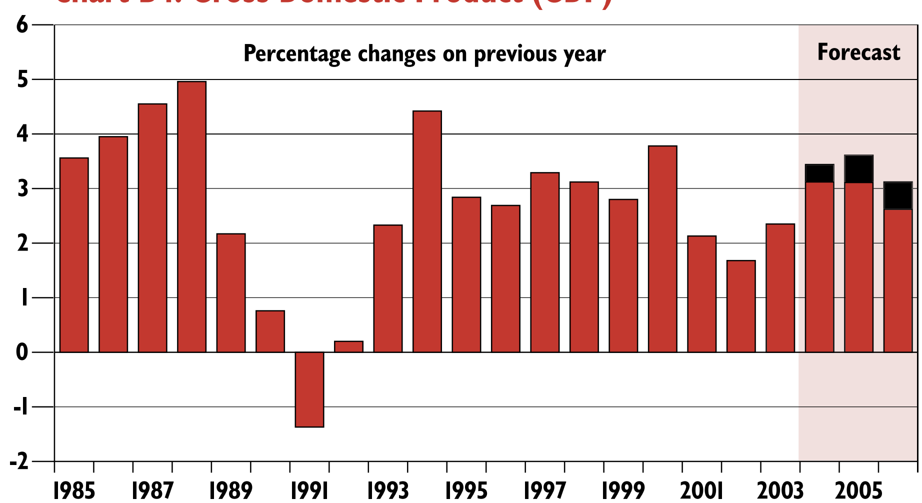
B26 The output gap can be broken down into components by comparing output per hour, average hours worked and the employment rate against their assumed trend levels that make up the overall trend output projection. Such analysis tends to suggest that the deviation of output per hour from trend accounts for only a relatively small part of the estimated 1¼ per cent output gap in the fourth quarter of 2003, with cyclical weakness in average hours worked and the employment rate judged to be somewhat more significant factors:

- earlier in 2003, output per hour was significantly further below its assumed trend but, with output accelerating and hours remaining relatively weak, output per hour has been growing at above trend rates since last spring, narrowing its contribution to the negative output gap. Indeed, non-oil output per hour worked is estimated to have risen by 2¾ per cent over the year to the fourth quarter of 2003;
- at least part of the sharp fall in average hours worked during the period of global economic downturn to the second half of 2002 is judged to have been cyclical, and not yet to have unwound: average hours worked have remained broadly flat since late 2002; and
- despite some business survey indicators of labour availability currently suggesting little slack in the labour market, subdued wage pressures provide evidence that the employment rate is below trend, consistent with unemployment being somewhat above its sustainable rate.

Prospects

B27 As demand continues to accelerate into 2004, GDP is forecast to grow by 3 to 3½ per cent both this year and in 2005. The output gap is forecast to close by early 2006 and GDP growth is forecast to moderate thereafter, with the economy projected to remain at trend. The 2004 Budget forecast for GDP growth is therefore the same as in the 2003 Budget and Pre-Budget Reports in every year of the current projection period.

Chart B4: Gross Domestic Product (GDP)[1]



[1] Shaded areas on bars represent forecast ranges.

B28 The forecast for CPI inflation is also broadly unchanged compared with the 2003 Pre-Budget Report. Inflation is expected to remain a little below its symmetrical 2 per cent target in 2004 as existing slack in the economy continues to subdue domestically generated pricing pressures. However, inflation is expected to return to target by mid-2005 as the lagged effects of sterling's depreciation against the euro since 2002, combined with the effects – already evident in commodity prices – of the strengthening synchronised recovery in the world economy (Box B3), feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

Demand

Private consumption

B29 Consumer confidence was temporarily dented in early 2003 by heightened geo-political uncertainties and global economic weakness. As a result, real private household consumption registered only its second, albeit marginal, fall for eight years during the first quarter of last year.

B30 Against a backdrop of easing international uncertainties, private consumption rebounded in the second quarter and picked up further momentum over the second half of 2003, increasing by 1.1 per cent in each of the last two quarters of the year. Having remained broadly flat in the first few months of 2003, retail sales have also shown resumed growth since last summer. In the three months to January, retail sales volumes were 1.7 per cent up on the previous three months, over double the rate in the corresponding period a year earlier when international uncertainties were close to their peak. Nonetheless, despite the pick-up in consumers' expenditure growth through last year, real private consumption growth for 2003 as a whole, of 2.9 per cent, was at its weakest for eight years.

B31 The Budget 2004 forecast assumes that the renewed momentum seen in private consumption since early last year moderates. While sound economic fundamentals coupled with sustained strong labour market outcomes should provide support to private consumption, monetary policy has already been tightened in recent months, and relatively high levels of personal debt and weaker growth of disposable incomes can eventually be expected to dampen spending. Private consumption is forecast to grow by 3 to 3¼ per cent this year, and by 2¼ to 2¾ per cent in both 2005 and 2006. Thus, growth in private consumption is expected to be below the rate of growth of the economy as a whole throughout the forecast period.

Investment

B32 Business investment shows signs of having increased in recent months, following a prolonged period of weakness during which global uncertainty reduced companies' appetite to undertake capital expenditure. In the final quarter of 2003, business investment rose by 1.3 per cent on the previous quarter and stood 0.6 per cent higher than a year earlier.

B33 Previous experience suggests that business investment often lags GDP growth in the initial phases of an upswing, and survey evidence indicates investment intentions have risen sharply in recent months. For example, the British Chambers of Commerce (BCC) survey for the final quarter of last year showed service sector companies' plans to raise investment in plant and machinery at their highest since the onset of the world economic slowdown in early 2001. Moreover, manufacturers' investment intentions stood at their highest level for six years. Data on capital goods industries' output also offer grounds to suggest that a further acceleration in investment demand is in the pipeline, with production of capital equipment rising by 3¾ per cent in the year to the final quarter of 2003.

B34 Business investment is forecast to pick up through this year as the global recovery gathers pace. The sharp improvements in business confidence already seen should increasingly translate into higher levels of capital expenditure through 2004 and 2005, as companies respond to growing demand and bring postponed investment projects back on stream.

Exports

B35 Export growth also resumed in late 2003, although interpreting recent trends is complicated by the incidence of VAT missing trader intra-Community (MTIC) fraud and the closure of several fraudulent businesses in 2003. Moreover, the recent move by HM Customs and Excise to an electronic system of recording non-EU exports, from a previously paper-based system, may have made appropriate seasonal adjustment more difficult in the short term.

B36 Excluding MTIC trade, volumes of goods exports rose 2¼ per cent between the third and fourth quarters of 2003, to stand over 9 per cent up on a year earlier. For 2003 as a whole, goods export volumes excluding MTIC trade were 3½ per cent higher than in 2002. This masks far stronger growth in volumes to non-EU destinations, including the US, but relatively flat export volumes to the EU, despite a fall of around 10 per cent in sterling's value against the euro over the past two years or so.

Table B4: Contributions to GDP[1] growth[2,3]

	Percentage points unless otherwise stated			
		Forecast		
	2003	2004	2005	2006
Private consumption	2	2¼	1¾	1¾
Business investment	–¼	½	¾	½
Government	¾	¾	1	¾
Change in inventories	0	0	0	0
Net trade	–¼	–¼	0	0
GDP growth, per cent	**2¼**	**3¼**	**3¼**	**2¾**

[1] *Fixed base volumes.*

[2] *Components may not sum to total due to rounding and omission of private residential investment, the transfer costs of land and existing buildings and the statistical discrepancy.*

[3] *Based on central case. For the purpose of public finance projections, forecasts are based on the bottom of the forecast GDP range.*

B37 Export growth is expected to pick up more significantly through 2004 and 2005 as external demand continues to accelerate. The weakening of sterling against the euro should provide a boost to export volumes as euro area GDP growth picks up and the lags between exchange rates and trade flows work through. However, sterling's rise against the US dollar could inhibit demand from the US and other economies whose currencies are linked to that of the US.

B38 Strengthening demand at the national level appears, according to recent private sector business survey evidence, to be mirrored by the patterns in most countries and regions of the UK. For example, the BCC Survey for the final quarter of 2003 reported rising manufacturing orders in nine of the twelve regions and countries, and increasing services orders in eight. Scotland was the only part of the UK to report declines in both manufacturing and services order books.

Output

Manufacturing

B39 Manufacturing output has shown tentative signs of strengthening in recent months, although it still remains relatively subdued. Manufacturing production rose in every quarter of 2003, increasing a little for the year as a whole in line with the 2003 Pre-Budget Report forecast, and stood just over 1 per cent up on a year earlier in the three months to January 2004.

B40 However, despite official manufacturing output figures thus far pointing to only a moderate pick-up, forward-looking business surveys offer evidence that manufacturing output is set to accelerate into 2004. This contrast between official output data and business surveys is discussed further in Box B4. Recent Chartered Institute of Purchasing and Supply (CIPS) Reports suggest manufacturing activity, as measured by the composite Purchasing Managers' Index (PMI), has been at around a four-year high. January's survey also showed new orders growing at their fastest rate since December 1999; and although February saw an easing back, growth remained comfortably within positive territory. The BCC survey for the final quarter of 2003 showed export orders rising at their fastest rate for almost seven years, with domestic orders also picking up to a little above the long-run average for the series. These results were closely mirrored by robust results from the Confederation of British

Industry (CBI) Quarterly Industrial Trends Survey for the final quarter. Moreover, survey evidence suggests this turnaround in manufacturing is proving regionally widespread. Indeed, the latest CBI/Experian Regional Trends Survey showed business optimism in almost half the regions and countries of the UK at its highest level for at least five years.

B41 The Budget forecast shows recovery in manufacturing output becoming increasingly evident in 2004 and into 2005. A continued global economic recovery is expected to underpin strengthening external demand for UK manufactures over the forecast horizon. At the same time, the pick-up in UK business investment is also expected to act as a spur to rising manufacturing output. Manufacturing output is forecast to rise by 1½ to 2 per cent this year, and by 1¾ to 2¼ per cent in both 2005 and 2006.

Services

B42 Service sector output growth weakened in the first half of 2003 as heightened international uncertainties fed through to lower demand in many key areas of services activity. For example, some service businesses dependent on overseas travel and tourism were affected by reduced visitor numbers around the peak of geo-political tensions in early 2003: after correcting for seasonal patterns, overseas visitors to the UK fell by over 8½ per cent between the final quarter of 2002 and the second quarter of 2003. Meanwhile, financial intermediation output was broadly flat between the end of 2002 and mid-2003, likely reflecting economic uncertainty and financial market volatility around that time. Having averaged 0.9 per cent a quarter in the previous six years, growth in service sector output was just 0.3 per cent in the first and second quarters of 2003.

B43 Service sector output growth has gathered pace since then, with growth of 1 per cent in both the third and fourth quarters of 2003. In particular, two sectors – financial intermediation and real estate, renting and business activities – saw output rebounding strongly over the latter stages of the year.

B44 Survey evidence points to a continuation of this pattern into 2004. The CIPS Report on Services for January 2004, for example, showed activity and new orders in the service sector growing at or close to their fastest rates for around four years, with business expectations remaining at historically high levels.

B45 Construction output has been significantly boosted in recent years by strong government investment in priority areas of public service delivery. While quarterly growth of construction output cooled in the second half of 2003, rates of annual growth remain brisk, with output increasing by over 6 per cent in 2003 as a whole.

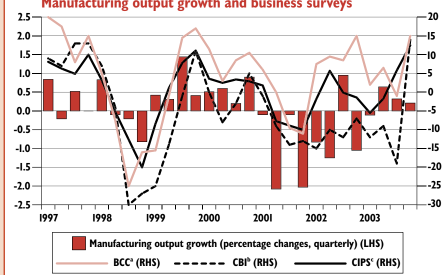
B46 Recent evidence from the Royal Bank of Scotland's Purchasing Managers' Indices suggest the pick-up in business sector output growth has been relatively broad-based across the countries and regions of the UK, with February results suggesting activity has accelerated most strongly in London, the South East and Northern Ireland.

Box B4: Reconciling recent business surveys with the Index of Production

In recent months, nearly all major private sector business surveys have suggested that a strong recovery in manufacturing output is underway. For example, the headline PMI figure in the December 2003 and the January 2004 CIPS Report on Manufacturing was at its highest level since 1999. The CBI Industrial Trends Survey for the final quarter was similarly upbeat – the output and total orders balances reached their highest levels since the mid-1990s. Meanwhile, the BCC survey showed export orders at their highest for seven years in the final quarter of 2003.

In contrast, official Index of Production figures have, thus far, painted a weaker picture. For example, manufacturing output in the three months to January 2004 grew only marginally on the previous three months, and the level of output still remains $5\frac{3}{4}$ per cent lower than its peak in December 2000.

Manufacturing output growth and business surveys



[a] Manufacturing home and export sales.
[b] Volume of output.
[c] Purchasing Managers Index (PMI).

This would not be the first time that private survey results have failed to be mirrored in official output figures. During the Asian crisis in 1999, survey indicators proved too pessimistic, significantly overstating actual output losses. It is plausible that they have been correspondingly too optimistic during the recent upswing. However, there are a number of other reasons that could help reconcile the differing conclusions drawn from business surveys and official data in recent months:

- **surveys may be telling more about manufacturing activity going forward than about current output. For example, responses to survey questions regarding the number of new orders or levels of business sentiment are likely to be more related to future output than current production;**
- **both Index of Production and private survey data are often revised, and it may be that current discrepancies are reconciled as further information becomes available; and**
- **surveys only record the balance of firms reporting increased activity; they do not measure the magnitude of such increases. It is therefore possible that while many firms and sectors have seen a gradual rise in output, others are yet to reap the benefits of stronger demand and their production has remained flat. Consequently, survey readings could be overstating actual output growth. This may particularly be the case during the initial stages of a recovery as increased demand takes time to filter down through the supply chain.**

Despite official figures thus far pointing to only a modest recovery in manufacturing as a whole, some sectors have still performed strongly over recent months, with rates of growth well above that for the economy as a whole. For example, in the three months to January, output of machine tools and other special purpose machinery was up by around 10 per cent, pharmaceuticals up 13 per cent and televisions, VCRs and stereos up almost 22 per cent on the same three months a year earlier. As the global economy continues to gather strength and investment recovers, UK manufacturing should experience a more broad-based recovery throughout 2004 and into 2005.

Box B5: The Allsopp Review

Christopher Allsopp is undertaking a review of statistics for economic policymaking, examining the statistics and information needed to support the Government's key regional policy objectives, and whether official economic statistics have properly reflected the changing economic structure of the UK. His First Report to the Chancellor of the Exchequer, the Governor of the Bank of England and the National Statistician was published on 10 December.

The Report explained how the devolution and regional economic policy agendas have led to a growing demand for regional data that is not met adequately under present arrangements. Its recommendations responded to the current and future needs of policymakers and the wider user community, including business and academics, at both national and local levels. These included:

- bringing Regional Accounts more into the National Accounts framework, including development of an improved and timely measure of regional real Gross Value Added;
- expanding the range of microeconomic and sub-regional data already available, with the infrastructure used by the Office for National Statistics' (ONS) Neighbourhood Statistics Service becoming the primary platform for area-based National Statistics;
- an ONS or Government Statistical Service (GSS) presence in the English regions to complement that which already exists in Scotland, Wales and Northern Ireland; and
- greater access for the ONS to administrative data held within government, which could improve both regional and national data while offering important savings in the compliance burden on business.

Christopher Allsopp and the Review Team have been involved in a range of events to present and discuss the conclusions and recommendations of the First Report. A large number of useful comments have been received and were generally supportive of the First Report's recommendations. There were 30 responses from government, regional and private sector bodies and individuals to the formal consultation that followed the First Report, and the team is very grateful to all who have contributed.

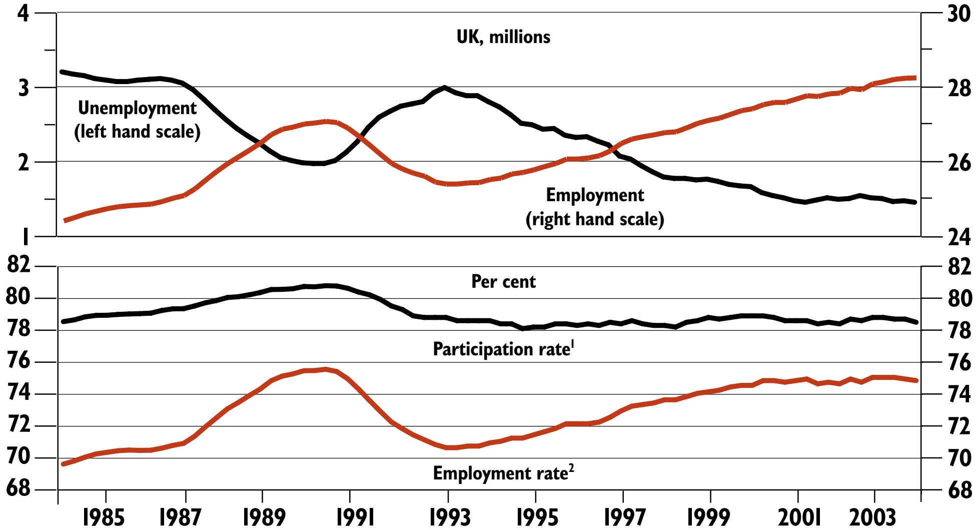
The two areas that attracted most comment were the suggestion of an ONS or GSS presence in the English regions, and the possible use of administrative and tax data for statistical purposes, where the potential benefits appear considerable, but there remain a number of difficult issues to be resolved. The Final Report, to be published after the Budget, will note that there is considerable variation in the English Regions' institutional frameworks, and propose that the decision on the location of regional statisticians should be taken on a region-by-region basis in consultation with key users and regional bodies, consistent within an outward-looking role and protection of sensitive information.

The Final Report will also consider in more detail whether official statistics properly reflect the changing economic structure of the UK, and make further recommendations to improve the coverage and quality of the economic statistics. The full set of recommendations will include changes to those in the First Report to reflect comments received, but the broad thrust of the recommendations on regional data remains unchanged.

The labour market

B47 The UK labour market has continued to build on the excellent performance of recent years, providing further evidence that the Government's supply-side reforms are creating a more dynamic and flexible labour market in the UK.

Chart B5: LFS employment, unemployment and participation



[1] *Percentage of the working-age population who are economically active (i.e. employed or unemployed).*
[2] *Percentage of the working-age population in employment.*

Unemployment

B48 Unemployment, on the International Labour Organisation (ILO) measure, declined by almost 55,000 between the fourth quarters of 2002 and 2003, to stand a little below 1.5 million. The rate of ILO unemployment, at 4.9 per cent, is at its lowest for almost 30 years, and has been the lowest of all G7 economies since October 2001. The majority of the UK countries and regions saw declining rates of unemployment in the year to the fourth quarter of 2003. The claimant count measure of unemployment declined by 40,300 in the year to January 2004 to stand just above 892,000. The claimant count rate in January was 2.9 per cent, the first time it has dipped below 3 per cent since April 1975. With the exception of the South East, the level of claimant count unemployment has fallen in every region and country of the UK in the past year.

Employment

B49 Numbers of economically active individuals have risen further since the end of 2002, increasing by just over 100,000 in the year to the fourth quarter of last year. However, with unemployment declining, employment has expanded even more sharply than activity. The level of employment increased by 156,000 in the year to the final quarter of 2003, with the working-age employment rate remaining broadly stable.

B50 Self-employment has continued to outpace overall employment over recent months. There were 294,000 more self-employed workers in the final quarter of 2003 than a year earlier, 80 per cent of whom were in full-time self-employment. By contrast, growth in the number of part-time employees has been more than offset by declining numbers of full-time employees.

B51 Some of the sectors particularly affected by weak international conditions in recent years also appear to have begun expanding their workforces again. For example, employment in distribution, hotels and restaurants rose by 11,000 between the second and third quarters of 2003, making up some of the job losses incurred around the time of peak geo-political uncertainties early in 2003. Employment in finance and business services, which fell through most of 2002, rose by almost 100,000 in the year to September 2003. Government spending has continued to contribute to employment growth in public administration, education and health: growth of jobs in these sectors averaged just under 40,000 a quarter over the year to September 2003, very similar to the rate of increase over the previous 12 months. Buoyant construction sector activity, partly related to government spending on priority public services, has given a significant boost to construction employment, which expanded by 105,000 in the year to the third quarter of 2003.

Average hours worked

B52 Weekly average hours worked eased back following the onset of the global slowdown in 2001, demonstrating a highly flexible cyclical response by businesses and workers to the effects of a weak global environment. Despite the pick-up in GDP growth over the second half of 2003, weekly average hours worked have not yet picked up, suggesting that cyclical weakness has still to unwind.

Average earnings

B53 Whole economy average earnings growth remains modest, and the three-month average rate has now been consistently below 4 per cent for over two years. In the final quarter of 2003, average earnings were just under 3½ per cent up on a year earlier. There has been some narrowing of the differential between rates of average earnings growth in the private and public sectors. In particular, timing changes in the awarding of local government pay settlements in 2002 temporarily raised the annual rate of public sector average earnings growth in late summer and early autumn 2003, but have subsequently fallen out of the annual comparisons. On a three-month average basis, the differential between public and private sector average earnings growth was at its narrowest for over a year in December 2003, with public sector earnings 4.4 per cent higher than a year earlier and private sector earnings up 3.2 per cent.

Productivity

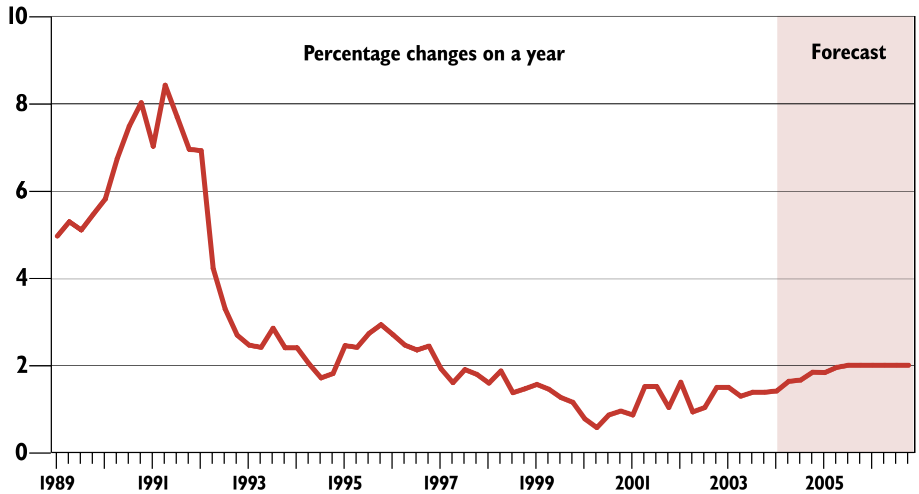
B54 With output rising strongly and average hours worked remaining subdued, growth of productivity, as measured on an output per hour basis, has picked up significantly compared with the cyclical lows experienced at the peak of global uncertainties early last year. Non-oil output per hour worked is estimated to have risen by over 1¼ per cent in the final quarter of last year, following growth averaging ¾ per cent in the previous two quarters. The quarterly rate of growth in the fourth quarter was the fastest rate since the first quarter of 2000, and the annual rate of growth rose to 2¾ per cent, well above its estimated trend rate.

THE UK FORECAST IN DETAIL

Inflation

B55 Underlying inflation remains firmly in check. Since the inception of the present monetary policy framework in 1997, CPI inflation has averaged 1.3 per cent. Over the same period, RPIX inflation, which was the target of monetary policy until the switch to the CPI target at the time of the 2003 Pre-Budget Report, averaged 2.4 per cent, very close to its 2½ per cent target. Almost two thirds of the average differential between the two measures over this period is accounted for by housing components excluded from the CPI but included in the RPIX measure.

Chart B6: CPI[1]



[1]Outturns until 2003Q4; forecasts for every second quarter from 2004Q1 to 2006Q4.

B56 CPI inflation has remained broadly unchanged since the 2003 Pre-Budget Report, standing at 1.3 per cent in February 2004. Seasonal increases in airfares over the recent Christmas period were lower than a year earlier, but subsequent discounting on tickets was shallower. Reductions on clothing and footwear prices were also more subdued than in late 2002 and early 2003, with new season stocks coming in at higher prices. Downward contributions have come from satellite and digital television subscriptions, where unchanged pricing this year contrasted with increases in early 2003, and from declining charges for television and video rentals.

House price inflation

B57 House price inflation has eased back significantly over the past year or so, despite appearing to edge up in early 2004. Office of the Deputy Prime Minister (ODPM) statistics show the annual rate of UK house price inflation declining by around two thirds between the beginning and the end of 2003, to 8¼ per cent in December, before rising to 9¾ per cent in January 2004. However, this masks variations between regions and countries. For example, while house prices in Wales and the North East have risen at roughly twice the national average over the past year, increases in London and the South East have continued to undershoot those in most of the country, although prices in these regions do appear to have firmed a little of late. As a result of moderating house price inflation, while housing components remain the largest single factor in the differential between RPIX and CPI inflation, the size of the wedge attributable to them has diminished by over 0.4 percentage points since its peak in April 2003. Indeed, of late the overall gap between RPIX inflation (2.3 per cent) and CPI inflation (1.3 per cent) has been around its lowest for 16 months.

Prospects

B58 CPI inflation is forecast to rise gradually through this year, reflecting partly offsetting factors. The effects of the continued synchronised strengthening of the world economy, already evident in commodity prices (as discussed in Box B3), allied with the lagged effects of the weakening in sterling against the euro since 2002, are forecast to lift import prices. This is expected more than to offset downward pressures on domestically generated inflation from continued slack in the economy built up over the course of the recent world economic slowdown. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations. CPI inflation is expected to settle at its 2 per cent target by mid-2005. The differential between CPI and RPIX inflation is expected to diminish further over the same period to ½ percentage point, the size of the underlying formulae effect. Thereafter the differential is expected to remain broadly stable, rising slightly to round to ¾ percentage points in the Budget forecast, depending on a range of economic factors.

The household sector

Private consumption

B59 Growth of real household consumption eased back in 2003, increasing by 2.8 per cent, its slowest annual rate since 1995. In early 2003, consumer confidence was adversely affected by heightened global uncertainties and sluggish near-term prospects for the world economy. As a result, real private consumption growth in the first quarter of 2003 was at its weakest for over two years, with household expenditure registering a marginal contraction on the quarter. Moreover, much of the growth in household consumption volumes over the past year appears to have been spurred by strong competition exerting downward pressures on prices in parts of the retail and service sectors: in nominal terms private consumption in 2003 grew by 4.4 per cent, its slowest rate since 1949, and its share in GDP fell by more than in any year since 1977. This further supports the evidence set out in the 2003 Pre-Budget Report that since the mid-1990s the data in nominal terms indicate growth in private consumption has been more sustainable than the real measures suggest. However, it also suggests that, independent of the temporary effects of the global uncertainties prevailing earlier in 2003, households' expenditure patterns have gradually begun to adjust to relatively high levels of indebtedness and the past two years of slower growth in real incomes compared with the previous three years.

Table B5: Household sector[1] expenditure and income

	Percentage changes on previous year unless otherwise stated			
		Forecast		
	2003	2004	2005	2006
Household consumption[2]	3	3 to 3¼	2¼ to 2¾	2¼ to 2¾
Real household disposable income	2¾	3 to 3¼	2½ to 3	2 to 2½
Saving ratio (level, per cent)	5¼	5	5½	5½

[1] *Including non-profit institutions serving households.*
[2] *Chained volume measures.*

B60 Nonetheless, as international uncertainties have receded, growth in real consumer spending has picked up from its low in early 2003 and revealed more momentum than previously expected, with growth of 1 per cent or more in each of the past three quarters. Retail sales growth has also risen: retail sales volumes were 1.7 per cent up in the three months to January 2004 compared with the previous three months, double the rate of growth recorded for the same period in 2003. This has corresponded with a broad strengthening of consumer confidence indicators. In February 2004, the composite measure of consumers' confidence was well above its long-run average, with households' sentiment in the outlook for the general economy having risen sharply since late last year.

Household debt

B61 The unexpected momentum of private consumption since early 2003 has been accompanied by continued growth in household borrowing at historically high rates. In the three months to January 2004, the stock of household debt was up by just over 13 per cent on a year earlier. However, this masks a pick-up in the growth of secured debt and significant cooling in the rate of consumer credit growth. Indeed, while secured lending grew at its fastest annual rate since mid-1989 in the final quarter of 2003, credit registered its weakest rise for nine years.

B62 Although the ratio of household debt to income has climbed to historically high levels, this needs to be viewed alongside developments in household assets. The ratio of household debt to total net wealth is currently estimated to be no higher than it was in 1995. Moreover, more than three quarters of the increase in household mortgage debt since early 2000 has been matched by the build-up of household holdings of money and deposits. This is consistent both with the view that much of mortgage equity withdrawal (MEW) over this period has been saved rather than used to finance spending, and with the relatively stable saving ratio in recent years. It also suggests that the risk of moderation in house price inflation and sharply lower MEW leading to faltering consumer spending growth should not be overstated. In any case, despite strong increases in MEW, households' equity in housing has continued to build up: equity is estimated to have risen recently to three quarters of house values, which is high by historical standards. This reduces the likelihood of MEW coming rapidly to an end.

B63 The relative stability of the household saving ratio over the past six years, around an average rate of about 5¾ per cent, is perhaps surprising in view of the rise in the ratio of household gross wealth to income over the same period, which might have been expected to reduce the motive to save out of current income.

Prospects

B64 Despite its recent strengthening in momentum, real household consumption growth in 2004 is forecast to remain comfortably below the rates seen over much of the period between 1996 and 2002. Monetary policy has already been tightened, and with household debt remaining at relatively high levels, and disposable income growth having moderated, consumers' appetite for additional net borrowing can be expected to moderate. Private consumption is forecast to rise by 3 to 3¼ per cent this year and 2¼ to 2¾ per cent in both 2005 and 2006. The saving ratio is expected to remain broadly stable over the forecast horizon.

Companies and investment

Business investment

B65 Latest business investment data tentatively suggest that corporate sector capital expenditure has picked up following a protracted period during which global uncertainty held back investment plans. Business investment rose by 1.3 per cent between the third and fourth quarters of 2003 and stood 0.6 per cent higher than in the final quarter of the previous year – the first time annual growth has turned positive for nine quarters. Moreover, nominal spending on computer hardware and software also rose over the final quarter, increasing by around 7½ per cent.

B66 In the past, business investment has tended to lag the turnaround in GDP, so it is perhaps unsurprising that companies have only recently increased capital expenditure. However, past experience also suggests that once business investment enters into a recovery phase it can often increase more rapidly than expected and temporarily at rates well above the rate of output growth.

Table B6: Gross fixed capital formation

	Percentage changes on previous year			
		Forecast		
	2003	2004	2005	2006
Whole economy[1]	2½	5½ to 5¾	6½ to 7	4¼ to 4¾
of which:				
Business[2,3]	–1	3½ to 4	5½ to 6¼	4¾ to 5¼
Private dwellings[3]	11¼	5½ to 5¾	3¼ to 3¾	1½ to 2
General government[3,4]	19	17	18	6¾

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

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

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

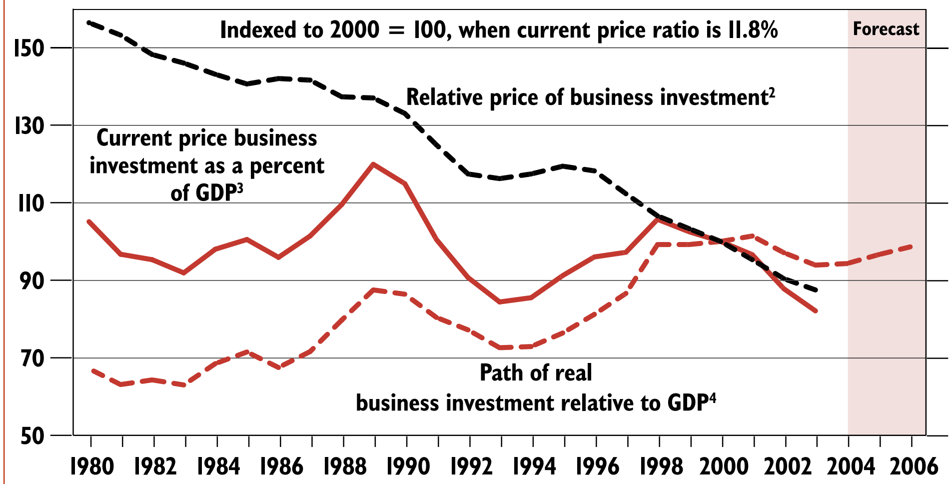
[4] *Includes National Health Service Trusts.*

B67 Business surveys provide firmer evidence that a more significant pick-up in business investment may now be beginning to emerge. The BCC survey for the final quarter of 2003 suggests investment intentions are rising in nearly every region and country of the UK, with only Scottish manufacturers reporting a decline in expected spending on plant and machinery. Within manufacturing, the North East and Yorkshire and Humberside reported particularly robust plans to step up capital expenditure, while the East and West Midlands recorded the strongest investment intentions within the service sector. The BCC survey also showed service sector companies' plans to invest in new plant and machinery at their highest since the beginning of 2001. Moreover, manufacturers' investment intentions rose to their highest level for six years. The January CBI Industrial Trends Survey pointed to a strengthening of investment plans in the manufacturing sector too.

B68 There has been debate recently on whether corporate pension fund deficits may serve as a brake on investment. As equity prices declined over the three years or so to early 2003, large deficits were incurred on many defined benefit schemes. For large companies that have ready access to external finance, these deficits should not threaten clearly profitable investment projects, though more marginal projects might be deterred if internal funds get diverted into pension funds because internal finance is cheaper than external finance. Cash flow constraints are likely to be more binding on investment by small and medium-sized enterprises where recourse to external finance is a less viable option. However, serious pension fund deficits tend to be concentrated amongst larger companies.

B69 In any case, for many funds the issue can be addressed through gradual adjustment, rather than immediate correction; and the 30 per cent rise in equity prices since their trough in March 2003 has boosted the value of fund assets. Rising bond yields over the same period will have partly offset this effect by depressing the value of bonds within pension funds' asset portfolios. However, rising bond yields will also have lowered the discounted present value of fund liabilities. Overall there seems little doubt that the net effect of movements in bond and equity prices over the past 12 months has been to reduce deficits. Chapter 5 describes the action the Government is taking to improve the availability and quality of statistics on pension fund deficits.

Chart B7: Business investment[1]



[1] *Business investment includes investment by public corporations (except National Health Service Trusts) and investment under the Private Finace Initiative.*
[2] *Ratio of implied business investment deflator to GDP deflator.*
[3] *Ratio of business investment to GDP in current prices.*
[4] *Ratio of business investment to GDP in chained volume measures.*

Prospects **B70** Business investment is forecast to accelerate over this year and into 2005. With demand already having strengthened and business expectations rising, firms can be expected to become significantly more confident about committing to increased investment expenditure. Improvements in company balance sheets since the late 1990s' ICT boom, allied with continued sound fundamentals, also offer solid foundations for the corporate sector to step-up investment plans, with private non-financial corporations now having been net lenders for six consecutive quarters. Profitability has already picked up: rates of return outside of the UK Continental Shelf stood at 11.7 per cent in the third quarter of 2003, compared with a recent trough of 10.4 per cent at the end of 2002. Moreover, the share of corporate profits in national income has risen in recent quarters and, at a little over 25 per cent, was at its highest since the start of 2000 in the final quarter of last year. Business investment is forecast to rise by 3½ to 4 per cent in 2004 and by 5½ to 6¼ per cent in 2005.

B71 General government investment is estimated to have risen 19 per cent in 2003, the fastest annual rate of growth for 13 years. With government investment expected to continue growing strongly, in line with the Government's spending plans, whole economy fixed capital formation is expected to grow significantly faster than private consumption and GDP in all forecast years.

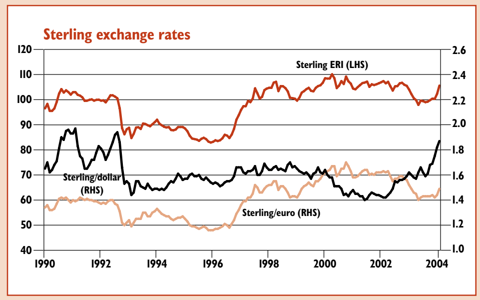
Trade and the balance of payments

Goods exports **B72** There are tentative signs emerging that the strengthening of the world economic environment is already feeding through to increased external demand for UK goods and services. Movements in goods export volume data have been distorted since 2002 by HM Customs and Excise having made significant progress in tackling VAT MTIC fraud, with several firms having ceased operations, resulting in a sharp drop in illicit exports. Excluding MTIC trade, UK export volumes of goods rose over 9 per cent in the year to the final quarter of 2003, the fastest growth since late 2000. In addition, the recent move by HM Customs and Excise to an electronic system of recording non-EU exports, from a previously paper-based system, may have made appropriate seasonal adjustment more difficult in the short term.

Box B6: Implications of recent movements in the sterling exchange rate

Although the overall sterling exchange rate index (ERI) is currently close to levels prevailing two years ago, this masks divergent movements within the basket of currencies that make up the ERI. Compared with early 2002, sterling has risen by around a quarter against the US dollar, and has recently been trading at close to an eleven-year high. By contrast, sterling has weakened by around 10 per cent against the euro, and is not far from its lowest level since the single currency's inception in January 1999. Moreover, with UK inflation having been consistently below the euro area average in recent years, sterling has weakened by even more against the euro when measured in real terms.

Movements in exchange rates have implications for UK trade flows. The euro area is by far the UK's largest single trading partner, accounting for approximately 50 per cent of all UK trade in goods and services, compared with just 15 per cent of trade with the US. The depreciation of sterling relative to the euro over the past two years is therefore expected to provide a significant boost to the UK's exports to the euro area, although domestic demand in euro member states will also be an important factor in determining near-term prospects. At the same time, the rise in sterling against the US dollar is likely to dampen export demand from the US although, thus far at least, robust US GDP growth has tended to obscure any effects. With many emerging market currencies linked to the US dollar, these impacts are likely to extend to trade with some third countries.



However, compositional differences between the UK's trade patterns with the EU and US suggest that recent exchange rate movements could have different impacts on the UK's goods and services sectors. Around 55 per cent of all UK goods exports are destined for euro area markets, almost four times the share of goods exports to and imports from the US. Yet the euro area only accounts for around a third of UK services export trade, while the US accounts for a quarter, significantly above the US share in goods. Only around a fifth of total UK exports to the euro area is in services, against 45 per cent of exports destined for the US. Goods exporters, including manufacturers, are likely to receive a proportionately greater boost from sterling's depreciation against the euro, while services firms may incur a relatively bigger impact from the pound's strengthening against the US dollar. Nonetheless, the UK is the second largest exporter of services in the world, and underlying competitive advantages should allow service firms to prove resilient to increased pressure in dollar-denominated markets.

Exchange rate movements also have potential implications for relative prices and inflationary pressures. A weaker exchange rate tends to raise the sterling price of imports and exports, with domestic firms, at least in the short term, capturing some of the improved competitiveness through higher margins. A stronger exchange rate typically has the opposite effects, and there is already evidence that recent movements in bilateral exchange rates are having an impact on trade pricing. For example, while both goods export and import prices to non-EU countries fell in 2003, export prices to the EU rose at their fastest rate for a decade, with import prices rising at their sharpest rate for eight years.

Table B7: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			Goods and services balance
	Exports	Imports	Exports	Imports	Terms of trade[2]	
2003	–½	¾	1¼	½	¾	–33¼
Forecast						
2004	5¼ to 5½	5½ to 6	1½	1¼	¼	–35¾
2005	6¾ to 7¼	6 to 6½	3	2¾	¼	–35¾
2006	6¼ to 6¾	5¾ to 6¼	2¾	2¾	0	–36¼

[1] *Average value indices.*
[2] *Ratio of export to import prices.*

B73 The pattern of UK goods exports over the past year or so appears broadly consistent with the recent composition of growth amongst industrialised nations. Export volume growth to the rest of the EU appears to have been further held back by relatively weak EU GDP growth over much of 2003. Excluding MTIC trade, goods exports to the EU in the final quarter of 2003 are estimated to have stood around 4 per cent lower than a year earlier. By contrast, exports to non-EU economies have picked up, with goods exports already having surpassed levels reached at the onset of the global downturn in 2001. For example, in value terms, goods exports to the US rose by almost 15 per cent in the year to the final quarter of 2003.

B74 The pick-up in external demand seen so far appears to be feeding through to nearly every region and country of the UK. The BCC survey for the final quarter of 2003 showed that every region except Yorkshire and Humberside recorded growth in export sales, with Scotland recording the strongest balance. Moreover, the survey pointed to further export growth going forward, with export orders rising in every region except Wales, and particularly strong readings from the South East and Scotland. Despite the latest CBI/Experian survey reporting a slightly different regional balance, it also suggested that the sharpest turnaround in export demand was experienced in Scotland.

Services exports

B75 Exports of services too appear to have been boosted by strengthening global conditions in recent months. In the first half of 2003, services export volumes were adversely affected by heightened global uncertainty, and declined for three consecutive quarters between the end of 2002 and mid-2003. Indeed, with the exception of the third quarter of 2001, when the effects of the events of 11 September 2001 had their most direct impact on travel, the UK registered its lowest surplus on trade in services for over seven years in the second quarter of 2003. More recent months suggest the easing of international uncertainties and rising external demand have given a renewed boost to services exports. Overseas visitors have become less reluctant to travel, increasing demand in tourism-related industries, while financial and business services exports have also increased following the drop in demand that corresponded with global uncertainties in early 2003.

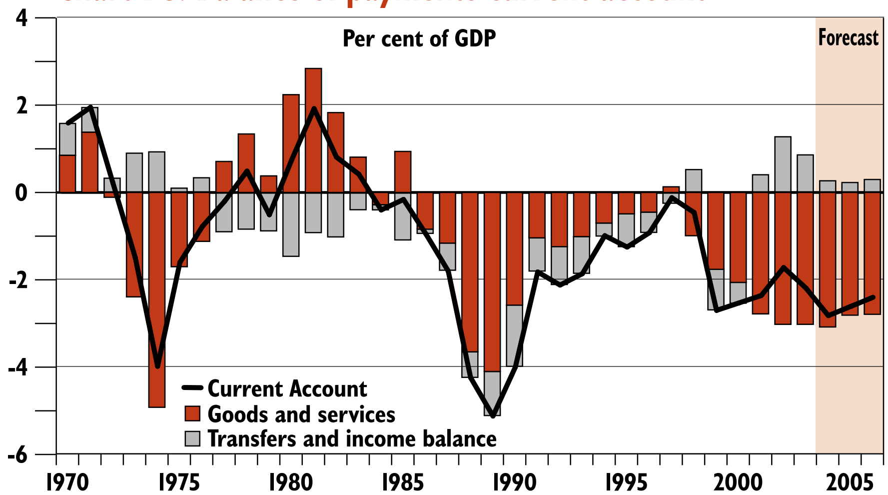
Sterling ERI

B76 The sterling ERI has strengthened a little since the 2003 Pre-Budget Report. This mainly reflects further rises in sterling's exchange rate with the US dollar, which has recently been trading at around an eleven year high. Sterling has been relatively more stable against the euro, but remains significantly weaker in relation to it than for most of the first four years of the euro's existence. Recent exchange rate developments are discussed in more detail in Box B6.

Overseas income

B77 The UK's surplus on overseas income declined in 2003, albeit from unusually high levels. Despite global economic weakness, the UK income surplus was at a record level in the first quarter of 2003 as high oil prices boosted earnings of UK petroleum companies' overseas operations, and financial market volatility hampered profitability of overseas institutions based in the City of London. It has subsequently moderated as these temporary influences have waned, although it remains substantially in surplus.

Chart B8: Balance of payments current account



Prospects

B78 Looking forward, export volumes are expected to accelerate over coming months. The strengthening of the world economy, and the corresponding pick-up in world trade growth, should make itself increasingly felt in external demand through this year and next, giving a significant boost to UK export growth. At the same time, the lagged effects of sterling's weakening against the euro since 2002 are likely to give an additional fillip to UK exports over the period ahead. However, against this, the recent weakness of the US dollar may dampen demand growth from the US and other smaller economies whose currencies are linked to that of the US.

B79 Projected surpluses on overseas income, albeit at more modest levels than seen over recent years, are expected partly to counter continued deficits on trade. Relative to GDP, the current account deficit is expected to remain modest compared to historical peaks, stabilising at around 2½ per cent of GDP from next year.

Independent forecasts

B80 At the time of last year's Budget, independent forecasts for 2004 UK GDP growth averaged 2.4 per cent, and the average remained at that level through to August 2003, with new forecasts that month averaging slightly less, at 2.3 per cent. This was well below the Budget 2003 forecast range of 3 to 3½ per cent, with only 8 per cent of forecasters at the time falling within that band.

B81 Since last summer, over 90 per cent of forecasters included in the comparison have revised up growth projections for 2004. The independent average has consequently risen to reach 3.0 per cent, consistent with the unchanged Budget forecast range of 3 to 3½ per cent for the first time, while the average of new forecasts made in the past month is a little higher than the overall consensus, at 3.1 per cent. Almost two thirds of forecasts included in the comparison are now within or above the Budget range.

B82 The independent average forecast for CPI inflation in 2004 is 1.6 per cent, but rises to only fractionally below the Government's symmetrical 2 per cent target in 2005.

Table B8: Budget and independent[1] forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2004			2005		
		Independent			Independent	
	March Budget	Average	Range	March Budget	Average	Range
Gross domestic product	3 to 3½	3.0	2.4 to 3.8	3 to 3½	2.6	0.4 to 3.5
CPI (Q4)	1¾	1.7	1.2 to 2.3	2	1.9	1.2 to 2.7
Current account (£ billion)	–32¾	–27.3	–37.4 to –18.0	–32	–28.3	–53.2 to –10.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts'*, March 2004.

Forecast risks

B83 Risks on the upside and downside have changed little since the time of the 2003 Pre-Budget Report. In particular, a number of ongoing risks and uncertainties to the world economy would, if realised, influence the UK. Although the US dollar's decline against some other major currencies in recent months has continued to be orderly, large global imbalances mean that much sharper movements in major exchange rates cannot be ruled out. UK external demand also faces downside risk from world labour markets, which have generally remained weak despite strengthening G7 GDP growth. However, after several years of relatively subdued activity, pent-up demand may prompt a sharper bounce in UK export markets' growth than currently assumed.

B84 In the UK, downside risks continue to be associated with the outlook for consumer spending. While the forecast allows for a moderation in the growth of private consumption, expenditure could undergo a sharper than expected correction if, for example, house prices were to decline significantly or the world economy were to suffer a negative shock.

B85 On the upside, the pick-up in growth seen since early 2003 could prove stronger than expected in the short term. In particular, business investment has, in the past, tended to surprise on the upside once into an upswing, and private sector capital expenditure could once more turn out stronger than forecast over the projection period. Similarly, private consumption could again prove to have more near-term momentum than envisaged in the Budget forecast, although this would raise the risk of a sharp correction in the opposite direction further out.

Table B9: Summary of economic prospects[1, 2, 3]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[4]			Average errors from past forecasts[5]	
	2003	2004	2005	2006	2004	2005
Output at constant market prices						
Gross domestic product (GDP)	2¼	3 to 3½	3 to 3½	2½ to 3	¾	½
Manufacturing output	¼	1½ to 2	1¾ to 2¼	1¾ to 2¼	1¼	2
Expenditure components of GDP at constant market prices[6]						
Domestic demand	2¾	3¼ to 3½	3 to 3½	2½ to 3	½	¾
Household consumption[7]	3	3 to 3¼	2¼ to 2¾	2¼ to 2¾	½	1
General government consumption	2	2¼	2½	2½	¾	1
Fixed investment	2½	5½ to 5¾	6½ to 7	4¼ to 4¾	1¾	1¾
Change in inventories[8]	0	0	0	0	¼	¼
Exports of goods and services	–½	5¼ to 5½	6¾ to 7¼	6¼ to 6¾	2¼	3½
Imports of goods and services	¾	5½ to 6	6 to 6½	5¾ to 6¼	2¼	2¾
Balance of payments current account						
£ billion	–24	–32¾	–32	–31¼	7½	9½
per cent of GDP	–2¼	–2¾	–2½	–2½	¾	¾
Inflation						
CPI (Q4)	1½	1¾	2	2	–	–
Producer output prices (Q4)[9]	1½	2¼	2	2	1	1½
GDP deflator at market prices	3	2¼	2½	2¾	¼	¾
Money GDP at market prices						
£ billion	1100	1160 to 1164	1226 to 1236	1291 to 1308	9	9
percentage change	5½	5½ to 5¾	5¾ to 6¼	5¼ to 5¾	¾	¾

[1] *The forecast is consistent with output, income and expenditure data for the fourth quarter of 2003 released by the Office for National Statistics on 25 February 2004. See also footnote 1 on the first page of this chapter.*

[2] *All growth rates in tables throughout this chapter are rounded to the nearest ¼ percentage point.*

[3] *As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral 2¾ per cent assumption for the trend rate of output growth. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of 2½ per cent a year trend growth used as the basis for projecting the public finances.*

[4] *The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

[5] *Average absolute errors for year-ahead projections made in spring forecasts over the past ten years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2004 and 2005.*

[6] *Further detail on the expenditure components of GDP is given in Table B10.*

[7] *Includes households and non-profit institutions serving households.*

[8] *Contribution to GDP growth, percentage points.*

[9] *Excluding excise duties.*

Table B10: Gross domestic product and its components

		£ billion chained volume measures at market prices, seasonally adjusted									
		Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
2003		687.1	189.6	174.4	1.5	1052.6	271.3	1323.9	313.7	0.9	1011.1
2004		708.0 to 710.2	193.7	183.8 to 184.4	1.7 to 2.3	1087.2 to 1090.5	285.7 to 286.6	1372.9 to 1377.1	331.1 to 332.1	0.8	1042.6 to 1045.8
2005		723.5 to 729.2	198.6	195.8 to 197.3	1.9 to 3.5	1119.7 to 1128.6	305.2 to 307.6	1424.9 to 1436.2	350.6 to 353.4	0.8	1075.1 to 1083.6
2006		739.4 to 748.9	203.8	203.9 to 206.5	1.2 to 3.8	1148.2 to 1163.0	324.6 to 328.8	1472.8 to 1491.7	370.3 to 375.1	0.8	1103.2 to 1117.4
2003	1st half	339.8	94.3	86.1	0.9	521.2	135.9	657.1	156.1	0.5	501.4
	2nd half	347.2	95.4	88.3	0.6	531.4	135.4	666.8	157.5	0.4	509.7
2004	1st half	352.2 to 352.8	96.4	90.4 to 90.6	0.8 to 0.9	539.8 to 540.7	140.3 to 140.6	680.1 to 681.3	163.0 to 163.3	0.4	517.4 to 518.4
	2nd half	355.9 to 357.4	97.3	93.4 to 93.8	0.9 to 1.3	547.5 to 549.8	145.4 to 146.0	692.8 to 695.8	168.0 to 168.7	0.4	525.2 to 527.4
2005	1st half	359.7 to 362.1	98.7	96.5 to 97.2	0.8 to 1.5	555.7 to 559.5	150.2 to 151.2	705.9 to 710.7	172.9 to 174.0	0.4	533.5 to 537.1
	2nd half	363.7 to 367.1	99.9	99.2 to 100.1	1.0 to 2.0	563.9 to 569.1	155.0 to 156.4	718.9 to 725.5	177.7 to 179.3	0.4	541.6 to 546.6
2006	1st half	367.7 to 371.9	101.3	101.2 to 102.3	0.7 to 1.9	570.8 to 577.4	159.8 to 161.7	730.6 to 739.1	182.6 to 184.8	0.4	548.4 to 554.7
	2nd half	371.7 to 376.9	102.5	102.7 to 104.2	0.5 to 2.0	577.4 to 585.6	164.7 to 167.1	742.2 to 752.6	187.7 to 190.3	0.4	554.9 to 562.7
		Percentage changes on previous year[4,5]									
2003		3	2	2½	0	2¾	–½	2	¾	0	2¼
2004		3 to 3¼	2¼	5½ to 5¾	0	3¼ to 3½	5¼ to 5½	3¾ to 4	5½ to 6	0	3 to 3½
2005		2¼ to 2¾	2½	6½ to 7	0	3 to 3½	6¾ to 7¼	3¾ to 4¼	6 to 6½	0	3 to 3½
2006		2¼ to 2¾	2½	4¼ to 4¾	0	2½ to 3	6¼ to 6¾	3¼ to 3¾	5¾ to 6¼	0	2½ to 3

[1] *Includes households and non-profit institutions serving households.*

[2] *Also includes acquisitions less disposals of valuables.*

[3] *Expenditure adjustment.*

[4] *For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.*

[5] *Growth ranges for GDP components do not necessarily sum to the ½ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

C THE PUBLIC FINANCES

The latest projections for the public finances show that the Government is on track to meet its fiscal rules over the economic cycle:

- **the current budget since the start of the current economic cycle in 1999-2000 shows an average annual surplus up to 2005-06 of 0.1 per cent of GDP. The Government is therefore on track to meet the golden rule on the basis of cautious assumptions. There is a margin against the golden rule of £11 billion in this cycle, including the AME margin. The current budget returns to balance by 2006-07, and the cyclically-adjusted current budget in the cautious case moves back to balance by the end of the projection period; and**
- **public sector net debt is projected to be low and stable over the next five years, stabilising at just under 36½ per cent of GDP at the end of the projection period – £53 billion below the 40 per cent ceiling set in the sustainable investment rule.**

INTRODUCTION

C1 Chapter 2 describes the Government's fiscal policy framework and shows how the projections of the public finances are consistent with meeting the fiscal rules. This chapter explains the latest outturns and the fiscal projections in more detail. It includes:

- five-year projections of the current budget and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule, respectively;
- projections of public sector net borrowing, the fiscal aggregate relevant to assessing the impact of fiscal policy on the economy;
- projections of the cyclically-adjusted fiscal balances; and
- detailed analyses of the outlook for government receipts and expenditure.

C2 The fiscal projections continue to be based on deliberately cautious key assumptions audited by the National Audit Office (NAO).

MEETING THE FISCAL RULES

C3 Table C1 shows five-year projections for the current budget and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule respectively. Outturns and projections of other important measures of the public finances, including net borrowing and cyclically-adjusted fiscal balances, are also shown.

C4 As explained in Chapter 2, the Government's provisional view is that the current economic cycle started in 1999-2000. Based on the assumptions used in these projections, the economy will return to trend, ending the current cycle, in 2005-06.

Table C1: Summary of public sector finances

	Per cent of GDP							
	Outturns		Estimate	Projections				
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Fairness and prudence								
Surplus on current budget	0.9	–1.2	–1.9	–0.9	–0.4	0.0	0.3	0.7
Average surplus since 1999-2000	1.7	1.0	0.4	0.2	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	0.6	–0.6	–1.0	–0.2	–0.2	0.0	0.3	0.7
Long-term sustainability								
Public sector net debt[1]	30.2	30.8	33.2	34.4	35.3	35.9	36.3	36.4
Core debt[1]	30.8	30.8	32.2	32.9	33.7	34.3	34.8	34.9
Net worth[2]	25.0	24.3	22.0	19.6	17.1	16.5	15.4	15.5
Primary balance	1.7	–0.6	–1.7	–1.1	–0.8	–0.5	–0.2	–0.1
Economic impact								
Net investment	0.9	1.0	1.5	1.9	2.0	2.1	2.2	2.2
Public sector net borrowing (PSNB)	0.1	2.2	3.4	2.8	2.5	2.1	1.9	1.6
Cyclically-adjusted PSNB	0.4	1.6	2.4	2.1	2.3	2.1	1.9	1.6
Financing								
Central government net cash requirement	0.3	2.1	3.8	3.0	2.6	2.4	1.9	1.6
Public sector net cash requirement	0.3	2.1	3.9	2.9	2.5	2.3	1.9	1.6
European commitments								
Treaty deficit[3]	0.0	2.1	3.2	2.6	2.4	2.0	1.9	1.6
Cyclically-adjusted Treaty deficit[3]	0.3	1.5	2.3	1.9	2.2	2.0	1.9	1.6
Treaty debt ratio[4]	37.9	37.9	39.8	40.9	41.5	41.9	42.2	42.1
Memo: Output gap	0.0	–1.2	–1.4	–0.8	–0.1	0.0	0.0	0.0

[1] *Debt at end March; GDP centred on end March.*
[2] *Net worth at end December; GDP centred on end December.*
[3] *General government net borrowing on a Maastricht basis.*
[4] *General government gross debt measured on a Maastricht basis.*

The golden rule

C5 The projections show the average current budget since the start of the current economic cycle in 1999-2000 up to 2005-06 in surplus by an annual 0.1 per cent of GDP and the Government is therefore on track to meet the golden rule on the basis of cautious assumptions. There is a margin against the golden rule of £11 billion in this cycle, including the AME margin. If the economic cycle were to have started in 1997-98, the average surplus on the current budget up to 2005-06 would be 0.2 per cent of GDP. The cyclically-adjusted surplus, which allows underlying or structural trends in the indicators to be seen more clearly by removing the estimated effects of the economic cycle, shows a deficit from 2002-03 to 2005-06 before returning to balance in 2006-07.

C6 The economy is projected to return to trend by early 2006. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2008-09 is 0.1 per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on track to continue to meet the golden rule after the end of this economic cycle.

The sustainable investment rule

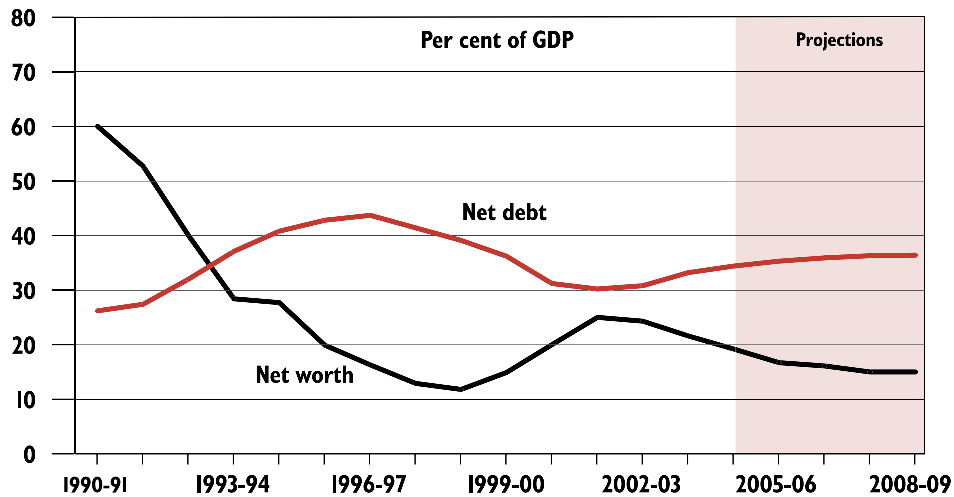
C7 The sustainable investment rule is comfortably met over the economic cycle. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and expenditure taken by the Government, including the decision to repay debt using the proceeds from the auction of spectrum licences, reduced debt to around 30 per cent of GDP by the end of 2001-02. It is now projected to increase slowly, as the Government borrows modestly to fund increased investment in public services, stabilising at just under 36½ per cent at the end of the projection period – £53 billion below the 40 per cent level. The revision to debt also includes the impact of fully incorporating Blue Book 2003 changes to the classification of business rates, which increases the public sector net cash requirement by around £1 billion per year. The projections for core debt, which exclude the estimated impact of the economic cycle, increase more slowly to around 35 per cent of GDP.

Net worth

C8 Net worth is the approximate stock counterpart of the current budget. Declines of net worth are expected for the remainder of the projection period from the high level of 25 per cent of GDP in 2001-02. At present, net worth is not used as a key indicator of the public finances, mainly as a result of the difficulties involved in accurately measuring many government assets and liabilities.

C9 Chart C1 shows public sector net debt and net worth as a per cent of GDP from 1990-91 to 2008-09.

Chart C1: Public sector net debt and net worth



Net investment

C10 As a result of decisions taken in the 2002 Spending Review, public sector net investment is projected to rise steadily to 2¼ per cent of GDP in 2008-09. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level, well below 40 per cent of GDP.

Net borrowing

C11 This increase in net investment, together with the new projections for the current budget, mean that public sector net borrowing is expected to be around 3½ per cent of GDP in 2003-04 and then fall to around 1½ per cent of GDP in 2008-09. Cyclically-adjusted net borrowing in 2003-04 is below 2½ per cent of GDP.

Financing

C12 The central government net cash requirement was 2.1 per cent of GDP in 2002-03. It is projected to increase in 2003-04 before decreasing to 1.6 per cent of GDP in 2008-09, mirroring the profile of net borrowing.

European commitments **C13** Table C1 shows the Treaty measures of debt and deficit used for the purposes of the Excessive Deficit Procedure – Article 104 of the Treaty.

CHANGES TO THE FISCAL BALANCES

C14 Table C2 compares the latest estimates for the main fiscal balances with those in the 2003 Pre-Budget Report and in Budget 2003.

Table C2: Fiscal balances compared with Budget 2003 and the 2003 Pre-Budget Report

	Outturn[1]	Estimate[2]	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Surplus on current budget (£ billion)							
Budget 2003	–11.7	–8.4	–1	2	6	9	–
Effect of revisions and forecasting changes:							
Receipts[3]	–0.5	–5.5	–4	–4	–3	–1	–
Current expenditure[4]	0.4	–2.9	–2	–2	–3	–3	–
Effect of discretionary changes	0.0	–2.5	–1	–1	0	0	–
2003 PBR	–11.8	–19.3	–8	–5	0	4	8
Effect of revisions and forecasting changes:							
Receipts[3]	–0.4	–1.3	–2	–1	0	0	1
Current expenditure[4]	–0.1	–0.6	1	1	1	1	1
Effect of discretionary changes[5]	0.0	0.0	–1	–1	–1	–1	0
Budget 2004	**–12.3**	**–21.3**	**–11**	**–5**	**0**	**4**	**9**
Net borrowing (£ billion)							
Budget 2003	24.0	27.3	24	23	22	22	–
Changes to current budget	0.1	10.9	7	7	6	4	–
Forecasting changes to net investment	–1.5	–0.9	0	0	0	0	–
Discretionary changes to net investment	0.0	0.0	0	0	0	0	–
2003 PBR	22.5	37.4	31	30	27	27	24
Changes to current budget	0.5	1.9	2	1	0	0	–1
Forecasting changes to net investment	–0.1	–1.8	0	0	0	0	0
Discretionary changes to net investment	0.0	0.0	0	0	0	0	0
Budget 2004	**22.9**	**37.5**	**33**	**31**	**27**	**27**	**23**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2003	–0.5	0.2	0.5	0.4	0.4	0.6	–
2003 PBR	–0.6	–0.8	–0.1	–0.1	0.0	0.3	0.6
Budget 2004	**–0.6**	**–1.0**	**–0.2**	**–0.2**	**0.0**	**0.3**	**0.7**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2003	1.7	1.5	1.5	1.7	1.7	1.6	–
2003 PBR	1.6	2.4	2.0	2.2	2.0	1.9	1.7
Budget 2004	**1.6**	**2.4**	**2.1**	**2.3**	**2.1**	**1.9**	**1.6**
Net debt (per cent of GDP)							
Budget 2003	30.9	32.2	32.7	33.2	33.5	33.8	–
2003 PBR	30.9	32.8	33.8	34.6	35.1	35.4	35.5
Budget 2004	**30.8**	**33.2**	**34.4**	**35.3**	**35.9**	**36.3**	**36.4**

[1] *The 2002-03 figures were estimates in Budget 2003.*
[2] *The 2003-04 figures were projections in Budget 2003.*
[3] *Further details given in table C7.*
[4] *Includes depreciation.*
[5] *Includes measures announced since the 2003 Pre-Budget Report.*

Changes between Budget 2003 and the Pre-Budget Report

C15 In the 2003 Pre-Budget Report, receipts were revised down in all years. This was mainly due to changes in the composition of GDP. In particular, lower than expected growth in wages and salaries reduced receipts from income tax and social security contributions.

C16 The discretionary changes of £2½ billion made in 2003-04 announced in the 2003 Pre-Budget Report reflect the carrying forward of the £2 billion unallocated special reserve into 2003-04 and the addition of a further £500 million. A further £300 million was added in 2004-05 as a prudent allowance against continuing commitments.

C17 Overall, in the 2003 Pre-Budget Report the current budget in 2003-04 was revised from a deficit of £8.4 billion to a deficit of £19.3 billion, and from a deficit of £1 billion to a deficit of £8 billion in 2004-05.

Changes between the Pre-Budget Report and the Budget 2004

C18 The fiscal projections contained in this Budget are broadly in line with those in the 2003 Pre-Budget Report. Over half of the £1.3 billion downward revision to receipts in 2003-04 reflects a fiscally neutral adjustment to public corporations gross operating surpluses which is offset by lower expenditure and feeds through into the future years. The remaining difference in receipts in 2003-04 is largely explained by temporary or timing effects that have no impact on the underlying position. Current spending in 2003-04 is higher, largely because of changes to the timing of net contributions to the EU and re-profiling of tax credit payment schedules.

C19 Discretionary measures announced in this Budget, include a £100 payment to pensioner households with someone aged 70 or over to help with their council tax bills, local authority business growth incentives, a new Inland Revenue compliance package and other budget policy decisions set out in Chapter A. They also include the re-setting of the AME margin (which adds £1 billion to spending in 2004-05, and around £2 billion from 2005-06 onwards). In total, the discretionary measures reduce the current budget by around £1 billion a year from 2004-05 onwards.

FORECAST DIFFERENCES AND RISKS

C20 The fiscal balances represent the difference between two large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been around 1 per cent of GDP. This difference tends to grow as the forecast horizon lengthens. A full account of differences between the year-ahead projections made in Budget 2001 and Budget 2002, and the subsequent outturns, is provided in the *End of year fiscal report*, published alongside the 2003 Pre-Budget Report.

C21 As explained in Chapter B, UK GDP has grown strongly in recent months, with the major uncertainties that dominated the international economic outlook in early 2003 receding, global demand continuing to pick up and UK macroeconomic fundamentals remaining sound, business and consumer confidence have strengthened. As a result, domestic demand growth rose significantly through last year as private consumption growth recovered from temporary lows and business investment started to rise.

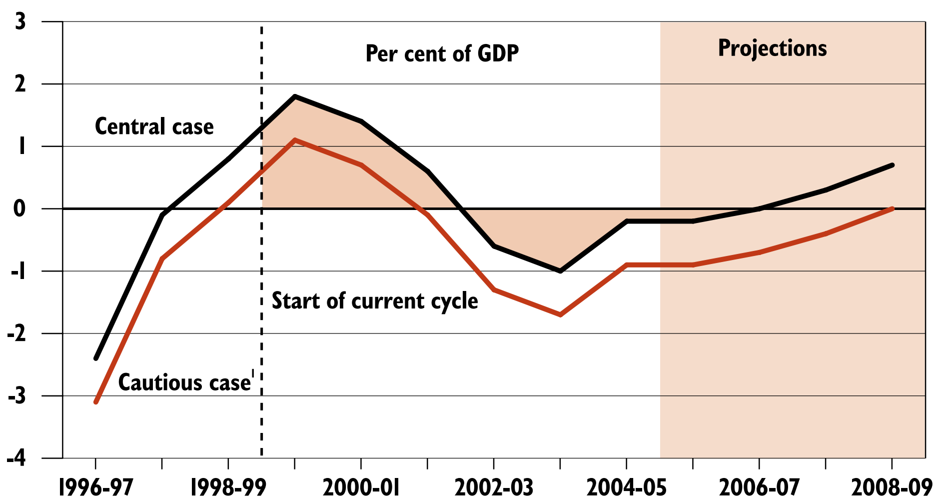
C22 Risks on the upside and downside have changed little since the time of the 2003 Pre-Budget Report. Although the US dollar's decline against some other major currencies in recent months has continued to be orderly, large global imbalances mean that much sharper movements in major exchange rates cannot be ruled out. In the UK, downside risks continue to be associated with the outlook for consumer spending. However, on the upside, the pick-up in growth seen since early 2003 could prove stronger than expected, in the short term.

C23 Short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure – notably social security – vary directly with the economic cycle. Earlier work by the Treasury[1] suggests that if GDP growth were one percentage point higher or lower than assumed over the coming year, net borrowing might be lower or higher by 0.4 per cent of GDP in the first year and by a further 0.3 per cent of GDP the following year. These figures are now closer to 0.5 and 0.2 per cent respectively, as the introduction of the corporation tax instalment system has reduced the lag between profits and tax receipts.[2] However, not all cycles will conform exactly to these parameters, notably because the estimates are based on historical data (since which time both the state of the economy and the tax regime have changed) and because cycles differ in respects other than magnitude.

C24 Projected differences in short-term growth forecasts may have only a temporary effect on public finances. For a given path of trend output, higher or lower growth in the short term will be followed by lower or higher growth later on, and the public finances may be a little affected on average over the cycle.

C25 However, changes in the estimated cyclical position of the economy in relation to its trend – the output gap – will have a lasting effect on prospects. For this reason, the Government has remained vigilant to the uncertainties inherent in forecasting the public finances and created a margin against unexpected events through the use of cautious, audited assumptions and the use of the cautious case to stress test the resilience of public finance projections to unexpected events. Combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, the Government can now draw on this margin to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full, while remaining on track to meet the fiscal rules.

Chart C2: Cyclically-adjusted surplus on current budget



[1] *Cautious case assumes trend output one percentage point lower in relation to actual output than in the central case.*

[1] *Fiscal policy: public finances and the cycle*, HM Treasury, March 1999.

[2] The Treasury's approach to cyclical adjustment is set out in Annex A of the 2003 *End of year fiscal report*.

ASSUMPTIONS

C26 The fiscal projections are based on the following assumptions:

- the economy follows the path in Chapter B. In the interests of caution, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend output growth of 2½ per cent a year up to 2006-07, ¼ percentage point lower than the Government's neutral view. The Government's view of trend output growth is reduced to 2½ per cent in 2007-08 and 2008-09, and so, to maintain a cautious approach, an assumption of 2¼ per cent is used in the public finance projections, still ¼ percentage point lower than the Government's neutral view;

- there are no tax changes beyond those announced in or before this Budget and the indexation of rates and allowances. Consistent with the *Code for fiscal stability*, the forecast does not take account of measures proposed in this Budget for consultation, other proposals where final decisions have yet to be taken such as the Pension Protection Fund, or others that cannot be costed accurately, including the Graduate Contributions scheme;

- firm Departmental Expenditure Limits (DEL) as set out in the 2002 Spending Review up to 2005-06, but adjusted to the impact of policy decisions and DEL/AME reclassifications;

- total Annually Managed Expenditure (AME) programmes through to 2005-06 have been reviewed. The total has been adjusted for DEL/AME reclassifications, and for the estimated costs of spending measures announced in this Budget. In accordance with usual practice the Government has decided to reset the AME margin to £1 billion in 2004-05 and to £2 billion in 2005-06;

- although DEL and AME totals for 2006-07 onwards have not yet been determined, Budget 2004 sets firm overall spending limits for the 2004 Spending Review period. This allows current spending to increase by an average of 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumption for trend economic growth and consistent with the nominal growth rates set out in Budget 2003 and the 2003 Pre-Budget Report. Spending growth rates in 2008-09 are also based on those in the 2003 Pre-Budget Report, adjusted for policy decisions; and

- the capital expenditure of the 2004 Spending Review envelope is based on public sector net investment increasing from 2 per cent of GDP in 2005-06 to 2¼ per cent of GDP by 2007-08. Net investment remains at 2¼ per cent of GDP in the spending projection of 2008-09.

Table C3: Economic assumptions for the public finance projections

	Percentage changes on previous year						
	Outturn	Estimate	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Output (GDP)	1¾	2¾	3	3	2½	2¼	2¼
Prices							
CPI	1¼	1¼	1¾	2	2	2	2
GDP deflator	3¼	2¾	2¼	2½	2¾	2¾	2¾
RPI[1] (September)	1½	3	3	2¾	2¾	2¾	2¾
Rossi[2] (September)	1¼	2	1¾	2¼	2¼	2¼	2¼
Money GDP[3] (£ billion)	1054	1115	1176	1243	1308	1372	1440

[1] *Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.*

[2] *RPI excluding housing costs, used for uprating certain social security benefits.*

[3] *Not seasonally adjusted.*

The audited assumptions

C27 A number of key assumptions that underpin the public finance projections are independently audited by the Comptroller and Auditor General under a three-year rolling review process. Details of all the audited assumptions are given in Box C1.

C28 For this Budget, the Comptroller and Auditor General audited the assumptions on the composition of GDP and on government financing. In both cases the review concluded that the assumptions were reasonable and continue to be so for the future.

C29 As described in Chapter 5, Budget 2004 unveils a new compliance and enforcement package for direct taxes and national insurance contributions (NICs). Consistent with previous practice, the estimates of the extra revenue delivered by the package include the direct and preventive effects of the package and make no allowances for indirect effects. Therefore, while the package is expected to produce an additional £2 billion in revenue over the next three years, in line with the Government's cautious approach to the public finances, a lower figure of £1.7 billion has been included in the public finances forecast. The Comptroller and Auditor General has audited the approach adopted to estimate the revenue benefits of the package and concluded that though there are uncertainties in the estimate of benefits, it is reasonable and incorporates caution.

C30 As explained in Box C2, in the light of the volatility in the observed ratio of VAT to consumption, a new approach to project VAT receipts has been used for the projections in Budget 2004. As Box C2 illustrates, the new approach adopts a more comprehensive approach to model the tax base than the old one. The Comptroller and Auditor General has also completed an audit of the assumption on the VAT gap used to project VAT receipts in the new approach. In his report, the Comptroller and Auditor General concluded that the assumption is reasonable and has features that introduce caution in the projections for VAT.

Box C1: Key assumptions audited by the NAO[a]

• Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
• Trend GDP growth	2½ per cent a year to 2006-07 and 2¼ per cent in 2007-08 and 2008-09.
• UK claimant unemployment	Remaining at recent levels of 0.92 million.
• Interest rates	3-month market rates change in line with market expectations (as of 5 March).
• Equity prices[b]	FTSE All-Share index rises from 2271 (close 5 March) in line with money GDP.
• VAT[b,c]	The VAT gap will rise by 0.5 percentage points per year from a level that is at least as high as the estimated outturn for the current year.
• Consistency of price indicies[b]	Projections of price indices used to project the public finances are consistent with CPI.
• Composition of GDP[c]	Shares of labour income and profits in national income are broadly constant in the medium term.
• Funding[c]	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
• Oil prices	$27.4 a barrel in 2004, the average of independent forecasts, and then constant in real terms.
• Tobacco	The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For Budget 2004, a share of 18 per cent has been used in all forecast years.

[a] For details of all NAO audits before the 2003 Pre-Budget Report, see Budget 2003, 9 April 2003 (HC500)

[b] Audit of Assumptions for the 2003 Pre-Budget Report, 10 December 2003 (HC35)

[c] Audit of Assumptions for Budget 2004, 17 March 2004 (HC434)

FISCAL AGGREGATES

C31 Tables C4 and C5 provide more detail on the projections for the current and capital budgets.

Table C4: Current and capital budgets

	Outturn	Estimate	Projections				
£ billion	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Current budget							
Current receipts	396.2	421.5	455	490	522	553	583
Current expenditure	394.0	428.0	450	479	504	530	554
Depreciation	14.4	14.8	16	16	17	18	19
Surplus on current budget	**–12.3**	**–21.3**	**–11**	**–5**	**0**	**4**	**9**
Capital budget							
Gross investment	31.1	37.0	43	47	48	53	55
Less asset sales	–6.1	–6.0	–6	–6	–4	–4	–4
Less depreciation	–14.4	–14.8	–16	–16	–17	–18	–19
Net investment	10.6	16.2	22	25	27	31	32
Net borrowing	**22.9**	**37.5**	**33**	**31**	**27**	**27**	**23**
Public sector net debt – end year	**334.1**	**379.7**	**416**	**450**	**481**	**511**	**537**
Memos:							
Treaty deficit[1]	22.3	36.2	30	30	27	27	24
Treaty debt[2]	399.8	443.3	481	516	548	579	606

[1] *General government net borrowing on a Maastricht basis.*
[2] *General government gross debt on a Maastricht basis.*

Table C5: Current and capital budgets

	Outturn	Estimate	Projections				
Per cent of GDP	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Current budget							
Current receipts	37.6	37.8	38.7	39.4	39.9	40.3	40.5
Current expenditure	37.4	38.4	38.2	38.5	38.6	38.6	38.5
Depreciation	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget	**–1.2**	**–1.9**	**–0.9**	**–0.4**	**0.0**	**0.3**	**0.7**
Capital budget							
Gross investment	2.9	3.3	3.7	3.8	3.7	3.8	3.8
Less asset sales	–0.6	–0.5	–0.5	–0.4	–0.3	–0.3	–0.3
Less depreciation	–1.4	–1.3	–1.3	–1.3	–1.3	–1.3	–1.3
Net investment	1.0	1.5	1.9	2.0	2.1	2.2	2.2
Net borrowing	**2.2**	**3.4**	**2.8**	**2.5**	**2.1**	**1.9**	**1.6**
Public sector net debt – end year	**30.8**	**33.2**	**34.4**	**35.3**	**35.9**	**36.3**	**36.4**
Memos:							
Treaty deficit[1]	2.1	3.2	2.6	2.4	2.0	1.9	1.6
Treaty debt ratio[2]	37.9	39.8	40.9	41.5	41.9	42.2	42.1

[1] *General government net borrowing on a Maastricht basis.*
[2] *General government gross debt on a Maastricht basis.*

C32 Following a deficit of 3 per cent of GDP in 1996-97, current budget surpluses of more than 2 per cent were recorded in 1999-2000 and 2000-01. These surpluses have allowed the Government to use fiscal policy to support monetary policy during the recent economic slowdown, and as a result the current budget is now in deficit. However, as the economy moves back to trend, the current budget moves back towards balance, and by the end of the projection period is in surplus by more than ½ per cent of GDP.

C33 The current budget surplus is equal to public sector receipts minus public sector current expenditure and depreciation. Underlying the projections of the current budget up to 2005-06 are steady increases in the ratio of public sector receipts. The reasons behind this increase are explained in later sections. The current expenditure projections are based on decisions made in and since the 2002 Spending Review. They also reflect decisions about the 2004 Spending Review envelope for total spending as set out in Chapter 6.

C34 Table C4 also shows that net investment is projected to increase from £16.2 billion in 2003-04 to £32 billion in 2008-09, as the Government seeks to rectify historical under-investment in public infrastructure. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, as debt is being held below 36½ per cent of GDP throughout the projection period, well within the 40 per cent limit set by the sustainable investment rule.

RECEIPTS

C35 This section looks in detail at the projections for public sector tax receipts. It begins by looking at the main determinants of changes in the overall projections since the 2003 Pre-Budget Report, before looking in detail at changes in the projections of individual tax receipts. Finally, it provides updated forecasts for the tax-GDP ratios.

Changes in total receipts since the 2003 Pre-Budget Report

C36 Table C6 provides a detailed breakdown of the main factors that have led to changes in the overall projections since the 2003 Pre-Budget Report.

Table C6: Changes in current receipts since the 2003 Pre-Budget Report

	£ billion					
	Estimate	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Effect on receipts of non-discretionary changes in:						
Assumptions audited by the NAO	0	0	1	1½	1½	2
of which:						
VAT forecast assumption	*0*	*–½*	*0*	*½*	*1*	*1*
Equity prices	*0*	*½*	*1*	*1*	*1*	*1*
Other economic determinants	–1	0	½	½	½	1
of which:						
Consumers' expenditure	*0*	*½*	*½*	*½*	*½*	*0*
Fiscal forecasting changes	0	–1	–1	–1½	–1½	–1½
Other	–½	–½	–½	–½	–½	–1
Total before discretionary changes[1]	**–1½**	**–1½**	**–½**	**0**	**0**	**½**
Discretionary changes[2]	0	0	1½	2	2	2
Total change[1]	**–1½**	**–1½**	**½**	**1½**	**2**	**3**

[1] *Total may not sum due to rounding.*
[2] *Includes measures announced since the 2003 Pre-Budget Report.*

C37 Public sector receipts are estimated to be around £422 billion in 2003-04, £1.3 billion lower than estimated in the 2003 Pre-Budget Report. However, over half of this revision is due to a fiscally neutral change in NHS gross operating surpluses, which results in an equal reduction in Department of Health spending. This revision reduces receipts and spending by around £0.7 billion in each year, and is identified in the other line in Table C6.

C38 The remaining revision to receipts in 2003-04 is largely due to a £0.7 billion revision to estimated corporation tax revenues, including those from North Sea companies. This is largely a result of higher than expected tax repayments in relation to previous years' liabilities, and to temporarily higher capital allowances, which have no impact on underlying profits. These changes are included in the fiscal forecasting changes line in Table C6.

C39 Receipts in 2004-05 are also expected to be marginally lower than forecast in the 2003 Pre-Budget Report, but from 2005-06 onwards, receipts are expected to be higher than previously projected. This is mainly a result of:

- the impact of the new VAT forecasting methodology, described in Box C2. Although this assumtpion is more cautious in the short term, in the medium term it increases the VAT receipts forecast by around £1 billion each year;
- higher equity prices. The starting point for the audited assumption regarding equity prices is a FTSE all share value of 2271, compared with the 2003 Pre-Budget Report starting point of 2154. This adds around £1 billion to receipts from corporation tax receipts from life assurance companies, stamp duty receipts and capital taxes, by 2008-09;
- higher consumers' expenditure, reflecting higher than expected growth in the latter half of 2003; and
- discretionary changes announced in this Budget, including the Inland Revenue compliance package described in Chapter 5.

Offsetting these increases are:

- higher than expected levels of incorporation observed since the Pre-Budget Report, which reduces self-assessment tax receipts by more than it increases corporation tax receipts; and
- lower forecasts of council tax revenues, which are based on stylised assumptions of council tax increases and have no impact on fiscal balances, as explained in paragraph C52.

Both these changes are scored under fiscal forecasting changes in Table C6.

Tax-by-tax analysis

C40 Table C7 shows the changes to the projections of individual taxes since Budget 2003 and the 2003 Pre-Budget Report for 2003-04 and 2004-05. Table C8 contains updated projections for the main components of public sector receipts for 2002-03, 2003-04 and 2004-05.

Table C7: Changes in current receipts by tax since Budget 2003 and the 2003 Pre-Budget Report

	£ billion			
	Budget 2003		2003 PBR	
	2003-04	2004-05	2003-04	2004-05
Income tax (gross of tax credits)	–3.0	–3.6	0.3	–0.4
Social security contributions	–2.2	–2.8	–0.3	–0.7
Non-North Sea corporation tax[1]	–2.0	–1.6	–0.5	0.4
Less tax credits[2]	–0.3	0.3	–0.3	–0.2
North Sea revenues	–0.4	–1.5	–0.4	–0.1
Capital taxes[3]	0.1	0.5	0.2	0.1
Stamp duty	–0.4	0.2	0.0	0.1
Value added tax	3.1	3.0	0.7	0.9
Excise duties[4]	0.0	0.5	0.1	–0.6
Other taxes and royalties[5]	0.4	–0.5	–0.2	–0.4
Net taxes and social security contributions	**–4.7**	**–5.5**	**–0.4**	**–1.1**
Other receipts and accounting adjustments	–2.1	–0.3	–0.9	–0.4
Current receipts	**–6.8**	**–5.7**	**–1.3**	**–1.5**

[1] *National Accounts measure: gross of enhanced and payable tax credits.*
[2] *Includes enhanced company tax credits that offset tax liability.*
[3] *Capital gains tax and inheritance tax.*
[4] *Fuel, alcohol and tobacco duties.*
[5] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*

Table C8: Current receipts

	£ billion		
	Outturn 2002-03	Estimate 2003-04	Projection 2004-05
Inland Revenue			
Income tax (gross of tax credits)	112.6	119.1	127.8
Social security contributions	64.6	72.2	77.7
Corporation tax[1]	29.5	28.7	34.8
Tax credits[2]	–3.4	–4.8	–4.1
Petroleum revenue tax	1.0	1.2	1.0
Capital gains tax	1.6	1.2	1.5
Inheritance tax	2.4	2.5	2.8
Stamp duties	7.5	7.5	9.4
Total Inland Revenue (net of tax credits)	**215.8**	**227.6**	**251.0**
Customs and Excise			
Value added tax	63.5	69.7	73.1
Fuel duties	22.1	22.8	24.4
Tobacco duties	8.1	8.1	8.1
Spirits duties	2.3	2.4	2.4
Wine duties	1.9	2.0	2.0
Beer and cider duties	3.1	3.2	3.3
Betting and gaming duties	1.3	1.3	1.3
Air passenger duty	0.8	0.8	0.9
Insurance premium tax	2.1	2.3	2.4
Landfill tax	0.5	0.6	0.6
Climate change levy	0.8	0.8	0.8
Aggregates levy	0.2	0.3	0.3
Customs duties and levies	1.9	1.9	1.9
Total Customs and Excise	**108.7**	**116.4**	**121.6**
Vehicle excise duties	4.6	4.7	4.9
Oil royalties	0.4	0.0	0.0
Business rates[3]	18.5	18.7	19.1
Council tax	16.7	18.6	19.7
Other taxes and royalties[4]	10.9	12.3	13.2
Net taxes and social security contributions[5]	**375.6**	**398.2**	**429.4**
Accruals adjustments on taxes	–0.3	3.0	0.8
Less own resources contribution to European Communities (EC) budget	–4.4	–4.5	–3.7
Less PC corporation tax payments	–0.1	–0.1	–0.1
Tax credits adjustment[6]	1.1	0.5	0.6
Interest and dividends	4.5	4.1	4.9
Other receipts[7]	19.8	20.3	22.7
Current receipts	**396.2**	**421.5**	**454.7**
Memo:			
North Sea revenues[8]	4.9	4.3	3.6

[1] *National Accounts measure: gross of enhanced and payable tax credits.*
[2] *Includes enhanced company tax credits.*
[3] *Includes district council rates in Northern Ireland paid by business.*
[4] *Includes VAT refunds and money paid into the National Lottery Distribution Fund.*
[5] *Includes VAT and 'traditional own resources' contributions to EC budget.*
[6] *Tax credits which are scored as negative tax in the calculation of NTSSC but expenditure in the National accounts.*
[7] *Includes gross operating surplus and rent; net of oil royalties and business rate payments by Local Authorities.*
[8] *Consists of North Sea corporation tax, petroleum revenue tax and royalties.*

Income tax and social security contributions

C41 Taken together, income tax receipts and social security contributions in 2003-04 are expected to be broadly unchanged from the 2003 Pre-Budget report estimates. Self-assessment receipts were higher than expected but underlying PAYE and NICs receipts have been slightly lower reflecting modest average earnings growth. However, the very buoyant levels of receipts in January and February show that bonus payments, primarily in the financial sector, have recovered in line with 2003 Pre-Budget Report estimates of financial sector profits.

C42 In 2004-05 receipts have been revised down by around £1 billion. Around £½ billion of this reduction reflects the analysis undertaken by HM Treasury and Inland Revenue, following the announcement in the 2003 Pre-Budget Report that the Government was concerned about the trend in tax-induced incorporation by self-employed individuals. Chapter 5 describes the steps the Government is taking. The 2004-05 revision also reflects lower interest rates, which lowers income tax receipts from interest income. This difference carries through into future years, although is partly offset by lower forecasts of the RPI which reduces future tax allowances, and discretionary measures announced in this Budget.

Non-North Sea corporation tax

C43 Non-North Sea corporation tax receipts in 2003-04 are estimated to be around £0.5 billion lower than estimated in the 2003 Pre-Budget Report. However, this is largely due to temporarily higher capital allowances, and repayments in respect of previous years' liabilities. These factors do not affect estimated underlying profits in the current year, which are broadly in line with the 2003 Pre-Budget Report projections.

C44 Receipts in 2004-05 and subsequent years are higher than in the 2003 Pre-Budget report, largely because of:

- the impact of higher equity prices on tax receipts from life assurance companies, adding about £¼ billion in 2004-05 and £½ billion from 2005-06 onwards;
- the new Inland Revenue compliance package; and
- budget policy decisions including, from 2005-06, the introduction of a 19 per cent minimum rate of corporation tax on distributed profits, as described in Chapter 5. The net impact of this measure and of the estimated reduction in tax payments by small businesses incorporating for tax reasons since Budget 2003 are set out in Table A1.

The overall impact of these discretionary measures grows over time and, together with the baseline impact of incorporations on corporation tax receipts, adds around 0.2 percentage points to the corporation tax to GDP ratio by the end of the forecast period.

Tax credits

C45 Tax credits that score as negative tax in current receipts are expected to be around £¼ billion higher than forecast in the 2003 Pre-Budget Report in both 2003-04 and 2004-05. This is mainly because of changes in the profile of recovery of overpayments. This also impacts on spending projections (see paragraph C67).

North Sea revenues

C46 North Sea revenues in 2003-04 are expected to be £0.4 billion lower than was anticipated at the time of the 2003 Pre-Budget Report. As with non-North Sea companies, this is largely due to higher repayments in respect of previous years' liabilities, and does not impact on underlying profits. Higher oil prices (allowing for changes in the exchange rate) have a positive impact on revenues in all forecast years. However, in the short term, these impacts are more than offset by lower production forecasts.

Capital gains, inheritance tax and stamp duties

C47 Receipts from capital gains tax, inheritance tax and stamp duties in 2003-04 are expected to be £0.2 billion higher than projected in the 2003 Pre-Budget report. This is mainly a result of higher than expected January 2004 receipts of capital gains tax. Receipts from 2005-06 onwards have been revised up by around £½ billion each year, partly explained by higher equity prices.

VAT receipts

C48 VAT receipts are expected to be around £69.7 billion in 2003-04, £0.7 billion higher than forecast in the 2003 Pre-Budget Report, and £3.1 billion higher than forecast in Budget 2003. HM Customs and Excise considers that the reasons for the increase include the following:

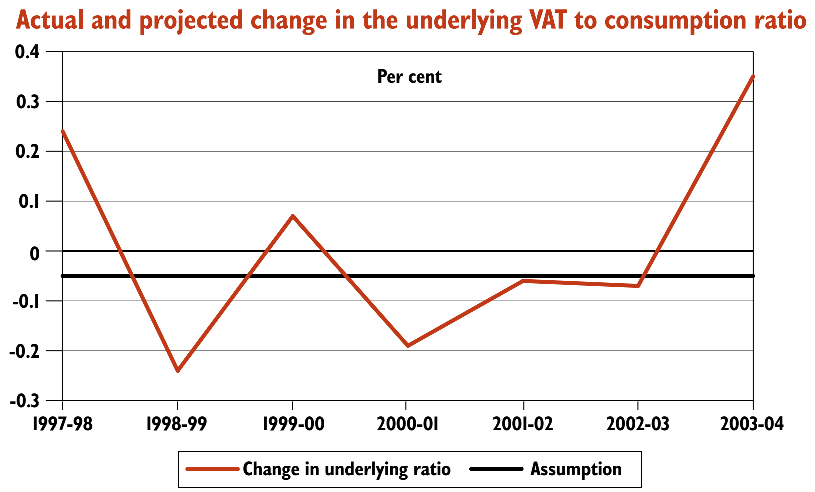
- the Budget 2003 forecast, based on the VAT ratio assumption, did not take account of rising expenditure on the wider (non-consumer) tax base; and
- there have been higher than forecast reductions in the level of VAT losses.

C49 As a result, HM Customs and Excise have developed a new method for forecasting VAT revenues that takes account of the whole VAT tax base rather than just consumers' expenditure (see Box C2). The new method involves making an assumption about the future size of the VAT gap (the difference between the theoretical level of VAT receipts given expenditure and VAT rates, and actual VAT receipts). The NAO have audited the assumption used for projecting the VAT gap and have concluded that it is reasonable and has features that introduce caution into the projections.

C50 The new methodology and assumption is more cautious than the previous approach in the short term, reducing receipts by around £0.5 billion, but increases receipts by around £1 billion in the medium term.

Box C2: Forecasting VAT receipts

Since 1997, VAT receipts forecasts have been based on the audited assumption that the ratio of underlying VAT receipts to consumers' expenditure will decline by 0.05 percentage points per year. However, volatility in the observed ratio has meant that this approach has resulted in some significant forecasting errors, as shown in the chart.



While the existing assumptions were used for the Pre-Budget Report forecast, as approved by the NAO for the short term, for Budget 2004, HM Customs and Excise have concluded that the change in the ratio in 2003-04 could be partly explained by changes in the composition of the VAT tax base. In particular, a shift towards non-consumer forms of VATable expenditure. As a result, HM Customs and Excise have developed a new forecasting methodology that can explicitly take account of these factors. It involves:

- **(i)** **Producing estimates and forecasts of the VAT tax base and VAT Theoretical Tax Liability (VTTL) (the amount of VAT the government would receive if there was no fraud and avoidance).**
- **(ii)** **Comparing the current year VTTL with estimated VAT receipts to derive the VAT gap, expressed as a percentage of the VTTL, and assume that it grows from at least this level by 0.5 percentage points per year.**
- **(iii)** **Adjust the resulting VAT gap projections for the future impact of anti fraud and avoidance measures, and then deduct the resulting VAT gap projection from the VTTL forecast to derive VAT receipts forecast.**

The assumption that the VAT gap grows by 0.5 percentage points per year is based on its long-run trend of around 0.4 percentage points a year, which is estimated across a period in which there was significant growth in VAT losses from Missing Trader Intra-Community (MTIC) fraud and alcohol and tobacco smuggling, both of which are now being successfully tackled.

The new approach to forecasting VAT receipts is also consistent with HM Customs and Excise's new approach to tackling VAT losses, which includes a target for reducing the VAT gap to 12 per cent by 2005-06. The NAO were invited to audit the assumption on the VAT gap, and have concluded that it is reasonable and has features that introduce caution in the projections. More details are available in the NAO report on Audit of Assumptions for Budget 2004.

Other HM Customs and Excise taxes

C51 Receipts from other HM Customs and Excise taxes in 2003-04 are expected to be broadly in line with 2003 Pre-Budget Report estimates. However, receipts from 2004-05 onwards are expected to be lower, largely due to downward revisions to the RPI forecast, which is used to revalorise excise duties.

Council tax

C52 Council tax increases are determined annually by local authorities, not by the Government, and the council tax figures for 2004-05 onwards are projections based on stylised assumptions, not government forecasts. The projected increase in 2004-05 is based on the latest available estimates released by the Chartered Institute for Public Finance and Accountancy (CIPFA),[3] and the increases for later years on the average increases in council tax over the period from 1993-94 onwards. These increases are lower than those assumed in the 2003 Pre-Budget Report and projected council tax is about £½ billion a year lower from 2005-06. However these changes are broadly balanced by changes to locally financed expenditure and have no effect on the fiscal aggregates.

Other taxes

C53 The main changes to other taxes since the 2003 Pre-Budget Report reflects lower than expected outturns for VED and VAT refunds, which knock through into future years.

Other receipts

C54 In total, other public sector receipts have been revised down by £1.1 billion in 2003-04 and £0.2 billion in 2004-05. This partly reflects lower gross operating surpluses of NHS trusts. Trusts are expected to make a profit as a return on their assets, which they fund from the prices they charge to the Department of Health for providing clinical services. From 2003-04 onwards the expected rate of return has been reduced, meaning that trusts will reduce the prices they charge the Department of Health and consequently make around £0.7 billion less profit. This will be offset by lower expenditure by Department of Health to leave the current surplus unaffected. In addition, payments of taxes to the EC have been higher than expected in 2003-04, although this is mainly a timing effect and is expected to result in lower payments in 2004-05.

Tax-GDP ratio

C55 Table C9 shows projections of receipts from major taxes as a per cent of GDP, and Table C10 sets out the current and previous projections of the overall tax-GDP ratio.

C56 The tax-GDP ratio has fallen from 37.3 per cent in 2000-01 to an estimated 35.7 per cent in 2003-04. This has largely been a result of:

- significant falls in equity prices. At the time of Budget 2000, the FTSE all share index was 3126. By Budget 2003, it had fallen to 1778. This led to significant reductions in corporation tax receipts from life assurance companies, stamp duty, capital gains tax, and inheritance tax; and
- a reduction in the profitability of financial companies. The global economic slowdown observed over the past few years, together with the fall in equity prices described above, has had a paricularly adverse impact on the profitability of financial companies. This had a direct impact on non-North Sea corporation tax receipts, which fell as a percentage of GDP from 3.6 per cent in 1999-00 to an estimated 2.3 per cent in 2003-04.

[3] *Lowest council tax rises in nine years* – CIPFA press release, 2 March 2004.

C57 However, over the past year the financial sector has started to recover. Equity prices are now around 28 per cent higher than they were at the time of Budget 2003. Financial companies have started to report increased profitability and pay higher bonuses to their employees, very much in line with 2003 Pre-Budget Report estimates. The Budget projections assume that financial company profits will continue to recover back to their historic trend with GDP. This assumption explains much of the rise in the corporation tax to GDP ratio over the projection period. Other factors underlying the rise in the tax-GDP ratio shown in Table C9 include:

- normal fiscal drag, which adds around 0.1 percentage points a year to the income tax-GDP ratio;
- a recovery of financial sector bonus payments, which are generally subject to the higher rate of income tax, and therefore increase the effective tax rate on wages and salaries;
- the lagged impact of the recovery of equity prices observed in 2003; and
- discretionary measures announced in this and previous Budgets.

Table C9: Current receipts as a proportion of GDP

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Income tax (gross of tax credits)	10.7	10.7	10.9	11.1	11.2	11.4	11.6
Social security contributions	6.1	6.5	6.6	6.6	6.6	6.7	6.8
Non-North Sea corporation tax[1]	2.5	2.3	2.7	3.2	3.3	3.4	3.4
Tax credits[2]	–0.3	–0.4	–0.3	–0.3	–0.3	–0.3	–0.3
North Sea revenues[3]	0.5	0.4	0.3	0.3	0.3	0.3	0.3
Value added tax	6.0	6.3	6.2	6.2	6.2	6.2	6.2
Excise duties[4]	3.6	3.5	3.4	3.4	3.3	3.3	3.2
Other taxes and royalties[5]	6.6	6.6	6.7	6.9	7.0	7.1	7.1
Net taxes and social security contributions[6]	**35.6**	**35.7**	**36.5**	**37.3**	**37.8**	**38.1**	**38.3**
Accruals adjustments on taxes	0.0	0.3	0.2	0.1	0.1	0.1	0.1
Less EC transfers	–0.4	–0.4	–0.3	–0.3	–0.3	–0.3	–0.2
Tax credits[7]	0.1	0.0	0.0	0.0	0.1	0.1	0.1
Other receipts[8]	2.3	2.2	2.3	2.2	2.2	2.2	2.2
Current receipts	**37.6**	**37.8**	**38.7**	**39.4**	**39.9**	**40.3**	**40.5**

[1] *Gross of enhanced and payable tax credits.*
[2] *Tax credits scored as negative tax in net taxes and social security contributions.*
[3] *Includes oil royalties, petroleum revenue tax and North Sea corporation tax.*
[4] *Fuel, alcohol and tobacco duties.*
[5] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*
[6] *Includes VAT and 'own resources' contributions to EC budget. Cash basis.*
[7] *Tax credits scored as negative tax in net taxes and social security contributions but expenditure in the national accounts.*
[8] *Mainly gross operating surplus and rent, excluding oil royalties. Net of local authority business rate payments.*

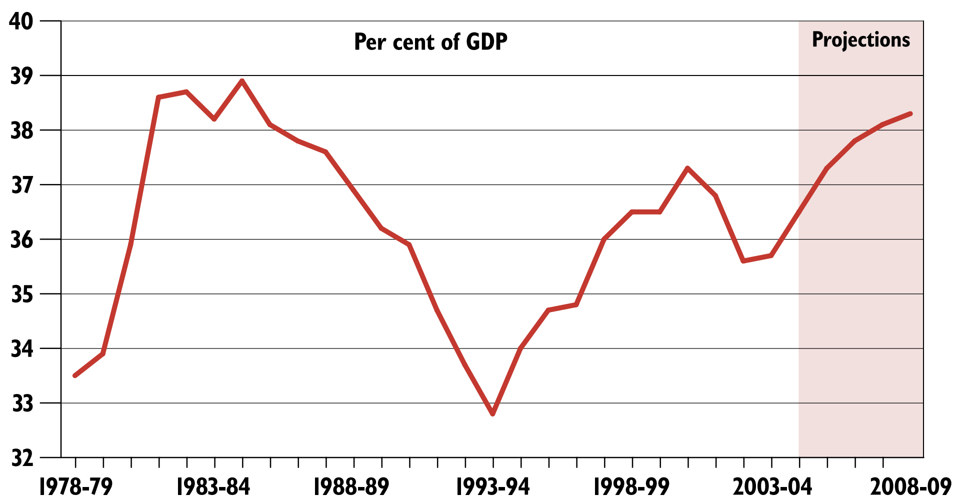
Table C10: Net taxes and social security contributions[1]

	Per cent of GDP						
	Outturn[2]	Estimate[3]	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Budget 2003	35.6	36.3	37.1	37.6	37.9	38.2	
2003 PBR	35.6	35.9	36.7	37.3	37.7	38.0	38.2
Budget 2004	**35.6**	**35.7**	**36.5**	**37.3**	**37.8**	**38.1**	**38.3**

[1] *Cash basis. Uses OECD definition of negative tax tax credits.*
[2] *The 2002-03 figures were estimates in Budget 2003.*
[3] *The 2003-04 figures were projections in Budget 2003.*

C58 Chart C3 shows the tax-GDP ratio from 1978-79 to 2008-09.

Chart C3: Tax-GDP ratio[1]



[1] *Net taxes and social security contributions as defined in Table C10*

PUBLIC EXPENDITURE

Total Managed Expenditure

C59 The spending projections cover the whole of the public sector, using the national accounts aggregate Total Managed Expenditure (TME). For fiscal aggregates purposes, TME is split into national accounts components covering public sector current expenditure, public sector net investment and depreciation. For budgeting and other purposes, TME is split into Departmental Expenditure Limits (DEL) – firm three year limits for departments' programme expenditure – and Annually Managed Expenditure (AME) – expenditure that is not easily subject to firm multi-year limits. However, until departmental allocations are set in the 2004 Spending Review, DEL and AME figures are only available to 2005-06.

C60 Forecasting changes have led to lower TME in each year, but this is mainly a result of fiscally neutral changes, which amount to about £1 billion a year. Without these changes current spending is about £1½ billion higher in 2003-04 but capital spending is £1¾ billion lower. In later years, forecasting changes have little effect on capital spending and only add small amounts to current spending.

C61 Discretionary changes to TME include scorecard measures on pensioners and Housing Benefit as described in Chapter A and the effects of resetting the AME margin.

C62 Table C11 sets out projected spending on DEL and the main components of AME to 2005-06 and Table C12 shows changes since the 2003 Pre-Budget Report.

Departmental Expenditure Limits

C63 Apart from budget policy decisions, the only overall changes to DEL for 2003-04 to 2005-06 since the 2003 Pre-Budget Report are reclassifications between DEL and AME and the fiscally neutral change to the Department of Health's spending described in paragraph C54. The reclassifications include:

- a £0.5 billion switch from Office of the Deputy Prime Minister's (ODPM) DEL to the Department for Work and Pensions' AME from 2004-05 onwards for rent rebates;
- an overall increase of £0.7 billion in various departments' pension contributions in DEL from 2005-06, which will be offset by higher receipts in the Civil Service Pension Scheme's AME; and
- a switch of £0.35 billion from the Department of Health's DEL to their AME in 2004-05 for the capital spending of foundation hospitals.

C64 There have also been some small switches between cash and non-cash spending and between resource and capital DEL. Table C13 shows DEL by resource and capital budgets by department. In line with previous practice, the DEL total for the current year incorporates an allowance for shortfall reflecting likely under-spends against departmental forecasts.

Annually Managed Expenditure

C65 The main economic assumptions underpinning the AME projections are set out in Box C1 and Table C3. In particular it is assumed that the UK claimant count unemployment remains at its recent level of 0.92 million, which is now higher than the most recent average of independent forecasts. The AME total is also affected by the reclassifications described in paragraph C63.

C66 Increases in forecast social security expenditure are due to revised population projections and increased uptake of benefits by pensioners and the disabled. The forecast also includes £4 billion for the rent rebate element of the Housing Revenue Account Subsidy, reflecting the switch of this expenditure from ODPM to Department for Work and Pensions in 2004-05. For consistency, this element has been included in social security spending across the forecast period.

C67 Compared to the 2003 Pre-Budget Report forecasts, spending on the Child and Working Tax Credits has increased in 2003-04, primarily because of re-profiling of payment schedules. The effects diminish as the payment schedule becomes established and as a result there are only modest changes to forecast costs in future years.

C68 Net public service pensions figures are reported on a Financial Reporting Standard 17 (FRS17) basis and record movements in the change in the liability of the various pensions schemes including the accruing costs as members serve additional years. Changes since the 2003 Pre-Budget Report reflect continued revision of estimated pension scheme liabilities following the introduction of FRS17. National accounts pensions expenditure, which is recorded on a transactions basis, shows only small changes from the 2003 Pre-Budget Report, with the exception of 2005-06, where there is a reduction of £0.7 billion, due to an increase in employer contributions to the Principal Civil Service Pension Scheme. This is balanced by an increase in DEL spending.

C69 Other departmental expenditure shows little change from the 2003 Pre-Budget Report except for an increase of £1.3 billion in 2004-05. This is mainly due to higher lending to the Export Credit Guarantee Department (ECGD) and public corporations, and to the switch to Department of Health capital AME outlined in paragraph C63. These changes have no impact on TME.

C70 Net payments to EC institutions in 2003-04 are estimated to be £1.0 billion higher than in the 2003 Pre-Budget Report, largely because of changes in the timing of payments. The payments for the Commission's calendar year budget period are scheduled on a monthly basis, but the Commission can ask for earlier payments and this accounts for about £0.7 billion of the extra payments in 2003-04. Payments for the rest of 2004, which fall into 2004-05, will be lower by the same amount, but other factors including a higher UK share of VAT and gross national income based payments, which reflects higher levels of economic growth in UK than in other member states, increase payments in all years. In order to improve the clarity of the forecasts, all the forecasts for net payments are now on a 'spot' basis. Previously forecasts beyond the current year were on a 'trended' basis, which were designed to smooth out fluctuations over the forecast period, but especially when there are timing and other changes affecting particular years, 'spot' forecasts should give a much better indicator of actual payments within a year.

C71 Changes to local authority self-financed expenditure (LASFE) reflect the revision of the forecasting assumption made for increases in Council Tax. This is outlined in more detail in paragraph C52.

C72 Central government gross debt interest payments in 2004-05 are lower than at the 2003 Pre-Budget Report. This reflects revisions to borrowing and slightly lower projections for inflation, affecting the accrued uplift for index-linked gilts, together with generally lower market expectations for interest rates. Debt interest payments in 2005-06 are slightly higher because the effect of upward revisions to borrowing more than offset lower interest rates.

C73 The main accounting adjustments, which reconcile the DEL and AME measures of spending with the national accounts measure, are shown in Table C14. Changes to the accounting adjustments since the last forecast are mainly due to:

- increases in the Financial Reporting Standard 17 (FRS17) measure of public sector pensions spending, on which departmental budgets are now based but which have no impact on the national accounts measure of pension spending;
- increases to provisions, which score in departmental budgets when they are recognised but do not score in national accounts until the cash expenditure actually happens;
- changes to financial transactions mainly because of changes in lending to public corporations, as described in paragraph C69; and
- reduced profits of public corporations, mainly NHS trusts, which are within budgets and are removed in the accounting adjustments. As explained in C54, from 2003-04 these profits will drop by some £0.7 billion per year, which will feed through via the accounting adjustments into lower Total Managed Expenditure. The effect is offset by lower receipts to leave the current surplus unaffected.

Table C11: Total Managed Expenditure 2002–03 to 2005–06

	£ billion			
	Outturn	Estimate	Projections	
	2002-03	2003-04	2004-05	2005-06
Departmental Expenditure Limits				
Resource Budget	235.3	251.9	263.9	284.0
Capital Budget	20.7	23.9	26.3	28.9
Less depreciation	–15.5	–10.5	–11.0	–11.7
Total Departmental Expenditure Limits	**240.6**	**265.3**	**279.3**	**301.1**
Annually Managed Expenditure				
Social security benefits[1,2]	109.9	116.7	123.3	127.8
Tax credits[1]	10.0	14.0	13.8	14.3
Common Agricultural Policy	2.6	2.5	2.5	2.5
Net public service pensions[3]	3.5	0.7	0.4	–0.3
National Lottery	1.8	2.0	2.0	1.6
Non-cash items in AME	30.1	30.0	28.1	29.7
Other departmental expenditure	2.3	1.9	2.7	2.8
Net payments to EC institutions[4]	2.3	2.4	2.7	3.7
Locally financed expenditure	19.7	22.4	24.2	26.0
Central government gross debt interest	20.9	22.2	23.9	25.4
Public corporations' own-financed capital expenditure	2.0	2.5	2.6	2.5
Total AME before margin and accounting adjustments	**205.0**	**217.4**	**226.3**	**235.9**
AME margin	0.0	0.0	1.0	2.0
Accounting adjustments[5]	–26.5	–23.6	–19.0	–18.7
Annually Managed Expenditure	**178.5**	**193.7**	**208.3**	**219.2**
Total Managed Expenditure	**419.1**	**459.0**	**487.6**	**520.4**
of which:				
Public sector current expenditure	394.0	428.0	449.7	478.9
Public sector net investment	10.6	16.2	22.4	25.2
Public sector depreciation	14.4	14.8	15.5	16.3

[1] *For 2002-03 to 2004-05, child allowances in Income Support and Jobseekers' Allowance, which, from 2003-04, are paid as part of the Child Tax Credit, have been included in the tax credits line and excluded from the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.*

[2] *For 2002-03 to 2003-04, the rent rebate element of Housing Revenue Account subsidies, which, from 2004-05, are administered by DWP, have been included in the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.*

[3] *Net public service pensions expenditure is reported under FRS17 accounting requirements.*

[4] *Net payments to EC Institutions exclude the UK's contribution to the cost of EC aid to non-Member States (which is attributed to the aid programme).*

Net payments therefore differ from the UK's net contribution to the EC Budget, latest estimates for which are (in £ billion):

2002-03	2003-04	2004-05	2005-06
3.1	3.3	3.3	4.3

[5] *Excludes depreciation.*

C74 Chart C4 shows TME as a percentage of GDP from 1970-71 to 2005-06.

Chart C4: Total Managed Expenditure

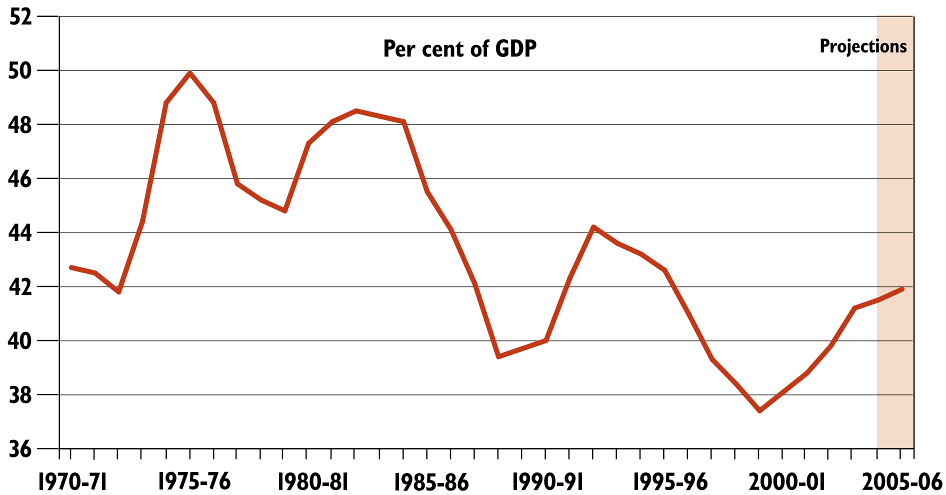


Table C12: Changes to Total Managed Expenditure since the 2003 Pre-Budget Report

	£ billion			
	Outturn	Estimate	Projections	
	2002-03	2003-04	2004-05	2005-06
Departmental Expenditure Limits				
Resource Budget	–0.3	–0.2	–0.3	0.4
Capital Budget	–0.6	–0.7	–0.4	–0.1
Less depreciation	–0.1	0.0	0.1	0.2
Total Departmental Expenditure Limits	**–1.0**	**–1.0**	**–0.6**	**0.5**
Annually Managed Expenditure				
Social security benefits	0.1	–0.1	1.6	0.8
Tax credits	0.1	0.9	0.5	0.0
Common Agricultural Policy	0.0	0.0	0.0	0.0
Net public sector pensions[1]	2.2	4.1	4.2	4.0
National Lottery	0.0	–0.1	0.0	0.0
Non cash items in AME	0.6	3.5	–0.2	0.2
Other departmental expenditure	–0.1	–0.1	1.3	0.2
Net payments to EC institutions	0.0	1.0	–0.3	0.1
Locally financed expenditure	0.1	–0.1	–0.6	–0.4
Central government gross debt interest	0.0	–0.2	–0.9	0.2
Public corporations' own-financed capital expenditure	0.0	0.0	0.0	0.0
Total AME before margin and accounting adjustments	**3.0**	**8.8**	**5.7**	**4.9**
AME margin	0.0	–0.3	1.0	2.0
Accounting adjustments[2]	–2.0	–8.6	–5.8	–6.1
Annually Managed Expenditure	**1.0**	**–0.1**	**0.9**	**0.8**
Total Managed Expenditure	**0.0**	**–1.1**	**0.3**	**1.3**
of which:				
Public sector current expenditure	0.1	0.6	0.6	1.4
Public sector net investment	–0.1	–1.8	–0.3	–0.1
Public sector depreciation	0.0	0.0	0.0	0.0

[1] *Net public sector pensions expenditure is reported under FRS17 accounting requirements.*
[2] *Accounting Adjustments are net of depreciation.*

Table C13: Departmental Expenditure Limits – resource and capital budgets

	£ billion			
	Outturn	Estimate	Plans	
	2002-03	2003-04	2004-05	2005-06
Resource Budget				
Education and Skills	21.2	22.9	23.9	26.7
Health	55.9	63.1	68.7	74.8
of which: NHS	54.2	61.4	66.5	72.6
Transport	6.2	8.0	7.5	8.4
Office of the Deputy Prime Minister	3.9	4.7	4.7	5.0
Local Government	37.4	41.0	43.4	45.8
Home Office	11.1	11.9	12.2	13.0
Departments for Constitutional Affairs	3.3	3.3	3.3	3.5
Attorney General's Departments	0.5	0.6	0.5	0.6
Defence	36.4	32.3	31.6	32.5
Foreign and Commonwealth Office	1.5	1.7	1.5	1.6
International Development	3.6	3.9	3.8	4.5
Trade and Industry	4.0	5.0	5.0	5.5
Environment, Food and Rural Affairs	2.3	2.8	3.1	3.2
Culture, Media and Sport	1.2	1.4	1.5	1.5
Work and Pensions	7.3	8.4	8.1	8.3
Scotland[1]	16.6	18.9	19.6	20.9
Wales[1]	9.1	10.0	10.4	11.1
Northern Ireland Executive[1]	6.6	6.7	6.8	7.2
Northern Ireland Office	1.1	1.1	1.1	1.2
Chancellor's Departments	4.4	4.7	4.8	5.1
Cabinet Office	1.6	1.8	1.9	1.9
Invest to Save Budget	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	0.5	1.5
Unallocated special reserve[2]	0.0	0.0	0.3	0.0
Allowance for shortfall[3]	0.0	–2.2	0.0	0.0
Total Resource Budget DEL	**235.3**	**251.9**	**263.9**	**284.0**
Capital Budget				
Education and Skills	2.7	3.4	3.8	4.4
Health	2.0	2.7	3.0	4.3
of which: NHS	1.9	2.6	2.9	4.2
Transport	3.1	3.3	3.7	3.3
Office of the Deputy Prime Minister	1.5	2.2	2.3	2.4
Local Government	0.2	0.2	0.3	0.3
Home Office	0.7	1.0	1.0	1.1
Departments for Constitutional Affairs	0.1	0.2	0.1	0.1
Attorney General's Departments	0.0	0.0	0.0	0.0
Defence	6.1	6.4	6.3	6.9
Foreign and Commonwealth Office	0.1	0.1	0.1	0.1
International Development	0.0	0.0	0.0	0.0
Trade and Industry	0.3	0.6	0.2	0.1
Environment, Food and Rural Affairs	0.3	0.3	0.3	0.3
Culture, Media and Sport	0.0	0.2	0.1	0.1
Work and Pensions	0.3	0.2	0.2	0.1
Scotland[1]	1.6	1.3	2.0	2.1
Wales[1]	0.7	0.7	0.9	1.0
Northern Ireland Executive[1]	0.5	0.5	0.4	0.4
Northern Ireland Office	0.1	0.1	0.1	0.1
Chancellor's Departments	0.3	0.3	0.3	0.3
Cabinet Office	0.2	0.6	0.2	0.2
Invest to Save Budget	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	1.0	1.1
Allowance for shortfall[3]	0.0	–0.4	0.0	0.0
Total Capital Budget DEL	**20.7**	**23.9**	**26.3**	**28.9**
Depreciation	**–15.5**	**–10.5**	**–11.0**	**–11.7**
Total Departmental Expenditure Limits	**240.6**	**265.3**	**279.3**	**301.1**
Total education spending	53.9	59.4	63.2	68.1

1 *For Scotland, Wales and Northern Ireland, the split between current and capital budgets is decided by the respective executives.*
2 *This represents provision for the costs of the military conflict in Iraq and other International obligations.*
3 *The allowance for shortfall reflect likely underspends in departmental forecasts.*

Table C14: Accounting adjustments

	£ billion			
	Outturn	Estimate	Projections	
	2002-03	2003-04	2004-05	2005-06
Tax credits for individuals	0.9	0.1	0.0	0.0
Pensions	–19.8	–21.2	–21.8	–23.3
European Community contributions	–4.1	–4.4	–4.0	–3.9
Other central government programmes	2.0	2.2	2.4	2.4
VAT refunds	8.8	10.3	11.1	12.2
Central government non-trading capital consumption	4.5	4.6	4.9	5.2
Non-cash items in resource budgets and not in TME	–19.6	–15.0	–12.7	–13.6
Expenditure financed by revenue receipts	0.2	0.2	0.3	0.3
Local authorities	4.6	4.8	5.0	5.3
General government consolidation	–5.6	–4.2	–4.8	–4.9
Public corporations	1.4	0.9	1.0	1.1
Financial transactions	–0.5	–0.3	0.1	0.8
Other accounting adjustments	0.7	–1.6	–0.3	–0.3
Total accounting adjustments	**–26.5**	**–23.6**	**–19.0**	**–18.7**

C75 Table C15 shows public sector capital expenditure from 2002-03 to 2005-06.

Table C15: Public sector capital expenditure

	£ billion			
	Outturn	Estimate	Projections	
	2002-03	2003-04	2004-05	2005-06
Capital Budget DEL	20.7	23.9	26.3	28.9
Locally financed expenditure	0.2	1.1	2.0	2.1
National Lottery	0.9	1.0	1.0	0.8
Public corporations' own-financed capital expenditure	2.0	2.5	2.6	2.5
Other capital spending in AME	1.3	2.5	5.8	6.9
AME margin	0.0	0.0	0.1	0.2
Public sector gross investment[1]	**25.0**	**31.0**	**37.9**	**41.5**
Less depreciation	14.4	14.8	15.5	16.3
Public sector net investment	**10.6**	**16.2**	**22.4**	**25.2**
Proceeds from the sale of fixed assets[2]	6.1	6.0	5.5	5.5

[1] *This and previous lines are all net of sales of fixed assets.*
[2] *Projections of total receipts from the sale of fixed assets by public sector.*

C76 Table C16 shows estimated receipts from loans and sales of assets from 2002-03 to 2005-06. The figures for sales of financial assets include proceeds of £0.1 billion for the sale of a stake in QinetiQ (formerly the Defence Evaluation and Research Agency) in the first quarter of 2003. The proceeds of the Public Private Partnership (PPP) will be £0.2 billion, including receipts in 2001-02 and those due in future years.

Table C16: Loans and sales of assets

	£ billion			
	Outturn	Estimate	Projections	
	2002-03	2003-04	2004-05	2005-06
Sales of fixed assets				
Central government	1.0	1.0	1.0	1.0
Local authorities	5.1	5.0	4.5	4.5
Total sales of fixed assets	**6.1**	**6.0**	**5.5**	**5.5**
Total loans and sales of financial assets	**–2.8**	**–2.3**	**–2.0**	**–2.0**
Total loans and sales of assets	**3.3**	**3.7**	**3.5**	**3.5**

PRIVATE FINANCE INITIATIVE

C77 Under the Private Finance Initiative (PFI) and other similar arrangements the public sector contracts to purchase services from the private sector on a long-term basis so as to take advantage of private sector management skills incentivised by having private finance at risk. The private sector has always been involved in the building and maintenance of public infrastructure, but PFI ensures that contractors are bound into long-term maintenance contracts and shoulder responsibility for the quality of the work they do. With PFI, the public sector defines what is required to meet public needs and ensures, by contract, delivery of the outputs it sets. It has rights under those contracts to change the output required from time to time. Consequently, with PFI the public sector can harness the private sector to deliver investment in better quality public services while maintaining frontline services in the public sector.

C78 The Government only uses PFI where it is appropriate and where it expects it to deliver value for money based on an assessment of the lifetime costs of both providing and maintaining the underlying asset and of the running costs of delivering the required level of service. In assessing where PFI is appropriate, the Government's approach is based on its commitment to efficiency, equity and accountability, and on the Prime Minister's principles of public service reform. PFI is only used where it can meet these requirements, and where the value for money it offers is not at the expense of the terms and conditions of staff. The Government is committed to securing the best value for its investment programme by ensuring that there is no inherent bias in favour of one procurement option over another.

C79 Table C17 shows a breakdown by department of the estimated investment in public services resulting from signed contracts and Table C18 shows the capital value of contracts expected to reach preferred bidder stage within the next three years.

C80 Under PFI, the public sector contracts for services, including the availability and management of facilities, and not assets. Capital investment is only one of the activities undertaken by the private sector in order to supply these services. The figures in Tables C17 and C18 therefore do not reflect the total value of contracts.

C81 Table C19 shows a forecast of the estimated payments for services flowing from new private investment in signed projects over the next 25 years. Actual expenditure will depend on the details of the payment mechanism for each contract. Payments may be lower than estimated due to deductions from the service payments caused by the supplier's failure to meet the required performance standards. In addition, variances may occur due to changes in the service requirements agreed during the course of the contracts. Payments may also vary as a result of the early termination of a contract triggering contractual arrangements for compensation on termination.

Table C17: Departmental estimate of capital spending by the private sector (signed deals)[1,2]

	£ million		
		Projections	
	2004-05	2005-06	2006-07
Education and Skills[3]	471	0	0
Health	460	412	292
Transport[4]	1858	1704	1380
ODPM	34	23	78
Home Office	82	6	0
Constitutional Affairs	13	13	4
Defence	778	453	286
Foreign and Commonwealth Office	6	5	5
Trade and Industry	5	3	4
Environment, Food and Rural Affairs	56	39	23
Work and Pensions	38	40	31
Scotland	148	17	0
Wales	39	9	0
Northern Ireland Executive	13	41	16
Chancellor's departments	46	37	34
Cabinet Office	6	1	0
Culture, Media and Sports	13	5	0
Total	**4066**	**2808**	**2153**

1 *Investment in assets scored on the public sector balance sheet also score as public sector net investment.Figures are for investment under PFI-type contracts only.*
2 *PFI activity in local authority projects is included under the sponsoring central government department.*
3 *Excludes private finance activity in educational institutions classified to the private sector.*
4 *Includes estimates of the capital expenditure for the London Underground Limited Public Private Partnership PFI Contracts in the years that investments are expected to take place.*

Table C18: Estimated aggregated capital value of projects at preferred bidder stage

	£ million		
		Projections	
	2004-05	2005-06	2006-07
Health	1955	1052	0
Education and Skills	695	0	0
Transport	107	0	0
Home Office	139	0	0
Constitutional Affairs	20	16	4
Defence	96	242	149
Culture, Media and Sports	32	24	16
ODPM	63	49	36
Environment, Food and Rural Affairs	28	7	1
Scotland	117	116	132
Wales	80	0	0
Northern Ireland Executive	0	24	0
Total	**3332**	**1530**	**338**

Table C19: Estimated payments under PFI contracts – April 2004 (signed deals)[1]

£ billion

Projections			
2004-05	5.5	2017-18	5.8
2005-06	6.0	2018-19	3.8
2006-07	6.3	2019-20	3.9
2007-08	6.3	2020-21	4.0
2008-09	6.1	2021-22	3.2
2009-10	6.3	2022-23	3.2
2010-11	6.2	2023-24	3.2
2011-12	6.1	2024-25	3.3
2012-13	6.2	2025-26	3.2
2013-14	6.2	2026-27	2.9
2014-15	6.1	2027-28	2.7
2015-16	6.2	2028-29	2.6
2016-17	6.2	2029-30	2.4

[1] *The figures between 2004-05 and 2017-18 include estimated payments for the LUL PPP contracts. These contracts contain periodic reviews every 7.5 years and therefore the service payments are not fixed after 2009-10.*

FINANCING REQUIREMENT

C82 Table C20 presents projections of the net cash requirement by sector, giving details of financial transactions that do not affect net borrowing (the change in the sector's net financial indebtedness) but do affect its financial requirement. In the updated projections central government accounts receivable/payable are also increased by around £1 billion a year as a result of full incorporation of the classification changes to business rates introduced in the 2003 National Accounts Blue Book.

Table C20: Public sector net cash requirement

	£ billion							
	2003-04				2004-05			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**36.7**	**–0.4**	**1.2**	**37.5**	**30.9**	**–0.4**	**2.5**	**32.9**
Financial transactions								
Net lending to private sector and abroad	2.3	–0.1	0.0	2.3	2.0	–0.1	0.0	2.0
Cash expenditure on company securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Accounts receivable/payable	5.8	0.0	–0.7	5.1	2.6	0.0	–0.7	1.9
Adjustment for interest on gilts	–1.2	0.0	0.0	–1.2	–2.4	0.0	0.0	–2.4
Miscellaneous financial transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Own account net cash requirement	43.8	–0.5	0.5	43.7	33.2	–0.5	1.8	34.5
Net lending within the public sector	–1.5	2.6	–1.1	0.0	2.4	0.0	–2.4	0.0
Net cash requirement[1]	**42.3**	**2.1**	**–0.6**	**43.7**	**35.6**	**–0.5**	**–0.6**	**34.5**

[1] *Market and overseas borrowing for local government and public corporation sectors.*

C83 Table C21 updates the financing arithmetic for both 2003-04 and 2004-05 in line with the new forecast for the public finances. The forecast for the central government net cash requirement (CGNCR) for 2003-04 is £42.3 billion, an increase of £1.8 billion on the 2003 Pre-Budget Report forecast. Additionally, there has been a £0.2 billion increase in the expected sterling offset from the issuance of the foreign currency bond in July 2003 and a £0.7 billion increase in the forecast of National Savings & Investments' net contribution. This means that the net financing requirement for 2003-04 is now forecast to be £58.0 billion, an increase of £0.9 billion from the 2003 Pre-Budget Report forecast. Gross gilt sales are now forecast to be £49.8 billion, an increase of £0.1 billion from the 2003 Pre-Budget Report forecast. The remainder of the increase in the net financing requirement will now be met by increasing the planned changes in the net short-term debt position by £0.8 billion. This is made up of an increase in the outstanding stock of Treasury bills in market hands at end-March 2004 of £1.0 billion to £19.3 billion and a £0.2 billion reduction in the planned rundown of the DMO's net short-term cash position which is forecast to be £0.4 billion at end-March 2004. The latter includes the £200 million DMO deposit at the Bank of England that is held in order to facilitate cash management operations.

C84 The forecast for the CGNCR for 2004-05 is £35.6 billion. Gross redemptions are £14.7 billion and National Savings & Investments' net contribution is estimated to be £2.0 billion. This means that the net financing requirement for 2004-05 is forecast to be £48.3 billion. DMO will aim to meet the net financing requirement by:

- gross gilts issuance of £48.0 billion; and
- an increase in the net short-term debt position of £0.3 billion.

C85 Full details of the financing remit including the structure of issuance and a gilt auction calendar for 2004-05 can be found in the *Debt and Reserves Management Report 2004-05* which is published today.

Table C21: Financing requirement forecast

	£ billion				
	2003-04				2004-05
	Mar-2003 Provisional remit[1]	Apr-2003 Revised remit[2]	Dec-2003 Pre-Budget Report	Mar-2004 Budget	Mar-2004 Budget
Central government net cash requirement	**30.2**	**35.3**	**40.5**	**42.3**	**35.6**
Net financing of official reserves			–1.6	–1.8	
Gilt redemptions	21.1	21.1	21.1	21.1	14.7
Debt buy-backs			0.2	0.2	
Gross financing requirement	**51.3**	**56.4**	**60.2**	**61.8**	**50.3**
Less assumed net NS&I's net contribution	1.5	1.5	3.0	3.7	2.0
Less change in DMO's cash balance at BoE	0.0	0.1	0.1	0.1	0.0
Net financing requirement	**49.8**	**54.8**	**57.1**	**58.0**	**48.3**
Financed by					
Gross gilt sales	**40.0**	**47.4**	**49.7**	**49.8**	**48.0**
Changes in short term debt	**9.8**	**7.4**	**7.4**	**8.2**	**0.3**

Note: Figures may not sum due to rounding.

[1] *The Provisional Debt Management Report 2003-04 was published on 20 March 2003 in advance of Budget 2003 in order to comply with the Code for Fiscal Stability.*

[2] *Budget 2003 financing arithmetic revised on 23 April 2003 in line with outturns for FY2002-03.*

ANALYSIS BY SUBSECTOR AND ECONOMIC CATEGORY

C86 Table C22 shows a breakdown of general government transactions by economic category for 2002-03 to 2005-06. Table C23 shows a more detailed breakdown for public sector transactions by sub-sector and economic category for each of these years.

Table C22: General government transactions by economic category

	£ billion			
	Outturn	Estimate	Projections	
	2002-03	2003-04	2004-05	2005-06
Current receipts				
Taxes on income and wealth	142.9	146.8	162.8	180.1
Taxes on production and imports	142.2	151.7	161.0	171.1
Other current taxes	19.5	21.4	22.6	24.3
Taxes on capital	2.4	2.5	2.8	3.1
Social contributions	63.6	73.8	77.9	82.5
Gross operating surplus	9.4	9.7	10.2	10.7
Rent and other current transfers	2.1	1.6	1.7	1.7
Interest and dividends from private sector and abroad	3.9	3.5	4.3	4.4
Interest and dividends from public sector	7.2	7.3	8.0	8.4
Total current receipts	**393.3**	**418.2**	**451.2**	**486.3**
Current expenditure				
Current expenditure on goods and services	214.6	234.4	247.5	265.9
Subsidies	6.9	6.9	5.6	5.7
Net social benefits	128.4	137.7	145.5	150.2
Net current grants abroad	–0.6	0.1	–0.9	–2.2
Other current grants	23.4	26.3	26.8	31.7
Interest and dividends paid	21.3	22.5	24.2	25.7
AME margin	0.0	0.0	0.9	1.8
Total current expenditure	**393.9**	**427.9**	**449.5**	**478.7**
Depreciation	9.4	9.7	10.2	10.7
Surplus on current budget	**–10.1**	**–19.3**	**–8.5**	**–3.2**
Capital expenditure				
Gross domestic fixed capital formation	13.0	17.2	22.2	25.7
Less depreciation	–9.4	–9.7	–10.2	–10.7
Increase in inventories	0.0	–0.2	–0.4	–0.4
Capital grants (net) within public sector	1.4	0.8	0.6	0.6
Capital grants to private sector	7.7	9.7	10.6	12.3
Capital grants from private sector	–0.9	–0.9	–1.0	–0.9
AME margin	0.0	0.0	0.1	0.2
Net investment	**11.9**	**17.0**	**22.0**	**26.8**
Net borrowing[1]	**21.9**	**36.3**	**30.4**	**29.9**
of which:				
Central government net borrowing	24.1	36.7	30.9	30.3
Local authority net borrowing	–2.1	–0.4	–0.4	–0.4
Gross debt (Maastricht basis)				
Central government	347.1	388.5	426.7	462.5
Local government	52.7	54.8	54.3	53.7

[1] *Although this is based on the ESA95 definition of general government net borrowing (GGNB), the projections are identical to GGNB calculated on a Maastricht definition.*

Table C23: Public sector transactions by sub–sector and economic category

	£ billion			
	2002-03			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	142.9	0.0	–0.1	142.9
Taxes on production and imports	142.1	0.1	0.0	142.2
Other current taxes	3.7	15.8	0.0	19.5
Taxes on capital	2.4	0.0	0.0	2.4
Social contributions	63.6	0.0	0.0	63.6
Gross operating surplus	4.5	4.9	9.0	18.4
Rent and other current transfers	2.1	0.0	0.6	2.8
Interest and dividends from private sector and abroad	3.3	0.7	0.5	4.5
Interest and dividends from public sector	6.2	1.0	–7.2	0.0
Total current receipts	**370.8**	**22.5**	**2.9**	**396.2**
Current expenditure				
Current expenditure on goods and services	131.6	83.1	0.0	214.6
Subsidies	5.8	1.1	0.0	6.9
Net social benefits	115.3	13.1	0.0	128.4
Net current grants abroad	–0.6	0.0	0.0	–0.6
Current grants (net) within public sector	78.7	–78.7	0.0	0.0
Other current grants	23.3	0.0	0.0	23.4
Interest and dividends paid	20.9	0.3	0.1	21.4
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**374.9**	**19.0**	**0.1**	**394.0**
Depreciation	4.5	4.9	5.0	14.4
Surplus on current budget	**–8.7**	**–1.4**	**–2.2**	**–12.3**
Capital expenditure				
Gross domestic fixed capital formation	4.9	8.1	5.0	18.0
Less depreciation	–4.5	–4.9	–5.0	–14.4
Increase in inventories	0.0	0.0	–0.1	–0.1
Capital grants (net) within public sector	8.7	–7.3	–1.4	0.0
Capital grants to private sector	6.6	1.1	0.3	8.0
Capital grants from private sector	–0.4	–0.5	0.0	–0.9
AME margin	0.0	0.0	0.0	0.0
Net investment	**15.4**	**–3.5**	**–1.2**	**10.6**
Net borrowing	**24.1**	**–2.1**	**1.0**	**22.9**

Table C23: Public sector transactions by sub–sector and economic category

	£ billion			
	2003-04			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	146.8	0.0	–0.1	146.7
Taxes on production and imports	151.6	0.1	0.0	151.7
Other current taxes	3.8	17.6	0.0	21.4
Taxes on capital	2.5	0.0	0.0	2.5
Social contributions	73.8	0.0	0.0	73.8
Gross operating surplus	4.6	5.1	10.0	19.7
Rent and other current transfers	1.6	0.0	0.0	1.6
Interest and dividends from private sector and abroad	2.8	0.7	0.6	4.1
Interest and dividends from public sector	5.2	2.1	–7.3	0.0
Total current receipts	**392.6**	**25.6**	**3.3**	**421.5**
Current expenditure				
Current expenditure on goods and services	142.5	91.9	0.0	234.4
Subsidies	5.8	1.1	0.0	6.9
Net social benefits	122.3	15.3	0.0	137.7
Net current grants abroad	0.1	0.0	0.0	0.1
Current grants (net) within public sector	87.5	–87.5	0.0	0.0
Other current grants	26.2	0.0	0.0	26.3
Interest and dividends paid	22.2	0.3	0.1	22.6
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**406.7**	**21.2**	**0.1**	**428.0**
Depreciation	4.6	5.1	5.2	14.8
Surplus on current budget	**–18.7**	**–0.6**	**–2.0**	**–21.3**
Capital expenditure				
Gross domestic fixed capital formation	7.1	10.1	4.9	22.1
Less depreciation	–4.6	–5.1	–5.2	–14.8
Increase in inventories	–0.2	0.0	0.0	–0.2
Capital grants (net) within public sector	7.7	–6.9	–0.8	0.0
Capital grants to private sector	8.5	1.3	0.3	10.0
Capital grants from private sector	–0.3	–0.5	0.0	–0.9
AME margin	0.0	0.0	0.0	0.0
Net investment	**18.1**	**–1.1**	**–0.8**	**16.2**
Net borrowing	**36.7**	**–0.4**	**1.2**	**37.5**

Table C23: Public sector transactions by sub–sector and economic category

	£ billion			
	2004-05			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	162.8	0.0	–0.1	162.7
Taxes on production and imports	160.9	0.2	0.0	161.0
Other current taxes	3.9	18.7	0.0	22.6
Taxes on capital	2.8	0.0	0.0	2.8
Social contributions	77.9	0.0	0.0	77.9
Gross operating surplus	4.9	5.3	10.9	21.1
Rent and other current transfers	1.7	0.0	0.0	1.7
Interest and dividends from private sector and abroad	3.4	0.9	0.6	4.9
Interest and dividends from public sector	4.3	3.7	–8.0	0.0
Total current receipts	**422.4**	**28.8**	**3.4**	**454.7**
Current expenditure				
Current expenditure on goods and services	151.1	96.4	0.0	247.5
Subsidies	4.3	1.2	0.0	5.6
Net social benefits	129.7	15.8	0.0	145.5
Net current grants abroad	–0.9	0.0	0.0	–0.9
Current grants (net) within public sector	91.5	–91.5	0.0	0.0
Other current grants	26.7	0.0	0.0	26.8
Interest and dividends paid	23.9	0.3	0.2	24.4
AME margin	0.9	0.0	0.0	0.9
Total current expenditure	**427.3**	**22.2**	**0.2**	**449.7**
Depreciation	4.9	5.3	5.4	15.5
Surplus on current budget	**–9.7**	**1.2**	**–2.1**	**–10.5**
Capital expenditure				
Gross domestic fixed capital formation	8.5	13.7	6.1	28.3
Less depreciation	–4.9	–5.3	–5.4	–15.5
Increase in inventories	–0.4	0.0	0.0	–0.4
Capital grants (net) within public sector	8.8	–8.2	–0.6	0.0
Capital grants to private sector	9.3	1.3	0.3	10.9
Capital grants from private sector	–0.3	–0.7	0.0	–1.0
AME margin	0.1	0.0	0.0	0.1
Net investment	**21.2**	**0.8**	**0.4**	**22.4**
Net borrowing	**30.9**	**–0.4**	**2.5**	**32.9**

Table C23: Public sector transactions by sub–sector and economic category

	£ billion			
	2005-06			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	180.1	0.0	–0.1	180.0
Taxes on production and imports	170.9	0.2	0.0	171.1
Other current taxes	4.2	20.2	0.0	24.3
Taxes on capital	3.1	0.0	0.0	3.1
Social contributions	82.5	0.0	0.0	82.5
Gross operating surplus	5.2	5.6	11.3	22.0
Rent and other current transfers	1.7	0.0	0.0	1.7
Interest and dividends from private sector and abroad	3.3	1.1	0.7	5.1
Interest and dividends from public sector	4.5	3.9	–8.4	0.0
Total current receipts	**455.4**	**30.9**	**3.5**	**489.8**
Current expenditure				
Current expenditure on goods and services	162.8	103.1	0.0	265.9
Subsidies	4.3	1.3	0.0	5.7
Net social benefits	134.3	15.9	0.0	150.2
Net current grants abroad	–2.2	0.0	0.0	–2.2
Current grants (net) within public sector	96.7	–96.7	0.0	0.0
Other current grants	31.6	0.0	0.0	31.7
Interest and dividends paid	25.4	0.3	0.2	25.9
AME margin	1.8	0.0	0.0	1.8
Total current expenditure	**454.7**	**24.0**	**0.2**	**478.9**
Depreciation	5.2	5.6	5.6	16.3
Surplus on current budget	**–4.5**	**1.3**	**–2.3**	**–5.5**
Capital expenditure				
Gross domestic fixed capital formation	11.4	14.3	4.3	30.0
Less depreciation	–5.2	–5.6	–5.6	–16.3
Increase in inventories	–0.4	0.0	0.0	–0.4
Capital grants (net) within public sector	9.3	–8.7	–0.6	0.0
Capital grants to private sector	10.9	1.4	0.3	12.6
Capital grants from private sector	–0.3	–0.6	0.0	–0.9
AME margin	0.2	0.0	0.0	0.2
Net investment	**25.8**	**0.9**	**–1.6**	**25.2**
Net borrowing	**30.3**	**–0.4**	**0.7**	**30.6**

HISTORICAL SERIES

Table C24: Historical series of public sector balances, receipts and debt

	Per cent of GDP								
	Public sector current budget	Cyclically-adjusted surplus on current budget	Public sector net borrowing	Cyclically-adjusted public sector net borrowing	Public sector net cash requirement	Net taxes and social security contributions	Public sector current receipts	Public sector net debt[1]	Public sector net worth[2]
1970-71	6.7	7.3	–0.6	–1.2	1.2		43.3		
1971-72	4.2	5.2	1.1	0.0	1.4		41.4		
1972-73	2.0	2.2	2.8	2.6	3.6		39.0		
1973-74	0.3	–1.0	4.9	6.2	5.9		39.6		
1974-75	–1.1	–2.3	6.6	7.8	9.0		42.3	52.1	
1975-76	–1.6	–1.3	7.0	6.7	9.3		42.9	53.9	
1976-77	–1.2	–0.4	5.5	4.7	6.4		43.3	52.4	
1977-78	–1.4	–1.0	4.3	3.9	3.7		41.5	49.0	
1978-79	–2.6	–2.5	5.0	4.9	5.2	33.5	40.2	47.1	
1979-80	–1.9	–1.8	4.1	4.0	4.7	33.9	40.7	43.9	
1980-81	–3.0	–1.1	4.9	2.9	5.2	35.9	42.4	46.1	
1981-82	–1.4	2.6	2.3	–1.7	3.3	38.6	45.8	46.1	
1982-83	–1.5	2.8	3.0	–1.3	3.2	38.7	45.5	44.8	
1983-84	–2.0	1.6	3.8	0.2	3.2	38.2	44.4	45.3	
1984-85	–2.2	0.8	3.7	0.7	3.1	38.9	44.3	45.2	
1985-86	–1.2	0.6	2.4	0.6	1.6	38.1	43.2	43.4	
1986-87	–1.4	–1.2	2.1	1.9	0.9	37.8	42.0	41.1	
1987-88	–0.3	–1.6	1.0	2.2	–0.7	37.6	41.1	36.8	73.6
1988-89	1.7	–0.9	–1.3	1.3	–3.0	36.9	40.7	30.6	78.7
1989-90	1.4	–1.4	–0.2	2.6	–1.3	36.2	39.9	27.7	70.6
1990-91	0.4	–1.2	1.0	2.6	–0.1	35.9	38.9	26.2	60.0
1991-92	–1.9	–1.5	3.8	3.3	2.3	34.7	38.6	27.4	52.7
1992-93	–5.6	–3.6	7.6	5.6	5.9	33.7	36.6	32.0	40.0
1993-94	–6.2	–3.9	7.8	5.5	7.1	32.8	35.7	37.1	28.4
1994-95	–4.8	–3.3	6.3	4.8	5.3	34.0	36.9	40.8	27.7
1995-96	–3.3	–2.6	4.8	4.0	4.3	34.7	37.8	42.8	19.9
1996-97	–2.8	–2.3	3.5	3.0	2.9	34.8	37.2	43.7	16.3
1997-98	–0.1	–0.1	0.8	0.7	0.1	36.0	38.4	41.4	12.9
1998-99	1.1	0.8	–0.4	–0.1	–0.8	36.5	38.7	39.1	11.8
1999-00	2.1	1.8	–1.7	–1.3	–0.9	36.5	39.0	36.2	14.9
2000-01	2.1	1.4	–1.6	–0.9	–3.9	37.3	39.7	31.2	20.0
2001-02	0.9	0.6	0.1	0.4	0.3	36.8	38.8	30.2	25.0
2002-03	–1.2	–0.6	2.2	1.6	2.1	35.6	37.6	30.8	24.3

[1] *At end-March; GDP centred on end-March.*

[2] *At end-December; GDP centred on end-December.*

Table C25: Historical series of government expenditure

	£ billion (2002–03 prices)				Per cent of GDP			
	Public sector current expenditure	Public sector net investment	Public sector gross investment[1]	Total managed expenditure	Public sector current expenditure	Public sector net investment	Public sector gross investment[1]	Total managed expenditure
1970-71	165.9	31.1	51.0	216.8	32.6	6.1	10.0	42.7
1971-72	174.0	27.5	47.9	221.9	33.3	5.3	9.2	42.5
1972-73	181.4	26.4	47.8	229.1	33.1	4.8	8.7	41.9
1973-74	199.7	29.7	53.7	253.4	35.1	5.2	9.4	44.5
1974-75	221.0	31.5	57.2	278.2	38.8	5.5	10.0	48.9
1975-76	225.7	30.9	56.7	282.5	39.9	5.5	10.0	49.9
1976-77	232.2	25.2	52.0	284.2	39.9	4.3	8.9	48.8
1977-78	229.0	17.1	44.0	273.0	38.4	2.9	7.4	45.8
1978-79	236.0	14.9	42.3	278.3	38.4	2.4	6.9	45.3
1979-80	241.7	13.8	41.6	283.3	38.2	2.2	6.6	44.8
1980-81	249.0	11.1	39.3	288.3	40.8	1.8	6.4	47.3
1981-82	260.2	5.7	33.7	293.9	42.6	0.9	5.5	48.1
1982-83	265.6	9.3	36.5	302.1	42.7	1.5	5.9	48.5
1983-84	274.1	11.6	38.5	312.6	42.3	1.8	5.9	48.2
1984-85	281.6	10.1	35.8	317.4	42.6	1.5	5.4	48.0
1985-86	281.7	8.6	31.4	313.2	41.0	1.2	4.6	45.6
1986-87	286.2	5.1	28.3	314.5	40.1	0.7	4.0	44.1
1987-88	289.4	5.0	26.3	315.7	38.6	0.7	3.5	42.1
1988-89	282.5	2.8	24.9	307.4	36.2	0.4	3.2	39.4
1989-90	284.6	9.5	31.8	316.4	35.7	1.2	4.0	39.7
1990-91	286.1	11.5	30.9	317.0	36.1	1.4	3.9	40.0
1991-92	303.4	14.6	31.0	334.4	38.4	1.8	3.9	42.3
1992-93	318.3	15.9	31.2	349.5	40.3	2.0	3.9	44.2
1993-94	328.0	13.0	27.9	356.0	40.1	1.6	3.4	43.6
1994-95	339.1	12.8	28.2	367.3	39.8	1.5	3.3	43.2
1995-96	344.0	12.4	27.8	371.8	39.4	1.4	3.2	42.6
1996-97	344.8	6.8	20.7	365.4	38.5	0.8	2.3	40.8
1997-98	344.6	6.3	19.7	364.4	37.1	0.7	2.1	39.2
1998-99	344.5	7.0	20.6	365.1	36.1	0.7	2.2	38.3
1999-00	350.7	4.5	18.3	368.9	35.5	0.5	1.9	37.4
2000-01	369.8	5.3	19.3	389.1	36.2	0.5	1.9	38.1
2001-02	379.5	9.8	24.1	403.6	36.6	0.9	2.3	38.9
2002-03	394.0	10.6	25.0	419.1	37.4	1.0	2.4	39.8

[1] *Net of sales of fixed assets*

CONVENTIONS USED IN PRESENTING THE PUBLIC FINANCES

FORMAT FOR THE PUBLIC FINANCES

The June 1998 Economic and Fiscal Strategy Report (EFSR), set out a new format for presenting the public finances that corresponded more closely to the two fiscal rules. The three principle measures are:

- **the surplus on current budget (relevant to the golden rule);**
- **public sector net borrowing; and**
- **the public sector net debt ratio (relevant to the sustainable investment rule).**

These measures are based on the National Accounts and are consistent with the European System of Accounts 1995 (ESA95). Estimates and forecasts of the public sector net cash requirement (formerly called the public sector borrowing requirement) are still shown in the FSBR, but they are given less prominence.

The fiscal rules are similar to the criteria for deficits and debt laid down in the Treaty but there are important definitional differences:

- **UK fiscal rules cover the whole public sector, whereas the Treaty deficit and debt only includes general (i.e. central and local) government;**
- **the fiscal rules apply over the whole economic cycle, not year to year;**
- **the current budget excludes capital spending, which is included in the Treaty deficit measure; and**
- **the UK debt measure is net of liquid assets, whereas the Treaty measure uses gross debt.**

From February 2000 the Treaty deficit moved to being reported on an ESA95 basis.

NATIONAL ACCOUNTS

The **National Accounts** record most transactions, including most taxes (although not corporation tax, self-assessment income tax and some other Inland Revenue taxes which, because of practical difficulties, are scored on a cash basis) on an accruals basis, and impute the value of some transactions where no money changes hands (for example, non-trading capital consumption).

Outturn values (those for 2002-03 and earlier years) for the National Accounts series are those most recently published by the Office for National Statistics (ONS). Full details of the sources for each table are included in *Budget 2004 technical annex: data sources, economy forecasts and charts,* available on the Treasury's internet site and on request from the Treasury's Public Enquiry Unit (020 7270 4558).

The outturn figures do not take account of reclassifications and other changes which have been announced by the ONS, but not yet reflected in series published in either the quarterly Public Sector Accounts release (last published in December 2003) or the monthly Public Sector Finance release (last published in February 2004). The main outstanding changes are:

- the reclassification of NHS Trusts from public corporations to central government, which has no effect on public sector aggregates, but will increase general government net borrowing and the Treaty deficit by up to 0.1 per cent of GDP a year; and
- the decision announced in February 2004 to change the date when Network Rail moved from public to private sector from 16 August 2002 to 1 April 2003. This change is expected to add about £0.6 billion to the public sector current deficit for 2002-03 and about £1.5 billion to net borrowing. Public sector net debt for the second half of 2002-03 will increase by about 1 per cent of GDP, but this will only be a temporary effect.

Both these changes affect other parts of the National Accounts and the ONS are planning to make the changes to National Accounts and public sector fiscal measures in June 2004.

The principle measures drawn from the National Accounts are described below.

FISCAL AGGREGATES

The **current budget** (formerly known as the current balance) measures the balance of current account revenue over current expenditure (including depreciation). The definition of the current budget presented in this chapter is very similar to the National Accounts concept of net saving. It differs only in that it includes taxes on capital (mainly inheritance tax) in current rather than capital receipts. The current budget is used to measure progress against the golden rule. The actual measure is the average surplus on the current budget expressed as a ratio to GDP over the economic cycle.

Public sector net borrowing (formerly known as the financial deficit in the UK National Accounts) is the balance between expenditure and income in the consolidated current and capital accounts. It differs from the public sector net cash requirement in that it is measured on an accruals basis and because certain financial transactions (notably net lending and net acquisition of other financial assets, which affect the level of borrowing but not the public sector's net financial indebtedness) are excluded from public sector net borrowing but included in the public sector net cash requirement.

Public sector net debt is approximately the stock analogue of the public sector net cash requirement. It measures the public sector's financial liabilities to the private sector and abroad, net of short-term financial assets such as bank deposits and foreign exchange reserves.

General government gross debt, the Treaty debt ratio, is the measure of debt used in the European Union's Excessive Deficit Procedure. As a general government measure, it excludes the debt of public corporations. It measures general government's total financial liabilities before netting off short-term financial assets.

Public sector net worth represents the public sector's overall net balance sheet position. It is equal to the sum of the public sector's financial and non-financial assets less its total financial liabilities. The estimates of tangible assets are subject to wide margins of error, because they depend on broad assumptions, for example about asset lives, which may not be appropriate in all cases. The introduction of resource accounting for central government departments will lead in time to an improvement in data quality, as audited information compiled from detailed asset registers becomes available.

PUBLIC SECTOR RECEIPTS

Net taxes and social security contributions (NTSSC) is a measure of net cash payments made to UK government and differs in several respects from the National Accounts measure of total public sector current receipts (PSCR). A reconciliation between the two aggregates is given in the lower half of Table C8. The main adjustments are:

- accruals adjustments, mainly on income tax, national insurance contributions and VAT, are added to change the basis of figures from cash to National Accounts accruals;
- some tax payments that are collected by the Government, but then paid to the EC, are subtracted as they do not score as government receipts in the National Accounts;
- tax paid by public corporations is also subtracted, as it has no impact on overall public sector receipts;
- an adjustment is made for tax credits. In NTSSC, all tax credits are scored as negative tax to the extent that they are less than or equal to the tax liability of the household, and as public expenditure where they exceed the liability, in line with OECD Revenue Statistics guidelines. Although the ONS have adopted this treatment for the Working Tax Credit and Child Tax Credit, which were introduced in April 2003, they have continued to treat the Working Families' Tax Credit (WFTC), the Disabled Person's Tax Credit (DPTC) and enhanced and payable company tax credits entirely as public expenditure in the National Accounts. Those parts of WFTC, DPTC and company tax credits that offset tax liability in NTSSC are added back into current receipts in Table C8;
- interest and other non-tax receipts, which are excluded from NTSSC, are added. This excludes oil royalties, as they are already included in NTSSC, even though the National Accounts treat them as non-tax receipts; and
- business rates paid by local authorities are included in the calculation of NTSSC but not PSCR. These are therefore deducted from NTSSC before arrived at PSCR.

TOTAL MANAGED EXPENDITURE

Public expenditure is measured across the whole of the public sector using the aggregate **Total Managed Expenditure (TME)**. TME is the sum of the public sector current expenditure, public sector net investment and public sector depreciation. These aggregates are based on National Accounts definitions defined under ESA95.

Public sector current expenditure is the sum of expenditure on pay, and related costs, plus spending on goods and services, and current grants made to the private sector. Current expenditure is net of receipts from sales of goods and services.

Public sector capital expenditure is shown in Table C15. It includes:

- gross domestic fixed capital formation (i.e. expenditure on fixed assets such as schools and hospitals, roads, computers, plant and machinery and intangible assets) net of receipts from sales of fixed assets (e.g. council houses and surplus land);
- grants in support of capital expenditure in the private sector; and
- the value of the physical increase in stocks (for central government, primarily agricultural commodity stocks).

Public sector net investment: in Table C1 nets off depreciation of the public sector's stock of fixed assets.

Public sector depreciation: is the annual charge that is made in relation to the reduction in value of the public sector's capital assets over a particular financial year.

For budgeting purposes, TME is further split into Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME):

Departmental Expenditure Limits (DEL) are firm three-year spending limits for departments. In general DEL will cover all running costs and all programme expenditure except that spending that is included in departmental Annually Managed Expenditure due to it not being reasonably subject to close control over the three year period. DEL has distinct resource and capital budgets, as shown in Table C13.

Annually Managed Expenditure (AME) is spending that cannot be reasonably subject to firm multi-year limits. AME components are shown in Table C11 and are defined as follows:

Social security benefits in AME expenditure covers contributory, non-contributory and income-related benefits for children, people of working age and pensioners. Broadly, benefits are paid in respect of retirement, unemployment, incapacity, or disability, caring responsibilities and bereavement, as well as housing costs for all groups with effect from Budget 2004. Some expenditure on housing-related benefits is, however, covered by the locally financed expenditure category.

Tax credits for individuals scored as expenditure includes spending on the Working Families' Tax Credit and Disabled Person's Tax Credit and that element of the Working Tax Credit and the Child Tax Credit that is classified as public expenditure under National Accounts definitions. For 2002-03 to 2004-05, expenditure related to the child allowances in Income Support and Jobseekers' Allowance, which, from 2003-04, are paid as part of the Child Tax Credit, have been included in the tax credit line rather than the social security benefits line in order to present figures on a consistent definition over the period shown.

Common Agriculture Policy expenditure comprises direct payments to farmers and market price supports (intervention purchases and export refunds).

Net public service pensions. The main unfunded public service pension schemes, following FRS17, report any increase in liabilities accrued in the period less contributions received from employers, employees and inward transfers. This line does not include an amount for the unwinding of the discount rate on the liability (which scores elsewhere in AME). For some small unfunded schemes, information is not available on an FRS17 basis, and these schemes report the difference between the cash paid out during the year and any contributions received.

National Lottery expenditures relate to the distribution of the money received from the National Lottery for good causes. Funds are drawn down by Distributor Bodies and directed towards Lottery funded projects.

Non-cash items in AME. Under the 2002 Spending Review resource budgeting regime, a department's spending budget includes certain items that do not have a cash component at the time when the expense is recorded. Examples include depreciation, cost of capital charges and provisions.

Other departmental expenditure aggregates all other expenditure made by departments that is not separately identified in the AME table.

Net payments to EC (European Communities) institutions is the balance between the UK's gross contribution to the EC Budget minus the UK abatement and public sector receipts from the EC budget (net contribution to EC budget). For domestic public expenditure planning purposes part of the UK's contribution to the EC budget is attributed to the overseas aid programme and excluded from the net payments to EC institutions figures.

Locally financed expenditure consists of local authority self-financed expenditure (LASFE) and Scottish spending financed by local taxation (non-domestic rates and, if and when levied, the Scottish variable rate of income tax). LASFE is the difference between total local authority expenditure, including most gross debt interest but net of capital receipts, and central government support to local authorities (i.e. Aggregate External Finance (AEF), specific grants and credit approvals).

Central government debt interest is shown gross – only interest paid within the public sector is netted off. All other receipts of interest and dividends are included in current receipts. The capital uplift on index-linked gilts is also scored here as interest at the time it accrues as is the amortisation of discounts on gilts at issue.

Public corporations' own-financed capital expenditure. This is the amount of capital expenditure by public corporations that is not financed by general government.

AME margin is an unallocated margin on total AME spending and is included as a measure of caution against AME expenditure exceeding its forecast levels.

The accounting adjustments reconcile the DEL and AME framework of departmental budgets to the national accounts measure of TME, and are shown in Table C14.

Tax credits adds in spending on individuals' tax credits which is scored as negative tax in net taxes and social security contributions but as public expenditure in National Accounts. As explained in the public sector current receipts section this mainly includes elements of WFTC and DPTC, which were replaced by new tax credits in 2003-04.

Pensions adjusts from the AME treatment to the national accounts measure by removing increases to liabilities scored in the net public sector pension line, removing increases to the liabilities arising from the unwinding of the discount rate that are scored in the other non-cash items in AME, and adding in the expenditure charged directly to the scheme's balance sheet.

European Community contributions deduct traditional own resources (i.e. payments of customs duties and agricultural and sugar levies) and VAT contributions to the EC, which are included in the net payments to EC institutions line in AME but excluded from TME.

Other central government programmes covers various items which relate to central government programme expenditure and where budgeting and national accounts treatment differ, for example the depreciation costs of NHS trusts and tax credits for companies.

VAT refunds adds back refunds obtained by central government departments, local authorities and certain public corporations. DEL and AME programme expenditure are measured net of these refunds, while TME is recorded with VAT paid.

Central government non-trading capital consumption (i.e. depreciation) as measured by ONS for national accounts is added.

Non-cash items in resource budgets and not in TME includes cost of capital charge, write-offs, notional audit fee, take-up, movements in the value, and release of provisions, the subsidy and bad debt element of student loans, and movements in stocks.

Expenditure financed by revenue receipts adds in certain receipts which are deducted from departmental budgets but which are not treated as negative expenditure in TME.

Local authorities adds in local authority depreciation and subsidies paid to local authority trading bodies, and deducts capital grants from local authorities to public corporations, local authority receipts of investment grants from private sector developers and certain licence fees collected by local authorities.

General government consolidation adjusts for the fact that payments of certain taxes, grants and interest that are within the public sector do not score in TME, as TME is a consolidated public sector concept.

Public corporations adds receipts from public corporations of interest, dividends and equity withdrawals that are netted-off in budgets, interest paid by public corporations to the private sector and abroad (as property income paid by the public sector to the rest of the economy is in TME, but not in departmental budgets) and deducts the profit/ loss of NHS trusts and Forestry Enterprise.

Financial transactions deducts net lending, acquisition of securities and profit/ loss on sale of financial assets.

Other accounting adjustments deducts depreciation and impairments in AME, and reconciles to actual and expected national accounts outturn.

LIST OF ABBREVIATIONS

AEI	Average earnings index
AHC	After housing costs
AIS	Accrued Income Scheme
AME	Annually Managed Expenditure
AMLD	Amusement Machine Licence Duty
APD	Air passenger duty
BCC	British Chamber of Commerce
BSC	British Crime Survey
BHC	Before housing costs
BoE	Bank of England
BRTF	Better Regulation Task Force
CAP	Common Agricultural Policy
CASC	Community Amateur Sports Club
CBI	Confederation of British Industry
CBO	Congressional Budget Office
CCAs	Climate Change Agreements
CCL	Climate change levy
CEF	Commonwealth Education Fund
CGNCR	Central government net cash requirement
CHP	Combined heat and power
CJS	Criminal Justice System
COFOG	Classifications of functions of government
CPA	Coalition Provisional Authority
CPA	Comprehensive Performance Assessment
CPI	Consumer Prices Index
CSCS	Construction Skills Certification Scheme
CTC	Child Tax Credit
CTF	Child Trust Fund
DDA	Disability Discrimination Act
DEFRA	Department for Environment, Food and Rural Affairs
DEL	Departmental Expenditure Limit
DETR	Department of Environment, Transport and the Regions
DfES	Department for Education and Skills
DfT	Department for Transport
DPTC	Disabled Person's Tax Credit
DTI	Department of Trade and Industry
DVLA	Driver and Vehicle Licensing Agency
DWP	Department for Work and Pensions
E&A	Exploration and appraisal
EASA	Easy Access Savings Account
ECA	Enhanced capital allowance
ECB	European Central Bank
ECF	Enterprise Capital Fund
ECOFIN	Council of European Finance Ministers
EFSR	Economic and Fiscal Strategy Report
EIS	Enterprise Investment Scheme

EMU	Economic and Monetary Union
EPC	Economic Policy Committee
EPD	Energy Products Directive
ESA95	European System of Accounts 1995
ETPs	Employer Training Pilots
EU	European Union
EU ETS	EU Emissions Trading Scheme
FOBT	Fixed Odds Betting Terminals
FRS17	Financial Reporting Standard 17
FSA	Financial Services Authority
FSBR	Financial Statement and Budget Report
G7	Group of Seven. A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, UK and US).
G8	Group of Eight. A group of eight major industrial nations (comprising: Canada, France, Germany, Italy, Japan, Russia, UK and US).
GAD	Government Actuary's Department
GAP	Guaranteed Asset Protection
GAVI	Global Alliance for Vaccines and Immunisation
GCSE	General Certificate of Secondary Education
GDP	Gross Domestic Product
GP	General Practitioner
GSS	Government Statistical Service
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
HIPC	Heavily Indebted Poor Countries
IAG	Information, Advice and Guidance
ICT	Information and Communications Technology
ICTA	Income and Corporation Taxes Act
IFF	International Finance Facility
IHT	Inheritance Tax
ILO	International Labour Organisation
IMF	International Monetary Fund
ISA	Individual Savings Account
ISC	Institutional Shareholders Committee
IT	Information Technology
ITEPA	Income Tax (Employment and Pensions) Act
JSA	Jobseeker's Allowance
LASFE	Local authority self-financed expenditure
LFS	Labour Force Survey
LHA	Local Housing Allowance
LPC	Low Pay Commission
LPG	Liquefied Petroleum Gas
LSC	Learning and Skills Council
MA	Modern Apprenticeship
MBA	Master of Business Administration

MDGs	Millennium Development Goals
MDRs	Marginal Reduction Rates
MPC	Monetary Policy Committee
MTA	Minimum Training Allowance
MtC	Million tonnes of carbon
MTIC	Missing Trader Intra-Community
NAEI	National Atmospheric Emissions Inventory
NAO	National Audit Office
ND25+	New Deal for those aged 25 and over
ND50+	New Deal for those aged 50 and over
NDDP	New Deal for disabled people
NDLP	New Deal for lone parents
NDP	New Deal for partners
NDYP	New Deal for young people
NETCEN	National Environmental Technology Centre
NG	Natural gas
NHS	National Health Service
NICs	National Insurance Contributions
NIESR	National Institute of Economic and Social Research
NS&I	National Savings & Investment
NTSSC	Net taxes and social security contributions
NVQ	National Vocational Qualification
ODPM	Office of the Deputy Prime Minister
OECD	Organisation for Economic Co-operation and Development
OFSTED	Office for Standards in Education
OFT	Office of Fair Trading
OGC	Office of Government Commerce
ONS	Office for National Statistics
PAYE	Pay As you Earn
PCT	Primary Care Trust
PDG	Planning Delivery Grant
PFI	Private Finance Initiative
PIF	Property Investment Fund
PMI	Purchasing Managers' Index
PSA	Public Service Agreement
PSCR	Public sector current receipts
PSNB	Public sector net borrowing
PSNI	Public sector net investment
R&D	Research and Development
RDA	Regional Development Agency
RHMF	Road haulage modernisation fund
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
SBIT	Small Business Investment Taskforce
SBS	Small Business Service
SDAs	Service Delivery Agreements
SDLT	Stamp Duty Land Tax

SFLG	Small Firms Loan Guarantee
SGP	Stability and Growth Pact
SME	Small and medium-sized enterprise
SRO	Scientific Research Organisation
TME	Total Managed Expenditure
ULSD	Ultra-low sulphur diesel
ULSP	Ultra-low sulphur petrol
VAT	Value Added Tax
VCS	Voluntary community sector
VCT	Venture Capital Trust
VED	Vehicle excise duty
WFTC	Working Families' Tax Credit
WTC	Working Tax Credit

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