DELIVERING ECONOMIC STABILITY

Convergence Programme submitted in line with the Stability and Growth Pact

December 2000

INTRODUCTION – DELIVERING ECONOMIC STABILITY

1.1 The Government's macroeconomic framework is continuing to deliver macroeconomic stability, which is a precondition for high and stable levels of growth and employment.

1.2 The Government has put in place frameworks for monetary and fiscal policy, based on the principles of transparency, responsibility and accountability, to deliver economic stability for the long term. The **monetary policy framework** with operational independence for the Bank of England is designed to deliver low and stable inflation, while the **fiscal policy framework,** underpinned by two strict fiscal rules, is designed to deliver sound public finances. A **public spending framework** is integrated into the fiscal framework, providing greater certainty for long-term planning and a greater focus on the outcomes that will be delivered.

1.3 This report, "Delivering Economic Stability", updates the UK's 1999 Convergence Programme to reflect the latest Government forecasts for the economy and public finances, which were published in the Pre-Budget Report on 8 November 2000[1]. The public finance projections in the Pre-Budget Report have a different status to those included in the Budget – they present an interim forecast update and do not necessarily represent the outcome the Government is seeking.

1.4 This update also therefore takes account of Budget 2000[2] and the 2000 Spending Review[3]. Taking into account recent improvements to Government receipts, the fiscal stance is projected to be at least as tight as forecast in the Budget, which locked in fiscal tightening to an even greater extent than had been projected in the 1999 Budget. Fiscal policy continues to support monetary policy.

Macroeconomic stability

1.5 Chapter 2 provides a brief outline of how the macroeconomic framework that the Government has put in place is helping to deliver economic stability. Output growth has remained stable and positive, inflation has remained close to the Government's 2½ per cent target and interest rates have been lower and more stable than in the past. At the same time, a healthy and sustainable position for the public finances has been achieved.

1.6 This chapter also summarises the Government's updated projections for the public finances, consistent with the Government's two fiscal rules. The measure specified in the Treaty for government deficit is projected to remain close to balance over the projection period, and the Treaty definition for government debt is projected to fall below 40 per cent of GDP from 2001-02 onwards.

[1] Pre-Budget Report, HM Treasury, November 2000: http://www.hm-treasury.gov.uk/pbr2000/index.html
[2] Budget 2000, HM Treasury, March 2000: http://www.hm-treasury.gov.uk/budget2000/index.html
[3] Spending Review2000, New Public Spending Plans 2001-2004, HM Treasury, July 2000: http://www.hm-treasury.gov.uk/sr2000/index.html

Productivity and economic reform

1.7 Locking in stability provides the opportunity to raise the UK's productivity performance and deliver stronger, sustainable growth in output and employment with low and stable levels of inflation and interest rates. Economic reform also plays a key role in delivering the ambitious ten-year goal set for the European Union at the Lisbon European Council in March 2000, to which the Government is firmly committed. Chapter 2 includes a summary of the Government's strategy towards meeting these objectives.

Forecasts

1.8 Chapter 3 provides updated forecasts for the UK economy in the period to 2003. Growth of 3 per cent is expected in 2000, moderating to 2¼-2¾ per cent in 2001, while the number of people in work has risen by more than one million since spring 1997 – unemployment, at 5.5 per cent, is close to its lowest level since 1979.

Public finances

1.9 Chapter 4 summarises the latest Government projections for the public finances, including a breakdown of Government expenditure and receipts. It includes:

- five-year ahead projections of the current budget surplus and public sector net debt, the key aggregates for assessing performance against the Government's fiscal rules;
- projections of public sector net borrowing, general government net borrowing and general government gross debt;
- consistent projections of the cyclically adjusted fiscal balances;
- detail on government receipts and expenditure; and
- information on the long-term sustainability of the public finances.

Annexes

1.10 Annex A provides details of the differences in key indicators between this update of the programme and the 1999 update. Annex B provides details of the financial impact of this year's Budget measures, calculated at the time of its publication in March 2000. These figures are due to be updated at the time of the next Budget, in 2001. They will then take into account developments since March.

Box 1.1 Background to the 2000 update: "Delivering Economic Stability"

The Government has submitted programmes under the Stability and Growth Pact (SGP) for each of the last two years. The SGP requires Member States to provide information on economic developments in their country, for the purposes of the multilateral surveillance procedure under Article 99 of the Treaty establishing the European Community (ex Article 103). The UK is required to present the following information in its Convergence Programme:

- information on the medium-term objective for the budgetary position of close to balance or in surplus, and the adjustment path towards this objective;
- the main assumptions about expected economic developments and important economic developments;
- a description of budgetary and other economic policy measures being taken, or proposed, to achieve the objectives of the programme; and
- an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

2 POLICY FRAMEWORK AND OBJECTIVES

Objectives of Economic Policy

2.1 The Government's central economic objective is high and stable levels of growth and employment. Its aim is to fulfil Britain's economic potential, building a stronger economy and a fairer society in which everyone can contribute to and share in rising prosperity and a better quality of life. The key elements of the Government's economic strategy are:

- delivering macroeconomic stability;
- meeting the productivity challenge, raising productivity through promoting competition, enterprise and innovation, investment in physical capital and skills, and public sector productivity improvements;
- increasing employment opportunity for all;
- ensuring fairness for families and communities; and
- protecting the environment.

2.2 This objective, and the elements through which the Government plans to meet it, are consistent with the objectives of the European Community as set out in Article 2 of the Treaty. They are also consistent with the Broad Economic Policy Guidelines of the Member States and the Community.

Delivering Macroeconomic Stability

The importance of stability

2.3 Economic history demonstrates clearly that stability is an essential platform for achieving high and sustainable levels of growth and employment. Economic instability imposes significant costs on the economy and society. The UK's economic record has made clear the importance of establishing a macroeconomic policy framework that promotes stability.

2.4 Since 1997, the Government has put in place a new open and transparent framework for macroeconomic policy, defining clear policy objectives and a division of responsibility which gives proper accountability. Despite a large external shock in 1998, output growth has remained stable and above 2 per cent in each of the last three years, with growth of 3 per cent expected this year.

2.5 Through pre-emptive action, steady and stable growth is now being accompanied by record levels of employment, low inflation and a sound fiscal position. This has enabled the Government to raise investment in Britain's key public services on a sustainable basis in the 2000 Spending Review.

Monetary Policy and Objectives

The monetary policy framework

2.6 The new monetary policy framework has helped to keep inflation close to the Government's target:

- Objectives are clear and precise. The primary objective of monetary policy is price stability. Without prejudice to this objective, there is a requirement that monetary policy also supports the Government's wider economic policy objectives.
- Policy is implemented by an independent Monetary Policy Committee (MPC) at the Bank of England. The MPC consists of highly respected, independent experts charged with, and held accountable for, setting interest rates to meet the Government's inflation target – a symmetric inflation target of 2½ per cent annual growth in the Retail Price Index excluding mortgage interest payments (RPIX).
- Mechanisms are designed to promote openness, transparency and accountability, such as the publication of voting records, minutes of the monthly MPC meetings, and a quarterly *Inflation Report*.
- The "Open letter" system, whereby if inflation deviates more than one percentage point above or below target, the Governor of the Bank of England must explain why inflation has diverged from target, the action that will be taken to deal with the divergence, and when inflation is expected to return to target.

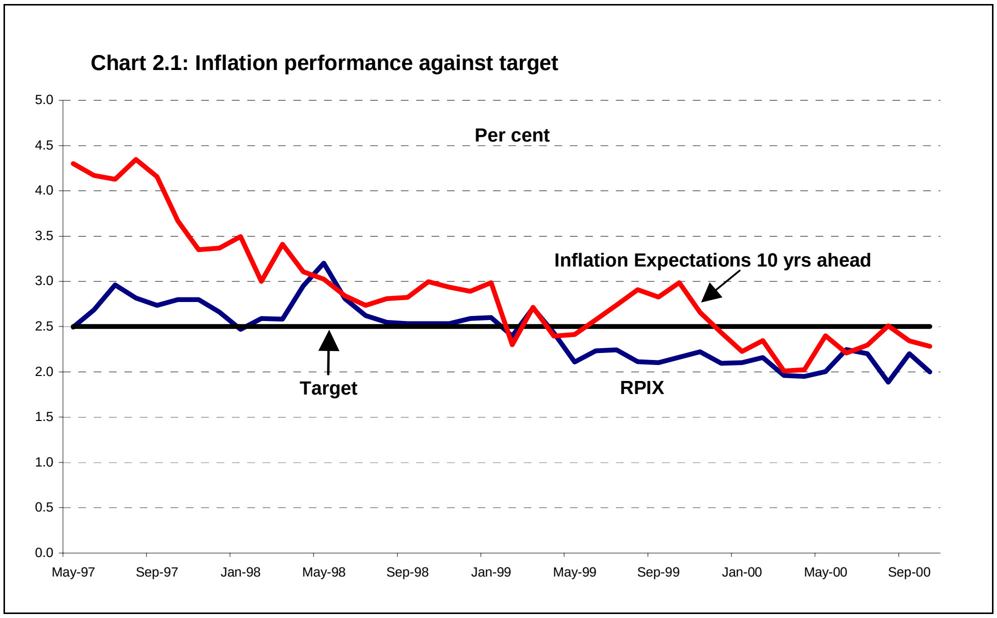
2.7 Co-ordination between monetary and fiscal policy is well established. The Government sets the symmetric inflation target for the MPC to achieve. In addition, both monetary and fiscal policy have the same objective of helping to achieve long-term growth and employment by delivering economic stability.

2.8 Co-ordination is further enhanced by clearly defined objectives and transparent procedures. The MPC and the Government (in setting fiscal policy) are each aware of what the other is trying to achieve and how the other will react to their policy decisions. This process is assisted by the presence of a representative from HM Treasury at MPC meetings who is able to provide detailed information on fiscal policy.

Benefits of the monetary policy framework

2.9 Interest rate decisions have been made in a forward-looking manner, taking account of the fact that they impact on output and inflation with a lag. Rates peaked in 1998 at 7½ per cent, a much lower level than in previous cycles when they often responded to economic shocks too late.

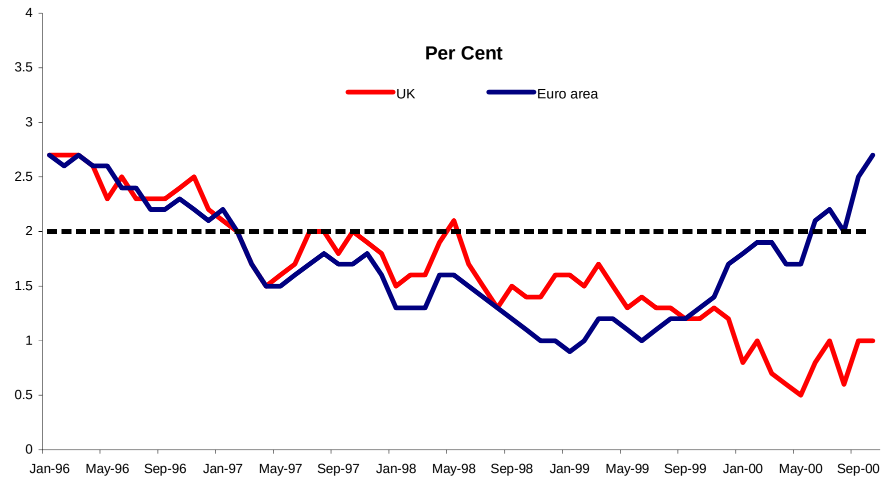
2.10 Since May 1997, RPIX has moved in a narrow band between a low of 1.9 per cent and a high of 3.2 per cent, averaging 2.5 percent over this period, in line with the Government's target (see Chart 2.1). Inflation expectations, as measured by survey and financial markets data, show that inflation is expected to remain close to the Government's target, having fallen from over 4 per cent in 1997. This suggests that the MPC has established a high degree of credibility and that wage and price setters in the economy may be keeping increases in wages and prices at sustainable levels.



HICP **2.11** Due to differences in coverage and methodology, the HICP index differs from RPIX. The HICP measure of inflation currently stands at around 1.0 percentage points below RPIX inflation. However, divergence between the two measures due to differences in coverage varies through time, leaving a more persistent differential due to methodology of around 0.5 percentage points.[4] Measured on an HICP basis, the UK inflation rate is below the euro area average, and is comfortably within the ECB's definition of price stability (see Chart 2.2).

[4] See "The Harmonised Index of Consumer Prices (HICP): Some Factual Information" HM Treasury, November 1998. Available at http://www.hm-treasury.gov.uk/pub/html/prebudgetNov98/hicp.pdf

Chart 2.2: UK and euro area average inflation rates



2.12 Official short-term interest rates have remained at 6 per cent since February 2000. The short-term interest rate differential between the UK and euro area has narrowed, reflecting a sustained reduction in both the level of inflation and inflation expectations in the UK. This year, the differential between UK 10-year gilts and equivalent German bund yields has been eliminated. Long-term rates have fallen to around their lowest levels for over 35 years**,** and have not exceeded 6 per cent for over two years (compared to an average of over 10 per cent in the 1980s).

Table 2.1: HICP inflation and long-term interest rates

	HICP[1]	Long-term Interest rates[2]
UK	1	5.1
EU15	2.4*	5.4
Euro area	2.7*	5.2

[1] October 2000 figures
[2] Average 10 year yield on gilts in October 2000
* Provisional

Fiscal Policy and Objectives

The fiscal policy framework

2.13 Reforms to the monetary policy framework have been accompanied by a parallel set of reforms to fiscal policy, ensuring that high standards of transparency, responsibility and accountability apply to fiscal policy decisions. The two arms of policy work in a co-ordinated way to deliver economic stability, with the objectives of both monetary and fiscal policy set by the Government.

2.14 The Government implemented its new framework for fiscal policy based on a set of five principles – transparency, stability, responsibility, fairness (including between generations) and efficiency. These principles were enshrined in the Finance Act 1998 and the Code for Fiscal Stability, approved by the House of Commons in December 1998. The Code sets out how these principles relate to the formulation and implementation of fiscal policy in practice.

2.15 The Government's key objectives for fiscal policy are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly both within and across 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.

Fiscal rules

2.16 These objectives are embodied in 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. It is met when, over the economic cycle, the current budget is in balance or surplus; 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 equal, a reduction in public sector net debt to below 40 per cent of GDP over the economic cycle is desirable.

2.17 The rules are both set over the cycle to allow Public Sector Net Borrowing (PSNB) to vary between years, in keeping with the cyclical position of the economy. PSNB is defined as the sum of current spending, including depreciation and net investment, less total revenues.[5]

2.18 The golden rule distinguishes between current spending, which benefits the current generation, and capital spending, which benefits both current and future generations. By allowing the current generation to borrow to fund only capital spending, with current spending met by current receipts, the golden rule helps to match the cost and benefits of public spending over time – consistent with the Government's objective of generational equity. The golden rule also enhances the efficiency of government spending because it means that growth enhancing public investment is not sacrificed for current

[5] The Treaty definition of the deficit measures general government net borrowing, which is equivalent to PSNB minus borrowing by public corporations and excluding financial transactions.

spending. The sustainable investment rule complements this by ensuring that borrowing for public investment is conducted in a responsible way.

2.19 The Government maintains a prudent approach to the public finances, taking into account the cyclical component of the current budget, by publishing a more cautious scenario for the cyclical position of the economy in which the output gap is 1 per cent higher than the central view. (See Chapter 4: Outlook for the Public Finances).

Benefits of the fiscal policy framework

2.20 Fiscal policy has supported monetary policy throughout the economic cycle. The substantial fiscal tightening in 1997-98 and 1998-99 supported monetary policy when output was above its trend level, while also eliminating the large structural deficit. The fiscal tightening continued in 1999-2000, at a time when inflationary pressures were mounting. The MPC raised the repo rate until February this year. Since then it has remained unchanged at 6 per cent, while market expectations have fallen by over 50 basis points.

2.21 The public finances have been transformed. A prudent and responsible approach to fiscal management has seen the Government reduce public sector net borrowing by £44 billion since 1996-97 – from 3.6 per cent of GDP in 1996-97 to a net repayment of 1.8 per cent of GDP in 1999-00. Among the areas in which the Government has made savings are:

- lower growth in spending on social security, through cutting the cost of worklessness (due primarily to lower unemployment); and
- reduced debt interest payments resulting from debt repayment (including the proceeds of the auction of mobile phone licences) and lower interest rates from improved credibility.

2.22 As a result, changes in social security benefits and debt interest payments are expected to account for 17 per cent of the change in Total Managed Expenditure (TME) in the period 2000-01 to 2003-04, compared to 42 per cent in the period to 1978-79 to 1996-97.

Taking account of the cycle

2.23 The Government takes care to ensure that cyclical improvements in the public finances are not confused with structural improvements. There has been a significant structural improvement in the public finances between 1996-97 and 1999-00. The cyclically adjusted current budget has moved from a deficit of over ½ per cent of GDP in 1997-98 to a surplus of 1.9 per cent in 1999-00. On a cyclically adjusted basis, the current surplus remains clearly positive throughout the projection period, to 2005-06.

2.24 This, together with the protection provided to government investment by the golden rule, is allowing a more than doubling of net investment by 2003-04. Net investment is forecast to rise from a projected 0.7 per cent of GDP in 2000-01 to 1.7 per cent by 2003-04, addressing years of neglect in public infrastructure.

Fiscal stance

2.25 The overall impact of fiscal policy on the economy can be assessed by looking at changes in Public Sector Net Borrowing (PSNB). On a cyclically adjusted basis, a surplus of 0.8 per cent of GDP is estimated for the current fiscal year, compared with the Budget 2000 estimate of 0.5 per cent of GDP. Table 2.2 below illustrates that in each year of the projection period, the fiscal stance (as measured by the cyclically-adjusted PSNB) is on track to be at least as tight as set out in Budget 2000.

Table 2.2: PSNB comparison with Budget 2000

	Outturn[1]	Projections				
	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05
Cyclically-adjusted PSNB						
Budget 2000	-1.2	-0.5	-0.3	0.5	1.1	1.1
Pre-Budget Report 2000	-1.6	-0.8	-0.3	0.3	1.1	1.1

[1] 1999-2000 figures were estimates in Budget 2000

2.26 Looking forward, PSNB is projected to move into deficit by 2003-04 because the Government is planning to borrow modestly to fund its increased investment in the country's capital stock. This is fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being kept at a stable and prudent level, well below 40 per cent.

Public sector finances

2.27 A full summary of public sector finances is given in Chapter 4. This shows that:

- The profile of the current budget balance shows that the Government is well on track to meet the golden rule over the projection period, with the average surplus on the current budget from 1999-2000 projected to be at least 1 per cent of GDP throughout the next five years;
- Public sector net debt is projected to fall to around 32 per cent of GDP this year and then to about 30 per cent in 2002-03, thereafter remaining broadly stable and well below 40 per cent;
- Net borrowing is projected to move into modest deficit towards the end of the forecast period, but remaining close to balance and consistent with the sustainable investment rule as net investment increases over the next three years;
- On the Treaty definition, general government gross debt is projected to decline from 40.1 per cent of GDP in 2000-01 to 35.4 per cent by 2005-06.

Box 2.1: The radio spectrum auction and the public finances

The recent auction of licences covering the use of part of the UK's radio spectrum raised £22.5 billion in total, considerably more than forecast at Budget time. In line with the view of the Office for National Statistics[1], the proceeds from the auction will be accrued over the length of the licences, which expire in 2021.

The Government has decided that the payments will be used to reduce public sector net debt. The effect of this is to reduce debt interest payments over the next few years and beyond. This is in line with the Government's prudent approach, ensuring that a long-term view is taken of the public finances while fiscal policy continues to support monetary policy in the short term.

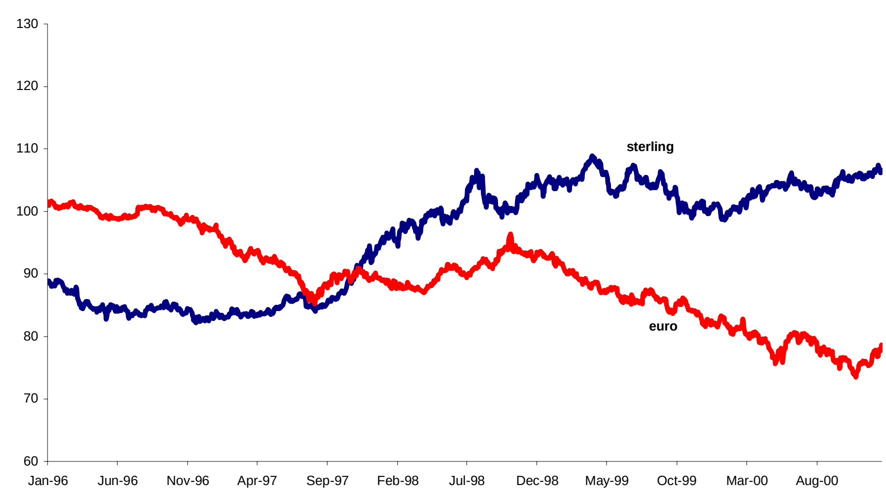
Savings from lower debt interest payments were factored into the Spending review and are making room for additional spending on key public services over several years and not just in the first year the money is received. This ensures that the proceeds from the auctions are spread over time so that future generations also benefit from the one-time improvement in the public finances – in line with the Government's objective of generational equity.

[1] ONS Press Release of 4 August 2000 "Accounts Treatment of Spectrum Licence Receipts".

Exchange Rate Stability

2.28 The Government believes that 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. The exchange rate should therefore be seen as the outcome of all other economic policies.

Chart 2.3: Sterling & euro effective exchange rate indices



2.29 Previous UK experience has shown that an exchange rate target without these fundamentals in place can be counter-productive and lead to less, not more, stability in the medium term. The Government intends to achieve exchange rate stability over the medium term through its policies for achieving greater economic stability. The new monetary and fiscal policy frameworks provide an anchor for achieving greater stability.

2.30 A summary of UK trade and balance of payments is provided in Chapter 3.

Economic and Monetary Union

UK policy

2.31 The Government's policy towards membership of the single currency remains as set out by the Chancellor of the Exchequer in October 1997. As the Government's original assessment of the economic case for the UK joining EMU stated, the UK needs a period of economic stability to demonstrate that convergence is sustainable. In principle, the Government is in favour of joining a successful single currency, provided the economic case for the UK joining is clear and unambiguous.

2.32 Since the publication of the previous update to the UK convergence programme, further progress has been made in preparing both the private and public sectors for the introduction of the euro, and for possible EMU entry. See Box 2.2 for more detail.

Box 2.2: EMU and EMU preparations

The Government's policy on membership of the single currency remains as set out by the Chancellor of the Exchequer in his statement to the House of Commons in October 1997, and restated by the Prime Minister in February 1999. The determining factor underpinning any Government decision on membership of the single currency 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. The Government has said that it will make another assessment of the five tests early in the next Parliament. Because of the magnitude of the decision, the Government believes that, whenever a decision to enter is taken by Government, it should be put to a referendum of the British people.

The Government is committed to ensuring that the UK retains a genuine option to join a successful single currency. Over the past three years, the Government has worked intensively with the business community, wider public sector and voluntary groups both to ensure that the necessary preparations were in place to deal with the euro from 1 January 1999, and to take forward detailed planning work for possible UK entry, if that is what Government, Parliament and the people decide.

The Government has provided a range of practical help for UK businesses trading in the euro, including case studies, fact sheets and electronic tools. It has carried out surveys, and worked with 12 Regional Euro Forums to provide help at the local level. It also prepares regular progress reports on euro preparations.

The Treasury published the second Outline National Changeover Plan in March 2000. The plan, which was drawn up in consultation with business, the voluntary sector and the public sector, sets out the planning assumptions for a possible changeover to the euro. The public sector has given a clear signal of its commitment to prepare, undertaking targeted investment as part of the ongoing modernisation of public sector systems.

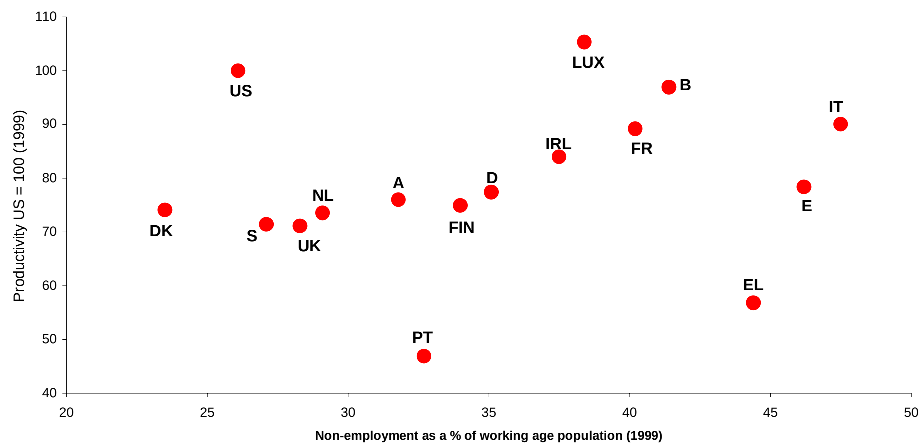
Economic Reform

2.33 The Government is fully committed to promoting economic reform in all areas of the economy. The platform of macroeconomic stability provides the basis for raising productivity – the key to achieving sustained increases in the economy's growth potential and higher living standards.

2.34 Economic reform also plays a key role in delivering the ambitious ten year goal set for the European Union at the Lisbon European Council in March 2000, which the Government is firmly committed to. Through their annual Cardiff reports[6], Member States share best practice of product and capital market reforms and contribute to the further impetus for economic reform provided by the Broad Economic Policy Guidelines. The UK domestic reform agenda is well served by the policies of European economic reform agreed at Lisbon, as both share the same aim of raising the trend growth rate through increased levels of employment and productivity.

2.35 Chart 2.4 below illustrates that countries face different starting points in the challenge to achieve high levels of both productivity and employment. For the UK, it is clear that emphasis should be placed on achieving improved productivity performance, while maintaining high levels of employment.

Chart 2.4: Non-employment rates and productivity levels in EU countries



Note: Non-employment data for Greece is 1998 data

Employment **2.36** UK employment has performed well over recent years. Employment growth has averaged 1.4 per cent in the last four years, and the UK employment rate is now higher than most other OECD countries.

[6] "UK Progress Report on Economic Reform", HM Treasury, November 2000 is available at http://www.hm-treasury.gov.uk/pdf/2000/cardiff2311.pdf

2.37 The Government's reform of labour markets is centred on the objective of employment opportunity for all, with a strategy to help people move from welfare into work. Macroeconomic stability is a prerequisite for achieving this aim, but it is not enough to secure job opportunities for all. The Government has introduced radical reforms of the tax and benefit system backed up by active labour market policies to achieve this aim.[7]

2.38 Major reforms introduced by the Government include:

- Welfare to work – through the New Deal programmes which have already helped around 240,000 unemployed young people back into work, and over 150,000 have gained valuable work experience and training.
- making work pay – through reform of the tax and benefit system, the Government is committed to making work pay and easing the transition into work. It has introduced the Working Families' Tax Credit, a new 10p rate of income tax (from April 1999), cut the basic rate of tax to 22p (from April 2000) and reformed National Insurance Contributions to improve work incentives at the lower end of the labour market.
- the National Minimum Wage introduced in April 1999 underpins these measures. The Low Pay Commission's Second Report, which assessed its initial impact, confirmed that the National Minimum Wage has been a success and has not had any harmful effects on employment or the economy. The Low Pay Commission has been asked by the Government to continue to monitor its impact.

2.39 UK productivity, on the other hand, has not performed as well. Whichever measure of productivity is used, the UK has a sizeable gap compared with other major industrialised countries.

Productivity

2.40 The Government's central economic objective is to achieve high and stable levels of growth and employment, thus raising living standards. Growth in productivity is the key to achieving this. In addition, the long-term ambition of the Government, set out in the 1999 Pre-Budget Report, is for the UK to have a faster rise in productivity than its main competitors over the next decade. Setting out its strategy for meeting this objective, the Government published a paper alongside the 2000 Pre-Budget Report, "Productivity in the UK: Evidence and the Government's Approach".[8]

2.41 Current UK productivity levels lag those in the US, France and Germany. Output per worker is 45 per cent higher in the US, 18 per cent higher in France and 11 per cent greater in Germany. If the UK were to close the gap with the US, for example, output per capita would be over £6,000 higher.

[7] For further information see: "The Goal of Full Employment: Employment Opportunity for all Throughout Britain", HM Treasury, Feb 2000. Available at: http://www.hm-treasury.gov.uk/pdf/2000/emplo290200.pdf

[8] Available at: http://www.hm-treasury.gov.uk/pdf/2000/productivity7_11.pdf

2.42 Rather than interfering directly with the way businesses are run, the Government considers the best approach for narrowing the gap is for it to provide the best possible environment for firms to reach their productivity potential. This approach has two strands:

- providing macroeconomic stability. This is an essential precondition for long-term growth by allowing firms to make decisions with greater certainty and at lower cost; and
- implementing microeconomic reforms to allow markets to function efficiently, thereby ensuring the best use of resources to generate growth.

2.43 All markets have a role to play in generating growth:

- efficient product markets create competitive pressures – one of the main sources of productivity growth;
- well functioning capital markets ensure firms and individuals have adequate access to capital to finance investments, including investments in research and human capital; and
- labour market efficiency allows employment to rise in accordance with demand, ensures the economy can adjust to new growth opportunities and rewards workers according to their performance.

2.44 These microeconomic reforms are targeted at correcting market failures (externalities, market power and a lack of information) and other impediments (e.g. poor regulation).

2.45 Mindful of the need to address the market failures at the point at which they occur, the Government has developed a policy agenda on productivity that identifies five priority areas for action – the five drivers of productivity growth (competition, enterprise and innovation, investment, skills and public sector productivity). The strategy is built around overcoming market failures in the following areas:

Competition – by introducing a new competition regime with the 1998 Competition Act, by announcing major reform of mergers taking Ministers out of merger decisions, and reviews of major sectors such as water, airports and the professions;

Enterprise and Innovation – by providing external support such as the Small Business Service, improving incentives for enterprise by reforming Capital Gains Tax, major reforms to the tax and VAT system to encourage investment in research (such as the R&D tax credit), and initiatives to promote research clusters and links between universities and firms;

Investment – by encouraging investment through reforms to corporation tax, removing payable tax credits, abolishing Advance Corporation Tax, and a doubling of net public sector investment by 2003-04; and

Skills – including investment in education and training, measures to develop life-long learning, and reforms to the work permit system together with promoting share ownership to ensure the UK can compete for skilled workers.

2.46 **Public sector productivity** is the fifth driver of productivity growth. The Government aims to improve productivity in this sector by using Public Private Partnership and Public Service Agreements (PSAs), introducing the Public Services Productivity Panel, and through the creation of the Office for Government Commerce to deliver substantial savings on government procurement.

3 ECONOMIC OUTLOOK

Prospects for Economic Growth

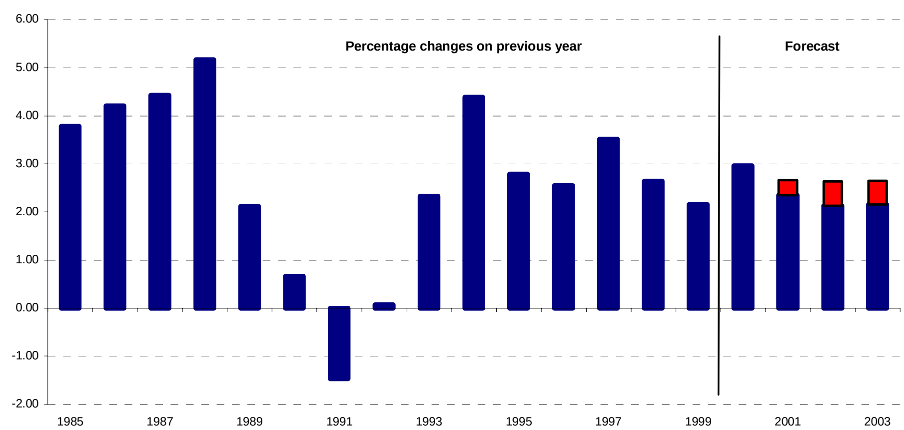
3.1 The UK economy has experienced strong growth in output and employment during the course of the year. Helped by low inflation, proactive policy responses and a sharper than expected improvement in external demand, the UK has continued a strong recovery from a temporary slowing in late 1998 associated with the slowdown in global activity.

GDP growth

3.2 The latest estimate of GDP[9] shows total output rising by 0.7 per cent in the third quarter of 2000, and by 2.9 per cent on a year earlier, exceeding its estimated trend rate. Household consumption growth still exceeds longer-term sustainable rates. The balance of growth has improved, with stronger world demand boosting net exports and final domestic demand growth moderating in 2000.

3.3 Projections for GDP growth in later years are presented as ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-point of the ranges is based on a neutral assumption of 2½ per cent a year for the trend rate of growth. Projections for the public finances continue to be based on the cautious 2¼ per cent a year trend growth assumption, as they will be in Budget 2001.

Chart 3.1: Gross Domestic Product (GDP)[1]



[1] Areas shaded red on bars represent forecast ranges

[9] Released on 23 November 2000

Inflation **3.4** RPIX inflation has remained subdued, despite the effect of sharply higher oil prices this year. The deflationary trend in retail goods prices has more than accounted for the modest undershoot of RPIX inflation relative to target, driven by a 16 per cent decline in import prices of goods and services between spring 1996 and late 1999.

3.5 RPIX inflation is now predicted gradually to rise back to its 2½ per cent target in mid-2001. Compression of margins has so far offset direct pressure from oil price rises – margins have been squeezed at the retail level, with around half of goods sectors now showing year-on-year reductions in prices. However, import price inflation has now turned positive which, combined with a decline in the offsetting contribution from falling business margins, accounts for the anticipated rise.

3.6 The short-term inflation outlook remains finely balanced. Further moderation in domestic demand is expected to keep growth in average earnings within sustainable limits, although upside risks remain. Downside risks also exist: net export growth could be hit by weaker than expected global demand; a stronger than forecast compression of retail margins is possible; and, the medium-term mix of growth and inflation might be more permanently improved through an underlying improvement in supply-side performance. The forecast does not assume any underlying improvement in productivity growth associated with the rapid adoption of new economy technologies and associated diffusion of know-how.

Table 3.1: Summary of forecast

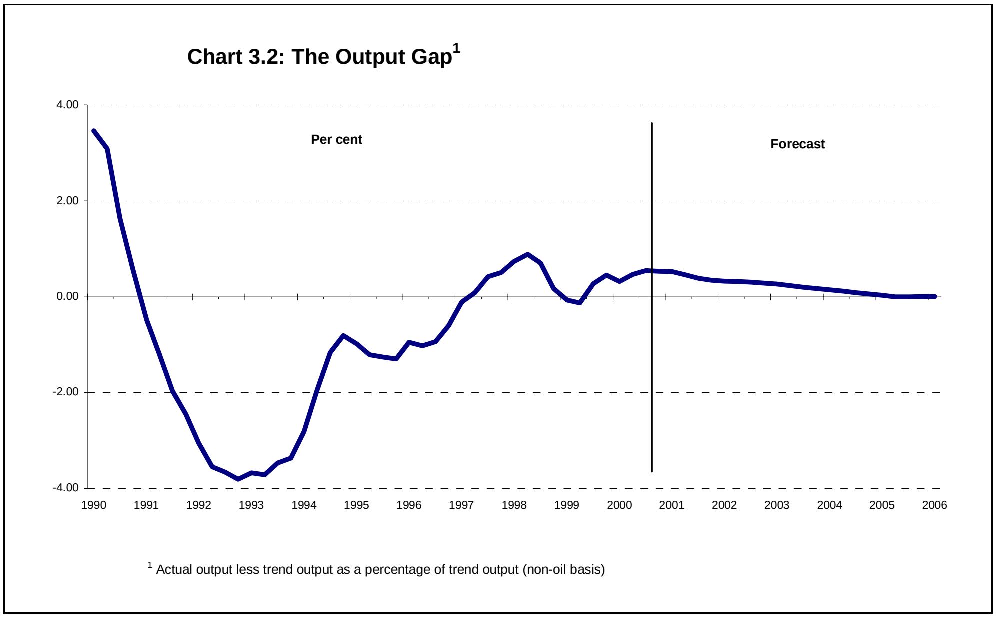
			Forecast		
	1999	2000	2001	2002	2003
GDP growth (per cent)	2¼	3	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
RPIX inflation (per cent, Q4)	2¼	2¼	2½	2½	2½

Cyclical Position

Economic cycle **3.7** Measures of domestically generated inflation and growth in domestic costs have remained relatively subdued since the first half of 1997, when the economy was judged to have been on trend. Evidence suggests that output returned to potential around the middle of 1999, from having been above in 1997 and 1998, and with a brief period below trend in early 1999.

3.8 Subsequently, most survey measures of capacity and labour utilisation have begun to move above their long-run averages. Buoyant output growth can be accommodated for a period, given the starting position of RPIX inflation below the Government's 2½ per cent inflation target. Interest rates were raised pre-emptively in the six months up to the Budget and the fiscal stance has remained tight, with the full impact on private spending likely to build further into 2001. GDP growth is forecast to ease from 3 per cent in 2000 to its estimated sustainable rate of 2¼ to 2¾ per cent in 2001 and later years.

The output gap **3.9** Given the closeness to trend throughout the period 1997 to 1999, possible measurement errors, and the prospect of future data revisions, it is difficult to conclude for certain whether the economy has completed a full, albeit short and shallow, economic cycle between the first half of 1997 and mid-1999. For the purposes of the 2000 Pre-Budget Report and the assessment of the fiscal rules, the provisional judgement remains that a cycle may have been completed by mid-1999 when the current cycle is assumed to begin. On these bases, the fiscal rules were clearly met over this period.



Interest Rates

Importance of stability **3.10** Greater economic stability in the UK has helped narrow the interest rate differential with the euro area. This reflects a sustained reduction in both the level of inflation and inflation expectations. Interest rates have been significantly less volatile since 1997, remaining between 5 per cent and 7.5 per cent. By contrast, between 1984 and 1997 interest rates fluctuated between 5.25 per cent and 15 per cent.

Prospects **3.11** Moreover, inflation expectations of market participants 10 years ahead have fallen from over 4 per cent in April 1997 to levels close to the 2½ per cent inflation target. Reflecting this, long-term interest rates have fallen to historically low levels.

Employment

Employment **3.12** Favourable economic developments in 2000 and recent years reflect a clear underlying improvement in labour market performance. The Labour Force Survey (LFS) measure of employment in the three months to October 2000 was around 300,000 up on a year earlier, and has risen by more than one million in total since spring 1997. Consequently, the working-age employment rate lies close to its previous record high of 75 per cent.

Unemployment **3.13** Unemployment has also fallen significantly in recent years, on the ILO measure from 7.2 per cent in spring 1997 to 5.5 per cent currently.

3.14 Nonetheless, underlying earnings growth has fallen just below 4½ per cent during the course of 2000, and the headline measure has shown a sharper fall since earlier in the year as the impact of bonuses and millennium-related payments has weakened. Earnings growth of 4 to 4½ per cent in the medium term is thought to be consistent with the inflation target of 2.5 per cent, given trend productivity growth of 2 per cent. With no upward trend in unit wage cost growth in recent years, it appears that the sustainable rate of unemployment (NAIRU) has fallen broadly in line with actual unemployment, to around 5½ per cent on the ILO measure.

Chart 3.3: LFS employment and unemployment

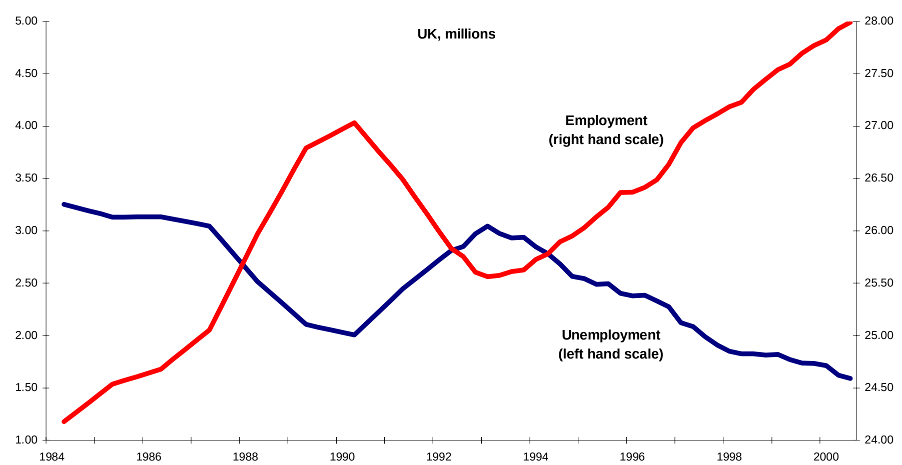
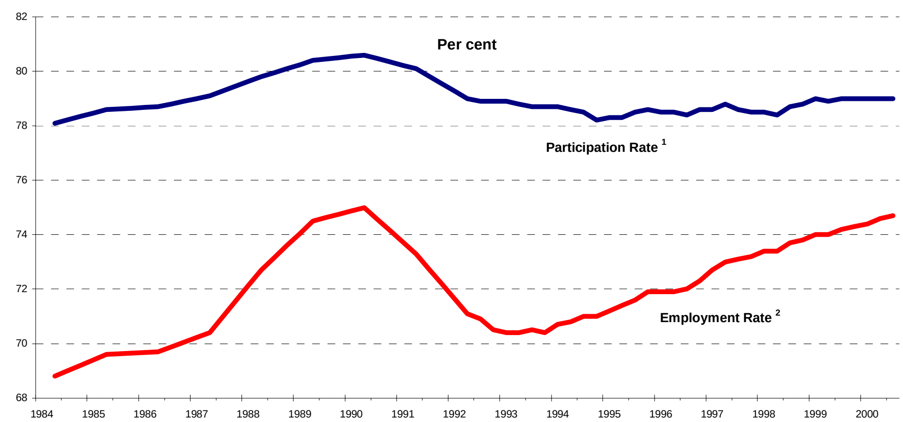


Chart 3.4: Labour force participation and employment rates

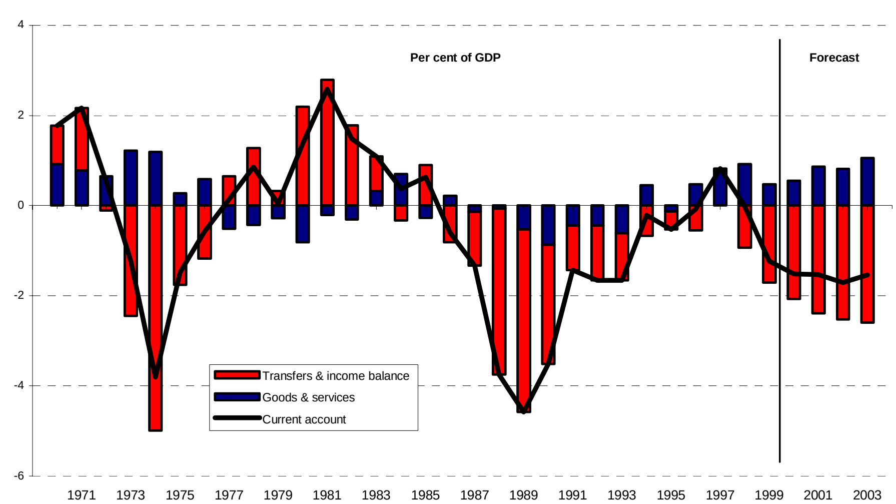


[1] Employment as a per cent of working-age population
[2] Percentage of the population of working age who are economically active (I.e. employed or unemployed)

Trade and the Balance of Payments

3.15 The widening of the UK balance of payments deficit since 1997 has levelled out significantly (see chart 3.5); the non-oil trade deficit rose only modestly in the first half of 2000 compared to the previous six-month period, to 2.5 per cent of GDP. This has largely been due to a sharp acceleration in UK export markets, now anticipated to grow by over 9 per cent in 2000 as a whole. However, net exports have continued to restrain UK growth in 2000, albeit less so than in previous years, as strong domestic demand and competitive import prices have led to import volumes slightly outpacing export volumes.

Chart 3.5: Balance of payments current account



Box 3.1 The economic impact of higher oil prices

Oil prices rose sharply from their trough of $10 per barrel in early 1999 to more than $30 per barrel in September 2000, and a ten-year high of $35 per barrel in mid-October. The Pre-Budget Report audited assumption is that prices fall back towards the middle of the $22-$28 per barrel OPEC target range by end-2001, as both OPEC and non-OPEC production is stepped up and oil stocks are rebuilt.

By raising production costs and so constraining supply, higher oil prices tend to depress GDP growth, simultaneously pushing up inflation and employment. As an illustration, the International Monetary Fund (IMF) estimates that a $10 per barrel increase in oil prices lasting for 1 year may reduce OECD growth by around 0.4 percentage points, while simultaneously raising price levels by between 0.4 and 0.8 percentage points[1]. However, it is second round impacts on wages and other prices, as well as movements in business and consumer confidence, which will largely determine the overall economic effects.

As a small net exporter of oil, potential output losses for the UK may be partly offset by increased North Sea production and gains to UK incomes resulting from the improvement in the terms of trade. The UK therefore differs from most other industrialised economies. While UK exports more generally will be affected by any reduction in global activity due to dearer oil, the overall outlook for world trade growth is buoyant.

The effect on inflation has been felt mainly through increased motoring costs, with higher petrol prices contributing, on average, 0.6 percentage points to inflation in 2000. Wider impacts have so far been relatively mild, as producers have been able to pass on only a small part of the increase in input prices. This narrowing in producer margins may not be sustainable in the longer term, however, should oil prices stay at high levels.

[1] World Economic Outlook, IMF, October 2000

The World Economy

3.16 The world economic outlook has strengthened considerably since the Budget in March 2000. Growth in all regions has surpassed expectations, and a more balanced pattern of economic activity is emerging in the G7. World trade has also picked up, driven by buoyant US demand. But high oil prices, if sustained, could impede the current expansion and trigger higher inflation. Significant current account imbalances, high equity valuations, and recent movements in the major exchange rates also pose risks for the world economy.

3.17 Euro area activity is now stronger than expected, boosted by the global recovery and currency weakness. High levels of consumer and business confidence have been accompanied by a significant decline in unemployment. The value of the euro and higher oil prices have prompted the ECB to raise interest rates by 1¾ percentage points during 2000, which seems likely to stabilise growth at healthy levels.

3.18 The balance of G7 output and demand is expected to improve gradually next year as European growth continues and the US economy slows. G7 growth is expected to peak at 4 per cent this year before falling back to 3 per cent in 2001 and 2¾ in 2002.

Summary of Economic Prospects

Table 3.2: Summary of economic prospects [1]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[2]				Average errors from past forecasts [3]
	1999	2000	2001	2002	2003	
Output at constant market prices						
GDP	2¼	3	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾	1
Manufacturing Output	0	1¼	2 to 2¼	1¾ to 2¼	1¾ to 2¼	2
Expenditure components of GDP at constant market prices[4]						
Domestic demand	3¾	3½	2½ to 3	2¼ to 2¾	2¼ to 2¾	1¼
Household Consumption[5]	4¼	3½	2¼ to 2½	1¾ to 2¼	2 to 2½	1¼
General Government consumption	3¼	2¼	4	4	3½	1½
Fixed investment	6	2½	4¼ to 4½	3¾ to 4¼	3¼ to 3¾	2¾
Change in inventories[6]	-¾	½	-¼	-¼ to 0	-¼	¼
Export of goods and services	3¼	8	7 to 7½	6 to 6½	5½ to 6	2
Imports of goods and services	7¾	9	7¼ to 7½	6 to 6½	5½ to 6	2
Balance of payments current account						
£ billion	-11	-14¼	-15	-17½	-16¾	6½
per cent of GDP	-1¼	-1½	-1½	-1¾	-1½	¾
Inflation						
RPIX (Q4)	2¼	2¼	2½	2½	2½	1
Producer output prices (Q4)[7]	1¼	2	2	2	2¼	1¼
GDP deflatorGDP deflator at market prices (financial year)	2½	2	2½	2½	2½	1
Money GDP at market prices (financial year)						
£ billion	904	950	995 to 999	1042 to 1051	1091 to 1106	12
percentage change	5	5	4¾ to 5¼	4¾ to 5¼	4¾ to 5¼	1¼

[1] The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2000, released by the Office for National Statistics on 27 September 2000, and the preliminary GDP estimate for the third quarter released on 20 October.

[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 autumn forecasts over the past 10 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 2001.

[4] Further detail on the expenditure components of GDP is given in the Pre-Budget Report.

[5] Includes households and non-profit institutions serving households.

[6] Contribution to GDP growth, percentage points.

[7] Excluding excise duties.

4 OUTLOOK FOR THE PUBLIC FINANCES

4.1 This section provides projections of the public finances, notably with reference to the reference values for government debt and deficit specified in the Treaty. Public finance projections continue to be based on a prudent and deliberately cautious assumption of 2¼ per cent per year for trend GDP growth.

4.2 Since the previous Convergence Programme was submitted, Budget 2000 set a firm spending envelope for the next three years, allocating additional resources for key public services as a result of prudent management of the public finances. The 2000 Spending Review in July provided a detailed breakdown of spending plans, which will have an important impact on the productivity and sustainable growth of the economy – in particular by improving economic infrastructure and the skills of the labour force, enhancing capital accumulation, and supporting research and development. Annex B provides a summary of the measures taken in Budget 2000 and the November 2000 Pre-Budget Report.

4.3 This investment programme demonstrates the Government's commitment to the renewal and modernisation of the capital stock, reversing years of under-investment in line with the emphasis placed on UK investment in the 2000 Broad Economic Policy Guidelines, by delivering sustained growth in public investment over the next three years.

4.4 A summary of public sector finances is given in Table 4.1.

Table 4.1: Summary of public sector finances[1]

	Per cent of GDP							
	Outturns		Estimate			Projections		
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Fairness and prudence								
Surplus on current budget	0.8	2.1	1.7	1.6	1.3	0.7	0.7	0.7
Average surplus since 1999-2000		2.1	1.9	1.8	1.7	1.5	1.4	1.3
Cyclically-adjusted surplus on current budget	0.5	1.9	1.5	1.4	1.1	0.6	0.7	0.7
Long-term sustainability								
Public sector net debt[2]	39.6	36.8	32.3	30.9	30.1	30.2	30.3	30.4
Net worth[2, 3]	12.2	17.3	18.7	20.1	20.4	20.3	20.1	19.6
Primary balance	3.3	4.3	3.3	2.6	1.8	0.8	0.7	0.5
Economic impact								
Net investment	0.4	0.3	0.7	1.0	1.4	1.7	1.8	1.8
Public sector net borrowing (PSNB)	-0.3	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.1
Cyclically-adjusted PSNB	0.0	-1.6	-0.8	-0.3	0.3	1.1	1.1	1.1
Financing								
Central government net cash requirement[2]	-0.5	-1.0	-3.0	-0.1	0.5	1.4	1.4	1.4
European commitments								
Maastricht deficit[4]	-0.7	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.1
Maastricht debt ratio[5]	46.8	43.6	40.1	37.7	36.1	35.6	35.5	35.4
Memo: Output gap	0.4	0.2	0.5	0.4	0.3	0.2	0.1	0.0

[1] *Excluding windfall tax receipts and associated spending.*
[2] *Including windfall tax receipts and associated spending.*
[3] *Previously net wealth.*
[4] *General government net borrowing on an ESA95 basis. The Maastricht definition includes the windfall tax and associated spending.*
[5] *General government gross debt.*

Current balance and general government deficit

Consistency with the golden rule

4.5 The current budget balance improved from a surplus of ¾ per cent of GDP in 1998-99 to nearly 2¼ per cent of GDP in 1999-2000. The surpluses are projected to fall gradually over the next few years, from 1¾ per cent in 2000-01 to around ¾ per cent of GDP by 2003-04.

4.6 Consistent with the need to maintain a cautious approach, this profile shows that the Government is well on track to meet the golden rule over the projection period, with the average surplus on the current budget from 1999-2000 projected to be at least 1 per cent of GDP throughout the next five years.

Consistency with the sustainable investment rule

4.7 Net borrowing is equal to net investment minus the surplus on the current budget. Public sector net investment is projected to be ¾ per cent of GDP in 2000-01, implying a repayment of net borrowing of around 1 per cent of GDP. In line with the Government's commitment to address neglect in the public infrastructure, net investment is set to rise to 1¾ per cent of GDP over the next three years. The rapid growth in net investment results in a declining repayment of public sector net borrowing next year and, together with the effect of slower economic growth, modest deficits over the remainder of the period, consistent with meeting the sustainable investment rule. In particular, public sector net debt as a proportion of GDP falls steadily from 36¾ per cent in 1999-00 to around 30 per cent in 2002-03.

4.8 The primary balance is equal to net borrowing excluding net debt interest payments – thus abstracting from the implications of past fiscal deficits - and is projected to be in surplus by 3¼ per cent of GDP in 2000-01. It is projected to be in surplus by an average of 1½ per cent of GDP over the next five years.

Table 4.2: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate			Projections		
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Current budget							
Current receipts	39.4	40.0	40.2	40.0	39.6	39.6	39.6
Current expenditure	35.7	36.8	37.1	37.2	37.4	37.4	37.4
Depreciation	1.6	1.6	1.6	1.5	1.5	1.5	1.5
Surplus on current budget (including WTAS[1])	2.1	1.7	1.5	1.2	0.7	0.7	0.7
Surplus on current budget[2]	**2.1**	**1.7**	**1.6**	**1.3**	**0.7**	**0.7**	**0.7**
Capital budget							
Gross investment	2.5	2.7	3.0	3.3	3.5	3.6	3.6
less asset sales	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3
less depreciation	-1.6	-1.6	-1.6	-1.5	-1.5	-1.5	-1.5
Net investment	0.4	0.7	1.1	1.4	1.7	1.8	1.8
Net borrowing (including WTAS[1])	-1.7	-0.9	-0.5	0.2	0.9	1.0	1.1
Net borrowing[2]	**-1.8**	**-1.1**	**-0.6**	**0.1**	**0.9**	**1.0**	**1.1**
Public sector net debt- end year	**36.8**	**32.3**	**30.9**	**30.1**	**30.2**	**30.3**	**30.4**
General government net borrowing[3]	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.1
General government gross debt [3]	43.6	40.1	37.7	36.1	35.6	35.5	35.4

1 Windfall tax receipts and associated spending.

2 Excluding windfall tax receipts and associated spending.

3 Treaty measures of the government deficit and debt. On an ESA95 basis

Treaty objectives

4.9 Consistent with the two fiscal rules, the Government also remains on course to meet the Maastricht Treaty and Stability and Growth Pact commitments. Following a surplus of 1.8 per cent in 1999-2000, the general government financial balance is expected to move gradually towards balance in 2002-03; the small deficit projected from 2002-03 entirely reflects the increases to net investment. The forecast figures are, on the measure of general government net borrowing, consistent with meeting the objective of the Stability and Growth Pact of achieving a budgetary position of close to balance or in surplus over the medium term.

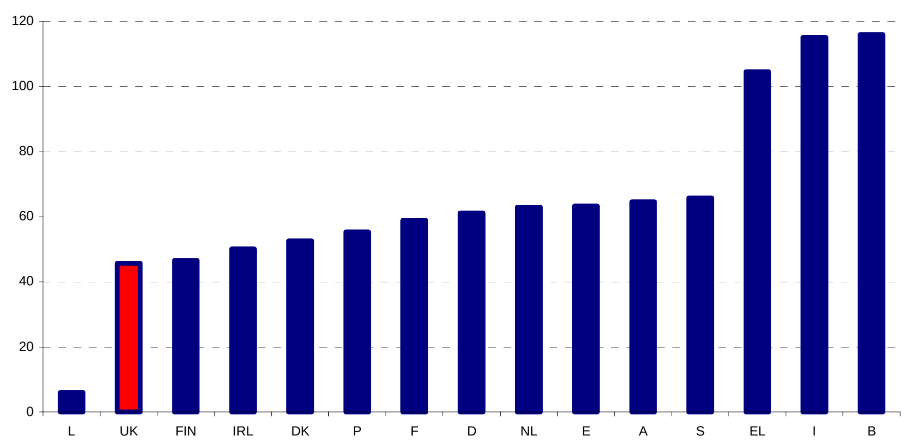
4.10 The Treaty definition of debt - general government gross debt - is projected to decline from 40.1 per cent of GDP in 2000-01 to 35.4 per cent by 2005-06. The UK's debt and deficit positions are well below the euro area and EU-15 averages, and are expected to remain comfortably inside the 3 per cent and 60 per cent Treaty reference values.

Table 4.3: Debt and deficit positions [1]

	General government net borrowing	General government gross debt
UK [2]	-1.8	43.6
UK [3]	-1.3	45.7
EU15 [3]	0.7	67.5
Euro area [3]	1.3	72.1

[1] ESA95 basis
[2] UK fiscal year estimate (1999-2000)
[3] European Commission, 1999 figures

Chart 4.1: EU general government gross debt (1999) [1]



[1] Government gross debt as defined in Council Regulation (EC) No 3605; Source: European Commission Autumn 2000 Forecasts

4.11 Debt interest is forecast to be around £5½ billion a year lower by 2003-04 than in 1997-98 reflecting the benefits of macroeconomic stability and lower interest rates.

Cyclical Adjustment and Sensitivities

4.12 The Government takes care not to treat cyclical improvements to the public finances as structural improvements. It is important to allow room for the operation of the automatic stabilisers, so that they can play their full role in smoothing the path of the economy.

4.13 There has been a significant structural improvement in the public finances since 1996-97 – the cyclically adjusted current balance has moved from a deficit of over 2 per cent of GDP to a surplus of similar size in 1999-2000, falling slightly to 1½ per cent of GDP in 2000-01 (projection). The balance remains in surplus throughout the forecast period.

Table 4.4: Fiscal balances [1]

	Per cent of GDP							
	Outturns			Projections				
	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Budget Balances								
Surplus on current budget	0.8	2.1	1.7	1.6	1.3	0.7	0.7	0.7
Average surplus since 1999-2000		2.1	1.9	1.8	1.7	1.5	1.4	1.3
Net borrowing	-0.3	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.1
Cyclically-adjusted budget balances								
Surplus on current budget	0.5	1.9	1.5	1.4	1.1	0.6	0.7	0.7
Net borrowing	0.0	-1.6	-0.8	-0.3	0.3	1.1	1.1	1.1
Memo:								
Output gap	0.4	0.2	0.5	0.4	0.3	0.2	0.1	0.0

[1] Excluding windfall tax receipts and associated benefits

4.14 There has been a similar structural improvement in cyclically adjusted net borrowing from a deficit of over 1 per cent of GDP in 1997-98 to a net repayment in each of the years 1999-2000 through to 2001-02, representing fiscal tightening. In the following years, cyclically adjusted net borrowing becomes modestly positive, reflecting the projected increase in net investment from 0.7 per cent of GDP in 2000-01 to 1.8 per cent of GDP in 2004-05.

Forecast errors and risks

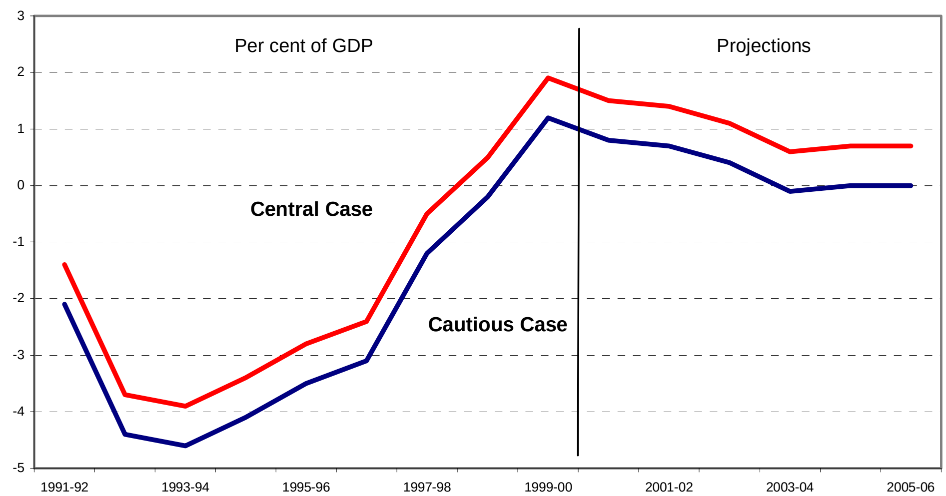
4.15 Short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure (particularly social security) vary directly with the economic cycle. If GDP growth were 1 per cent higher or lower than assumed over the coming year, net borrowing might be lower or higher by 0.4 per cent of GDP in the first year (equivalent to around £4 billion) and lower or higher by a further 0.3 per cent (£3 billion) in the second year.

4.16 Errors in the forecasts of short-term growth 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 so there may be little effect on the public finances, on average, over the cycle. However, errors in estimating the cyclical position of the economy in relation to its trend will have a permanent effect on prospects. And errors in estimating trend GDP growth can have significant cumulative implications for net borrowing.

4.17 It is because of this that that the Government publishes projections illustrating the effect of uncertainty over the cyclical position of the economy by showing a cautious case in which the output gap is 1 per cent higher than the central view. Chart 4.2 illustrates this more cautious case, which implies that a greater proportion of the projected surplus on the current budget is due to cyclical strength of the economy. For example, an output gap that is one per cent larger implies a reduction in the structural surplus on the current budget of around ¾ per cent of GDP a year.

4.18 Even in this more cautious case, the cyclically-adjusted current budget is estimated to have been comfortably in surplus in 1999-2000, and on this more cautious basis, the Government is on track to meet the golden rule over the economic cycle.

Chart 4.2: Cyclically-adjusted surplus on current budget



General Government Receipts

4.19 Total receipts are projected to rise by 6½ per cent this year, and by 5 per cent in 2001-02. This compares with projected money GDP growth of 4¾ per cent in both years. Most of the additional buoyancy is attributable to income tax and North Sea revenues, as a result of a number of factors, including higher employment and earnings growth, and higher oil prices. Non-North Sea corporation tax is expected to fall significantly this year but partially recover in 2001-02.

Table 4.5: Current receipts

	Per cent of GDP						
	Outturn	Estimate			Projections		
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Income tax (gross of tax credits)	10.6	10.9	11.0	11.2	11.3	11.4	11.5
Non-North Sea corporation tax (gross of tax credits)	3.6	3.1	3.4	3.4	3.2	3.2	3.2
Tax credits[1]	-0.3	-0.5	-0.7	-0.8	-0.7	-0.7	-0.7
of which:							
Working Families' Tax Credit2	-0.1	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
North Sea revenues[3]	0.3	0.6	0.7	0.7	0.6	0.5	0.4
Value added tax	6.2	6.2	6.2	6.1	6.1	6.0	6.0
Excise duties[4]	3.8	3.9	3.8	3.8	3.7	3.6	3.5
Social security contributions	6.2	6.3	6.3	6.1	6.1	6.2	6.2
Other taxes and royalties[5]	6.5	6.8	6.8	6.8	6.7	6.7	6.7
Net taxes and social security contributions[6]	36.9	37.3	37.5	37.3	36.9	36.9	36.8
Accruals adjustments on taxes	0.5	0.3	0.1	0.1	0.1	0.1	0.1
less EU transfers	-0.6	-0.7	-0.5	-0.4	-0.4	-0.3	-0.3
Tax credits[7]	0.3	0.5	0.6	0.5	0.5	0.5	0.5
Other receipts	2.3	2.6	2.5	2.5	2.4	2.4	2.4
Current receipts[8]	39.4	40.0	40.2	40.0	39.6	39.6	39.6
Memo:							
Current receipts (£bn)	357.1	380.3	399	416	432	452	473

1 Mainly MIRAS and tax reliefs under the Working Families' Tax Credit and Children's Tax Credit schemes. Includes corporation tax credits (R&D tax credit and tax credit for cleaning contaminated sites).

2 The Working Families' Tax Credit will, subject to legislative constraints, be replaced in 2003 by a new integrated system of support for children and an employment tax credit.

3 Includes oil royalties, petroleum revenue tax and North Sea corporation tax (after ACT set-off).

4 Fuel, alcohol and tobacco duties.

5 Includes Council Tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.

6 Includes VAT and 'own resources' contributions to EU budget. Net of income tax credits. Cash basis.

7 Excludes Children's Tax Credit, which scores as a tax repayment in the national accounts.

8 Accruals basis.

Income tax

4.20 Income tax receipts (net of income tax credits) are expected to be about £99 billion in 2000-01, about £6 billion higher than in 1999-2000, largely as a result of higher pay-as-you-earn (PAYE) tax (and despite the introduction of the Working Families Tax Credit in October 1999). Some of the increase in PAYE reflects earlier Budget measures, such as the ending of tax relief on profit related pay (announced in the November 1996 Budget and phased out over a number of years), as well as employment and earnings growth. Income tax receipts are expected to grow throughout the forecast period.

Corporation tax

4.21 Receipts of corporation tax over the next few years are significantly affected by recent changes to the tax regime involving the introduction of instalment payments. The transitional arrangements for the new system and relatively low profits increases mean that receipts are lower in 2000-01 than in 1999-2000. Receipts are expected to rise in 2001-02 and again in 2002-03, but then fall back in 2003-04 when the 4-year transition period to quarterly instalments ends.

North Sea revenues

4.22 Receipts from oil royalties, petroleum revenue tax and corporation tax on oil and gas production are forecast to be much higher in 2000-01 than in 1999-2000 because of the impact of higher oil prices. Further details of oil price effects are included in Box 4.1

Box 4.1 – The Impact of Higher Oil Prices on Government Revenue

In 1999-2000 total oil-related receipts amounted to about £27½ billion. This included fuel duties (£22½ billion), VAT on petrol and diesel (approximately £2½billion), and £2½ billion from North Sea revenues (royalties, petroleum revenue tax (PRT) and corporation tax). Oil companies also pay corporation tax on their profits from refining and distribution. Box 3.1 discusses the economic impact of higher oil prices on the economy in general and such effects could in turn impact on other government receipts.

Only North Sea revenues are significantly affected by higher oil prices. Fuel duties are levied as a fixed amount on each litre purchased, and hence are not directly affected by oil prices (but to the extent higher petrol prices reduce consumption, the impact is negative). Although higher petrol pump prices increase VAT from fuel, this will largely displace VAT receipts from other household spending, with little overall effect on VAT revenues. VAT on petrol and diesel purchased for business use is generally reclaimed.

The three components of North Sea revenues are all scored on a cash receipts basis in the national accounts and hence the impact of higher oil prices on government revenues depends on the time lags involved in the payment of the various taxes.

The average oil price for calendar 2000 is now estimated to be about $6 higher than the $22.40 assumed at the time of the Budget, with much higher prices in the second half of the year. North Sea revenues are expected to be £1 billion higher in 2000-01 than in the Budget forecast. The PBR forecasts also allow for other factors such as exchange rate changes and declining production levels.

The Pre-Budget Report (PBR) projections of North Sea revenue are based on the audited assumption of an oil price of $25.40 for calendar year 2001. This is the average of independent forecasts for the year ahead, which is used in the public finance projections unless it shows a rising oil price. A temporary change of $1 in this price across the whole calendar year would lead to a change of about £225 million in North Sea revenues in financial year 2001-02 and a change of about £60 million in 2002-03. A sustained price change of $1 from 2001 onwards would change revenues by £225 million in 2001-02 and about £300 million in subsequent years, assuming no changes in production from 2001 levels or in the other factors affecting tax liabilities. This assumes that companies will be able to estimate their annual corporation tax liabilities accurately at the time each instalment is due.

Social security

4.23 Social security (National Insurance) contributions are projected to be £59.8 billion in 2000-01, an increase of 6 per cent over 1999-2000, largely because of growth in earnings and employment. More moderate growth is expected in later years reflecting assumed higher rates of 'contracting out' as individuals increasingly make use of stakeholder pensions.

Spectrum licence receipts

4.24 The auction earlier this year of licences to access the electromagnetic spectrum by mobile phone companies raised £22.5 billion. In line with the Office for National Statistics' views on the accounting treatment of these receipts, they are treated as rent in these forecasts and spread evenly over the whole of the 21-year licence period. Further information on the radio spectrum auctions is given in Box 2.1.

General Government Expenditure

4.25 Consistent with the Government's new frameworks for monetary and fiscal policy, the Government undertook a thorough assessment of public spending needs in the 1998 Comprehensive Spending Review (CSR). The Government's spending framework is based on:

- Departmental Expenditure Limits (DEL), which have now been set for all government departments over three years. Each DEL provides the department with a solid basis for planning their own costs effectively; and
- Annually Managed Expenditure (AME), which covers those elements of spending which cannot reasonably be subject to firm multi-year limits and are instead subject to tough annual scrutiny as part of the Budget process.

For each department, separate budgets are set for resource (current) and capital spending, removing the bias against investment inherent in the previous planning regime.

4.26 Furthermore, each department is committed, through Public Service Agreements (PSAs) to achieve specific performance targets. First published after the 1998 CSR, PSAs have since been developed further, and are monitored on a quarterly basis by a Cabinet level committee. The Government has promised to give progress reports against targets annually.

4.27 The plans set out in the CSR were extended to 2003-04 in the 2000 Spending Review that reported in July 2000. New PSAs also form an integral part of the new settlement, with targets that are more focussed on outcomes. Additionally, Service Delivery Agreements (SDAs) have been established to complement and underpin the PSAs, providing more detail on how priorities will be delivered efficiently and effectively. For further detail, see "Planning Sustainable Public Spending – Lessons from Previous Policy Experience".[10]

Projections

4.28 The Government adhered to the fiscal rules in setting a firm spending envelope in Budget 2000, and subsequently, the Spending Review announced in July 2000. However, within that envelope, the Government has been able to allocate additional resources to key public services as a result of prudent management of the public finances – notably lower growth in spending on social security, and reduced debt interest payments resulting both from lower interest rate expectations and the debt repayment following the auction of mobile phone licences.

[10] "Planning Sustainable Public Spending: Lessons from Previous Policy Experience", HM Treasury, November 2000. Available from http://www.hm-treasury.gov.uk

4.29 The latest projections for the public finances, contained in the Pre-Budget Report, are illustrated in the following table.

Table 4.6: Total Managed Expenditure

	£ billion								
	Outturn	Estimate	Projections			Changes since 2000 Spending Review [4]			
	1999-00	2000-01	2001-02	2002-03	2003-04	2000-01	2001-02	2002-03	2003-04
Departmental Expenditure Limits	176.8	195.2	210.5	227.7	244.3	0.0	-1.6	-1.5	-1.4
Annually Managed Expenditure									
Social security benefits	97.2	99.0	105.0	108.7	112.8	-0.4	0.6	1.4	0.9
Housing Revenue Account subsidies	3.2	3.2	4.6	4.3	4.1	-0.2	1.3	1.1	1.0
Common Agricultural Policy	2.7	2.7	2.8	2.7	2.8	0.0	-0.1	-0.1	0.0
Export Credits Guarantee Department	0.9	1.1	0.3	0.2	0.0	0.3	0.0	0.0	0.1
Self-financing public corporations capital spending	1.0	1.4	1.5	1.2	1.0	-0.2	0.3	-0.1	-0.3
Net public service pensions	5.2	5.5	5.5	5.7	6.0	-0.2	0.0	0.0	0.0
National Lottery	1.9	2.2	2.2	2.1	2.1	-0.1	0.2	0.0	0.0
Other programme expenditure	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-cash items :									
Depreciation	7.3	6.9	7.3	8.4	9.0	-0.4	-0.5	0.1	0.3
Cost of capital charges	13.0	12.8	12.8	12.0	12.3	-0.1	-0.5	-1.5	-1.5
Provisions and other charges	0.6	0.1	0.0	0.1	0.3	0.5	0.2	0.1	0.1
Total departmental AME (incl. non-cash items)	133.0	134.9	141.9	145.4	150.3	-0.9	1.5	1.1	0.5
Other AME :									
Net Payments to EC institutions[1]	2.9	2.8	2.6	2.5	2.8	0.1	0.1	-0.1	-0.1
Locally financed expenditure	17.2	18.4	19.3	20.2	21.1	0.4	0.4	0.4	0.5
CG debt interest	25.5	26.9	24.6	24.8	24.4	-0.1	-1.5	-0.5	-0.3
Accounting and other adjustments[2]	-13.8	-9.2	-6.7	-6.0	-5.0	-0.7	1.4	1.8	2.1
Total Other AME	31.7	38.9	39.8	41.5	43.3	-0.2	0.5	1.6	2.2
AME Margin	0.0	2.6	2.7	3.6	4.6	1.1	1.7	1.6	1.6
Annually Managed Expenditure	164.7	176.4	184.4	190.5	198.2	0.0	3.7	4.3	4.3
Total Managed Expenditure (TME)	341.5	371.6	394.9	418.3	442.5	0.0	2.1	2.8	2.9
of which:									
Public sector current expenditure	323.9	349.6	368.8	387.8	407.8	0.2	1.9	3.2	3.5
Public sector net investment	3.2	7.0	10.7	14.5	18.2	-0.3	0.1	-0.5	-0.8
Public sector depreciation	14.4	15.0	15.4	16.0	16.5	0.0	0.0	0.1	0.2

[1] 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 £bn):

	1999-00	2000-01	2001-02	2002-03	2003-04
Figures from 2001-02 are trend estimates.	3.3	3.4	3.3	3.4	3.7

[2] Includes adjustments to deduct non-cash items in DEL and departmental AME which do not score in TME.

[3] Includes a reconciliation adjustment to national accounts estimate of TME.

[4] Figures for DEL and AME reflect a classification change since the 2000 Spending Review which switches expenditure from DEL to AME. This results from the introduction of the Major Repairs Allowance in April 2001.

4.30 On public expenditure, projections for Total Managed Expenditure (TME) are unchanged for 2000-01 from the Spending review White Paper. Since the Budget there have been significant savings in social security benefits and debt interest payments, before the effect of new Pre-Budget Report measures is taken into account. Before taking into account the new measures, social security and debt interest payments are forecast to be about £1 billion lower this year and around £3 billion lower in 2001-02 than at the Spending Review, although there are some increases to forecasts for other AME spending programmes.

4.31 In considering the impact of additional discretionary policy changes on the fiscal position, the Government has considered:

- the importance of ensuring that the fiscal rules are met over the cycle;
- its broader, medium-term fiscal policy objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and across generations; and
- the need to ensure that fiscal policy supports monetary policy.

4.32 Within these strict constraints, and in the light of improved forecasts, it has been possible to:

- release additional resources for pensioners worth £2½ billion a year by 2002-03; and
- introduce a package of tax reforms to encourage UK productivity, while protecting the environment in the longer term.

Public Sector Investment

4.33 In line with the Government's commitment to address neglect in the public infrastructure, public investment is set to more than double to 0.7 per cent of GDP in 2000-01 from 0.3 per cent last year, and is forecast to increase steadily over the next three years before levelling at around 1.8 per cent of GDP from 2004-05 onwards. The following table provides a breakdown of public sector capital expenditure. In addition, the Government continues to use the Private Finance Initiative (PFI) and Public Private Partnerships (PPPs) to support its capital investment programme, in areas as diverse as education, hospitals, defence, IT, and property management.

Table 4.7: Public sector capital expenditure

	£ billion				
	1999-00	2000-01	2001-02	2002-03	2003-04
CG spending and LA support in DEL	9.9	13.7	16.8	20.9	25.0
Locally financed spending	0.9	0.8	2.2	2.2	2.1
National Lottery	1.4	1.3	1.3	1.3	1.3
Public corporations[1]	4.5	4.5	4.5	4.7	4.8
Other capital spending in AME	0.9	1.0	1.0	1.1	1.1
Allocation of reserve and AME margin	0.0	0.7	0.3	0.4	0.5
Public sector gross investment[2]	**17.6**	**22.0**	**26.2**	**30.5**	**34.7**
Less depreciation	-14.4	-15.0	-15.4	-16.0	-16.5
Public sector net investment[2]	**3.2**	**7.0**	**10.7**	**14.5**	**18.2**
Proceeds from the sale of fixed assets[3]	4.8	3.8	3.8	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

Assumptions Underlying the Public Finance Projections

4.34 The National Audit Office (NAO)[11] audits the key assumptions underlying the fiscal projections. For the latest Pre-Budget Report, the NAO have reviewed the assumptions for equity prices, the consistency of price indices and deflators, and the ratio of VAT receipts to consumption, commenting that it was reasonable to continue using these assumptions.

4.35 Following these reviews, the key assumptions and conventions used for the public finance projections are unchanged. Details are given in Box 4.2 – a similar box was included in the 1999 Convergence Programme.

4.36 The fiscal projections assume that the economy follows the path described in Chapter 3. In the interests of caution, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend growth of 2¼ per cent a year, the lower end of the GDP growth ranges in Chapter 3. The main economic assumptions are summarised in Table 4.8.

Table 4.8: Economic assumptions for public finance projections

	Percentage changes on previous year						
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Output (GDP)	2½	3	2¼	2¼	2¼	2¼	2¼
Prices							
RPIX	2¼	2¼	2½	2½	2½	2½	2½
GDP deflator	2½	2	2½	2½	2½	2½	2½
RPI (September[1])	1	3¼	2½	2¾	2½	2½	2½
Rossi[2] (September[1])	1½	1½	2¼	2¼	2¼	2¼	2¼
Money GDP (£ billion)	907	950	995	1042	1091	1142	1196

[1] Used for projecting social security expenditure over the following financial year.
[2] RPI excluding housing costs, used for uprating certain social security benefits.

[11] The NAO is accountable to Parliament and totally independent of Government. The Head of the NAO certifies the accounts of all Government departments and a wide range of other public sector bodies, and has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which Departments and other bodies have used their resources.

Box 4.2: 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]	2¼ per cent a year.
• UK claimant unemployment[1, 4]	Constant at recent levels, 1.05 million.
• Interest rates[1, 6]	3-month market rates change in line with market expectations (as of March 14).
• Equity prices[2]	FT-All share index rises from 3046 in line with money GDP.
• VAT[2]	Ratio of VAT to consumption falls by 0.05 percentage points a year.
• GDP deflator and RPI[2]	Projections of price indices used to plan public expenditure are consistent with RPIX.
• Composition of GDP[3]	Shares of labour income and profits in national income are broadly constant in the medium term.
• Funding[3]	Funding assumptions used to project debt interest are consistent with the public finances forecast and with financing policy.
• Oil prices[5]	$25.40 a barrel in 2001, the average of independent forecasts, 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)

Long-term Public Finances

4.37 The Government is aware of the need to examine and plan for the long-term effects that the changing demographic profile in the UK will have for taxation and spending plans.

4.38 The study presented in this section formed an integral part of the 2000 Economic and Fiscal Strategy Report (EFSR), published in conjunction with the March 2000 Budget. With the Code for Fiscal Stability requiring the Government to publish illustrative long-term projections covering a period of at least 10 years as part of the annual EFSR, the Government will present updated studies at the time of future budgets, taking into account new policy announcements as well as the latest information on demographic, economic, spending and revenue trends.

Demographic trends

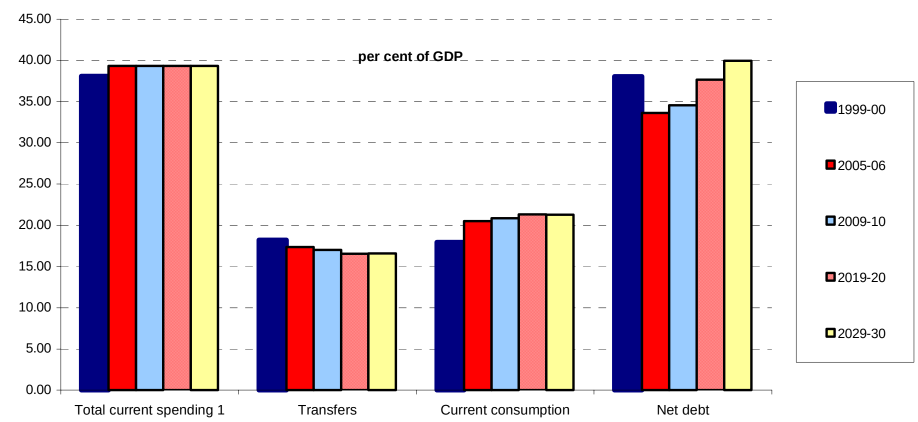
4.39 Even though the future ageing of the UK population is broadly comparable with past trends, the demographic challenges the UK faces nonetheless emphasise the importance of a sound long-term strategy. By 2036 around one in four people in the UK will be aged 65 or over, compared to around one in six in 2000, with the average age set to rise from slightly less than 39 years today to around 41½ years.

4.40 While considerable, the ageing of the population in the UK is expected to be less pronounced than in most other western European countries and it is expected that the impact on UK public finances will be relatively limited. Nonetheless, the issue cannot be ignored. The reduced proportion of the population of traditional working age and the greater demand for services for the aged will both have implications for government revenue and spending.

4.41 The assumptions and methodology underpinning the Government's long-term fiscal projections is detailed in Box 4.3.

Projections

Chart 4.3: Baseline Projections



[1] Total current spending equals current receipts from 2005-06 onwards

4.42 The projections illustrated show that - given the assumptions for transfer payments and taxation - public sector current consumption can grow at an average real rate of around 2½ per cent each year and still remain consistent with meeting the Government's fiscal rules. The growth rate of real current consumption can exceed that of real GDP mainly as result of the declining trend for transfers as a share of GDP. This, in turn, is primarily driven by the projection path for social security benefits: as the majority of benefits are indexed by prices, they remain constant in terms of purchasing power and fall as a share of GDP over time. Falling debt interest payments as a share of GDP in the medium term also contribute to the reduction in transfers.

Box 4.3: Assumptions Underlying Long-term Fiscal Projections

The Treasury's model for long-term fiscal projections examines the sustainability of the public finances by determining at what rate current consumption - such as current spending on health and education - can grow while still allowing the Government to meet its fiscal rules. This is done by projecting forward taxation, transfer payments and capital consumption (depreciation). The difference then indicates the financial resources available for current consumption. The projections are intended to show the impact of extending the current policy setting forward. A number of assumptions are made to approximate current policy from a modelling perspective.

Consistent with the approach to projecting the public finances in the short term, the key **economic assumptions** used represents a cautious case. In particular, the expected effects of the Government's reforms to increase labour market activity and productivity are not taken into account in the baseline scenario.

Crucially, the long-term rate of economic growth used in these projections is lower than the Government's neutral projection of trend economic growth. This is due to the use of cautious assumptions for both productivity and labour force growth, with the former and latter assumed to stabilise some ¼ and ½ percentage points respectively below the rates used in the neutral projection of trend growth. For example, higher short-term productivity growth may reflect 'catch-up' effects and female participation rates cannot be expected to continue to grow forever.

Tax revenues are subject to a number of influences in both the short and long term and their long-term implications are difficult to project. For this reason, the key **tax assumption** used is to project total current receipts as a constant share of GDP without making assumptions about the source of that revenue.

The main **spending assumptions** relate to transfers and capital consumption. Transfers are made up of three separate components, social security transfers, interest payments and other transfers. The projections of social security transfers take into account the current social security framework. The calculation of interest payments requires assumptions both about interest rates and the level of investment. We model interest rates using market expectations and the existing spread of financial assets to which those rates apply. The amount of investment is determined by assuming a constant investment profile at the same proportion of GDP from 2004-05 to 2019-20. From 2020-21 the rate of investment is reduced slightly to stabilise net debt at 40 per cent of GDP. This approach is consistent both with meeting the sustainable investment rule and, in the absence of an explicit investment target beyond 2004-05, current policy settings.

The capital consumption data are calculated based on the forward profile for investment. This 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.

4.43 The projected changes in net debt emphasise the importance of ensuring sound public finances in the short term to prepare for future developments. Net debt is projected to fall markedly by 2005-06 before edging up again thereafter, stabilising at slightly below 40 per cent of GDP. The main reason for this longer-term increase in the net debt ratio is the combination of continuing strong public sector investment and the cautious projection of trend growth over this period.

4.44 In an alternative scenario, the impact of a higher labour market participation rate on the public finances was also studied in the 2000 EFSR. The results show that even small increases in participation rates can support relatively large increases in current consumption. The main driver of this outcome is the fact that economic growth has increased along with the increase in the labour force. In addition, spending on transfers falls slightly as benefit recipients move into the workforce. The resulting combination of higher tax revenues and lower social security transfers leaves the Government in a stronger fiscal position.

4.45 The general conclusion of the projections has been supported by work undertaken by the National Institute of Economic and Social Research (NIESR) for HM Treasury. The Institute's set of generational accounts for the UK suggest only a modest generational imbalance and a broadly sustainable position.[12]

Uncertainties and policy responses

4.46 Nonetheless, it is important not to become complacent, despite the generally positive projections, not least because the underlying dataset is subject to a number of substantial uncertainties over a long period. For example, a different demographic profile (perhaps due to changing mortality and/or migration trends) would have an impact on the demand for social security, health and education services. The Government is also facing uncertainty regarding the cost of a number of other expenditures such as nuclear decommissioning. Moreover, there are uncertainties about the demand for, and cost of providing, public services over time.

4.47 The UK believes that the best way to deal with these uncertainties is to develop policies that take the ageing of the population into account and minimise the risk of the public finances becoming unsustainable. Policies in this direction include, *inter alia*, the future increase in the retirement age for women, reforming the welfare system and modernising public-sector service provision, and assisting people to provide for retirement incomes for themselves. As suggested by the results of the alternative scenario, initiatives to raise trend economic growth would also make a difference. These developments will all play an important role in ensuring sustainable public finances in the long term.

Future work – the Code for Fiscal Stability

4.48 The Government will continue to examine the potential impact of both the ageing of the population and other long-term effects. This reflects the high degree of uncertainty surrounding long-term analysis of fiscal trends and the fact that small changes in economic and policy variables can have significant effects over long time frames. As part of its Code for Fiscal Stability the Government will therefore present revised projections in the 2001 Budget that will take into account the latest assumptions and policy initiatives.

[12] "Generational Accounting in the UK" by Robert Cardarelli, James Sefton and Laurence Kotlikoff, November 1998.

ANNEX A COMPARISON WITH 1999 PROJECTIONS

A.1 The main differences between this report and the 1999 update have been discussed in Chapters 3 and 4. As illustrated by Table A1 below, GDP growth is expected to be higher this year than predicted at the time of the 1999 Pre-Budget Report, while inflation is expected to return to its 2½ per cent target in mid-2001.

Table A.1: Comparing GDP growth and inflation between 1999 and 2000 Pre-Budget Reports

	Percentage changes on previous year							
	1999		2000		2001		2002	
	1999	2000	1999	2000	1999	2000	1999	2000
GDP Growth	1¾	2¼	2½ to 3	3	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
RPIX Inflation	2	2¼	2½	2¼	2½	2½	2½	2½

A.2 Table A2 sets out the differences between the two programmes in relation to the public finances. Outturns for the current budget surplus and Public Sector Net Borrowing (PSNB) were stronger than expected, and this persists into 2000-01 and 2001-02. In 2000-01 the PSNB repayment is expected to be around 1 per cent of GDP, larger than projected a year ago. In line with the Government's commitment to strengthen the public infrastructure, public investment is forecast to increase steadily, reaching 1.4 per cent of GDP by 2002-03.

Table A.2: Comparing public sector finances between 1999 and 2000 Pre-Budget Reports [1]

	Per cent of GDP							
	1999-00		2000-01		2001-02		2002-03	
	1999	2000	1999	2000	1999	2000	1999	2000
Current receipts	39.6	39.4	39.6	40.0	39.8	40.2	39.8	40
Current expenditure	37.0	35.7	37.1	36.8	37.0	37.1	37.1	37.2
Surplus on current budget	1.1	2.1	1.2	1.7	1.3	1.6	1.2	1.3
Net investment	0.7	0.4	0.9	0.7	1.1	1.1	1.3	1.4
Public sector net borrowing	-0.4	-1.8	-0.3	-1.1	-0.3	-0.6	0.1	0.1
Cyclically adjusted surplus on current budget	0.9	1.9	1.0	1.5	1.2	1.4	1.2	1.1
Cyclically adjusted PSNB	-0.2	-1.6	-0.2	-0.8	-0.2	-0.3	0.1	0.3
General government net borrowing	-0.3	-1.8	-0.2	-1.1	0.2	-0.6	0.1	0.1
General government gross debt	44.9	43.6	43.1	40.1	41.3	37.7	39.9	36.1

[1] Figures on ESA 95 basis

A.3 The improvements in current surplus and PSNB are also apparent on a cyclically adjusted basis.

A.4 Public finances projections in the PBR are interim forecasts, and do not necessarily represent the outcome the Government is seeking. The interim forecast shows that the fiscal stance is expected to be at least as tight as Budget 2000. Table A3 sets out the differences in relation to the public finances between Budget 99 and Budget 2000. The fiscal stance projected in Budget 2000 was tighter than in Budget 99.

Table A.3: Comparing public sector finances between Budgets [1]

	Per cent of GDP							
	1999-00		2000-01		2001-02		2002-03	
	1999 Budget	2000 Budget	1999 Budget	2000 Budget	1999 Budget	2000 Budget	1999 Budget	2000 Budget
Current receipts	39.2	39.6	39.4	39.7	39.5	39.9	39.6	39.8
Current expenditure	37.4	36.2	37.4	36.8	37.1	36.9	37.1	37.1
Surplus on current budget	0.3	1.9	0.4	1.5	0.8	1.6	0.9	1.2
Net investment	0.6	0.6	0.8	0.9	1.0	1.2	1.2	1.5
Public sector net borrowing	0.3	-1.3	0.4	-0.7	0.1	-0.5	0.3	0.3
Cyclically adjusted surplus on current budget	0.6	1.8	1.0	1.3	1.1	1.3	0.9	1.0
Cyclically adjusted PSNB	0.0	-1.2	-0.2	-0.5	-0.1	-0.3	0.3	0.5
General government net borrowing	0.3	-1.3	0.2	-0.6	0.2	-0.3	0.1	0.3
General government gross debt	46.6	44.8	45.3	42.7	43.5	40.9	42.2	39.8

[1] Figures on ESA 79 basis

ANNEX B THE FISCAL IMPACT OF BUDGET AND PBR MEASURES

B.1 Table B.1 below shows the financial implications of measures announced in the **2000 Budget**. This table will be updated in the next Budget, taking into account changes from the Pre-Budget Report (PBR) and measures announced in the Budget itself.

Budget Measures

Table B.1 (+ve is an Exchequer yield) £ million

	2000-01	2001-02	2002-03	2003-04
MEETING THE PRODUCTIVITY CHALLENGE				
1 New all-employee share plan	-120	-280	-370	-120
2 Abolition of stamp duty on intellectual property	-5	-5	-5	-5
3 Corporate venturing scheme	-5	-25	-50	-5
4 Capital gains tax reform	0	-225	-275	0
5 Abolition of withholding tax on international bonds and foreign dividends	0	-300	*	0
Small business				
6 Enterprise Management Incentives	-30	-50	-60	-30
7 EIS/VCTs: reduction in minimum holding period and technical changes	-5	-15	-25	-5
8 Permanent first year capital allowances for small and medium sized enterprises at 40%	*	-190	-330	*
9 First year capital allowances for small enterprises for information and communication technology at 100% for three years	0	-90	-90	0
10 Discount for filing of tax returns over the internet and electronic payment	-5	-30	0	-5
Large business				
11 Extending group rules for corporation tax losses and company gains	-60	-100	-65	-60
12 Changes to double taxation relief	40	140	120	40
13 Reduction in interest rates on overdue quarterly instalments and de-minimis limit for CT instalments raised to £10,000	-5	*	*	-5
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
14 Income tax: indexation of allowances and limits	0	0	0	-470
15 Reduction in employer national insurance contribution rate by 0.1 percentage points from April 2002	0	0	-350	0
Transition to work package				
16 £100 Job Grant	0	-20	-20	0
17 Income Support Mortgage Interest run-on for 4 weeks on taking work	0	-10	-10	0
18 Income Support Mortgage Interest 52 week linking rule	0	-5	-5	0
19 Simplification of Housing Benefit Extended Payments Scheme	0	-15	-15	0
20 Increasing £15 earnings disregard in income-related benefits to £20	0	-20	-20	0

	(+ve is an Exchequer yield)			£ million
	2000-01 indexed	**2001-02 indexed**	**2002-03 indexed**	**2000-01 non-indexed**
FAIRNESS FOR FAMILIES AND COMMUNITIES				
Measures for families with children				
Tackling child poverty				
21 Increase Children's Tax Credit by £0.50 from April 2001	0	-100	-130	0
22 Increase Working Families' Tax Credit under 16 child credit and income related benefits by £4.35 from June 2000 and October 2000 respectively	-665	-1,260	-1,295	-665
Maternity package				
23 Extension of Working Families' Tax Credit to those receiving maternity pay	0	-40	-80	0
24 Increase Sure Start Maternity Grant by £100	-5	-20	-20	-5
Fairness to pensioners				
25 Increase minimum income guarantee capital limits for pensioners from April 2001	0	-145	-145	0
26 £150 Winter Allowance from December 2000	-430	-430	-430	-430
Securing the tax base				
27 Capital gains tax: use of trusts and offshore companies	0	120	125	0
28 Stamp duty: transfer of property and company reorganisations	50	100	100	50
29 Life assurance company taxation: modification of apportionment rules	50	115	120	50
30 Insurance companies and Lloyds: reserves	0	30	120	0
31 Rent factoring	20	50	80	20
32 Controlled Foreign Companies	40	120	150	40
33 Petroleum Revenue Tax: preventing misuse of safeguard relief	0	10	30	0
34 VAT: capital asset disposals	5	5	5	5
Duties and other tax changes				
35 Relaxation for flights from Scottish Highlands and Islands from April 2001	0	-5	-5	0
36 Other reforms to Air Passenger Duty	-5	-75	-85	0
37 Stamp duty: 3 per cent rate for transfer of land and property above £250,000 and 4 per cent above £500,000	290	295	365	290
38 Stamp duty: Registered Social Landlords	-10	-20	-20	-10
39 Enhancement to charities tax package	0	-5	-15	0
40 Alcohol: freeze duty on spirits and revalorise all other alcohol duties	-25	-25	-20	140
41 VAT: reduced rates on sanitary protection	-10	-35	-35	-10
42 Inheritance tax: index threshold	0	0	0	-15
43 Extending current Individual Savings Account subscription limits for 1 year to April 2001	-40	-70	-75	-40
44 5% real increase to tobacco duty	235	405	415	375
45 Reform of amusement machine licence duty	-5	*	*	-5
46 VAT: indexation of registration and deregistration thresholds	0	0	0	-5
47 Construction industry scheme: reducing the deduction rate	-150	-50	-50	-150
48 VAT: exemption	15	15	15	15
49 VAT: credit supplies	-20	-20	-20	-20

	2000-01 indexed	2001-02 indexed	2002-03 indexed	2000-01 non-indexed
	(+ve is an Exchequer yield)			£ million
PROTECTING THE ENVIRONMENT				
50 Revalorisation of hydrocarbon oil duties	0	0	0	715
51 Ultra low sulphur petrol - introducing a 1p differential with unleaded petrol	*	-15	-35	*
52 VAT: revalorisation of fuel scale charges for business cars	0	0	0	60
53 Extending reduced VAT rate for energy saving materials	-35	-35	-35	-35
54 Affordable warmth scheme: capital allowances	*	-10	-20	*
55 Aggregates levy	0	0	385	0
Vehicle Excise Duty:				
56 Reduce VED rates for goods vehicles	-45	-45	-45	-45
57 Introduction of graduated VED system for new cars from March 2001	0	-80	-140	0
58 Increase threshold for reduced VED rates for private and light goods vehicles tax class to 1,200cc (from 1,100cc) from March 2001	-120	-120	-120	-120
59 Revalorisation of VED rates for existing Private and Light Goods Vehicles deferred until March 2001	-110	0	0	-110
TOTAL	**-1,165**	**-2,580**	**-2,480**	**-570**

* negligible.

Pre-Budget Report measures

B.2 Table B.2 below sets out the effect of the measures announced in the November 2000 Pre-Budget Report on the fiscal projections.

Table B.2		(+ve is an Exchequer yield)		£ million
	2000-01	**2001-02**	**2002-03**	**2003-04**
Total	**-720**	**-2,615**	**-3,945**	**-3,930**
Pensioners Package	**-435**	**-1,830**	**-2,540**	**-2,595**
of which: Increase Winter Fuel Payment for Winter 2000 [1]	-435	0	0	0
Increase in basic state pension and Minimum Income Guarantee for 2001-02 and 2002-03	0	-1,830	-2,450	-2,595
Disability and carers package	**0**	**-180**	**-205**	**-220**
One year nominal freeze for all fuel duties	**0**	**-560**	**-575**	**-590**
Rebate of lorry VED [1]	**-265**	**0**	**0**	**0**
Urban Regeneration Package	**0**	**-165**	**-245**	**-230**
of which: Stamp duty: exemption for property within disadvantaged communities	0	-50	-100	-100
Tax relief for residential communities	0	-80	-90	-90
Tax relief for cleaning contaminated sites	0	-35	-55	-40
Unapproved share options	**-20**	**200**	**-230**	**-80**
Green transport measures	**0**	**-45**	**-50**	**-50**
of which: Reform of authorised mileage rates	0	-40	-40	-40
Green travel package	0	-5	-10	-10
Extending £7000 ISA limit for 5 years to April 2006	**0**	**-20**	**-80**	**-140**
Abolition of capital limits for Sure Start Maternity Grant and funeral payments	**0**	**-10**	**-15**	**-15**
Extend CGT business asset definition	**0**	**-5**	**-5**	**-10**

[1] These measures have no effect on overall expenditure because the costs will be met from the AME margin.