HM Treasury

UNITED KINGDOM CONVERGENCE PROGRAMME

December 1998

Contents

1. Introduction

The central objective of the Government's economic policy is high and stable levels of growth and employment. In pursuing this aim, the Government has adopted a policy framework designed to:

- bring about greater economic stability;
- encourage work; and
- promote higher productivity.

Achieving greater stability than in the past - through a reformed macroeconomic policy framework - should provide an essential platform for closer convergence of the economic performance of the UK and other Member States. Consistently low inflation and the elimination of structural imbalance in the public finances will help keep the economy close to its trend path. Over time, it will allow the UK economic and interest rate cycle to move closer to that of the single currency area. This should provide the basis for more stability in the sterling-euro exchange rate.

Structural reforms in labour, capital and product markets are needed to complement macroeconomic stability to ensure growth and employment for all of our citizens. Article 102a of the Treaty obliges Member States and the Community to "act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources". A single currency makes pro-employment policies all the more necessary to ensure economies can adjust.

In the UK, measures have been put in place to improve the functioning of the labour market such as Welfare to Work, tax and benefit reform and policies to raise skill levels. Measures to encourage innovation and enterprise, strengthen competition and regulatory arrangements will also benefit product and capital markets. These policies will help raise productive potential and the trend rate of growth. They should also improve the flexibility of the economy to respond to unforeseen shocks, thus helping to ensure that the UK could maximise the benefits of the single currency.

Macroeconomic stability and structural reform go hand in hand. A considered view of convergence should take both into account. The recent UK Employment Action Plan and UK Progress Report on Product, Services and Capital Markets set out the details of policies designed to improve structural economic performance. This Convergence Programme sets out the information required under the Stability and Growth Pact and updates the Convergence Programme submitted in September 1997. In his statement to the House of Commons in October 1997, the Chancellor of the Exchequer said that "it is essential that Government and business prepare intensively during this Parliament, so that Britain will be in a position to join a single currency, should we wish to, early in the next Parliament". This Programme explains the Government's strategy for achieving the stability and convergence required to do so, subject to the consent of the Government, Parliament, and the public in a referendum.

2. Policy framework and objectives

The reasons for the Government's decision to exercise its opt out from the third stage of economic and monetary union were given in a statement to Parliament by the Chancellor of the Exchequer and an accompanying Treasury Paper in October 1997[1]. However, the Government also then announced, for the first time, a commitment to the principle of a single currency and that in its view, membership of a successful single currency would be beneficial to Britain and to Europe. The key to whether the Government would recommend joining in the future would be whether the economic benefits were clear and unambiguous, in particular, whether the British economy had achieved sustainable convergence, in a demonstrable way, and was sufficiently flexible to be able to live with a single interest rate set to achieve price stability for the Eurozone as a whole.

In order to reach this judgement, the Chancellor announced that five economic tests would be applied, covering cyclical convergence, flexibility, investment, financial services, and employment and growth.

Article 109j(1) of the Maastricht Treaty rightly emphasises the importance of achieving a high degree of sustainable convergence if a country is to join EMU. Sustainable convergence means that the UK:

- can match the long-term inflation performance of the euro area;
- would normally face similar inflationary pressure, so that differences between the interest rates required for price stability in the UK and those required in the rest of Europe are minimised;
- has adequate scope to respond to divergences through being able to use the fiscal automatic stabilisers and through the operation of flexible markets.

Moreover, to ensure that membership is a genuine option, both public and private sectors are beginning to prepare now for the single currency. The Government's preparations are outlined in the box overleaf.

2.1 The historical context

The behaviour of inflation and the pattern of the cycle are closely connected. The UK's present divergence with the euro area, illustrated, for example, by a short term interest rate differential of some 3 percentage points is not a new phenomenon. It reflects in part the legacy of Britain's past susceptibility to more volatile economic cycles, and, notably, the damaging boom of the late 1980s and the severe recession that followed in the early 1990s.

A history of high, and volatile, inflation rates have contributed to the excessive volatility of the UK economy. Over the past 40 years UK output has fluctuated more than in any other major European economy, and this instability more than doubled

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1 HM Treasury, *UK Membership of the Single Currency - An Assessment of the Five Economic Tests*, October 1997

between 1979 and 1996.

The UK's preparations

The UK is drawing up an outline National Changeover Plan. This will set out the steps the UK needs to follow if it decides to join EMU. It will be published early in the New Year, and take account of extensive consultation between the Treasury and over 100 external organisations, including trade associations and businesses. The Changeover Plan will be developed over time, drawing on the experience of "first wave" countries, and further dialogue with UK organisations likely to be affected.

The plan will take account of discussions with a variety of sectors including the wholesale and retail financial sectors, retailing, small and medium-sized enterprises, and the public sector, as well as the potential need for an education and information campaign in the event of joining.

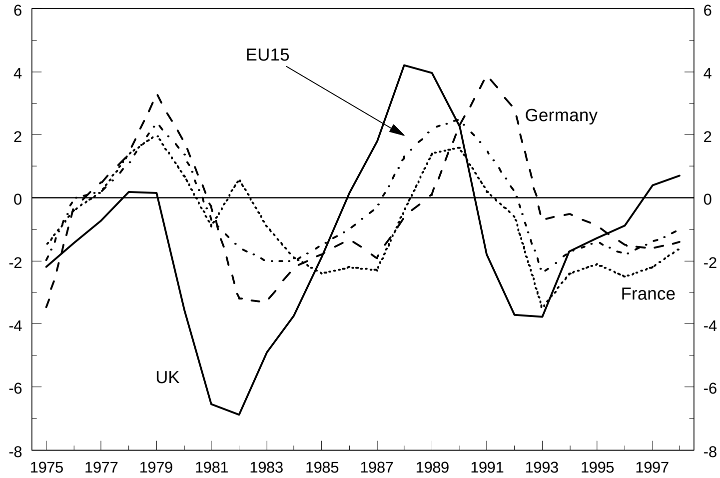
The public sector is increasingly engaged in preparing for the euro. A ministerial committee, led by Patricia Hewitt, Economic Secretary to the Treasury, is overseeing preparations. Each Government department has nominated a Minister to sit on this committee. Underneath this committee there are now over 1,500 "euro co-ordinators" established throughout the wider public sector.

From 1 January 1999, firms in the UK will be able to pay taxes in euro, including VAT and National Insurance Contributions, issue or re-denominate share capital in euro, file accounts and a number of other financial returns in euro. The Government has also announced that agricultural traders will have the option of receiving certain agricultural payments in euro by autumn 2000.

By 1 January 1999, over 10,000 Customs and Excise officers will be in a position to advise on the euro. The Department of Trade and Industry is planning legislation to ease share re-denomination in 1999. And steps are in place for systematic monitoring of use of the euro in the UK from next year. The Government has produced guidance outlining the rules which govern spending for possible UK entry.

Historically, the divergence between the British and continental economies has reflected both macroeconomic and structural differences. No two countries are ever identical, but the UK has certain features that mark it out from other countries in the EU: for example, higher than average non-EU trade, oil, and differences in the financing of the personal and corporate sectors, though these differences are becoming less distinct over time.

Chart 2.1 - Output gaps since 1975



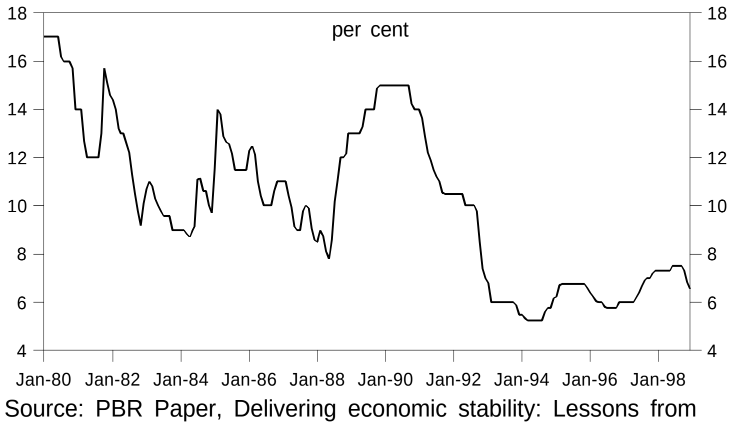
Source: The 1998 Pre-Budget Report (PBR) and OECD

Policy has also played an important role in shaping the UK cycle. Macroeconomic policy can play a vital role in helping stabilise the economy. But it can also be destabilising if not managed effectively. The evidence suggests that macroeconomic policy errors must take some of the blame for the resulting instability.

Instability in monetary and fiscal policy

- Short-term interest rates have been highly volatile during the last 20 years, though less so since 1992. This partly reflects the fact that monetary policy throughout much of this period targeted variables other than inflation.

Chart 2.2 - Base rates since 1980



Source: PBR Paper, Delivering economic stability: Lessons from macroeconomic policy experience

- The UK's fiscal deficit has also been highly volatile over the last two decades, reflecting a lack of clearly defined and consistently applied fiscal policy objectives. Moreover, a failure to take account of the effects of the economic cycle at times gave a misleading picture of the health of the public finances, leading to a lack of caution and inappropriate policy decisions.

2.2 A stability-oriented macroeconomic policy framework

It is the Government's clear objective to put an end to this volatility. A new stability-oriented framework for macroeconomic policy has thus been put in place over the last year and a half.

Monetary policy

The first step was to put monetary policy onto a stable long-term footing by giving the Bank of England operational responsibility for setting interest rates. The Bank of England Act 1998 gave statutory effect to these arrangements. The new monetary policy framework is based on a forward-looking approach and a clear and precise objective: an inflation target, defined by the annual increase in the Retail Prices Index excluding mortgage interest payments (RPIX), of 2½ per cent. The target applies at all times and is symmetric. The "open letter" system requires the Governor of the Bank of England to write to the Chancellor if inflation is more than 1 per cent above or below target. Following the recent announcement by the ECB that the Harmonised Index of Consumer Prices (HICP) will form the basis of their price stability objective, the Government has also said that it will monitor this inflation rate alongside RPIX inflation from January 1999.

The new monetary policy framework is based on a high degree of transparency and openness in the decision-making process. The exchange rate is one of the factors taken into account by the Bank of England's Monetary Policy Committee when it sets interest rates to meet the inflation target. The open nature of the UK economy means that the exchange rate can be an important influence, as over half of UK trade is with EU countries. The Bank of England publishes a quarterly Inflation Report and minutes of the meetings of the Bank's Monetary Policy Committee are released within two weeks. Greater transparency has increased the accountability of monetary policy-making, and has enhanced the credibility and effectiveness of policy.

Fiscal Policy

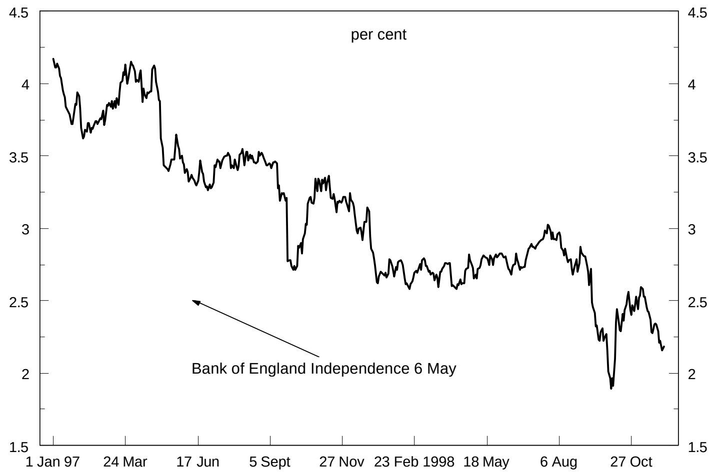
Transparency and clarity of objectives are also features of the Government's new framework for fiscal policy. The Code for Fiscal Stability, underpinned by the Finance Act 1998, sets out the framework. It provides a similar discipline for fiscal policy as the Bank of England Act provides for monetary policy. The Code was approved by Parliament in December 1998. The framework builds on the lessons learned from past experience and sets policy in the context of clear fiscal principles, the need for prudence and best practice accounting standards. Within this framework, the Government's two fiscal rules - the golden rule and the sustainable investment rule - are based on achieving sound public finances and long term economic stability in keeping with the Stability and Growth Pact. These are discussed in more detail in Chapter 5.

2.3 Rewards of the new framework

The changes to the framework have strengthened the credibility of policy, and have already brought tangible results:

- inflation is at the target level of 2½ per cent;
- inflation expectations of independent forecasters are at the target level for the first time - over ½ percentage point lower than before the new monetary framework was introduced - and longer-term expectations implicit in financial markets have fallen by over 1½ percentage points to a similar level;
- long-term interest rates are at their lowest levels for 35 years; and 5-year forward spreads against German bunds are about 30 basis points compared with well over 100 basis points two years ago; and
- the structural fiscal deficit has been all but eliminated; and the Government is on track to meet its fiscal rules.

Chart 2.3 - Inflation expectations 5 year ahead, derived from index-linked and conventional gilts, January 1997 to present



Source: PBR Paper, Delivering economic stability: Lessons from macroeconomic policy experience

By locking in low inflation and sound public finances, the economy is much better placed to respond to adverse developments. The robust and forward-looking new framework, with its inbuilt capacity to react to new challenges, means that the extreme volatility of the economy should be a thing of the past. By strengthening the macroeconomic framework there is a much greater chance of the UK achieving stability and sustainable convergence.

2.4 Greater exchange rate stability

The UK Government believes that durable exchange rate stability can only be achieved on the basis of sound economic fundamentals, in particular low and stable inflation, steady and sustainable growth and sound public finances. As the Luxembourg European Council stated on 13 December 1997 “in general exchange rates should be seen as the outcome of all other economic policies”. Previous UK experience has shown that an exchange rate target without these fundamentals in place can be counterproductive, and lead to less not more stability in the medium-term. The Government intends to meet its commitment to exchange rate stability in the medium-term through its policies for achieving greater economic stability.

In the last few years, sterling has fluctuated widely against the Deutschemark. There are a number of reasons for this: uncertainty surrounding the introduction of the euro and the behaviour of the dollar-Deutschemark exchange rate; cyclical divergences between UK and euro area economies; and the introduction of the new framework for monetary and fiscal policy in the UK.

For an economy such as the UK, domestic stability must be a precondition for external stability. The new monetary and fiscal policy frameworks provide an anchor for low inflation expectations in the UK. The Government is confident that the new arrangements provide the best platform to deliver greater stability in the sterling-euro exchange rate.

2.5 Flexibility and convergence

Joining a monetary union means giving up an independent monetary policy. Participating member states are unable to fine tune their economies through interest rate adjustments and the exchange rate will no longer be able to fluctuate against those of other Member States. More fundamental changes in the way all economies operate will be required to deal with changes in economic conditions.

Macroeconomic stability needs to be accompanied by microeconomic reform, to ensure the flexibility required to live with a single interest rate. This will ensure that divergences in economic cycles are kept to a minimum. The Government has launched a wide ranging series of reforms to help to make labour, product and capital markets work more effectively. In the labour market New Deals have been introduced for the young and long-term unemployed. Reforms to the tax and benefit system are being implemented to make work pay, including reduced national insurance contributions and the new Working Families Tax Credit. The Government has also launched a campaign to raise productivity. Several initiatives have been introduced to promote innovation and enterprise, reform capital markets and improve the climate for investment, encourage competition, and raise skills levels (see Chapter 3).

2.6 Conclusion

The Government is committed to ensuring the British people face a genuine option to join the single currency. The Government has already begun practical preparations. For economic policy the essential preparations are twofold:

- stability-oriented macroeconomic policy to reduce the volatility in the economy which has caused us to diverge from continental countries in the past and which has generated excessive volatility in the exchange rate.

- microeconomic reforms to tackle the structural weaknesses in the economy, to allow for adjustment to changes in economic circumstances in the absence of an independent monetary policy should we join EMU.

These policies are, of course, beneficial in their own right. But they are also the essential foundations for achieving the convergence required to ensure a genuine option to join the single currency. This requires that convergence must be capable of being sustained and likely to be sustained - the economy must demonstrate a settled period of convergence.

Table 2.1: Convergence criteria from the Maastricht Treaty, 1998

	Q3 HICP Inflation (per cent)	Long -term Interest rates (per cent)‡	General government net borrowing*†	General government gross debt*†
UK	1.3	4.75	0.8	47.9
EU-countries	1.1	4.32	-1.8	70.3
Euro-countries	1.0	4.09	-2.3	73.8
Convergence criteria	2.0	6.04	-3.0	60.0

*UK figures for financial year 1998-99

†Autumn 1998 Commission forecasts except UK

‡Weighted one month average yield of 10 year bonds on 15 December 1998

3. Structural reforms

The Government attaches a great deal of importance to complementing macroeconomic policies to promote stability, growth and low inflation, with microeconomic policies to improve economic performance. This will also help ensure that labour, product and capital markets have sufficient strength and adaptability to deal with shocks to the economy; and thus better able to cope with the single currency, in the event of UK entry.

3.1 Product, services and capital market reforms

Despite having a flexible capital market and having the most financial products available in Europe, the UK remains well behind leading industrial countries in terms of manufacturing productivity. The underlying issues were set out in the UK Progress Report on Product, Services and Capital Markets.

The Progress Report summarises action that is being taken towards meeting three key objectives:

- ensuring that competitive pressures in the economy are strengthened to encourage and reward innovative business, and to ensure consumers enjoy the benefits of productivity gains through fair prices and improved quality and choice;

- taking a better regulatory approach to markets, which promotes economic growth while protecting the individual and the public interest;

- encouraging enterprise and innovation to ensure that ideas and opportunities are fully exploited.

The Report also highlighted some specific examples of UK policies for reform where progress is important, including:

- The Private Finance Initiative - good practice in public procurement policy.

- Narrowing international price differentials - the persistence of which are a good gauge of lack of competitive pressure.

- Electronic-commerce - a new global market place, with massive potential.

- Utilities - where competition is increasing, and regulation is being improved.

- Financial services - where the regulatory system is being enhanced to enable it to keep pace with the markets.

- R&D - where a review is examining options to encourage investment.

- Venture capital - where the EU lags behind the US.

The Government has also fundamentally restructured the corporate tax system, and capital gains tax has been reformed to reduce the burden on long-term investors. It is also introducing new legislation to strengthen the existing framework for tackling monopolies, cartels and other anti-competitive practices.

These reforms are a start, but there is still much to do. The next stage will be to undertake a process of peer review with other Member States, where the UK is keen to exchange views about best practice and to look for ways of learning from the experiences and ideas of other Member States.

3.2 Labour market reforms

The Government remains committed to the EU employment policy framework of Employment Guidelines and Employment Action Plans. The UK's Employment Action Plan sets out the UK's employment policies in more detail.

The Government has begun to implement its Welfare to Work programme, funded from the £5.2 billion Windfall Tax on the privatised industries, which includes:

- the New Deal for those aged 18-24; 186,000 have joined this programme up to end October and over 38,000 have so far moved into jobs;

- the New Deal for those aged 25 plus; since June 1998 those unemployed for over two years have been eligible for a £75 subsidy a week to help them into work. Since November 1998 there have also been a series of innovative pilots based on the more intensive approach pioneered for 18-24 year olds;

- the New Deal for lone parents - rolled out nationally in October 1998 following successful pilots in which 87 per cent of those invited for interview chose to participate in the programme;

- the New Deal for disabled people which is already offering disabled people the chance to work and to fulfil their full potential.

- the New Deal for Partners of the Unemployed - which will help the partners of the unemployed into work. In the past these people have themselves been disproportionately likely to be out of work - as the benefit system has assumed that they cannot or do not want to work.

The Government has also embarked on a series of reforms over the next year to make work pay. The gap between in-work and out-of-work income is often too small to encourage people to move off benefits. Once in work, many people on low income face an unacceptable poverty trap in which improvements in their pay are clawed back by the combined effects of the tax and benefit system.

These distortions contribute to high levels of structural unemployment and low levels of labour market participation. Measures to make work pay include:

- the introduction of the Working Families Tax Credit. This will provide a guaranteed minimum income of £190 for families with one member in full time work and reduce the tax burden on families so that those with earnings of less than £220 per week - half male average earnings - will no longer pay any tax.

- the National Minimum Wage, which will help underpin the Government's welfare reforms. It will help to promote work incentives, ensure greater fairness and remove the worst exploitation;
- National Insurance Reform will simplify National Insurance Contributions for both employees and employers and by removing the 'entry fees' and 'steps' in the system, remove labour market distortions and reduce the burden on the low paid.

4. Economic outlook

This section outlines the prospects for the UK economy for the next few years.

4.1 World economic background

Prospects for the world economy have deteriorated in the past year. Japan is in recession, and several countries, in total accounting for around a quarter of world GDP, are expected to suffer a fall in output.

Overall, however, provided demand in the US and Europe continues to grow at a reasonable pace, the outlook for global activity should remain one of continued expansion. This will be helped by G7's recognition that the balance of risks has shifted from high inflation to concerns about low growth. Recent interest rate cuts in the US and the co-ordinated move across the euro area will help support world demand.

Table 4.1 - The world economy

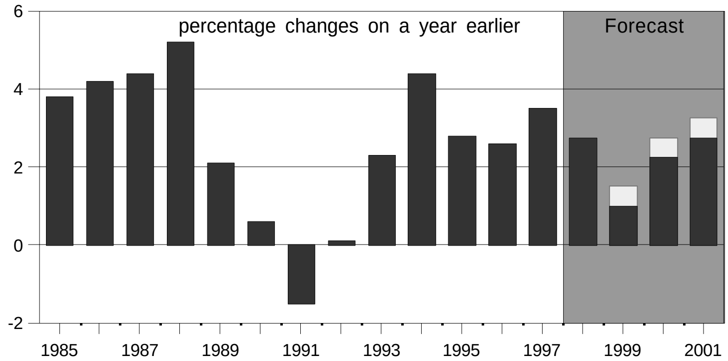
		Percentage change on a year earlier			
		Forecast			
	1997	1998	1999	2000	2001
Major 7 countries					
Real GDP	2¾	1¾	1½	2¼	2¼
Consumer price inflation	2	1½	1½	2	2
World trade in manufactures	11½	4½	5½	5¾	7¼
UK export markets	10½	7¼	6¼	6¾	7

Source: PBR

4.2 Growth in the UK in 1998 and 1999

Following strong growth of 3½ per cent in 1997, UK GDP is expected to increase by 2¾ per cent in 1998. This is broadly in line with what was expected at the time of the March Budget and the previous Convergence Programme. It was expected then that the impact of tight monetary and fiscal policies, the appreciation of sterling and the impact of events in Asia would lead to a slowing of the economy to below its trend rate during 1998. The latest figures show that GDP growth has slowed to 1.6 per cent on an annualised basis in the third quarter. Within total GDP, growth in service sector has slowed but remains stronger than in the manufacturing sector. Much as expected, the main driving force behind the slowing of demand growth has been weaker growth in household consumption.

Chart 4.1 - GDP growth 1985-2001



[1]Light areas on bars represent opportunity ranges

Source: PBR

Independent forecasts for UK growth changed little between March and late summer, remaining in line with the Budget forecast. However, two broad strands of recent evidence point to more moderate growth in the immediate period ahead:

- underlying trade performance has been weaker than expected, accounted for by a worsening in net trade with countries outside the EU and particularly in Asia; and
- business surveys, especially in manufacturing, have indicated lower trade, output and confidence in the third and fourth quarters of 1998.

On the assumption of no further deterioration in the world economic outlook, UK GDP is forecast to grow between 1 and 1½ per cent in 1999: ¾ percentage points lower than anticipated in the March budget.

The lower projection can be more than accounted for by the effects of the deterioration in the world economy on UK exports and financial markets. UK export markets are now expected to grow more slowly than previously foreseen. As UK exports represent around one third of GDP, this effect alone reduces GDP by around ½ per cent in 1999.

The Government's view is that growth can be enhanced by its labour market policies and responsible wage bargaining. Higher growth arises from the possibility that positive outcomes will deliver a reduction in the sustainable rate of unemployment. In the forecast table below, therefore, growth is presented in terms of opportunity ranges.

Table 4.2 - Summary of forecast

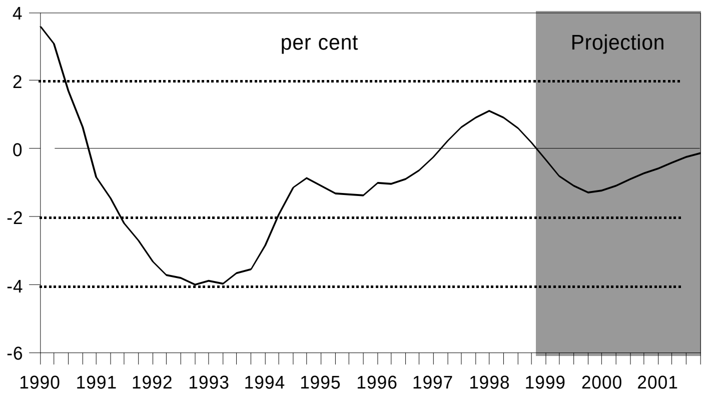
		Forecast			
	1997	1998	1999	2000	2001
Real GDP Growth (per cent)	3½	2¾	1 to 1½	2¼ to 2¾	2¾ to 3¼
Inflation (RPI ex MIPs, per cent, Q4)	2¾	2½	2½	2½	2½

Source:PBR

4.3 The output gap and the longer term

The output gap is estimated to have peaked at just over 1 per cent in early 1998, before falling back to around ½ per cent in the third quarter. While these estimates are uncertain, this reinforces the need for a further slowing in activity to reduce domestically generated inflationary pressures.

Chart 4.2 - The UK's output gap



[1] Actual output less trend output as a percent of trend output (non-oil basis)

Source: PBR

Future fluctuations in the size of the output gap are expected to be much smaller than in previous cycles. This reflects the expected impact of the policy framework the Government has put in place. Compared with the last economic cycle:

- Monetary policy has been tightened much earlier. Base rates were raised as output moved through trend in 1997. In the upswing of the previous cycle, tightening began in mid-1988, some 8 quarters after the economy passed through trend and when output was already a long way above potential.

- Recent cuts in rates to 6¼ per cent began 3 quarters after the estimated peak in the output gap and with output close to trend and inflation on target. In late 1990, interest rates began to fall from 15 per cent - more than twice the current level - much later, some 8 quarters after the peak. Although output was by then only a little above trend, RPIX inflation was over 9 per cent.

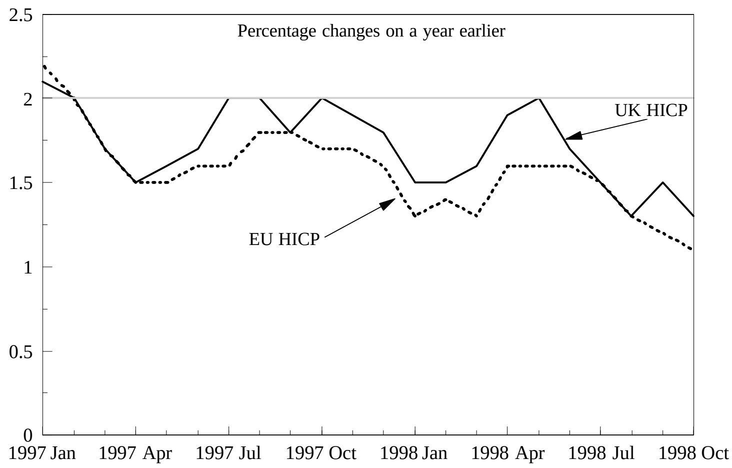
- Fiscal policy has supported monetary policy. A reduction in the structural deficit of almost 3 per cent of GDP since 1996-97 occurred as output grew above its trend growth rate and monetary policy was tightened. In the previous cycle, as output moved towards and then through trend, there was a structural loosening of fiscal policy. This complicated the task of monetary policy.

As growth slows, domestically-generated inflationary pressures will weaken. The scale of the cyclical slowdown, combined with a forward-looking policy approach, is expected to permit a cyclical recovery from early 2000 to bring the economy back to its trend level by 2002. It is, of course, uncertain how far this scenario would bring about convergence of the output gaps of the UK and the euro area, not least because the difficulty in estimating the output gap for the euro area and projecting growth and productive potential in those Member States. A comparison of the current forecasts against those in the previous Convergence Programme can be found in Annex A.

4.4 Inflation

The Government's targeted measure of inflation, RPIX, recently peaked in May 1998 and averaged 3 per cent during the second quarter as a whole. It fell back to 2½ per cent, the Government's target rate in August and has been at that level since then. The relevant convergence criterion is that inflation should not exceed by 1½ percentage points the three best performing Member States in terms of price stability measured by the Harmonised Index of Consumer Prices (HICP). In the UK, HICP inflation was 1.3 per cent in the year to October 1998, compared with 1.0 per cent for the euro area and well within 1½ per cent of the best three performers. The UK's inflation performance is consistent with the ECB's definition of price stability.

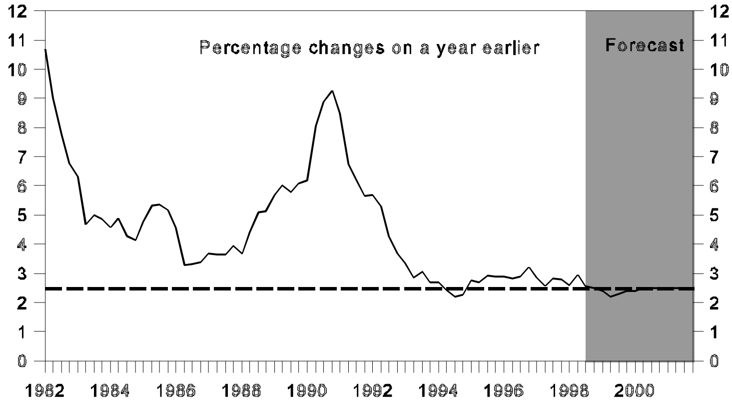
Chart 4.3: UK and EU HICP inflation from 1997 onwards



Source: ONS

Recent inflation outturns have benefited from the continued decline in import prices, caused by global developments, including falling commodity prices. Downward pressure on domestically-generated inflation is expected from early 1999 as the negative output gap begins to bite. The near-term prospect of import prices remains subdued, so RPI ex MIPs inflation may dip temporarily below its 2½ per cent target in the first half of 1999. However, import price inflation is likely to start picking up through 1999, as the effects of the previous exchange rate appreciation unwind and combine with the effects of the recent depreciation. Inflation is expected to return to target by the end of the year. Thereafter, it is expected to remain at target, with further downward pressure on domestically-generated inflation until the economy returns to trend in 2002 offset by a continued rise in import price inflation.

Chart 4.4 - RPIX inflation



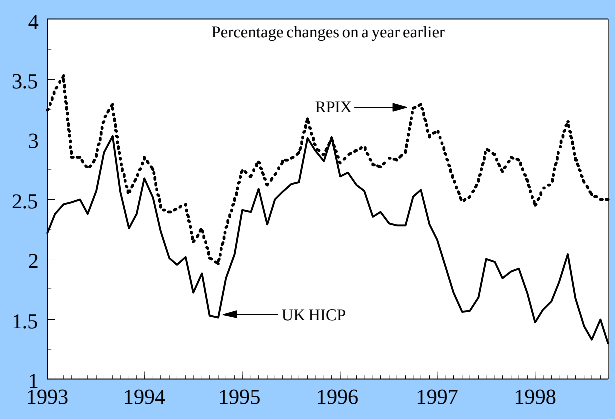
Source: PBR

The Harmonised Index of Consumer Prices

Harmonised Indices of Consumer Prices (HICPs) have been developed by the statistical offices of the member states, in conjunction with Eurostat. The construction of the HICPs is intended to facilitate inflation comparisons between countries and will be used by the European Central Bank as the price measure for assessing its price stability objective.

The UK HICP has been calculated from the same raw price data as the RPI. There are however a number of methodological and coverage differences between the series including the use of the geometrical mean and exclusion of several components of housing costs. A paper published by the Treasury, *The Harmonised Index of Consumer Prices (HICP): Some Factual Information*, shows that HICP inflation has been on average 0.5 percentage points *lower* than RPIX inflation over the past ten years. Of this, about 0.4 percentage points can be attributed to the geometric mean effect and about 0.1 percentage points to differences in coverage. This difference has been increasing over time, and UK HICP is currently just over 1 per cent lower than RPIX, very close to the Eurozone average, and within the ECB's definition of price stability and Maastricht criteria for inflation.

Chart 4.5: RPIX and HICP inflation



Source: PBR paper - The Harmonised Index of Consumer Prices(HICP) Some Factual Information

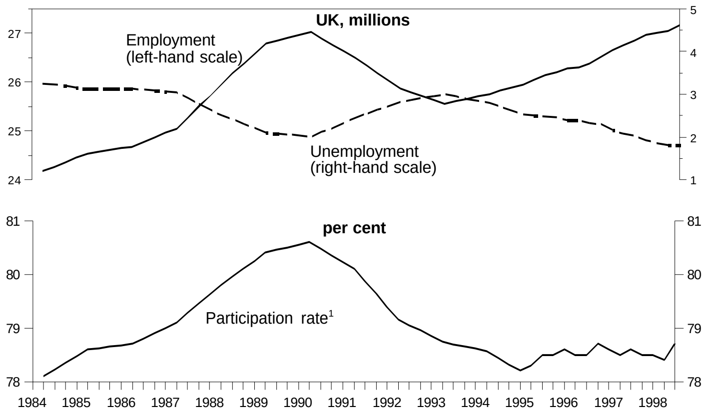
4.5 Interest rates

The yield spread on long-term (10-year) bonds against Germany has narrowed markedly, from over 1½ percentage points in April 1997 to below ¾ percentage point at present. This means that the UK is well within the Treaty convergence criterion for long-term interest rates.

4.6 The labour market

The labour market has performed well over the past year. Employment has risen strongly and unemployment has declined sharply. In the three months to October the Labour Force Survey measure of employment was up around 260,000 on a year earlier, and ILO unemployment had fallen by 128,000.

Chart 4.6: LFS employment, unemployment and participation rate



[1] Percentage of the population of working age who are economically active (i.e. employed or unemployed).

Source: PBR

As the economy slows further, it will be even more important that the labour market functions effectively. In particular, it will be vital that those becoming unemployed do not become permanently detached from the labour market. To this end, the Government's policies on encouraging work will make the UK labour market better equipped to deal with the economic downturn. These policies are outlined in the Employment Action Plan.

4.7 Trade

The strength of sterling and the Asian crisis have been the key issues for UK trade in 1998. Export volume growth has slowed sharply and is forecast to remain subdued next year, reflecting the further fall in the growth of UK export markets and continued, albeit eased, exchange rate effects. Import volume growth started to slow in 1998 with the deceleration in final domestic demand, and this is expected to continue in 1999. But exports are expected to pick up from 2000 and grow more in line with imports as UK export market growth recovers and the effects of the recent easing of the exchange rate feed through. As a result, after a large swing into deficit between 1997 and 1999, the current account deficit is forecast to stabilise at around 1 per cent of GDP thereafter. This is modest by historical standards.

Table 4.3 - Summary of economic prospects

	Percentage changes on a year earlier unless otherwise stated				
		Forecast			
	1997	1998	1999	2000	2001
Output at constant market prices					
Gross domestic product (GDP)	3½	2¾	1 to 1½	2¼ to 2¾	2¾ to 3¼
Manufacturing output	1	¼	-¼ to ¼	¾ to 1¼	2 to 2½
Expenditure components of GDP at constant market prices					
Domestic demand	4	4	1½ to 2	2¼ to 2¾	2¾ to 3¼
Household consumption	4¼	3	1¾ to 2¼	2¼ to 2¾	2¼ to 2¾
General government consumption	0	2¼	2½	1¾	2¼
Fixed investment	6	6¼	1¾ to 2¼	3 to 3½	3½ to 4
Change in inventories	¼	½	-½ to -¼	0	¼
Exports of goods and services	8½	3¼	2¾ to 3¼	4¾ to 5¼	6 to 6½
Imports of goods and services	9½	7¼	4¼ to 4¾	4½ to 5	5½ to 6
Balance of payments current account					
£ billion	8	-1¾	-7½	-8¾	-9¼
per cent of GDP	1	-¼	-¾	-1	-1
Inflation					
RPIX	2¾	2½	2½	2½	2½
Producer output prices (Q4)	-¼	-¾	½	1¾	2¼
GDP deflator at market prices (financial year)	2½	2¾	2½	2½	2½
Money GDP at market prices (financial year)					
£ billion	814	855	884 to 890	930 to 940	979 to 994
percentage change	6½	5	3½ to 4	5 to 5½	5¼ to 5¾

Source: PBR

5. Outlook for the public finances

5.1 The fiscal framework

The primary responsibility of fiscal policy in the Government's long-term macroeconomic framework is to contribute to economic stability through sound public finances. This is essential for convergence and conforms with the Stability and Growth Pact.

At the heart of this strategy lie:

- a transparent fiscal framework, as set out in the Code for Fiscal Stability, and two tough fiscal rules to bring the public finances back under control.

- a new regime for planning and controlling public spending, based on firm three-year public expenditure allocations: the plans announced in the Economic and Fiscal Strategy Report in June provide better incentives for departments to manage their budgets efficiently and ensure the tight fiscal position is locked in over the economic cycle.

The Government's two fiscal rules, set to govern policy over the course of this Parliament are:

- **the golden rule**: on average over the economic cycle, the Government will borrow only to invest and not to fund current spending; and

- **the sustainable investment rule**: net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. The Government believes that, other things equal, it is desirable net public debt be reduced to below 40 per cent of GDP over the economic cycle.

The fiscal framework is characterised by a high degree of openness and transparency. The Code for Fiscal Stability(see box) builds on the lessons learned from past experience and sets policy in the context of clear fiscal principles, reporting arrangements and best-practice accounting standards.

The golden rule helps to match the costs and benefits of public spending across generations by drawing a clear distinction between current and capital spending, and ensures that current spending is paid for as it occurs and is not a burden on future generations. The sustainable investment rule ensures that the Government can maintain its current spending and taxation policies while continuing to meet its debt interest obligations, even in the face of adverse shocks.

The Code for Fiscal Stability

The Code, which is underpinned by the Finance Act 1998, represents an important step in modernising Britain's economic policy framework in parallel with the Government's reforms to monetary policy. It enshrines five key principles which lie at the heart of the Government's fiscal policy framework:

- **transparency** in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts;
- **stability** in the fiscal policy-making process and in the way fiscal policy impacts on the economy;
- **responsibility** in the management of the public finances
- **fairness**, including between generations; and
- **efficiency** in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.

The Code will ensure that all governments set fiscal and debt management policy consistent with these principles, and must state explicitly their fiscal objectives. In this way, Parliament and the public can scrutinise fiscal policy properly, helping to rebuild trust and confidence in economic policy. To facilitate scrutiny, the Code sets out a detailed and transparent reporting framework and requires governments to follow best practice accounting methods. The latter includes moving to a Resource Accounting and Budgeting approach to planning and accounting for government spending. By planning, controlling and accounting for departmental spending on a full accruals basis the distinction between current and capital spending will be taken one stage further.

This framework is based firmly on achieving sound public finances and long-term economic stability. It is thus in keeping with the Stability and Growth Pact. Within the framework, there is an inbuilt capacity to respond to changing economic circumstances by allowing the automatic stabilisers to operate. By setting the golden rule over the economic cycle, any current deficits recorded during an economic slowdown must be offset by current surpluses during a period of stronger economic growth. In this way, the framework provides a basis for long-term economic stability, but allows flexibility within the cycle to help smooth out economic fluctuations.

The Government is also able to support monetary policy with appropriate fiscal policy settings as, for example, with the fiscal tightening introduced in the July 1997 and March 1998 Budgets (see table below) consistent with meeting the fiscal rules. In this way, the framework sets a long-term goal for policy without imposing inappropriate restrictions on its flexible operation.

Table 5.1: Fiscal tightening: cumulative change since 1996-97 (per cent of GDP)

	1997-98	1998-99
General government net borrowing	-3¼	-4¾

Source: PBR

The tightening of policy and firm fiscal objectives have helped bring about a significant improvement in the budgetary position. This improvement was recognised by the abrogation of the UK's excessive deficit on 1 May 1998.

The Government's fiscal projections show general government net borrowing close to balance or in surplus in each of the next five years, and general government gross debt falling to 40½ per cent of GDP by 2003-04. These projections allow ample capacity for the automatic stabilisers to respond to changing economic circumstances, while keeping the deficit below 3 per cent of GDP. Therefore the public finances are, and will continue to be, well within the Treaty reference values for the foreseeable future.

5.2 The fiscal projections

Assumptions

Projections of the public finances are based on a cautious set of assumptions, independently audited by the National Audit Office - including those for trend GDP growth(of 2¼ per cent), unemployment, inflation, interest rates. It is assumed that:

- the economy follows the path described in Table 5.2. In the interests of caution, the lower end of the opportunity range for GDP growth in Table 4.1 has been used;
- these growth forecasts are consistent with those of the European Commission and many independent forecasters; and
- the plans incorporate a margin for uncertainty, with the projections showing that the Government will over-achieve its rules.

In addition the projections assume:

- public spending is in line with the plans set out in June's Economic and Fiscal Strategy Report (EFSR), which set the overall spending envelope for the Comprehensive Spending Review (CSR) in July. Specifically, current spending is set to grow on average at an annual rate of 2¼ per cent in real terms over the next three years, the same rate as the estimated trend growth rate of the economy; net investment is planned to grow faster than this, rising to just over 1 per cent of GDP;
- there are no tax changes beyond those already announced in past Budgets; and

- the spending plans include reserves to cater for genuine contingencies.

Table 5.2: Economic assumptions for public finance projections

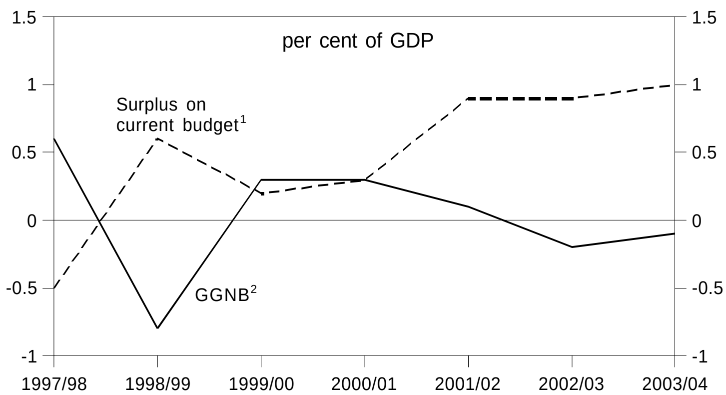
	Percentage changes on previous year					
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Output (GDP)	2¼	1	2½	2¾	2½	2¼
Prices						
RPIX	2½	2¼	2½	2½	2½	2½
GDP deflator	2¾	2½	2½	2½	2½	2½
Money GDP (£ billion)	**855**	**884**	**930**	**979**	**1028**	**1078**

Source: PBR

5.3 The current balance and general government deficit

After a deficit of 0.6 per cent of GDP in 1997-98, the general government net balance is estimated to be in surplus by ¾ per cent of GDP in 1998-99. The UK's deficit is well below the 3 per cent of GDP reference values set out in the Maastricht Treaty, and is also much lower than many other Member States.

Chart 5.1 - Government balances as per cent of GDP



[1] excluding windfall tax and associated spending

[2] General government net borrowing. The Maastricht definition does not exclude the windfall tax and associated spending.

Source: PBR

Table 5.3 - The public sector's finances (as per cent of GDP)

	Outturn	Estimate			Projections		
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Surplus on current budget	-0.5	0.6	0.2	0.3	0.9	0.9	1.0
Net investment	0.5	0.5	0.7	0.9	1.1	1.1	1.1
Public sector net borrowing excluding windfall tax	1.0	-0.2	0.5	0.5	0.2	0.2	0.1
General government net borrowing	0.6	-0.8	0.3	0.3	0.1	-0.2	-0.1
General government gross debt	50.4	47.9	46.7	45.4	43.7	42.0	40.4

Source: PBR

The forecast surplus on the current budget of ¾ per cent of GDP in 1998-99 compares with a deficit of over 3 per cent of GDP two years earlier. Roughly ¾ per cent of this 3¾ per cent improvement is accounted for by tax changes in the 1997 and 1998 Budgets. An estimated 1 per cent is accounted for by above trend growth. The remainder mainly reflects relatively slow growth of public expenditure, as the Government has fulfilled its manifesto commitment to keep within the spending limits it inherited for the first two years.

Public sector net investment is expected to remain at around ½ per cent of GDP in 1998-99 before increasing over the next three years.

Inevitably the public finances are affected by the economic slowdown projected for next year. The current budget surplus is reduced, as slower growth in income and expenditure and the fall in equity prices since July reduce growth in tax revenues. However, this reduction is cyclical and the structural surplus continues to improve. Public investment is unaffected by the cyclical slowdown. The overall general government position is expected to fluctuate between a small deficit of ¼ per cent of GDP and a surplus of ¼ per cent over the projection period. Table 5.3 shows projections for the current and capital budgets as percentages of GDP.

5.4 General government receipts

Total receipts are projected to rise by 0.4 per cent in 1998-99. About 0.3 per cent of this increase is accounted for by Budget measures. Excluding the windfall tax, the ratio of total receipts to GDP is projected to increase next year by 0.3 per cent. This increase is wholly accounted for by past Budget measures .

The slowdown in economic growth, and profits in particular, is reflected in lower receipts of corporation tax. The underlying ratio of receipts to GDP - after allowing for Budget changes - falls slightly in 1999-2000 and 2000-01. Thereafter, total receipts are projected to increase slightly in relation to GDP.

Public Sector Investment

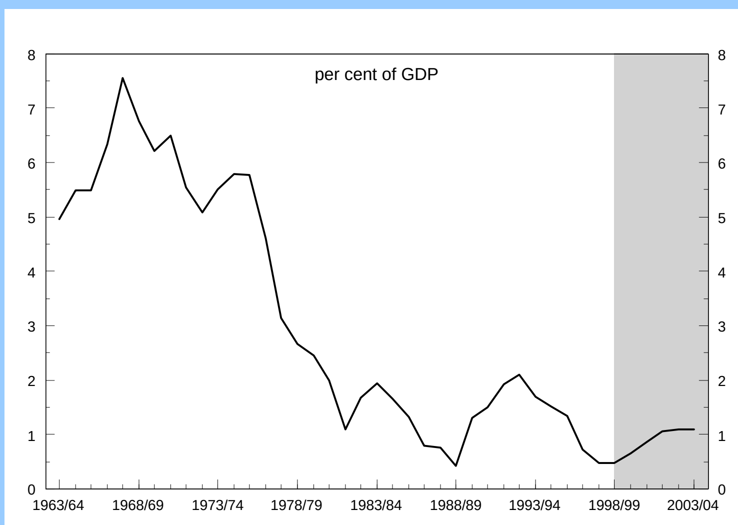
Public investment has fallen sharply as a share of both national income and public spending over recent years. The existence of maintenance and other backlogs in parts of the public sector implies a need for higher investment. By making a clear distinction between current and capital spending, the new fiscal framework removes the bias against public investment and paves the way fro an improved position.

It is important that public investment is set at a prudent and responsible level that does not threaten the sustainability of the public finances. This is why the Government is also committed to holding the public debt ratio over the cycle at a stable and prudent level.

Over the next three years the legacy of under-investment is being addressed. The Investing in Britain Fund will provide for the renewal, reform and modernisation of the UK's infrastructure by providing a catch-up increase in public investment. A Capital Modernisation Fund worth £2½ billion will be used to finance innovative projects that deliver new public services, and increase the quality and effectiveness of existing services in innovative ways -to improve productivity and serve the Better Government agenda.

These developments will allow progress while ensuring that the fiscal rules are met. Net investment is forecast to increase from its present level of 0.5 per cent of GDP to 1.1 per cent of GDP by 2001-02 and continue at this share of GDP thereafter. Where it is in the public interest, the Government will encourage the use of private sector finance through public-private partnerships. Developing appropriate partnerships with the private sector can improve the management of assets, deliver value for money and improve quality and service levels. This approach is in keeping with the recent Commission paper "Government investment in the framework of economic strategy".

Chart 5.3: Public sector net investment



Source: ONS and EFSR

Table 5.4: Budget forecasts of current receipts and expenditure (per cent of GDP)

	Outturn	Estimate			Projections		
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Current receipts	38.9	39.3	39.3	39.4	39.8	39.9	39.9
Current expenditure	37.4	36.8	37.6	37.6	37.4	37.4	37.3
Depreciation	1.7	1.7	1.7	1.6	1.6	1.6	1.6
Surplus on current budget	-0.5	0.6	0.2	0.3	0.9	0.9	1.0

Source: PBR

5.5 Government expenditure

Control Total spending in 1998-99 - the last in the old expenditure framework - is estimated to be some £1¼ billion lower than planned, mainly as a result of lower than expected social security spending. Central government gross debt interest has been revised down by £1½ billion, reflecting lower government borrowing this year.

Expenditure plans for the whole of the public sector, covering the years 1999-2000 to 2001-2002 were set out in the EFSR and in detail in July's CSR. Current spending plans, as a share of GDP are set out in Table 5.4 above, and net investment in Table 5.3. Much of the improvement in the public finances will come from continued tight control of these expenditure programmes.

The totals set out in the EFSR formally locked in the fiscal tightening of the past year and introduced a tough new regime for the long-term control of public expenditure. The public spending round - an annual cycle of year-on-year incremental bids by departments - is being replaced by a framework based on stable three-year plans. These plans will create a clearer distinction between current and capital spending, and mean that services will be justified by a proper analysis of their effectiveness. They will help the Government meet its priorities while remaining consistent with the fiscal rules and overall economic stability.

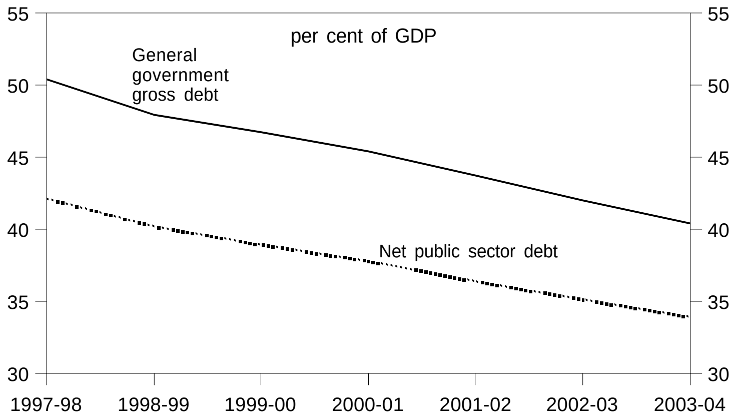
Long-term pressures

The Government is aware of the potential pressure on the public finances from expenditure stemming from an ageing population. In accordance with the Code, long-term projections are being prepared for 1999's EFSR. One of the reasons for reducing the debt ratio is to give room for manouevre over future expenditure pressures and ensure that the sustainability of the public finances is not threatened.

5.6 Government debt

The debt burden rose sharply in the first half of the 1990s as a result of high levels of borrowing and slow growth in money GDP. However, by 1997-98, general government gross debt was at 50.4 per cent of GDP, well below the 60 per cent reference value. As a result of the Government's deficit reduction programme, general government gross debt is forecast to fall towards 40 per cent of GDP by 2003-04.

Chart 5.2: Public sector debt



Source: PBR

5.7 Cyclically-adjusted budget balances

Table 5.5 below shows current surplus and net borrowing on a cyclically adjusted basis. The structural budgetary position in 1998-99 is expected to be very close to balance, an improvement of almost 1 per cent of GDP compared with a year ago. The projections beyond this are similarly close to balance or in surplus. Thus the UK fulfils the medium-term objective of the Stability and Growth Pact.

Table 5.5 - Cyclically adjusted budget balances (per cent of GDP)

	Outturn	Estimate	Projections				
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Surplus on current budget	-0.6	0.3	0.5	1.0	1.2	1.0	1.0
Average surplus since 1997-98	-0.6	-0.2	0.0	0.3	0.5	0.6	0.6
Public Sector Net Borrowing	1.1	0.2	0.2	-0.1	-0.1	0.1	0.1

Source: PBR

5.8 Public finance measures

Since the last UK Convergence Programme, the Government has published the FSBR in March 1998, the EFSR in June, the CSR in July, and the PBR in November. Details of the Budget measures and their effects on the public finances can be found in Annex B. These have been approved by Parliament. Details of the new public spending plans were set out in the Comprehensive Spending Review, published in July. These were debated by Parliament at that time. The PBR updated the public finances projections on the basis of the new macroeconomic forecast. The Budget's aims were to encourage work and enterprise, and create a fairer society. The Budget included, for example:

- a £1.4 billion reform of national insurance contributions to improve work incentives, especially for those at the lower end of the income scale;

- the proposed introduction of Working Families Tax Credit, to make work pay for families;

- a cut in the main rate of corporation tax to 30 per cent;

- structural reforms to the capital gains tax;

- extension of the New Deal initiative to improve employment opportunities to people detached from the labour market;

- further increases in fuel, tobacco and alcohol duties.

The Government has also assessed which of its assets can be sold to finance investment in key public services; and which can be exploited better (especially through public-private partnerships). In this context, the Government has said it will:

- introduce legislation to establish a public-private partnership based on the sale of a majority stake in the National Air Traffic Services;

- sell a further tranche of student loans in 1999-2000, thus transferring part of the default risk to the private sector and financing the Government's objectives;

5.9 Sensitivity of the public finances

Risks and error margins

The projections of the public finances should be placed within realistic error margins. The average absolute error (i.e. the average error irrespective of whether the errors have been positive or negative) for one-year ahead forecasts of net borrowing has been over 1 per cent of GDP. The error is still larger for projections further ahead. Much of this arises from errors in the forecasts of GDP, reflecting the volatility of the UK economic cycle.

Table 5.6: Average errors in Budget forecasts of public sector net borrowing

	Per cent of GDP
One-year ahead	1.2(1.0)
Two-years ahead	2.0(1.4)
Three-years ahead	3.0(2.0)
Four-years ahead	4.1(2.4)

For period 1985-86 to 1997-98. Figures in brackets are adjusted for the estimated effect of errors in the GDP forecast
Source: PBR

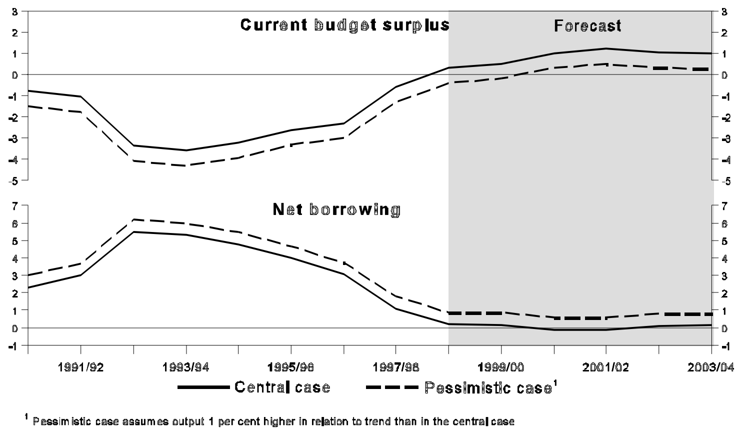
The precise cyclical path of the economy is inevitably uncertain. If the profile of growth were to differ from that assumed, the short term outlook for the public finances would be affected. If GDP growth were 1 per cent higher or lower than the central projection in the coming financial year, Treasury estimates suggest net borrowing might be lower or higher by around 0.4 per cent of GDP, equivalent to £3½ billion in the first year, and by a further 0.3 per cent, equivalent to £2½ billion, in the second year - a 0.7 per cent of GDP impact in total. Higher or lower growth would have an impact on debt levels as well. There is roughly a one for one relationship between the deficit and debt.

There are both upside and downside risks to the forecasts. Nonetheless, with the public finances currently close to structural balance there is some room for manouevre while ensuring that the deficit remains consistently below the 3 per cent deficit reference value. For example, if world conditions worsened and caused UK's export market growth to be 1 percentage point lower than supposed next year - a large deviation - the cumulative impact on borrowing might be around ¼ per cent of GDP, and the budgetary position would remain close to balance.

Risks in estimating the cycle

Whereas errors in short-term growth forecasts may have only a temporary effect on the public finances, errors in estimating the current cyclical position of the economy - the output gap - will have a permanent effect on prospects. If output were higher relative to trend than has been assumed, the prospects for the public finances would be less favourable, as lower economic growth would be implied on average over the remainder of the cycle.

Chart 5.4 - Cyclically adjusted budget balances: central and pessimistic cases



Source: PBR

The chart above illustrates a pessimistic case where in addition to the prudent assumptions, trend output is assumed to be 1 per cent lower than the central view. On average, between 1997-98 and 2003-04, the cyclically-adjusted current balance is close to balance. Throughout the period, cyclically-adjusted net borrowing is higher than in the central case (balance) by around ¾ per cent of GDP. Nonetheless, the deficit remains well within the 3 per cent reference value.

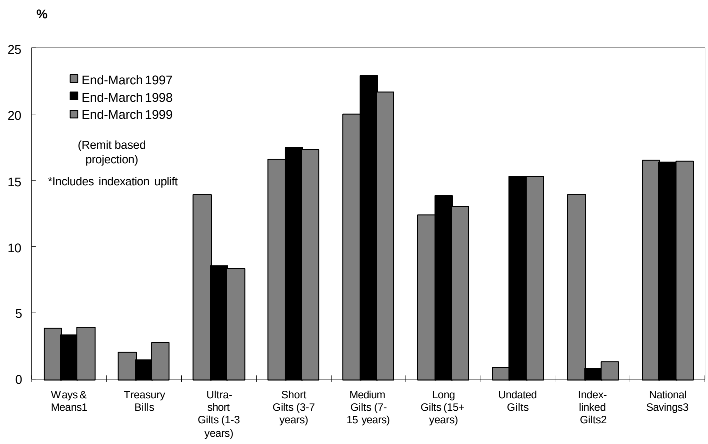
Table 5.7 - Central government gross debt interest (£ billion)

		Forecast			
	1997-98	1998-99	1999-00	2000-01	2001-02
Central government gross debt interest	29.8	29.5	28.3	28.4	28.0

Source: PBR

Central government gross debt interest expenditure is estimated to be less than 4 per cent of GDP for 1998-99. The UK government finances are not very sensitive to interest rates. The proportion of UK debt that is short-term, and therefore interest rate sensitive, is low. Chart 5.5 below shows the structure of total government debt. Ultra-short gilts and short gilts are the most interest sensitive, and currently they comprise just over 30 per cent of total Government debt.

Chart 5.5 - Structure of total government debt



Source: Debt Management Report

In auditing the assumptions underlying the 1997 Budget the National Audit Office assessed the impact on debt interest payments of different interest rates. Table 5.8 below shows the impact of a sustained 1 per cent increase in short interest rates on net debt interest payments, other things being equal. The impact amounts to under 0.1 per cent of GDP, illustrating the point that the UK public finances are not sensitive to interest rate assumptions.

Table 5.8: Interest rate impact on central government net debt interest payments (£ billion) of a one percentage point change

1999-00	2000-01	2001-02	2002-03	2003-04
0.9	0.5	0.5	0.5	0.5

Source: NAO

ANNEX A: SUMMARY COMPARISON OF 1997 AND 1998 CONVERGENCE PROGRAMMES)

	1997		1998	
	1997CP	1998CP	1997CP	1998CP
Real GDP growth (per cent)*	3¼	3½	2½	2¾
Inflation (RPIX, Q4)	2½	2¾	2¾	2½
General government net borrowing (per cent of GDP)*	1.6	0.6	0.3	-0.8
General government gross debt (per cent of GDP)*	53	50.4	51.5	47.9

* Financial years 1997-98 and 1998-99 used for public finances figures. 1997 Convergence Programme only forecast for 1998-99; figures beyond that used three sets of illustrative projections, pending the outcome of the Comprehensive Spending Review.
Source: PBR and 1997 Convergence Programme

ANNEX B: THE BUDGET MEASURES

£ million

		1998-99 non-indexed	1998-99 indexed	1999-00 indexed	2000-01 indexed
	ENCOURAGING WORK				
1	Working Families Tax Credit	-	-	-420	-1,350
2	New deal for Communities	-15	-15		
3	Linking rules for lone parents and disabled people	-10	-10	-10	-10
4	National insurance contributions: abolish entry rate for employee NICs from April 1999	-	-	-1,200	-1,350
5	Disabled Person's Tax Credit	neg	neg	-5	-5
	PROMOTING ENTERPRISE				
6	Corporation tax 1% cut in main rate from April 1999	0	0	neg	-700
7	Corporation tax 1% cut in small companies rate from April 1999	0	0	neg	-90
8	Abolish ACT and introduce quarterly payments of corporation tax	+100	+100	+1,600	+2,000
9	Abolish quarterly accounting for gilts	0	0	-600	neg
10	Capital Gains Tax: structural reform	neg	neg	-25	+25
11	Tax incentives for venture capital - changes to re-investment relief	neg	neg	+20	+30
12	Tax incentives for venture capital - other changes	+5	+5	neg	-10
13	Increase first year capital allowances for SMEs to 40% for one year	neg	neg	-140	-160
14	University challenge	neg	neg	-10	-10
15	VAT regestration threshold to £50,000	-5	-5	-10	-5
	CREATING A FAIRER SOCIETY				
16	Indexation of income tax allowances	-820	0	0	0
17	Indexation of income tax lower rate band	-90	0	0	0
18	Indexation of income tax basic rate limit	-270	0	0	0
19	Removing marginal deduction rates over 100 per cent for working familes in HB and CTB	0	0	-10	-10
20	Investing in health: waiting lists initiative	-500	-500		
21	Investing in education	-250	-250		
22	Child support package (excluding all WFTC and DPTC elements)	-170	-170	-1,215	-1,220
23	Married couple's allowance - cutting relief from 15% to 10% from April 1999. 65s and over compensated.	-	-	+720	+1,080
24	Individual savings account	neg	neg	+30	-30
25	Inheritance tax: index threshold	-30	0	0	0
26	Stamp duty: increase rates for transfers of property above £250,000	+390	+390	+470	+520
27	Insurance Premium Tax extended to all travel insurance to 17.5%	+5	+5	+15	+20
28	Increase total tobacco duties in December 98 except hand rolled tobacco by 5.25 % above inflation; freeze hand rolled tobacco	+25	0	0	0
29	Alcohol: revalorise in Jan 1999 (except spirits)	+20	0	0	0
30	Alcohol: freeze duty on spirits	0	-5	-20	-20
31	VAT: fuel scale charges	+5	+5	+5	+5
32	Alcohol: further step towards alignment of low strength sparkling wine and sparkiling cider	-5	-5	-5	-5
33	Hydrocarbon oils - duty rate increases for gas oil and fuel oil	+25	+25	+25	+25
34	Millennium Gift Aid	-15	-15	-25	-20
	Gambling				
35	Gaming duty	+20	+20	+25	+25
36	Increase rates of AMLD (top 2 bands)	+20	+15	+20	+20
37	Increase exemption for skill with play	-5	-5	-5	-5

Annex B: The Budget Measures Continued

+ve is an Exchequer yield
£ million

		1998-99 non-indexed	1998-99 indexed	1999-00 indexed	2000-01 indexed
	Environmental measures				
38	Bring forward road fuel escalator to March 17	+1,515	+1,110	+1,040	+1,150
39	Increase differential between diesel and unleaded petrol to 1p this year, to 3p next year and to 4p the year after; and between diesel and ULSD to 2p this year and 3p the year after	+120	+120	+335	+455
40	super unleaded petrol 1.15p increase	+10	+10	+10	+10
41	VED: freeze for all vehicles	0	-145	-145	-145
42	Company cars fuel scales increased	+70	+70	+160	+275
43	Cut VAT rate on energy saving materials in HEES schemes to 5%	-5	-5	-10	-10
44	VED:Concession for low emission buses and lorries	neg	neg	-5	-10
45	Increase Bus fuel duty Rebate	-40	-40	-40	-40
46	Public transport	-175	-175	-300	-50
47	Landfill tax increase standard rate to £10, exemption for waste used in site restoration	0	-5	+50	+60
	Simplification/deregulation				
48	Employment termination payments	-5	-5	-10	-5
49	Simplify schedule A: corporation tax changes	neg	neg	+50	neg
	Securing the tax base				
50	Abolish foreign earnings deduction	+100	+100	+300	+250
51	Professional businesses: withdrawal of cash basis	0	0	neg	+40
52	Counter capital gain buying	+10	+10	+100	+100
53	Reform of policy holder taxation	0	0	+30	+100
54	Action on offshore trusts	neg	neg	+10	+50
55	End PRP exploitation	+5	+5	+5	+5
56	Charge on temporary non-residents	neg	neg	+20	+20
57	Controlled Foreign Companies: tighten rules	0	0	+50	+100
58	Transfer pricing: modernise legislation	0	0	+20	+50
59	PAYE avoidance	+25	+25	neg	neg
60	Limiting relief for foreign tax on certain interest and dividends	neg	neg	+10	+50
61	VAT: limit exemption for sport	+5	+5	+5	+5
62	VAT: preventing abuse by taxing certain services received from outside the EC	neg	neg	neg	neg
	Carry forward from 1997-98 -1500				
	allocated to; Health (line 20) -500				
	Education (line 21) -250				
	Transport (line 46) -175				
	New Deal for Communities (line 2) -250				
	Control Total elements of child support (line 22) -60				
63	*Residual carry forward transferred to Reserve -500*	*-500*	*-500*		
	Total cost(-)/yield(+)	*-435*	*+165*	*+915*	*+1,210*
	Total cost(-)/yield(+) excluding cashflow yield from line 8	*-535*	*+65*	*-685*	*-790*

Source: FSBR