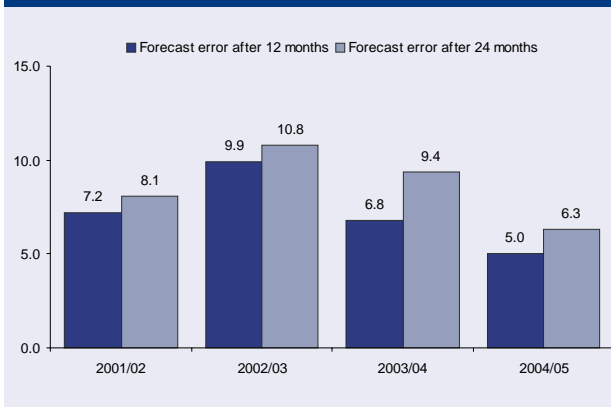


current receipts forecasting errors (£ billion)



these shortfalls have led to borrowing overshoots and pressure for discretionary tax rises to limit the gap.

Despite the extra £5bn of borrowing for 2005/06 announced in the Pre-Budget, past experience suggests that receipts are likely to fall short by a further £3bn or so this fiscal year. Should the same degree of forecasting error persist, one danger would be renewed accusations that business is somehow not paying its 'fair share', or has been somehow avoiding tax which it 'ought' to have paid - even though initial over-optimism on the Treasury's part would appear the far more likely explanation.

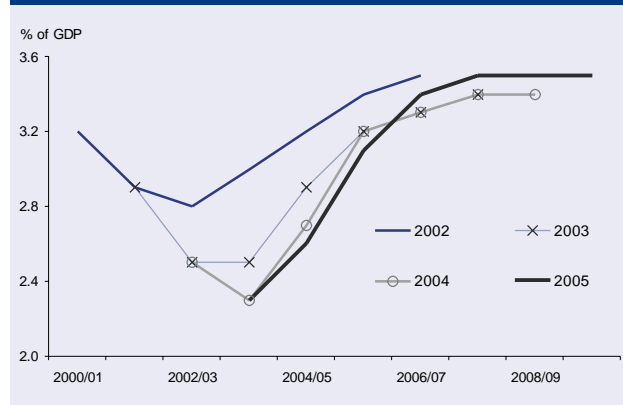
Over-optimistic assumptions?

Going forward, the December Pre-Budget projections rely on some optimistic assumptions. Whilst the Chancellor downgraded his economic growth projections for both 2005 and 2006, he envisages a robust bounceback in 2007 and 2008, reflecting the Treasury view that the economy now has a fairly significant amount of spare capacity. But if - as many others believe - the economy is now running only just below 'full capacity', then 2.5% would be more realistic, bringing about a corresponding shortfall in revenues. With real-terms spending growth of 3.2% planned for 2006/07, and 2.8% for 2007/08, and with the subsequent period of relative spending restraint awaiting confirmation in the 2007 Comprehensive Spending Review (CSR), there is still a risk that borrowing will not fall back as much as planned, bringing pressure for further discretionary tax rises.

The Pre-Budget projections further assume a significant improvement in the ratio of tax revenues to income - and especially so in the case of corporation tax. Corporation tax receipts grew by almost 20% in 2004/05, and while this was lower than the Treasury expected, it brought to an end a run of three years of decline, during which

forecasts of a strong rebound were disappointed. The chart illustrates how corporation tax receipts (excluding North Sea receipts) have persistently disappointed.

HMT forecasts of non-north sea corporation tax receipts



For 2005/06 corporation tax receipts were originally forecast to rise 28% in Budget 2005, though this was downgraded to 22% in the December Pre-Budget. While the December public finances data suggest this downgraded forecast can be achieved for this fiscal year, growth of 20% is again expected by the Treasury during 2006/07. Considering that corporate profits growth plateaued through 2003 and 2004 with the corporate profits share of GDP stabilising, to sustain this rate of corporate tax receipts growth seems optimistic - and more so given past forecasting errors.

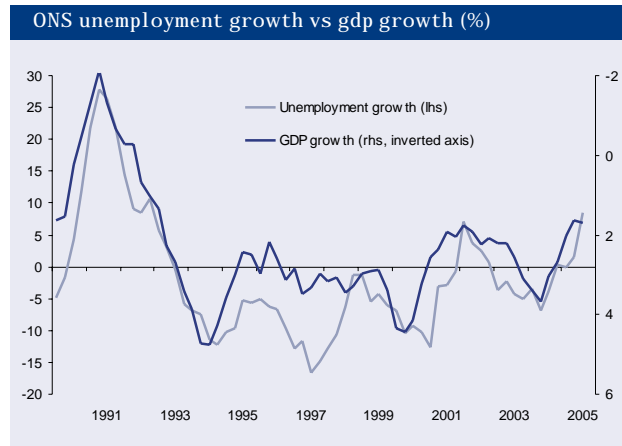
Some commentators have argued that given the relative spending restraint pencilled in for 2008 and beyond, only £2-3bn of discretionary tax rises would now be needed to keep public sector borrowing on the path set out in the Pre-Budget. However, given the relatively optimistic Treasury assumptions on economic growth and tax receipts (especially corporation tax receipts), and with future spending totals presumably open to revision in the CSR, the balance of risks points to borrowing holding up more than planned, in the absence of policy action.

We therefore remain concerned that discretionary tax rises in excess of £3bn per annum would be needed, if borrowing is to be kept on the path currently projected while also sticking to today's spending plans. In that respect it would be prudent to get a tighter grip on spending straightaway. Otherwise, one way or another, pressures on business will mount - whether through the 'automatic' rebound in corporation tax that the government expects, early discretionary tax rises to make up for the likely shortfall, or the threat of more drastic policy action at a later date.

Focus on.....the Labour Market

The latest labour market statistics, covering the period of September to November 2005, confirmed expectations of significant weakening in the labour market. Quarterly unemployment growth (ILO definition) was highest for over a decade, as was the increase in the unemployment rate. Meanwhile, employment fell by 0.3% and earnings growth (3-month average) fell to 3.4% over the quarter.

There has been some debate as to why, up until the latest data set, employment growth was relatively robust compared to GDP growth, which started to fall in the third quarter of 2004. One possible explanation for this is that immigration flows have picked up over 2004-05, keeping wage growth down and employment growth up. Although the migration data is not timely, there is some evidence that this is the case. Employment figures, even though they have showed a slight fall, would have been

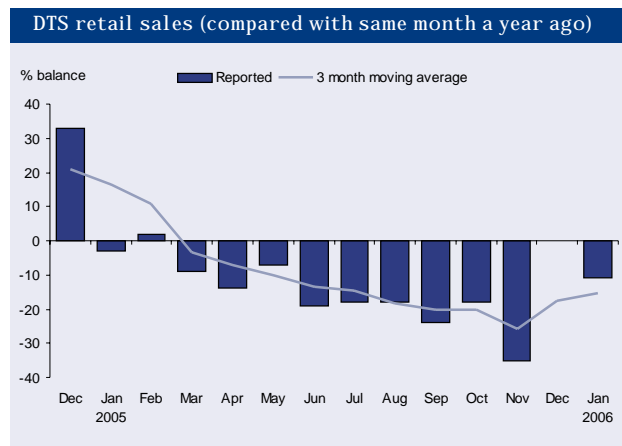


much weaker without the migration effect. Meanwhile, unemployment has reacted to the slowing of GDP with a lag typical of the relationship over the last decade (see above).

Recent CBI Survey Results

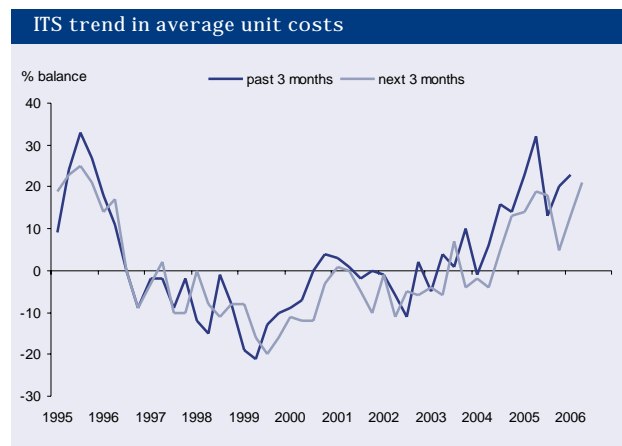
Monthly Distributive Trends Survey

- Retail sales volumes fell again over the year to January, after stabilising on an annual basis in December's survey. However, the decline was more modest than in June - November, and in line with retailers' expectations. Wholesalers also reported a fall in sales volumes, as did motor traders, although the decline in the latter sector was the slowest for over a year. Looking forward, retailers expect sales to be broadly stable in the year to February, whilst motor traders expect a modest increase. However, wholesalers expect the decline in sales to continue.



Quarterly Industrial Trends Survey

- The squeeze on profits became even tighter in the three months to January, with the difference between trends in costs and domestic prices in the 20s for four consecutive quarters for the first time since 1991-2. Firms have been unable to pass on the strong growth in costs to customers. New orders fell slightly, with export orders performing better than domestic orders. Employment and investment intentions weakened as firms became more concerned about demand. However, more 'soft' investment (training and innovation) is planned as firms concentrate on improving efficiency rather than expanding capacity.



Key statistics on the UK economy

Economic indicators	12Mth% Unless stated											
	2004	2005	2003 Q4	2004 Q1	Q2	Q3	Q4	2005 Q1	Q2	Q3	Q4	
GDP	3.2	1.8	3.2	3.4	3.7	3.0	2.6	2.0	1.6	1.7	1.8	
Total Fixed Investment	5.2	NA	-0.8	2.8	6.6	7.2	4.2	4.0	1.4	3.9	NA	
Manufacturing Investment	2.5	NA	2.5	-8.6	8.4	6.8	4.8	3.6	4.3	5.8	NA	
Construction Output	3.3	1.5	5.9	5.9	4.0	1.8	1.9	1.7	1.8	1.5	1.1	
Total Household Consumption	3.6	NA	2.4	3.3	3.4	3.8	3.8	2.8	1.7	1.4	NA	
Company Profits	7.2	NA	5.9	2.9	8.9	6.1	10.9	5.0	2.0	-2.3	NA	
Savings Ratio (%)	4.4	NA	5.8	5.0	4.2	4.3	4.1	4.7	5.6	5.5	NA	
Current Account (£bn)	-23.2	NA	-5.7	-4.8	-5.5	-9.0	-3.9	-6.7	-1.4	-10.2	NA	
Services Trade Balance (£bn)	21.4	NA	4.2	5.3	5.5	5.2	5.4	5.1	5.0	2.9	NA	
			2005									
	2004	2005	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	
Manufacturing Output (3m/3m yr ago)	1.8	-0.6	-0.7	-1.4	-0.9	-0.3	0.2	0.1	-0.4	-1.1	NA	
Retail Sales (3m/3m yr ago)	5.9	2.0	2.4	1.6	1.4	1.2	1.2	0.9	1.1	1.6	2.7	
ILO unemployment (mn)	1.43	1.43	1.41	1.43	1.44	1.42	1.42	1.43	1.49	1.53	NA	
Goods Trade Balance (£bn)	-60.4	NA	-5.3	-5.1	-4.4	-5.4	-5.9	-5.6	-4.6	-6.0	NA	
Consumer Prices Index (CPI)	1.3	2.1	1.9	1.9	2.0	2.3	2.4	2.5	2.3	2.1	2.0	
Retail Prices Index (RPI)	3.0	2.8	3.2	2.9	2.9	2.9	2.8	2.7	2.5	2.4	2.2	
Producer Prices Index - output	2.5	2.8	3.3	2.7	2.5	3.1	3.0	3.3	2.6	2.3	2.4	
- input	4.0	11.6	10.1	7.4	11.9	14.2	13.0	10.3	9.0	13.6	17.2	
Manufacturing Unit Labour Costs	-2.5	NA	0.8	-0.9	-0.7	-1.4	0.0	1.9	1.8	2.7	NA	
Average Earnings (3mth avg) - manufacturing	3.7	NA	3.5	3.0	2.6	2.8	3.5	4.1	4.5	4.5	NA	
- services	4.2	NA	5.0	4.5	4.5	4.6	4.4	4.1	3.4	3.2	NA	
- whole economy	4.3	NA	4.6	4.1	4.1	4.2	4.2	4.1	3.6	3.4	NA	
Financial indicators	Period average											
			2005									2006
	2004	2005	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	
\$/£	1.83	1.82	1.85	1.82	1.75	1.79	1.81	1.76	1.74	1.74	1.77	
Euro/£	1.47	1.46	1.46	1.50	1.45	1.46	1.48	1.47	1.47	1.47	1.46	
£ Effective (Jan 2005=100)	101.6	100.5	101.1	101.9	99.0	99.8	100.8	99.8	99.5	99.6	99.2	
UK Base Rate (end month)	4.40	4.65	4.75	4.75	4.75	4.50	4.50	4.50	4.50	4.50	4.50	
U.S. 3-mth interest rate	1.62	3.55	3.27	3.43	3.53	3.80	3.91	4.17	4.35	4.49	4.60	
Eurozone 3-mth interest rate	2.11	2.18	2.13	2.11	2.11	2.13	2.14	2.20	2.36	2.47	2.51	
UK 10-yr interest rate	4.87	4.41	4.41	4.27	4.21	4.30	4.21	4.35	4.32	4.24	4.10	
FTSE 100	4521.4	5156.7	4926.2	5050.3	5228.0	5307.4	5392.6	5292.9	5458.2	5551.6	5692.3	
CBI survey data*												
quarterly			2004				2005				2006	
	Jul	Oct	Jan	Apr	Jul	Oct	Jan	Apr	Jul	Oct	Jan	
Industrial Trends Survey - business confidence	-13	-7	+17	+12	+7	-10	-22	-15	-16	-21	-14	
- unit cost expectations	-4	-2	-4	+5	+13	+14	+19	+18	+5	+13	+21	
- plant investment intentions	-23	-14	+6	-1	0	-17	-19	-16	-15	-19	-14	
monthly			2005									2006
	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	
Industrial Trends Survey - output expectations	+9	+5	-1	-5	+6	+3	+6	+2	-4	-4	+1	
- price expectations	+9	+5	-3	-6	-11	-8	-8	-1	-5	0	+12	
Distributive Trades Survey - retail sales volumes	-9	-14	-7	-19	-18	-18	-24	-18	-35	0	-11	

* balance = % of respondents reporting increases less % of respondents reporting falls. For further details on official data please contact the Office for National Statistics, +44 (0)20 7533 6363/6364.

further information

www.cbi.org.uk

For detailed economic information please contact: Victoria Rance
DL: +44 (0)20 7395 8111 **E:** victoria.rance@cbi.org.uk