HM TREASURY

# LONG-TERM SUSTAINABILITY

## Convergence Programme for the United Kingdom

### Submitted in line with the Stability and Growth Pact

**December 2004**

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## Charts



## Tables

# 1 INTRODUCTION

1.1 **The forecasts for the UK economy and public finances set out in this Programme show that the UK's public finances are robust and sustainable.** With inflation low and stable, interest rates set by the Monetary Policy Committee in order to meet the Government's symmetric inflation target and fiscal policy supporting monetary policy over the economic cycle, the UK weathered the economic downturn, which began in 2001, better that many other industrialized countries and remains well placed to maintain stability and ensure the public finances remain sustainable in the long term.

1.2 The global recovery gathered momentum during 2004, despite higher world oil prices. In the UK GDP has grown strongly over the past year with significant evidence of a rebalancing in the composition of demand. While a number of risks continue to surround the international outlook, sound macroeconomic fundamentals, recent strong and more broadly-based growth and continued expansion in the world economy point to a further period of relatively strong UK output growth.

### The importance of sustainability

1.3 **Sustainable public finances are an essential prerequisite to achieving steady long-term economic growth.** There has been a shift towards more medium-term planning within fiscal frameworks by governments around the world, and a greater emphasis on the long term. This has been motivated by countries becoming increasingly aware of the importance of looking at the long term, in part so as to prepare for the common problem of an ageing population. The focus of the UK's attention has long been on fiscal sustainability and this helps create an environment conducive to sustained long-term economic growth and should help promote inter-generational fairness. Consequently, the Government published, in December 2004, its third *Long-Term Public Finance Report*[1]. This report, to be produced annually, seeks to extend and complement existing analysis[2] and introduces additional indicators to assess long-term fiscal sustainability. Using these techniques, and a range of plausible assumptions, it is possible to build up a comprehensive picture of the long-term sustainability of the public finances in the light of future developments (as shown in Chapter 4).

1.4 This regular annual Convergence Programme, "**Long-Term Sustainability**", updates the UK's 2003 Convergence Programme to reflect the latest Government forecasts for the economy and public finances, which were published in the Pre-Budget Report on 2 December 2004[3]. The public finance projections in the Pre-Budget Report have a different status to those included in the Budget – they are an interim forecast update and do not necessarily represent the outcome the Government is seeking. This update therefore also takes account of Budget 2004[4], as well as taking account of the latest biennial Government spending review, completed in 2004[5].

[1] *Long-Term Public-Finance Report: an analysis of fiscal sustainability*, HM Treasury, December 2004
[2] In Annex A of the Economic and Fiscal Strategy Report (EFSR), which sets out 30-year public finance projections
[3] *Pre-Budget Report*, HM Treasury, December 2004
[4] *Budget 2004*, HM Treasury, March 2004
[5] *2004 Spending Review,* HM Treasury, July 2004

**1.5** The latest public finance projections are consistent with the UK Government's prudent interpretation of the Stability and Growth Pact, which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). The projections meet the EU Treaty reference values for general government gross debt (60 per cent GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period.

**The macroeconomic framework**

**1.6** Chapter 2 of this report provides an outline of the UK Government's framework for monetary and fiscal policy and for public spending, which forms an integrated strategy for maintaining high and stable levels of growth and employment, and for minimizing the adverse impact of external events:

- the monetary policy framework in the UK is delivering low and stable inflation and is enabling the Bank of England's Monetary Policy Committee (MPC) to respond quickly to risks to the symmetrical inflation target;

- the fiscal policy framework in the UK is delivering sustainable public finances, while supporting monetary policy over the cycle. The fiscal rules are set over the cycle and the automatic stabilisers are allowed to operate fully, which lets fiscal policy smooth the path of the economy in the face of fluctuations in demand. Fiscal policy has supported monetary policy in limiting the impact of adverse global developments on the UK economy. Despite fragile global conditions, UK employment has risen to record levels and unemployment is at generational lows; and

- the fiscal rules, which the Government continues to meet, are also the foundation of the UK Government's public spending framework, which, with tough decisions on taxation and spending, is delivering substantial resources to reform and modernise public services. The UK Government believes that sustainable public finances are a prerequisite to achieving stable long-term economic growth, which in turn is essential in guaranteeing that everybody participates in the growing prosperity of the country. The Government also seeks to ensure that spending and taxation impact fairly between generations.

**Economic forecasts**

**1.7** UK GDP has grown strongly over the past year. As many of the key uncertainties that had substantially dampened international activity receded during 2003, business and consumer confidence rose around the world and supported a solid resumption of output growth and world trade. Indeed, global growth in 2004 is robust, despite higher oil prices, which have been driven to record nominal highs largely by exceptionally strong demand growth. Against this background of robust growth in global output and trade, UK GDP accelerated from mid-2003, and annual growth has now remained above trend for four consecutive quarters. There is also now significant evidence of a rebalancing in the composition of UK demand growth: latest data reveal private consumption has grown at more moderate rates over recent years than previously thought, while business investment has picked up strongly. However, despite historically high rates of world economic growth over the past year, a number of risks continue to surround the international outlook, some of which have become more prominent since Budget 2004. High oil prices, global imbalances, household and corporate balance sheet adjustment, the need for fiscal consolidation in a number of countries and the possibility that inflationary pressures could build, present downside risks.

**1.8** With the economy still judged to be below trend, sound domestic fundamentals allied with a still buoyant outlook for world trade should allow a further period of growth at above trend rates over the short-term forecast horizon, without generating inflationary pressures. However, underlying growth has been easing gradually since late 2003 – when quarterly growth was at its fastest for almost four years – and this pattern is expected to persist through next year as the economy moves back towards trend. In the 2004 Pre- Budget Report forecast:

- UK GDP is expected to grow by 3¼ per cent in 2004 and is forecast to remain within the 3 to 3 ½ per cent range for 2005 as a whole. unchanged since the 2003 Budget forecast, as remaining slack in the economy is absorbed. This masks a continued easing in underlying growth during the course of 2005 before the output gap closes by early 2006.

- Consumer Prices Index (CPI) inflation is expected to rise gradually back to target by mid-2006, helped by monetary policy anchoring inflation expectations, and as upward pressure from import prices, accentuated by the recent depreciation of sterling, feeds through.

**Public finances**

**1.9** Chapter 4 summarises the public sector finance position and outlines how the public finances have remained sound in the face of temporary weaknesses in receipts, related to the global slowdown and international capital markets:

- **the economic cycle**. The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began. The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year of the projection period. The economy is projected to return to trend by early 2006, meaning that over the whole cycle the average surplus on the current budget would be 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £8 billion in this cycle, including the AME margin.

- **sustainability**. The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector net debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle. With net debt forecast to stabilise at 37 per cent in 2009/10, and general government gross debt forecast to stabilise at 43 per cent (one of the lowest debt levels in the EU) by 2009/10, the Government is demonstrating its continued commitment to long-term sustainability

- **public investment**. Sound public finances that are sustainable over the economic cycle are not only essential to ensure economic stability; they are also necessary to deliver the sustainable investment in public services required to deliver standards that meet public expectations. In keeping with the 2004 Broad Economic Policy Guidelines, this updated Programme also demonstrates the UK Government's commitment to address historical under-investment in public services in the UK, PSNI rising to 2 ¼ per cent of GDP by 2007/08. The Government's goal is to deliver world class public services, including high-quality education and training, a modern and reliable transport network, and an effective and responsive health service, through sustained investment and reform.

**Productivity and economic reform in Europe**

**1.10** The Government is continuing to press for changes that will improve the flexibility of the European economy and so enhance its productivity performance. In the past, Europe has sometimes adopted economic strategies that were insufficiently responsive to changing economic circumstances, overly uniform, or too insular. The Government believes that the EU needs to be flexible, reforming, open, and globally orientated. In the context of globalisation, it needs to capitalize on the diversity of its economies and the Government will work for further progress at next spring's European Council on economic reform.

**Annex A & Annex B**

**1.11** Annex A provides details of the differences in key indicators between this update of the Programme and the 2003 update. Annex B provides details of the financial impact of the 2004 Budget policy decisions, and subsequent announcements.

**Annex C**

**1.12** Annex C of this Convergence Programme is Annex C of the December Pre-Budget Report 2004 *Flexibility in the UK economy.* Reforms that promote flexibility and fairness are central to achieving the Government's goal to deliver high and stable levels of growth, with opportunity and rising living standards for all. Annex C explains the UK Government's approach of combining flexibility with fairness, and the action the Government has taken to boost flexibility in labour, product and capital markets since the March Budget 2004 and in the December Pre-Budget Report 2004.

**Box 1.1: Background to the 2004 update "Long-term Sustainability"**

The Government has submitted programmes under the Stability and Growth Pact for each of the last five years. The Stability and Growth Pact requires Member States to provide information on economic developments in their country, for the purposes of the multilateral surveillance procedure under Articles 99 and 104 of the EU Treaty (ex Articles 103 and 104c). 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 for the general government surplus/deficit, the expected path for the general government debt ratio, the medium-term monetary policy objectives, and the relationship of those to price and exchange rate stability;
- the main assumptions about expected economic developments and important economic variables;
- 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.

In July 2001 the ECOFIN Council agreed an updated Code of Conduct on content and format of Stability and Convergence Programmes[6]. This 2004 update reflects the Code of Conduct. The updated Programme is subject to the usual UK Parliamentary scrutiny and approval under Section 5 of the European Communities (Amendment) Act 1993.

[6] *Opinion on the content and format of stability and convergence programmes*, EFC/ECFIN/404/01-REV 1

# 2 POLICY FRAMEWORK & OBJECTIVES

## Objectives of Economic Policy

**2.1** The Government's central economic objective is to raise the rate of sustainable growth and achieve rising prosperity through creating economic and employment opportunities for all. The key elements of the Government's economic strategy are:

- maintaining macroeconomic stability;
- meeting the productivity challenge;
- increasing employment opportunity for all;
- ensuring fairness for families and communities;
- delivering high quality public services; and
- protecting the environment.

**2.2** These objectives, and the elements through which the Government plans to meet them, 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, and with a prudent interpretation of the EU Stability and Growth Pact.

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

## Sustainability for the Long Term

**The importance of sustainability**

**2.4** While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability*[2]. Many developed countries face significant challenges over the long term as a result of ageing populations. For example, the demand for health and long-term care is likely to rise as a result of the increased number of older people.

[1] Further details can be found in *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002.
[2] *Code for Fiscal Stability*, HM Treasury, 1998

**2.5** An updated analysis of long-term fiscal sustainability is published alongside the Pre-Budget Report in the 2004 *Long-term public finance report*. Based on the latest population projections the report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances, updating the illustrative long-term projections set out in Budget 2004. To provide a comprehensive and robust analysis, the report:

- shows performance against a wide range of indicators;
- includes analysis based on different population projections to test the robustness of the conclusions; and
- provides spending projections for education, health and pensions

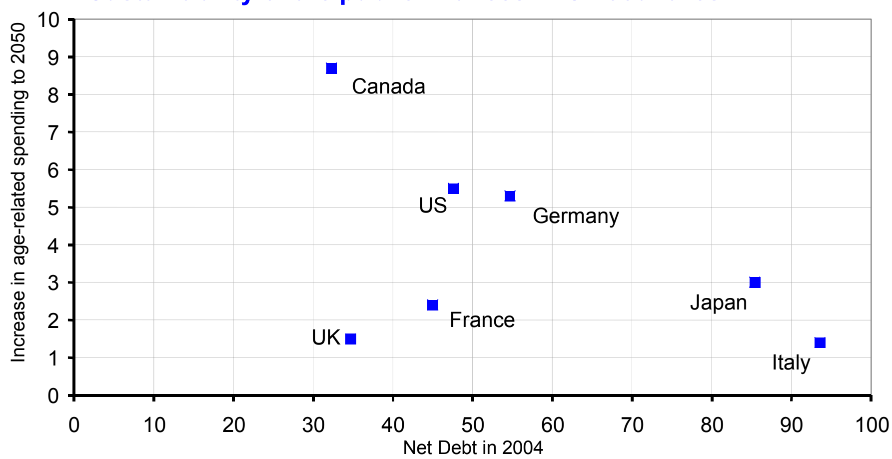
**2.6** Using a range of sustainability indicators, including the intertemporal budget gap and fiscal gap, and based on current policies and reasonable assumptions, the report shows that the public finances are sustainable in the longer term. The UK is in a strong position relative to many other countries to meet the challenges of an ageing population.

**Box 2.1: Long-term sustainability in the G7**

The challenges posed by an ageing population vary considerably between countries. The chart below shows the relationship between the ratio of net debt to GDP and the projected increase in age-related spending over the period to 2050.

The chart shows that a number of countries face a large projected increase in age-related spending over the next 50 years or so, of up to around 9 per cent of GDP, primarily due to large increases in pension and health spending. Of those countries with relatively small projected increases in age-related spending, some have a high starting level of debt, which could prove a burden in the future. In contrast, the UK has one of the lowest debt to GDP ratios in the G7, and faces only a relatively small increase in age-related spending, illustrating that the UK is well placed to meet the long-term challenges of an ageing population.

**Sustainability of the public finances in G7 countries**




*Source: Net financial liabilities from OECD Economic Outlook 75 (June 2004), Increase in age-related spending for UK from 2004 Long-term public finance report, other EU countries from European Commission's assessments of Member States' Stability and Convergence Programmes 2004 and for non-EU countries from OECD Economic Outlook 69 (June 2001).*

**…and flexibility**

2.7 In June 2003, the Government made an assessment of the five tests, which assess the economic case for joining the single currency, as set out in Box 2.3. The assessment set out a reform agenda of concrete and practical steps, including reforms at national, regional and local level to enhance flexibility of labour, capital and product markets in the UK. The Government announced it would publish six monthly flexibility reports, the third of which accompanies this Convergence Programme.

## Monetary Policy

**The monetary policy framework**

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

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

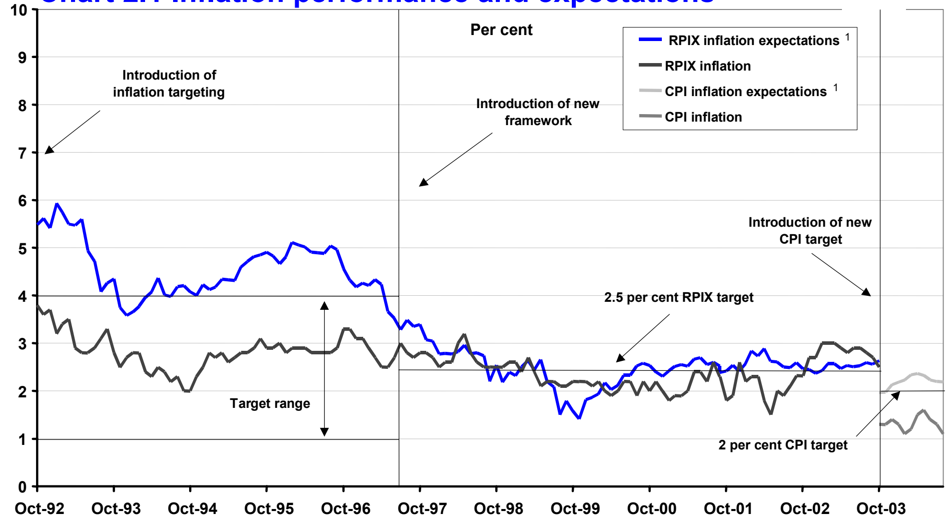
2.9 These arrangements have removed the risk that short-term political factors can influence monetary policy and ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target.

## Performance of the Monetary Policy Framework

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

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target of 2.5 per cent, the longest period of sustained low inflation for the last 30 years; and
- inflation expectations have remained close to target following the switch from a 2.5 per cent RPIX target to a 2 per cent CPI target – implied market expectations are that CPI inflation will be close to the 2 per cent target. CPI inflation has been within 1 percentage point of its target since its inception in December 2003.

**Chart 2.1 Inflation performance and expectations**




*[1] Implied expecttions of average RPI inflation ten years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI expectations and stylised assumptions about expected differences between RPI and CPI inflation in the medium term, including that the geometric averaging lowers CPI inflation by 0.5 percentage points relative to RPI inflation.*

**2.11** The monetary policy framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped to keep output relatively close to its trend level, while ensuring that inflation remained close to target. Consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation as growth strengthens, the MPC has raised interest rates on five occasions since November 2003 to reach 4.75 per cent.

**2.12** Long-term interest rates have remained at historically low levels and have averaged just under 5 per cent this year. Low long-term rates reduce the Government's debt interest payments, free up resources for public services and help to promote investment throughout the economy. Ten-year forward rates, which abstract from cyclical differences, remain below those in the United States and the euro area. Ten-year forward rates have fallen marginally in the United Kingdom over the year from 4.7 per cent in March 2004 to 4.6 per cent in November 2004[3] as they have in the United States and the euro area.

**Table 2.1: Inflation and long-term interest rates in 2004**

| | Inflation | 10 year-forward rate | Long term 30 year interest rates |
|---|---|---|---|
| UK | 1.3 | 4.6 | 4.6 |
| Euro Area | 2.4 | 4.9 | 3.8 |

*Note:Inflation reported on a consistent basis: UK refers to CPI, euro area refers to HICP*
*Source: EcoWin*

## Fiscal Policy

**The fiscal policy framework**

**2.13** The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[3] – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

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

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

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

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

- the sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

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

- the rules are set over the **economic cycle**. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and

- the rules work together to promote capital investment while ensuring **sustainable public finances in the long term**. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level. To meet the sustainable investment rule with confidence, **net debt will be maintained below 40 per cent of GDP** in each and every year of the current economic cycle.

[3] *Code for Fiscal Stability*, HM Treasury, 1998

**Box 2.2: Caution in the public finance projections**

Forecasting the public finances inevitably involves a significant margin of uncertainty, particularly for the fiscal balances, which represent the differences between two very large aggregates. The Government's fiscal framework specifically recognises this uncertainty. The projections for the public finances are therefore based on cautious assumptions, including for trend growth, which help to build a margin against unexpected events. These assumptions are audited by the NAO on a three-year rolling-review basis to ensure that they remain both reasonable and cautious. It is important that the assumptions remain reasonable as well as cautious, as excessive caution could distort the management of the public finances, particularly public spending. The NAO-audited assumptions include those for: privatisation proceeds; trend GDP growth; UK claimant unemployment; interest rates; equity prices; projecting the VAT gap; consistency of price indices; shares of labour income and profits in national income; funding; oil prices; and tobacco smuggling.

One of the key audited assumptions is that for the trend rate of GDP growth for the public finance projections, which is assumed to be ¼ of a percentage point below the neutral view. This means that the rate of economic growth used to forecast the public finances is the bottom end of the projection range. For example, in this Pre-Budget Report, the forecast for economic growth used in the public finance projections over the period 2005-06 to 2009-10 averages under 2½ per cent, ¼ per cent below the central case, implying the level of GDP used in the public finance forecast is 1.4 per cent below the neutral view in 2009- 10.

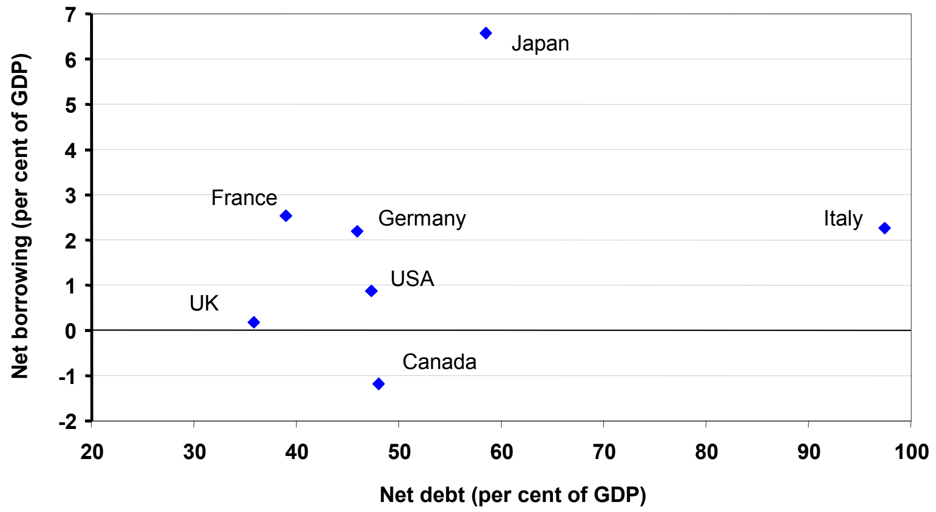
For the 2004 Pre-Budget Report, no assumptions were due for audit and the assumptions examined in previous audits have not been changed.

**End of year fiscal report**

**2.16** In order to enhance the reporting of fiscal developments an *End of year fiscal report* (EYFR) is published alongside the 2004 Pre-Budget Report. This annual report compares forecasts and outturns of the public finances, identifying the possible reasons for differences. The EFYR helps to foster transparency by enhancing the Government's reporting and analysis of fiscal developments and ensures that the UK is fully in line with international best practice, including the International Monetary Fund's *Code of Good Practices on Fiscal Transparency*.

## Fiscal Strategy and Sustainability

Chart 2.2: Public finances in the G7, average 1997-2003

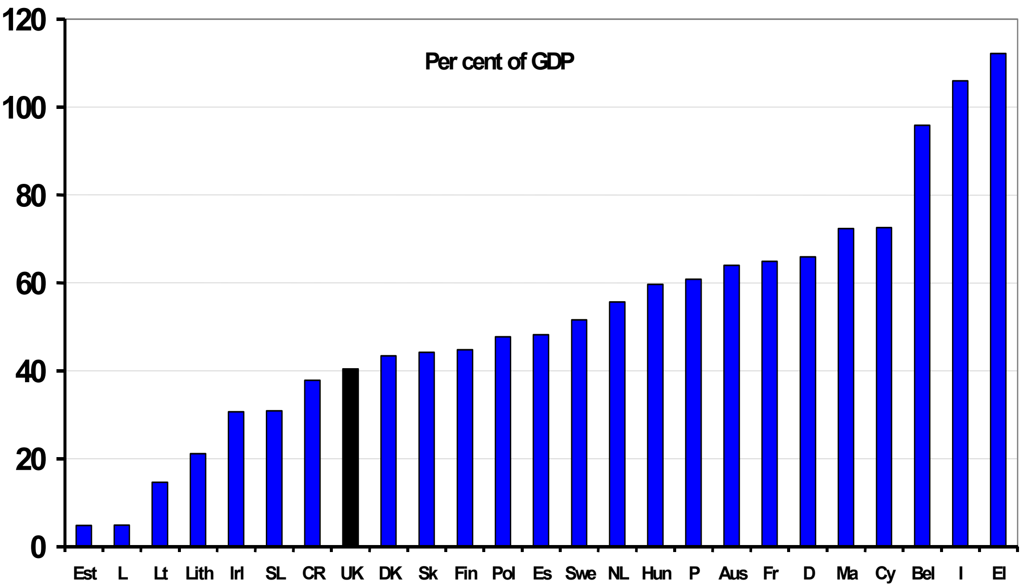



Source: OECD Economic Outlook 75, June 2004

**Sound and sustainable public finances**

2.17 The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by around 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. In more recent years, fiscal policy supported monetary policy as the economy moved below trend: between 2000-01 and 2003-04, the fiscal stance eased by around 3 per cent of GDP. Public sector net debt was also reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.2 shows, since 1997 the UK's public finances have compared favourably with other countries.

Chart 2.3: General government gross debt, 2004



**Fiscal balances**

**2.18** Table 2.2 presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government is meeting its strict fiscal rules over the economic cycle.

**Table 2.2: Summary of public sector finances**

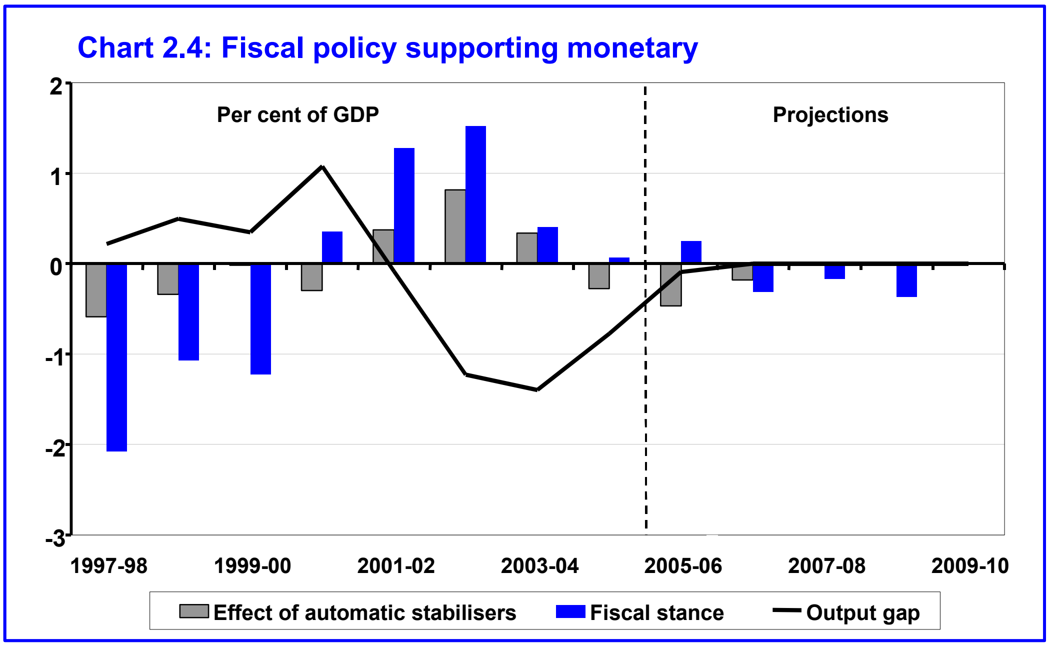
| | Per cent of GDP | | | | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | Estimate | | | Projections | | |
| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
| **Fairness and prudence** | | | | | | | |
| Surplus on current budget | -1.9 | -1.1 | -0.6 | 0.0 | 0.3 | 0.6 | 0.8 |
| Average surplus since 1999-2000 | 0.4 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 |
| Cyclically-adjusted surplus on current budget | -1.0 | -0.4 | -0.4 | 0.1 | 0.3 | 0.6 | 0.8 |
| **Long-term sustainability** | | | | | | | |
| Public sector net debt[1] | 32.9 | 34.3 | 35.4 | 36.2 | 36.8 | 37.0 | 37.1 |
| Core debt [1] | 31.6 | 32.4 | 33.4 | 34.3 | 35.0 | 35.3 | 35.4 |
| Net worth [2] | 22.0 | 19.6 | 17.1 | 16.5 | 15.4 | 15.5 | 14.8 |
| Primary balance | -1.5 | -1.3 | -1.0 | -0.5 | -0.3 | 0.0 | 0.2 |
| **Economic impact** | | | | | | | |
| Net investment | 1.2 | 1.8 | 2.1 | 2.2 | 2.3 | 2.2 | 2.3 |
| Public sector net borrowing (PSNB) | 3.1 | 2.9 | 2.7 | 2.2 | 2.0 | 1.6 | 1.5 |
| Cyclically-adjusted PSNB | 2.2 | 2.2 | 2.5 | 2.2 | 2.0 | 1.6 | 1.5 |
| **Financing** | | | | | | | |
| Central government net cash requirement | 3.5 | 3.4 | 2.9 | 2.5 | 2.1 | 1.7 | 1.8 |
| Public sector net cash requirement | 3.6 | 3.1 | 2.8 | 2.5 | 2.2 | 1.8 | 1.8 |
| **European commitments** | | | | | | | |
| Treaty deficit[3] | 3.1 | 2.8 | 2.7 | 2.2 | 2.0 | 1.6 | 1.5 |
| Cyclically-adjusted Treaty deficit | 2.2 | 2.2 | 2.5 | 2.2 | 2.0 | 1.6 | 1.5 |
| Treaty debt ratio[1,4] | 39.5 | 40.9 | 41.8 | 42.4 | 42.8 | 42.8 | 42.6 |
| *Memo: Output gap* | -1.4 | -0.8 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 |

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

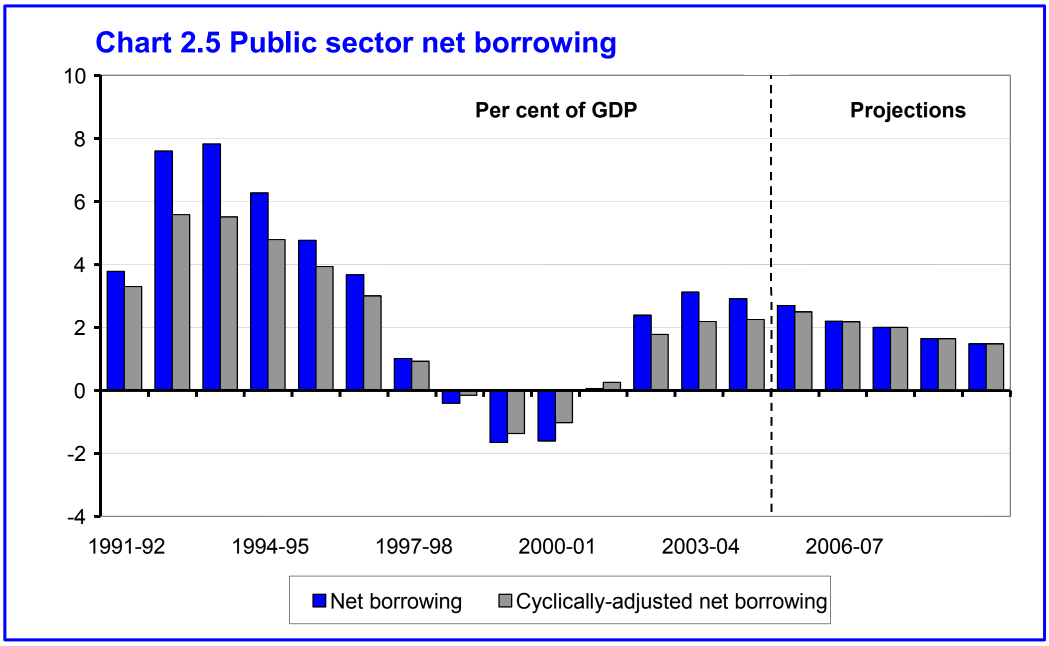
**2.19** The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box 4.2 and *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in the 2004 Pre-Budget Report, showing that the Government is meeting its fiscal rules over the cycle, while maintaining low debt and sustainable public finances, combined with sustainable increases in public sector net investment, are fully consistent with the prudent interpretation of the Pact.

**2.20** While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and play a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.5 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.

**2.21** During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. More recently, fiscal policy has continued to support monetary policy in helping to deliver economic stability, through the automatic stabilisers and an easing of the fiscal stance when the economy moved below trend. Subsequently as the economy returns to trend the overall impact of fiscal policy moves back to a more neutral position.




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




**Forecasts vs Outturns**

**2.23** Table 2.3 provides a summary of comparison of the year-ahead projections for main fiscal aggregates in Budget 2002 and Budget 2003 compared with the latest outturn information. More information is set out in the 2004 *End of year fiscal report.*

**Table 2.3: Fiscal balances**

| Per cent of GDP | 2002-03 | | | 2003-04 | | |
|---|---|---|---|---|---|---|
| | Budget 2002 forecast | Outturn | Difference | Budget 2003 forecast | Outturn | Difference |
| Surplus on current budget | 0.3 | -1.3 | -1.6 | -0.8 | -1.9 | -1.1 |
| *Memo: average absolute difference, current budget, since 1998-99* | | | *1.1* | | | *1.1* |
| Cyclically-adjusted surplus on current budget | 0.5 | -0.7 | -1.2 | 0.2 | -1.0 | -1.1 |
| Public sector net borrowing | 1.1 | 2.4 | 1.3 | 2.5 | 3.1 | 0.7 |
| *Memo: average absolute difference between forecast and outturn net borrowing since 1970-71* | | | *1.2* | | | *1.2* |
| Cyclically-adjusted public sector net borrowing | 0.9 | 1.8 | 0.9 | 1.5 | 2.2 | 0.6 |
| Public sector net debt | 30.2 | 31.5 | 1.4 | 32.2 | 32.9 | 0.7 |

**2.24** A full account of public sector finances is given in Chapter 4. In summary:

- the current budget since the start of the current economic cycle in 1999-2000 show an average surplus up to 2005-06 of 0.1 per cent of GDP, showing the Government is meeting the golden rule on the basis of cautious assumptions. The average annual current surplus from 2005-06 to the end of the forecast period is about ¼ per cent of GDP; and

- public sector net debt is projected to be low and stable over the forecast period stabilising at 37 per cent of GDP, well below the 40 per cent ceiling set in the sustainable investment rule.

## Releasing Resources for High-Quality Public Services

**2.25** The Government's goal is to deliver world class public services, including high-quality education and training, a modern and reliable transport network, and an effective and responsive health service, through sustained investment and reform. World-class public services are central to delivering the Government's objective of building a flexible economy and fair society, well-placed to prosper in the global economy both now and in the future. Efficiency is central to this objective, to allow sustained improvements in performance into the long term. The Government aims to:

- deliver resources to the front line, ensuring that the best value for money is achieved for the taxpayer;

- provide sustained investment in the Government's long-term priorities, to achieve clear, outcome-focused goals for performance; and

- work within long-term planning horizons, set most recently in the 2004 Spending Review, on the basis of sound public finances and a stable economy.

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

**2004 Spending Review**

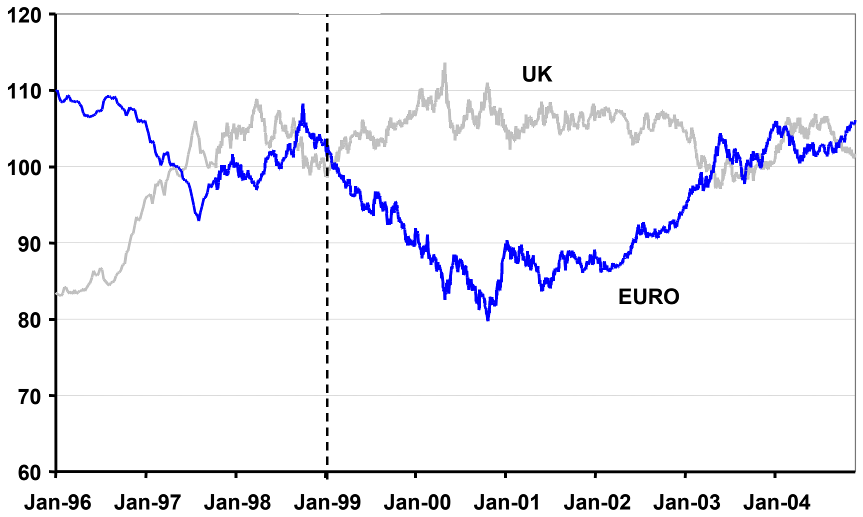
**2.27** In the 2000 and 2002 Spending Reviews, the Government delivered sustained and significant increases in investment in its priorities, while ensuring stability by continuing to meet its strict fiscal rules. The 2004 Spending Review set priority outcome targets in departmental Public Service Agreements (PSAs), alongside spending plans for 2005-06 to 2007-08 that lock in these increases, while providing for further investment in priority public services. The 2004 Spending Review plans provided for:

- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;
- public sector net investment (PSNI) to rise from 2 per cent of GDP to 2¼ per cent by 2007-08, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

## 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 2.6: Sterling and the euro effective exchange rate**




*Source: EcoWin*

**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 monetary and fiscal policy frameworks provide an anchor for achieving greater stability.

**2.30** Since Budget 2004, the sterling effective exchange rate has depreciated by just under 3 per cent. Over a longer period, the effective exchange rate has been relatively stable. The volatility of sterling's effective exchange rate has been around half that of the euro and just over a third of that of the US dollar since 1999.

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

## Economic and Monetary Union

2.32 The Government's policy on membership of the single currency is set out in Box 2.3

### Box 2.3: Government policy on EMU

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

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

The Government is committed to publishing six-monthly reports on trends and progress in increasing flexibility in the UK economy, the third of which is in Annex C of this Programme.

As the Chancellor announced in Budget 2004, "while the Government does not propose a euro assessment be initiated at the time of this Budget, the Treasury will again review progress at Budget time next year".

The Government also remains committed to the European Union's Lisbon strategy on economic reform, launched in March 2000, and will continue to work with Member States and the EU institutions to build on progress so far and to accelerate the pace of reform in order to meet the Lisbon challenge.

## Long-Term Economic Performance

**Flexibility…**

2.33 The Government's economic objective is to build a strong economy and fair society, where there is opportunity and security for all. Reforms which promote flexibility and fairness are central to achieving this goal. Rapid technological progress and strong competition in global markets mean that the profitability and competitiveness of different industries and occupations are continually evolving. A flexible economy responds to such changes in economic conditions efficiently and quickly. Annex C of this Convergence Programme explains the UK Government's approach of combining flexibility with fairness, and the action the Government has taken to boost flexibility in labour, product and capital markets since April Budget 2004 and in the December Pre-Budget Report 2004.

**2.34** A high degree of flexibility minimizes disruptions to output and employment and helps an economy to sustain high rates of productivity growth and employment. Flexible and dynamic markets are therefore a precondition for economic strength. Flexibility is especially important when a country needs to adjust to a country-specific shock within a monetary union, where monetary policy at a national level is not an option. The overall flexibility of the economy depends on the interaction of flexibility in the labour, capital and product markets.

**…and productivity**

**2.35** Many of the important characteristics of a flexible economy are also key drivers of productivity growth. The ability to switch resources readily between firms and industries improves the economy's resilience in adverse market conditions and its capacity to develop and implement the technological advances and organizational changes that raise productivity and wages. The Government's overall strategy for promoting productivity and enterprise in the UK economy, through reforms which boost competition, enterprise, skills, innovation and investment is set out in the Pre-Budget Report.

**Economic Reform in Europe**

**2.36** The Government is continuing to press for changes that will improve the flexibility of the European economy and so enhance its productivity performance. In the past, Europe has sometimes adopted economic strategies that were insufficiently responsive to changing economic circumstances, overly uniform, too insular. The Government believes that the EU needs to be flexible, reforming, open, and globally orientated. In the context of globalisation, it needs to capitalize on the diversity of its economies and the Government will work for further progress at next spring's European Council on economic reform. In particular, Europe must build on Wim Kok's Report on the Mid-Term Review of the Lisbon strategy, using National Action Plans to make specific commitments to further reform.

# 3 Economic Outlook

## The World Economy

**3.1** The global economy has shown considerable strength over the past year, with growth rates comparable to those last seen 20 years ago. World growth during 2004 is estimated to be around 5 per cent – almost double the growth rate of 2001 when a number of the world's major economies suffered a slowdown. The strength of world growth is the result of much improved developments in both advanced and emerging economies. The US, Japan, China and wider Asia have all experienced strong growth, as have some other advanced economies where domestic demand has been strong. Growth in the euro area has improved and is now at around trend rates, although this is still low in comparison with other G7 economies.

**3.2** The recovery in advanced and emerging economies has contributed to a marked pick-up in world trade, from very low growth in 2001, with stronger intra-regional trade in Asia and Europe also contributing to strong growth. Some key economies, particularly Germany, Japan and much of emerging Asia, have been dependent on net exports to support GDP growth. This has led to a continuation of global imbalances, and highlights one of the risks to sustainable and balanced global growth going forward.

**3.3** A number of other risks and uncertainties continue to surround the global economic outlook. High oil prices, household and corporate balance sheet adjustment, the need for fiscal consolidation in a number of countries and the possibility that inflationary pressures could build, present downside risks. These factors can influence growth directly, for example by lowering profit margins and household disposable income, and can also have secondary effects through confidence channels with a potentially larger impact on growth. On the upside, oil prices could decline more rapidly than expected and orderly monetary and fiscal adjustment could boost confidence, which would tend to strengthen growth.

**3.4** High and rising oil prices reflect the combined effects of a number of supply uncertainties, low stocks and rapidly rising demand. Whilst higher oil prices appear to have had some dampening effect on economic activity since the middle of 2004, the strength of world demand that has contributed to pushing up prices has remained robust.

## Prospects for UK Economic Growth

**GDP growth**

**3.5** During the global economic downturn that began in 2000, the Government's macroeconomic framework allowed the UK economy to remain resilient against the challenges and uncertainties arising from prolonged international weakness. In contrast to previous world slowdowns, low inflation and sound public finances allowed UK macroeconomic policy to respond swiftly to support output in the face of the significant weakening in global growth. The UK was the only G7 economy to avoid any quarters of negative growth between 2001 and 2003. The UK continues to experience its longest unbroken expansion since the introduction of quarterly national accounts data 50 years ago, with GDP now having grown for 49 consecutive quarters.

**3.6** UK GDP growth began to pick up sharply during the second quarter of 2003, as some of the previous major international uncertainties diminished and recovery in the world economy became more firmly entrenched. Business and consumer confidence rose from their early 2003 lows and, with UK domestic macroeconomic fundamentals remaining sound, rising confidence quickly translated into a pick-up in domestic demand growth in the second half of last year. Final domestic demand grew at its strongest rate for five years in the first quarter of 2004, at 1.2 per cent on the quarter, but has since moderated a little.

**3.7** In 2003 as a whole UK GDP rose 2.2 per cent, somewhat below its estimated trend rate. However, annual growth had already moved above trend by the final quarter of 2003, for the first time in three years, and it continued at above trend rates through the first half of 2004. GDP growth of 0.9 per cent in the third quarter of 2003 was followed by 1.0 per cent in the final quarter, 0.7 per cent in the first quarter of 2004 and 0.9 per cent in the second.

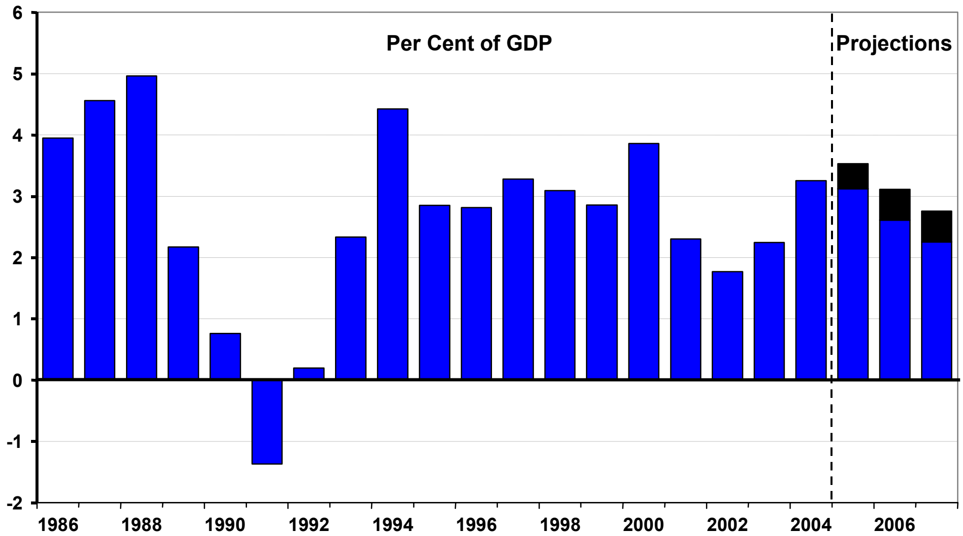
**3.8** Latest data suggest that growth in the economy eased in the third quarter of 2004 compared with the first half of the year, with GDP currently estimated to have risen by 0.4 per cent between the second and third quarters, though non-oil Gross Value Added (GVA) was up 0.5 per cent. The GDP reading appears to have been erratically low, with underlying growth considerably stronger.

**Economic cycle and the output gap**

**3.9** The Treasury's neutral estimate of the economy's trend rate of output growth for the 2004 Pre-Budget Report is 2¾ per cent a year to the end of 2006 and 2½ per cent from early 2007 onwards, unchanged from Budget 2004 and first introduced in Budget 2002. In light of recent output data, the trend growth assumption implies a negative output gap in the third quarter of 2004 at around 1 per cent of non-oil GVA.

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

**Chart 3.1: Gross Domestic Product**




Note: Shaded areas on bars represent forecast ranges

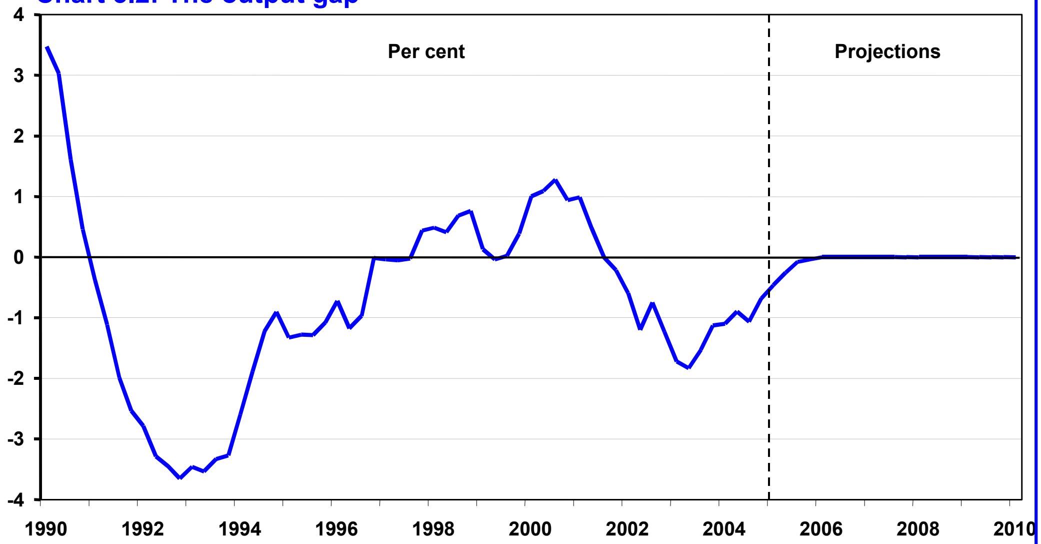
**Inflation** **3.11** Consumer Prices Index (CPI) inflation remains low. Over the past year, it has averaged 1.3 per cent, below the Government's symmetrical 2 per cent target. UK inflation remains among the lowest of all 25 EU countries. Recent inflation outturns reflect a variety of factors, with downward contributions more than offsetting a number of upward influence.

**3.12** CPI inflation is expected to rise gradually back to target by mid-2006, as upward pressure from import prices feeds through. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

### Table 3.1: Summary of UK forecast

| | Outturn | Forecast | | | |
|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 |
| GDP growth (per cent) | 2¼ | 3¼ | 3 to 3½ | 2½ to 3 | 2¼ to 2¾ |
| CPI inflation (per cent, Q4) | 1½ | 1¼ | 1¾ | 2 | 2 |

### Chart 3.2: The output gap[1]




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

## Employment

**Employment** **3.13** The labour market has remained robust in 2004, building further on the achievements of the Government's supply-side reforms in creating a more dynamic and flexible labour market. In the year to the third quarter, employment rose by just over 230,000. Although the employment rate has come down fractionally from its recent peak earlier in 2004, this reflects the population of working age rising a little faster than employment.

**Unemployment** **3.14** Unemployment, measured on the International Labour Organisation (ILO) definition, declined by just under 110,000 in the year to the third quarter, with the rate falling to 4.6 per cent – the lowest among the G7 economies. Claimant unemployment has also continued to trend down, albeit a little more slowly than ILO unemployment, and stood at 2.7 per cent in October, 0.3 percentage points lower than a year earlier. Claimant unemployment has now been consistently below 1 million for over three and a half years.

## Consumption

**3.15** Real private consumption has grown broadly in line with the expansion of the economy as a whole over the recent past. It increased by almost 3 per cent in the year to the third quarter of 2004, supported by continued domestic macroeconomic stability with low inflation and further strong labour market outcomes. The four-quarter growth rate has averaged just under 3 per cent for the past year, in line with its post-2000 average and only marginally above the estimated trend rate of growth of the economy. In contrast, over the five years up to 2000, real private consumption had grown at an unsustainable average rate of over 4 per cent a year. Further evidence of the sustainability of recent rates of real private consumption growth is given by the declining share of *nominal* consumption in *money* GDP since 2001, with falling relative consumer prices providing significant support for real growth in spending. Although, the household saving ratio has recently moved slightly above its average since the late 1990s, over this period it has essentially been broadly flat, reflecting consumption on average growing in line with disposable income.

**3.16** With household debt still at historically high levels, households are expected to continue to be reluctant to increase spending at a faster rate than income. Recent interest rate increases and weaker growth in house prices may also act as further constraining factors on consumer spending growth. Private consumption is expected to rise by 3¼ per cent this year, broadly in line with GDP growth for the year. Thereafter, private consumption growth is forecast to be below GDP growth.

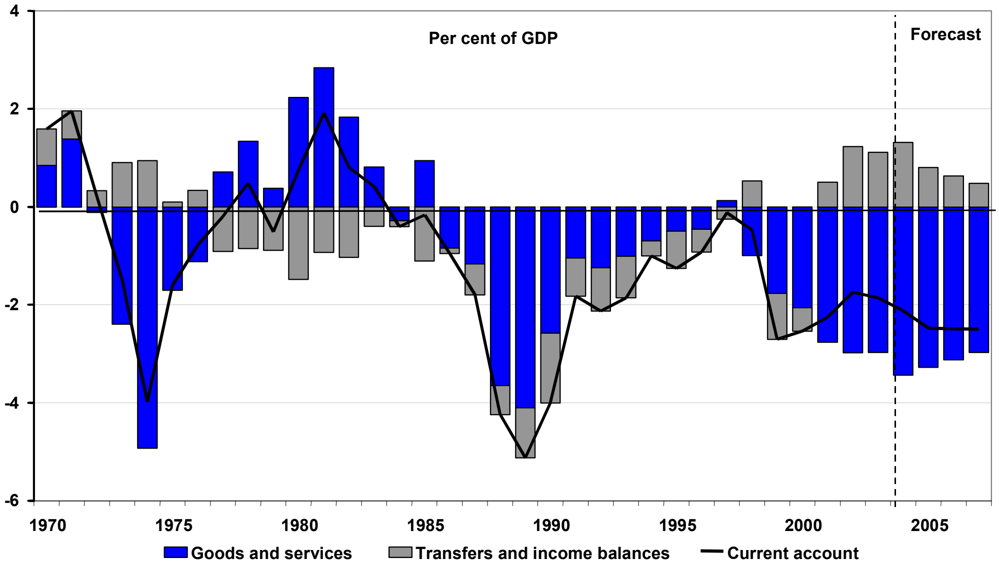
## Investment

**3.17** Investment has strengthened significantly since early 2003, spurred by faster growth in government investment, continued strong growth in investment in private dwellings, and a marked upturn in business investment following what latest data show to have been a relatively shallow decline in the face of weakness in the world economy. With global conditions having strengthened, business confidence has risen compared with early 2003, and capital expenditure has followed suit. At the same time, private non-financial corporations have strengthened their balance sheets, becoming strong net lenders over the past two years, notwithstanding the stronger investment. Business investment has now grown for six consecutive quarters, and has clearly recovered from the effects of world economic weakness between 2001 and 2003.

**3.18** Business investment is expected to rise by 5¾ per cent in 2004. With profitability and corporate balance sheets having strengthened considerably, and demand still judged to be growing strongly, business investment is expected to continue to grow solidly over the forecast horizon, albeit at a slightly slower rate than this year. It is forecast to rise by 4½ to 5 per cent in 2005 and by 3½ to 4¼ per cent in 2006.

## Trade and the Balance of Payments

**Chart 3.3: Balance of payments current account**




**3.19** Export growth is forecast to gather more momentum in coming quarters as the recent pick-up in external demand continues to filter through to UK exports. Moreover, the sterling Exchange Rate Index has depreciated since the summer, largely due to a softening in the pound's value against the euro. This should provide some additional impetus to export growth over the forecast horizon. Goods and services export volumes are forecast to rise by 6 ½ to 7 per cent next year, building on growth of around 2¼ per cent this year and following two years when exports were more or less flat.

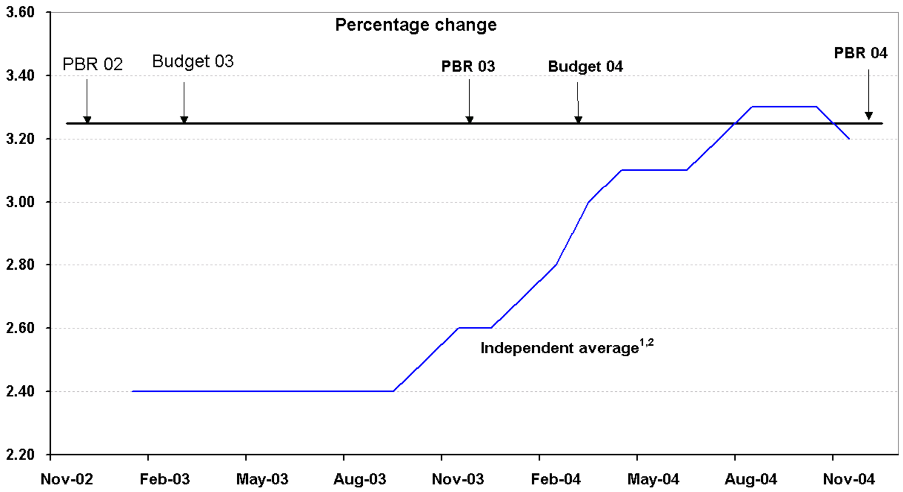
## Independent forecasts

**3.20** The 2004 Pre-Budget Report forecast for GDP growth in 2004 of 3 ¼ per cent is at the centre of the forecast range of 3 to 3 ½ per cent that has been maintained unchanged since it was first published as a two-year ahead forecast in the 2002 Pre-Budget Report. In contrast, the average of independent forecasts for GDP growth in 2004 (which was not fully canvassed until early 2003) was 2.4 per cent at the time of Budget 2003, rising progressively after the summer to 2.6 per cent by the time of Pre-Budget Report 2003 and 3.0 per cent by the time of Budget 2004. Subsequently the independent average for 2004 has increased further, and in November stood at 3.2 per cent, exactly in the middle of the 3 to 3 ½ per cent range. The Treasury's recent economic forecasting performance is discussed in Box 3.1.

### Box 3.1: Recent economic forecasting performance

As was the case at the time of Budget 2004, the Pre-Budget Report forecast for UK GDP growth in 2005 is higher than the latest external consensus, as presented in HM Treasury's comparison of independent forecasts.

**HM Treasury and independent average GDP forecasts for 2004**




[1] *Forecasts for the UK economy: A comparison of independent forecasts*, HM Treasury
[2] *The average of independent forecasts for 2004 was not fully canvassed until January 2003*

This is not the first time in recent years that Treasury forecasts have been above the prevailing consensus for a prolonged period. As discussed elsewhere in this annex, at the time of Budget 2003, the Treasury's GDP growth forecast for 2004 – at 3 to 3½ per cent –was significantly above the independent average but outside forecasters have subsequently converged on the Treasury's projection, as shown in the chart. Moreover, during the Asian and emerging markets crisis of the late 1990s, outside forecasters took a more pessimistic view of UK prospects at the time of Budget 1999: the independent average for GDP growth in that year was 0.6 per cent, compared with the Budget forecast range of 1 to 1½ per cent. In the event, the Treasury's projection proved closer to the actual outturn for the year, although both Treasury and outside forecasts proved too pessimistic, with subsequent data revisions for 1999 now showing GDP growth of 2.9 per cent.

More generally, the Treasury's recent forecasting record has been relatively good. Analysis of forecast errors for current and year-ahead forecasts made since 1995 indicates that Treasury forecasts have on average outperformed the independent consensus. However, both HM Treasury and the independent forecast have tended to under-predict GDP growth more often than they have over-predicted it in recent years.

# Summary of Economic Prospects

## Table 3.2: Summary of economic prospects [1,2,3]

| | | | | | | |
|---|---|---|---|---|---|---|
| | Percentage changes on a year earlier unless otherwise stated | | | | | |
| | | Forecast[4] | | | | Average errors from past forecasts[5] |
| | 2003 | 2004 | 2005 | 2006 | 2007 | |
| **Output at constant market prices** | | | | | | |
| Gross domestic product (GDP) | 2¼ | 3¼ | 3 to 3½ | 2½ to 3 | 2¼ to 2¾ | ¾ |
| Manufacturing output | ½ | 1¼ | 1¼ to 1¾ | 1¾ to 2¼ | 1¾ to 2¼ | 1¾ |
| **Expenditure components of GDP at constant market prices** | | | | | | |
| Domestic demand | 2½ | 4 | 3 to 3½ | 2½ to 3 | 2¼ to 2¾ | ¾ |
| Household consumption[6] | 2¼ | 3¼ | 2¼ to 2¾ | 2 to 2½ | 2 to 2½ | ¾ |
| General government consumption | 3½ | 4½ | 3 | 3 | 2½ | 1 |
| Fixed investment | 2¼ | 6½ | 6¾ to 7¼ | 3¼ to 3¾ | 2¾ to 3¼ | 2¼ |
| Change in inventories[7] | 0 | 0 | 0 | 0 to ¼ | 0 | ¼ |
| Exports of goods and services | 0 | 2¼ | 6½ to 7 | 6¼ to 6¾ | 6¼ to 6¾ | 2½ |
| Imports of goods and services | 1¼ | 4¾ | 6 to 6¼ | 5¼ to 5¾ | 5¼ to 5¾ | 2¼ |
| **Balance of payments current account** | | | | | | |
| £ billion | -20½ | -24¾ | -30¼ | -31¾ | -33¼ | 9 |
| per cent of GDP | -1¾ | -2¼ | -2½ | -2½ | -2½ | ¾ |
| **Inflation** | | | | | | |
| CPI (Q4) | 1½ | 1¼ | 1¾ | 2 | 2 | - |
| Producer output prices (Q4)[8] | 1½ | 3½ | 2½ | 2 | 2 | 1½ |
| GDP deflator at market prices | 3 | 2¼ | 2½ | 2¾ | 2¾ | ¾ |
| **Money GDP at market prices** | | | | | | |
| £ billion | 1100 | 1161.00 | 1226 to 1231 | 1292 to 1303 | 1356 to 1376 | 8 |
| percentage change | 5¼ | 5½ | 5¾ to 6 | 5¼ to 5¾ | 5 to 5½ | ¾ |

*[1] The forecast is consistent with the national accounts and balance of payments statisitcs to the second quarter of 2004, released by the Office for National Statistics on 29 September 2004, and output, income and expenditure data to the third quarter released on 26 November 2004.*

*[2] All growth rates in tables throughout this chapter are rounded to the nearest 1/4 percentage point.*

*[3] The economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of 2 1/2 per cent a year trend growth used as the basis for projecting the public finances.*

*[4] The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

*[5] Average absolute errors for year-ahead projections made in autumn forecasts over the past ten years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2004 and 2005.*

*[6] Includes households and non-profit institutions serving households.*

*[7] Contribution to GDP growth, percentage points.*

*[8] Excluding excise duties.*

# 4 OUTLOOK FOR THE PUBLIC FINANCES

**4.1** Over the past seven and a half years, the Government has laid the foundations for long-term economic stability. Extensive reforms to the frameworks for monetary and fiscal policy have established a platform of stability with low inflation, low interest rates, low unemployment and sound and sustainable public finances, as discussed in Chapter 2. This section sets out projections for the public finances, which continue to be based on prudent and cautious assumptions.

**4.2** Table 4.1 shows six-year projections for the current budget and public sector net debt, the key aggregates for assessing the Government's performance against its golden rule and sustainable investment rule respectively. Outturns and projections of other important measures of the public finances, including net borrowing, both in actual and cyclically-adjusted terms, and debt, are also shown.

### Table 4.1: Summary of public sector finances

| | Per cent of GDP | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Outturns | | Estimate | | | Projections | | |
| | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
| **Fairness and prudence** | | | | | | | | |
| Surplus on current budget | -1.3 | -1.9 | -1.1 | -0.6 | 0.0 | 0.3 | 0.6 | 0.8 |
| Average surplus since 1999-2000 | 1.0 | 0.4 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 |
| Cyclically-adjusted surplus on current budget | -0.7 | -1.0 | -0.4 | -0.4 | 0.1 | 0.3 | 0.6 | 0.8 |
| **Long-term sustainability** | | | | | | | | |
| Public sector net debt [1] | 31.5 | 32.9 | 34.3 | 35.4 | 36.2 | 36.8 | 37.0 | 37.1 |
| Core debt [1] | 31.1 | 31.6 | 32.4 | 33.4 | 34.3 | 35.0 | 35.3 | 35.4 |
| Net worth [2] | 24.2 | 22.0 | 19.6 | 17.1 | 16.5 | 15.4 | 15.5 | 14.8 |
| Primary balance | -0.8 | -1.5 | -1.3 | -1.0 | -0.5 | -0.3 | 0.0 | 0.2 |
| **Economic impact** | | | | | | | | |
| Net investment | 1.1 | 1.2 | 1.8 | 2.1 | 2.2 | 2.3 | 2.2 | 2.3 |
| Public sector net borrowing (PSNB) | 2.4 | 3.1 | 2.9 | 2.7 | 2.2 | 2.0 | 1.6 | 1.5 |
| Cyclically-adjusted PSNB | 1.8 | 2.2 | 2.2 | 2.5 | 2.2 | 2.0 | 1.6 | 1.5 |
| **Financing** | | | | | | | | |
| Central government net cash requirement | 2.1 | 3.5 | 3.4 | 2.9 | 2.5 | 2.1 | 1.7 | 1.8 |
| Public sector net cash requirement | 2.3 | 3.6 | 3.1 | 2.8 | 2.5 | 2.2 | 1.8 | 1.8 |
| **European commitments** | | | | | | | | |
| *Treaty deficit* [3] | 2.2 | 3.1 | 2.8 | 2.7 | 2.2 | 2.0 | 1.6 | 1.5 |
| *Cyclically-adjusted Treaty deficit* [3] | 1.6 | 2.2 | 2.2 | 2.5 | 2.2 | 2.0 | 1.6 | 1.5 |
| *Treaty debt ratio* [4] | 37.8 | 39.5 | 40.9 | 41.8 | 42.4 | 42.8 | 42.8 | 42.6 |
| *Memo: Output gap* | *-1.2* | *-1.4* | *-0.8* | *-0.1* | *0.0* | *0.0* | *0.0* | *0.0* |

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

## Meeting the Fiscal Rules

**Golden rule**

**4.3** The surplus on the current budget represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of inter-generational fairness.

**4.4** The average surplus on the current budget since 1999-2000, which on the Government's provisional judgment is the start of the current cycle, is positive in every year of the projection period. The economy is projected to return to trend by early 2006, meaning that over the whole cycle the average surplus on the current budget would be 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £8 billion in this cycle, including the AME margin.

**Box 4.1: Measuring the golden rule**

The golden rule will be met if the average annual surplus on the current budget expressed as a ratio to GDP, measured from the year in which the economic cycle begins up to and including the year in which the economic cycle ends, is in balance or surplus [a]. This is shown in Table 4.1, which reports the average surplus since the beginning of the cycle, rounded to one decimal place. When the economic cycle has been judged to have finished, it will be this measure that is used to determine whether the golden rule has been met.

The rationale for the Government's fiscal rules and their measurement is discussed in detail in Chapter 9 of Reforming Britain's economic and financial policy [b]. The golden rule helps to promote intergenerational fairness and is fully consistent with the Government's objective of sustainable public finances.

The margin against the golden rule shows the amount by which receipts can be lower than projected or spending higher than projected over the remainder of the economic cycle and the Government continue to meet the golden rule. The margin against the golden rule includes the AME margin, which is a safety margin within Total Managed Expenditure (TME) to guard against unexpected events. Any AME Margin that remains unspent at the end of the year will add to the current surplus.

a This measure has been used since the beginning of the framework: Budget 1997 used this measure when commenting on the golden rule over the then most recently completed economic cycle; the Economic and Fiscal Strategy Report 1998, which adopted the current format for the presentation of the public finances that corresponds more closely to the fiscal rules, included the average annual surplus on the current budget as a ratio to GDP since the beginning of the cycle; and Budget 2000 reported on performance against the golden rule over the short economic cycle that ran from 1997-98 to 1999-2000 using this measure.
b Balls and O'Donnell (eds.), 2002.

**4.5** With the economy assumed to be on trend from early 2006 onwards the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2009-10 is ¼ per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule after the end of this economic cycle.

**Sustainable investment rule**

**4.6** The sustainable investment rule is also comfortably met over the projection period. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and spending taken by the Government, including the decision to use the proceeds from the auction of spectrum licenses to repay debt, reduced net debt to around 30 per cent of GDP by the end of 2001-02. Net debt is expected to remain low and stable, stabilising at around 37 per cent by the end of the projection period. Therefore, the Government comfortably meets its sustainable investment rule.

a
b

**4.7** Core debt is projected to rise to around 35½ per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. Core debt excludes the estimated impact of the economic cycle on public sector net debt. This is consistent with the fiscal rules, and with the key objective of intergenerational fairness that underpins the fiscal framework.

**EU commitments**

**4.8** Table 4.1 shows that the Pre-Budget Report projections meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period. The projections are consistent with the Government's prudent interpretation of the Stability and Growth Pact (see Box 4.2), which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty).

**4.9** With net debt forecast to stabilise at 37 per cent in 2009/10, and general government gross debt forecast to stabilise at 43 per cent (one of the lowest debt levels in the EU) by 2009/10, the Government is demonstrating its continued commitment to long-term sustainability. In keeping with the 2004 Broad Economic Policy Guidelines, the projections contained in Table 4.1 also demonstrate the Government's commitment to address the historical under-investment in public services in the UK. Public investment rises to 2¼ per cent of GDP by the end of the period. Nominal general government net borrowing, on the Treaty definition, is projected to continue to fall from 2.8 per cent in 2004-05 to 2.7 per cent in 2005-06 to 1.5 per cent by 2009/10. In cyclically-adjusted terms, general government net borrowing will be 2.2 per cent in 2004-05 falling to 1.5 per cent by 2009/10. Taking into account borrowing for investment as specified in the EU Treaty, this is consistent with meeting a budgetary position of close to balance or in surplus over the medium term.

**Current and capital budgets**

**4.10** Table 4.2 provides more detail on the projections for the current and capital budgets for the public sector.

**Table 4.2: Current and capital budgets**

| | | | | Per cent of GDP | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | Estimate | | | Projections | | |
| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
| **Current budget** | | | | | | | |
| Current receipts | 37.5 | 38.3 | 39.2 | 39.8 | 40.2 | 40.4 | 40.5 |
| Current expenditure | 38.1 | 38.1 | 38.5 | 38.4 | 38.6 | 38.5 | 38.4 |
| Depreciation | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| **Surplus on current budget** | **-1.9** | **-1.1** | **-0.6** | **0.0** | **0.3** | **0.6** | **0.8** |
| **Capital budget** | | | | | | | |
| Gross investment | 3.0 | 3.6 | 3.8 | 3.8 | 3.8 | 3.8 | 3.6 |
| *Less asset sales* | -0.5 | -0.5 | -0.4 | -0.3 | -0.3 | -0.3 | 0.0 |
| *Less depreciation* | -1.3 | -1.3 | -1.3 | -1.3 | -1.3 | -1.3 | -1.3 |
| Net investment | 1.2 | 1.8 | 2.1 | 2.2 | 2.3 | 2.2 | 2.3 |
| **Net borrowing** | **3.1** | **2.9** | **2.7** | **2.2** | **2.0** | **1.6** | **1.5** |
| *Memos:* | | | | | | | |
| Treat deficit[1] | 3.1 | 2.8 | 2.7 | 2.2 | 2.0 | 1.6 | 1.5 |
| Treaty debt ratio[2] | 39.5 | 40.9 | 41.8 | 42.4 | 42.8 | 42.8 | 42.6 |

[1] *General government net borrowing on a Maastricht basis*

[2] *General government gross debt on a Maastricht basis.*

## Economic Assumptions

**4.11** The main economic assumptions are summarised in Table 4.3.

### Table 4.3: Economic assumptions for the public finance projections

| | Percentage changes on previous year | | | | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | Estimate | Projections | | | | |
| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
| Output (GDP) | 2¾ | 3¼ | 3 | 2½ | 2¼ | 2¼ | 2¼ |
| Prices | | | | | | | |
| CPI | 1¼ | 1¼ | 1¾ | 2 | 2 | 2 | 2 |
| GDP deflator | 2¾ | 2¼ | 2½ | 2¾ | 2¾ | 2¾ | 2¾ |
| RPI[1] (September) | 3 | 3 | 2¼ | 2½ | 2¾ | 2¾ | 2¾ |
| Rossi[2] (September) | 2 | 1¼ | 2¼ | 2½ | 2¼ | 2¼ | 2¼ |
| Money GDP[3] (£ billion) | 1116 | 1176 | 1243 | 1308 | 1373 | 1440 | 1511 |

[1] *Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.*
[2] *RPI excluding housing costs, used for uprating certain social security benefits.*
[3] *Not seasonally adjusted.*

**4.12** As detailed in Box 4.2, a number of key assumptions that underpin the public finance projections are audited by the Comptroller and Auditor General under a three-year rolling review to ensure that they remain reasonable and cautious. This prudent approach to fiscal policy builds in a safety margin against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in taxation or spending.

**Box 4.2: Key assumptions audited by the NAO**

| | |
|---|---|
| • Privatisation proceeds | Credit is taken only for proceeds from sales that have been announced. |
| • Trend GDP growth | 2½ per cent a year to 2006-07 and 2¼ per cent in subsequent years. |
| • UK claimant unemployment | Rising slowly to 0.89 million in 2007-08, from recent levels of 0.84 million. |
| • Interest rates | 3-month market rates change in line with market expectations (as of 19 November). |
| • Equity prices [b] | FTSE All-Share index rises from 2,389 (close 18 November) in line with money GDP. |
| • VAT [b,c] | The VAT gap will rise by 0.5 percentage points per year from a level that is at least as high as the estimated outturn for the current year. |
| • Consistency of price indicies [b] | Projections of price indices used to project the public finances are consistent with CPI. |
| • Composition of GDP [c] | Shares of labour income and profits in national income are broadly constant in the medium term. |
| • Funding [c] | Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy. |
| • Oil prices | $38.2 a barrel in 2005, the average of independent forecasts, and then constant in real terms. |
| • Tobacco | The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. A share of 14.5 per cent, in line with the latest outturn for 2003-04, is used for 2005-06 onwards. |

*a For details of all NAO audits before the 2003 Pre-Budget Report, see Budget 2003, 9 April 2003 (HC500).*

*b Audit of Assumptions for the 2003 Pre-Budget Report, 10 December 2003 (HC35).*

*c Audit of Assumptions for the 2004 Budget, 17 March 2004 (HC434).*

## Forecast Differences and Risks

**4.13** The fiscal balances represent the difference between large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been around 1 per cent of GDP. These tend to grow as the forecast horizon lengthens. A full account of differences between the projections made in Budget 2002 and Budget 2003 and the subsequent outturns is provided in the *End of year fiscal report.*

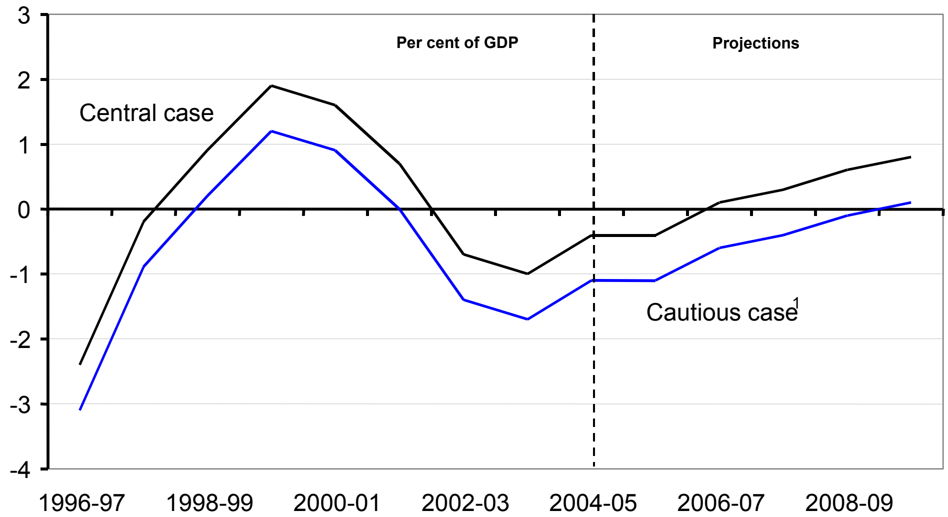
**The economic outlook**

**4.14** As detailed in Chapter 3, UK GDP growth began to pick up sharply during the second quarter of 2003, as some of the previous major international uncertainties diminished, and recovery in the world economy became more firmly entrenched. Sound macroeconomic fundamentals, recent underlying growth at above trend rates, and continued strong growth in the world economy point to a further period of robust growth in demand for UK output. On the supply side, evidence of remaining slack in the economy supports the judgement that the economy has the potential for a period of further above trend growth in the short term, without risking inflationary pressures.

**4.15** However, although the overall shape of the economic forecast is broadly unchanged from Budget time, the configuration of the surrounding risks and uncertainties has changed. In particular, high oil prices – if sustained – would tend to dampen growth, though to the extent that they partly reflect strong global demand rather than supply-side or risk premia shocks there are likely to be offsetting effects. Global developments remain an influence on the UK outlook, and challenging judgements will continue to be faced in setting monetary and fiscal policy. In the UK forecast, as has been the case in 2004, business investment could continue to surprise on the upside, and there may be headroom for stronger consumer spending.

**4.16** Chart 4.1 illustrates the Pre-Budget Report projection for the cautious case explained in Box 2.2.

**Chart 4.1: Cyclically adjusted surplus on current budget**




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

## General Government Finances

**4.17** Table 4.4 gives a breakdown of general government finances.

## Table 4.4: General government finances

| | Per cent of GDP | | | | |
|---|---|---|---|---|---|
| | Outturn | Estimate | Projections | | |
| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
| Total current receipts | 37.4 | 38.1 | 39.0 | 39.5 | 40.0 |
| Total current expenditure | 38.1 | 38.1 | 38.5 | 38.4 | 38.6 |
| Depreciation | 0.9 | 1.0 | 1.0 | 1.0 | 1.0 |
| **Surplus on current budget** | **-1.7** | **-1.0** | **-0.5** | **0.1** | **0.3** |
| Net investment | 1.4 | 1.9 | 2.2 | 2.4 | 2.4 |
| **Net borrowing [1]** | **3.1** | **2.9** | **2.7** | **2.2** | **2.0** |
| Net interest payments | 1.2 | 1.1 | 1.1 | 1.1 | 1.1 |
| **Primary balance** | **-2.0** | **-1.8** | **-1.6** | **-1.1** | **-0.9** |
| *Current receipts* | | | | | |
| Taxes on income and wealth | 13.0 | 13.8 | 14.5 | 15.1 | 15.4 |
| Taxes on production and imports | 13.3 | 13.3 | 13.4 | 13.3 | 13.3 |
| Other current taxes | 2.1 | 2.0 | 2.1 | 2.1 | 2.2 |
| Taxes on capital | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 |
| Social contributions | 6.7 | 6.6 | 6.7 | 6.7 | 6.8 |
| Interest income | 0.9 | 1.0 | 0.9 | 0.9 | 0.9 |
| Other | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 |
| **Total current receipts** | **37.4** | **38.1** | **39.0** | **39.5** | **40.0** |
| *Current expenditure* | | | | | |
| Current expenditure on goods and services | 20.9 | 21.1 | 21.2 | 21.5 | 21.8 |
| Net social benefits | 12.1 | 12.4 | 12.2 | 11.9 | 11.8 |
| Net current grants | 2.5 | 2.1 | 2.3 | 2.3 | 2.3 |
| Interest and dividends paid | 2.0 | 2.1 | 2.1 | 2.1 | 2.0 |
| Subsidies | 0.7 | 0.5 | 0.5 | 0.5 | 0.5 |
| AME margin | 0.0 | 0.0 | 0.2 | 0.1 | 0.2 |
| **Total current expenditure** | **38.1** | **38.1** | **38.5** | **38.4** | **38.6** |
| *Capital expenditure* | | | | | |
| Gross domestic fixed capital formation | 1.6 | 1.9 | 2.2 | 2.3 | 2.4 |
| Other capital expenditure | -0.2 | 0.0 | 0.0 | 0.0 | -0.1 |
| **Net investment** | **1.4** | **1.9** | **2.2** | **2.4** | 2.4 |
| **Total expenditure** | **39.5** | **40.0** | **40.7** | **40.8** | **41.0** |

*[1] Although this is based on the ESA95 definition of general government net borrowing (GGNB), the forecasts are identical to GGNB calculated on a Maastrict definition.*

## Receipts

**4.18** The latest projections for general government receipts, contained in the Pre-Budget Report, are shown in Table 4.4.

**4.18** The forecast for public sector current receipts for 2004-05 has been revised down by £3.7 billion since Budget 2004. However about £1½ billion of this change is due to the fiscally neutral reclassification of NHS trusts from the public corporation sector to central government. Current receipts remain lower throughout the forecast, although the shortfall in receipts relative to Budget 2004 gradually diminishes. Table 4.5 breaks down the causes of these revisions between economic assumptions audited by the NAO, other economic determinants, fiscal forecasting changes, and other factors.

## Table 4.5: Changes in current receipts since Budget 2004

| | Estimate 2004-05 | 2005-06 | 2006-07 | Projections 2007-08 | 2008-09 |
|---|---|---|---|---|---|
| Effect on receipts of non-discretionary changes in: | | | | | |
| Assumptions audited by the NAO | 1½ | 2 | 2 | 1½ | 1½ |
| *of which:* | | | | | |
| Oil price | 1½ | 2 | 2 | 2 | 2 |
| Other economic determinants | ½ | -1 | -1 | -½ | -½ |
| Fiscal forecasting changes | -4 | -2½ | -1½ | -1½ | -1½ |
| Other | -1½ | -1 | -1 | -1 | -1 |
| **Total before discretionary changes [1]** | **-3½** | **-3** | **-2** | **-1** | **-1½** |
| Discretionary changes | 0 | 0 | ½ | ½ | ½ |
| **Total change [1]** | **-3½** | **-3** | **-1½** | **-½** | **-½** |

[1] *Total may not sum due to rounding.*

**4.19** Changes in economic determinants audited by the NAO increase public sector receipts by between £1½ billion and £2 billion from 2004-05 onwards. The main impact from the NAO assumptions is through the higher oil price. Oil prices are expected to average $38.2 a barrel in 2005, around $10 higher than assumed in Budget 2004. Only the direct effect of this increase on North Sea corporation tax and petroleum revenue tax is included in this category. The overall effect on the public finances is likely to be limited due to a number of offsetting effects from higher oil prices on fuel duties, inflation and the wider economy. In particular higher pump prices are expected to reduce demand for road fuel and lead to a reduction in fuel duties of around £½ billion a year in fuel duties. This is included in other economic determinants here.

**4.20** Considering other economic determinants for 2005-06 onwards, changes to current price GDP components have a small downward effect on receipts over the forecast period mainly due to slower growth in the GDP components that are used to project the VAT tax base, including modestly lower growth in nominal consumer expenditure.

**4.21** Fiscal forecasting differences include all changes to corporation tax other than those directly applicable to GDP receipts.

**4.22** Other factors include reclassifications in the 2004 Blue Book, the ONS reclassified NHS Trusts to the central government sector rather than public corporations. This classification change has no effect on the public sector as a whole, but it does reduce the public sector gross operating surplus and VAT refunds. This has the effect of reducing both receipts and expenditure by around £1½ billion each year and is included in the other category in Table 4.5.

## Expenditure

**4.23** The spending projections cover the whole of the public sector, using the national accounts aggregate Total Managed Expenditure (TME). For fiscal aggregates purposes, TME is split into national accounts components covering public sector current expenditure, public sector net investment and depreciation. For budgeting and other purposes, TME is split into Departmental Expenditure Limits (DEL) firm three year limits for departments' programme expenditure – and Annually Managed Expenditure (AME) – expenditure that is not easily subject to firm multi-year limits.

**4.24** Expenditure items that are large, potentially volatile and demand-led – such as social security benefits and debt interest payments – are collectively known as Annually Managed Expenditure (AME). These items are subject to tough scrutiny twice a year as part of the Budget and Pre-Budget Report process to ensure that volatility in AME does not threaten fiscal stability. The Government recognizes the uncertainties in planning public expenditure, allows for this through the DEL reserve and AME margin and remains vigilant to pressures and risks. Taken together, DEL and AME add up to Total Managed Expenditure (TME), the broadest measure of total public expenditure.

**Projections**

**4.25** The latest projections for general government expenditure, contained in the Pre-Budget Report, are included in Table 4.4. As shown in Chapter 2, the Government's spending plans are fully consistent with meeting its strict fiscal rules.

**4.26** Since 11 September 2001, the Government has given increased priority to improving the UK's ability to respond to the terrorist threat. In total, annual spending on counterterrorism and resilience across departments will be over £2 billion in 2007-08, compared with £1.5 billion in 2004-05 and less than £1 billion before 11 September 2001. Since the Spending Review, the Government has allocated, in total, a further £105 million to this priority: to the Office of the Deputy Prime Minister for civil resilience; for counter-terrorism measures in the Home Office; and to strengthen HM Customs and Excise's work on improving security at ports.

**4.27** The Government has to date provided £4.4 billion to meet the extra costs of the military conflicts in Afghanistan and Iraq and other international obligations. In this Pre-Budget Report, as a prudent allowance against continuing commitments, the Government adds £520 million to the special reserve for 2004-05 – raising the overall provision to nearly £5 billion by April 2005.

**Box 4.3: The Stability and Growth Pact**

The Stability and Growth Pact was finalised at the European Council in June 1997 to ensure that EU member states maintain sound and sustainable government finances through the medium-term budgetary objective of "close to balance or in surplus".

Fiscal sustainability is a pre-condition for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy coordination as set out in the EU Treaty. The Government supports a prudent interpretation of the Pact that builds on the Code of Conduct, agreed by member states in June 2001 and the March 2003 ECOFIN conclusions agreed by Finance Ministers on strengthening budgetary coordination. Specifically, it would take into account:

- the economic cycle - by allowing automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy.
- sustainability - low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilizers to operate, and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations, as detailed later in this Chapter and in the 2004 *Long-term public finance report*; and
- public investment - public investment contributes to the provision of high-quality public services and can help underpin a flexible, high-productivity economy.

The Government published The Stability and Growth Pact: A Discussion Paper alongside the 2004 Budget. The paper assesses the performance of the Pact against the principles of credibility, flexibility and legitimacy and considers how a prudent interpretation helps the Pact to better achieve its objectives.

A prudent interpretation of the Pact will lock in longer-term fiscal discipline and sustainability, enhancing credibility, while allowing the automatic stabilisers to smooth fluctuations in output, and enabling appropriate increases in investment in public services.

## Taking Account of the Economic Cycle

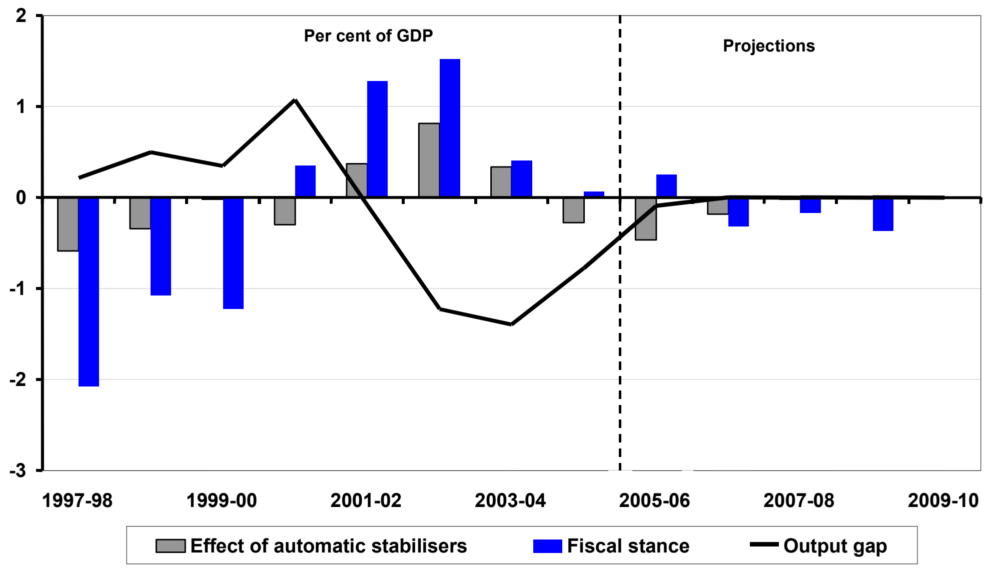
**4.28** The Government supports a prudent interpretation of the Stability and Growth Pact (see Box 4.2). The first key element of this prudent interpretation takes account of the economic cycle. It is important to focus on cyclically-adjusted fiscal balances when assessing public finances and subsequent policy decisions.

**The automatic stabilisers**

**4.29** While the primary objective of fiscal policy is to ensure sound public finances, it also affects the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.5 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.

**4.30** During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. More recently, fiscal policy has continued to support monetary policy in helping to deliver economic stability, through the automatic stabilisers and an easing of the fiscal stance when the economy moved below trend. Subsequently as the economy returns to trend the overall impact of fiscal policy moves back to a more neutral position.

**Chart 4.2: Fiscal policy supporting monetary policy**




**4.31** As noted earlier, in cyclically-adjusted terms, general government net borrowing will be 2.2 per cent in 2004-05 falling to 1.5 per cent by 2009/10. Nominal general government net borrowing on the Treaty definition, will be 2.8 per cent in 2004-05, falling to 2.7 per cent in 2005-06 and to 1.5 per cent by the end of the period.

## Sustainability for the Long Term

**4.32** Long-term sustainability is a key element of a prudent interpretation of the Stability and Growth Pact. A key element of this prudent interpretation takes account of sustainability. In 2002 the Government published its first *Long-term public finance report* with the intention of providing a comprehensive analysis of long-term economic and demographic developments, and their likely impact on the public finances. In 2003 the Government presented its second *Long-term public finance report* and announced that the report would become an annual publication.

**4.33** The 2004 *Long-term public finance report* complements the illustrative long-term fiscal projections presented in Annex A of the Economic and Fiscal Strategy Report (EFSR), published at the time of the Budget. The Government is committed to updating and reporting regularly on its assessments of long-term fiscal sustainability, both through the *Long-term public finance report* and through the illustrative long-term fiscal projections presented with each Budget.

**4.34** The publication of the *Long-term public finance report* is motivated by the Government's belief that sustainable public finances are a prerequisite to achieving high and stable rates of long-term economic growth, which is shared by all, and to ensuring that spending and taxation impact fairly between generations. It is therefore important for the Government to have a good understanding of potential future social and economic trends, and the fiscal implications of current policy for future generations. As well as assisting strategic decision-making, more information on long-term fiscal trends greatly improves fiscal transparency and credibility.

**Comprehensive assessment**

**4.35** It is important that any assessment of long-term fiscal sustainability is as comprehensive as possible. This year's report therefore uses the same wide range of approaches to assessing long-term fiscal sustainability as last year's report. These are: net debt, intertemporal budget constraint, fiscal gaps and an alternative fiscal indicator based on the fiscal gap concept.[1] As in 2002 and 2003, this year's report also uses the top-down approach used for the illustrative long-term fiscal projections in Annex A of the EFSR.[2]

**Long-term demographic trends**

**4.36** One of the key socio-economic challenges that all developed economies are facing over the coming decades is the ageing of their populations. The ageing trend is mainly driven by increases in longevity (life expectancy) and continuing low fertility rates (the number of children per woman). In many developed countries these factors are also predicted to lead to a decline in the size of the working-age population, with potentially adverse effects on trend growth. These trends will have profound effects on Britain's society and economy over the coming decades.

**4.36** In the UK, the Government Actuary's Department (GAD) produces the official population projections. GAD published its latest principal population projections, the 2003-based interim projections, in September 2004.[3] These projections are based on the latest population revisions produced by the Office for National Statistics (ONS) and replace the 2002-based projections, which were released in December 2003 after the publication of the 2003 *Long-term public finance report*. Since the publication of last year's report, there have therefore been two revisions to the population projections.

**4.37** According to the latest principal population projections, the UK's population will increase from 59.6 million in 2003 to around 66½ million by 2035, and then stabilise. With the fertility rate assumed to remain below the replacement rate of 2.1 children per woman (the rate which is necessary to stabilise the population size naturally), the increase in the total population is mainly due to assumed long-term net migration of around 130,000 people per year. This overall increase masks wide variations between the growth rates of different age groups, with the younger working-age population and the number of children projected to remain relatively stable over the period, while the 55-64 year olds show a moderate rise of 20 per cent by 2053. This contrasts with large projected increases for the older age-groups: the 65-84 year olds are projected to grow by around 55 per cent, and the 85+ group are projected to grow by nearly 400 per cent by the mid 2050s.

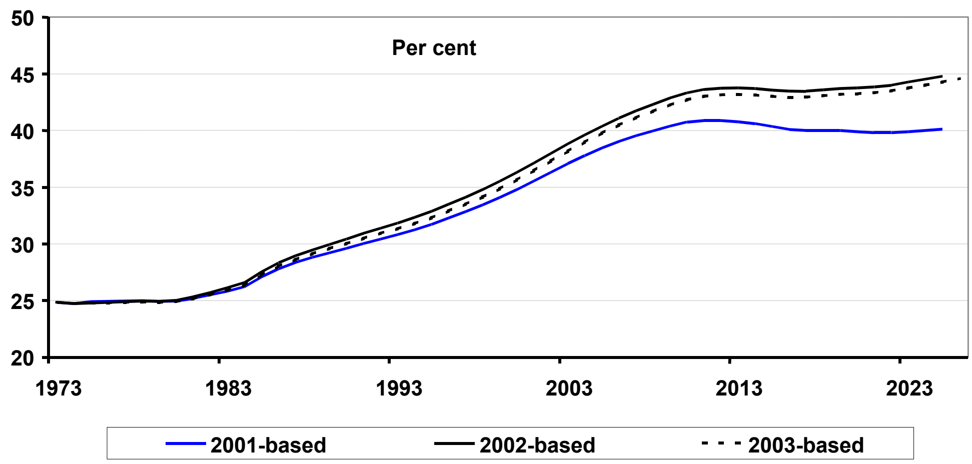
[1] For the results of the alternative fiscal gap indicator, see 2004 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004, page 57.

[2] This year's report also provides indicative numbers for net liabilities, which are taken from un-audited data developed as part of the Government's Whole of Government Accounts programme. See 2004 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004, Chapters 3 and 5 for more details.

[3] In October 2004, the GAD also published updated variant population projections. However, this year's *Long-term public finance report* presents results only based on the principal population projections.

4.38 The effect of these changes can be best illustrated by the evolution of the demographic old-age dependency ratio. This ratio shows the number of people aged 65 years and over relative to the number of people aged 16 to 64 years. As can be seen from Chart 4.3 the demographic old-age dependency ratio has edged up slightly since the early 1970s, reaching around 25 per cent in the mid 1990s. The ageing process is expected to accelerate significantly after 2010, with the demographic old-age dependency ratio projected to rise to nearly 43 per cent by 2040 and then 45 per cent by the mid 2050s in the principal projections. Chart 4.3 also shows that the demographic old-age dependency ratio is now projected to be nearly 5 percentage points higher in the mid 2050s than in the 2001-based interim population projections, which were used for the 2002 and 2003 Long-term public finance reports.[4] In addition, and mainly due to the higher net migration assumption compared with the 2001-based dataset, the total population is also projected to rise more rapidly, stabilising at around 66½ million rather than 63½ million.

**Chart 4.3: Demographic old-age dependency ratios**




*Source: Government Actuary's Department, 2001-based interim, 2002 based and 2003-based interim population projections.*

**Long-term assumptions**

4.39 The long-term projections are based on the assumption of current policy, in other words it is assumed that the Government will leave current policy unchanged in the future. This should not be interpreted as meaning that policy will not change over time but it is used so that the long-term projections do not prejudge future Government policy. Current policy has been interpreted as all policy already in place or announced in this year's Pre-Budget Report.

[4] The 2003-based interim principal projections are therefore very similar to the high longevity variant published as part of the 2001-based interim projections.

4.40 The majority of the spending and revenue projections are based on the same separate spending and revenue profiles for males and females as used in the 2002 and 2003 reports. However, there is one important exception. One of the key potential drivers of future health spending is the health of the elderly, and in particular the degree to which there is an expansion or compression of morbidity. Due to the modelling approach adopted in the 2002 and 2003 Long-term public finance reports the health projections implicitly assumed a total expansion of morbidity. The health projections in this year's report are based on the assumption that the *proportion* of life spent in ill health is constant, which implies some expansion of morbidity, in proportion to the increase in the number of years spent in good health.[5]

4.41 As in previous reports, and to improve comparability, the baseline projections underlying the main results assume that the overall employment rate remains unchanged beyond the medium term.[6] This means that changes in employment levels are entirely due to changes in the size of the working-age population. Up to 2009-10, the projections are consistent with medium-term projections in the 2004 Pre-Budget Report. The productivity growth assumption (output per person) used in the baseline scenario is 2 per cent per year beyond the medium-term horizon, as in previous reports.[7] This is the average long-term productivity growth rate for the UK since the mid 1950s. Table 4.6 presents the real GDP growth rate over the next five decades.

### Table 4.6: Real GDP growth and its components in the baseline scenario [1] (annual percentage change)

| Year | 2013-14 to 2022-23 | 2023-24 to 2032-33 | 2033-34 to 2042-43 | 2043-44 to 2052-53 |
|---|---|---|---|---|
| Productivity | 2 | 2 | 2 | 2 |
| Employment | 0 | -¼ | 0 | 0 |
| **Real GDP** | **2** | **1¾** | **2** | **2** |

[1] *Productivity growth is 1¾ per cent and 2¼ per cent in the high and low productivity scenarios respectively.*

4.42 The intertemporal budget gap and fiscal gap approaches to assessing long-term fiscal sustainability require a real discount/debt interest rate assumption. Based on index-linked gilts[8], and consistent with the Government's Green Book, the report presents results based on real interest/discount rate assumptions of 2½ per cent, 3 per cent and 3½ per cent.

**Spending and revenue projections**

4.43 The changing demographic structure of the UK's population – and especially the ageing aspect – is projected to have only a limited impact on public spending over the coming decades. Table 4.7 summarises the spending projections.

[5] For example, the Ageing, Health and Retirement in Europe (AGIR) Project, a pan-European study financed by the European Commission has examined whether the trend towards longer life expectancy has been accompanied by comparable increases in the expectancy of a life in good health. They suggest two assumptions, which they believe would capture the likely upper and lower trends one can reasonably expect concerning future advances in healthy life expectancies. An optimistic assumption would be that the number of years in bad health remains constant as life expectancy increases, the so-called 'shift to the right' scenario. The second, and more pessimistic, assumption is the one used for the projections presented in this year's report. See 2004 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004, Chapters 2 and 4 for more details.

[6] This year's report also presents an alternative scenario, in which future employment levels are projected using the cohort approach. See 2004 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004, Chapters 4 and 5.

[7] Lower and higher productivity growth assumptions of 1¾ per cent and 2¼ per cent per year respectively are also used in the report to provide some sensitivity analysis.

[8] *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004, Chart 4.3

**Table 4.7: Spending and revenue projections (per cent of GDP)**

| | 2003-04 | 2013-14 | 2023-24 | 2033-34 | 2043-44 | 2053-54 |
|---|---|---|---|---|---|---|
| Education | 5.1 | 5.4 | 5.1 | 5.3 | 5.2 | 5.2 |
| State pensions[1] | 5.0 | 5.1 | 5.0 | 5.5 | 5.4 | 5.6 |
| Health[2] (inc. long-term care) | 7.9 | 9.2 | 9.4 | 10.3 | 10.8 | 11.0 |
| *of which long-term care*[3] | *1.0* | *1.1* | *1.1* | *1.3* | *1.4* | *1.5* |
| Public service pensions[4] | 1.5 | 1.8 | 2.1 | 2.3 | 2.2 | 2.2 |
| **Total age-related spending** | **19.5** | **21.5** | **21.7** | **23.4** | **23.7** | **24.0** |
| Other spending | 21.1 | 20.3 | 19.7 | 19.9 | 19.4 | 19.1 |
| **Total spending**[4] | 40.6 | 41.9 | 41.3 | 43.3 | 43.1 | 43.1 |
| **Total revenue**[6] | **36.7** | **39.4** | **38.6** | **39.8** | **40.0** | **40.0** |

[1] *Defined as the sum of the basic state pension, including the State Second Pension, Minimum Income Guarantee and Pension Credit, Over 75 TV licences, Christmas Bonus and Winter Fuel*

[2] *Gross NHS spending.*

[3] *Excluding long-term care provided within the NHS which is accounted for under Health.*

[4] *In the 2002 and 2003 Long-term public finances report, public service pensions were included under Other spending.*

[5] *Total spending including gross investment but excluding interest and dividend payments.*

[6] *Excluding interest and dividends received.*

**4.44** Education spending is projected to remain relatively stable over the coming decades, fluctuating around 5¼ per cent of GDP beyond the medium term. This reflects the fact that the number of people of education age (either in schools, higher education or further education) is projected to vary only slightly. The increase from 5.1 per cent in 2003-04 to 5.4 per cent in 2013-14 reflects the substantial increase in education spending over the medium term first announced in the 2002 Spending Review and confirmed in the 2004 Spending Review.

**4.45** State pension spending is projected to rise slightly over the next 50 years, increasing from 5 per cent of GDP in 2003-04 to 5.6 per cent by 2053-54.

**4.46** This year the health projections are based on the assumption that future increases in life expectancy can be enjoyed partly in good health (see paragraph 4.40). Notwithstanding this change, health spending is projected to increase from 6.9 per cent in 2003-04 to 9½ per cent of GDP by 2053-54 as the population ages.[9] Of this an increase of around 1¼ percentage points of GDP by 2007-08 reflects the substantial increase in NHS spending announced in Budget 2002. As in previous years though, non-demographic factors that might affect health spending in the future are not modelled.

**4.47** This year's long-term care projections are based on the same morbidity assumption as the health projections. In other words, long-term care is no longer assumed to remain constant as a share of GDP as it was in the 2002 and 2003 Long-term public finance reports. Based on the new assumption, long-term care is projected to rise from 1 per cent of GDP now to 1½ per cent by 2053-54.[10]

[9] Without the change in the morbidity assumption (see paragraph 4.40), health spending would have risen to 10.3 per cent of GDP by 2053-54 in the projections.

[10] Long-term care spending is projected to increase by 0.4 percentage points between 2013-14 and 2053-54. This compares with a zero increase in last year's report. Had the same modelling assumptions been used for health and long-term care as in the 2002 and 2003 Long-term public finance reports, then age-related spending would have been 0.4 percentage points higher by 2053-54 than shown in Table 4.7.

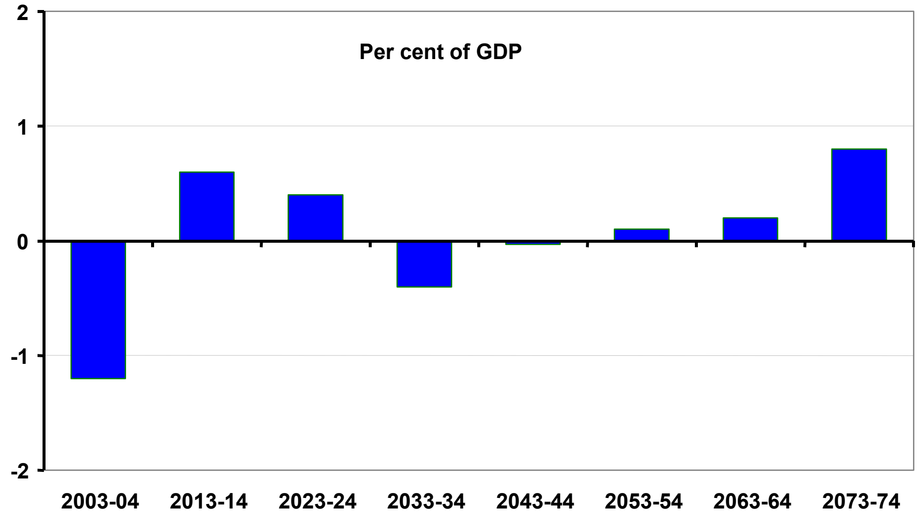
**4.48** Expenditure on public service pensions, which had previously been counted under other spending, is projected to increase from around 1½ per cent of GDP now to 2.2 per cent by 2053-54. This projected increase reflects changes in the size of the public service workforce, increased longevity and the fact that some schemes, particularly the NHS scheme, are not yet mature. The projected spending increase would be higher but for the proposed reforms to these schemes, particularly the increase in normal public service pension age from 60 years to 65 years to be introduced for new entrants from 2006.

**4.49** Other spending (which, for example, includes all social security items not listed explicitly under state pensions) is projected to fall by around 1½ per cent of GDP beyond the medium term.

**4.50** Revenue is projected to rise as a share of GDP between 2003-04 and 2013-14. This reflects the increases forecast over the medium-term horizon. Beyond the medium term, revenue is projected to remain stable as a share of GDP.

**4.51** As a result of the projected spending and revenue trends, the general government primary balance is projected to be in surplus in 2013-14 before moving into deficit by the late 2020s. Chart 4.4 shows that the projected deficit on the primary balance is most marked, as a share of GDP, around 2035, when spending pressures are projected to be greatest. However, in the very long term the primary balance is projected to return to surplus again as a result of the fact that the ageing process has run its course and due to the continued relative decline of social security spending.

**Chart 4.4: Primary balance**




*Source: HM Treasury.*

**4.52** Annex A of the 2004 EFSR, published in Budget 2004, showed that the UK's public finances are broadly sustainable in the long term. Moreover, it showed that: first, current public consumption can grow at around the same annual rate as GDP after the medium term while meeting the Government's golden rule; second, public sector net investment can grow more or less in line with the economy without jeopardising the sustainable investment rule; and third, the net debt to GDP ratio is projected to remain below 40 per cent by the end of the projection period. These conclusions are supported by updated illustrative long-term fiscal projections, which are based on the medium-term forecast as presented in the 2004 Pre-Budget Report, and updated population projections.

**Intertemporal budget balance**

4.53 The report also assesses the long-term sustainability of the public finances using a number of approaches, in particular the intertemporal budget constraint (IBC) and fiscal gaps. The IBC states that the present discounted value (PDV) of all future revenue should be equal to the PDV of future spending and today's outstanding debt burden. Put differently, the current level of debt must be equal to the PDV of all future primary balances. If the present discounted value of future primary balances is not sufficient to cover the current debt burden (and hence the IBC is not met), then the extent of the imbalance is called the intertemporal budget gap (IBG). The IBG can be used to calculate the immediate and permanent change in the fiscal stance that is needed to meet the IBC.

4.54 Table 4.8 presents estimates of the intertemporal budget gap under a range of discount rate and productivity rate assumptions. It is likely that higher rates of productivity will be associated with higher real interest/discount rates. The results show that whether revenue (or spending) needs to change at all to maintain intertemporal balance depends to some extent on the discount rate assumption. If a low discount rate is used, as could be justified by the low real interest rate on long-term UK government bonds, the condition for intertemporal balance is exceeded in each case regardless of the productivity assumption.

### Table 4.8: Intertemporal budget gaps[1] (per cent of GDP)

| Discount rate (per cent) | 2½ | 3 | 3½ |
|---|---|---|---|
| Lower productivity (1¾ per cent) | -1¼ | 1 | 1¾ |
| Baseline (2 per cent) | -1¼ | 0 | ¾ |
| Higher productivity (2¼ per cent) | -3¼ | -1¼ | 0 |

[1] *Fiscal tightening (or loosening) in 2003-04 and a permanent, proportionate fiscal tightening (or loosening) thereafter needed to ensure intertemporal balance. Rounded to the nearest quarter percentage point.*

**Fiscal gaps**

4.55 The fiscal gap concept takes a sustainable debt to GDP ratio as a starting point for thinking about long-term fiscal sustainability. The fiscal gap measure represents the change in the primary balance needed to attain a particular debt target at a particular point in time. A negative fiscal gap, for example, implies that fiscal policy could be loosened while still attaining a particular debt level in the future. Taking the 40 per cent net debt to GDP ratio of the sustainable investment rule as the target, it is therefore possible to use the fiscal gap concept to estimate the primary balance that is consistent with the Government's sustainable investment rule over different time horizons. Table 4.9 shows the fiscal gaps in the baseline scenario on a range of interest rate assumptions and a range of target years, where the change in the primary balance is assumed to occur from 2010-11 onwards.

### Table 4.9: Fiscal gaps [1] in baseline scenario [2] (per cent of GDP)

| Interest rate (per cent) | 2½ | 3 | 3½ |
|---|---|---|---|
| **Target year**[3] | | | |
| 2023-24 | -¾ | -¾ | -½ |
| 2033-34 | -½ | -¼ | 0 |
| 2043-44 | -¼ | 0 | ¼ |
| 2053-54 | ¼ | 0 | ¼ |

[1] *Change to primary balance needed to attain a particular debt level at terminal year. Rounded to nearest quarter percentage point.*
[2] *2 per cent productivity growth.*
[3] *Net debt target is reached at end of year specified.*

**4.56** The results show that the UK public finances are in a solid long-term position. For example, the Government could loosen its fiscal stance slightly if it aimed for a net debt to GDP ratio of 40 per cent by 2033-34 in the baseline case. If the horizon were extended to 2043-44 and beyond, the Government could leave its fiscal stance unchanged and still ensure that net debt reaches 40 per cent of GDP in the target year.

**Sustainable public finances**

**4.57** The updated results confirm the findings of last year's report that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries to face the challenges of an ageing society.

## Public Investment

**4.58** The Government supports a prudent interpretation of the Stability and Growth Pact (see Box 4.2). The third key element of this prudent interpretation takes account of the important role of public investment. Against a background of sound public finances and economic stability, public investment contributes to the provision of high quality public services and can help to raise the overall productive potential of the economy.

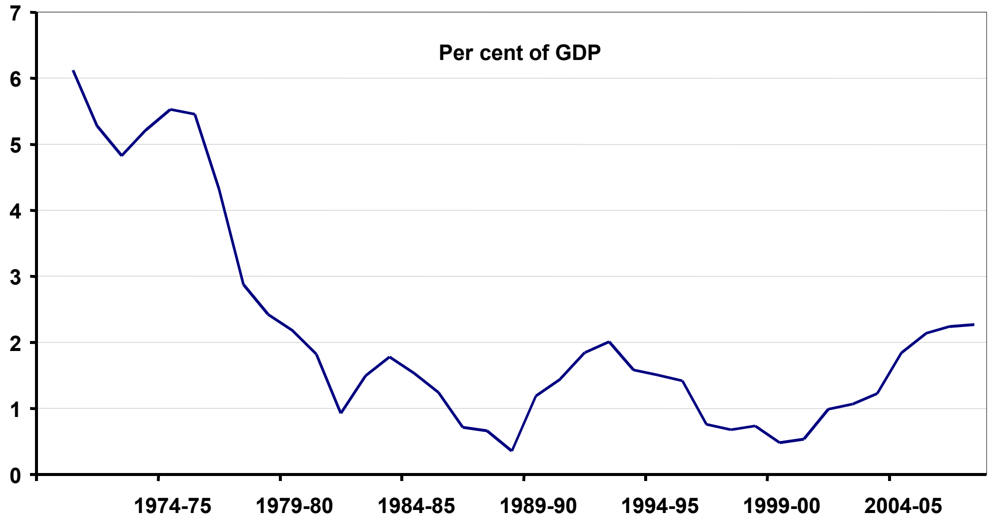
**4.59** The UK has historically invested less of its national income in key public services than comparable economies such as the UK and many EU countries. OECD data show that throughout the 1970s, 1980s and 1990s, the UK spent a significantly lower share of its GDP on health than France, Germany and the US. In 1997, total health spending per capita in the UK was lower than in every other EU country except for Greece, Ireland, Portugal and Spain. Spending on educational institutions as a proportion of GDP in the UK has also lagged behind that in the US and many EU countries.

**4.60** In keeping with the 2003 Broad Economic Policy Guidelines, the projections contained in Table 4.1 demonstrate the Government's commitment to address the historical under-investment in public services in the UK. Public investment rises to 2 ¼ per cent of GDP by the end of the period.

**4.61** Extensive reform of the system for managing public expenditure, underpinned by the new fiscal framework, and prudent management of the economy and the public finances have enabled the Government to deliver a step change in resources for key public service priorities in the three Spending reviews since 1998. After a period of relative stagnation in the mid-1990s, since the 1998 Comprehensive Spending Review, health and education have benefited from sustained and significant real increases in investment. By 2006, public spending on education in the UK is set to about 50 per cent higher in real terms than in 1997, and by 2008 spending on the UK NHS will be approximately 90 per cent higher in real terms than in 1997.

**4.62** Government is addressing the legacy of underinvestment in the UK's infrastructure by reforming the public spending framework to ensure prioritisation of investment, and by providing for increasing public capital spending. To date, the Government has delivered significant increases in capital investment in public services with net investment increasing to an estimated £21.7 billion in 2004-05. Although estimated investment this year, mainly in local authorities and public corporations, is below the Budget 2004 forecasts, resources will be carried forward to future years to ensure delivery of the Government's aggregate investment plans. Total investment in public services, which includes gross capital spending by the public sector, including that financed by asset sales, and estimated investment scored to the private sector undertaken through Public Private Partnerships (PPPs), is set to rise to almost £60 billion by 2007-08.

**Chart 4.5: Public sector net investment**




**4.63** Public sector net investment in 2003-04 fell £2½ billion short of the estimate made in Budget 2004, but was still 21 per cent higher than in 2002-03. Net investment to date in 2004-05 is 13 per cent higher than in the same period of 2003-04 and, in line with previous experiences, is expected to increase significantly over the remainder of the year. However, lower than expected investment, especially by local authorities and public corporations, means that overall investment is unlikely to meet the Budget 2004 forecast and the forecast for capital expenditure in 2004-05 has been reduced by £1¼ billion. To reinforce the Government's commitment to increasing public sector investment, this expenditure has been carried forward to 2005-06 and 2006-07, consistent with the overall intention to increase public sector net investment to 2¼ per cent of GDP by 2007-08.

**4.64** The other changes to net investment over the 2004 Spending Review period reflect the timing changes, capital expenditure announced in the Spending Review and changes to National Accounts depreciation. Although net investment remains at 2¼ per cent of GDP in 2008-09, gross investment is about £1½ billion lower because of the reduction in depreciation.

**4.65** Table 4.10 provides a breakdown of public service capital expenditure from 2002-03 to 2005-06.

### Table 4.10: Public sector capital expenditure

| £ billion | Outturn 2003-04 | Estimate 2004-05 | Projections 2005-06 | 2006-07 |
|---|---|---|---|---|
| Capital Budget DEL | 23.2 | 26.2 | 29.1 | 31.5 |
| Locally-fianced expenditure | 0.3 | 2.1 | 2.1 | 2.3 |
| National Lottery | 1.2 | 0.9 | 0.9 | 0.8 |
| Public corporations' own finaced capital expenditure | 2.5 | 2.3 | 2.2 | 2.2 |
| Other capital spending in AME | 0.8 | 4.7 | 7.8 | 8.7 |
| AME margin | 0.0 | 0.4 | 0.0 | 0.6 |
| **Public sector gross investment**[1] | 28.0 | 36.6 | 42.3 | 46.0 |
| Less depreciation | 14.3 | 14.9 | 15.8 | 16.7 |
| **Public sector net investment** | 13.7 | 21.7 | 26.5 | 29.3 |
| Proceeds from the sale of fixed assets[2] | 6.0 | 5.5 | 5.5 | 3.8 |

*[1] This and previous lines are all net of sales of fixed assets.*
*[2] Projections of total receipts from the sale of fixed assets by public sector.*

**4.66** Table 4.11 shows general government debt repayments.

### Table 4.11: General government debt repayments

| | Per cent of GDP Outturn 2003-04 | Estimate 2004-05 | Projections 2005-06 | 2006-07 |
|---|---|---|---|---|
| Net debt level[1] | 32.9 | 34.3 | 35.4 | 36.2 |
| Gross debt level (Maastricht definition) | 39.5 | 40.9 | 41.8 | 42.4 |
| Change in gross debt | 1.8 | 1.3 | 1.0 | 0.5 |
| **Contributions to change in gross debt** | | | | |
| Primary balance[2] | 2.0 | 1.8 | 1.6 | 1.1 |
| Interest payments[2] | 1.2 | 1.1 | 1.1 | 1.1 |
| Nominal GDP growth | -2.2 | -2.2 | -2.4 | -2.2 |
| Other factors influencing the debt ratio | 0.8 | 0.7 | 0.6 | 0.5 |
| *Memo: implicit interest rate on debt* | *5.1* | *5.0* | *4.9* | *4.9* |

*Note: This table is derived from Pre-Budget Report tables.*
*[1] Public sector net debt.*
*[2] Primary balance based on net interest payments for consistency with UK public sector definition. Interest payments given net of interest receipts.*

**4.67** Table 4.12 shows net borrowing by sub-sectors.

### Table 4.12: Net borrowing by sub-sectors

| | £ billion Outturn 2003-04 | Projections 2004-05 | 2005-06 | 2006-07 |
|---|---|---|---|---|
| General government[1] | 34.9 | 34.9 | 33.6 | 33.7 |
| Central government | 37.0 | 37.0 | 35.4 | 31.7 |
| Local authorities | -2.1 | -2.1 | -1.8 | 2.0 |

*[1] Although this is based on the ESA95 definition of general government net borrowing (GGNB), the projections are identical to GGNB*

## Delivering High-Quality Public Services

**4.68** The Government's long-term goal is to deliver world-class public services through investment and reform while ensuring that taxpayers receive value for money. Strong and dependable public services lay the foundations for a flexible, high productivity economy, supporting greater efficiency among businesses and adaptability within the workforce. They also promote opportunity and security for all, helping to tackle poverty and social exclusion and improving quality of life.

**2004 Spending Review**

**4.69** In the 2000 and 2002 Spending Reviews, the Government delivered sustained and significant increases in investment in its priorities, while ensuring stability by continuing to meet its strict fiscal rules. The 2004 Spending Review set priority outcome targets in departmental Public Service Agreements (PSAs), alongside spending plans for 2005-06 to 2007-08 that lock in these increases, while providing for further investment in priority public services. The 2004 Spending Review plans provided for:

- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;
- public sector net investment (PSNI) to rise from 2 per cent of GDP to 2 ¼ per cent by 2007-08, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

**4.70** Sound public finances that are sustainable over the economic cycle are not only essential to ensure economic stability, they are also necessary for sustainable investment in public services. The fiscal rules, described in detail in Chapter 2, are the foundation of the Government's public spending framework, ensuring that the public finances are sustainable over the economic cycle and that spending and taxation impact fairly between generations. The rules have important consequences for the budgeting regime, removing the past discrimination against investment and ensuring that borrowing for investment is conducted in a responsible way.

### Box 4.4: Departmental progress on efficiency

**The Department of Health (DoH)** has negotiated a price cut with the drugs industry of 7 per cent, providing savings of £370 million per year on branded medicines in England. This will be channelled back into front-line NHS services by local Primary Care Trusts. Further savings on generic medicines will increase total savings for the NHS of £1bn per year from 2005-06 available for allocation to front-line health services. DoH has also announced savings in its arms-length bodies: savings of £140 million in 2005-06, rising to £500 million by 2007-08; staffing reduced by around 5,000 and another 750 posts released for front-line service delivery by 2007-08.

**The Department for Work and Pensions** has relocated 2,050 posts and has reduced workforce numbers by over 6,000 – well on course to deliver the ambitious targets set in the 2004 Spending Review.

**The Ministry of Defence** has consolidated army junior entry training in North Yorkshire, resulting in 1,230 posts relocating out of the South East, and has reduced HQ numbers by around 300 staff. It is also on track to deliver over £400 million in savings through improved Defence Logistics available for allocation to front-line defence services.

**The Department for Transport (DfT)** will deliver efficiency gains of around £140 million in 2004-05 as a result of the Highways Agency improving its procurement regime and the DVLA implementing electronic service delivery. On top of its existing efficiency programme, and as part of implementing the reform agenda set out in the recent Rail White Paper, the DfT is legislating to streamline the public sector organisations involved in the delivery of rail services – including abolishing the Strategic Rail Authority (SRA). Further detailed design work remains to be carried out, but these reforms will reduce by about half, from around 600, the current public sector posts covering rail in the DfT, the SRA and their associated bodies.

**The Inland Revenue and HM Customs and Excise** are on track to meet their workforce targets, with reductions of 836 staff and relocation of 274 posts during 2004-05.

**The Department for Education and Skills** has reduced its workforce by 450; the **Department of Health** is on track to reduce its HQ staffing by over 700 by the end of 2004-05; and the **Department for Environment Food and Rural Affairs** has already delivered a reduction of 120 staff this year. **The Office for Standards in Education (Ofsted)** has announced plans for a workforce reduction of 500, with the relocation of 324 posts to Manchester, Nottingham and Bristol, by 2007-08.

**The Police Service** is on track to deliver total efficiency improvements of £190 million in 2004-05 through improved procurement and more effective use of officers' time.

**The Department of Trade and Industry** has moved 85 posts out of London, and the **Department for International Development** has moved 45 posts with a further 40 to follow during 2005.

**National Savings and Investments** will continue to build on the efficiency gains achieved so far through their partnership with Siemens Business Service, as announced by Siemens on 13 August 2004.

**Local Government** is expected to release £30 million of resources this year through e-enabling service delivery and securing unit cost savings in e-payment mechanisms and e-procurement. This builds on £20 million of cashable savings achieved last year.

### Box 4.5: Measuring efficiency and productivity in the public services

Improving the efficiency and productivity of the public sector are important components of the Government's objective of excellent and equitable public services. Both efficiency and productivity are concerned with the relationship between public sector inputs and outputs. They can both be improved by reducing the amount of inputs, while maintaining the same level of service provision, or by producing additional outputs – either greater quality or quantity – for the same level of inputs. There are currently two complementary processes respectively developing ways of improving efficiency and measuring productivity:

- the Government's efficiency programme follows the conclusions of Sir Peter Gershon's independent review of public sector efficiency, which focused on releasing "major resources out of activities which can be undertaken more efficiently into front line services that meet the public's highest priorities". As part of Spending Review 2004, departments agreed efficiency targets, alongside outcome-focused PSAs and departmental budgets, to ensure that significant resources can be released to front-line activities, and to deliver further improvements in public sector performance. In delivering these targets, departments will focus on processes in areas that can be simplified or streamlined; and

- the Atkinson Review was commissioned by the National Statistician to advise on ways of measuring public services' output and productivity for the National Accounts, focusing mainly on four major areas of spending – health, education, public order and safety, and social protection. National Accounts measures of output and productivity need to be as complete as possible, measuring output across all relevant spending.

Improvements to the service received by users as a result of the Government's efficiency programme, may come in ways that will be captured by current National Accounts measures of output, for example, more out-patient appointments. However, they may also come through other effects such as better communication skills among pupils as a result of spending more time with teachers. These effects are harder to measure and will not necessarily be fully captured in the current National Accounts. Consequently, efficiency savings arising from Sir Peter Gershon's review of efficiency may have impacts in terms of improvements for users which are not reflected in the National Accounts measures of productivity.

Both measures are important, and alongside PSA targets, which incorporate equity objectives not relevant to National Accounts, they form a range of indicators that are necessary to inform policy decisions and to help ensure public accountability and transparency. Improving measurement and making measures publicly available is therefore an important part of the Government's commitment to accountability in the provision of public services. Nevertheless, it is clear that no single indicator, however well measured, can ever fully describe the performance of complex public services.

## Delivering Progress and Reform

**4.71** In addition to the focus on improved efficiency, broader reform of the public services is needed to ensure they can meet the Government's long-term objective of building a flexible economy and fair society. The investment delivered in the last three spending reviews has translated into significant improvements in public service outcomes, as set out below. As in previous Spending Reviews, to ensure these improvements continue, extra investment provided in the 2004 Spending Review is linked to reforms to enhance further service delivery and ensure that public resources are focused where it counts – on the patient, the pupil and the citizen. The next steps in public service reform build on existing strong foundations to enable continuing improvement in public services. The 2004 Spending Review announced measures to:

- strengthen further the achievement of national objectives;
- increase devolution and flexibility for front-line professionals and communities;
- enable front-line staff to develop a new professionalism; and
- achieve more personalised public services.

**4.72** As part of the 2004 Spending Review, the framework of PSAs was strengthened and refined to reflect the conclusions of the Devolving Decision Making Review, published alongside Budget 2004.[5] In particular, the Government has strengthened PSAs by:

- focusing even more closely on outcomes, removing input targets and giving the front line maximum scope to determine how to deliver outcomes most effectively at the local level in consultation with stakeholders and the public;
- introducing PSA 'standards' in particular areas of public service delivery. PSA standards highlight areas where the Government's ambitions for delivery expressed in previous PSA targets have been achieved but where performance data will continue to be monitored and reported to ensure that high levels of performance are maintained;
- increased consultation with a wide range of stakeholders, particularly the front line, on the phrasing and measurement of targets;
- greater use of evidence and analysis to ensure that the targets are informed by delivery expertise and best practice; and
- reducing the burdens on front-line staff by the removal of 500 Service Delivery Agreements (SDAs) that previously set targets below PSAs and increasing the freedom to set local priorities alongside national targets, for example through reformed local PSAs.

**4.73** Progress against PSA targets will continue to be made public regularly through Autumn Performance Reports, Departmental Reports and web-based reporting.

**4.74** Improvements to the PSA framework will be matched by reform of inspection. The Government will work to ensure that independent audit and inspection continues to challenge the public services to improve further, by taking greater account of the experiences of those who use the services under assessment. It will work to rationalise further inspection and regulation regimes to maintain public confidence without unnecessary burden to public service providers.

# A COMPARISON WITH 2003 PROJECTIONS

**A1** The main differences between this report and the 2001 update have been discussed in Chapters 3 and 4. As illustrated by Table A.1 below, GDP growth is expected to be lower this year than predicted at the time of the 2001 Pre-Budget Report, although faster growth is expected in 2003-04 to 2005-06. Inflation is expected to return to its 2½ per cent target in 2004-05.

### Table A.1: Comparing GDP growth and inflation between the 2003 and 2004 Pre-Budget Reports

| | Per cent of GDP | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2003 | | 2004 | | 2005 | | 2006 | |
| | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 |
| GDP growth | 2 | 2¼ | 3 to 3½ | 3¼ | 3 to 3½ | 3 to 3½ | 2½ to 3 | 2½ to 3 |
| CPI inflation (Q4) [1] | 1½ | 1½ | 1¾ | 1¼ | 2 | 1¾ | 2 | 2 |

[1] RPIX was replaced by CPI as the inflation target in the 2003 Pre-Budget Report

**A2** Table A.2 sets out the differences between the two programmes in relation to the public finances. This shows that the current budget has been revised down from a surplus of 0.3 per cent of GDP to a deficit of 0.5 per cent in 2002-03, and from a surplus of 0.4 per cent of GDP to a deficit of 0.4 per cent of GDP in 2003-04. It also shows that public sector net borrowing (PSNB) has been revised up from 1.1 per cent of GDP to 1.9 per cent in 2002-03 and from 1.3 per cent of GDP to 2.2 per cent of GDP in 2003-04. Current estimates of the impact of changes in the output gap on the public finances over previous cycles suggest that automatic stabilisers account for £9 billion of the change in the current budget and net borrowing in 2003-04. As a result the cyclically-adjusted fiscal balances are only slightly changed from their Budget 2002 levels, while the actual fiscal balances are projected to return to their Budget 2002 levels in the medium term.

### Table A.2: Comparing public sector finances between the 2003 and 2004 Pre-Budget

| | Per cent of GDP | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2003-04 | | 2004-05 | | 2005-06 | | 2006-07 | | 2007-08 | | 2008-09 | |
| | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 |
| Current receipts | 38.1 | 37.5 | 38.9 | 38.3 | 39.5 | 39.2 | 39.9 | 39.8 | 40.2 | 40.2 | 40.4 | 40.4 |
| Current expenditure (inc depreciation) | 38.5 | 38.1 | 38.2 | 38.1 | 38.6 | 38.5 | 38.5 | 38.4 | 38.6 | 38.6 | 38.5 | 38.5 |
| Surplus on current budget | -1.7 | -1.9 | -0.7 | -1.1 | -0.4 | -0.6 | 0 | 0.0 | 0.0 | 0.3 | 0.6 | 0.6 |
| Net investment | 1.6 | 1.2 | 1.9 | 1.8 | 2 | 2.1 | 2.1 | 2.2 | 2.2 | 2.3 | 2.2 | 2.2 |
| Public sector net borrowing | 3.4 | 3.1 | 2.6 | 2.9 | 2.4 | 2.7 | 2.1 | 2.2 | 1.9 | 2.0 | 1.7 | 1.6 |
| Cyclically-adjusted surplus on current budget | -0.8 | -1.0 | -0.1 | -0.4 | -0.1 | -0.4 | 0.0 | 0.1 | 0.3 | 0.3 | 0.6 | 0.6 |
| Cyclically-adjusted PSNB | 2.4 | 2.2 | 2 | 2.2 | 2.2 | 2.5 | 2 | 2.2 | 1.9 | 2.0 | 1.7 | 1.6 |
| Treaty deficit[1] | 3.3 | 3.1 | 2.6 | 2.7 | 2.4 | 2.7 | 2.1 | 2.2 | 2.0 | 2.0 | 1.8 | 1.6 |
| Treaty debt ratio[2] | 39.3 | 39.5 | 40.2 | 40.9 | 40.8 | 41.8 | 41.1 | 41.4 | 41.4 | 42.8 | 41.5 | 42.8 |

[1] General government net borrowing on a Maastricht basis.
[1] General government gross debt on a Maastricht basis.

**A3** Public finance projections in the Pre-Budget Report are interim forecasts, and do not necessarily represent the outcome the Government is seeking. The interim forecast shows that the current budget surpluses are projected to fall temporarily over the short term, mainly reflecting the effects of weaker growth, the impact of the audited assumptions, and weaker financial company profits (these are discussed in more detail in Chapter 4). Over the medium term, stronger economic growth and a return in financial company profits to a cautious view of their long-term trend will push the current surplus back towards Budget 2002 levels.

**A4** Table A.3 sets out the differences in relation to the public finances between Budget 2001 and Budget 2002.

### Table A.3: Comparing public sector finances between the 2003 and 2004 Budgets

| | Per cent of GDP | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2003-04 | | 2004-05 | | 2005-06 | | 2006-07 | | 2007-08 | | 2008-09 | |
| | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 |
| Current receipts | 38.6 | 37.8 | 39.2 | 38.7 | 39.8 | 39.4 | 40.1 | 39.9 | 40.4 | 40.3 | - | 40.5 |
| Current expenditure (inc depreciation) | 38.1 | 38.4 | 38.1 | 38.2 | 38.4 | 38.5 | 38.4 | 38.6 | 38.5 | 38.6 | - | 38.5 |
| Surplus on current budget | -0.8 | -1.9 | -0.1 | -0.9 | 0.2 | -0.4 | 0.4 | 0.0 | 0.6 | 0.3 | - | 0.7 |
| Net investment | 1.7 | 1.5 | 2.0 | 1.9 | 2.1 | 2.0 | 2.1 | 2.1 | 2.2 | 2.2 | - | 2.2 |
| Public sector net borrowing | 2.5 | 3.4 | 2.1 | 2.8 | 1.9 | 2.5 | 1.7 | 2.1 | 1.6 | 1.9 | - | 1.6 |
| Cyclically-adjusted surplus on current budget | 0.2 | -1.0 | 0.5 | -0.2 | 0.4 | -0.2 | 0.4 | 0.0 | 0.6 | 0.3 | - | 0.7 |
| Cyclically-adjusted PSNB | 1.5 | 2.4 | 1.5 | 2.1 | 1.7 | 2.3 | 1.7 | 2.1 | 1.6 | 1.9 | - | 1.6 |
| Treaty deficit[1] | 2.4 | 3.2 | 2.1 | 2.6 | 1.9 | 2.4 | 1.7 | 2.0 | 1.7 | 1.9 | - | 1.6 |
| Treaty debt ratio[2] | 39.0 | 39.8 | 39.4 | 40.9 | 39.6 | 41.5 | 39.9 | 41.9 | 40.1 | 42.2 | - | 42.1 |

[1] *General government net borrowing on a Maastricht basis.*
[2] *General government gross debt on a Maasticht basis.*

# B The Fiscal Impact Of Budget Measures

Budget policy decisions

## Table B1: Budget 2004 policy decisions

(+ve is an Exchequer yield)

| | 2004-05 indexed | 2005-06 indexed | 2006-07 indexed |
|---|---|---|---|
| **MEETING THE PRODUCTIVITY CHALLENGE** | | | |
| 1 Venture capital schemes: improvements | 0 | -55 | -60 |
| 2 VAT: revalorise registration and deregistration thresholds | 0 | 0 | 0 |
| 3 Business Premises Renovation Allowance | 0 | -10 | -35 |
| 4 Capital allowances: one year increase for small enterprises | * | -55 | +15 |
| 5 Local Authority Business Growth Incentives | 0 | -150 | -300 |
| **INCREASING EMPLOYMENT OPPORTUNITY FOR ALL** | | | |
| 6 Housing Benefit: align rules with tax credits | -5 | -35 | -35 |
| 7 Housing Benefit and Council Tax Benefit: backdating for up to 12 months | -10 | -15 | -10 |
| 8 Housing Benefit: private sector second round pathfinders | 0 | -15 | -15 |
| **BUILDING A FAIRER SOCIETY** | | | |
| **Supporting families and pensioners** | | | |
| 9 Income tax: index starting and basic rate limits | 0 | 0 | 0 |
| 10 Pensions tax simplication | 0 | 0 | -25 |
| 11 £100 payment to pensioners | -475 | 0 | 0 |
| 12 Pension Credit backdating for up to 12 months | -5 | -15 | -15 |
| 13 Pension schemes earnings cap: indexation | 0 | 0 | 0 |
| 14 Modernising trusts | 0 | 0 | -5 |
| 15 Payroll Giving: grant scheme for SMEs | -5 | -5 | 0 |
| **Protecting tax revenues** | | | |
| 16 Finance leasing: closing loopholes | +75 | +110 | +110 |
| 17 Life companies | +5 | +10 | +10 |
| 18 Red diesel: supporting the UK oils fraud strategy | +80 | +180 | +190 |
| 19 VAT: transfers of going concern | +155 | +140 | +125 |
| 20 VAT: demonstrator cars | * | +5 | +5 |
| 21 Distributed profits: minimum rate | +10 | +340 | +490 |
| 22 Customs: allocation for alcohol strategy | 0 | -15 | -10 |
| **Duties and other tax changes** | | | |
| 23 Inheritance tax: index threshold | 0 | 0 | 0 |
| 24 Tobacco duties: revalorise rates | 0 | 0 | 0 |
| 25 Alcohol duties: freeze spirits duty until end of this Parliament | -35 | -70 | -70 |
| 26 Alcohol duties: revalorise beer and wine duties and freeze other rates | -5 | -5 | -5 |
| 27 Small breweries' relief: extension | -5 | -5 | -5 |
| **PROTECTING THE ENVIRONMENT** | | | |
| **Environment** | | | |
| 28 Enhanced capital allowances for additional energy saving technologies | * | -5 | -10 |
| 29 Landlords' energy saving allowance | * | -10 | -10 |
| 30 Changes to Climate Change Agreement eligibility criteria | -5 | -25 | -25 |
| 31 Climate change levy: freeze | -25 | -25 | -25 |
| 32 Aggregates levy: freeze | -10 | -10 | -10 |
| 33 Aggregates levy: extension of Northern Ireland credit scheme | -15 | -20 | -25 |
| 34 Recycling of landfill tax credit scheme | 0 | 0 | -245 |
| **Transport** | | | |
| 35 Fuel duties: revalorise rates from 1 September 2004 and introduce differential between sulphur free and other main road fuels | -300 | 0 | 0 |
| 36 Fuel duties: increase road fuel gases by 1p over next three years | +5 | +10 | +10 |
| 37 Fuel duties: differentials for bioethanol and biodiesel at 20p until 2007 | * | +5 | +10 |
| 38 Company vans: reform | * | -30 | -30 |
| 39 Air passenger duties: freeze rates | -25 | -30 | -30 |
| 40 VED: freeze rates | -130 | -130 | -135 |
| **TOTAL BUDGET MEASURES** | **-725** | **+65** | **-170** |

** negligible*

**A5** Table B.2 sets out the effect of policy decisions announced in the December 2004 Pre-Budget Report or since Budget 2004 on the fiscal projections.

**Pre-Budget Report policy decisions**

## Table B.2: Estimated costs of 2004 Pre-Budget Report decisions and others announced since Budget 2004[1]

| (+ve is an Exchequer yield) | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| **Meeting the productivity challenge** | | | | |
| National Employer Training Program | 0 | 0 | -80 | -160 |
| New Deal for Skills | 0 | -10 | -10 | -25 |
| **Increasing employment opportunity for all** | | | | |
| Incapacity benefit: additional pathways to work | 0 | * | -60 | -65 |
| Increasing Working Tax Credit thresholds | 0 | -140 | -140 | -140 |
| **Building a fairer society** | | | | |
| Social Fund reform | 0 | 0 | -5 | -5 |
| £50 payment for the over 70s | 0 | -260 | 0 | 0 |
| Tax consequences of the Civil Partnership Act | 0 | -10 | -25 | -30 |
| VAT: grant to Band Aid 20 | 0 | -5 | * | * |
| Modernising the taxation of leasing | 0 | 0 | 65 | 170 |
| **10 Year Childcare Strategy** | | | | |
| Working tax Credit: increase childcare element to 80% | 0 | 0 | -130 | -130 |
| Working tax Credit: increase childcare limit to £175/£300 per week | 0 | -30 | -30 | -30 |
| Extension of paid maternity leave to nine months | 0 | 0 | 0 | -285 |
| Improving childcare quality and sustainability | 0 | 0 | -240 | -155 |
| **Protecting revenues** | | | | |
| Capital gains option avoidance | 10 | 50 | 80 | 80 |
| Remuneration based avoidance | 200 | 500 | 500 | 500 |
| Reform of film tax relief | 20 | 90 | 110 | 120 |
| Life insurance companies avoidance | 0 | 35 | 50 | 50 |
| Abuse of Controlled Foreign Companies regime | 0 | 30 | 50 | 80 |
| Abuse of double tax relief | 0 | 145 | 200 | 200 |
| VAT: Abuse of input tax rules | 15 | 45 | 45 | 50 |
| Loans and financial instrument avoidance | 10 | 115 | 150 | 150 |
| **Protecting the environment** | | | | |
| Company car tax: reform of diesel supplement | 0 | 0 | 40 | 100 |
| Fuel duties: freeze of main interest rates | -370 | -665 | -685 | -710 |
| Rebated oils: narrowing of the differential | -80 | -105 | -110 | -110 |
| **Other Pre-Budget report policy decisions** | | | | |
| Additional to local authorities | 0 | -150 | 0 | 0 |
| Additional to special reserve | -520 | 0 | 0 | 0 |
| **TOTAL POLICY DECISIONS** | -715 | -365 | -225 | -345 |

**Negligible*

*[1] Costings shown relative to an indexed base.*

# C FLEXIBILITY IN THE UK ECONOMY

**C1** The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Ensuring opportunity for all in the global economy requires taking long-term decisions to promote flexibility and fairness.

**C2** *Long-term global economic challenges and opportunities for the UK*, published alongside the Pre-Budget Report, sets out how the far-reaching changes in technology, production and trading patterns are reshaping the global economy. Faster information flows and falling communication costs are breaking down geographical barriers to economic activity. International trade and investment is growing and production is becoming increasingly flexible, specialised and dispersed across continents. Many emerging markets are growing strongly and their workforces are developing higher skills levels and becoming more productive. These trends suggest that the next ten years and beyond will see fundamental change in the global economy. Flexibility in labour, product and capital markets is critical to ensuring that individuals and firms can adapt to changes and thrive in a globally competitive environment.

**C3** The Government is committed to advancing flexibility and fairness together. In the more competitive and integrated global economy, the future pace of change will be ever quicker and more intense. This has great potential benefits in terms of growth and prosperity but also entails difficult adjustments for individuals and firms as labour and capital are redeployed from traditional sectors to expanding ones. It is critical to ensure fairness through policies that expand opportunity and choice, and provide security for the vulnerable, while maintaining incentives to work and save. The introduction of the National Minimum Wage and reforms to the tax and benefits systems help to cushion the impact of economic shocks on household incomes, while high quality and responsive services such as Jobcentre Plus, provide incentives and practical support to enable people to re-enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

**C4** In his statement to the House of Commons on 9 June 2003 on UK membership of the single currency, the Chancellor gave a commitment to publish six monthly reports on trends and progress in labour, product and capital markets. This annex is the third of these reports. It complements a range of other information the Government produces on economic developments and structural policy reforms in both the UK and internationally, particularly across Europe. The report records progress on the Government's reforms of labour, product and capital markets, which promote flexibility and fairness.

**C5** This annex is divided into two sections:

- the first section explains the importance of a flexible economy in a global context and how the Government's policies combine flexibility with fairness; and
- the second section sets out the action the Government has taken to boost flexibility in labour, product and capital markets since Budget 2004 and in this Pre-Budget Report.

## WHY FLEXIBILITY MATTERS

**Why flexibility is needed**

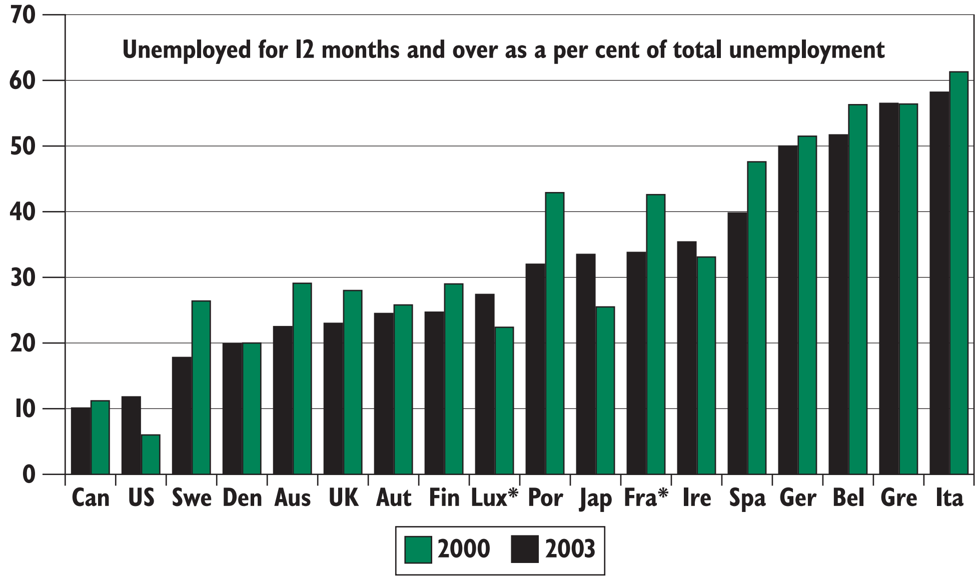
**C6** Flexibility is the ability of firms and individuals to respond to economic change efficiently and quickly. Economic change can come in many different forms. In recent years, advances in information and communications technology, the increased integration of emerging markets with the global economy and high oil prices have been prominent developments affecting industry. In an increasingly integrated global economy, the pace of these changes is faster than in the past. If markets and individuals do not have the flexibility and adaptability to respond to change, then exposure to foreign competition in new markets and new technologies may result in falling relative earnings or long-term unemployment, particularly among lower skilled workers.

**Characteristics of flexibility**

**C7** Economic flexibility describes an economy's capacity to adjust to such changes. There are many different ways in which workers and firms can adjust to change. For firms, adjustment may involve altering prices or changing a product line. For a worker, adjustment may be learning a new skill, moving into a different job in the same firm or even changing employer. Adjustment is achieved by a combination of changes occurring in the labour, product and capital markets supplemented, if necessary, by complementary changes in the stance of monetary and fiscal policy. Flexibility is about minimising the costs of adjustment.

**C8** In a flexible economy, people will move in and out of employment, both within and between industries, as the demand for labour, products and capital change. One indicator of flexibility within a country is the rate of long-term unemployment. A country with large numbers of long-term unemployed is not adjusting labour or production fast enough. The UK, partly as a result of the effectiveness of the New Deal regime, has lower rates of long-term unemployment compared to many European countries. Chart C1 shows how the UK long-term unemployment rate has fallen from 28 per cent in 2000 to 23 per cent in 2003, although this still remains above the levels achieved in the US and Canada.

Chart C1: Long-term unemployment




*Source: OECD Employment Outlook, 2004.*

*Note: * indicates 2002 data*

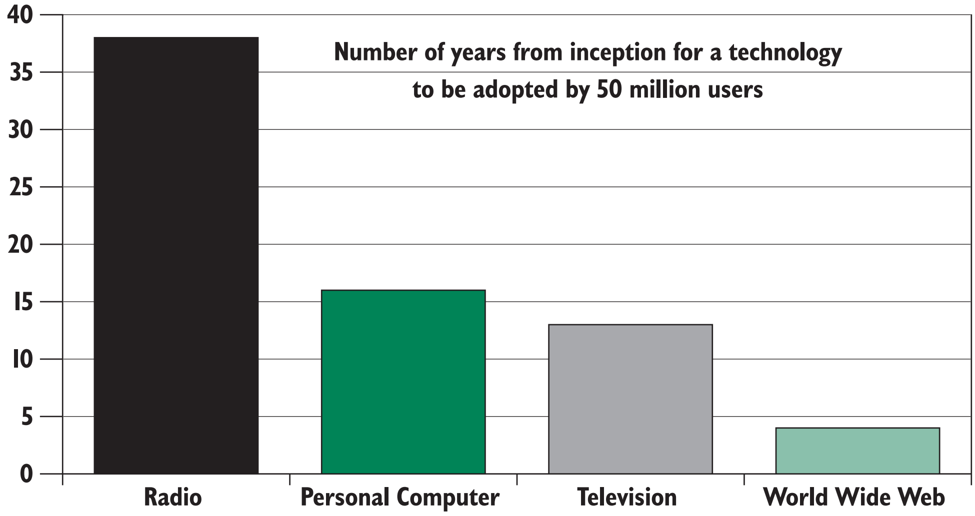
## FLEXIBILITY AND THE GLOBAL ECONOMY

**Globalisation and flexibility**

**C9** As set out in *Long-term global economic challenges and opportunities for the UK*, published alongside this Pre-Budget Report, changes in the global economy can deliver significant potential benefits. However, global change also creates new challenges. To succeed in an increasingly integrated global economy, countries need to be flexible, open and outward looking. If firms and individuals do not have the flexibility and adaptability to respond to change then exposure to overseas competition and new technologies can entail large transitional costs. The UK economy, as an open and global economy, is constantly undergoing a process of structural change, with the amount of labour and capital required by some industries declining, freeing up resources for use in the production of new goods and services.

**C10** A key feature of the changing global economy is the rapid rate of technology change. As the pace of global economic change has accelerated, competition and innovation have shortened the typical life cycle of products, leading to faster renewal. As Chart C2 demonstrates, the pace of take-up of new technology has increased over recent years. As a result, firms' abilities to adapt and to take advantage of new technologies and markets are increasingly crucial to their success. The same is also true in the labour market where employees must update their skills more frequently than before and the concept of a job-for-life no longer holds.

Chart C2: Pace of take-up of new technology




Source: Economist 1999.

**Flexibility, skills and innovation in the global economy**

**C11** Structural change is a constant feature of a well-functioning, flexible economy. As some sectors decline, so other sectors – requiring different skills – will expand. More integrated global markets and cross-border trade and investment are likely to lead to an increased pace of structural change. Increasing rewards to innovation mean that the UK will increasingly depend on its ability to create new knowledge and translate it into innovative goods and services. In addition, the number of skilled workers are rising rapidly in emerging markets such as China and India. This will create great opportunities for the global economy but, if the UK is to make full use of these opportunities, it needs to ensure it has a highly skilled, flexible workforce.

**C12** The pace of technological change and global integration are expected to increase demand for a more highly skilled workforce with the ability to adapt to changing technologies and shifting product demand. For advanced economies, looking to move into high-value added areas, there will be a premium on high-skilled workers. Moreover, skills that were once regarded as high-level are now increasingly viewed as basic skills. So countries will need to invest in the skills of their whole workforces, and ensure that they equip individuals to re-skill continually in order to compete and adjust in the global economy.

**Capital market flexibility in the global economy**

**C13** Advances in information and communications technology have facilitated the development of new financial products and enabled a greater integration of international capital markets. These developments have increased the opportunities for risk sharing and portfolio diversification. They have extended the range of financing options available to entrepreneurs, firms and households, thereby increasing both the flexibility and the resilience of the financial system. Increased financial market flexibility can also help economic adjustment by making it easier for areas with high unemployment to attract the investment needed to develop new businesses and create new jobs.

## Flexibility and fairness – the UK approach

**C14** The Government is committed to promoting fairness alongside flexibility and enterprise so that everyone can take advantage of opportunities to achieve their full potential in an outward-looking, flexible economy. The reforms of the welfare state introduced by the Government reflect its aims of eradicating child poverty, supporting parents to balance their work and family life, promoting saving and ensuring security for all in old age. The Government is also committed to a modern and fair tax and benefit system. The introduction of the National Minimum Wage and reforms to the tax and benefits systems help to cushion the impact of economic shocks on household incomes, while high quality and responsive services, such as Jobcentre Plus, provide incentives and practical support to enable people to re-enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

**C15** Flexibility in labour, product and capital markets is critical to economic success in a globally competitive environment. However, in the short term, flexibility may be associated with considerable changes as labour and capital are redeployed from traditional activities into expanding industries. At any point in time, these costs will fall disproportionately on particular individuals and particular industries. For the individuals concerned this may entail considerable short-term costs, in terms of income, and in the challenges they face to acquire new skills and find new employment. It is therefore important that flexibility is accompanied by measures that enable individuals to cope with and benefit from change. Such measures ensure that flexibility is accompanied by fairness. For example, policies that support individuals through periods of unemployment, and equip them to re-enter the labour force, promote fairness by ensuring that these dislocation costs are minimised. They also contribute to flexibility by enabling individuals to make the transition between different forms of employment more rapidly.

**C16** The regulatory environment is an important determinant of both flexibility and fairness. Effective and well-focused regulation can play a vital role in correcting market failures, ensuring health and safety and good working practices and in driving up standards. However, unnecessary or poorly designed regulation can be an obstacle to flexibility, restricting employment growth and competitiveness, particularly for smaller firms. The Government is committed to ensuring that the negative impacts of the regulatory framework are minimised. This includes clear impact assessments for new legislation; removing unnecessary, ineffective or counterproductive regulation; and ensuring that where legislation is appropriate it is simple, clear and effective.

## FLEXIBILITY IN LABOUR, PRODUCT AND CAPITAL MARKETS

**C17** The overall flexibility of the economy depends on the interaction of flexibility in the labour, capital and product markets, as illustrated in Box C1. This interdependence implies that the overall flexibility of the economy depends on each market working as effectively as possible. The diagram illustrates how changes originating in the product market are transmitted to the labour and capital market and back to the product market. Further rounds of adjustment and feedback will occur until the balance of supply and demand is restored in each market. Changes originating in labour and capital markets, for example, as a result of tax and benefit changes, which affect labour supply or a change in risk aversion affecting the cost of capital, will similarly be transmitted to other markets, with the economy's overall adjustment reflecting the interactions between all three markets.

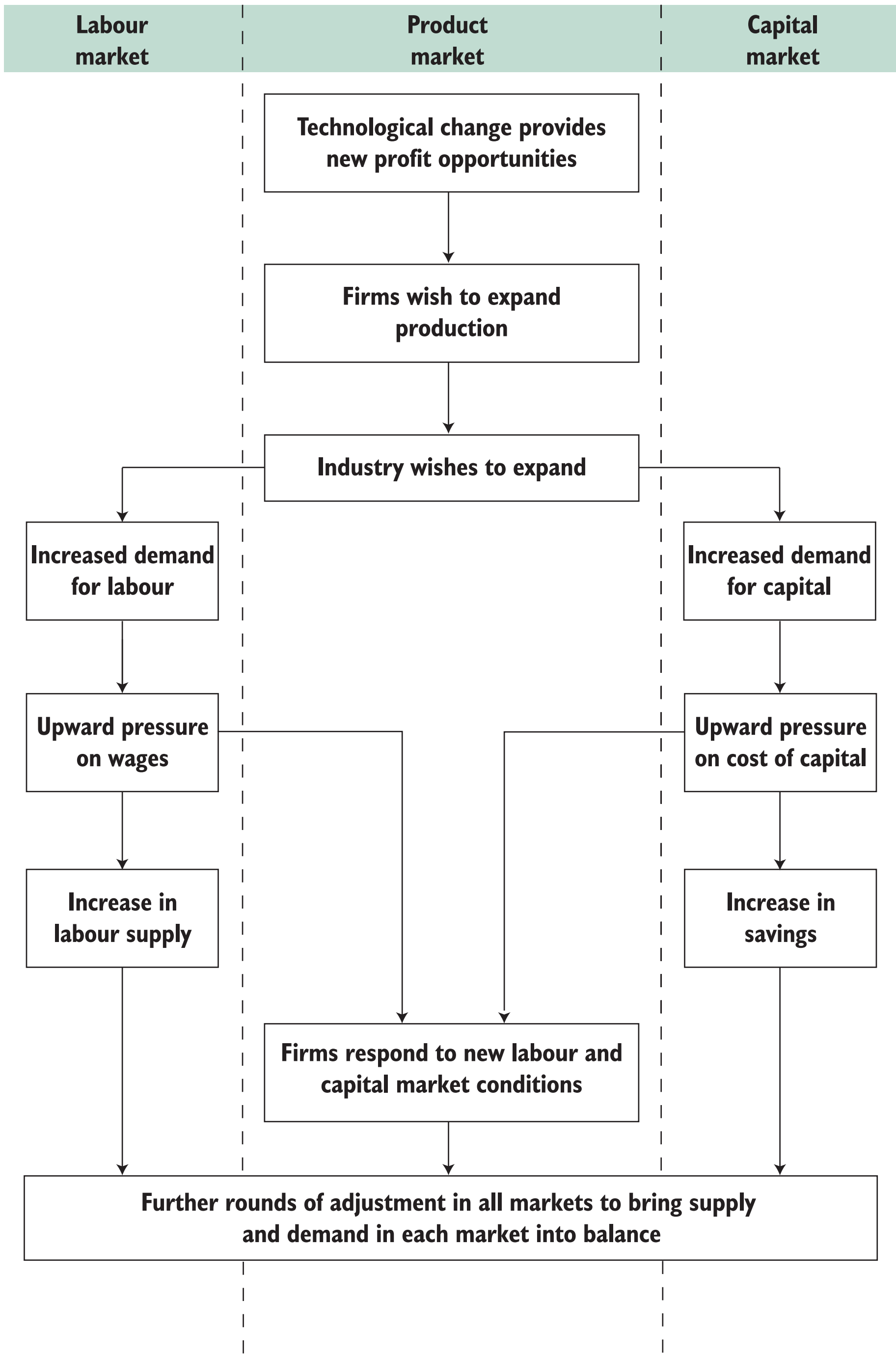
**Labour market flexibility**

**C18** The performance of the labour market is central to the well being of the economy and society. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes. Backed up by policies which equip people rapidly to adjust to change and provide support for those who are not in employment, it implies an economy that is fairer, more competitive and more productive.

**C19** The key characteristics of a flexible labour market are that:

- wages adjust to maintain the balance between labour supply and labour demand;
- the labour force is equipped with transferable skills that employers require, enabling the rapid redeployment of labour within or between firms when labour demand changes;
- firms do not find it prohibitively costly to create employment or to vary it when needed;
- workers are able to commute easily or move residence in order to find employment;
- working patterns meet the needs of both employers and employees, increasing labour supply; and
- there is an institutional environment that encourages labour force participation, equips people to adapt to change and provides support for those without employment, enabling them to remain active participants in the labour market.

**Box C1: The interaction between labour, product and capital markets**




**Product market flexibility**

**C20** Product market flexibility relates to the ease with which firms are able to respond to changing market conditions. For individual firms or industries, increased flexibility enables them to respond rapidly, allowing firms to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive market environment.

**C21** The main characteristics of a flexible product market are that:

- there is a competitive environment which rewards efficiency, discourages waste and provides firms with strong incentives to adapt the range and quality of their goods and services to provide their customers with good quality products at competitive prices;
- there is a strong capacity for innovation, enabling firms to develop and implement new processes and products ahead of their competitors;
- there are low barriers to entry which allow new firms to challenge incumbents creating incentives for innovation and efficiency; and
- a regulatory environment in which the constraints on business yield clear benefits to the wider economy, and are not disproportionately costly in terms of their effect on firms' incentives to hire, train, innovate and invest.

**Capital market flexibility**

**C22** Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively. Efficient capital markets ensure that business, entrepreneurs and innovators have ready access to the funds they require in order to develop their ideas. Capital markets also play an important role in balancing the risks and returns of different uses of capital, screening out projects that have an unacceptably high level of risk.

**C23** Flexible capital markets can also play a role in underpinning flexibility in labour and product markets. They should allow individuals to borrow when necessary in order to enhance their education and skills with beneficial effects on productivity and the employability of the individuals concerned.

**C24** In product markets, flexible access to finance should allow firms to reallocate resources efficiently and to invest, as appropriate, in new processes and products.

**C25** A flexible capital market can also promote fairness by enabling all individuals to take advantage of educational and business opportunities. However, government intervention may on occasions be required to ensure that information asymmetries do not lead to some individuals being unfairly denied access to capital markets.

**C26** The main characteristics of a flexible capital market are that:

- firms have a range of financing options available to them, which allows them to access the capital they require at a competitive price, and on competitive terms. This applies particularly to firms seeking capital for high risk projects, where efficient capital markets are best placed to price the risk appropriately;
- firms and households have the ability to hold a diverse portfolio of assets spread across regions and sectors, so that they can use income from these assets to insure against a fall in income that is specific to their own region and sector; and
- there is sufficient borrowing and lending capacity in credit markets to allow households and business to smooth fluctuations in income.

## MEASURES TO PROMOTE FLEXIBILITY

**C27** This section of the report summarises the action the Government has taken since Budget 2004 and in this Pre-Budget Report to promote flexibility and fairness in the UK economy.

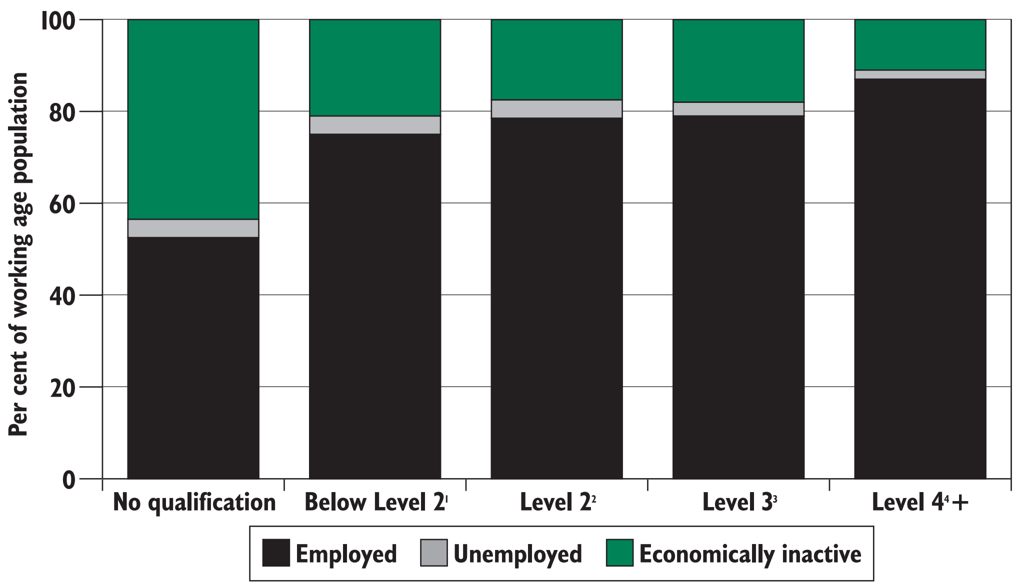
### Measures to promote flexibility and fairness in labour markets

**C28** The Government's long-term goal is employment opportunity for all – the modern definition of full employment. In an increasingly open and integrated global economy, the countries that will prosper are those with flexible and outward looking economies, which can react effectively to changing economic circumstances. This Pre-Budget Report sets out action to build on the successful recent performance of the UK labour market, and tackle the long-term challenges of increasing flexibility, reducing inactivity and helping those groups in society that face particular barriers to work.

**Developing skills**

**C29** *Skills in the global economy*, published alongside the Pre-Budget Report, explains that a highly-skilled workforce with a culture of lifelong learning is likely to be able to adapt faster and more effectively to global change: intensifying international competition; accelerating technological change and changing patterns of consumer demand. The proportion of people in the UK with high level qualifications, such as degrees, compares well internationally. However, the proportion of the workforce with intermediate level skills in the UK is comparatively low and a large proportion of people possess low or no qualifications. The Government is committed to ensuring that all adults can acquire the skills necessary to move into sustainable jobs, progress into more skilled employment and adapt to change in the workforce. Chart C3 shows how an increase in educational attainment increases the likelihood of being in work, illustrating the importance of education for individuals and the economy.

**Chart C3: Economic activity and highest qualification**




*Source: Labour Force Survey, Winter 2003.*
*1: 5 GCSEs A* – G or NVQ Level 1*
*2: 5 GCSEs A* – C or NVQ Level 2*
*3: A Level or NVQ Level 3*
*4: degree, postgraduate or NVQ Level 4 or 5*

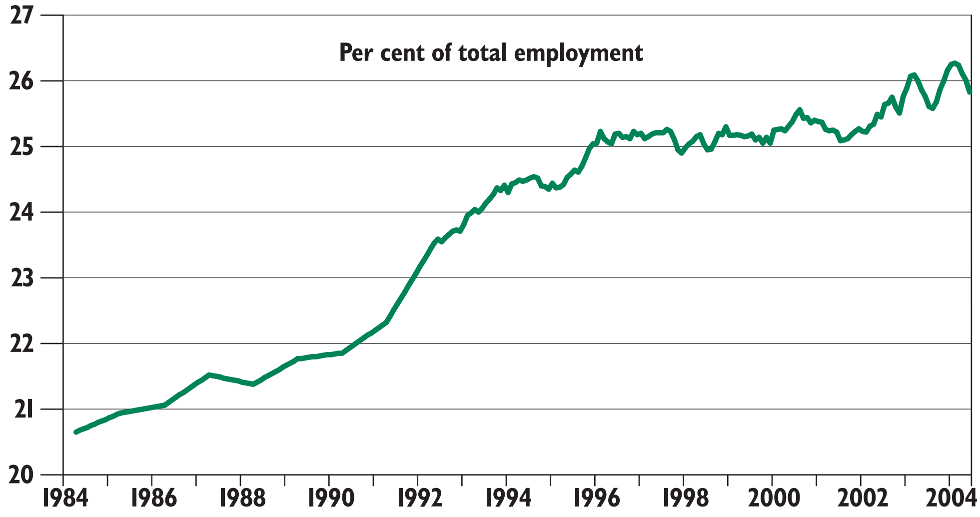
**C30** Chapter 6 in this Pre-Budget Report describes the Government's programme for driving improvement at all levels of the education system. Chapter 3 sets out the measures the Government is taking to achieve its ambitions of raising workforce skill levels and enhancing employability. Measures include:

- a **National Employer Training Programme** providing free and flexibly delivered training for low-skilled adults in work;
- an **independent review to be led by Sandy Leitch,** Chairman of the National Employment Panel and formerly a Chief Executive of Zurich Financial Services to examine the UK's future skills needs and priorities;
- implementing the **New Deal for skills**; and
- piloting a **Learning Allowance** that will allow benefit claimants to participate in full-time training as well as pilots of a skills coaching service to provide one-to-one personalised support.

**Employment flexibility**

**C31** If labour demand and supply are to be matched efficiently, a range of working patterns are needed, which give employers the flexibility to vary capacity levels and employees the choice to balance their work and other responsibilities, for example, through reduced hours or temporary work. The UK shows a significant degree of employment flexibility, with a wide distribution of hours worked and widespread adoption of flexible working practices. Chart C4 shows how the incidence of part-time employment in the UK increased over the 1980s, early 1990s and in the past few years.

**Chart C4: Part-time employment in the UK**




*Source: Labour force survey 2004.*

**C32** In line with its determination to advance both flexibility and fairness in the labour market, the Government is committed to giving parents more choice and support in balancing their work and family responsibilities. The Government's strategy involves supporting parents' choices; tailoring financial support to families' circumstances; enhancing access to good quality childcare and parenting services; and working in partnership with business to promote the benefits of flexible working and support the take up of best practice approaches. New initiatives introduced since the Budget, and described further in Chapter 5, include:

- **a ten-year strategy for childcare**, setting out how the Government will achieve its long-term vision of affordable, good quality childcare for all parents who need it, and provide parents with real choices in balancing work and family responsibilities;
- an extension of paid **maternity leave** from six months to nine months from April 2007 and improvements to financial support for childcare costs;
- **improvements to the childcare element** of the Working Tax Credits; and
- allocating **£769 million in additional funding for Sure Start** in the 2004 Spending Review to establish Children's Centres in every community, increase the number of childcare places available and set up a pilot to extend free early education.

**Improving labour market opportunities**

**C33** The performance of the UK labour market has been strong over recent years by both historical and international standards. However, the Government is determined to achieve its goal of employment opportunity for all by ensuring that everybody who is able and wants to work is given the appropriate assistance to help them to do so, while maintaining support for those people who are unable to work.

**C34** To this end, the Government has introduced a number of measures, described fully in Chapter 4, to provide support to individuals to help them overcome the barriers to work that they face, including:

- a major expansion of the **Pathways to Work pilots** for incapacity benefits claimants;
- a package of changes to further help people on **incapacity benefits**;
- an extension of the **In-Work Credit for lone parents** to six further pilot areas; and
- a revised and strengthened **Jobseeker's Agreement** with a clearer focus on the jobseeker's responsibilities and personal record of job search.

**Promoting geographical mobility**

**C35** A labour force that is able to move within and between regions enhances labour market flexibility by enabling workers to move to available employment opportunities. Evidence suggests that in the UK, as elsewhere in Europe, geographic labour mobility is low compared to the US. The Government has introduced several measures that aim to raise the ability and incentives for workers to commute or move location in order to find employment.

**C36** In March 2004, Kate Barker published her final report[1], setting out the reasons underlying the lack of supply responsiveness of housing in the UK. The Government accepted the central recommendation of this report that there should be a step change in housing supply, making it easier for households to access employment opportunities wherever they occur. To achieve this goal the Government announced:

- **an additional £1.3 billion for housing in 2007-08** compared to 2004-05; and
- **the Planning Delivery Grant** (PDG) where over £150 million has been allocated to planning authorities to drive up the performance of the planning system.

**C37** The current system of Housing Benefit can be complex, both for claimants to understand and Local Authorities to deliver, and is acting as a constraint on labour mobility both in and between regions. The Housing Benefit reform programme is now addressing these difficulties in the following ways:

- a **Housing Benefit Reform Fund worth £180m during 2006-08** to enable the roll out of flat-rate allowances and to improve the administration and structure of the Housing Benefit system; and
- a series of measures to continue to **simplify the Housing Benefit and Council Tax Benefit** system.

## Measures to promote flexibility and fairness in product markets

**C38** Chapter 3 of this Pre-Budget Report sets out the Government's programme of reform aimed at promoting flexibility and boosting productivity growth in the UK economy by focusing on measures which boost competition, enterprise, innovation, skills and investment.

**Competition**

**C39** Competition enhances flexibility by providing incentives for firms to respond quickly to changes in market conditions. Competitive pressures on firms in UK product markets results in firms striving to adopt more efficient working methods and to develop new products and services which meet the changing demands of consumers. Greater competition enhances the incentives for firms to innovate and to invest in order to raise their productivity and keep ahead of their rivals.

**C40** Globalisation, through international trade and investment, adds to the competitive intensity of the economy. Open markets, with low barriers to trade and investment, permit access to new opportunities in new countries and markets. This facilitates specialisation in those goods and services that economies produce more efficiently.

**C41** The Government continues to take steps to enhance competition, empower consumers and promote flexibility, discussed in more detail in Chapter 3. These include:

- progress on **promoting competition in a number of specific markets**;
- a range of **measures to protect consumers** including an ongoing review of the UK consumer framework; and
- action to improve **competition in public procurement**.

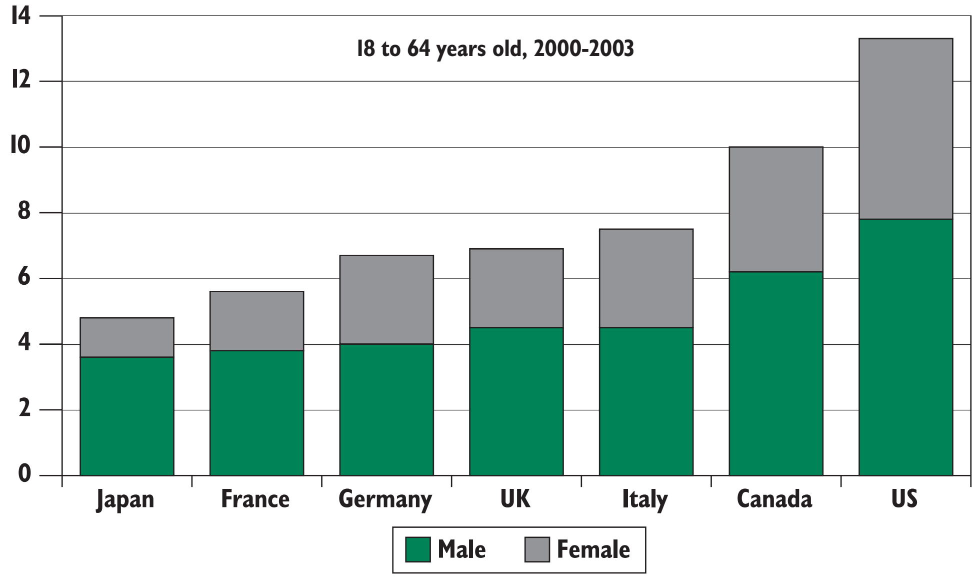
[1] *Delivering Stability: Securing Our Future Housing Needs*, Kate Barker, March 2004.

**Enterprise**

**C42** Enterprise is a key driver of a modern, high-productivity economy in which opportunity is open to all. The Government believes it is essential to make the UK a more entrepreneurial economy, so that it is well placed to meet the long-term opportunities and challenges of an increasingly globalised economy.

**C43** A good indicator of the enterprise culture in an economy is the proportion of the population who start a new business. Chart C5 shows the number of people starting a new business in the UK compared to the other G7 countries. The chart shows that the UK, with 6.9 start-ups per 100 people, is less entrepreneurial than some countries. The chart also shows that the proportion of women starting a company in the UK (35 per cent of new start-ups) is smaller than in the US (41 per cent), Canada (38 per cent) or Italy (40 per cent), all of which have higher aggregate totals than the UK.

**Chart C5: Number of start-ups per 100 people by gender**




*Source: Global Entrepreneurship Monitor 2003.*

**C44** Since Budget 2004, the Government has introduced a number of initiatives to improve enterprise education and culture in the UK, described further in Chapter 3. These include:

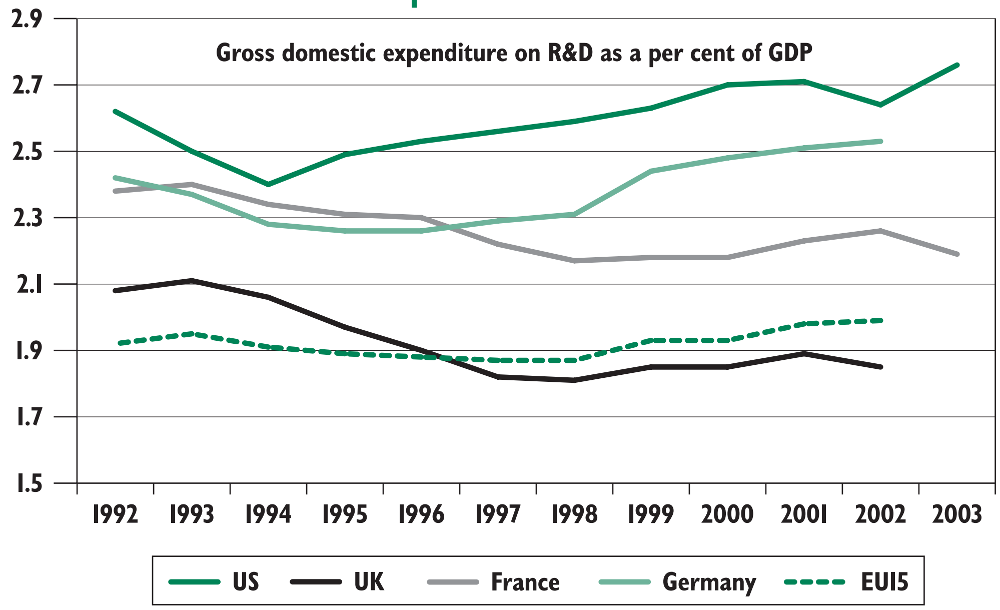
- publication of the interim report of the **Hampton Review** recommending improvements to the current system of regulatory inspection and enforcement, to reduce the administrative burden on business;
- reforms to reduce the **regulatory burden on enterprise**, including the extension of Common Commencement Dates to other areas of legislation and progress on the Panel for Regulatory Accountability;
- measures to **improve the tax system** including simplifying tax administration for small businesses and modernising the structure and administration of business tax; and
- a variety of measures to improve enterprise through **education and create a climate in which entrepreneurial activity is valued**.

**Science and innovation**

**C45** Science and innovation are key drivers of productivity growth. Recent OECD research suggests that 1 per cent growth in public research and development leads to a 0.17 per cent increase in total factor productivity in the long run[2]. The rate of technological change is particularly rapid in today's integrated global economy. This impacts on production methods and new product development and increases the importance of innovation for businesses. The UK's future prosperity is likely to depend increasingly on the capacity to expand knowledge through science and translate it into innovative products and better services.

**C46** The UK has an excellent science base but, in recent years, has been investing less on R&D research as a proportion of GDP in comparison to other major developed economies. While the UK still performs well in international comparisons of academic publications and citations, this position is unlikely to continue without an increase in public and private R&D investment.

## Chart C6: Total R&D expenditure




*Source: Eurostat.*
*2003 data not available for Germany, EU15 and UK.*

**C47** The Government is taking steps to promote science and innovation in the UK economy through increase in investment and by encouraging the commercial potential of primary research, discussed in more detail in Chapter 3. Further steps since the Budget include:

- implementation of the ten-year **Science and Innovation Investment Framework**, through strengthening the partnership with business on raising investment in UK R&D and taking forward the recommendations of the **Lambert review** of business-university collaboration; and

- legislation to remove the tax uncertainty for researchers involved in public sector and **university spin-off companies** to encourage the commercial development of public sector research.

[2] *R&D and Productivity Growth: Panel data analysis of 16 OECD countries*, Guellec and van Pottelsberghe de la Potterie, 2001.

**Investment** **C48** Investing in new technology and capital is important if firms are to respond to new opportunities in a competitive and entrepreneurial way. Where there are financial or structural barriers to new investment, firms' competitiveness will be constrained. In addition, investment in underlying infrastructure can help to facilitate flexibility in wider labour and product markets. The Government has undertaken the following action since the Budget to promote investment in the UK economy, discussed in more detail in Chapter 3:

- **implementation of the changes recommended by the Graham Review** on the Small Firms Loan Guarantee by the end of 2005; and
- draft guidance for investment managers interested in bidding to establish one of the new pathfinder **Enterprise Capital Funds**.

## Measures to promote flexibility and fairness in capital markets

**C49** Capital markets contribute to the flexibility of the economy by providing entrepreneurs and firms with the finance they require to fund their activities. A flexible capital market ensures that finance is provided at the lowest price appropriate to the investment risk borne by the provider. Efficient capital markets enable individuals to smooth out fluctuations in their income by offering a wide range of saving vehicles and allowing individuals prudently to borrow against future income.

**SME finance** **C50** The ability to access external sources of finance is essential if small businesses are to take full advantage of the investment opportunities available to them. Access to finance enables entrepreneurs and innovators to develop their ideas, ensuring that resources get directed to where they can be most profitably employed. The Government aims to ensure that the process of capital allocation works well for all businesses and that funds are allocated to all those companies who can profitably use them regardless of their size. New measures introduced include:

- easing of financial regulation by allowing **self-certification of sophisticated or high net worth investors**, making it easier for small firms to raise finance from business angels; and
- consultation on the implementation of the new **EU Prospectus Directive**, which will remove further barriers to small firms raising finance.

**Investment and corporate finance** **C51** An effective regulatory framework for investment decisions ensures that capital is allocated to the most efficient purposes, thus enhancing productivity, improving returns to investors and reducing the cost of capital. Improved transparency of information flows, better monitoring by principals and more effective accountability by agents are key elements of this framework. Over the past six years, the Government has undertaken a comprehensive review of all aspects of the investment chain, which connects individual savers and investing companies, and this is discussed more fully in Chapter 3. The Government has undertaken a programme of reform, going with the grain of the workings of markets. The complex interactions between the weaknesses at different points in the chain mean that each problem needs to be addressed if the overall goal of promoting more efficient approaches to investment is to be realised. The most recent elements to improve the workings of the investment chain include:

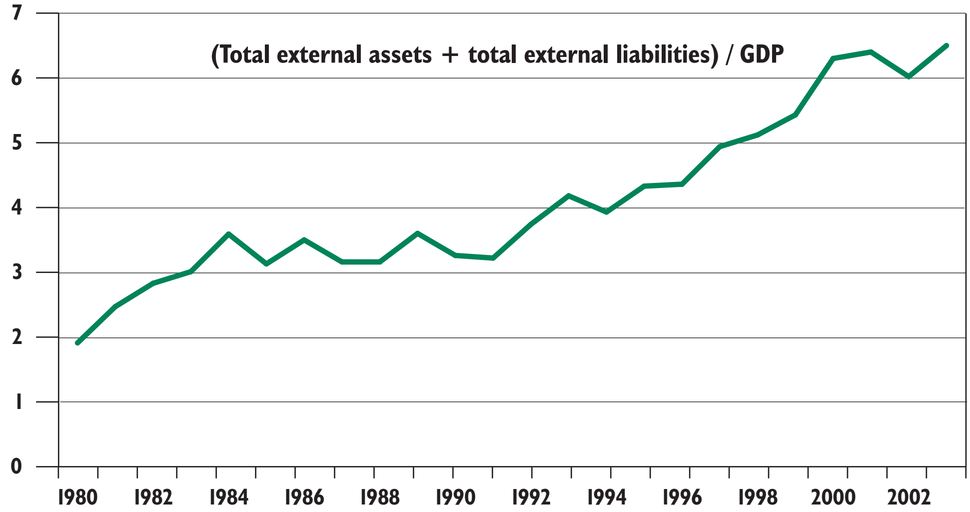
- measures to improve the efficiency of **pension funds**: strengthening the **competence of pension fund trustees**; and improving returns through the deregulation of investment restrictions;
- inviting Paul Myners to conduct an **independent review of the governance of mutual life offices**, which will report before the end of this year;
- enhancing the quality of information to investors through better **audit regulation, more extensive disclosure rules for listed companies and measures to improve shareholder voting;** and
- introducing, in the near future, deregulatory reforms to place **open-ended investment companies** on a more similar regulatory footing to authorised unit trusts.

**Capital Markets integration**

**C52** Capital market flexibility is enhanced by greater integration of domestic and international capital markets. Greater integration provides access to deeper and more liquid capital markets with probable benefits in terms of a lower cost of capital as a result of a more efficient allocation of capital. This will ensure that savers get the best return on their money and are able to hold a diversified portfolio of assets while funds flow to firms offering the best investment opportunities encouraging innovation. Global capital integration also facilitates risk sharing where a decline in returns in one market can be offset by increasing returns in another.

**C53** Chart C7 shows a summary volume-based measure of international financial integration used by the IMF.[4] The measure is the sum of total UK external assets and liabilities as a percentage of GDP and can be used as a proxy for financial openness and capital market integration. The chart suggests capital market integration has increased over 300 per cent in the UK since 1980, with a marked acceleration during the 1990s.

**Chart C7: Evolution of international financial integration in the UK**




*Source: ONS United Kingdom Balance of Payments – The Pink Book.*

[4] *International Financial Integration;* IMF working paper 03/86; April 2003.

**C54** The Government also continues to work with other EU Member States towards the creation of an integrated EU capital market and to press for greater integration of EU-US capital markets. Recent important steps in this direction have included:

- joint HM Treasury/FSA consultation on UK implementation of the EU's **Market Abuse Directive**. Implementation will introduce largely minor changes to the UK's existing regime promoting the integrity of financial markets and thereby their role in the process of capital allocation; and
- consultation on proposals for UK implementation of the **EU Prospectus Directive**.

**C55** Assets and savings provide opportunity and independence throughout life, flexibility to adjust to unforeseen events and financial security in retirement. Based on the principle of progressive universalism, the Government seeks to make asset ownership accessible to all and will provide more help for those who need it most. The Government seeks to provide targeted support and incentives for saving from childhood, through working life and into retirement. Chapter 5 highlights three measures the Government is taking to further promote saving and asset ownership:

- consulting on retaining the current **Individual Savings Accounts** limits;
- a larger **Saving Gateway** pilot; and
- consultation on a further payment at age 7 in the **Child Trust Fund**.

## CONCLUSIONS

**C56** Globalisation and the rapid pace of technological change highlight the importance of flexible and dynamic economies. Flexible labour product and capital markets which allow businesses and individuals to respond to changes in technology, consumer prices and competitive pressures by quickly adapting their production techniques, investment and employment, provides the key to economic success in a globally competitive environment.

**C57** As was highlighted in the Treasury 's economic assessment of the case for joining EMU, a high level of flexibility is especially important when a country needs to adjust to country-specific shocks within a monetary union, since a country-specific monetary policy response is not an option.

**C58** The Government is committed to the approach of advancing flexibility and fairness together, by enabling individuals and firms to cope with and respond to change. This report sets out the range of specific measures the Government is implementing in pursuit of these objectives, to ensure that the UK economy is well equipped to respond to current, and future, opportunities and challenges. A review of progress on the Government's reform agenda will be published at the time of Budget 2005