Budget 2002

The strength to make long-term decisions: Investing in an enterprising, fairer Britain

Economic and Fiscal Strategy Report and Financial Statement and Budget Report April 2002

Return to an Order of the House of Commons dated 17 April 2002

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Paul Boateng
Her Majesty's Treasury
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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 Union.

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1 OVERVIEW

Budget 2002, *The strength to make long-term decisions: Investing in an enterprising, fairer Britain*, comprises the Economic and Fiscal Strategy Report (EFSR) and the Financial Statement and Budget Report (FSBR).

The EFSR sets out:

- **the Government's long-term goals and the comprehensive strategy it is pursuing to achieve them;**
- **the progress that has been made so far; and**
- **the further steps the Government is taking in Budget 2002 to advance its long-term goals.**

The FSBR provides:

- **a summary of each of the main Budget measures and how they affect the Budget arithmetic; and**
- **updated assessments and forecasts of the economy and the public finances.**

INTRODUCTION

1.1 The Government's objective is to build a stronger, more enterprising economy and a fairer society, extending economic opportunity and supporting those most in need to ensure that rising national prosperity is shared by all.

1.2 Stability, productivity and employment opportunity are the foundations of the Government's economic strategy. Over the past five years, the Government has taken tough decisions and introduced wide-ranging reforms to deliver high and stable levels of growth and employment, establishing a platform of economic stability based on low inflation and sound public finances. Rising national prosperity has allowed the Government to devote more resources to its priorities – including reducing poverty among children and pensioners and investing more in reform of Britain's public services.

1.3 Last year, global economic conditions posed significant challenges for policy-makers. Weaker growth, falling business confidence and increased uncertainty in the aftermath of 11 September tested the economic strength of countries around the world. Because the UK entered this period with sound economic fundamentals and a policy framework that was well placed to respond to the risks, the economy proved better able to cope with global instability than on previous occasions, growing faster than any other G7 economy over the year as a whole.

1.4 Just as the Government took tough decisions on the economy to deliver economic stability, it must now have the strength to take the long-term decisions necessary to build a stronger, fairer, and more enterprising Britain. Budget 2002 introduces further important reforms to promote work and enterprise, tackle poverty and deliver the sustained investment needed to modernise Britain's public services, raising standards to the level of the best. The Budget advances the Government's long-term goals of:

- maintaining economic stability, ensuring that the fiscal rules are met, inflation remains low, and the UK has faster productivity growth than its main competitors;

- sustaining a higher proportion of people in employment than ever before, while seeking to ensure full employment in every UK region;
- eradicating child poverty and tackling pensioner poverty, extending opportunity for all children and providing security for all pensioners;
- establishing world-class public services, delivering investment to improve national healthcare for all, raise standards in education, modernise Britain's transport and tackle crime; and
- tackling global poverty and climate change, helping to achieve the international community's Millennium Development Goals by 2015, and achieving the UK's commitments under the Kyoto Protocol.

MAINTAINING MACROECONOMIC STABILITY

1.5 The Government's goal is to maintain long-term economic stability, with low and stable inflation and sound public finances. Chapter 2 describes how the Government is working to achieve its goal and summarises prospects for the UK economy and the public finances, full details of which are set out in Chapters B and C of the FSBR.

The policy framework

1.6 The Government's macroeconomic policy framework is based on the principles of transparency, responsibility and accountability, and is designed to ensure lasting economic stability to allow businesses, individuals and the Government to plan effectively for the long-term. The Bank of England has operational independence to set interest rates to meet the Government's inflation target, while fiscal policy is underpinned by two strict fiscal rules which ensure sound public finances over the medium-term. The fiscal rules underpin the Government's public spending framework which reinforces incentives for long-term planning and delivers a sharper focus on the quality and outcome of public service provision. These policies work together in a coherent and integrated way.

1.7 Since the new policy frameworks were introduced, the economy has experienced a period of stability and growth. Employment has risen to record levels and inflation has been lower and more stable than in the past. Tough decisions on taxation and spending taken over the course of the last Parliament have put the public finances on a sustainable footing, freeing up resources for investment in public services and allowing fiscal policy to support monetary policy during last year's slowdown in the global economy.

The economy

1.8 GDP in the major G7 economies grew by just 1 per cent last year, in line with the Pre-Budget Report forecast. For the first time since 1974, growth slowed significantly and simultaneously in the US, Europe and Japan, accompanied by sharp declines in world trade growth, investment, industrial production and stock markets. Prospects for G7 growth this year have however improved since the time of the Pre-Budget Report and the US economy is now expected to propel a G7 recovery during 2002. In the Budget 2002 forecast:

- **G7 GDP** is expected to grow by $1\frac{1}{2}$ per cent in 2002, rising to $2\frac{3}{4}$ per cent in 2003; and
- **world trade** is expected to grow by $2\frac{1}{4}$ per cent in 2002, before picking up in 2003 as the global recovery gathers pace. UK export markets are expected to mirror this trend, rising by just $1\frac{3}{4}$ per cent in 2002 before growth picks up to almost 8 per cent in 2003.

1.9 In the UK last year, sound economic fundamentals and decisive macroeconomic policy action supported domestic demand and ensured that the economy coped well with the global economic slowdown and rising uncertainty. The economy grew by 2.2 per cent in 2001, in line with the Pre-Budget Report projection and the lower end of the Budget 2001 forecast range. Growth is expected to strengthen and become more balanced over the forecast period as stronger external demand provides impetus to investment and exports. In the Budget 2002 forecast:

- **GDP** is expected to increase by 2 to 2$^1/_2$ per cent in 2002, rising to 3 to 3$^1/_2$ per cent in 2003 before returning to trend in 2004;
- the economy is continuing to experience its longest period of sustained low inflation since the 1960s. **RPIX inflation** is expected to remain close to the Government's 2$^1/_2$ per cent target over the forecast period; and
- while the downside **risks** associated with the terrorist attacks of 11 September have diminished since the Pre-Budget Report, prospects for UK growth will continue to be affected by the pace and timing of the global recovery. However, with sound public finances and low inflation, policy is well placed to respond to continuing risks.

Trend growth

1.10 The economic projections presented in this Budget are anchored on a neutral assumption of 2$^3/_4$ per cent for annual trend output growth over the period. This revised estimate underpins the mid-points of the Budget 2002 economic forecast ranges and is in line with those produced by a number of independent organisations, including the IMF. The revision partly reflects the impact of higher assumed growth in the working age population due to migration. Maintaining previous practice, no allowance has been made for productivity improvements associated with the Government's strategy for raising the UK's productivity performance. For reasons of prudence, the projections of the public finances presented in this Budget are based on an assumption for trend output growth that is $^1/_4$ percentage point lower than the Government's neutral view. The National Audit Office have judged that using a 2$^1/_2$ per cent trend growth rate as the basis for the fiscal projections is reasonable and cautious.

The public finances

1.11 The slowdown in the world economy affected the fiscal balances last year. The provisional outturn for the current budget in 2001-02 shows a surplus of £10.6 billion, compared with a projection of £16 billion at the time of Budget 2001. The provisional outturn for net borrowing in 2001-02 is £1.3 billion, compared with a projected net repayment of £5 billion in Budget 2001. The provisional outturn estimates are close to those identified in the Pre-Budget Report interim forecast.

1.12 The change over the past year has been driven largely by a reduction in receipts – particularly of corporation tax – caused by weaker global growth, lower equity prices and a deterioration in financial companies' profits. Lower receipts have been only partly offset by further non-discretionary savings in Annually Managed Expenditure (AME) as the benefits of lower unemployment and sound public finances have led to lower social security and debt interest payments.

Budget decisions

1.13 Against this backdrop, the Government is now taking further long-term decisions to advance its goals. Budget 2002:

- **introduces a package of measures to encourage enterprise**, supporting business growth and development by rewarding innovation and reducing regulation and compliance costs;
- **takes further steps to promote employment**, improving work incentives for people on low incomes, and targeting further assistance on those groups and regions facing the most serious barriers to work;
- **introduces new measures to tackle child poverty**, supporting families with

children in recognition of the costs and responsibilities that come with parenthood;

- **takes action to protect the government revenue base and close loopholes in the tax system**, tackling tax fraud and avoidance, and promoting fairness;

- **adds £4 billion to Departmental Expenditure Limits** in 2003-04 and **sets firm overall spending limits** for the three-year period of the 2002 Spending Review, allowing:

  - **current spending**, excluding spending on health, to increase by $2^1/_2$ per cent a year in real terms in 2004-05 and 2005-06. Current spending will rise in total by an average of 3.3 per cent a year in real terms over the same period; and
  - **public sector net investment** to rise from its 1.8 per cent of GDP target in 2003-04 to 2 per cent of GDP by 2005-06, continuing to address the legacy of under-investment in Britain's public infrastructure, while meeting the sustainable investment rule.

- within the overall envelope for public spending, and in response to the recommendations of the Wanless Review of long-term health trends, delivers substantial increases in investment to place the National Health Service (NHS) on a sustainable long-term financial footing and ensure that resources are available for reform. The Budget provides for **7.4 per cent average annual real terms growth in UK NHS spending over the five years to 2007–08, and 7.5 per cent growth in England**.

1.14 After allowing for non-discretionary changes to receipts and spending, and taking into account the Budget decisions – including significant increases in resources for the National Health Service – the Government remains on track to meet its strict fiscal rules. In order to ensure sound public finances over the medium-term:

- from April 2003, there will be an **additional one per cent national insurance contribution (NIC) by employers, employees and the self-employed on all earnings above the NICs threshold**. This is in addition to existing rates of contribution below the upper earnings limit for employees and the upper profits limit for the self-employed. These limits will be increased in line with inflation in 2003-04; and

- **the income tax personal allowance for those aged under 65 and the NICs threshold will be frozen** in 2003-04.

Meeting the fiscal rules

1.15 The surplus on the current budget is expected to decline from 1.1 per cent of GDP in 2001-02 to 0.3 per cent of GDP in 2002-03. Thereafter, it is expected to rise to 0.7 per cent in 2006-07. On a cyclically-adjusted basis, the current budget is expected to remain in surplus throughout the forecast period, while the average surplus since the start of the current cycle also stays positive throughout, leaving the Government on track to meet the golden rule, including in the cautious case. Public sector net debt is expected to remain low and stable at around 31 per cent of GDP – comfortably meeting the sustainable investment rule, and well below 40 per cent.

Table 1.1: Fiscal balances compared with Budget 2001 and the 2001 Pre-Budget Report[1]

	Outturn[2]		Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Surplus on current budget (£ billion)							
Budget 2001	22.3	15.9	14	8	9	9	–
PBR 2001	25.1	10.3	3	4	7	8	9
Budget 2002	**21.6**	**10.6**	**3**	**7**	**9**	**7**	**9**
Net borrowing (£ billion)							
Budget 2001	–15.0	–4.7	2	10	11	12	–
PBR 2001	–18.8	2.5	12	15	13	13	13
Budget 2002	**–15.9**	**1.3**	**11**	**13**	**13**	**17**	**18**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2001	2.0	1.2	1.0	0.6	0.7	0.7	–
PBR 2001	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Budget 2002[3]	**1.8**	**1.0**	**0.5**	**0.6**	**0.7**	**0.6**	**0.7**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2001	–1.3	–0.1	0.4	1.1	1.1	1.1	–
PBR 2001	–1.6	0.3	1.1	1.4	1.2	1.1	1.1
Budget 2002[2]	**–1.2**	**0.2**	**0.9**	**1.2**	**1.2**	**1.4**	**1.4**
Public sector net debt (per cent of GDP)							
Budget 2001	31.8	30.3	29.6	29.7	29.9	30.0	–
PBR 2001	31.2	30.7	30.6	31.0	31.1	31.1	31.1
Budget 2002[3]	**31.3**	**30.4**	**30.2**	**30.4**	**30.4**	**30.7**	**31.0**

[1] *Excluding Windfall Tax receipts and associated spending.*

[2] *The 2000–2001 figures were estimates in Budget 2001. The 2001-02 figures were projections in Budget 2001 and PBR 2001.*

[3] *These figures are estimates in 2001-02.*

1.16 The Budget also locks in the fiscal stance in the Pre-Budget Report this year and over the next two years. Compared with the Pre-Budget Report, there is a small fiscal tightening this year and next as growth gathers pace and the economy returns to trend.

1.17 Consistent with the requirements of the *Code for Fiscal Stability*, Annex A of the EFSR presents illustrative long-term fiscal projections and examines the long-term sustainability of the public finances. The projections indicate that the UK has a broadly sustainable fiscal position in the long term and that the impact of an ageing population on the public finances is expected to be both manageable, and less marked than in most other EU countries.

MEETING THE PRODUCTIVITY CHALLENGE

1.18 Raising the UK's sustainable rate of productivity growth is central to the Government's economic strategy. Improving Britain's productivity performance is a key route to higher prosperity and living standards and advances the Government's objectives to tackle poverty and improve public services. Chapter 3 describes the steps the Government is taking to achieve its long-term goal of ensuring that the UK achieves faster productivity growth than its main competitors, closing the productivity gap which exists between the UK and many other advanced industrial economies.

Measures so far

1.19 The Government has taken significant steps to raise Britain's productivity growth, focusing its action on five important drivers of productivity performance:

- **competition:** through strengthened powers for the Office of Fair Trading and improvements to the overall competition regime introduced in the

Competition Act 1998, as well as detailed investigations into competition in specific markets, including banking and the professions;

- **enterprise and innovation:** through reduced corporation tax rates and important reforms to capital gains tax, a Share Incentive Plan and improvements to Enterprise Management Incentives to help smaller companies recruit and retain highly-skilled people, a research and development (R&D) tax credit for small and medium-sized companies, and an exemption from stamp duty for property transfers up to £150,000 in Britain's most disadvantaged areas;
- **investment:** with a comprehensive review of institutional investment in the UK, proposals to improve dramatically the flexibility, speed and responsiveness of the land-use planning system; and public spending plans that reverse the legacy of under-funding of Britain's public infrastructure;
- **skills:** by providing substantial extra resources to raise standards in primary and secondary schools and additional funding for higher education places; and
- **public sector productivity:** with a greater focus on outcomes for public service delivery through Public Service Agreements (PSAs), Departmental Investment Strategies (DISs) to improve public sector investment, and the creation of an Office for Government Commerce to deliver more efficient procurement across government.

Budget measures

1.20 The Government's Enterprise Bill will enhance the UK's competition regime and modernise the laws on insolvency, bringing down the barriers to enterprise and entrepreneurial activity. Budget 2002 introduces further measures to support enterprise and the drivers of productivity growth, including:

- ➢ a reduction in the **corporation tax starting rate from 10 per cent to zero** from April 2002, meaning that 150,000 companies will no longer pay any corporation tax;
- ➢ a reduction in the **small companies' rate of corporation tax by 1 percentage point to 19 per cent** from April 2002, benefiting a further 335,000 companies;
- ➢ a package of measures to **reduce the burden of VAT and payroll administration** to simplify the tax system and reduce compliance costs for small businesses;
- ➢ reforms to establish a **modern and competitive business tax system**, including an exemption for gains and losses on substantial shareholdings; relief for the costs of intellectual property, goodwill and other intangible assets; and a new regime for the taxation of loan relationships, derivative contracts and foreign exchange gains and losses;
- ➢ **abolishing stamp duty** for non-residential property transfers in disadvantaged areas and a new **Community Investment Tax Credit** to promote enterprise and wealth creation in under-invested communities;
- ➢ a new **volume-based research and development tax credit for large companies** to boost the UK's innovation performance;
- ➢ **Employer Training Pilots to test new measures to improve access to training** and enable employees to attain basic and level 2 skills; and
- ➢ additional funding of **£30 million to help small organisations attain Investors in People** status.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.21 The Government's long-term goal is to sustain a higher proportion of people in work than ever before by the end of the decade. The strength of the economy depends on the number of people in work and how productive they are. For the majority of individuals and their families, employment is also the single most effective means of avoiding poverty, both now and in the future. Chapter 4 describes the steps the Government is taking to advance its goal, ensuring that employment opportunity is extended to all groups and every area in the country.

Measures so far

1.22 The Government's strategy for delivering higher than ever levels of employment focuses on helping people move from welfare to work, targeting extra support on those areas and groups that face the most serious barriers to work, and making work pay. It has introduced a wide range of measures in each of these areas:

- **welfare to work:** reducing structural unemployment through the New Deal programmes for young people and the long-term unemployed, addressing concentrations of economic inactivity through the New Deal programmes for lone parents and people with disabilities, and launching Jobcentre Plus to provide an active, employment-focussed service to all working age benefit recipients;
- **tackling regional worklessness:** establishing Action Teams to tackle deep-seated employment problems in disadvantaged areas, and creating a new Rapid Response Service to support people affected by large-scale redundancies, especially in deprived areas; and
- **making work pay:** with reforms to the tax and benefit system underpinned by the National Minimum Wage, the introduction of the Working Families' Tax Credit (WFTC) and the Disabled Person's Tax Credit (DPTC) to improve work incentives among families with children and people with disabilities, simplified extended payments in Housing Benefit, and increased childcare provision and support through the National Childcare Strategy.

Budget measures

1.23 Budget 2002 takes further steps to promote work, ensuring that every person in every area of Britain who is able to work has the opportunity to do so:

- ➤ the **basic credit in the Working Families' and Disabled Person's Tax Credits** will be increased by £2.50 a week from June 2002, on top of the increases in line with indexation in April 2002;
- ➤ the new **Working Tax Credit** will be introduced from April 2003 to help tackle poor work incentives and persistent poverty among working people, including those without children. On its introduction, the Working Tax Credit will guarantee minimum incomes of:
  - ➤ £183 a week for a single earner couple without children, aged 25 or over and working full time on the minimum wage; and
  - ➤ £237 a week for a family with one child and one earner working full time on the minimum wage.
- ➤ **the New Deal 25+ will be extended** in pilot areas to jobseekers who have been unemployed for a total of 18 months over the previous three years. Pilots will identify eligible individuals at their six month Restart interview;
- ➤ **mandatory Gateway to work courses** will be introduced for all jobseekers on the New Deal 25+ in London, Manchester, Dundee and Swansea;

- a new **mentor service** will start to be introduced to provide advice and support to lone parents seeking to enter work;
- **mandatory personal adviser meetings will be extended** to all lone parents on Income Support with children under the age of five;
- **childcare coordinators** will be established in every Jobcentre plus district to improve access to information on local childcare provision;
- **eligibility for the childcare tax credit** element of the Working Tax Credit will be extended to those who use approved childcare in their own homes; and
- new funding will be made available to help **Action Teams support transport solutions** in deprived areas where travel is a barrier to work.

BUILDING A FAIRER SOCIETY

1.24 A strong and productive economy must be underpinned by fairness and social inclusion so that everyone has the chance to fulfil their potential and share in rising national prosperity. The Government has placed welfare reform at the heart of its strategy for promoting fairness, offering extra help to those who need it most – families with children, pensioners and people with disabilities. It is determined to achieve its long-term goals of abolishing child poverty and tackling pensioner poverty and is pursuing a wider strategy to reward saving, strengthen local communities, tackle global poverty and establish a modern tax system in which everyone – individuals and businesses – pays a fair share.

Measures so far

1.25 As described in Chapter 5, the Government has introduced a number of important reforms to address these priorities:

- **support for families and children:** tackling child poverty through the introduction of the WFTC and the Children's Tax Credit; targeted support for low-income parents through the Sure Start Maternity Grant; a Children's Fund to improve the support available to children, young people and their families; and increased financial support through the tax and benefit system in recognition of the costs and responsibilities that come with parenthood;

- **fairness for pensioners:** by introducing a comprehensive package of support to improve pensioners' living standards, including the Minimum Income Guarantee (MIG) uprated by earnings for the poorest pensioners, guaranteed increases in the basic state pension and a commitment to raise the basic state pension each year from 2004-05 by $2^1/_2$ per cent or the increase in the September Retail Price Index if that is higher, a new Pension Credit from 2003 to ensure that low and modest income pensioners are rewarded for their savings, free TV licences for those aged 75 or over, and an annual winter fuel payment – set at £200 a year for the remainder of this Parliament – for households containing someone aged 60 or over; and

- **supporting saving:** by introducing the State Second Pension and stakeholder pensions to help people provide for security in old age, establishing Individual Savings Accounts (ISAs) and retaining the £7,000 annual contribution limit until April 2006, and consulting on the Saving Gateway and Child Trust Fund.

Budget measures

1.26 Building on this comprehensive programme of reform, the Government is taking further steps to tackle child and pensioner poverty, encourage saving, tackle global poverty and promote a modern and fair tax system.

Tackling child and pensioner poverty

1.27 To provide support for families and children and to help tackle child poverty, the Government is now:

- increasing the **child allowances in Income Support and Jobseeker's Allowance** by £3.50 a week from October 2002, in addition to the increases in the WFTC and DPTC described above;
- introducing a new **Child Tax Credit** from April 2003 to provide a single, seamless system of income-related support for families with children. On its introduction, the Child Tax Credit, and universal Child Benefit, will guarantee support of:
  - £26.50 a week for the first child for the 85 per cent of families with an income of less than £50,000 a year; and
  - £54.25 a week for the first child in families with an income of less than £13,000 a year.
- increasing the **income tax personal allowance for 65 to 74 year olds** in 2003-04 to £6,610, ensuring that no pensioner aged 65 or over will pay tax on income of less than £127 a week; and
- implementing the comprehensive package of **support for pensioners** previously announced and summarised above, including the Pension Credit from 2003 and guaranteed increases in the basic state pension.

Supporting saving

1.28 To extend the benefits of saving and asset ownership, Budget 2002 announces:

- **steps to modernise the annuities market,** to increase the choice for consumers and help to ensure that annuities provide a secure income in retirement; and
- the **launch of Saving Gateway pilot projects** in four pilot areas from August 2002.

Tackling global poverty

1.29 To promote further progress towards the international community's Millennium Development Goals, Budget 2002 introduces:

- a new **tax credit to encourage R&D into drugs and vaccines** to treat specific diseases threatening lives in the least developed countries; and
- a new **relief to encourage industry to donate medical equipment and supplies** to developing countries.

Establishing a modern and fair tax system

1.30 Budget 2002 introduces further measures to promote a modern and fair tax system, including:

- **reforms to close loopholes in stamp duty on property**, modernising the current regime and ensuring it applies fairly to all relevant transactions;
- important changes to the **North Sea tax regime** to establish a regime that raises a fair share of revenue while promoting long-term investment;

- reform of the **taxation of foreign companies' branches** operating in the UK to bring the UK into line with international practice;
- **freezing the duties on spirits, wine and beer**; introducing reduced rates of duty on beer produced by the UK's small brewing industry; increasing the duty on spirits-based coolers to the level of that on spirits; and **increasing tobacco duties** in line with inflation;
- further support through the tax system for **community amateur sports clubs and charities,** and to encourage charitable donations; and
- new **measures to tackle indirect tax fraud and unfair tax avoidance** to protect the revenue base and promote fairness.

DELIVERING HIGH QUALITY PUBLIC SERVICES

1.31 The Government's long-term goal is to deliver world class public services through sustained increases in investment and modernisation to improve performance. Strong and dependable public services are a vital part of the Government's strategy for extending opportunity, tackling poverty and social exclusion and delivering higher living standards for all. They also lay the foundations for a successful, high productivity economy. Enterprise, employment and economic stability provide the platform from which the Government is working to deliver lasting improvements in Britain's public services.

Measures so far

1.32 Chapter 6 describes the steps the Government has already taken to strengthen public services, including:

- **establishing a new framework for controlling public spending** that provides greater certainty for long-term planning and ensures that resources are allocated to priority public services and linked clearly to improvements in public service delivery;
- **allocating substantial increases in resources** over the three year period of the 2000 Spending Review. As a result of economic stability, and significant savings on debt interest and social security payments, the 2000 Spending Review was able to plan an additional £50 billion of departmental spending on public services by 2003-04 compared with 2000-01;
- **strengthening the delivery of local public services** by establishing stretching new outcome-based targets with local authorities in return for greater freedoms, flexibilities and financial rewards if they succeed; and
- commissioning an independent review, led by Derek Wanless, of the **trends affecting the UK health service over the next two decades** and their implications for funding and other resource requirements. The interim report of the review was published in November 2001.

Budget measures

1.33 The Government is currently conducting a Spending Review to determine how departments' programmes can most effectively deliver investment and modernisation in priority public services and to establish new departmental annual spending plans up to and including 2005-06. In Budget 2002, the Government is:

- **adding £4 billion to Departmental Expenditure Limits** in 2003-04 and **setting firm overall spending limits** for the period of the 2002 Spending Review, as described earlier in this chapter;

- publishing **Derek Wanless' final report to the Chancellor on long-term health trends.** The report identifies the main factors that will affect the health service over the next two decades and the resources required to ensure that the NHS can provide a publicly-funded, comprehensive, high quality service on the basis of clinical need;
- responding to the conclusions of the Wanless Review by immediately **allocating £2.4 billion of the new DEL addition to UK health spending**, and providing for an average annual **7.4 per cent real terms increase in UK NHS spending up to 2007-08, and 7.5 per cent in England**;
- immediately **allocating £0.4 billion of the new DEL addition to personal social services spending**, and providing for an average annual **6 per cent real terms increase in spending on personal social services over the three years to 2005-06**; and
- making these new resources conditional on a **comprehensive programme of health service reform** to ensure delivery of the Government's priorities for health and personal social services and value for money for the taxpayer. The details will be set out by the Secretary of State for Health.

PROTECTING THE ENVIRONMENT

1.34 The aim of sustainable development is to ensure a better quality of life for everyone, today and for future generations. It can be achieved by balancing economic and social progress with action to protect and improve the environment. Climate change, poor air quality and environmental degradation in urban and rural areas all threaten the quality of life for every citizen. The Government is therefore using a range of economic instruments to tackle local environmental problems and to ensure that the UK fulfils its international commitments under the Kyoto Protocol.

Measures so far

1.35 Chapter 7 describes the steps the Government has already taken to deliver its environmental objectives:

- **tackling climate change and improving air quality:** through the introduction of the climate change levy in April 2001 which is encouraging business to become more energy-efficient, a range of tax incentives and reforms to promote the development and take-up of greener fuels and cleaner vehicles, and the launch of the world's first economy-wide greenhouse gas emissions trading scheme in April 2002;
- **regenerating Britain's towns and cities:** with a significant package of fiscal measures to support sustainable regeneration of urban areas, including targeted VAT reliefs, tax incentives for cleaning up contaminated land and a stamp duty exemption to promote investment and economic regeneration in deprived areas; and
- **protecting Britain's countryside and natural resources:** with continued annual increases in the standard rate of landfill tax, a new aggregates levy to tackle the environmental costs of quarrying, and continuing work to limit the harmful environmental consequences of pesticide use.

Budget measures

1.36 To make further progress towards achieving its environmental objectives, while responding to the recent high and volatile levels of world oil prices, the Government is now:

- introducing **two new exemptions from the climate change levy** (CCL) for sources of electricity generation with environmental benefits, and freezing the rates of the CCL;

- ➤ introducing further **enhanced capital allowances for investments** in environmentally-friendly technologies to promote business energy-efficiency;
- ➤ freezing **the duty on the main road fuels and on road fuel gases**;
- ➤ planning to introduce **duty incentives favouring sulphur-free fuels** in 2003 and to exempt **hydrogen** from fuel duty in the future;
- ➤ **freezing vehicle excise duty (VED) rates**, introducing a new **low-carbon VED rate for cars** with the lowest emissions, and reforming **VED for motorcycles and vans** to reflect environmental benefits;
- ➤ introducing **enhanced capital allowances for business cars with low emissions** and, on a revenue neutral basis, **restructuring the fuel scale charge** from 2003-04 to relate it to carbon dioxide emissions rather than engine size;
- ➤ introducing **a distance-based lorry road-user charge** in 2005 or 2006 to ensure that lorry operators contribute to the cost of using UK roads irrespective of their nationality;
- ➤ **freezing air passenger duty** and extending the scope of the lower rates that currently apply to European Economic Area countries; and
- ➤ announcing plans to **review the use of economic instruments to deal with environmental issues associated with agriculture**.

1.37 Table 7.1 of the EFSR shows how the Government's policies fit into the overall framework of its environmental strategy. Table 7.2 sets out the environmental impact of measures which have a significant effect on the environment or which serve an environmental purpose.

BUDGET MEASURES AND THEIR IMPACT ON HOUSEHOLDS

1.38 The measures introduced in this and previous Budgets support the Government's objectives of promoting work and tackling child and pensioner poverty, while laying the foundations for further sustained investment in Britain's public services.

1.39 As a result of the freezing of the personal allowance and the one per cent rise in national insurance contributions, in 2003–04:

- a person on median earnings of £21,400 will pay an additional £3.70 a week;
- a person on 50 per cent of median earnings of £10,700 will pay an additional £1.65 a week; and
- a person on 150 per cent of median earnings of £32,100 will pay an additional £5.75 a week.

1.40 This Budget rewards work and supports families. As a result of all personal tax and benefit measures:

- a single earner family on median earnings of £21,400 and with two children will be £3.90 a week better off as a result of the Child Tax Credit;
- 50 per cent of families with children will be better off, even after the freezing of the personal allowance and the one per cent rise in national insurance contributions; and
- a single person, aged 25 or over, and working 35 hours a week at the National Minimum Wage will be £21.55 a week better off as a result of the Working Tax Credit.

1.41 As a result of the personal tax and benefit measures introduced since 1997, on average by October 2003[1,2]:

- households will be £740 a year better off;
- families with children will be £1,200 a year better off; and
- pensioner households will be £1,150 a year better off.

1.42 As a result of personal tax and benefit reforms since 1997[1]:

- by April 2003, families with children in the poorest fifth of the population will, on average, be £2,400 a year better off; and
- by October 2003[2], on average, the poorest third of pensioner households will be over £1,500 a year better off.

1.43 Table 1.2 lists the key Budget policy decisions and their impact on government spending and revenue. Further details are provided in Chapter A of the FSBR.

[1] Compared with an indexed 1997-98 base.

[2] The Pension Credit is introduced from October 2003.

Table 1.2: Budget 2002 policy decisions

(+ve is an Exchequer yield) £ million

	2002-03 indexed	2003-04 indexed	2004-05 indexed	2002-03 non-indexed
MEETING THE FISCAL RULES AND FUNDING PUBLIC SERVICES				
1 Freeze in income tax personal allowance and national insurance thresholds	0	+700	+850	0
2 Additional class 1 primary national insurance contribution for employees	0	+3,550	+3,700	0
3 Additional class 1 secondary national insurance contribution for employers	0	+3,900	+4,100	0
4 Additional class 4 national insurance contribution for the self-employed	0	+450	+450	0
MEETING THE PRODUCTIVITY CHALLENGE				
Supporting small business				
5 Corporation tax: reduce small companies' rate to 19 per cent and starting rate to 0 per cent	–20	–265	–450	–20
6 Venture Capital Trusts – flexibility of rules	–5	–5	–5	–5
7 Revalorise thresholds for VAT registration and deregistration	0	0	0	–5
Enterprise and innovation				
8 Abolition of stamp duty on goodwill	–50	–50	–50	–50
9 Exemption for gains on substantial shareholdings	–70	–130	–150	–70
10 Capital gains tax: simplification	–10	–15	–15	–10
11 Relaxation of the rules on withholding tax for exempt bodies	–10	–45	*	–10
12 Introduction of Community Investment Tax Credit	*	–5	–5	*
13 Changes to the Construction Industry Scheme	–55	–10	*	–55
14 Reform of taxation of intellectual property	–70	–160	–190	–70
15 Research and development tax credit at 25% for larger companies	–200	–400	–400	–200
16 New rules on loan relationships, derivative contracts and foreign exchange	0	+230	+350	0
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
17 Income tax: indexation of allowances and limits in 2002-03	0	0	0	–330
18 Working Tax Credit (WTC) for families without children	0	–250	–300	0
BUILDING A FAIRER SOCIETY				
Supporting families and communities				
19 Child Tax Credit and WTC for families with children and associated measures	–500	–2,450	–2,300	–500
20 Income tax: over-indexation of age related allowances for ages 65-74	0	–55	–75	0
21 Eligibility of home childcare for childcare tax credit	0	–10	–15	0
22 Income tax: indexation of pension schemes earnings cap	0	0	0	–5
23 Relief for community amateur sports clubs	*	–5	–10	*
24 Introduction of the Vaccines Tax Credit	*	–10	–20	*
25 Relief for gifts of real property to charities	*	–10	–20	*
26 VAT: reliefs for charity buildings	*	–10	–10	*
27 Measures to encourage charitable giving	*	–30	–20	*

Table 1.2: Budget 2002 policy decisions

(+ve is an Exchequer yield)				£ million
	2002-03 indexed	2003-04 indexed	2004-05 indexed	2002-03 non-indexed
A modern and fair tax system				
28 Tackling stamp duty avoidance	+150	+150	+450	+150
29 Film tax relief: restriction to feature films intended for cinema release	+15	+225	+295	+15
30 Manufactured payments: restriction of tax relief	0	+15	+10	0
31 North Sea taxation: introduction of 10 per cent supplementary charge and 100 per cent first year allowances	+100	+450	+600	+100
32 Modernise taxation of foreign company UK branches	0	+350	+650	0
33 VAT anti-avoidance: face-value vouchers	0	+120	+105	0
34 VAT anti-avoidance: hire purchase agreements	+40	+45	+45	+40
35 VAT anti-avoidance: partial exemption override	+195	+185	+170	+195
36 Oils fraud strategy	+100	+290	+550	+100
Duties and other tax changes				
37 Tobacco duties: revalorisation of rates	0	0	0	+135
38 Alcohol duties: beer duty relief for small brewers	–10	–15	–15	–10
39 Alcohol duties: 2 per cent cut for cider; freeze other rates	–95	–105	–105	–5
40 Alcohol duties: increase duty on coolers to spirits rate	+170	+195	+210	+170
41 Inheritance tax: over-index threshold to £250,000	–15	–25	–30	–40
42 Mutual Assistance in Recovery of Debts: implementation of provisions	+10	+10	+10	+10
PROTECTING THE ENVIRONMENT				
43 Enhanced capital allowances for green technologies	–20	–40	–40	–20
44 Climate change levy: freeze	–15	–20	–20	0
45 Climate change levy: tax incentives for combined heat and power	–15	–15	–15	–15
Transport and the environment				
46 Extension of tax exemption for employer subsidised bus services	–10	–15	–20	–10
47 Fuel duties: freeze rates	–395	–415	–420	0
48 Air passenger duty: freeze rates	–5	–20	–20	0
49 Air passenger duty: expansion of scope of lower rate	–25	–70	–75	–25
50 VED: freeze all rates	–80	–85	–90	0
51 VED: creation of new low CO_2 car band	*	*	–5	*
52 Reform of VED for motorbikes	–10	–10	–10	–10
53 Introduction of incentives for cleaner vans	*	*	–5	*
54 VAT simplification: annual adjustment of car fuel scale charges	0	0	0	–15
TOTAL BUDGET MEASURES	**–905**	**+6,115**	**+7,640**	**–565**

* *Negligible.*

ADDITIONAL BUDGET POLICY DECISIONS[1]		
Additions to DEL	0	–4,000
Resetting of AME margin	+180	–525

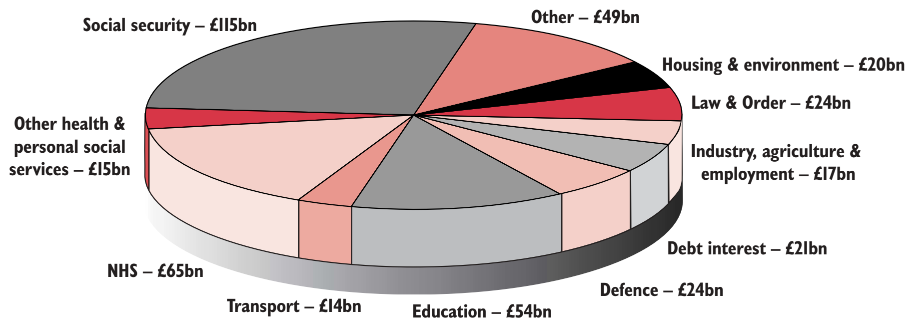
[1] *See Table 2.4 for details of the envelope for the 2002 Spending Review. Final decisions on the split between DEL and AME will be taken in the Spending Review.*

GOVERNMENT SPENDING AND REVENUE

1.45 Chart 1.1 presents public spending by main function. Total public spending (Total Managed Expenditure – TME) is expected to be around £418 billion in the current financial year, 2002-03. TME is divided into Departmental Expenditure Limits (DEL), shown in Table C14 of the FSBR, and Annually Managed Expenditure (AME), shown in Table C11 of the FSBR. A number of DELs, particularly those of the devolved administrations, contribute to spending on more than one function. Chart 1.1 also includes spending by local authorities, rather than the grants they receive from central government, which are included in Tables C11 and C14 of the FSBR.

Chart 1.1: Government spending by function

Total managed expenditure: £418 billion

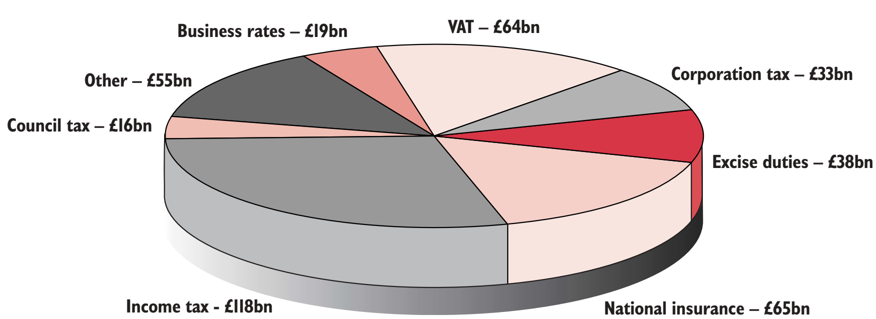


Source: HM Treasury, 2002–03 projections. Other expenditure includes spending on central administration; culture, media and sport; international cooperation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments.

1.46 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £407 in 2002-03. Table C7 of the FSBR provides a more detailed breakdown of receipts consistent with this chart.

Chart 1.2: Government receipts

Total receipts: £407 billion



Source: HM Treasury, 2002–03 projections. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts (eg. interest and dividends).

2 Maintaining Macroeconomic Stability

Sound economic fundamentals and the Government's macroeconomic framework ensured the UK economy was able to steer a course of stability in the face of the slowdown in the world economy in 2001:

- **the monetary policy framework is delivering low and stable inflation, which enabled the Monetary Policy Committee to respond to weaker global growth;**
- **by meeting the fiscal rules over the cycle, fiscal policy has supported monetary policy as slower growth led to a temporary slowdown in government receipts.**

Growth in the UK is expected to gather pace and become more balanced in 2002, underpinned by a global economic recovery. Budget 2002 locks in economic stability for the future:

- **based on cautious assumptions, the Government remains on track to meet both its strict fiscal rules over the cycle, including in the cautious case; and**
- **the fiscal stance this year and over the next two years is at least as tight as in the Pre-Budget Report: compared with the Pre-Budget Report, there is a small fiscal tightening this year and next.**

Consistent with meeting the fiscal rules, Budget 2002:

- **implements a comprehensive Budget package to promote enterprise and work and to tackle child poverty and takes action to close loopholes in the tax system and protect the revenue base;**
- **adds £4 billion to DEL in 2003–04 and sets firm overall limits for public spending for the period of the 2002 Spending Review;**
- **within this envelope, delivers substantial increases in resources over five years to reform the NHS and improve standards of health care;**
- **raises national insurance contributions (NICs) paid by employers, employees and the self-employed by one per cent on all earnings, including above the NICs threshold, from April 2003; and**
- **freezes the NICs threshold and income tax personal allowance for those aged under 65 in 2003–04.**

As a result of these measures, Budget 2002 maintains the conditions for economic stability, continuing the Government's prudent approach to managing the public finances, while releasing substantial resources for the Government's priorities.

THE MACROECONOMIC FRAMEWORK

2.1 The Government's reforms to the macroeconomic framework ensured that the UK was well placed to respond to the slowdown in world growth during 2001. From a platform of low inflation and fiscal discipline, the UK was able to maintain steady and stable growth in the face of faltering global demand and rising economic uncertainty.

2.2 The macroeconomic framework is designed to maintain long-term economic stability. Large and unpredictable fluctuations in output, employment and inflation impose significant economic and social costs and can hold back the economy's long-term growth potential. Stability helps businesses, individuals and the Government to plan effectively for the long term, improving the quantity and quality of long-term investment in physical and human capital, and helping to raise levels of productivity.

2.3 The framework is built on a set of clear principles based on transparency, accountability and responsibility.[1] The increasing interdependence of the world economy means that the Government must address the causes of domestic and international instability, minimising the risk and impact of disruption from external events. The different components of the framework are working in an integrated way to maintain macroeconomic stability.

The monetary policy framework

2.4 Since its introduction in 1997, the monetary policy framework has helped to keep inflation close to the Government's target and has achieved a high degree of credibility. As a result, the Bank of England's Monetary Policy Committee (MPC) was able to respond pre-emptively to the global slowdown, limiting the impact of world events on the UK economy. The principles of the framework are:

- full operational independence for the MPC in setting interest rates to meet the Government's inflation target. **The Government is reaffirming in Budget 2002 the target of 2½ per cent for the 12 month increase in the Retail Prices Index excluding mortgage interest payments (RPIX)**, which applies at all times.
- clear and precise objectives. The primary objective of monetary policy is price stability, while the symmetry in the Government's inflation target ensures that outcomes below target are treated as seriously as outcomes above target. Monetary policy therefore helps to support the Government's wider economic policy objective of high and stable levels of growth and employment;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility, embedded in 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 set out in an open letter to the Chancellor the reasons for the deviation, what action the MPC proposes to take, how long it will be before inflation returns to target and how this meets the MPC's remit.

2.5 These arrangements have removed the suspicion of short-term political influence over monetary policy and ensure that interest rates are set in a forward-looking manner to meet the Government's symmetric inflation target.

The fiscal policy framework

2.6 The reforms to the monetary policy framework have been accompanied by a parallel set of reforms to fiscal policy, ensuring that the highest standards of transparency, responsibility and accountability apply to fiscal policy decisions.

[1] Further detail can be found in: *Reforming Britain's Economic and Financial Policy*, HM Treasury, (2002).

2.7 *The Code for Fiscal Stability* sets out the five key principles of fiscal management which are at the heart of the framework – transparency, stability, responsibility, fairness and efficiency. The Code also requires the Government to state its objectives and fiscal rules through which it operates fiscal policy based on these principles. The Government's key objectives are:

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

2.8 These objectives are implemented through the Government's two fiscal rules, against which the performance of fiscal policy can be judged:

- **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.

2.9 These fiscal rules promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects:

- the rules are set over the cycle, allowing fiscal balances to vary between years in line with the cyclical position of the economy; and
- the interaction of the two rules promotes capital investment while ensuring sustainable public finances in the longer term. The golden rule requires the current budget to be in balance or surplus on average over the cycle, allowing the Government to borrow only for capital spending. The sustainable investment rule limits government borrowing to a stable and prudent level.

2.10 The fiscal framework also recognises that projections of the current budget and net debt inevitably involve a considerable element of uncertainty. Projections of the public finances are therefore deliberately based on prudent assumptions for key economic variables. These assumptions, which include the trend rate of growth, the level of unemployment, and oil and equity prices, are audited by the National Audit Office (NAO) under a three-year rolling review to ensure they remain both reasonable and cautious. This minimises the need for unexpected changes in direction in taxation or spending.

End of Year Fiscal Report

2.11 Reporting on the performance of the public finances against the fiscal rules and published projections is an important element of a transparent fiscal policy – one of the principles of fiscal management set out in the *Code for Fiscal Stability*. In accordance with this principle and the requirements of the Code, Chapter C of the Financial Statement and Budget Report (FSBR) includes provisional outturn information for 2001-02, an analysis of the outturn for 2000-01, as well as other historical data. **In order to further enhance its reporting of fiscal developments, the Government intends to publish End of Year Fiscal Reports to provide more retrospective information on the public finances, including their performance against the fiscal rules and published forecasts and plans**. The first Report will be published alongside the Pre-Budget Report later this year and will cover the two years 2000–01 and 2001–02.

Box 2.1: Informing households about tax and spending decisions

The Government is committed to ensuring that households are fully informed about tax and spending decisions. Taxpayers have a right to know how their money is being used and the public services they can expect in return. The Government has taken a number of steps to improve access to information about Budget decisions, including:

- **the release of all published documentation on the Internet shortly after completion of the Chancellor's statement to Parliament, ensuring that this information is easy to find and use. Almost 200,000 separate copies of documents were viewed this way following the November 2001 Pre-Budget Report, while a quarter of a million pages were viewed by visitors to the site in the first week of December 2001 alone; and**
- **the production of a summary leaflet presenting the main decisions taken in Budgets and Pre-Budget Reports and a breakdown of government spending and revenue. The leaflet is available free of charge from the Treasury and is published on the Internet. Copies of the leaflet are also distributed nationwide through libraries, educational establishments, citizens advice bureaus, Jobcentres, NHS hospitals, GPs' surgeries, and other organisations.**

The Government will continue to explore the most effective means of disseminating information, including the distribution of a leaflet to households.

The public spending framework

2.12 Sound public finances are a pre-requisite for sustainable investment in public services. The fiscal rules are the foundation of the spending framework and have important consequences for the structure of the budgeting regime. The main elements of the framework are:

- three-year Departmental Expenditure Limits (DEL) to help departments plan and manage resources more effectively over the medium term. The 2002 Spending Review will establish new departmental annual spending plans up to and including 2005-06 and within the firm overall spending limits announced in this Budget;
- Annually Managed Expenditure (AME) which covers those elements of spending which cannot reasonably be subject to firm multi-year limits. DEL and AME sum to Total Managed Expenditure (TME);
- separate resource (current) and capital budgets for each department, consistent with the distinction in the fiscal rules. Departments are required to manage their resource and capital budgets separately, removing the historical bias against investment; and
- Public Service Agreements (PSAs) through which each department is committed to deliver challenging outcome-focused targets.

2.13 The Government's public spending framework and priorities for the 2002 Spending Review are described in more detail in Chapter 6.

THE PERFORMANCE OF THE FRAMEWORK

2.14 The Government's framework for monetary and fiscal policy and for public spending form an integrated strategy for maintaining high and stable levels of growth and employment, and for minimising the impact of external events.

Monetary strategy

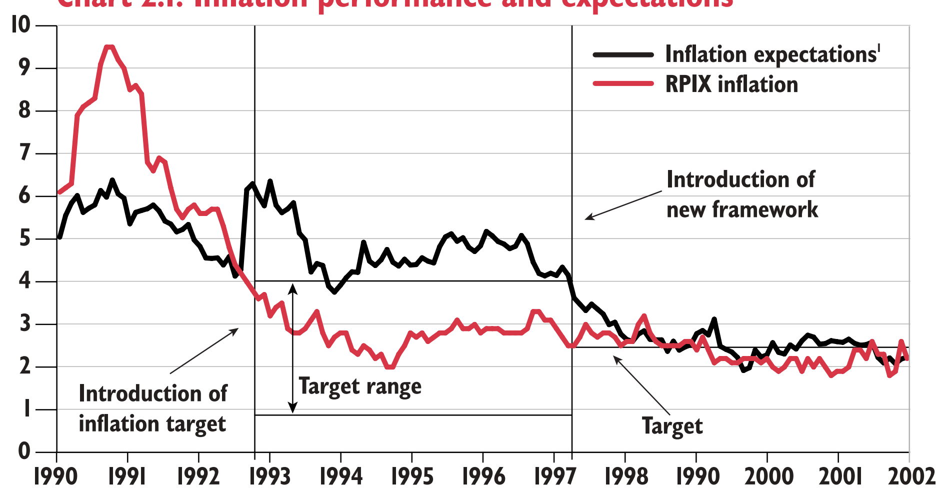
2.15 The monetary policy framework has helped to enhance the credibility of economic policy-making and is delivering tangible results:

- RPIX inflation has averaged 2.4 per cent since May 1997 – close to the Government's target – and has fluctuated in the narrow range of 1.8 to 3.2 per cent;
- long-term inflation expectations in financial markets remain in line with the Government's target, having fallen from over 4 per cent between 1994 and early 1997 to 2½ per cent by mid-1998;
- official short-term interest rates have been much less volatile since 1997, remaining in a narrow band of between 4 and 7.5 per cent; and
- long-term interest rates are around their lowest levels for over 35 years, helping to reduce the Government's debt interest payments and free-up more resources for investment in public services.

2.16 The monetary policy framework has proved successful in reacting to unforeseen shocks. The MPC responded to the global slowdown during 2001 by cutting interest rates seven times, and by 2 percentage points altogether, from 6 per cent to 4 per cent. This pre-emptive action helped to ensure that activity remained strong throughout the year.

2.17 More recently, interest rates have been held at 4 per cent since November 2001, as weak external demand has been balanced by buoyant consumption. Uncertainty over prospects for the world economy and the timing of any rebalancing between domestic and external demand have prompted the MPC to avoid policy changes while the outlook for inflation is so close to target.

Chart 2.1: Inflation performance and expectations



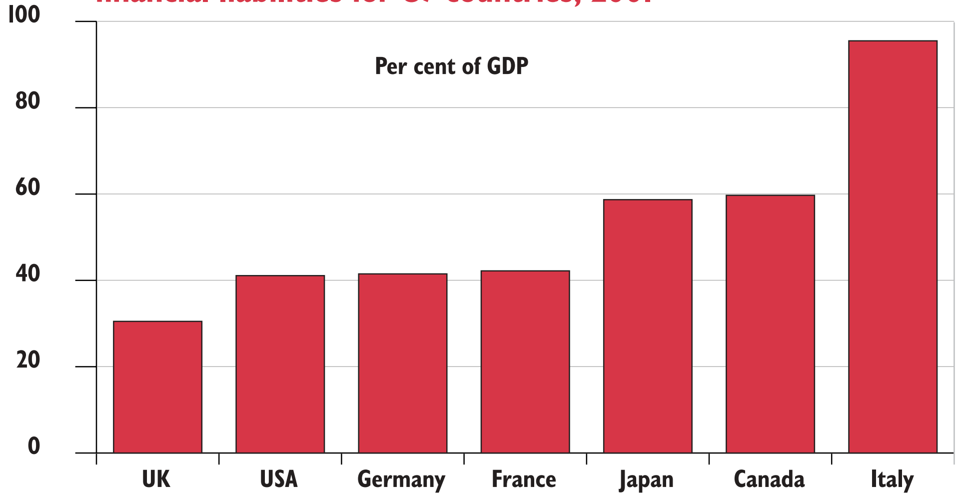
[1] *Ten year ahead market inflation expectations*

Fiscal strategy

2.18 On fiscal policy, the Government has taken a number of important steps over the past five years to restore the public finances to a sustainable position. These have included working within the previous Government's spending plans for the first two years, further fiscal consolidation through a series of tax changes, and using the proceeds from the auction of spectrum licences to reduce net debt. As a result of these decisions, and with the benefits of greater economic stability, fiscal policy was tightened in structural terms by $4^1/_2$ percentage points of GDP between 1996–97 and 2000–01, supporting monetary policy at a time when the economy was generally above trend.

2.19 The Government has also repaid over £50 billion of debt. In total, public sector net debt has been reduced from 44 per cent of GDP to under 31 per cent, the lowest of any G7 country. This is illustrated by Chart 2.2 which shows OECD estimates for 2001.

Chart 2.2: OECD estimates of general government net financial liabilities for G7 countries, 2001



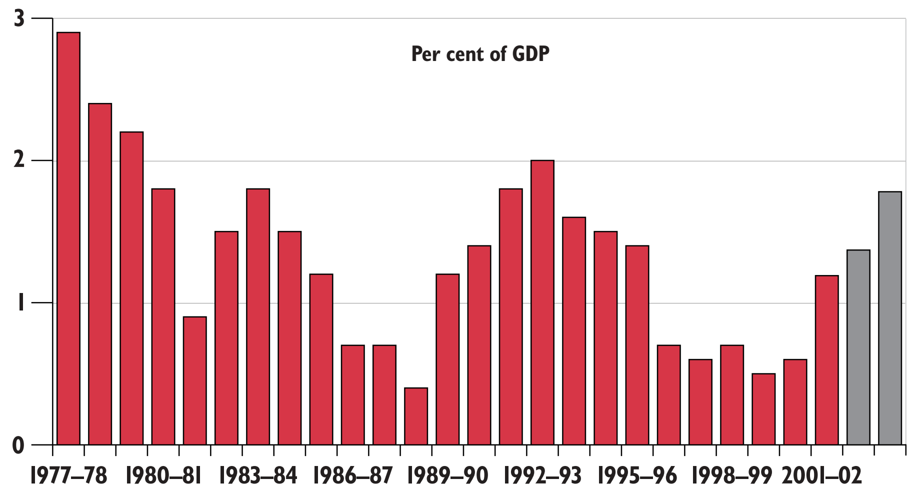
Source: OECD Economic Outlook December 2001

2.20 Low and stable debt levels, and strong surpluses on the current budget, left the public finances well placed to support monetary policy in limiting the impact of the global slowdown in 2001. Lower unemployment and sound public finances have also enabled the Government to release substantial new resources for priority public services, as a result of significant savings from:

- reduced debt interest payments, which are expected to be nearly £12 billion lower in real terms in 2002–03 than in 1997–98 as a result of net debt repayments and lower interest rates; and
- lower growth in spending on social security. Spending on benefits for the unemployed is forecast to be nearly £5 billion lower in 2002–03 than in 1996–97 in real terms.

2.21 As part of this strategy, the Government is addressing the historic under-investment in Britain's public infrastructure. The decline in public investment is illustrated in Chart 2.3 which shows that the level of public sector net investment fell from 2.9 per cent of GDP in 1977–78 to under 1 per cent in the second half of the 1990s. Although a significant part of the decline was the result of privatisation and asset sales, the chart demonstrates that levels of investment have fallen to historically low levels. Chapter 6 describes the steps the Government is taking to reverse this under-investment. Net investment is projected to more than double between 2000–01 and 2003–04.

Chart 2.3: Public sector net investment



Box 2.2: EMU and EMU preparations

The Government's policy on membership of the single currency remains as set out by the Chancellor in his statement to Parliament in October 1997. The determining factor underpinning any Government decision is the national economic interest and whether the economic case for joining is clear and unambiguous.

The Government has set out five economic tests which must be met before any decision to join can be made. A comprehensive and rigorous assessment of the five tests will be made within two years of the start of this Parliament. On the basis of the assessment, the Government will decide whether the five tests have been met. If a decision to recommend joining is taken by the Government, it will be put to a vote in Parliament and then to a referendum of the British people.

In June 2001, the Chancellor explained that the Treasury would undertake necessary preliminary and technical work before the assessment of the five tests is started. The scope of this work was set out in the original October 1997 assessment and includes:

- **the cyclical behaviour of the UK economy relative to the euro area and their relative responses to economic shocks;**
- **the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work;**
- **the impact of the single currency on the cost and availability of capital, macroeconomic stability, the stability of the real effective exchange rate and the location, quality and quantity of investment;**
- **the effect of the single currency on financial services, including the changes that have occurred in this sector in the UK and the euro area since 1997; and**
- **the impact of the single currency on trade, competition, productivity and employment.**

Further detail was set out in the Treasury paper, *Preliminary and technical work to prepare for the assessment of the five tests for UK membership of the single currency*.

The Government is also continuing work on EMU preparations. On 1 January 2002, the twelve countries of the euro area introduced euro cash. On 28 February 2002, national currencies ceased to be legal tender. The Government welcomes reports from euro area countries and the European Commission that the changeover went smoothly, and the Treasury has been gathering information on the exercise. This supports a number of elements of the Government's policy towards EMU preparations: the public sector can play a key leading role; early planning helps to ensure a smooth changeover and to reduce costs; and the illustrative timetable for a UK changeover remains a sound planning assumption.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.22 Last year economic growth slowed simultaneously and significantly in the US, Europe and Japan. World trade growth, investment, industrial production and stock markets all declined sharply and demand for ICT-related products collapsed. The events of 11 September heightened uncertainty and further weakened business confidence across the world.

Table 2.1: The world economy

	Percentage change on a year earlier, unless otherwise stated			
		Forecast		
	2001	2002	2003	2004
Major 7 countries[1]				
Real GDP	1	$1^1/_2$	$2^3/_4$	$2^1/_2$
Consumer price inflation[2]	$1^1/_2$	$1^1/_2$	$1^1/_2$	$1^1/_2$
World trade in goods and services	0	$2^1/_4$	$8^1/_2$	$7^1/_4$
UK export markets[3]	$-^1/_4$	$1^3/_4$	$7^3/_4$	6

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

[2] *Per cent,Q4. For UK, RPIX.*

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

2.23 In contrast to previous periods of faltering global demand and rising economic uncertainty, the Goverment's macroeconomic framework coped well. Robust consumer demand played a key role in supporting economic growth, underpinned by a series of interest rate cuts by the MPC. Fiscal policy supported monetary policy in sustaining demand over the course of the year. Growth in the UK was 2.2 per cent during 2001, in line with the Pre-Budget Report projection and the lower end of the Budget 2001 forecast range.

Economic prospects

2.24 The risks to the global economic outlook associated with the events of 11 September have now clearly diminished, and prospects for G7 activity this year are stronger than at the time of the Pre-Budget Report. In the US – which is expected to lead a global recovery – strong household consumption and some rebuilding of stocks are projected to underpin growth during the first half of 2002. A more broad-based global recovery is expected to gather pace from the middle of the year with business investment and world trade strengthening and monetary policy returning to a more neutral stance.

Table 2.2: Summary of UK forecast

		Forecast		
	2001	2002	2003	2004
GDP growth (per cent)	$2^1/_4$	2 to $2^1/_2$	3 to $3^1/_2$	$2^1/_2$ to 3
RPIX inflation (per cent, Q4)	2	$2^1/_4$	$2^1/_2$	$2^1/_2$

2.25 Table 2.2 summarises the outlook for UK growth and inflation. GDP is expected to grow by between 2 and $2^1/_2$ per cent in 2002, strengthening to between 3 and $3^1/_2$ per cent in 2003, before returning to a trend of $2^3/_4$ per cent in 2004. Growth is also expected to become more balanced in 2002. Household spending is forecast to moderate to sustainable growth rates while stronger external demand should support a recovery in business investment and exports. This should also boost UK manufacturing output from the second half of this year, while strengthening demand for ICT-related products is expected to stimulate a revival in high-technology sectors.

2.26 The UK continues to experience the longest period of sustained low inflation since the 1960s. Annual RPIX inflation averaged 2.1 per cent in 2001, unchanged from 2000 and a little below the Government's target of 2.5 per cent. Looking ahead, subdued input price pressures should continue to exert a downward influence on RPIX during 2002. Rising prices for commodities and imported goods, and a small positive output gap, are expected to bring inflation back up to target by mid 2003.

2.27 Nonetheless, the projected pick-up in UK growth remains heavily dependent on the global economic outlook. A faltering world recovery, for example, would have knock-on effects to confidence and activity in the UK. Conversely, the scale of the policy loosening during 2001 could yet lead to a much stronger than anticipated G7 recovery this year. With interest rates at historically low levels there also remains a risk that household consumption in the UK will moderate more gradually than forecast, boosting activity in the short term but raising the likelihood of a sharper correction at some point in the future. But, with sound public finances and low inflation, the UK remains well placed to respond if any of these risks materialise.

The trend rate of growth of the economy

2.28 The trend rate of growth of the economy is the rate at which output can increase over the medium term without placing upward or downward pressure on inflation. Over the short term, the actual level of output tends to cycle around the trend level of output. The estimate of the difference between actual and trend output, or output gap, is an indicator of inflationary pressure.

Economic cycle

2.29 Based on business survey indicators of capacity and labour utilisation and other labour market indicators, the economy was judged in the Pre-Budget Report to have completed a small cycle between the first half of 1997 and mid-1999, before moving slightly above trend in 2000 and the first half of 2001. The latest available evidence suggests that the impact of weaker global growth has since brought the economy back to trend in the third quarter of 2001, completing a further half-cycle. On this basis, trend output growth is estimated to have been a little below $2^{3}/_{4}$ per cent a year since the first half of 1997.

2.30 Given the closeness of output to trend throughout the period since 1997, possible measurement errors and the prospect of further data revisions, it remains difficult to judge the cyclical path of the economy with certainty. However, for the purposes of assessing performance against the fiscal rules, the provisional judgement remains that a small cycle may have been completed by mid-1999 when the current cycle is assumed to have begun.

Prospects for trend growth

2.31 The Government's latest assessment of the prospects for trend growth is set out in the Budget paper, *Trend growth: recent developments and prospects*. This builds on the approach used in the Government's previous analysis[2] by decomposing trend output growth into its component elements. For the first time the methodology also distinguishes the impact of trends in average hours worked.

2.32 The Government's assessment, which is summarised in Chapter B of the Financial Statement and Budget Report (FSBR), concludes that a neutral view of the prospects for trend output growth is $2^{3}/_{4}$ per cent a year. This is in line with a number of independent organisations, including the IMF. The small upward revision in the Government's estimate results from a modest increase to the estimated impact of net migration on the working age population, and a small increase in the contribution to trend growth from the employment rate. Importantly, the neutral estimate of labour productivity growth continues to be based on past trends. The Government is maintaining its approach of not making any allowance for possible productivity improvements resulting from the Government's wide range of policies designed to raise the economy's growth potential, until this has demonstrably been achieved.

[2] *Trend growth – prospects and implications for policy*, HM Treasury, November 1999.

Caution and the public finances

2.33 Looking forward over the projection period, the public finances continue to be based on a deliberately cautious assumption for trend output growth that is $^{1}/_{4}$ percentage point lower than the Government's neutral view. Box 2.3 explains the importance of basing projections of the public finances on the prudent assumption of $2^{1}/_{2}$ per cent. The assumption has been audited by the NAO, as required by the *Code for Fiscal Stability*. The Comptroller and Auditor General has concluded that the assumption is reasonable and cautious.[3]

Box 2.3: Trend growth and fiscal policy

Measures of trend growth play an important role in the conduct of macroeconomic policy. Accurate estimates of trend growth are necessary to:

- **ensure that the public finances are placed on a sound and sustainable footing by taking account of the temporary impact of the economic cycle and by providing a robust assessment of the structural prospects for the public finances in the medium term; and**
- **provide an estimate of the spare capacity in the economy so that fiscal policy can play a role in supporting monetary policy through the economic cycle.**

In the past, optimistic expectations about the potential or trend growth of the economy led to inappropriate policy decisions and added to instability. In order to take account of this forecast risk, the Government deliberately uses a cautious assumption for trend growth for the public finance projections that is $^{1}/_{4}$ percentage point lower than its neutral view. Increasing the fiscal trend growth assumption from $2^{1}/_{4}$ to $2^{1}/_{2}$ per cent a year in step with the increase in the neutral view from $2^{1}/_{2}$ to $2^{3}/_{4}$ per cent will maintain the same $^{1}/_{4}$ percentage point margin of caution as previous projections, while ensuring that the public finance projections also remain reasonable and appropriately cautious, improving medium-term planning of public spending.

RECENT FISCAL TRENDS AND OUTLOOK

2.34 Budget 2002 is the first definitive forecast since Budget 2001. It updates the Pre-Budget Report interim projections which showed a significant but temporary fall in receipts during 2001–02 and 2002–03.

2.35 The provisional 2001-02 outturn for the public sector current budget shows a surplus of £10.6 billion, compared with a projection of £16 billion at the time of Budget 2001 and £$10^{1}/_{4}$ billion in the Pre-Budget Report. For public sector net borrowing, the provisional 2001–02 outturn is £1.3 billion, compared with a projected net repayment of £5 billion in Budget 2001 and net borrowing of £$2^{1}/_{2}$ billion in the Pre-Budget Report. Despite the impact of the temporary shortfall in receipts on the fiscal balances, the sound fiscal position means that the Government has been able to let fiscal policy support monetary policy as the economy moved below trend, while still remaining on track to meet the fiscal rules over the cycle.

Non discretionary changes – receipts

2.36 Receipts are now expected to be £7.6 billion lower in 2001-02 than forecast in Budget 2001, close to the Pre-Budget Report forecast. This reflects the impact of weaker world growth, lower equity prices and a deterioration in financial companies' profits. Since the Pre-Budget Report, outturn data for corporation tax and NICs in 2001–02 has been lower than projected, although outturns for income tax have been higher.

[3] *Audit of Assumptions for the 2002 Budget*, April 2002, (HC760).

2.37 The projection for receipts remains significantly lower in 2002-03 than in the Budget 2001 forecast, in line with the Pre-Budget Report update. In the medium term, and based on cautious audited assumptions, receipts recover to a higher level than projected in Budget 2001. The effect of the $^1/_4$ point revision to the trend growth assumption is set out in Table 2.5. Its impact cumulates over the projection period, increasing the overall level of receipts by £5 billion in 2006-07. Since the Pre-Budget Report, the impact of the other audited assumptions has had a broadly neutral impact over the forecast horizon, slightly weaker equity prices and oil prices (based on the average price over three months) are offset by the effect of higher interest rate expectations on receipts. Chapter C of the FSBR analyses the forecasting changes in more detail.

Non-discretionary changes – spending

2.38 On spending, the estimated outturn for TME in 2001–02 is £1.6 billion lower than forecast in Budget 2001 and £1.5 billion lower than in the Pre-Budget Report. While firm outturn information for DEL is not yet available, the estimate is for a small underspend of £0.7 billion in 2001–02 against the Pre-Budget Report plan. The lower estimate for TME therefore also reflects changes to the forecast for AME.

2.39 Expenditure on social security benefits and debt interest payments is expected to be almost £1 billion lower in 2001-02 than forecast in Budget 2001 and £2$^3/_4$ billion lower in 2002-03. Table 2.3 decomposes the changes into those arising from social security expenditure and those arising from lower debt interest payments. It excludes the impact of Pre-Budget Report measures and Budget 2002 policy decisions on social security. The table shows that the benefits of economic stability, lower unemployment and sound public finances are leading to a structural improvement in public spending, which is freeing up resources for the Government's priorities.

Table 2.3: Savings in Annually Managed Expenditure since Budget 2001 due to social security and debt interest before policy decisions

	£ billion		
	2001–02	2002–03	2003–04
Change from Budget 2001			
Social security benefits[1]	–0.3	–0.1	–0.6
Central government debt interest[2]	–0.6	–2.6	–0.3
Of which, changes since PBR 2001			
Social security benefits[1]	*–0.4*	*–0.5*	*–0.6*
Central government debt interest	*0.0*	*–0.3*	*0.0*

[1] *Excluding PBR measures and Budget policy decisions on social security benefits.*

[2] *Excluding reclassifications.*

2.40 The savings shown in Table 2.3 include further non-discretionary improvements in addition to those identified in the Pre-Budget Report forecast. In particular, social security benefits are forecast to be significantly lower in 2002-03 and 2003-04 as a result of lower outturn data and the audited assumption on unemployment. Chapter C of the FSBR analyses the Budget forecast for AME in further detail.

BUDGET DECISIONS

2.41 The Budget is the definitive statement of the Government's desired fiscal policy settings. In making its Budget decisions, based on the structural position of the public finances, the Government has considered:

- the need to ensure that, over the economic cycle, the Government will continue to meet its tough fiscal rules;
- its fiscal policy objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and across generations; and

- how fiscal policy can best support monetary policy over the economic cycle.

2.42 After taking account of these objectives, the Budget:

- **introduces a package of measures to encourage enterprise,** by rewarding innovation and supporting business growth and development, and reducing regulation and compliance costs;
- **takes further steps to promote employment,** improving work incentives for people on low incomes, and targeting further assistance on those groups and regions facing the most serious barriers to work;
- **introduces new measures to tackle child poverty,** supporting families with children in recognition of the costs and responsibilities that come with parenthood;
- **takes action to protect the government's revenue base and close down loopholes in the tax system,** tackling tax fraud and avoidance, and promoting fairness;
- **adds an additional £4 billion to Departmental Expenditure Limits** in 2003–04 and **sets firm overall spending limits** for the three-year period of the 2002 Spending Review up to 2005–06, allowing:
  - **current spending**, excluding spending on health, to increase by $2^1/_2$ per cent a year in real terms in 2004-05 and 2005-06. Current spending will rise in total by an average of 3.3 per cent a year in real terms over the same period; and
  - **public sector net investment** to rise from its 1.8 per cent of GDP target in 2003–04 to 2 per cent of GDP by 2005–06, continuing to address the legacy of under-investment in Britain's public infrastructure while meeting the sustainable investment rule.
- within the overall envelope for public spending, and in response to the recommendations of the Wanless Review of long-term health trends, delivers substantial increases in investment to place the National Health Service (NHS)[4] on a sustainable long-term financial footing and ensure that resources are available for reform. The Budget provides for **7.4 per cent average annual real terms growth in UK NHS spending over the five years to 2007–08, and 7.5 per cent growth in England.**

2.43 After allowing for non-discretionary changes to receipts and spending, and taking into account the Budget decisions – including significant increases in resources for the National Health Service – the Government remains on track to meet its strict fiscal rules, including in the cautious case. In order to ensure sound public finances over the medium-term:

- from April 2003, there will be an **additional one per cent national insurance contribution (NIC) by employers, employees and the self-employed on all earnings above the NICs threshold**. This is in addition to existing rates of contribution below the upper earnings limit for employees and the upper profits limit for the self-employed. These limits will be increased in line with inflation in 2003–04; and
- **the income tax personal allowance for those aged under 65 and the NICs threshold will be frozen** in 2003–04.

[4] The convention in the fiscal projections for public spending after 2005-06, prior to plans being set in the 2004 Spending Review, is set out in paragraph C22 of the FSBR. Looking further ahead, Annex A of the EFSR presents illustrative long-term fiscal projections which show that the fiscal position is sustainable in the long term, based on cautious and prudent assumptions.

2.44 Table 2.4 sets out the impact of these decisions on the fiscal balances compared with the Pre-Budget Report. The impact of Budget measures, additional policy decisions and the spending review envelope, combined with forecasting changes, leaves the current balance unchanged in 2002–03, increases the surplus in the following two years by £3 billion and £2 billion and reduces it slightly in 2005–06. Additionally, in the light of sustained low levels of net debt, the Government has decided to increase modestly net borrowing in the medium term to fund much needed investment in public infrastructure. In taking these decisions, the Government is ensuring that it remains firmly on track to meet its strict fiscal rules, including in the cautious case. A full explanation of the firm spending limits within which the 2002 Spending Review will be completed is provided in Chapter 6. Budget measures and additional policy decisions are set out in Chapter A of the FSBR.

Table 2.4: Budget policy decisions and spending review additions[1]

	Projections			
£ billion	**2002–03**	**2003–04**	**2004–05**	**2005–06**
Surplus on current budget				
PBR 2001	**3**	**4**	**7**	**8**
Change between PBR and Budget	0	3	2	–1
of which:				
Forecasting changes	*1*	*1*	*2½*	*4½*
Budget measures on tax and AME	*–1*	*6*	*7½*	*8½*
Additional Budget policy decision on DEL	–	*–3½*	–	–
Reset AME margin	*0*	*–½*	–	–
Spending additions in SR2002 period (current)	–	–	*–8*	*–14*
Budget 2002	**3**	**7**	**9**	**7**
Net borrowing				
PBR 2001	**12**	**15**	**13**	**13**
Change between PBR and Budget	–1	–1½	–½	4
of which:				
Changes to the current budget	*0*	*–3*	*–2*	*1*
Additional Budget policy decision on DEL	–	*½*	–	–
Forecasting changes to net investment	*–½*	*½*	–	–
Spending additions in SR2002 period (net investment)	–	–	*2*	*3*
Budget 2002	**11**	**13**	**13**	**17**

[1] *Figures may not sum to totals due to rounding.*

MEDIUM TERM FISCAL PROJECTIONS

2.45 Table 2.5 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2001 and the Pre-Budget Report. Changes in the fiscal balances are decomposed into those explained by policy measures and those due to forecasting changes, including the revision to the underlying trend growth assumption. 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.

2.46 The revised outturn for 2000–01 shows the current surplus to be £½ billion lower, and net borrowing £1 billion higher, than estimated in Budget 2001. The revisions since the Pre-Budget Report return the provisional outturn to levels close to the Budget forecast and mainly reflect upward revisions to spending.

Table 2.5: Fiscal aggregates compared with Budget 2001[1]

	Outturn[2]		Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Fiscal balances[3]							
Surplus on current budget (£ billion)							
Budget 2001	**22.3**	**16**	**14**	**8**	**9**	**9**	**–**
Effect of forecasting changes	2.8	–5.2	–11	–3	0	2	–
Effect of policy measures	–	–0.3	0	–2	–3	–3	–
PBR 2001	**25.1**	**10.3**	**3**	**4**	**7**	**8**	**9**
Effect of forecasting changes	–3.5	0.3	1	1	2	5	7
of which: revision to trend growth assumption	–	–	*1*	*2*	*3*	*4*	*5*
Budget policy decisions/SR2002 additions[4]	–	–	–1	2	0	–6	–8
Budget 2002	**21.6**	**10.6**	**3**	**7**	**9**	**7**	**9**
Net borrowing (£ billion)							
Budget 2001	**–15.0**	**–5**	**2**	**10**	**11**	**12**	**–**
Effect of forecasting changes	–3.8	5.2	11	3	0	–2	–
Effect of PBR policy measures	–	2.0	–1	1	3	3	–
PBR 2001	**–18.8**	**2.5**	**12**	**15**	**13**	**13**	**13**
Effect of forecasting changes	2.9	–1.2	–1	–1	–2	–5	–7
of which: revision to trend growth assumption	–	–	*–1*	*–2*	*–3*	*–4*	*–5*
Budget policy decisions/SR2002 additions[4]	–	–	0	–1	2	9	13
Budget 2002	**–15.9**	**1.3**	**11**	**13**	**13**	**17**	**18**
Net debt (per cent of GDP)							
Budget 2001	31.8	30.3	29.6	29.7	29.9	30.0	–
PBR 2001	31.2	30.7	30.6	31.0	31.1	31.1	31.1
Budget 2002	**31.3**	**30.4**	**30.2**	**30.4**	**30.4**	**30.7**	**31.0**

[1] *Including windfall tax receipts and associated spending.*

[2] *The 2000–01 figures were estimates in Budget 2001. The 2001-02 figures were projections in Budget 2001 and PBR 2001.*

[3] *Figures may not sum to totals due to rounding.*

[4] *The convention for public spending after 2005-06 is set out in paragraph C22.*

2.47 The headline figures for the current budget and net borrowing are in line with the Pre-Budget Report projections in 2001-02 and 2002-03. The combined impact of Budget decisions and forecasting changes, including to the trend growth assumption, mean that the projections return to a path similar to that in Budget 2001 over 2003-04 and 2004-05. Further out, the increase in public investment will lead to moderately higher net borrowing, fully consistent with the fiscal rules since net debt remains at or below 31 per cent throughout the next five years, well below 40 per cent.

2.48 Table 2.6 sets out the underlying structural position of the fiscal balances, adjusted for the impact of the economic cycle on the public finances. The cyclically-adjusted current surplus for 2001-02 is estimated to be 1 per cent of GDP, the same as the Pre-Budget Report forecast and slightly below the Budget 2001 forecast of 1.2 per cent. On a cyclically-adjusted basis, net borrowing is now expected to equal 0.2 per cent of GDP, compared with a small net repayment of 0.1 per cent forecast in Budget 2001 and net borrowing of 0.3 per cent in the Pre-Budget Report.

Table 2.6: Cyclically-adjusted fiscal balances

	Per cent of GDP						
	Outturn[1]			Projections			
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Surplus on current budget							
Budget 2001	2.0	1.2	1.0	0.6	0.7	0.7	–
PBR 2001	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Budget 2002	**1.8**	**1.0**	**0.5**	**0.6**	**0.7**	**0.6**	**0.7**
Net borrowing							
Budget 2001	-1.3	-0.1	0.4	1.1	1.1	1.1	–
PBR 2001	-1.6	0.3	1.1	1.4	1.2	1.1	1.1
Budget 2002	**-1.2**	**0.2**	**0.9**	**1.2**	**1.2**	**1.4**	**1.4**

[1] *The 2000-01 figures were estimates in Budget 2001. The 2001-02 figures were projections in Budget 2001 and PBR 2001.*

Fiscal stance **2.49** In both 2002–03 and 2003–04, cyclically-adjusted net borrowing is projected to be 0.2 per cent of GDP lower than in the Pre-Budget Report. It returns to its Pre-Budget Report level in 2004–05. The fiscal stance this year and over the next two years is therefore at least as tight as projected in November. Compared with the Pre–Budget Report, there is a small fiscal tightening this year and next as growth gathers pace during 2002 and the economy returns to trend. This is illustrated in Table 2.8.

ADHERING TO PRINCIPLES

2.50 Table 2.7 presents a summary of the key fiscal aggregates based on the five themes of fairness and prudence, 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.

Golden rule **2.51** The surplus on the current budget 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 it is therefore an important indicator of intergenerational fairness. The table shows that the estimated surplus on the current budget was 1.1 per cent of GDP in 2001-02. It is then projected to fall to 0.3 per cent in 2002-03, including as a result of temporarily weaker tax receipts, before levelling at around 0.7 per cent of GDP for the remainder of the forecast period.

Table 2.7: Summary of public sector finances[1]

	Per cent of GDP						
	Outturn			Projections			
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Fairness and prudence							
Surplus on current budget	2.3	1.1	0.3	0.6	0.8	0.6	0.7
Average surplus since 1999-2000	2.3	1.9	1.5	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	1.8	1.0	0.5	0.6	0.7	0.6	0.7
Long-term sustainability							
Public sector net debt	31.3	30.4	30.2	30.4	30.4	30.7	31.0
Core debt[2]	31.0	30.2	29.9	30.1	30.2	30.5	30.8
Net worth	19.5	20.8	21.4	21.4	21.0	20.3	20.1
Primary balance	3.8	1.7	0.6	0.5	0.4	0.1	0.0
Economic impact							
Net investment	0.6	1.2	1.4	1.8	1.9	2.0	2.1
Public sector net borrowing (PSNB)	-1.7	0.1	1.1	1.2	1.1	1.4	1.4
Cyclically-adjusted PSNB	-1.2	0.2	0.9	1.2	1.2	1.4	1.4
Financing							
Central government net cash requirement	-3.7	0.3	1.3	1.6	1.4	1.7	1.9
European commitments							
Treaty deficit[3]	-1.7	0.2	1.0	1.1	1.1	1.4	1.5
Cyclically-adjusted treaty deficit[3]	-1.2	0.3	0.8	1.1	1.2	1.4	1.5
Treaty debt ratio[4]	40.1	38.0	36.9	36.6	36.5	36.6	36.8
Memo: Output gap	0.8	-0.2	-0.2	0.1	0.0	0.0	0.0

[1] *Including windfall tax receipts and associated spending.*

[2] *See box 2.4 for an explanation of core debt.*

[3] *General government net borrowing.*

[4] *General government gross debt.*

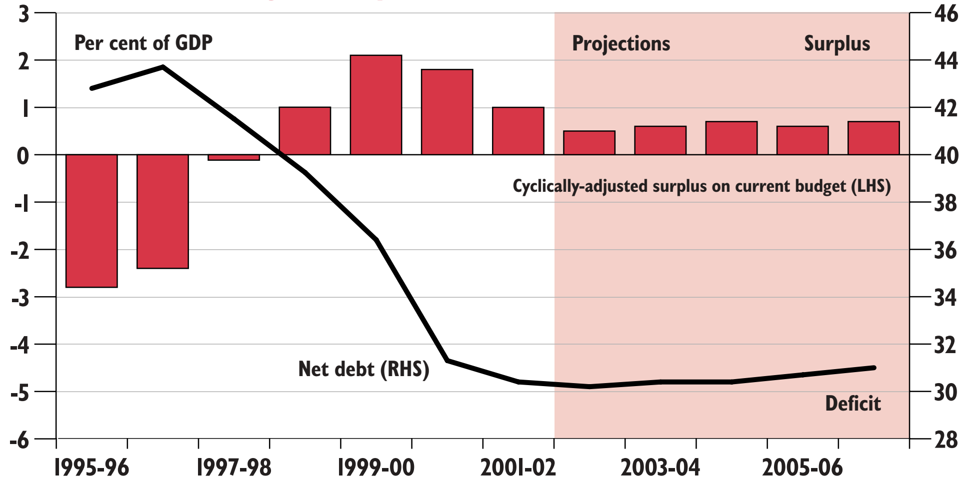
2.52 On a cyclically-adjusted basis, the current budget remains in surplus throughout the projection period. The average surplus since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, also stays positive, remaining over 1 per cent over the next five years. On this basis, the Government is on track to meet the golden rule.

Sustainable investment rule

2.53 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public debt at a low and sustainable level. The Budget projections show that, even after the decision moderately to increase net investment in the medium term, net debt is expected to rise slightly to 31 per cent of GDP through the forecast period – comfortably meeting the sustainable investment rule, and well below 40 per cent. As a result of sound public finances and greater economic stability, the Government can increase investment in the public capital stock while maintaining a buffer against unexpected events. Debt interest payments also remain low. They are projected to be lower in 2002-03 than at any time since the First World War, releasing a greater proportion of public spending to frontline public services.

2.54 Chart 2.4 illustrates the low net debt ratio and the projected cyclically-adjusted current budget surpluses. It demonstrates that the Government met its fiscal rules over the economic cycle completed between the first half of 1997 and mid-1999, and is on track to meet them throughout the forecast period.

Chart 2.4: Meeting the fiscal rules – cyclically adjusted surplus on current budget and public sector net debt



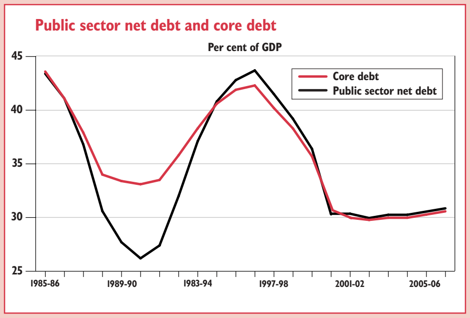
2.55 A further measure of the sustainability of the Government's fiscal position is net worth – the difference between the total assets and liabilities of the Government. Net worth is projected to remain broadly stable throughout the forecast period. This is because the Government is investing to enhance the public sector capital stock while maintaining debt at a prudent level.

Box 2.4: Core debt

A key aspect of the fiscal framework is that both fiscal rules – the golden rule and the sustainable investment rule – are set over the economic cycle. This promotes economic stability by allowing the automatic stabilisers to operate freely. Setting the rules over the cycle also permits fiscal policy to support monetary policy in smoothing the path of the economy in the face of variations in demand.

Forecasts of the public finances since the 1998 Pre-Budget Report have included cyclically-adjusted figures for current budget surplus and public sector net borrowing to illustrate the impact of the cycle on these key fiscal balances. To increase the transparency of the framework the Treasury will, from this Budget on, also publish figures for a new measure of net debt excluding cyclical fluctuations – core debt. Estimates of core debt will be updated in future Budget and Pre-Budget Report forecasts according to a transparent methodology set out in a technical paper published alongside this Budget.

Core debt is estimated at 31 per cent of GDP in 2000-01, very similar to the value for total debt of 31.3 per cent. The chart below shows that the difference between core and total debt has been slight in recent years, reflecting stability in the economy as a whole. However, the measures diverge more widely further back due to differences between actual and cyclically adjusted deficits, when the economy was significantly away from trend as in the late 1980s.



Core and total net debt (per cent of GDP, end of year)

	Core Debt	Total Debt
1990-91	33.1	26.2
1997-98	40.2	41.5
1998-99	38.3	39.2
1999-00	35.7	36.4
2000-01	31.0	31.3
2006-07*	30.8	31.0

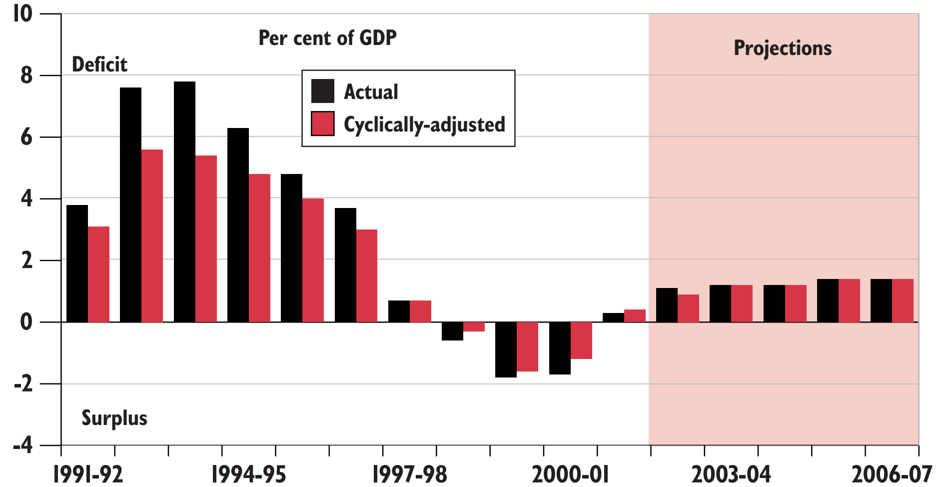
* Projection

The publication of core debt figures increases the transparency of the fiscal framework and assists analysis of performance against the sustainable investment rule, when the economy may be away from trend. Core debt also provides the Government with a tool for monitoring the evolution of debt accumulated as a result of new investment in public services while complying strictly with its firm fiscal rules. The Budget projections show that core debt will rise slowly to 31 per cent of GDP, as the Government borrows modestly to fund increased investment in priority public services, consistent with the fiscal rules.

Economic impact

2.56 While the primary objective of fiscal policy is to ensure sound public finances, fiscal policy 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). The projection for net borrowing is shown in Chart 2.5 which sets out actual and cyclically-adjusted figures as a percentage of GDP. The chart shows the projected move from surplus into deficit over the medium term. The Government has decided to increase net borrowing modestly to fund increased investment in the country's capital stock. 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.

Chart 2.5: Public sector net borrowing – actual and cyclically-adjusted



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

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

2.58 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).

2.59 Table 2.8 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 2001 and the 2001 Pre-Budget Report, and the changes since the Pre-Budget Report.

Table 2.8: The overall fiscal impact

	Percentage points of GDP					
	Outturn	Projections				
	2001–02	2002–03	2003–04	2004–05	2005–06	2006-07
Change from Budget 2001 to PBR 2001						
Post Budget and PBR measures	0.0	0.0	0.2	0.2	0.2	–
+						
non-discretionary factors	0.4	0.6	0.1	–0.1	–0.2	–
=						
CHANGE IN FISCAL STANCE	0.4	0.7	0.3	0.2	0.1	–
+						
automatic stabilisers	0.3	0.3	0.1	0.1	0.0	–
=						
OVERALL FISCAL IMPACT	0.7	1.0	0.4	0.2	0.1	–
Change from PBR 2001 to Budget 2002						
Budget policy decisions[1]	0.0	0.0	–0.1	0.2	0.7	1.0
+						
non-discretionary factors	–0.1	–0.2	–0.1	–0.2	–0.4	–0.6
=						
CHANGE IN FISCAL STANCE	–0.1	**–0.2**	**–0.2**	**–0.1**	0.3	0.4
+						
automatic stabilisers	0.0	0.1	0.1	0.0	0.0	0.0
=						
OVERALL FISCAL IMPACT	–0.1	–0.1	–0.2	0.0	0.3	0.4

[1] *Includes convention for public spending after 2005–06 set out in paragraph C22.*

2.60 In 2001–02, as the economy moved below trend, the overall impact of fiscal policy was to support monetary policy by a further 0.7 per cent of GDP between Budget 2001 and the Pre-Budget Report. This occurred mainly because of the impact of slower global growth and weaker equity prices on receipts. As noted in the Pre-Budget Report, the estimates of the cyclically-adjusted fiscal balances understate the extent to which the reduction in receipts is temporary and can be attributed to the automatic stabilisers.[5]

2.61 The table shows that, compared with the Pre-Budget Report, the combined impact of Budget measures and non-discretionary factors results in a small tightening in the fiscal stance in 2002–03 and 2003–04. Fiscal policy is therefore supporting monetary policy as growth gathers pace during the course of 2002 and the economy returns to trend.

2.62 Based on cautious audited assumptions, the total impact of Budget decisions, including the effect of increased net investment on net borrowing, more than offsets the projected non-discretionary improvements to the public finances from 2005–06. However, the amount of caution from the audited assumptions rises over the projection period and therefore the outcome of fiscal policy and its impact on the economy will not necessarily reflect these projections. Nonetheless, within the context of sound public finances, and consistent with meeting the fiscal rules, increases in public consumption and investment, in part offset through increases in general taxation and NICs, will contribute to more balanced growth in the medium term.

[5] See paragraph 2.47 of the 2001 Pre-Budget Report, HM Treasury. The Treasury's methodology for cyclically-adjusting budget balances is set out in: *Fiscal policy: public finances and the cycle*, March 1999.

Financing

2.63 The Debt and Reserves Management Report 2002–03 (DRMR) was published on 14 March 2002, in advance of the Budget due to the requirements of the *Code for Fiscal Stability*. The forecast for the financing requirement was based on the Pre-Budget Report projection for the central government net cash requirement (CGNCR) in 2002–03. In the DRMR it was announced that the provisional net financing requirement of £32.3 billion for 2002–03 would be met by gross gilts issuance of £23 billion and a £9.3 billion adjustment in the net short-term debt position.

2.64 The CGNCR outturn for 2001–02 is £2.9 billion, £3.4 billion lower than forecast in the Pre–Budget Report. The forecast for the CGNCR for 2002–03 is now £13.5 billion. Revisions to the projected level of redemptions and the Debt Manangement Office's cash balance at the Bank of England mean that the net financing requirement for 2002-03 is £32.1 billion. In line with the contingencies outlined in the DRMR, these changes have been accommodated by reducing gross gilt sales by £0.6 billion to £22.4 billion. The total adjustment in net short term debt remains at £9.7 billion. Full details and a revised financing table can be found in Chapter C of the FSBR.

European commitments

2.65 The Budget 2002 projections easily meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period. The projections are consistent with the Government's prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). Based on cautious assumptions and consistent with the Government's fiscal rules, the cyclically-adjusted Treaty deficit is projected to increase to 1.4 per cent of GDP by the end of the projection period as the Government borrows modestly to fund increased investment in the public capital stock. The increases in investment will boost the productive capacity of the economy and will not put macroeconomic stability at risk. General government gross debt remains well below 60 per cent, ensuring the public finances are sustainable.

Box 2.5: The Stability and Growth Pact

The Stability and Growth Pact was finalised at the European Council in June 1997 to ensure that EU Member States safeguard sound and sustainable government finances through the medium-term budgetary objective of "close to balance or surplus." Fiscal sustainability is a precondition for macroeconomic stability and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy co-ordination set out in the EU Treaty. Building on the Code of Conduct, agreed by Member States in June 2001, the Government supports a prudent interpretation that takes into account:

- **the economic cycle: by allowing the automatic stabilisers to operate symmetrically over the cycle, fiscal policy can support monetary policy in smoothing economic fluctuations in the face of variations in demand. Focusing on cyclically-adjusted fiscal balances is therefore important when assessing the appropriateness of budgetary policies;**
- **sustainability: low debt levels enhance the sustainability of the public finances, give more room for manoeuvre to allow the automatic stabilisers to operate and provide a sound basis for investment in priority public services or reforms to promote productivity, employment and fairness. Any assessment of the sustainability of public finances also needs to take account of the budgetary impact of ageing populations and, where possible, generational accounts (see Annex A); and**
- **public investment: in the context of sound public finances and economic stability, public investment not only raises welfare through the provision of high quality public services, but can also help raise the overall productive potential of the economy. However, after historic under-investment, the UK currently has the lowest level of public investment of any major EU country. The Government is committed to delivering rapid growth in investment so as to renew and modernise the capital stock. Budget 2002 sets new spending limits for the 2002 Spending Review which allow for a further rise in public sector net investment to 2 per cent of GDP by 2005-06, consistent with meeting the fiscal rules and maintaining low levels of debt.**

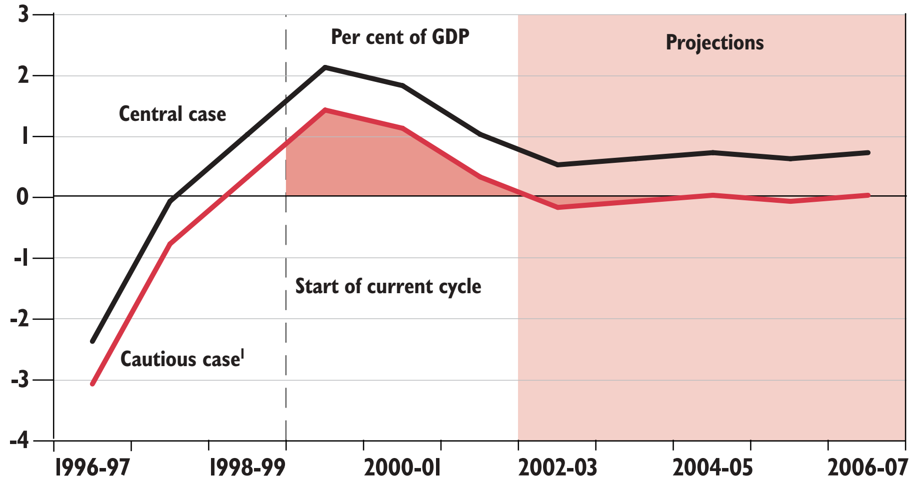
A prudent interpretation of the Pact will lock in longer term fiscal discipline and sustainability, enhancing credibility, while allowing appropriate flexibility over the economic cycle to increase public investment in priority public services.

Dealing with uncertainty

2.66 As fiscal balances represent the difference between two large aggregates, forecasts of them are inevitably subject to wide margins of error. The cautious assumptions audited by the NAO, including the trend growth assumption, take account of possible misjudgements about the trend growth of the economy in the medium term. The importance of accommodating this error source explains why the Government continues to base its public finance projections on a trend growth assumption $^1/_4$ percentage point lower than its neutral view.

2.67 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 1 percentage point lower than on the central case. Chart 2.6 illustrates the forecast for this cautious case.

Chart 2.6: 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.*

2.68 The chart shows that the cyclically-adjusted current surplus in the cautious case remained in strong surplus in 1999–00, the start of the current cycle, and again in 2000–01. It is then projected to move towards balance in 2001–02, and into a small deficit in 2002–03, before returning broadly to balance for the remainder of the projection period. The cyclically-adjusted current budget remains in surplus on average in the cautious case, meeting the 'stress test' of the golden rule. The Government therefore remains on track to meet the golden rule over the cycle, including in the cautious case. Meeting the cautious case and maintaining the $^1/_4$ point margin of caution in the trend growth assumption underpinning the fiscal projections increases the probability of meeting the fiscal rules and also maintains the buffer against fiscal risks.

Long-term fiscal projections

2.69 The Government must ensure that its short and medium-term fiscal policy decisions are consistent with long-term fiscal sustainability. Failure to do so could not only have detrimental effects on long-term economic growth, but would be inconsistent with the principles of fiscal management set out in the *Code for Fiscal Stability*. Annex A presents illustrative long-term fiscal projections for the UK which show that the fiscal position is sustainable in the long term, with net debt projected to remain below 40 per cent of GDP.

3 Meeting the Productivity Challenge

Productivity is a key determinant of economic performance and living standards. The Government's long-term economic goal is that Britain will achieve a higher rate of productivity growth than its main competitors, closing the productivity gap.

The Government's Enterprise Bill will enhance the UK's competition regime and modernise the laws on insolvency, bringing down barriers to enterprise and helping to create a more entrepreneurial culture. Budget 2002 sets out the further steps the Government is now taking to support the drivers of productivity growth, including:

- a reduction in the **corporation tax starting rate from 10 per cent to zero from April 2002**, meaning that 150,000 companies will no longer pay any corporation tax;
- a reduction in the **small companies' rate of corporation tax by one percentage point to 19 per cent from April 2002**, reducing the corporation tax bills of a further 335,000 companies;
- reforms to **reduce the burden of VAT and payroll administration** to simplify the tax system and reduce compliance costs for small businesses;
- announcing successful bidders to run **pilot projects to improve 'investment readiness'** among small firms;
- reforms to establish a modern and competitive business tax system, including an exemption for gains and losses on **substantial shareholdings**, relief for the costs of **intellectual property**, goodwill and other intangible assets, and reform of the rules governing **withholding tax** at source;
- **abolishing stamp duty** for non-residential property transfers in disadvantaged areas and introducing a new **Community Investment Tax Credit** to promote enterprise and wealth creation in under-invested communities;
- introducing a **volume-based research and development tax credit for large companies** to boost the UK's innovation performance;
- announcing details of **pilots to test new measures to improve access to training** and enable employees to attain basic and level 2 skills; and
- additional funding of **£30 million to help small organisations attain Investors in People status**.

The Productivity Challenge

3.1 Increasing the sustainable rate of UK productivity growth is central to the Government's economic strategy. Productivity growth, alongside high and stable levels of employment, is an important driver of long-term economic performance. Improving the UK's productivity performance is therefore essential to deliver higher living standards, tackle poverty and build world-class public services.

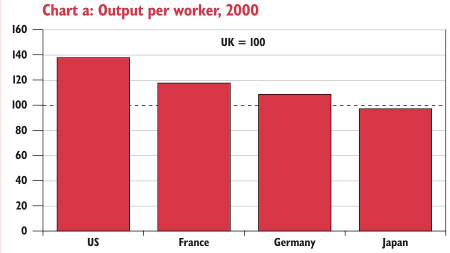
3.2 The UK has a poor track record on productivity. Historically, the UK economy has suffered from macroeconomic instability and microeconomic failures which have inhibited enterprise and innovation, stifled effective competition and discouraged firms and individuals from investing for the long term. This has led to a substantial productivity gap between the UK and many other advanced industrial economies. Further details of the productivity gap are set out in Box 3.1.

Box 3.1: The productivity gap

By international standards, the UK's productivity performance has historically been weak. Whether measured in terms of output per worker or output per hour, the productivity gap between the UK and its main competitors is substantial.

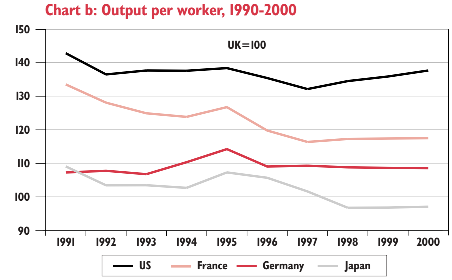
The Government's central measure of productivity is output per worker. This has the advantage of being relatively straightforward to quantify and is immediately related to the Government's economic growth objectives. As shown in chart (a), on this measure, productivity in the US – the world's most productive economy – is 38 per cent higher than in the UK. Productivity in France and Germany is 18 and nine per cent higher respectively. Measured in terms of output per hour, the gap against the US narrows slightly – to 25 per cent – while the gap against France and Germany widens to 27 per cent and 25 per cent.

Chart a: Output per worker, 2000



Source: ONS

Chart b: Output per worker, 1990-2000



Source: ONS

Closing the productivity gap is a long-term challenge. As chart (b) shows, the gap relative to France has narrowed over the last 10 years, while the gap against Japan has closed. The productivity gap against the US has remained relatively stable at around 40 per cent, although there has been some widening in recent years as a result of strong US productivity performance.

Following productivity growth of 2.0 per cent during 2000, with employment remaining at historically high levels, the UK registered a weaker productivity performance during 2001. Productivity grew by 1.3 per cent across the economy as a whole and by 1.9 per cent in manufacturing, with firms tending to retain labour despite weaker external demand. However, the continued strength of UK economic fundamentals should support a resumption of stronger productivity gains beyond the near term.

The Government's approach

3.3 The Government's strategy for closing the productivity gap has two broad strands: maintaining macroeconomic stability to help businesses and individuals plan for the future, and implementing microeconomic reforms to remove the barriers that prevent markets from functioning efficiently. These microeconomic reforms address historic weaknesses in the five key drivers of productivity performance:

- strengthening **competition** to encourage firms to innovate, minimise costs and provide better quality goods and services to the consumer;
- promoting **enterprise and innovation** to unlock the potential of new technologies and working practices, supporting entrepreneurship, risk-taking and management across the country;
- encouraging **investment** to improve the UK's stock of physical capital in every sector and industry;
- improving the **skills** base to maximise the contribution of human capital to growth; and
- improving the **productivity of public services**.

3.4 Government has a key role to play in supporting productivity growth – creating the best possible environment for private enterprise and investment and working directly to increase the productivity of public services. However, the productivity gap cannot be closed without a wider effort across the economy. The Government is therefore working alongside business, trade unions and other stakeholders at the regional, national and international levels to tackle the obstacles to greater productivity.

CBI-TUC productivity campaign

3.5 In this context, the Government welcomes progress made by the joint CBI-TUC productivity working groups in identifying key areas for action. Following recommendations by the investment and best practice working groups, in December 2001 the Government announced an additional £20 million package of support for best practice initiatives in the manufacturing sector and set out proposals for a major reform of the planning system.

3.6 In Budget 2002, the Government is taking further steps to implement the recommendations of the CBI-TUC working groups, including:

- setting out further details of pilots to improve access to workforce training. The Government agrees with the diagnosis in the CBI-TUC skills working group report that 'the major challenge is to help more individuals to achieve an initial level 2 qualification';
- introducing a new research and development tax credit for large companies, as recommended by the innovation working group; and
- announcing additional funding of £30 million to help small organisations attain Investors in People (IiP) status, reflecting the conclusions of the skills working group.

3.7 The Government welcomes proposals from the CBI and the TUC to continue joint working through the creation of a new CBI-TUC Productivity Group. The Group will report regularly to the Government before the Budget and the Pre-Budget Report.

Working across the regions

3.8 The Government is committed to ensuring that the benefits of improved productivity are felt in all regions across the UK. The Government's approach to tackling the productivity challenge at a regional level was set out alongside the 2001 Pre-Budget Report.[1] To drive

[1] *Productivity in the UK: 3 – The regional dimension*, HM Treasury and the Department for Trade and Industry, November 2001.

forward progress, the Government has set a Public Service Agreement (PSA) target to raise the rate of sustainable growth by increasing the trend growth rate of GDP per capita in all regions, with a long-term regional economic ambition to reduce the persistent gap in performance between the regions. Regional economic policy must be focused on raising the performance of the weakest regions, rather than the simple redistribution of existing economic activity.

3.9 The Regional Development Agencies (RDAs) are central to the Government's response to the productivity challenge. The RDAs operate as strategic leaders for economic development in their region, working in partnership with key regional, sub-regional and local bodies. In addition to considerable budgets, rising to £1.7 billion in 2003-04, the RDAs have been given unprecedented flexibility and autonomy to find the most effective way of meeting stretching targets set by central government. From 1 April 2002, RDA funding is being provided under a single cross-departmental framework, the Single Pot, to give RDAs the greatest possible flexibility in deploying their resources. The 2002 Spending Review, described in Chapter 6, will consider how best to strengthen the RDAs' ability to deliver better outcomes.

3.10 The 2002 Spending Review will also assess the impact of departments' policies on different regions and seek to ensure that spending is targeted at those areas where it is needed most and will be most effective. In addition, the Deputy Prime Minister will shortly publish a White Paper setting out the Government's further detailed proposals for devolution in the English regions.

European economic reform

3.11 At the Lisbon European Council meeting in March 2000, the European Union (EU) set itself the goal of becoming the most competitive and dynamic knowledge-based economy in the world. Significant progress has been achieved since then, including five million new jobs, a further liberalised telecommunications market and a Charter for Small Firms. The Barcelona Council meeting of March 2002 took forward the EU's ambitious agenda, approving commitments to:

- fully open up the non-domestic energy market – 60 per cent of the total EU energy market – to free and fair competition;
- boost levels of research and development towards a target of 3 per cent of GDP by 2010;
- complete the single market in financial services, itself capable of boosting EU GDP by half a percentage point according to some estimates;
- bring forward proposals to reduce regulation on business by June 2002; and
- deliver broadband technology widely across the EU by 2005.

3.12 The Government will continue to push for further reform, building on the progress made at Barcelona. The Government's White Paper on economic reform in Europe[2], published in February 2002, sets out the next steps in this process, including labour market reform to help regain full employment, the full opening up of all energy markets in Europe, less but better targeted state aid, a review of the EU-US trade and investment relationship and a successful conclusion to the WTO's Doha development trade round. The Government is committed to realising these challenging goals for the benefit of consumers and industry within the EU and beyond.

Public services productivity

3.13 As well as creating the right environment for business to raise productivity, government must also strive for greater efficiency. Public services account for a substantial part of the economy, and productivity within the public sector therefore has an important and direct impact on the productivity performance of the economy as a whole. Increased public services productivity is also important because it gives people the public services they

[2] *Realising Europe's potential: Economic reform in Europe*, HM Treasury, 28 February 2002.

require, ensures that taxpayers receive better value for money, and helps to lay foundations for a high productivity economy through improved education, health and transport infrastructure.

3.14 The Government's approach to increasing the productivity of public services focuses on allocating resources to priority areas and programmes, and reforming delivery so that these resources are used as effectively as possible. This approach, and the steps the Government is taking as part of the 2002 Spending Review, are described in detail in Chapter 6.

COMPETITION

3.15 Competition is an important driver of productivity performance. Vigorous competition strengthens incentives to innovate and ensures that resources are allocated to the most efficient firms. By encouraging firms to reduce prices and improve the quality and choice of goods and services, it is also the most effective way of ensuring that consumers receive a fair deal.

The competition regime

3.16 The Government is committed to strengthening the UK's overall competition regime and has consulted widely on proposals for reform.[3] The Enterprise Bill, which was introduced on 26 March 2002, implements the Government's reform programme. Among other measures, the Bill will:

- give full independence to the UK competition authorities, so that they will take decisions free from political interference in the overwhelming majority of cases;
- give the Office of Fair Trading (OFT) a clear proactive role to keep markets under review and enable it to refer markets to the Competition Commission where they may not be working well;
- improve the mergers and monopolies investigations regimes, giving greater certainty through clearer timetables and a more transparent decision-making process; and
- introduce new criminal penalties for individuals who engage in cartels, covering the most serious forms of anti-competitive activity.

3.17 The Enterprise Bill also includes provisions to modernise the rules for insolvency (described later in this chapter). Together, this package of reform will help to bring down barriers to enterprise, provide greater opportunity for all and create a more entrepreneurial culture.

Promoting competition in specific markets

3.18 The OFT is already taking action to promote competition in specific markets as part of its new proactive role. In October 2001, the OFT launched three studies into competition in the markets for information technology (IT) goods and services, pharmacies, and extended warranties for electrical goods. The OFT has also responded to the first 'super-complaint' made by the Consumers' Association, launching a full investigation into the market for private dentistry.

[3] *Productivity and enterprise: A world class competition regime*, Department of Trade and Industry, July 2001.

The professions 3.19 The OFT's report into competition in the professions, published in March 2002, identified a number of issues in relation to professional rules that may hinder effective competition in the provision of professional services. In response to the report, the Government is acting to remove the special regime that provides for the exclusion of professional rules from competition law, by repealing Schedule 4 to the Competition Act as part of the Enterprise Bill. Following active dialogue between the OFT and the professions, professional bodies have carried out reviews of their own rules and have already agreed a number of improvements. Building on these, the OFT and the Lord Chancellor's Department (LCD) are now taking forward work to resolve any remaining competition concerns. The LCD has already stated that it plans to consult before the summer recess on matters that fall to it and will publish the results of this consultation as soon as possible. The OFT will also shortly be making a statement about its next steps.

Small business banking 3.20 The Competition Commission report into small business banking was published in March 2002. The report concluded that a complex monopoly exists in the supply of banking services to small and medium-sized enterprises (SMEs) and identified practices carried out by the eight main clearing banks in the UK which restrict or distort competition and operate against the public interest. The report also proposed a series of remedies, including measures to improve transparency and reduce the costs of switching accounts. As these remedies will take some time to have effect, the Commission recommended that the four largest banks should offer all SME customers in England and Wales interest on their current account at 2.5 per cent below the Bank of England base rate, free banking, or a choice between the two. The Chancellor and the Secretary of State for Trade and Industry have asked the Director General of Fair Trading to seek undertakings to implement these recommendations. He will report to Ministers in June 2002.

Payment systems 3.21 The Government is committed to introducing legislation to give the OFT new powers to promote competition in payment systems. Legislation will be introduced as soon as parliamentary time allows.

The water industry 3.22 As previously announced, the Government proposes to extend competition for non-household customers using large quantities of water. The Government will publish a consultation paper setting out detailed proposals later this year.

New cars 3.23 The Government welcomes the European Commission's proposals for major pro-consumer reforms of the new cars block exemption. The proposals should lead to greater price competition and a better deal for consumers. The new regulation is due to come into force on 1 October 2002, with a proposed transition period of one year.

The European trade mark regime 3.24 The Government is also committed to liberalising the existing European trade mark exhaustion regime and is seeking the support of Member States for this change. The current trademark regime allows brand owners to prevent the import of their products where they have already been marketed outside the European Economic Area, so giving power to brand owners to stop parallel importing into the Community. This prevents, for example, supermarkets from selling branded jeans at prices lower than in high street shops. Liberalising the trade mark regime would allow businesses to source from low-cost markets, applying strong downward pressure on prices and stimulating competition to the advantage of UK and other European Union consumers.

Box 3.2: Regulatory reform

Effective and well-focused regulation can play a vital role in correcting market failure, promoting fairness and ensuring public safety. Unnecessary or poorly implemented regulation, however, can restrict competition, stifle innovation and deter investment. The Government is committed to ensuring high standards of regulation across the UK and Europe. This requires changing the culture of regulation through institutional and procedural reform, lifting barriers to enterprise by reforming or removing specific regulations, and improving communication with business.

Institutional and procedural reform has an important role to play in minimising the burden of regulation on business. A major institutional reform, simplifying the regulatory environment and embodying principles of good regulation, was completed on 1 December 2001, when the Financial Services Authority assumed its powers and responsibilities under the Financial Services and Markets Act 2000. In an important reform to the policy-making process, the OFT now plays a new role in assessing the effects on competition of existing and proposed new regulations.

These changes have been accompanied by wide-ranging reform of specific regulations. In February 2002, the Government announced a package of 260 deregulatory measures, including simplifying fire safety regulation by moving from an inspection and certification regime to a risk-based approach. The Government has also published a Green Paper on reform of the land use planning system, setting out proposals to reduce dramatically the regulatory burden imposed by the current system.

The Goverment is also easing regulatory burdens by improving communication with business, especially SMEs. The Government will apply the lessons from the cross-cutting review of services to small business to deliver clearer presentation and more effective dissemination of regulatory information.

ENTERPRISE

3.25 An environment that encourages enterprise and supports people who take opportunities and risks is a crucial ingredient of productivity improvement. New and more dynamic businesses increase competitive pressure in markets and facilitate the introduction of new ideas, technologies and more efficient working practices. The Government is therefore taking further steps to:

- establish and maintain a modern and competitive business tax system;
- provide support for small and new business – encouraging business start-ups and promoting a culture of entrepreneurship;
- extend the enterprise culture throughout the country by tackling the obstacles to business growth and investment in Britain's most disadvantaged areas; and
- promote a better understanding of business, the economy and enterprise throughout the school and further education systems.

A modern and competitive business tax system

3.26 To provide stability for business in the longer term, and to ensure that the UK is an attractive place to start-up or locate a company, the Government has introduced a number of significant reforms to the business tax regime, including:

- a reduction in the main rate of corporation tax to 30 per cent;
- the introduction of a 10 per cent starting rate for small companies – the lowest in the European Union – to support enterprising individuals starting up their own companies;
- the introduction of a generous capital gains tax (CGT) taper for business assets to encourage investment and entrepreneurial activity. The 2001 Pre-Budget Report confirmed that, from 6 April 2002, the effective rate of tax for a higher rate taxpayer would be reduced to 20 per cent for assets held for one year and to 10 per cent after only two years, making the UK regime among the most favourable in the world. The Government is considering the case for further changes to the CGT regime for non-business assets; and
- the abolition of the requirement to withhold tax on interest and royalties between companies in the UK.

3.27 Budget 2002 takes further steps to build a corporate tax regime which recognises the realities of the modern business environment and competes with the best in the world. Following consultation, the Government is now introducing:

- **an exemption for gains and losses on most substantial shareholdings in trading companies from 1 April 2002** to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial, rather than tax, reasons;
- **a new regime for providing tax relief to companies for the costs of intellectual property, goodwill and other intangible assets from 1 April 2002** to encourage business to take advantage of new opportunities in the emerging knowledge-based economy;
- **an exemption from stamp duty for transfers of goodwill from 23 April 2002** to reduce the costs of buying businesses. This exemption puts goodwill on a consistent footing with intellectual property, exempted from stamp duty in 2000; and
- **a new regime for loan relationships, derivative contracts and foreign exchange gains and losses for accounting periods starting on or after 1 October 2002** to create a coherent regime governing the taxation of debt and derivative contracts.

3.28 The Government is also committed to reducing compliance burdens for business and investors. Budget 2002 therefore announces:

- **reform of the rules governing withholding tax at source** so that:
  - companies may choose to pay cross-border royalties without deducting tax at source, reducing administrative burdens for UK companies seeking access to international know-how;
  - financial dealers can make certain payments gross of tax, creating a level playing field with banks; and

- local authorities, pension funds, charities and other tax exempt bodies can receive more payments from companies without suffering deduction of tax at source.

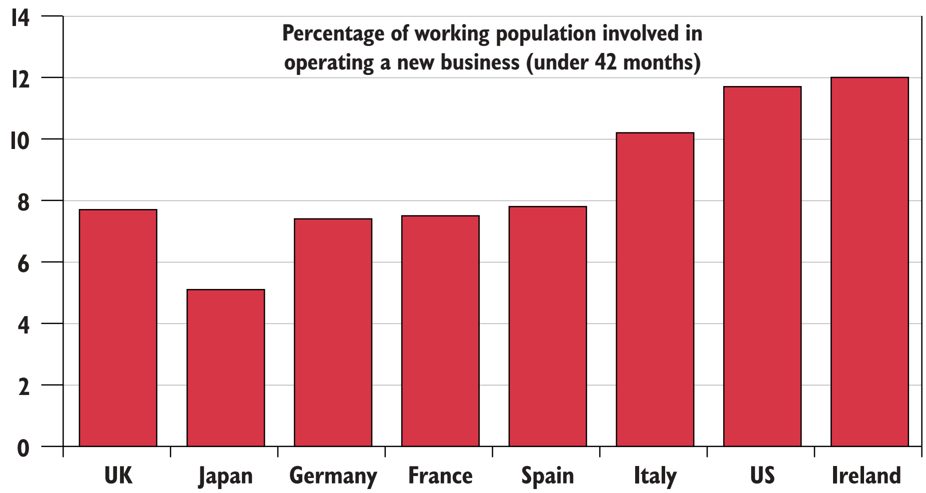
- **simplification of the CGT regime** to reduce compliance costs, in particular for those who invest in business and for employees.

3.29 The Government will **consider further steps that might be taken to reform and modernise the corporation tax regime and will publish a consultation document in summer 2002** to take forward its programme of reform.[4] To ensure that the UK remains the best possible location for business investment, the document will consider the case for bringing the remaining taxable gains made by companies into an income regime, examine the merits of rationalising the schedular system of taxation for companies, and review the scope for greater alignment between the treatment of investment and trading companies. Changes of this sort would have to take account of a range of issues, including the special position of businesses such as life assurance.

Supporting small business and promoting entrepreneurship

3.30 In seeking to make Britain one of the most competitive environments for business in the world, the Government is committed to rewarding entrepreneurial spirit and promoting growth, especially among new and small businesses. As Chart 3.1 shows, while small business creation in the UK is broadly comparable with many other European countries, the UK has failed to achieve the levels of entrepreneurship seen in the US.

Chart 3.1: The enterprise gap



Source: Global Entrepreneur Monitor, 2001

[4] The Government's strategy for reform was set out in *Large business taxation: the Government's strategy and corporate tax reforms*, HM Treasury, July 2001.

Corporation tax

3.31 In order to provide further support to new and growing companies, with effect from 1 April 2002:

- **the corporation tax starting rate – already the lowest in the European Union – is reduced from 10 per cent to zero**, meaning that 150,000 small companies will no longer pay any corporation tax; and
- **the small companies' rate is reduced from 20 to 19 per cent**, reducing the corporation tax bills of a further 335,000 companies.

3.32 These reforms mean that all companies with taxable profits of less than £10,000 will pay no corporation tax. Small taxpaying companies will save a maximum of £3,000 and an average of around £700 every year.

Simplifying VAT for small businesses

3.33 In recent Budgets, the Government has introduced a series of measures designed to allow small and newly-registered businesses to manage their entry into the VAT system, reduce their VAT administration burden and improve their cash flow. Building on the measures announced in the 2001 Pre-Budget Report, Budget 2002 introduces a range of further reforms:

- **the VAT registration threshold will be increased in line with inflation from £54,000 to £55,000**, keeping more than 4,000 businesses outside the VAT net, and maintaining the UK's threshold as the highest in the European Union;
- **the optional VAT flat-rate scheme will be extended in April 2003** to a further 200,000 businesses with turnover up to £150,000. The current scheme allows more than 500,000 businesses with turnover up to £100,000 to avoid accounting for VAT on every purchase and sale, cutting their compliance costs by up to £1,000 a year;
- **further reforms will be made to the VAT penalty regime**, to ensure that when businesses with turnover up to £150,000 are late with VAT payments, they are offered advice and support rather than facing automatic fines; and
- following consultation, **targeted reforms will be introduced in 2003 to allow approved importers to delay accounting for the VAT due on imported goods until they submit their regular VAT returns**, cutting compliance and cash flow burdens which are currently estimated to cost UK importers £175 million a year.

Easing the burden of payroll

3.34 The administrative burden imposed by payroll obligations can be a significant obstacle to small firm development. In June 2001, the Government asked Patrick Carter to undertake a review of payroll services in the UK. The review was published alongside the 2001 Pre-Budget Report.

3.35 The Pre-Budget Report invited comments on the specific proposals set out in the review, including the use of cash incentives to encourage smaller employers to file electronically, and the introduction of mandatory electronic filing by 2004 for larger employers and by 2007 for all employers. While the consultation revealed general support for making greater use of IT, many respondents regarded the adoption of universal e-filing by 2007 as too ambitious, particularly for smaller employers. Although the Government believes that all employers should in due course file returns electronically, it recognises that achieving this by 2007 will be difficult for the smallest employers. **The Government therefore proposes to implement a three stage move towards universal e-filing:**

- the largest employers, with 250 or more employees, will be required to file electronically for the year 2004-05 onwards;
- employers with 50 or more employees will be required to file electronically from the year 2005-06; and
- incentive payments to encourage smaller employers, with fewer than 50 employees, to file electronically will commence for 2004-05, at a level of £250, tapering to £75 by 2008-09. The Government proposes that electronic filing of employer returns should become a universal requirement from 2010, for the filing of 2009-10 returns.

3.36 To help business in dealing with payroll issues generally and, in particular, to encourage firms to realise the advantages and cost savings of greater use of IT, the Inland Revenue will also make improvements in the support services it offers to employers.

Promoting business start-ups

3.37 New entrepreneurs need clear information on what government can do for them, what government requires from them and where they can access help and advice. **The Department of Trade and Industry will shortly consult on a national strategy for start-ups,** building on the emerging conclusions of the cross-cutting review of goverment services for small business. The consultation paper will seek views on proposals for a new resource pack and on whether government should establish a helpline for start-ups. The resource pack would bring together in a single document information on government requirements and support, and would be made available through a wide range of outlets and over the internet. The helpline could complement the pack and provide a contact number for those thinking of starting a business to obtain information and advice on a comprehensive range of government services and requirements.

Improving access to risk capital

3.38 For many small businesses and entrepreneurs, access to risk capital is the key to realising growth potential. The Government is committed to increasing the supply of risk capital to UK enterprises and has encouraged private sector provision through a range of tax measures, including the introduction of the capital gains tax taper for business assets. Private equity investment in the UK has more than doubled since 1997 and now accounts for 38 per cent of the European total.

3.39 Despite the growth in private sector activity, many small firms still face problems in accessing risk capital, particularly for smaller amounts. To address this funding gap, the Government will shortly be announcing the first successful bidders to deliver a £50 million Early Growth Funding initiative, which is intended to help at least 1,000 businesses over the next three years. This will complement the Regional Venture Capital Funds, currently being set up in every English region, which will deliver £270 million of investment in small firms through a mixture of public and private finance.

3.40 A key financing option for small firms is provided by Venture Capital Trusts (VCTs), which deliver growth capital funding to companies that are generally too small to attract larger commercial venture capital finance. VCTs have already raised well over £1 billion from investors and the Government is now developing the scheme by **introducing provisions to allow VCTs to merge and be wound up while preserving the benefits to investors.**

Investment readiness

3.41 As well as stimulating supply, the Government is concerned to improve effective demand for equity finance by ensuring that entrepreneurs know how to access appropriate finance and understand its benefits. The Government is now **announcing successful bidders to run six pilot projects in different parts of the country to inform small firms about different financing options and offer a programme of support to help small firms become 'investment-ready'**.

Insolvency **3.42** Many potential entrepreneurs are dissuaded from starting new businesses by the perceived costs of failure. The Enterprise Bill, introduced on 26 March 2002, takes further steps toward reducing the stigma attached to business failure and creating effective incentives for the rescue of viable businesses. In particular:

- reforms to personal bankruptcy law will substantially reduce the cost and stigma of business failure in most cases, while providing stronger sanctions against the unscrupulous or dishonest;
- corporate insolvency will be conducted in a way that recognises the interests of all creditors, and provides the greatest incentive for the rescue of companies and their businesses;
- Crown preference, which allows many tax debts to be paid ahead of other unsecured creditors, will be abolished. The benefit of this reform will go mainly to unsecured creditors; and
- the financial regime for the Insolvency Service will be modernised, allowing creditors to receive the maximum possible investment return, and creating a simpler and more transparent fee structure.

Promoting enterprise in disadvantaged areas

3.43 The Government is committed to encouraging enterprise, investment and wealth creation across all regions in Britain. To ensure that Britain's most disadvantaged communities are not left behind, it is introducing a range of measures to encourage investment and enterprise in these areas.

Community Investment Tax Credit **3.44** The Social Investment Taskforce, chaired by Sir Ronald Cohen, reported to the Chancellor in October 2000. The report recommended a new Community Investment Tax Credit (CITC) to encourage private investment in not-for-profit and profit-seeking enterprises in under-invested communities.

3.45 Following consultation, in July 2001 the Government announced its intention to proceed with a tax credit, available to both individual and corporate investors making either debt or equity investments. The 2001 Pre-Budget Report described a range of adjustments to the scheme to improve the allocation process and increase access to the CITC. The Government now intends to make a number of additional refinements to the operation of the tax credit:

- greater flexibility in the rules for the structure of loans qualifying for the credit and the use of funds by intermediaries;
- an emphasis on the role of social enterprises as well as for-profit businesses, including a generous regime for property development for social enterprise;
- an increase in the limit on the amount of funds that can be raised by wholesale intermediaries, from £10 million to £20 million; and
- treatment of bodies which become accredited between 17 April 2002 and 5 April 2003 as if they had been accredited from 17 April 2002.

3.46 The Government has published draft legislation for consultation, along with a draft prospectus for organisations wishing to accredit for the CITC. As announced in the Pre-Budget Report, the accreditation process will be run by the Small Business Service (SBS). **The Government intends to proceed with implementation of the CITC and will legislate in Finance Bill 2002.** The scheme will become operational once state aids approval has been obtained.

Community Development Venture Fund

3.47 The Social Investment Taskforce also recommended that the Government help set up a Community Development Venture Fund – a matched funding partnership between government and the venture capital industry to provide finance for firms operating in disadvantaged areas. The Government has now committed £20 million, and remains confident that private investors will provide a further £20 million, to create a £40 million fund. State aids approval has been obtained and the fund will be launched shortly.

Land and property in deprived areas

3.48 Since 30 November 2001, an exemption from stamp duty has been available for all property transfers up to £150,000 in the UK's most disadvantaged areas. One of a range of measures set out in the Urban White Paper, the exemption aims to encourage businesses and families to locate in these areas, boosting local enterprise and employment. To reduce further the cost to business of investing in deprived areas, **the Government will legislate in the Finance Bill to abolish stamp duty for all non-residential transfers in qualifying areas, subject to state aids approval.** Details of further measures in the Urban White Paper are set out in Chapter 7.

Enterprise and education

3.49 Strengthening the links between the education system and business is vital to promote an enterprise culture for the future.

Davies review of enterprise and education

3.50 In February 2002, Sir Howard Davies, Chairman of the Financial Services Authority (FSA), reported to the Chancellor and the Secretaries of State for Trade and Industry and Education and Skills on how to promote better understanding of business, the economy and enterprise throughout the school and further education systems. To equip young people with the enterprising skills and attributes needed to thrive in the modern workplace, the review recommended:

- a national agenda for building enterprise capability, business understanding and financial literacy in all young people;
- increasing the opportunities for young people to experience enterprise activity before leaving school, for example through mini-company schemes. These opportunities should be supported jointly by government and the business sector; and
- introducing a range of support and evaluation measures to ensure that teachers are assisted in promoting enterprise education, and that the value of government and business investment is maximised.

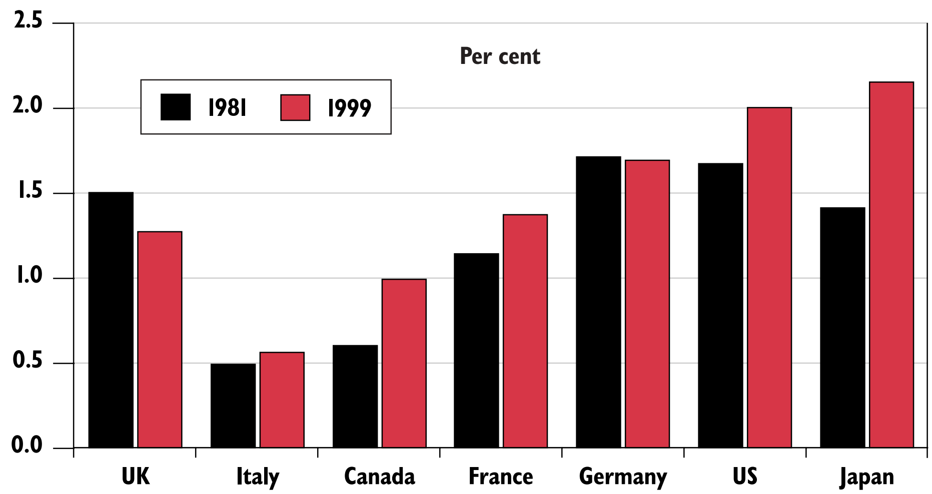
3.51 The Government welcomes the Davies report and agrees with its central conclusion that building a deeper and wider entrepreneurial culture must start in schools and colleges. **The Government will publish a formal response and implementation plan shortly.** Decisions on the major spending recommendations set out in the report will be taken in the context of the 2002 Spending Review.

INNOVATION

3.52 Innovation is a key catalyst for productivity growth. New ideas can act to open up new markets and opportunities for firms, through the creation of new and improved products and services. New technologies and the development of new processes also allow efficiency gains, enabling businesses to reduce their cost base and provide a better deal for consumers.

3.53 By international standards, levels of innovation in the UK have historically been low. As Chart 3.2 shows, levels of UK private sector investment in research and development (R&D), a key input to successful innovation, are significantly below those achieved in many other advanced industrial countries.

Chart 3.2: Business R&D expenditure as a proportion of GDP



Source: OECD

Research and development tax credit

3.54 To address this gap and to support the private sector in its efforts to raise R&D, Budget 2000 introduced an R&D tax credit for small and medium-sized companies. The Government has since consulted on extending this credit to all companies and is now **introducing an R&D tax credit for large companies. The tax credit will be available to all companies that do not already qualify for the SME credit, for R&D expenditure incurred on or after 1 April 2002.**

3.55 In designing the tax credit, the Government has sought to maximise the incentives for companies to undertake additional R&D. The consultation exercise identified the following important design elements:

- the credit must be stable, so that companies can rely on it;
- the credit must be transparent and predictable, so that companies can build the tax savings into their investment decisions; and
- the credit must be simple in design, to minimise the costs of administration.

3.56 Consistent with these principles, the tax credit will be based on a simple volume design, payable to the company that carries out the R&D. **The credit, which will take the form of a super-deduction against income chargeable to corporation tax, will be given at the rate of 125 per cent of all qualifying R&D expenditure.**

3.57 To ensure that the tax credit rewards all companies for the R&D they undertake in the UK, it will be available for all directly incurred expenditure regardless of how this is financed. This means that large companies will be able to claim credit for expenditure on work subcontracted to them by another large company. There will be no requirement for the company to own any intellectual property resulting from the R&D. To promote business links with academic research, companies that fund research undertaken collaboratively with universities, charities and certain not-for-profit research organisations will also qualify.

3.58 Alongside this tax credit, **UK companies will also be able to claim additional relief for the costs of R&D into drugs and vaccines to treat diseases threatening lives in the least developed countries.** Further details of this provision are set out in Chapter 5.

The Roberts review

3.59 Business, universities and the public sector need to be able to recruit and retain skilled scientists and engineers to underpin their R&D activities. In Budget 2001, the Chancellor and the Secretaries of State for Trade and Industry and for Education and Skills asked Sir Gareth Roberts to undertake a review of the supply of scientists and engineers in the UK.

3.60 Sir Gareth reported on 15 April 2002. The review sets out a number of recommendations to address issues throughout the supply chain for scientists and engineers – in schools, in universities and in relation to employment in R&D – including:

- addressing difficulties in the recruitment and retention of design and technology, maths, science and ICT teachers by considering issues relating to their training and remuneration;
- investing in the modernisation of school and undergraduate teaching laboratories and addressing other factors influencing practical work in schools and universities;
- encouraging participation, particularly by women, in science and engineering through appropriate course design and careers advice;
- improving the funding, training and career paths available to postgraduate students and postdoctoral researchers;
- addressing difficulties in the recruitment and retention of academic staff through enabling universities to respond better to market pressures in setting salaries; and
- improving the opportunities for scientists and engineers offered by R&D employers, and developing both the research collaboration and the coherence of skills communication between businesses and universities.

Supporting science and research

3.61 The supply of skilled scientists and engineers, comprehensively examined by the Roberts review, is a key element of the UK's scientific capability. However, skilled scientists and engineers can only undertake world-class research and innovation if they are properly motivated, funded and directed. This is a challenge for private sector firms carrying out R&D, as well as for government and others who fund and make use of the science base.

3.62 To complement the work of the Roberts review, and in preparation for the 2002 Spending Review, the Government is therefore taking forward a cross-cutting review of science and research in the UK. It is already apparent that sustaining and enhancing the science base in an increasingly competitive environment will pose major challenges for all key funders and users of UK science and research. The Government intends to play its full part in meeting those challenges, but a fully effective response will depend on complementary action by others.

3.63 In the past two Spending Reviews, the Government, in partnership with the Wellcome Trust, has allocated around £1.75 billion to investment in science infrastructure. Recent evidence suggests that while this money has helped, efforts should continue to address the issues that have arisen about the balance between different funding streams, as charities and industry, alongside government, fund increasing volumes of research. Dealing with these issues will require all parties to work in partnership, recognising that the long-term sustainability of the science base is a shared responsibility between research institutions and all funders and users. This will mean ensuring that the short-term quest for research output does not compromise the long-term sustainability of the science base.

3.64 The universities will have a key role to play. Universities have responded well to the challenge of improving research in recent years. As the 2001 Research Assessment Exercise shows, the quality of research in the UK has never been higher. This same drive now needs to be applied to the changes that will be necessary to ensure that the UK can properly sustain current research output as well as moving into new research fields. There will be particular challenges in improving financial and project management at universities so that they are better able to meet the needs of research customers, and in ensuring that university pay can respond to market pressures for the best and most promising research talent at all levels.

3.65 The Roberts review and the preparatory work of the cross-cutting review provide a comprehensive overview of the UK's science base. The Government will build on this work, in cooperation with other stakeholders, to develop a strategy for science in the context of the 2002 Spending Review.

Managing the radio spectrum

3.66 Radio spectrum is a key national asset of growing economic and social importance. It is vital that the spectrum management regime is sufficiently flexible to accommodate emerging changes in technology and the growth in demand for mobile communications. The Government has taken steps in recent years to improve the regime, making it more responsive to market developments and creating incentives for efficient spectrum use.

3.67 In March 2001, the Chancellor and the Secretary of State for Trade and Industry appointed Professor Martin Cave of Warwick Business School to conduct an independent review of spectrum management in the UK. Professor Cave's report was published on 6 March 2002. The review's over-arching conclusion is that all spectrum users should be exposed to the value of the spectrum they use. It advocates the introduction of market-based mechanisms for spectrum management, such as auctions and trading for both public and private sector users. Where a market-based approach is not practical or desirable, it recommends that the pricing and charging of spectrum can be used to ensure that all users are exposed to the value of the asset under their control. The Government will respond to the review's recommendations in the summer.

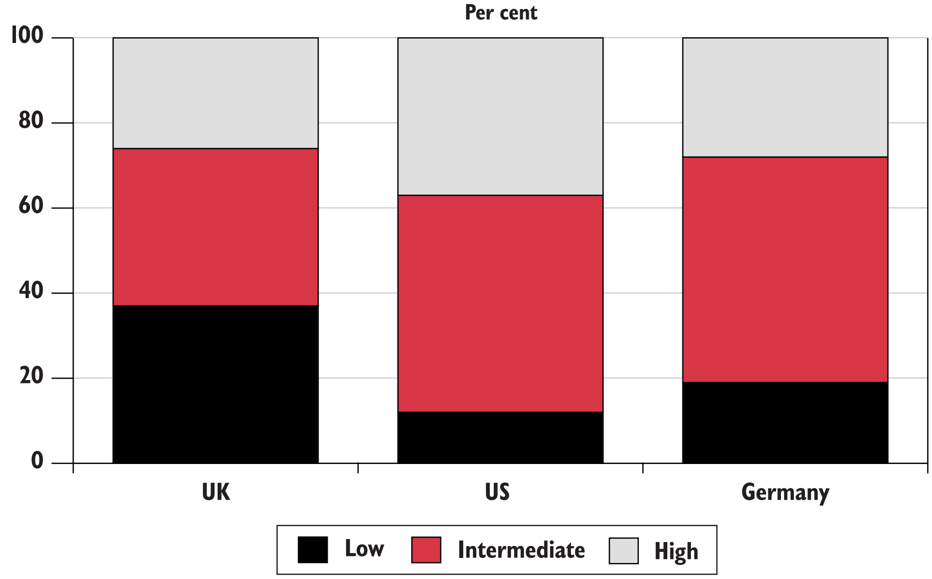
SKILLS

3.68 The quantity and quality of skilled labour available in an economy is an important determinant of economic performance and productivity growth. Skilled workers can often adapt faster and more effectively to change, and may be better at implementing new investments and pursuing innovation.[5] A highly skilled workforce enables firms to update working practices and products at the rate demanded by rapidly changing markets, making the economy more flexible and productive in the longer term.

3.69 International evidence suggests that the UK suffers from significant skills shortages, especially at the lower-intermediate level. In particular, a higher proportion of the UK population have low skills compared with Germany, other European countries and the US.

[5] See, for example, R. Cassen and G. Mavrotas: *Education and training for manufacturing development* in M. Godfrey (ed): *Skill Development for International Competitiveness*, University of Sussex, 1997.

Chart 3.3: Employees by skill level



Source: OECD, 2001

Note: International comparisons of workforce skills are complicated by the difficulty in establishing equivalencies between countries with widely different education systems. The data used here is drawn from OECD (2001) which, unlike previous studies, compares both work-related and academic based qualifications across countries. The study shows the UK with a greater human capital deficit compared to the US than the data cited in 'Productivity in the UK: Enterprise and the Productivity Challenge', HM Treasury, June 2001. More detailed discussion of this issue may be found in the accompanying document, 'Developing Workforce Skills: Piloting a New Approach'. Low skills are defined as International Standard Classification of Education (ISCED) levels 0-2, intermediate skills as ISCED level 3 and high skills as ISCED levels 4-6.

3.70 To improve UK skill levels and increase productivity, government action needs to address both the skill levels of young people entering the workforce from education and the opportunities for those already in the workforce to continue to acquire new skills.

Developing the skills of young people

Primary and secondary education

3.71 The Government is committed to raising standards across the education system. Between 1997 and 2001, the proportion of 11 year olds reaching expected reading levels increased by 12 per cent, while those achieving expected levels in maths rose by nine per cent. The proportion of 16 year olds achieving five A*-C grades at GCSE also increased from 45 per cent in 1997 to 50 per cent in 2001.

3.72 Despite these improvements, the UK education system still faces significant challenges. In 1999, the UK had one of the lowest post-16 participation rates of any developed country – the rate among 17 year olds was 74 per cent in the UK, compared with 83 per cent in the US, 91 per cent in France and 92 per cent in Germany. Increasing participation rates requires an education system that is flexible enough to meet the varied needs and interests of all young people. As a step towards this, in February 2002 the Government announced major new proposals to transform secondary education, including new options for young people who wish to follow vocational pathways from the age of 14 and more choice for all young people. Breaking down the barriers between academic and vocational education is crucial if more young people are to remain in education after the age of 16 and acquire the skills they need to progress.

Modern Apprenticeships

3.73 To widen the vocational choices available to young people and enhance skill levels among those entering the workforce, the Government also intends to reform, strengthen and expand the Modern Apprenticeships scheme. In November 2001, the Government announced:

- a target for 2004 that 28 per cent of young people should enter an apprenticeship before they are 22;
- an entitlement, from 2004, to an apprenticeship place for all 16 and 17 year-olds with five or more GCSEs at A*-G, including maths and English;
- a national framework for apprenticeships to ensure world-class standards, with high quality Apprenticeship Agents to help more employers deliver apprenticeships; and
- a major three-year £16 million marketing campaign aimed at promoting apprenticeships and increasing take-up among both young people and employers.

Higher education

3.74 Higher education is also central to the development of a highly skilled workforce. The Government's aim is that, by 2010, 50 per cent of young people will have the chance to participate in higher education. The Government is pursuing two key objectives: widening access to higher education, and improving the current funding system to ensure that universities are better able to respond to demand and to sustain teaching and research excellence. Further decisions will be taken in the context of the 2002 Spending Review.

Developing workforce skills

3.75 While improvements in the skills of young people help to lay the foundations for long-term improvements in the UK skills base, their effect will only be gradual. Two-thirds of today's workforce will still be in the labour market in 2020, and more than one-third have qualifications below level 2. A faster improvement in the skills base can only be achieved by updating the skills of those already in the workforce.

3.76 Workforce training in the UK is limited by a range of market failures. Individuals and businesses may be unable to gain the full returns to investment in training and commonly face credit constraints. Survey evidence also suggests that people are often poorly informed about the value of training and that time and money are important barriers to take-up. These market failures affect low-skilled workers in particular – people with lower qualifications are much less likely to receive training. There is also strong evidence to suggest that those who work for small firms are less likely to receive training than those who work for larger firms.

3.77 The 2001 Pre-Budget Report set out a vision for UK training and skills based on shared responsibilities between employers, individuals and government. The vision centres on increasing the demand for training by reducing the barriers which prevent people – particularly low-skilled people – from training. It recognises that the voluntary training policies of the past have often failed to reach those with the lowest levels of skills who need most government support to train.

3.78 As outlined in the Pre-Budget Report, one policy approach now being considered by the Government, and being tested through new pilot schemes, would build on existing basic skills policy, lifelong learning and the commitment shown to improving education since 1997. The approach to be tested consists of four complementary, linked elements:

- free learning provision and accreditation for employees without basic skills or level 2 qualifications to work towards recognised qualifications up to the level 2 standard (including basic skills), with approved providers. This would build on the current provision of free courses for basic skills under the Government's *Skills for Life* initiative;

- some form of arrangement for individuals to take up training – such as a minimum entitlement for all employees who have not attained basic skills or level 2 qualifications to paid time off each year to train towards the standard;
- financial support for employers whose staff take time off to train to acquire basic literacy, numeracy and ICT skills and to progress to level 2, with additional financial incentives for small firms. This financial incentive could be delivered through a tax credit or some other mechanism. The Government will consult on these options, which will be developed jointly with the Department for Education and Skills and alongside the wider work of the Performance and Innovation Unit (PIU); and
- extended information, advice and guidance for employers and individuals taking part in, or considering taking part in, any new system. Among other possibilities, these could include arrangements along the lines of Union Learning Representatives.

3.79 To take forward this strategy, **new Employer Training Pilots will be operated by local Learning and Skill Councils in Birmingham and Solihull, Derbyshire, Essex, Greater Manchester, Tyne and Wear, and Wiltshire and Swindon from September 2002**. The pilots will test different periods of time off for employees to train towards the level 2 standard and different levels of compensation for employers. Further details of the national pilot model and of individual pilots are set out in the accompanying paper, *Developing Workforce Skills: Piloting a New Approach*.

3.80 The Employer Training Pilots are only one aspect of the Government's commitment to improving UK skills and supporting those in the workforce who most need training to progress in employment. The PIU is taking forward the workforce development strategy set out in its November 2001 paper in close cooperation with the Learning and Skills Council (LSC) and other government departments.

Investors in People

3.81 The CBI-TUC joint report on skills identified increasing the take-up of Investors in People (IiP) by small organisations as a key priority for raising skill levels across the economy. The Government believes that working to obtain the IiP standard can help firms to identify skill needs and act strategically to raise general skill levels. **Budget 2002 therefore announces additional funding of £30 million for the Department for Education and Skills to encourage small organisations to reach the IiP standard.** The LSC will work with the CBI-TUC Productivity Group and others, building on the joint LSC and IiP UK action plan, to ensure that small organisations are supported in a way that meets the needs of both employees and employers as effectively as possible. Further details will be announced shortly.

Migration

3.82 Recruiting staff from overseas can be a valuable tool for employers facing skill shortages in the UK, and the Government has therefore taken action to reform the work permit and immigration systems. Work permits now last for up to five years, rather than four, and processing times have fallen significantly, with more than 95 per cent of complete applications processed within 24 hours of receipt. Procedures have also been revised to make it easier for overseas students to obtain permission to work in the UK on graduation.

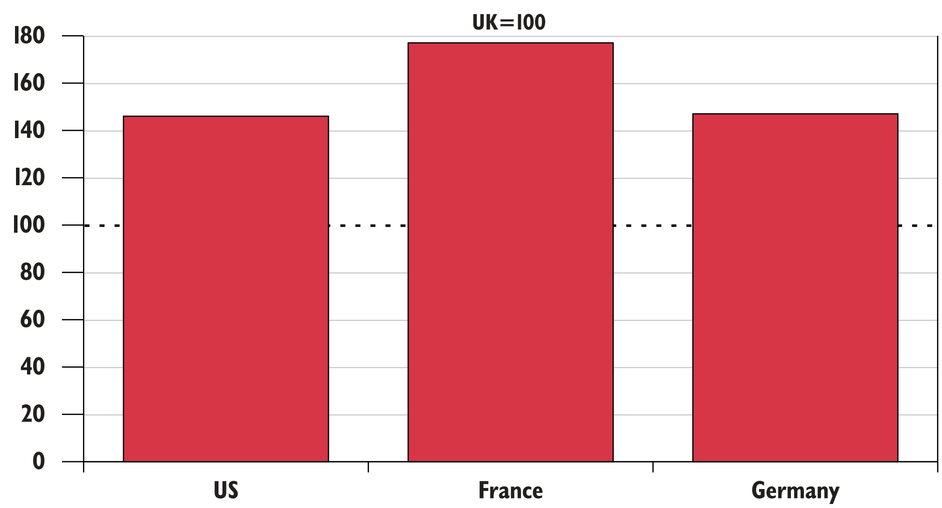
3.83 To support employers further in their efforts to recruit highly skilled staff, a new Highly Skilled Migrant Scheme was launched on 28 January 2002. The scheme enables highly skilled individuals to come to the UK without a specific job offer. Applicants can demonstrate their eligibility for the scheme through educational qualifications, work experience, achievements in their field or past income. The Government will keep the scheme under review to ensure that it continues to operate as effectively as possible.

Management **3.84** The CBI-TUC investment working group highlighted the importance of management and leadership skills in helping companies to grow and raise productivity. The Council for Excellence in Management and Leadership (CEML) is due to publish its final report to the Government in May, with recommendations to 'ensure that the UK is able to develop the managers and leaders of the future to match the best in the world'. The Government will respond to these recommendations in due course.

INVESTMENT

3.85 Economic theory and empirical evidence both suggest that physical capital is closely linked to productivity growth and performance. As a result of long-term under-investment, the UK today is significantly less capital intensive than its major competitors, contributing to the productivity gap.

Chart 3.4: Relative capital per worker, 1999



Source: O'Mahony and de Boer, 2000

3.86 A stable macroeconomic environment is essential to help business plan and undertake long-term investment projects. But to establish the conditions for future sustained increases in investment, action is also needed to address market failures at the microeconomic level. The Government is therefore introducing targeted reforms designed to remedy these failures and help to reverse Britain's legacy of under-investment.

Planning **3.87** An effective planning system is vital for successful investment decisions in a modern economy. In December 2001, the Government published a Green Paper on planning reform, setting out proposals to improve the speed, flexibility and responsiveness of the current system. The Government will set out its final proposals in the summer and take forward legislation as soon as parliamentary time allows.

The Myners review of institutional investment **3.88** The Myners review of institutional investment in the UK was published in March 2001. In October 2001, the Government confirmed that it would take forward all of the recommendations of the review, including revised Codes of Investment Principles to encourage diversity in investment approaches. In March 2003, the Government will conduct an assessment of the effectiveness of these principles in delivering change.

3.89 Following the Myners review, the Government published three consultation documents on 4 February 2002, covering proposed legislation on:

- pension scheme trustees: pension funds' investment decisions are of vital importance to the future security of their members and to the health of the wider economy. Trustees therefore need to increase the skills and resources they bring to the job;
- shareholder activism: the review found a culture of non-intervention among UK institutional investors. The Government proposes to introduce a duty for trustees and fund managers to intervene in companies, where it is in the beneficiaries' interests; and
- independent custodians: the review proposed increasing pension fund members' security by requiring funds to have an independent custodian.

The Minimum Funding Requirement

3.90 In March 2001, the Government also published proposals to replace the Minimum Funding Requirement (MFR) with a long-term, scheme-specific, funding standard based on transparency and disclosure, and introduce additional measures to strengthen security. Implementing these proposals will require primary legislation, and the Government has set up a consultation panel with representatives from the pensions industry and other interested parties to assist with this process. In February 2002, the Government announced an interim package of changes that will improve the operation of the MFR in the period leading up to its replacement and increase protection for pension scheme members where an employer decides to wind up a scheme voluntarily.

The Sandler review of retail savings

3.91 In June 2001, the Government appointed Ron Sandler, former CEO of Lloyd's of London, to conduct a review of the long-term savings industry. The review is examining the markets for medium and long-term savings products purchased by retail customers, identifying the competitive forces and incentives that drive the industries concerned and analysing potential policy responses. The review will report to the Government in summer 2002. The Government's wider strategy for promoting saving and asset ownership is described in Chapter 5.

Corporate governance and non-executive directors

3.92 The Company Law Review, published in July 2001, drew attention to a growing body of evidence from the US suggesting that companies with a strong contingent of non-executives produce superior performance. Building on the work of the Myners and Company Law Reviews, including the Government's recent proposals to strengthen the duties of institutional investors, the Chancellor and the Secretary of State for Trade and Industry have therefore appointed Derek Higgs to lead an independent review of the role and effectiveness of non-executive directors in the UK. A consultation document will be published in due course. The review will assess:

- the population of non-executive directors in the UK – who they are, how they are appointed, and how they can be drawn from a wider pool of talent;
- the independence and effectiveness of non-executives, including the role of the Combined Code;
- the actual and potential relationship between non-executives and institutional investors; and
- what more could be done – by individual boards, institutional investors or government – to strengthen the quality, independence and effectiveness of UK non-executive directors.

4 INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

The Government's long-term employment goal is to ensure a higher proportion of people in work than ever before, by the end of the decade.

Worklessness is a constraint on Britain's economic growth potential and one of the most important causes of poverty and deprivation. To advance its long-term goal the Government is tackling structural weaknesses in the labour market, extending New Deal support to disadvantaged jobseekers and improving work incentives. Budget 2002 takes forward this comprehensive programme of reform by:

- introducing a new **Working Tax Credit** from April 2003 to help tackle poor work incentives and persistent poverty among working people. On its introduction, the Working Tax Credit will guarantee minimum incomes of:
  - £183 a week for a single earner couple without children, aged 25 and over and working full time on the minimum wage; and
  - £237 a week for a family with one child and one earner working full time on the minimum wage.
- increasing the **basic credit in the Working Families' Tax Credit, and the couple and lone parent credit in the Disabled Person's Tax Credit,** by £2.50 a week from June 2002, to further improve work incentives;
- **extending the New Deal 25+** in pilot areas on a mandatory basis to jobseekers who have been unemployed for a total of 18 months over the previous three years;
- introducing **mandatory Gateway to work courses** for all jobseekers on the New Deal 25+ in London, Manchester, Dundee and Swansea;
- introducing a new **mentor service** to provide advice and support for lone parents seeking to enter work, and **extending mandatory personal adviser meetings** to all lone parents on Income Support with children under five;
- **extending eligibility for the childcare tax credit** to those who use approved childcare in their own home, and introducing **dedicated childcare coordinators** in every Jobcentre plus district; and
- launching a dedicated **£5 million per annum fund to enable Action Teams to support transport solutions** in areas where travel is a barrier to work.

INTRODUCTION

4.1 The Government is determined to extend employment opportunity more widely than ever before. The strength of the economy depends on the number of people in work and how productive they are. For the majority of individuals and their families, employment is also the single most effective means of avoiding poverty, both now and in the future. The Government has therefore set itself an ambitious long-term goal to sustain a higher proportion of people in work than ever before.

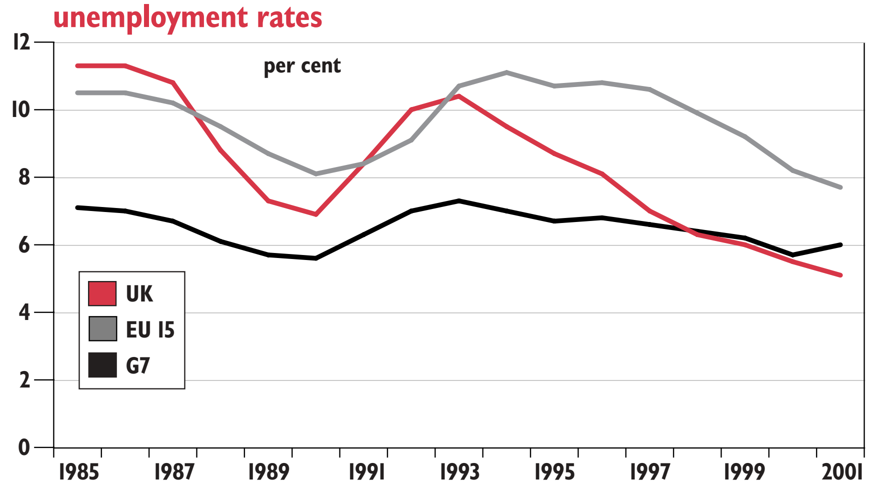
4.2 Macroeconomic stability is a prerequisite for achieving the Government's goal. But stability alone does not ensure employment opportunity for all. For this, it must be supported by microeconomic reforms to improve the functioning of the labour market – tackling structural unemployment, improving work incentives and addressing the specific problems faced by particular groups or local areas. The Government's strategy for delivering higher employment therefore comprises:

- Welfare to Work policies that prevent unemployed people from becoming detached from the labour market and help the long-term unemployed and inactive achieve a successful return to work;
- targeted measures to assist those areas and groups that face the most serious barriers to work, helping to re-attach the economically inactive to the labour market and ensuring that employment opportunity is spread fairly throughout the country; and
- reforms to strengthen work incentives and ensure that individuals are rewarded for moving into, and progressing within, employment.

Delivering employment opportunity for all

4.3 This strategy has helped to deliver a stronger and more flexible labour market that has been better able to respond to pressures in the international economy. UK labour market performance in recent years compares favourably with previous periods, and is strong by international standards. Despite recent weakness in the global economy, unemployment is low and falling. The claimant count measure has stayed below one million for the first time since the mid-1970s, while International Labour Organisation (ILO) unemployment is the lowest among the major industrialised nations for the first time since the 1950s. There are also more people in work than ever before, with employment levels 1½ million higher today than in spring 1997.

Chart 4.1: UK, G7 and European Union ILO unemployment rates



4.4 The Government's New Deal programmes have also delivered structural improvements in the labour market, helping to reduce long-term and youth long-term unemployment and to address the barriers to work faced by many disadvantaged groups, including lone parents and the over 50s. For example:

- long-term and youth long-term unemployment have both fallen by more than three quarters since 1997;
- the employment rate of lone parents has risen above 50 per cent for the first time in more than 20 years; and
- since spring 1997, employment has risen and unemployment fallen in every UK region.

4.5 Yet despite this significant progress, employment opportunities remain unequal. The employment rates of lone parents, the over 50s, ethnic minorities and people with disabilities all remain below the national average, while certain deprived areas continue to endure unacceptably high levels of worklessness. In this Budget, and in the forthcoming Spending Review, the Government is therefore taking further steps to advance its long-term employment goal, assisting all groups and regions in the labour market.

Box 4.1: Promoting employment opportunity across Europe

As well as extending employment opportunity at home, the UK is promoting labour market reform in the European Union (EU). The Lisbon (March 2000) and Stockholm (March 2001) European Councils both put jobs at the heart of the EU's agenda, setting ambitious employment targets which reinforced the EU's long-term goal of "full employment - opportunity for all". Since Lisbon, substantial progress has been made:

- **5 million new jobs have been created across the EU;**
- **the EU employment rate has increased to 63.9 per cent in 2001, compared with 59.8 per cent in 1995; and**
- **the proportion of people living in workless households has fallen from 4.5 per cent to 4.1 per cent.**

Notwithstanding these improvements, the EU still has a long way to go to achieve its goals. The Barcelona European Council, in March this year, reaffirmed the EU's commitment to reinforcing labour market reform. The challenge is a considerable one, but underpins EU aims for social justice.

The Barcelona Council emphasised the importance of the Luxembourg Process, which will be reviewed this year. The aim of the review must be to link the European Employment Strategy more closely with the Lisbon agenda, encouraging Member States to develop tailored solutions to national problems, while providing support through a non-legislative process of peer review, benchmarking and best practice.

The EU needs labour markets which foster job creation, while maintaining decent standards in work. An EU endeavouring to raise its productivity must also concentrate on the flexibility of its labour force. This flexibility encompases geographical and occupational mobility and skills, as well as the ability of wages and working hours to adjust to different economic circumstances; and it applies to employers as much as employees. The Government believes that further work to improve the flexibility of European labour markets is the best route to ensuring job creation across the EU and provides the best possible safeguard against social exclusion.

TACKLING UNEMPLOYMENT

4.6 For most people who become unemployed, worklessness is a short-term experience. Around 75 per cent of Jobseeker's Allowance (JSA) claims end within six months, and over 90 per cent end within one year. Those who do not return to work rapidly are, however, at much greater risk of prolonged disadvantage. The Government's Welfare to Work strategy is therefore designed to tackle long-term unemployment, equipping people with the skills and opportunities they need to find and remain in work, and ensuring that they do not become detached from the labour market while out of work.

Tackling long-term unemployment

4.7 All newly unemployed jobseekers attend mandatory fortnightly interviews with Jobcentre advisers, to ensure they keep in touch with the labour market. After six months a variety of more intensive help becomes available. For many, this provision is sufficient to secure a return to work.

New Deal

4.8 For those who experience greater difficulty in returning to work, the New Deal provides additional support to increase long-term employment prospects. The New Deal for young people (NDYP), for 18 to 24 year olds, and the New Deal for those aged 25 and over (ND25+) offer intensive support for young and older long-term unemployed people. Both programmes provide tailored support from personal advisers, and can include help with jobsearch, opportunities to build and improve basic skills, training and subsidised employment.

4.9 These New Deal programmes have already helped to deliver substantial reductions in the numbers of long-term unemployed, more than achieving the Government's targets for the last Parliament. To date, more than 350,000 long-term unemployed 18 to 24 year olds have found jobs through NDYP, while ND25+ has helped over 90,000 older long-term unemployed people back into work.

Building on the New Deal 25+

4.10 Following success within NDYP, the Government now **plans to extend a more intensive approach to the Gateway period of New Deal 25+**. Operating in London, Manchester, Dundee and Swansea – covering a number of the country's most disadvantaged areas – this provision will help to address the needs of those who have been out of work for some time, as well as those who have been made redundant and are facing difficulties in re-entering the labour market.

4.11 The Government is also addressing the needs of jobseekers who have experienced repeat spells of unemployment, and are therefore at particular risk of becoming long-term unemployed. To test the effectiveness of offering New Deal help earlier to this group, the Government is **introducing mandatory pilot schemes to extend eligibility for ND25+ to all jobseekers who have been unemployed for a total of 18 months over the previous three years,** rather than 18 of the previous 21 months. Pilots will identify eligible individuals at their six month Restart interview.

Employment Zones

4.12 Employment Zones (EZs) are testing an alternative approach to helping long-term unemployed people aged 25 and over find work, and early evidence is encouraging. Currently operating in 15 disadvantaged areas of England, Scotland and Wales, EZs allow jobseekers and their personal advisers to make more flexible use of the funds available to overcome individual barriers to work.

Over 50s

4.13 While their overall employment position has improved in recent years, at 68 per cent the employment rate of people aged between 50 and state pension age remains below the national average for all people of working age. Introduced throughout the country in 2000, the New Deal for the over 50s (ND50+) offers a package of personal advice, help with job search and in-work training and support. Additional financial support for the first year in work (currently delivered through the Employment Credit) will from 2003 be delivered as part of the Working Tax Credit. By the end of January 2002, over 61,000 people had found new jobs through the ND50+ programme, and evidence suggests that 42 per cent of claimants would not have taken the job they are in without the Employment Credit.

Rapid Response Service

4.14 Although all areas will naturally experience and absorb some flows in and out of work, some local economies and local labour markets can suffer long-term damage when redundancies occur. Areas with existing high unemployment, or that are heavily dependent on one industry, are particularly at risk. The Rapid Response Service (RRS) brings together the Job Transition Service and the Rapid Response Fund to enhance support in these areas. The RRS aims to prevent long-term damage by offering flexible help which reflects the needs of individuals, employers and the local economy.

HELPING THE INACTIVE

4.15 High levels of economic inactivity are a waste of human resources and a constraint on Britain's economic strength. Tackling the causes of inactivity is central to the Government's strategy for delivering employment opportunity for all.

4.16 At the time of the Pre-Budget Report, the Government published a detailed analysis of the current state of inactivity in the UK[1]. There are currently more than $7^3/_4$ million people of working age who are economically inactive – neither working, nor looking for work – around half of whom are on benefits. These people are less likely to move into work than the unemployed, and are more likely to suffer long-term poverty. A disproportionate number of the inactive are found in particular groups in the population, including lone parents and the long-term sick and disabled. To help integrate the inactive into the labour market, the Government is working to overcome the barriers to participation faced by these groups and is implementing a step change in the level of work-focused support provided to all inactive benefit claimants.

Jobcentre Plus

4.17 In April 2002, the Government launched Jobcentre Plus, a new organisation bringing together the Employment Service and those parts of the Benefits Agency dealing with working age people. Jobcentre Plus delivers for the first time an active, work-focused service to all benefit claimants of working age, both unemployed and inactive. Anyone making a claim for benefit at a Jobcentre Plus office will receive an interview with a personal adviser to discuss the opportunities available for taking up work, and have access to job vacancies, information, advice, training and support. This balancing of rights and responsibilities is at the heart of the Government's strategy of work for those who can, and security for those who cannot.

4.18 Jobcentre Plus is already operational in 56 offices, and the Government has an ambitious plan for national extension. As announced in March 2002, **a further 225 new Jobcentre Plus offices will be rolled out between October 2002 and April 2003,** delivering a work-first approach to 1.4 million benefit claimants, including 400,000 people on inactive benefits.

Help for lone parents

4.19 The Government recognises the difficult choices faced by lone parents seeking to balance work and caring responsibilities and is offering a range of practical assistance to all those who might benefit. The overwhelming majority of lone parents do want to work, and helping them find employment is key to reducing child poverty. The Government has therefore set a target for 70 per cent of lone parents to be in work by 2010, compared with just over 51 per cent in 2000.

[1] *The Changing Welfare State: employment opportunity for all*, HM Treasury and the Department for Work and Pensions, November 2001.

New Deal for lone parents

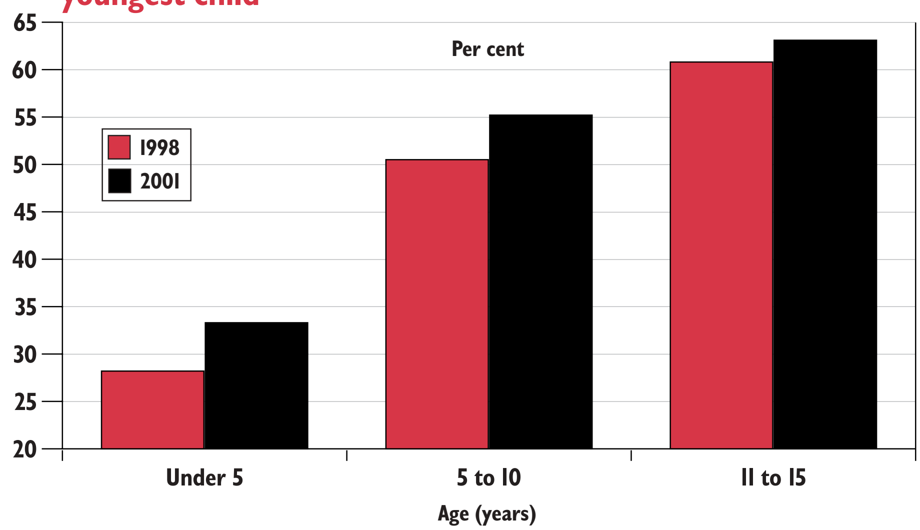
4.20 The New Deal for lone parents (NDLP) provides a comprehensive package of support, including a personal adviser, help with training, education and childcare, and advice on benefits, in-work financial support and self-employment. By the end of January 2002, over 315,000 lone parents had participated in the New Deal and over 145,000 had found employment.

4.21 Budget 2001 introduced steps to ensure that lone parents are informed about the help and support available to them. A new advisory and outreach service has begun extending information to lone parents across the country – especially to those living in isolated communities – and lone parents on Income Support with children over the age of five are required to attend regular personal adviser interviews.

4.22 **The requirement to attend personal adviser meetings is now being extended to all lone parents on Income Support with children under the age of five**. This will build on the recent improvement in the employment rates of lone parents with young children, and ensure that all lone parents with new or existing Income Support claims are subject to the personal adviser regime.

4.23 In addition following the success of recent pilots, **the Government will start to introduce a mentoring service for lone parents.** Mentors will be able to provide confidential support and advice to lone parents on a wide range of issues, increasing the help available to lone parents seeking to make the transition into work.

Chart 4.2: Employment rate of lone parents by age of youngest child



Assistance with childcare

4.24 For many working families, and for lone parents in particular, a lack of suitable and affordable childcare is a major barrier to employment. The Government is committed to helping families balance their work and caring responsibilities, while ensuring that the only childcare it funds is safe, good quality care. The childcare component of the Working Families' Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC) provides generous support to assist with the costs of approved childcare, and already benefits over three times the number of families that received the Family Credit childcare disregard at its peak. This assistance will continue as part of the Working Tax Credit from April 2003.

4.25 The Government is introducing changes to improve support for, and satisfy the needs of, more working parents. **From April 2003, eligibility for the childcare tax credit element of the Working Tax Credit will include those who use approved childcare in their own home,** benefiting families who need home-based care, such as those with disabled children or parents who work outside conventional hours. The Department for Education and Skills (DfES) is to consult shortly on a scheme to regulate childcare in the parent's home.

4.26 The Department of Health will be introducing regulations covering domiciliary workers and nurses' agencies. **Childcare regulated under these schemes will be eligible for the childcare tax credit from April 2003**, allowing more families to receive help with childcare costs. The DfES is also considering schemes to cover childcare provided in schools, and for children over the age of seven. The devolved administrations are responsible for developing their own systems of regulation and, where appropriate, care regulated through these systems will be eligible for the childcare tax credit.

4.27 To ensure that jobseekers with children and their personal advisers have access to information on childcare provision in their area, Budget 2002 also announces that **from April 2003 there will be a dedicated childcare coordinator in every Jobcentre Plus district.** Lone parents may also receive financial assistance through the Adviser Discretion Fund, where up-front childcare costs represent a barrier to moving into work.

National Childcare Strategy

4.28 The Government's National Childcare Strategy aims to help childcare providers meet the growing demand for affordable, accessible and good quality care. Around 538,000 children have already benefited from extra childcare places created between April 1997 and September 2001. By March 2004, around one million children will have benefited from additional places in England alone. To improve childcare provision in disadvantaged areas, the 2000 Spending Review also provided resources for the Neighbourhood Childcare Initiative, which is funding 45,000 new day care places in Neighbourhood Nursery Centres. The first Neighbourhood Nurseries are opening in the coming months.

4.29 To build on the measures in place, the Government is undertaking a cross-departmental review of childcare to inform the 2002 Spending Review. The review aims to deliver a ten year vision and strategy for childcare, taking into account its contribution to employment, education and quality of life.

Help for partners

4.30 Workless households today account for a large and growing share of unemployment. In couples where one partner is unemployed, the probability of the other partner being in work is greatly reduced. This is also the case for working age partners of the economically inactive: where the head of a household is inactive, the likelihood of the other partner being in work is less than 40 per cent. These households, the majority of which include children, are mostly in poverty.

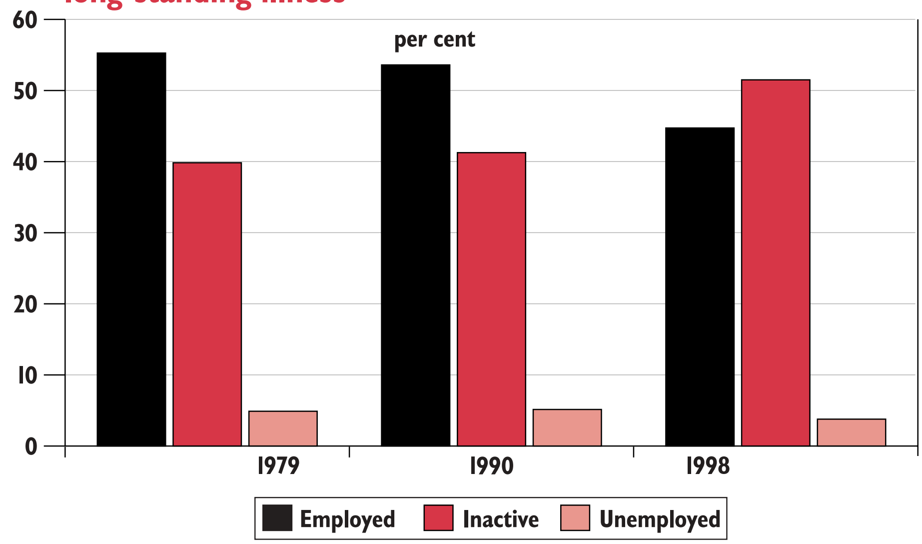
New Deal for partners

4.31 The Government is targeting additional support on these households through the New Deal for partners – a personal adviser service for dependent partners of benefit claimants. Since April 2001, childless partners of the unemployed, where at least one partner was born after 1976, have become joint Jobseeker's Allowance claimants. As announced in Budget 2001, **from October 2002, joint claims will be extended to all childless partners of the unemployed where at least one partner was born after 1957.** To ensure that all partners of benefit claimants are offered the help and support they need to return to work, the Government is also currently legislating to **introduce annual work-focused interviews for partners of benefit claimants with children, in line with those being provided for lone parents.**

Help for people with disabilities

4.32 People with disabilities or long-standing health problems who drop out of employment risk becoming detached from the labour market and suffering persistent worklessness. The same is true for those who develop disabilities while in work. Over the last 20 years, the inactivity and employment rates of people with disabilities have deteriorated compared with those of the working age population as a whole. Although there has been no corresponding deterioration in health, the number of people claiming incapacity-related benefits has more than doubled and now stands at 2.7 million. Chart 4.3 shows the rise in inactivity and fall in employment among people reporting a limiting long-standing illness, compared with previous peaks in the economic cycle.

Chart 4.3: Economic status of people reporting a limiting long-standing illness



4.33 The Government is determined to help those who can work to find employment. As Jobcentre Plus rolls out, more disabled people will be offered an active, work-first service that focuses on what they can, rather than cannot, do. This approach is supported by new permitted work rules, which enable people on Incapacity Benefit (IB) to try small amounts of work, and move closer to the labour market, without losing their benefit. Since 1 April 2002, IB recipients have been allowed to undertake up to 12 months of permitted work, for up to 16 hours a week, and earn up to £66 each week.

New Deal for disabled people

4.34 The New Deal for disabled people (NDDP) provides a gateway to engage those moving onto Incapacity Benefit and a network of innovative job brokers to help disabled people move into employment. Following the success of regional trials, the NDDP was extended to all areas of the UK in 2001. More than 30,000 people have participated in the programme, including pilots, and over 10,000 of these have been helped into jobs.

Support in work

4.35 To help disabled people already in employment, **the Government will also be testing the effectiveness of retention and rehabilitation schemes from late 2002.** These pilot schemes will assess the impact of early interventions in support of workers at risk of losing their job through sickness or disability. From 2003, disabled people in work will also receive specific financial support through the Working Tax Credit rather than the Disabled Person's Tax Credit. The rates for the Working Tax Credit (set out later in this chapter) mean that the guaranteed minimum income for a single disabled person working 35 hours a week on the minimum wage will rise by over £21 per week to £194.

Help for people with low skills

4.36 Significant numbers of jobseekers and lone parents have levels of basic skills which disadvantage them in the labour market. The Government has a number of initiatives to improve the levels of adult basic skills, including screening for lone parents when they enter the New Deal. The Government would like to develop these approaches further, including in the light of evidence from alternative approaches piloted with Jobseeker's Allowance claimants.

TACKLING REGIONAL WORKLESSNESS

4.37 Despite the strong labour market performance of recent years, within every region there remain localised pockets of high worklessness and deprivation. These areas have failed to share in the rising national prosperity that economic stability has brought.

4.38 Local authority districts that suffer from low employment rates do not simply lack jobs. Many are found alongside other districts with large numbers of vacancies or jobs, while many more contain a high proportion of people with multiple barriers to work. For these clients, the national New Deal programmes may not be sufficient to address their needs. The Government's goal of full employment in every region therefore requires policies to address the barriers which prevent local people from taking local jobs, as well as additional support for the most disadvantaged groups.

Action Teams

4.39 To tackle the obstacles to employment in some of the worst affected areas, the Government has established Action Teams in 63 areas of England, Scotland and Wales. Action Teams focus their resources on the long-term unemployed and the economically inactive, working closely with employers to identify suitable vacancies and match them with clients, and using their resources in innovative ways to overcome specific local barriers to work.

StepUP

4.40 In other areas, the Government is piloting a new scheme which builds on the New Deal experience of disadvantaged jobseekers to enable them to compete more effectively in the labour market. Announced by the Secretary of State for Work and Pensions in November 2001, StepUP will support these jobseekers as they move quickly into transitional employment. Placements will last for a maximum of 12 months and be tailored according to the needs of the local labour market. **Twenty StepUP pilots across the whole of the UK are now planned, with the first six in operation by the end of April 2002.**

Transport

4.41 Even in areas with substantial numbers of vacancies, people can remain out of work for long periods because their expectations regarding travel to work are limited. The Government is committed to enforcing the obligations on jobseekers that form part of the Jobseeker's Agreement, and claimants have a responsibility to make reasonable efforts to travel to work. In return, the Government is helping to widen jobseekers travel-to-work horizons, by:

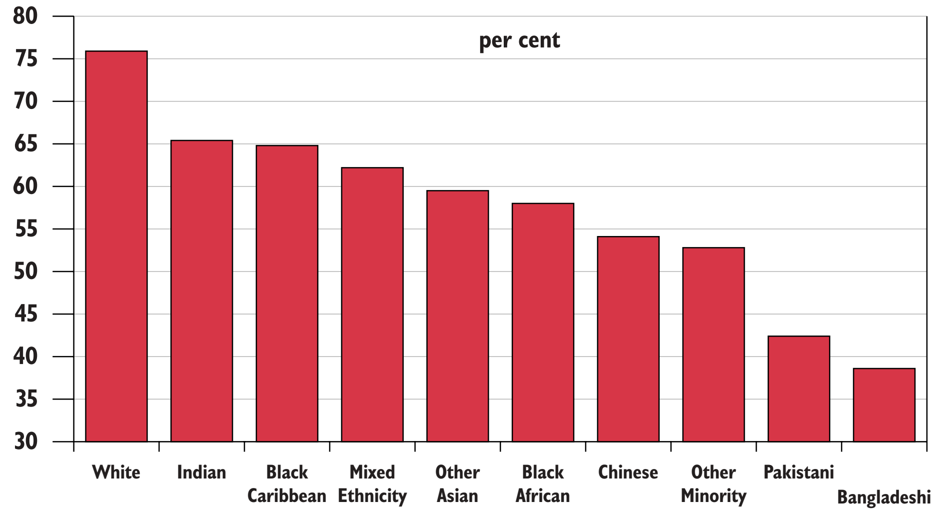
- **launching a dedicated £5 million per annum fund to enable Action Teams to support transport solutions in areas of acute deprivation where travel is a barrier to work;**
- **expanding personalised travel planning services in Jobcentres,** including by exploring electronic access, to help jobseekers find out how to get to jobs; and
- a review of bus subsidies, described in Chapter 7, to ensure they support the needs of disadvantaged areas and groups.

4.42 In addition to these targeted reforms, the Government has also launched a ten year Plan for Transport, backed by significant and sustained resources, to reverse years of under-investment and deliver a better and more reliable nationwide transport system.

Ethnic minorities

4.43 The labour market position of ethnic minority groups tends to be worse than that of the rest of the population. Unemployment rates among ethnic minorities can be up to three or four times higher, while employment rates are also significantly lower.

Chart 4.4: Employment rates by ethnic origin



Source: Labour Force Survey, Spring 2001

4.44 The Government is already taking steps to address the difficulties faced by ethnic minority groups. Many members of these groups live in disadvantaged areas currently being targeted by Action Teams, which have the flexibility to respond to the specific barriers to work their clients face. In addition, tailored outreach programmes are being introduced in four main areas – Greater London, West Yorkshire, Greater Manchester and the West Midlands – to help ethnic minorities access the range of support available to them.

4.45 The Cabinet Office Performance and Innovation Unit (PIU) will report in summer 2002 on the labour market disadvantages faced by black and Asian people. The Government will propose further actions to address long-standing ethnic inequalities in the labour market in the light of recommendations contained in the PIU report.

Funding for Welfare to Work

4.46 As set out in the Pre-Budget Report, the majority of the Welfare to Work programme is now delivered by the Department for Work and Pensions (DWP). Expenditure plans and outturn information will be set out in the DWP annual report. In this Budget, and in future Budgets and Pre-Budget Reports, the Government will report on that element of the Welfare to Work programme funded by the one-off Windfall Tax, until such time as the Windfall Tax resources are exhausted.

Table 4.1: Allocation of the Windfall Tax

£million	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04[2]	TOTAL
Spending by programme[1]								
New Deal for young people	50	200	310	300	330	320	60	1570
New Deal for 25 plus	0	10	90	110	230	280	60	780
New Deal for over 50s	0	0	5	20	10	20	5	50
New Deal for lone parents	0	20	40	40	60	140	30	320
New Deal for disabled people[3]	0	5	20	10	20	60	10	125
New Deal for partners	0	0	5	10	10	30	5	60
Childcare	0	20	10	5	0	0	0	35
University for Industry[4]	0	5	0	0	0	0	0	5
Workforce development[5]	0	0	0	0	0	30	40	70
ONE pilots[6]	0	0	0	5	5	0	0	10
Action Teams	0	0	0	10	50	70	20	150
Enterprise Development	0	0	0	10	20	10	0	40
Modernising the Employment service	0	0	0	40	0	0	0	40
Total Expenditure	**50**	**260**	**480**	**550**	**710**	**960**	**220**	**3240**
Capital Costs[7]	**90**	**270**	**260**	**750**	**450**	**0**	**0**	**1830**
Estimated Windfall Tax Margin								**130**
Windfall Tax receipts	**2600**	**2600**						**5200**

[1] *Rounded to the nearest £10 million, except where expenditure is less than £5 million. Constituent elements may not sum to totals because of rounding.*
[2] *Windfall Tax expenditure is significantly reduced in 2003-04 as Windfall Tax resources are exhausted. Remaining in year expenditure will be topped up with general Government revenues.*
[3] *Includes £10 million in 1999-00, an element of the November 1998 announcements on Welfare Reform.*
[4] *Start up and development costs. Other costs of the UfI are funded from within Departmental Expenditure Limits.*
[5] *Includes workforce development pilots budgeted to cost £40 million, of which £25 million will come from Windfall Tax, with the remaining £15 million provided by the DfES. Profile of expenditure may be subject to change. The Windfall Tax also provides £30 million to encourage more small organisations to reach the Investors in People standard.*
[6] *Funding for repeat interviews. Other funding comes from the Invest to Save budget.*
[7] *Includes New Deal for schools – capital spending on renewal of school infrastructure, to help raise standards.*

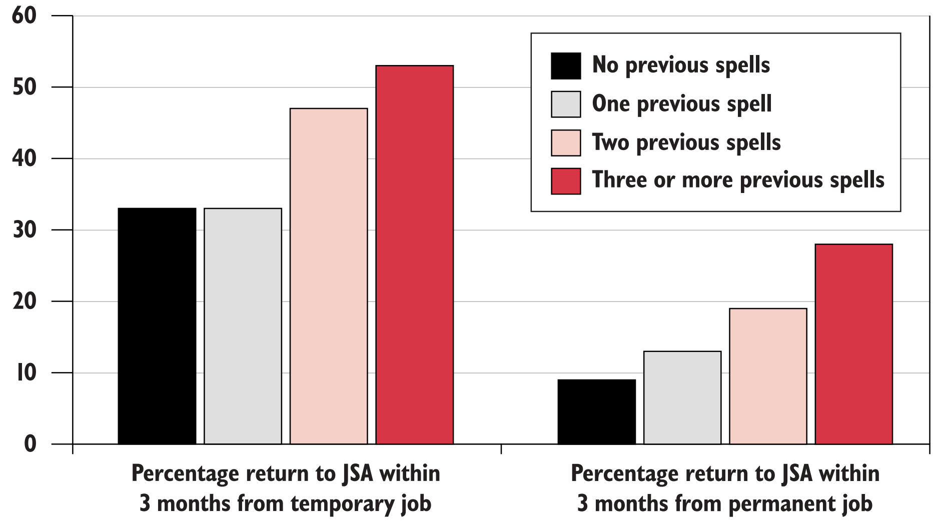
EASING THE TRANSITION TO WORK

4.47 The transition into work can be a difficult period, especially for those who have been out of work for long periods. Entry wages are typically lower than for those already in employment, and there are often additional difficulties in adjusting to work. A smooth transition to work improves the prospects of individuals remaining in employment, and progressing beyond entry-level jobs.

Retention and advancement

4.48 Some people continually move between low-paid work and unemployment, enduring a 'low pay, no pay' cycle. Around 25 per cent of people who leave Jobseeker's Allowance return to benefits within three months, and almost 40 per cent return within six months. The wages that people return to work on are also typically lower than for those already in work.

Chart 4.5: Percentage returning to JSA from work within three months, by number of previous spells on JSA



4.49 Budget 2001 announced a demonstration project to explore how best to improve job stability and advancement among low paid workers and those moving off welfare. The design phase is now underway and further announcements will be made in the autumn about the next stages of the project. The project will explore a range of interventions, such as post-employment support from a personal adviser and other instruments.

Housing Benefit

4.50 Housing costs are of particular concern to many people moving into work. Evidence suggests that worklessness is concentrated among tenants, especially those in social housing, and around 3.8 million low-income tenants still rely on Housing Benefit for help with their rent. Easing the return to work for tenants is therefore an important strand of the Government's strategy for delivering higher employment.

4.51 A number of recent reports, including the Housing Green Paper[2], have highlighted problems associated with Housing Benefit. Delays in processing claims can make it difficult for tenants to be sure that they will be better off in work and can lead to rent arrears and debt, thereby reducing work incentives.

4.52 The Government has taken a number of steps to alleviate these administrative problems, working with local authorities and other organisations to improve administration, restructuring rents in the social sector to inform the choices tenants make about their homes, and moving 800,000 people off Housing Benefit through higher employment and higher in-work support. Housing Benefit will cost almost £1 billion less in real terms in 2002-03 than in 1996-97. The Government is now considering what further action is needed to improve the administration of Housing Benefit as part of the 2002 Spending Review and is continuing to examine the case for longer term reform.

[2] *Quality and Choice: a decent home for all*, DETR, April 2000

MAKING WORK PAY

4.53 An individual's decision about whether and how much to work depends greatly on their household's gain from that work. The Government's reforms to help improve work incentives are designed to tackle two key problems:

- the unemployment trap, when those without work find that the difference between in- and out-of-work incomes is too small to provide an incentive to take a job; and

- the poverty trap, when those already in work may be discouraged from working longer hours or taking a better paid job because it may leave them little better off.

4.54 The Government is committed to tackling these problems by ensuring that work pays more than welfare and by improving incentives to move up the earnings ladder. The Government also wants to improve the choices faced by families seeking to balance work and family responsibilites.

National Minimum Wage

4.55 The National Minimum Wage, introduced in April 1999, ensures fair minimum standards of pay, and underpins the Government's tax and benefit reforms. In October 2001, the National Minimum Wage was increased to £4.10 an hour for workers aged 22 and over and to £3.50 an hour for workers aged between 18 and 21. **As announced by the Secretary of State for Trade and Industry on 15 April, these rates will be increased to £4.20 and £3.60 respectively in October 2002.**

Making work pay for all

4.56 The Government has introduced a series of reforms to help make work pay at all levels of the labour market, but especially for those on low incomes. At 22 pence, the basic rate of income tax is at its lowest level for 70 years, while the 10 pence starting rate of income tax has halved the marginal tax rate of nearly two million low earners since it was introduced in 1999. Reforms to national insurance contributions (NICs) in the last Parliament mean around one million low earners no longer pay any NICs at all, while retaining entitlement to contributory benefits.

Equal pay

4.57 The Government is also committed to driving forward action on equal pay. The Kingsmill review of Women's Employment and Pay reported to the Government in December 2001. The Government welcomes the report, which examines non-legislative and cost effective measures to deliver improvements in women's employment prospects and participation in the labour market.

4.58 To tackle problems of pay discrimination, and ensure that those affected receive proper redress, the Government is taking a number of steps, including:

- encouraging public and private sector employers to conduct pay reviews, simplifying them by promoting the Equal Opportunities Commission's pay review model and the revision of the Equal Pay Code. It is also supporting best practice through Fair Pay Champions and the Castle Awards;

- speeding up and simplifying the employment tribunal process to provide more effective settlement of pay disputes; and

- demonstrating best practice itself. As part of the Modernising Government programme, departments and agencies will carry out reviews of their pay systems by April 2003 and prepare action plans to reduce pay gaps which reflect gender, race or disability.

Additional targeted support

4.59 To improve work incentives for families with children, the Working Families' Tax Credit (WFTC) was introduced in October 1999. Nearly 1.3 million families are now receiving WFTC – over 450,000 more than received Family Credit at its peak. These families are on average receiving around £40 a week more than they would have under Family Credit. The WFTC also includes a generous childcare component to help working families with childcare costs, benefiting over three times the number of families that received the Family Credit childcare disregard.

4.60 The Disabled Person's Tax Credit (DPTC) was launched alongside the WFTC. The DPTC offers in-work support to people with disabilities who work 16 hours or more a week, and who are receiving, or have recently received, one of a number of qualifying benefits, or who satisfy the special rules which govern the "Fast-Track" route to DPTC. Over 32,000 people are currently receiving DPTC – over 70 per cent more than received Disability Working Allowance at its peak – and the number continues to grow.

The Working Tax Credit

4.61 As part of the next steps in tax and benefit reform, **from April 2003 the Government will be introducing two new tax credits: the Working Tax Credit and the Child Tax Credit.** Following the success of WFTC and DPTC, the Working Tax Credit is designed to help tackle poor work incentives and persistent poverty among working people. It will carry over the adult elements of WFTC and DPTC and extend in-work support to workers without children or disabilities. It will also replace the Employment Credit 50+ by including a return-to-work element for people aged 50 or over who have been receiving certain out-of-work benefits for at least six months.

4.62 The Government has consulted widely on the design of the Working Tax Credit and has considered carefully the responses it received. In the light of these responses it has decided that:

- entitlement to the Working Tax Credit will be based on annual income, in line with the Child Tax Credit and the rest of the tax system;
- eligibility will be extended to people aged 25 and over without children or a disability – those most likely to face poor work incentives or persistent poverty – who work 30 hours or more a week;
- those with children or a disability will be eligible for Working Tax Credit provided they work 16 hours a week or more. A 30 hour premium will be available to such couples with children who jointly work 30 hours or more a week, and to disabled workers who work 30 hours or more;
- the childcare element of the Working Tax Credit will be paid directly to the person with main responsibility for care of the children – usually the mother – alongside the new Child Tax Credit. This childcare element recognises the extra costs faced by working parents with childcare needs, mirroring arrangements in the WFTC and the DPTC; and
- the arrangements for payment of tax credit via the employer, including the application procedure for advance funding, will be simplified to help both recipients and employers.

4.63 **Budget 2002 announces the rates and thresholds that will apply to the Working Tax Credit from April 2003.** Details of the rates and thresholds are provided in Chapter A of the Financial Statement and Budget Report and are summarised in Table 4.2. The Working Tax Credit is described in more detail in the accompanying Budget paper, *The Child and Working Tax Credits*[3].

[3] *The Child and Working Tax Credits, The Modernisation of Britain's Tax and Benefit System, No. 10*, HM Treasury and Inland Revenue, April 2002

4.64 To improve work incentives further ahead of the new introduction of the Working Tax Credits, the **basic credit in the Working Families' Tax Credit, and the credit for couples and lone parents in the Disabled Person's Tax Credit, will rise by £2.50 a week from June 2002**, on top of the increases in line with indexation in April 2002.

Table 4.2: The principal elements of the Working Tax Credit

	2003-04 weekly amounts (£)
Basic element	29.20
Couple and lone parent element	28.80
30 hours element	11.90
Maximum credit for lone parents and couples	69.90
Childcare element	
–maximum eligible cost	*200*
–maximum eligible cost for one child	*135*
–percentage of costs covered	*70*
Income below which maximum Working Tax Credit is payable	97.00
Withdrawal rate (per cent)	37

The effect of the Government's reforms to make work pay

4.65 Building on the Government's personal tax and benefit reforms since 1997, and taking into account the changes to national insurance contributions and the income tax personal allowance announced in this Budget, the Working and Child Tax Credits advance the Government's aim of making work pay.

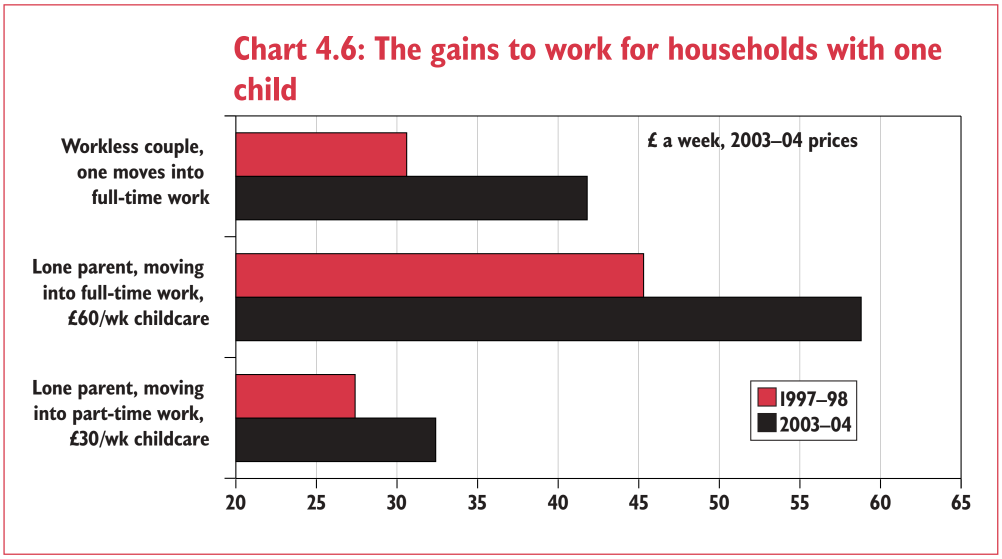
4.66 The Government guarantees a minimum level of income for parents moving into employment. These guaranteed minimum levels of income are set out in Table 4.3, for a family with one child and one person working at the National Minimum Wage.

Table 4.3: Minimum incomes for working families

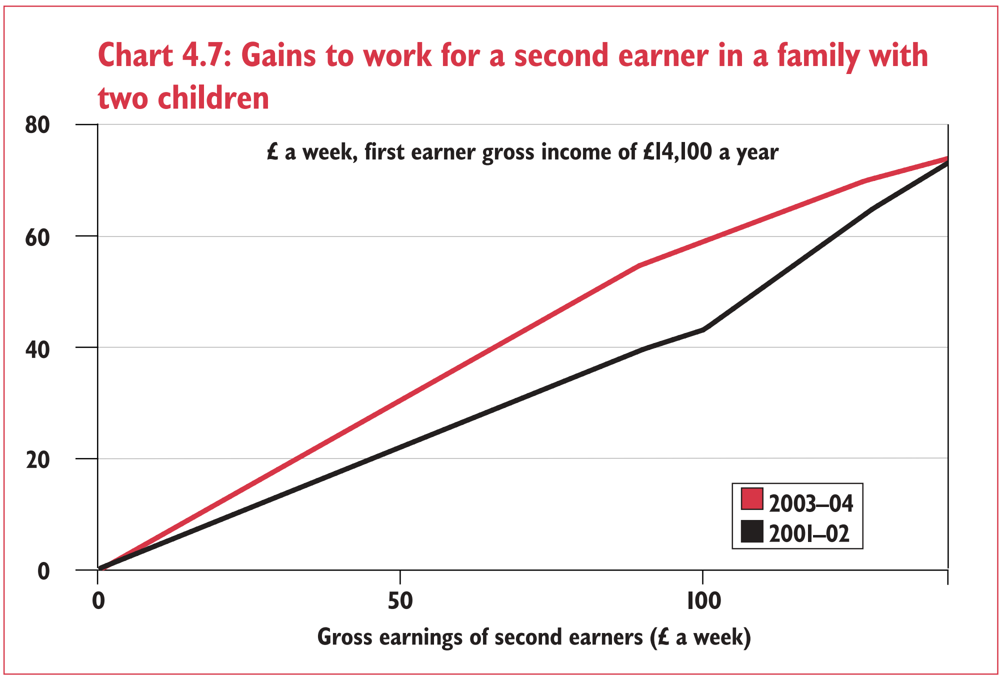
£ a week	October 01	April 02	April 03
Family working 35 hours with one child	225	227	237
Family working 16 hours with one child	166	167	179

Note: Assumes prevailing rate of National Minimum Wage and that family is eligible for Working Families' Tax Credit and Working Tax Credit/Child Tax Credit

4.67 The Government's reforms are helping to ensure that work pays more than welfare, addressing the problem of the unemployment trap. The gain to work has increased, while security for those out of work has been maintained and enhanced. Chart 4.6 shows how the gains to work have improved for different households as a result of measures since 1997.



4.68 The new tax credits will also improve the financial rewards to work for the non-working partner in a single earner couple. This is, in part, a result of withdrawing the new tax credits on the basis of gross rather than net income. Chart 4.7 shows how the gains to work for a second earner (where the first earner is on half average earnings of £14,100) will improve under the new tax credits. At typical entry wages, the gain to work for a second earner taking a part-time job will have increased by around £14 a week.



4.69 These measures have also helped to lessen the poverty trap. Many low income families, who often face very high marginal deduction rates, now keep more of each additional pound that they earn, losing less through reduced benefits and higher taxes. In 1997, almost 750,000 families faced marginal deduction rates of over 70 per cent. As a result of measures introduced by the Government, this number has fallen by nearly half a million.

Table 4.4: The effects of the Government's reforms on high marginal deduction rates

Marginal deduction rate [1]	Before Budget 1998[2]	2002-03 tax and benefits system[3]	After introduction of new tax credits[4]
Over 100 per cent	5,000	0	0
Over 90 per cent	130,000	45,000	45,000
Over 80 per cent	300,000	210,000	200,000
Over 70 per cent	740,000	255,000	260,000
Over 60 per cent	760,000	940,000	1,450,000

[1] *Cumulative figures for working households in receipt of income-related benefits or WFTC (new tax credits from 2003).*

[2] *Based on 1997–98 caseload and take-up estimates.*

[3] *Based on 1999–2000 caseload and take-up estimates.*

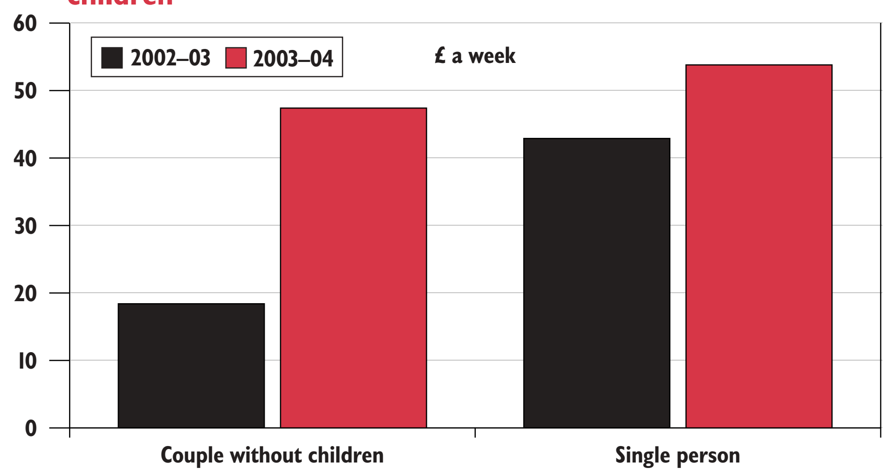
[4] *After Budget 2002 including new tax credits, based on 1999–2000 caseload and take-up assumptions.*

4.70 This analysis does not take into account the way in which the new tax credits will respond to rises in income, described in detail in *The Child and Working Tax Credit*. The new tax credits only respond to rises in income in the current year of more than £2,500, disregarding the first £2,500 of any rise. This means that recipients will not see their tax credits reduced as soon as their income rises, so reducing the effective marginal deduction in any one year.

Support for workers without children

4.71 Making the Working Tax Credit available to all those aged 25 and over and without children will also help to improve work incentives for this group. Chart 4.8 shows how the gain to work at typical entry wages will be improved by the Working Tax Credit.

Chart 4.8: Gains to work for people aged 25 or over without children



Note: the gain to work is the difference between in-work incomes (net wages and tax credits) and out of work benefits.

4.72 The Working Tax Credit complements the National Minimum Wage by increasing the guaranteed minimum income in work of people without children moving into work. These guaranteed minimum levels of income are set out in Table 4.5. For a couple without children, the minimum income in work under the Working Tax Credit is equivalent to a National Minimum Wage of £5.25 an hour.

Table 4.5: Minimum income for someone aged over 25 in work

£ a week	April 02	April 03
Couple (one earner)	130	183
Single person	130	154

Note: Assumes the individual works 35 hours at the National Minimum Wage

Support for workers with disabilities

4.73 The Working Tax Credit will bring people with disabilities into the same system of support as other workers. Payments will be made for each individual who qualifies, improving work incentives for the second disabled earner in a couple. The basic payment for a single worker will be £68.35 per week from April 2003, around £5 more than would be payable under the DPTC.

4.74 From April 2002, the DPTC, with the minimum wage, guarantees a minimum weekly income of £172 for a single person in full time work. With the Working Tax Credit this will rise by over £20 to £194 a week. Table 4.6 shows the Minimum Income Guarantees for a single person with an illness or a disability, but without children, working at the National Minimum Wage.

Table 4.6: Minimum income guarantee for a single person working with a disability or illness

£ a week	October 01	April 02	April 03
Working 35 hours	170	172	194
Working 16 hours	126	127	135
Working 35 hours with a severe disability	236	239	267
Working 16 hours with a severe disability	192	194	209

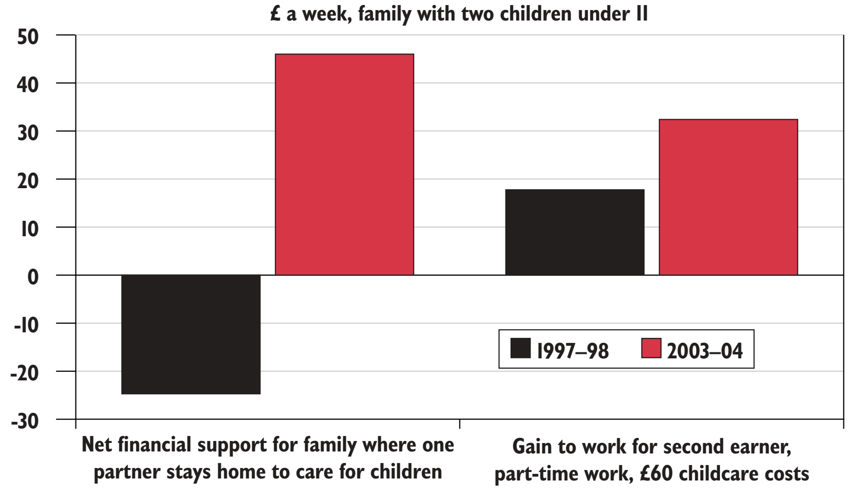
Note: Assumes prevailing rate of National Minimum Wage, that worker is eligible for Disabled Person's Tax Credit/Working Tax Credit, and that worker with severe disability is receiving higher rate care component of Disability Living Allowance.

Improving the choices for working families

4.75 The Government's reforms have already eased the burden on parents seeking to balance work and childcare, making it easier for one parent in a couple to remain at home to care for their children. Reforms to the structure of support, including the introduction of the new tax credits, improve the financial returns to work for parents seeking to re-enter employment.

4.76 Chart 4.9 shows the effects of the Government's reforms on a family with two children under 11 in which the main earner has an income of half average earnings (£14,100), and one parent remains at home to care for the children. Under the 1997–98 tax and benefit system, the family would have paid £25 more in income tax and NICs than they received in benefit. In 2003-04, a family making the same choice would receive around £40 a week in net financial support. The gains to work, if that parent chooses to work part-time, will have increased by 80 per cent.

Chart 4.9: Support for families' choices over balancing work and caring



Note: net financial support equals tax credits (Family Credit in 1997-98) plus Child Benefit less income tax and National Insurance Contributions.

4.77 The new tax credits will provide help with childcare costs to families further up the income distribution. For example, a family with two children, maximum childcare costs and an income of £35,000 a year can, as a result of the Working Tax Credit and Child Tax Credit, receive up to £50 a week in financial support. This reflects the Government's approach to helping families with children: providing support to all families, while offering the greatest help to those who need it most. The Government's wider strategy for supporting families, and tackling child poverty, is described in the next chapter.

5 BUILDING A FAIRER SOCIETY

The Government is committed to building a fairer and more inclusive society in which everyone can contribute to, and benefit from, rising national prosperity. Budget 2002 continues the Government's work to tackle child poverty, provide security for pensioners, encourage saving, tackle global poverty and promote a modern and fair tax system. To realise its goals in these areas, the Government is:

- introducing a new **Child Tax Credit** from April 2003 to provide a single, seamless system of income-related support for families with children;
- increasing the **child allowances in Income Support and Jobseeker's Allowance** by £3.50 a week from October 2002 to reduce further the number of children in poverty in advance of the new Child Tax Credit;
- confirming the comprehensive package of support for pensioners announced in the Pre-Budget Report, including guaranteed increases in **the basic state pension**, a new **Pension Credit** from 2003, and **winter fuel payments** of £200 a year for each year of this Parliament;
- increasing the **income tax personal allowance for 65 to 74 year olds** in 2003-04 to £6,610, ensuring that no pensioner aged 65 or over will pay tax on income of less than £127 a week;
- **modernising the annuities market** to increase the choice for consumers and help to ensure that annuities provide a secure income in retirement;
- launching **Saving Gateway pilot projects** in four pilot areas from August 2002 to promote a regular savings habit among low-income groups;
- introducing a **new tax credit to promote research and development into drugs and vaccines** for diseases threatening lives in the world's poorest countries;
- **closing loopholes in stamp duty on property**, modernising the current regime and ensuring it applies fairly to all relevant transactions;
- making important changes to the **North Sea tax regime** and modernising the **taxation of foreign companies' branches in the UK**;
- taking further steps to ensure a **fair system of alcohol and tobacco taxation**;
- providing further support through the tax system for **community amateur sports clubs and charities**, and to encourage charitable donations; and
- implementing a range of **measures to tackle indirect tax fraud and unfair tax avoidance**.

INTRODUCTION

5.1 Previous chapters have set out how the Government is helping to deliver a strong and stable economy, based on high and stable levels of growth and employment and faster productivity growth. This chapter describes how the Government is working to ensure that economic strength is underpinned by fairness and social inclusion so that every individual has the chance to fulfil their potential, regardless of their circumstances or where they live.

A modern welfare state

5.2 Since 1997, the Government has placed welfare reform at the heart of its strategy for promoting fairness and inclusion. A modern welfare state is the means to ensure that everyone in society has an equal chance to share in rising national prosperity.

5.3 Although the world has changed greatly since Beveridge published his vision in 1942, the principles which underpin the welfare state remain those of:

- **opportunity** for people to improve their circumstances and the circumstances of their families;
- **security** to protect people from undue hardship that can arise from life events; and
- **responsibility** of everyone to themselves, their families and society to make the most of opportunities, for example through employment.

5.4 The old welfare system was failing on many counts. It was passive and reactive, delivering poor quality, fragmented services. Welfare benefits were seen as being mainly for the poor, and were stigmatising as a result. High marginal rates of withdrawal of benefits meant that people did not always see much gain from moving into work or increasing their hours. Vulnerable groups, notably children, were left behind as others benefited from rising living standards.

5.5 The new welfare system puts into practice the principles of progressive universalism, giving everyone a stake in the system while offering more help to those who need it most. Modern, high quality, integrated services, such as Jobcentre Plus and the Pension Service, will offer active advice and support, tailored to people's circumstances. Where appropriate, financial support will be delivered through the tax system, reducing stigma. Fewer families suffer from very high marginal deduction rates when they move into work or increase their hours; and there is a renewed focus on children and pensioners.

5.6 This chapter describes how the Government is applying these principles of welfare support to help families with children and tackle child poverty, deliver security for pensioners and tackle pensioner poverty, and provide help for people with disabilities. It also sets out the Government's wider strategy for building a fairer society – supporting saving and asset ownership, strengthening community life, and establishing a modern and fair tax system – and explains how the Government is leading international efforts to achieve the Millennium Development Goals.

SUPPORT FOR FAMILIES AND CHILDREN

The challenge of child poverty

5.7 The Government's aim is for every child to have the best possible start in life. Over the past two decades, while the economy has grown, the proportion of children living in low-income households has risen sharply. Those living in poorer neighbourhoods have often had to cope with the worst public services too, including education, health and housing.

5.8 Tackling childhood disadvantage is particularly important because childhood experience lays the foundations for later life. Children growing up in low-income households are more likely than others to have poor health, perform badly at school, experience unemployment as adults or earn lower wages. The Government is therefore committed to halving child poverty by 2010 and abolishing it within a generation.

5.9 The Government's strategy was set out in the 2001 Pre-Budget Report document, *Tackling child poverty: giving every child the best possible start in life*. The strategy has four main elements:

- **helping to ensure a decent family income**, with work for those who can and support for those who cannot;
- **delivering excellent public services** in all neighbourhoods, and targeted interventions for those with additional needs;
- **support for parents** so that parents can provide better support for their children; and
- **harnessing the power and expertise of the voluntary and community sectors**, promoting innovation and good practice.

Financial support for families with children

5.10 The Government is committed to helping families with children through the tax and benefit system. Its approach is based on two principles:

- providing financial support for all families with children, recognising the costs and responsibilities which come with parenthood; and
- offering more help to those who need it most, when they need it most. This includes families on lower incomes, and those with children under one.

5.11 Over the course of the last Parliament the Government introduced a range of measures to help provide decent family incomes, including:

- record increases in Child Benefit, with a 26 per cent real terms rise for the first child. Child Benefit is now worth £15.75 a week for the first child and £10.55 for subsequent children;
- the introduction of the Children's Tax Credit in April 2001 as a replacement for the Married Couple's Allowance. The Children's Tax Credit is worth up to £10.17 extra a week for around 4.6 million families;
- the introduction of the Working Families' Tax Credit (WFTC) which benefits nearly 1.3 million families – over 450,000 more than previously received Family Credit. On average, these families are now receiving £40 a week more under WFTC than under Family Credit; and
- increasing the children's allowances in Income Support and other income-related benefits, raising rates for children under 11 by 80 per cent in real terms.

5.12 As described in Chapter 4, the Government has also taken action to improve the affordability, accessibility and quality of childcare, improving the choices faced by parents seeking to balance work and childcare responsibilities.

Support in the early years of a child's life

5.13 The birth of a child places considerable financial pressure on families. Families on low incomes face particularly difficult and restricted choices about how to support their children in the early months.

5.14 In the past, the tax and benefit systems failed to provide adequate support for people with very young children. Financial help has been insufficient and not available quickly enough after the birth of a child. To help new parents on low incomes, the Government is therefore introducing a range of measures, including:

- an increase in the Children's Tax Credit to £20.17 a week for families in the year of a child's birth from April 2002;
- an increase in the flat rate of Statutory Maternity Pay (SMP) and Maternity Allowance to £75 a week from April 2002 and then **to £100 a week (or 90 per cent of previous earnings if that is lower) from April 2003**. In addition, **the period of maternity pay will be extended, at this enhanced rate, from 18 to 26 weeks from April 2003**. Good maternity provision enables mothers to spend the crucial first months with their babies and eases the return to work afterwards;
- **granting working fathers the right to two weeks of paid paternity leave, paid at the same flat rate as SMP, from April 2003**. This will enable working fathers to spend more time with their partner and new child;
- **granting low-paid fathers access to Income Support for the duration of their paternity leave**. From April 2003, Income Support will be extended to low-paid fathers on paternity leave who are not entitled to statutory paternity pay. Those who do receive statutory paternity pay will also be able to claim Income Support if they are normally low paid. This will provide low-paid fathers with the level of benefit support available to parents taking parental leave;
- **introducing paid adoption leave from April 2003 to support adoptive parents in the vital first months after adopting a child**. This will be paid for the same period and at the same flat rate as SMP, starting when the child is first placed with the family. Adoptive parents will be able to choose which of them takes adoption leave. The other parent will be able to take two weeks' paid paternity leave;
- doubling the threshold for Small Employer Relief to £40,000 from April 2002, ensuring that around 60 per cent of all firms paying SMP each year can reclaim their costs in full, plus a percentage on top in compensation. **Small Employer Relief will also apply to statutory paternity and adoption pay from their introduction in April 2003**; and
- an increase in the Sure Start Maternity Grant to £500 from April 2002 – five times the level in 1997 – which will benefit over 200,000 families each year.

New tax credits

5.15 **From April 2003 the Government is introducing a new system to support families, tackle child poverty and make work pay**. The system will separate support for adults from support for the children in a family, while providing a common framework for assessing entitlement:

- **the Child Tax Credit**, will provide a single system of support, integrating all the existing, income-related elements of support for children; and
- **the Working Tax Credit**, discussed in detail in Chapter 4, will extend the principle of in-work support to those without children or a disability.

The two new tax credits are described in more detail in the accompanying Budget paper, *The Child and Working Tax Credits*[1].

The Child Tax Credit

5.16 Income-related support for families is currently provided through several different instruments and is administered by different parts of government. Parents also receive different levels of financial assistance for children depending on whether they are in or out of work.

5.17 The Child Tax Credit will provide a single, seamless system of income-related support for families with children. Building on the foundation of universal Child Benefit, it will bring together the assistance for children currently provided through the child elements of the WFTC, the Disabled Person's Tax Credit (DPTC), and Income Support or Jobseeker's Allowance, as well as the existing Children's Tax Credit. It will provide:

- a secure stream of income for families with children which does not depend on the employment status of the parents, creating a stable income bridge when families move into work. It will also extend eligibility to people who are currently excluded from all but Child Benefit, such as students and student nurses;
- a system in which all support for children is paid direct to the main carer, usually the mother, in line with Child Benefit;
- greater transparency, bringing together all income-related child payments into a single, payable tax credit, administered by the Inland Revenue;
- a common framework for assessment, so that all families are part of the same system and poorer families do not feel the stigma associated with the current forms of support;
- a less intrusive, annual system, under which families whose circumstances remain the same will only need to contact the Inland Revenue about tax credits once a year;
- a modern income test, which rewards and does not penalise saving, taking into account the income from capital rather than the capital itself; and
- a more responsive system, in which a family's tax credit award can be adjusted to reflect changes in a family's income and circumstances.

5.18 **Budget 2002 announces the rates and thresholds that will apply to the Child Tax Credit from April 2003**. Full details of the rates and thresholds are provided in Chapter A of the Financial Statement and Budget Report and are summarised in Table 5.1.

[1] *The Child and Working Tax Credits: The Modernisation of Britain's Tax and Benefit System, No. 10*, HM Treasury and Inland Revenue, April 2002.

5.19 To reduce further the numbers of children living in poverty, Budget 2002 **increases the child allowances in Income Support and Jobseeker's Allowance by £3.50 a week from October 2002,** aligning the rates for families with children in and out of work in advance of the Child Tax Credit in April 2003. In addition, **from April 2003, the rates of Child Benefit will rise in line with indexation to at least £16.05 and £10.75 respectively**.

Table 5.1: The principal elements of the Child Tax Credit and Child Benefit

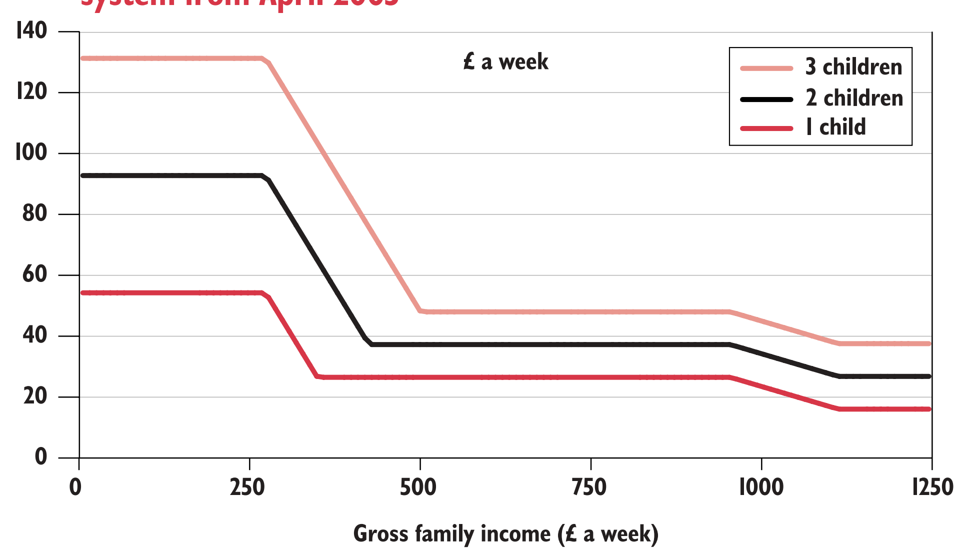
	2003-04 weekly amounts	
	First child	For each subsequent child
Child Benefit	£16.05	£10.75
Child Tax Credit		
– family element	£10.45	
– child element	£27.75	£27.75
Maximum support	£54.25	£38.50

5.20 As shown in Table 5.1, the Child Tax Credit will build further on the progress made so far. Paid on top of Child Benefit, the Child Tax Credit will provide:

- a family element of £10.45 a week for all families with incomes of less than £50,000, gradually withdrawn for families with incomes above this amount; and
- a child element of £27.75 a week for each child or young person for families with incomes of up to £13,000 a year, gradually withdrawn for families with higher incomes. From April 2004, the child element will be uprated at least in line with earnings rather than prices for the rest of the Parliament.

5.21 Chart 5.1 shows the level of support that families will receive from the Child Tax Credit and Child Benefit from April 2003. While all families receive some support, more financial help is offered to those who need it most.

Chart 5.1: Support for children through the tax and benefit system from April 2003



5.22 Table 5.2 shows the weekly levels of support that the Child Tax Credit and Child Benefit will guarantee families from April 2003.

Table 5.2: Guaranteed levels of support for families from April 2003

Annual family income	less than £13,000	less than £50,000	All families
Proportion of families (per cent)	*25*	*85*	*100*
1 child	£54.25	£26.50	£16.05
2 children	£92.75	£37.25	£26.80
3 children	£131.25	£48.00	£37.55

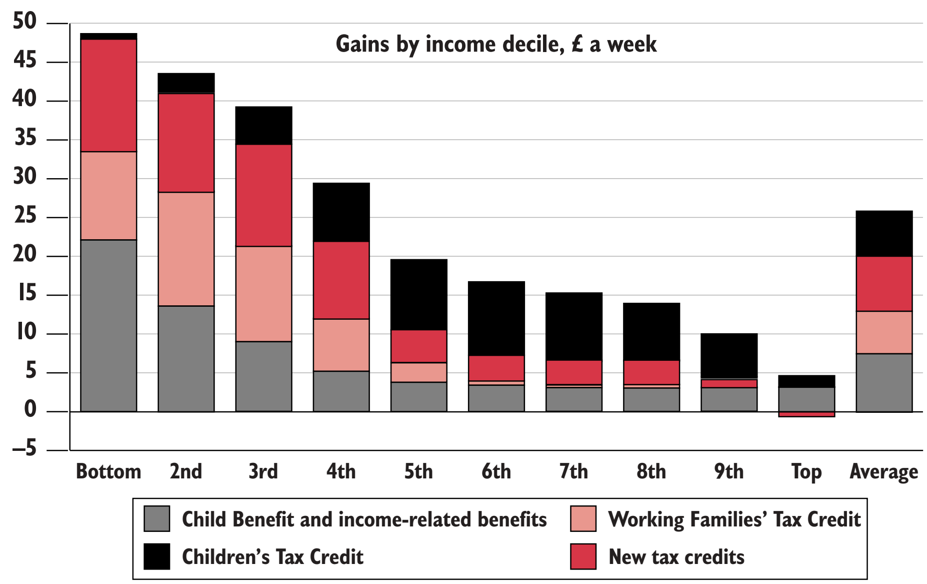
Effects of measures to increase support for families with children

5.23 As a result of the Government's personal tax and benefit reforms since 1997, including the changes to national insurance contributions and the income tax personal allowance announced in this Budget, by April 2003:

- families with children will be, on average, £1,200 a year better off, while those in the poorest fifth of the population will be, on average, over £2,400 a year better off in real terms;
- a single-earner family with two young children on half average earnings of £14,100 will be £3,490 a year better off in real terms; and
- a single-earner family on average earnings of £28,200 and with two children will be £310 a year better off in real terms.

5.24 Chart 5.2 shows the impact of the Government's reforms since 1997, including the introduction of the new tax credits, by decile on families with children.

Chart 5.2: Gains for families as a result of children's measures by 2003



Box 5.1: The Child Tax Credit and the child poverty ambition

The Government's long-term goal is to halve child poverty by 2010 and to abolish it within a generation. The new Child Tax Credit is central to the Government's strategy for achieving this objective.

The Government assesses the impact of its tax and benefit policies on low-income households compared with what would otherwise have happened if the Government had done no more than index 1997 policies to prices[1]. This enables the Government to estimate the full impact of Budget measures, aside from wider economic and demographic changes. The figures below comprise both:

- **a reduction in the number of children in relative poverty; and**
- **the number of children who would otherwise have fallen into relative poverty, as median real income and earnings rise.**

Effects of personal tax and benefit reforms announced since 1997

	50 per cent of median income	60 per cent of median income	70 per cent of median income
Number of children in households lifted above low-income thresholds, compared with a 1997 indexed regime	2.2 million	1.5 million	0.8 million

Note: Estimates are for the full year impact when all measures up to 2003-04 have been introduced. Incomes are measured after housing costs and include the self-employed. Thresholds are on a contemporary year basis.

These assessments are complemented by a target which reflects all economic and demographic changes: the Public Service Agreement set in the 2000 Spending Review, to reduce the number of children in contemporary low-income households by a quarter by 2004 compared with 1998-99. This requires action to ensure that the benefits of reforms introduced during the last Parliament are sustained as the economy grows, as well as additional steps to raise low incomes. By 2000-01 the number of children in households below 60 per cent of contemporary median income had fallen by 0.3 million compared with 1998-99 and by 0.5 million compared with 1996-97, even though the 2000-01 figures do not reflect the full effect of all measures announced to date.

Against an absolute line, there have been significant real gains for low-income families, with the number of children below the 1996-97 60 per cent median income line, fixed in real terms, falling by 1.4 million between 1996-97 and 2000-01.

[1] The methodology is similar to that used in independent research. See, for example, David Piachaud and Holly Sutherland, *Journal of Social Policy*, Volume 30, 2001.

5.25 The Government's annual report on poverty and social exclusion *Opportunity for All*[2] monitors progress against a range of indicators, including family income and services. The Department for Work and Pensions will be publishing a consulation document on how best to build on the Government's existing indicators to measure child poverty in the long term, seeking views on a range of approaches proposed by academics and poverty experts from the UK and overseas.

[2] *Opportunity for All: Making Progress*, Cm5260, September 2001.

Public Services to tackle child poverty

5.26 Strong and dependable public services are essential to tackle both the underlying causes of poverty and deprivation and their effects. As described in Chapter 6, the Government is committed to building world class public services throughout the country and is delivering significant and sustained increases in investment in priority areas, including health, education and housing. This section explains how the Government is providing targeted public services to tackle child poverty.

Sure Start

5.27 Sure Start aims to promote the physical, intellectual and social development of pre-school children. Managed through local partnerships between parents, private and voluntary organisations and statutory services, over 430 Sure Start programmes have now been announced, of which more than 250 are operational. By March 2004, 500 programmes will be operating across the country, reaching 400,000 children and around one third of young children living in poverty.

Children's Fund

5.28 The 2000 Spending Review announced £450 million for a new Children's Fund over the three years to 2003-04. The Children's Fund has two elements – the Prevention Fund and the Local Network Fund. The Prevention Fund is being used to support Children's Fund partnerships which provide improved, coordinated local services for children at risk of social exclusion and their families. Some 77 Children's Fund partnerships have now received full or partial approval for their plans and the first grant payments were made in October 2001. The partnerships will be rolled out across the country by 2003-04.

5.29 The Local Network Fund – £70 million over three years – is being distributed directly to community groups through a network of local funds to support projects for children in local communities. These local funds are already operating in 34 areas and a further 13 areas will begin to benefit from April 2003, ensuring that funds will be available in all Local Network areas.

Education Maintenance Allowances

5.30 Education is a crucial influence on a child's life chances. A decent education builds employment opportunity and enhances the well-being of people throughout their lives. Compared with their peers, those 16 to 18 year olds who do not participate in education, training or employment are, as adults, more likely to earn less in work, to experience depression, to be in poor physical health and to have a criminal record; all acting as barriers to employment.

5.31 In recognition of the financial barriers which prevent some young people continuing in education, the Government has introduced Education Maintenance Allowances (EMAs) to enable young people from poorer families to pursue education beyond the age of 16. EMAs are now being piloted in one third of Local Education Authorities.

5.32 Initial evidence from the pilot programme suggests that EMAs are delivering positive results. Educational participation has increased, on average, by 5 percentage points among those eligible for support. Young people from the poorest families have shown the strongest results, with participation among this group increasing by 7 percentage points. The impact appears to have been greatest among young men.

5.33 While these early signs are encouraging, success can only be determined by considering the impact of EMAs on retention and achievement. The Government will continue to review the performance of EMAs over the longer term, as reiterated in the 2001 Pre-Budget Report, and will consider whether EMAs should eventually replace Child Benefit for young people over 16 years of age.

Box 5.2: Women and welfare reform

The Government is determined to create opportunities for all. This includes helping women into work, supporting mothers and providing security for older women, through:

- **the new tax credits, which will improve choices for mothers, supporting couples with one earner and improving work incentives for second earners. The Child Tax Credit and childcare tax credit element of the Working Tax Credit will be paid to the main carer – usually the mother. Couples with children who both work will be able to combine their hours to get the 30 hour premium in the Working Tax Credit;**
- **enhanced maternity pay and leave, and the introduction of paid paternity leave, which will provide extra support for parents after the birth of their child, while enabling them to maintain attachment to the labour market;**
- **the childcare tax credit, which provides significant extra help for parents combining caring responsibilities with paid work, and the National Childcare Strategy which will have created additional places for one million children by March 2004. Budget 2002 announces support for parents using approved childcare in their own home and the introduction of dedicated childcare coordinators in every Jobcentre Plus district;**
- **the National Minimum Wage, which disproportionately benefits woman, and will be increased to £4.20 an hour in October 2002 for workers aged 22 and over; and**
- **the Pension Credit, which is specifically designed to target extra help on those with low and modest incomes or savings. Many of the poorest pensioners who stand to gain most from the Pension Credit are women; two-thirds of people entitled to the Pension Credit will be women.**

FAIRNESS FOR PEOPLE WITH DISABILITIES

5.34 The Government is determined to increase opportunities for people with disabilities to lead independent and fulfilling lives. The New Deal for disabled people (NDDP) is helping those who can and wish to work make a successful return to employment. From April 2003, the Working Tax Credit will continue to increase the gains to work for people with disabilities, replacing the existing help in the Disabled Person's Tax Credit. Both of these measures are described in more detail in Chapter 4.

5.35 The Government believes that people with disabilities who are unable to work should have financial security and support. The Disability Income Guarantee, introduced in April 2001, is ensuring that severely disabled people under 60 years of age and on income-related benefits now receive a guaranteed minimum income of at least £144.45 a week for single people, and £189.95 a week for couples. Reforms to Incapacity Benefit have also provided up to £28.10 a week extra for people who were disabled before the age of 20.

Support for families with disabled children

5.36 In recognition of the fact that families with disabled children often need extra help, the disabled child premium was increased in April 2002 by £5 a week on top of the normal uprating, to a new rate of £35.50. **In April 2003, it will rise again by £5 above inflation – to more than £40 a week on top of basic Income Support or tax credits**. This will benefit around 80,000 children and provide further help for families on low incomes, both in and out of work, with disabled children.

Support for people with high care needs

5.37 To help severely disabled people with high care needs, entitlement to the Independent Living Fund has also been improved. From April 2002, the earnings of disabled people and their partners have been disregarded completely, worth an average of £130 a week to those families. In addition, the capital limits have been raised, extending help to people with savings of up to £18,500.

5.38 Delivering fairness for disabled people also requires action beyond financial support. Discrimination, in the workplace and beyond, must also be prevented. Building on the establishment of the Disability Rights Commission in April 2000, the Government last year consulted on proposals to strengthen the Disability Discrimination Act (DDA)[3]. **The Government is also currently consulting on how to give force to the provisions of the Employment Directive[4], and proposes to make changes to the DDA in 2004**.

FAIRNESS FOR PENSIONERS

5.39 A fair society guarantees security for people in their old age. The Government is therefore committed to developing policies which enable pensioners to share in the country's rising prosperity and which tackle pensioner poverty. This means:

- offering extra financial support to the poorest pensioners through a minimum income guarantee;
- rewarding today's low and modest-income pensioners who have saved for their retirement through the new Pension Credit;
- helping all pensioners by guaranteeing a minimum increase in the annual basic state pension and providing additional help with the costs of winter fuel; and
- creating a sustainable system of support which enables today's workforce – tomorrow's pensioners – to plan ahead and make decent provision for their retirement, protecting themselves against poverty in the future.

Tackling pensioner poverty

5.40 The Government's first priority has been to help those in greatest need. The pattern of pensioner incomes today reflects that of the working age population. As with earners, the richest fifth of pensioners are now three times better off than the poorest fifth.

5.41 To ensure that more pensioners are able to share in rising national prosperity, the Government has reformed Income Support for pensioners, introducing a more generous Minimum Income Guarantee (MIG). **The level of the MIG will be raised in line with earnings throughout this Parliament.** Over two million pensioners currently benefit from this extra support and the Government is determined to promote further take-up. The introduction of the Pension Service in April 2002, and the Pension Credit from 2003, will encourage more people to claim the support to which they are entitled.

[3] *Towards Inclusion: Civil Rights for Disabled People*, Department for Education and Employment, March 2001.

[4] *Towards Equality and Diversity: Implementing the Race and Employment Directives*, Department for Trade and Industry.

Security for all pensioners

5.42 The Government is also committed to ensuring that all pensioners have security in retirement, not just the poorest. As well as providing targeted support to those who need it most, the Government has therefore:

- increased the basic state pension by more than inflation in each of the last two years. In April 2002, the full basic state pension was increased by £3 to £75.50 a week for single pensioners, and by £4.80 to £120.70 a week for couples;
- **guaranteed that the full annual basic state pension will rise by at least £100 for a single pensioner and £160 for pensioner couples in 2003-04. In future years the basic state pension will rise each year by 2.5 per cent or the increase in the September Retail Prices Index, whichever is higher;**
- introduced winter fuel payments, paid to around 11 million people aged 60 and over each winter. As announced in the Pre-Budget Report, **winter fuel payments will be maintained at £200 each year for the remainder of this Parliament**; and
- introduced free TV licences for households with someone aged 75 or over and free eye tests for all those 60 and over, benefiting pensioners, regardless of their income.

The Pension Credit: rewarding low and modest-income pensioners

5.43 The Government believes that there is more to do to tackle pensioner poverty and to ensure that pensioners share in rising economic prosperity. This means providing greater support, not only for the very poorest, but also for those on low and modest incomes.

5.44 As announced in the Pre-Budget Report, **the Government is introducing a new Pension Credit from 2003 at a cost of £2 billion in the first full year**. The Pension Credit represents a fundamental reform of the welfare system. It will bring pensioners' income up to a guaranteed minimum entitlement and ensure that millions of pensioners who have saved modest amounts – through an occupational scheme, a stakeholder pension, the State Second Pension or another means – will gain from having done so and be rewarded for their thrift and effort. In addition, the current MIG capital regime will be revised and the MIG's intrusive weekly means-test abolished for the vast majority of pensioners. People on Housing Benefit and Council Tax Benefit will also be protected to ensure that they receive the full benefit of the Pension Credit. The Pension Service will make it easier for pensioners to claim all their entitlements.

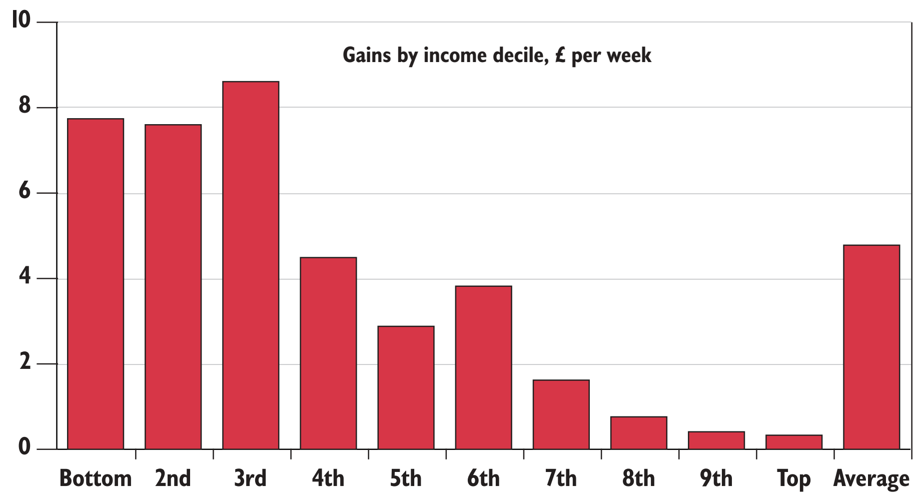
5.45 The guaranteed minimum entitlement in the Pension Credit will be linked to the growth in average earnings throughout this Parliament. As a result, all pensioners receiving the Credit will gain, year-on-year, a larger increase in support from the state than they would receive from an earnings link in the basic state pension. The poorest third of pensioners will be on average over £250 a year better off following the introduction of the Pension Credit than they would have been if the equivalent amount had been spent on raising the basic state pension.

5.46 Based on current assumptions about future growth in prices and earnings, and taking into account the further changes the Government has announced it will make, on its introduction in 2003 the Pension Credit will:

- reward pensioners whose savings, second pensions or earnings give them incomes of up to around £135 a week for single pensioners and £200 a week for couples;
- mean that no single pensioner need live on less than £100 a week and no pensioner couple on less than £154 a week;
- extend support to around half of all pensioner households; and
- provide on average around £400 extra a year to eligible pensioner households, with some gaining up to £1,000 a year.

5.47 Chart 5.3 shows the average gains by income decile in current prices as a result of the introduction of the Pension Credit.

Chart 5.3: Overall gains for pensioner families from the introduction of the Pension Credit

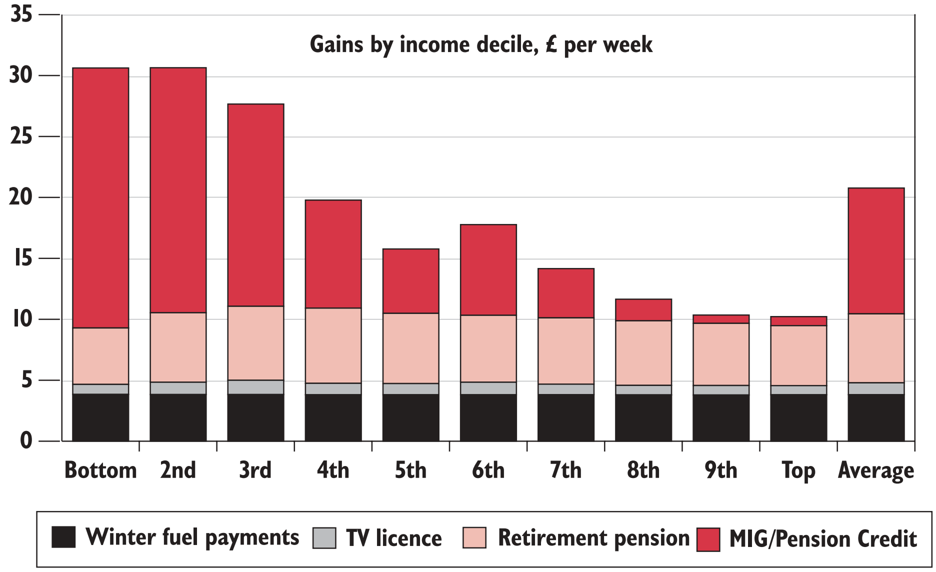


5.48 Taken together, these measures form a comprehensive package of support to tackle pensioner poverty and help all pensioners. Compared with the 1997 system, as a result of the Government's measures including the Pension Credit, on average:

- pensioner households will be over £1,150 a year better off in real terms – around £22.50 extra a week; and
- the poorest third of pensioner households will have gained over £1,500 a year in real terms.

5.49 Chart 5.4 shows the distributional impact, in current prices, of the Government's pensioner policies up to Budget 2002, including the Pension Credit.

Chart 5.4: Overall gains for pensioner families from pensioner policies



5.50 This financial year, the Government will be spending around £6 billion extra in real terms on pensioners as a result of policies introduced since 1997. This will ensure that the poorest third of pensioners receive an additional £2.5 billion – three times more than an earnings link in the basic state pension would have given them.

Support for pensioners who pay tax

5.51 In the same way that the Pension Credit will deliver year-on-year increases to low and modest-income pensioners, so the Government intends to help older taxpayers too. Most pensioners have no income tax to pay. But for those who do, **the age-related personal allowances will be raised in 2003-04 for those aged 65 to 74 to £6,610 and for those aged 75 or more by £240 a year more than the amount which would result from statutory indexation**. This will ensure that no pensioner aged 65 or over will pay tax on income of less than £127 a week. **Subsequently, the age-related allowances will be raised at least in line with earnings rather than prices for the remainder of this Parliament**.

SUPPORTING SAVING

5.52 The Government recognises the value of saving and asset-ownership in providing people with security, comfort in retirement and long-term independence and opportunity. To address the problems that may have discouraged saving in the past, it is working to improve the environment for saving, increase incentives to save, and ensure that people have the information and skills they need to make the right saving choices.

Saving for retirement

5.53 Helping people provide for financial security in old age – protecting future pensioners from the poverty and inequality that many of today's pensioners have had to bear – is a key aim of the Government's savings strategy. The Government is therefore providing today's workers with the opportunity to build up a decent second pension by the time they retire.

State Second Pension

5.54 The State Earnings Related Pension Scheme (SERPS) provides a second pension for those earning enough to pay national insurance contributions and who are not contracted out into an occupational or personal pension scheme. SERPS reform will provide more support in retirement than in the past for moderate and low-income workers, and for carers and the disabled. Some 18 million people stand to gain from the introduction of the State Second Pension in April 2002.

Stakeholder pensions

5.55 In addition, the launch of stakeholder pensions in April 2001 has extended the benefits of pension saving to previously excluded groups. Since 8 October 2001, employers with five or more employees that do not offer an employer's pension to all employees have been required to offer access to a stakeholder pension to eligible employees. This has made stakeholder pensions available through the workplace to the majority of those currently without a private pension.

5.56 A year after their introduction, stakeholder pensions have become established as a viable financial product. With over 50 stakeholder pension schemes now registered, the Government remains on track to meet its target of making stakeholder pensions widely available. By the end of February 2002, 320,000 employers had made stakeholder pension schemes available to their employees and over 750,000 individual stakeholder pensions had been sold.[5] Many of the schemes exceed the minimum requirements set by the Government, and low stakeholder pension charges have helped to exert a general downward pressure on pension charges.

[5] Figures up to 28 February 2002 calculated by the Association of British Insurers (ABI), 30 March 2002.

Box 5.3: Private pensions

Saving for a pension should be a key consideration for most individuals throughout their working lives. The need to save is much greater than in the past. People are living longer, so pensions have to go further than in previous generations. On average a 65 year old man retiring now can expect to live another 16 years – four years longer than his counterpart in 1961. In the last few decades there has also been a trend towards earlier retirement, with many people ending their working lives in their 50s. For most people, however, it may not be realistic to save enough in perhaps 30 years of work to support a good standard of living during another 30 years of retirement. Government, employers and individuals all need to look seriously at finding ways of encouraging people to save more of their earnings for retirement and extending working lives.

A number of employers have recently shifted from defined benefit to defined contribution pension schemes. Each has its advantages over the other. Depending on their circumstances, businesses and their employees will have reason to prefer either arrangement. However, the Government is concerned that a number of employers have taken the opportunity to reduce their pension contributions.

The Government's concern is to raise the level of saving for pensions by whatever means is most appropriate. Employees themselves have a responsibility to ensure that they are well informed about their own pension provision and the Government has introduced Combined Pension Forecasts to assist with this. Around 15 million employees should have received forecasts by April 2006, helping more people to decide whether they need to be saving more.

The Government has also set up three coordinated reviews, led by Alan Pickering, the Inland Revenue and Ron Sandler, to examine different aspects of pension provision. Respectively, these reviews are looking at:

- **simplifying the regulatory regime for private pensions;**
- **simplifying the taxation of occupational pensions, reducing administrative burdens and making pension provision easier to understand; and**
- **the operation of the market for long-term retail savings, including personal pensions.**

These reviews will produce proposals to encourage pension saving, reducing burdens on employers and providers, and to ensure consumers are well served by the long term savings market. The Government will consult on these proposals later this year. The aim will be to reduce complex regulation, improve information and education and consider what action the Government and employers might take to encourage employees to save towards their retirement. This will be an important step towards securing a decent standard of living in retirement for an ageing population.

Annuities **5.57** Annuities continue to provide a financially efficient and secure means of turning pension capital saved through defined contribution pension arrangements into income that lasts for the whole of an individual's retirement. As announced in the Pre-Budget Report, the Government has recently consulted on proposals to modernise the provision of annuities, in line with the principles of:

- where possible, increasing the level of retirement income that people can expect to gain through an annuity;

- ensuring that funds saved with the benefit of tax relief are used to provide a secure income in retirement and do not become a tax-favoured savings vehicle for non-pension purposes or a source of funding for non-retirement income; and
- contributing to the Government's aim of encouraging people to save more for their own retirement.

5.58 Following the Government's consultation exercise, it **plans to increase the choice available for consumers in the annuities market**. In particular, the Government will:

- work with providers of annuities to increase flexibility by allowing people who already have an annuity to change the terms of their contract with their existing provider - for example, from a flat annuity to an indexed annuity. This should provide extra flexibility for pensioners whose personal circumstances or preferences change; and
- consistent with the principles outlined above, bring forward powers to enable new generic kinds of annuity to be used to turn pension savings into retirement income, making it easier for companies to create innovative new products - for example, limited period annuities.

5.59 In addition, the Financial Services Authority (FSA) will shortly announce the results of last year's consultation on proposals to require pension providers to inform their personal pension customers as they approach retirement of their entitlement to purchase annuities from a different provider. The Government is continuing to work with the FSA to ensure that the market works effectively for individuals; in particular, that people have all the information and advice they need, delivered through the most effective channels, at the right time, to make the correct choice for them.

Improving incentives to save

5.60 The Government has consulted widely on two new targeted policies – the Saving Gateway and the Child Trust Fund – designed to extend the benefits of saving and asset-ownership, especially to lower-income earners. Initial consultation results and detailed proposals for further consultation were set out in *Delivering Saving and Assets*, published alongside the 2001 Pre-Budget Report.

The Saving Gateway

5.61 The Saving Gateway would be an account targeted at individuals from low-income groups, providing a Government-funded match for all money saved, up to a limit. It would offer individuals a valuable financial incentive to develop a regular saving habit and provide tailored financial information to inform saving choices.

5.62 As announced in the Pre-Budget Report, **the Government will shortly be launching a number of Saving Gateway pilot projects**. The pilots will be run in conjunction with the Community Finance and Learning Initiative (CFLI), led by the Department for Education and Skills. Four CFLI sites have been selected in which to run the pilots, in Gorton, Tower Hamlets, Cumbria and Cambridgeshire. The Government has also reached agreement with Halifax plc to act as a partner in the pilots, providing the services of its branches, staff and account systems in the pilot areas. The outreach and training functions of the CFLI are currently up and running in each pilot area, and the pilots themselves are expected to begin in August 2002, lasting for two-and-a-half years including evaluation.

5.63 Further development of the Saving Gateway, including the appropriate level of the match rate, the criteria to be used to determine eligibility, and the interaction between financial education and the account, will be made in the context of findings from the pilots, which have been designed to provide a regular stream of information and data from their establishment through to their closure.

The Child Trust Fund

5.64 As well as supporting saving, the Government is committed to spreading the benefits of asset-ownership. The Child Trust Fund (CTF) is a proposal for a universal account, with endowments paid to all children at birth and at ages 5, 11 and 16, with children from the poorest families receiving the most help. *Delivering Saving and Assets* consulted on two detailed proposals for delivering the CTF:

- **an open-market model,** in which the CTF would be delivered by financial service providers, like Individual Savings Accounts (ISAs) and stakeholder pensions; and
- **a licensed-provider approach,** with a more limited number of providers offering the CTF in partnership with the Government.

5.65 The consultation period has now ended and the Government is examining the responses received. It will develop further proposals taking into account the consultation results, associated policy issues and the conclusions of the 2002 Spending Review. The Government expects to be able to provide an update on aspects of its proposals in the run-up to Budget 2003, and will announce further decisions consistent with normal practice involving decisions relating to Annually Managed Expenditure.

Individual Savings Accounts

5.66 Individual Savings Accounts (ISAs), the Government's primary vehicle for tax-advantaged saving, continue to be extremely popular. Since their launch in April 1999, more than 12 million investors – around one in four adults – have contributed over £78 billion to ISAs. In the first three quarters of 2001-02, subscriptions to mini-cash ISAs grew significantly year-on-year, rising by 36 per cent to £12.5 billion. This increase more than offset the decline in subscriptions to Maxi ISAs probably caused by the uncertain investment climate – overall ISA subscriptions rose by nearly £500 million over the same period the year before. By 2006, savers will be receiving around £800 million a year more in tax relief than if Personal Equity Plans (PEPs) and Tax-Exempt Special Savings Accounts (TESSAs) had remained.

STRENGTHENING COMMUNITY LIFE

5.67 Conditions in Britain's most disadvantaged communities are unacceptably poor. Those living in poorer neighbourhoods must often cope with a run-down physical environment, limited opportunities and the worst public services. Chapter 3 describes the steps the Government is taking to promote enterprise and investment in disadvantaged communities and Chapter 7 sets out the Government's approach to urban regeneration. This section describes the additional steps the Government is taking to build stronger communities and tackle social exclusion across the country.

Public services to tackle social exclusion

Neighbourhood Renewal

5.68 The worst incidences of people living in poverty and social exclusion are concentrated in poor neighbourhoods. These areas suffer from many sources of deprivation – low levels of employment, high crime rates, poor health, low levels of educational attainment and poor quality housing. Public services can help solve some of these problems, but in the past they have consistently failed to deliver lasting improvements. The Government is therefore working to ensure that public services deliver improved outcomes for those living in the most deprived neighbourhoods.

5.69 As part of the National Strategy for Neighbourhood Renewal the Government is targeting extra resources on those neighbourhoods that fall furthest behind the rest of the country. The 2000 Spending Review set specific Public Service Agreement 'floor targets' to ensure that everybody, wherever they live, can expect decent standards of public service provision. In addition, the Neighbourhood Renewal Fund is providing £900 million over three years to the 88 most deprived areas in England, to help to deliver service improvements in the poorest neighbourhoods.

5.70 At a local level, neighbourhood renewal is overseen by Local Strategic Partnerships (LSPs) which bring together public, private, community and voluntary sector partners to coordinate solutions to tackle social exclusion. In recognition of the fact that social exclusion occurs more widely in both urban and rural areas, LSPs are now being set up across England.

Box 5.4: The New Deal for Communities

As a test-bed for new ideas in neighbourhood renewal, the New Deal for Communities (NDC) is investing almost £2 billion over 10 years in 39 of the most deprived neighbourhoods around the country.

Since the launch of the programme in 1998, NDC partnerships have become well established and many local projects are already delivering results. Examples of the NDC in action include a community-driven crime fighting initiative in East Manchester which helped to deliver a 25 per cent drop in local crime in its first year of operation, and a reorganisation of street-cleaning delivery in Bristol which ensured that the NDC area provided the most efficient cleaning service in the city. As one element of the National Strategy for Neighbourhood Renewal, the NDC plays an important role in improving understanding of 'what works' in neighbourhood renewal and in spreading best practice throughout LSPs across the country.

Strong communities and the voluntary sector

Community amateur sports clubs

5.71 Community amateur sports clubs (CASCs) play a valuable role in promoting the health and cohesion of their local communities. The Government encourages CASCs to apply for charitable status, which offers the full range of charity tax reliefs, 80 per cent mandatory business rate relief as well as additional funding opportunities. For those CASCs that cannot or do not wish to apply for charitable status, Budget 2002 introduces **a package of tax measures giving CASCs access to tax reliefs on income and donations, similar to those available to charities** and as set out in the Government's November 2001 consultation document[6]. The Government will also allocate **£20 million from the Capital Modernisation Fund to provide new or refurbished community sports facilities**. The Government will continue to have a constructive dialogue with sport to assist further in its development.

[6] *Promoting Sport in the Community*, HM Treasury, November 2001.

Charitable donations

5.72 The tax rules for gifts to charity were reformed in Budget 2000 to improve incentives for giving and to make the system work better for charities themselves. Budget 2002 takes further steps to encourage donations, by announcing new plans to **enable taxpayers to direct tax repayments to nominated charities, and allowing higher rate taxpayers to claim relief for Gift Aid donations immediately when they make their tax return.** The Government will continue to consider ways of encouraging charitable giving. Budget 2002 also introduces **a new tax relief for gifts to charity of land or buildings**, benefiting all charities that accept a freehold or leasehold property.

Charity buildings

5.73 To help charities use their buildings in a more flexible and cost effective way, and to encourage the creation of more residential accommodation for some of the most vulnerable people in society, Budget 2002 introduces a range of **VAT reliefs for charity buildings, including residential communal homes**.

A MODERN AND FAIR TAX SYSTEM

5.74 The Government is committed to creating a modern and fair tax system which encourages work, saving and investment, raises sufficient revenue to pay for investment in public services, and in which everyone – households and businesses alike – pays their fair share. The tax system must be modernised so as to keep pace with developments in business practice and the global economy and ensure that individual tax regimes continue to meet objectives. Equally, loopholes, which give scope for avoidance, must be closed so that the burden of tax does not fall unfairly on compliant taxpayers. In addition to the measures described in previous chapters, this Budget takes forward the tax modernising agenda in a number of areas.

Modernising stamp duty

5.75 Budget 2002 introduces reforms to **close loopholes in stamp duty on property** to ensure that the charge applies fairly to all relevant transactions in UK land and buildings, and to pave the way for the introduction of paperless electronic conveyancing. The reforms will mainly affect commercial transactions.

5.76 The existing stamp duty regime allows many large commercial transactions to take place without incurring a stamp duty charge. The Government is taking immediate action to discourage techniques used to side-step the current charge. A stamp duty charge will be triggered by a contract for all deals over £10 million. Group relief and de-merger relief will in future be recovered when subsidiaries are sold within two years of acquiring an interest in property from another group company. The penalty regime is also to be amended so that documents executed outside the UK no longer receive any advantage.

5.77 The reformed regime, to be introduced late next year, will create a mandatory tax to ensure that deals which are currently structured to side-step the charge are subject to stamp duty in future. In the longer term, electronic conveyancing should facilitate quicker and easier residential purchases and include the collection of stamp duty electronically.

Lease duty

5.78 Stamp duty as it applies to the grant of new leases (known as “lease duty”) will also be reviewed as part of the reform proposals so that it better reflects modern commercial practice, and to bring the charge into line with stamp duty on sales of equivalent valued property.

Taxation of foreign companies' branches

5.79 A weakness in the UK tax system means that some large, profitable foreign companies operating in the UK through branches for commercial reasons pay little or no corporation tax. Recent work by the Organisation for Economic Cooperation and Development (OECD) has shown that this puts the UK out of line with international practice among major industrialised countries. Budget 2002 therefore **takes steps to modernise the taxation of foreign companies operating in the UK through branches**.

5.80 From 1 January 2003, capital will be attributed to a UK branch for tax purposes, based on the amount of capital that would be needed if the branch were an independent company. This will mean that branches pay a fair share of corporation tax, reflecting the profits they make from activities carried out in the UK. The reform will ensure a more level playing field between UK-based banks and their foreign competitors, bringing the UK closer into line with established international practice. This builds on existing rules in the UK tax system that already apply to foreign companies operating in the UK through subsidiaries. The Government will consult on the technical details of the legislation.

North Sea tax regime

5.81 The Government is committed to maintaining an active UK oil and gas industry and to promoting future development of the nation's oil and gas reserves. However, the North Sea fiscal regime currently fails to strike the right balance between promoting investment and taking a fair share of revenue derived from a national resource, and is therefore in need of reform.

5.82 Budget 2002 introduces **important changes to the North Sea tax regime. With effect from Budget day, companies will pay a 10 per cent supplementary charge on North Sea profits and will receive a 100 per cent first year allowance for capital expenditure in the North Sea**. These changes will ensure a regime that raises a fair share of revenue and encourages long-term investment, establishing a more secure basis on which companies can plan for the future. Subject to consultation with the industry, the Government intends to abolish Royalty.

Residence and domicile

5.83 The Government is reviewing the residence and domicile rules as they affect the tax liabilities of individuals. The Government believes that modernisation of these rules needs to be based on clear principles: the rules should be fair, clear, easy to operate, and support the competitiveness of the British economy. As this is a complex area, all those affected should have the opportunity to contribute to the discussion. The Government will report on this issue in time for the Pre-Budget Report.

Betting

The Gross Profits Tax

5.84 In October 2001, the Government abolished the tax on betting stakes and replaced it with a 15 per cent tax on bookmakers' gross profits, making it possible for bookmakers to remove the deductions charged to punters, and grow their domestic and international business from a UK base. As a result of these reforms the largest bookmakers have relocated all their offshore operations to the UK, creating more than 2,000 new jobs in their high-street shops and call centres. Average turnover has increased by around 30 per cent, and revenue receipts are on target to match and exceed projected revenue streams under the old system.

Pools betting

5.85 As announced in the Pre-Budget Report, the Government is **abolishing the current pools betting duty and replacing it with a 15 per cent tax on pools companies' gross profits**. As a result of this reform, which took effect from 1 April 2002, the leading pools companies have agreed to extend their current funding of sport and the arts until April 2004. The Government has also abolished the tax liability on charities and sports clubs running smaller pools-based competitions.

5.86 As the next step in these reforms, the Government will be considering the scope to abolish the tax on bingo stakes and replace it with a gross profits tax on bingo companies.

Modernising VAT

VAT and museums

5.87 Budget 2001 announced the introduction of a new scheme to refund the main national museums and galleries the VAT they incur on their purchases, thereby removing the barrier which was preventing those museums and galleries from moving over to free admission. As a result of this scheme, those institutions which had been charging for admission have now moved over to free entry, with many seeing their visitor numbers double as a result.

Alcohol

5.88 Since 1997, the Government has taken consistent steps to deliver a fairer balance in the burden of taxation falling on different alcoholic drinks and different types of drink-producers. Budget 2002 introduces a further package of measures to increase the fairness of the alcohol duty regime:

- the rate of **duty on spirits will be frozen** for the fifth Budget in succession, equivalent to a cut of 12 pence per bottle in real terms;
- the rates of **duty on wine and beer produced by larger brewers will be frozen** for the second Budget in succession;
- **reduced rates of duty worth up to £40 per barrel will be introduced on the beer produced by the UK's traditional small brewing industry**, providing savings of up to 50 per cent for each brewer, helping them to compete more effectively; and
- **spirits-based coolers**, consumption of which has increased rapidly in recent years and which have, until now, been taxed at a concessionary low rate, **will have their duty brought into line with spirits**.

5.89 As a result of the duty freezes in the last five Budgets, this is now the longest period since the 1950s during which the duty on spirits has not risen, and the price of a bottle of spirits is now 73 pence lower than it otherwise would have been.

Tobacco

5.90 Smoking is the single greatest cause of preventable illness and premature death in the UK, killing 120,000 people every year. Research has consistently shown that the demand for cigarettes is affected by their price, and that high tax levels can help encourage existing smokers to smoke less or quit and discourage younger people from taking up the habit. Maintaining the real price of cigarettes and tobacco protects these vital health objectives. **Tobacco duty will therefore be increased in line with inflation from Budget day**, adding 6 pence to the price of an average packet of cigarettes.

Tackling tax abuse

Tackling tobacco smuggling

5.91 Like other types of smuggling and fraud, tobacco smuggling undermines honest retailers, involves widespread and serious criminality, and drains government revenue. By providing an unregulated supply of cheap tobacco, tobacco smuggling also undermines the Government's efforts to cut smoking addiction. Stemming this supply increases the average price of tobacco and helps to protect these health objectives.

5.92 In the 2001 Pre-Budget Report, the Government reported encouraging results from the first year of its *Tackling Tobacco Smuggling* strategy. In 2000-01, more than 2.8 billion cigarettes destined for the UK market were seized and dozens of organised smuggling gangs broken up. HM Customs and Excise met their key target for 2000-01 to hold the illicit share of the UK cigarette market to 21 per cent, and remain on track to slow, stop and reverse the growth in tobacco smuggling by 2003.

Cross-Channel smuggling

5.93 Good results have also been achieved in tackling cross-Channel smuggling of both alcohol and tobacco in 2000-01. Overall revenue losses from cross-Channel smuggling fell by 76 per cent in 2000-01 – well in excess of the Government's 10 per cent target. More than 10,000 vehicles used by smugglers were also seized and 56 organised smuggling gangs were broken up.

Tackling indirect tax fraud

5.94 The Government set out the strategic principles underpinning its approach to fraud in *Tackling Indirect Tax Fraud*, published alongside the 2001 Pre-Budget Report. The paper showed how the effectiveness of the Government's approach had been demonstrated by the *Tackling Tobacco Smuggling* strategy, described the steps being taken to tackle fraud in other areas, and set out a number of proposals for consultation.

5.95 In the wake of this consultation, the Government will now take further immediate steps to improve the effectiveness of its efforts to tackle indirect tax fraud, including the **introduction of a comprehensive strategy to tackle the rising problem of oils fraud** and the **agreement of a joint programme of cooperation with the spirits industry to trace and track illicit consignments of spirits**.

5.96 The Government will set out further details of its strategies to tackle indirect tax fraud and improve business compliance, including any resource implications, in the context of the 2002 Spending Review.

Tackling unfair tax avoidance

5.97 Left unchecked, schemes and devices designed to avoid tax can increase the burdens falling on the majority of ordinary taxpayers, undermine the stability of the public finances, and put other businesses at a competitive disadvantage. In addition to tackling fraud and smuggling, **the Government is therefore taking a number of steps to tackle unfair tax avoidance**, including:

- a series of **measures to prevent avoidance of VAT**:
  - blocking a scheme used to avoid VAT on second-hand goods, particularly in respect of business cars;
  - following consultation, legislating at the earliest opportunity to block loopholes in the VAT treatment of face-value vouchers; and
  - ensuring that the VAT recovered by the largest partially-exempt businesses fairly reflects their level of taxable activity.
- **changes to the tax regime for British qualifying films** to restrict relief to films intended for theatrical release at the commercial cinema, subject to discussion with the industry on the details of implementation;
- **changes to restrict the circumstances in which tax relief is available for manufactured payments**; and
- **the introduction of a reserve power for HM Treasury to make regulations specifying jurisdictions in which all controlled foreign companies (CFCs) would fall within the charge to tax under the CFC rules**. The Government hopes that jurisdictions will make these changes, removing the necessity for regulations.

PROMOTING INTERNATIONAL POVERTY REDUCTION

5.98 The Government's long-term goal is to tackle global poverty and help to achieve the international community's Millennium Development Goals (MDGs) by 2015. These goals include halving the proportion of people living in extreme poverty, reducing child and maternal mortality, ensuring that no child is denied primary education, and reversing the spread of HIV/AIDS, malaria and other killer diseases.

Box 5.5: Financing for Development

In March 2002, developed and developing countries, multilateral institutions, non-Governmental organisations and representatives from the private sector attended a major United Nations conference on Financing for Development. The Monterrey Conference represents a turning point in the international community's approach to development, recognising the need for a new deal based on the rights and responsibilities of both developed and developing countries.

Governments at the conference pledged significant increases in Official Development Assistance to the poorest countries. Following the publication of a UK paper on the case for aid[1], European Union Member States agreed collectively to raise their aid budgets by an estimated $7 billion a year by 2006. The US also pledged additional aid volumes of $10 billion between 2004 and 2006 and an additional $5 billion thereafter.

While these increases represent real progress, they still fall short of the aid levels necessary to achieve the Millennium Development Goals (MDGs), which the World Bank estimates will require $40 to $60 billion each year. In November 2001, the Chancellor proposed an International Development Trust Fund, to pool contributions and leverage private sector finance, to deliver the level of funding needed to meet the MDGs. Having secured substantial new resources, the UK will continue to seek further progress, to ensure that no developing country genuinely committed to good governance, economic reform and poverty reduction will be denied the chance to achieve the Millennium Development Goals through lack of finance.

[1] ***The case for aid to the poorest countries*, HM Treasury and the Department for International Development, March 2002**

Commonwealth Education Fund

5.99 The Government is working closely with other countries to ensure that every child has access to primary education. Today, 113 million children – 75 million of them in Commonwealth countries – lack access to basic education. Since 1997, the Department for International Development has committed over £650 million to achieving universal primary education in developing countries. As announced in Budget 2001, the Government has also launched a new Commonwealth Education Fund, with a £10 million initial endowment, to strengthen civil society in developing countries and to help the poorest and most marginalised children to complete good quality primary education. The Government will match contributions to the Fund from business and individuals, pound for pound, including tax relief.

Tackling the diseases of poverty

5.100 Every year almost 6 million people die from HIV/AIDS, malaria and tuberculosis, almost all in the world's poorest countries. Tackling these diseases, and improving health outcomes for poor people in developing countries, requires a comprehensive approach.

5.101 Since 1997, the Department for International Development has agreed new bilateral commitments worth over £1 billion to help improve the provision of basic healthcare in poor countries. Through its High Level Working Group on Access to Medicines, the Government is developing further proposals on trade, patents and pricing of medicines. The Government has taken a leading role in the development of the Global Fund to fight HIV/AIDS, malaria and tuberculosis. International commitments to the Fund now stand at $1.9 billion, of which the Government has so far pledged $200 million. To complement these strategies, as announced in Budget 2001, and following further consultation, the Government is now:

- **introducing a new tax credit to encourage companies to increase research and development (R&D) into vaccines and medicines for the prevention and treatment of malaria, TB and those strains of AIDS which predominantly affect people in developing countries**. The credit will reinforce and extend existing R&D incentives, providing 50 per cent relief on qualifying expenditure on top of all other R&D allowances. Companies will also be entitled to claim relief on financial contributions toward independent research into these diseases by charities, universities and scientific research organisations; and
- **introducing a new relief, with effect from 1 April 2002, to encourage responsible donations of medical supplies and equipment to developing countries, in support of those countries' own health strategies and the needs of their people**. This relief will allow companies to deduct from their taxable profits the cost of donations made for humanitarian purposes together with the cost of transport, delivery and distribution of donated goods. In implementing this measure, the Government will encourage adherence to the voluntary guidelines on donations set out by the World Health Organisation.

Debt relief

5.102 The Government continues to be a leading advocate of debt relief through the Heavily Indebted Poor Countries (HIPC) initiative, and is encouraging other countries to adopt the UK's practice of providing 100 per cent bilateral relief to reduce poverty. So far, 26 countries have received debt relief worth $62 billion under the HIPC initiative, while five countries have completed the process. The Government has already provided £236 million of bilateral debt relief and has pledged $375 million to the multilateral institutions in support of the HIPC initiative. The Government has also granted interim debt relief of over £697 million, which will become irrevocable when countries complete the HIPC process. For the remaining 16 HIPCs, the Government is prepared to write off a further £1.1 billion. Debt relief must however lead to a sustainable exit from indebtedness; the Government will continue working with its international partners to ensure that assistance under the HIPC initiative is able to deliver this.

6 Delivering High Quality Public Services

The Government's long-term goal is to deliver world-class public services through investment and reform to ensure that taxpayers receive value for money. Budget 2002 lays the foundations for further sustained investment and reform in public services, consistent with the fiscal rules, by:

- **releasing an additional £100 million for schools improvement and £250 million to tackle crime and counter the threat of terrorism in 2002-03;**
- **adding £4 billion to Departmental Expenditure Limits (DEL) in 2003-04 and setting firm overall spending limits for the three-year period of the 2002 Spending Review up to 2005-06, allowing:**
  - **current spending, excluding spending on health, to increase by 2½ per cent a year in real terms in 2004-05 and 2005-06. Current spending will rise in total by an average of 3.3 per cent a year in real terms over the same period; and**
  - **public sector net investment to rise from its 2003-04 target of 1.8 per cent of GDP to 2 per cent by 2005-06, to address the historic under-investment in Britain's public infrastructure.**

Decisions on departmental spending allocations will be announced in the 2002 Spending Review. In Budget 2002, the Government is responding to the Wanless Review of long-term health trends, by:

- **immediately allocating £2.4 billion of the new DEL addition to UK health spending, and providing for an average annual 7.4 per cent real terms increase in UK spending on the NHS up to 2007-08. Health spending in England will rise by 7.5 per cent a year on average;**
- **providing for an extra £0.4 billion allocation to personal social services in England in 2003-04, and an average annual 6 per cent real terms increase over the three years to 2005-06; and**
- **making these new resources conditional on a comprehensive programme of health service reform to ensure the efficient delivery of the Government's key priorities for health and social services.**

INTRODUCTION

6.1 The Government's long-term goal is to deliver world-class public services through sustained increases in investment and reforms to ensure that taxpayers receive value for money. Strong and dependable public services are vital to extend opportunity, tackle poverty and social exclusion and improve the quality of life for all. They also lay the foundations for a successful, high productivity economy.

6.2 Through its action to maintain macroeconomic stability, the Government has already been able to deliver significant and sustained investment in Britain's public services, while ensuring that the fiscal rules are met. To advance its long-term goal, the Government will build on these foundations in the 2002 Spending Review, ensuring that resources are available for investment in priority services over the next three years and that departments' programmes can effectively deliver modernisation and reform.

INVESTMENT AND REFORM

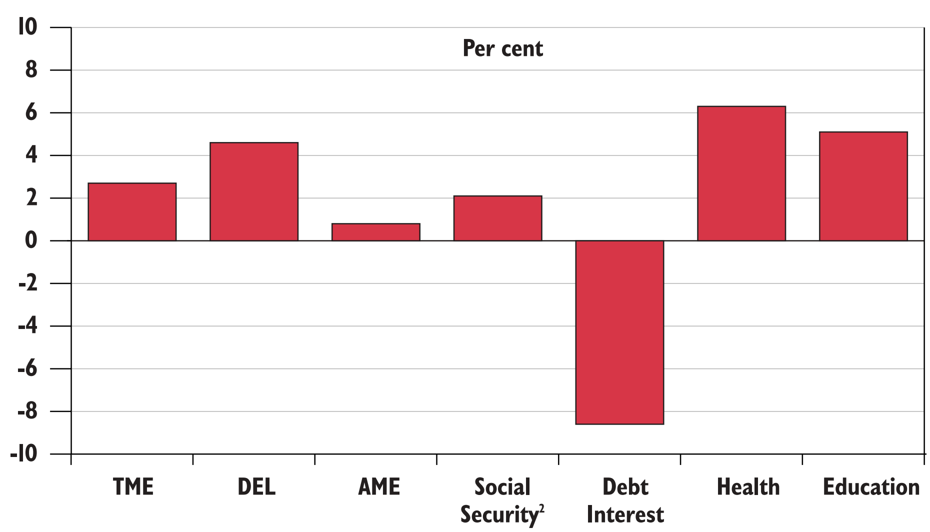
6.3 The Government's approach to building world class public services involves providing investment in return for reforms in delivery and improvements in outcomes.

6.4 To help departments plan for the medium term, the Government has introduced a system of firm and fixed Departmental Expenditure Limits (DEL) for spending stretching over three years, and reviewed every two. Expenditure items that are large, potentially volatile and demand-led – such as social security benefits and payments under the Common Agricultural Policy – are collectively known as Annually Managed Expenditure (AME). These items are subject to tough annual scrutiny as part of the Budget forecasting process to ensure that spending does not threaten fiscal stability. Taken together, DEL and AME add up to Total Managed Expenditure (TME), the Government's measure of public sector spending.

Delivering resources to priorities

6.5 Prudent management of the economy has allowed the Government to deliver significant increases in resources for frontline public services. Chart 6.1 shows the real growth in DEL and AME expenditure between 1997-98 and 2002-03. Social security payments and tax credits are forecast to have grown, on average, by 2.1 per cent a year in real terms over this period, compared with 4.1 per cent a year between 1991-92 and 1996-97. Debt interest payments, which rose by 6.6 per cent a year on average between 1991-92 and 1996-97, are expected to have fallen by 8.6 per cent a year in real terms between 1997-98 and 2002-03. By spending less on these areas as a proportion of total public spending, the Government has been able to release more money for frontline public services within DEL.

Chart 6.1: Releasing resources for public service priorities[1]



[1] *Average annual real growth rates in categories of spending 1997-98 to 2002-03, including Budget 2002 changes.*
[2] *For the purposes of comparison, social security includes the Working Families' Tax Credit and the Disabled Person's Tax Credit.*

Source: HM Treasury

6.6 These resources have been directed toward the Government's priorities. For example, spending on health will have increased by 6.3 per cent a year, on average, in real terms between 1997-98 and 2002-03, and education by 5.1 per cent. The Goverment has also been able to meet other pressures – for example to combat terrorism - without jeopardising its plans for investment in public services.

Box 6.1: Combating terrorism

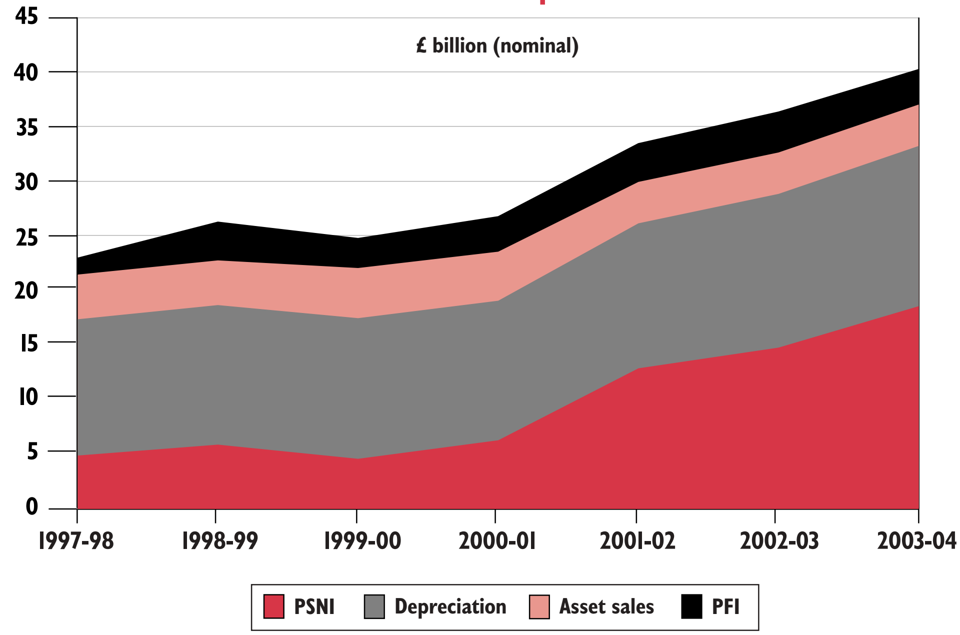
The terrorist attacks of 11 September had repercussions around the world, directing attention toward a new sort of warfare. The Government has provided additional funding for measures to counter the security and economic implications of the September attacks, which include:

- **allocating an additional £155 million to the Ministry of Defence for new military equipment and urgent operational requirements;**
- **funding humanitarian assistance to Afghanistan, and elsewhere, with over £120 million of new support for the region;**
- **an additional £20 million of resources to strengthen the UK's tough anti-terrorist financing regime and to fund other anti-terrorism measures. Before the fall of Kabul the UK froze $100 million of assets belonging to the Taleban, Usama Bin Laden and al-Qa'ida. Of these funds, $85 million have been unfrozen and are being returned to the new Afghan authorities;**
- **ensuring that the aviation industry could continue business by providing airlines with an insurance guarantee;**
- **providing a further £30 million of funding to the Metropolitan police and other forces; and**
- **entering into a unique partnership with the tourism industry in a major promotional campaign in the United States and Western Europe. The Government has allocated £20 million, which will be matched by the industry, to the Million Visitor Campaign.**

6.7 The plans for the 2002 Spending Review, described later in this chapter, add a further £4 billion to departmental spending in 2003-04, including a £2.8 billion allocation to health and personal social services.

6.8 To deliver vital improvements in the nation's infrastructure, public sector net investment (PSNI) is set to more than double over the 2000 Spending Review period, to nearly £20 billion, or 1.8 per cent of national income, by 2003-04. Chart 6.2 shows how total UK investment in public services, which includes PSNI, depreciation, recycled proceeds from public sector asset sales and investment under the Private Finance Initiative (PFI), will rise to over £41 billion by 2003-04, compared with a level of £23 billion in 1997-98.

Chart 6.2: UK total investment in public services



Source: HM Treasury

6.9 Budget 2002 takes further steps to accelerate delivery in the priority areas of education and crime reduction in 2002-03. In particular, in 2002-03 the Government is releasing:

- **£100 million from the Capital Modernisation Fund for 2002-03 to tackle past under-investment in schools**. This will allow additional direct capital payments worth around £2,500 to a typical primary school and £7,100 to a typical secondary school; and

- **£250 million, with an extra £110 million from the Reserve, for the Home Office** to tackle street crime and associated pressures, and counter the threat of terrorism.

Using resources effectively

6.10 Improving public services is not simply a matter of increasing investment. Resources must also be allocated and used efficiently to ensure that they deliver genuine public service reform and give the taxpayer value for money.

6.11 A modern and effective framework for the planning and control of public spending is needed to improve the quality and cost-effectiveness of public services. The Government's public spending framework is underpinned by four important principles:

- consistency with a long-term, prudent and transparent regime for managing the public finances as a whole;

- the judgement of success by policy outcomes rather than resource inputs;

- strong incentives for departments and their partners in service delivery to plan over several years and plan together where necessary; and

- the proper costing and management of capital assets to provide the right incentives for public investment.

The public spending framework

6.12 The Government's public spending framework is also underpinned by the fiscal rules. The fiscal rules, described in detail in Chapter 2, ensure that the public finances are sustainable over the economic cycle and that spending and taxation impact fairly within and between generations. The rules have important consequences for the budgeting regime, removing the past discrimination against investment and ensuring that borrowing for investment is conducted in a responsible way.

6.13 Building on the foundation of the fiscal rules, the Government has introduced a significant number of important innovations to the budgeting system, including:

- separate departmental **allocations for resource and capital spending** which ensure that growth-enhancing public investment is not sacrificed to meet short-term current pressures. This supports the Government's golden rule;
- **Public Service Agreements** (PSAs) which set out, for each department, the public service improvements that the Government is committed to achieving, alongside the resources which make them possible. Existing PSA targets will be reviewed and, where necessary, improved as part of the 2002 Spending Review;
- **firm and fixed plans** for departmental services spending stretching over three years, and reviewed every two. These Departmental Expenditure Limits (DELs) replace the old annual system of expenditure planning and provide departments with greater certainty over the medium term;
- **ten year plans** for the National Health Service (NHS) and transport, reflecting the need to plan beyond the three-year horizons of firm DEL plans in specific areas;
- **full end-year flexibility (EYF)** which allows departments to retain resources not fully spent at the end of the year and is designed to engineer a lasting change in the traditional "use it or lose it" mindset of public sector budget holders;
- **a National Asset Register**[1] to improve the way in which the public sector asset base, valued at £480 billion, is managed. The Register helps departments to use their assets effectively and to judge whether individual assets are still required. The UK is the only country in the world with access to a register of this kind;
- **resource accounts and budgets** which enable the full economic costs of decisions to be reflected in public sector financial information, rather than simply the cash consequences, giving departments new incentives to maximise the benefits from their capital stock and to manage their liabilities more effectively;
- **central funds**, including the Invest to Save Budget and the Capital Modernisation Fund which reward innovative ideas on a competitive basis (see box 6.2); and
- **pooled budgets**, such as the Criminal Justice Reserve where the Home Office, Lord Chancellor's Department and Crown Prosecution Service can access a single fund subject to joint agreement, to spend on cross-cutting initiatives.

[1] The National Asset Register, HM Treasury, Cm 5221, July 2001

Box 6.2: Central funds for innovation

Invest to Save Budget (ISB)

The ISB provides venture capital for the public sector, to encourage innovative and joined-up delivery of public services. The Government has allocated over £300 million to 335 cutting edge partnership projects across central government and the wider public and voluntary sectors. For example:

- ***Forecasting the Nation's Health* is an ISB funded project, which is tracking links between changes in the weather and patterns of illness. It uses meteorological data to make localised NHS workload forecasts over a seven to ten day period. This helps hospitals to plan ahead and is already saving money.**

Capital Modernisation Fund (CMF)

The CMF was set up as part of the Comprehensive Spending Review with an initial £2.5 billion endowment. The 2000 Spending Review allocated a further £2.5 billion. CMF resources are allocated annually, on a challenge basis, to projects that promote more modern and effective methods of public service delivery. A total of £3.9 billion has now been allocated to 116 projects, many of which are already delivering real public service improvements. For example:

- **as a result of a £360 million allocation to the *Primary Care Modernisation Programme*, the Department of Health opened 42 NHS "walk-in" centres, providing health advice and minor treatment services without the need for an appointment. Over one million people visited the centres in 2001, reducing pressures on GPs and hospital accident and emergency departments; and**
- **an *IT Learning Centres* project in inner-city schools was allocated £100 million in the first round of the CMF. The project is setting up IT centres in major city areas to enhance teaching and learning across the whole curriculum through state of the art educational technology. The Centres are based in secondary schools but are intended to serve as a resource for other schools in the area, as well as the local community as a whole. The first phase of the project is now complete and 69 centres have been opened. A further 15 centres will be opened by September 2003.**

Reforming delivery

6.14 Besides reform of the budgetary framework, improving public services also requires change and reform in management culture and systems. The Prime Minister has set out the Government's four principles of public service reform:[2]

- **national standards,** which means working with hospitals, schools, police forces, and local government to agree tough targets, with performance independently monitored so that people can see how their local services compare;
- **devolution**, whereby central government has to give successful frontline professionals the freedom to deliver;
- **flexibility**, which means removing artificial bureaucratic barriers which prevent staff improving local services; and
- **choice**, acknowledging that customers should increasingly be given the kind of options that they take for granted in other walks of life.

[2] *Reforming our Public Services*, March 2002

6.15 The Prime Minister has also established a Delivery Unit under the day-to-day supervision of Lord Macdonald, Minister for the Cabinet Office. Concentrating on the key areas of health, education, law and order, and transport, the Unit is working closely with the Treasury to strengthen the capacity of the responsible departments to deliver effectively on particularly challenging targets. The aim of the Unit is to ensure that the Government's ambitious programme of public service reform is translated into genuine improvements on the ground.

6.16 The Government has also conducted a cross-cutting review of the public sector labour market to help to ensure that public sector employers can recruit, retain and motivate suitably qualified staff to deliver customer-focused public services. Sponsoring departments or employers are required to develop workforce strategies tailored to their individual service programmes, with the aim of attracting and retaining workers in specific fields, taking into account local or regional challenges. These strategies should involve elements such as flexible work arrangements, including movements across sectors; training and career progression; the removal of disincentives to working past retirement age; and pay and benefits to address local issues. Details of other cross-cutting reviews of public services are provided later in this chapter.

Improving delivery of local public services

6.17 Improving public service delivery is not just a task for central government. Local government provides a range of vital public services, including schools and care for the elderly. It spends more than £60 billion each year. The Government is therefore committed to modernising local government to ensure that high quality and cost-effective services are provided throughout the country.

6.18 To strengthen the delivery of local public services, local Public Service Agreements (PSAs) have been negotiated with nearly 50 local authorities that have committed to deliver more stretching outcomes in return for greater flexibilities, freedoms and financial rewards if they succeed. Local PSAs strengthen the links between central and local government, providing help for local authorities to deliver, while ensuring that national priorities are met. They have won widespread endorsement in local government and are being rolled out to a further 100 larger councils over the next eighteen months. This initiative will be updated to reflect the outcomes of the 2002 Spending Review, and in particular to incorporate revised national PSA targets for which local authorities are important delivery partners.

Focusing investment on results

6.19 Public Service Agreements (PSAs) were introduced for each department following the 1998 Comprehensive Spending Review. PSAs set out the key outcomes that the Government is committed to achieving in return for investment. By linking funding to the delivery of improvements in services and outcomes for consumers, PSAs are central to the Government's strategy for improving public services.

6.20 This section describes how the Government has performed so far against some of its key PSA targets. Where improvements are needed, Ministers will be looking for further reforms to ensure that targets are met; where performance is on track, the presumption will be that the reforms already in place are working.

Box 6.3: Accountability for Government performance

The Government is committed to providing reliable performance information on PSA targets, so that the public can have confidence that departments are delivering what they say they are. In response to Lord Sharman's Report, *Holding to Account*, the Government has invited the Comptroller and Auditor General to take responsibility, under his existing powers, for the validation of systems used in reporting on PSA targets where measurement of performance depends on data. The Government has also decided to publish reports on departments' performance against PSA targets in the autumn, as well as in the spring.

Health

6.21 In July 2000, the Government published the ten year NHS Plan, setting out a series of ambitious objectives to be delivered with increased resources allocated in the 2000 Spending Review. The NHS is making good progress against a number of these objectives. Maximum waiting times for inpatient treatment have fallen from 18 months to 15 months, and all hospitals are now operating booked admissions systems in at least two specialities. However, further progress is needed to meet some other targets, including those to reduce maximum outpatient waits and delays in discharging elderly people from hospital, though in both these cases the trend is now improving.

Education

6.22 There have been significant improvements in education. Half of all 16-year olds achieved five A*-C grades at GCSE in 2001, a year ahead of target. In the same year, the number of infant class sizes larger than 30 was all but eliminated. A further four targets are on course to be met this year. While results for literacy and numeracy at age 11 last year showed that performance was static after earlier significant improvements, the Department for Education and Skills is confident that results will improve this year and is working with Local Education Authorities to meet the target for 2002. Two targets for 2002 – to reduce truancies and increase the proportion of 19 year olds with a level 2 qualification – have proved more challenging. In both these cases the department re-evaluated its plans and committed to new objectives in SR2000.

Transport

6.23 The number of people killed or seriously injured on the roads is 6 per cent below the 2000 target, and the equivalent child accident reduction target has been bettered by 17 per cent. Rail use had increased by 30 per cent between 1997 and 2000, but Hatfield and recent problems have restricted growth. Although numbers are now back above pre-Hatfield levels, reaching the 2010 target requires a 50 per cent increase; and while the Government is on course to reduce congestion on trunk roads by 2010, urban congestion is predicted to continue to rise. Bus use has grown significantly in London and some other urban areas, helping to advance the national target of a 10 per cent increase by 2010.

Crime

6.24 Overall crime levels have fallen. In the two years to March 2001, domestic burglary fell by 15 per cent and vehicle crime by 10 per cent. While the overall number of crimes for which an offender was brought to justice fell between 1999-2000 and 2000-01, the average time from arrest to sentence for persistent young offenders has more than halved from 142 days to 67 days.

Housing

6.25 Over eight million people live in more than four million local authority and housing association homes. The availability and condition of social housing, and the systems through which people gain access to it and help with its costs, are vitally important for tackling poverty and regenerating deprived neighbourhoods. Between April 1999 and 2001 the backlog of repairs was reduced by around 120,000 dwellings with around 660,000 council houses benefiting from new investment. The Government is on course to bring a third of non-decent social housing (around 700,000 homes) up to a decent standard by 2004, as part of its long-term target to make all social housing decent by 2010. The 2000 Spending Review committed over £39 billion of investment for new housing, the maintenance and renewal of existing stock and support for tenants with housing costs. The Government has also embarked on important reforms to rents, Housing Benefit and the regulation of private landlords, and has published a Green Paper on planning reform setting out proposals to improve dramatically the land use planning system.

Defence

6.26 The main PSA targets for defence focus on implementation of elements of the 1998 Strategic Defence Review (SDR). A number of these SDR targets have been met, including the establishment of the Joint Helicopter Command, the launch of the Procurement Executive as the Defence Procurement Agency, and a reduction in the value of non-munitions stockholdings by £2.2 billion. The public-private partnership (PPP) for the Defence Evaluation and Research Agency was not completed in April this year as planned, but the majority of its business has been vested as Qinetiq plc, and the PPP is now expected during the course of 2002-03. The targets for raising manning levels in the armed forces have been rolled forward to 2004.

THE 2002 SPENDING REVIEW

Aim of the Review

6.27 The Government is currently conducting a Spending Review to ensure that funds are available to spend on priority services up to 2005-06. The Review will report by the summer. The aim of the Review is to determine how departments' programmes can best contribute to the achievement of the Government's priorities, including:

- the delivery of high quality, efficient and responsive public services through investment linked to reform and modernisation;
- raising productivity, in the public sector and outside, through improved skills, research and infrastructure;
- extending opportunity and prosperity more widely, and tackling child poverty and social exclusion;
- improving the quality of life in both urban and rural areas; and
- securing a modern international role for Britain through cooperation with our European and international partners.

6.28 The 2002 Spending Review will be the first Review in which departments' performance against their PSA targets will be an input into decisions on resources and reform, helping to ensure that investment is directed to achieve the most cost effective outcomes. The Cabinet Committee on Public Services and Public Expenditure (PSX), supported by the Treasury and the Prime Minister's Delivery Unit, is looking closely at how departments have been performing against their existing PSA targets and scrutinising carefully departments' assessments of their resource needs. Where departments have made proposals for new spending, they have been required to accompany these with stretching targets and clear plans for effective delivery. Where that requires change, investment will be conditional on reform.

6.29 Compared with previous reviews, the 2002 Spending Review will also:

- involve a greater concentration on assembling a substantial and relevant evidence base on the effectiveness of programmes;
- be conducted and published on a full resource budgeting basis; and
- give consideration to the need to plan beyond the three-year horizons of firm

DEL plans in specific areas, building on the Transport Ten Year Plan and the NHS Plan.

Outputs from the Review

6.30 The main outputs of the Review will include:

- new Departmental Expenditure Limits (DELs), rolling forward the existing plans for 2003-04 and setting new plans for 2004-05 and 2005-06;
- Public Service Agreements (PSAs) rolling forward and, in some cases, being developed further in line with priorities;
- revised Departmental Investment Strategies linking PSA targets to capital plans; and
- a series of cross-cutting reviews of policy areas spanning several departments' responsibilities.

Cross-cutting reviews

6.31 The Government has been conducting a number of cross-cutting reviews as part of the 2002 Spending Review. The reviews aim to find effective solutions to some of the biggest challenges facing public services, through coordinated departmental policies, resources and implementation efforts. By examining issues across departments, the reviews seek to avoid wasteful duplication, identify and fill gaps in services, and ensure that resources are used effectively and efficiently.

6.32 The findings of the reviews will be reflected in departments' spending plans, pooled budgets and PSA targets where appropriate. The reviews address:

- the trends affecting the size and composition of the **public sector workforce** and how best to ensure that public sector employees make a positive contribution to public service delivery, described earlier;
- the factors contributing to **health inequalities** and how government services could be better integrated to narrow the health gap across socio-economic groups;
- the ways in which Government policies, funding and targets can deliver improvements in the safety and attractiveness of **public space**, as described in Chapter 7;
- the role of the **voluntary sector** in working alongside central and local government to deliver public services;
- the opportunities for improving the delivery of government **services for small business**;
- the funding of the UK science base and the effectiveness of government departments' own **science and research** programmes. Details of the Government's strategy for supporting science and research, building on the findings of this review, are set out in Chapter 3; and
- the integrated delivery of government programmes and services to help **children at risk** from poverty and social exclusion.

New spending plans

6.33 As described in Chapter 2, Budget 2002 sustains and increases the resources for public services already announced and **adds £4 billion to Departmental Expenditure Limits (DEL)**

in 2003-04. The Budget sets firm overall spending plans for the period of the 2002 Spending Review up to and including 2005-06, allowing:

- **current spending**, excluding spending on health, to increase by 2½ per cent a year in real terms in 2004-05 and 2005-06. Current spending will rise in total by an average of 3.3 per cent a year in real terms over the same period; and
- **public sector net investment** to rise from the 2003-04 target of 1.8 per cent of GDP to 2 per cent by 2005-06, to address the historic under-investment in Britain's public infrastructure.

6.34 In the Spending Review, Ministers are examining how these resources can best be allocated to deliver modernisation and reform in priority areas. New departmental spending plans will be set at the end of the Review. For the first time, departments' spending limits will be set on a full resource budgeting basis and include the full economic cost of holding and using capital assets, and incurring longer-term liabilities. The rationale for this move, a full explanation of the changes themselves, and a reconciliation back to previous departmental budgeting information, was published at the time of the Pre-Budget Report[3]. Although the budgetary control on departments from 2003-04 onwards will be on a full resource budgeting basis, the Government will publish the outcome on both bases to aid transparency and promote understanding of the new system. Box 6.5 explains the impact of this reform on the new plans for the National Health Service.

6.35 Alongside reforms to be negotiated in the Spending Review, the plans for public spending announced in this Budget will deliver the step change needed to help bring Britain's public services up to the level of the best.

A modern National Health Service and social care system

The Wanless Review of Long-Term Health Trends

6.36 In Budget 2001 the Chancellor commissioned Derek Wanless, former Group Chief Executive of NatWest Bank, to undertake an independent review of the long-term trends that will affect the health service in the UK over the next 20 years and the resources required to deliver a publicly funded, comprehensive, and high quality service available on the basis of clinical need and not ability to pay. The Review published an interim report for consultation in November 2001 and has now published its final report. The main conclusions of the Review are summarised in Box 6.4.

[3] *Better Management of Public Services: Resource Budgeting and the 2002 Spending Review*, HM Treasury, November 2001

Box 6.4: Main conclusions of the Wanless Review

The Review concludes that both additional resources and reform are needed to deliver a world-class health service.

According to the Review, the UK will need to devote a substantially larger share of its national income to health over the next 20 years – with total health spending rising from around 7.7 per cent of GDP at present to between 10.6 and 12.5 per cent of GDP in 20 years' time. Across the 20-year period as a whole, this implies growth in UK NHS spending of between 4.2 and 5.1 per cent a year in real terms.

The Review also considers the profile of spending over the 20 year horizon. The most rapid spending is projected in the early years, reflecting the need to deliver improvements in standards as quickly as possible. However, it stresses the dangers of attempting to expand activity too rapidly given the existence of short-term capacity constraints, particularly related to the workforce.

The Review projects real terms growth in UK NHS spending of between 7.1 and 7.3 per cent a year over the period from 2003-04 to 2007-08. It suggests that these growth rates are at the upper end of what should sensibly be spent.

In later years, the Review suggests that higher levels of activity in the health service are likely to have significant workforce implications, requiring the need for changes in the skill mix and other means of improving productivity.

The Review emphasises that while additional resources are necessary, success in achieving a high quality health service will not be guaranteed by higher spending alone and that there is a need to ensure that all resources are used to maximum effect. The Report makes a number of observations and recommendations in this respect. In particular, it points to:

- **the importance of setting national standards for clinical care and integrated information and communication technology (ICT) systems;**
- **the significant scope to give more discretion to those delivering care at the local level, helping to drive up performance across the board;**
- **the need for a mechanism to ensure regular and rigorous independent audit of all health care spending;**
- **the vital interface between health and social care, and the need for similar quality improvements in the social care sector; and**
- **the need for public engagement to increase health awareness, based on a better understanding of rights and responsibilities. For example, the Review recommends a greater role for patient and business representatives in local health care decisions, and other means of raising understanding and involvement in the development of local health services.**

The Government's response

6.37 The Government accepts the conclusions of the Review. To deliver the increase in resources needed for reform, it has decided to **allocate an additional £2.4 billion to UK health spending in 2003-04 and that UK NHS spending should grow by 7.4 per cent a year after inflation over the five years to 2007-08. Health spending in England will rise by 7.5 per cent a year.** Table 6.1 sets out the new spending plans in detail. The plans provide the NHS with stable growth in funding at a rate that exceeds even the growth over the 2000 Spending Review period. UK health spending as a proportion of GDP is projected to reach 9.4 per cent by 2007-08. The plans include substantial increases in capital for investment in modern IT, buildings and equipment.

Table 6.1: NHS spending in the UK[1]

£billion	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	Average real growth
Previous plans	65.4	69.7					
New provision		72.1	79.3	87.2	95.9	105.6	7.4%
of which, England	*53.5*	*59.0*	*65.0*	*71.6*	*78.9*	*87.1*	*7.5%*

[1] As budgets are set on a full resource budgeting basis (see Box 6.6), these near-cash numbers are indicative. UK figures are subject to the decisions of the devolved administrations.

6.38 Taking into account these new resources, Table 6.2 shows that total UK health spending will rise to 9.4 per cent of GDP in 2007-08.

Table 6.2: UK health spending as a proportion of GDP

Per cent of GDP	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Total UK health spending	7.7	8.0	8.3	8.7	9.0	9.4
of which						
Gross UK NHS spending[1]	*6.6*	*6.9*	*7.2*	*7.5*	*7.8*	*8.2*
Non-NHS health spending[2]	*1.2*	*1.2*	*1.2*	*1.2*	*1.2*	*1.2*

[1] The NHS budget is net of certain receipts. To measure total health spending in line with the national accounts, total NHS spending is gross of these receipts.

[2] Includes an additional 1.1 per cent of GDP for private spending on health, as assumed in the Wanless report, as well as minor changes for charity spend and national accounts classifications. Total assumption for non NHS health spending is 1.15 per cent so some totals may not sum due to rounding.

Box 6.5: NHS spending and the move to resource budgeting

The 2002 Spending Review will be the first Review to be conducted on a full resource budgeting basis, and the resulting DEL spending plans will be set and controlled on this basis. The table below shows the same plans for the NHS in England, and indicative plans for the UK, but set out on a full resource budgeting basis, including the full economic costs of holding assets and creating new liabilities.

NHS spending on a full resource budgeting basis[1]

£billion	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	Average real growth
Previous plans	68.1	72.2					
New plans		74.8	82.2	90.5	99.4	109.4	7.3%
of which England	*55.8*	*61.3*	*67.4*	*74.4*	*81.8*	*90.2*	*7.4%*

[1] These figures are on a full resource budget basis. UK figures are subject to the decisions of all devolved administrations.

The difference between these numbers and those shown in Table 6.1 reflects increases in the NHS resource budget baseline due to costs associated with holding and using capital assets, and the changes in provisions to cover liabilities. For those reasons, resource budgets are generally higher than those expressed in cash terms. The analysis contained in the Wanless Review is based on full resource budgeting data. Expressed on a resource budgeting basis, the annual growth in the UK NHS budget after inflation is 7.3 per cent, in line with the Wanless Review recommendations. For a full discussion of the move to resource budgeting, see *Better Management of Public Services: Resource Budgeting and the 2002 Spending Review, HM Treasury, November 2001*.

6.39 In addition, because of the importance that the Wanless Review attaches to investment in social services, the Government has decided to **allocate an additional £0.4 billion to spending on personal social services in 2003-04 and to plan for increases in English social services resources in the period to 2006 at 6 per cent a year on average in real terms**. Details of social services resources, including Standard Spending Assessment and Department of Health (DH) special grants, will be announced at the conclusion of the Spending Review, along with the consequences of this commitment for the Devolved Administrations. Table 6.3 sets out the new plans.

Table 6.3: Personal Social Services spending in England[1]

£billion	2002-03	2003-04	2004-05	2005-06	Average real growth
Previous plans	11.4	12.2			
New plans		12.5	13.4	14.6	6.0%

[1] *Standard Spending Assessment plus DH grant. Actual spending is subject to the decisions of local authorities.*

Reforms to ensure delivery

6.40 The Government is determined to match new resources with reform. These new resources are conditional on reform to ensure delivery of the priorities set out in the PSA Delivery Contract (see Box 6.6.). The Secretary of State for Health will announce how, with the guarantee of sustained investment, these reforms will establish:

- devolution of power to front line organisations and new financial incentives to improve performance;
- increased choice for patients;
- improved standards of social services care for the elderly;
- the separation of the standard-setting role of the Department of Health from the delivery role of the NHS; and
- new independent regulators, with powers enshrined in legislation to audit and inspect local health services and scrutinise patients' complaints, and a duty to report to the public on money spent and standards achieved.

Box 6.6: New Department of Health draft PSA Delivery Contract

The Government will publish a new PSA Delivery Contract for the Department of Health at the end of the 2002 Spending Review, setting out targets to take forward the next stage of the ten-year NHS Plan. This will bring together the Department's Delivery Contract and its PSA. The Treasury and the Prime Minister's Delivery Unit will work with the Department of Health to develop the targets and ensure delivery. There will be publicly available summary delivery plans for each priority area. All the areas covered by the existing PSA will be covered in the new PSA Delivery Contract. As well as existing over-arching targets on health inequalities there will also be a focus on the following priority issues.

Improve service standards

Cut waiting times:

- reduce the maximum wait for an outpatient appointment to three months, and the maximum wait for inpatient treatment to six months by the end of 2005. This will be followed by progressive further cuts in waiting with the aim of reaching a maximum inpatient and day case waiting time of three months by 2008;
- reduce maximum waits for emergency services: end long trolley waits in Accident and Emergency (A&E) by reducing to four hours by 2004 the maximum wait from arrival to admission, transfer or discharge; and
- speed up access to GPs: guaranteed access to a primary care professional within 24 hours and to a primary care doctor within 48 hours by 2004.

Increase choice for patients by providing treatment at a time and place that suits them in accordance with their clinical need: all outpatient appointments and planned inpatient admissions will be pre-booked by 2005.

Improving health outcomes for everyone

Reduce substantially mortality rates from the major killer diseases by 2010: from heart disease by at least 40 per cent in people under 75; from cancer by at least 20 per cent in people under 75; and from suicide and undetermined injury by at least 20 per cent.

Improve standards of care for older people so that they can live independently with a high quality of life.

Value for money

Enhance accountability to patients and the public by providing better information on health and NHS performance.

Improve value for money for the taxpayer: the NHS and social services will deliver year on year gains of at least 2 per cent in quality and cost efficiency.

The detailed targets in these and other PSA areas, including drug treatment and patient experience, will be announced at the end of the Spending Review. In the case of children's services, this work will take account of the conclusions of the cross-cutting review of children at risk.

Funding principles

6.41 Given its other priorities, and the need to meet its strict fiscal rules, the Government is raising national insurance contributions (NICs) from April 2003, and freezing the personal allowance for those aged under 65 in 2003-04, so that it can deliver over five years the 7.4 per cent annual real growth in spending planned for the NHS.

6.42 The NHS has always been and will continue to be funded in part from NICs. But the Government does not support the hypothecation of revenues to the NHS or other public services, since it would make public services subject to the ups and downs of the economic cycle and unpredictable changes in revenues. It would not provide what the NHS needs: a sound long-term and sustainable stream of funding.

6.43 The Chancellor set out the case for continuing to fund the NHS from revenues in his speech of 20 March at the Social Market Foundation. Because the range of medical treatments is growing, and some are more expensive than ever, the risks to a family's finances would be greater than ever if the costs were met from charges or insurance payments.

6.44 General taxation and NICs provide affordable, comprehensive cover for health care as the costs are spread as widely and fairly as possible. General taxation provides health care that is free at the point of need, accessible to all irrespective of their income. It also minimises the administrative costs of providing the funds. In contrast:

- charges would mean the sick paying for being sick. The experience of other countries is that charges deter the sick from seeking treatment, to their own detriment and that of their dependants;
- private insurance would fail to help those in greatest need, tend not to extend to chronic or emergency care, and often require co-payments by the insured. If insurance companies take advantage of growing knowledge of genetics, people predisposed to a particular illness seem likely to be put at a further disadvantage. Because of the administrative costs of private insurance, and a fragmentation of service, private insurance tends also to be more expensive than the alternatives; and
- social insurance systems such as those used by France, Germany and the Netherlands reflect the regional or local organisation of health, in contrast to Britain's national service. They tend to deny to some the full range of benefits and create anomalies. They may also bear disproportionately on employers. France is increasing the share of health spending borne by general taxation both to reduce the exclusion of the needy and to widen the revenue base.

6.45 Within the range of alternatives for revenue funding, NICs offer several advantages:

- unlike indirect taxes, and because the new one per cent payment will extend beyond the upper earnings and profits limits for employees and the self-employed, NICs are strictly related to earnings and so a measure of people's ability to pay;
- most of those in work will contribute through NICs and the freezing of the tax allowance for those aged under 65. However, unlike income tax, the great majority of pensioners will not have to contribute as they do not pay NICs; and the age-related personal allowances will be increased in 2003-04 so that no pensioner aged 65 or over will pay tax on incomes of less than £127 a week; and
- NICs are levied on both employers and employees. Higher employers' contributions reflect their interest in a healthy labour supply. The CBI has estimated that workplace absence cost British business over £10 billion in 1999[2].

[2] *Focus on Absence* survey, CBI, June 2000

A ILLUSTRATIVE LONG-TERM FISCAL PROJECTIONS

The Government's budgetary decisions need to be consistent with sustainable public finances over the long term to ensure that they promote long-term economic growth and intergenerational equity. The illustrative long-term fiscal projections presented in this annex allow the Government to assess the sustainability of its fiscal policies, consistent with the requirements of the *Code for Fiscal Stability*. Based on particularly cautious assumptions, the projections show that:

- **given the projected profile for tax revenue and transfers, current public consumption can grow slightly faster than GDP growth in the long run while meeting the Government's golden rule;**
- **public sector net investment can grow close to the economy's growth rate over the projection period without jeopardising the sustainable investment rule. The net debt to GDP ratio is projected to remain below 40 per cent in the long run; and**
- **the Government is well placed to deal with potential future spending needs, for example due to the health needs of an ageing population.**

INTRODUCTION

A1 A key objective of the Government's fiscal policy framework is to secure sound public finances over the short and medium term. However, the Government must also ensure that its fiscal policy decisions are consistent with a sustainable long-term framework. Failure to do so would see financial burdens being shifted to future generations, with detrimental effects on long-term economic growth. It would also be inconsistent with the principles of fiscal management set out in the *Code for Fiscal Stability*.

Illustrative long-term projections

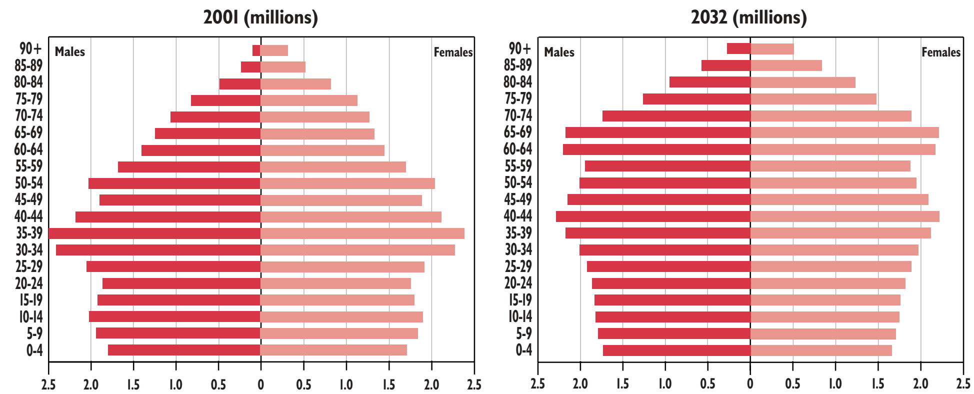
A2 The *Code* requires the Government to publish illustrative long-term projections covering a period of at least 10 years; in practice, a 30-year horizon has been adopted. The projections published in Budget 1999, 2000 and 2001 showed that the UK's long-term fiscal position was relatively favourable and that, as a result, current public consumption could grow at a faster rate than economic growth without jeopardising the Government's fiscal rules.

A3 The projections in this annex incorporate revised spending and revenue projections and provide an up-to-date assessment of the sustainability of UK fiscal policy. The underlying assumptions and the methodology used remain broadly unchanged from previous years.

DEMOGRAPHIC TRENDS

A4 As in most other European Union (EU) and Organisation for Economic Cooperation and Development (OECD) countries, an ageing population represents a challenge to the UK in the decades ahead. In March 2002, the Government Actuary's Department (GAD) published its latest set of population projections for the UK. The principal projections (first published in November 2001) show that, whereas only one in seven people in the UK were aged 65 or over in 1980, that share had risen to nearly one in six in 2001 and is predicted to rise to nearly one in five by 2020. Life expectancy at birth is expected to rise from 75.6 years in 2001 to 79.5 years in 2032 for males, and from 80.2 years to 83.7 years for females. The median age is projected to be nearly 44 years in 2032 – around six years higher than in 2001. Chart A1 shows the UK's age pyramid in 2001 and in 2032.

Chart A1: UK population by age and sex



Source: Government Actuary's Department, 2000-based principal population projections.

A5 The UK's population is, however, ageing less rapidly than the populations of most other EU Member States. According to the European Commission, for example, the UK's old-age dependency rate (the number of people aged 65 and over as a percentage of those aged 15 to 64) is set to rise from 24 per cent in 2000 to 37 per cent in 2030, compared with a projected rise from 24 per cent to 41 per cent over the same period in the EU as a whole[1].

A6 Nonetheless, while the UK faces a less severe demographic challenge than many other European countries, and the impact of an ageing population on the public finances is expected to be manageable, there is no room for complacency. Demographic developments will continue to have implications for government spending and revenue (for example, in the form of greater demand for health care and other services for the elderly), emphasising the importance of a sound long-term strategy for the public finances.

[1] *Budgetary challenges posed by ageing populations: the impact on public spending on pensions, health and long-term care for the elderly and possible indicators of the long-term sustainability of public finances*, EPC, 2001.

METHODOLOGY AND ASSUMPTIONS

A7 The Treasury's methodology for producing long-term fiscal projections examines the sustainability of the public finances by determining the rate at which current public consumption (current spending on items such as health and education) can grow while ensuring that the Government meets its fiscal rules. This is achieved by projecting the evolution of taxation and transfer payments (such as pensions) and capital consumption (depreciation) in the coming decades on the basis of prudent and cautious assumptions. Subtracting transfers and capital consumption from tax revenues indicates the financial resources available for current public consumption. This methodology is unchanged since Budget 1999 and was described in detail in Budget 2000[2].

A8 The taxation, transfers and capital consumption projections are based on existing policies and, unless explicitly stated otherwise, assume that the Government will leave these policies unchanged in the future. This does not imply that policy will in practice remain unchanged, but ensures that the projections give an indication of how the public finances are likely to develop on current policy settings.

Economic assumptions

A9 Table A1 sets out the key economic assumptions underlying the projections[3]. Given that the projections cover a period of 30 years, a range of assumptions could be considered plausible. The long-term economic assumptions remain unchanged from those underpinning previous long-term fiscal projections. The greater degree of uncertainty involved in projecting long-term trends is one reason for adopting particularly cautious assumptions for this exercise. As such it is assumed that annual real growth will average $2^1/_4$ per cent between 2007-08 and 2011-12 and $1^3/_4$ per cent between 2012-13 and 2031-32.

Table A1: Long-term economic assumptions for baseline projections

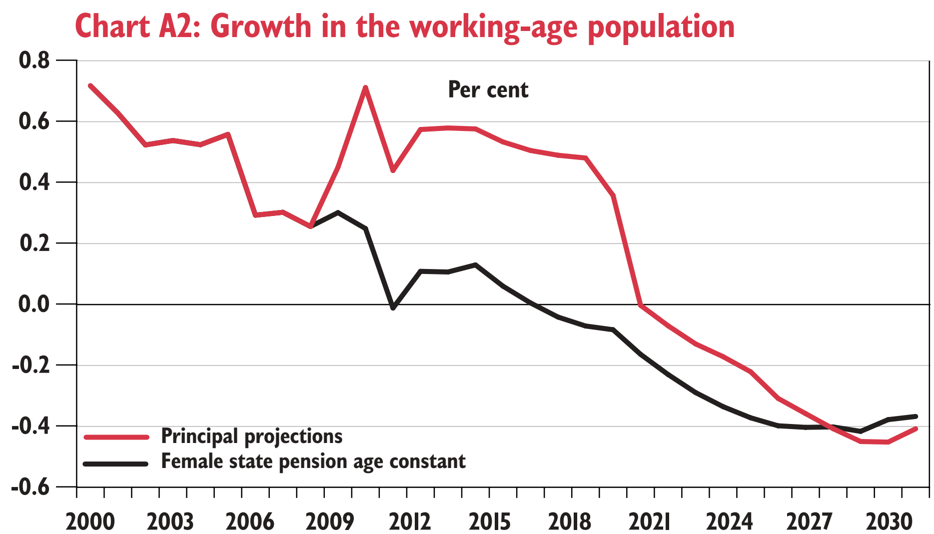
	Average annual real growth, per cent	
	2007–08 to 2011–12	2012–13 to 2031–32
Productivity	2	$1^3/_4$
Employment	$^1/_4$	0
GDP	$2^1/_4$	$1^3/_4$
Inflation	$2^1/_2$	$2^1/_2$

A10 While 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, the assumption of $1^3/_4$ per cent productivity growth a year from 2012-13 is motivated by the Government's prudent and cautious approach. Regarding population growth, the illustrative fiscal projections are based on GAD's principal projections for the population of working age. This is somewhat more cautious than the assumption used for the period 2002 to 2006, which is based on the mid-point of GAD's principal and high net migration projections.

[2] See Box A1 of Budget 2000 (page 129).

[3] For the period up to and including 2007-08, the projections and assumptions presented in Chapter C of the FSBR are used.

A11 GAD's principal projections show the working-age population growing at an average annual rate of 0.34 per cent between 2007-08 and 2011-12 before stabilising at around 0.5 per cent up to 2020-21. Between 2021-22 and 2031-32 annual average growth is projected to be negative. As shown in Chart A2, the increase in the working-age population depends on the gradual rise in the state pension age for females from 60 years in 2010 to 65 years by 2020. The long-term fiscal projections assume zero employment growth after 2011-12. This is an approximation to this demographic profile assuming the employment rate is constant.



Source: Government Actuary's Department, 2000-based principal population projections.

Taxation and spending assumptions

A12 For the period up to and including 2007–08, covering the five year plans for health announced in this Budget, the illustrative long-term fiscal projections are based on the forecasts and assumptions presented in Chapter C of the Financial statement and Budget Report (FSBR). Tax revenues are assumed to be equal to total current spending from 2007–08 onwards. This implies that the current budget is projected to be in balance, meeting the golden rule. From 2008–09, total current spending and tax revenues are assumed to grow in line with GDP. This approach is equivalent to saying that the Government will continue to raise the same amount of revenue as a proportion of GDP as in 2007–08, offsetting possible changes in tax bases by changing policy in a revenue neutral way.

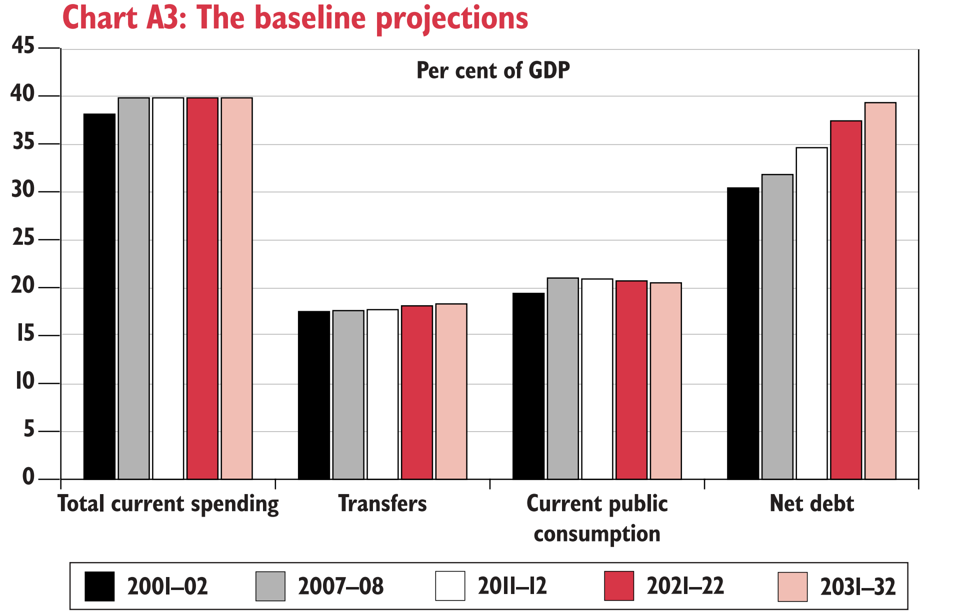
A13 Current public consumption is calculated as the difference between receipts and other spending which comprises transfers and capital consumption. Transfers are made up of three separate components: social security transfers; interest payments; and other transfers. Social security transfers include state pensions and - for the first time - the long-term costs of the Pension Credit[4]. The calculation of interest payments requires assumptions about interest rates and the level of public sector debt. As in the medium-term forecasts, 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 debt simply reflects public sector net investment. The share of public sector net investment in GDP is assumed to be $2^1/_4$ per cent up to 2011-12 and then 1.8 per cent of GDP. This approach is consistent both with meeting the sustainable investment rule.

A14 To calculate capital consumption, the Treasury uses the forward profile for investment that provides information on additions to the capital stock. The 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 BASELINE PROJECTIONS

A15 Chart A3 shows the projected evolution of total current spending, transfers, current public consumption and net debt between 2001-02 and 2031-32, given the baseline assumptions. As a percentage of GDP, total current spending is projected to increase between 2001-02 and 2007-08. Transfers and net debt are predicted to rise gradually over the projection period, with net debt rising towards 40 per cent of GDP by 2031-32, consistent with the sustainable investment rule. Current public consumption is projected to rise from 19.4 per cent of GDP in 2001-02 to 21.0 per cent in 2007–08, to remain stable until 2015–16 and to fall slightly towards the end of the projection period. Despite this, current public consumption as a percentage of GDP in 2031-32 will be higher than in 2001-02. This relative expansion reflects the fact that current public consumption can grow at a slightly faster average annual rate than GDP while still meeting the fiscal rules.

Chart A3: The baseline projections



[4] Calculated in conjunction with the Department for Work and Pensions. The social security transfer projections are based on the latest demographic projections by GAD.

A16 With total current spending (by assumption) remaining constant as a percentage of GDP from 2008-09 onwards, the gradual decrease in current public consumption as a share of GDP from 2016-17 onwards is entirely due to the increasing trend for transfers as a proportion of GDP. This largely reflects an increase in debt interest payments as a share of GDP - which is itself due to a higher share of net debt in GDP. Compared with the long-term fiscal projections in Budget 2001, social security spending as a share of GDP is also slightly higher, reflecting the inclusion of the Pension Credit. With the underlying assumptions remaining more or less unchanged, these illustrative projections produce a broadly similar picture to those presented in previous Budgets.

A17 The projected changes in net debt mainly reflect the higher ratio of public investment to GDP up to 2011–12. This emphasises the importance of ensuring sound public finances in the short term to prepare for future developments. On current projections, net debt will rise gradually to reach 39.3 per cent of GDP in 2031-32 given the baseline growth and investment assumptions.

External studies

A18 The general conclusion of the baseline projections has been supported by various external studies. Generational accounts provide one of the most sophisticated methods of analysing long-term fiscal sustainability. Following independent research, backed by the National Institute of Economic and Social Research (NIESR), the first set of generational accounts for the UK were published in 2000[5]. The results, based on policies in place or legislated for at the time of the study (1998), indicated that the UK faced only a modest generational imbalance and that the public finances were sustainable in the long run. This conclusion compared favourably with those reached for other countries, many of which were found to face marked imbalances[6].

A19 The NIESR has updated the UK's generational accounts to include subsequent policy changes, such as the Pension Credit, and revised demographic assumptions. Taking into account all policy changes prior to Budget 2002, the updated accounts confirm the 1998 finding that the UK's public finances are broadly sustainable in the long term. The 2002 accounts also show that present policy is largely generationally neutral in the sense that current generations are not favoured over future generations in terms of net lifetime tax transfers with the Government.

ALTERNATIVE SCENARIO

A20 This section analyses the sensitivity of the projections to higher productivity growth[7]. All other assumptions are unchanged. As mentioned above, the productivity assumption in the baseline scenario is particularly cautious. Increasing the sustainable rate of UK productivity growth, and closing the productivity gap that exists between the UK and its main competitors, is central to the Government's economic strategy. Chapter 3 describes the measures the Government is introducing to support the drivers of productivity growth in the UK. The alternative scenario presented here assumes productivity growth of $2^1/_4$ per cent a year from 2007-08 onwards – a quarter of a percentage point higher than the baseline scenario between 2007-08 and 2011-12, and half a percentage point higher than the baseline scenario between 2012-13 and 2031-32.

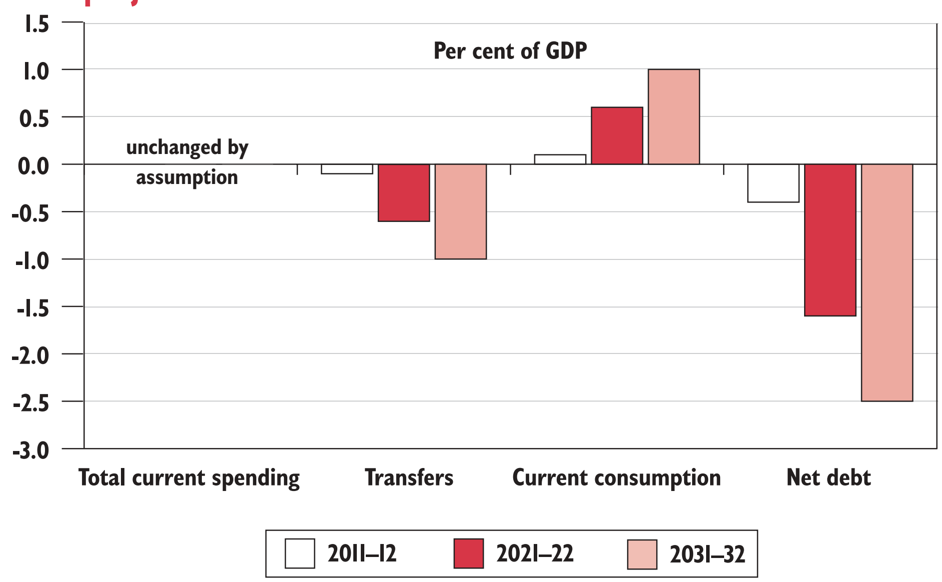
[5] *Generational Accounting in the UK*, by Roberto Cardarelli, James Sefton and Laurence J. Kotlikoff, The Economic Journal, 2000.

[6] *Generational Accounting Around the World*, edited by Alan Auerbach, Laurence Kotlikoff and Willi Leibfritz, 1999.

[7] Alternative scenarios presented in previous Budgets have studied the effects of assuming stronger economic growth and higher public investment, a higher labour market participation rate and lower social transfers.

A21 The alternative projections show, not surprisingly, that faster productivity growth would have significant beneficial consequences for the public finances. Instead of rising by 1.1 percentage points from 19.4 per cent in 2001-02 to 20.5 per cent in 2031–32, the share of current public consumption in GDP could rise by 2.1 percentage points to 21.5 per cent. This means that the average annual growth rate of current public consumption can be markedly higher than the underlying real GDP growth rate. This is mainly due to the fact that the share of social security transfers in GDP falls relative to the baseline projections, but also because the share of debt interest payments rises less rapidly. Chart A4 shows the differences between the baseline and alternative projections.

Chart A4: Differences between baseline and alternative projections



CONCLUSIONS

A22 The long-term fiscal projections presented in this annex show that the UK's public finances are broadly sustainable over the long term, confirming earlier findings. Consistent with meeting the golden rule, current public consumption can grow slightly faster than GDP in the baseline projections, providing the resources to meet potential future spending needs – for example, to meet the health care needs of an ageing population. The alternative projections show that stronger productivity growth would increase this margin further. Furthermore, public sector net investment can grow more or less in line with the economy without jeopardising the sustainable investment rule. Net debt is projected to remain below 40 per cent of GDP in the long run.

A23 Despite this relatively favourable position, there is no room for complacency. Notwithstanding the use of prudent and cautious assumptions, a wide range of unforeseen developments and spending pressures could arise over the projection period. The Government will therefore continue to publish and evaluate long-term fiscal projections to ensure that all fiscal policy decisions are set firmly within a sustainable long-term framework and take account of the latest demographic and economic projections.

B THE ECONOMY

The synchronised slowdown of growth in the US, Europe and Japan was a major influence on developments in the UK economy during 2001. But, in contrast to previous episodes of faltering global demand and rising economic uncertainty, the platform of low inflation and sound public finances delivered by the Government's new macroeconomic framework enabled policy to sustain stability and growth in the UK. In 2001:

- **UK Gross Domestic Product (GDP) grew by $2^1/_4$ per cent, in line with the Pre-Budget Report projection and the lower end of the Budget 2001 forecast range;**
- **robust growth was supported by strong consumer demand, underpinned by the Monetary Policy Committee's decisive action to cut interest rates to their lowest level since 1964; and**
- **employment rose to new record highs during the year, and is now $1^1/_2$ million higher than in spring 1997, reflecting the ongoing success of Government policies designed to deliver increased employment opportunity and enhanced labour market flexibility.**

Prospects for a recovery in G7 economic growth have improved significantly since the Pre-Budget Report, and latest indicators suggest that an upturn in UK economic activity is already under way. Looking ahead:

- **UK GDP growth is forecast to be between 2 and $2^1/_2$ per cent in 2002, gathering pace during the year as the world economic recovery becomes more broad-based, and rising to between 3 and $3^1/_2$ per cent in 2003 before returning to trend the following year;**
- **growth is also forecast to become more balanced as stronger external demand and improved business confidence stimulate recoveries in UK exports and business investment, while household consumption moderates gradually to sustainable rates;**
- **the GDP forecast path is judged to be consistent with RPIX inflation remaining close to the Government's $2^1/_2$ per cent target; and**
- **the trend rate of output growth is now projected to be $2^3/_4$ per cent over the forecast period, supported by an updated assessment which incorporates the latest evidence. The mid-points of the economic forecast ranges are anchored around this neutral assumption.**

INTRODUCTION[1,2]

B1 This chapter discusses economic developments since the November 2001 Pre-Budget Report and provides updated forecasts for the UK and other major economies in the period to 2004. It begins with an outline of world economic developments and prospects. The subsequent discussion sets out the key features of the UK forecast and the associated risks, followed by a more detailed assessment of sector-specific issues.

[1] The UK forecast is consistent with national accounts and balance of payments statistics to the fourth quarter of 2001, released by the Office for National Statistics on 27 March 2002. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk), and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

THE WORLD ECONOMY

Table B1: The world economy

	Percentage changes on a year earlier unless otherwise stated			
		Forecast		
	2001	2002	2003	2004
Major 7 countries[1]				
Real GDP	1	$1\frac{1}{2}$	$2\frac{3}{4}$	$2\frac{1}{2}$
Consumer price inflation[2]	$1\frac{1}{2}$	$1\frac{1}{2}$	$1\frac{1}{2}$	$1\frac{1}{2}$
World trade in goods and services	0	$2\frac{1}{4}$	$8\frac{1}{2}$	$7\frac{1}{4}$
UK export markets[3]	$-\frac{1}{4}$	$1\frac{3}{4}$	$7\frac{3}{4}$	6

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

[2] *Per cent, Q4. For UK, RPIX.*

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

Overview

B2 Last year, economic growth slowed significantly and simultaneously in the US, Europe and Japan. World trade growth, investment, industrial production and stock market valuations all declined sharply, and demand for information and communications technology (ICT) related goods collapsed. The terrorist attacks of 11 September heightened short-term uncertainty and weakened business confidence across the world economy, but the timely policy response appears to have prevented a prolonged downturn in activity. While firms held back production in the final months of 2001, lower interest rates and oil prices helped to support consumption, so that inventories were run down sharply across the world's major economies.

B3 Prospects for G7 growth in 2002 have improved significantly since the time of the Pre-Budget Report. A recovery is expected to be led by rebuilding of stocks in the short term, and to become more broad-based from the middle of this year with business investment picking up, world trade growth strengthening and monetary policy returning to a more neutral stance. The US is forecast to lead the G7 recovery, with a revival in Euro-area activity following closely behind. The immediate outlook for Japan remains weak, though improving external demand and the effects of the yen's depreciation should provide some stimulus to activity later this year. Developing economies were clearly affected by weaker world growth last year, but are expected to benefit from the upturn in global demand during 2002.

G7 activity

B4 G7 GDP grew by 1 per cent in 2001, in line with the Pre-Budget Report forecast, and prospects for growth in 2002 have improved significantly since then. G7 growth is now expected to rise to $1\frac{1}{2}$ per cent this year, compared with the previous projection of $\frac{3}{4}$ per cent, with the difference largely reflecting improved prospects for US growth in the first half of the year. While stronger overall G7 activity this year will limit the scope for growth to pick up further in 2003, growth next year is nonetheless expected to reach $2\frac{3}{4}$ per cent.

B5 The US economy grew by just 1.2 per cent last year, its slowest annual rate since 1991. Investment fell sharply after a number of years of strong growth, and weak demand for ICT-related capital goods contributed to a $4\frac{1}{4}$ per cent year-on-year fall in manufacturing output. US GDP contracted in the third quarter of the year, and heightened uncertainty after 11 September further depressed business confidence and investment. However, decisive monetary policy action and lower oil prices boosted household consumption which, along with strong government spending, underpinned a return to growth in the fourth quarter of the year. Unexpectedly strong US consumer demand during the final months of 2001 contributed to a sharp rundown of inventories.

B6 Business confidence in the US has improved markedly in recent months as economic uncertainty associated with 11 September has diminished, and more gradual inventory liquidation is expected to boost production during the first half of 2002. Thereafter, growth is expected to become more balanced as sustained domestic consumption, strengthening external demand and expectations of ongoing productivity gains boost confidence and prompt renewed growth in business investment.

B7 Growth in the Euro-area also slowed significantly during 2001, with weakness in Germany particularly marked. Output contracted and confidence weakened further in the fourth quarter of the year, though forward-looking surveys have now recouped their losses since 11 September. Fading inventory liquidation, stronger US growth and the continuing effects of last year's interest rate cuts are expected to support a revival in Euro-area growth during 2002.

B8 Japan's economy is estimated to have contracted by 0.5 per cent last year and is expected to remain weak in the short term, with deflationary pressures persisting and unemployment remaining historically high. However, there are signs that production is stabilising, and the economy is expected to return to modest growth later this year as strengthening external demand and the effects of the yen's depreciation provide some stimulus to exports. Nonetheless, the economy is expected to register negative growth in 2002 as a whole.

Forecast issues and risks

B9 Decisive policy action helped to ensure that the short-term downside economic risks associated with the terrorist attacks of 11 September subsided relatively quickly, and that the world economy avoided a sharper or more protracted downturn. With clear signs of improving confidence in the US and Europe, it is possible that the strength of this year's recovery in G7 growth and world trade may exceed expectations. The scope for the recent acceleration in US productivity to continue, and to be emulated in other major economies, presents further upside potential to global growth prospects. In Japan, while progress towards structural reform may have mixed implications for growth and inflation in the short term, it would provide a welcome boost to medium-term economic prospects.

B10 However, there are also significant downside risks to the anticipated revival in global activity. The world economic outlook continues to depend on the prospects for sustained growth in the US, where any setback to business confidence would threaten the expected upturn in investment, and renewed weakness in equity or labour markets would present downside risks to consumption. Current high levels of household and corporate indebtedness could also constrain the pace of the US recovery, while a sudden sharp depreciation of the dollar remains a possibility given the level of the US current account deficit (see Box B1). Elsewhere, further sustained progress on economic reform is needed to enhance growth potential in the Euro-area, while the weakness of the banking sector in Japan presents clear economic risks. A sustained period of high oil prices would also adversely affect G7 growth.

Box B1: Financial imbalances in the US economy

Sustained economic growth in the US during the second half of the 1990s was accompanied by rising household and corporate indebtedness, together with a widening current account deficit. Financial imbalances often arise during periods of strong economic growth and can be financed by an inflow of foreign capital attracted by profitable investment opportunities. However, if they reflect overly optimistic expectations of future economic performance, any downward revision to expectations could prompt a sudden, sharp adjustment to economic activity.

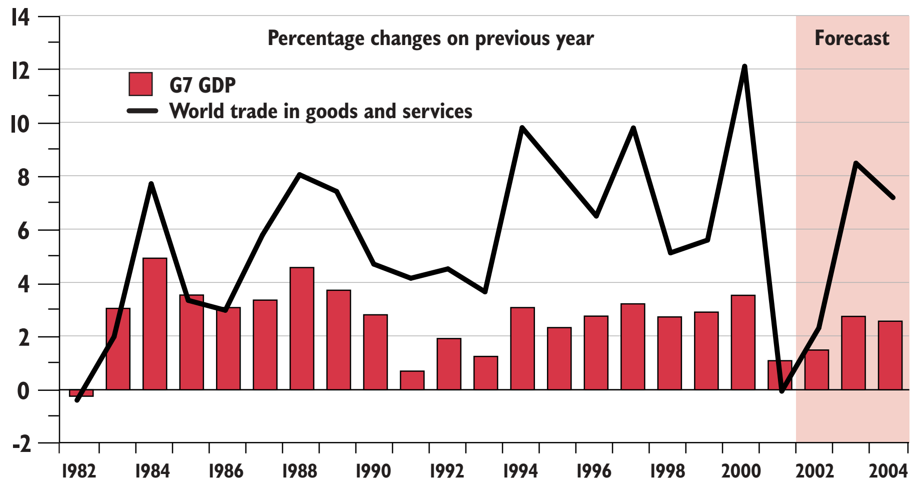
In the US, the marked acceleration in productivity over recent years suggests that expectations of stronger economic growth in the future are well founded. But the willingness of foreign investors to continue financing the US current account deficit will depend heavily on whether they expect recent relative productivity gains to be sustained. A benign scenario in relation to the unwinding of imbalances would see productivity in other major economies starting to catch up with that in the US, as they also benefit from 'new economy' gains. This would widen investment opportunities, allowing the dollar to adjust which, together with higher US domestic saving, would allow the imbalances in the US economy to unwind in a relatively slow and orderly manner.

An alternative scenario is that recent productivity gains in the US are not sustained, prompting households and firms to revise expectations and rebalance their financial positions more rapidly than anticipated. This could also reduce the supply of foreign capital, prompting a sudden adjustment in the value of the dollar. At the time of the Pre-Budget Report, it was feared that uncertainty surrounding the likely supply-side impact of the events of 11 September might bring about such a scenario. These fears have now largely abated, but there remains a risk that these imbalances will unwind rapidly at some point in the future, prompting financial market instability and presenting risks to global economic prospects.

World trade

B11 World trade was badly affected by the synchronised slowdown in global growth and the collapse in demand for highly traded ICT goods during 2001, and is now estimated to have contracted marginally in 2001 as a whole. However, world trade growth is expected to increase to $2^1/_4$ per cent in 2002, as the G7 recovery gathers pace and demand for ICT-related and other investment goods picks up, before rising to $8^1/_2$ per cent in 2003. UK export markets are expected to recover broadly in line with world trade, growing by $1^3/_4$ per cent in 2002 and almost 8 per cent in 2003.

Chart B1: G7 GDP and world trade



Emerging markets and developing countries

B12 Emerging markets and the world's poorest economies were clearly affected as world trade, commodity prices and tourist revenues weakened last year. The slump in demand for ICT-related goods particularly affected emerging economies in Asia, which are highly open and depend heavily upon trade in these products. Eastern European economies were affected by weaker demand in the Euro-area.

B13 Many of the world's poorest economies are dependent upon primary commodity exports, and therefore suffered disproportionately last year as a result of low commodity prices and weakening external demand. Resources released under the Highly Indebted Poor Countries (HIPC) initiative are, however, likely to have helped to sustain growth. There are now 26 countries benefiting from over £40 billion in HIPC debt relief, 22 of which are in Africa.

Box B2: Emerging market financial crises

In 2001, two significant emerging markets – Turkey and Argentina – experienced economic and financial crises. Both countries received significant financial assistance from the IMF and abandoned their fixed exchange rate systems. In Turkey, which is now following a comprehensive reform programme, recent indicators suggest that conditions are beginning to improve, with a fragile return of confidence. In contrast, the situation in Argentina has deteriorated rapidly since its debt default at the end of last year.

A notable feature of both crises is that neither triggered the contagion to other emerging market countries associated with many previous crises. As a result, foreign direct investment to emerging markets – their most important source of finance – held up well last year. One reason for the lack of contagion is that investors are increasingly able to differentiate between risk in different emerging markets. The fact that few other significant emerging markets exhibited the same vulnerabilities as those which led to difficulties in Turkey and Argentina will have further limited contagion. Moreover, given that financial market concerns over Argentina had been building for some time, investors were able gradually to reduce their exposure, instead of reacting abruptly to unanticipated events.

In the light of this relative lack of contagion, and given clearer signs of a recovery in G7 activity, conditions for emerging market financing and the outlook for emerging markets have improved significantly since the time of the Pre-Budget Report.

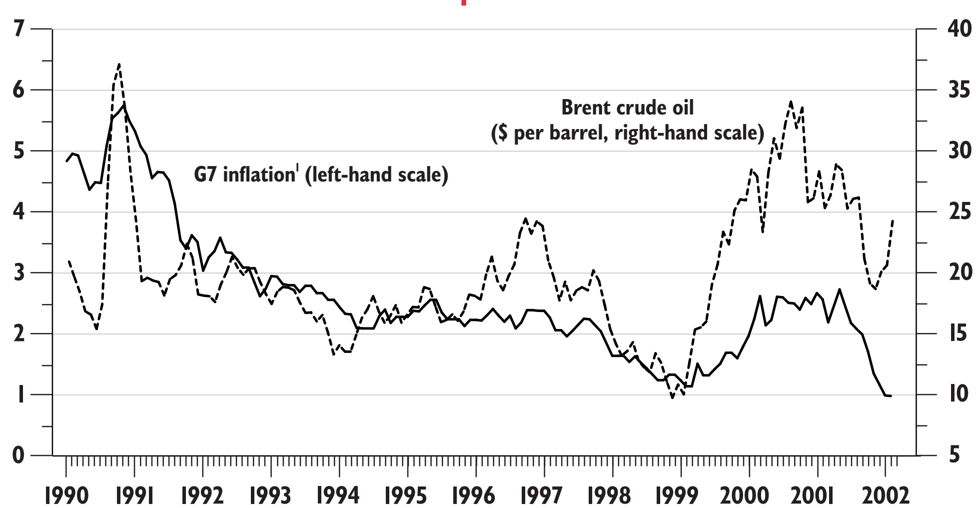
Oil and commodity prices

B14 Weak global demand and good harvests put downward pressure on almost all primary commodity prices in 2001. Oil prices fell to two-year lows as a result of weak global demand and a re-evaluation of market conditions after 11 September, but rose sharply towards the end of the first quarter of 2002 as the prospects for global demand strengthened and political developments in the Middle East raised concerns over future supply. Circumstances in the Middle East may continue to put upward pressure on prices and encourage volatility. Given improved prospects for a global recovery, most other commodity prices are also now picking up, and this trend is expected to continue through 2002.

G7 inflation

B15 G7 headline inflation fell from a peak of over 2½ per cent in spring 2001 to an average of 1½ per cent in the final quarter, consistent with a small negative output gap and lower oil prices. G7 inflation eased further in January, but is forecast to increase slightly to 1½ per cent by the final quarter of 2002, in line with the recovery in commodity prices and strengthening economic activity. Inflation is forecast to remain at this rate thereafter, with output growth around trend.

Chart B2: G7 inflation and oil prices



[1] *Consumer price index, percentage change on a year earlier.*

UK ECONOMY OVERVIEW

Summary

B16 Last year, in contrast to previous episodes of faltering global demand and rising economic uncertainty, the platform of low inflation and sound public finances delivered by the Government's new macroeconomic framework enabled policy to sustain stability and growth in the UK. Decisive action by the Monetary Policy Committee supported consumer demand, and helped to counter the additional near-term economic risks posed by the terrorist attacks of 11 September, while fiscal policy supported monetary policy in sustaining demand over the course of the year.

B17 There are now clear signs that activity in the UK is strengthening, and growth is forecast to gather pace during the course of this year as the world economic recovery becomes more broad-based. UK growth is also expected to become more balanced as stronger external demand provides renewed impetus to UK exports and business investment, while household consumption moderates gradually to sustainable rates.

B18 The economic forecast is now anchored around a neutral assumption for trend output growth of $2^3/_4$ per cent a year, supported by an updated assessment of the prospects for trend growth and based on the judgement that the economy was operating at potential in the third quarter of last year. Consistent with past practice, projections for the public finances presented in Chapter C are based on the cautious assumption that trend growth is $^1/_4$ percentage point lower than the neutral view.

Table B2: Summary of forecast

		Forecast		
	2001	2002	2003	2004
GDP growth (per cent)	$2^1/_4$	2 to $2^1/_2$	3 to $3^1/_2$	$2^1/_2$ to 3
RPIX inflation (per cent, Q4)	2	$2^1/_4$	$2^1/_2$	$2^1/_2$

Recent developments

B19 The pattern of UK growth over the past year has been influenced by the global downturn in trade, industrial production and investment, and by heightened uncertainty following the events of 11 September. Nonetheless, decisive interest rate cuts helped to ensure that consumer demand remained robust throughout the year, while fiscal policy also supported growth. As a result, GDP is estimated to have grown by 2.2 per cent last year – in line with the Pre-Budget Report projection and the lower end of the Budget 2001 forecast range.

B20 The important role played by household consumption in supporting GDP growth through 2001 was also underpinned by the resilience of the labour market, which helped to sustain consumer confidence and to ensure strong growth of real household disposable incomes. The impact on consumption of weaker equity values was compensated for by rising housing wealth. In contrast, the synchronised world slowdown and collapse in demand for ICT-related goods led to a marked contraction in UK manufacturing output and exports, and depressed business confidence and investment. The trade deficit widened in 2001 as external demand weakened and domestic consumption remained robust, though these effects were partly offset by falling demand for imports of intermediate and investment goods. Overall imports of goods and services grew by just $2^3/_4$ per cent, well below normal rates.

B21 At the time of the Pre-Budget Report, it was assumed that the terrorist attacks of 11 September would delay the global recovery until the second half of 2002, with knock-on effects to confidence and activity in the UK. In the immediate aftermath of the attacks, domestic business confidence deteriorated sharply, with the effects extending well beyond those firms directly affected by the downturn in external demand. Households also perceived that prospects for the UK economy had weakened, though they remained confident in the outlook for their own finances.

B22 Pre-emptive action by the Monetary Policy Committee helped to ensure that the downturn in UK consumer confidence after 11 September was short-lived. The aggregate GfK measure[3] fell back in September and October, but remained above its long-run average and had returned close to a record high by January. While retailers reported a fall in sales in the days immediately after 11 September, the attacks do not appear to have had a significant lasting effect on consumer demand, and household consumption rose by 0.9 per cent in the final quarter of 2001. Although retail sales volumes levelled off around the turn of the year, they rebounded strongly in February. Other indicators of consumer activity and demand also suggest that household spending has retained more momentum in early 2002 than anticipated in the Pre-Budget Report.

B23 Notwithstanding the strength of consumption, GDP registered zero growth in the fourth quarter of last year, as weak business confidence prompted firms to hold back production and defer investment. Continued strong consumer demand was partly met by a rundown in inventories, which reduced quarter-on-quarter GDP growth by ½ percentage point. UK exports continued to fall as external demand remained weak, particularly from the Euro-area, and net trade exerted a significant drag on GDP growth as imports picked up modestly following significant contractions in the previous two quarters. Recent evidence from UK business surveys suggests that UK activity is likely to have strengthened in early 2002, with indicators of confidence, current activity and new orders improving in both manufacturing and service sectors. Indeed, official data showed a rise in manufacturing output in February.

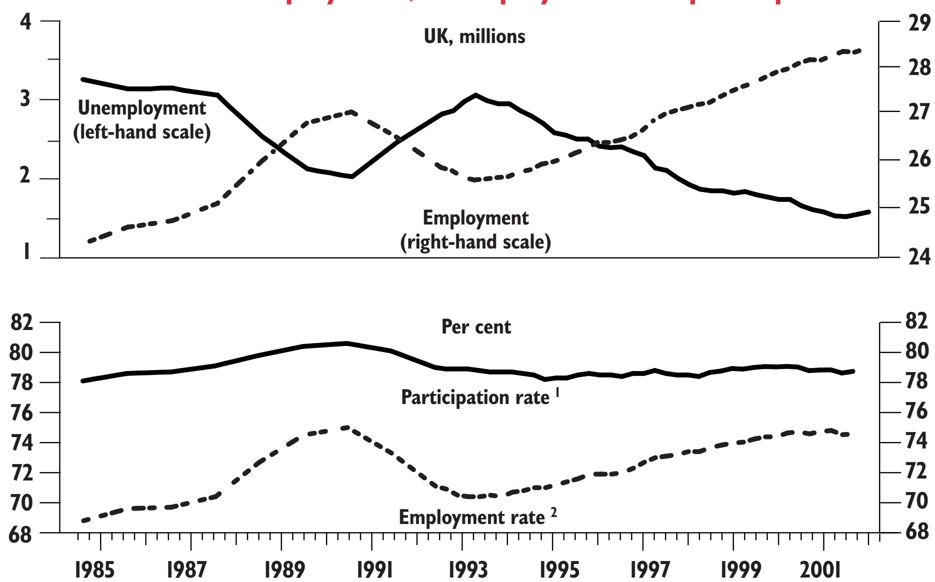
B24 Despite the effects of the world slowdown on business confidence, employment rose to new record highs in late 2001 and early 2002, having risen by more than 1½ million over the past five years. Although the population of working age has grown strongly, the Labour Force Survey (LFS) working-age employment rate is now just 0.3 percentage points below its spring 2001 peak, while unemployment rates remain close to their lowest levels since the 1970s on both International Labour Organisation (ILO) and claimant count measures. Underlying earnings growth (excluding bonuses) has fallen back to within sustainable limits, and weak commodity and import prices also contributed to keeping RPIX inflation below target for most of 2001 – its average of 2.1 per cent for the year as a whole was the same as 2000, the lowest annual figure since 1963. RPIX inflation rose marginally above target in January 2002, but subsequently fell back, and underlying inflationary pressures remain subdued.

The labour market

B25 The labour market proved remarkably resilient last year in the face of the global economic slowdown, though survey indicators of firms' demand for labour fell back in the second half of 2001. Consistent with expectations that the slowdown in activity would be short-lived, LFS measures show that firms responded mainly by reducing average hours per worker: total employment hardly fell, and then only over the summer. Indeed, towards the end of last year, employment increased to then record highs. It has since risen further and average hours worked have stabilised. Latest evidence from the Recruitment and Employment Confederation's Report on Jobs tends to confirm that a recovery in demand for labour is already under way. Continued stability in the labour market over the past year has underlined the importance of the new macroeconomic policy framework, and of policies to make work pay and promote greater labour market flexibility, in delivering sound economic fundamentals and increased employment opportunity.

[3] Consumer confidence indicators published by Martin Hamblin GfK (Gesellschaft für Konsumforschung) on behalf of the European Commission.

Chart B3: 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.*

B26 In the three months to February, LFS employment was 170,000 higher than a year earlier, with the increase almost entirely accounted for by rising full-time employment. Moreover, the apparent pause in employment growth over last summer may be at least partly explained by the ending of around 70,000 temporary jobs associated with the Census collection in the spring. Abstracting from this, temporary employment has remained on a downward trend since 1997, coinciding with continued strong growth of total employment. Increased willingness among employers to take on permanent staff may partly reflect greater confidence in future economic stability.

B27 With employment remaining more robust than in past economic slowdowns, unemployment rates have remained at, or very close to, levels last achieved in the 1970s. The ILO rate is now only marginally higher than its spring 2001 trough and, at just over 5 per cent, remains below most estimates of the NAIRU[4], which is judged to have fallen broadly in line with actual unemployment over recent years. The claimant count remains below 1 million, and longer-term claimant unemployment (12 months plus) has continued to decline, with a fall of more than 43,000 over the past year. Although the claimant count rose slightly in the latter months of 2001, it has resumed falling in early 2002. Inflows to claimant unemployment, which often prove a timely indicator of the direction of future labour market developments, began falling last December having risen between July and November.

B28 The favourable trend in unemployment will, in part, reflect the ongoing success of the New Deal programmes. Over 350,000 young people and over 90,000 other long-term unemployed people have moved into work through the New Deal for Young People and the New Deal 25 plus respectively. Long-term youth and adult unemployment have both fallen by three quarters since spring 1997[5]. Recent extensions to the New Deals, and other measures described in Chapter 4, should also help to tackle the problem of working-age inactivity. There remain nearly 4 million people of working age who are economically inactive and on benefits, including people with disabilities or health problems, and lone parents. LFS data indicate that over 2¼ million people of working age who are economically inactive report that they want a job.

[4] Non-accelerating inflation rate of unemployment.
[5] Claimant count. Long-term youth unemployment: aged 18–24, over 6 months duration. Long-term adult unemployment: aged 25+, over 18 months duration. Youth claimant unemployment over 12 months duration has been virtually eradicated.

B29 Earnings growth was more clearly affected than employment as the world economy slowed which, together with the adjustment of average hours worked, gives evidence of the labour market's flexibility. Having risen above 5 per cent in early 2001, the whole-economy headline measure fell back to just 1.9 per cent for the three months to Febuary 2002. In the private sector, weaker bonuses account for a large part of this deceleration, though growth in underlying earnings (excluding bonuses) has also eased, from over 5 per cent last summer to around $4^1/_4$ per cent in recent months. Public sector earnings growth continues to outpace that of the private sector, but has moderated from a peak of 5.7 per cent last autumn to 4.7 per cent in Febuary.

B30 The robustness of employment as output growth moved below trend last year led to a cyclical downturn in productivity growth, which is expected to be reversed as output growth strengthens during 2002. The cyclical dip in whole economy productivity growth in the second half of last year was more marked in terms of output per job than output per hour, reflecting the downward adjustment in average hours worked. Manufacturing productivity has fallen back as a consequence of the significant reductions in output, with sharp falls in the electrical and optical engineering sector alone subtracting almost $^1/_2$ percentage point from growth of whole-economy output per job in the year to the final quarter of 2001. In the first half of last year, the combination of strong earnings growth and more modest productivity gains implied a significant pick-up in annual growth of unit wage costs, though this began to ease in the second half as earnings growth moderated.

Trend output growth

B31 The latest available data from private-sector surveys and other sources support the judgement that the economy was on trend in the first half of 1997 and in mid-1999, and suggest that the economy moved back to trend in the third quarter of 2001. Table B3 presents a decomposition of trend output growth over the last two full economic cycles, and for the period between the first half of 1997 and the third quarter of 2001. Consideration of the latter period ensures that all available data can be taken into account when projecting components of trend output growth going forward. Moreover, relative to the short cycle judged to have ended in mid-1999, estimates of trend growth rates over this longer period are less sensitive to data revisions at the on-trend points, which may take place for several years after data are first published.

B32 Since the Pre-Budget Report, the decomposition has been developed further to take into account variations in hours worked. Thus the decomposition now includes productivity measured on the basis of output per hour worked and distinguishes the contribution to trend growth of average hours worked per person. For the purposes of decomposing trend growth, this represents an analytical refinement of the previous approach, where the productivity component was measured in terms of output per job with no further breakdown. Hours data are obtained from the LFS, and the employment rate is now expressed in terms of the more familiar LFS working-age employment rate, rather than the workforce jobs based measure previously used. This improves the consistency of the decomposition in the sense that the hours, employment and population components are all now based on LFS measures. Moreover, changes in the NAIRU and the trend inactivity rate, each of which contribute to trend employment rate growth, are naturally defined in terms of numbers of people.

B33 Looking at the recent past, the underlying trend rate of growth of output per hour worked is estimated to have been 2.1 per cent, a touch higher than over the last two full economic cycles. However, the new decomposition shows that trend growth of output per worker has been depressed in recent years by an unusually steep rate of decline in average hours per worker. Growth in the employment rate has continued to make a positive contribution to trend output growth, particularly during the short cycle ending in mid-1999, and the working-age population has increased more rapidly since 1997 than over the previous cycle.

B34 Table B3 shows projections for the various components in the period to 2006. These projections are described in more detail in Box B3 and in a technical paper[6] published alongside the Budget. They are consistent with a neutral assumption of 2³/₄ per cent a year for the trend rate of output growth over this period. The mid-points of the economic forecast ranges are anchored around this neutral assumption, which does not rely on any improvement in the underlying trend rate of growth in output per hour worked relative to recent experience.

Table B3: 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)
Over full economic cycles						
1986Q2 to 1997H1	2.06	1.84	–0.14	0.45	0.35	**2.51**
1997H1 to mid-1999	1.91	1.55	–0.28	0.72	0.63	**2.64**
Since 1997H1						
1997H1 to 2001Q3	2.14	1.96	–0.37	0.36	0.66	**2.63**
Projection[5]						
2001Q3 to 2006Q4	2.1	2.0	–0.1	0.2	0.6	**2³/₄**

[1] *Treasury analysis based on the judgement that 1986Q2, 1997H1, mid-1999 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. Hours, employment and population data are consistent with revised LFS data released on 17 April 2002. 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 allowances 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 underlying the mid-points of the GDP growth ranges from 2001Q4.*

B35 Consistent with past practice, projections for the public finances are based upon the lower end of the economic forecast ranges, which are anchored around the deliberately cautious assumption of annual trend output growth ¹/₄ percentage point lower than the neutral view. The symmetric upper bounds of the forecast ranges illustrate the potential for stronger supply-side performance, based on Government policies designed to increase the rate of productivity growth and to deliver enhanced employment opportunity.

[6] *Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002.

Box B3: Projections for components of trend output growth

This box sets out the basis for the projections for the components of trend output growth presented in Table B3. More detail is presented in an accompanying paper[1].

The neutral assumption underpinning the economic forecast in this chapter entails trend underlying labour productivity on an output per hour basis continuing to grow in line with the evidence for the recent past. No allowance is made for the clear upside potential for enhanced productivity growth associated either with strong growth of ICT-related investment in recent years, or with the Government's comprehensive strategy to improve the UK's productivity performance.

The trend decline in average hours worked steepened in the second half of the 1990s. This is likely to have reflected a number of one-off factors, including: a fall in the number of self-employed, who tend to work above average hours; higher employment amongst 16-24 year-olds in full-time education, who tend to work relatively short hours; and the Working Time Directive, introduced in April 1999, which will have encouraged reductions in average hours at the upper end of the distribution.

Many of these factors are now likely to have run their course. Over the past couple of years, the shares of self-employment and of students in total employment have stabilised. On this basis, a case could be made for simply projecting a flat trend in average hours worked. However, the neutral projection for trend average hours worked assumes a decline of 0.1 per cent a year over the forecast period, in line with the trend decline over the 1986-97 economic cycle.

With the employment rate now close to its historic high, the scope for further increases is more limited than in the past. Accordingly, trend growth in the employment rate is projected at 0.2 per cent a year over the forecast period, a more moderate rate than in recent years or the previous two economic cycles. Activity rates within nearly all age and gender cohorts have increased over the recent past, and it is assumed that further increases in trend activity rates within cohorts will outweigh the negative effect of changing demographics. As in the Pre-Budget Report, the projection allows for only a very slight further decline in the NAIRU, despite a much higher estimated rate of decline over the recent past. The projection does not include any explicit allowance for the impact of Government policies which could further boost the employment rate in the coming years.

Assumed growth in the population of working age is based on the latest population projections published by the Government Actuary's Department (GAD). However, the 'principal' GAD projection for net migration appears excessively cautious in the light of recent experience. Net migration has been consistently under-predicted in recent years, and the Treasury projection for the population of working age presented in Table B3 therefore assumes a level of net migration half-way between the GAD's 'principal' and 'high' migration projections. This is close to the average level of net migration for the latest three years of published data (1997-1999), although rather lower than the average for the latest two years.

[1] *Trend Growth: Recent Developments and Prospects,* HM Treasury, April 2002.

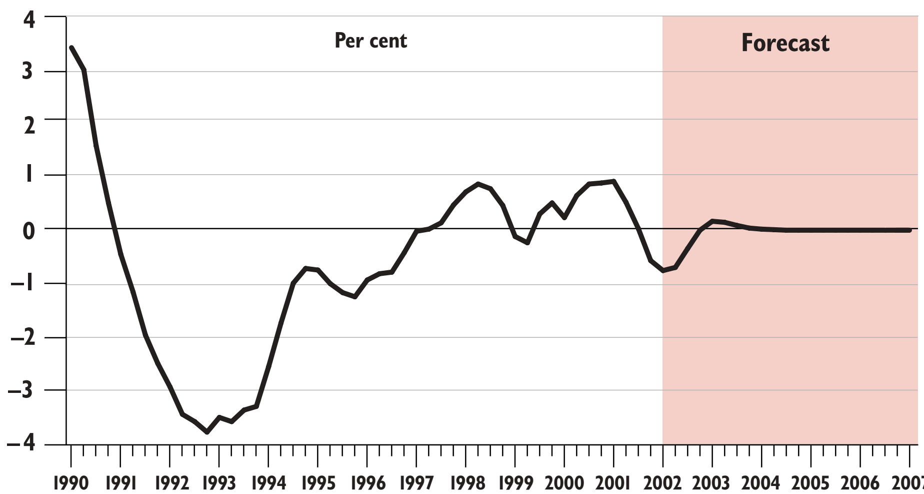
Output and demand

B36 The judgement that the economy was operating at potential in the third quarter of 2001 implies that a modest negative output gap opened up as GDP registered zero growth in the fourth quarter. Although survey evidence points towards an upturn in activity in the first quarter of 2002, growth is expected to have remained below trend, and the output gap is projected to have widened to over $^{3}/_{4}$ per cent of GDP.

B37 As at the time of the Pre-Budget Report, GDP is forecast to increase by between 2 and $2^1/_2$ per cent in 2002, with growth moving above trend and strengthening through the year as the world economic recovery becomes more broad-based. Growth is now forecast to rise to between 3 and $3^1/_2$ per cent in 2003, before returning to trend in 2004. Over the forecast period, GDP growth averages around $^1/_4$ percentage point a year stronger than in the Pre-Budget Report forecast, reflecting the higher projection for the trend rate of output growth.

B38 The forecast shows a return to more balanced growth as stronger external demand supports a recovery in business investment and exports, and as household consumption growth moderates to sustainable rates. Improving business confidence and strengthening external demand are expected to prompt a recovery in business investment from mid-2002, with growth rising to between $5^1/_2$ and $6^1/_4$ per cent in 2003 as deferred capital spending plans continue to come on stream. Public sector investment and current spending are projected to make an increased contribution to growth over the forecast horizon, as the overall spending envelope set in this Budget for the 2002 Spending Review allows for higher public expenditure from 2003-04 than assumed in the Pre-Budget Report.

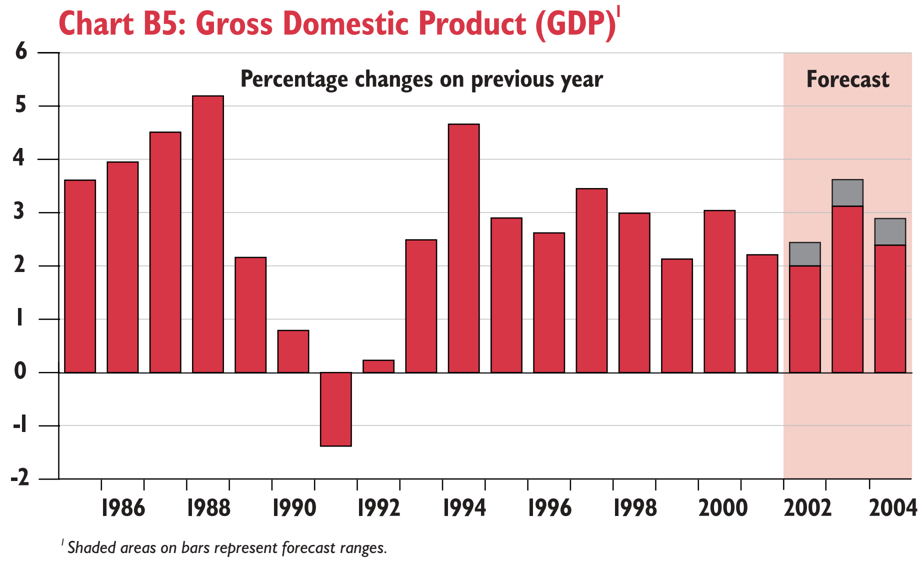
Chart B4: The output gap[1]



[1] *Actual output less trend output as a percentage of trend output (non-oil basis).*

B39 Reductions in interest rates were instrumental in supporting consumer confidence in the UK following the events of 11 September, and household consumption appears to have maintained more momentum into early 2002 than anticipated at the time of the Pre-Budget Report. Nonetheless, household consumption growth is expected to begin to moderate in the second half of this year and to grow more in line with developments in income and wealth thereafter, as households limit further accumulation of debt.

B40 Stronger external demand and the anticipated pick-up in world trade should also provide a significant boost to UK export growth, which is projected to increase markedly in the second half of this year, and to rise to between $7^3/_4$ and $8^1/_4$ per cent next year. Stronger exports and domestic business investment are forecast to raise demand for imports of intermediate and investment goods. Nevertheless, the acceleration in imports is expected to be limited by the combination of easing demand for imported consumer goods and the compositional shift towards spending on public services, which typically have relatively low import intensity. As a result, net trade is projected to exert a broadly neutral influence on GDP growth as exports rise faster than imports from the second half of 2002.



B41 Although domestic demand for consumer goods is therefore likely to grow more modestly than over recent years, the anticipated recovery in trade and investment in the UK and across the world economy is expected to provide a significant boost to UK manufacturing output, which was particularly affected by the global slowdown. Strengthening demand for ICT-related goods should stimulate a revival in the high-technology sectors, output of which weakened sharply last year. Other UK manufacturers should also benefit from the more general upturn in external demand. Manufacturing output growth is now expected to move above trend in the second half of 2002 and into 2003 (see Box B4), though output in 2002 as a whole is likely to be significantly weaker than in 2001.

B42 The downside risks associated with the events of 11 September have clearly diminished since the time of the Pre-Budget Report, with pre-emptive monetary policy action heading off any prolonged downturn in confidence and activity in the UK. However, prospects for a sustained upturn in growth continue to depend heavily on the strength of external demand. Any setback to the global recovery would delay the anticipated pick-up in UK export growth, prolong the current weakness in profitability and deter the projected strengthening of business investment. The knock-on effects to UK labour and equity markets could also prompt a sharper than expected deceleration of household consumption.

B43 Conversely, the possibility of a stronger than anticipated recovery in external demand presents upside risks to UK growth, and particularly to business investment and trade. A strong world recovery could also stimulate consumer demand significantly during 2002 and, with interest rates currently at historically low levels and debt servicing costs affordable, there remains a risk that consumption will moderate more gradually than forecast. While this would boost domestic demand in the short term, any further rises in household indebtedness would increase the likelihood of a sharper downward correction in consumption at some point in the future. Stronger than anticipated household consumption growth would also present upside risks to UK inflation.

Box B4: Manufacturing output: developments and prospects

Last year was a testing period for manufacturers across the world as global growth slowed, demand for ICT-related goods collapsed and uncertainty increased after the terrorist attacks of 11 September. Manufacturing output was affected in all the world's major economies in 2001: it fell by $2^1/_4$ per cent in the UK, compared with more than 4 per cent in the US and around $7^3/_4$ per cent in Japan. While manufacturing output increased marginally in France and Germany during 2001 as a whole, by the fourth quarter it was respectively, $2^1/_2$ and 4 per cent down on a year earlier.

In the UK, manufacturers were particularly affected by the collapse in global demand for ICT-related goods, with high-technology exports accounting for roughly 60 per cent of the fall in finished manufactured exports last year. Moreover, falling output in the ICT sector[1] accounted for almost half of the decline in total UK manufacturing output during 2001, compared with a quarter in the US and Germany and around 10 per cent in France, reflecting a particularly sharp downturn in UK telecommunications production. This might have been compounded by higher rates of mobile phone ownership in the UK reducing demand for new handsets relative to other countries.

Despite the impact of the global slowdown and weaker demand for ICT-related goods, output did increase in some UK manufacturing sectors last year. Output in the chemicals-related industries, which grew on average by $2^1/_4$ per cent a year over the five years to 2000, rose by a further 3.6 per cent during 2001; food, drink and tobacco industries registered an increase of 1.4 per cent; and car production increased by around $6^3/_4$ per cent between the first and second halves of the year.

Looking ahead, the foundations for a sustained recovery in manufacturing output now appear to be in place. Improving world economic prospects have already contributed to a pick-up in survey measures of confidence and activity amongst UK manufacturers, and should support a manufacturing recovery during 2002. Manufacturing output increased by 0.4 per cent in February on the official measure, consistent with the Chartered Institute of Purchasing & Supply (CIPS) Report on Manufacturing, which indicated rising output in February and March. Moreover, output expectations measures in both the CBI Industrial Trends survey and the Engineering Employers' Federation Engineering Outlook have recorded clear improvements this year.

Moreover, evidence from Asia that ICT-related intra-regional trade and exports to the US have picked up suggests that the ICT cycle may be bottoming out. Production of ICT goods in the US has stabilised after contracting by around 4 per cent in each of the last two quarters of 2001, while ICT output in the UK rose in February having been on a downward trend since the start of 2001.

The Budget forecast shows a further contraction of UK manufacturing output in 2002 as a whole, but this largely reflects the extent of the fall through last year, and disguises positive second quarter growth and an expected return to above-trend rates of growth in the second half of the year. Indeed, in the year to the first quarter of 2003, manufacturing output is forecast to grow by 3 per cent.

[1] ICT sector refers to the electrical and optical equipment sector for the UK, France and Germany, and the electrical machinery sector for the US.

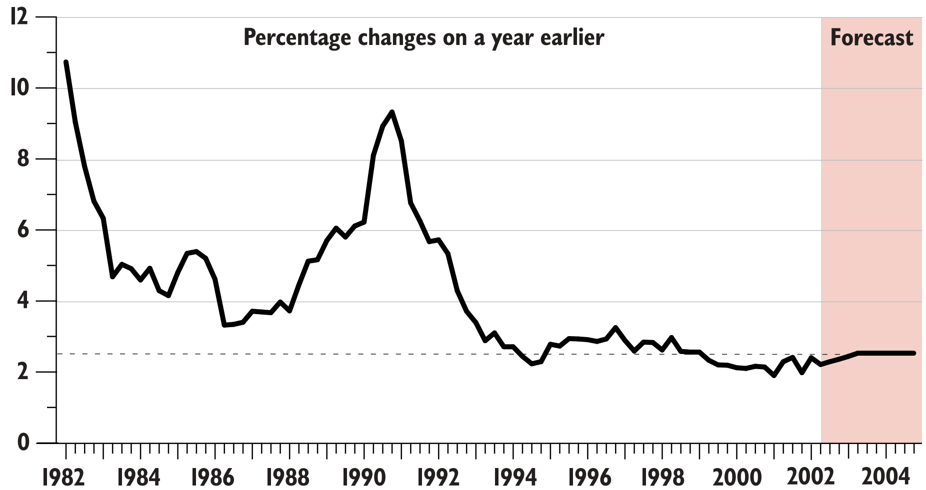
Inflation

B44 The UK continues to experience the longest period of sustained low inflation since the 1960s. Annual RPIX inflation averaged 2.1 per cent in 2001, unchanged from 2000 and a little below the Government's $2^1/_2$ per cent target. Low and stable inflation allowed the Monetary Policy Committee to reduce interest rates during the course of last year in response to rising uncertainty over prospects for the world economy. All-items RPI inflation declined sharply during the year, reaching a low of just 0.7 per cent in December, reflecting falling mortgage interest payments.

B45 Annual RPIX inflation stood at 2 per cent in the final quarter of 2001. This was a little below the Pre-Budget Report forecast, owing to further petrol price cuts and a broader easing of core inflationary pressures. RPIX inflation spiked up to 2.6 per cent in January 2002 as past cuts in petrol prices dropped out of the annual comparison, and as discounting in the New Year sales was less aggressive than in 2001, but averaged 2.4 per cent for the first quarter as a whole. Rebuilding of retailers' margins is expected to make a positive contribution to inflation this year, though this effect is likely to diminish as moderating consumer demand reduces retailers' pricing power later in the year.

B46 Volatile price movements last year mean that the monthly profile for RPIX inflation is likely to remain erratic in the months ahead. Abstracting from these base effects, subdued price pressures further back in the supply chain should continue to exert a downward influence on RPIX inflation throughout 2002. Annual producer input price inflation has been negative since the middle of last year, reflecting low prices of oil and a range of commodity imports and, although oil prices have been higher recently, survey measures of cost and output price expectations remain low. Easing wage pressures and a cyclical upturn in productivity growth are expected to contribute to a moderation in annual unit wage cost growth this year.

Chart B6: RPIX[1]



[1] *Outturns until 2002Q1; forecasts for every second quarter from 2002Q2 to 2004Q4.*

B47 RPIX inflation is therefore projected to remain a little below target at the end of 2002, and to return to target by mid-2003 as a small positive output gap temporarily emerges and as commodity and other import prices pick up. GDP deflator inflation is projected to rise slightly above 2½ per cent for 2002 as a whole, mainly on account of a sizeable positive terms of trade contribution, but to fall back to 2½ per cent in 2003.

B48 Uncertainties surrounding future prospects for consumer demand present a clear risk to the inflation forecast. Unexpected strength in consumer spending could offer retailers scope to rebuild margins further than anticipated, pushing inflation higher; whereas high levels of household debt could prompt a sharper slowdown in consumer demand, which would have the opposite effect. World economic developments will also affect UK inflation through their potential impact on import prices, domestic confidence and demand, while any significant adjustment in the value of sterling would directly affect the cost of imported goods. However, if the recent weakness of the euro has encouraged European suppliers to increase margins rather than to reduce sterling-denominated prices, any future euro appreciation would not necessarily translate into a proportionate increase in UK import prices.

Independent forecasts

B49 Independent forecasts show a clear consensus for strengthening UK growth as external demand picks up in the period ahead. The average of all independent forecasts for GDP growth in 2002 is only marginally below the lower end of the Budget forecast range, and two thirds of the independent forecasts made within the last month lie within or above the Budget forecast range.

B50 For 2003, the average independent forecast for growth is around ½ percentage point below the mid-point of the Budget forecast range. Independent forecasts have sometimes been overly pessimistic at times of heightened world economic uncertainty in the past. At the time of Budget 1999, in the aftermath of the Asian crisis, independent forecasts for UK growth in 1999 and 2000 were significantly below the Government's projections. In the event, growth in both years exceeded even the upper end of the Budget 1999 forecast ranges.

B51 Independent forecasts for RPIX inflation are very close to the Budget projection, and to the Government's 2½ per cent target, reflecting the credibility of the new monetary policy framework. The average forecasts for the balance of payments current account show modestly smaller deficits in 2002 and 2003 than the Budget projections but, as usual, there is a wide range of forecasts around the independent average.

Table B4: Budget and independent[1] forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2002			2003		
		Independent			Independent	
	April Budget	Average	Range	April Budget	Average	Range
Gross domestic product	2 to 2½	1.9	0.4 to 2.7	3 to 3½	2.7	–0.1 to 3.6
RPIX (Q4)	2¼	2.2	1.6 to 3.1	2½	2.4	1.8 to 3.3
Current account (£ billion)	–25¾	–21.0	–29.7 to –10.0	–23¾	–22.7	–49.1 to –8.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', April 2002.*

UK FORECAST IN DETAIL

The household sector

B52 Household consumption grew by around 1 per cent a quarter throughout 2001, but growth in real household disposable income was even stronger, supported by a resilient labour market and targeted government support to households. Consequently, the saving ratio averaged 1 percentage point higher last year than in 2000, consistent with the Budget 2001 forecast.

B53 Annual growth of household consumption has remained stable at around 4 per cent in each of the past six years, with households adjusting saving to cushion the effects of fluctuating income growth on spending. At the same time, growth of household consumption has, on average, exceeded that of real disposable incomes. The persistent relative strength of consumption growth may partly be accounted for by rising housing wealth, but it has also been accompanied by a significant increase in household indebtedness. This may, in part, have reflected lower and more stable inflation and interest rates relative to past experience, which have kept debt servicing costs stable relative to disposable incomes. However, growth in consumption cannot be sustained indefinitely at rates exceeding the trend growth rate of the economy. Households are therefore expected to limit further borrowing over the forecast horizon as they approach desired balance sheet positions.

Table B5: Household sector[1] expenditure and income

	Percentage changes on previous year unless otherwise stated			
		Forecast		
	2001	2002	2003	2004
Household consumption[2]	$3^3/_4$	3 to $3^1/_2$	$2^1/_4$ to $2^3/_4$	$1^3/_4$ to $2^1/_4$
Real household disposable income	5	$1^1/_4$ to $1^3/_4$	2 to $2^1/_2$	$2^1/_2$ to 3
Saving ratio (level, per cent)	$5^1/_2$	$3^3/_4$	$4^1/_4$	$4^3/_4$

[1] *Including non-profit institutions serving households.*
[2] *At constant prices.*

B54 With debt expanding less rapidly, household consumption is expected to grow more closely in line with developments in income and wealth. Household income growth is expected to slow significantly in 2002 as earnings growth continues to be depressed by negative bonus effects, particularly in the early part of the year. The lagged effects of falling equity prices over the past two years are also expected to restrain consumption growth this year, and house price inflation is projected to moderate towards its long-run relationship with earnings. Accordingly, although consumption growth appears to have maintained significant momentum in early 2002, it is forecast to begin to ease gradually during the second half of the year. But over the year as a whole, households are expected to cushion the impact of weaker disposable income growth through some temporary reduction in the saving ratio. By 2004, growth in consumer spending is expected to have slowed to below disposable income growth, with the saving ratio rising to $4^3/_4$ per cent.

B55 Nonetheless, considerable uncertainty still surrounds the outlook for consumption. Although debt servicing costs remain modest relative to disposable incomes, any sharp adjustment in households' expectations of future incomes or interest rates could prompt consumers to rein in spending and rebuild savings more rapidly than expected. The probability and scale of any such adjustment is difficult to assess but, with inflationary pressures remaining subdued and the economy judged to be operating currently below potential, financial markets do not expect interest rates to rise to levels witnessed in previous economic cycles. Present levels of indebtedness therefore appear less likely to cause financial distress than in the past, although the possibility that house prices have risen above sustainable levels may compound the risk of households being overly exposed to any rise in the burden of debt interest payments.

B56 Alternatively, recent interest rate cuts could provide a greater than anticipated stimulus to consumer demand in the remainder of this year, particularly if the strength of the world economic recovery exceeds expectations. Households' confidence in the outlook for their own finances has returned to record levels, house prices have been rising rapidly in the face of inelastic housing supply, and the pause in growth of retail sales volumes around the turn of the year was followed by a sharp pick-up in February. Nonetheless, continued unanticipated strength in consumer spending would, if funded by further increases in indebtedness, increase the likelihood of a sharper downward correction to consumption at some point in the future.

Companies and investment

B57 Slower world economic growth last year clearly affected UK companies. The manufacturing sector, which directly exports around 40 per cent of its gross output, was particularly affected by weaker external demand and by the slump in demand for ICT-related goods (see Box B4).

Table B6: Gross fixed capital formation

	Percentage changes on previous year			
		Forecast		
	2001	2002	2003	2004
Whole economy[1]	1/4	1 1/2 to 2	5 3/4 to 6 1/4	4 1/4 to 4 3/4
of which:				
Business[2,3]	–1 1/4	–1 to –1/2	5 1/2 to 6 1/4	3 3/4 to 4 1/4
Private dwellings[3]	–1 3/4	–2 1/4 to –2	2 to 2 1/2	2 to 2 1/2
General government[3,4]	11 3/4	26 1/4	12 1/2	10 3/4

[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.*

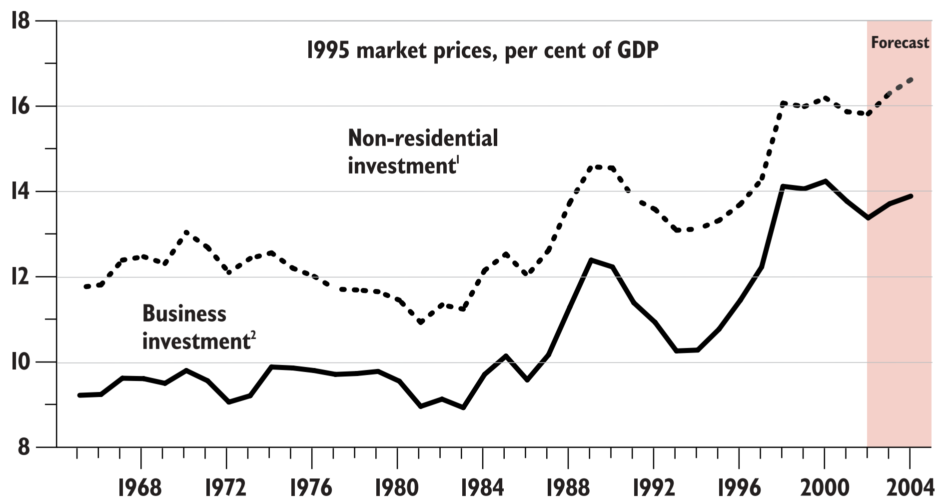
[3] *Excludes purchases less sales of land and existing buildings.*

[4] *Includes National Health Service Trusts.*

B58 Business investment growth was widely expected to moderate in 2001, having increased at an average annual rate of almost 9 per cent between 1995 and 2000. In the event, investment in the private service sector contracted through 2001, and manufacturing investment was particularly depressed in the second half of the year. Business investment fell by 1 1/4 per cent, as firms deferred capital spending in the face of weak and increasingly uncertain global demand. CBI surveys report that uncertainties surrounding future demand were the most commonly cited restraint on investment growth, particularly in the aftermath of 11 September. Weaker corporate profitability and lower equity market valuations are also likely to have had a negative influence, though interest rate cuts will have provided some support to company finances.

B59 The outlook for companies has improved in recent months, and trading conditions are expected to strengthen further as economic recovery takes shape in the UK's major export markets. Survey measures of UK business confidence have picked up since the end of last year, with indicators of current output and new orders bottoming out or improving in surveys of both manufacturing and service sectors. Manufacturing inventories rose in the first quarter of 2001 but fell back in subsequent quarters, so any upturn in demand is now more likely to translate into increased production.

Chart B7: Business and non-residential investment ratios



[1] *Whole economy less dwellings.*

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

B60 Most survey measures of the level of spare capacity in the economy had moved above their long-run averages by early 2002, suggesting that business investment is likely to remain muted in the first half of the year. Thereafter, strengthening demand, confidence and profitability are expected to encourage firms to realise investment plans that were deferred in the uncertain climate of the past year. Continued technological advances should also provide an incentive for firms to upgrade existing machinery and equipment and, while ICT-related investment growth is not expected to return to the very strong rates witnessed in the late 1990s, telecommunications companies are likely to invest in new network infrastructure associated with third-generation (3G) technologies. Renewed momentum in business investment, coupled with rising external demand for ICT-related and other manufactured goods, should help to underpin a strong recovery in UK manufacturing output later this year and into 2003.

B61 Business investment remains close to its record share of GDP, measured at constant (1995) prices, averaging almost 14 per cent in 2001, and this share is forecast to rise towards its all-time high as business investment growth strengthens. General goverment investment is projected to accelerate further in 2002, having increased by almost 12 per cent last year, and growth is projected to remain in double digits in both 2003 and 2004. Whole-economy investment growth is therefore expected to rise from between 1½ and 2 per cent in 2002 to between 5¾ and 6¼ per cent in 2003.

Trade and the balance of payments

B62 The synchronised slowdown in the world economy inevitably affected UK trade. Weaker growth in the UK's major export markets, together with the global slump in demand for highly-traded ICT goods, led to a marked contraction in UK exports from the second quarter of 2001. The scale of the downturn in exports and domestic business investment, which have a higher import content than other components of final demand, meant that imports weakened much more sharply than projected in Budget 2001 (see Box B5), helping to moderate the widening of the deficit on trade in goods and services. In the final quarter of 2001, import volumes were 2½ per cent down on a year earlier.

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]	
2001	1	2¾	0	0	0	–21¼
Forecast						
2002	–1½ to –1	1 to 1½	1¼	–½	1¾	–24
2003	7¾ to 8¼	6½ to 7	3	3½	–¾	–24¾
2004	6½ to 7	6 to 6½	3½	3½	0	–25½

[1] *Average value indices.*
[2] *Ratio of export to import prices.*

Box B5: Explaining the recent weakness of imports

Despite the strength of domestic demand last year, imports turned out substantially weaker than forecast in Budget 2001. UK trade data reveal that, while imports of consumption goods increased in 2001, imports of capital and intermediate goods fell by almost 10 per cent and over 20 per cent respectively in the year to the fourth quarter. Closer examination of the relationship between imports and selected expenditure components of final demand confirms that imports tend to be more closely correlated with growth of investment and exports than with household consumption.

There are no readily available and timely measures of the overall import content of individual components of final expenditure[1]. However, there are reasons to believe the import content of household consumption expenditure is lower than that of business investment and exports. Almost half of household consumption is accounted for by services, many of which are not highly traded. At the same time it seems reasonable to assume that many non-durable goods, which account for around a quarter of consumption, are unlikely to have high import content.

By contrast, capital goods are often either imported directly or contain imported components. While investment spending is only equivalent to roughly one-third of household consumption, the trade data indicate that investment and consumption goods account for a broadly similar proportion of total imports. The slowdown in business investment in the UK during 2001 is therefore likely to have had a greater impact on imports than its share of total final expenditure would suggest. Similarly, the slowdown in investment growth in other major industrialised economies may also have played an important role in explaining the collapse in world trade growth during 2001.

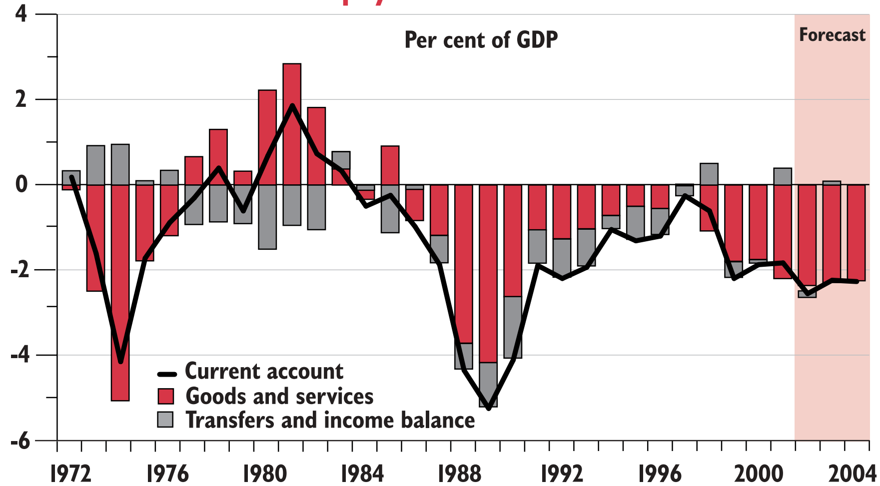
International production linkages may explain the close correlation between UK imports and exports. Multinational corporations are able to source different components from different countries, importing and re-exporting goods at various stages of the production process to take advantage of price and cost differentials. This is particularly common in industries where high value-to-weight ratios mean that transport costs are relatively low, such as ICT-related goods. In the UK, such goods account for around a quarter of manufactured imports, approximately double their share in manufactured output. The sharp slowdown in ICT-related exports will also therefore have contributed to the deceleration in total UK imports and world trade more generally.

Looking ahead, the projected recovery in investment and exports is likely to lead to a significant pick-up in import growth in the near term. However, this is expected to be limited by moderating household consumption growth and by the increasing share of government spending, which has a particularly low import content, in final expenditure.

[1]The overall import content of final demand components comprises not only goods and services imported directly to final demand, but also indirect imports used as intermediate inputs in producing domestic goods and services to supply final demand. Estimates are not readily available for the UK in recent years, though in principle they could be derived from analysis of input-output information.

B63 Having increased over recent years, the goods deficit with non-EU countries narrowed in the second half of 2001, as the fall in import volumes from non-EU sources was particularly severe. This may partly have reflected the sharp slowdown in ICT-related imports, which account for a large share of goods imports from certain non-EU sources: 25 per cent for the US and 40 per cent for south-east Asia, compared with just over 15 per cent for goods imports from the EU. Meanwhile, the deficit on trade in goods with the EU widened significantly towards the end of 2001, reflecting the more modest decline in imports from the region and the impact of weakening Euro-area economic growth on demand for UK exports. Excluding a significant one-off fall in exports of services in September, which reflected insurance claims following the terrorist attacks in the US, the surplus on trade in services fell modestly in 2001.

Chart B8: Balance of payments current account



B64 Looking forward, UK exports are forecast to pick up as export market growth strengthens later in 2002 and into 2003. Year-on-year growth is still projected to be negative for 2002 as a whole, but export volumes in the second half of the year are forecast to be almost 4 per cent higher than in the first half. Imports are also expected to accelerate significantly this year, as the projected pick-up in final demand is led by investment and exports. Nonetheless, the anticipated moderation in household consumption growth and the increasing share of final expenditure accounted for by government spending, which generally has a relatively low import content, are expected to limit import growth over the medium term. Import volumes are therefore projected to grow less rapidly than exports from the second half of 2002, so that the deficit on trade in goods and services levels off at 2¼ per cent of GDP.

B65 The relatively modest widening of the trade deficit, combined with a significant rise in the net surplus on income and transfers, meant that the current account deficit increased only marginally in 2001 as a whole. Although it rose significantly in the fourth quarter as the erratic investment income surplus fell back sharply, it is expected to narrow gradually from the second half of this year as UK earnings on overseas assets return to more normal levels and the trade deficit levels off. Thereafter, the current account deficit is expected to stabilise at 2¼ per cent of GDP, a level which is readily financeable and which remains well below past peaks.

Table B8: Summary of economic prospects[1]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[2]			Average errors from past forecasts[3]	
	2001	2002	2003	2004	2002	2003
Output at constant market prices						
Gross domestic product (GDP)	2¼	2 to 2½	3 to 3½	2½ to 3	¾	½
Manufacturing output	–2¼	–3 to –2½	2¼ to 2¾	1¾ to 2¼	1	1¾
Expenditure components of GDP at constant market prices[4]						
Domestic demand	2¾	2¾ to 3¼	3 to 3½	2½ to 3	½	1
Household consumption[5]	3¾	3 to 3½	2¼ to 2¾	1¾ to 2¼	¾	1¼
General government consumption	2¾	3¼	3¼	3¼	¾	1
Fixed investment	¼	1½ to 2	5¾ to 6¼	4¼ to 4¾	2	2¼
Change in inventories[6]	–¼	0	0	0	¼	¼
Exports of goods and services	1	–1½ to –1	7¾ to 8¼	6½ to 7	2½	2½
Imports of goods and services	2¾	1 to 1½	6½ to 7	6 to 6½	2½	3
Balance of payments current account						
£ billion	–17½	–25¾	–23¾	–25½	6¾	7
per cent of GDP	–1¾	–2½	–2¼	–2¼	¾	¾
Inflation						
RPIX (Q4)	2	2¼	2½	2½	½	½
Producer output prices (Q4)[7]	–¼	1	2	2¼	1	1½
GDP deflator at market prices	2½	2¾	2½	2½	½	¾
Money GDP at market prices						
£ billion	989	1036 to 1041	1094 to 1104	1149 to 1166	8	13
percentage change	4¾	4¾ to 5¼	5½ to 6	5 to 5½	¾	1¼

[1] *The forecast is consistent with national accounts and balance of payments statistics to the fourth quarter of 2001, released by the Office for National Statistics on 27 March 2002.*

[2] *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.*

[3] *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 per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2002 and 2003.*

[4] *Further detail on the expenditure components of GDP is given in Table B9.*

[5] *Includes households and non-profit institutions serving households.*

[6] *Contribution to GDP growth, percentage points.*

[7] *Excluding excise duties.*

Table B9: Gross domestic product and its components

	£ billion at 1995 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
2001	580.2	158.1	156.6	1.2	896.4	288.4	1184.8	338.8	–0.3	845.7
2002	598.3 to 600.8	163.3	158.9 to 159.6	0.9 to 1.6	921.4 to 925.4	284.0 to 285.2	1205.4 to 1210.6	342.5 to 344.0	–0.3	862.6 to 866.3
2003	611.0 to 616.6	168.8	168.1 to 169.7	0.1 to 1.7	948.1 to 956.8	306.2 to 309.0	1254.3 to 1265.8	364.5 to 367.8	–0.3	889.5 to 897.7
2004	621.8 to 630.6	174.3	175.3 to 177.7	–0.3 to 2.2	971.1 to 984.8	326.0 to 330.7	1297.1 to 1315.4	386.1 to 391.5	–0.3	910.8 to 923.6
2001 1st half	287.2	79.1	78.5	1.2	446.2	147.4	593.6	172.0	–0.2	421.4
2nd half	293.0	78.9	78.0	0.0	450.2	141.0	591.2	166.8	–0.1	424.3
2002 1st half	297.4 to 298.3	81.4	78.8 to 79.0	–0.7 to –0.5	456.9 to 458.3	139.4 to 139.8	596.3 to 598.1	168.8 to 169.3	–0.1	427.3 to 428.6
2nd half	300.9 to 302.5	81.9	80.1 to 80.6	1.7 to 2.1	464.5 to 467.1	144.6 to 145.4	609.2 to 612.5	173.7 to 174.7	–0.1	435.3 to 437.7
2003 1st half	304.0 to 306.4	83.7	82.9 to 83.6	0.8 to 1.5	471.4 to 475.2	150.4 to 151.6	621.8 to 626.8	179.5 to 180.9	–0.1	442.2 to 445.7
2nd half	307.0 to 310.2	85.1	85.2 to 86.1	–0.7 to 0.2	476.6 to 481.6	155.8 to 157.4	632.4 to 639.0	185.0 to 186.9	–0.1	447.3 to 451.9
2004 1st half	309.6 to 313.6	87.0	86.8 to 87.9	–0.9 to 0.2	482.5 to 488.7	160.6 to 162.6	643.1 to 651.4	190.3 to 192.8	–0.1	452.6 to 458.4
2nd half	312.2 to 317.0	87.3	88.5 to 89.8	0.6 to 2.0	488.6 to 496.0	165.5 to 168.0	654.0 to 664.1	195.7 to 198.7	–0.1	458.2 to 465.2
	Percentage changes on previous year[4,5]									
2001	3¾	2¾	¼	–¼	2¾	1	2¼	2¾	0	2¼
2002	3 to 3½	3¼	1½ to 2	0	2¾ to 3¼	–1½ to –1	1¾ to 2¼	1 to 1½	0	2 to 2½
2003	2¼ to 2¾	3¼	5¾ to 6¼	0	3 to 3½	7¾ to 8¼	4 to 4½	6½ to 7	0	3 to 3½
2004	1¾ to 2¼	3¼	4¼ to 4¾	0	2½ to 3	6½ to 7	3½ to 4	6 to 6½	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 per cent 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 remains on track to meet its strict fiscal rules. Low and stable debt levels combined with strong surpluses on the current budget left the public finances well placed to accomodate the impact of the global slowdown in 2001. Budget 2002 projections show that:

- **the current budget remains in surplus over the economic cycle, even using cautious assumptions and including in the cautious case, ensuring that the Government remains on track to meet the golden rule;**
- **public sector net debt is expected to remain low and stable at around 31 per cent of GDP; comfortably meeting the sustainable investment rule;**
- **the fiscal stance this year and over the next two years is at least as tight as in the Pre-Budget Report; and**
- **in the medium term, and in light of the low levels of net debt, the Government is moderately increasing net borrowing to fund investment in priority public services.**

Budget 2002 therefore maintains the conditions for economic stability, continuing the Government's prudent approach to managing the public finances, while releasing substantial resources for the Government's long-term goals.

INTRODUCTION

C1 Chapter 2 describes the Government's fiscal 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 surplus 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). The latest assumptions are set out in Box C1 and include a revised assumption for trend output growth of $2^1/_2$ per cent a year.

MEETING THE FISCAL RULES

C3 The Government remains firmly on track to meet the fiscal rules throughout the next five years. Table C1 compares the latest estimates for the main fiscal balances with those in the Pre-Budget Report and Budget 2001.

C4 In the Pre-Budget Report, receipts for 2001–02 were revised down significantly – mainly as a result of the effects of the global economic downturn. An explanation of the impact of the slowdown on different taxes was included in the Pre-Budget Report. Receipts outturns since November have been about £1 billion lower than in the Pre-Budget Report. However, reflecting lower outturns for spending, the provisional outturn for the current surplus in 2001–02 is £10.6 billion, £0.3 billion higher than projected in November.

C5 The provisional outturn for net investment in 2001–02 is slightly lower than in the Pre-Budget Report, and public sector net borrowing is £1.2 billion lower at £1.3 billion. The revised fiscal projections show that fiscal policy supported monetary policy in 2001 through the automatic stabilisers as the economy moved slightly below trend, while continuing to meet the two fiscal rules.

C6 Receipts in 2002–03 are considerably lower than projected in Budget 2001 but much the same as in the Pre-Budget Report. The current surplus is expected to return to its Pre-Budget Report level in 2002–03 and is higher in 2003–04 and 2004–05 because of Budget measures and stronger economic growth, mainly resulting from the change to the trend output growth assumption. Over the five year period as a whole the projected current surplus is higher than in the Pre-Budget Report.

C7 In both 2002–03 and 2003–04, cyclically-adjusted net borrowing is projected to be 0.2 per cent of GDP lower than in the Pre-Budget Report, before returning to its Pre–Budget Report level in 2004–05. The fiscal stance this year and over the next two years is therefore at least as tight as projected in November. Compared with the Pre-Budget Report, there is a small fiscal tightening this year and next as growth gathers pace during 2002 and the economy returns to trend. Over the medium term, the Government has decided to increase net borrowing modestly to fund investment in improving the public infrastructure, increasing public sector net investment gradually from less then $^3/_4$ per cent of GDP in 2000–01 to over 2 per cent of GDP by 2006–07. With net debt of around 31 per cent of GDP over the projection period, these planned increases are fully consistent with meeting the fiscal rules comfortably.

Table C1: Fiscal balances compared with Budget 2001 and the 2001 Pre-Budget Report[1]

	Outturn[2]		Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Surplus on current budget (£ billion)							
Budget 2001	22.3	15.9	14	8	9	9	
PBR 2001	25.1	10.3	3	4	7	8	9
Budget 2002	**21.6**	**10.6**	**3**	**7**	**9**	**7**	**9**
Net borrowing (£ billion)							
Budget 2001	–15.0	–4.7	2	10	11	12	
PBR 2001	–18.8	2.5	12	15	13	13	13
Budget 2002	**–15.9**	**1.3**	**11**	**13**	**13**	**17**	**18**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2001	2.0	1.2	1.0	0.6	0.7	0.7	
PBR 2001	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Budget 2002[3]	**1.8**	**1.0**	**0.5**	**0.6**	**0.7**	**0.6**	**0.7**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2001	–1.3	–0.1	0.4	1.1	1.1	1.1	
PBR 2001	–1.6	0.3	1.1	1.4	1.2	1.1	1.1
Budget 2002[3]	**–1.2**	**0.2**	**0.9**	**1.2**	**1.2**	**1.4**	**1.4**

[1] *Including Windfall Tax receipts and associated spending.*

[2] *The 2000–01 figures were estimates in Budget 2001; the 2001–02 figures were projections in Budget 2001 and PBR 2001.*

[3] *These figures are estimates in 2001–02.*

C8 Table C2 shows five-year projections of the current budget surplus and public sector net debt as a percentage of GDP, the key fiscal 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 net worth, are also shown.

Table C2: Summary of public sector finances

	Per cent of GDP							
	Outturns		Estimate	Projections				
	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Fairness and prudence								
Surplus on current budget	2.3	2.3	1.1	0.3	0.6	0.8	0.6	0.7
Average surplus since 1999–2000	2.3	2.3	1.9	1.5	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	2.1	1.8	1.0	0.5	0.6	0.7	0.6	0.7
Long-term sustainability								
Public sector net debt	36.4	31.3	30.4	30.2	30.4	30.4	30.7	31.0
Core debt[1]	35.7	31.0	30.2	29.9	30.1	30.2	30.5	30.8
Net worth[2]	14.7	19.5	20.8	21.4	21.4	21.0	20.3	20.1
Primary balance	4.1	3.8	1.7	0.6	0.5	0.4	0.1	0.0
Economic impact								
Net investment	0.5	0.6	1.2	1.4	1.8	1.9	2.0	2.1
Public sector net borrowing (PSNB)	–1.8	–1.7	0.1	1.1	1.2	1.1	1.4	1.4
Cyclically-adjusted PSNB	–1.6	–1.2	0.2	0.9	1.2	1.2	1.4	1.4
Financing								
Central government net cash requirement	–1.0	–3.7	0.3	1.3	1.6	1.4	1.7	1.9
European commitments								
Treaty deficit[3]	–1.7	–1.7	0.2	1.0	1.1	1.1	1.4	1.5
Cyclically-adjusted Treaty deficit[3]	–1.5	–1.2	0.3	0.8	1.1	1.2	1.4	1.5
Treaty debt ratio[4]	43.4	40.1	38.0	36.9	36.6	36.5	36.6	36.8
Memo: Output gap	0.2	0.8	–0.2	–0.2	0.1	0.0	0.0	0.0

[1] *See box 2.4.*
[2] *At end December; GDP centered on end-December.*
[3] *General government net borrowing on an ESA95 basis.*
[4] *General government gross debt on Maastricht basis.*

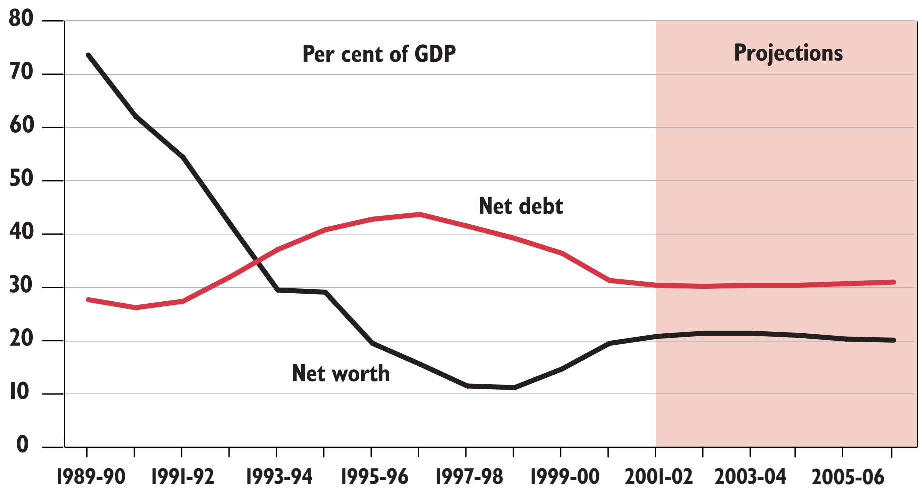
C9 The projections show that, as in Budget 2001 and the Pre-Budget Report, the Government remains on track to meet the golden rule over the forecast period. The current budget balance improved from a deficit of 3 per cent of GDP in 1996–97 to surpluses of over 2 per cent in 1999–2000 and 2000–01, and 1 per cent in 2001–02. While the surplus temporarily falls to about $^1/_4$ per cent of GDP in 2002–03, it recovers to around $^3/_4$ per cent over the rest of the period. The average surplus on the current budget from 1999–2000 is projected to be over 1 per cent of GDP in each year, consistent with the golden rule over the projection period. Table C2 also shows the updated estimates of the cyclically-adjusted current budget. These allow underlying or structural trends in the indicators to be seen more clearly, once the estimated effects of the economic cycle are removed.

C10 The sustainable investment rule is also comfortably met over the projection period. In 1996–97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and spending taken by the Government over the course of the last Parliament, including the decision to use the proceeds from the auction of spectrum licences to repay debt, means that net debt is projected to stay around 31 per cent of GDP throughout the projection period.

C11 As explained in Box 2.4, in order to increase the transparency of the framework, Table C2 now includes figures for a measure of net debt excluding cyclical fluctuations – core debt. The Budget 2002 projections show that over the next few years core debt will grow slowly as the Government borrows modestly to fund increased investment in priority public services, consistent with the fiscal rules.

C12 Net worth is the approximate stock counterpart of the current budget balance. Current budget surpluses of over 2 per cent of GDP in recent years have begun to raise net worth to an estimated 21 per cent of GDP in 2001–02. At present, net worth is not used as a key indicator of the public finances, mainly due to the difficulties in measuring accurately many government assets and liabilities.

Chart C1: Public sector net debt and net worth



C13 The primary balance is equal to net borrowing excluding net debt interest payments – thus abstracting from the implications of past fiscal deficits. If real interest rates exceed trend output growth, a primary surplus is required to stabilise the net debt ratio. The primary balance is projected to be in surplus by over $1^1/_2$ per cent of GDP in 2001–02, and to remain positive throughout the projection period.

C14 As a result of the spending measures announced in the Budget, public sector net investment is projected to rise steadily to 2.1 per cent of GDP by 2006–07. 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. This increase in net investment, together with the new projections of the surplus on the current budget, mean that public sector net borrowing is expected to rise from 0.1 per cent of GDP in 2001–02 to 1.4 per cent in 2006–07.

C15 The central government net cash requirement was a repayment of $3^{3}/_{4}$ per cent of GDP in 2000–01. This largely reflected the receipts from the auction of licences to access the electromagnetic spectrum. The net cash requirement moved to a modest deficit in 2001–02, and the deficit is projected to increase in 2002–03 and subsequent years, mirroring the profile of public sector net borrowing.

C16 Table C2 also shows the Treaty measures of the deficit and debt used in the Excessive Deficits Procedure. The reference levels of 3 per cent of GDP for the deficit and 60 per cent of GDP for net debt are comfortably achieved throughout the projection period.

FORECAST ERRORS AND RISKS

C17 The fiscal balances represent the difference between two large aggregates of spending and receipts and are inevitably subject to wide margins of forecast error. Over the past five years, the average absolute error (the average error irrespective of whether the errors have been positive or negative) for one-year ahead forecasts of net borrowing has been around 1 per cent of GDP. The error tends to grow as the forecast horizon lengthens. Much of this error arises from forecast errors of GDP.

C18 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[1] suggested that if GDP growth were 1 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 in the following year. Allowing for the reduction in the lag between profits and corporation tax receipts resulting from the introduction of the instalment system, these figures are now closer to 0.5 and 0.2 per cent respectively. However, not all cycles will conform exactly to these parameters, notably because the estimates are based on historical data (since which time both the economy and tax regime have changed) and because cycles differ in respects other than magnitude.

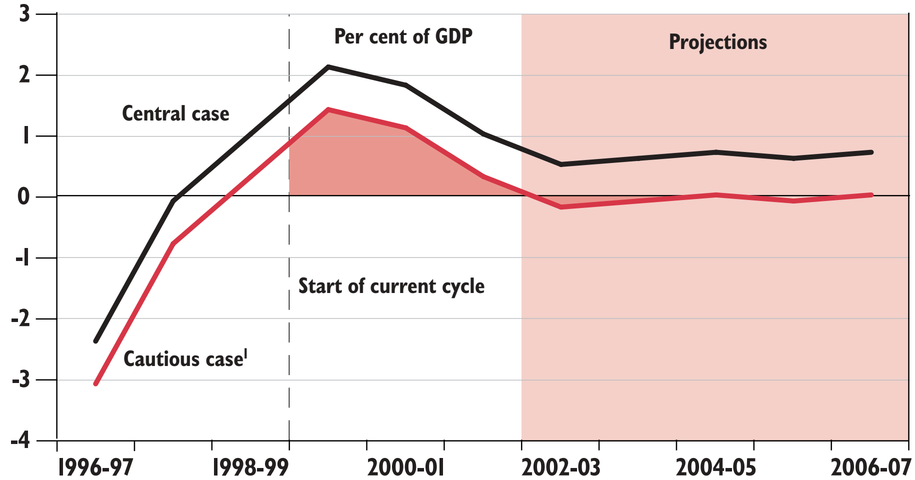
C19 Errors in short–term growth forecasts may have only a temporary effect on the public finances. For a given path of trend output, higher or lower growth in the short–term will be followed by lower or higher growth later on, and the public finances may be little affected on average over the cycle. However, errors in estimating the cyclical position of the economy in relation to its trend – the output gap – will have a permanent effect on prospects.

C20 For this reason, the public finance projections are deliberately based on assumptions for key economic variables, including the trend rate of growth of the economy in the medium term. These are audited by the NAO to ensure they remain both reasonable and cautious. Details of these assumptions are given in Box C1.

C21 In addition, the public finance projections are stress–tested against an alternative cautious case, in which the output gap is assumed to be 1 percentage point higher than the central view. This scenario would imply that a greater proportion of the projected surplus on the current budget was due to the cyclical strength of the economy: a 1 per cent larger positive output gap reduces the structural surplus on the current budget by about $^{3}/_{4}$ per cent of GDP a year. This is illustrated in Chart C2. Even in this more cautious case, the cyclically–adjusted current budget is estimated to have been comfortably in surplus over the past four years. The impact of the temporary fall in receipts means that it moves into deficit over the short term, before returning broadly to balance from 2004–05. However, the average surplus on the cyclically-adjusted current budget in the cautious case from 1999–2000 only falls to a minimum of $^{1}/_{4}$ per cent of GDP in each year.

[1] See *Fiscal Policy: Public Finances and the Cycle*, HM Treasury, March 1999.

Chart C2: 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.*

ASSUMPTIONS

C22 The fiscal projections are based on the following assumptions:

- the economy follows the path described in Chapter B. In the interests of caution, the fiscal projections continue to be based on a deliberately prudent and cautious assumption of trend output growth that is $^1/_4$ percentage point lower than the Government's neutral view. Thus, the projections are now based on trend output growth of $2^1/_2$ per cent a year;

- there are no tax changes beyond those already 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 which cannot be costed accurately in advance of consultation, including the intention to abolish Royalty on North Sea oil;

- forecasts for individual Annually Managed Expenditure (AME) programmes through to 2003–04 have been reviewed and further additions made for new spending measures in AME announced in this Budget. Following usual practice, the Government has decided to reset the AME margin to £1 billion in 2002–03 and £2 billion in 2003–04;

- beyond 2003–04, current expenditure in AME, excluding measures introduced in the Pre-Budget Report and in this Budget, which are projected separately, is projected to grow at $1^3/_4$ per cent a year in real terms, in line with recent trends;

- firm overall spending plans for the 2002 Spending Review from 2003-04 to 2005-06 are set out in Chapter 6 in paragraph 6.33. Decisions on departmental spending allocations will be announced in the 2002 Spending Review;

- prior to spending plans being set in the 2004 Spending Review, the fiscal projections assume DEL growth after 2005–06 of 2.5 per cent in real terms, in line with the assumption on economic growth used for the public finances, supplemented by an addition to allow for the 5 year health settlement of the difference between planned health growth and health's long term average growth, 3.6 per cent. This delivers DEL growth of 3.8 per cent in 2006–07. Other spending in AME is forecast to grow at 1.75 per cent in real terms in line with its long-term trend after 2005–06; and

- within these aggregates, net investment is forecast to increase from 2.0 per cent over the 2002 Spending Review period of 2.1 per cent in 2006–07 towards an assumption of 2.25 per cent of GDP in 2007–08, remaining consistent with the sustainable investment rule.

A full explanation of the firm DEL spending limits for resource and capital expenditure within which the 2002 Spending Review will be completed is provided in Chapter 6. Details of tax changes and other Budget policy decisions are set out in Chapter A.

Table C3: Economic assumptions for public finance projections

Percentage changes on previous year

	Outturn	Projections[1]					
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Output (GDP)	3	$1\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$
Prices							
RPIX	2	$2\frac{1}{4}$	$2\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$
GDP deflator	$1\frac{3}{4}$	$2\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$
RPI[2] (September)	$3\frac{1}{4}$	$1\frac{3}{4}$	2	$3\frac{1}{2}$	$2\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$
Rossi[3] (September)	$1\frac{1}{2}$	$1\frac{3}{4}$	$1\frac{3}{4}$	$2\frac{1}{4}$	$2\frac{1}{4}$	2	2
Money GDP[4] (£ billion)	956	1000	1051	1108	1163	1222	1284

[1] *The figure for RPIX in 2001–02 is an outturn.*

[2] *Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.*

[3] *RPI excluding housing costs, used for uprating certain social security benefits.*

[4] *Not seasonally adjusted.*

C23 The key assumptions underlying the fiscal projections are audited by the NAO. For this Budget, the NAO have reviewed the Government's revised trend growth assumptions. The NAO have also audited the assumption on UK claimant unemployment under the three–year rolling review process. The reviews concluded that both the new trend output growth and unemployment assumptions remain reasonable and cautious.

Box C1: Key assumptions audited by the NAO

• Privatisation proceeds[1,6]	Credit is taken only for proceeds from sales that have been announced.
• Trend GDP growth[1,6,9]	2½ per cent a year.
• UK claimant unemployment[1,4,7,9]	Rising slowly to 1.00 million in 2003–04, from recent levels of 0.95 million, consistent with average of independent forecasts.
• Interest rates[1,6,7]	3–month market rates change in line with market expectations (as of 10 April).
• Equity prices[2,7]	FT–All share index rises from 2542 (close 5 April) from Q2 2002 in line with money GDP.
• VAT[2,7]	Ratio of underlying VAT receipts to consumption falls by 0.05 percentage points a year.
• GDP deflator and RPI[2,7]	Projections of price indices used to plan public expenditure are consistent with RPIX.
• Composition of GDP[3,8]	Shares of labour income and profits in national income are broadly constant in the medium term.
• Funding[3,8]	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
• Oil prices[5]	$21.5 a barrel in 2002, the average for Q1 2002, and then constant in real terms.
• Anti–tobacco smuggling measures[6]	Only direct effects, including deterrent effects of fiscal marks, are allowed for.

[1] Audit of Assumptions for the July 1997 Budget Projections, 19 June 1997 (HC3693).
[2] Audit of Assumptions for the Pre-Budget Report, 25 November 1997 (HC361).
[3] Audit of Assumptions for the Budget, 19 March 1998 (HC616).
[4] Audit of the Unemployment Assumption for the March 1999 Budget Projections, 9 March 1999 (HC294).
[5] Audit of the Oil Price Assumption for the Pre-Budget Report, November 1999 (HC873).
[6] Audit of Assumptions for the March 2000 Budget, 21 March 2000 (HC348).
[7] Audit of Assumptions for the Pre-Budget 2000 Report, 8 November 2000 (HC959).
[8] Audit of Assumptions for the March 2001 Budget, 7 March 2001 (HC304).
[9] Audit of Assumptions for the April 2002 Budget, 17 April 2002 (HC760).

FISCAL AGGREGATES

C24 Tables C4 and C5 provide further detail on the projections of the current and capital budgets. As in the Pre-Budget Report, the tables show the current surplus and net borrowing both including and excluding Windfall Tax and associated spending (WTAS). WTAS now has much less impact and, unless otherwise stated, all projections now cover all public expenditure. Latest estimates of associated spending are given in Table 4.1.

Table C4: Current and capital budgets

	£ billion						
	Outturns		Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Current budget							
Current receipts[1]	383.0	390.8	407	442	468	494	520
Current expenditure[1]	348.8	367.4	390	420	444	471	495
Depreciation[1]	12.7	12.8	14	15	15	16	17
Surplus on current budget (excluding WTAS[2])	22.1	11.4	4	7	9	7	9
Surplus on current budget	**21.6**	**10.6**	**3**	**7**	**9**	**7**	**9**
Capital budget							
Gross investment	23.4	29.9	32	38	41	44	47
less asset sales	–5.0	–5.1	–4	–4	–4	–4	–4
less depreciation[1]	–12.7	–12.8	–14	–15	–15	–16	–17
Net investment	5.7	12.0	14	20	22	24	27
Net borrowing (excluding WTAS[2])	–17.2	0.1	10	13	13	17	18
Net borrowing	**–15.9**	**1.3**	**11**	**13**	**13**	**17**	**18**
Public sector net debt – end year	**305.9**	**310.6**	**326**	**345**	**363**	**385**	**408**
Memos:							
Treaty deficit[3]	–16.1	1.7	10	13	13	17	19
Treaty debt[4]	383.6	380.5	388	406	424	447	472

[1] *These figures are estimates in 2001–02.*
[2] *Windfall Tax receipts and associated spending.*
[3] *General government net borrowing on an ESA95 basis.*
[4] *General government gross debt.*

C25 The current budget surplus is equal to public sector receipts minus public sector current expenditure and depreciation. As explained in paragraph C6, the current budget is projected to be in surplus in each year of the projection period, showing that the Government remains firmly on track to meet the golden rule throughout.

C26 Underlying the projections of the current budget surplus are steady rises in the ratio of public sector receipts and current expenditure to GDP, largely reflecting measures announced in this Budget.

C27 Table C4 also shows public sector net investment more than doubling from £12 billion in 2001–02 to £27 billion in 2006–07 as a result of the Government's aim to improve public infrastructure. 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 at around 31 per cent of GDP, well under 40 per cent of GDP, as shown in Table C5.

Table C5: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Current budget							
Current receipts	40.1	39.1	38.7	39.9	40.2	40.4	40.5
Current expenditure	36.5	36.7	37.1	37.9	38.2	38.5	38.5
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget (excluding WTAS[1])	2.3	1.1	0.4	0.6	0.8	0.6	0.7
Surplus on current budget	**2.3**	**1.1**	**0.3**	**0.6**	**0.8**	**0.6**	**0.7**
Capital budget							
Gross investment	2.4	3.0	3.1	3.4	3.5	3.6	3.7
less asset sales	–0.5	–0.5	–0.4	–0.3	–0.3	–0.3	–0.3
less depreciation	–1.3	–1.3	–1.3	–1.3	–1.3	–1.3	–1.3
Net investment	0.6	1.2	1.4	1.8	1.9	2.0	2.1
Net borrowing (excluding WTAS[1])	–1.8	0.1	1.0	1.2	1.1	1.4	1.4
Net borrowing	**–1.7**	**0.1**	**1.1**	**1.2**	**1.1**	**1.4**	**1.4**
Public sector net debt – end year	**31.3**	**30.4**	**30.2**	**30.4**	**30.4**	**30.7**	**31.0**
Memos:							
Treaty deficit[2]	–1.7	0.2	1.0	1.1	1.1	1.4	1.5
Treaty debt ratio[3]	40.1	38.0	36.9	36.6	36.5	36.6	36.8

[1] *Windfall Tax receipts and associated spending.*
[2] *General government net borrowing on an ESA95 basis.*
[3] *General government gross debt.*

C28 Table C6 provides an analysis of the changes to the projections of the main fiscal aggregates since Budget 2001 and the Pre-Budget Report.

C29 The short term downward revisions to current budget surpluses and the corresponding increases in net borrowing between Budget 2001 and the Pre-Budget Report were mainly due to revised forecasts of public sector receipts, largely driven by lower financial company profits and changes to GDP. The fiscal aggregates were then projected to move back towards their Budget 2001 levels as the economy moved back to trend.

C30 The tax measures announced in this Budget, together with the stronger economic forecast and other forecasting changes, mean that receipts are now projected to be higher than in the Pre-Budget Report. The impact of the $^1/_4$ point increase in the trend output growth assumption cumulates over the projection period, increasing the projected level of receipts by £5 billion in the final year.

C31 The Government's Budget decisions, combined with forecasting changes, result in a fiscal stance over the next two years that is at least as tight as projected in the Pre-Budget Report. Borrowing is slightly higher in the medium term as a result of planned increases in investment.

Table C6: Fiscal balances compared with Budget 2001 and the 2001 Pre-Budget Report

	Outturn[1]		Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Surplus on current budget (£ billion)							
Budget 2001	**22.3**	**15.9**	**14**	**8**	**9**	**9**	**–**
Effect of forecasting changes	2.8	–5.2	–11	–3	0	2	–
Effect of policy measures	–	–0.3	0	–2	–3	–3	–
PBR 2001	**25.1**	**10.3**	**3**	**4**	**7**	**8**	**9**
Effect of forecasting changes	–3.5	0.3	1	1	2	5	7
of which: revision to trend growth assumption	–	–	*1*	*2*	*3*	*4*	*5*
Budget policy decisions/SR 2002 additions[2]	–	–	–1	2	0	–6	–8
Budget 2002	**21.6**	**10.6**	**3**	**7**	**9**	**7**	**9**
Net borrowing							
Budget 2001	**–15**	**–4.7**	**2**	**10**	**11**	**12**	–
Effect of forecasting changes	–3.8	5.2	11	3	0	–2	–
Effect of policy measures	–	2.0	–1	1	3	3	–
PBR 2001	**–18.8**	**2.5**	**12**	**15**	**13**	**13**	**13**
Effect of forecasting changes	2.9	–1.2	–1	–1	–2	–5	–7
of which: revision to trend growth assumption	–	–	*–1*	*–2*	*–3*	*–4*	*–5*
Budget policy decisions/SR 2002 additions[2]	–	–	0	–1	2	9	13
Budget 2002	**–15.9**	**1.3**	**11**	**13**	**13**	**17**	**18**

Note: Figures may not sum due to rounding.

[1] The 2000–01 figures were estimates in Budget 2001; the 2001–02 figures were projections in Budget 2001 and PBR 2001.

[2] The assumptions for public spending in 2006–07 are set out in paragraph C22.

RECEIPTS

C32 Table C7 gives detailed projections of receipts to 2002–03. Changes in the receipts projections since Budget 2001 and the Pre-Budget Report are shown in Table C8. Projections of receipts as a percentage of GDP to 2006–07 are shown in Table C9. Table C10 sets out the projections of the tax–GDP ratio.

C33 The introduction of the Working Tax Credit and Child Tax Credit has been accompanied by a review of the classification of all personal tax credits. This has affected the definition of the net taxes and social security contributions measure, which is the basis for the tax-GDP ratio. The change is described in more detail in Box C2.

C34 Table C8 shows that relative to Budget 2001, receipts are estimated to have been around £7½ billion lower in 2001–02, and are projected to be lower by around £9 billion in 2002–03. The downward revisions to receipts at the time of the Pre-Budget Report were largely due to falls in oil prices, equity prices and financial company profits.

C35 Latest estimates for receipts in 2001–02 show a downward revision of £½ billion since the Pre-Budget Report. This relates mainly to lower than expected corporation tax and social security contributions. These falls are expected to be temporary, for the reasons discussed below, and was partly offset by higher than expected outturns for income tax.

C36 Net taxes and social security contributions are estimated to have risen by 2¾ per cent in 2001–02, considerably lower than the increase in money GDP. As a result the tax-GDP ratio fell from 37.7 per cent in 2000–01 to 37.0 per cent. The classification change has little effect on this fall, as it has much the same effect on both 2000–01 and 2001–02.

Box C2: The classification of personal tax credits

As set out in Chapters 4 and 5, the Government is introducing a new system of support to tackle child poverty and make work pay. The system will separate support for adults from support for children while providing a common framework for assessing entitlement and rationalising administration.

Two new tax credits, the Working Tax Credit and the Child Tax Credit will be introduced from April 2003. They will replace:

- Working Families' Tax Credit (WFTC) and the Disabled Person's Tax Credit (DPTC), which are currently classified as spending in the National Accounts but until now as negative taxation for the purposes of calculating net taxes and social security contributions, as used in the tax–GDP ratio;
- the Children's Tax Credit, which is classified as negative taxation for all purposes; and
- New Deal Employment Credit for the over 50s and income related elements of support for children in Income Support and Jobseeker's Allowance, which are classified as public expenditure for all purposes.

On 20 February 2002, the Office for National Statistics (ONS) announced that the Working and Child Tax Credits would be classified in the National Accounts as negative taxation to the extent that credits are less than or equal to the tax liability of the household, and as public expenditure where credits exceed the liability. The ONS will continue to classify WFTC and DPTC as public expenditure.

This decision on the new tax credits is consistent with OECD guidance, which has recently been reviewed following extensive consultation including with the UK. However, in contrast to the ONS, the OECD will also be applying the same classification rules to WFTC and other tax credits, giving a more consistent time series. The OECD decision is likely to be adopted by other international bodies.

The Government has consistently argued that tax credits paid through the pay packet should be classified as negative taxation. Accordingly it has decided to adopt the OECD classification rules for the purposes of calculating net taxes and social security contributions, as used in the tax–GDP ratio consistent with international best practice. All the figures for net taxes and social security contributions shown in Tables C7 to C10 and C23 have been revised to bring them into line with the new definition. OECD numbers are measured on a cash basis. This change adds about 0.5 percentage points to the tax–GDP ratio for 1999–2000 onwards.

All other fiscal aggregates will continue to be measured on a National Accounts basis.

Table C7: Current receipts

	£ billion		
	Outturns		Projection
	2000–01	2001–02	2002–03
Inland Revenue			
Income tax (gross of tax credits)	106.0	110.2	117.5
Corporation tax[1]	32.4	32.4	33.2
Tax credits[2]	–1.2	–2.6	–3.9
Petroleum revenue tax	1.5	1.3	1.4
Capital gains tax	3.2	2.9	1.8
Inheritance tax	2.2	2.3	2.5
Stamp duties	8.2	7.1	8.2
Social security contributions	60.6	63.2	65.0
Total Inland Revenue (net of tax credits)	**212.9**	**216.9**	**225.6**
Customs and Excise			
Value added tax	58.5	61.1	63.9
Fuel duties	22.6	21.9	23.1
Tobacco duties	7.6	7.8	7.7
Spirits duties	1.8	1.9	2.0
Wine duties	1.8	2.0	2.2
Beer and cider duties	3.0	3.1	3.1
Betting and gaming duties	1.5	1.4	1.3
Air passenger duty	1.0	0.8	0.8
Insurance premium tax	1.7	1.9	1.9
Landfill tax	0.5	0.5	0.5
Climate change levy	0.0	0.6	0.9
Aggregates levy	0.0	0.0	0.2
Customs duties and levies	2.1	2.0	2.1
Total Customs and Excise	**102.2**	**104.9**	**109.7**
Vehicle excise duties	4.3	4.4	4.5
Oil royalties	0.6	0.6	0.5
Business rates[3]	17.3	18.2	18.5
Council tax	14.2	14.9	16.1
Other taxes and royalties[4]	9.0	10.6	10.7
Net taxes and social security contributions[5]	**360.4**	**370.3**	**385.6**
Accrual adjustments on taxes	2.8	0.9	0.8
less own resources contribution to EC budget	–6.3	–6.1	–5.4
less PC corporation tax payments	–0.1	–0.1	–0.2
Tax credits[6]	1.2	1.2	1.6
Interest and dividends	5.8	4.2	4.2
Other receipts[7]	19.4	20.4	20.6
Current receipts	**383.0**	**390.8**	**407.2**
Memo:			
North Sea revenues[8]	4.3	5.2	5.3

[1] *National Accounts measure gross of enhanced and payable tax credits.*

[2] *Personal tax credits scored as negative tax under OECD rules, plus enhanced and payable company tax credits (zero in 2000–01, £50 million in 2001–02 and £350 million in 2002–03).*

[3] *Includes district council rates in Northern Ireland paid by business.*

[4] *Includes money paid into the National Lottery Distribution Fund.*

[5] *Includes VAT and 'traditional own resources' contributions to EC budget. Refer to Box C2 for further details. Cash basis.*

[6] *Tax credits scored as expenditure in the National Accounts but negative tax in net taxes and social security contributions.*

[7] *Includes gross operating surplus and rent; net of oil royalties.*

[8] *Consists of North Sea corporation tax (before ACT set–off), petroleum revenue tax and royalties.*

Table C8: Changes in current receipts since Budget 2001 and the 2001 Pre-Budget Report

	£ billion			
	Budget 2001		PBR 2001	
	2001–02	2002–03	2001–02	2002–03
Income tax (gross of tax credits)	–1.3	–0.5	0.6	1.5
Non–North Sea corporation tax[1]	–5.0	–5.8	–0.7	–1.9
Tax credits[2]	0.2	0.0	0.2	0.0
North Sea revenues	–0.7	–0.6	–0.2	0.1
Capital taxes[3]	0.5	–0.2	–0.1	–0.1
Stamp duty	–0.9	–0.4	–0.3	0.5
Value added tax	–0.3	0.0	–0.3	0.1
Excise duties[4]	–0.3	0.1	–0.3	0.2
Social security contributions	0.6	0.3	–1.0	–0.7
Other taxes and royalties[5]	1.3	1.0	1.0	0.4
Net taxes and social security contributions	–5.8	–6.1	–1.2	0.2
Other receipts and accounting adjustments	–1.7	–2.8	0.8	0.8
Current receipts	**–7.6**	**–8.9**	**–0.4**	**1.0**

[1] *National Accounts measure gross of enhanced and payable tax credits.*
[2] *Personal tax credits scored as negative tax under OECD rules, plus enhanced and payable company tax credits (zero in 2000–01, £50 million in 2001–02 and £350 million in 2002–03); Budget 2001 and PBR 2001 estimates have been revised accordingly.*
[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 C9: Current receipts Budget 2002

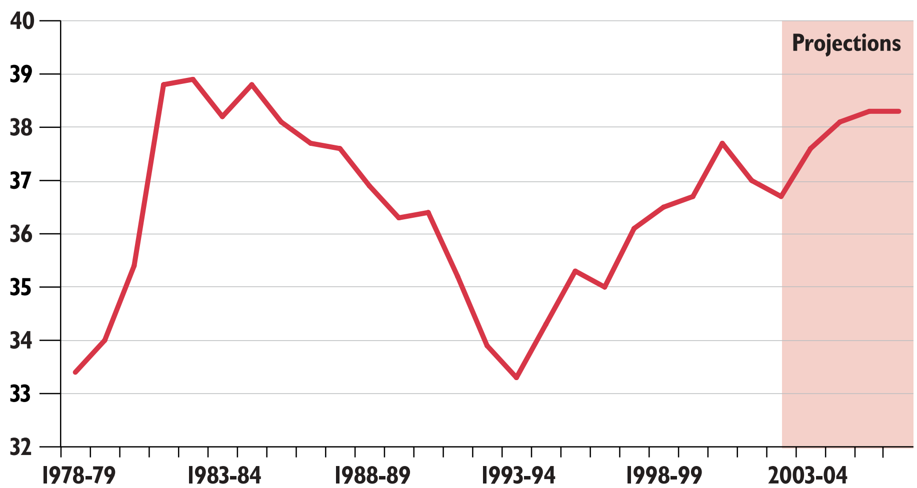
	Per cent of GDP						
	Outturn	Estimate	Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Income tax (gross of tax credits)	11.1	11.0	11.2	11.4	11.5	11.7	11.8
Non–North Sea corporation tax[1]	3.2	2.9	2.8	3.0	3.2	3.4	3.5
Tax credits[2]	–0.1	–0.3	–0.4	–0.3	–0.2	–0.2	–0.2
of which:							
Working Families' Tax Credit[3]	–0.1	–0.1	–0.1	0.0	0.0	0.0	0.0
North Sea revenues[4]	0.5	0.5	0.5	0.5	0.5	0.5	0.4
Value added tax	6.1	6.1	6.1	6.0	5.9	5.9	5.8
Excise duties[5]	3.9	3.7	3.6	3.5	3.5	3.4	3.3
Social security contributions	6.3	6.3	6.2	6.7	6.9	6.9	6.9
Other taxes and royalties[6]	6.8	6.8	6.7	6.6	6.7	6.8	6.8
Net taxes and social security contributions[7]	37.7	37.0	36.7	37.6	38.1	38.3	38.3
Accruals adjustments on taxes	0.3	0.1	0.1	0.3	0.1	0.1	0.1
less EC transfers	–0.7	–0.6	–0.5	–0.4	–0.4	–0.4	–0.3
Tax credits[8]	0.1	0.1	0.2	0.1	0.1	0.1	0.1
Other receipts	2.6	2.5	2.3	2.4	2.4	2.3	2.3
Current receipts [9]	40.1	39.1	38.7	39.9	40.2	40.4	40.5
Memo:							
Current receipts (£ billion)	383.0	390.8	407	442	468	494	520

[1] *National Accounts measure gross of enhanced and payable tax credits.*
[2] *Personal tax credits scored as negative tax under OECD rules, plus enhanced and payable company tax credits (zero in 2000–01, £50 million in 2001–02 and £350 million in 2002–03).*
[3] *The Working Families' Tax Credit will be replaced in 2003 by a new system of tax credits.*
[4] *Includes oil royalties, petroleum revenue tax and North Sea corporation tax.*
[5] *Fuel, alcohol and tobacco duties.*
[6] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*
[7] *Includes VAT and 'own resources' contributions to EC budget. Cash basis. Refer to Box C2 for further details.*
[8] *Tax credits scored as expenditure in the National Accounts but negative tax in net taxes and social security contributions.*
[9] *Accruals basis.*

C37 The tax-GDP ratio falls further to 36.7 per cent in 2002–03, before increasing to 37.6 per cent in 2003–04. This increase is mainly the result of measures effective from 2003–04 onwards and the economy returning to trend. There are further modest increases in the tax-GDP ratio over subsequent years, as was the case in the Pre-Budget Report. Factors contributing to this include fiscal drag, a continued expectation that financial company profits and bonuses will recover as was anticipated in the Pre-Budget Report, and a yield from tax measures which is anticipated to increase slightly from year to year.

C38 Table C10 shows the changes to the tax–GDP ratio since Budget 2001 and the Pre-Budget Report. The changes in 2001–02 partly reflect revisions to GDP and lower outturn receipts. In subsequent years the changes largely reflect Budget 2002 decisions on tax.

Chart C3: Tax-GDP ratio[1]



[1] Net taxes and social security contributions as defined in Table C10.

Table C10: Net taxes and social security contributions[1]

	Per cent of GDP						
	Outturn[2]	Estimate			Projections		
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Budget 2001[3]	38.1	38.0	37.8	37.5	37.5	37.4	
PBR 2001[3]	37.8	37.2	36.8	36.9	37.1	37.2	37.2
Budget 2002	**37.7**	**37.0**	**36.7**	**37.6**	**38.1**	**38.3**	**38.3**

[1] Cash basis; refer to box C2 for further details.
[2] The 2000–01 figures were estimates in Budget 2001.
[3] Previous Budget and Pre-Budget Report projections have been revised so that they are consistent with the new classification of tax credits (see Box C2).

Income tax

C39 Provisional outturn estimates suggest income tax receipts in 2001–02 were £110 billion, around £$^{1}/_{2}$ billion more than projected in the Pre-Budget Report. This mainly reflects stronger than expected PAYE. Although tax on bonus payments does seem to have been lower than in the corresponding months of 2000–01, the reduction was not as large as anticipated in the Pre-Budget Report.

C40 Receipts in 2002–03 are projected to be about £1½ billion higher than in the Pre-Budget Report, because of the higher 2001–02 outturn, higher wages and salaries growth, upward revisions to National Accounts components affecting future self assessment tax receipts, and slightly higher market expectations for interest rates, which lead to higher tax on savings income.

C41 In later years there are larger increases compared with the Pre-Budget Report, mainly as a result of higher income growth, arising from the changed assumption on trend output growth, and Budget measures.

Non-North Sea corporation tax

C42 Non-North Sea corporation tax in 2001–02 was around £¾ billion below the Pre-Budget Report projection, over half of which reflected stronger than expected repayments. This outturn leads to lower projections for 2002–03 and 2003–04. The projections for all years incorporate a revised profile of payments and repayments derived from the data now available on the quarterly instalment system that was introduced for large companies in 1999. This shows that companies, on average, pay more in their instalments and balancing payments than required by their self–assessments, and subsequently claim repayments. This revised profile indicates that repayments will be higher than projected in the Pre-Budget Report, but has a neutral impact on overall corporation tax receipts in the later years of the forecast. Further changes reflect the revision to the trend output growth assumption, and Budget measures. The projection for financial company profits is broadly consistent with independent forecasts for financial companies profits, where these are available.

North Sea revenues

C43 Under the terms of the assumption as audited by the NAO, the oil price used in these projections is based on the average of independent forecasts if this is lower than recent levels. Otherwise recent levels are used. The latest available average of independent forecasts for 2002 is $21.6, which is slightly above the average oil price in Q1 2002 of $21.5. The latter has therefore been used as the base price for these projections. As a result of this cautious assumption prices are around $1½ lower than assumed in the Pre-Budget Report throughout the forecast period.

C44 North Sea revenues in 2001–02 were slightly lower than projected in the Pre-Budget Report, mainly reflecting the weakness of oil prices at the end of 2001. The effects of lower oil prices over the forecast period are more than offset by upward revisions to the oil production projections and Budget measures, and projected revenues are higher than in the Pre-Budget Report from 2004–05 onwards.

Capital taxes

C45 The Budget forecast for capital gains tax is little changed from the Pre-Budget Report, with effects of the modest decrease in equity prices offset by higher property prices. Inheritance tax receipts in 2001–02 were slightly lower than projected in the Pre-Budget Report. This shortfall has been projected forward, but is more than offset by the effects of higher property prices by 2003–04.

Stamp duty

C46 Stamp duty in 2001–02 was slightly lower than projected in the Pre-Budget Report, but 2002–03 receipts are expected to be around £½ billion higher because of recent property market turnover and price levels. Receipts in 2003–04 are much the same level as in the Pre-Budget Report, as the modest fall in the equity price projection is offset by a higher property price projection. In later years receipts are up to £1 billion higher, partly because the higher forecast for property prices more than offsets the lower equity price projection, and partly because of Budget measures.

Tax credits **C47** The classification changes described in Box C2 reduce the level of tax credit payments scoring as negative tax and this change explains almost all of the changes since published Budget 2001 and the Pre-Budget Report estimates. These classification changes are offset by equal and opposite changes in other receipts and accounting adjustments.

Social security contributions **C48** Provisional cash receipts of social security contributions in 2001–02 were £1 billion lower than projected in the Pre-Budget Report. About a third of this shortfall reflects higher rebates that are usually paid a year in arrears in respect of people contracted out of SERPS. The 2001–02 shortfall is projected forward but recent information suggests that growth in these rebates is now likely to be lower than expected in the Pre-Budget Report and the combined effect of these changes leads to higher net receipts in later years of the forecast. In addition, higher wages and salaries growth arising from the changed trend output growth assumption also leads to higher receipts, but the largest effect from 2003–04 onwards reflects the Budget measures.

VAT **C49** VAT receipts in 2001–02 were £61.1 billion, around £0.3 billion below the Pre-Budget Report forecast. The forecast of VAT revenues in 2002–03 and all future years continues to be governed by the NAO audited assumption that, after allowing for the effects of VAT measures, the ratio of VAT receipts to consumer spending declines gradually, by 0.05 percentage points a year. The shortfall in 2001–02 will therefore automatically depress receipts in future years. However, the Budget forecast of higher consumers' expenditure growth in the short term combined with the VAT anti–avoidance measures described in Chapter A mean that VAT receipts are expected to be slightly higher than their Pre-Budget Report levels in 2002–03, 2003–04, and 2004–05, before returning towards their Pre-Budget Report levels as household spending growth moderates to more sustainable rates.

Excise duties **C50** Excise duties in 2001–02 were slightly lower than forecast in the Pre-Budget Report. This is mainly because the later than usual date of the Budget means that the additional receipts associated with the forestalling of road fuel duties will now be received in April 2002 rather than March 2002. This timing issue decreases receipts in 2001–02 by around £0.2 billion with an offsetting increase in 2002–03. The introduction of the oils fraud strategy described in Chapter A and the increase in demand resulting from the lower oil price forecast means that hydrocarbon oil receipts in future years are then expected to be higher than their Pre-Budget Report levels.

C51 Alcohol and tobacco duties in 2001–02 were broadly in line with their Pre-Budget Report forecasts. Receipts in future years are expected to be slightly higher, almost entirely as a result of Budget measures. The ratio of excise duties to GDP is expected to decline over the forecast period, reflecting the fact that the consumption of products subject to excise duties grows by less than real GDP.

PUBLIC EXPENDITURE

C52 Table C11 shows projections for public expenditure through to 2003–04, the last year covered by the 2000 Spending Review. The projections cover the whole public sector using the aggregate Total Managed Expenditure (TME). TME is split into Departmental Expenditure Limits (DEL), firm three year limits for departments' programme spending, and Annually Managed Expenditure (AME), spending that is not easily subject to firm multi–year limits.

C53 Table C12 shows changes in DEL, AME and TME since the Pre-Budget Report. It is provisionally estimated that the DEL total for 2001–02 will be underspent by £0.7 billion. A further addition of £4 billion has been made to DEL in 2003–04, which includes £2.4 billion for the NHS. The remaining £1.6 billion includes provisions for the government's personal social services. The remainder will be allocated in the 2002 Spending Review. Table C14 shows DEL in terms of resource and capital budgets. These have been updated since the Pre-Budget Report to reflect transfers between departments and programmes, additions, and allocations from central funds. The allowance for shortfall of £2 billion, in line with Budget 2001, represents a cautious estimate of likely further underspend beneath departmental estimates.

C54 Forecasts of individual AME programmes were reviewed in the Pre-Budget Report and have been reviewed again for this Budget. In addition, and following usual practice, the Government has decided to reset the AME margin to £1 billion in 2002–03 and £2 billion in 2003–04. Further additions have also been made for new spending measures in AME announced at this Budget. These add approximately £$^3/_4$ billion to AME in 2002–03 and £3$^1/_2$ billion in 2003–04.

C55 The main economic assumptions underpinning the AME projections are set out in Box C1 and in Table C3. In particular, it is assumed that UK claimant unemployment will increase slightly, in line with the average of independent forecasts, from its recent level of 0.95 million (the average of the three months ending in March 2002) to 1.00 million in 2003–04.

C56 Excluding new measures and the effect of re–setting the margin, the main changes to AME projections since the Pre-Budget Report are lower forecasts for social security benefit expenditure and public sector pensions, and higher forecasts for locally financed expenditure. Reductions in the social security forecasts are mainly due to the lower assumption for unemployment, which reduces the social security forecast by just over £$^1/_2$ billion by 2003–04, together with further reductions to reflect lower than expected outturn expenditure in 2001–02. In 2002–03 these reductions are partially offset by extra expenditure resulting from the increase of child allowances in Income Support and Jobseekers' Allowance of £3.50 a week announced in this Budget. In 2003–04 these allowances are drawn together with other support for children in the new Child Tax Credit and this reduces forecast social security expenditure by a further £0.4 billion. Forecasts of locally financed expenditure are higher than in the Pre-Budget Report due to higher assumptions for future council tax settlements. These reflect recent outturn data on actual settlements.

Table C11: Total Managed Expenditure 2000–01 to 2003–04

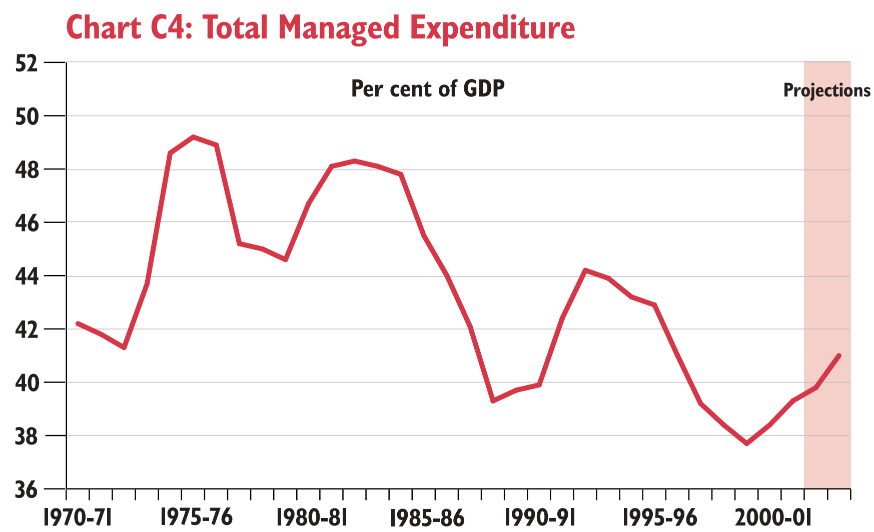
	£ billion			
	Outturn	Estimate	Projections	
	2000–01	2001–02	2002–03	2003–04
Departmental Expenditure Limits				
Resource Budget	171.8	187.8	201.2	214.0
Capital Budget	20.6	24.0	28.3	33.5
Budget 2002 addition				1.6
Total Departmental Expenditure Limits	**192.3**	**211.8**	**229.5**	**249.0**
Annually Managed Expenditure				
Departmental AME:				
Social security benefits	99.1	105.1	109.0	113.9
Housing Revenue Account subsidies	3.1	4.5	4.5	4.4
Common Agricultural Policy	2.6	4.7	2.6	2.6
Export Credits Guarantee Department	1.3	0.2	0.4	–0.2
Self–financing public corporations' capital expenditure	1.4	1.1	1.2	1.2
Net public service pensions	5.2	5.2	5.1	5.4
National Lottery	1.9	1.7	2.3	2.3
Other programme expenditure	0.2	0.2	0.1	0.0
Non–cash items :				
Depreciation	7.1	7.9	8.8	9.5
Cost of capital charges	13.5	14.3	14.6	15.5
Provisions and other charges	8.9	1.3	2.9	3.0
Total departmental AME[1]	**144.3**	**146.2**	**151.5**	**157.6**
Other AME :				
Net payments to EC institutions[2]	3.7	0.8	2.2	2.4
Locally financed expenditure	18.4	19.4	20.7	21.9
Central government gross debt interest	25.9	22.2	21.1	23.2
Accounting and other adjustments	–17.5	–8.2	–7.6	–1.6
Total Other AME	**30.6**	**34.1**	**36.4**	**45.9**
AME Margin	0.0	0.0	1.0	2.0
Annually Managed Expenditure	**174.8**	**180.3**	**188.9**	**205.5**
Total Managed Expenditure	**367.2**	**392.1**	**418.4**	**454.6**
of which:				
Public sector current expenditure	348.8	367.4	389.9	420.3
Public sector net investment	5.7	12.0	14.4	19.7
Public sector depreciation	12.7	12.8	14.0	14.6

[1] Including non–cash items.

[2] 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):

2000-01	2001-02	2002-03	2003-04
4.3	1.5	3.0	3.2

The trended forecast for 2001–02 is £3.1 billion.



C57 Other changes to the AME projections include the lower forecasts for the Export Credits Guarantee Department ECGD, particularly in 2003–04, as a result of new assumptions about the amount of business likely to be available for refinancing. ECGD's refinancing of loans, which it has guaranteed, does not score in TME, which follows National Accounts definitions and excludes financial transactions. These changes are offset within the accounting adjustments and therefore do not affect total AME. Forecasts of debt interest payments are not significantly different from those in the Pre-Budget Report. Changes reflect a combination of lower payments due to lower borrowing in 2001–02, offset by the effect of higher interest rates and, in 2003–04, higher accrued uplift on index linked gilts due to a slightly higher forecast for the RPI.

C58 Details of the main accounting adjustments, which comprise those items within TME but outside DEL and AME main programmes are shown in Table C13. Of these adjustments VAT refunded on general government expenditure is higher than forecast at the Pre-Budget Report. These changes are however offset by equivalent changes to receipts. Forecasts for tax credits are significantly higher in 2003–04 as a result of the introduction of the new tax credits.

Table C12: Changes in Total Managed Expenditure since Budget 2001 and the 2001 Pre-Budget Report

	£ billion							
	Budget 2001				PBR 2001			
	2000–01	2001–02	2002–03	2003–04	2000–01	2001–02	2002–03	2003–04
Departmental Expenditure Limits								
Resource Budget	–0.5	0.8	2.0	3.3	1.0	0.2	–0.1	2.1
Capital Budget	–1.4	–1.2	–1.1	–0.9	0.4	–0.9	0.0	0.3
Budget 2002 addition				1.6				1.6
Total Departmental Expenditure Limits	**–1.9**	**–0.4**	**0.9**	**4.0**	**1.4**	**–0.7**	**–0.1**	**4.0**
Annually Managed Expenditure								
Departmental AME:								
Social security benefits	0.0	0.2	0.4	0.4	–0.1	–0.3	–0.3	–1.2
Housing Revenue Account subsidies	–0.1	0.0	0.2	0.3	–0.1	0.0	0.1	0.2
Common Agricultural Policy	–0.1	2.1	0.0	0.0	0.0	0.2	–0.1	–0.1
Export Credits Guarantee Department	0.2	–0.5	–0.1	–0.6	0.1	–0.6	–0.2	–0.8
Self-financing public corporations' capital expenditure	0.0	0.1	0.0	0.3	0.0	0.0	–0.1	0.1
Net public service pensions	–0.2	–0.4	–0.5	–0.5	0.2	–0.1	–0.4	–0.4
National Lottery	–0.1	–0.6	0.1	0.5	0.0	–0.4	0.1	0.0
Other programme expenditure	0.3	0.2	0.3	0.3	0.0	0.0	0.1	0.1
Non-cash items :								
Depreciation	–0.7	–0.4	–0.1	–0.2	0.1	–0.2	–0.3	–0.1
Cost of capital charges	–0.3	0.9	0.2	0.7	–0.4	0.7	0.6	0.9
Provisions and other charges	7.9	1.9	2.3	2.0	4.1	1.5	1.0	0.7
Total departmental AME[1]	**6.8**	**3.2**	**2.7**	**3.1**	**3.9**	**0.6**	**0.5**	**–0.5**
Other AME :								
Net payments to EC institutions	0.2	–1.9	–0.4	–0.6	0.0	0.0	0.0	0.0
Locally financed expenditure	0.5	0.2	0.6	0.9	0.1	0.0	0.5	0.7
Central government gross debt interest	–0.6	–1.0	–3.0	–0.8	–0.2	0.0	–0.3	0.0
Accounting and other adjustments	–6.0	–0.7	0.8	6.4	–1.6	–1.4	–0.2	5.5
Total Other AME	**–6.0**	**–3.4**	**–2.0**	**5.9**	**–1.6**	**–1.3**	**–0.1**	**6.3**
AME Margin	0.0	–1.0	–1.0	–1.0	0.0	–0.2	–0.2	0.5
Annually Managed Expenditure	**0.8**	**–1.1**	**–0.3**	**8.0**	**2.3**	**–0.9**	**0.2**	**6.3**
Total Managed Expenditure	**–1.1**	**–1.6**	**0.6**	**12.0**	**3.7**	**–1.5**	**0.2**	**10.3**
of which:								
Public sector current expenditure	2.8	0.3	3.5	13.0	4.3	–0.3	0.5	9.2
Public sector net investment	–1.7	0.8	–0.9	1.0	–0.6	–0.9	–0.3	1.1
Public sector depreciation	–2.2	–2.7	–2.0	–2.0	0.0	–0.4	0.0	0.0

[1] *Including non-cash items.*

Table C13: Accounting and other adjustments

	£ billion			
	Outturn	Estimate	Projections	
	2000–01	2001–02	2002–03	2003–04
1 Non–trading capital consumption	7.7	7.8	8.5	8.9
2 VAT refunded on general government expenditure	6.7	7.5	8.2	9.0
3 EC Contributions	–6.3	–6.1	–5.4	–4.9
4 Tax credits	5.1	6.0	6.8	10.7
of which personal tax credits[1]	*4.6*	*5.5*	*6.2*	*9.8*
5 Adjustments for public corporations	4.1	4.2	4.6	5.1
6 Intra general government debt interest	–3.0	–3.0	–3.0	–3.0
7 Financial transactions in departmental budgets	–2.0	–1.2	–1.3	–1.3
8 Adjustments for expenditure financed by receipts	0.2	0.2	0.2	0.2
9 Other accounting adjustments	–0.1	0.1	0.3	1.9
less				
non–cash items in DEL	0.2	0.2	0.2	0.2
non–cash items in AME	29.5	23.5	26.3	28.0
Total accounting and other adjustments	**–17.5**	**–8.2**	**–7.6**	**–1.6**

[1] *Personal tax credits include expenditure on the Working Families' Tax Credit, the Disabled Person's Tax Credit and that bit of the Working Tax Credit and Child Tax Credit scoring as expenditure in the National Accounts. Further information on the classification of personal tax credits is given in Box C2.*

Table C14: Departmental Expenditure Limits – resource and capital budgets

	£ billion			
	Outturn	Estimate	Plans	
	2000–01	2001–02	2002–03	2003–04
Resource Budget				
Education and Skills	14.3	17.0	20.2	21.5
Health	43.6	48.8	53.4	58.5
of which: NHS	*42.7*	*47.7*	*51.2*	*56.1*
Transport and the Regions	3.7	4.2	5.2	5.2
Local Government	35.3	36.9	37.4	40.1
Home Office	8.4	9.6	9.4	9.6
Lord Chancellor's Departments	2.5	2.9	2.7	2.8
Attorney General's Departments	0.4	0.4	0.4	0.4
Defence	19.2	18.9	18.9	18.9
Foreign and Commonwealth Office	1.2	1.3	1.3	1.2
International Development	2.4	2.8	2.9	3.2
Trade and Industry	3.0	3.9	3.7	3.3
Environment, Food and Rural Affairs	1.5	2.4	1.7	1.7
Culture, Media and Sport	0.9	0.9	1.2	1.2
Work and Pensions (administration)[1]	5.9	6.3	6.9	7.5
Scotland[2]	12.6	14.2	15.3	16.3
Wales[2]	6.8	7.7	8.2	8.8
Northern Ireland Executive[2]	4.4	5.2	5.2	5.5
Northern Ireland Office	0.9	1.1	1.1	1.0
Chancellor's Departments	3.5	3.9	4.0	4.0
Cabinet Office	1.2	1.4	1.4	1.5
Invest to Save Budget	0.0	0.0	0.0	0.1
Capital Modernisation Fund	0.0	0.0	0.0	0.0
Policy Innovation Fund	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	0.7	1.7
Allowance for shortfall	0.0	–2.0	0.0	0.0
Total Resource Budget DEL	**171.8**	**187.8**	**201.2**	**214.0**
Capital Budget				
Education and Skills	1.6	2.5	3.0	3.9
Health	1.3	1.9	2.4	3.0
of which: NHS	*1.3*	*1.8*	*2.3*	*2.9*
Transport and the Regions	6.0	6.8	8.5	10.4
Local Government	0.1	0.1	0.3	0.3
Home Office	0.5	0.9	0.9	0.8
Lord Chancellor's Departments	0.1	0.1	0.1	0.1
Attorney General's Departments	0.0	0.0	0.0	0.0
Defence	5.7	5.6	5.7	6.0
Foreign and Commonwealth Office	0.1	0.1	0.1	0.2
International Development	0.2	0.3	0.4	0.4
Trade and Industry[3]	0.3	0.6	0.8	1.0
Environment, Food and Rural Affairs	0.3	0.5	0.5	0.5
Culture, Media and Sport	0.0	0.0	0.1	0.1
Work and Pensions (administration)[1]	0.8	0.2	0.1	0.1
Scotland[2]	2.0	2.3	2.4	2.4
Wales[2]	0.8	0.9	1.1	1.1
Northern Ireland Executive[2]	0.6	0.8	0.6	0.9
Northern Ireland Office	0.0	0.1	0.1	0.0
Chancellor's Departments	–0.2	0.2	0.2	0.2
Cabinet Office	0.2	0.2	0.2	0.2
Invest to Save Budget	0.0	0.0	0.0	0.0
Capital Modernisation fund	0.0	0.0	0.9	1.2
Policy Innovation Fund	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	0.0	0.7
Allowance for shortfall	0.0	0.0	0.0	0.0
Total Capital Budget DEL	**20.6**	**24.0**	**28.3**	**33.5**
Budget 2002 addition				1.6
Total Departmental Expenditure Limits	**192.3**	**211.8**	**229.5**	**249.0**
Total education spending	44.2	50.9	53.7	58.1

[1] *Includes Welfare to Work expenditure financed by the Windfall Tax.*

[2] *For Scotland, Wales and Northern Ireland, the split between current and capital budgets is decided by the respective executives.*

[3] *Includes the capital expenditure of the Export Credits Guarantee Department.*

C59 Table C15 gives a breakdown of public sector capital expenditure.

Table C15: Public sector capital expenditure

				£ billion
	Outturn	Estimate	Projections	
	2000–01	2001–02	2002–03	2003–04
CG spending and LA support in DEL	11.6	14.7	17.3	22.8
Locally–financed spending	0.0	1.9	2.0	1.9
National Lottery	1.1	0.9	1.3	1.3
Public corporations[1]	4.6	4.7	6.2	5.7
Other capital spending in AME	1.0	2.4	1.7	1.9
Allocation of DEL reserve	0.0	0.0	0.0	0.7
Public sector gross investment[2]	**18.4**	**24.8**	**28.4**	**34.3**
Less depreciation	12.7	12.8	14.0	14.6
Public sector net investment[2]	**5.7**	**12.0**	**14.4**	**19.7**
Proceeds from the sale of fixed assets[3]	5.0	5.1	3.8	3.8

[1] *Public corporations' capital expenditure is partly within DEL and partly within AME.*
[2] *This and previous lines are all net of sales of fixed assets.*
[3] *Projections of total receipts from the sale of fixed assets by public sector. These receipts are taken into account in arriving at public sector gross and net investment, which are net of sales of fixed assets.*

C60 Table C16 shows estimated receipts from loans and sales of assets from 2000–01 to 2003–04. The table shows that, following fixed asset sales of approximately £5 billion a year in 2000–01 and 2001–02, the Government expects further sales of approximately £4 billion in each of the next two years.

C61 The figures for sales of financial assets include outturn proceeds from the sale of a stake in the National Air Traffic Services in the first half of 2001 and estimated proceeds from the Public Private Partnership for QinetiQ (formerly the Defence Evaluation and Research Agency).

Table C16: Loans and sales of assets

				£ billion
	Outturn	Estimate	Projections	
	2000–01	2001–02	2002–03	2003–04
Sales of fixed assets[1]				
Central government	1.4	0.8	1.0	1.0
Local authorities	3.6	4.3	2.8	2.8
Total sales of fixed assets	**5.0**	**5.1**	**3.8**	**3.8**
Total loans and sales of financial assets	**–3.4**	**–1.8**	**–2.5**	**–2.4**
Total loans and sales of assets	**1.6**	**3.3**	**1.2**	**1.4**

[1] *National accounts definition of capital. Excludes single use fighting equipment by Ministry of Defence, which is treated as capital under resource accounting, and expenditure on and sale of which will be included in the capital budget under resource budgeting.*

PRIVATE FINANCE INITIATIVE

C62 Under the Private Finance Initiative (PFI) the public sector purchases services from a private sector partner. In addition to requiring capital investment to be undertaken by the private sector, the ability of the private sector partner to be innovative and manage risks appropriately allocated to it can result in a specified level of service at a price that represents value for money.

C63 The PFI has now become an established method of delivering many public services that require significant investment in capital assets. Projects with a combined capital value of around £18 billion have been approved since May 1997 in such diverse areas as schools, colleges, hospitals, local authorities, defence IT and property management. Approval of a PFI scheme depends on a thorough assessment of the lifetime costs of both providing and maintaining the underlying asset and the running costs of delivering the required service. The PFI provides considerable opportunities for the private sector; in return the contractual relationship with the public sector ensures the ongoing delivery of cost effective and quality services.

C64 The Government is committed to developing PFI and other partnership arrangements with the private sector to further enhance the delivery of public services and to ensure the delivery of a higher sustainable level of public sector investment. The Government wants to exploit all commercial potential and spare capacity in public sector assets through a sensible balance of risk and reward.

C65 Table C17 shows a breakdown by department of the estimated public sector investment resulting from signed contracts and Table C18 to those expected to reach preferred bidder stage within the next three years. From 2002–03 to 2004–05, some £25.5 billion of new investment is expected as a result of PPP and PFI.

Table C17: Departmental estimate of capital spending by the private sector (signed deals)

			£ million
		Projections	
	2002–03	2003–04	2004–05
Defence	262	105	0
Foreign and Commonwealth Office and Overseas Development	9	8	8
Environment, Food and Rural Affairs	16	3	0
Trade and Industry	16	14	11
Transport, Local Government and the Regions	1 076	1 005	458
Education and Skills[1]	9	0	0
Home Office	84	13	2
Legal Departments	47	24	9
Culture, Media and Sport	1	0	0
Health	311	126	55
Work and Pensions	67	14	22
GCHQ	42	7	0
Scotland	118	19	0
Wales	12	0	0
Northern Ireland	42	11	3
Cabinet Office	0	0	0
Chancellor's Departments	32	7	13
Local authorities[2,3]	1 580	1 900	1 900
Greater London Authority	0	0	0
Total	**3 724**	**3 256**	**2 481**

[1] *Excludes private finance activity in education institutions classified to the private sector. Schools projects funded through Revenue Support Grant are included in the local authority figures.*

[2] *Figures represent spending on projects supported by central government through Revenue Support Grant.*

[3] *PFI activity in local authority schools is included in the local authority line.*

C66 Under PFI, the public sector contracts for services not assets, and capital investment is only one of the activities undertaken by the private sector in order to supply services. The figures in Tables C17 and C18, therefore, do not reflect the total value of the contracts.

Table C18: Estimated aggregated capital value of projects at preferred bidder stage

			£ million
		Projections	
	2002–03	2003–04	2004–05
Defence	879	198	0
Foreign and Commonwealth Office and Overseas Development	0	0	0
Environment, Food and Rural Affairs	0	0	0
Trade and Industry	0	0	0
Transport, Local Government and the Regions[1]	16 080	0	0
Education and Skills	0	0	0
Home Office	40	24	0
Legal Departments	58	26	0
Culture, Media and Sport	0	0	0
Health	40	67	129
GCHQ	0	0	0
Work and Pensions	3	0	0
Scotland	33	0	0
Wales	55	70	59
Northern Ireland	61	16	0
Customs & Excise	0	0	0
Cabinet Office	4	4	4
Chancellor's Departments	2	20	25
Local authorities	0	0	0
Greater London Authority	0	0	0
Total	**17 255**	**425**	**217**

[1] *This figure represents the estimated capital value of the LUL PPP Contracts.*

C67 Table C19 shows a forecast of the estimated payments by the public sector flowing from private investment in signed projects over the next twenty–five years. Actual expenditure will depend on the details of the payment mechanism for each contract. There has been a technical change to the treatment of local authority expenditure within this table, which now takes into account the full cost to government of the PFI contracts rather than simply the capital support element.

Table C19: Estimated payments under PFI contracts – April 2002 (signed deals)

£ million			
2002–03	4 545	2015–16	3 940
2003–04	4 907	2016–17	3 943
2004–05	4 944	2017–18	3 898
2005–06	4 964	2018–19	3 071
2006–07	4 980	2019–20	3 323
2007–08	5 026	2020–21	3 434
2008–09	4 786	2021–22	2 923
2009–10	4 726	2022–23	3 013
2010–11	4 453	2023–24	2 982
2011–12	4 384	2024–25	2 995
2012–13	4 199	2025–26	2 708
2013–14	4 105	2026–27	940
2014–15	3 945	2027–28	617

FINANCING REQUIREMENT

Table C20: Public sector net cash requirement

	£ billion							
	2001–02				2002–03			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**2.5**	**–0.6**	**–0.6**	**1.3**	**9.0**	**0.9**	**1.2**	**11.2**
Financial transactions								
Net lending to private sector and abroad	2.4	0.2	–0.3	2.3	2.5	–0.1	0.0	2.5
Cash expenditure on company securities	–0.5	–0.3	0.1	–0.7	0.1	0.0	0.0	0.1
Accruals adjustments on receipts	–0.5	0.0	1.0	0.5	1.9	0.0	0.0	1.9
Other accruals adjustments	–0.4	0.0	0.0	–0.4	–1.8	0.0	0.0	–1.8
Miscellaneous financial transactions	0.4	0.1	–0.3	0.2	0.0	0.0	0.0	0.0
Own account net cash requirement	3.9	–0.5	–0.1	3.2	11.7	0.9	1.2	13.8
Net lending within the public sector	–0.9	0.1	0.8	0.0	1.9	–0.3	–1.6	0.0
Net cash requirement [1]	2.9	–0.4	0.7	3.2	13.5	0.6	–0.4	13.8

[1] *Market and overseas borrowing for local government and public corporation sectors.*

C68 In order to comply with the *Code for Fiscal Stability*, the *Debt and Reserves Management Report 2002–03* (DRMR) was published on 14 March 2002 in advance of Budget 2002. As well as an update of the financing arithmetic for 2001–02, it also outlined indicative financing arithmetic for 2002–03. The forecasts for both years' arithmetic were based on the public finance projections published in the Pre-Budget Report. For 2002–03, the preliminary net financing requirement was £32.3 billion. This was to be met by gross gilt issuance of £23 billion and a £9.3 billion adjustment in the short–term debt position.

C69 Table C21 updates the financing arithmetic for both 2001–02 and 2002–03 to allow for both the publication of the outturn data for 2001–02 and also the update of the forecast for 2002–03 of the central government net cash requirement.

C70 The outturn for the central government net cash requirement 2001–02 is £2.9 billion, a reduction of £3.4 billion from the Pre-Budget Report forecast. Additionally, there have been changes to the Debt Management Office's gilt buy-back target and adjustment of their cash deposit at the Bank of England. These changes have resulted in an end of March 2002 level of the Debt Management Office's net cash position of £11 billion. This is an increase of £3.3 billion on the forecast level published in March 2002.

C71 The forecast for the central government net cash requirement for 2002–03 is £13.5 billion. Additionally, changes in the forecast levels of redemptions and the Debt Management Office's cash deposit at the Bank of England mean that the revised net financing requirement for 2002–03 is £32.1 billion, a decrease of £0.2 billion from the forecast published in the DRMR.

C72 In order to meet this financing need, the Debt Management Office's remit for 2002–03 has been adjusted such that:

- gross gilt sales have been reduced by £0.2 billion to £22.8 billion; but
- the adjustment of the short-term debt level remains at £9.3 billion.

C73 Full details of these measures and complete financing tables for 2001–02 and 2002–03 can be found on the Debt Management Office's website (www.dmo.gov.uk).

Table C21: Financing requirement forecast

£ billion	2001–02					2002–03	
	Mar–2001 Original remit	Apr–2001 Revised remit[1]	Nov–2001 Pre-Budget Report	Mar–2002 DRMR	Apr–2002 Budget	Mar–2002 DRMR	Apr–2002 Budget
Central government net cash requirement	**0.3**	**0.3**	**6.3**	**6.3**	**2.9**	**13.6**	**13.5**
Accrued uplift on maturing index–linked gilts	1.1	1.1	1.1	1.1	1.1	0.0	0.0
Net financing of official reserves	1.3	1.3	1.3	1.2	1.2	0.0	0.0
Gilt redemptions	16.7	16.7	16.7	16.7	16.7	17.2	17.0
Debt buy–backs	1.0	1.0	0.5	0.5	0.6	0.0	0.0
Gross financing requirement	**20.4**	**20.4**	**25.9**	**25.8**	**22.5**	**30.8**	**30.5**
Less assumed net National Savings contribution	–3.0	–3.0	0.0	–0.2	–0.2	–1.5	–1.5
Less change in DMO cash balance at BoE	0.0	0.3	0.3	0.3	0.4	0.0	–0.1
Net financing requirement	**23.4**	**23.1**	**25.6**	**25.7**	**22.3**	**32.3**	**32.1**
Financed by							
Gross gilt sales	**13.5**	**13.5**	**14.0**	**13.7**	**13.7**	**23.0**	**22.8**
Changes in short term debt	**9.9**	**9.6**	**11.6**	**12.0**	**8.6**	**9.3**	**9.3**

Note: Figures may not sum due to rounding

[1] An update of 2001–02's financing arithmetic was published when the outturn for 2000–01 was published.

Table C22: Public sector transactions by sub-sector and economic category

		£ billion				
		2001–02				
		General government				
	Line	Central government	Local authorities	Total	Public corporations	Public sector
Current Receipts						
Taxes on income and wealth	*1*	146.0	0.0	146.0	–0.1	145.9
Taxes on production and imports	*2*	135.7	0.5	136.3	0.0	136.3
Other current taxes	*3*	3.2	14.9	18.0	0.0	18.0
Taxes on capital	*4*	2.3	0.0	2.3	0.0	2.3
Social contributions	*5*	63.0	0.0	63.0	0.0	63.0
Gross operating surplus	*6*	4.3	3.4	7.8	10.6	18.4
Rent and other current transfers	*7*	2.0	0.0	2.0	0.6	2.6
Interest and dividends from private sector and abroad	*8*	3.2	0.7	4.0	0.2	4.2
Interest and dividends from public sector	*9*	6.1	1.7	7.8	–7.8	0.0
Total current receipts	***10***	**365.9**	**21.3**	**387.2**	**3.6**	**390.8**
Current expenditure						
Current expenditure on goods and services	*11*	116.9	76.9	193.7	0.0	193.7
Subsidies	*12*	4.7	0.9	5.6	0.0	5.6
Net social benefits	*13*	112.4	12.3	124.7	0.0	124.7
Net current grants abroad	*14*	–1.7	0.0	–1.7	0.0	–1.7
Current grants (net) within public sector	*15*	73.9	–73.9	0.0	0.0	0.0
Other current grants	*16*	22.4	0.0	22.4	0.0	22.4
Interest and dividends paid	*17*	22.2	0.4	22.5	0.1	22.6
Apportionment of AME margin	*18*	0.0	0.0	0.0	0.0	0.0
Total current expenditure	***19***	**350.8**	**16.5**	**367.3**	**0.1**	**367.4**
Depreciation	*20*	4.3	3.4	7.8	5.0	12.8
Surplus on current budget	***21***	**10.8**	**1.3**	**12.1**	**–1.5**	**10.6**
Capital expenditure						
Gross domestic fixed capital formation	*22*	6.3	7.7	14.0	4.7	18.7
Less depreciation	*23*	–4.3	–3.4	–7.8	–5.0	–12.8
Increase in inventories	*24*	0.0	0.0	0.0	0.0	0.0
Capital grants (net) within public sector	*25*	6.0	–4.2	1.8	–1.8	0.0
Capital grants to private sector	*26*	5.3	1.2	6.5	0.0	6.5
Capital grants from private sector	*27*	0.0	–0.5	–0.5	0.3	–0.5
Net capital expenditure	***28***	**13.2**	**0.7**	**14.0**	**–2.0**	**12.0**
Net borrowing	**29**	**2.5**	**–0.6**	**1.9**	**–0.6**	**1.3**

Table C22: Public sector transactions by sub-sector and economic category

	General government					
	£ billion					
	2002–03					
Line	Central government	Local authorities	Total	Public corporations	Public sector	
						Current Receipts
1	152.4	0.0	152.4	–0.2	152.3	Taxes on income and wealth
2	143.4	0.2	143.6	0.0	143.6	Taxes on production and imports
3	3.2	16.1	19.4	0.0	19.4	Other current taxes
4	2.5	0.0	2.5	0.0	2.5	Taxes on capital
5	64.2	0.0	64.2	0.0	64.2	Social contributions
6	4.8	3.7	8.5	10.1	18.6	Gross operating surplus
7	1.8	0.0	1.8	0.7	2.5	Rent and other current transfers
8	3.1	0.8	3.9	0.3	4.2	Interest and dividends from private sector and abroad
9	5.6	1.8	7.4	–7.4	0.0	Interest and dividends from public sector
10	**381.1**	**22.6**	**403.6**	**3.5**	**407.2**	**Total current receipts**
						Current expenditure
11	128.1	80.3	208.4	0.0	208.4	Current expenditure on goods and services
12	6.3	1.2	7.5	0.0	7.5	Subsidies
13	116.5	12.4	129.0	0.0	129.0	Net social benefits
14	–0.1	0.0	–0.1	0.0	–0.1	Net current grants abroad
15	76.5	–76.5	0.0	0.0	0.0	Current grants (net) within public sector
16	22.6	0.0	22.6	0.0	22.6	Other current grants
17	21.1	0.3	21.5	0.1	21.6	Interest and dividends paid
18	1.0	0.0	1.0	0.0	1.0	Apportionment of AME margin
19	**372.0**	**17.8**	**389.8**	**0.1**	**389.9**	**Total current expenditure**
20	4.8	3.7	8.5	5.5	14.0	Depreciation
21	**4.2**	**1.1**	**5.3**	**–2.1**	**3.2**	**Surplus on current budget**
						Capital expenditure
22	6.0	10.5	16.5	6.2	22.7	Gross domestic fixed capital formation
23	–4.8	–3.7	–8.5	–5.5	–14.0	*Less* depreciation
24	0.0	0.0	0.0	0.1	0.1	Increase in inventories
25	7.2	–5.5	1.7	–1.7	0.0	Capital grants (net) within public sector
26	5.0	1.4	6.4	0.0	6.4	Capital grants to private sector
27	0.0	–0.7	–0.7	0.0	–0.7	Capital grants from private sector
28	**13.3**	**2.0**	**15.3**	**–0.9**	**14.4**	**Net capital expenditure**
29	**9.1**	**0.9**	**10.0**	**1.2**	**11.2**	**Net borrowing**

Table C22: Public sector transactions by sub-sector and economic category

		£ billion				
		2003–04				
		General government				
	Line	Central government	Local authorities	Total	Public corporations	Public sector
Current Receipts						
Taxes on income and wealth	*1*	165.3	0.0	165.3	–0.2	165.1
Taxes on production and imports	*2*	149.6	0.2	149.8	0.0	149.8
Other current taxes	*3*	3.5	17.3	20.8	0.0	20.8
Taxes on capital	*4*	2.6	0.0	2.6	0.0	2.6
Social contributions	*5*	76.3	0.0	76.3	0.0	76.3
Gross operating surplus	*6*	5.0	3.9	8.9	10.5	19.4
Rent and other current transfers	*7*	1.8	0.0	1.8	0.7	2.6
Interest and dividends from private sector and abroad	*8*	3.9	0.9	4.8	0.2	5.0
Interest and dividends from public sector	*9*	5.7	2.0	7.7	–7.7	0.0
Total current receipts	***10***	**413.7**	**24.2**	**438.0**	**3.6**	**441.6**
Current Expenditure						
Current expenditure on goods and services	*11*	136.5	87.3	223.8	0.0	223.8
Subsidies	*12*	6.6	1.3	7.9	0.0	7.9
Net social benefits	*13*	125.1	13.0	138.1	0.0	138.1
Net current grants abroad	*14*	–0.9	0.0	–0.9	0.0	–0.9
Current grants (net) within public sector	*15*	82.6	–82.6	0.0	0.0	0.0
Other current grants	*16*	25.6	0.0	25.6	0.0	25.6
Interest and dividends paid	*17*	23.2	0.4	23.5	0.1	23.7
Apportionment of AME margin	*18*	2.0	0.0	2.0	0.0	2.0
Total current expenditure	***19***	**400.8**	**19.3**	**420.1**	**0.1**	**420.3**
Depreciation	*20*	5.0	3.9	8.9	5.7	14.6
Surplus on current budget	***21***	**7.9**	**1.1**	**8.9**	**–2.2**	**6.7**
Capital expenditure						
Gross domestic fixed capital formation	*22*	8.4	11.9	20.3	5.7	26.0
Less depreciation	*23*	–5.0	–3.9	–8.9	–5.7	–14.6
Increase in inventories	*24*	–0.1	0.0	–0.1	0.1	0.0
Capital grants (net) within public sector	*25*	8.5	–6.6	1.9	–1.9	0.0
Capital grants to private sector	*26*	7.4	1.5	8.9	0.0	8.9
Capital grants from private sector	*27*	0.0	–0.6	–0.6	0.0	–0.6
Net capital expenditure	***28***	**19.2**	**2.4**	**21.5**	**–1.8**	**19.7**
Net borrowing	***29***	**11.3**	**1.3**	**12.6**	**0.4**	**13.0**

Table C23: Historical series of public sector balances, receipts and debt

	Per cent of GDP									
	Public sector current budget	Public sector net borrowing	Cyclically adjusted public sector net borrowing	Public sector net cash requirement	General government net borrowing[1]	Net taxes and social security contributions[2]	Public sector current receipts	Public sector net debt[3]	General government gross debt[4]	Public sector net worth[5]
1970–71	6.7	–0.6	–0.8	1.2	–2.1		43.3			
1971–72	4.2	1.1	0.5	1.4	–0.7		41.4			
1972–73	2.0	2.8	2.7	3.6	2.2		39.0			
1973–74	0.3	4.9	5.7	5.9	4.4		39.5			
1974–75	–1.1	6.6	7.2	9.0	4.1		42.3	52.1	60.4	
1975–76	–1.6	7.0	6.5	9.3	4.8		42.9	53.9	58.7	
1976–77	–1.2	5.5	4.8	6.4	4.1		43.3	52.4	59.1	
1977–78	–1.4	4.3	3.8	3.7	3.6		41.5	49.0	57.1	
1978–79	–2.6	5.0	4.8	5.2	4.3	33.2	40.2	47.1	56.2	
1979–80	–1.9	4.1	4.0	4.7	3.0	33.9	40.7	43.9	51.8	
1980–81	–3.0	4.9	2.9	5.2	3.8	35.7	42.4	46.1	52.9	
1981–82	–1.4	2.3	–1.7	3.3	3.3	38.7	45.8	46.1	51.7	
1982–83	–1.5	3.0	–1.1	3.2	3.1	39.0	45.5	44.8	50.4	
1983–84	–2.0	3.8	0.6	3.2	3.8	38.2	44.5	45.3	50.4	
1984–85	–2.2	3.7	1.0	3.1	3.3	38.9	44.4	45.2	50.3	
1985–86	–1.2	2.4	0.9	1.6	2.6	38.1	43.1	43.4	49.5	
1986–87	–1.4	2.1	1.9	0.9	2.3	37.8	42.0	41.1	48.9	
1987–88	–0.3	1.0	2.1	–0.7	1.3	37.6	41.1	36.8	46.5	75.2
1988–89	1.7	–1.3	1.2	–3.0	–0.9	36.9	40.7	30.6	40.6	81.7
1989–90	1.4	–0.2	2.5	–1.3	0.3	36.2	39.9	27.7	35.5	73.6
1990–91	0.4	1.0	2.6	–0.1	1.4	36.3	39.0	26.2	33.3	62.1
1991–92	–1.9	3.8	3.2	2.3	3.7	35.0	38.6	27.4	34.4	54.4
1992–93	–5.6	7.6	5.5	5.9	7.4	34.0	36.6	32.0	40.6	41.8
1993–94	–6.2	7.8	5.4	7.1	7.8	33.0	35.8	37.1	45.9	29.5
1994–95	–4.8	6.3	4.9	5.3	6.5	34.2	36.9	40.8	49.4	29.1
1995–96	–3.4	4.8	4.0	4.3	5.0	35.0	37.8	42.8	51.9	19.5
1996–97	–3.0	3.7	3.1	2.9	3.9	35.0	37.4	43.7	52.1	15.6
1997–98	–0.1	0.7	0.7	0.1	0.8	36.1	38.5	41.5	49.0	11.5
1998–99	1.3	–0.6	–0.3	–0.8	–0.6	36.5	39.0	39.2	46.3	11.2
1999–00	2.3	–1.8	–1.6	–0.9	–1.7	36.7	39.4	36.4	43.4	14.7
2000–01	2.3	–1.7	–1.2	–3.9	–1.7	37.7	40.1	31.3	40.1	19.5

[1] *UK National Accounts definition.*

[2] *Consistent with the new OECD classification of personal tax credits.*

[3] *At end–March; GDP centred on end–March.*

[4] *Maastricht measure from 1993.*

[5] *At end–December; GDP centred on end–December.*

Table C24: Historical series of government expenditure

	£ billion (2000–01 prices)				Per cent of GDP			
	Public sector current expenditure	Public sector net capital expenditure	General government expenditure	Total Managed Expenditure	Public sector current expenditure	Public sector net capital expenditure	General government expenditure	Total Managed Expenditure
1970–71	157.3	29.5	198.9	205.6	32.6	6.1	41.3	42.7
1971–72	164.5	26.0	204.9	209.8	33.3	5.3	41.5	42.5
1972–73	171.9	25.0	213.3	217.1	33.1	4.8	41.1	41.8
1973–74	188.8	28.1	229.1	239.6	35.0	5.2	42.5	44.4
1974–75	208.6	29.7	257.4	262.6	38.8	5.5	47.9	48.8
1975–76	213.3	29.2	257.5	266.9	39.9	5.5	48.1	49.9
1976–77	219.4	23.8	250.8	268.4	39.9	4.3	45.6	48.8
1977–78	216.2	16.2	239.2	257.7	38.4	2.9	42.5	45.8
1978–79	222.6	14.1	250.6	262.6	38.4	2.4	43.2	45.2
1979–80	228.3	13.1	257.0	267.7	38.2	2.2	43.0	44.8
1980–81	235.0	10.5	264.9	272.0	40.8	1.8	46.1	47.3
1981–82	245.5	5.4	268.8	277.3	42.6	0.9	46.6	48.1
1982–83	251.1	8.8	274.7	285.5	42.7	1.5	46.7	48.5
1983–84	259.2	10.9	277.9	295.6	42.3	1.8	45.4	48.3
1984–85	266.2	9.6	283.5	300.0	42.6	1.5	45.4	48.1
1985–86	266.2	8.1	281.7	295.9	41.0	1.2	43.4	45.5
1986–87	270.1	4.8	281.0	296.9	40.1	0.7	41.8	44.1
1987–88	273.7	4.7	282.5	298.6	38.6	0.7	39.8	42.1
1988–89	267.4	2.6	275.6	291.0	36.2	0.4	37.3	39.4
1989–90	269.4	9.0	289.0	299.4	35.7	1.2	38.3	39.7
1990–91	271.0	10.9	288.5	300.3	36.1	1.4	38.4	40.0
1991–92	287.2	13.8	304.0	316.5	38.4	1.8	40.7	42.3
1992–93	301.6	15.0	320.3	331.1	40.3	2.0	42.8	44.2
1993–94	311.5	12.3	330.9	338.1	40.1	1.6	42.6	43.6
1994–95	322.6	12.2	340.3	349.4	39.9	1.5	42.0	43.2
1995–96	327.4	11.7	347.6	353.9	39.4	1.4	41.8	42.6
1996–97	330.8	5.8	341.9	350.4	38.7	0.7	40.0	41.0
1997–98	328.2	5.2	341.8	346.8	37.2	0.6	38.7	39.2
1998–99	328.1	6.1	343.8	347.5	36.2	0.7	38.0	38.4
1999–00	332.9	4.8	348.8	350.6	35.7	0.5	37.4	37.6
2000–01	348.8	5.7	365.8	364.9	36.5	0.6	38.3	38.2

CONVENTIONS USED IN PRESENTING THE PUBLIC FINANCES

FORMAT FOR THE PUBLIC FINANCES

The June 1998 Economic and Fiscal Strategy Report (EFSR), set out a new format for presenting the public finances that corresponded more closely to the two fiscal rules. The three principal measures are:

- **the surplus on 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), on an accruals basis, and impute the value of some transactions where no money changes hands (for example, non–trading capital consumption). The principal measures drawn from the national accounts are described below.

The **current budget** (formerly known as the current balance) measures the balance of current account revenue over current expenditure. The definition of the current balance 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.

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 because 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.

General government net borrowing, the Treaty deficit, which excludes net borrowing of public corporations, is the most internationally comparable measure of the budget deficit. It is reported to the European Commission under the Treaty, using the definitions in ESA95.

CASH BASIS

The cash approach measures the actual cash transactions between the public sector and the rest of the economy. It is the starting point for monthly estimates of net borrowing.

PUBLIC SECTOR CURRENT RECEIPTS

Net taxes and social security contributions in Table C10 are measured on a cash basis, rather than a national accounts (accruals) basis and, as far as possible, relate to actual cash flows. The definition has been amended to follow OECD guidance in rules and classification of tax and social security contributions.

The accounting adjustments put these cash figures on to a national accounts (accruals) basis. Those elements of the UK contribution to the EC budget that relate to the UK tax base are deducted as, under ESA95, they are treated for the National Accounts as taxes imposed directly by the European Union. Tax credits that score as expenditure in the National Accounts but as negative taxation in net taxes and social security contributions, such as WFTC payments that offset income tax liability, are added back.

TOTAL MANAGED EXPENDITURE

Public sector capital expenditure is shown in Table C15. It includes:

(i) gross domestic fixed capital formation (i.e. expenditure on fixed assets schools, hospitals, roads, computers, plant and machinery, intangible assets etc) net of receipts from sales of fixed assets (e.g. council houses and surplus land);

(ii) grants in support of capital spending by the private sector; and

(iii) the value of the physical increase in stocks (for central government, primarily agricultural commodity stocks).

Net investment in Table C2 nets off depreciation of the public sector's stock of fixed assets.

Departmental Expenditure Limits (DEL) have distinct resource and capital budgets, shown in Table C14.

Annually Managed Expenditure (AME) components are shown in Table C11. These include all of social security spending, housing revenue account subsidies, the Common Agricultural Policy, export credits, net payments to EC institutions, spending by self financing public corporations, public service pensions net of contributions, spending financed by the national lottery and central government gross debt interest.

Total Managed Expenditure (TME), the sum of DEL and AME, is shown in Table C11.

Export Credits Guarantee Department programme includes the activities of the Guaranteed Export Finance Corporation (GEFCO), whose sole business is to refinance export loans guaranteed by ECGD, thus reducing the cost to Government. The refinancing activities are financial transactions affecting only the net cash requirement and so are netted out in the accounting adjustments.

Locally financed expenditure comprises 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 central government is netted off; all other receipts of interest and dividends are included in current receipts. The capital uplift on index–linked gilts is scored as interest at the time it accrues, whereas the net cash requirement records the actual payments of capital uplift on the redemption of index–linked gilts (the uplift which accrued while the stock was in market hands). Interest paid includes the amortisation of discounts on gilts at issue.

The **accounting adjustments** include various items within TME but outside DEL, which are not shown separately in Table C11. These details are shown in Table C13. The definition of each line is as follows:

Line one adds the value of general government non–trading capital consumption.

Line two adds back VAT refunded to central government departments, local authorities and certain public corporations. DEL and AME programme expenditure are measured net of these refunds, while Total Managed Expenditure is recorded with the VAT paid.

Line three deducts traditional own resources (i.e. payments of Customs duties and agricultural and sugar levies) and VAT contributions to the European Community, which are included in the net payments to EC institutions line in AME, but excluded from TME.

Line four adds tax credits which score as public expenditure under national accounting conventions. This includes Mortgage Interest Relief, Life Assurance Premium Relief, and (from 1999–2000) the Working Families' Tax Credit and Disabled Person's Tax Credit, and the enhanced and payable elements of company tax credits.

Line five moves the scoring of public corporations' current and capital spending on to a national accounts basis. It adds in capital expenditure and debt interest payments to the private sector that do not score in departmental budgets and removes capital grants to public corporations and operating surpluses that do not score in departmental budgets.

Line six removes intra–public sector debt interest and dividend payments and receipts, which are included elsewhere in DEL and AME.

Line seven deducts those financial transactions, which are scored in DEL and AME.

Line eight removes the deduction of receipts relating to regulation of industry that are netted off in DEL but should not be netted off in TME. It also deducts certain local authorities' receipts that are netted off TME.

Line nine shows other adjustments and includes, among others, the deduction of grants paid to local authorities by non–departmental public bodies classified to the central government sector.

DEBT AND WEALTH

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 Deficits 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.

LIST OF ABBREVIATIONS

AME	Annually Managed Expenditure
APD	Air passenger duty
BoE	Bank of England
BRC	British Retail Consortium
CASC	Community amateur sports club
CBI	Confederation of British Industry
CCL	Climate change levy
CDFI	Community Development Finance Institution
CEML	Council for Excellence in Management and Leadership
CEO	Chief Executive Officer
CFC	Controlled foreign company
CFLI	Community Finance and Learning Initiative
CGNCR	Central government net cash requirement
CGT	Capital gains tax
CHP	Combined heat and power
CIS	Construction industry scheme
CITC	Community Investment Tax Credit
CJU	Criminal Justice Unit
CMF	Capital Modernisation Fund
CMM	Coal mine methane
CNG	Compressed Natural Gas
CPI	Consumer Price Inflation
CTF	Child Trust Fund
DDA	Disability Discrimination Act
DEL	Departmental Expenditure Limit
DEFRA	Department for Environment, Food and Rural Affairs
DfES	Department for Education and Skills
DfID	Department for International Development
DIS	Departmental Investment Strategy
DPTC	Disabled Person's Tax Credit
DRMR	Debt and Reserves Management Report
DTI	Department for Trade and Industry
DTLR	Department for Transport, Local Government and the Regions
DVLA	Driver and Vehicle Licensing Agency
DWP	Department for Work and Pensions
EC	European Commission
ECA	Enhanced capital allowance
ECGD	Export Credits Guarantee Department
EC50+	Employment Credit for the over 50s
EEC	Energy Efficiency Commitment
EFSR	Economic and Fiscal Strategy Report
EMA	Educational Maintenance Allowance
EMU	Economic and Monetary Union
EU	European Union
EYF	End-year flexibility
EZ	Employment Zone

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).
GAD	Government Actuary's Department
GCSE	General Certificate of Secondary Education
GDP	Gross Domestic Product
GEFCO	Guaranteed Export Finance Corporation
GNP	Gross National Product
GTC	Green Technology Challenge
g/km	grams per kilometre
HIPC	Heavily Indebted Poor Countries
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome
IB	Incapacity Benefit
ICT	Information and communications technologies
IiP	Investors in People
ILO	International Labour Organisation
IMF	International Monetary Fund
ISA	Individual Savings Account
ISB	Invest to Save Budget
ISCED	International Standard Classification of Education
IT	Information Technology
JSA	Jobseeker's Allowance
LASFE	Local authority self-financed expenditure
LEL	Lower earnings limit
LFS	Labour Force Survey
LPG	Liquefied Petroleum Gas
LSP	Local Strategic Partnership
LTCS	Landfill tax credit scheme
MDGs	Millennium Development Goals
MIG	Minimum Income Guarantee
MFR	Minimum Funding Requirement
MPC	Monetary Policy Committee
MtC	Million tonnes of carbon
NAIRU	Non-accelerating inflation rate of unemployment
NAO	National Audit Office
NDC	New Deal for Communities
NDDP	New Deal for disabled people
NDLP	New Deal for lone parents
NDYP	New Deal for young people
ND25+	New Deal for the over 25s
ND50+	New Deal for the over 50s
NETCN	National Environmental Technology Centre
NICs	National insurance contributions
NIESR	National Institute of Economic and Social Research
NHS	National Health Service
NMW	National Minimum Wage
NVQ	National Vocational Qualification

ONS	Office of National Statistics
OECD	Organisation for Economic Cooperation and Development
OFT	Office of Fair Trading
PAYE	Pay as You Earn
PBR	Pre-Budget Report
PFI	Private Finance Initiative
PIU	Performance and Innovation Unit
PPP	Public-private partnership
PSA	Public Service Agreement
PSNB	Public sector net borrowing
PSNI	Public sector net investment
PSPPU	Public Services Productivity Panel Unit
PT	Primary threshold
RAB	Resource Accounting and Budgeting
R&D	Research and development
RDAs	Regional Development Agencies
ROSSI	Retail Price Index excluding housing costs
RPI	Retail Price Index
RPIX	Retail Price Index excluding mortgage interest payments
RRS	Rapid Response Service
SAP	Statutory Adoption Pay
SBS	Small Business Service
SDR	Strategic Defence Review
SERPS	State Earnings Related Pension Scheme
SGP	Stability and Growth Pact
SME	Small and medium-sized enterprise
SMP	Statutory Maternity Pay
SPP	Statutory Paternity Pay
ST	Secondary threshold
TME	Total Managed Expenditure
TUC	Trades Union Congress
UEL	Upper earnings limit
ULSD	Ultra-low sulphur diesel
ULSP	Ultra-low sulphur petrol
UN	United Nations
URC	Urban Regeneration Company
VAT	Value Added Tax
VCT	Venture Capital Trust
VED	Vehicle excise duty
WFTC	Working Families' Tax Credit
WGAP	Working Group on Ageing Populations
WTAS	Windfall Tax and associated spending
WTO	World Trade Organisation

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C2	Cyclically-adjusted surplus on current budget
C3	Tax-GDP ratio
C4	Total Managed Expenditure

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