UK Convergence Programme 1999

December 1999

HM Treasury

1 Introduction

1.01 The Government submitted its first convergence programme under the Stability and Growth Pact (SGP) in December last year[1]. The SGP requires Member States to provide information on economic developments in their country, for the purposes of the multilateral surveillance procedure under Article 99 of the Treaty (ex Article 103 of the Maastricht Treaty). The UK is required to present the following information in its Convergence Programme[2]:

- information on the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective;
- the main assumptions about expected economic developments and important economic 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.

1.02 This programme updates the UK's 1998 Convergence Programme to reflect the latest Government forecasts for the economy and public finances which were published in the Pre-Budget Report (PBR)[3]. There has been no change in the Government's overall economic or budgetary strategy, and projections for cyclically-adjusted public sector net borrowing show that the fiscal stance is broadly unchanged from the time of the Budget in March this year and the previous Convergence Programme.

1.03 Chapter 2 briefly outlines the Government's economic strategy and how this is helping to deliver economic stability. It demonstrates how Government policy provides an essential basis for price stability, sound public finances, exchange rate stability and for strong, sustainable growth conducive to employment creation. For example, it shows how the new monetary policy framework has reduced inflation expectations and helped bring inflation rates down to the EU11 average.

1.04 It also gives the latest projections of the public finances. These show that the underlying position remains sound. The measure specified in the Treaty for the government deficit is projected to remain close to balance over the forecast period, and the Treaty definition for government debt is projected to fall below 40 per cent of GDP. The Government believes that these stability-orientated policies will help provide an essential platform for closer convergence with the other Member States.

1.05 Chapter 2 also discusses the Government's economic reform strategy and highlights some key measures that have been taken so far to make work pay, strengthen competition, encourage enterprise and investment, improve skill levels and enhance public sector productivity.

1.06 Chapter 3 summarises the Government's latest economic forecast, including the expected path for GDP, and retail price inflation. The latest data show that with low inflation, sound public finances and a relatively secure private sector financial position, together with prompt policy reaction by the Bank of England the economy has dealt well with the impact of the global financial instability of 1998.

1.07 Chapter 4 summarises the Government's latest projections for the public finances, including a break-down of Government expenditure and receipts on an ESA95 basis. These

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[1] Prior to the Stability and Growth Pact regulations which were agreed in July 1997, the UK under the multilateral provisions of the Treaty (Article 99 (ex Article 103)) was already submitting material on the position of the economy and outlook for public finances to the Commission.

[2] More detailed requirements are specified in the Code of Conduct on the format and content of the new stability and convergence programmes, Opinion of the Monetary Committee on the format and content of stability programmes, Document MC/II/482 final of 16 September 1998, endorsed by ECOFIN Council on 12 October 1998.

[3] Pre-Budget Report, HM Treasury, November 1999. Also available from http://www.hm-treasury.gov.uk.

projections are an interim forecast update. They do not necessary reflect the outcome that the Government is seeking - decisions on the appropriate fiscal stance will be taken in next year's Budget. Consistent with the conclusions of the Helsinki report on economic policy coordination[4], this chapter also includes long-term projections of the sustainability of the public finances and considers the effect that demographic changes are likely to have on taxation and spending. It also outlines the Government's new public spending framework, and its approach to the delivery of public services.

1.08 The programme gives details in Annex A of the differences in key indicators between this updated programme and the previous Convergence Programme.

1.09 Annex B provides details of the financial impact of this year's Budget measures, calculated at the time of publication. These figures will be updated at the time of the next Budget, taking into account developments since March, including a downward revision to the future revenues from the Climate Change Levy made in the PBR.

4 Report by the ECOFIN Council to the European Council in Helsinki on Economic and Policy Coordination: review of the instruments and experience in Stage 3 of EMU. 13123/1/99 of 29 November 1999.

2 Policy Framework and Objectives

Objectives of Economic Policy

2.01 The Government's central economic policy objective is to achieve high and stable levels of growth and employment. The Government is committed to building a fairer and more inclusive society so that the benefits of economic growth can be shared by everyone and deliver a better quality of life.

2.02 The key elements of the Government's strategy for achieving this are to:

- lock-in economic stability;
- raise productivity through promoting enterprise and investment;
- increase employment opportunity for all;
- ensure fairness for families and communities; and
- protect the environment.

2.03 These are consistent with the objectives of the European Community as set out in Article 2 of the Treaty, which include the promotion of balanced economic activities, sustainable and non-inflationary growth, high levels of employment and standards of living and a respect for the environment. These objectives, and the policies designed to meet them, are also consistent with the Broad Economic Policy Guidelines of the Member States and the Community.

Delivering macroeconomic stability

2.04 The focus of this updated Convergence Programme is on the policies the Government is undertaking to achieve macroeconomic stability. Macroeconomic stability is central to the achievement of the Government's economic objectives. Instability damages investment and long-term growth, wastes valuable resources and has significant social and economic costs.

2.05 Achieving greater economic stability than in the past should provide an essential platform for closer convergence of the economic performance of the UK and other Member States. The Government's policy towards membership of the single currency remains as set out by the Chancellor in October 1997. In principle, the Government is in favour of joining a successful single currency, provided the economic benefits of joining are clear and unambiguous.

2.06 Since the publication of the previous Convergence Programme, significant further progress has been made in preparing both the private and public sectors for the advent of the euro from 1 January this year and for possible EMU membership. See Box 2.1 for more details.

BOX 2.1 - EMU Policy and progress on euro preparations

UK policy towards EMU membership remains as set out by the Chancellor in his October 1997 statement. The determining factor underpinning any Government decision to recommend membership is whether the economic benefits are clear and unambiguous. If they are, there is no constitutional bar to membership. The final decision would be taken by the British people in a referendum. The Chancellor has set out five economic tests which determine the economic case for considering membership. These five tests are whether there can be sustainable convergence between Britain and the economies of the single currency; whether there is sufficient flexibility to cope with economic change; the effect on investment; the impact on the UK's financial services industry; andwhether joining EMU is good for employment.

The Government has said that it is not realistic for the UK to meet these tests during the course of this Parliament, but the tests will be assessed again early in the next Parliament.

The Government is committed to ensuring that the British people face a genuine choice to join a successful single currency should the five economic tests be met. The new macroeconomic frameworks will help to achieve greater economic stability than in the past which should provide an essential platform for closer convergence of the economic performance of the UK with the euro area economies. Further progress on economic reform in the UK and the rest of Europe will help provide the flexibility required to live with a single interest rate and ensure that any divergences in economic cycles are kept to a minimum.

Over the past two years, the Government has worked intensively with the business community, public sector and voluntary groups to ensure that the necessary preparations were in place to deal with the euro from 1 January 1999, and to take forward detailed planning work for possible UK entry, if that is what Government, Parliament and the people decide.

The Government has provided a range of practical tools for UK businesses to help them deal with the euro. It has produced factsheets, case studies, electronic tools and progress reports on preparations, the third of which was published in November 1999. As part of its preparations strategy, the Government has carried out surveys, a national communications campaign and set up 12 regional fora to help preparations at the local level.

An outline National Changeover Plan for possible entry to the single currency was published in February 1999. This is a consultative document which set out the practical steps which would need to be taken if the UK were to join the euro. The public sector has given a clear signal of its commitment to prepare.

Monetary Policy and Objectives

2.07 A broad consensus now exists that price stability is an essential pre-condition for achieving high and stable levels of growth and employment. This means that the goal of monetary policy should be price stability.

2.08 The new monetary policy framework was introduced as a response to the poor inflation record of the past three decades. During the 1970s, inflation averaged 13%, peaking at almost 27% in August 1975. During the 1980s, annual inflation averaged 7% and in the early 1990s, inflation again peaked at a high level of over 9%.

2.09 The new framework incorporates a number of principles (see Box 2.2), given a statutory basis in the *Bank of England Act 1998*. The key elements of reform were:

- **a symmetric inflation target** of 2½% annual growth in the Retail Price Index excluding mortgage interest payment (RPIX)[5] and a requirement that monetary policy also supports the Government's wider economic policy objectives.
- the establishment of the **Monetary Policy Committee** (MPC) consisting of highly respected, independent experts, charged with, and held accountable for, setting interest rates to meet the Government's inflation target.
- a series of mechanisms to promote **openness, transparency and accountability** such as the publication of voting records, minutes of the monthly MPC meetings, and a quarterly *Inflation Report.*
- the introduction of an **"open letter" system** whereby, if inflation deviates more than one percentage point above or below target, the Governor of the Bank of England must explain why inflation has diverged from target, the action that will be taken to deal with the divergence, and when inflation is expected to return to target.

BOX 2.2 - Principles of the new Monetary Policy Framework[6]

The Government's new monetary policy framework is based on eight principles:

1. A platform of stability, including low and stable inflation is necessary for high and stable levels of growth and employment.
2. The goal of monetary policy, price stability, should be defined in terms of an inflation target which is clear and stable over time.
3. A symmetric inflation target is vital so that monetary policy is forward looking and supports Government objectives for growth and employment.
4. There should be a clear separation of roles and responsibilities with respect to the setting of the framework and the implementation of monetary policy to meet the inflation target.
5. An independent committee of experts, backed up by specific procedures, should have responsibility for implementing monetary policy to achieve the Government's inflation target.
6. Monetary policy should be characterised by high levels of openness, transparency and accountability.
7. The framework must allow monetary policy to respond sensibly in the face of certain specific types of economic shocks.
8. Monetary and fiscal policy should support each other in promoting stability.

[5] Due to differences in coverage and methodology the HICP index differs from RPIX. The HICP measure currently stands at around 1¼%, 1 percentage point below RPIX inflation. Half of this differential reflects coverage differences. This divergence is expected to narrow in 2000, leaving a more persistent differential of 0.5 percentage points reflecting the differences in construction methods.

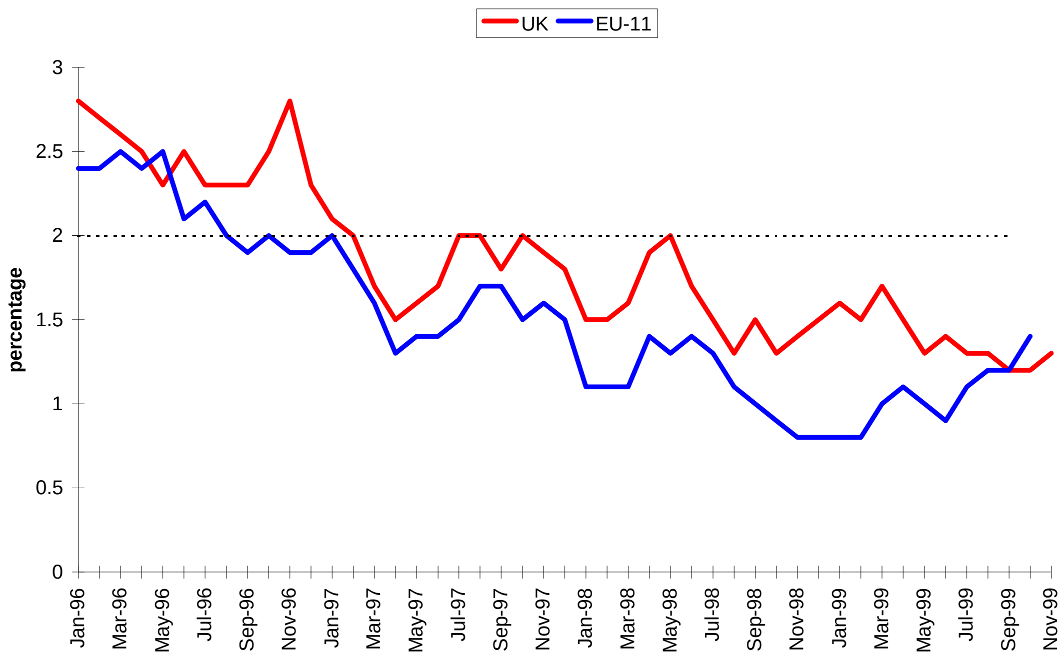
[6] See "The New Monetary Policy Framework", HM Treasury, November 1999 for more discussion. Available on the Internet at http:// www.hm-treasury.gov.uk

Benefits of the new monetary policy framework

2.10 Since the introduction of the new monetary policy framework, RPIX inflation has averaged 2.6% and moved within a narrow band of 2.1% to 3.2%, with no breach of the thresholds that require an open letter from the Governor of the Bank of England. The new framework has established clear objectives and procedures, improved accountability and transparency. This has allowed monetary policy decisions to be conducted in a pro-active and forward-looking manner, enabling price stability to be maintained and avoiding a return to the damaging boom and bust cycles of the past. There has also been much greater coordination of fiscal and monetary policy based on clear objectives and a high degree of transparency in the decision-making process to meet those objectives.

2.11 Measured on a HICP basis, the UK inflation rate is very close to the EU11 average, and is comfortably within the upper limit of the ECB's definition of price stability.

Chart 2.1 - UK and EU-11 average inflation rates



2.12 The greater economic stability is reflected in the behaviour of interest rates. Interest rates in this economic cycle peaked at 7½ per cent for four months in 1998, compared to a peak of 15 per cent for a year in the previous economic cycle. Rates are now 5½% and mortgage rates are close to historically low levels. Looking ahead, inflation expectations of financial market participants 10 years ahead, are just under 2½ per cent, consistent with the inflation target.

2.13 The short-term interest rate differential between the UK and the euro area has narrowed to 2½ percentage points, reflecting a sustained reduction in both the level of inflation and inflationary expectations in the UK. The 10 year differential between gilts and German Bunds has narrowed to almost zero. Long-term rates have fallen to levels not seen in a generation.

Fiscal Policy and Objectives

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

2.15 The new fiscal policy framework is based around a set of five central principles - transparency, stability, responsibility, fairness (including between the generations) and efficiency.

2.16 These principles were enshrined in the *Finance Act 1998* which legislated for the *Code for Fiscal Stability*. The Code explains how these principles are to be reflected in the formulation and implementation of fiscal policy in practice.

2.17 The Government has specified two fiscal rules:

- the **golden rule** so that, over the economic cycle, the Government will only borrow to invest and not to fund current spending; and
- the **sustainable investment rule** where public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.

2.18 The primary objective of fiscal policy is to ensure the medium-term sustainability of the public finances and fairness between generations. Fiscal policy can also play a short-term role in supporting monetary policy. This is the reason that the two fiscal rules are set over the cycle - it allows Public Sector Net Borrowing (PSNB) to vary between years, in keeping with the cyclical position of the economy.

2.19 Consistent with these rules, over the short-term, fiscal policy should support monetary policy by:

- allowing the automatic stabilisers to play their role in smoothing the path of the economy; and
- where prudent, providing further support to monetary policy through changes in the fiscal stance.

2.20 The fiscal rules provide benchmarks against which the performance of fiscal policy can be judged. The Government will meet the golden rule, if, on average over an economic cycle, the current budget is in balance or in surplus. The Government also believes that other things being equal, a modest reduction in net public sector debt to below 40 per cent of GDP over the economic cycle is desirable. The Government is well on track to meet these fiscal rules.

Benefits of the new fiscal policy framework

2.21 The position of the public finances has been transformed. The Government reduced public borrowing by £30 billion in its first two years of office - a fiscal tightening of some 3 per cent of GDP. The projections show for 1999-2000 and thereafter, that this structural improvement is set to be locked in.

2.22 In monitoring the public finances, great attention is paid to cyclically-adjusted figures. This helps ensure that apparent improvements in the public finances are not confused with structural improvements. There has been a significant structural improvement in the public finances between 1996-97 and 1998-99. The cyclically-adjusted current budget has moved from a deficit of over ½ per cent of GDP in 1997-98 to a surplus last year. It is expected to rise further this year to nearly 1 per cent of GDP and remain at around 1 per cent of GDP over the next five years.

2.23 The distinction made between current and capital spending in the golden rule protects Government investment. Public sector net investment is set to almost double to just over 1 per cent of GDP by 2001-02, beginning to address the years of neglect in public sector infrastructure, but consistent with a falling debt-GDP ratio. Net investment is projected to rise to around 1½ per cent of GDP in 2003-04.

2.24 Projections for general government net borrowing and general government gross debt are given in the table below. These show that, on the basis of these measures, the UK is expecting modest surpluses this year and for the next two years. Gross debt as a proportion of GDP is expected to fall to around 41 per cent by 2001-02 and to below 40 per cent by 2004-05. The UK's debt and deficit positions compare favourably with the euro area and EU15 averages, and are expected to remain comfortably inside the 3 per cent and 60 per cent Treaty reference values.

Table 2.1 - Fiscal Balances and Treaty debt and deficit ratios

	Outturns	Estimate	Projections				
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Budget balances							
Surplus on current budget	0.8	1.1	1.2	1.3	1.2	1.1	1.0
Average surplus since 1997-98	0.1	0.4	0.6	0.8	0.8	0.9	0.9
Net borrowing	-0.3	-0.4	-0.3	-0.3	0.1	0.4	0.5
Cyclically-adjusted budget balances							
Surplus on current budget	0.6	0.9	1.0	1.2	1.2	1.1	1.0
Net borrowing	0.0	-0.2	-0.2	-0.2	0.1	0.4	0.5
Memo:							
General government net borrowing[1]							
ESA79	-0.9	-0.5	-0.5	-0.3	-0.2	0.3	0.3
ESA95	-0.5	-0.3	-0.2	-0.2	0.1	0.4	0.5
General government gross debt[1,2]							
ESA79	47.4	45.3	43.5	41.7	40.3	39.2	38.3
ESA95	47.0	44.9	43.1	41.3	39.9	38.8	38.0

Excluding Windfall tax receipts and associated spending.

[1] Treaty measures of the government deficit and debt. From February 2000, the Treaty measures will move from being reported under ESA79 to ESA95 accounting conventions.

[2] The move to ESA95 accounting conventions does not affect the stock of gross debt, but it does increase money GDP, by about £8 billion in 1998-99.

2.25 The tightening of the fiscal stance during 1997-98 supported monetary policy in containing the inflationary pressures which were emerging when the economy was above trend, as well as restoring the public finances to a sound position. This enabled interest rates to peak at a much lower level and to subsequently fall more quickly.

Table 2.2 - Inflation, public finances and long-term interest rates, 1999

	HICP inflation	Long term interest rates [1]	General government net borrowing [2,3,4]	General government gross debt [2,3,4]
UK	1.3	5.3	-0.5	45.3
EU-15 average	1.3*	5.4	1.0	68.8
EU-11 average	1.4*	4.8	1.6	73.1

[1] Average 10 year yield on gilts in November 1999

[2] UK fiscal year estimate, 1999-00

[3] Commission Autumn Forecasts for EU11 and EU15

[4] ESA79 basis.

* October 1999 figures, Eurostat

Exchange rate stability

2.26 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 been seen as the outcome of all other economic policies.

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

Economic reform

2.28 The Government is fully committed to promoting economic reform in all areas of the economy. Attention has been focussed on reform of labour markets with a strategy to help people move from welfare into work, make work pay and help ease the transition to work.

2.29 Major reforms already introduced by the Government include:

- **welfare to work** - through the New Deal programmes which have already benefited around 350,000 young people and over 170,000 long-term unemployed people.
- **making work pay** - through reform of the tax and benefit system, including the new Working Families Tax Credit, reform of NICs, the new 10p rate of income tax from April 1999 and the cut in the basic rate of income tax to 22p from April 2000. This is underpinned by the National Minimum Wage which was introduced in April 1999.

2.30 The Government has recently announced some new measures to enhance the services of the New Deal for the 25s and over, bringing the rights and responsibilities for the over 25s into line with those for young people. For example, there will be a new national network of job-broking call centres to provide a single national number for employers to call with details of vacancies and for jobseekers to contact for up-to-date information on the availability of jobs.

Enhancements to the New Deal for Lone Parents were also recently announced, inviting those on Income Support with children from the age of three to participate.

2.31 The Government is also committed to reform of capital and product markets and to ensure that consumers benefit through more choice, better quality and lower prices[7]. The Government has a long-term economic ambition to have a faster rise in productivity than its main trading partners as it closes the productivity gap and has a clear strategy to achieve this.

2.32 This strategy of reform is built around:

- **strengthening competition** - by modernising the country's anti-trust legislation, by liberalising and improving the regulation of the utilities sector, and through continuing to make progress in implementing Single Market legislation.
- **encouraging enterprise and innovation** - by dismantling barriers to SME's wanting to expand, by encouraging e-commerce, and through encouraging increased investment in R&D. The Government recently announced a series of measures to encourage greater company share ownership, and details of an R&D tax credit for SMEs.
- **improving skill levels** - through investing an extra £19bn in education over the next three years, and the introduction of Individual Learning Accounts to enable the low-skilled to gain the qualifications that they need. As a long-term economic ambition, school and college leavers will gain the highest possible qualification that they can, with the majority going onto higher education for the first time.
- **improving conditions for investment** - by delivering macroeconomic stability as well as providing incentives for savings and investment. The Government recently announced, for example, details of a £20m venture capital challenge fund to finance early stage high technology businesses and an extension of 40% capital allowances for small and medium sized enterprises.
- **enhancing public sector productivity** -through more efficient public procurement exercises, and delivery of services, and the use of public-private partnerships.

[7] The latest *UK Progress Report on Product, Service and Capital Markets*, HM Treasury, November 1999 discusses the Government's strategy for economic reform in more detail. Also available on http://www.hm-treasury.gov.uk

3 Economic outlook

Prospects for economic growth

3.01 With low inflation, sound public finances and a relatively secure private sector financial position, the UK economy was well-placed to deal with the impact of global financial instability in 1998. Monetary policy responded pro-actively to events, with base rates falling from a relatively low peak of 7½% in June 1998 to 5% in June this year. This followed a timely, and co-ordinated fiscal and monetary policy tightening in the period to mid-1998.

3.02 Latest data show the economy grew just below its trend rate from late 1997, with a temporary pause around the end of 1998. This was largely a result of falling export volumes in Asian and later, in European markets. By contrast, household financial strength and continued falls in unemployment were reflected in high levels of consumer confidence. Together with the prompt policy reaction by the Bank of England this has contributed to the stronger economic expansion in 1999 than expected at the time of the previous Convergence Programme.

3.03 Overall, GDP is forecast to grow by 1¾% in 1999, higher than the 1 to 1½% Budget forecast and much stronger than the consensus of independent forecasters in March.

3.04 Projections for GDP growth in later years are presented as ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-point of the ranges is based on the assumption of 2½ per cent a year for the trend rate of growth. This is the Government's neutral assessment of the economy's growth potential over the medium term - see Box 3.1 for more details. Public finance projections remain based on a prudent, and deliberately cautious assumption of 2¼% per year for trend growth.

Table 3.1 - Summary of forecast

		Forecast			
	1998	1999	2000	2001	2002
GDP growth (per cent)	2¼	1¾	2½ to 3	2¼ to 2¾	2¼ to 2¾
RPIX inflation (per cent, Q4)	2½	2	2½	2½	2½

BOX 3.1 - Trend growth[8]

Over the medium term, the trend rate of growth determines the pace at which the economy can expand without putting upward pressure on inflation. It can be considered in terms of growth in trend labour productivity and trend employment. Growth in employment can be further broken down into growth in the working-age population and growth in the sustainable employment rate.

In 1999, the economic outlook was highly uncertain due to the emergence of significant macroeconomic imbalances. Against this background the Government judged that is was sensible to present its forecasts for economic growth as ranges.

With the accumulation of evidence on the UK's performance, including clear signs of an improvement in the sustainable rate of unemployment, the Government believes that it is possible to give a firmer indication of the outlook for trend growth than in the opportunity ranges for growth it published on entering office.

On the basis of a careful and balanced assessment of past and future trends, the Government believes that a neutral assumption for the trend rate of growth in the medium term is 2½ per cent a year.

Per cent per annum

	Labour productivity[1]		Change in employment rate[2]	Population of working age[3]	**Estimated trend growth**
	underlying	actual			
1990s[4]	2.1	2.3	-0.3	0.3	2¼
Forecast[5]	2.1	2.0	0.1	0.4	2½

1 Output per workforce job.
2 Change in ratio of workforce jobs to UK household population, percentage points per annum.
3 UK household basis.
4 Between estimated on-trend points at the end of 1990 and 1998.
5 Neutral case assumptions underlying the mid-point of the GDP growth ranges from 2000Q1.

This is a balanced assessment, assuming a very modest increase in the employment rate, and not banking on any improvement in the underlying productivity performance over the experience of the 1990s - see table above. In this sense the Government's neutral estimate of trend growth is subject to upside risk, but it is taking a deliberately prudent approach, erring on the side of caution where uncertainties still exist.

The upper ends of the ranges for GDP growth presented in Table 3.1 on the previous page illustrate the potential for stronger non-inflationary growth. The Government has introduced a wide range of policies designed to improve productivity and the economy's growth potential, including measure to improve economic stability, get more people into work and encourage investment and enterprise. Together with responsible wage bargaining, they offer the potential for growth at or beyond the upper ends of the GDP forecast ranges over the medium term.

8 See "Trend Growth - prospects and implications for policy", HM Treasury, November 1999. Also available at http://www.hm-treasury.gov.uk

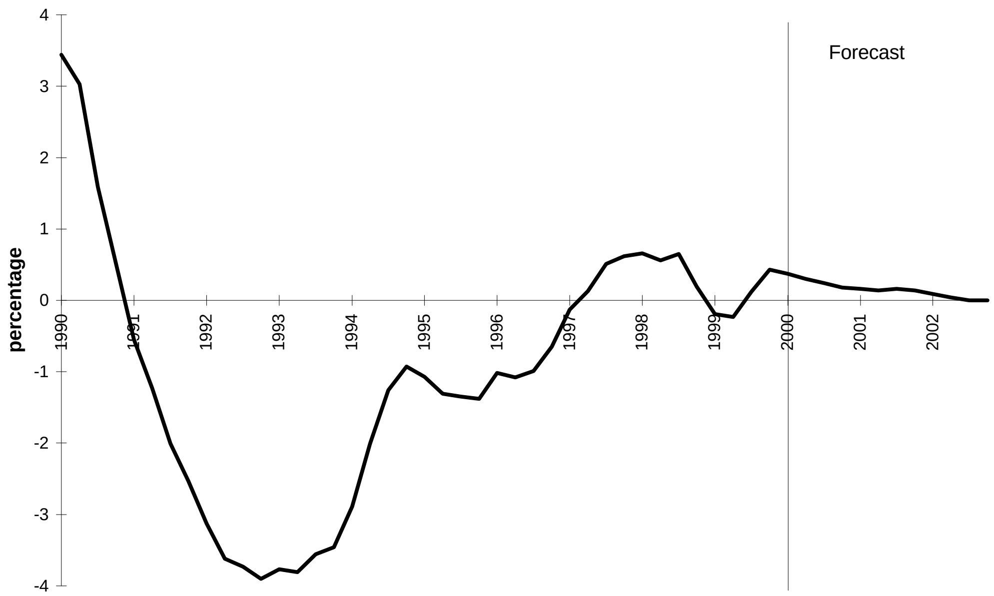
Cyclical position

3.05 Stronger than expected growth this year means that the level of output is provisionally estimated to have returned to its trend level in the third quarter of 1999. This view is broadly supported by survey evidence, and contrasts with Budget expectations when the output gap was expected to widen to around -1 per cent of GDP.

3.06 Strengthening exports, and the prospect of a more neutral contribution to growth from inventories than in 1999, implies that some slowing in final domestic demand will be necessary in order to keep the economy close to its sustainable path in 2000.

3.07 Overall, GDP is forecast to grow by 2½ to 3% per cent next year, and is expected to be slightly above trend in the first half of 2000.

Chart 3.1 - The output gap



3.08 GDP is now forecast to grow by 2¼ to 2¾ per cent in 2001, the mid-point of the range coinciding with the neutral outlook for trend growth. GDP growth is expected to remain within this 2¼ to 2¾ per cent range in 2002. Ensuring that the economy does not outrun its potential for non-inflationary growth over the next few years is necessary to secure a continued platform for stability and sustained increases in output and employment.

Inflation

3.09 RPIX inflation has remained close to target during the past year, fluctuating in a narrow band between 2 and 2¾%. It moved just below the inflation target of 2½% during the summer, helped by the continued weakness in import prices and a compression of margins at both the producer and retailer levels. This has masked the impact of a doubling in oil prices since the start of the year and strong growth in domestic unit wage costs.

3.10 As Chart 2.1 in the previous chapter showed, the latest figures show that HICP inflation in the UK and the average of the euro area are now very close to each other and remain comfortably within the upper limit of the ECB's definition of price stability.

3.11 During the course of next year, RPIX inflation is forecast to gradually rise to its target level. This reflects the impact of rising import inflation and little further compression of margins outweighing an easing in unit labour cost growth and lower indirect tax effects. From the second quarter of 2000 the forecast adopts the conventional assumption of inflation-indexed rises in fuel and tobacco duty levels. This assumption replaces the previous escalator uprating. Decisions on any real increases in excise duties will be announced at Budget time.

Interest rates

3.12 Greater stability in the UK has helped narrow the interest rate differential with the euro area. Short-term interest rate differentials between the UK and the Euro area have narrowed to 2½ percentage points at the end of 1999. The fiscal projections are based on market expectations of interest rates as of November 4 1999.

3.13 Inflation expectations of financial market participants 10 years ahead have fallen from over 4% in April 1997 to just under 2½% in October 1999. This is consistent with the 2½% target for RPIX.

3.14 Reflecting these lower inflation expectations, long-term interest rates have also fallen to very low levels. Yields on UK 10 year bonds in November were 5.3%, below the average for the EU15 of 5.4%. Low long-term interest rates imply that financial markets expect inflation to remain under control which will help maintain economic stability.

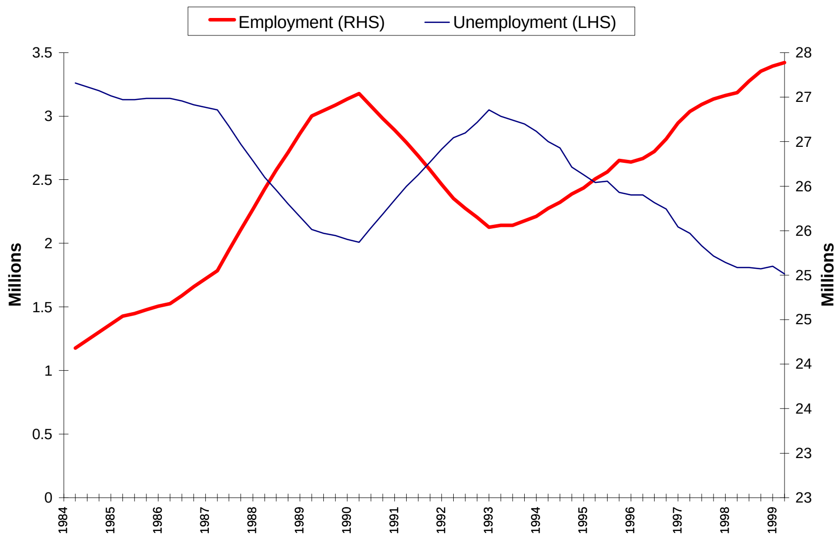
3.15 The tightening of the fiscal stance during 1997-98 supported monetary policy in containing the inflationary pressures which were emerging when the economy was above trend. This has enabled interest rates to peak at a much lower level and to subsequently fall more quickly.

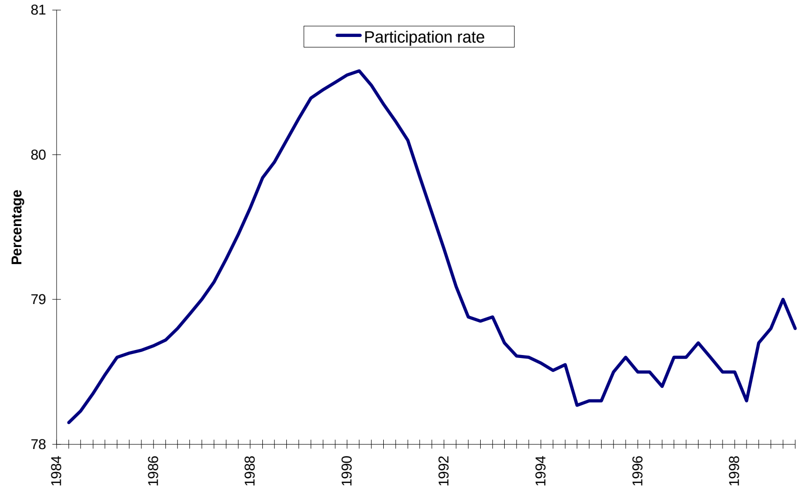
Employment

3.16 Labour market activity has remained unexpectedly robust, despite the slowdown in growth last year. The employment rate is close to its record high of 75%, as measured by the Labour Force Survey.

3.17 Unemployment has continued to decline, with the rate now under 6%. Nevertheless, earnings growth has eased since Spring 1998 and settlements have also come down. This recent downward trend in earnings growth provides evidence that the NAIRU may have declined broadly in line with actual unemployment over recent years. This may be associated with the improved regional balance of labour market activity.

Chart 3.3 - Employment, unemployment and participation rates





Trade and world economic outlook

3.18 From a position of broad balance in 1998, the current account deficit is expected to rise to around 1½ per cent of GDP in 1999. This deterioration has been caused by a reduction in the surplus on investment income and a weakening in net trade in goods and services during the first half of the year. Goods exports fell by around £3 billion compared to the second half of 1998, with sales to slower growing EU markets down by £2¼ billion.

3.19 Strains in the global financial markets have eased, and recovery has taken hold in much of Asia. The EU is the UK's major trading partner accounting for 58% of the UK's exports. Up to 3½ million jobs are affected by our trade with Europe. The recovery in the European economies is forecast to continue. Policies to achieve stability need to be complemented by the economic reform of markets to help ensure that this recovery is sustained.

3.20 Expansion in the US is continuing and as a result, G7 growth is expected pick up this year to 2¾ per cent. This improvement in world economic prospects is now feeding through into a marked improvement in the UK's export performance. Total goods export volumes rose by nearly 9% in the third quarter compared to the previous quarter, and survey measures of export confidence have also strengthened markedly. Growth in import volumes has also strengthened recently and so net trade overall is expected to make a broadly neutral contribution to GDP growth from now on. Overall, the current account deficit is expected to show a narrowing underlying trend, falling to around 1 per cent of GDP in 2002.

Chart 3.4 - Balance of Payments current account

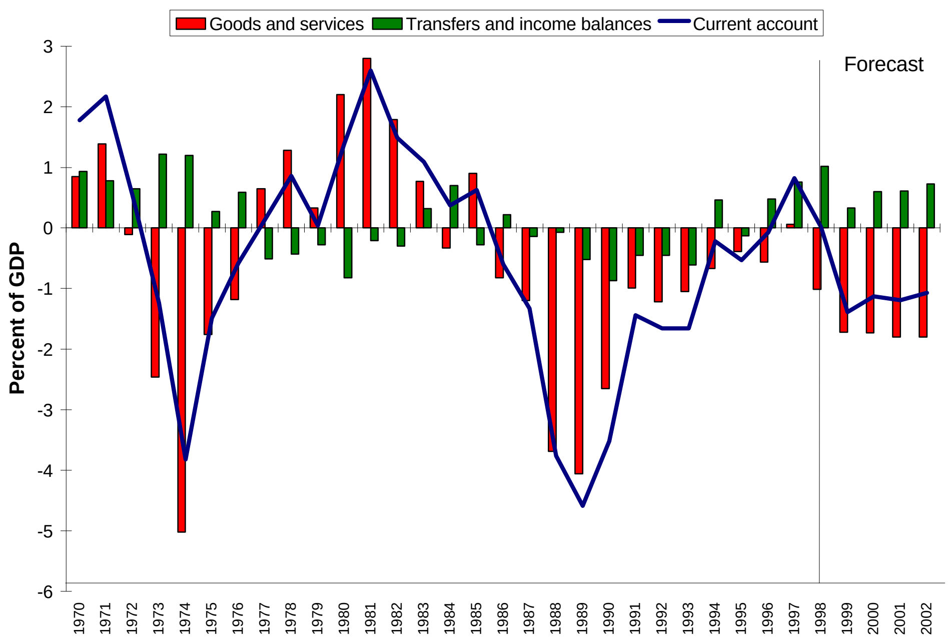


Table 3.2 - Summary of economic prospects[9]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast [1]				Average errors from past forecasts [2]
	1998	1999	2000	2001	2002	
Output at constant market prices						
Gross domestic product (GDP)	2¼	1¾	2½ to 3	2¼ to 2¾	2¼ to 2¾	1
Manufacturing output	¼	-¼	1½ to 2	2 to 2½	2 to 2½	2
Expenditure components of GDP at constant market prices[3]						
Domestic demand	4	3¼	2¾ to 3	2¼ to 2½	2 to 2½	1
Household consumption[4]	3¼	4	2½ to 2¾	2 to 2½	2¼ to 2¾	1
General government consumption	1	3¾	3	2	1½	1½
Fixed investment	9¾	4¼	2¼ to 2½	2½ to 3	3¼ to 3¾	2¼
Change in inventories[5]	0	-¾	¼ to ¼	0 to ¼	0 to 0	¼
Exports of goods and services	2	2¼	6½ to 6¾	5 to 5½	5½ to 6	2
Imports of goods and services	8½	6¼	6 to 6½	4½ to 5	5 to 5½	2
Balance of payments current account						
£ billion	¼	-12¼	-10¼	-11½	-10¾	6¼
per cent of GDP	0	-1½	-1	-1¼	-1	¾
Inflation						
RPIX (Q4)	2½	2	2½	2½	2½	1
Producer output prices (Q4)[6]	-¾	¾	2	2½	2½	1¼
GDP deflator at market prices (financial year)	2½	2¼	2½	2½	2½	1
Money GDP at market prices (financial year)						
£ billion	851	890	934 to 939	978 to 988	1024 to 1039	11
percentage change	4½	4¾	5 to 5½	4¾ to 5¼	4¾ to 5¼	1¼

[1] 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.
[2] Average absolute errors for year-ahead projections made in autumn forecasts over the past ten years. The average errors for the current account a calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2000.
[3] Further detail on the expenditure components of GDP is given in Table 10.
[4] Includes households and non-profit institutions serving households.
[5] Contribution to GDP growth, percentage points.
[6] Excluding excise duties.

[9] The forecast is consistent with national accounts and balance of payments statistics to the second quarter of 1999, released by the Office for National Statistics on 22 September 1999, and the preliminary GDP estimates for the third quarter released on 22 October 1999.

4 Outlook for the public finances

4.01 This section provides projections of the public finances and relates these to the fiscal framework and the reference values specified in the Treaty for government debt and deficit positions. Public finance projections remain based on a prudent and deliberately cautious assumption of 2¼ per cent per year for trend growth.

4.02 The Government's public finance statistics are all published on an ESA95 basis unless otherwise stated. General government gross debt and general government net borrowing ratios are given on an ESA79 and ESA95 basis this year for ease of comparison across Member States, not all of which have switched to the new system of accounts.

4.03 Moving to an ESA95 basis has a small positive effect on net borrowing as a percentage of GDP but has no effect on the measurement of the stock of gross debt.

Current balance and general government deficit

4.04 The current surplus for 1999 is expected to be just over 1 per cent of GDP. A similar improvement is expected in net borrowing, with a repayment of around ½ per cent of GDP expected for this year compared to a small deficit of £3 billion anticipated at the time of the Budget.

4.05 Net investment is projected to nearly double as a percentage of GDP between 1997-98 and 2001-02 from 0.6 per cent of GDP to 1.1 per cent of GDP, so the repayment on net borrowing is expected to remain at about £3 billion or 0.3 per cent of GDP. From 2001-02 onwards, with the economy growing at trend, net borrowing moves from surplus to modest deficits.

4.06 The average surplus on the current budget since the economy was last judged to be on trend in 1997-98 is projected to increase towards 1 per cent of GDP by the end of the projection period - remaining on track to meet the golden rule of borrowing only to invest and not to finance current spending.

4.07 On the measure of general government net borrowing, small repayments of up to ½ per cent of GDP are also projected until 2001-02.[10] This is consistent with meeting the objective of the Stability and Growth Pact of achieving a budgetary position of close to balance or surplus over the medium term.

[10] Up to 2002-03 on an ESA79 basis.

Table 4.1 - Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate	Projections				
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Current budget							
Current receipts	39.4	39.6	39.6	39.8	39.8	39.7	39.5
Current expenditure	36.7	37.0	37.1	37.0	37.1	37.1	37.1
Depreciation	1.6	1.6	1.5	1.5	1.5	1.5	1.4
Surplus on current budget (including WTAS[1])	1.1	1.0	1.0	1.2	1.2	1.1	1.0
Surplus on current budget[2]	**0.8**	**1.1**	**1.2**	**1.3**	**1.2**	**1.1**	**1.0**
Capital budget							
Gross investment	2.7	2.7	2.8	3.0	3.2	3.3	3.2
less asset sales	-0.5	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3
less depreciation	-1.6	-1.6	-1.5	-1.5	-1.5	-1.5	-1.4
Net investment	0.6	0.7	0.9	1.1	1.3	1.5	1.5
Net borrowing (including WTAS[1)])	-0.5	-0.2	-0.1	-0.1	0.1	0.4	0.5
Net borrowing[2]	**-0.3**	**-0.4**	**-0.3**	**-0.3**	**0.1**	**0.4**	**0.5**
Public sector net debt	**40.3**	**38.2**	**36.9**	**35.3**	**34.1**	**33.2**	**32.5**
Memos:							
General government net borrowing[3]							
ESA79	-0.9	-0.5	-0.5	-0.3	-0.2	0.3	0.3
ESA95	-0.5	-0.3	-0.2	-0.2	0.1	0.4	0.5
General government gross debt [3,4]							
ESA79	47.4	45.3	43.5	41.7	40.3	39.2	38.3
ESA95	47.0	44.9	43.1	41.3	39.9	38.8	38.0

[1] Windfall tax receipts and associated spending.

[2] Excluding windfall tax receipts and associated spending.

[3] Treaty measures of the government deficit and debt. From February 2000, the Treaty measures will move from being reported under ESA79 to ESA95 accounting conventions.

[4] The move to ESA95 accounting conventions does not affect the stock of gross debt, but it does increase money GDP, by about £8 billion in 1998-99

Cyclical adjustment and sensitivities

4.08 Looking at the surplus on current budget and net borrowing can be misleading when trying to assess the underlying position of the public finances. The economic cycle can have an important short-term impact on the public finances through the operation of automatic stabilisers. For example, the surpluses recorded in the late 1980s turned out to be misleading and largely due to cyclical factors as the adjusted current balance remained in deficit during this time. To avoid making the mistakes of the past, it is important to look at the cyclically-adjusted, or structural fiscal balances.

4.09 There has been a significant structural improvement in the public finances between 1996-97 and 1998-99, with the improvement locked in from 1999-00 onwards. The cyclically-adjusted current budget has moved from deficit two years ago, to a surplus of over ½ per cent of GDP last year. It is expected to rise further this year to nearly 1 per cent of GDP and remain at around 1 per cent of GDP over the next five years.

Table 4.2 - Cyclically-adjusted fiscal balances

Excluding windfall tax receipts and associated benefits

	Per cent of GDP							
	Outturns		Estimate	Projections				
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Budget balances								
Surplus on current budget	-0.6	0.8	1.1	1.2	1.3	1.2	1.1	1.0
Average surplus since 1997-98	-0.6	0.1	0.4	0.6	0.8	0.8	0.9	0.9
Net borrowing	1.2	-0.3	-0.4	-0.3	-0.3	0.1	0.4	0.5
Cyclically-adjusted budget balances								
Surplus on current budget	-0.6	0.6	0.9	1.0	1.2	1.2	1.1	1.0
Net borrowing	1.2	0.0	-0.2	-0.2	-0.2	0.1	0.4	0.5
Memo:								
Output gap	0.5	0.3	0.2	0.2	0.1	0.0	0.0	0.0

4.10 Similarly, there has been a structural improvement in cyclically-adjusted net borrowing from a deficit of over 1 per cent of GDP in 1997-98 to a small net repayment in 1999-00. In following years, the cyclically-adjusted net borrowing is small and very similar to the projections of the Budget and previous Convergence Programme.

4.11 Short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure (especially social security payments) vary automatically over the cycle. If GDP were 1 per cent higher or lower than assumed over the coming year, for example, net borrowing can be expected to be lower or higher by about ½ per cent of GDP (equivalent to around £4 billion) in the first year and lower or higher by a further ¼ per cent of GDP (£2 billion) in the second year.

General government receipts

4.12 Total receipts in 1998-99 were over £1 billion higher than expected at Budget time, mostly reflecting higher than expected income tax and VAT receipts towards the end of the year. In 1999-00, receipts are expected to be £7 billion above Budget expectations. In part this reflects stronger GDP growth this year, together with higher than expected growth of the tax base for given GDP.

Table 4.3 - Current receipts

	Per cent of GDP						
	Outturn	Estimate	Projections				
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Income tax (gross of tax credits)	10.4	10.6	10.7	10.9	11.1	11.2	11.3
Income tax credits[1]	-0.2	-0.4	-0.5	-0.7	-0.7	-0.7	-0.7
of which Working Families' Tax Credit		-0.1	-0.5	-0.5	-0.5	-0.5	-0.5
Corporation tax	3.5	3.8	3.5	3.7	3.6	3.5	3.3
Windfall tax	0.3						
Value added tax	6.1	6.3	6.2	6.2	6.1	6.1	6.1
Excise duties[2]	4.2	3.9	4.0	3.9	3.9	3.8	3.7
Social security contributions	6.5	6.3	6.3	6.3	6.3	6.4	6.3
Other taxes and royalties[3]	6.6	6.6	6.7	6.8	6.8	6.7	6.8
Net taxes and social security contributions[4]	37.4	37.0	36.8	37.2	37.2	37.0	36.8
Accruals adjustments on taxes	0.0	0.4	0.3	0.1	0.1	0.1	0.1
less EU transfers	-0.7	-0.7	-0.6	-0.5	-0.5	-0.4	-0.3
Income tax credits[5]	0.2	0.4	0.5	0.6	0.6	0.6	0.6
Other receipts	2.6	2.5	2.6	2.4	2.4	2.4	2.3
Current receipts (including windfall tax)[6]	39.4	39.6	39.6	39.8	39.8	39.7	39.5
Current receipts (excluding windfall tax)[6]	39.1	39.6	39.6	39.8	39.8	39.7	39.5
Memo:							
Current receipts (£bn)[5, 6]	335.5	352.1	370	389	407	426	444

[1] *Mainly MIRAS and tax reliefs under the Working Families' Tax Credit and Children's Tax Credit schemes.*

[2] *Fuel, alcohol and tobacco duties.*

[3] *Includes Council Tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes. Net of bus fuel duty rebate.*

[4] *Includes VAT and 'own resources' contributions to EU budget. Net of income tax credits. Cash basis.*

[5] *Excludes Children's Tax Credit, which scores as a tax repayment in the national accounts.*

[6] *Accruals basis.*

4.13 Income tax receipts in 1998-99 were nearly £1 billion higher than forecast at the time of the Budget. About half of this reflects a higher proportion of self-assessment receipts being allocated to income tax rather than capital gains tax. The rest reflects higher PAYE at the end of the year, in turn reflecting higher than expected wages and salaries. Wages and salaries growth is similarly expected to exceed the Budget projections this year and next, partly reflecting the recent strength of employment.

4.14 Receipts of corporation tax in 1999-00 are expected to be about £3½ billion above the Budget forecast. Contributory factors to this higher forecast include - higher than expected payments of Advance Corporation Tax (ACT) before its abolition; the first instalment of payments of corporation tax for profits in 1999 were above forecast; and the rapid recovery in oil prices during 1999 led to higher tax payments on North Sea production.

4.15 VAT receipts in 1999-00 are expected to exceed the Budget forecast, reflecting higher levels of consumer spending. Cash receipts of excise duties are expected to fall short of Budget forecasts by about £1¾ billion this year, mostly from a fall in tobacco duty revenue. The effect of changing the assumption about the future path of road fuel and tobacco excises is to reduce receipts in 2000-01 by £1¼ billion in cash terms, building up to £6 billion by 2003-04 in total.

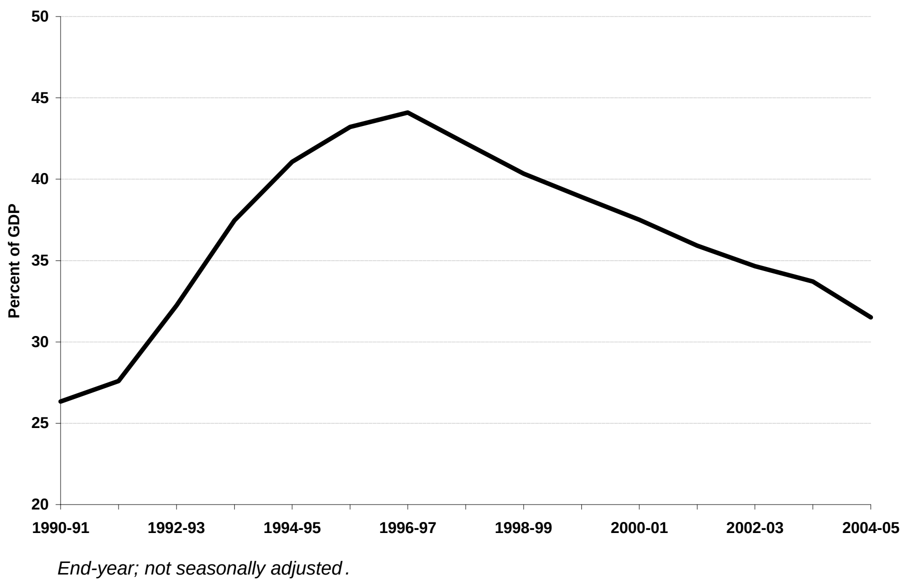
4.16 Total taxes as a percentage of GDP, measured on a cash basis, and net of taxes and social security contributions are estimated to fall by nearly ½ percentage point this year to 37% and to remain close to this level on average over the next five years.

General government debt

4.17 The net debt ratio is expected to fall from just over 40 per cent of GDP last March to under 33% by March 2005. This is consistent with the sustainable investment rule and reflects the continued improvement in the position of the public finances.

4.18 The Treaty definition of general government gross debt is similarly projected to fall, from just under 45% this year to 38% by 2004-05.

Chart 4.2 - Public sector net debt



General government expenditure

4.19 The Government has implemented a new regime for planning and controlling public spending. The previous framework had encouraged short-term planning and discriminated against investment. Its primary focus was on controlling the quantity of spending, with insufficient emphasis given to controlling the quality and effectiveness of current and capital spending. The new framework addresses these issues.

4.20 Each Government Department is also committed, through new Public Service Agreements (PSAs) for testing performance and efficiency targets for the modernisation of public services. The first of these PSAs, published in December 1998[11] set out the key results the public can expect in return for the investment it is making in public services. The Government has promised to give progress reports against targets annually.

4.21 A further review of public spending will take place next year, when the plans set in 1998 will be rolled forward for a further two years. The third year of the current plans, 2001-02, will become the first year of the new three-year planning period. New PSA targets will be agreed as part of the Spending Review.

4.22 The projections for the public finances, covered by the Comprehensive Spending Review, are shown in the table below. Total Managed Expenditure with the exception of 1999-00

[11] Public Services for the Future, Modernisation, Reform and Accountability (Cm 4181).

is unchanged from the previous Budget. The change represents the carry-forward of an underspend of £0.7 billion within Departmental Expenditure Limits last year. Compared to the previous Convergence Programme, the figures for Annual Managed Expenditure which includes social security benefits and debt interest have been revised downwards.

Table 4.4 - Total Managed Expenditure 1998-99 to 2001-02

					£ billion		
	Outturn	Estimate	Projections		Changes since Budget 99		
	1998-99	1999-00	2000-01	2001-02	1999-00	2000-01	2001-02
Departmental Expenditure Limits	**167.5**	**179.9**	**189.7**	**199.5**	**0.7**	**0.0**	**0.0**
Annually Managed Expenditure							
Social security benefits	93.3	97.2	99.0	103.6	-1.9	-2.5	-2.8
Housing Revenue Account subsidies	3.5	3.4	3.3	3.2	0.0	-0.1	-0.3
Common Agricultural Policy	2.7	2.6	2.6	2.7	0.1	-0.1	-0.1
Export Credits Guarantee Department	-0.2	0.8	1.0	0.7	0.3	0.2	-0.1
Net payment to EC institutions[1]	3.6	2.7	2.6	2.5	0.0	0.0	-0.4
Self-financing public corporations	-0.3	0.2	0.2	-0.1	0.3	0.4	0.2
Locally financed expenditure	16.1	17.2	18.0	19.3	0.2	-0.3	-0.5
Net public service pensions	4.7	5.8	5.9	6.0	-0.3	-0.2	-0.2
National Lottery	1.6	2.0	2.5	2.5	-0.6	-0.2	-0.3
Central government gross debt interest	29.3	25.7	28.4	28.1	-0.3	0.7	0.9
Accounting and other adjustments	9.2	9.0	11.8	12.9	-0.2	0.1	0.1
AME margin	0.0	3.5	3.9	6.4	2.5	1.9	3.4
Annually Managed Expenditure	**163.6**	**170.0**	**179.1**	**187.8**	**0.0**	**0.0**	**0.0**
Total Managed Expenditure	**331.0**	**349.9**	**368.8**	**387.3**	0.7	0.0	0.0
of which:							
Current expenditure	312.5	329.7	346.2	362.2	*0.7*	*0.1*	*0.2*
Net investment	5.0	6.4	8.4	10.4	*0.9*	*0.9*	*0.8*
Depreciation	13.6	13.8	14.2	14.7	*-1.0*	*-1.0*	*-1.0*

[1] *Net payments to EC institutions exclude the UK's contribution to the cost of EC aid to non-Member States (which is attributed to the aid programme). Net payments therefore differ from the UK's net contribution to the EC Budget, latest estimates for which are (in £ billion): Figures from 1999-2000 are trend estimates.*

	1998-99	1999-00	2000-01	2001-02
	4.1	*3.1*	*3.3*	*3.3*

Public sector investment

4.23 The Comprehensive Spending Review in July 1998 set out plans for public sector net investment to double as a percentage of GDP from ½ per cent in 1998 to over 1 per cent by 2001-02. The new fiscal framework, by making a clear distinction between current and capital spending, removes the bias against public investment and enables the Government to better invest in its public infrastructure.

4.24 The Government also continues to use the Private Finance Initiative (PFI) and Public-Private Partnership (PPPs) to support its capital investment programme. Projects worth around £4 billion have been signed since the General Election in such diverse areas as schools, hospitals, IT, defence and property management.

Table 4.5 - Public sector capital expenditure

	£ billion			
	1998-99	1999-00	2000-01	2001-02
CG spending and LA support in DEL	10.7	12.1	14.3	16.5
Locally financed spending	0.8	0.9	0.7	0.7
National Lottery	1.4	1.7	2.1	2.1
Public corporations[1]	4.1	4.7	4.5	4.5
Other capital spending in AME	1.5	0.7	0.8	1.1
Allocation of reserve and AME margin	0.0	0.2	0.2	0.2
Public sector gross investment[2]	**18.6**	**20.2**	**22.6**	**25.1**
Less depreciation	-13.6	-13.8	-14.2	-14.7
Public sector net investment[2]	**5.0**	**6.4**	**8.4**	**10.4**
Proceeds from the sale of fixed assets[3]	4.3	3.8	3.8	3.8

[1] *Public corporations' capital expenditure is partly within DEL and partly within AME.*

[2] *This and previous lines are all net of sales of fixed assets.*

[3] *Projections of total receipts from the sale of fixed assets by public sector. These receipts are taken into account in arriving at public sector gross and net investment, which are net of sales of fixed assets.*

Assumptions underlying the public finance projections

4.25 Eleven key assumptions underlying the fiscal projections are audited by the National Audit Office (NAO)[12] - see Box 4.1 below. The assumption for trend GDP growth for the fiscal

[12] The NAO is accountable to Parliament and totally independent of Government. The head of the Office, the Comptroller and Auditor General, certifies the accounts of all Government Departments and a wide range of other public sector bodies, and has statutory authority to report to Parliament on the economy, efficiency and

projections remains as audited by the NAO at 2¼ per cent per year. UK claimant unemployment is assumed flat at recent levels, equity prices are projected to grow in line with money GDP, and interest rates are projected to follow market expectations.

4.26 The projections are also based on a new oil price assumption that has been endorsed by the NAO, so that when the average of independent forecasters shows a fall, this average is used for calculating North Sea revenues and then remains constant in real terms thereafter. When the average shows a rise in oil prices, the Government assumes that they remain constant in real terms as under the previous convention.

4.27 In addition, the public finances take into account the Government's decision to move decisions on tobacco and fuel duties onto a discretionary basis. The Government is committed to meeting its environmental objectives, but the future yields will depend on Budget decisions. In line with the *Code for Fiscal Stability*, the effects of real increases in duty have therefore been removed from the public finance projections in keeping with the approach taken to the scoring of other tax revenues.

effectiveness with which Departments and other bodies have used their resources.

BOX 4.1 Key assumptions audited by the National Audit Office

C *Privatisation proceeds*[1]	Credit is taken only for proceeds from sales that have been announced.
C *Spend to Save*[1]	Only direct effects of the Spend to Save programme on receipts and spending are allowed for.
C *Trend GDP growth*[1]	2¼ per cent a year.
C *UK claimant unemployment*[1, 4]	Constant at recent levels, 1.23 million.
C *Interest rates*[1]	3 month market rates change in line with market expectations as of November 4.
C *Equity prices*[2]	FT-All share index rises from 2,850 in line with money GDP.
C *VAT*[2]	Ratio of VAT to consumption falls by 0.05 percentage points a year.
C *GDP deflator and RPI*[2]	Projections of price indices used to plan public expenditure are consistent with RPIX.
C *Composition of GDP*[3]	Shares of labour income and profits in national income are broadly constant in the medium term.
C *Funding*[3]	Funding assumptions used to project debt interest are consistent with the public finances forecast and with financing policy.
C *Oil prices*[5]	$18.70 a barrel in 2000, the average of independent forecasts, and then constant in real terms.

[1] *See Audit of Assumptions for the July 1997 Budget Projections, 19 June 1997 (HC3693)*

[2] *Audit of Assumptions for the Pre-Budget Report, 25 November 1997 (HC361)*

[3] *Audit of Assumptions for the Budget, 19th March 1998 (HC616)*

[4] *Audit of the Unemployment Assumption for the March 1999 Budget Projections, 9 March 1999 (HC294)*

[5] *Audit of the Oil Price Assumption for the Pre-Budget Report November 1999 (HC873)*

4.28 In addition to the NAO audited assumptions, the Government uses its economic forecasts for real output growth, the GDP deflator, money GDP, RPI, RPIX and Rossi to estimate future Government receipts and expenditures.

Table 4.6 - Economic assumptions for public finance projections

	Percentage changes on previous year						
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Output (GDP)- PBR	1¾	2¼	2¼	2¼	2¼	2¼	2¼
Output (GDP)- Budget 99	1¾	1	2½	2¾	2½	2¼	
GDP deflator- PBR	2½	2¼	2½	2½	2½	2½	2½
GDP deflator- Budget 99	2½	2½	2½	2½	2½	2½	
Money GDP (£ billion)- PBR	851	890	934	978	1024	1073	1124
Money GDP (£ billion)- Budget 99	848	880	925	975	1023	1072	
RPIX- PBR	2¾	2¼	2½	2½	2½	2½	2½
RPIX- Budget 99	2¾	2¼	2½	2½	2½	2½	
RPI (September[1])- PBR	3¼	1	3½	2½	3	2½	2¼
RPI (September[1])- Budget 99	3¼	1¼	3	2¾			
Rossi[2] (September[1])- PBR	2¼	1¾	1¾	2	2	2	2
Rossi[2] (September[1])- Budget 99	2¼	2	2	2			

[1] *Used for projecting social security expenditure over the following financial year.*

[2] *RPI excluding housing costs, used for uprating certain social security benefits.*

4.29 The projections are also made on the basis that:

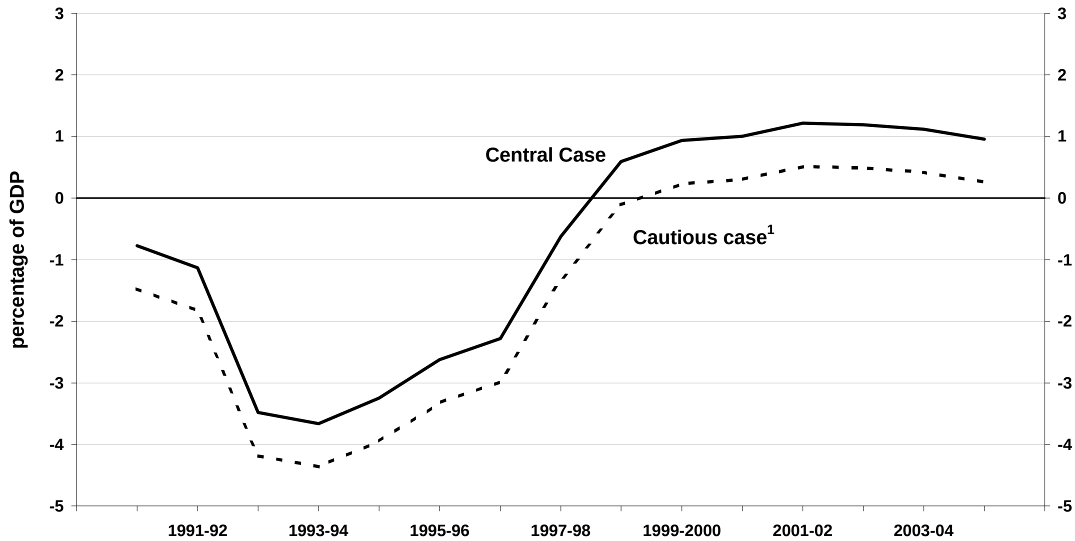
- the economy follows the path of the economic forecast, although with output growth assumed at a cautious 2¼%.
- there are no tax changes beyond those already announced in the Budget and PBR and rates and allowances are indexed in line with inflation. This includes tobacco and fuel duties which are now determined on a Budget by Budget basis.
- Department Expenditure Limits (DEL) remain in line with previous spending commitments made in the Comprehensive Spending Review in July 1998.
- Annual Managed Expenditure (AME) is unchanged from the Budget projections and any changes to components of AME result in offsetting changes in the AME margin.

Risks and uncertainty

4.30 Forecasting the public finances and fiscal balances involves a high degree of uncertainty as they are calculated as the difference between two large aggregates of spending and receipts. Forecasts of them are inevitably subject to wide margins of error. Over the past five years, for example, the average absolute error for 1 year ahead forecasts of net borrowing has been over 1 per cent of GDP, or plus or minus £9 billion at today's prices.

4.31 One particular source of uncertainty is the economy's position in relation to its sustainable long-term trend. The Government publishes an additional projection based on a more cautious case in which trend output is assumed to be 1 per cent lower than in the central projection. This scenario models the implications of assuming that a greater proportion of the projected surplus on the current budget results from the cyclical strength of the economy. The chart shows that even under the more cautious case surpluses on the current budget are projected over the medium term.

Chart 4.3 - Cyclically-adjusted surplus on current budget



[1] *Cautious case assumes trend output 1 per cent lower in relation to actual output than in the central case.*

4.32 The Government is also aware of the need to examine and plan for the long-term effects that the changing demographic profile in the UK will have for taxation and spending plans. See Box 4.2 for details.

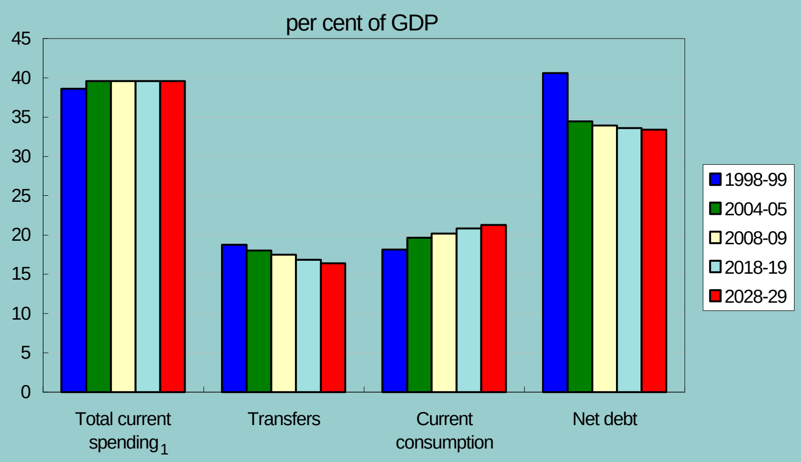
BOX 4.2 - Long term projections of the public finances

Over the next 30 years the structure of the UK population and the nature of the services they require will undergo substantial change.

For this reason, a key requirement of the Code for Fiscal Stability is to publish illustrative long-term fiscal projections each year. The first set of long-term projections, along with the underlying methodology and assumptions, were published in the 1999 Economic and Fiscal Strategy Report. The projections do not pre-empt policy decisions beyond the 1999 Budget and therefore cannot be interpreted as reflecting the direction of future policy.

The baseline illustrative projections are set out in the chart below. They show that, given the assumptions for transfer payments, current consumption can grow at around 2½ per cent for the next 30 years and still remain consistent with meeting the fiscal rules. On average this equates to rises of around £5 billion in total current spending each year, or £126 billion in total (in 1998-99 terms) from 2004-05.

Baseline long-term projections



1 Total current spending equals current receipts from 2004-05 onwards.

One of the main reasons for this strong level of sustainable consumption growth is the projected declining trend for social security benefits. As the majority of benefits in the UK are indexed by prices, they remain constant in terms of purchasing power and fall as a share of GDP over time. This trend, along with falling debt interest payments, is reflected in lower transfer payments over time.

Overall these projections show a broadly sustainable long-term position for the UK's public finances. Increases in productivity and labour force participation would further strengthen this position creating the potential for improvements in the quality and quantity of public services or reductions in taxation. However, these findings need to be interpreted with caution as the impact of current policies and future demographic trends on the public finances is uncertain over such a long period.

ANNEX A Comparison to 1998 Convergence Programme

1. The main differences from the previous Convergence Programme and Budget figures have been discussed in Sections 3 and 4 of this updated programme. For example, GDP growth is expected to be higher this year than predicted at the time of the Budget. This has been one of the factors behind an improvement in the public finances. Inflation on the other hand is still expected to be on target from 2000, although the latest figures indicate a slight dip below the target this year.

Table A1 - Comparing GDP growth and inflation between convergence programmes

	1998		1999		2000		2001	
	1998 CP	1999 CP	1998 CP	1999 CP	1998 CP	1999 CP	1998 CP	1999 CP
GDP growth (per cent)	2¾	2¼	1 to 1½	1¾	2¼ to 2¾	2½ to 3	2¾ to 3¼	2¼ to 2¾
RPIX inflation (per cent, Q4)	2½	2½	2½	2	2½	2½	2½	2½

2. The improvement in the surplus on the current budget and in Public Sector Net Borrowing (PSNB) are also the result of higher outturn figures for 1998 than expected in the Budget and the previous Convergence Programme and the favourable shift in the composition of GDP growth which has increased the tax base.

3. The public finance projections have also been affected by the decision announced in the PBR to move decisions about the tobacco and fuel duties to a Budget by Budget basis. In line with the Code for Fiscal Stability, the effects of real increases in duty have therefore been removed from the public finance projections, in keeping with the approach taken to the scoring of other tax revenues.

4. The improvement in current surplus and PSNB is also apparent for 1998-99 and 1999-00 on a cyclically-adjusted basis, but the forward projections remain broadly as in the previous Convergence Programme. This means that the fiscal stance[13] is broadly unchanged from the Budget and the previous Convergence Programme, with the fiscal tightening achieved since 1996-97 continuing to be locked in.

Table A2 - Comparing public sector finances as percentage of GDP between Convergence Programmes

[13] The absolute fiscal stance is defined as the change in cyclically-adjusted PSNB during the period covered by the Budget projections.

ANNEX B The fiscal impact of 1999 Budget measures

1. The table below shows the financial implications of measures announced in the 1999 Budget. An update of this table will be published in the next Budget, taking into account changes from the PBR and measures announced in the Budget itself.

Table B1 - 1999 Budget measures

	1998-99		1999-00		2000-01		2001-02		2002-03		2003-04	
	1998 CP	1999 CP	1998 CP	1999 CP	1998 CP	1999 CP	1998 CP	1999 CP	1998 CP	1999 CP	1998 CP	1999 CP
Current receipts	39.3	39.4	39.3	39.6	39.4	39.6	39.8	39.8	39.9	39.8	39.9	39.7
Current expenditure	36.8	36.7	37.6	37	37.6	37.1	37.4	37	37.4	37.1	37.3	37.1
Net investment	0.5	0.6	0.7	0.7	0.9	0.9	1.1	1.1	1.1	1.3	1.1	1.5
Surplus on current budget	0.6	0.8	0.2	1.1	0.3	1.2	0.9	1.3	0.9	1.2	1	1.1
Public sector net borrowing	-0.3	-0.3	0.5	-0.4	0.5	-0.3	0.2	-0.3	0.2	0.1	0.1	0.4
Cyclically-adjusted surplus on current budget	0.3	0.6	0.5	0.9	1.0	1.0	1.2	1.2	1.0	1.2	1.0	1.1
Cyclically-adjusted PSNB	0.2	0	0.2	-0.2	-0.1	-0.2	-0.1	-0.2	0.1	0.1	0.1	0.4
General government net borrowing[1]	-0.8	-0.9	0.3	-0.5	0.3	-0.5	0.1	-0.3	-0.2	-0.2	-0.1	0.3
General government gross debt[1]	47.9	47.4	46.7	45.3	45.4	43.5	43.7	41.7	42	40.3	40.4	39.1

[1] ESA79 basis for comparison to 1998 convergence programme

	1999-00 non-indexed	1999-00 indexed	2000-01 indexed	2001-02 indexed
RAISING PRODUCTIVITY				
1 Corporation tax: new 10 per cent rate for the smallest companies from April 2000	0	0	0	-100
2 Extension of first year capital allowances for SMEs at 40%, for one year	*	*	-175	-150
3 Research and development tax credit	0	0	*	-100
4 Tax relief for employer-loaned computers	-5	-5	-15	-30
5 Individual Learning Accounts: making employer contributions to employee ILAs tax and NICs free	0	0	-10	-10
6 Abolition of Vocational Training Relief (VTR)	*	*	25	50
INCREASING EMPLOYMENT OPPORTUNITY				
Tax-benefit reform to promote work incentives				
Income tax:				
7 Indexation of most allowances and limits	-1050	0	0	0
8 New 10p rate from April 1999	-1600	-1500	-1800	-1800
9 Basic rate reduced to 22 per cent from April 2000	0	0	-2250	-2800
National insurance contributions				
10 Indexation of thresholds	-45	0	0	0
11 Alignment of threshold with income tax personal allowance, in two stages, beginning April 2000	0	0	-850	-1800
12 Increase in upper earnings limits for employee contributions in April 2000 and April 2001	0	0	430	750
13 Reform of self-employment contribution rates and profits limits from April 2000	0	0	240	290
14 Reduction in employer contribution rate by 0.5 percentage points from April 2001	0	0	0	-1700
Benefits:				
15 New Deal package for the over 50s: Employment Credit	-10	-10	-110	-110
16 Income Support: two week extension for lone parents moving into work	-10	-10	-20	-20
BUILDING A FAIRER SOCIETY				
Measures for families with children				
17 Abolition of married couples allowance from April 2000 for those born after 5 April 1935	0	0	1600	2050
18 Introduction of the Children's Tax Credit from April 2001:	0	0	0	-1400
19 with increases in Income Support and child premia	-220	-220	-550	-550
20 and with increases in Working Families Tax Credit and Disabled Person's Tax Credit	-180	-180	-650	-750
21 Child Benefit: indexation of rates and uprating from April 2000 to £15 per week for first child and £10 per week for subsequent children	0	0	-255	-255
22 Sure Start Maternity Grant	0	0	-20	-20
23 Maternity pay reforms	0	0	0	-15
Fairness to pensioners				
24 Increasing personal allowances for older people	0	0	-100	-100
25 Increase minimum income guarantee for pensioners	0	0	-220	-220
26 £100 Winter Allowance from 1999	0	0	-640	-640

Securing the tax base				
27 Abolition of mortgage interest relief from April	0	0	1350	1400
28 Countering avoidance in the provision of personal services	0	0	475	375
29 Extension of employer NICs to all benefits in kind which are subject to income tax from April 2000	0	0	415	440
30 Controlled Foreign Companies (CFCs) taxation of dividends	0	0	0	20
31 Capital gains tax on sale of companies	40	40	130	130
32 Stamp duty: compliance	25	25	25	25
33 VAT: changes to partial exemption rules	70	70	75	75
34 VAT: group treatment	5	5	10	10
35 Enlarging VAT exemption on financing arrangements	95	95	100	100
36 VAT: bringing supplies by certain organisations in line with trade unions and professional bodies	-10	-10	0	0
37 Taxation of reverse premiums	20	20	50	50
Environmental measures				
38 Climate change levy	0	0	0	1750
39 Energy efficiency measures and support for renewable energy sources	0	0	0	-50
40 Green transport plans	-5	-5	-5	-5
41 Increase in minor oils duties	30	25	55	90
42 Hydocarbon oil duty escalator	1675	0	0	0
43 Cut in duty on higher octance unleaded petrol	20	20	60	40
44 Company car taxation: reduction in business mileage discounts from April 1999	270	270	265	260
45 Landfill tax: introduction of five year escalator	0	0	45	85
Vehicle excise duty				
46 Graduated VED - reduction of charge for small cars and indexation for others	40	-85	0	0
47 New VED for heavy lorries	45	45	40	35
48 Freeze other lorry VED	-20	-20	-20	-20
Other				
49 Tobacco - aligning escalator with Budget day, freeze handrolled tobacco	630	620	410	465
50 Alcohol - aligning revalorisation point with Budget day and freeze	0	*	-10	-10
51 Gifts of equipment by business to charities	*	*	-5	-10
52 Inheritance tax: index threshold	-30	0	0	0
53 Capital gains tax: rate adjustment	*	*	-45	20
54 VAT: indexation of registration and deregistration thresholds	-30	-30	-20	-15
55 Football clubs: assistance for transition to new accounting rules	*	*	-45	20
56 Revised rate of pools betting duty from 26.5% to 17.5%.	-30	-30	-20	-15
57 Removing the income tax charge on mobile phones	-25	-25	-30	-35
58 Stamp duty: 2.5% rate for transfer of land and property above £250,000 and 3.5% above £500,000	270	270	310	340
59 Increase in the rate of insurance premium tax by 1 percentage point (to 5%)	210	210	290	300
60 VAT: option to tax land and property rules	30	30	30	30
61 Lloyds insurance market: simplifying capital gains	*	*	-5	-5
TOTAL	**-570**	**-1065**	**-1385**	**-3555**