



HM TREASURY

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# **SUSTAINABILITY FOR THE LONG TERM**

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**Convergence Programme for the United Kingdom**

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

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December 2002



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# 1 INTRODUCTION

**1.1 Strong economic fundamentals and decisive macroeconomic policy have left the UK better placed than in previous world slowdowns to maintain stability.** Slower than expected growth, further declines on global equity markets, continued global uncertainty and the risks in today's global environment (including global acts of terrorism) have challenged the economic strength of countries the world over, threatening the prosperity and living standards of many. Last year saw the sharpest slowdown in global growth for three decades. However, the UK economy grew faster than any other G7 country last year and is well placed to benefit when the global recovery gathers pace.

## The importance of sustainability

**1.2 Sustainable public finances are an essential prerequisite to achieving steady long-term economic growth.** There has been a shift towards more medium-term planning within fiscal frameworks by governments around the world, and a greater emphasis on the long term. This has been motivated mainly by countries attaining control over their short and medium-term fiscal positions and becoming increasingly aware of the importance of looking at the long term, in part so as to prepare for the common problem of an ageing population. The focus of the UK's attention has long been on fiscal sustainability and this helps create an environment conducive to sustained long-term economic growth and should help promote inter-generational fairness. Consequently, the Government published, in November 2002, the first *Long-Term Public Finance Report*<sup>1</sup>. This report, to be produced annually, seeks to extend and complement existing analysis<sup>2</sup> and introduces additional indicators to assess long-term fiscal sustainability. Using these techniques, and a range of plausible assumptions, it is possible to build up a comprehensive picture of the long-term sustainability of the public finances in the light of future developments (as shown in Chapter 4).

**1.3** This Convergence Programme, "**Sustainability for the long term**", updates the UK's 2001 Convergence Programme to reflect the latest Government forecasts for the economy and public finances, which were published in the Pre-Budget Report on 27 November 2002<sup>3</sup>. The public finance projections in the Pre-Budget Report have a different status to those included in the Budget – they are an interim forecast update and do not necessarily represent the outcome the Government is seeking. This update therefore also takes account of Budget 2002<sup>4</sup>, as well as taking account of the latest biennial Government spending review, completed in 2002<sup>5</sup>.

## Prudent interpretation

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

<sup>1</sup> *Long-Term Public-Finance Report: an analysis of fiscal sustainability*, HM Treasury, November 2002

<sup>2</sup> In Annex A of the Economic and Fiscal Strategy Report (EFSR), which sets out 30-year public finance projections

<sup>3</sup> *Pre-Budget Report*, HM Treasury, November 2002

<sup>4</sup> *Budget 2002*, HM Treasury, April 2002

<sup>5</sup> *2002 Spending Review*, HM Treasury, July 2002

### The macroeconomic framework

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

- the **monetary policy framework in the UK** is delivering low and stable inflation and is enabling the Bank of England's Monetary Policy Committee (MPC) to respond quickly to risks to the symmetrical inflation target;
- the **fiscal policy framework in the UK** is delivering sustainable public finances, while supporting monetary policy over the cycle. The fiscal rules are set over the cycle and the automatic stabilisers are allowed to operate fully, which lets fiscal policy smooth the path of the economy in the face of fluctuations in demand. Fiscal policy has supported monetary policy in limiting the impact of adverse global developments on the UK economy. Despite fragile global conditions, UK employment has risen to record levels and unemployment is at generational lows; and
- the fiscal rules, which the Government continues to meet, are also the foundation of the UK Government's **public spending framework**, which, with tough decisions on taxation and spending, is delivering substantial resources to reform and modernise public services. The UK Government believes that sustainable public finances are a prerequisite to achieving stable long-term economic growth, which in turn is essential in guaranteeing that everybody participates in the growing prosperity of the country. The Government also seeks to ensure that spending and taxation impact fairly between generations.

### Economic forecasts

1.6 Chapter 3 provides updated forecasts for the UK economy in the period to 2005. In an integrated global economy, no country can be fully immune to international developments, and uncertainty in the outlook for global demand has affected UK economic prospects in the short term, deterring companies from expanding investment and increasing production. However, the UK economy grew faster than any other G7 country last year and is well placed to benefit when the global recovery gathers pace. UK GDP is forecast to rise by 1.6 per cent in 2002, below the Budget forecast, due to renewed uncertainty in the world economy. A strengthening in the pace of global recovery from next year should subsequently allow the economy to achieve a temporary period of above trend growth, GDP rising by 2½ to 3 per cent in 2003 and by 3 to 3½ per cent in 2004, before returning to trend in 2005.

### Public finances

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

- **the economic cycle.** The average current budget since the start of the present cycle in 1999-2000 is comfortably in surplus, ensuring that the Government is on track to meet the golden rule, using cautious assumptions and in the cautious case. This is confirmed by the cyclically-adjusted current budget, which is in surplus in every year throughout the projection period. As a result of tough decisions on taxation and spending, and with the benefits of greater economic stability, fiscal policy was tightened in structural terms by over 4 percentage points of GDP between 1996-97 and 2000-01, supporting monetary policy during a period when the economy was generally above trend;

- **sustainability.** These actions, including the use of the £22.5 billion proceeds from the auction of spectrum licences, have allowed the Government to repay more than £50 billion of debt since 1996-97. Public sector net debt has been reduced from 44 per cent of GDP in 1996-97 to under 31 per cent of GDP - lower than that in any other G7 economy and among the lowest in the EU. Low and stable debt levels, combined with accumulated current budget surpluses over the course of the economic cycle, have allowed the automatic stabilisers to operate fully, helping to limit the impact of the more recent global slowdown on the UK economy, and comfortably meeting the sustainable investment rule; and
- **public investment.** Building on the increases delivered in the last Parliament, the 2002 Spending Review planned an additional £63 billion of departmental spending by 2005-06 compared with this financial year – an average annual increase in public services spending of over 5 per cent a year in real terms. To address the legacy of under-investment in public services, public sector net investment, projected to be almost three times higher this year than in 1997-98, is planned to rise further to 2 per cent of GDP in 2005-06.

### Productivity and economic reform in Europe

**1.8** Productivity growth, alongside high and stable levels of employment, is an important determinant of long-term economic performance and rising living standards. Increasing the sustainable rate of UK productivity growth is central to the Government's economic strategy. The UK has historically experienced low rates of productivity growth by international standards. If the economy is to continue to deliver growing prosperity in a global marketplace for business, investment and skills, it is essential that faster productivity growth is achieved. Just as it seeks to raise domestic productivity, so the Government is also working to promote economic reform and productivity growth in Europe, building on the progress made at the Barcelona, Stockholm and Lisbon Spring European Councils. The Government's White Paper on economic reform<sup>6</sup> describes the next steps in this process. The Government will report on developments in economic reform since the White Paper in a progress report early in 2003.

### Annexes

**1.9** Annex A provides details of the differences in key indicators between this update of the programme and the 2001 update. Annex B provides details of the financial impact of the 2002 Budget policy decisions, and subsequent announcements.

<sup>6</sup> *Realising Europe's Potential: Economic Reform in Europe*, HM Treasury, February 2002

**Box 1.1: Background to the 2002 update “Sustainability for the long term”**

The Government has submitted programmes under the Stability and Growth Pact for each of the last four years. The Stability and Growth Pact requires Member States to provide information on economic developments in their country, for the purposes of the multilateral surveillance procedure under Articles 99 and 104 of the EU Treaty (ex Articles 103 and 104c). The UK is required to present the following information in its Convergence Programme:

- information on the medium-term objective for the budgetary position of “close to balance or in surplus” and the adjustment path towards this objective for the general government surplus/deficit, the expected path for the general government debt ratio, the medium-term monetary policy objectives, and the relationship of those to price and exchange rate stability;
- the main assumptions about expected economic developments and important economic variables;
- a description of budgetary and other economic policy measures being taken, or proposed, to achieve the objectives of the programme; and
- an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

In July 2001 the ECOFIN Council agreed an updated Code of Conduct on content and format of Stability and Convergence Programmes<sup>7</sup>. This 2002 update reflects the Code of Conduct alongside the Government’s obligations to the UK Parliament under Section 5 of the European Communities (Amendment) Act 1993.

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<sup>7</sup> *Opinion on the content and format of stability and convergence programmes*, EFC/ECFIN/404/01-REV 1



# 2

## POLICY FRAMEWORK & OBJECTIVES

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### Objectives of Economic Policy

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

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

2.2 These objectives, and the elements through which the Government plans to meet them, are consistent with the objectives of the European Community as set out in Article 2 of the Treaty. They are also consistent with the Broad Economic Policy Guidelines of the Member States and the Community, and with a prudent interpretation of the EU Stability and Growth Pact.

### Sustainability for the Long Term

#### The importance of sustainability

2.3 While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Sustainable public finances are an essential prerequisite to achieving steady long-term economic growth. Failure to ensure fiscal policy decisions are sustainable would see financial burdens shifted to future generations, with detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management set out in the *Code for fiscal stability*.

2.4 A new analysis of long-term fiscal sustainability in the UK, the *Long-Term Public Finance Report*, was published alongside the 2002 Pre-Budget Report. The *Long-Term Public Finance Report* provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances. It updates the illustrative long-term fiscal projections set out in Budget 2002<sup>8</sup> and confirms the findings of the Budget projections.

2.5 Based on reasonable assumptions, the report shows that the public finances are sustainable in the longer term, and that current policies impact fairly between generations. Given the projected profiles for tax revenues and transfers, current consumption can grow slightly faster than GDP growth in the long term while still meeting the golden rule. Public sector net investment can grow close to the economy's growth rate over the 30-year projection period without jeopardising the sustainable investment rule, and the net debt to GDP ratio is projected to remain below 40 per cent.

<sup>8</sup> Illustrative long-term fiscal projections, Annex A of the Economic and Fiscal Strategy Report, *Budget 2002*, HM Treasury, April 2002

2.6 The *Long-Term Public Finance Report* presents a series of additional indicators, including generational accounts, fiscal gaps and projections of spending on education, pensions, health and long-term care - together, about half of all public spending. These indicators confirm the overall result that the UK fiscal position is sustainable in the long term and that the UK is in a strong position relative to many other developed countries. They also demonstrate that there is a high degree of inter-generational fairness, particularly when account is taken of announced increases in public investment which will benefit both current and future generations. Chapter 4 of this programme outlines the content of this report in more detail.

### The importance of stability

2.7 The Government's macroeconomic framework is based on the principles of transparency, responsibility and accountability. The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by two strict rules that aim to secure sound public finances over the medium term. The fiscal rules are the foundation of the Government's public spending framework, which ensures long-term planning while putting in place incentives to increase the quality of public services and deliver specified outcomes. These coordinated policies work together to form a coherent and integrated strategy.

### Monetary Policy

### The monetary policy framework

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

- clear and precise objectives. The primary objective of monetary policy is to deliver price stability. The Government's single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's target of 2½ per cent for the 12-month increase in the Retail Prices Index excluding mortgage interest payments (RPIX), which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings, and the publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the clear inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how this meets the MPC's remit.

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

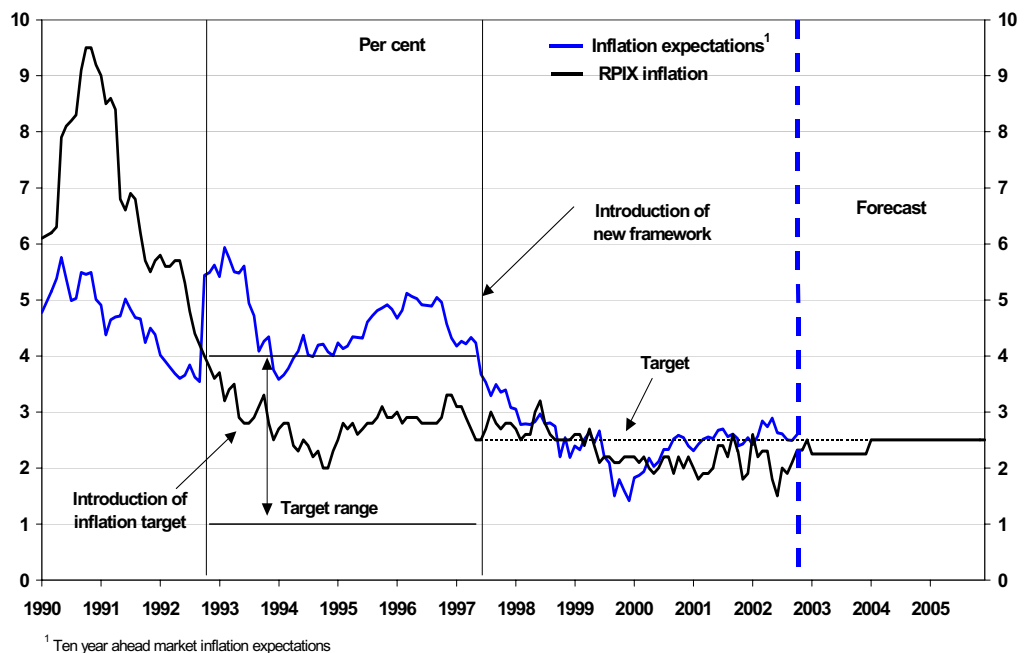
### Benefits of the monetary policy framework

**2.10** The monetary policy framework has enhanced the credibility and transparency of economic policy-making and continues to deliver positive results. Since the framework was introduced, RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government's target and within the range outside of which an open letter would be triggered. Long-term inflation expectations, as measured by financial markets data, show that inflation is expected to remain close to the Government's inflation target, having fallen from over 4 per cent in 1997.

**2.11** The framework has dealt successfully with unforeseen shocks. The MPC responded promptly and decisively to the global slowdown during 2001 and the events of 11 September by cutting interest rates seven times, and by a total of 2 percentage points, from 6 to 4 per cent. This decisive policy response helped to keep output close to its potential level throughout the year, while ensuring that inflation continued to remain close to target.

**2.12** Since November 2001 the MPC has held official short-term interest rates at 4 per cent, as buoyant growth in domestic consumption and rising house prices have helped counteract the effect of slower growth in the world economy, weak investment growth and turbulence in foreign exchange and equity markets. Long-term interest rates are around their lowest levels for over 40 years, helping to restrict the size of debt interest payments and freeing up valuable resources for investment in public services. Market expectations reflect investor confidence that the monetary framework will continue to deliver inflation close to target.

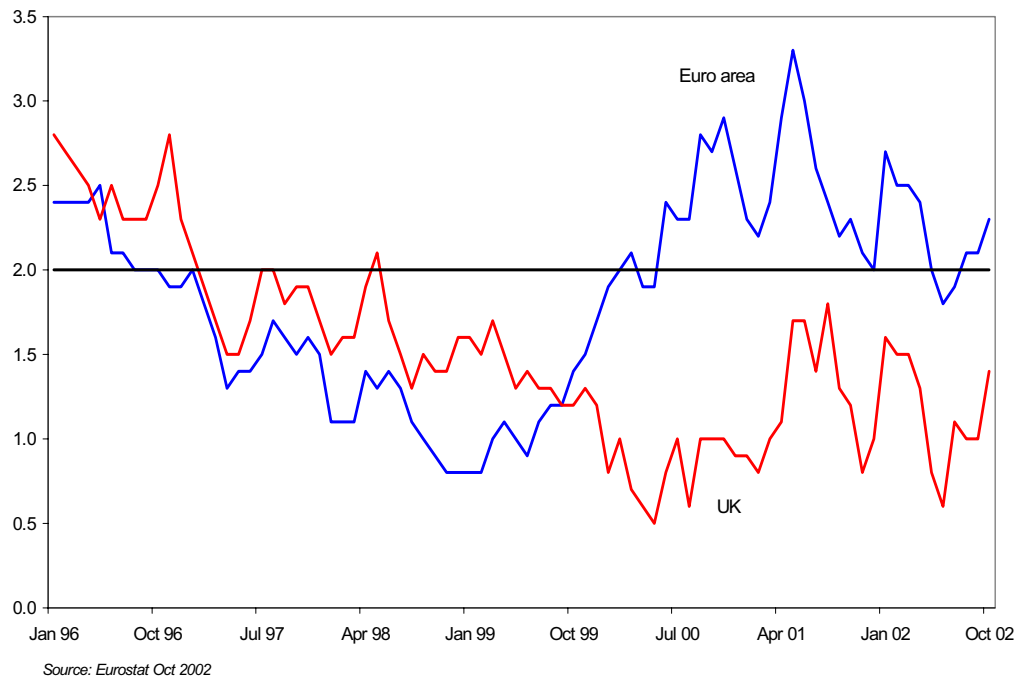
**Chart 2.1: Inflation performance and expectations**



**HICP 2.13** Due to differences in coverage and methodology, the HICP index differs from RPIX. The HICP measure of inflation currently stands just under 1.0 percentage point below RPIX inflation. However, divergence between the two measures due to differences in coverage varies through time, leaving a more persistent differential due to methodology of around 0.5 percentage points<sup>9</sup>. Measured on an HICP basis, the UK inflation rate is below the euro area average, and is comfortably below the ECB's stated definition of price stability, of an annual increase in inflation of up to 2 per cent.

<sup>9</sup> See *The harmonised index of consumer prices (HICP): some factual information*, HM Treasury, November 1998

Chart 2.2: UK and euro-area average HICP inflation rates



**2.14** Three-month interest rates currently stand at 4 per cent, reflecting a sustained reduction in both the level of inflation and inflation expectations in the UK. UK long-term interest rates have fallen to around their lowest levels for over 40 years.

Table 2.1: HICP inflation and long-term interest rates in 2002

	HICP	Long-term interest rates
<b>UK</b>	1.4	4.61
<b>EU 15</b>	2.1	4.58
<b>Euro area</b>	2.3	4.62

Source: Eurostat, October 2002

## Fiscal Policy

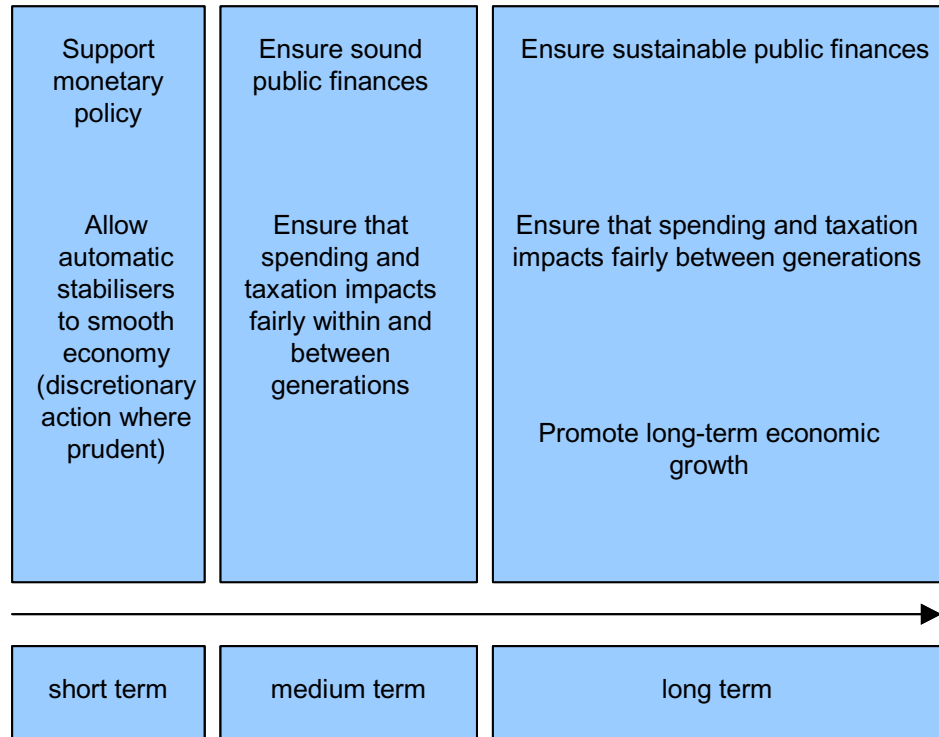
### The fiscal policy framework

**2.15** The Government's fiscal policy framework is based on five key principles of fiscal management set out in the *Code for fiscal stability* – transparency, stability, responsibility, fairness and efficiency. The Code, enshrined in legislation through the 1998 Finance Act, describes how these principles relate to the formulation and implementation of policy and requires the Government to state both its objectives and the fiscal rules through which policy is operated. The Government's fiscal policy objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

**2.16** In the long run, fiscal policy supports the Government's long-term goals by ensuring that the public finances are sustainable, contributing to a stable environment that promotes economic growth. While it is beyond the scope of this report to explicitly model the linkages between long-term economic growth and long-term fiscal policy, there exists a general consensus that a stable environment assists economic growth in the long run<sup>10</sup>. This environment is important for achieving the Government's objective to build a stronger, more enterprising economy and a fairer society, extending economic opportunity and supporting those most in need to ensure that rising national prosperity is shared by all. The objectives for fiscal policy are summarised in Chart 2.3.

**Chart 2.3: Objectives for fiscal policy**



*Source: Long-Term Public Finance Report, HM Treasury, November 2002*

**Fiscal rules** **2.17** These objectives are implemented through two fiscal rules, against which the performance of fiscal policy can be judged. The fiscal rules are:

- **the golden rule:** over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- **the sustainable investment rule:** public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

<sup>10</sup> See also *Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability*, HM Treasury, 2002

**2.18** The fiscal rules promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects. First, the rules are set over the **economic cycle**, allowing the fiscal balances to vary between years in line with the cyclical position of the economy. This allows the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand (and the use of discretionary measures where prudent). Second, the interaction of the two rules promotes capital **investment** while ensuring **sustainable** public finances over the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only for capital spending. The sustainable investment rule ensures that borrowing for investment is conducted in a responsible way.

#### Box 2.1: Taking account of the cycle - the automatic stabilisers

Several features of the taxation and spending regime help to stabilise the economy over the economic cycle. As the economy strengthens, incomes tend to rise, resulting in higher income and corporation tax receipts. At the same time, lower unemployment rates reduce social security spending. As the economy weakens, the opposite effects occur. This means that government borrowing tends to fall when growth is relatively high, and rises when growth is relatively low. These 'automatic' effects help to reduce volatility in output over the cycle, by boosting aggregate demand when the economy is below trend, and reducing aggregate demand when the economy is above trend.

The Government's objectives for fiscal policy are to ensure sound public finances, while allowing the automatic stabilisers to operate over the cycle. This permits fiscal policy to support monetary policy in smoothing the path of the economy in the face of variations in demand, and explains why the fiscal rules are set over the economic cycle. For the golden rule, it means the surpluses in the current budget in periods of stronger growth can offset deficits in periods of weaker growth, helping to stabilise the economy. Public debt will tend to rise as a proportion of GDP during periods of weaker growth, and fall as a proportion of GDP during periods of stronger growth.

The strength of the automatic stabilisers depends on the characteristics of the taxation and spending regime, such as the progressivity of taxes, as well as the composition of changes in demand in the economy. Their impact can be seen by examining the difference between actual public sector net borrowing (PSNB) and the cyclically-adjusted PSNB position. Attempting to balance the current budget at all times would significantly increase swings in output over the economic cycle, damaging economic stability.

**2.19** The UK fiscal framework also recognises that projections of the current budget and net debt are subject to uncertainty. The average absolute difference between the year-ahead forecast of public sector net borrowing and the outturn has been around 1 per cent of GDP over the last ten years. Projections of the public finances are therefore based on deliberately prudent assumptions for key economic variables, including the trend rate of growth, the level of unemployment and equity prices. These assumptions are audited by the Comptroller and Auditor General under a three-year rolling review<sup>11</sup> to ensure that they remain reasonable and cautious. This approach minimises the need for unexpected changes in the direction of taxation or spending.

<sup>11</sup> *Audit of Assumptions for the 2002 Pre-Budget Report, 27 November 2002*

**End of year fiscal report**

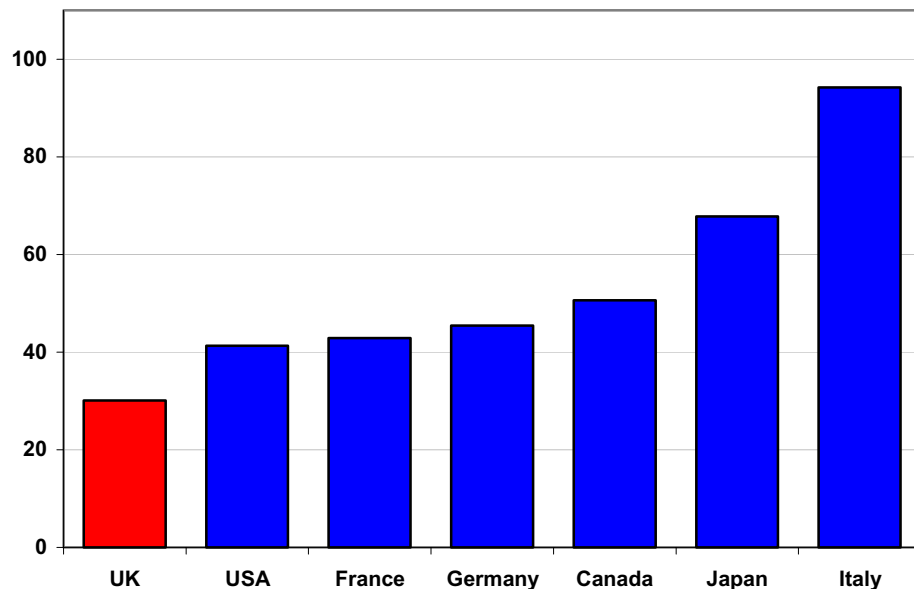
**2.20** In order to enhance its reporting of fiscal developments, a new *End of year fiscal report* was published for the first time alongside the 2002 Pre-Budget Report<sup>12</sup>. The Report provides detailed retrospective information on the public finances in 2000-01 and 2001-02, including their performance against the fiscal rules and against published forecasts and plans. The *End of year fiscal report* further enhances the Government's commitment to transparency in fiscal policy and brings the UK fully into line with international best practice.

**Fiscal Strategy and Sustainability****Sound and sustainable public finances**

**2.21** As a result of tough decisions on taxation and spending, the public finances have been restored to a position of sustainability. Fiscal policy was tightened in structural terms by over 4 percentage points of GDP between 1996-97 and 2000-01, supporting monetary policy during a period when the economy was generally above trend. These actions, including the use of the £22.5 billion proceeds from the auction of spectrum licences, have allowed the Government to repay more than £50 billion of debt since 1996-97. Public sector net debt has been reduced from 44 per cent of GDP in 1996-97 to under 31 per cent of GDP - lower than that in any other G7 economy and gross debt at under 38 per cent in 2002 is amongst the lowest in the EU.

**2.22** Low and stable debt levels, combined with accumulated current budget surpluses over the course of the economic cycle, have allowed the automatic stabilisers to operate fully, helping to limit the impact of the more recent global slowdown on the UK economy. Modest levels of borrowing over the forecast period reflect sustained capital investment in public services. In addition to the operation of the automatic stabilisers this year and next year, rising public spending, including investment, will support monetary policy in maintaining economic stability as the economy remains below trend. Higher investment spending is sustainable and fully consistent with the fiscal rules since net debt remains at a stable and prudent level over the forecast period.

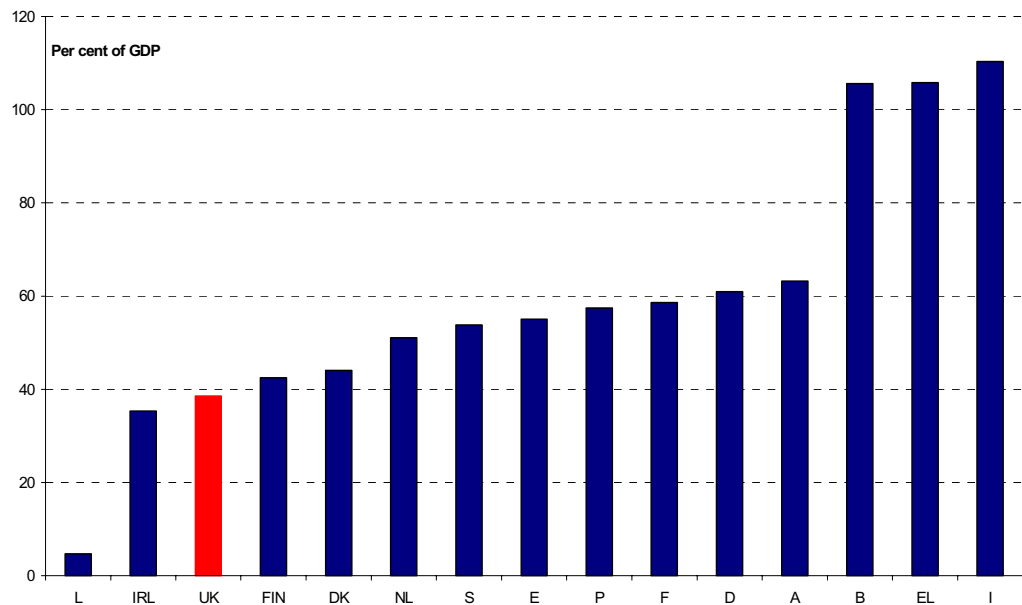
**Chart 2.4: OECD estimate of general government net financial liabilities for G7 countries, 2002 (per cent of GDP)**



Source: OECD Economic Outlook June 2002

<sup>12</sup> *End of year fiscal report*, HM Treasury, November 2002

Chart 2.5: General government gross debt, 2002



Source: European Commission, Autumn 2002 forecasts

## Fiscal balances

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

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

	Per cent of GDP							
	Outturns				Projections			
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
<b>Fairness and prudence</b>								
Surplus on current budget	2.2	0.8	-0.5	-0.4	0.2	0.4	0.6	0.7
Average surplus since 1999-2000	2.2	1.7	1.2	0.8	0.7	0.7	0.7	0.7
Cyclically-adjusted surplus on current budget	1.7	0.7	0.2	0.3	0.6	0.5	0.6	0.7
<b>Long-term sustainability</b>								
Public sector net debt	31.2	30.4	31.0	32.1	32.4	32.6	32.7	33.0
Core debt	31.1	30.3	30.3	30.6	30.6	30.8	31.0	31.3
Net worth <sup>1</sup>	21.3	26.5	26.7	22.2	20.6	19.5	19.0	17.9
Primary balance	3.8	1.7	-0.3	-0.6	0.0	0.0	0.1	0.0
<b>Economic impact</b>								
Net investment	0.6	0.9	1.4	1.8	1.9	2.0	2.1	2.2
Public sector net borrowing (PSNB)	-1.7	0.1	1.9	2.2	1.6	1.6	1.5	1.5
Cyclically-adjusted PSNB	-1.2	0.2	1.2	1.5	1.3	1.5	1.5	1.5
<b>Financing</b>								
Central government net cash requirement	-3.7	0.3	1.8	2.8	1.9	1.7	1.9	1.6
<b>European commitments</b>								
Treaty deficit <sup>2</sup>	-1.7	0.2	1.8	2.2	1.7	1.6	1.6	1.6
Cyclically-adjusted Treaty deficit	-1.2	0.2	1.1	1.4	1.3	1.5	1.6	1.6
Treaty debt ratio <sup>3</sup>	39.9	38.2	37.9	38.8	38.9	38.9	39.1	39.2
Memo: Output gap	0.9	-0.3	-1.3	-1.0	-0.3	0.0	0.0	0.0

<sup>1</sup> At end-December; GDP centred on end-December.

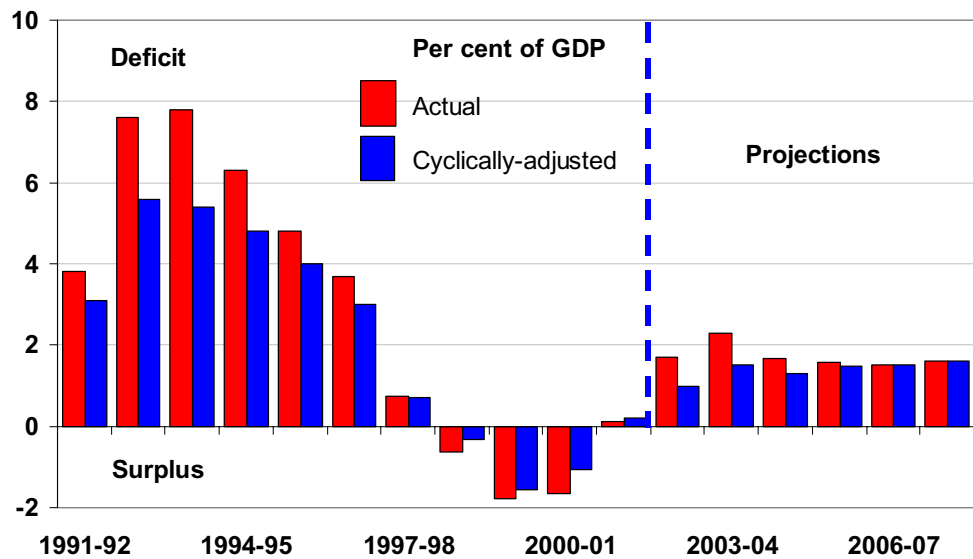
<sup>2</sup> General government net borrowing on a Maastricht basis.

<sup>3</sup> General government gross debt.



2.24 While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB), which moved from surplus into moderate deficit in this period. This reflects changes in both the fiscal stance (that part of PSNB resulting from changes in cyclically-adjusted PSNB) and the automatic stabilisers (that part which results from the impact of the economic cycle such as changes in elements of social security spending). Chart 2.6 sets out the interim projections for actual and cyclically-adjusted net borrowing.

Chart 2.6: Public sector net borrowing – actual and cyclically-adjusted



2.25 Outturn information in Table 2.3 shows that, relative to the year-ahead forecasts in Budget 2000 and Budget 2001, the fiscal stance supported monetary policy in maintaining economic stability. In 2000-01 there was a significant tightening of the fiscal stance relative to that anticipated in Budget 2000. The surplus on cyclically-adjusted net borrowing was 1.2 per cent of GDP; compared to the Budget 2000 forecast of 0.3 per cent, a tightening of 0.9 percentage points. This greater than forecast surplus of receipts over spending supported monetary policy as the economy was above trend, as illustrated in Chart 3.2. Higher than forecast growth meant the automatic stabilizers also operated to a greater extent than forecast. In total the overall fiscal impact was tighter by 1.2 percentage points of GDP.

Table 2.3: Fiscal balances<sup>1</sup>

	2000-01			2001-02		
	Budget 2000 forecast	Outturn	Difference	Budget 2001 forecast	Outturn	Difference
<b>Fiscal balances (£ billion)</b>						
Surplus on current budget	12.9	21.3	8.4	15.9	7.7	-8.2
Public sector net borrowing	-4.7	-15.9	-11.2	-4.7	1.2	5.8
<b>Fiscal balances (per cent of GDP)</b>						
Surplus on current budget	1.4	2.2	0.9	1.6	0.8	-0.8
Public sector net borrowing	-0.5	-1.7	-1.2	-0.5	0.1	0.6
<b>Cyclically adjusted balances (per cent of GDP)</b>						
Surplus on current budget	1.2	1.7	0.6	1.2	0.7	-0.5
Public sector net borrowing	-0.3	-1.2	-0.9	-0.1	0.2	0.3

<sup>1</sup> Including Windfall Tax and associated spending.

**2.26** For 2001-02, the outturn information suggests a slight easing of the fiscal stance compared to the Budget 2001 forecast, which supported monetary policy as the economy moved below trend. The outturn for cyclically-adjusted net borrowing is 0.2 per cent of GDP compared to the forecast cyclically-adjusted net repayment of 0.1 per cent. As in 2000-01, the automatic stabilisers operated to a greater extent than forecast, which meant that the overall fiscal impact was greater than forecast by 0.6 percentage points of GDP.

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

- the average current budget since the start of the present cycle in 1999-2000 is comfortably in surplus, ensuring the Government is on track to meet the golden rule, using cautious assumptions and in the cautious case;
- this is confirmed by the cyclically-adjusted current budget, which allows for the impact of the economic cycle and is in surplus in every year throughout the projection period;
- public sector net debt is projected to be low and stable throughout the next five years, comfortably meeting the sustainable investment rule and, at 31 to 33 per cent of GDP, the lowest in the G7;
- the general government projections comfortably meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period; and
- the projections are consistent with a prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty).

### Releasing Resources for High-Quality Public Services

**2.28** Sound public finances that are sustainable over the cycle are a prerequisite for sustainable investment in public services.

**2.29** The Government's long-term goal is to deliver world-class public services through investment and reforms to ensure that taxpayers receive real value for money. Through its action to maintain macroeconomic stability and ensure that the fiscal rules are met, it has delivered significant and sustained increases in the resources available to strengthen Britain's public services. Since the last Convergence Programme, the latest of the biennial spending reviews has completed. In the 2002 Spending Review the Government set out departmental spending plans for the three years from 2003-04 to 2005-06, within the overall envelope for total public spending set in Budget 2002 and consistent with the fiscal rules.

**2.30** Public Service Agreements (PSAs) are central to the Government's strategy for improving public services. The PSAs published as part of the 2002 Spending Review set targets for the full range of public services, detailing the outcomes that departments are required to deliver with the money allocated to their expenditure programmes. Instead of focusing on the resources going in to public services, PSAs focus on the outcomes that the public really care about, such as better health, educational achievement, and lower levels of crime. PSAs are an integral part of the Government's spending plans.

**2.31** Prudent management of the public finances has allowed the Government to sustain and increase the resources available for key public services, while continuing to meet the fiscal rules. The 2002 Spending Review established departmental spending plans for the years 2003-04 to 2005-06, consistent with the firm 'envelope' for total public spending set out in Budget 2002. This 'envelope' allows:

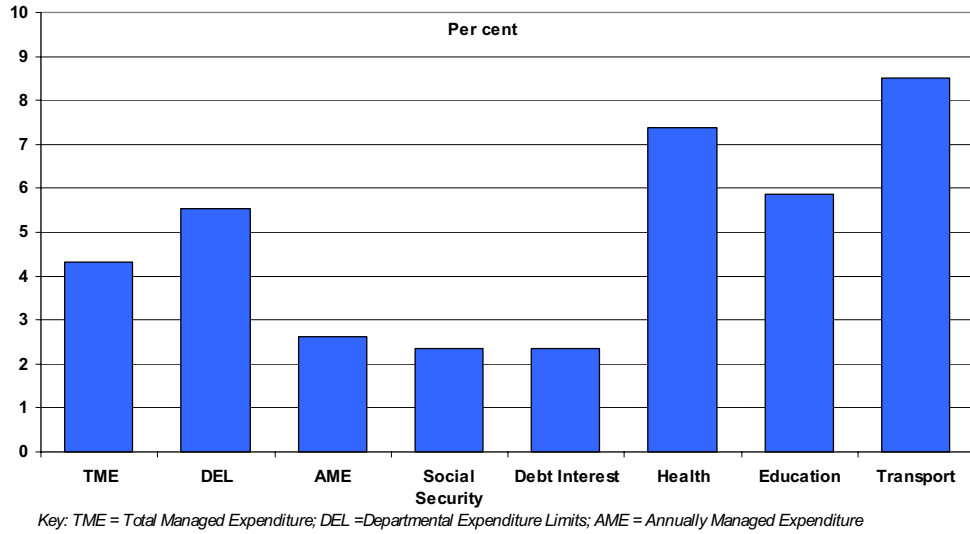
- current spending to rise in total by 3.3 per cent a year in real terms in 2004-05 and 2005-06; and
- public sector net investment to rise from its target of 1.8 per cent of GDP in 2003-04, to 2 per cent of GDP by 2005-06 and to 2¼ per cent by 2007-08, to continue to address the legacy of under-investment in Britain's public infrastructure, while comfortably meeting the sustainable investment rule.

**2.32** Total public spending will rise by 4.3 per cent a year on average in real terms over the period of the 2002 Spending Review. Within this, the Government has been able to target additional resources on priority public services while securing savings on interest payments and social security, thereby improving the overall quality of public expenditure:

- between 1996-97 and 2005-06, social security payments are forecast to grow by just 1.9 per cent a year in real terms, compared with over 4 per cent between 1991-92 and 1996-97; and
- debt interest payments have fallen by £7 billion since 1996-97 and are expected to fall by 3.7 per cent a year on average in real terms between 1996-97 and 2005-06, compared with an annual average real terms increase of over 6 per cent between 1991-92 and 1996-97.

**2.33** Overall, social security, tax credits and debt interest payments will amount to just 23 per cent of the additional public spending planned over the three years to 2005-06, compared with 57 per cent between 1991-92 and 1996-97. Chart 2.7 illustrates how these savings have been channelled into priority services so that, within the fiscal rules, education spending can grow by 5.9 per cent, UK health spending by 7.4 per cent and UK transport spending by 8.5 per cent a year.

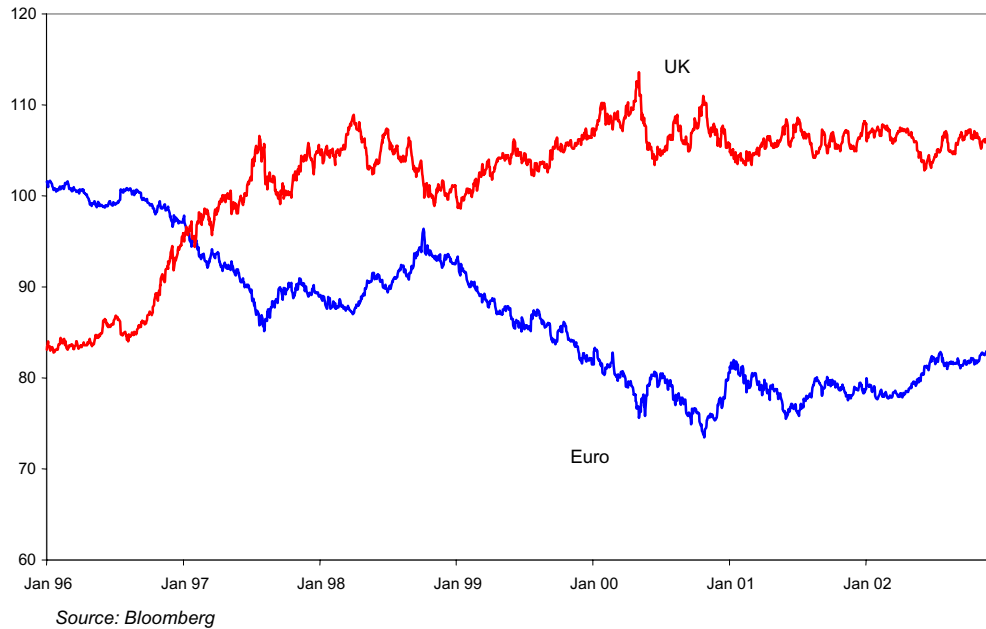
**Chart 2.7: Improving the quality of public spending – real annual growth rate, 2002-03 to 2005-06**



**Exchange Rate Stability**

2.34 The Government believes that exchange rate stability can only be achieved on the basis of sound economic fundamentals, in particular, low and stable inflation, steady and sustainable growth and sound public finances. The exchange rate should therefore be seen as the outcome of all other economic policies.

**Chart 2.8: Sterling and the euro effective exchange rate indices**



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

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

### Economic and Monetary Union

#### UK policy

**2.37** The Government's policy on membership of the single currency remains as set out by the Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous. See Box 2.2 for more detail.

#### Box 2.2: Government policy on EMU

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

The Government has set out five economic tests which must be met before any decision to join can be made. A comprehensive and rigorous assessment of the five tests will be made within two years of the start of this Parliament, by June 2003. On the basis of the assessment, the Government will decide whether the five tests have been met. If a decision to recommend joining is taken by the Government, it will be put to a vote in Parliament and then to a referendum of the British people.

The preliminary analysis supporting the five tests assessment – technical work needed to enable the assessment to be completed within two years of the start of the Parliament – is well underway. A number of supporting studies encompassing the preliminary and technical work will be published alongside the assessment.

The Government is also committed to ensuring that preparations are made so that the British people would be in a position to exercise genuine choice in a referendum, should the economic tests be met. The Government's Outline National Changeover Plan<sup>13</sup> describes how the UK can be ready for a smooth and cost-effective changeover should Government, Parliament and the people decide to join the single currency. The Treasury has monitored the changeover in the Euro-area to gather examples of best practice. This work has been published in the Government's Sixth report on Euro Preparations<sup>14</sup>, which also contains an update on preparations for a possible UK changeover.

The Government continues to help small and medium-sized enterprises (SMEs) consider the impact of the euro on the way they do business and is committed to ensuring that UK business has access to the information it needs to take advantage of opportunities in the euro-area.

<sup>13</sup> *Second Outline National Changeover Plan*, HM Treasury, March 2000

<sup>14</sup> *Sixth report on Euro Preparations*, HM Treasury, July 2002

## Long-Term Economic Performance

### Productivity and employment

**2.38** Productivity growth, alongside high and stable levels of employment, is an important determinant of long-term economic performance and rising living standards. Increasing the sustainable rate of UK productivity growth is central to the Government's economic strategy. The UK has historically experienced low rates of productivity growth by international standards. Macroeconomic instability and microeconomic failures have inhibited competition, enterprise and innovation, and discouraged firms and individuals from long-term investment in human and capital resources. If the economy is to continue to deliver growing prosperity in a global marketplace for business, investment and skills, it is essential that faster productivity growth is achieved.

### Economic reform in Europe

**2.39** Just as it seeks to raise domestic productivity, so the Government is also working to promote economic reform and productivity growth in Europe. In March 2002, the Barcelona Council gave renewed impetus to an ambitious agenda of reform, approving new commitments to liberalise non-domestic energy markets, complete the single market in financial services, boost levels of research and development and reduce regulatory burdens on business. Economic reform in Europe holds the potential to strengthen the drivers of UK productivity and the Government is committed to promoting change, building on the progress made in Barcelona, Stockholm and Lisbon. The Government's White Paper on economic reform describes the next steps in this process, including:

- further reform of labour markets to meet EU employment targets and establish employment opportunity for all;
- less and better-targeted state aid;
- continued improvement of the EU's competition regime;
- work to deliver a genuine single market in services, including financial services, as well as in manufacturing; and
- the full opening up of gas, electricity and telecoms markets.

**2.40** The Government will report on developments since the White Paper in a progress report early in 2003.

### Employment

**2.41** The Government's long-term goal is to ensure a higher proportion of people in work than ever before by 2010. The strength of the economy depends on the number of people in work and how productive they are. For many individuals and their families, employment is also the single most effective means of avoiding poverty, both now and in the future.

**2.42** Macroeconomic stability, a flexible labour market and investment in education are essential for achieving high levels of employment. They also underpin a comprehensive programme of microeconomic reform, including:

- Welfare to Work policies that help the long-term unemployed achieve a successful return to work. The New Deal programmes have helped to reduce long-term unemployment by more than three quarters since 1997 and have sharply reduced youth long-term unemployment, while Employment Zones are allowing jobseekers and their personal advisers to use funds more flexibly to overcome individual barriers to work. UK unemployment, at 5.3 per cent, is now the lowest among the G7 economies for the first time since the 1950s;

- tailored support for disadvantaged groups and areas that suffer from particularly low levels of employment. New Deal support has been extended to lone parents, disabled people and partners of the unemployed, helping to reduce the number of workless households, while Action Teams are tackling serious employment problems in disadvantaged areas throughout Britain. The national roll-out of Jobcentre Plus is providing an active, work-focused service to all working age benefit recipients, whether unemployed or economically inactive; and
- reforms to make work pay and ensure that individuals are rewarded as they move into and progress within employment. Reforms to the tax and benefit system, underpinned by the National Minimum Wage, the Working Families' Tax Credit (WFTC) and the Disabled Person's Tax Credit, and, from April 2003, the Child and Working Tax Credits, are improving work incentives for families with children, people with disabilities and those in low paid work. These reforms guarantee minimum incomes from employment and help to ensure that work pays more than welfare.

**2.43** The robust performance of the labour market in recent years sets the UK apart from most other industrialised countries, many of which have seen unemployment rates rise significantly as global demand has weakened. The Government is determined to build on this success and is now taking further steps to address the remaining barriers that prevent people from taking up work, including:

- piloting a programme of intensive support in neighbourhoods with very high concentrations of worklessness. The pilots will begin from April 2004 in twelve of the most deprived neighbourhoods in the country;
- extending eligibility for the Job Grant, and introducing a new higher rate of £250 for households with children, to ease the transition to work;
- reforming the administration and design of Housing Benefit to reduce inefficiencies in the current system and ease the transition to work for tenants;
- piloting new measures to improve employment retention and advancement among the low paid and those moving off welfare as part of a demonstration project from October 2003;
- extending Employment Zones to lone parents and people returning to the New Deal for a second time, and testing the impact of multiple providers in the same areas; and
- piloting new means of support to help those with health problems and disabilities find work, including enhanced advice on the return to work and a new return to work credit of £40 a week, from October 2003.

### Productivity

**2.44** The UK has historically experienced low rates of productivity growth by international standards. Macroeconomic instability and microeconomic failures have inhibited competition, enterprise and innovation, and discouraged firms and individuals from long-term investment in human and capital resources. If the economy is to continue to deliver growing prosperity in a global marketplace for business, investment and skills, it is essential that faster productivity growth is achieved.

2.45 The Government is pursuing a wide-ranging strategy to tackle the barriers to productivity growth and close the productivity gap. Macroeconomic stability is helping businesses, individuals and the Government plan effectively for the long term, improving the quantity and quality of investment in physical and human capital. Microeconomic reform aims to remove barriers that prevent markets from functioning efficiently, allowing firms and workers to maximise their productive potential. The Government's programme of microeconomic reform targets historic weaknesses in five key drivers of productivity performance:

- strengthening the competition regime, to encourage firms to innovate and minimise costs, and to deliver better quality goods and services to customers;
- promoting enterprise, to help new and established businesses start up, develop and grow;
- supporting science and innovation, to utilise the potential of new technologies and to develop more efficient ways of working;
- improving skills, through better education for young people and greater training opportunities for those already in the workforce; and
- encouraging investment to improve the stock of physical capital in all sectors and industries.





# 3

## ECONOMIC OUTLOOK

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### The World Economy

**3.1** Following the sharpest slowdown in world growth for close to 30 years in 2001, a recovery in world trade and industrial production during the first half of this year provided clear evidence that a global economic recovery was underway. However, the immediate outlook for the world economy has weakened in more recent months as corporate accounting scandals, further declines on global equity markets, developments in the Middle East and rising oil prices have compounded existing uncertainty over the strength of the world economy. Consequently, the global economic recovery currently appears to have less momentum than was anticipated earlier in the year.

**3.2** Compared with the Budget forecast, G7 GDP growth is now expected to be weaker until the middle of 2003, before gaining strength thereafter. However, continued volatility in global equity markets and the possibility of renewed rises in oil prices pose a clear risk to the global economic outlook. Heightened investor uncertainty, as a result of any more high profile corporate failures or deterioration in the political situation in the Middle East, could delay the global investment recovery. Household consumption would be further negatively affected by the impact of any additional equity price falls on household wealth. Accommodating fiscal and monetary policy could yet, however, lead to a stronger than anticipated global recovery. A swift diminution of tensions in the Middle East could also bolster confidence.

### Prospects for UK Economic Growth

**3.3** International conditions have continued to be a major influence on UK economic developments and prospects as an uncertain outlook for global demand has deterred companies from investing and stepping up production. In the face of the present uncertainties, the Government remains vigilant to potential risks surrounding economic prospects.

**3.4** The economic stability delivered by the Government's macroeconomic reforms has nonetheless left the UK economy in a relatively strong position. The lowest rates of unemployment since the 1970s, subdued inflation and historically low interest rates have all helped cushion domestic consumer demand from external weakness, ensuring that the UK continues to experience the longest unbroken economic expansion on record. Sound fundamentals also mean the economy is well placed to respond positively when the world economic recovery gathers pace.

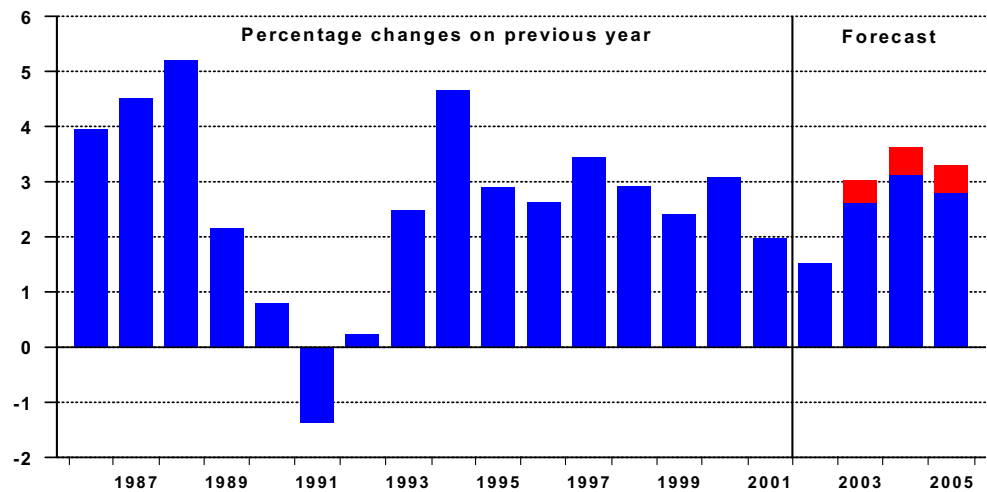
**GDP growth 3.5** UK GDP is estimated to have risen by 0.6 per cent in the second quarter and by 0.8 per cent in the third quarter, to stand 1.8 per cent up on a year earlier. With the strain of ongoing global uncertainty this year continuing to be felt in weak business investment, GDP growth has continued to be more than accounted for by household consumption.

**3.6** Projections for GDP growth from 2003 are presented as ranges, based on alternative assumptions about the supply-side performance of the economy. From mid-2003, a strengthening in the pace of global recovery should allow the UK to achieve a temporary period of non-inflationary above trend growth, rising to between 3 and 3½ per cent in 2004. A rebalancing of growth becomes gradually more evident over the forecast horizon. In particular, household consumption growth is expected to moderate, as the delayed effects of stock market falls and weaker income growth take hold, and the appetite for further increases in debt recedes.

**3.7** At the time of Budget 2002 the Treasury published a paper<sup>15</sup> setting out its latest assessment of the trend rate of output growth over the recent past and the neutral rate around which to anchor economic forecasts. The analysis concluded that the neutral rate of trend growth over the period covered by Budget 2002 was 2¾ per cent, compared with the previous estimate of 2½ per cent. Consistent with past practice, projections for the public finances are based on the deliberately cautious assumption of annual trend output growth ¼ percentage point lower than the neutral view.

**3.8** Despite new and revised data released since the Budget, there are no reasons to change the projection made in the Budget paper of 2¾ per cent trend output growth going forward. However, estimates of the *composition* of trend growth for both the recent past and going forward have been affected - with trend output growth now estimated to be more productivity rich, but with a smaller contribution from population growth.

**Chart 3.1: Gross Domestic Product (GDP)<sup>1</sup>**



<sup>1</sup> Note: Areas shaded red on bars represent forecast ranges.

**Inflation 3.9** RPIX inflation has remained below the Government's target since Budget time, although monthly movements have been unusually erratic of late. The divergence between goods and services price inflation has widened further this year, as services price inflation has picked up and weak and highly competitive global markets have continued to exert downward pricing pressures on more exposed tradeable sectors.

**3.10** RPIX inflation is expected to fall marginally below target next year, with downward pressure from slack in the economy, but to edge up to its 2½ per cent target during 2004 as the effects of a pick-up in import prices and the economy accelerating back to trend work through.

**Table 3.1: Summary of forecast**

	2001	Forecast			
		2002	2003	2004	2005
GDP growth (per cent)	2	1½	2½ to 3	3 to 3½	2¾ to 3¼
RPIX inflation (per cent, Q4)	2	2½	2¼	2½	2½

<sup>15</sup> *Trend growth: recent developments and prospects*, HM Treasury, April 2002

## Cyclical Position

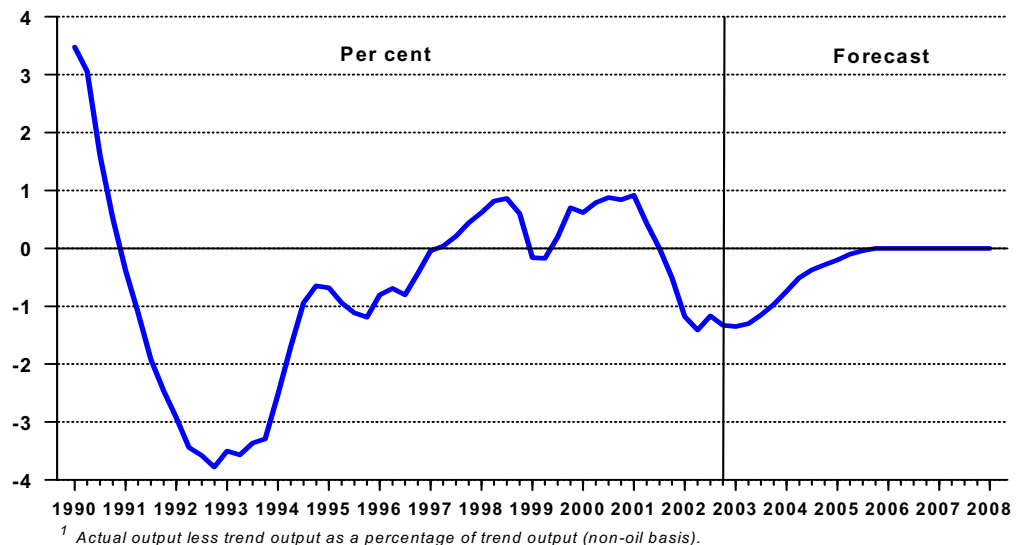
### Economic cycle and the output gap

**3.11** As a result of a modest downgrade to growth in late 2001 and weaker than projected growth so far this year, the latest national accounts data suggest the economy has built up a larger negative output gap than expected at Budget time, although its precise magnitude remains sensitive to potential data revisions in future.

**3.12** On the basis that the economy was last on-trend in the third quarter of 2001, and with trend growth since then of 2¾ per cent, the implied size of the negative output gap in the third quarter of 2002 is just under 1¼ per cent. Measured output gaps of a similar magnitude also occurred at the end of 1995 and in mid-1991. However, the labour market appears tighter than on these previous occasions, probably reflecting confidence that the cyclical slowdown will not persist. The behaviour of average hours worked, which have fallen while employment has held up, tends to support this.

**3.13** For the purposes of assessing performance against the fiscal rules, the provisional judgement remains that a small cycle may have been completed by mid-1999 when the current cycle is assumed to begin. But whether the current cycle started in 1997 or 1999 does not affect the judgment that the Government remains firmly on track to meet the fiscal rules over the cycle.

**Chart 3.2: The Output Gap<sup>1</sup>**



## Interest Rates

**3.14** As the world economy turned down in 2001, the independent MPC of the Bank of England was able to reduce interest rates on four occasions in the first eight months of the year. Further rate reductions after the terrorist atrocities of 11 September made a total of seven cuts and a cumulative reduction of 2 percentage points during 2001. This helped to restore business and consumer confidence to around the levels prevailing before the terrorist attacks, and to mitigate against any further drags on activity amidst already very difficult global conditions. With inflation having remained a little below target for much of this year, interest rates have been kept at their lowest for almost 40 years.

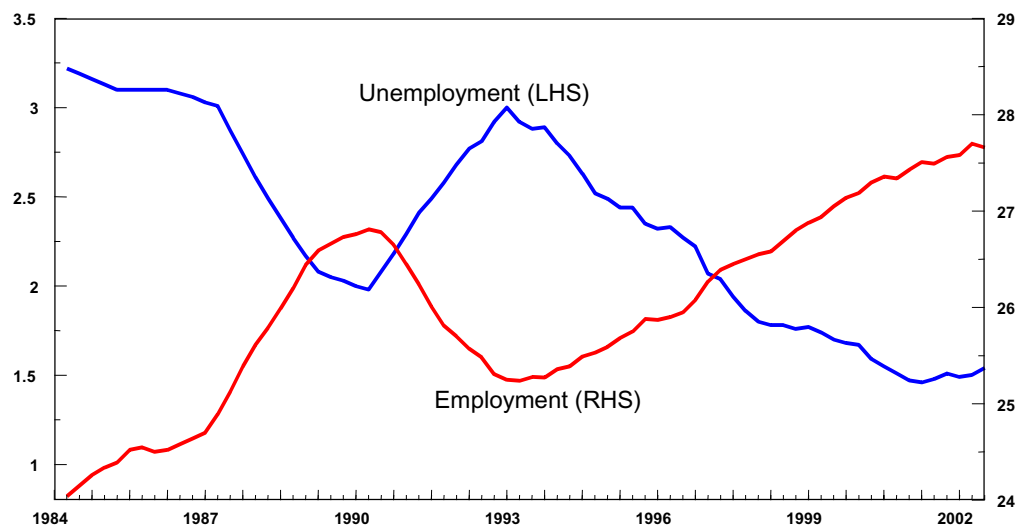
**3.15** The monetary policy framework has enhanced the credibility and transparency of economic policy-making and continues to deliver positive results. Since the framework was introduced, RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government's target and within the range outside of which an open letter would be triggered. Long-term inflation expectations, as measured by survey and financial markets data, show that inflation is expected to remain close to the Government's inflation target, having fallen from over 4 per cent in 1997.

### Employment

**Employment 3.16** The UK labour market has remained buoyant in 2002, outstripping most analysts' expectations by a significant margin. In the third quarter, the Labour Force Survey (LFS) measure of employment was 175,000 higher than a year earlier and, despite continued strong expansion in the population of working age, the working age employment rate has been stable over the past year or so, as has the inactivity rate.

**Unemployment 3.17** ILO unemployment has been nudging up since spring last year, but by a lot less than the rise in the population of working age. Indeed, in the year to the third quarter of 2002, increased employment successfully absorbed over three quarters of the 185,000 increase in the population of working age. While the rate of ILO unemployment has increased a little, to 5.3 per cent in the third quarter, and is now judged to be above its sustainable rate, claimant count unemployment, at 3.1 per cent, remains at its lowest rate since August 1975. Claimant outflows have continued to increase modestly against broadly flat inflows.

**Chart 3.3: LFS employment and unemployment (UK millions)**



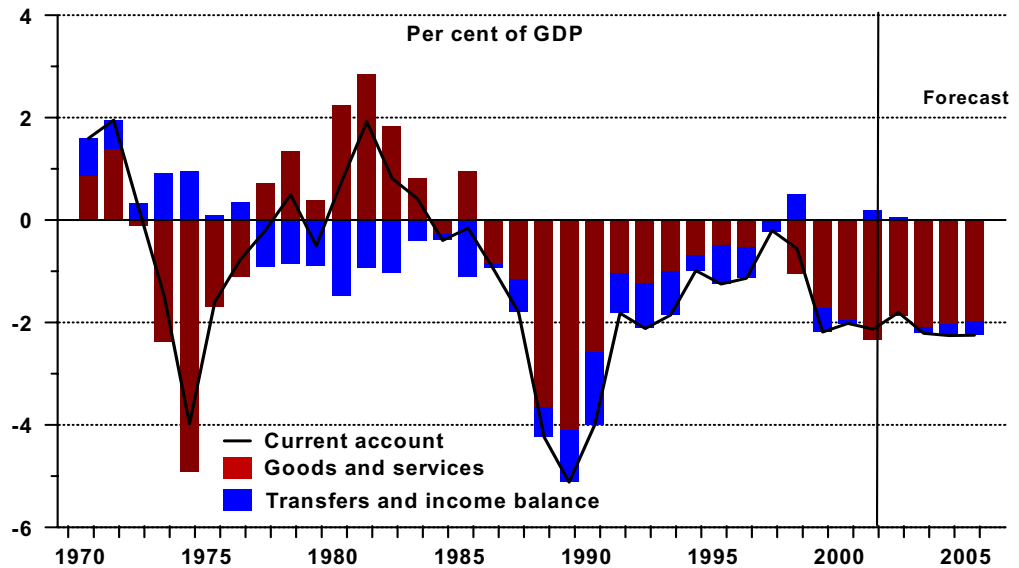
### Investment

**3.18** The slowdown in the global economy last year clearly had a marked impact on UK business investment. Amidst heightened global uncertainties, business investment has weakened further in 2002.

**3.19** While significant global downside risks remain, businesses are now better placed than they were last year to revive postponed investment plans once uncertainty recedes and the pace of recovery in the global economy strengthens. Investment growth is therefore forecast to pick up from next year. Strengthening global demand, reduced uncertainty and improvements in corporate finances are expected to encourage firms to replace existing assets, bring deferred capital spending back on stream and begin expanding capacity again.

### Trade and the Balance of Payments

**Chart 3.4: Balance of Payments current account**



**3.20** Trade flows have been volatile in recent months. Taking the first half of the year as a whole, export volumes were up on the second half of 2001. Imports also picked up in the first half of 2002, but growth remained muted and almost entirely accounted for by consumer goods as global fragility, weak investment demand and a still delicate manufacturing recovery held back imports of capital and intermediate goods. However, following this broadly encouraging start to 2002, the third quarter saw growth in exports and imports of goods fall back, indicating that overall growth earlier in the year failed to gather any significant momentum amidst fragile worldwide business confidence. The current account deficit declined in the first half of 2002 and is expected to narrow markedly over 2002 as a whole, mainly due to a lower trade deficit.

**3.21** The deficit on trade in goods and services in 2002 is expected to be around £19 billion, significantly lower than forecast at Budget time. The deficit is forecast to widen slightly next year. Export volume growth is expected to pick up further in 2003 as the recovery in the world economy gains momentum. But import growth is also expected to increase from next year, as the recovery in manufacturing output moves onto a surer footing, and businesses again start to increase investment spending. Over the next two years, the current account deficit is forecast to widen a little, levelling out at around 2¼ per cent from 2004.

## Summary of Economic Prospects

Table 3.2: Summary of economic prospects

	Percentage changes on a year earlier unless otherwise stated					Average errors from past forecasts <sup>3</sup>
	2001	2002	2003	Forecast <sup>2</sup>		
				2004	2005	
<b>Output at constant market prices</b>						
Gross domestic product (GDP)	2	1½	2½ to 3	3 to 3½	2¾ to 3¼	1
Manufacturing output	-2½	-4	1¼ to 2¼	2¼ to 2¾	1¼ to 2¼	1¼
<b>Expenditure components of GDP at constant market prices<sup>4</sup></b>						
Domestic demand	2¾	2¼	3 to 3½	3¼ to 3¾	2¾ to 3¼	1
Household consumption <sup>5</sup>	4	3½	2¼ to 2½	2¾ to 3¼	2¼ to 2¾	1¼
General government consumption	3	4½	3¾	3	3½	1
Fixed investment	¼	-4¼	6½ to 7	4 to 4½	4¼ to 4¾	2
Change in inventories <sup>6</sup>	-¾	-¼	-¼ to 0	¼	0	¼
Exports of goods and services	1¼	-1¼	3¾ to 4¼	7¾ to 8¼	6¾ to 7¼	2½
Imports of goods and services	2¾	¼	4¾ to 5	7 to 7½	6¼ to 6¾	2½
<b>Balance of payments</b>						
<b>current account</b>						
£ billion	-21	-18¾	-24	-26	-27¼	6¾
per cent of GDP	-2¼	-1¼	-2¼	-2¼	-2¼	¾
<b>Inflation</b>						
RPIX (Q4)	2	2½	2¼	2½	2½	½
Producer output prices (Q4) <sup>7</sup>	-¼	¾	1¼	2¼	2	1
GDP deflator at market prices	2	3	2	2½	2½	¾
<b>Money GDP at market prices</b>						
£ billion	988	1033	1082 to 1087	1143 to 1153	1204 to 1220	13
percentage change	4	4½	4¾ to 5¼	5½ to 6	5¼ to 5¾	1¼

<sup>1</sup>The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2002, released by the Office for National Statistics on 27 September 2002, and output, income and expenditure data for the third quarter released on 27 November.

<sup>2</sup>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.

<sup>3</sup>Average absolute errors for year-ahead projections made in autumn forecasts over the past ten years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2003.

<sup>4</sup>Further detail on the expenditure components of GDP is given in Table A9 of the 2002 Pre-Budget Report (Cm 5664).

<sup>5</sup>Includes households and non-profit institutions serving households.

<sup>6</sup>Contribution to GDP growth, percentage points.

<sup>7</sup>Excluding excise duties.

# 4

## OUTLOOK FOR THE PUBLIC FINANCES

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

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

**Table 4.1: Summary of public sector finances**

	Per cent of GDP							
	Outturns				Projections			
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
<b>Fairness and prudence</b>								
Surplus on current budget	2.2	0.8	-0.5	-0.4	0.2	0.4	0.6	0.7
Average surplus since 1999-2000	2.2	1.7	1.2	0.8	0.7	0.7	0.7	0.7
Cyclically-adjusted surplus on current budget	1.7	0.7	0.2	0.3	0.6	0.5	0.6	0.7
<b>Long-term sustainability</b>								
Public sector net debt	31.2	30.4	31.0	32.1	32.4	32.6	32.7	33.0
Core debt	31.1	30.3	30.3	30.6	30.6	30.8	31.0	31.3
Net worth <sup>1</sup>	21.3	26.5	26.7	22.2	20.6	19.5	19.0	17.9
Primary balance	3.8	1.7	-0.3	-0.6	0.0	0.0	0.1	0.0
<b>Economic impact</b>								
Net investment	0.6	0.9	1.4	1.8	1.9	2.0	2.1	2.2
Public sector net borrowing (PSNB)	-1.7	0.1	1.9	2.2	1.6	1.6	1.5	1.5
Cyclically-adjusted PSNB	-1.2	0.2	1.2	1.5	1.3	1.5	1.5	1.5
<b>Financing</b>								
Central government net cash requirement	-3.7	0.3	1.8	2.8	1.9	1.7	1.9	1.6
<b>European commitments</b>								
Treaty deficit <sup>2</sup>	-1.7	0.2	1.8	2.2	1.7	1.6	1.6	1.6
Cyclically-adjusted Treaty deficit	-1.2	0.2	1.1	1.4	1.3	1.5	1.6	1.6
Treaty debt ratio <sup>3</sup>	39.9	38.2	37.9	38.8	38.9	38.9	39.1	39.2
Memo: Output gap	0.9	-0.3	-1.3	-1.0	-0.3	0.0	0.0	0.0

<sup>1</sup> At end-December; GDP centred on end-December.

<sup>2</sup> General government net borrowing on a Maastricht basis.

<sup>3</sup> General government gross debt.

### Meeting the Fiscal Rules

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



**4.4** The public finance projections in Table 4.1 show that the Government is firmly on track to meet the golden rule. Over the period of this cycle, from 1999-2000 to 2005-06, the current budget is comfortably in surplus, with an accumulated surplus of £46 billion. Similarly, the average surplus on the current budget is positive since the start of the cycle and throughout the projection period. The same is true were the cycle to have started in 1997-98. The cyclically-adjusted surplus, which allows underlying or structural trends in the indicators to be seen more clearly by removing the estimated effects of the economic cycle, is also positive in every year of the forecast.

**4.5** Following a deficit of 3 per cent of GDP in 1996-97, current budget surpluses of more than 2 per cent were recorded in 1999-2000 and 2000-01 and of about  $\frac{3}{4}$  per cent in 2001-02. Largely as a result of cyclical and other temporary factors, the current budget moves into a deficit of about  $\frac{1}{2}$  per cent of GDP in 2002-03 and 2003-04, before returning to surplus in 2004-05 and recovering to a surplus of around  $\frac{3}{4}$  per cent of GDP by 2007-08.

**Sustainable investment rule**

**4.6** The sustainable investment rule is also met comfortably over the projection period. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and spending taken by the Government over the course of the last Parliament, including the decision to use the proceeds from the auction of spectrum licences to repay debt, reduced net debt to around 30 per cent of GDP by the end of 2001-02. It is now projected to grow slowly and stabilise at around 33 per cent of GDP by 2007-08, as the Government borrows modestly to fund increased investment in public services, consistent with the fiscal rules.

**4.7** The projections for core debt, which exclude the estimated impact of the economic cycle, increase more slowly to just over 31 per cent of GDP, as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key principle of inter-generational fairness which underpins the fiscal framework. Economic stability has meant that levels of core debt have been very similar to total net debt over recent years, and a similar relationship is expected over the forecast period.

**EU commitments**

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

**4.9** Based on cautious assumptions and consistent with the Government's fiscal rules, Table 4.1 also shows that the cyclically-adjusted Treaty deficit is projected to remain at or below 1.6 per cent of GDP throughout the projection period. Against a background of low and stable debt levels that remain consistently well below the 60 per cent reference value – ensuring the public finances are sustainable – and taking into account prudent borrowing for investment as specified in the EU Treaty, this is consistent with meeting the objective of the Stability and Growth Pact of achieving a budgetary position of close to balance or in surplus over the medium term.

**Current and capital budgets**

**4.10** Table 4.2 provides more detail on the projections for the current and capital budgets. The tables show the current budget and net borrowing both including and excluding Windfall Tax and associated spending (WTAS). WTAS now has much less impact and, unless otherwise stated, all projections now cover all public expenditure.

Table 4.2: Current and capital budgets

	Per cent of GDP						
	Outturn 2001-02	2002-03	2003-04	Projections 2004-05 2005-06 2006-07 2007-08			
<b>Current budget</b>							
Current receipts	39.2	38.3	39.3	39.9	40.4	40.6	40.8
Current expenditure	37.0	37.5	38.4	38.4	38.6	38.7	38.8
Depreciation	1.3	1.4	1.3	1.3	1.3	1.3	1.3
Surplus on current budget (excluding WTAS <sup>1</sup> )	0.8	-0.5	-0.4	0.3	0.4	0.6	0.7
<b>Surplus on current budget</b>	<b>0.8</b>	<b>-0.5</b>	<b>-0.4</b>	<b>0.2</b>	<b>0.4</b>	<b>0.6</b>	<b>0.7</b>
<b>Capital budget</b>							
Gross investment	2.7	3.1	3.5	3.5	3.6	3.7	3.9
less asset sales	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3
less depreciation	-1.3	-1.4	-1.3	-1.3	-1.3	-1.3	-1.3
Net investment	0.9	1.4	1.8	1.9	2.0	2.1	2.2
Net borrowing (excluding WTAS <sup>1</sup> )	0.0	1.8	2.2	1.6	1.6	1.5	1.5
<b>Net borrowing</b>	<b>0.1</b>	<b>1.9</b>	<b>2.2</b>	<b>1.6</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>

<sup>1</sup> Windfall Tax receipts and associated spending.

## Economic Assumptions

**4.11** The fiscal projections assume that the economy follows the path described in Chapter 3. In the interests of caution, the fiscal projections are based on the deliberately prudent and cautious assumption of trend growth of 2½ per cent a year up to 2006-07, ¼ percentage point lower than the Government's neutral view. Beyond 2006-07, projections by the Government Actuary's Department (GAD) imply a slowdown in the growth of the population of working age, due to demographic effects. As set out in the Budget 2002 paper, the Government's neutral view of trend output growth is reduced to 2½ per cent in 2007-08, and so, to maintain a cautious approach, an assumption of 2¼ per cent is used in the public finance projections in that year, still ¼ percentage point lower than the Government's neutral view. The main economic assumptions are summarised in Table 4.3.

Table 4.3: Economic assumptions for the public finance projections

	Percentage changes on previous year						
	Outturn 2001-02	2002-03	2003-04	Projections 2004-05 2005-06 2006-07 2007-08			
Output (GDP)	1½	2	2¾	3	2¾	2½	2¼
Prices							
RPIX	2¼	2¼	2¼	2½	2½	2½	2½
GDP deflator	2¼	2½	2¼	2½	2½	2½	2½
RPI <sup>1</sup> (September)	1¾	1½	2½	3	2¾	2½	2½
Rossi <sup>2</sup> (September)	1¾	1	1¾	2¼	2	2	2
Money GDP <sup>3</sup> (£ billion)	998	1044	1096	1158	1220	1281	1342

<sup>1</sup> Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.

<sup>2</sup> RPI excluding housing costs, used for uprating certain social security benefits.

<sup>3</sup> Not seasonally adjusted.

**4.12** The public finance projections are deliberately based on cautious assumptions for key economic variables, including the trend rate of growth of the economy in the medium term. These are independently audited by the National Audit Office (NAO)<sup>16</sup> to ensure they are both reasonable and cautious. Details of these assumptions are given in Box 4.1. An asymmetric approach to fiscal policy, which is in contrast to the symmetric approach taken to monetary policy, is particularly important to build in a safety margin against unexpected events. It gives greater certainty that, over the medium term, the Government is planning to spend only what it can afford on existing tax plans.

**4.13** Fiscal balances represent the difference between two large aggregates, and forecasts of them are inevitably subject to wide margins of error. The use of cautious assumptions audited by the NAO builds an allowance into the public finance projections to guard against unexpected events.

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<sup>16</sup> The NAO is accountable to Parliament and totally independent of Government. The Head of the NAO certifies the accounts of all Government departments and a wide range of other public sector bodies, and has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which Departments and other bodies have used their resources

**Box 4.1: Key assumptions audited by the NAO**

Privatisation proceeds <sup>1,6</sup>	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth <sup>1,6,9</sup>	2½ per cent a year to 2006-07 and 2¼ per cent in 2007-08.
UK claimant unemployment <sup>1,4,7,9</sup>	Rising slowly to 0.99 million in 2005-06, from recent levels of 0.94 million, consistent with the average of independent forecasts.
Interest rates <sup>1,6,7</sup>	3-month market rates change in line with market expectations (as of 15 November).
Equity prices <sup>2,7</sup>	FTSE All-Share index rises from 1963 (close 15 November) in line with money GDP.
VAT <sup>2,7,10</sup>	Ratio of VAT to consumption falls by 0.05 percentage points a year.
GDP deflator and RPI <sup>2,7</sup>	Projections of price indices used to plan public expenditure are consistent with RPIX.
Composition of GDP <sup>3,8</sup>	Shares of labour income and profits in national income are broadly constant in the medium term.
Funding <sup>3,8</sup>	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Oil prices <sup>5,10</sup>	\$25.10 a barrel in 2003, the average of independent forecasts, and then constant in real terms.
Tobacco <sup>6,10</sup>	Only direct effects of the tobacco anti-smuggling strategy, including deterrent effects of fiscal marks, and any existing indirect effects are allowed for.

<sup>1</sup> *Audit of Assumptions for the July 1997 Budget Projections, 19 June 1997*

<sup>2</sup> *Audit of Assumptions for the Pre-Budget Report, 25 November 1997*

<sup>3</sup> *Audit of Assumptions for the Budget, 19 March 1998*

<sup>4</sup> *Audit of the Unemployment Assumption for the March 1999 Budget Projections, 9 March 1999*

<sup>5</sup> *Audit of the Oil Price Assumption for the Pre-Budget Report, November 1999*

<sup>6</sup> *Audit of Assumptions for the March 2000 Budget, 21 March 2000*

<sup>7</sup> *Audit of Assumptions for the Pre-Budget 2000 Report, 8 November 2000*

<sup>8</sup> *Audit of Assumptions for the March 2001 Budget, 7 March 2001*

<sup>9</sup> *Audit of Assumptions for the April 2002 Budget, 17 April 2001*

<sup>10</sup> *Audit of Assumptions for the 2002 Pre-Budget Report, 27 November 2002*

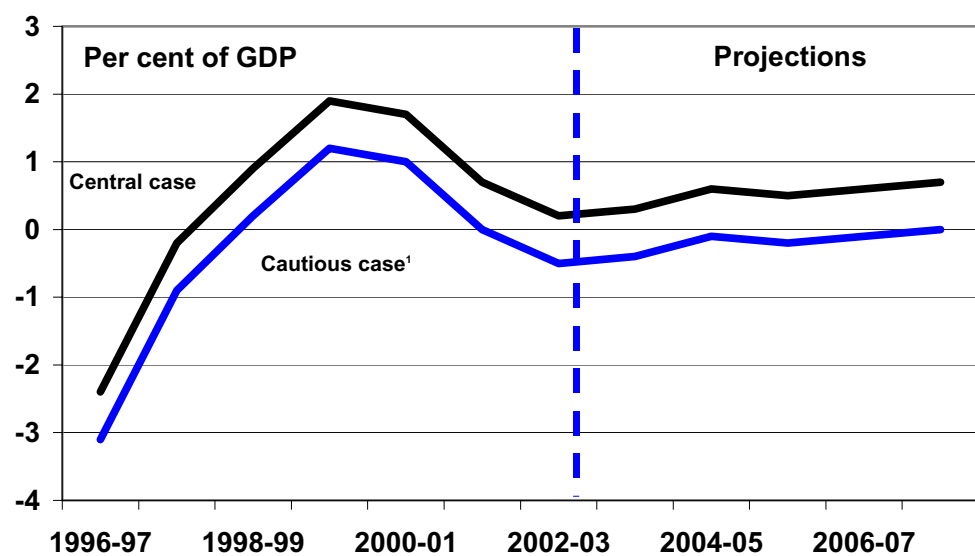
### Forecast Differences and Risks

**4.14** Short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure - notably social security - vary directly with the economic cycle. Earlier work<sup>17</sup> suggested that if GDP growth were one percentage point higher or lower than assumed over the coming year, net borrowing might be lower or higher by 0.4 per cent of GDP in the first year and by a further 0.3 per cent of GDP the following year. These figures are now closer to 0.5 and 0.2 per cent respectively, as the introduction of the corporation tax installment system has reduced the lag between profits and tax receipts. However, not all cycles will conform exactly to these parameters, notably because the estimates are based on historical data (since which time both the state of the economy and the tax regime have changed) and because cycles differ in respects other than magnitude.

**4.15** Forecast differences in short-term growth forecasts may have only a temporary effect on the public finances. For a given path of trend output, higher or lower growth in the short term will be followed by lower or higher growth later on, and the public finances may be little affected on average over the cycle.

**4.16** However, changes in the estimated cyclical position of the economy in relation to its trend - the output gap - will have a permanent effect on prospects. For this reason the public finances projections are 'stress-tested' against an alternative cautious case, in which the level of trend output is assumed to be 1 percentage point lower than the Government's central view. This scenario would imply that a greater proportion of any projected surplus on the current budget was due to the cyclical strength of the economy - a 1 percentage point larger positive output gap reduces the structural surplus on the current budget by about  $\frac{3}{4}$  per cent of GDP a year. This is illustrated in Chart 4.1. Even in this more cautious case, the cyclically-adjusted current budget is estimated to have been comfortably in surplus over the past four years. The impact of the temporary fall in receipts means that it is projected to move into a modest deficit over the short term, before returning broadly to balance towards the end of the projection period. However, since the start of the current cycle, the average surplus on the cyclically-adjusted current budget in the cautious case stays positive in each year, meaning that the golden rule is met, even in the cautious case.

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



<sup>1</sup> Cautious case assumes trend output 1 percentage point lower in relation to actual output than in the central case.

<sup>17</sup> *Fiscal Policy: public finances and the cycle*, HM Treasury, March 1999

## General Government Finances

4.17 Table 4.4 gives a breakdown of general government finances.

**Table 4.4: General government finances**

	Per cent of GDP				
	Outturn	Projections			
	2001-02	2002-03	2003-04	2004-05	2005-06
Total current receipts	38.8	38.0	38.9	39.6	40.0
Total current expenditure	37.0	37.5	38.3	38.3	38.6
Depreciation	0.8	0.8	0.8	0.8	0.8
<b>Surplus on current budget</b>	<b>0.9</b>	<b>-0.3</b>	<b>-0.3</b>	<b>0.4</b>	<b>0.6</b>
Net investment	1.1	1.5	1.9	2.1	2.2
<b>Net borrowing<sup>1</sup></b>	<b>0.2</b>	<b>1.8</b>	<b>2.2</b>	<b>1.7</b>	<b>1.6</b>
Net interest payments	1.1	1.0	1.0	1.0	1.0
<b>Primary balance</b>	<b>1.0</b>	<b>-0.8</b>	<b>-1.2</b>	<b>-0.6</b>	<b>-0.6</b>
<i>Current receipts</i>					
Taxes on income and wealth	14.5	13.8	14.0	14.7	15.1
Taxes on production and imports	13.7	13.8	13.7	13.7	13.7
Other current taxes	1.8	1.9	1.9	1.9	2.0
Taxes on capital	0.2	0.2	0.2	0.3	0.3
Social contributions	6.4	6.2	7.0	7.0	7.0
Interest income	1.1	1.0	1.0	1.0	1.0
Other	1.0	1.0	1.0	1.0	0.9
<b>Total current receipts</b>	<b>38.8</b>	<b>38.0</b>	<b>38.9</b>	<b>39.6</b>	<b>40.0</b>
<i>Current expenditure</i>					
Current expenditure on goods and services	19.8	20.3	20.8	20.8	21.3
Net social benefits	12.5	12.5	12.5	12.3	12.2
Net current grants	1.8	2.1	2.3	2.5	2.5
Interest and dividends paid	2.3	2.0	2.0	2.1	2.0
Subsidies	0.6	0.6	0.6	0.6	0.6
AME margin	0.0	0.0	0.1	0.0	0.0
<b>Total current expenditure</b>	<b>37.0</b>	<b>37.5</b>	<b>38.3</b>	<b>38.3</b>	<b>38.6</b>
<i>Capital expenditure</i>					
Gross domestic fixed capital formation	1.2	1.5	1.9	2.0	2.1
Other capital expenditure	0.0	-0.1	0.1	0.0	0.1
<b>Net investment</b>	<b>1.1</b>	<b>1.5</b>	<b>1.9</b>	<b>2.1</b>	<b>2.2</b>
<b>Total expenditure</b>	<b>38.1</b>	<b>38.9</b>	<b>40.3</b>	<b>40.4</b>	<b>40.8</b>

Note: This table is derived from Pre-Budget Report Table B24.

<sup>1</sup> Although this is based on the ESA95 definition of general government net borrowing (GGNB), the forecasts are identical to GGNB calculated on a Maastricht definition.

## Receipts

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

4.19 As shown in Table 4.5, relative to Budget 2002, current public sector receipts are projected to be around £7½ billion lower in 2002-03 and around £11½ billion lower in 2003-04. Most of these falls are explained by cyclical or other temporary factors. As a result, overall levels of receipts are expected to return to their Budget 2002 levels over the medium term.

Table 4.5: Changes in public sector current receipts since Budget 2002

	£ billion			
	2002-03	Projections		
	2003-04	2004-05	2005-06	
Effect on receipts of changes in:				
<b>Assumptions audited by the NAO</b>	<b>0</b>	<b>-3<sup>1</sup>/<sub>2</sub></b>	<b>-3</b>	<b>-2<sup>1</sup>/<sub>2</sub></b>
<i>of which: Equity prices</i>	-1	-3 <sup>1</sup> / <sub>2</sub>	-4	-4
<i>Revised tobacco and VAT assumptions</i>	0	<sup>1</sup> / <sub>2</sub>	1 <sup>1</sup> / <sub>2</sub>	2
<b>Financial company profits</b>	<b>-5</b>	<b>-5</b>	<b>-3<sup>1</sup>/<sub>2</sub></b>	<b>-1<sup>1</sup>/<sub>2</sub></b>
<b>Other economic and forecasting effects<sup>1</sup></b>	<b>-2<sup>1</sup>/<sub>2</sub></b>	<b>-3<sup>1</sup>/<sub>2</sub></b>	<b><sup>1</sup>/<sub>2</sub></b>	<b>2</b>
<b>Total before policy changes</b>	<b>-8</b>	<b>-12</b>	<b>-6</b>	<b>-2</b>
Policy decisions since Budget 2002 affecting receipts	<sup>1</sup> / <sub>2</sub>	<sup>1</sup> / <sub>2</sub>	<sup>1</sup> / <sub>2</sub>	<sup>1</sup> / <sub>2</sub>
<b>Total change</b>	<b>-7<sup>1</sup>/<sub>2</sub></b>	<b>-11<sup>1</sup>/<sub>2</sub></b>	<b>-5<sup>1</sup>/<sub>2</sub></b>	<b>-1<sup>1</sup>/<sub>2</sub></b>

<sup>1</sup> Excluding assumptions audited by the NAO.

**4.20** The assumptions audited by the NAO explain only a small proportion of the fall in receipts in 2002-03. However, they have a much larger impact in subsequent years, mainly because of changes in equity prices. The audited assumption underpinning the current projections is that equity prices increase in line with money GDP from the existing level of the FTSE All-Share Index, 1963 in these projections, compared with the Budget 2002 starting point of 2542. As a result, equity prices are 23 per cent lower than the Budget forecast for 2002-03 and 25 per cent lower for 2003-04. Equity price levels are important determinants of capital taxes, stamp duty and, because of their impact on the capital gains of life insurance companies, corporation tax, though the timing of the impact varies from tax to tax, and the size of the impact increases after the first year. Lower equity prices reduce receipts by around £1 billion in 2002-03, by £3<sup>1</sup>/<sub>2</sub> billion in 2003-04, and by around £4 billion a year from 2004-05 onwards.

**4.21** Updates to the audited assumptions for VAT and tobacco add about £<sup>1</sup>/<sub>2</sub> billion to receipts in 2003-04 and increasing amounts thereafter, reaching almost £2 billion in 2007-08. These effects are also shown in the audited assumptions section of Table 4.5. The Government aims to reduce VAT fraud by more than £2 billion a year by 2005-06, but in line with its audited, cautious approach to forecasting a lower figure of £1.4 billion a year is used here.

**4.22** A large proportion of the temporary shortfall in receipts relative to the Budget 2002 forecast is explained by temporarily lower levels of financial companies' profits resulting from the impact of global events, especially further downturns in international capital markets. This impacts most significantly on the corporation tax paid by financial companies and on income tax, through their impact on the level of salaries, especially bonuses, paid by financial companies to their employees.

**4.23** The other economic and forecasting effects line in Table 4.5 is driven by a large number of different, but interrelated, factors working in different directions at different times. Some of these effects are temporary but others persist throughout the projection period. They include changes to other economic determinants such as GDP components and price effects and fiscal forecasting changes, which reflect recent tax receipts data that cannot be explained by changes in economic determinants, and changes arising from the models used to forecast receipts relating to, for example, average tax rates. The figures for 2003-04 onwards include a fall of about £2 billion a year in respect of the revision to the split of tax credits between their negative tax and expenditure components. This has no overall impact on the current budget or on net borrowing.

## Expenditure

**4.24** Consistent with the Government's new frameworks for monetary and fiscal policy, the Government divides spending into:

- Departmental Expenditure Limits (DEL), which are set for all government departments over three years. Each DEL provides the department with a solid basis for planning their own costs effectively. Separate budgets are set for resource (current) and capital spending, removing the bias against investment inherent in the previous planning regime; and
- Annually Managed Expenditure (AME), which covers those elements of spending which cannot reasonably be subject to firm multi-year limits and are instead subject to tough annual scrutiny as part of the Budget process.

**Projections 4.25** The latest projections for general government expenditure, contained in the Pre-Budget Report, are included in Table 4.4.

**4.26** Significant investment in the reform and modernisation of public services has been delivered within this framework. The 2002 Spending Review established departmental spending plans for the three years to 2005-06, and for the five years to 2007-08 for UK spending on the NHS, consistent with the firm overall 'envelope' set in Budget 2002 and within the Government's strict fiscal rules.



#### Box 4.2: The Stability and Growth Pact

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

Fiscal sustainability is a pre-condition for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy coordination as set out in the EU Treaty. Building on the Code of Conduct, agreed by member states in June 2001, the Government supports a prudent interpretation of the Stability and Growth Pact which takes into account the following factors:

- **the economic cycle** - allowing automatic stabilisers to operate fully and symmetrically over the cycle will ensure that fiscal policy supports monetary policy in smoothing economic fluctuations. It is therefore important to focus on cyclically-adjusted fiscal balances when assessing public finances and subsequent policy decisions;
- **sustainability** - low debt levels enhance the sustainability of the public finances, allow more room for the operation of the automatic stabilisers, and provide a sound basis for investment in public services and reforms to encourage productivity, employment and fairness. In considering the sustainability of public finances, it is necessary to examine the budgetary impact of an ageing population and, where possible, generational accounts. The *Long-term Public Finance Report*, published alongside the 2002 Pre-Budget Report, presents such an assessment; and
- **public investment** - against a background of sound public finances and economic stability, public investment contributes to the provision of high quality public services and can help to raise the overall productive potential of the economy. The 2002 Spending Review set new plans to increase public sector net investment in the UK to 2 per cent of GDP by 2005-06 - a five-fold increase compared to 1997-98 - while meeting the fiscal rules and maintaining low levels of debt.

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

### Taking Account of the Economic Cycle

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

**4.28** Since Budget 2000, the Government's provisional judgment has been that the economy completed a full, albeit short, cycle between the first half of 1997 and mid-1999. Therefore, as explained in Chapter 3, the Government's provisional view is that the current economic cycle began in mid-1999, with output moving slightly above trend in 2000 and the first half of 2001. Based on the assumptions used in these projections, the economy will next return to trend levels, ending the current cycle, in 2005-06.

**4.29** As shown earlier, the cyclically-adjusted Treaty deficit is projected to be at or below 1.6 per cent of GDP throughout the projection period and the cyclically-adjusted surplus is positive in every year of the forecast.

**The automatic stabilisers** 4.30 By allowing the fiscal balances to vary between the years in line with the cyclical position of the economy, the automatic stabilisers are able to operate freely to help smooth the path of the economy in the face of variations in demand.

4.31 Table 4.6 sets out the impact on the current budget of changes since Budget 2002 attributable to the operation of the automatic stabilisers, other non-discretionary factors and policy decisions since Budget 2002. The impact of the different factors on public sector net borrowing is very similar, as the projections for public sector net investment are little changed.

**Table 4.6: Factors behind changes to the current budget since Budget 2002**

£ billion	Projections			
	2002-03	2003-04	2004-05	2005-06
Automatic stabilisers	-5.8	-9	-5	-1
Other non-discretionary factors	-2.1	-4	-2	-2
Policy decisions since Budget 2002	-1.0	1	0	1
<b>Total change</b>	<b>-8.9</b>	<b>-12</b>	<b>-6</b>	<b>-2</b>

Note: Figures may not sum due to rounding

4.32 Table 4.6 shows that £5.8 billion of the change in the current budget in 2002-03, and £9 billion in 2003-04, can be attributed to the automatic stabilisers. The change in the automatic stabilisers declines over the forecast period as the economy returns to trend. These estimates of the changes in the size of the automatic stabilisers are based on the average impact of changes in the output gap on the public finances over previous cycles. They reflect both the direct impact of changes in GDP and its components, and other factors that are determinants of tax receipts, including changes in asset prices, to the extent that they have been related to changes in the output gap in the past.

### Sustainability for the Long Term

4.33 The Government supports a prudent interpretation of the Stability and Growth Pact (see Box 4.2). The second key element of this prudent interpretation takes account of sustainability. The Government believes that sustainable public finances are a prerequisite to achieving stable long-term economic growth, which in turn is essential in guaranteeing that everybody participates in the growing prosperity of the country. The Government also seeks to ensure that spending and taxation impact fairly between generations.

4.34 The UK's fiscal framework provides the setting for transparent, long-term decision-making. The framework is guided by the *Code for fiscal stability*, which sets out a commitment to managing the public finances in the long-term interests of the UK. The objectives for fiscal policy and the Government's two fiscal rules, the golden rule and sustainable investment rule, reflect the Government's long-term focus and are discussed in Chapter 2 of this Report.

4.35 To measure progress against the Government's commitment to its objectives and long-term interests, the *Code for fiscal stability* requires the publication of an Economic and Fiscal Strategy Report (EFSR) outlining the Government's long-term goals, strategy for the future, and how it is progressing in meeting its fiscal policy objectives.

### Illustrative long-term fiscal projections

4.36 Within the EFSR, the *Code for fiscal stability* requires that illustrative long-term projections of the outlook for the key fiscal aggregates are presented for a period of no less than 10 years into the future, based on a range of plausible assumptions, so as to shed light on the inter-generational impact and sustainability of fiscal policy. These projections are presented in Annex A of the EFSR (and published in the Budget) and in practice cover a 30-year horizon. The projections presented in Annex A of the EFSR are conducted using a top-down assessment.

4.37 In addition to the projections in Annex A of the EFSR, the Government has committed itself to publishing a *Long-Term Public Finance Report* on an annual basis. The first *Long-Term Public Finance Report* was published alongside the 2002 Pre-Budget Report.

#### Long-Term Public Finance Report

4.38 The *Long-Term Public Finance Report* seeks to extend and complement the analysis in Annex A of the EFSR (an updated version of which was included in the *Long-Term Public Finance Report*). To this end the report aims to provide:

- a comprehensive picture of the sustainability of the public finances over the long term, based on a range of plausible assumptions;
- an indication of the degree of inter-generational fairness;
- better quality information to guide policy and enhance decision-making and planning by both the Government and individuals; and
- a framework for examining the effects of demography and other long-term trends on the public finances.

4.39 As stated above, the Government already conducts a top-down assessment of long-term fiscal sustainability. However, due to the modelling approach, these do not identify specific long-term spending trends. The *Long-Term Public Finance Report* therefore introduces a number of other techniques to assess long-term fiscal sustainability. The techniques used in detail are: fiscal gap modelling, generational accounting and a bottom-up approach. The latter can show the evolution of specific revenue and spending items, as a per cent of GDP, over time<sup>18</sup>.

4.40 Using these techniques, and a range of plausible assumptions, it is possible to build up a comprehensive picture of the long-term sustainability of the public finances in the light of future developments.

4.41 The *Long-Term Public Finance Report* shows that the UK's public finances, based on current policies, are sustainable in the long term and that the UK is in a strong position to face the long-term challenges in the decades ahead. The report also shows that current policies have a high degree of inter-generational fairness in the sense that spending trends can be sustained with a roughly constant tax burden without increasing the debt burden relative to GDP over time.

#### Long-term challenges

4.42 One of the most important future developments is the continued changing structure of the UK's population<sup>19</sup>. The GAD published 2001-based interim principal population projections in November that take account of the findings of the 2001 Census. The 2001 Census found that the total population was over one million lower than previously estimated in 2000.

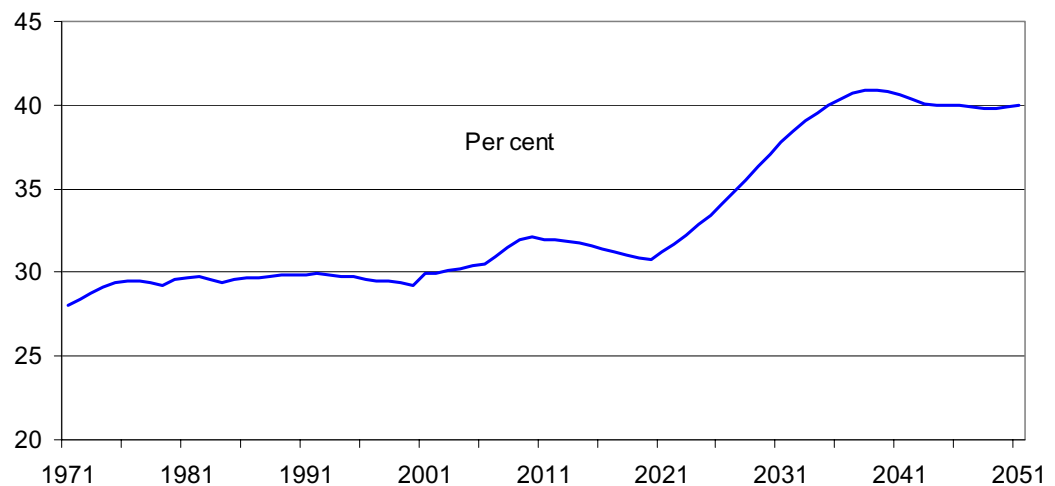
#### Ageing population

4.43 According to GAD's principal population projections the UK population will rise from 58.8 million in 2001 to nearly 64 million by the mid-2030s. After 2035 total population will remain more or less stable until at least 2050. The UK's population is also projected to age and its composition to change. According to the latest population projections, the median age will increase from 38 years in 2001 to around 44½ years by 2040 before stabilising. This is partly due to the large cohort of the 1960s baby-boom generation reaching retirement age but also to life expectancy for males and females being predicted to edge up from 75.7 years in 2001 to 79.9 years in 2050 for males and from 80.4 years to 84.1 years for females. At the same time the number of younger people is projected to fall slightly.

<sup>18</sup> The techniques are explained in detail in Chapter 4 of the *Long-Term Public Finance Report: an analysis of fiscal sustainability*, HM Treasury, November 2002

<sup>19</sup> Other long-term trends such as technological advances in health provision are also discussed but are not, with the exception of a compression of morbidity in the case of long-term care, modelled in the projections

Chart 4.2: Old-age dependency ratio



Source: Government Actuary's Department 2001-based interim principal population projections and historical data

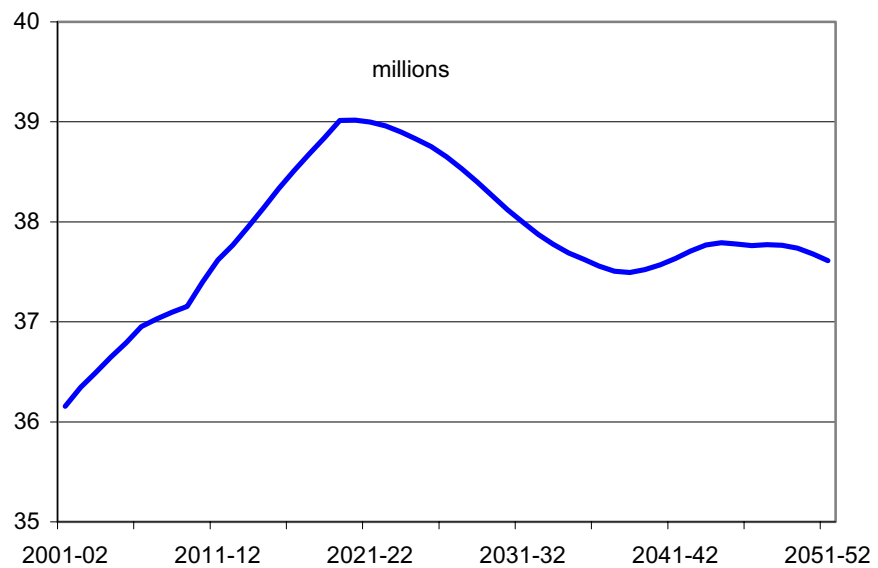
**Assumptions 4.44** Given the enormous uncertainties involved when conducting long-term projections, it is crucial to state clearly the assumptions used. The *Long-Term Public Finance Report* is consistent with the medium-term forecast presented in the 2002 Pre-Budget Report. Beyond the medium-term forecast period, the *Long-Term Public Finance Report* is based on a range of plausible assumptions and provides sensitivity analysis to 'stress test' the results. Assumptions are needed for: policy, employment and productivity growth (and hence GDP growth), discount/debt interest rate, and spending and revenue profiles.

**4.45** The *Long-Term Public Finance Report* is based on the assumption of current policy; in other words, it is assumed that the Government will leave current policy unchanged in the future. Current policy has been interpreted as all policy already in place or announced in the 2002 Pre-Budget Report. Beyond the medium-term forecast period, spending and revenue, with a few exceptions, are entirely driven by demographic changes<sup>20</sup>.

**4.46** The employment rate of the working-age population is assumed to remain unchanged from 2007-08 onwards, the end of the medium-term forecast period. Changes in employment levels are therefore entirely due to changes in the size of the working-age population. Chart 4.3 shows the likely evolution of the number of people of working age over the coming decades as projected in GAD's 2001-interim principal population projections. The continued rise between 2010-11 and 2020-21 is entirely due to the increase of the female state pension age. The *Long-Term Public Finance Report* is based on the 2001-based interim principal population projections.

<sup>20</sup> For more details on modeling and exceptions see Chapter 5 of *Long-Term Public Finance Report: an analysis of fiscal sustainability*, HM Treasury, November 2002

Chart 4.3: Population of working age



Source: Government Actuary's Department 2001-based interim principal population projections

**4.47** The productivity growth assumption used in the baseline scenario is 2 per cent per year. This is the average long-term productivity growth rate for the UK since the mid-1950s. It is also the neutral productivity assumption used in the Government's medium-term forecast. Table 4.7 shows average real GDP growth in the coming decades for the baseline scenario.

Table 4.7: Real GDP growth and its components in the baseline scenario (per cent)

Year	2011-12 to 2020-21	2021-22 to 2030-31	2031-32 to 2040-41	2041-42 to 2050-51	2051-52 to 2060-61
Productivity	2.0	2.0	2.0	2.0	2.0
Employment	$\frac{1}{4}$	$-\frac{1}{4}$	0.0	0.0	$-\frac{1}{4}$
<b>Real GDP</b>	<b><math>2\frac{1}{4}</math></b>	<b><math>1\frac{3}{4}</math></b>	<b>2.0</b>	<b>2.0</b>	<b><math>1\frac{3}{4}</math></b>

**4.48** The fiscal gap and generational accounts approaches require a discount/debt interest rate assumption. Based on index-linked gilts, and consistent with the Government's Green Book<sup>21</sup>, the report assumes discount/debt interest rates of 2 per cent, 2½ per cent and 3 per cent.

#### Revenue projections

**4.49** Total revenue is projected to fall marginally over the next 50 years in the *Long-Term Public Finance Report*. Total revenue, as a share of GDP, was 39.4 per cent in 2001-02 and is projected to be 40.1 per cent in 2011-12, 38.7 per cent in 2021-22, 39.2 per cent in 2031-32, 39.0 per cent in 2041-42 and 38.4 per cent in 2051-52. However, the projections do not pick up all the potential developments on the revenue side that can be expected. In fact, there are several reasons why total revenue may rise as a share of GDP without a change in policy. For example, the number of pensioners with significant pension entitlements is expected to increase over the coming decades. While contributions to pension schemes are tax exempt (up to generous limits), the future income stream that a funded pension generates is taxed. There is evidence that such policy could have a significant upward pressure on revenue in countries with well-established funded pension systems<sup>22</sup>.

<sup>21</sup> *Appraisal and Evaluation in Central Government, 'The Green Book'*, HM Treasury, 1997

<sup>22</sup> *Long-Term Public Finance Report: an analysis of fiscal sustainability*, HM Treasury, November 2002, pages 39 – 40

**Spending projections** 4.50 Table 4.8 summarises the spending projections as presented in the *Long-Term Public Finance Report*. Table 4.8 shows that the changing demographic structure of the UK's population – and especially the ageing aspect – is expected to have only a limited impact on the public finances over the coming decades. This contrasts with the findings in many other developed countries, where the spending pressures are much greater. Spending on education and pensions is projected to remain more or less stable as a share of GDP after the end of the medium-term forecast period. The most marked increase is projected in health spending. Health spending is projected, based on the assumptions in the report, to rise from 8¼ per cent of GDP in 2007-08 to 9¾ per cent by 2051-52. Overall spending is projected to increase slightly, as a share of GDP, over the next 30 years and then fall back. So total spending, as a share of GDP, is projected to be very similar in 2051-52 as in 2007-08. The substantial increase in spending between 2001-02 and 2007-08 largely reflects the Government's increased spending on public services, in particular, on health and education.

**Table 4.8: Spending projections**

Year	2001-02	2011-12	2021-22	2031-32	2041-42	2051-52
Pensions <sup>1</sup>	5.0	5.0	4.8	5.2	5.0	4.8
Health <sup>2</sup>	6.3	8.2	8.5	9.3	9.7	9.8
Education	4.6	5.9	5.6	5.8	5.7	5.7
Long-term care <sup>3,4</sup>	0.9	1.2	1.2	1.2	1.2	1.2
<b>Total age-related spending</b>	<b>16.9</b>	<b>20.3</b>	<b>20.1</b>	<b>21.4</b>	<b>21.6</b>	<b>21.5</b>
Other spending	21.7	20.3	19.6	20.0	19.8	19.3
<b>Total spending<sup>5</sup></b>	<b>38.6</b>	<b>40.6</b>	<b>39.7</b>	<b>41.4</b>	<b>41.4</b>	<b>40.8</b>

<sup>1</sup> Defined as the sum of basic state pension, SERPS/S2P, Minimum Income Guarantee and Pension Credit, Winter Fuel Payments, concessionary TV licenses, contributory and non-contributory Christmas bonus and non-contributory retirement pension. <sup>2</sup> Gross NHS spending. <sup>3</sup> Compression of morbidity assumed. <sup>4</sup> Excluding long-term care provided within the NHS which is accounted for under Health. <sup>5</sup> Total spending including gross investment.

4.51 The pension projections differ in a number of ways from earlier long-term pension projections for the UK. The main difference relative to the most recent UK pension projections, produced by HM Treasury in the context of the European Union's Economic Policy Committee (EPC)<sup>23</sup>, are that slightly different employment rate and productivity growth assumptions are used, demographic trends are based on GAD's latest 2001-interim principal population projections and the Pension Credit is included. In addition, HM Treasury's projections conducted for the EPC exercise were on a wider definition of public pensions<sup>24</sup>. The projections in the *Long-Term Public Finance Report* are – in terms of GDP – correspondingly lower.

4.52 The health projections build in the substantial medium-term increases in health spending announced in Budget 2002 in response to the Wanless Review<sup>25</sup>. Future decisions on implementing the Wanless recommendations after 2008 are a matter of future spending reviews. Compared with HM Treasury's health projections produced for the EPC, the projections in the *Long-Term Public Finance Report* show a more pronounced increase in health spending as a share of GDP over the next 50 years. The difference mainly reflects the substantial increase in funding to the National Health Service announced in Budget 2002 up to 2007-08.

<sup>23</sup> *Budgetary challenges posed by ageing populations*, Economic Policy Committee, October 2001

<sup>24</sup> See Chapter 6 of *Long-Term Public Finance Report: an analysis of fiscal sustainability*, HM Treasury, November 2002 for more details on definitions used

<sup>25</sup> *Securing our Future Health: Taking a Long-Term View*, Derek Wanless, April 2002

**4.53** Education spending, as a share of GDP, is projected to remain very stable between 2011-12 and 2051-52. This reflects the fact that the number of people of education age (either in schools, higher education or further education) is projected to vary only slightly. The increase between 2001-02 and 2011-12 reflects the substantial increase in education spending announced in the 2002 Spending Review up to 2005-06.

**4.54** Long-term care spending is assumed to remain constant, as a share of GDP, from 2011-12 onwards. This main motivation for this assumption is that it is likely that higher life expectancy will generally go hand in hand with a rise in the number of years enjoyed in good health. The long-term projections therefore assume the existence of a trend called compression of morbidity<sup>26</sup>.

**4.55** The gradual decline of other spending between 2001-02 and 2021-22 largely reflects the assumption that most non-pension social benefits (which represent nearly a third of other spending) will rise in line with prices after 2007-08, reducing their share in GDP. Other spending also includes public sector occupational pensions, which remain small as a share of GDP in the projections.

**Updated long-term  
fiscal projections**

**4.56** A common starting point for thinking about long-term fiscal sustainability is to consider a sustainable debt to GDP ratio. Indeed, the Government's sustainable investment rule is based on this idea<sup>27</sup>. The *Long-Term Public Finance Report* updated the illustrative long-term fiscal projections presented in Budget 2002 based on the medium-term forecast presented in the 2002 Pre-Budget Report. The updated illustrative long-term fiscal projections show a very similar picture of overall long-term fiscal sustainability as those presented in Budget 2002. With the results of the updated illustrative long-term fiscal projections only marginally different from those presented in Annex A of Budget 2002, the conclusions drawn earlier remain valid: the UK's public finances are broadly sustainable over the long term. Consistent with meeting the golden rule, current consumption can grow slightly faster than GDP in the projections, providing the resources to meet future spending needs. Furthermore, public sector net investment can grow more or less in line with the economy without jeopardising the sustainable investment rule. Net debt is projected to remain below 40 per cent of GDP over the projection horizon of the illustrative long-term fiscal projections.

**Fiscal gaps**

**4.57** The *Long-Term Public Finance Report* also uses fiscal gaps to assess the long-term sustainability of the public finances. The fiscal gap concept also takes a sustainable debt to GDP ratio as a starting point for thinking about long-term fiscal sustainability. The fiscal gap measure represents the change in the primary balance<sup>28</sup> needed to attain a particular net debt target (assumed to be 40 per cent to be consistent with the Government's sustainable investment rule) at a particular point in time. Table 4.9 shows the baseline scenario projections under a variety of assumptions regarding the debt interest rate.

<sup>26</sup> See Chapters 3 and 6 of the *Long-Term Public Finance Report: an analysis of fiscal sustainability*, HM Treasury, November 2002, for a detailed discussion of compression of morbidity and for a projections based on the assumption of no compression of morbidity

<sup>27</sup> See Chapter 2 of this programme for more details

<sup>28</sup> The primary balance is not identical to the difference between total revenue and total spending presented above. To derive the primary balance a number of adjustments have to be made, including taking account of depreciation

Table 4.9: Fiscal gaps<sup>1</sup> in baseline scenario with 2 per cent productivity growth

(per cent of GDP)			
Interest rate (per cent)	2 <sup>1</sup> / <sub>2</sub>	3	3 <sup>1</sup> / <sub>2</sub>
Year			
2016-17 <sup>2</sup>	-1 <sup>1</sup> / <sub>4</sub>	-1	-3 <sup>3</sup> / <sub>4</sub>
2021-22	-3 <sup>3</sup> / <sub>4</sub>	-1 <sup>1</sup> / <sub>2</sub>	-1 <sup>1</sup> / <sub>2</sub>
2031-32	0	1 <sup>1</sup> / <sub>4</sub>	1 <sup>1</sup> / <sub>4</sub>
2041-42	1 <sup>1</sup> / <sub>2</sub>	1 <sup>1</sup> / <sub>2</sub>	3 <sup>3</sup> / <sub>4</sub>
2051-52	3 <sup>3</sup> / <sub>4</sub>	3 <sup>3</sup> / <sub>4</sub>	1

<sup>1</sup> Change to primary balance needed to attain a net debt target of 40 per cent in the year shown. Rounded to nearest quarter percentage point. <sup>2</sup> Net debt target reached at end of the year specified.

4.58 The results show that the UK public finances are in a strong long-term position. Table 4.9 shows that the Government could reduce its primary balance if it aimed for a net debt to GDP ratio of 40 per cent by 2021-22 in the baseline case. If the horizon is extended, the Government would have to tighten fiscal policy only slightly to ensure that net debt stays at 40 per cent of GDP. Generally, it should also be emphasised that all the numbers in Table 4.9 are small (representing around 1 percentage point of GDP or less). This needs to be seen in the context of an average absolute forecasting error on the year-ahead forecast on public sector net borrowing of 1 per cent of GDP since 1989-90.

#### Intertemporal balance

4.59 The technique of generational accounts can be used to calculate the intertemporal budget gap and inter-generational balance gap<sup>29</sup>. A positive intertemporal budget gap indicates that the government would have to raise taxes (or lower spending, or a combination of the two) to establish intertemporal balance. The public finances are in intertemporal balance if future revenue is sufficient to meet future spending needs and pay off today's debt burden. The *Long-Term Public Finance Report* notes that the intertemporal balance concept is an overly-stringent condition for long-term sustainability in the sense that at the end of the assumed projection horizon all government debt is repaid. However, fiscal sustainability does not require zero debt. Nevertheless, it is a useful indicator that can be monitored over time and between countries.

4.60 Table 4.10 shows the intertemporal budget gap in the baseline scenario for the three discount rate assumptions. As can be seen whether revenues need to rise (or spending to fall) depends entirely on the discount rate assumption. If a low discount rate is used, as could be justified by the low real interest rate on long-term UK government bonds, the condition for intertemporal balance is exceeded in the baseline scenario. Even under the higher discount rate total revenue would have to be raised by only 1<sup>1</sup>/<sub>4</sub> per cent (or spending cut) to establish intertemporal balance.

Table 4.10: Intertemporal budget gaps<sup>1</sup>

(per cent of GDP)			
Discount rate (per cent)	2 <sup>1</sup> / <sub>2</sub>	3	3 <sup>1</sup> / <sub>2</sub>
Baseline (2 per cent)	-1	1 <sup>1</sup> / <sub>2</sub>	1 <sup>1</sup> / <sub>4</sub>

<sup>1</sup> Tax increase (or decrease) in 2001-02 and a permanent, proportionate tax increase (or decrease) thereafter needed to ensure intertemporal balance. Rounded to the nearest quarter percentage point.

<sup>29</sup> For more information on these measures, for example how they are derived, and their respective strengths and weaknesses see Chapters 4 and 6 of *Long-Term Public Finance Report: an analysis of fiscal sustainability*, HM Treasury, November 2002



**Inter-generational fairness** 4.61 One of the key objectives for fiscal policy is that spending and taxation impacts fairly within and between generations. The report shows that there is a high degree of inter-generational fairness in the sense that spending trends can be sustained with a roughly constant tax burden without increasing the debt burden relative to GDP over time. The inter-generational balance gap, the second main indicator derived in the generational accounts, supports this finding.

**Summary** 4.62 Using a number of indicators and based on a range of feasible assumptions, the *Long-Term Public Finance Report* shows that the UK public finances are sustainable in the long term and that the UK is in a strong position to face the fiscal challenges of an ageing population. The projections confirm the results of the Annex A-style projections as presented in the EFSR and of earlier studies that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries.

4.63 Using various concepts, including generational accounting, the report provides a range of sustainability indicators. The sustainability indicators also suggest a high-degree of inter-generational fairness.

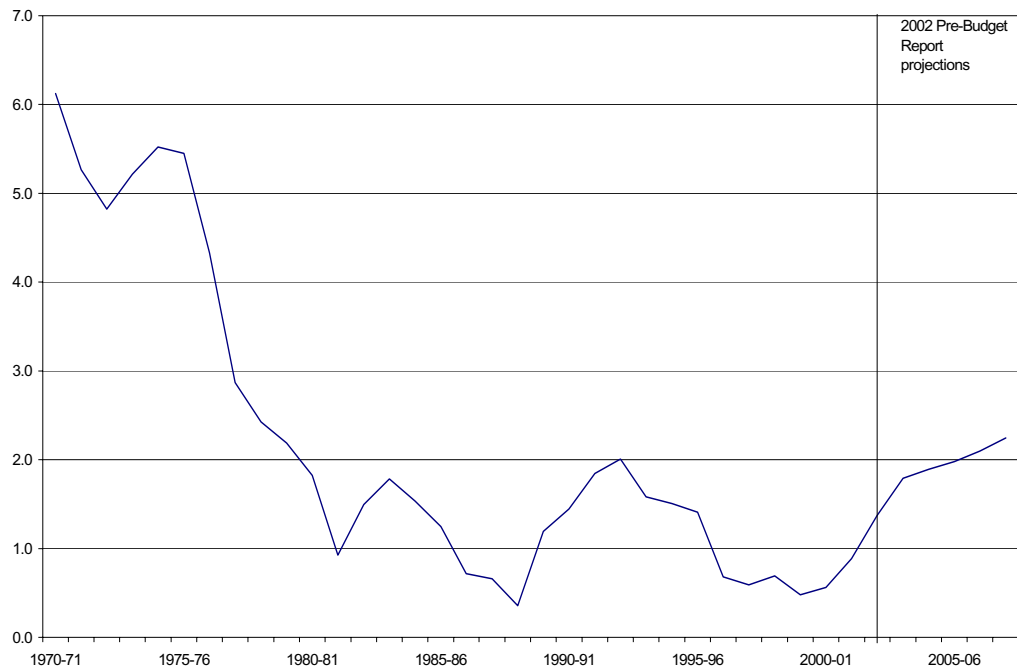
4.64 The *Long-Term Public Finance Report* along with the *End of year fiscal report* mark a major development of the UK's fiscal framework. In particular, they provide substantially more transparency and detailed analysis on both the distant future and the recent past. Both are intended to provide further reassurance that the tough decisions made in the past have put the UK in a secure position to face the challenges of the future without resorting to sudden and unexpected changes in policy.

## Public Investment

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

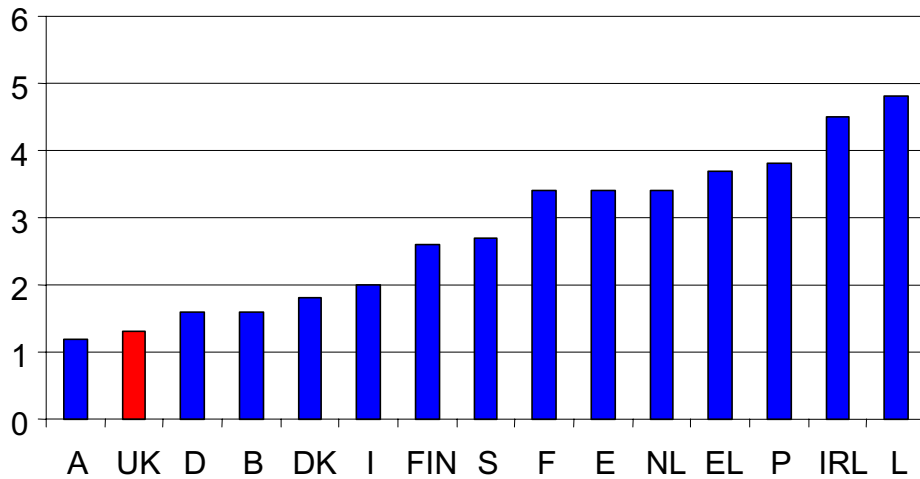
4.66 Net borrowing is equal to net investment minus the surplus on the current budget. Table 4.1 shows that public sector net investment is projected to be approximately 1.4 per cent of GDP in 2002-03, rising to 2.2 per cent of GDP in 2007-08, as the Government seeks to rectify historical under-investment in public infrastructure. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, as debt is being held at 33 per cent of GDP or below throughout the projection period, well within the 40 per cent limit set by the sustainable investment rule.

Chart 4.4 Public sector net investment (per cent of GDP)



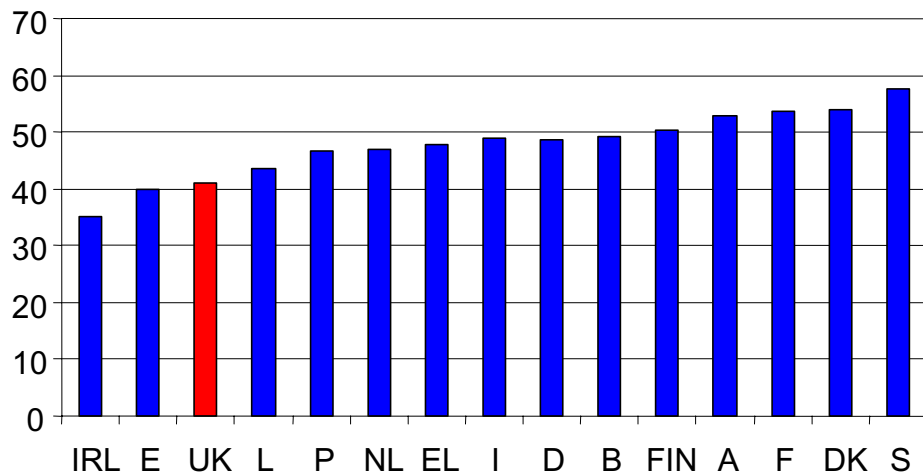
**4.67** The UK's relatively poor record on investment in public infrastructure is also evident from Charts 4.5 and 4.6. These show that the UK has amongst one of the lowest levels of general government net investment and general government total expenditure over the period 1970-2004 than most other EU countries.

Chart 4.5: Public investment, 1971-2004 (per cent of GDP)



Source: European Commission, Autumn 2002 forecasts

Chart 4.6: Total expenditure, general government, 1970-2004 (per cent of GDP)



Source: European Commission, Autumn 2002 forecasts

**Capital expenditure 4.68** Both gross domestic fixed capital formation and capital grants are expected to increase rapidly over the next three years, in line with the Government's commitment to address neglect in public infrastructure. Table 4.1 shows that public sector net investment is set to increase substantially to 1.4 per cent of GDP in 2002-03 and is forecast to increase steadily, reaching around 2 per cent of GDP in 2005-06.

**4.69** Table 4.11 provides a breakdown of public sector capital expenditure. In addition, the Government continues to use the Private Finance Initiative (PFI) and Public Private Partnerships (PPPs) to support its capital investment programme, in areas as diverse as education, hospitals, defence, IT, and property management.

Table 4.11: Public sector capital expenditure

	£ billion				
	Outturn 2001-02	2002-03	Projections		
			2003-04	2004-05	2005-06
Capital Budget DEL	18.1	21.3	25.2	27.6	30.1
Locally financed expenditure	1.7	1.8	1.7	1.7	1.6
National Lottery	0.9	1.0	1.1	1.0	0.6
Public Corporations own-financed capital expenditure	1.9	2.5	2.8	2.6	2.7
Other capital spending in AME	-0.4	1.9	3.3	4.4	5.3
AME margin	0.0	0.0	0.2	0.0	0.1
<b>Public sector gross investment<sup>1</sup></b>	<b>22.2</b>	<b>28.4</b>	<b>34.3</b>	<b>37.3</b>	<b>40.3</b>
Less depreciation	13.4	14.1	14.7	15.4	16.2
<b>Public sector net investment</b>	<b>8.8</b>	<b>14.3</b>	<b>19.6</b>	<b>21.9</b>	<b>24.1</b>
Proceeds from the sale of fixed assets <sup>2</sup>	4.3	3.8	3.8	3.8	3.8

<sup>1</sup> This and previous lines are all net of sales of fixed assets.

<sup>2</sup> Projections of total receipts from the sale of fixed assets by public sector.

4.70 Table 4.12 shows general government debt repayments.

**Table 4.12: General government debt repayments**

	Per cent of GDP				
	Outturn	Projections			
	2001-02	2002-03	2003-04	2004-05	2005-06
Net debt level <sup>1</sup>	30.4	31.0	32.1	32.4	32.6
Gross debt level	38.2	37.9	38.8	38.9	38.9
Change in gross debt	-1.7	-0.3	0.9	0.1	0.0
<b>Contributions to change in gross debt</b>					
Primary balance <sup>2</sup>	-1.0	0.8	1.2	0.6	0.6
Interest payments <sup>2</sup>	1.1	1.0	1.0	1.0	1.0
Nominal GDP growth	-1.4	-1.7	-1.8	-2.1	-1.9
Other factors influencing the debt ratio	-0.4	-0.4	0.5	0.5	0.4
<i>Memo: implicit interest rate on debt</i>	6.0	5.4	5.2	5.4	5.1

Note: This table is derived from Pre-Budget Report tables.

<sup>1</sup> Public sector net debt.

<sup>2</sup> Primary balance based on net interest payments for consistency with UK public sector definition. Interest payments given net of interest receipts.

4.71 Table 4.13 shows net borrowing by sub-sectors.

**Table 4.13: Net borrowing by sub-sectors**

	Per cent of GDP				
	Outturn	Projections			
	2001-02	2002-03	2003-04	2004-05	2005-06
General government	1.7	18.7	24.4	19.2	19.4
Central government	1.2	17.0	22.7	17.5	18.1
Local authorities	0.5	1.8	1.6	1.7	1.3

Note: This table is derived from Pre-Budget Report Table B24.

## Delivering High-Quality Public Services

4.72 The Government's long-term goal is to deliver world-class public services through investment and reform while ensuring that taxpayers receive value for money.

### 2002 Spending Review

4.73 Since the last Convergence Programme, the latest of the biennial spending reviews has been completed. The 2002 Spending Review set departmental spending plans for the three years up to 2005-06, and five years for the NHS, within the overall 'envelope' for total public spending set in Budget 2002 and consistent with the fiscal rules. These plans deliver substantial extra investment into public services:

- current spending will rise in total by 3.3 per cent a year in real terms in 2004-05 and 2005-06;
- public sector net investment is projected to rise from its 1.8 per cent of GDP target in 2003-04, to 2 per cent of GDP by 2005-06;
- UK spending on the NHS will increase by an average of 7.4 per cent a year in real terms over the five years to 2007-08; and
- over 75 per cent of additional spending will be allocated to the key priorities of health, education, personal social services, transport, housing and criminal justice.

**4.74** The Government is determined to secure value for money. In each area of public service delivery, resources allocated in the 2002 Spending Review are tied to reform and results. These are based on:

- clear long-term goals that focus service providers on the key outcomes the Government is seeking to achieve;
- independent audit and inspection to ensure that departments and agencies are held accountable for their performance, including through a new independent Commission for Healthcare Audit and Inspection, a Comprehensive Performance Assessment in local government and the new Police Standards Unit;
- maximum local flexibility and discretion to innovate to ensure that local service providers can respond to local conditions and demand, with new freedoms for high-performing local authorities, Regional Development Agencies, further education colleges and hospitals; and
- increased transparency about what is being achieved, with regular web-based reporting of progress against targets from April next year.

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

**Box 4.3: Funding long-term improvements in healthcare**

In Budget 2001 the Chancellor commissioned an independent review of the long-term trends and resource needs that will affect the health service in the UK over the next 20 years. In his report to the Chancellor in April 2002, Derek Wanless concluded that health spending would need to rise substantially over the next 20 years, and most rapidly in the short term so as to deliver improvements in standards as quickly as possible.

In Budget 2002, the Chancellor accepted the Wanless Review's recommendations and announced that UK NHS spending would grow by 7.4 per cent a year in real terms over the next five years. By 2007-08, total UK health spending is projected to reach 9.4 per cent of GDP. To deliver the largest ever sustained spending growth in the history of the NHS, while meeting the fiscal rules and other priorities, Budget 2002 raised national insurance contributions (NICs) by one per cent for employers, employees and the self-employed on all earnings above the NICs threshold from April 2003; and froze the income tax personal allowance for those aged under 65 in 2003-04.

The Government believes that general taxation and NICs provide affordable, comprehensive cover for healthcare as the costs are spread as widely and fairly as possible. They allow the Government to fund healthcare, through the NHS, that is free and accessible to all on the basis of need and not ability to pay. Because the range of medical treatments is growing, and some are more expensive than ever, the risks to a family's finances would be unmanageable if the costs were met from charges or insurance payments. Mr Wanless also concluded that the current funding system is both a fair and efficient one.

Evidence from other countries suggests that charges deter the sick from seeking treatment, to their own detriment and that of their dependents. Private insurance would fail to help those in greatest need, tend not to extend to chronic or emergency care, and be more expensive than the alternatives due to its administrative costs. Social insurance systems reflect the regional or local organisation of healthcare, in contrast to the UK's national service, and may bear disproportionately on employers.

In contrast, NICs offer several advantages as a source of revenue funding. Unlike indirect taxes, and because the new one per cent payment will extend beyond the upper limits for profits and earnings, they reflect people's ability to pay. While most of those in work will contribute, pensioners will not. NICs are also levied on employees and employers, ensuring that all those with an interest contribute to reform of the health service.

**4.76** Because they are based on prudent and cautious assumptions, the Government's spending plans for 2002-03 remain robust despite heightened uncertainty in the global economy. Total public spending is planned to rise by 4.4 per cent in real terms over the year as a whole, consistent with the plans for significant investment in public services set out in the 2000 Spending Review.

**4.77** Within existing spending plans, departments are able to draw on their accumulated stock of end-year flexibility (EYF). EYF allows departments to retain resources not fully spent at the end of the year for use in future years, helping them to plan more effectively and avoiding wasteful end-year surges in departmental spending. This year departments have chosen to draw down £2.9 billion to add to their authorised spending limits. As has been the case in previous years, the Government expects this net addition to spending to be more than offset by the end of the year by under-spends elsewhere within DEL.

**Box 4.4: Investing in better infrastructure**

The Government has delivered a significant increase in capital investment to reverse the decline seen over the previous two decades. This investment has been underpinned by Departmental Investment Strategies to ensure that capital programmes are delivered effectively. Significant results have been achieved.

In education:

- 20,000 schools have benefited from building improvements since 1997. By 2003-04, a typical secondary school will receive direct capital funding of around £75,000 and a typical primary school around £22,000. By 2004, over 650 schools will have benefited from rebuilding or major renewal;
- the computer to pupil ratio in primary schools is now 1:9.7 and 1:6 in secondary schools. These ratios will be improved to 1:8 and 1:5 respectively by 2004; and
- 553,000 childcare places had been created by June 2002, helping over one million children.

In health:

- over 1,300 GP premises have been upgraded. 10,000 GP practices and 1,000 hospitals are now connected to NHSnet, which handles 1.5 million messages per day with usage rising by 8 per cent a month; and
- an £8.5 billion hospital programme is now underway - the biggest in NHS history. By 2008, of the 68 major hospital schemes so far approved to proceed, over 50 will be operational with all of the remaining schemes under construction. The extra investment will allow an increase in treatment capacity equivalent to over 10,000 beds.

In transport:

- £4 billion has been invested in rail carriages. Since 1997, over 4,000 new carriages have been ordered, of which over 1,400 are already in service. Over 2,100 railway stations have been improved and 17 new stations built;
- spending on UK transport is rising at an average rate of 8.4 per cent a year after inflation;
- some £370 million from unallocated capital within the Ten-Year Plan has been brought forward into the Spending Review to accelerate delivery; and
- new funding, of around £1 billion a year, is being added to the Ten-Year Plan to support the delivery of the improvements to the London Underground to be provided through the Public-Private Partnership.

In crime:

- as a result of the 2000 Spending Review, the Home Office has allocated further funding of £146 million to its existing CCTV initiative, for 683 new CCTV schemes. 500 schemes are now in place and the remainder will be in operation by March 2003. Early findings from a number of implemented schemes have shown a very positive impact on crime reduction.

**Delivering Results 4.78** Alongside additional resources, the comprehensive programme of reform the Government has put in place aims to deliver significant improvements in public services. With more money invested, more results are required.

**4.79** Public Service Agreements (PSAs) are designed to improve performance by ensuring that all those involved in public service delivery can focus on clear long-term goals. Clear targets, against which performance is regularly monitored, also help policy makers to identify where further action might be needed. Departments will now publish progress reports against their PSA targets twice a year - once in the spring and once in the autumn. Departments are currently in the process of publishing their first autumn performance reports. This section summarises some of their content.

#### Health and social care

**4.80** The Department of Health is responsible for over £58 billion in 2002. Its aim is to transform the health and social care system so that it produces faster, fairer services that deliver better health and tackle health inequalities. The NHS has made good progress towards meeting many of its objectives and PSA targets, though some areas need to be addressed:

- mortality rates from cancer and coronary heart disease fell by nearly 7 and 14 per cent respectively in the three years to 2000, against a 20 per cent reduction target by 2010;
- the number of people waiting over three months for an out-patient appointment has almost halved since 2000, against a target of a maximum three month waiting time by 2005. Over the same period, the number of in-patients waiting over 12 months also fell by more than half, against a target of a maximum six month waiting time by 2005; and
- challenges remain to tackle the delayed discharge of older people from hospitals, improve the life chances of children in care, and strengthen accident and emergency provision.

#### Education and skills

**4.81** The Government plans to spend around £45 billion on education and skills in England this year. Important improvements have continued in all areas, though progress has not always been as fast as the Government wanted, highlighting the scale of the challenge in some areas of provision. In 2002:

- over half of all 16 year olds achieved five A\*-C grades at GCSE, exceeding the target;
- 75 and 73 per cent of 11 year olds achieved required standards in literacy and numeracy respectively, building on the substantial gains made over the last few years though falling a little short of the targets of 80 and 75 per cent; and
- the Government is on track to meet its target of helping 750,000 adults gain basic skills by 2004.

#### Crime

**4.82** The Government's aim is to build a safe, just and tolerant society. Nearly £15 billion will be spent this year on the fight against crime, and the Home Office, the Lord Chancellor's Department and the Crown Prosecution Service have all been set challenging targets. While further progress is needed in some areas, significant results have been achieved in others:

- overall crime levels, as recorded in the British Crime Survey, have fallen;
- by the end of March 2002, vehicle crime had fallen by 8.8 per cent, and domestic burglary by 9 per cent, against respective reduction targets of 30 per cent by 2004 and 25 per cent by 2005 compared with 1998-99 levels. In the two years to 2002, vehicle crime has fallen by 14 per cent and domestic burglary by 23 per cent;



- recorded robberies have increased by 35 per cent since March 2000 against a targeted 14 per cent reduction by 2005. However, since the Street Crime Initiative (SCI) began, the number of robbery offences in the ten SCI police force areas has fallen by 28 per cent; and
- figures for July 2000 reveal a 14 per cent fall in the reconviction rates of young offenders since 1997, well ahead of the targeted 5 per cent reduction by 2004.

**Transport 4.83** The Government's Ten-Year Plan for Transport sets ambitious targets to be delivered by 2010, supported by more than £180 billion of public and private spending. The Secretary of State for Transport reported on 17 December 2002<sup>30</sup> on progress toward delivering the Plan's ambitious objectives and the department is conducting a review to re-assess the way ahead, and to roll forward the Plan into the next decade. The baseline for congestion, against which performance will be measured, will be published alongside the progress report. Progress has been made in a number of areas:

- the number of deaths or serious injuries from road accidents has continued to decline - falling by 15 per cent compared with the average over the period 1994 to 1998, against a target of 40 per cent by 2010. For children, the decrease has been 27 per cent over the same period, against a target of 50 per cent by 2010;
- bus and light rail use increased by 1.1 per cent in 2001, although there are regional variations, against a new combined local public transport target of 12 per cent by 2010;
- network capacity on the London Underground increased by 2.5 per cent and reliability improved by 7 per cent compared with last year, in support of the Government's target to reduce journey times by increasing capacity and reducing delays; and
- the rail network was hit hard by the consequences of the accident at Hatfield, which led to extended disruption to services. Subsequently there has been a steady recovery in rail performance, though passenger levels are not yet at where they were pre-Hatfield. Passenger use increased by 2.6 per cent compared with 2000-01, against a target increase of 50 per cent by 2010 from 2000 levels.

**Housing 4.84** Over eight million people live in more than four million local authority and housing association homes. The availability and condition of social housing, and the systems through which people gain access to it and help with its costs, are vitally important for tackling poverty and regenerating deprived neighbourhoods. By 2005-06, investment in housing in England will have risen by £1.1 billion from this year's level to £5.9 billion. Through existing investment and reform, the Government:

- has enabled local authorities to reduce the backlog of council homes needing repairs by around 180,000 dwellings, with around 660,000 additional council houses benefiting from new investment;
- is on course to bring a third of non-decent social housing - around 500,000 homes - up to a decent standard between 2001 and 2004, as part of its long-term target to make all social housing decent by 2010;
- is building up to 22,700 affordable homes through the Housing Corporation in 2003-04, exceeding its social housing target for 2001-04; and
- has met six years early its target that, by 2008, 60 per cent of additional housing should be provided on previously-developed land and through conversions.

<sup>30</sup> *Delivering Better Transport: Progress Report*, Department of Transport, December 2002



# A

## COMPARISON WITH 2001 PROJECTIONS

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

**Table A.1: Comparing GDP growth and inflation between 2001 and 2002 Pre-Budget Reports**

	Percentage change on previous year									
	2001-02		2002-03		2003-04		2004-05		2005-06	
	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002
GDP growth	2	1½	2¼-2¾	2	2½-3	2¾-3¼	2¼-2¾	3-3½	2¼-2¾	2¾-3¼
RPIX inflation	2¼	2¼	2¼	2¼	2½	2¼	2½	2½	2½	2½

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

**Table A.2: Comparing public sector finances between 2001 and 2002 Pre-Budget Reports**

	Per cent of GDP									
	2001-02		2002-03		2003-04		2004-05		2005-06	
	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002
Current receipts	39.2	39.2	38.8	38.3	39.1	39.3	39.3	39.9	39.4	40.4
Current expenditure	36.8	37.0	37.2	37.5	37.4	38.4	37.4	38.4	37.4	38.6
Surplus on current budget	1.0	0.8	0.3	-0.5	0.4	-0.4	0.6	0.2	0.7	0.4
Net investment	1.3	0.9	1.4	1.4	1.7	1.8	1.8	1.9	1.8	2.0
Public sector net borrowing (PSNB)	0.3	0.1	1.1	1.9	1.3	2.2	1.2	1.6	1.1	1.6
Cyclically-adjusted surplus on current budget	1.0	0.7	0.3	0.2	0.3	0.3	0.5	0.6	0.7	0.5
Cyclically-adjusted PSNB	0.3	0.2	1.1	1.2	1.4	1.5	1.2	1.3	1.1	1.5
Treaty deficit <sup>1</sup>	0.2	0.2	1.1	1.8	1.3	2.2	1.1	1.7	1.0	1.6
Treaty debt ratio <sup>2</sup>	38.1	38.2	37.2	37.9	37.0	38.8	36.8	38.9	36.6	38.9

Note: Figures include Windfall Tax receipts and associated spending and are on an ESA 95 basis.

<sup>1</sup> General government net borrowing on a Maastricht basis.

<sup>2</sup> General government gross debt.

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

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

**Table A.3: Comparing public sector finances between 2001 and 2002 Budgets**

	Per cent of GDP									
	2001-02		2002-03		2003-04		2004-05		2005-06	
	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002
Current receipts	40.2	39.1	40.1	38.7	39.8	39.9	39.9	40.2	39.8	40.4
Current expenditure	37.1	36.7	37.3	37.1	37.5	37.9	37.5	38.2	37.5	38.5
Surplus on current budget	1.6	1.1	1.3	0.3	0.8	0.6	0.8	0.8	0.8	0.6
Net investment	1.1	1.2	1.5	1.4	1.7	1.8	1.8	1.9	1.8	2.0
Public sector net borrowing (PSNB)	-0.5	0.1	0.2	1.1	0.9	1.2	1.0	1.1	1.0	1.4
Cyclically-adjusted surplus on current budget	1.2	1.0	1.0	0.5	0.6	0.6	0.7	0.7	0.7	0.6
Cyclically-adjusted PSNB	-0.1	0.2	0.4	0.9	1.1	1.2	1.1	1.2	1.1	1.4
Treaty deficit <sup>1</sup>	-0.5	0.2	0.1	1.0	0.9	1.1	0.9	1.1	1.0	1.4
Treaty debt ratio <sup>2</sup>	37.6	38.0	36.1	36.9	35.7	36.6	35.6	36.5	35.6	36.6

Note: Figures include Windfall Tax receipts and associated spending and are on an ESA 95 basis.

<sup>1</sup> General government net borrowing on a Maastricht basis.

<sup>2</sup> General government gross debt.

# B

## THE FISCAL IMPACT OF BUDGET POLICY DECISIONS

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**B1** Chapters 2 and 4 set out details of the Government's fiscal framework and the public finance projections. In making additional discretionary policy changes, the Government takes into account:

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

B2 Table B.1 shows the financial implications of policy decisions announced in the 2002 Budget:

Budget policy decisions

Table B.1: Budget 2002 policy decisions

	(+ve is an Exchequer yield) £ million		
	2002-03	2003-04	2004-05
<b>MEETING THE FISCAL RULES AND FUNDING PUBLIC SERVICES</b>			
1 Freeze in income tax personal allowance and national insurance thresholds	0	700	850
2 Additional class 1 primary national insurance contribution for employees	0	3550	3700
3 Additional class 1 secondary national insurance contribution for employers	0	3900	4100
4. Additional class 4 national insurance contribution for the self-employed	0	450	450
<b>MEETING THE PRODUCTIVITY CHALLENGE</b>			
<b>Supporting small business</b>			
5 Corporation tax: reduce small companies' rate to 19 per cent and starting rate to 0 per cent	-20	-265	-450
6 Venture Capital Trusts - flexibility of rules	-5	-5	-5
7 Revalorise thresholds for VAT registration and deregistration	0	0	0
<b>Enterprise and innovation</b>			
8 Abolition of stamp duty on goodwill	-50	-50	-50
9 Exemption for gains on substantial shareholdings	-70	-130	-150
10 Capital gains tax: simplification	-10	-15	-15
11 Relaxation of the rules on withholding tax for exempt bodies	-10	-45	*
12 Introduction of Community Investment Tax Credit	*	-5	-5
13 Changes to the Construction Industry Scheme	-55	-10	*
14 Reform of taxation of intellectual property	-70	-160	-190
15 Research and development tax credit at 25% for larger companies	-200	-400	-400
16 New rules on loan relationships, derivative contracts and foreign exchange	0	230	350
<b>INCREASING EMPLOYMENT OPPORTUNITY FOR ALL</b>			
17 Income tax: indexation of allowances and limits in 2002-03	0	0	0
18 Working Tax Credit (WTC) for families without children	0	-250	-300
<b>BUILDING A FAIRER SOCIETY</b>			
<b>Supporting families and communities</b>			
19 Child Tax Credit and WTC for families with children and associated measures	-500	-2450	-2300
20 Income tax: over-indexation of age related allowances for ages 65-74	0	-55	-75
21 Eligibility of home childcare for childcare tax credit	0	-10	-15
22 Income tax: indexation of pension schemes earnings cap	0	0	0
23 Relief for community amateur sports clubs	*	-5	-10
24 Introduction of the Vaccines Tax Credit	*	-10	-20
25 Relief for gifts of real property to charities	*	-10	-20
26 VAT: reliefs for charity buildings	*	-10	-10
27 Measures to encourage charitable giving	*	-30	-20
<b>A modern and fair tax system</b>			
28 Tackling stamp duty avoidance	150	150	450
29 Film tax relief: restriction to feature films intended for cinema release	15	225	295
30 Manufactured payments: restriction of tax relief	0	15	10
31 North Sea taxation: introduction of 10 per cent supplementary charge and 100 per cent first year allow	100	450	600
32 Modernise taxation of foreign company UK branches	0	350	650
33 VAT anti-avoidance: face-value vouchers	0	120	105
34 VAT anti-avoidance: hire purchase agreements	40	45	45
35 VAT anti-avoidance: partial exemption override	195	185	170
36 Oils fraud strategy	100	290	550
<b>Duties and other tax changes</b>			
37 Tobacco duties: revalorisation of rates	0	0	0
38 Alcohol duties: beer duty relief for small brewers	-10	-15	-15
39 Alcohol duties: 2 per cent cut for cider; freeze other rates	-95	-105	-105
40 Alcohol duties: increase duty on coolers to spirits rate	170	195	210
41 Inheritance tax: over-index threshold to £250,000	-15	-25	-30
42 Mutual Assistance in Recovery of Debts: implementation of provisions	10	10	10
<b>PROTECTING THE ENVIRONMENT</b>			
43 Enhanced capital allowances for green technologies	-20	-40	-40
44 Climate change levy: freeze	-15	-20	-20
45 Climate change levy: tax incentives for combined heat and power	-15	-15	-15
<b>Transport and the environment</b>			
46 Extension of tax exemption for employer subsidised bus services	-10	-15	-20
47 Fuel duties: freeze rates	-395	-415	-420
48 Air passenger duty: freeze rates	-5	-20	-20
49 Air passenger duty: expansion of scope of lower rate	-25	-70	-75
50 VED: freeze all rates	-80	-85	-90
51 VED: creation of new low CO2 car band	*	*	-5
52 Reform of VED for motorbikes	-10	-10	-10
53 Introduction of incentives for cleaner vans	*	*	-5
54 VAT simplification: annual adjustment of car fuel scale charges	0	0	0
<b>TOTAL BUDGET MEASURES</b>	<b>-905</b>	<b>6115</b>	<b>7640</b>
* Negligible.			
<b>ADDITIONAL BUDGET POLICY DECISIONS</b>			
Additions to DEL	0	-4000	
Resetting of AME margin	180	-525	

B3 Table B.2 sets out the effect of policy decisions announced in the November 2002 Pre-Budget Report or since Budget 2002 on the fiscal projections.

**Pre-Budget Report policy decisions** **Table B.2: Estimated costs for the 2001 Pre-Budget Report policy decisions and others announced since Budget 2002<sup>1</sup>**

	(+ve is an Exchequer yield) £ million			
	2002-03	2003-04	2004-05	2005-06
<b>Measures announced since Budget 2002</b>				
Housing Benefit: standard rate pilot	0	-20	-20	-20
<i>Anti-avoidance measures</i>				
Derivative contracts: amendments to close loopholes in existing legislation	200	300	0	0
Controlled Foreign Companies: removing Ireland from excluded countries list	5	15	15	15
<b>Total measures announced since Budget 2002</b>	<b>205</b>	<b>295</b>	<b>-5</b>	<b>-5</b>
<b>Measures announced in the Pre-Budget Report</b>				
Share schemes - statutory corporation tax deduction	0	5	-45	-75
Transition to work: extending the Job Grant	0	0	-15	-15
Increases to the Social Fund budget	0	-25	-35	-45
Freeze of Class 2 NICs and indexation of other rates	0	-5	-5	-5
Extension of the Payroll Giving supplement for one year	0	-10	0	0
Abolition of North Sea Royalty from 1 January 2003	0	-170	-140	-120
Replacement of Landfill Tax Credit Scheme	0	100	110	110
<i>Anti-avoidance measures</i>				
Abuse of Employee Benefit Trusts	135	315	425	435
Acceleration of allowances through abuse of capital allowances rules	0	20	30	30
Controlled Foreign Companies: avoidance of UK tax on profits from extended warranties	0	0	50	170
Abuse of VAT on sale of freehold buildings	60	165	165	165
<b>Total Pre-Budget Report measures</b>	<b>195</b>	<b>395</b>	<b>540</b>	<b>650</b>
<b>Additional Pre-Budget Report policy decisions</b>				
Additional waste spending in DEL	0	-100	-110	-110
Reserve addition to DEL	-1000	0	0	0
Carry forward from 2001-02	-435	0	0	0
<b>Total policy decisions</b>	<b>-1035</b>	<b>590</b>	<b>425</b>	<b>535</b>

<sup>1</sup>All costings shown relative to an indexed base.