HM TREASURY

2010-11 Convergence Programme for the United Kingdom

submitted in line with the Stability and Growth Pact

April 2011

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ISBN 978-1-84532-866-5
PU1130

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1 Introduction

1.1 The Stability and Growth Pact (SGP) requires Member States to provide information on economic developments in their country, for the purposes of the multilateral surveillance procedure under Articles 121 and 126 of the EU Treaty.

1.2 Assessments under the SGP are subject to parliamentary scrutiny. The UK presents copies of the UK's Convergence Programme and Excessive Deficit Procedure (EDP) assessments to Parliament along with an Explanatory Memorandum.

1.3 Since the last Convergence Programme, a new Government has been elected. One of its first actions was to set up the new independent Office for Budget Responsibility (OBR), which introduces independence, greater transparency and credibility to the economic and fiscal forecasts. Major fiscal events since the election have been June Budget 2010, the October 2010 Spending Review and Budget 2011. This Convergence Programme draws on those publications, particularly Budget 2011.

1.4 The forecasts for the economy and public finances included in the United Kingdom's Convergence Programme are prepared by the independent OBR, information on which is set out in Chapter 5. The forecasts set out are taken from the OBR's March 2011 *Economic and fiscal outlook*, which was published alongside Budget 2011.[1]

1.5 The Convergence Programme is subject to UK Parliamentary scrutiny under Section 5 of the European Communities (Amendment) Act 1993.

Government policy

1.6 The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries.

1.7 Creating lasting prosperity requires the economy to change and to rebalance from unsustainable public spending toward net trade and private-sector investment. This will support the UK's long-term economic potential and help to create new jobs.

1.8 Government policy has an important role to play in supporting the necessary rebalancing toward sustainable, private sector-led growth and minimising risks to the recovery. The Government has set out a strategic policy response to the UK's exceptional economic and fiscal challenges:

- fiscal policy will bring the public finances back under control over the medium-term, addressing the largest budget deficit in the UK's post-war history. It is essential to mitigate downside risks from rising public debt, promote stability and provide businesses with the confidence they need to invest;
- monetary policy will ensure price stability, and thereby support wider economic stability;

[1] *Economic and fiscal outlook*, OBR, March 2011.

- reform of financial sector regulation will help to prevent the build-up of systemic risks and ensure financial stability, a pre-requisite for sustainable growth; and
- microeconomic policies will drive growth and position the UK at the forefront of the global economy, to meet the Government's ambitions to: create the most competitive tax system in the G20; make the UK the best place in Europe to start, finance and grow a business; encourage investment and exports as a route to a more balanced economy; and create a more educated workforce that is the most flexible in Europe.

1.9 In June Budget 2010 and Spending Review 2010 the Government took the first steps in implementing this strategy through urgent action to address the extraordinary rise in the deficit prior to and during the crisis.

1.10 Budget 2011 confirmed that the Government is continuing this course, and accelerates the process of reforming the British economy, to achieve a new model of sustainable and balanced growth.

Performance against EU obligations

1.11 Following the action the Government has taken, detail of which is set out in this Convergence Programme, the path set for fiscal policy is now consistent with the UK meeting its Excessive Deficit Procedure recommendation to reduce the Treaty deficit below 3 per cent of GDP in 2014-15. The OBR projects that the Treaty deficit will fall from 11.4 per cent of GDP in 2009-10 to 2.6 per cent of GDP in 2014-15, and that the Treaty debt ratio will be restored to a downward path from 2014-15.

Structure of the Convergence Programme

1.12 The first five chapters of this Convergence Programme detail Government policy on the fiscal position, sustainability of the public finances and the macro-economy, as required by the Code of Conduct.

1.13 Reflecting the establishment of the independent OBR, detail on their economic and fiscal forecasts is set out separately in the final four chapters of the Convergence Programme, drawing upon the OBR's *Economic and fiscal outlook*.

1.14 Annex A provides details of the financial impact of June Budget 2010, Spending Review 2010 and Budget 2011 policy decisions. Annex B provides supplementary data.

2 Overall Policy Framework and Objectives

2.1 All data included in this chapter is correct at the time of Budget 2011, which was published on 23 March 2011.

A strong and stable economy

Rebalancing the UK economy

2.2 Over the pre-crisis decade, developments in the UK economy were driven by unsustainable levels of private sector debt and rising public sector debt. Indeed, it has been estimated that the UK became the most indebted country in the world.[1]

2.3 Chart 2.1 highlights the rise in private sector debt in the UK. Households took on rising levels of mortgage debt to buy increasingly expensive housing, while by 2008 the debt of non-financial companies reached 110 per cent of GDP. Within the financial sector, the accumulation of debt was even greater. By 2007, the UK financial system had become the most highly leveraged of any major economy. The level of public sector net debt as a share of GDP steadily rose from 2001-02, as the government ran a persistent structural deficit, despite continued economic growth.

2.4 Public and private sector borrowing relied on finance from abroad. The UK's current account went from near balance in 1997 to a deficit of more than 3 per cent of GDP by 2006, which was, in absolute terms, the third largest in the world.

2.5 Increasing reliance on the financial sector and borrowing in the private and public sectors drove growing imbalances in the UK economy:

- Chart 2.2 shows that from 2001 onwards public spending grew steadily as a share of the economy and a structural deficit began to emerge. According to the OECD, by 2007 the UK had the largest structural deficit of any G7 economy. Moreover, the spending plans set out in the 2007 Comprehensive Spending Review were based on unsustainable revenue streams from the property boom and the financial sector. As tax receipts fell away during the crisis, the persistent gap between spending and revenue widened, with total public spending rising to around 47½ per cent of GDP by 2009-10; and
- higher public borrowing was used to finance increased public spending, driving up the price of public services, so that the proportion of the economy made up by government rose in the pre-crisis decade. By contrast, business investment as a percentage of GDP fell, leaving its share in the UK among the lowest in advanced economies.

2.6 Economic growth was unbalanced across the UK, concentrated in the South East, with some other parts of the country increasingly reliant on jobs funded by public spending. Growth relied on a limited number of sectors. Financial services' share of GDP rose from 6½ per cent in 1997

[1] *Debt and deleveraging The global credit bubble and its economic consequences*, McKinsey Global Institute, January 2010.

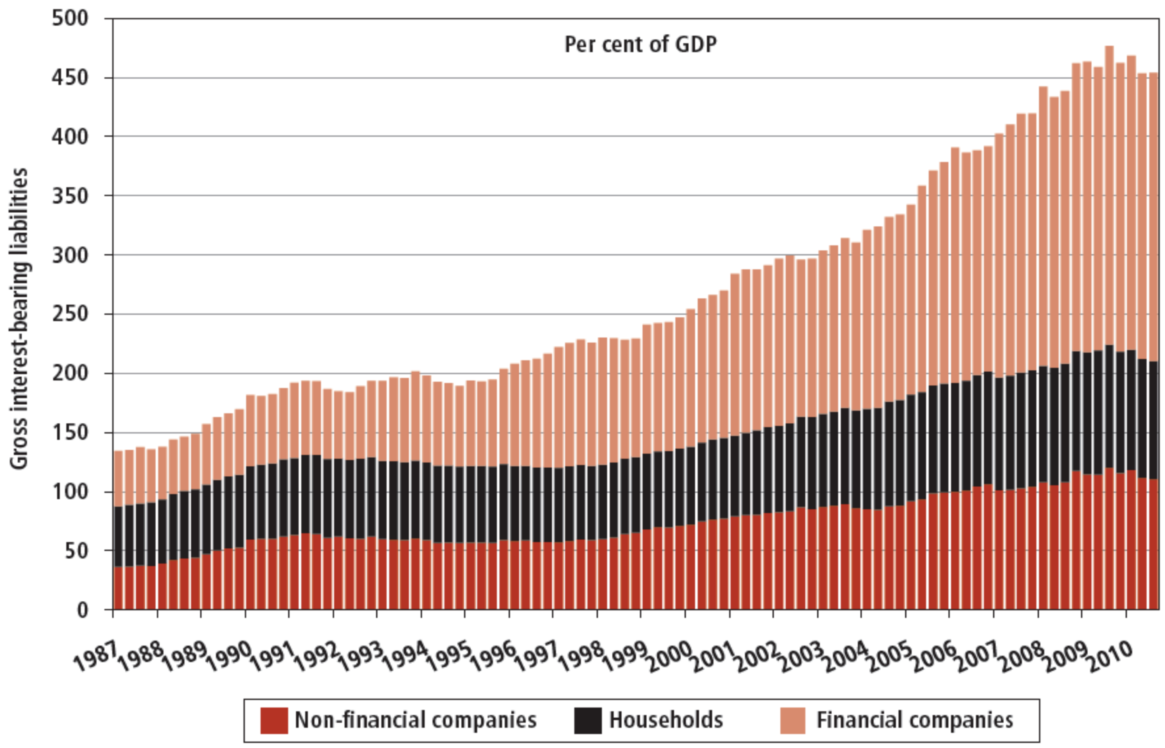
to 8½ per cent in 2007, while manufacturing's share nearly halved over the same period, from over 20 per cent to 12½ per cent.

2.7 This model of growth proved to be unsustainable. More than a quarter of the GDP per capita growth in the pre-crisis decade to 2007 was reversed during the financial crisis and recession of 2008 and 2009. As the OECD concluded in its March 2011 Economic Survey of the UK:

"The global financial crisis and the associated recession ended a 15-year period of continuous growth, rising employment and stable inflation. Significant imbalances had developed, however, in terms of public and external deficits, an excessively leveraged financial sector, high house prices and low household savings. The imbalances exacerbated the downturn during the global recession and contributed to a more pronounced fall in GDP, a larger fiscal deficit and higher inflation than in most of the OECD."[2]

2.8 The level of UK economic activity in current prices (money GDP) is estimated to be around 10 per cent lower in 2010-11 than it was forecast to be at Budget 2008. In other words, the economy is now around 10 per cent smaller than it was forecast to be only three years ago, reducing the resources available for government spending.

Chart 2.1: Private sector debt in the UK



Source: Office for National Statistics.

The Government's strategy

2.9 The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries. Creating lasting prosperity requires the economy to change and to rebalance: from unsustainable public

[2] *OECD Economic Surveys: United Kingdom 2011,* Organisation for Economic Co-operation and Development (OECD), March 2011.

spending toward net trade and investment, which will support the UK's long-term economic potential and help to create new jobs.

2.10 Government policy has an important role to play in supporting the necessary rebalancing toward sustainable, private sector-led growth and minimising risks to the recovery. The Government has set out a strategic policy response to the UK's exceptional economic and fiscal challenges:

- fiscal policy will bring the public finances back under control over the medium-term, addressing the largest budget deficit in the UK's post-war history. It is essential to mitigate downside risks from rising public debt, promote stability and provide businesses with the confidence they need to invest;
- monetary policy will ensure price stability, and thereby support wider economic stability;
- reform of financial sector regulation will help to prevent the build-up of systemic risks and ensure financial stability, a pre-requisite for sustainable growth; and
- microeconomic policies will drive growth and position the UK at the forefront of the global economy, to meet the Government's ambitions to: create the most competitive tax system in the G20; make the UK the best place in Europe to start, finance and grow a business; encourage investment and exports as a route to a more balanced economy; and create a more educated workforce that is the most flexible in Europe.

Fiscal Policy

2.11 The current historically high level of public borrowing risks undermining fairness, growth and economic stability in the UK. Tackling the deficit is essential as it will:

- reduce the UK's vulnerability to further shocks or a loss of market confidence, which could force a much sharper correction;
- underpin private sector confidence, supporting growth and job creation over the medium term;
- help keep long-term interest rates down, helping families and businesses through the lower costs of loans and mortgages;
- keep debt and debt interest paid by the Government – and ultimately the taxpayer – lower than would otherwise have been the case; and
- avoid accumulating substantial debts to fund spending that benefits today's generation at the expense of tomorrow's, which would be irresponsible and unfair.

2.12 June Budget 2010 set out comprehensive policies to bring the public finances back under control, demonstrating the Government's determination to reduce public sector borrowing and debt and promote confidence in the sustainability of the public finances. The Government:

- set fiscal plans to restore the public finances to a sustainable position;
- created the new Office for Budget Responsibility (OBR), introducing independence, greater transparency and credibility to the economic and fiscal forecast on which fiscal policy is based; and
- announced a clear, forward-looking fiscal mandate to guide fiscal policy decisions over the medium term.

Fiscal consolidation plan

2.13 The Government's fiscal consolidation plans have been designed with growth and fairness in mind, as far as possible:

- protecting the most productive public investment expenditure;
- avoiding punitive increases in tax rates on capital and labour; and
- reforming the welfare system to reward work.

2.14 As set out in Table 2.1, the Government plans a total consolidation of £126 billion a year by 2015-16, consisting of total reductions in spending of £95 billion and a net increase in taxes of £30 billion. Implementation of these plans is now underway. Under the plans that this Government inherited, £14 billion of spending cuts were planned in 2011-12, compared with 2010-11. This Government's spending cuts amount to £16 billion over the same period.

2.15 Taking the consolidation as a whole, 73 per cent of the total will be delivered by lower spending in 2014-15, rising to 76 per cent in 2015-16. This is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that largely rely on spending restraint promote growth.[3]

Table 2.1: Total consolidation plans over the forecast period

	£ billion					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Policy inherited by the Government	**1**	**26**	**41**	**58**	**72**	
Spending[1]	0.0	14	25	39	51	
Tax	1.0	12	16	19	21	
Spending share of consolidation (per cent)	*0*	*54*	*61*	*67*	*71*	
Total discretionary consolidation	**9.4**	**41**	**61**	**88**	**110**	**126**
Spending[1, 2, 3]	5.5	22	38	59	80	95
Tax[4]	3.8	20	23	29	30	30
Spending share of consolidation (per cent)	*59*	*53*	*62*	*67*	*73*	*76*

[1] *Spending consolidation is attributable to three factors. Reductions in DEL are calculated by assessing the latest nominal DEL totals (set out in Table 2.4) against a counterfactual of growing DELs in line with general inflation in the economy, as set out in Table 4.8 of the OBR's pre-Budget forecast (June 2010). The reduction in AME is the net effect of AME policy changes announced since June Budget 2010. Finally, the spending reduction also includes estimated debt interest savings now updated for Budget 2011 debt interest forecast assumptions.*

[2] *The spending share of the total consolidation is lower across the forecast period than that set out in Table 1.1 of June Budget 2010. This is largely the result of updating the total consolidation savings attributable to AME policies in line with the OBR's Budget 2011 AME forecast and the revision to the capital envelope at Spending Review 2010. (See Table 2.2 for updated costings of policy measures announced in Spending Review 2010 or earlier, but still to be implemented).*

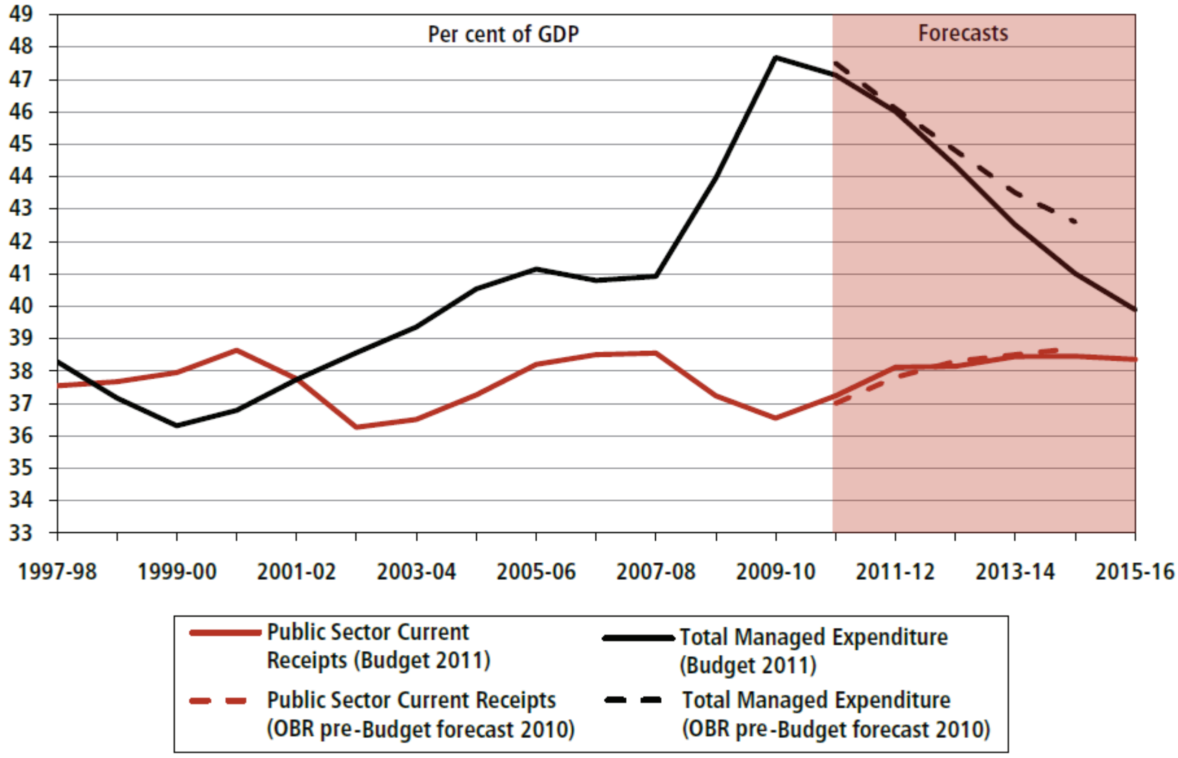
[3] *The Government has not set DELs for 2015-16. Figures shown above are based on the assumption that Total Managed Expenditure between 2014-15 and 2015-16 grows in line with inflation. (See Table 2.3 for the breakdown of Total Managed Expenditure across the forecast period).*

[4] *The tax consolidation figure includes an updated costing for the pensions tax relief measure (see Table 2.2) and tax measures from the scorecard (see Table 2.1).*

2.16 Chart 2.2 shows that, as a result of these plans, public spending is projected by the OBR to fall from around 47½ per cent of GDP in 2009-10 to around 40 per cent of GDP by 2015-16, while tax receipts are projected to rise from 36½ to around 38½ per cent of GDP over the same period, addressing the imbalances in the public finances.

[3] See *Economic Outlook No.81*, OECD, June 2007 and *OECD Economic Surveys: United Kingdom 2011*, OECD, March 2011.

Chart 2.2: Receipts and expenditure



Source: Office for Budget Responsibility and Office for National Statistics.

Implementation of fiscal consolidation

2.17 Implementation of the Government's fiscal plans is underway. The Government is on course to deliver the £6.2 billion of savings announced in May 2010.

2.18 Spending Review 2010 set firm and fixed departmental budgets for four years from 2011-12 to 2014-15, as well as announcing reforms to Annually Managed Expenditure (AME), including welfare and public service pensions. The Government protected spending on the NHS and overseas aid and also made choices to: prioritise fairness and social mobility; focus on spending that promotes long-term economic growth; and reform public services, to shift power away from central government to the local level and improve value for money.

2.19 The Government is implementing plans and reforms announced in the Spending Review. Legislation has been introduced to Parliament where necessary, including the Welfare Reform and Pensions and Savings Bills. Detailed funding settlements have also been announced, including for local government, schools and science.

2.20 The Government is committed to ensuring the spending consolidation is delivered. The Public Expenditure Cabinet Committee will oversee departments' implementation of their Spending Review plans, holding them to account on their progress. Business plans for each department, setting out information on key reform programmes and performance data on public services, are being finalised this spring. The public will be able to monitor progress on plans through monthly reports and a quarterly performance scorecard for each department.

2.21 The Government has implemented the tax plans for 2011-12 announced or confirmed in June Budget 2010, including the increase in the standard rate of VAT to 20 per cent on 4 January 2011.

The fiscal policy framework

The Office for Budget Responsibility

2.22 The creation of the independent OBR has significantly enhanced the credibility of the UK's fiscal policy. The IMF has welcomed the OBR as "*addressing deficiencies in the previous Government's fiscal framework*" and "*complementing the Government's commitment to fiscal discipline*",[4] while the OECD concluded "*This is clearly an important initiative in terms of strengthening government management of public spending and improving public confidence in the government's fiscal policy*".[5]

2.23 The OBR has now been placed on a permanent, statutory footing through the Budget Responsibility and National Audit Act 2011, which received Royal Assent on 22 March. The OBR has produced all the official forecasts of the economy and public finances since the General Election, independently of Ministers.

Fiscal objectives

2.24 To promote transparent fiscal policy-making, the new fiscal policy framework introduces a requirement for the Government to set out its fiscal policy objectives and fiscal mandate before Parliament in the Charter for Budget Responsibility. The Government published the Charter in draft on 22 November 2010, with the final version published on 4 April 2011. The Government's fiscal policy objectives, presented in the Charter, are to:

- ensure sustainable public finances that support confidence in the economy, promote intergenerational fairness, and ensure the effectiveness of wider Government policy; and
- support and improve the effectiveness of monetary policy in stabilising economic fluctuations.

The fiscal mandate and supplementary target for debt

2.25 The Government has set a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. At Budget 2011, the end of the forecast period was 2015-16.

2.26 The fiscal mandate is based on:

- the current balance, to protect the most productive public investment expenditure; and
- a cyclically-adjusted aggregate, to allow some fiscal flexibility at a time of economic uncertainty.

2.27 June Budget 2010 also announced a supplementary target for debt. This requires public sector net debt (PSND) as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are restored to a sustainable path.

2.28 The Government has asked the OBR independently to judge whether fiscal policy is consistent with: a greater than 50 per cent chance of meeting the mandate; and with a greater than 50 per cent chance of meeting the target for debt.

2.29 The choices of a five-year rolling forecast period for the fiscal mandate, supplemented by the fixed date for the debt target, reflect the exceptional environment in which the Government must address the fiscal challenge. They are designed to ensure that fiscal consolidation is

[4] *IMF UK Article IV Report*, November 2010.

[5] UK: Policies for a Sustainable Recovery, OECD, July 2010.

delivered over a realistic and credible timescale. Once the public finances are closer to balance the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

Monetary policy framework

2.30 At Budget 2011, the Government reaffirmed the inflation target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times. The Monetary Policy Committee (MPC) of the Bank of England has full operational independence to set policy to meet the inflation target. The MPC has maintained Bank Rate at 0.5 per cent since March 2009, and undertaken a programme of asset purchases, through the Asset Purchase Facility, financed by the issuance of central bank reserves totalling £200 billion. The Government confirmed in Budget 2011 that the Asset Purchase Facility will remain in place for the financial year 2011-12.

Financial regulation framework

2.31 The Government is implementing its plans to overhaul the tripartite system of financial regulation, by meeting its commitment to provide the Bank of England with:

- control of macro-prudential regulation, which relates to system-wide risks. The Government will legislate to create a Financial Policy Committee (FPC) within the Bank of England, with a clear macro-prudential remit to identify the risks that build up across the system as a whole and the power to ensure that action is taken to address those risks before they can threaten wider stability. An interim FPC was established in February 2011; and
- oversight of micro-prudential regulation, which focuses on risks within individual financial institutions. The Government will establish the Prudential Regulation Authority (PRA) as a subsidiary of the Bank. The PRA will promote the safety and soundness of the financial institutions it regulates, minimising the wider economic impact should a firm fail.

2.32 The Government intends to introduce primary legislation in 2011 to implement these reforms.

Microeconomic policy to support growth

2.33 *The Plan for Growth*,[6] published alongside Budget 2011, contains four overarching ambitions that will ensure progress is made towards achieving strong, sustainable and balanced growth. The ambitions are to:

- create the most competitive tax system in the G20;
- make the UK the best place in Europe to start, finance and grow a business;
- encourage investment and exports as a route to a more balanced economy; and
- create a more educated workforce that is the most flexible in Europe.

[6] *The Plan for Growth*, HM Treasury and Department for Business, Innovation and Skills, March 2011.

2.34 Each ambition is supported by a number of measurable benchmarks against which the Government expects to be judged. The Government will constantly benchmark the UK against best practice around the world.

2.35 More detail can also be found in the UK's National Reform Programme (NRP) 2011, under the Europe 2020 strategy, which sets out the UK's economic prospects and plans. This includes the actions taken to address the five key "bottlenecks" or obstacles to growth as agreed by the EU's Economic and Finance Affairs Council and the UK in June 2010. It also outlines the UK's approach to national monitoring and actions taken in support of the five headline European targets under Europe 2020 and agreed by the European Council in June 2010.

Recent economic developments

2.36 Global developments, the legacy of the past economic imbalances that built up over recent years, and the action that the Government is taking to address them provides the backdrop to UK economic developments since June Budget 2010.

Global developments

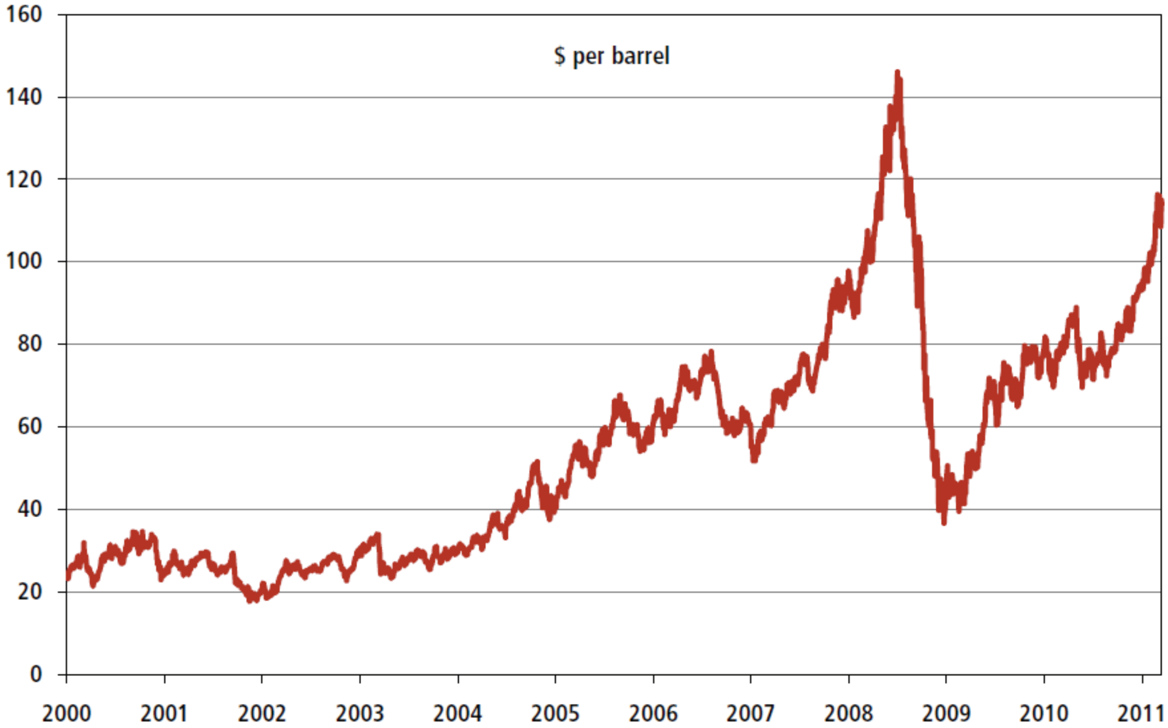
2.37 The world economy returned to growth in 2010, with world GDP rising by 5 per cent over the year.[7] However, this masks divergences across regions. In the major emerging markets, GDP and credit growth have rebounded rapidly. In advanced economies, such as the US and core euro area, recoveries have been more moderate and unemployment remains high. Growth in the euro area periphery has been hampered by sovereign debt crises. The UK is supporting Ireland through EU, IMF and bilateral packages. The G20 continue to work towards policy that delivers "*strong, sustainable and balanced growth*".[8]

2.38 Global financial markets have continued to experience volatility and heightened uncertainty in recent months, as a series of shocks have hit the global economy. Commodity prices have risen sharply, with dollar oil prices around 50 per cent higher than June last year, as shown in Chart 2.3, in part reflecting instability in the Middle East and North Africa. Stock markets gradually improved through the course of 2010, as the recovery in the world economy strengthened. In more recent weeks, markets have seen sharp falls following the devastating earthquake and tsunami in Japan. In response to volatility in the yen exchange rate associated with the events in Japan, the UK along with other G7 countries took part in a co-ordinated foreign currency intervention on 18 March 2011.

[7] *World Economic Outlook update,* IMF, January 2011.

[8] *G20 Finance Ministers and Central Bank Governors meeting,* Paris, February 2011.

Chart 2.3: Brent crude oil price



Source: Reuters.

UK activity and rebalancing[9]

2.39 In 2010, the UK economy grew by 1.3 per cent, but in line with previous recoveries, quarterly GDP growth has been choppy. Inflation has risen sharply, lifted by temporary factors such as a surge in global commodity prices and the effect of the 2008 depreciation of sterling on import prices. The labour market has shown signs of recovery with private sector employment growing by 428,000 over the course of 2010.

2.40 After four consecutive quarters of growth, the latest estimate from the Office for National Statistics (ONS) suggests GDP fell by 0.5 per cent in the final quarter of 2010.[10] The estimated decline largely reflects the temporary effect of bad weather in December, although the ONS estimate of the underlying strength of the economy was still weaker than expected. The bad weather adds to the significant uncertainty in assessing the underlying strength of the economy.

2.41 The rebalancing of the economy appears to be underway:

- manufacturing output continues to expand rapidly. In 2010, manufacturing output grew by 3.6 per cent, its fastest rate since 1994;
- the value of UK goods exports rose by 17 per cent in 2010, supported by growth to emerging markets: exports of goods to China rose by more than 40 per cent over the year. Recent surveys point toward continued export growth in the coming months, with both the Confederation of British Industry (CBI) and the Chartered Institute of Purchasing and Supply (CIPS) measures of export orders above their long-run averages; and

[9] All data from the Office for National Statistics unless otherwise stated.
[10] Estimate for Q4 GDP updated since Budget to a fall of 0.5%.

- business investment fell very sharply through the recession, but has started to recover and at an earlier stage than in previous recoveries. According to the latest estimate from the ONS, business investment has grown by nearly 7 per cent since the third quarter of 2009. Survey measures of investment intentions have strengthened, as shown in Chart 2.4. The reductions in the rate of corporation tax and healthy financial position of UK companies in aggregate should help support further investment growth.

Chart 2.4: Firms' investment intentions (Bank of England Agents' scores)

Note: The score can range from -5 to +5, with -5 denoting a rapidly falling level and +5 representing rapid growth.

Source: Bank of England.

2.42 Output in the services sector, which constitutes around three quarters of the economy, rose by 1.1 per cent in 2010. Construction output rose by 5.6 per cent in 2010, although quarterly output data, which can be volatile, has been uneven. Both the construction and services sectors were affected by the bad weather in December, but survey measures point to recovery at the start of this year.

2.43 Credit conditions have shown signs of stabilisation. Reports from the Bank of England Agents suggest credit availability for larger companies has improved and the cost of credit has decreased. However, credit conditions for smaller firms remain tight. According to the latest Bank of England Credit Conditions Survey, the availability of secured credit to households remained broadly unchanged over the second half of 2010. Net secured lending to households has remained stable, albeit at low levels.

2.44 In February 2011, the five largest banks operating in the UK (Barclays, HSBC, Lloyds Banking Group, The Royal Bank of Scotland and Santander) agreed to make £190 billion of new credit available to businesses this year. Of this total, £76 billion will be made available to small and medium-sized enterprises (SMEs), £10 billion more than the banks lent to SMEs in 2010.

Labour market

2.45 Employment has started to recover, in line with the rise in activity. While public sector employment began to fall from December 2009, and was down by 132,000 in the year to December 2010, private sector employment rose by 428,000. Consistent with this, redundancies have fallen to their lowest level since August 2008. The ILO unemployment rate rose slightly in the three months to January, to 8.0 per cent. The claimant count fell in February 2011 and is down by almost 130,000 on a year earlier.

2.46 Excluding the effect of bonus payments, whole economy earnings growth picked up progressively through 2010, but remains subdued by historical standards.

Inflation

2.47 Recent months have seen a large and unexpected surge in commodity prices. Since the summer of 2010, world agricultural commodity prices have risen by over 50 per cent,[11] while sterling oil prices have increased by around 40 per cent. These global developments along with other temporary factors, including the lagged effects of the 2008 depreciation of sterling, helped to push up inflation over the past year. CPI inflation was 4.4 per cent in February 2011. In its latest Inflation Report,[12] the Bank of England estimated that, excluding the contribution of these temporary factors, prices of other goods and services have on average increased at a rate below the inflation target in 2010 and that import prices, energy prices, and the increases in the standard rate of VAT together could be adding between 2 to 4 percentage points to CPI inflation in the final quarter of 2010.

Budget 2011 decisions

Fiscally neutral

2.48 Fiscal consolidation is necessary to reduce risks in the short term, restore private-sector confidence and underpin sustainable economic growth. Budget 2011 took place against a backdrop of ongoing global economic uncertainty in the wake of the financial crisis, including from ongoing sovereign debt concerns, most apparent in the euro area periphery, and continued adjustment in the global financial sector. This uncertainty reinforces the case for stability in the Government's plans for fiscal consolidation:

- delivering the Government's fiscal consolidation plan is essential to reduce the risks of a costly loss of market confidence in UK fiscal sustainability. There is evidence that the Government's fiscal plans are delivering improved market confidence;
- a consistent approach from Government in tackling the UK's large structural deficit provides much needed stability and certainty for businesses making hiring and investment decisions; and
- in the current context, stepping back from the Government's commitment to fiscal consolidation would, other things equal, risk prompting an offsetting monetary tightening such that overall there would be little, if any, net support to economic activity even in the short-term.

2.49 The IMF has endorsed the UK Government's action as "*essential*"[13] to ensure debt sustainability and concluded that it will help rebalance the economy. Similarly, the OECD's view is that "*the announcement and initial implementation of the fiscal consolidation programme strikes the right balance between addressing fiscal sustainability and thereby reducing tail-risks on the one hand, and preserving short-term growth on the other*."[14]

[11] As of mid March, according to the S&P GSCI Agricultural Index.
[12] *Inflation Report*, Bank of England, February 2011.
[13] IMF UK Article IV statement, September 2010.
[14] *OECD Economic Surveys: United Kingdom 2011*, OECD, March 2011.

2.50 Previous UK and international experience demonstrates that fiscal consolidation can be achieved alongside continued economic growth. The evidence from the fiscal tightening currently underway in the UK supports this conclusion. Table 2.3 shows Treasury estimates, based on the OBR's forecast, of the cyclically-adjusted primary balance, a measure that excludes the effects of the cycle and debt interest payments on the deficit and so illustrates the underlying fiscal position. This measure tightened by 2.3 per cent of GDP in 2010-11, compared with a year earlier, while the economy returned to growth of 1.3 per cent in 2010. In 2011-12, the projected tightening in the cyclically-adjusted primary balance is of an equivalent scale, at 2.2 per cent of GDP, and the economy is forecast to grow by 1.7 per cent in 2011.

2.51 The OBR forecasts public sector net borrowing to fall from its post-war peak of 11.1 per cent of GDP in 2009-10 to 9.9 per cent of GDP in 2010-11. This fall is largely as a result of the implementation of consolidation measures, including in-year reductions in spending and increases in VAT. The OBR forecasts borrowing to fall further to 7.9 per cent of GDP in 2011-12, which is still above the previous post-war peaks seen in the early 1990s and mid-1970s. Over the medium term, while the OBR forecasts for borrowing and debt are slightly higher than in June Budget 2010, their estimate of the path of the cyclically-adjusted current balance is broadly unchanged. This unchanged outlook for the underlying fiscal position, combined with the significant ongoing uncertainty in the outlook, demonstrates the need to stay the course of planned structural consolidation in the public finances.

2.52 Budget 2011 discretionary policy decisions have a neutral impact on the public finances. The costs of policy decisions announced in Budget 2011 are broadly offset in each year by measures to raise revenue. This balanced judgement reinforces the fiscal consolidation plans announced at June Budget 2010 and Spending Review 2010. Further detail is provided in Chapter 4.

Debt and reserves management

2.53 The *Debt and Reserves Management Report 2011-12*,[15] published alongside Budget 2011, set out details of the Government's financing plans for 2011-12. The projection for the Net Financing Requirement (NFR) in 2011-12 is £167.4 billion. This will be met by gross gilt sales of £169.0 billion and a reduction in the Treasury bill stock of £1.6 billion. Financing for 2011-12 will provide £6.0 billion of financing for the Official Reserves. The Government envisages sterling financing for the Official Reserves being held at a similar level on average over the three years up to, and including, 2014-15. This sterling financing will be sufficient to meet potential calls on the Official Reserves from the IMF and ensure the level of foreign currency reserves is sufficient. The Government retains the option of issuing foreign currency denominated securities. Following any such issuance, sterling financing for the reserves would be adjusted accordingly.

Reform of the spending framework

2.54 Delivering the Government's spending plans will require a more robust framework for spending control, given the scale of the challenge. The current framework splits expenditure into Departmental Expenditure Limits (DEL), which are fixed departmental budgets, and Annually Managed Expenditure (AME), which is not subject to such firm control. The Government is therefore considering options for strengthening control over AME by increasing the amount of spending that is managed within fixed budgets. This will improve incentives to manage AME, in particular social security spending which is the most significant component. Further detail will be set out by the summer.

[15] *Debt and Reserves Management Report 2011-12*, HM Treasury, March 2011.

2.55 Budget 2011 announced that a new Budget Exchange system will be introduced in 2011-12, to replace the End-Year Flexibility system. Further details are set out in Chapter 5. In addition, the Government is introducing a new framework to manage DECC's levy-funded spending, in order to cap the total impact of these policies on energy bills.

Action to address long-term fiscal pressures

2.56 Budget 2011 also announced action to address longer-term fiscal pressures, in particular those arising from an ageing population. The Government has already taken significant action to address future fiscal pressures arising from demographic change, including bringing forward the rise in the State Pension Age (SPA) from 65 to 66 to 2020 from 2026.

2.57 The Budget announced further measures to address long-term spending pressures, setting out the Government's initial response to the final report of the Independent Public Service Pensions Commission, and announcing that the Government will bring forward proposals to manage future increases in the State Pension Age more automatically in response to increases in longevity, including through a regular independent review of the implications of longevity changes.

2.58 The decisions the Government is taking to strengthen the tax system – including the increase in VAT announced at June Budget 2010, the move to CPI indexation of the benefit and direct tax system, and the introduction of the carbon price floor announced at Budget 2011 – will also help to support the long-term sustainability of the public finances.

2.59 Chapter 9 of the Convergence Programme sets out information on long-term fiscal sustainability, according to the OBR's November *Economic and fiscal outlook*. The OBR will publish its first fiscal sustainability report in July, which will provide a full analysis of the long-term sustainability of the UK's public finances.

Economic and fiscal forecast

2.60 Table 2.2 provides a summary of the OBR's central economic forecast. Chapters 6 and 7 of the Convergence Programme reproduce the OBR's economy and fiscal chapters from the March 2011 *Economic and fiscal outlook*, published alongside Budget 2011 and include key tables on the economic and fiscal forecast.[16]

Economic prospects

2.61 The OBR forecast is for a gradual recovery, as the legacy of unbalanced growth and excessive levels of debt continue to weigh on the economic outlook. The economy is forecast to grow by 1.7 per cent in 2011, lower than forecast in June Budget 2010. This mainly reflects higher-than-expected inflation this year, as a result of recent global commodity prices shocks, and the weak, weather-affected final quarter of 2010. GDP growth is then forecast to strengthen, with growth peaking at 2.9 per cent in 2013. Table 2.2 shows the forecast for GDP and contributions to growth.

[16] *Economic and fiscal outlook*, OBR, March 2011.

Table 2.2: Summary of OBR's central economic forecast

	Percentage points, unless otherwise stated						
	Pre-crisis decade average contribution[2]		Forecast				
		2010	2011	2012	2013	2014	2015
Gross domestic product	2.9	1.3	1.7	2.5	2.9	2.9	2.8
Main contributions							
Private consumption	2.1	0.5	0.4	0.8	1.2	1.3	1.4
Business investment	0.6	0.2	0.6	0.8	1.1	1.1	0.9
Dwellings investment[3]	0.1	0.1	0.2	0.2	0.3	0.3	0.2
Government[4]	0.6	0.4	-0.2	-0.5	-0.5	-0.5	-0.3
Change in inventories	0.0	1.4	0.2	0.0	0.0	0.0	0.0
Net trade	-0.6	-0.9	0.7	1.0	0.7	0.6	0.5
CPI inflation (Q4)		3.4	3.9	2.2	2.0	2.0	2.0

[1] *See OBR's* March 2011 Economic and Fiscal Outlook *for further details. All growth rates in this table are rounded to the nearest 1 decimal place. This is not intended to convey a degree of unwarranted accuracy. Components may not sum to total due to rounding, omission of transfer costs of land and existing buildings, and the statistical discrepancy.*

[2] *The average contribution to real GDP growth between 1997 and 2007. In 2006, private consumption accounted for 64 per cent of GDP, business investment for 10 per cent, dwellings investment for 6 per cent, Government for 23 per cent and change in inventories for less than 1 per cent. As explained in paragraph 1.6, more than a quarter of the GDP per capita growth in the pre-crisis decade to 2007 was reversed during the financial crisis and recession of 2008 and 2009.*

[3] *The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.*

[4] *The sum of government consumption and general government investment.*

Source: *Office for Budget Responsibility and Office for National Statistics.*

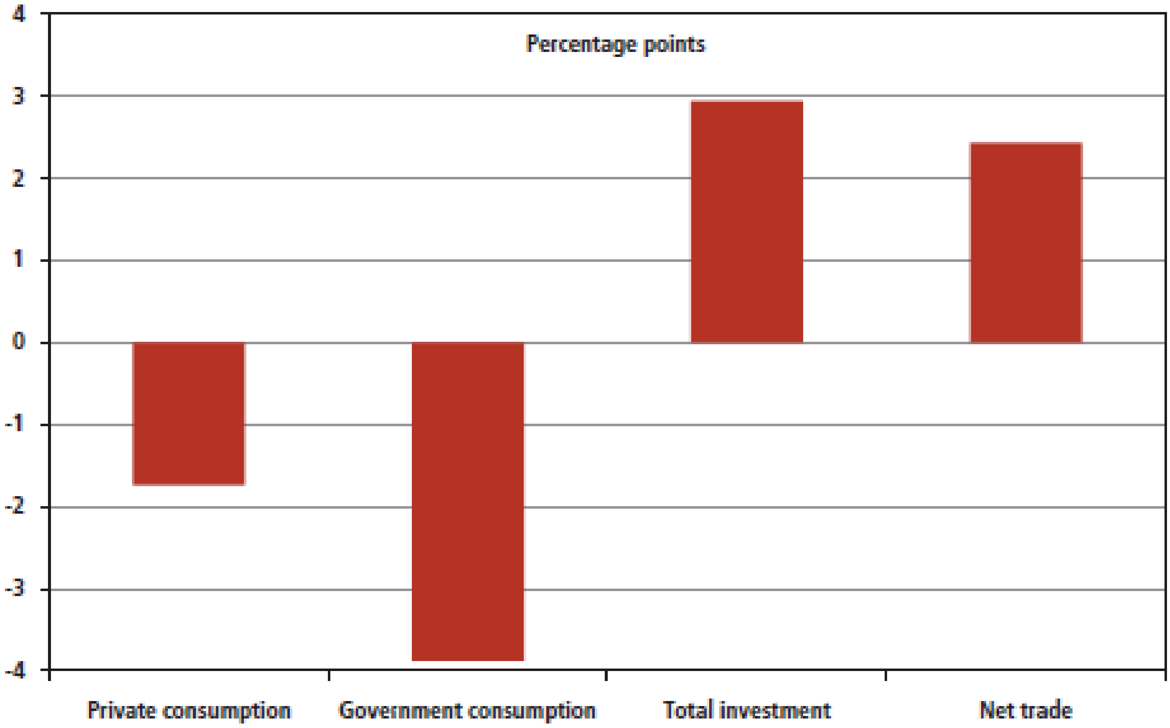
Rebalancing the economy

2.62 As set out earlier in the chapter, significant imbalances in the UK economy built up during the pre-crisis decade. The OBR are forecasting the economy to rebalance, away from private and government consumption towards net trade and investment. As Table 2.2 shows:

- the contribution of private consumption to growth is lower over the forecast period than in the pre-crisis decade. The contribution of government consumption is also forecast to be lower;
- business investment is forecast to grow by between 6½ to 11 per cent in each year over the forecast, and as a result its contribution to growth picks up to over 1 percentage point per year. However, business investment does not return to its pre-recession peak until the third quarter of 2013. This is almost a year later than whole economy output (GDP), and in line with previous recoveries; and
- having made a negative contribution on average through the pre-crisis decade, net trade is forecast to make a significant positive contribution to growth throughout the forecast period, with UK exporters continuing to gain market share into 2013.

2.63 Chart 2.5 shows that as a result of these trends the share of private consumption and government consumption in the economy is forecast to fall and the share of net trade and total investment to rise.

Chart 2.5: OBR forecast change in shares of GDP between 2010 and 2015[1]



[1] *Percentage point change in the share of nominal GDP between 2010-2015 for each expenditure component. Private consumption is forecast to change from 65.7 per cent of GDP in 2010 to 64.0 per cent in 2015, government consumption from 23.2 per cent to 19.3 per cent, fixed investment from 14.6 per cent to 17.5 per cent and net trade (the balance of trade) from -3.2 per cent to -0.8 per cent.*

Source: Office for Budget Responsibility and Office for National Statistics.

Trend output

2.64 The OBR's assessment of trend output growth, including the assumption of a constant structural unemployment rate of around 5¼ per cent, remains unchanged from their previous forecast in November 2010. The OBR's judgement is that the trend rate of growth is projected to be 2.35 per cent, falling back to 2.10 per cent from 2014 as demographic changes reduce the growth of potential labour supply. Based on the latest evidence from cyclical indicators, the output gap is judged to have been around -3 per cent in the third quarter of 2010.

Fiscal prospects

2.65 Table 2.3 provides a summary of the OBR's central forecast for the public finances.

Table 2.3: Overview of OBR central fiscal forecast

	Per cent of GDP						
	Outturn	Forecasts					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Deficit							
Public sector net borrowing	11.1	9.9	7.9	6.2	4.1	2.5	1.5
Surplus on current budget	-7.6	-7.1	-5.8	-4.5	-2.7	-1.2	-0.2
Primary balance	-9.2	-7.1	-5.0	-3.5	-1.3	0.3	1.3
Cyclically-adjusted net borrowing	8.9	7.4	5.3	3.7	2.0	1.0	0.5
Cyclically-adjusted surplus on current budget	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
Total policy decisions [1]		0.0	0.0	0.0	0.0	0.0	0.0
Treaty Deficit[2]	11.4	9.8	7.9	6.2	4.1	2.6	1.6
Debt							
Public sector net debt[3]	52.7	60.3	66.1	69.7	70.9	70.5	69.1
Treaty Debt ratio[4]	71.2	78.7	84.1	87.0	87.2	85.7	83.5
Output Gap	-4.2	-3.4	-3.9	-3.5	-2.8	-2.0	-1.3
Memo: HMT estimate of cyclically-adjusted primary balance [5]	-6.9	-4.6	-2.4	-0.9	0.8	1.9	2.3

[1] *Equivalent to the 'Total policy decisions' line in Table 2.1.*

[2] *General government net borrowing on a Maastricht basis.*

[3] *Debt at end March; GDP centred on end March.*

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

[5] *This is a Treasury estimate of the cyclically-adjusted primary balance. It has been calculated by applying the cyclical-adjustment methodology set out in Public finances and the cycle: Treasury Economic Working Paper No.5 (November 2008), which the OBR also use for their forecast of cyclically-adjusted aggregates.*

Source: Office for National Statistics, Office for Budget Responsibility, and HM Treasury

2.66 Taking account of the policy measures announced by the Government, the OBR projects that:

- public sector net borrowing will decline from its peak of 11.1 per cent of GDP in 2009-10 to 7.9 per cent of GDP in 2011-12, still higher than its peak in the 1990s recession, and then to 1.5 per cent of GDP in 2015-16;
- the cyclically-adjusted or 'structural' current deficit will be eliminated by 2014-15, with a projected surplus of 0.4 per cent of GDP in that year, rising to 0.8 per cent of GDP in 2015-16; and
- public sector net debt will peak at 70.9 per cent of GDP in 2013-14, before declining to 70.5 per cent of GDP in 2014-15 and 69.1 per cent of GDP in 2015-16.

2.67 The OBR's latest forecast shows that the outlook for the public finances is broadly unchanged since June Budget 2010. Public sector net borrowing this year is slightly lower than forecast in June and November, largely as a result of lower than expected public spending. The forecast for public sector net borrowing is slightly higher over the medium term, by 0.5 per cent of GDP in 2015-16, compared with June Budget 2010. This reflects the OBR's higher forecast for inflation, which results in higher projected AME expenditure on debt interest and social security payments, and also a slightly weaker short-term outlook for economic growth compared with June Budget 2010. However, the OBR's judgement is that this increased borrowing is largely temporary, cyclical borrowing that will reduce automatically as the economy returns to trend. This means that the forecast for the structural position of the public finances, as measured by the cyclically-adjusted current balance, is broadly unchanged since June Budget 2010, although slightly lower than estimated in November.

Performance against the mandate

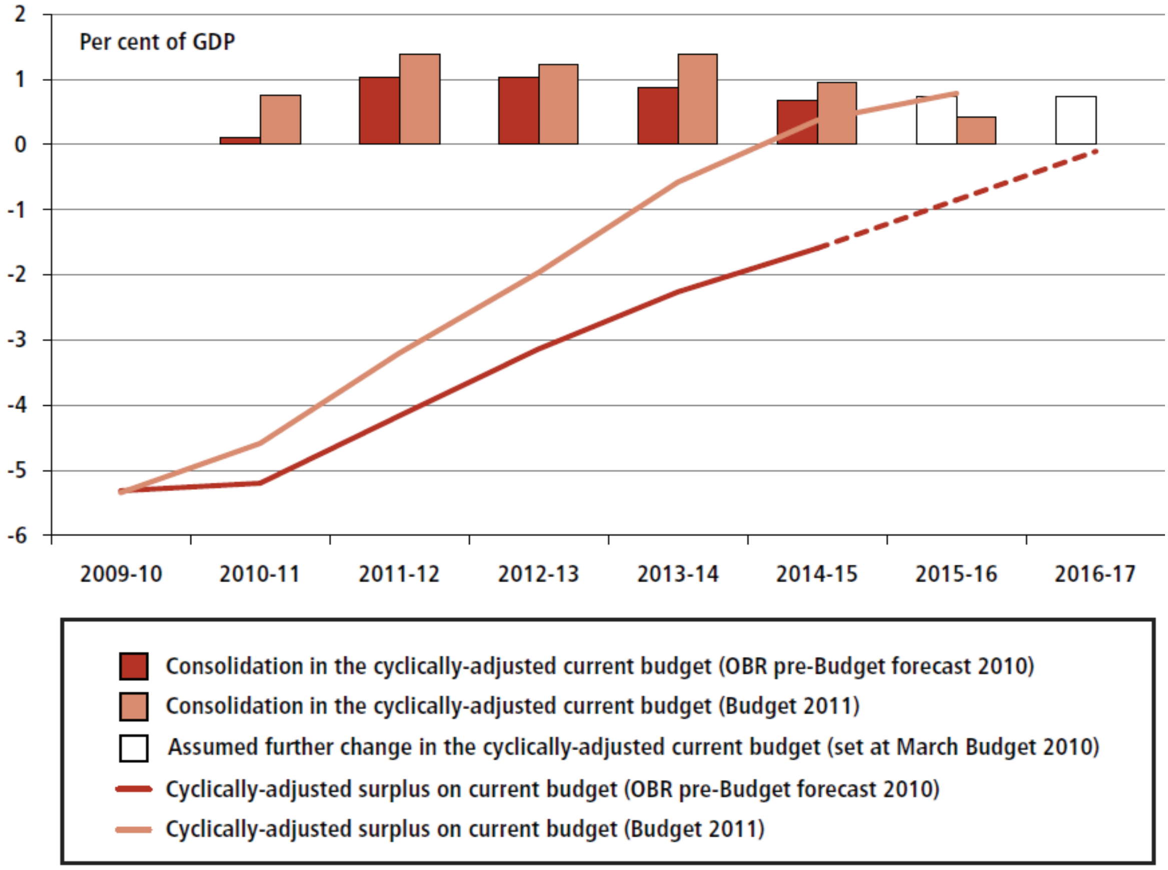
2.68 Charts 2.6 and 2.7 show performance against the Government's fiscal mandate and the supplementary debt target.

2.69 As set out in the OBR's March 2011 *Economic and fiscal outlook* the OBR's judgement is that the policies set out in Budget 2011 are consistent with a greater than 50 per cent chance of achieving the Government's fiscal mandate. Based on past forecasting performance and their central forecast, the OBR estimates that there is a roughly 70 per cent probability that the Government's fiscal mandate will be met.

2.70 It is also the OBR's assessment that the Government's policies have a greater than 50 per cent chance of meeting the target for debt in 2015-16.

2.71 As the OBR has highlighted, all forecasts are subject to uncertainty, but this applies in particular to fiscal forecasts at the present time. Recognising this, the Government has set policy to achieve a surplus on the cyclically-adjusted current budget, so that moderate shocks can be absorbed should they arise. The OBR's central Budget forecast is for the fiscal mandate to be achieved in 2014-15, a year early. The forecast also shows the debt target being achieved a year early in 2014-15.

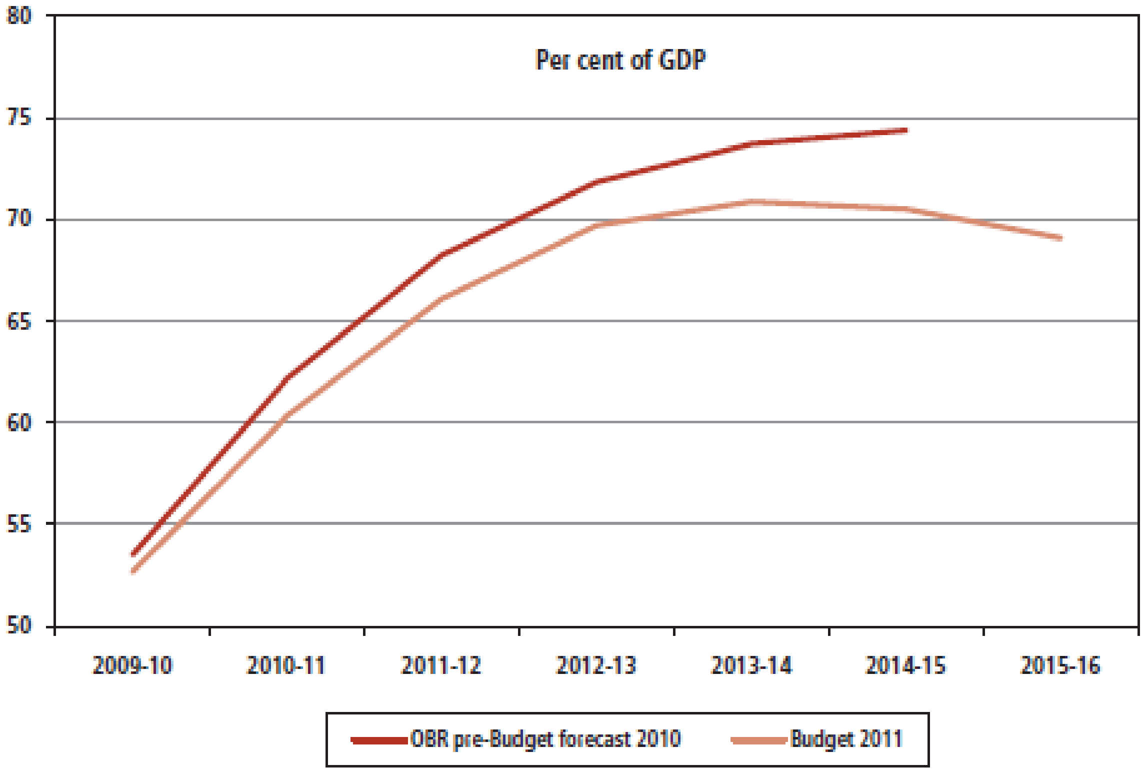
Chart 2.6: Consolidation in the cyclically-adjusted current budget



Note: The OBR pre-Budget forecast 2010 contained projections to 2014-15. The March Budget 2010 assumed further consolidation to 2016-17 based on the average change in the cyclically-adjusted current balance between 2009-10 and 2014-15. This Budget forecasts to 2015-16.

Source: Office for Budget Responsibility, HM Treasury and Office for National Statistics.

Chart 2.7: Public sector net debt



Source: Office for Budget Responsibility and Office for National Statistics.

3 Excessive Deficit Procedure

3.1 The UK entered into Excessive Deficit Procedure (EDP) following a decision by ECOFIN Council in July 2008. In November 2009, the Council concluded that the UK should correct its excessive deficit by reducing the Treaty deficit below 3 per cent of GDP by 2014-15 at the latest. A deadline of 2 June 2010 was established by the Council for the Government to take effective action to meet the recommendations. Some 23 other EU Member States are also currently subject to the Excessive Deficit Procedure.

3.2 As a result of the policy measures announced at June Budget 2010, the Treaty deficit was forecast by the OBR to fall to 2.2 per cent of GDP. Consequently, ECOFIN concluded in July that the UK had acted in accordance with its recommendations, and no additional step in the excessive deficit procedure was therefore necessary at this stage.

3.3 As Table 3.1 shows, the Office for Budget Responsibility's forecast in their March 2011 *Economic and fiscal outlook* projects that the Treaty deficit will fall from 11.4 per cent of GDP in 2009-10 to 2.6 per cent of GDP in 2014-15. Consequently, the path set for fiscal policy is consistent with the UK meeting the European Union's Excessive Deficit Procedure recommendation to reduce the Treaty deficit below 3 per cent of GDP in 2014-15.

3.4 Furthermore, the UK's Treaty debt ratio will be restored to a downward path from 2014-15, also shown in Table 3.1.

Table 3.1: Fiscal projections on a Maastricht basis

	Per cent of GDP						
	Outturn	Forecasts					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Deficit							
Treaty Deficit[1]	11.4	9.8	7.9	6.2	4.1	2.6	1.6
Debt							
Treaty Debt ratio[2]	71.2	78.7	84.1	87.0	87.2	85.7	83.5

1 General government net borrowing on a Maastricht basis.

2 General government gross debt on a Maastricht basis.

Source: Office for National Statistics, Office for Budget Responsibility.

4 Quality of Public Finances

The Government's spending choices and priorities

4.1 The Spending Review, published on 20 October 2010, set out how the Government will carry out Britain's deficit reduction plan.

4.2 The Government made choices through the Spending Review, with particular focus given to reducing welfare costs and wasteful spending. This has enabled the Government to prioritise spending on the NHS, schools, early years provision and the capital investments that support long term economic growth, setting the country on a new path towards long term prosperity and fairness. As a result of these choices, the Spending Review set out that departmental budgets other than health and overseas aid will be cut by an average of 19 per cent over four years, the same pace as planned by the previous government.

4.3 For the first time, the Spending Review covered key areas of Annually Managed Expenditure (AME) in addition to Departmental Expenditure Limits (DELs) for each government department and for the devolved administrations. It set out departmental spending plans for the four years until 2014-15 as well as savings and reforms to welfare, environmental levies and public service pensions.

4.4 On current spending, the Spending Review announced the detailed departmental budgets and other reforms necessary to deliver the planned reductions set out in June Budget 2010. On capital spending, the Spending Review undertook a zero-based review of projects to identify those with the highest economic value. In light of this, the Government increased the capital envelope by £2.3 billion a year by 2014-15 relative to the June Budget 2010 plan in order to ensure that capital projects of high long term economic value were funded. This change has no direct impact on the fiscal mandate, which targets the cyclically-adjusted current balance, and will also not alter the year in which public sector net debt as a percentage of GDP begins to fall.

4.5 As illustrated in Chart 2.2, the spending consolidation will restore spending as a share of the economy to a level closer to its historical average, thereby addressing the structural imbalance in the public finances.

Box 4.A: The Government's approach to the Spending Review

The Government took a completely new approach to the Spending Review, based on openness, innovation and consultation. The Spending Review Framework, published in June 2010, committed the Government to:

- engaging widely. It consulted with experts and the public through roundtable discussions and regional events, and has invited public sector workers and the public to submit money saving ideas through the Spending Challenge website. The most promising ideas from the Spending Challenge website and other representations made by consultees and others were taken into account;
- thinking innovatively about the role of government in society. The Spending Review set out a comprehensive programme of public service reform. The Government appointed an Independent Challenge Group to work with departments and the Treasury to consider opportunities for reform; and
- taking decisions collectively through the Public Expenditure Cabinet committee.

4.6 Decisions taken at the Spending Review confirmed key components of the Coalition Agreement setting out the Government's objectives and priorities for the Parliament, including commitments to:

- provide an NHS that is free at the point of use and available to everyone based on need not the ability to pay, with total NHS spending increasing in real terms in each year of the Parliament, including funding for priority hospital schemes including St Helier, Royal Oldham and West Cumberland;
- uprate the basic State Pension by a triple guarantee of earnings, prices or 2.5 per cent, whichever is highest, from 2011, while bringing forward the date at which the State Pension Age will start to rise to 66 to 2018 in order to ensure this is fiscally sustainable; and
- spend 0.7 per cent of GNI on overseas aid from 2013.

4.7 The Spending Review also secured an increase in the schools budget every year in real terms and additional early years provision for disadvantaged children, as well as meeting Britain's key security and defence commitments. Beyond this, the Spending Review aligned the allocation of public resources with the Government's overall objectives as set out in the Coalition Agreement. These prioritise:

- spending that promotes long term economic growth, introducing structural reforms to enable a private sector led recovery and building a low carbon economy; and
- fairness and social mobility, providing sustained routes out of poverty for the poorest.

4.8 These priorities are underpinned by radical reform of public services to build the Big Society where everyone plays their part, shifting power away from central government to the local level as well as getting the best possible value for taxpayers' money.

Growth

Prioritising growth-enhancing spending

4.9 Over the last decade, the UK's economy became unbalanced, and relied on unsustainable public spending and rising levels of public debt. For economic growth to be sustainable in the medium term, it must be based on a broad-based economy supporting private sector jobs, exports, investment and enterprise.

4.10 At the Spending Review the Government announced that it will:

- protect high value transport maintenance and investment, including over £10 billion over the Spending Review period on road, regional and local transport schemes,[1] including construction of the Mersey Gateway bridge; £14 billion for Network Rail, including major improvements to the East and West Coast Main Lines; £6 billion for upgrades and capital maintenance on the London Underground network; and funding to enable Crossrail to go ahead;
- ensure the UK remains a world leader in science and research by continuing support for the highest value scientific research, maintaining the science budget in cash terms over the Spending Review period with resource spending of £4.6 billion;
- increase adult apprenticeship funding by £250 million a year by 2014-15 relative to the level inherited from the previous government;
- invest in the low carbon economy, including through £1 billion of DEL funding and additional significant proceeds from asset sales for a UK-wide Green Investment Bank, and up to £1 billion for one of the world's first commercial scale carbon capture and storage demonstrations on an electricity generation plant; and
- put higher education on a sustainable financial footing, while providing support to individuals from low income backgrounds. Building on Lord Browne's Review of higher education funding and student finance, universities will be able to increase graduate contributions from the 2012-13 academic year.

The Plan for Growth

4.11 Building on the Government's action to restore economic stability and prioritise growth-enhancing spending, *The Plan for Growth*, published alongside Budget 2011, announced further measures to achieve four overarching ambitions for the British economy:

- to create the most competitive tax system in the G20;
- to make the UK the best place in Europe to start, finance and grow a business;
- to encourage investment and exports as a route to a more balanced economy; and
- to create a more educated workforce that is the most flexible in Europe.

4.12 *The Plan for Growth* set out a range of measures to support these ambitions. For example, the Government will:

- reduce the main rate of corporation tax by a further 1 per cent beyond the reductions announced in June Budget 2010. From April 2011, the rate will be reduced to 26 per cent and, by 2014, it will be reduced to 23 per cent;

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[1] Subject to completion of the appropriate statutory process

- drop existing proposals for specific regulations which would have cost business over £350 million a year;
- introduce a powerful new presumption in favour of sustainable development, so that the default answer to development is 'yes';
- reform the Enterprise Investment Scheme (EIS) and Venture Capital Trusts, including raising the rate of EIS income tax relief to 30 per cent from April 2011;
- invest an additional £100 million in science capital development in 2011-12 and £200 million of new funding for rail projects;
- establish 21 new Enterprise Zones;
- fund an additional 80,000 work experience places for young people, ensuring up to 100,000 places will be available over the next two years, and fund up to 50,000 additional apprenticeship places over the next four years; and
- expand the University Technical Colleges programme to establish at least 24 new colleges.

Fairness

Fairness for the future

4.13 Fairness is integral to the Government's fiscal strategy and to sustainable growth. Tackling the deficit will ensure that future generations are not burdened with unsustainable debt and will underpin private sector confidence, supporting growth and job creation over the medium term.

4.14 Social mobility is at the heart of the Government's vision for a fairer Britain. The Government believes that the existing system of support for the poorest has failed to deliver because it:

- relies too heavily on a complex means tested system of cash transfers and traps too many families in a cycle of welfare dependency; and
- fails to provide effective education and other services, particularly for young children, to help disadvantaged families improve their prospects.

4.15 As announced in the Spending Review, the Government is therefore protecting schools spending and increasing support for the poorest in the early years and at every stage of their education by:

- introducing a new fairness premium – worth £7.2 billion in total over the Spending Review period – to support the poorest which includes:
    - an extension from 2012-13 to 15 hours per week of free early education and care to all disadvantaged two year old children, as the cornerstone of a new focus on the foundation years before school;
    - a substantial new premium worth £2.5 billion targeted on the educational development of disadvantaged pupils. The premium will sit within a generous overall settlement for schools, with the 5 to 16s schools budget rising by 0.1 per cent in real terms each year; and
    - protecting those on the lowest incomes in higher education through a National Scholarship fund of £150 million a year by 2014-15.

- providing capital funding for new schools, rebuilding or refurbishing over 600 schools through the Building Schools for the Future programme and investing in new school provision in areas of demographic pressure;
- protecting funding for Sure Start services in cash terms, including new investment in Sure Start health visitors; and
- supporting further increases in participation for 16 to 19 learning, while moving towards raising the participation age to 18 by 2015.

4.16 The Government also announced plans in the Spending Review to:

- introduce fundamental reforms to simplify the welfare system, promoting work and personal responsibility through the new Universal Credit as well as providing enhanced support for those with the greatest barriers to employment through the Work Programme. The Universal Credit will be introduced over two Parliaments to replace the current complex system of means tested working age benefits. It will ensure that work always pays and reduce fraud and error, while helping ensure that the welfare system is affordable;
- put the welfare system on a sustainable footing, making net welfare savings of £7 billion a year, including through withdrawing Child Benefit from families with a higher rate taxpayer, reforming Employment and Support Allowance, controlling the cost of tax credits, and capping the amount a workless household can receive in benefits to no more than an average family gets by going out to work;
- make social housing more responsive, flexible and fair so that more people can access social housing in ways that better reflect their needs. In future, social housing will more effectively reflect individual needs and changing circumstances. Social landlords will be able to offer a growing proportion of new social tenants new intermediate rental contracts that are more flexible, at rent levels between current market and social rents. The terms of existing social tenancies and their rent levels remain unchanged. Taken together with continuing, but more modest, capital investment in social housing, this will allow the Government to deliver up to 150,000 new affordable homes over the Spending Review period; and
- allocate £2 billion a year of additional funding by 2014-15 to support social care. Combined with a programme of reform and efficiency savings, such as greater use of personal budgets, this will mean local authorities will be able to improve outcomes and will not need to reduce eligibility for services.

4.17 The reforms underpinning the Spending Review represent a significant increase in the opportunities and funding available to the voluntary and community sector (VCS) in the medium and longer term. However, to help VCS organisations prepare for these opportunities, the Spending Review made provision for a Transition Fund to support VCS organisations in the short term.

4.18 At Budget 2011 the Government set out the next steps in realising its vision of a fair, simple and efficient tax, benefit and pensions system which rewards work, saving and personal responsibility. In particular the Government will:

- increase the personal allowance for under 65s by £630 in April 2012, with the higher rate threshold unchanged, a further step towards the £10,000 personal allowance commitment;
- change the underlying indexation basis for direct taxes to the Consumer Prices Index (CPI) from April 2012. For the duration of this Parliament, the annual increases in the

employer NICs threshold, the age related allowance and other thresholds for older people will be over-indexed compared to the CPI and will increase by the equivalent of the Retail Prices Index (RPI);

- cut fuel duty by 1 pence per litre on Budget day. The fuel duty escalator will be replaced with a fair fuel stabiliser that increases tax on North Sea oil production when oil prices are high. The April 2011 inflation-only increase will be delayed to January 2012. The April 2012 increase will be delayed to August 2012. The Government will increase the Supplementary Charge on oil and gas production to 32 per cent from 24 March 2011;
- reform the state pension system for future pensioners so that it provides simple, contributory, flat-rate support above the level of the means tested Guarantee Credit;
- reform the taxation of non domiciles, including an increase in the annual charge for non domiciled individuals who have been in the UK for more than twelve years;
- tackle tax avoidance including action to prevent attempts to disguise employment income, raising around £4 billion over the Parliament; and
- reduce the rate of inheritance tax to 36 per cent from April 2012 for estates leaving 10 per cent or more to charity. Charities will also be allowed to claim new Gift Aid on up to £5,000 of small donations per year.

Everyone making a fair contribution

4.19 The Government will continue to support the most vulnerable while ensuring all sections of society who are able to do so contribute to deficit reduction. To do this and ensure that the choices made are fair, the Government for the first time has undertaken and published a distributional analysis of the impacts of the entire fiscal consolidation. Budget 2011 set out the most recent analysis. While the estimates have limitations and continue to be refined, they show that those in most need will continue to receive the most support from the state in absolute terms and, relative to the amount they consume, those on the highest incomes will experience the greatest reduction in the services they receive. The estimates also show that after combining the impact of tax, benefits and public service spending changes, the highest quintile of earners will make the greatest contribution towards reducing the deficit as a percentage of their income and benefits in kind.

4.20 Like all parts of the UK, the devolved administrations will bear a share of the cuts, although they will not be disproportionately affected. The reduction to their overall budget will be slightly better than the UK average, and they are free to allocate their budgets in line with local needs and priorities.

4.21 To ensure deficit reduction is implemented fairly, the Government will:

- take further action to combat tax fraud, evasion and avoidance with over £900 million of funding to raise an estimated £7 billion a year of extra tax revenue by 2014-15, while also making 25 per cent efficiency savings to focus funds on frontline tax collection;
- consult on major reforms to the legal aid system, targeting funding on those who need it most; and
- protect essential investment, which will mean that some public transport fare increases will be unavoidable. This will include raising rail fares where necessary.

4.22 The Government wants the UK to be one of the most competitive global centres for financial services. But it is only right that during difficult times, steps are taken to ensure that the banks make a full and fair contribution. The Government is taking forward its announcement in June Budget 2010 of a Bank Levy as an additional and permanent tax on the industry. Working with international partners, the Government is also committed to taking forward work on a Financial Activities Tax on profits and remuneration.

4.23 As announced at Budget 2011, from January 2012 the Government will increase the rate of the Bank Levy, a permanent tax on banks' balance sheets which, with the increase announced previously for 2011, is now expected to raise £10 billion over the lifetime of this Parliament. The increase in the rate from January 2012 offsets the further reduction in the rate of corporation tax announced in Budget 2011. This change will ensure that banks continue to make a fair contribution while also ensuring that they continue to be encouraged to move to less risky funding models. The Bank Levy will raise over £2.5 billion each year, as compared with the one-off net yield of £2.3 billion from the bank payroll tax.

Reform

4.24 The Government's plans are underpinned by a radical programme of public service reform, changing the way services are delivered by redistributing power away from central government and enabling sustainable, long term improvements in services. This programme is built on the Coalition principles of increasing freedom and sharing responsibility, by:

- localising power and funding, including by removing ringfencing around resources to local authorities and extending the use of personal budgets for service users;
- cutting burdens and regulations on frontline staff, including policing, education and procurement;
- increasing diversity of provision in public services through further use of payment by results, removing barriers to greater independent provision, and supporting communities, citizens and volunteers to play a bigger role in shaping and providing services; and
- improving the transparency, efficiency and accountability of public services.

4.25 As a result, the plans set out at the Spending Review:

- provide a settlement for local government that radically increases local authorities' freedom to manage their budgets, but will require tough choices on how services are delivered within reduced allocations;
- announce that the sentencing framework will be reformed so that it both punishes the guilty and rehabilitates offenders more effectively, stemming the unsustainable rise in the UK prison population. This will include paying private and voluntary sector providers by results for delivering reductions in reoffending;
- ensure the effectiveness of frontline policing can be protected by reviewing terms and conditions of service, and making efficiencies in IT, procurement and the back office to deliver savings; and
- take decisive action to cut the cost of central government, with a 34 per cent cut in administration budgets across the whole of Whitehall and its Arms Length Bodies, saving £5.9 billion a year by 2014-15.

4.26 The final report of Lord Hutton's Independent Public Service Pensions Commission was published on 10 March 2011. The Government accepts Lord Hutton's recommendations as a basis for consultation with public sector workers, trades unions and others, recognising that the position of the uniformed services will require particularly careful consideration. The Government will set out proposals in the autumn that are affordable, sustainable and fair to both the public sector workforce and the taxpayer.

4.27 On Defence, the Spending Review provides the resources needed to defend the UK and its interests, and to fulfil the Government's objectives to strengthen international peace and stability. The Spending Review fully funds Britain's operations in Afghanistan, and targets investment on cyber defence and other expected future threats, in line with the outcome of the Strategic Defence and Security Review.

Implementing the Spending Review

4.28 Implementation of the Government's fiscal plans is underway. The Government is on course to deliver the £6.2 billion of savings announced in May 2010.

4.29 Spending Review 2010 set firm and fixed departmental budgets for four years from 2011-12 to 2014-15, as well as announcing reforms to Annually Managed Expenditure (AME), including welfare and public service pensions. The Government protected spending on the NHS and overseas aid and also made choices to: prioritise fairness and social mobility; focus on spending that promotes long-term economic growth; and reform public services, to shift power away from central government to the local level and improve value for money.

4.30 The Government is implementing plans and reforms announced in the Spending Review. Legislation has been introduced to Parliament where necessary, including the Welfare Reform and Pensions and Savings Bills. Detailed funding settlements have also been announced, including for local government, schools and science.

4.31 The Government is committed to ensuring the spending consolidation is delivered. The Public Expenditure Cabinet Committee will oversee departments' implementation of their Spending Review plans, holding them to account on their progress. Business plans for each department, setting out information on key reform programmes and performance data on public services, are being finalised this spring. The public will be able to monitor progress on plans through monthly reports and a quarterly performance scorecard for each department.

4.32 The Government has implemented the tax plans for 2011-12 announced or confirmed in June Budget 2010, including the increase in the standard rate of VAT to 20 per cent on 4 January 2011.

4.33 Each Government department has published a business plan setting out the details of its reform plans, in particular:

- vision and priorities to 2014-15;
- a structural reform plan, including actions and deadlines for implementing reforms over the next two years; and
- the key indicators against which it will publish data to show the cost and impact of public services and departmental activities.

Summary of Total Managed Expenditure

4.34 Table 4.1 sets out the path for Total Managed Expenditure (TME), Public Sector Current Expenditure (PSCE) and Public Sector Gross Investment (PSGI) to 2015-16. This reflects the Spending Review 2010 announcement of an increase in PSGI of £2.3 billion a year by 2014-15 relative to the spending envelopes set out at June Budget 2010, to ensure that capital projects of high long term economic value are funded. It also reflects updated estimates of savings from AME policies. Budget 2011 confirmed that TME in 2015-16 will increase in line with general inflation in the economy.

Table 4.1: Total Managed Expenditure

	£ billion					
			Forecasts			
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
CURRENT EXPENDITURE						
Resource Annually Managed Expenditure	287.4	314.4	324.9	333.3	346.4	360.8
Resource Departmental Expenditure Limits[1]	345.4	342.3	344.7	349.1	348.2	352.5
of which						
RDEL excluding depreciation [2]	*326.1*	*326.3*	*327.1*	*331.1*	*329.0*	*333.1*
Public sector current expenditure	632.8	656.7	669.6	682.4	694.6	713.4
CAPITAL EXPENDITURE						
Capital Annually Managed Expenditure	11.5	9.2	8.0	8.5	8.8	7.7
Capital Departmental Expenditure Limits[1]	50.0	44.5	42.6	39.2	40.3	42.7
Public sector gross investment	61.6	53.7	50.7	47.7	49.1	50.4
TOTAL MANAGED EXPENDITURE	694.4	710.4	720.2	730.1	743.6	763.8
Memo: *TME if AME margin as set for Spending Review 2010 period is spent*		*711.4*	*722.2*	*733.1*	*747.6*	

[1] The Government has not set DEL for 2015-16. Implied DEL numbers for 2015-16 are calculated as the difference between Resource AME and PSCE for Resource DEL (RDEL) and the difference between Capital AME and PSGI in the case of Capital DEL.

[2] RDEL excluding ring-fenced non-cash depreciation is the Treasury's primary control within resource budgets and the basis on which Spending Review settlements were agreed.

Source: HM Treasury, Budget 2011

5 Institutional features of public finances

The fiscal policy framework

5.1 As detailed in Chapter 2, June Budget 2010 set out comprehensive policies to bring the public finances back under control, this action involved substantial fiscal framework reform, including:

- the creation of the new Office for Budget Responsibility (OBR), introducing independence, greater transparency and credibility to the economic and fiscal forecasts on which the Government's fiscal policy is based; and
- the announcement of a clear, forward-looking fiscal mandate and a supplementary target for debt to guide fiscal policy decisions over the medium term.

Office for Budget Responsibility

5.2 The Government's fiscal policy decisions are now based on the independent forecasts of the economy and public finances prepared by the OBR. These forecasts were previously determined by the judgements of the Chancellor of the Exchequer. Since the General Election in May 2010 the OBR has produced all the official forecasts of the economy and public finances, independently of Ministers.

5.3 The Government established the OBR on an interim basis on 17 May 2010. The interim body, chaired by Sir Alan Budd, provided an independent assessment of the UK economy and public finances on 14 June 2010.[1] The OBR produced the economy and public finances forecast on the basis of the Government's plans at June Budget 2010.

5.4 The OBR comprises the Chair of the OBR and the two other members of the Budget Responsibility Committee (BRC) and at least two non-executive members. It is supported by a civil service staff.

5.5 On 9 September 2010, the Government announced Robert Chote as its preferred candidate for the position of Chair of the OBR. Mr Chote's appointment was approved by the Treasury Select Committee on 16 September 2010. On 12 October 2010, the Government announced Professor Stephen Nickell and Graham Parker as its preferred candidates for membership of the Budget Responsibility Committee alongside Mr Chote. They were subsequently approved under the same process. The non-executive members are currently being recruited.

Remit of the OBR

5.6 The OBR has now been placed on a permanent, statutory footing through the Budget Responsibility and National Audit Act 2011, which received Royal Assent on 22 March 2011. Prior to this, the OBR operated on an interim basis consistent with the Terms of Reference published by the Treasury.

[1] Office for Budget Responsibility, pre-Budget forecast, June 2010

5.7 The main duty of the OBR is to examine and report on the sustainability of the public finances. This duty feeds directly into the Treasury's fiscal objective to deliver sound and sustainable public finances.

5.8 As set out in the Budget Responsibility and National Audit Act 2011, the OBR's responsibilities include:

- the production of at least two fiscal and economic forecasts each financial year, including independent scrutiny of the impact of policy measures and any resultant impact on the forecasts;
- an assessment of the extent to which the fiscal mandate has been, and is likely to be, achieved alongside these forecasts;
- an assessment of the accuracy of previous fiscal and economic forecasts at least once each financial year; and
- an analysis of the sustainability of the public finances at least once each financial year.

5.9 This remit provides for the OBR to investigate the impact of trends and policies on the public finances from a multitude of angles including through forecasting, long term projections and balance sheet analysis. The OBR must perform its duty objectively, transparently and impartially and on the basis of government policy. This protects the independence of the OBR and ensures a clear separation between analysis (which is the role of the OBR) and policy making (which is the responsibility of ministers). The OBR will have complete discretion in the performance of its duty, subject to its statutory obligations.

Transparent framework

5.10 To ensure credibility of the fiscal framework and protect the independence of the OBR it is vital for there to be transparency in the responsibilities of the OBR and the rest of Government. To support and clarify the provisions in the Act, there are a number of documents that seek to achieve this.[2]

5.11 The Charter for Budget Responsibility provides guidance to the OBR in line with, and in support of, the provisions in the Act. This guidance helps to explain the role of the OBR within the fiscal framework and provide greater clarity as to the OBR's duty to independently examine and report on the sustainability of the public finances.

5.12 For the OBR to perform its duties accurately and efficiently, close working with the rest of government will be essential. A Memorandum of Understanding establishes a transparent framework for cooperation between the OBR and the Treasury, as well as other parts of Government that the OBR will need to work closely with to perform its forecasting and analytical duties.

5.13 The OBR is accountable to Parliament and the Chancellor for the analysis it produces and the way it uses public funds. A framework document sets out the broad governance and management framework within which the OBR will operate.

Fiscal objectives

5.14 To promote transparent fiscal policy-making, the new fiscal policy framework, established by the Budget Responsibility and National Audit Act 2011, introduces a requirement for the Government to set out its fiscal policy objectives and fiscal mandate before Parliament in the

[2] Documents available at http://www.hm-treasury.gov.uk/data_obr_index.htm

Charter for Budget Responsibility. The Government published the final version of the Charter on 4 April 2011, having published a draft version on 22 November 2010.

5.15 The Government's fiscal policy objectives, presented in the Charter, are to:

- ensure sustainable public finances that support confidence in the economy, promote intergenerational fairness, and ensure the effectiveness of wider Government policy; and
- support and improve the effectiveness of monetary policy in stabilising economic fluctuations.

The fiscal mandate and supplementary target for debt

5.16 As previously detailed in Chapter 2, the Budget Responsibility & National Audit Act 2011 also requires the Government to set a means to achieving its fiscal objectives, its "fiscal mandate". The Government has set out a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. At Budget 2011, the end of the forecast period was 2015-16.

5.17 The fiscal mandate is based on:

- the current balance, to protect the most productive public investment expenditure; and
- a cyclically-adjusted aggregate, to allow some fiscal flexibility at a time of economic uncertainty.

5.18 June Budget 2010 also announced a supplementary target for debt. This requires public sector net debt (PSND) as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are restored to a sustainable path.

5.19 The Government has asked the OBR independently to judge whether fiscal policy is consistent with: a greater than 50 per cent chance of meeting the mandate; and with a greater than 50 per cent chance of meeting the target for debt.

5.20 The choices of a five-year rolling forecast period for the fiscal mandate, supplemented by the fixed date for the debt target, reflect the exceptional environment in which the Government must address the fiscal challenge. They are designed to ensure that fiscal consolidation is delivered over a realistic and credible timescale. Once the public finances are closer to balance the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

Reform of the spending framework

5.21 Delivering the Government's spending plans, set out in Chapters 2 and 4, will require a more robust framework for spending control, given the scale of the challenge. The current framework splits expenditure into Departmental Expenditure Limits (DEL), which are fixed departmental budgets, and Annually Managed Expenditure (AME), which is not subject to such firm control. The Government is therefore considering options for strengthening control over AME by increasing the amount of spending that is managed within fixed budgets. This will improve incentives to manage AME, in particular social security spending which is the most significant component. Further detail will be set out by the summer.

5.22 At Budget 2011, the Government announced that a new Budget Exchange system will be introduced in 2011-12, to replace the End-Year Flexibility system which has now been abolished. This will provide departments with flexibility to deal with slippage in expenditure while strengthening spending control. Budget Exchange will allow departments to surrender an underspend in advance of the end of the financial year in return for a corresponding increase in their budget in the following year, subject to a prudent limit.

5.23 In addition, the Government is introducing a new framework to control the levy-funded spending of the Department of Energy and Climate Change (DECC).

Accounting and Statistics

5.24 The independent Office for National Statistics compiles monthly statistics for the public sector and sub-sectors, on both a cash and accrued basis. Reconciliation tables between these are produced. The production is guided by the UK's code of practice which is consistent with the United Nations Fundamental Principles of Official Statistics and the European Statistics Code of Practice.

5.25 Information on the UK's contingent liabilities are published for all Central Government departments. The forthcoming publication of Whole of Government Accounts (WGA) will extend the coverage across Government.

5.26 Whole of Government Accounts (WGA) are full accruals based accounts covering the whole public sector and audited by the National Audit Office. WGA is a consolidation of the accounts of around 1500 bodies from central government, devolved administrations, the health service, local government and public corporations.

OBR's Economic and fiscal outlook: selected chapters

The Government's fiscal policy decisions are based on independent forecasts for the economy and public finances, prepared by the Office for Budget Responsibility (OBR). Creating the new OBR has introduced independence, greater transparency and credibility to the economic and fiscal forecasts on which fiscal policy is based.

In order to provide the EU Commission with the detail required by the Code of Conduct, the Convergence Programme draws on the reports produced by the OBR. Required information on Government policy and objectives has been set out in Chapters 1 to 5.

Chapters 6 to 8 reproduce the relevant chapters from the OBR's March 2011 *Economic and fiscal outlook.* All data contained in these chapters is correct as of 23 March 2011. Chapter 9 reproduces information on long-term fiscal sustainability from the OBR's November 2010 *Economic and fiscal outlook.* The OBR will publish its first fiscal sustainability report in July, which will provide a full analysis of the long-term sustainability of the UK's public finances.

These chapters are structured as follows:

- Chapter 6 of the Convergence Programme sets out the economic outlook for the UK;
- Chapter 7 of the Convergence Programme sets out the fiscal outlook for the UK, including information on general government balance and debt;
- Chapter 8 of the Convergence Programme relates to performance against the Government's targets. This includes sensitivity analysis and recognises uncertainty; and
- Chapter 9 of the Convergence Programme sets out information on the sustainability of the public finances.

Further detail and explanation can be found in the OBR reports.