

Convergence Programme for the United Kingdom

submitted in line with the
Stability and Growth Pact

December 2005



HM TREASURY



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1.1 The forecasts for the UK economy and public finances set out in this Programme show that the UK's public finances are robust and sustainable. The UK's ability to adapt and respond to continued global economic challenges is built on its success in entrenching macroeconomic stability. World growth in 2005, while still robust by historical standards, has moderated compared with 2004, due in part to a sustained rise in oil and petroleum product prices. This slowdown has been more pronounced among advanced economies, especially the UK's main export markets in Europe. Despite this, the UK economy continues its longest unbroken expansion since records began, with GDP now having grown for 53 consecutive quarters.

Macroeconomic stability

1.2 A more integrated global economy increases the speed and magnitude with which global shocks and imbalances can affect the UK and reinforces the need for a strong macroeconomic framework. The UK's framework has helped to underpin increased stability compared with earlier decades and compared with OECD and G7 countries, as explained in Box 2.1. According to the OECD, the UK is now the most stable economy in the G7 and the OECD. Stability allows businesses, individuals and the Government to plan more effectively for the long term, improving the quantity and quality of investment and helping to raise productivity.

1.3 The Government has submitted programmes under the Stability and Growth Pact for each of the last six 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).

1.4 This regular annual Convergence Programme updates the UK's 2004 Convergence Programme to reflect the latest Government forecasts for the economy and public finances, which were published in the Pre-Budget Report on 5 December 2005.¹ 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 2005,² as well as taking account of the latest Government spending review, completed in 2004.³ The updated Programme is subject to the usual UK Parliamentary scrutiny and approval under Section 5 of the European Communities (Amendment) Act 1993.

The macroeconomic framework

1.5 The Government's long-term goal is to maintain macroeconomic stability, ensuring the fiscal rules are met at all times and that inflation remains low. Chapter 2 of this Programme describes how the Government is working to achieve this goal and summarises prospects for the UK economy and public finances, full details of which are set out in Chapters 4 and 3. The Government's macroeconomic framework is based on the principles of transparency, responsibility and accountability and is designed to ensure lasting stability so that businesses, individuals and the Government can plan effectively for the long term:

¹ 2005 Pre-Budget Report, HM Treasury, December 2005

² Budget 2005, HM Treasury, March 2005

³ 2004 Spending Review, HM Treasury, July 2004

- the monetary policy framework has improved the credibility of policy making and continues to deliver clear benefits. Since the new framework was introduced, the UK has enjoyed the longest period of sustained low inflation since the 1960s. The monetary policy framework has given the Bank of England's Monetary Policy Committee (MPC) the flexibility to respond decisively to unexpected events over recent years;
- 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. The interim forecast update of the projections for the public finances published in the 2005 Pre-Budget Report shows that the Government is meeting its strict fiscal rules.

Economic forecasts

1.6 As set out in Chapter 3, world growth in 2005, while still robust, is judged to have moderated compared with 2004, due to a combination of high oil and petroleum product prices, structural difficulties adjusting to higher energy prices and other shocks, and cyclical slowdowns following above potential growth in some economies. This easing in growth rates has been more pronounced among advanced economies, especially the UK's main export markets in Europe. Despite this slowdown, the Government's macroeconomic framework has continued to deliver the UK's longest period of sustained and stable economic growth since records began fifty years ago. UK GDP has now expanded for 53 consecutive quarters. Moreover, the current economic expansion has now persisted for well over twice as long as the duration of the previous period of unbroken growth.

1.7 Sound macroeconomic fundamentals continue to support growth and stability in the UK, helping the economy to remain far more resilient to challenges and shocks than it has in the past. However, there have been three significant developments affecting the outlook for UK growth since Budget 2005: significant statistical revisions to the quarterly profile of growth; external shocks such as higher oil prices and weaker demand growth in the euro area; and some weakness in domestically-generated growth. In the 2005 Pre-Budget Report forecast:

- UK GDP is now expected to rise by 1¾ per cent in 2005 as a whole. Growth in 2006 is forecast to remain below trend at between 2-2½ per cent, picking up to 2¾ -3¼ per cent in 2007 and 2008, leading to a closing of the output gap in 2008-09.
- Consumer Prices Index (CPI) inflation is expected to remain a little above target in the short term as a result of the continued effects of rises in oil prices and increases in import prices. However, as the direct effects of oil price rises abate, the drag on domestic inflation from continued slack in the economy should become more dominant, bringing inflation back to a little below target later in 2006. As the output gap narrows and import prices continue to rise, inflation is forecast to rise back to its 2 per cent target in 2007.

Prudent interpretation

1.8 The Government supports 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).

Public finances

1.9 Chapter 4 summarises the outlook for the public sector finance position

including in terms of the cycle and Chapter 5 goes on to outline how the public finances are both sustainable in the longer term and of a quality that allows sustained investment to establish world class public services:

- **the economic cycle.** The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began in 1997-98.⁴ The average surplus on the current budget since 1997-98 is in balance or surplus in every year of the projection period. The economy is projected to return to trend in 2008-09, meaning that over the whole cycle the average surplus on the current budget would be 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £16 billion in this cycle, including the AME margin.
- **sustainability.** The Government's primary objective for fiscal policy is to ensure sound public finances over the medium term. This means maintaining public sector net debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle, forecast to stabilise at around 38 per cent in 2007-08. General government gross debt is forecast to stabilise at around 44 per cent of GDP from 2006-07. Chapter 5 discusses the sustainability of public finances including the revised long-term projections published in the long-term public finance report.
- **public investment.** The fiscal rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending over the course of the cycle. Consistent with the Broad Economic Policy Guidelines and the UK's Lisbon National Reform Programme,⁵ this updated Convergence Programme also demonstrates the UK Government's commitment to address historical under-investment in public services in the UK. The Government's goal is to deliver world class public services through sustained investment and reform. This updated Programme reports too on the Government's announcement in July 2005 that it intends to conduct a second Comprehensive Spending Review, reporting in 2007. A decade on from the first CSR, the 2007 CSR provides an opportunity for the Government to take stock of the progress it has made against its overarching goals, and to review fundamentally the effectiveness of departmental spending in delivering further advances. Through this work, the 2007 CSR will identify what additional long-term investments and reforms are needed to meet the challenges and opportunities of the years ahead. Chapter 6 discusses the quality of public finances.

⁴ Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002.

⁵ *Lisbon Strategy for Jobs and Growth: UK National Reform Programme*, HM Treasury, presented to Parliament on 13 October 2005.

Economic reform in Europe **1.10** Strengthening economic reform in Europe has been a key priority of the UK Presidency of the EU. The Government believes that structural reforms to promote greater flexibility in European labour, product and capital markets are crucial to ensuring that the EU can adapt to the challenges of globalisation and promote growth, employment creation and productivity. In the autumn of this year, Member States submitted their first Lisbon National Reform Programmes setting out the policies they intend to pursue to meet the challenges of globalisation. During the UK Presidency, further steps have also been taken to reduce the burden of EU regulation on businesses, strengthen the transatlantic economic relationship, and deliver greater integration in European financial services markets.

Annex A & Annex B **1.11** Annex A provides details of the financial impact of the Budget 2005 policy decisions, and subsequent announcements. Annex B provides supplementary information.

2

OVERALL POLICY FRAMEWORK AND OBJECTIVES

OBJECTIVES OF ECONOMIC POLICY

2.1 The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Key elements in the Government's long-term economic strategy are:

- maintaining macroeconomic stability;
- raising the sustainable rate of productivity growth;
- providing employment opportunity for all;
- ensuring fairness;
- delivering world-class public services; and
- addressing environmental challenges.

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 Lisbon Strategy, the Broad Economic Policy Guidelines, and with a prudent interpretation of the EU Stability and Growth Pact.

2.3 The UK Government's macroeconomic framework is based on the principles of transparency, responsibility and accountability, and is designed to ensure lasting stability so that businesses, individuals, and the Government can plan effectively for the long term. The Bank of England has operational independence to meet the Government's symmetrical inflation target. Fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term. The fiscal rules underpin the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes.

STABILITY AND SUSTAINABILITY

The importance of stability

2.4 The Government's macroeconomic framework is designed to maintain long-term economic stability. Large fluctuations in output, employment and inflation add to uncertainty for firms, consumers and the public sector, and can reduce the economy's long-term growth potential. Stability allows businesses, individuals and the Government to plan more effectively for the long term, improving the quality and quantity of investment in physical and human capital and helping to raise productivity.

2.5 A more integrated global economy increases the speed and magnitude with which global shocks and imbalances can affect the UK and reinforces the need for a strong macroeconomic framework. The UK's framework has helped underpin the increased stability compared with earlier decades and compared with other OECD and G7 countries, as explained in Box 2.1.

Box 2.1: Macroeconomic stability in the UK

Economic stability builds resilience against economic shocks, reduces the risk of unemployment, reduces the cost of borrowing, and allows firms and individuals to make better economic decisions for the long term. In its 2005 Survey of the United Kingdom, the OECD^a referred to the “impressive” stability and resilience of the UK economy since 1998. According to the OECD, the UK is now the most stable economy in the G7 and the OECD. It has the lowest variance of CPI^b inflation and the smallest absolute output gap over the period from 1998 to 2004, as shown in the table. As the OECD states ‘macroeconomic performance over the last decade has been a “paragon of stability”’.^a

UK’s ranking on key measures of stability, average 1998 to 2004

	Ranking among	
	G7	OECD (30 Countries)
Smallest absolute output gap	1st	1st
Lowest variance of CPI inflation	1st	1st

Source: OECD (2005)

The UK’s shift to a world-leading stable economic environment is particularly striking given that the UK was previously one of the most volatile G7 and OECD countries. As the OECD states, “This performance is a testament to the strength of the institutional arrangements for setting monetary and fiscal policy as well as to the flexibility of labour and product markets”.

The increased stability highlighted by the OECD has real impacts in terms of better standards of living and higher rates of growth.

^a *Survey of the United Kingdom, OECD, 2005.*

^b *The CPI (Consumer Prices Index) is called the HICP (Harmonised Index of Consumer Prices) in other European countries.*

The importance of sustainability

2.6 While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability*.¹

2.7 An updated analysis of long-term fiscal sustainability is published alongside the 2005 Pre-Budget Report in the 2005 *Long-term public finance report*.² Based on the latest population projections the report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances, updating the illustrative long-term projections set out in Budget 2005.

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

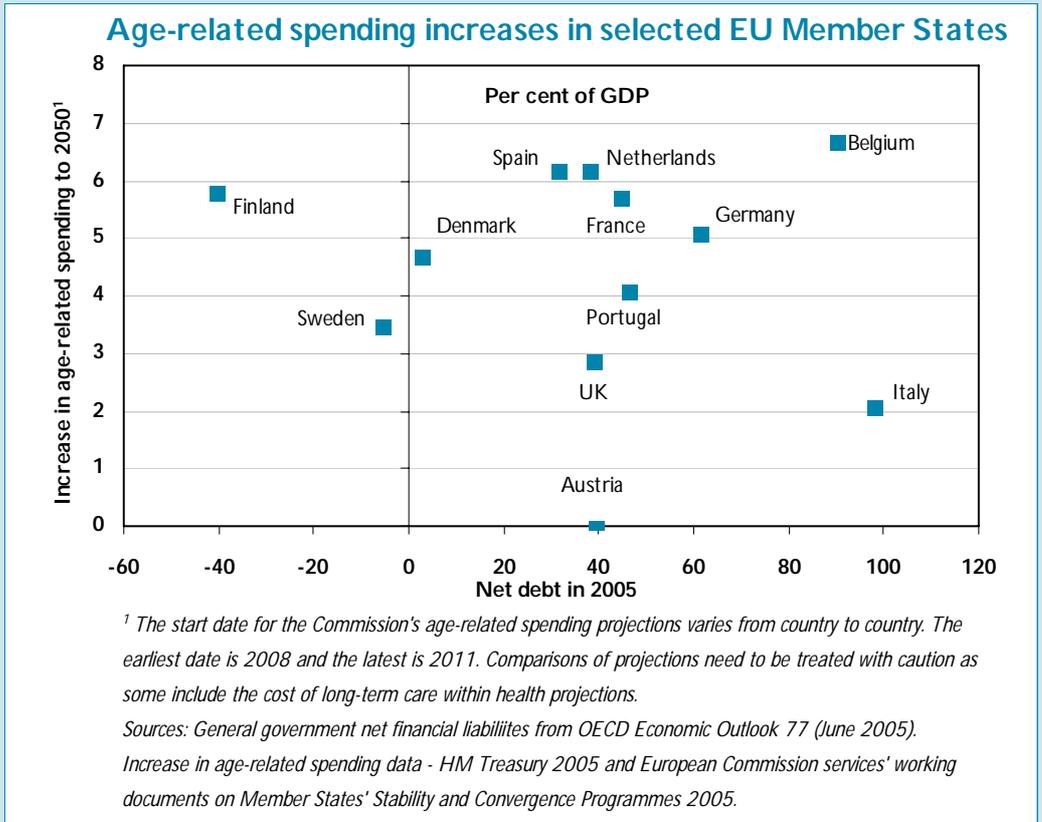
¹ *Code for Fiscal Stability*, HM Treasury, 1998

² *Long-term public finance report*, HM Treasury, 2005

of an ageing population. Chapter 5 provides further details on the sustainability of the UK public finances.

Box 2.2: Long-term sustainability in the EU

The challenges posed by an ageing population vary considerably between countries. The chart below shows the relationship between the ratio of general government net financial liabilities to GDP and the projected increase in age-related spending over the period to 2050 for twelve of the EU15 Member States.^a



The chart shows that a number of countries face a large projected increase in age-related spending in terms of GDP over the next 50 years, of more than 6 per cent of GDP in some cases, primarily due to large increases in pension and health spending. The UK has a relatively low ratio of debt to GDP and faces one of the smallest projected increases in age-related spending in the EU, suggesting that the UK is well-placed to meet the long-term challenges of an ageing population.

A full assessment of long-term sustainability requires a more comprehensive consideration of the demographic and non-demographic factors that could affect the public finances. Nevertheless, a country with a larger projected increase in age-related spending will, all else being equal, face a greater fiscal challenge over the long term. A more detailed analysis of the long-term trends and sustainability in different countries is presented in Chapter 5 of the 2005 *Long-term public finance report*.

^a Neither OECD nor Eurostat net financial liabilities data is available for three of the EU15 Member States, so they are not included in the chart.

MONETARY POLICY

Monetary policy framework 2.9 Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target. The framework is based on four key principles:

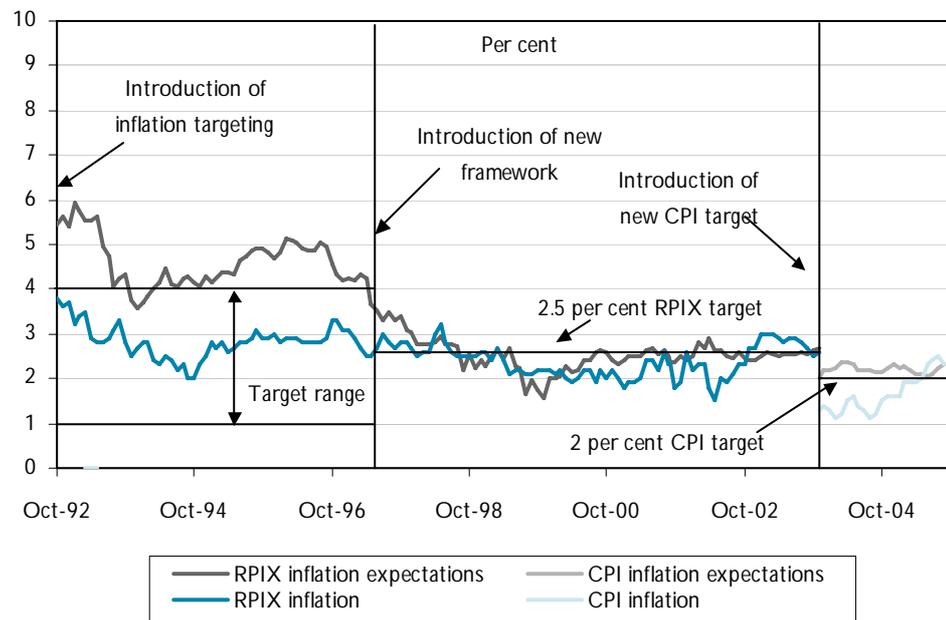
- clear and precise objectives. The objective of monetary policy is to deliver price stability. The adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and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

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

Performance of the monetary policy framework 2.11 The monetary policy framework has improved the credibility of policy making and continues to deliver clear benefits. Since the new framework was introduced:

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, averaged 2.4 per cent, just below the 2.5 per cent RPIX target;
- inflation expectations have remained close to target following the switch to a 2 per cent CPI target. CPI inflation has averaged 1.6 per cent since its inception in December 2003, remaining within 1 percentage point of its target at all times; and
- under both targets, the UK has enjoyed the longest period of sustained low inflation since the late 1960s.

Chart 2.1: Inflation performance and expectations¹



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

2.12 The monetary policy framework has given the MPC the flexibility to respond decisively to unexpected events over recent years. Consistent with its forward-looking approach, the MPC raised interest rates on five occasions from November 2003 to August 2004 to a level of 4¾ per cent. A year later the MPC cut rates by ¼ point responding to the slackening in the pressure of demand on supply capacity.

2.13 Low inflation expectations and a period of entrenched macroeconomic stability have helped UK long-term spot interest rates remain at historically low levels, averaging 4.4 per cent over the year. Ten-year forward rates have also averaged 4.4 per cent this year, marginally above those of the euro area and around ½ percentage point below those in the US.³ This compares with UK forward rates of 8 per cent in April 1997 before the introduction of the new macroeconomic framework. Low long-term interest rates reduce the Government’s debt interest payments, free up resources for public services and help promote investment.

³ Ten year forward rates are market expectations, formed today, of short rates in ten years’ time. They are less affected by short-term factors, such as the current cyclical position of the economy, than spot rates and are therefore a better basis for making international comparisons when cyclical conditions differ.

FISCAL POLICY

Fiscal policy framework

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

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

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

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

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

- the rules are set over the economic cycle. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and
- the rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

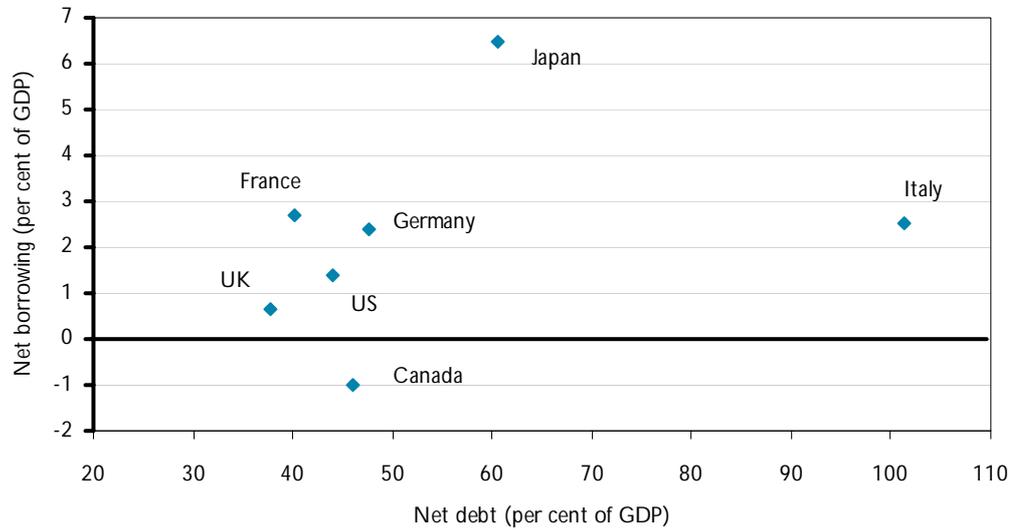
2.17 Details of the Government's performance against the fiscal rules are given in Chapter 4.

End of year fiscal report

2.18 In order to enhance the reporting of fiscal developments an *End of year fiscal report* (EYFR) is published alongside the 2005 Pre-Budget Report. This annual report compares forecasts and outturns of the public finances, identifying the possible reasons for differences. The EYFR helps to foster transparency by enhancing the Government's reporting and analysis of fiscal developments and ensures that the UK is fully in line with international best practice, including the International Monetary Fund's *Code of Good Practices on Fiscal Transparency*.

FISCAL STRATEGY AND SUSTAINABILITY

Chart 2.2 Public finances in the G7, average 1997-2004

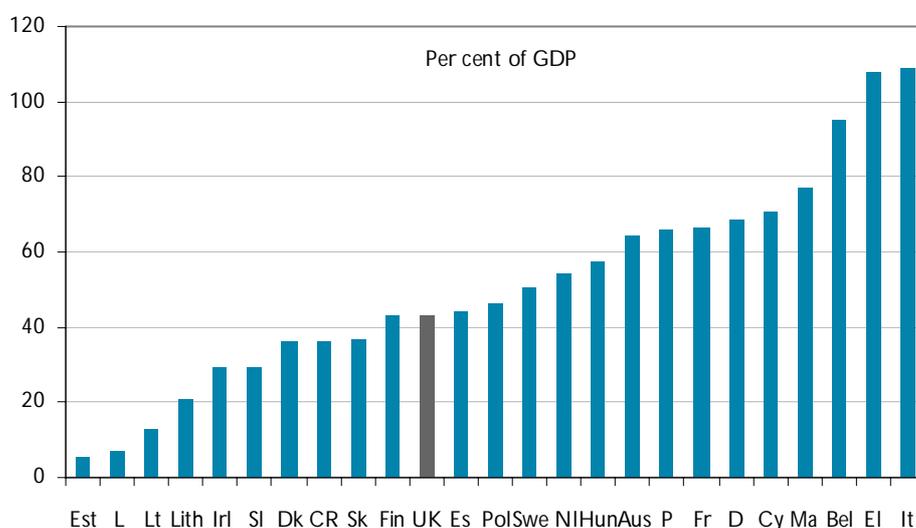


Source: OECD Economic Outlook 77, June 2005

Performance of the fiscal policy framework

2.19 The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by around 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend and reducing the level of net debt. In more recent years, fiscal policy supported monetary policy as the economy moved below trend in 2001, with support moderating as output returned towards trend. As Charts 2.2 and 2.3 show, since 1997 the UK's public finances have compared favourably with other countries.

Chart 2.3 General government gross debt, 2005



Source: *European Commission Autumn Forecasts 2005*

Fiscal balances 2.20 Table 4.1 (in Chapter 4) presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government is meeting its strict fiscal rules over the economic cycle.

2.21 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box 4.3. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in the 2005 Pre-Budget Report, showing that the Government is meeting its fiscal rules over the cycle, while maintaining low debt and sustainable public finances, combined with sustainable increases in public sector net investment, are fully consistent with the Government's prudent interpretation of the Pact.

Box 2.3: Independence for the Office for National Statistics

The Chancellor announced on 28 November 2005 that having reviewed the Framework for National Statistics, which was introduced in 2000, the Government proposes to legislate to make the Office for National Statistics (ONS) independent of government, making the governance and publication of official statistics the responsibility of a wholly separate body at arm's length from government and fully independent of it.

Drawing on the lessons of Bank of England independence, the Treasury will publish plans by early in the New Year to legislate for:

- the creation of an independent Governing Board for the ONS, with delegated responsibility for meeting an overall objective for the statistical system's integrity;
- the appointment of external members to the Board, drawn from leading experts in statistics, and including men and women from academia and business; and
- a new accountability to Parliament through regular reporting by the Board to explain and to be questioned by the Treasury Select Committee on their performance.

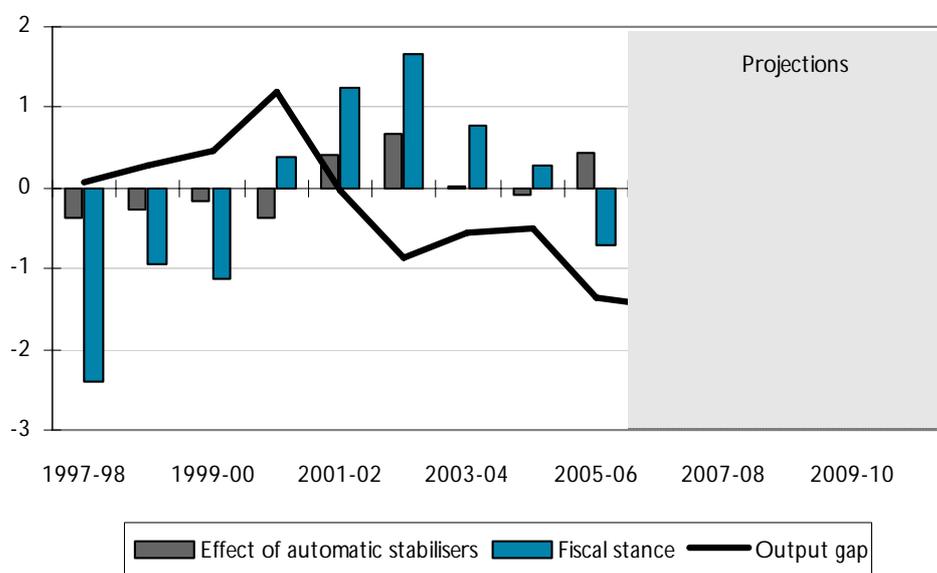
Automatic stabilisers

2.22 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), as shown in Chart 2.4.

2.23 During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy moved below trend in 2001, the automatic stabilisers and the fiscal stance supported the economy, with the degree of support moderating as output moved back towards trend in early 2004. In 2005-06 and 2006-07 there is expected to be a modest tightening in the impact of fiscal policy with the effect of the tighter fiscal stance just outweighing the effect of the automatic stabilisers. The tighter fiscal stance over 2005-06 and 2006-07 reflects the strength of underlying tax receipts from the oil and financial sectors.

2.24 In cyclically-adjusted terms, both public sector net borrowing and general government net borrowing will be 2.2 per cent in 2005-06, falling to 1.4 per cent and 1.5 per cent respectively by the end of the projection period. Actual general government net borrowing on the Treaty definition, will be 3.0 per cent in 2005-06, falling to 2.7 per cent in 2006-07 and to 1.5 per cent by the end of the projection period.

Chart 2.4: Fiscal Policy Supporting Monetary Policy

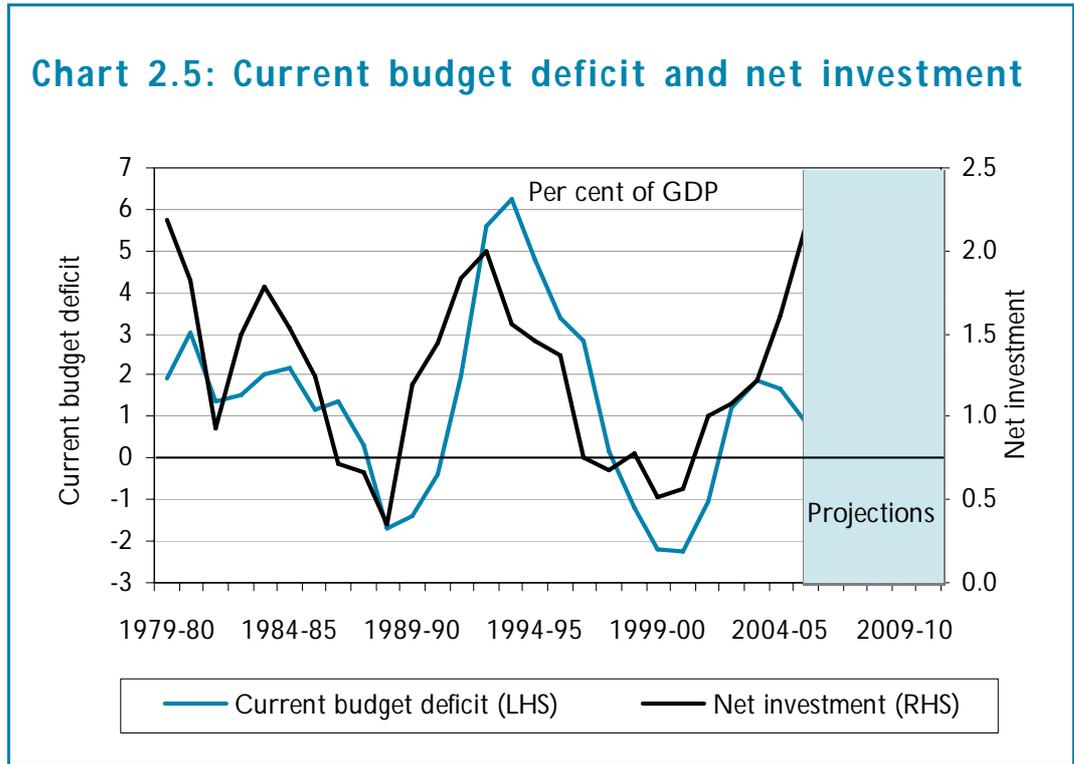


Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, ie the difference between PSNB and the cyclically-adjusted PSNB.

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

2.26 The fiscal framework makes a distinction between capital and current spending and therefore is designed to remove the bias against capital spending. Historically, it has been extremely rare for investment to grow during periods of fiscal consolidation, and prior to the introduction of the macroeconomic framework, it had not happened for 40 years. The effectiveness of the golden rule in eliminating this historic bias against capital spending is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment illustrated in the chart. As Chart 2.5 shows, this pattern of reducing borrowing while maintaining net investment will continue in the coming years.

Chart 2.5: Current budget deficit and net investment



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

- the current budget since the start of the current economic cycle in 1997-98 shows an average surplus up to 2008-09 of 0.1 per cent of GDP, showing the Government is meeting the golden rule on the basis of cautious assumptions;
- with the economy assumed to return to trend in 2008-09, the projections show, based on cautious assumptions, that the average surplus over the period 2008-09 to 2010-11 is $\frac{3}{4}$ per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule after the end of this economic cycle; and
- public sector net debt is projected to be low and stable over the forecast period stabilising at around 38 per cent of GDP, maintaining debt below the 40 per cent of GDP ceiling and meeting the sustainable investment rule.

Box 2.4: Caution in the public finance projections

A number of key assumptions that underpin the public finance projections are independently audited by the Comptroller and Auditor General to ensure that they remain reasonable and cautious. This prudent approach to fiscal policy builds an important safety margin into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending.

For the 2005 Pre-Budget Report, the Comptroller and Auditor General has audited the Treasury's judgement that the end date of the previous economic cycle was in the first half of 1997. The review concluded that, though there were uncertainties, there are reasonable grounds to date the end of the previous cycle to 1997 and that this would not reduce the extent of caution in making the fiscal projections. The NAO will also be asked to audit the end date of the current and future cycles once the Treasury has made a firm judgement.

The public finances continue to be based on a deliberately cautious assumption for trend output growth that is a ¼ percentage point lower than the Government's neutral view. The trend growth audit was due to have been completed at Budget 2005, but it was postponed because the economy was expected to return to trend around the end of 2005. Postponing the audit slightly until after the cycle was complete would have provided the Comptroller and Auditor General with information from an additional on-trend point. As the economy is now expected to return to trend in 2008-09, it is HM Treasury's intention to invite the NAO to complete its next rolling review of the trend growth assumption at Budget 2006.

The Comptroller and Auditor General also audited the oil price assumption and found that it has proved cautious over the three-year rolling review period and remains reasonable.

In addition the Comptroller and Auditor General audited the extension to the VAT forecasting rule in respect of the 2002 VAT strategy. He concluded that it was not possible at this stage to evaluate the degree to which the assumption has proved cautious and reasonable. A final assessment would require firmer direct evidence of the revenue effects of the strategy and would only be possible once final outturn data is available for 2005-06. Many uncertainties remain but HM Revenue and Customs has introduced some caution in the forward estimates by including only part of the forecast impacts in the fiscal projections. In light of the NAO's findings, HM Treasury has indicated that it intends to ask the Comptroller and Auditor General to carry out a further review of the forecasting assumptions that underlie VAT receipts, including those related to the VAT strategy, as part of his audit of Budget assumptions for Budget 2007 or before.

RELEASING RESOURCES FOR HIGH-QUALITY PUBLIC SERVICES

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

- *deliver resources to the front line*, with stable public finances and a reformed fiscal and budgetary framework providing the foundation for sustained increases in resources and investment in public assets;
- *ensure value for money*, to make the most of increased resources and fulfil the Government's obligation to taxpayers to employ resources efficiently and effectively; and
- *reform the delivery of public services*, to strengthen accountability and improve outcomes for society, including higher standards, reduced inequalities and greater user satisfaction.

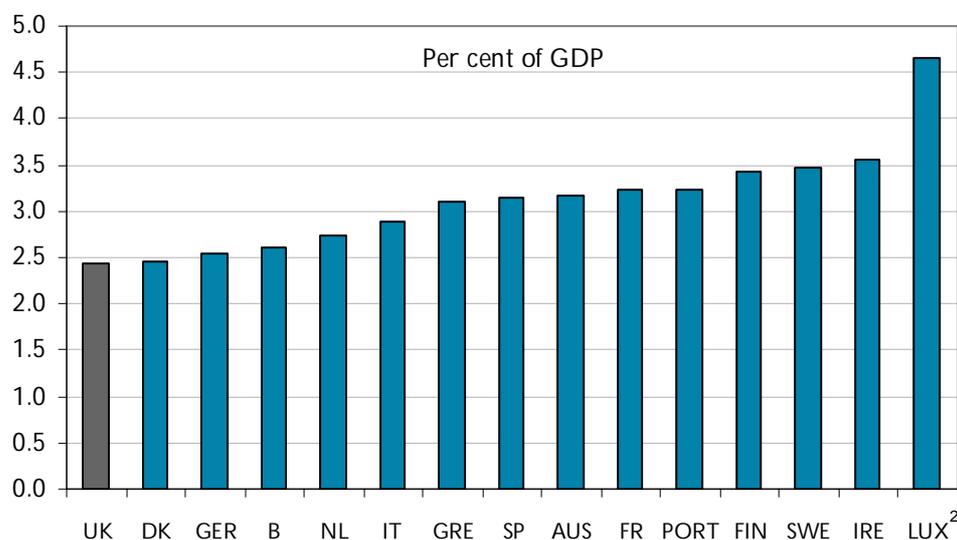
2.29 The fiscal rules underpin the Government's public spending framework. The golden rule increases the efficiency of public spending by ensuring that public investment is not sacrificed to meet short-term current spending pressures. Departments are now given separate allocations for resource and capital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

2.30 This approach is supported by the OECD, who comment that: "*For decades under investment in public infrastructure was an easy option for constraining public outlays. The government's first fiscal rule, the so called "golden rule", distinguishes between capital and current spending, and has helped to avoid such short term expediency. Indeed, the share of government investment in GDP has risen, and there are plans for it to rise further. Nevertheless, even after it rises to just under 2½ per cent of GDP next year, it still remains relatively modest compared with many other OECD countries and may be inadequate to correct years of neglect.*"⁴

2.31 Chart 2.6 shows UK public investment in comparison with other European countries.

⁴ *Economic Survey of the United Kingdom*, OECD, 2005

Chart 2.6: Public investment, 1971 to 2007¹



¹ Figures for 2005, 2006 and 2007 are forecasts.

² Data for Luxembourg is only available for the period 1991 to 2007.

Source: European Commission, Autumn 2005 forecasts

2004 Spending Review **2.32** The 2004 Spending Review set spending plans for the years 2005-06 to 2007-08, locking in the increased investment of previous spending reviews while providing for further investment in the most crucial areas of the public services. These plans provide for:

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

Comprehensive Spending Review **2.33** The overall spending limits set in Budget 2004 and confirmed in the 2004 Spending Review remain sustainable and fully consistent with the fiscal rules. Building on these firm foundations, the second Comprehensive Spending Review (CSR), reporting in 2007, will provide the opportunity for a fundamental and long-term review of the Government's priorities and expenditure. As outlined in more detail in Chapter 6, the CSR will take a zero-based approach to assessing the effectiveness of departments' baseline expenditure in delivering the outputs to which they are committed, and consider the further investments and reforms needed to ensure that Britain's public services are equipped to meet the global challenges of the decades ahead. The CSR will determine spending for 2008-09, 2009-10 and 2010-11, with allocations for 2007-08 held

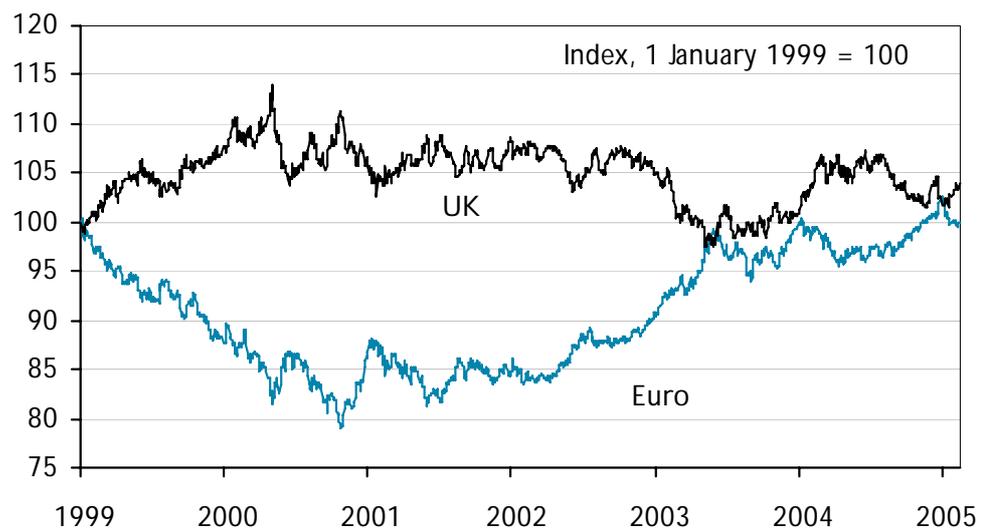
to the agreed figures already announced at the 2004 Spending Review. Chapter 6 provides further details on the CSR.

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.

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.

Chart 2.7: Sterling and the euro effective exchange rate



Source: EcoWin

2.36 Since Budget 2005, there has been a slight depreciation of the sterling effective exchange rate of around 1½ per cent. From a long-term perspective the exchange rate has continued a period of relative stability. Since the introduction of the euro in January 1999, the volatility of the sterling effective exchange rate has been under half that of the euro and under a third that of the US dollar.

ECONOMIC AND MONETARY UNION

2.37 The Government’s policy on membership of the single currency is set out in Box 2.5.

Box 2.5: Government policy on EMU

The Government's policy on membership of the single currency was set out by the Chancellor in a statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor is the national economic interest and whether, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous. An assessment of the five economic tests was published in June 2003, which concluded that: *"since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area."*

As part of the policy of 'prepare and decide', the Government coordinates appropriate euro preparations across the UK economy. The Government also supports business in dealing with the euro as a foreign currency. Further information is available on the Treasury's euro website www.euro.gov.uk.

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the June 2003 assessment, the latest progress report on which was made in Budget 2005. While the Government did not propose a euro assessment to be initiated at the time of Budget 2005, the Treasury will again review the situation at Budget time next year as required by the Chancellor's June 2003 statement.

Long-term economic performance

Flexibility... **2.38** The Government's economic objective is to build a strong economy and fair society, where there is opportunity and security for all. Reforms which promote flexibility and fairness are central to achieving this goal. Rapid technological progress and strong competition in global markets mean that the profitability and competitiveness of different industries and occupations are continually evolving. A flexible economy responds to such changes in economic conditions efficiently and quickly.

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

2.40 Flexible product and capital markets promote stability and wider economic success. Product market flexibility is key in intensifying competition and promoting enterprise and research, enabling firms to remain competitive in the face of economic change. Capital market flexibility allows for a more efficient allocation of capital, provides business with good access to finance and helps share risk across the economy, reducing the UK's overall vulnerability to shocks. More flexible capital markets also provide financial instruments that help consumers and firms to smooth their consumption paths.

2.41 Labour market flexibility is central to the performance of the UK economy. A more flexible and efficient labour market has the ability to adapt more rapidly to changing economic conditions, crucially reducing the period out of equilibrium and maintaining economic stability. Backed up by policies which enable people to adjust to change and provide support for those who are not in employment, labour market flexibility implies an economy that is fairer, more efficient and more competitive.

**...and
productivity**

2.42 The Government's strategy for improving productivity in this global environment has two broad strands: maintaining macroeconomic stability to help businesses and individuals plan for the future; and implementing microeconomic reforms to remove the barriers that prevent markets from functioning efficiently. *Globalisation and the UK: strength and opportunity to meet the economic challenge*, published on 2 December 2005,⁵ considers the factors affecting businesses' decisions as globalisation continues, including comparative advantage and the benefits of clustering, which influence trade and location patterns; and the importance of flexibility and macroeconomic stability in providing a foundation for a prosperous domestic economy. It identifies areas in which the UK is already well placed to meet the challenges of globalisation and where the Government is committed to doing more. The 2005 Pre-Budget Report sets out the Government's plans in these areas, in particular on skills, science and innovation, regulation, planning and land use, and transport infrastructure.

⁵ *Globalisation and the UK: strength and opportunity to meet the economic challenge*, HM Treasury, December 2005.

3

ECONOMIC OUTLOOK

THE WORLD ECONOMY

3.1 The world economy¹ grew at its strongest rate for three decades in 2004, with annual growth of over 5 per cent. World GDP growth has principally been driven by the US and China over the recent past. G7 GDP also grew relatively robustly during 2004, building on the recovery that became established during 2003, although as usual it did not grow as strongly as world GDP.

3.2 World growth in 2005, while still robust, has moderated compared with 2004, due to a combination of high oil product prices, cyclical moderation, and structural factors limiting resilience and adjustment to shocks in some countries. This easing in growth rates looks to have been more pronounced amongst advanced economies, especially the UK's main export markets, with emerging economies showing very little slowing during 2005. These patterns are expected to persist into 2006.

3.3 G7 growth has been led by the US, which has now been growing at or above potential rates for 10 consecutive quarters. Japan has made a marked recovery in the first half of 2005, and prospects for a further improvement in the sustainability of growth have firmed as domestic demand has begun to strengthen. However, euro area growth has been much more subdued, and has continued to under-perform forecasts, with the weakness in activity concentrated amongst the larger EU member states.

3.4 High and volatile oil prices stemming from strong demand growth, constrained spare capacity, and supply uncertainties initially had relatively limited impact on world growth. However, as oil price rises have started to feed through more significantly to higher pump prices, particularly during the summer amidst disruption to US refining capacity arising from hurricanes in the Gulf of Mexico, there has been a more discernible effect on consumption and confidence, especially in some advanced economies. Consequently, growth – while still healthy – has been pared by the negative effects on disposable incomes, profitability, and confidence. Developments also suggest that higher oil prices may be hitting productive potential outside the oil sector.

Table 3.1: The world economy

	Percentage changes on a year earlier unless otherwise stated				
	2004	Forecast			
		2005	2006	2007	2008
<i>Major 7 countries¹</i>					
Real GDP	3½	2½	2½	2½	2½
Consumer price inflation ²	2½	2¾	2¼	1¾	1¾
<i>Euro area</i>					
Real GDP	1¾	1½	1¾	2	2¼
World GDP	5	4¼	4¼	4¼	4
World trade in goods and services	10	6¾	7¾	7¼	7
UK export markets ³	9¼	6	7	6¾	6¼

¹ G7: US, Japan, Germany, France, UK, Italy and Canada.

² Per cent, Q4.

³ Other countries' imports of UK goods and services weighted according to their importance in UK exports.

¹ The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the forecast.

PROSPECTS FOR UK ECONOMIC GROWTH

GDP growth 3.5 The Government's macroeconomic framework has continued to deliver an unprecedented period of sustained and stable economic growth with low inflation. UK GDP has now expanded for 53 consecutive quarters. On the basis of quarterly national accounts data, this is the longest unbroken expansion since records began 50 years ago. Moreover, the current economic expansion has persisted for well over twice the duration of the previous period of unbroken growth, with output having grown by 25 per cent since 1997.

3.6 There have been three significant developments affecting the outlook for GDP growth since Budget 2005: significant statistical revision to the quarterly profile of growth, external shocks such as higher oil prices and weaker demand growth in the euro area, and some weakness in domestically-generated demand growth.

3.7 Extensive revisions to the UK national accounts were published by the Office for National Statistics (ONS) in the 2005 Blue Book dataset on 30 June. While GDP growth rates in 2001, 2002, 2003 and 2004 have all been revised up, the quarterly profile of growth through the course of last year now looks very different. Quarterly GDP growth is now estimated to have slowed from over 1 per cent in the first quarter of 2004 to just 0.3 per cent by the third quarter. The previous vintage of data had shown less strong growth through the year to early 2004, and a far less pronounced slowdown in the course of 2004. These 2004 data revisions since Budget 2005 arithmetically deduct almost $\frac{1}{2}$ percentage point from forecast growth for 2005 as a whole for any given quarterly growth path through 2005.

3.8 Other evidence, such as private business survey indicators, as well as labour market data, point to a less sharp slowing of growth around the middle of 2004, with a more even distribution of growth throughout the year. The distribution of growth in 2004 now looks particularly skewed, with strong above-trend growth in the first half followed by significantly below-trend growth in the second half.

3.9 The latest GDP data suggest that the economy entered 2005 with considerably less momentum than implicit in the Budget 2005 forecast. Moreover, growth is currently estimated to have remained significantly below its estimated trend rate (of around 0.7 per cent a quarter) in the first three quarters of 2005. GDP rose by 0.3 per cent in the first quarter, 0.5 per cent in the second quarter, and 0.4 per cent in the third quarter.

3.10 Non-oil GVA, which is the basis for Treasury estimates of trend growth, rose slightly more than total GDP in the third quarter, growing by 0.6 per cent on the quarter. This wedge between GVA and non-oil GVA growth reflects a particularly sharp drop in oil and gas production in the late summer, resulting from delayed maintenance work and the effects of a fire at BP's Schiehallion field which shut in some 100,000 barrels per day of production for three weeks in August.

3.11 Unexpected rises in oil prices, with Brent crude prices reaching new record highs in September of \$67 a barrel, have boosted inflation and had a negative impact on growth of demand and output. The stronger than expected rise in inflation over the past year, alongside weaker than expected and below-trend rates of GDP growth, is consistent with the view that the UK economy has experienced a negative supply-side shock as a result of the sustained increase in oil prices, as discussed in Box 3.1. At the same time, demand in the euro area – which accounts for around 50 per cent of UK

exports – has continued to grow at relatively subdued rates, significantly depressing UK export markets growth compared with expectations at the time of Budget 2005.

Box 3.1: The effect of oil prices on the UK's economy and public finances

Since Budget 2005, oil prices have significantly exceeded market expectations, as a result of robust demand growth, constrained spare capacity and supply disruptions. As a result of these developments, market forecasters have increased their expectation of the medium-term outlook for oil prices. Prices are expected to moderate from current high levels, but to be sustained at a higher level than the average over the last 20 years.

Despite the trade benefit from the UK still being a small net exporter of oil, increased petroleum costs still raise input costs and factory gate prices, reducing real incomes outside of the oil sector. Energy price rises have reduced real household disposable income growth, slowing private consumption growth by more than was expected in the Budget 2005 forecast. Evidence of higher than expected inflation and GDP growing at sub-trend rates is consistent with a negative supply shock to the economy from higher oil prices. Overall, the positive income effects derived by the UK's oil sector are outweighed by the negative effects of high oil prices on the rest of the economy.

Despite the large increases in consumer energy costs, overall UK inflation has been contained and inflation expectations have remained firmly anchored at close to the Government's symmetrical 2 per cent target, in contrast with the UK's past experience of high oil prices.

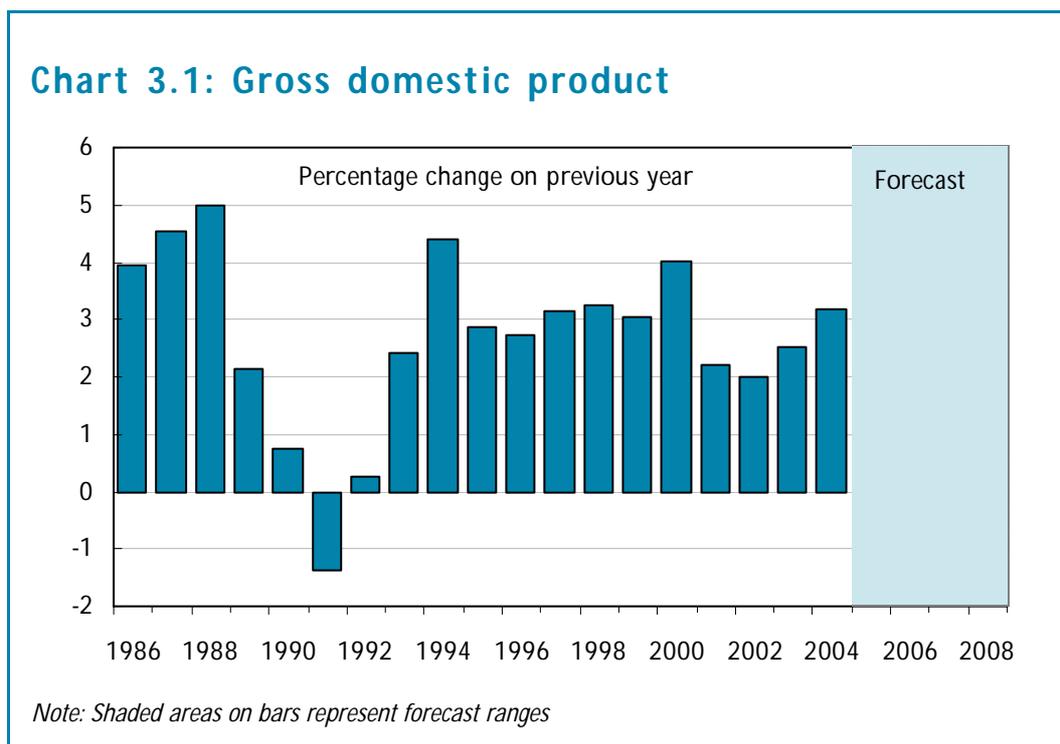
Oil prices also have an effect on the UK's public finances. Other things being equal, higher oil prices boost the tax take from petroleum revenue tax and North Sea corporation tax. There are a number of offsetting effects that limit the impact on the public finances as a whole. The scale of these offsetting effects, and in particular the effects that operate through the economic forecast, are extremely uncertain as they will depend on the response of individuals and businesses to rising prices. There will also be important timing effects, with any effects on inflation or the wider economy taking time to affect the public finances. The offsetting effects include those from:

- higher pump prices, which reduces demand for road fuels and therefore reduces revenues from fuel duties;
- any temporary increase in inflation, which increases the indexation of allowances and limits for income tax and national insurance contributions and of indexation of tax credits and social security benefits; and
- possible impacts on the wider economy, as discussed above. In particular, other things being equal, higher input prices may reduce companies' profit margins, reducing their profitability and therefore reducing receipts of non-North Sea corporation tax.

Overall, even after the North Sea oil measure announced in this Pre-Budget Report, the effects of oil prices on the public finances are broadly neutral.

3.12 In addition to these external shocks there has also been some weakness in domestically-generated demand growth. In particular, average earnings growth has been slower than expected, which has further reduced spending power. At a time of a slowdown in house price growth, this slower earnings growth has further contributed to the slowdown in consumption growth.

3.13 Chart 3.1 shows the evolution of GDP.



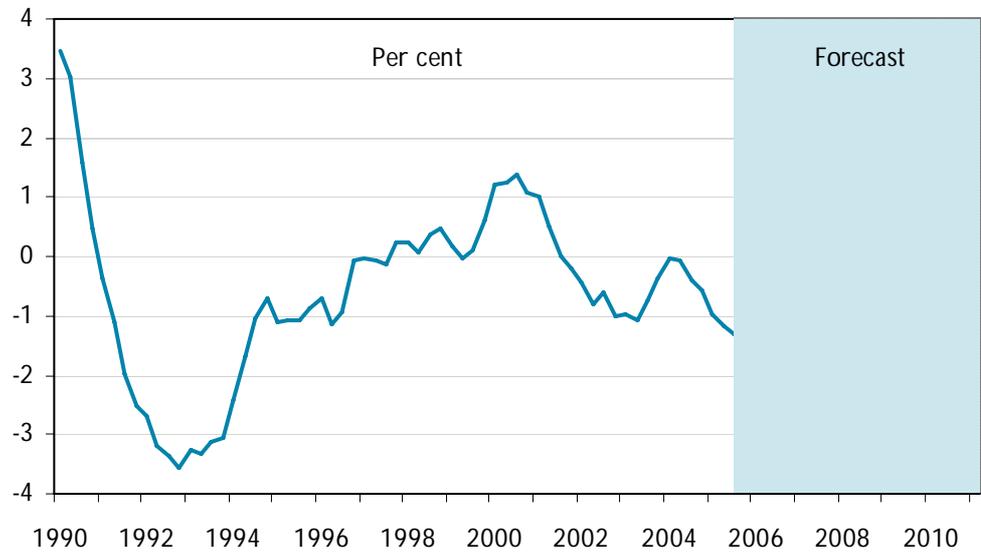
Economic cycle and the output gap

3.14 The Treasury's neutral estimate of the economy's trend output growth rate for the 2005 Pre-Budget Report is 2¾ percent a year to the end of 2006, slowing to 2½ per cent thereafter due to demographic effects, unchanged from Budget 2005.

3.15 As set out above, the recent significant revisions to non-oil GVA data released by the Office for National Statistics in June, supported by new data on market sector GVA, led the Treasury to revise its provisional judgement that the current cycle started in mid-1999. The Treasury's revised judgement is that the current economic cycle began in the first half of 1997, rather than in 1999. This assessment was set out in *Evidence on the UK economic cycle*² published by the Treasury in July 2005, and is discussed in Box 3.2. This revised assessment does not have implications for the output gap profile during the current down-phase of the cycle, because the assessment of the third quarter of 2001 as the latest on-trend point and the projection for trend output growth thereafter remain unchanged.

² *Evidence on the UK economic cycle*, HM Treasury, July 2005

Chart 3.2: The output gap¹



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

Box 3.2: Evidence on the UK economic cycle

Estimation of the economy's trend growth and cyclical position is central to the Treasury's assessment of economic prospects and the setting of fiscal policy. In June 2005, the Office of National Statistics (ONS) published significant revisions to GDP and Gross Value Added (GVA) dating back to 1996. Around the same time the ONS also published an experimental series for market sector GVA, which provides an alternative basis for measuring the economic cycle. In response to this new information, in July 2005, HM Treasury published a paper, *Evidence on the UK economic cycle*, presenting analysis of evidence relevant to the dating of the economic cycle.

At the time of Budget 2000, the Treasury made the provisional judgement that the economy may have completed a full cycle between 1997H1 and mid-1999. This judgement was provisional because the cycle was clearly indistinct by historical standards. Subsequent data revision up until Budget 2005 continued to show only an indistinct dip below trend in 1999, so this judgement remained provisional.

The revisions to GVA published by the ONS in June included a significant upward revision to 1999 GVA growth of 0.5 percentage points, with non-oil GVA growth in 1999 revised up to 3.1 per cent, from 1.8 per cent estimated at the time of Budget 2000. This significantly changed the profile of the economic cycle around 1999. There is now no evidence of a clear dip below trend in early 1999. So the below-trend phase of the previously identified 1997H1 to mid-1999 'cycle' now looks non-existent.

Chart (a): Whole economy GVA output gap estimates and data revisions

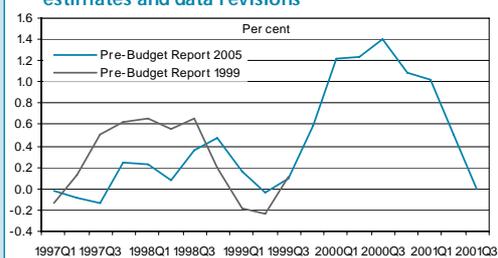
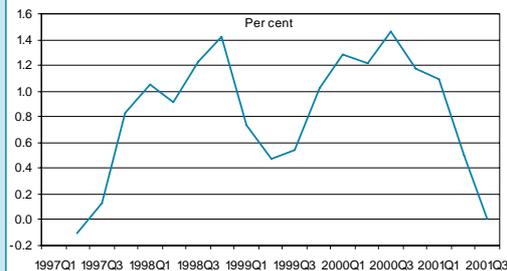


Chart (b): Market sector output gap



New market sector GVA data also released by the ONS in June 2005 reinforce the view that mid-1999 was not an end or start point of the economic cycle. As discussed in Budget 2005, market sector output may provide a better basis than whole economy output for measuring the output gap, because cycles are essentially a feature of the market sector. On the basis of these new market sector GVA data, output did not touch trend in 1999, remaining notably above trend throughout the period from the end of 1997 through to early 2001. New analysis by the Treasury of data on the labour share of value added offers further evidence on the dating of the latest cycle.

In conclusion, the recent revisions to GVA provide significant new information on the timing of the economic cycle since 1997. This evidence shows that while the economy was close to trend in 1999, this was not a period when the economy could be judged to have been at the end of a cycle or the beginning of a new one. Therefore, the Treasury's revised judgement, based on this new evidence, is that the current economic cycle began in the first half of 1997, rather than in 1999. This conclusion is corroborated by new data from the ONS for market sector GVA and new analysis of the labour share of value added.

Inflation 3.16 CPI inflation rose gradually from autumn 2004 through to September 2005, primarily reflecting the effects of higher oil prices on domestic fuel and energy prices,

which directly accounted for over half of the increase in inflation. Core inflation, which excludes energy prices and the volatile food component of the CPI, has remained at lower rates, although has still shown some pick-up through the course of this year, possibly in part reflecting the indirect effects of oil prices working their way through the supply chain. CPI inflation peaked at 2.5 per cent in September, up from 1.9 per cent at the time of the 2005 Budget. It eased back in October to 2.3 per cent. The pick-up in UK CPI inflation over the past year is similar to that seen in other major economies and UK inflation remains close to the European average.

3.17 CPI inflation is expected to ease back gradually, while remaining a little above target in coming months as the effects of higher world oil prices continue to work through to consumer prices. It is then forecast to dip slightly below target later in 2006, as the effects of previous energy price rises abate and ongoing slack in the economy continues to put downward pressure on domestically generated inflation, before returning to its 2 per cent target in 2007 as the output gap narrows and import prices continue to rise. The credibility of the Government's monetary policy framework is expected to continue to contribute in keeping inflation close to target through anchoring inflation expectations.

3.18 Against the backdrop of a strong world economy and above-trend UK GDP growth in late 2003 and into 2004, the independent Monetary Policy Committee (MPC) of the Bank of England pre-emptively raised interest rates by 25 basis points on five occasions between November 2003 and August 2004. With UK GDP growth dipping below trend, the MPC reduced the repo rate by 25 basis points on 4 August 2005. The 125 basis point increase in the repo rate, together with the slowdown in house price inflation, despite no surprises on either score relative to what was known or expected at Budget 2005, may also have contributed to the unforeseen slowdown in GDP growth by having a somewhat more pronounced impact on the economy than envisaged. A slightly expansionary fiscal stance supported the economy as output moved back towards trend in early 2004. In 2005-06 and 2006-07 there is expected to be a modest tightening in the impact of fiscal policy, with the effect of the tighter fiscal stance just outweighing the effect of the automatic stabilisers.

EMPLOYMENT

Employment 3.19 UK employment has continued to rise strongly, as the Government's supply-side reforms help create a more dynamic and flexible labour market. Further strong growth in the population of working age has been readily translated into employment, with only a very small rise in unemployment. The level of employment increased by 1¼ per cent in the year to the third quarter of 2005, the strongest rise in 18 months, with the employment rate steady over the past year or so. Despite robust employment growth, average earnings growth has been lower than expected.

Unemployment 3.20 UK unemployment, meanwhile, has fallen (on the conventional International Labour Organisation definition) to 4.7 per cent; down from 7.2 per cent in 1997 and around the lowest rate in 30 years. The UK unemployment rate is now the second lowest of the G7 economies.

CONSUMPTION

3.21 Real private consumption growth is estimated to have slowed sharply from the middle of 2004, with four-quarter growth falling from a rate of almost 4 per cent towards

the end of last year to just 1.6 per cent by the second quarter of 2005. A number of expected and unexpected developments have contributed to this slowdown.

3.22 The slowdown in the UK housing market since mid-2004 has been much as expected, and households have continued to adjust to high levels of personal debt by paying off borrowing and maintaining saving rates.

3.23 However, relative to the Budget forecast, the sustained and unexpected rise in oil prices has had the effect of raising consumer prices and thus reducing real household income growth, with a direct estimated impact on real income growth in the year to mid-2005 of up to 0.5 percentage points. In addition, uncertainty regarding future oil prices may have also served to dampen consumer confidence in recent months, further adversely affecting household expenditure growth. At the same time, average earnings growth has turned out lower than expected, also reducing households' spending power. In the year to the third quarter of 2005, average earnings rose by only just over 4 per cent on a year earlier, compared with the average of independent forecasts at the time of Budget 2005 of 4½ per cent for the year as whole.

3.24 Private consumption is expected to pick up slightly as the lagged effects of previous rises in oil prices diminish, and growth in real household disposable income picks up, although in 2006 oil prices are still expected to exert a drag and earnings growth is expected to remain subdued. So following growth of 1¾ per cent in 2005, private consumption is forecast to grow by 1¾ to 2¼ per cent next year, by 2¼ to 2¾ per cent in 2007 and by 2½ to 3 per cent in 2008, below GDP growth in each year of the forecast.

INVESTMENT

3.25 Business investment growth is estimated to have been relatively subdued in recent quarters, although early estimates are prone to large revisions. Over the first three quarters of 2005 business investment was 3 per cent up on a year earlier. Ongoing weak demand growth in the euro area has dampened demand for UK exports which, alongside muted private consumption expenditure growth, is likely to have encouraged the corporate sector to postpone capital spending decisions. Moreover, corporate gearing remains at historically high levels so, despite strong profitability, continued balance sheet concerns may also have motivated companies to continue adopting a cautious approach to investing, as is happening in a number of advanced economies.

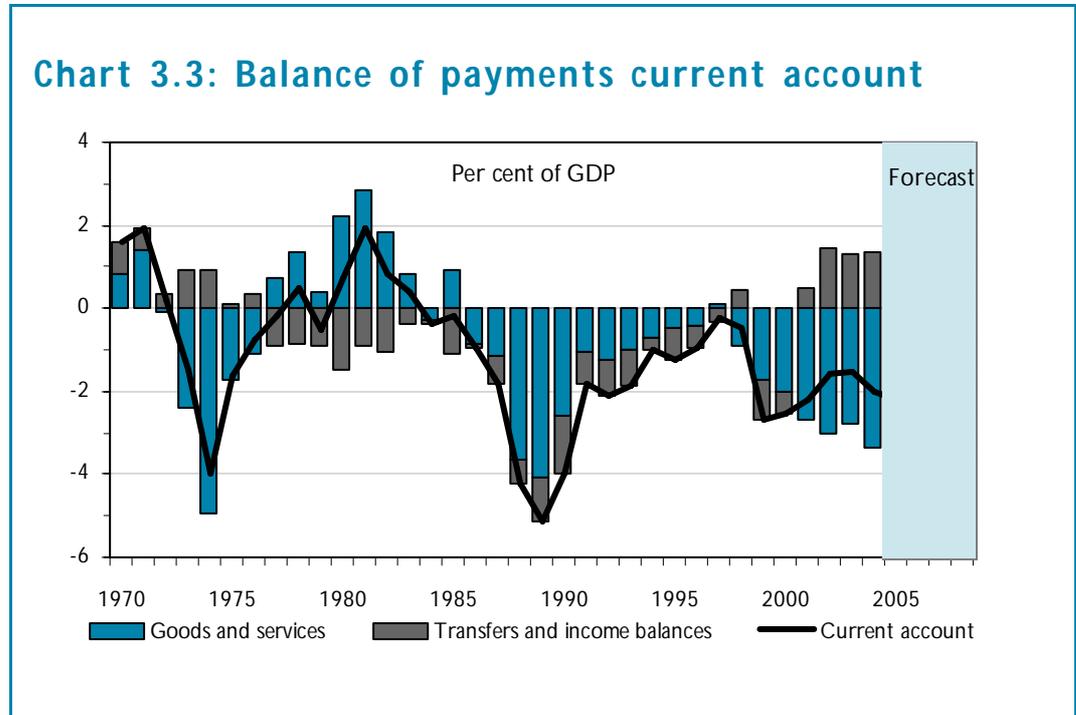
3.26 Below-trend GDP growth and high oil prices are expected to keep business investment subdued in the short term with growth of 3 per cent in 2005 as a whole. However, healthy rates of profitability and a benign financial environment should underpin strengthening rates of growth in private sector capital expenditure in 2006 and 2007 as companies respond to the expected acceleration of demand. So business investment is forecast to rise by 3 to 3½ per cent in 2006 and 4½ to 5¼ per cent in 2007.

TRADE AND THE BALANCE OF PAYMENTS

3.27 UK trade data have been particularly erratic over the recent past and have again been distorted by Missing Trader fraud. The higher than usual degree of noise has made it very difficult to interpret the recent trade data.

3.28 Total UK export volumes of goods and services are estimated to have risen by around 5½ per cent in the year to the third quarter of 2005, following similar growth in the year to the second quarter. However, recent quarterly growth has varied a lot, with a fall of ¾

per cent in the first quarter of 2005 followed by rises of 4¼ per cent in the second and ¾ per cent in the third. This masks an erratically large increase in goods exports in June, followed by an almost identical dip in July, which boosted second quarter growth and depressed that in the third. The underlying rise in exports over the recent past is thought to have been weaker than these data suggest, partly because of the effects of Missing Trader fraud.



3.29 External demand for UK output from non-EU countries appears to have remained significantly stronger than from the EU. In the third quarter of 2005, the volume of goods exports to non-EU countries was up by around 13 per cent on a year earlier, compared with growth of only around 4 per cent for goods exports to the EU, although Missing Trader activity is likely to have distorted these patterns somewhat.

3.30 Exports of services have remained broadly flat in recent quarters, although the UK has continued to maintain a robust surplus in services trade at close to record levels. Services trade in the third quarter was distorted by the recording of insurance payments relating to Hurricane Katrina.

INDEPENDENT FORECASTERS

3.31 The November average of independent forecasts for UK GDP growth in 2005 is 1.7 per cent, in line with the Pre-Budget Report 2005 forecast. For 2006, the latest independent average is for GDP growth of 2.1 per cent, just slightly below the middle of the Pre-Budget Report forecast range. Many prominent forecasting organisations are closely clustered around 2¼ per cent. The average of independent forecasts for CPI inflation shows it continuing to run above target in the fourth quarter of 2005, at 2.4 per cent, before dipping marginally below target by the end of 2006.

3.32 Despite growth for 2005 as a whole now expected to come in below the Budget 2005 forecast range, Treasury forecasts have still, on average, outperformed the independent consensus since 1997. Indeed, in a sample that includes Goldman Sachs, the IMF, the OECD, NIESR, the OEF, EC, HSBC, Deutsche Bank and JP Morgan, the Treasury has had the best GDP growth forecasting record of all since 1997.

SUMMARY OF ECONOMIC PROSPECTS

Table 3.2: Summary of economic prospects¹

	Percentage change on year earlier unless otherwise stated					Average errors from past forecasts ⁵
	Forecast ^{2, 3, 4}					
	2004	2005	2006	2007	2008	
Output at constant market prices						
Gross domestic product (GDP)	3¼	1¾	2 to 2½	2¾ to 3¼	2¾ to 3¼	½
Manufacturing output	2	-½	1 to 1¼	1¾ to 2¼	1¾ to 2¼	1½
Expenditure components of GDP at constant market prices⁶						
Domestic demand	3¾	1¾	2 to 2½	2¾ to 3¼	2¾ to 3¼	¾
Household consumption ⁷	3¾	1¾	1¾ to 2¼	2¼ to 2¾	2½ to 3	1
General government consumption	2½	1½	2	2½	2½	1¼
Fixed investment	5	2¾	3¾ to 4¼	4¾ to 5¼	4¼ to 4¾	2¼
Change in inventories ⁸	0	0	0	0	0	¼
Exports of goods and services	4	4¾	5 to 0	5¼ to 5¾	5 to 5½	2
Imports of goods and services	6	4¾	4½ to 5	4¾ to 5¼	4¾ to 5¼	2¼
Balance of payments current account						
£ billion	-23¼	-26½	-30	-32¾	-35¾	10
per cent of GDP	-2	-2¼	-2¼	-2½	-2½	¾
Inflation						
CPI (Q4)	1¼	2¼	1¾	2	2	-
Producer output prices (Q4) ⁹	3½	2¾	1¼	2	2	1
GDP deflator at market prices	2	2½	2½	2½	2¾	¾
Money GDP at market prices						
£ billion	1164	1212	1267 to 1273	1338 to 1350	1413 to 1433	9
percentage change	5¼	4¼	4½ to 5	5½ to 6	5¾ to 6¼	¾

¹ The forecast is consistent with output, income and expenditure data for the third quarter of 2005, released by the Office for National Statistics on 25 November 2005.

² All growth rates in tables throughout this annex are rounded to the nearest ¼ percentage point.

³ As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2¾ per cent to the end of 2006 and 2½ per cent thereafter. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances, which is ¼ percentage point below the neutral assumption.

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

⁵ Average absolute errors for year-ahead projections made in autumn forecasts over the past 10 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 2005 and 2006.

⁶ Further detail on the expenditure components of GDP is given in Table A10.

⁷ Includes households and non-profit institutions serving households.

⁸ Contribution to GDP growth, percentage points.

⁹ Excluding excise duties.

4

OUTLOOK FOR THE PUBLIC FINANCES

4.1 Since 1997, 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. This chapter sets out projections for the public finances, which continue to be based on prudent and cautious assumptions.

4.2 Table 4.1 shows 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			Estimate				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Fairness and prudence								
Surplus on current budget	-1.9	-1.7	-0.9	-0.3	0.0	0.5	0.7	0.8
Average surplus since 1997-98	0.5	0.2	0.1	0.1	0.0	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	-1.4	-1.3	-0.1	0.7	0.7	0.7	0.7	0.8
Long-term sustainability								
Public sector net debt ¹	32.8	34.7	36.5	37.4	37.9	38.2	38.2	38.2
Core debt ¹	32.5	34.1	35.1	35.1	35.1	35.3	35.5	35.6
Net worth ²	28.5	29.1	26.6	25.7	25.3	25.5	24.6	24.0
Primary balance	-1.5	-1.7	-1.3	-0.9	-0.5	-0.1	0.2	0.3
Economic impact								
Net investment	1.2	1.6	2.1	2.3	2.3	2.3	2.3	2.3
Public sector net borrowing (PSNB)	3.1	3.3	3.0	2.6	2.3	1.8	1.6	1.4
Cyclically-adjusted PSNB	2.7	2.9	2.2	1.6	1.6	1.6	1.5	1.4
Financing								
Central government net cash requirement	3.5	3.3	3.5	3.1	2.7	2.2	2.2	1.8
European commitments								
Treaty deficit ³	3.1	3.3	3.0	2.7	2.4	1.9	1.6	1.5
Cyclically-adjusted Treaty deficit ³	2.6	2.9	2.2	1.7	1.7	1.7	1.6	1.5
Treaty debt ratio ⁴	39.4	40.9	43.3	44.4	44.8	44.7	44.6	44.4
<i>Memo: Output gap</i>	-0.5	-0.5	-1.4	-1.5	-0.7	-0.1	0.0	0.0

¹ At end March, GDP centred on end March.

² At end December GDP centred on end December

³ General government net borrowing on a Maastricht basis.

⁴ General government gross debt on a Maastricht basis.

MEETING THE FISCAL RULES

Golden rule 4.3 The surplus on the current budget represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to

which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of inter-generational fairness.

4.4 The average surplus on the current budget since 1997-98 is in balance or surplus in every year of the projection period. The economy is projected to return to trend in 2008-09, meaning that over the whole cycle the average surplus on the current budget would be 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £16 billion in this cycle, including the Annually Managed Expenditure (AME) margin.

4.5 With the economy assumed to return to trend in 2008-09, the projections show, based on cautious assumptions, that the average surplus over the period 2008-09 to 2010-11 is $\frac{3}{4}$ per cent of GDP. At this early stage, and based on cautious assumptions, the Government will therefore continue to meet the golden rule after the end of this economic cycle.

Sustainable investment rule

4.6 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector net debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

4.7 Public sector net debt is expected to stabilise at around 38 per cent of GDP from 2007-08. Therefore the Government continues to meet its sustainable investment rule while continuing to borrow to fund increased long-term capital investment in public services. The UK also projects core debt which excludes the estimated impact of the economic cycle on net debt. Core debt rises only modestly from 35 per cent to around 35½ per cent of GDP at the end of the medium term horizon.

European commitments

4.8 Table 4.1 shows the Pre-Budget Report projections in the context of 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 4.3), which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty).

4.9 With net debt forecast to stabilise at around 38 per cent from 2007-08, and general government gross debt forecast to stabilise at around 44 per cent from 2006-07, the Government is demonstrating its continued commitment to long-term sustainability and meets the EU Treaty reference value for general government gross debt by a considerable margin. This is also consistent with the increased focus on sustainability in the recent reforms to the Stability and Growth Pact.

4.10 The UK's low debt levels and sustainable fiscal position provide the Government with the flexibility to invest in its public services (see Chapter 6 for further details). Against this background, and consistent with both the Broad Economic Policy Guidelines and the UK's Lisbon National Reform Programme, the projections contained in Table 4.1 demonstrate the Government's commitment to address the historical under-investment in public services in the UK. Public sector net investment is maintained at 2¼ per cent of GDP from 2006-07.

4.11 General government net borrowing as a percentage of GDP, on the Treaty definition, is projected to fall from 3.3 per cent in 2004-05 to 3.0 per cent in 2005-06, 2.7 per cent in 2006-07 and then further to 1.5 per cent by 2010-11. The cyclically-adjusted

Treaty deficit will fall from 2.9 per cent in 2004-05 to 2.2 per cent in 2005-06, and then to 1.5 per cent by 2010-11. Taking into account borrowing for investment, as specified in the EU Treaty and Council Regulation (EC) No 1055/05, this is consistent with the UK's medium-term budgetary objective and with meeting the Government's fiscal rules, of maintaining the current budget in balance or surplus over the cycle and maintaining net debt below 40 per cent of GDP, which is also consistent with maintaining gross debt well below 60 per cent of GDP.

4.12 The principles that guide the Government's approach to fiscal policy are set out in the *Code for fiscal stability*. The Government's fiscal policy objectives are stated in each Budget and Pre-Budget Report and are repeated in paragraph 2.15 of this updated Programme.

Current and capital budgets

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

Table 4.2: Current and capital budgets

	Outturn 2004-05	Estimate 2005-06	Per cent of GDP Projections				
			2006-07	2007-08	2008-09	2009-10	2010-11
Current budget							
Current receipts ¹	38.1	39.4	40.2	40.5	40.6	40.7	40.7
Current expenditure ¹	38.6	39.0	39.3	39.2	38.8	38.7	38.6
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget	-1.7	-0.9	-0.3	0.0	0.5	0.7	0.8
Capital budget							
Gross investment	3.4	3.9	4.1	4.0	3.9	3.9	3.8
Less asset sales	-0.5	-0.5	-0.5	-0.4	-0.3	-0.3	-0.3
Less depreciation	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Net investment	1.6	2.1	2.3	2.3	2.3	2.3	2.3
Net borrowing	3.3	3.0	2.6	2.3	1.8	1.6	1.4
Public sector net debt - end year	34.7	36.5	37.4	37.9	38.2	38.2	38.2
<i>Memos:</i>							
Treaty deficit ²	3.3	3.0	2.7	2.4	1.9	1.6	1.5
Treaty debt ratio ³	40.9	43.3	44.4	44.8	44.7	44.6	44.4

¹ On a national definitions basis.

² General government net borrowing on a Maastricht basis.

³ General government gross debt on a Maastricht basis.

ECONOMIC ASSUMPTIONS FOR THE FISCAL PROJECTIONS

The cautious approach

4.14 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 output growth represented by the lower end of the forecast range in Chapter 3. That is, trend growth of 2½ per cent a year up to 2006-07, ¼ percentage point lower than the Government's neutral view. The Government's neutral view of trend output growth is reduced to 2½ per cent between 2007-08 and 2010-11, and so, to maintain a cautious approach, an assumption of 2¼ per cent is used in the public finance projections, still ¼ percentage point lower than the Government's neutral view.

4.15 The main domestic economic assumptions are summarised in Table 4.3. Table 3.1 (in Chapter 3) summarises the main world economic assumptions.

Table 4.3: Economic assumptions for the public finance projections

	Percentage change on previous year						
	Outturn	Estimate	Projections				
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Output (GDP)	2¾	1¾	2¼	3	2¾	2¼	2¼
Prices							
CPI	1½	2¼	2	2	2	2	2
GDP deflator	2¼	2½	2½	2¾	2¾	2¾	2¾
RPI ¹ (September)	3	2¾	2½	2¾	2¾	2¾	2¾
Rossi ² (September)	1¼	2	2	2¼	2¼	2¼	2¼
Money GDP ³ (£ billion)	1176	1225	1283	1357	1431	1503	1577

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

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

³ Not seasonally adjusted.

4.16 As detailed in Box 4.1, a number of key assumptions that underpin the public finance projections are audited by the Comptroller and Auditor General under a three-year rolling review to ensure that they remain reasonable and cautious. This prudent approach to fiscal policy builds in a safety margin against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in taxation or spending. Oil prices are expected to average \$56 a barrel in 2006, in line with the average of independent forecasts, as this is lower than the average of oil prices over the three months prior to the 2005 Pre-Budget Report.

Box 4.1: Key assumptions audited by the NAO^a

Dating of the cycle ^e	The end date of the previous economic cycle was in the first half of 1997.
Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth	2½ per cent a year to 2006-07 and 2¼ per cent in subsequent years.
UK claimant unemployment ^d	Rising slowly to 0.97 million in 2007-08, from recent levels of 0.87 million.
Interest rates	3-month market rates change in line with market expectations (as of 24 November).
Equity prices ^b	FTSE All-share index rises from 2776 (close 24 November) in line with money GDP.
VAT ^{b,c,e}	The VAT gap will rise by 0.5 percentage points per year from a level that is at least as high as the estimated outturn for the current year.
Consistency of price indices ^b	Projections of price indices used to project the public finances are consistent with CPI.
Composition of GDP ^c	Shares of labour income and profits in national income are broadly constant in the medium term.
Funding ^c	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Oil prices ^e	\$56 a barrel in 2006, the average of independent forecasts, and then constant in real terms.
Tobacco	The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For the 2005 Pre-Budget Report, a share of 16 per cent is used for 2003-04 onwards.

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

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

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

^d Audit of Assumptions for the 2005 Budget, 16 March 2005 (HC452).

^e Audit of Assumptions for the 2005 Pre-Budget Report, 5 December 2005 (HC707).

Forecast Differences and Risks

4.17 The fiscal balances represent the difference between large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been around 1 per cent of GDP. These tend to grow as the forecast horizon lengthens. A full account of differences between the projections made in Budget 2003 and Budget 2004 and the subsequent outturns is provided in the *End of year fiscal report*.

Box 4.2: Forecasting

The table below provides a summary of comparison of the year-ahead projections for main fiscal aggregates in Budget 2003 and Budget 2004 compared with the latest outturn information. More information is set out in the 2005 *End of year fiscal report*.

	Per cent of GDP					
	2003-04			2004-05		
	Budget 2003 Forecast	Outturn	Difference	Budget 2004 Forecast	Outturn	Difference
Surplus on current budget	-0.8	-1.9	-1.1	-0.9	-1.7	-0.8
<i>Memo: average absolute difference, current budget, since 1998-99</i>			1.1			1.1
Cyclically-adjusted surplus on current budget	0.2	-1.4	-1.6	-0.2	-1.3	-1.1
Public sector net borrowing	2.5	3.1	0.6	2.8	3.3	0.5
<i>Memo: average absolute difference, net borrowing, since 1970-71</i>			1.2			1.2
Cyclically-adjusted public sector net borrowing	1.5	2.7	1.1	2.1	2.9	0.8
Public sector net debt	32.2	32.8	0.7	34.4	34.7	0.3

4.18 As set out in Chapter 3, despite growth for 2005 as a whole now expected to come in below the UK Budget 2005 forecast range, UK Treasury forecasts have still, on average, outperformed the independent consensus since 1997. Indeed, in a sample that includes Goldman Sachs, the IMF, the OECD, NIESR, the OEF, EC, HSBC, Deutsche Bank and JP Morgan, the Treasury has had the best GDP growth forecasting record of all since 1997.

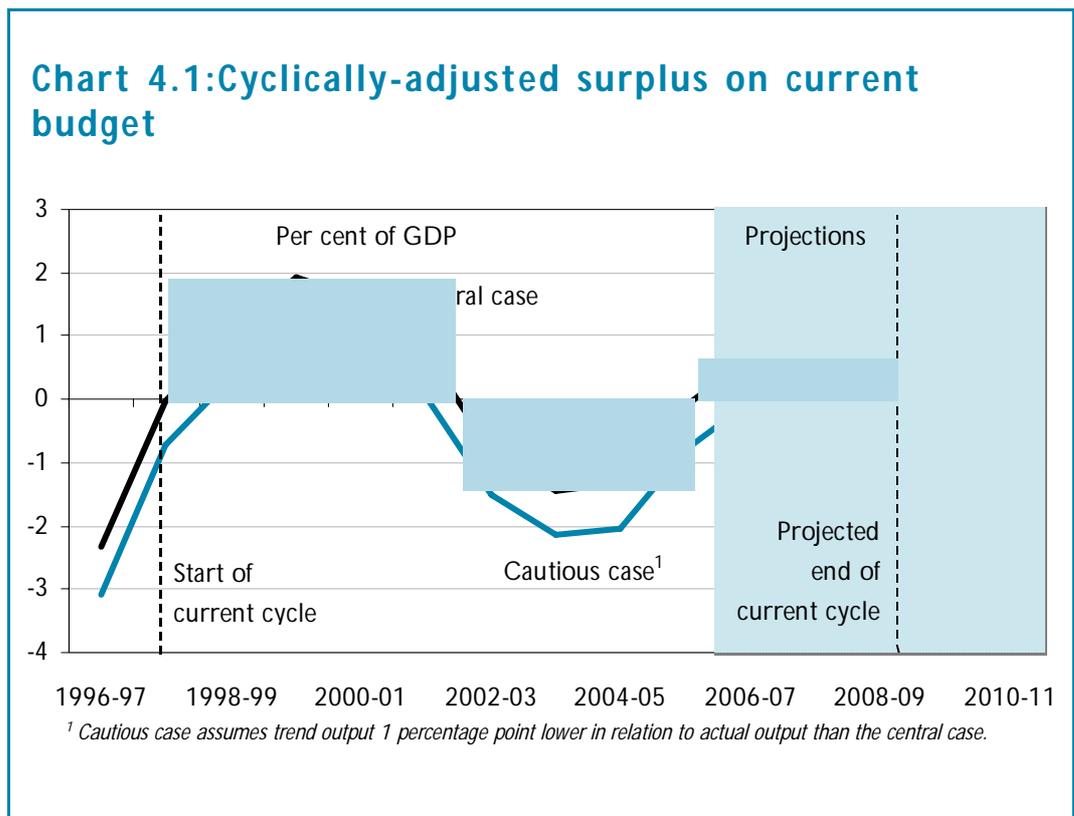
The economic outlook

4.19 As also explained in Chapter 3, UK GDP is now expected to rise by 1¾ per cent in 2005 as a whole. Growth in 2006 is forecast to be 2 to 2½ per cent. This reflects the continued drag on real household incomes arising from high oil prices, together with the ongoing effects of subdued earnings growth, acting to keep growth of private consumption at relatively moderate rates. High oil prices are expected to continue to be a drag on growth in 2006. Furthermore, the euro area, which accounts for around 50 per cent of UK exports, has continued to grow at relatively subdued rates, significantly depressing UK export market growth compared with expectations at the time of Budget 2005.

4.20 A similar set of risks surround the forecast as at UK Budget time (March 2005). Risks to the world economy, if realised, would inevitably impinge on the UK. Already high oil prices could hit the UK economy harder than expected in 2006. Were euro area growth to remain weaker than expected, this would continue to have an adverse impact on UK external demand and net trade. There are risks in both directions for private consumption growth, which may continue to undershoot expectations if average earnings growth continues to remain unexpectedly subdued, or could surprise on the upside if, for example, housing market developments prompted a rise in consumer confidence. Business investment growth could also surprise on the upside, given strong rates of profitability allied with a low cost of capital and benign financial conditions.

4.21 In terms of setting fiscal policy, an important source of potential error results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case, as illustrated in Chart 4.1. This shows that the Government will have a cyclically adjusted current surplus in the cautious case at the end of the projection period.

Long-term forecasts **4.22** Chapter 5 sets out the issues relating to the long-term fiscal projections.



GENERAL GOVERNMENT FINANCES

4.23 Table 4.4 gives a breakdown of general government finances.

Table 4.4: General government transactions by economic category

	£ billion			
	Outturn 2004-05	Estimate 2005-06	Projections 2006-07 2007-08	
<i>Current receipts</i>				
Taxes on income and wealth	161.8	179.9	197.6	213.2
Taxes on production and imports	154.9	162.4	170.0	178.6
Other current taxes	24.5	25.4	27.2	29.2
Taxes on capital	2.9	3.3	3.6	3.8
National insurance contributions	79.3	85.1	89.3	94.7
Gross operating surplus	10.8	11.6	12.5	13.4
Rent and other current transfers	1.9	1.9	2.0	2.0
Interest and dividends from private sector and abroad	4.5	4.0	3.9	4.0
Interest and dividends from public sector	4.5	5.6	6.2	6.7
Total current receipts	445.1	479.2	512.3	545.4
<i>Current expenditure</i>				
Current expenditure on goods and services	250.8	266.0	281.3	298.8
Subsidies	7.2	7.3	7.7	7.9
Net social benefits	139.6	145.4	149.9	155.5
Net current grants abroad	-0.6	-0.2	-0.7	-1.3
Other current grants	31.9	33.0	38.4	40.9
Interest and dividends paid	24.4	26.1	26.8	28.4
AME margin	0.0	0.0	0.5	1.5
Total current expenditure	453.3	477.7	503.9	531.6
Depreciation	10.8	11.6	12.5	13.4
Surplus on current budget	-18.9	-10.1	-4.1	0.4
<i>Capital expenditure</i>				
Gross domestic fixed capital formation	21.7	27.3	29.8	32.9
Less depreciation	-10.8	-11.6	-12.5	-13.4
Increase in inventories	0.0	0.2	0.1	0.1
Capital grants (net) within public sector	-0.2	0.5	0.6	0.6
Capital grants to private sector	10.0	12.1	13.0	12.9
Capital grants from private sector	-1.2	-1.2	-1.3	-1.2
AME margin	0.0	0.0	0.6	0.4
Net investment	19.5	27.3	30.4	32.2
Net borrowing¹	38.5	37.3	34.5	31.8
<i>of which:</i>				
Central government net borrowing	37.0	35.5	34.0	31.4
Local authority net borrowing	1.4	1.8	0.5	0.4
Gross debt (Maastricht basis)				
Central government	426.7	477.9	519.0	558.9
Local government	53.7	52.1	50.4	48.5

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

The Eurostat definition of total revenues and expenditure used in Table 2 of the Guidelines on the format and content of Stability and Convergence Programmes¹ differs from that used in the public finance projections outlined in this Convergence Programme. Both the UK projections and Eurostat classifications are ESA95 compatible. The differing total revenue and expenditure data is due to differing treatments of ESA95 components. For example, public sector pension contributions are

¹ Available at http://www.europa.eu.int/comm/index_en.htm

included as receipts in the Eurostat definition, but are subtracted from net social benefits in the UK projections definition. Both classifications produce the same figures for the Treaty deficit, and for all other fiscal aggregates.

DISCRETIONARY POLICY CHANGES IN THE PRE-BUDGET REPORT

4.24 In considering the impact of additional discretionary policy changes on the fiscal position, the Government has taken into account the following factors:

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

4.25 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all decisions announced in this Pre-Budget Report or since Budget 2005. This includes:

- an increase in North Sea oil taxation, striking the right balance between producers and consumers, to promote investment and ensure fairness for taxpayers;
- an extension of Winter Fuel Payments paid at £200 for households with someone aged 60 or over, rising to £300 for households with someone aged 80 or over, for the rest of this Parliament;
- an additional £300 million over three years to enable pensioners on Pension Credit to have central heating systems installed free of charge and to provide a £300 discount on central heating systems to all other pensioners who do not already have one in their homes;
- a continuation of the freeze in the main fuel duty rates and the duty rates for road fuel gases, due to continued oil market volatility; and
- action to protect tax revenues and modernise the tax system, including a number of measures to tackle tax fraud, avoidance and tax motivated incorporation.

4.26 In the 2002 Pre-Budget Report, the Government created a special reserve to meet the UK's international obligations. In this Pre-Budget Report, as a prudent allowance against continuing commitments, the Government is adding a further £580 million to the special reserve for 2005-06, and an additional £85 million to advance the ongoing fight against terrorism.

RECEIPTS

4.27 The latest projections for general government receipts, contained in the 2005 Pre-Budget Report, are shown in Table 4.4. Table 4.5 shows the effects of non-discretionary changes on public sector current receipts since Budget 2005. The forecast for public sector current receipts for 2005-06 has been revised down by £3½ billion since Budget 2005. Before allowing for discretionary changes, the shortfall increases to £6½ billion in 2006-07. However these shortfalls are lower than would be expected

given changes in the level of money GDP and its components, partly because of higher receipts from the North Sea taxes and partly because of the strong performance of the financial sector, which has not been affected by the slower economic growth in the same way as the rest of the economy. Current receipts remain lower throughout the forecast, although the shortfall in receipts relative to Budget 2005 diminishes.

Table 4.5: Changes in current receipts since Budget 2005

	£ billion				
	Estimate	Projections			
	2005-06	2006-07	2007-08	2008-09	2009-10
Effect on receipts of non-discretionary changes in:					
Oil prices on oil taxes	2	1½	2	2	2
Assumptions audited by the NAO	½	-½	0	0	-½
Money GDP and components	-4	-8	-8	-6½	-5
Other forecasting changes	-2	0	-½	0	0
Total before discretionary changes¹	-3½	-6½	-6½	-4½	-3½
Discretionary changes	0	2½	3	3	3
Total change¹	-3½	-4	-3½	-1½	-½

¹ Total may not sum due to rounding.

Oil prices on oil taxes

4.28 Relative to the Budget 2005 forecast, oil prices are around \$15 a barrel higher throughout the forecast. The effect on oil taxes increases receipts by around £2 billion a year. This line in Table 4.5 includes the oil price impact on North Sea corporation tax and petroleum revenue tax and the partially offsetting impact of higher pump prices on the demand for road fuels and hence on fuel duties. The offsetting effects on the public finances from higher oil prices on the wider economy are included in the money GDP and components line and the effects of any temporary increase in inflation in other forecasting changes. The oil price assumption, but not the consequential demand effect on fuel duties, is audited by the National Audit Office (NAO). Box 3.1 gives more detail on the effect of oil prices on the UK's economy and public finances.

Other assumptions audited by NAO

4.29 The main impact from changes to other audited assumptions are on equity prices and on the VAT assumption. These work in opposite directions and the overall impact is broadly neutral. Equity prices are expected to be around 5-7 per cent higher over the projection period than assumed in Budget 2005, boosting corporation tax receipts from life assurance companies, stamp duty receipts and capital taxes. The effect of the VAT assumption is to reduce revenues from 2006-07 onwards reflecting the higher estimate of the VAT gap in 2005-06.

Money GDP and its components

4.30 Moderate growth in average earnings, a slower rise in the profitability of industrial and commercial companies and the impact of a more modest than expected increase in nominal consumer spending lead to substantial reductions in receipts. The combined impact reduces current receipts by £4 billion in 2005-06, by £8 billion in 2006-07 and in 2007-08, before the shortfall diminishes as the economy has a period of above-trend growth during 2007 and 2008. Despite these higher real growth rates, the levels of money GDP and some of its components remain lower than in Budget 2005 and this leads to continued shortfalls even after the economy returns to trend. The data revisions to 2004 GDP estimates, discussed in Chapter 3, also have a downward impact on receipts throughout the forecast period.

Other forecasting changes

4.31 A large number of different factors contribute to other forecasting changes and together are expected to reduce current receipts by around £2 billion in 2005-06, partly because of the shortfall in VAT not directly explainable by GDP component changes. In later years the effect of this VAT shortfall is scored in the assumptions audited by the NAO line and the other forecasting changes broadly balance. These changes include reductions to corporation tax not directly attributable to GDP component changes and changes to North Sea oil production, which reduce receipts until 2009-10. The offsetting factors include the boost to income tax and National Insurance contributions from the buoyant financial sector and the effects of higher than expected commercial property prices.

EXPENDITURE

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

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

4.34 Table 4.6 shows the allocation of Total Managed Expenditure and Table 4.7 shows Departmental Expenditure Limits, both resource and capital budgets.

Table 4.6: Total Managed Expenditure 2004-05 to 2007-08

	£ billion			
	Outturn 2004-05	Estimate 2005-06	Projections 2006-07 2007-08	
Departmental Expenditure Limits				
Resource Budget	266.2	287.0	305.0	320.7
Capital Budget	25.4	29.1	32.0	35.2
<i>Less depreciation</i>	-8.4	-11.8	-12.1	-11.8
Total Departmental Expenditure Limits	283.3	304.3	324.8	344.1
Annually Managed Expenditure				
Social security benefits ¹	121.3	127.1	131.8	138.3
Tax credits ¹	15.3	15.4	14.7	14.6
Common Agricultural Policy	3.1	3.3	3.3	3.4
Net public service pensions ²	1.1	0.8	0.5	0.6
National Lottery	1.8	1.7	1.6	1.4
Non-cash items in AME	2.6	2.4	3.3	4.7
Other departmental expenditure	2.8	4.8	3.6	3.3
Net payments to EU institutions ³	3.3	3.1	2.8	4.5
Locally-financed expenditure*	25.7	27.0	28.1	29.6
Central government gross debt interest	24.0	25.6	26.4	28.0
Public corporations' own-financed capital expenditure	2.5	2.8	2.7	2.8
Total AME before margin and accounting adjustments	203.4	214.2	218.8	231.1
AME margin	0.0	0.0	1.1	1.8
Accounting adjustments ⁴	0.6	1.4	5.4	3.6
Annually Managed Expenditure	204.0	215.6	225.2	236.5
Total Managed Expenditure	487.3	519.9	550.1	580.7
<i>of which:</i>				
Public sector current expenditure	453.4	477.9	504.2	532.0
Public sector net investment	18.9	26.3	29.3	31.1
Public sector depreciation	14.9	15.7	16.6	17.5

¹ For 2004-05 to 2006-07, child allowances in Income Support and Jobseekers' Allowance, which, from 2003-04, are paid as part of the Child Tax Credit, have been included in the tax credits line and excluded from the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.

² Net public service pensions expenditure is reported on a national accounts basis.

³ Net payments to EU Institutions exclude the UK's contribution to the cost of EU aid to non-Member States (which is attributed to the aid programme). The estimate for 2005-06 and projections for 2006-07 and 2007-08 have not changed since the Budget. Annual projections are inherently volatile.

Net Payments therefore differ from the UK's net contribution to the EU Budget, latest estimates for which are (in £ billion):

	2004-05	2005-06	2006-07	2007-08
	3.9	3.8	3.4	5.2

⁴ Excludes depreciation.

* This expenditure is mainly financed by council tax revenue.

Table 4.7: Departmental Expenditure Limits – resource and capital budgets

	£ billion			
	Outturn	Estimate	Plans	
	2004-05	2005-06	2006-07	2007-08
Resource Budget				
Education and Skills	24.2	26.3	28.0	29.5
Health	67.9	74.9	81.8	89.2
of which: NHS	65.7	72.6	79.9	87.3
Transport	8.1	8.8	10.7	9.8
Office of the Deputy Prime Minister	6.2	6.0	6.6	7.2
Local Government	43.3	46.3	49.0	51.7
Home Office	12.1	12.8	13.3	14.0
Departments for Constitutional Affairs	3.4	3.8	3.8	3.8
Law Officers' Departments	0.6	0.7	0.7	0.7
Defence	31.3	33.0	32.7	33.0
Foreign and Commonwealth Office	1.7	1.8	1.7	1.7
International Development	3.8	4.5	5.0	5.3
Trade and Industry	5.1	6.2	6.3	6.4
Environment, Food and Rural Affairs	3.1	3.1	3.4	3.5
Culture, Media and Sport	1.4	1.6	1.6	1.7
Work and Pensions	8.4	8.5	8.3	8.3
Scotland ¹	20.0	21.5	22.8	24.1
Wales ¹	10.6	11.3	12.1	12.8
Northern Ireland Executive ¹	6.9	7.3	7.8	8.0
Northern Ireland Office	1.2	1.2	1.1	1.1
Chancellor's Departments	4.9	5.3	5.2	5.2
Cabinet Office	2.0	2.1	2.1	2.1
Invest to Save Budget	0.0	0.0	0.0	0.0
Reserve	0.0	0.4	1.1	1.5
Unallocated special reserve ²	0.0	0.8	0.0	0.0
Allowance for shortfall ²	0.0	-1.2	0.0	0.0
Total Resource Budget DEL	266.2	287.0	305.0	320.7
Capital Budget				
Education and Skills	3.8	4.4	4.9	5.6
Health	2.6	3.8	5.3	6.3
of which: NHS	2.5	3.7	5.2	6.1
Transport	3.3	3.3	4.1	4.2
Office of the Deputy Prime Minister	2.8	3.5	2.9	2.9
Local Government	0.3	0.4	0.2	0.2
Home Office	1.0	1.2	1.2	1.3
Departments for Constitutional Affairs	0.2	0.2	0.1	0.1
Law Officers' Departments	0.0	0.0	0.0	0.0
Defence	6.8	6.5	7.0	7.6
Foreign and Commonwealth Office	0.1	0.1	0.1	0.1
International Development	0.0	0.0	0.0	0.0
Trade and Industry	0.3	0.4	0.5	0.5
Environment, Food and Rural Affairs	0.3	0.3	0.4	0.4
Culture, Media and Sport	0.1	0.2	0.1	0.1
Work and Pensions	0.3	0.4	0.2	0.1
Scotland ¹	1.7	1.9	2.1	2.2
Wales ¹	0.9	0.9	1.1	1.2
Northern Ireland Executive ¹	0.4	0.4	0.4	0.5
Northern Ireland Office	0.1	0.1	0.1	0.1
Chancellor's Departments	0.4	0.4	0.4	0.5
Cabinet Office	0.2	0.3	0.3	0.3
Invest to Save Budget	0.0	0.0	0.0	0.0
Reserve	0.0	0.9	0.5	1.1
Allowance for shortfall ²	0.0	-0.6	0.0	0.0
Total Capital Budget DEL	25.4	29.1	31.9	35.2
Depreciation	-8.4	-11.8	-12.1	-11.8
Total Departmental Expenditure Limits	283.3	304.3	324.8	344.1
Total education spending	63.3	69.9	72.9	77.4

¹ For Scotland, Wales and Northern Ireland, the split between resource and capital budgets is indicative and reflects the consequential of the application of the Barnett formula to planned changes in UK departments' spending.

² This represents provision for the costs of military operations in Iraq and the UK's other international obligations.

Box 4.3: The Stability and Growth Pact

There has been significant debate recently of issues surrounding macroeconomic frameworks in Europe, particularly of the Stability and Growth Pact (SGP). The introduction of the SGP in the late 1990s represented a major step forward in recognising the importance of long-term budgetary discipline and as a framework for coordination by Member States of their fiscal policies. The UK has supported the principle of a strong SGP, recognising that fiscal sustainability is a prerequisite for macroeconomic stability, and that collective fiscal co-ordination is desirable within an integrated economic community, and essential for a successful monetary union. However the operation of the SGP highlighted a number of issues that needed to be addressed.

The UK Government has consistently advocated a prudent interpretation of the SGP. A prudent interpretation takes into account:

- the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy, so providing the flexibility to take the right decisions over the cycle;
- sustainability – taking into account that low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations; and
- public investment – recognising that public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.

The reforms to the SGP agreed in March 2005 rightly place a greater focus on the avoidance of pro-cyclical policies and on reducing and maintaining low debt, with the flexibility for low debt countries such as the UK to invest in the provision of much needed public services. During the UK's Presidency of the European Union and beyond, the Government has and will continue to work closely with Member States and EU institutions to ensure effective implementation of the new Pact going forward. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

SUSTAINABILITY FOR THE LONG TERM

5.1 Long-term sustainability is a key element of a prudent interpretation of the Stability and Growth Pact. In 2002 the Government published its first *Long-term public finance report* with the intention of providing a comprehensive analysis of long-term economic and demographic developments, and their likely impact on the public finances. In 2003 the Government presented its second *Long-term public finance report* and announced that the report would become an annual publication. The *Long-term public finance report* complements the illustrative long-term fiscal projections presented in Annex A of the *Economic and Fiscal Strategy Report* (EFSR), published at the time of the Budget. The Government is committed to updating and reporting regularly on its assessments of long-term fiscal sustainability, both through the Long-term public finance report and through the illustrative long-term fiscal projections presented with each Budget.

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

Comprehensive assessment

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

Long-term demographic trends

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

5.5 In the UK, the Government Actuary's Department (GAD) produces the official population projections. Since last year's Programme, GAD has updated its projections. This section therefore presents the long-term demographic trends based on the latest population projections.

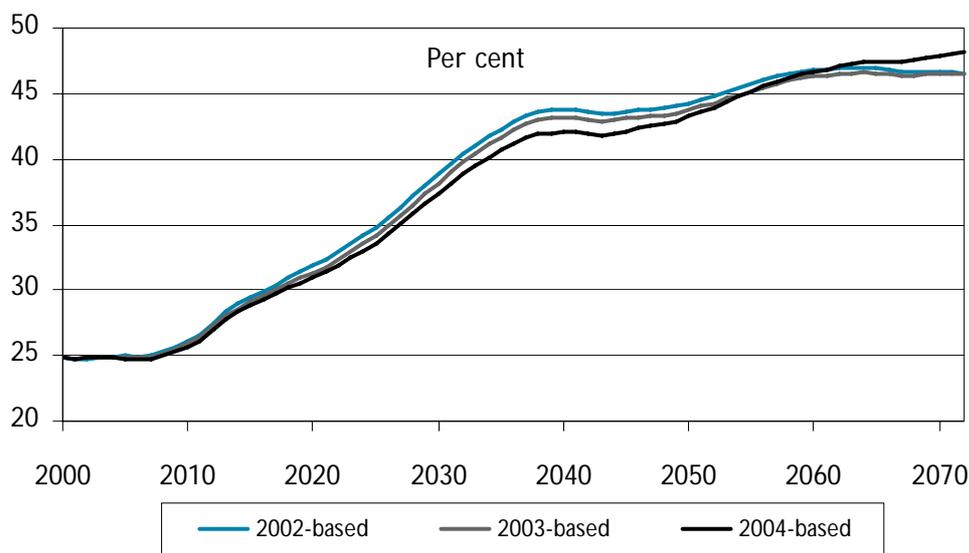
5.6 According to the latest (2004-based) principal population projections, the UK's population will increase from 59.8 million in 2004 to around 69.5 million by 2054. With the fertility rate assumed to remain below the replacement rate of 2.1 children per

¹ For the results of the alternative fiscal gap indicator, see 2005 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2005, page 52.

woman (the rate which is necessary to stabilise the population size naturally), the increase in the total population is due to the assumption that life expectancy will improve at a constant rate year-on-year, and to assumed long-term net migration of around 145,000 people per year. These assumptions are different from those used in GAD's 2003-based interim projections (used for last year's *Long term public finance report* and Programme), with the effect that the UK population is no longer projected to stabilise after 2035, but instead continues to trend upwards.

5.7 The effect of these changes can be best illustrated by the evolution of the demographic old-age dependency ratio. This ratio shows the number of people aged 65 years and over relative to the number of people aged 16 to 64 years. Chart 5.1 shows GAD's 2002-, 2003-based interims and 2004-based projections of the evolution of the demographic old-age dependency ratio, in each case based on the principal population projections. Using the 2004-based projections, the demographic old-age dependency ratio is projected to be around 45 per cent by the mid-2050s, very similar to that in previous population projections. Until the early 2050s, however, the ratio is projected to be lower in the 2004-based projections than in the earlier projections. This is because the effect of the change in the net migration assumption (which is now higher than in previous population projections) more than offsets that of the increase in the life expectancy assumption. However, the ratio is projected to continue to rise after the 2050s in the 2004-based projections, whereas in the 2003- and 2002-based projections it begins to stabilise in the 2060s. This is because the effect of the changed mortality assumption begins to dominate, pushing the projected ratio higher. The updated population projections demonstrate the necessity of continuing to assess the sustainability of the public finances on a regular basis.

Chart 5.1: Demographic old-age dependency ratios



Source: Government Actuary's Department, 2002-based, 2003-based interim and 2004-based principal population projections.

Long-term assumptions

5.8 The long-term projections are based on the assumption of current policy, in other words it is assumed that the Government will leave current policy unchanged in

the future. This should not be interpreted as meaning that policy will not change over time but it is used so that the long-term projections do not prejudice future Government policy. For example, the Government has made clear that decisions relating to the indexing of the Pension Credit will be made on a Budget and Spending Review timetable in the context of resources and priorities. As such, the projections set out here describe just one possible scenario of how the Pension Credit might evolve, but should not be taken as the Government’s policy. The particular scenario used for the purposes of the projections is where the parameters of the Pension Credit are uprated in such a way as to lead to an upper estimate of the possible cost of the Pension Credit in the long term, in order to be prudent and cautious.

5.9 This year’s Report uses the so-called ‘cohort’ method, for the employment projections. Studies by the Organisation for Economic Co-operation and Development (OECD)² and on-going analysis into the long-term sustainability of the public finances in EU Member States conducted by the EU’s Economic Policy Committee (EPC)³ also utilise this approach.

5.10 The cohort method of projecting employment trends captures the negative impact of an ageing workforce on overall participation (due to older workers generally having lower participation rates than younger workers) and the effect of current young cohorts gradually replacing current older cohorts.

5.11 Given assumptions regarding productivity and projections of employment growth, it is possible to derive projected GDP growth beyond the end of the medium-term forecast period. Table 5.1 shows the average real GDP growth rates in the coming decades for the baseline projections.

Table 5.1: Real GDP growth and its components in the baseline scenario (per cent)¹

	2014-15 to 2023-24	2024-25 to 2033-34	2034-35 to 2043-44	2044-45 to 2053-54
Productivity	2	2	2	2
Employment	0	0	0	0
Real GDP	2	2	2	2

¹ Productivity growth is 1¼ per cent and 2¼ per cent in the low and high productivity scenarios respectively.

Source: HM Treasury

5.12 The intertemporal budget gap and fiscal gap approaches to assessing long-term fiscal sustainability require a real discount/debt interest rate assumption. To provide some sensitivity analysis, the results are presented on the basis of three discount rate assumptions: 2½ per cent, 3 per cent and 3½ per cent.

SPENDING AND REVENUE PROJECTIONS

Spending 5.13 The changing demographic structure of the UK’s population – and especially the ageing aspect – is projected to lead to an increase in public spending over the coming

² *Coping with Ageing: A Dynamic Approach to Quantify the Impact of Alternative Policy Options on Future Labour Supply in OECD Countries*, OECD, June 2004.

³ *The 2005 projections of age-related expenditure (2004-2050) for the EU-25 Member States: underlying assumptions and projection methodologies*, European Union Economic Policy Committee, November 2005 (available at http://europa.eu.int/comm/economy_finance/publications/european_economy/2005/eespecialreport0405_en.htm).

decades. A significant proportion of this increase is projected to take place over the medium-term horizon though, reflecting the outcomes of the 2002 and 2004 Spending Reviews, and 5-year settlement on health.⁴ Beyond the medium term, spending on education is projected to remain more or less stable as a share of GDP, while state pensions are projected to rise by around 1½ percentage points. The increase in public service pension spending reflects to a large degree the maturing of the existing schemes. Health and long-term care spending are projected to increase the most in absolute terms, rising from a combined 8.4 per cent of GDP in 2004-05 to around 11¾ per cent by 2054-55. Table 5.2 summarises the spending and revenue projections.

Table 5.2: Spending and revenue projections (per cent of GDP)

	2004-05	2014-15	2024-25	2034-35	2044-45	2054-55
Education	5.5	5.4	5.4	5.4	5.3	5.4
State pensions ¹	5.0	5.0	5.1	5.5	5.8	6.6
Health ² (incl. long-term care)	8.4	9.5	10.0	10.8	11.2	11.7
<i>of which long-term care</i> ³	1.2	1.3	1.4	1.6	1.7	1.9
Public service pensions	1.5	1.7	2.0	2.2	2.1	2.1
Total age-related spending	20.4	21.6	22.5	23.9	24.4	25.8
Other spending	20.7	19.6	19.6	19.7	19.5	19.5
Total spending⁴	41.1	41.2	42.1	43.6	43.9	45.3
Total revenue⁵	37.3	39.7	40.4	41.3	41.5	41.9

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

² Gross NHS spending.

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

⁴ Total spending including gross investment but excluding interest and dividends payments.

⁵ Excluding interest and dividends received.

Education 5.14 Education spending is projected to remain relatively stable over the coming decades, fluctuating around 5½ per cent of GDP. 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.

State pensions 5.15 State pension spending⁵ is projected to increase from 5 per cent of GDP in 2004-05 to around 6½ per cent by 2054-55. These projections are based on the scenario that the parameters of the Pension Credit are uprated in such a way as to lead to an upper estimate of the possible cost of the Pension Credit in the long term, in order to be prudent and cautious, as described in paragraph 5.8.

Health 5.16 The health projections are based on the assumption that future increases in life expectancy can be enjoyed partly in good health. Health spending is projected to increase from 7.2 per cent in 2004-05 to nearly 10 per cent of GDP by 2054-55 as the population ages. Of this an increase of around 1 percentage point by 2007-08 reflects the substantial increase in NHS spending announced in Budget 2002⁶ in response to the

⁴ See *Budget 2002: Economic and fiscal strategy report: The strength to make long-term decisions: Investing in an enterprising, fairer Britain*, HM Treasury, April 2002, Chapter 6.

⁵ State pension spending is defined as the sum of the basic state pension, State Second Pension, Pension Credit, Winter Fuel Payments, Over 75 TV licences, and Christmas Bonus.

⁶ *Budget 2002: Economic and fiscal strategy report: The strength to make long-term decisions: Investing in an enterprising, fairer Britain*, HM Treasury, April 2002.

Wanless Review.⁷ As in previous years, though, non-demographic factors that might affect health spending beyond the medium term are not modelled.

Long-term care 5.17 The long-term care projections are based on the same morbidity assumption as the health projections. Based on this assumption, long-term care is projected to rise from 1.2 per cent of GDP now to nearly 2 per cent by 2054-55.

Public service pensions 5.18 Expenditure on public service pension benefits is projected to increase from around 1½ per cent of GDP now to around 2 per cent by 2054-55. This projected increase reflects changes in the size of the public service workforce, improved longevity and the fact that some schemes, and in particularly the NHS scheme, are not yet mature.

Other spending 5.19 Spending on education, state pensions, public service pensions, and health and long-term care amounted to roughly half of total government spending in 2004-05. This share is projected to rise to around 57 per cent by 2054-55. In terms of GDP, the total of education, state pension, public service pensions, and health and long-term care spending is projected to reach around 26 per cent by 2054-55. By contrast, other spending is projected to remain more or less stable as a share of GDP beyond the medium term. This is because projected increases in ‘other’ consumption and capital spending (i.e. those unrelated to education, health and long-term care) more or less offset projected relative falls in other spending items such as non-pension social transfers which are, based on current policies, mainly increased in line with prices.

Revenue 5.20 Revenue is projected to rise as a share of GDP between 2004-05 and 2014-15, reflecting to a large extent the increases forecast over the medium-term horizon. Beyond the medium term, revenue is projected to rise further, reaching nearly 42 per cent of GDP by 2054-55.⁸

FISCAL INDICATORS

Primary balance 5.21 As a result of the projected spending and revenue trends, the general government primary balance in the baseline scenario is projected to be in surplus in 2014-15. Table 5.3 shows that the primary balance is projected to remain in surplus until the mid 2040s, before going into deficit.⁹ The gradual deterioration in the primary balance in the very long term mainly reflects continued projected increases in age-related expenditure. The projected evolution of the general government primary balance will depend in part on the underlying productivity growth rate assumption, which affects the extent to which price-indexed social security transfers evolve relative to GDP. Table 5.3 presents the primary balances for the three productivity growth scenarios presented in this programme.

⁷ *Securing our Future Health: Taking a Long-Term View*, Derek Wanless, 2002.

⁸ For this year's *Long term public finance report* the income tax projections have been refined so as to be fully consistent with the employment projections. This has been achieved by projecting income tax revenue raised from those aged 16 years to 69 years on the basis of the age-specific employment projections, as generated by the cohort employment model. For income tax raised from those 70 years and over, it is assumed that it grows in line with the projected changes in the number of people in this age group.

⁹ To derive the primary balances in Table 5.3, it is necessary to add general government interest and dividends received to the spending and revenue projections. This follows the International Monetary Fund's Manual on Fiscal Transparency. See <http://www.imf.org/external/np/fad/trans/manual/gloss.htm>. Interest and dividends received are assumed to remain constant as a share of GDP beyond the medium term. Note that this definition of the primary balance differs from that conventionally used by HM Treasury which is defined as net borrowing less net interest expenditure (for example as in Table 4.1).

Primary balances in different scenarios **5.22** The projected general government primary balance differs between the three productivity scenarios. This is mainly due to the fact that a number of social security spending items are uprated in line with prices rather than earnings. Different productivity growth assumptions will therefore affect the evolution of these spending items as a share of GDP.

Table 5.3: General government primary balance (per cent of GDP)

	2004-05	2014-15	2024-25	2034-35	2044-45	2054-55
Lower productivity (1¾ per cent)	-1.0	1.0	0.5	-0.3	-0.4	-1.3
Baseline (2 per cent)	-1.0	1.0	0.7	0.1	0.1	-0.8
Higher productivity (2¼ per cent)	-1.0	1.1	1.0	0.4	0.4	-0.4

Source: HM Treasury.

Intertemporal budget balance **5.23** Table 5.4 presents estimates of the intertemporal budget gap, that is the increase/reduction in tax revenue as a share of GDP in 2004-05 and a proportionate increase/reduction thereafter to meet the intertemporal budget constraint under, a range of discount rate and productivity growth rate assumptions.¹⁰ It is likely that higher rates of productivity will be associated with higher real interest/discount rates. The results show that whether revenue (or spending) needs to change at all to maintain intertemporal balance depends to some extent on the discount rate assumption. If a lower discount rate is used, as could be justified by the low real interest rate on long-term UK government bonds, the condition for intertemporal balance is exceeded in each case regardless of the productivity assumption.

Table 5.4: Intertemporal budget gaps¹ (per cent of GDP)

Discount rate (per cent)	2½	3	3½
Lower productivity (1¾ per cent)	-½	¾	1¼
Baseline (2 per cent)	-1½	0	½
Higher productivity (2¼ per cent)	-3	-1¼	0

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

Fiscal gaps **5.24** The fiscal gap measure represents the change in the primary balance needed to attain a particular debt target at a particular point in time. A negative fiscal gap, for example, implies that fiscal policy could be loosened while still attaining a particular debt level in the future. Taking the 40 per cent net debt to GDP ratio from the UK's sustainable investment rule as the target, it is therefore possible to use the fiscal gap concept to estimate the primary balance that is consistent with the Government's sustainable investment rule over different time horizons.¹¹

¹⁰ The adjustment could also include changes on the spending side. In practice, structural reforms will be at least as important given the time horizon concerned.

¹¹ The fiscal gap and alternative fiscal gap calculations in the *2005 Long-term public finance report* are based on the public sector rather than the general government sector. This is to increase consistency with the Government's sustainable investment rule, which is defined over the public rather than the general government sector. To derive public sector spending and revenue from

Table 5.5: Fiscal gaps¹ in baseline scenario² (per cent of GDP)

Interest rate (per cent)	2½	3	3½
Target year ³			
2024-25	-½	-¼	0
2034-35	0	0	¼
2044-45	0	¼	½
2054-55	¼	½	½

¹ Change to primary balance needed to attain a particular debt level at terminal year. Rounded to nearest quarter percentage point.

² 2 per cent productivity growth.

³ Net debt target is reached at end of year specified.

5.25 The results show that the UK public finances are in a solid long-term position. Table 5.5 shows, for example, that (except in the high interest rate scenario) the Government is projected to achieve a net debt to GDP ratio of 40 per cent by 2034-35 in the baseline case without a change in the fiscal stance. Table 5.5 also shows that the Government could loosen fiscal policy slightly more (or tighten by slightly less) the lower the assumed interest rate. It should also be emphasised that all the numbers are small, varying between $-\frac{1}{2}$ and $\frac{1}{2}$ per cent of GDP. This needs to be seen in the context of an average absolute difference between forecast and outturn for public sector net borrowing of little over 1 per cent of GDP over the period 1970-71 to 2004-05. The 2005 *Long-term public finance report* also includes analysis illustrating the effect of assuming lower and higher productivity growth than the baseline scenario.

COMPARISON WITH OTHER PROJECTIONS

Differences from the 2004 *Long-term public finance report*

Spending **5.26** Beyond the medium-term horizon, overall spending is projected to increase by more, as a share of GDP, than in last year's Report. This is mainly due to larger projected increases in total age-related spending, none of which are related to changes in Government policies. First, state pension spending is projected to be higher. This is principally due to the long-term impacts of lower levels of contracting out of the State Second Pension at present, which increase long-term spending, the inclusion of new data from National Insurance records which suggest that more women are building up state pension entitlement on their own than had previously been thought, and refined modeling assumptions using the Department for Work and Pensions' new dynamic microsimulation tool, Pensim 2.¹² Second, health and long-term care spending are projected to increase by slightly more than in last year's Report, with the increased upward pressure created by the latest population projections. This is particularly the

the general government-based projections, it is assumed that all spending and revenue items linked to public corporations remain constant as a share of GDP after the medium term. The difference between the general government and public sector numbers is small. Note that for the fiscal gap and the alternative fiscal gap calculations, the primary balance is defined as net borrowing excluding *net* debt interest payments. This is consistent with the UK's definition of primary balance which, by excluding interest receipts, yields larger deficits and/or smaller surpluses than the IMF's definition. See *Analysing UK Fiscal Policy*, HM Treasury, November 1999, page 35. Excluding interest receipts is also consistent with calculating the fiscal gaps on a net debt basis.

¹² Note that the new population projections are not a major driver of the change in projected state pension spending from last year's Report.

case for the long-term care projections, which are especially sensitive to changes in the number of the oldest old (85 years and over).

Revenue 5.27 Revenue is projected to continue to rise as a share of GDP through to the end of the projection period, in contrast with last year's projections, where revenue as a share of GDP stabilised beyond the medium term. This is mainly due to refinements to the income tax projections to make the modelling consistent with the cohort employment model methodology.

Differences from the Economic Policy Committee's (EPC) projections

5.28 The Council of EU Finance Ministers (ECOFIN) has mandated the EPC to provide a new set of long-term fiscal projections. One of the key objectives of this exercise will be to incorporate recent policy developments in EU Member States in the projections. In addition, the EPC's report will use updated and refined assumptions and modelling techniques (including updated demographic assumptions) and will cover the ten new Member States that joined the EU in May 2004. Box 5.1 explains the key differences between the assumptions used in generating the projections presented in the *Long-term public finance report* and the EPC's commonly-agreed assumptions and methodologies.

Box 5.1: Long-term budgetary projections by the Economic Policy Committee

The long-term projections presented in the *2005 Long-term public finance report* are based on assumptions that differ in a number of ways from the commonly-agreed assumptions used by the Economic Policy Committee (EPC). The key differences in the underlying data used in the two sets of projections are as follows:

Population: As previously mentioned, the results presented in this chapter use population projections produced by the Government Actuary's Department (GAD). By contrast, the EPC's long-term budgetary projections use Eurostat population projections. GAD projects that the UK population will reach 69.2 million by 2050, whereas Eurostat projects that the UK population will be 64.3 million in 2050. Moreover, while the GAD projections envisage a steadily rising UK population to 2050 and beyond, under the Eurostat projections the population peaks at 64.7 million in 2040 and then begins to fall.

Dependency ratio: The two sets of projections also use different projected age structures for the UK population, as reflected in the demographic old-age dependency ratio. In both cases, the demographic old-age dependency ratio is projected to be on an upward trend during the period to 2050. However, under the Eurostat projections the ratio will reach 46 per cent by 2050, whereas GAD projects a lower ratio of 43 per cent by that year.

Employment levels: As noted, the results presented in this chapter use a cohort employment model to project employment levels in the economy. Using this model, employment is projected to be around 30.3 million in 2050, having peaked in 2024 at around 30.4 million and then remained fairly stable. The EPC employment projections are based on a similar cohort model but mainly due to differences in the underlying population projections yield a different profile. In the EPC projections, employment peaks in 2017 at 30.7 million and falls thereafter, reaching 28.9 million in 2050.

Productivity growth rates: For the baseline projections presented in this chapter, labour productivity growth is assumed to be 2 per cent per year throughout the projection period. By contrast, under the EPC assumptions productivity growth in the UK is assumed to increase over the next ten years, from 1.9 per cent per year in 2005 to 2½ per cent in 2012 and 2013. The productivity growth rate is then assumed to fall back to 1.7 per cent per year by 2029, before stabilising.

In addition to differences in underlying assumptions, the EPC's budgetary projections also use different modelling and projection methodologies for health, long-term care and education expenditures.^a For the pension projections, by contrast, the same methodologies are used for both sets of projections (though using different underlying assumptions, as explained above).

^a See *The 2005 projections of age-related expenditure (2004-2050) for the EU-25 Member States: underlying assumptions and projection methodologies*, European Union Economic Policy Committee, November 2005 (available at http://europa.eu.int/comm/economy_finance/publications/european_economy/2005/eespecialreport0405_en.htm) for a full explanation of the assumptions and methodologies agreed by the EPC.

6

QUALITY OF PUBLIC FINANCES

PUBLIC SERVICES

World class public services

6.1 Against a background of sound public finances and economic stability, the Government's goal is to deliver world-class public services through sustained investment matched by far-reaching reform. As highlighted in Chapter 2, modern and efficient public services are at the heart of the Government's vision of a society in which economic prosperity is underpinned by social justice. High-quality education and training, a modern and reliable transport network, an effective criminal justice system and a modern health service provide the essential foundations for a flexible and productive economy and a fair society, which is well placed to prosper in the increasingly competitive global economy.

A long-term strategy for public services

6.2 In June 1997 the incoming Government launched the first Comprehensive Spending Review (CSR) – a fundamental and in-depth examination of government spending which set the course of public services for the decade ahead. Building on the platform of stability provided by the new fiscal code, the CSR and subsequent Spending Reviews articulated the Government's overarching priorities for the long term: sustainable growth and employment; fairness and opportunity; modern and effective public services; and a secure and fair world. To achieve these ambitions, since 1997 the Government has established a public services strategy based on three key principles:

- *delivering resources to the front line*, with stable public finances and a reformed fiscal and budgetary framework providing the foundation for sustained increases in resources and investment in public assets;
- *ensuring value for money*, to make the most of increased resources and fulfil the Government's obligation to taxpayers to employ resources efficiently and effectively; and
- *reforming the delivery of public services*, to strengthen accountability and improve outcomes for society, including higher standards, reduced inequalities and greater user satisfaction.

6.3 Spending reviews set firm and fixed three-year Departmental Expenditure Limits (DEL) for each department. The Budget preceding a Spending Review sets an overall envelope for public spending for the period covered by the Spending Review that is consistent with the fiscal rules. The Treasury then allocates three year DELs to each department. Successive Spending Reviews have targeted resources at the Government's priorities, have matched these resources with reforms, and have set ambitious targets for improvements in key public services.

6.4 Recognising that the UK's public services must be equipped to respond to emerging and future challenges and opportunities, in July 2005 the Government announced that it intends to conduct a second Comprehensive Spending Review, reporting in 2007. A decade on from the first CSR, the 2007 CSR provides an opportunity for the Government to take stock of the progress it has made against its overarching goals, and to review fundamentally the effectiveness of departmental spending in delivering further advances. Through this work, the 2007 CSR will identify what additional long-term investments and reforms are needed to meet the challenges and opportunities of the years ahead.

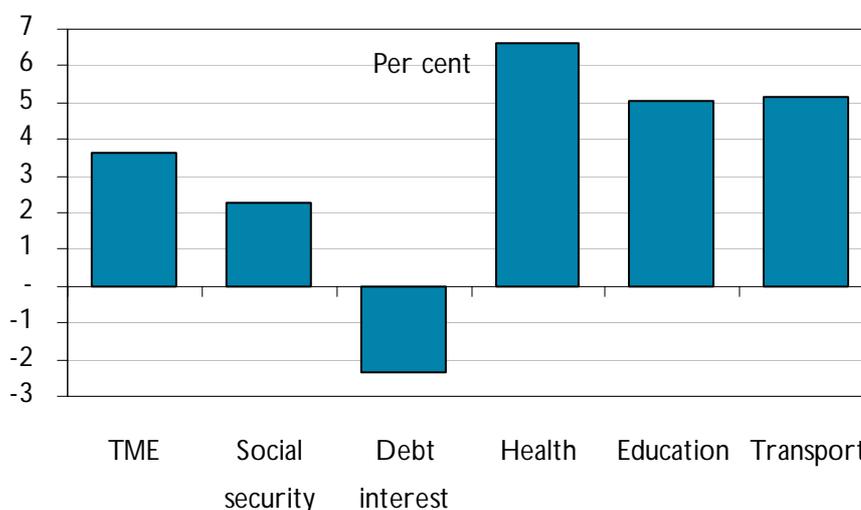
DELIVERING RESOURCES TO THE FRONT LINE

Increased resources for priorities

6.5 Extensive reform of the system for managing public expenditure, underpinned by the new fiscal framework, and prudent management of the economy and the public finances have enabled the Government to deliver a step change in resources for key public service priorities in the three Spending reviews since 1998. After a period of relative stagnation in the mid-1990s, since the 1998 Comprehensive Spending Review, health and education have benefited from sustained and significant real increases in investment. By the end of the 2004 Spending Review period, compared with 1997:

- public spending on the National Health Service will be around 90 per cent higher in real terms, and as a proportion of GDP total UK health spending is expected to rise from 6.8 per cent in 1996-97 to 9.2 per cent in 2007-08;
- total spending on schools in England will be over 65 per cent higher in real terms; as a percentage of GDP, UK education spending will rise from 4.7 per cent in 1996-97 to 5.6 per cent in 2007-08 – from one of the lowest in the industrial world to among the highest; and
- public expenditure on transport is planned to increase by over 60 per cent in real terms compared with a decade earlier.

Chart 6.1: Releasing resources for priorities – real annual average growth rate, 1997-98 to 2007-08



Source: HM Treasury

2004 Spending Review

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

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

Box 6.1: Ensuring value for money: Delivering the Gershon efficiency programme

Departments and local authorities have reported annual efficiency gains totalling £4.7 billion by the end of September 2005, with further gains achieved since then. The reported gains have been achieved through improvements across the public sector in the five key areas identified by the Gershon Review, including through the examples outlined below.

Procurement – getting better value from goods and services bought by government

- A £40 million saving from better accommodation contracts has contributed to a £250 million reduction in the cost of support for asylum seekers.
- The introduction of ‘Pulse Line’ technique has enabled quicker turn-around and greater availability of defence equipment such as the Harrier, Tornado, Puma helicopter and the Warrior fighting vehicle. For the Tornado alone, this will deliver average annual savings of £22 million and reduce headcount requirements by 150 posts.
- The Department of Work and Pension’s renegotiated IT contract will deliver average annual savings worth £180 million.

Productive time – freeing up time for front-line service delivery

- Better management of patient admissions has reduced the average hospital length of stay, cutting treatments costs by over £300 million so far and freeing-up over 1 million bed days to treat more patients, more quickly.
- The Metropolitan Police Service has achieved efficiency gains in officer time equivalent to £16.7 million from targeted action to reduce sickness levels.
- A new Probation Service computer system will automate the preparation of reports for court, saving 110,000 hours of probation officer time each year.

Corporate services – reducing running costs in HR, IT support and finance

- The Department of Health has set up a shared services joint venture company to manage NHS non-customer facing processes, delivering significant operational and efficiency benefits. Over 100 NHS organisations will be contracted by March 2006, with expected annual efficiency gains of at least £15 million by 2008.

Transactional services – streamlining interactions with customers

- The Department for Transport is making annual efficiency gains of over £350,000 through online booking of driving tests, with the convenience of being available 24 hours a day. Online bookings are now being made for half of all theory tests and one third of all practical driving tests.

Policy, funding and regulation – streamlining government machinery

- The first phase of NHS Arms Length Bodies (ALB) reduction and restructuring has reduced the number of bodies from 38 to 33, with a further reduction to 26 by March 2006. This will reduce operating costs by £60 million this year, rising to £250 million annual savings from March 2008.
- The Department for International Development has improved the efficiency and effectiveness of its aid programme for Ugandan health services by integrating its funding streams with those of the national government rather than funding specific projects. This has led to higher immunisation rates amongst children and increases in trained health workers – a doubling of health sector outcomes achieved with only a modest increase in resources.

PUBLIC INVESTMENT

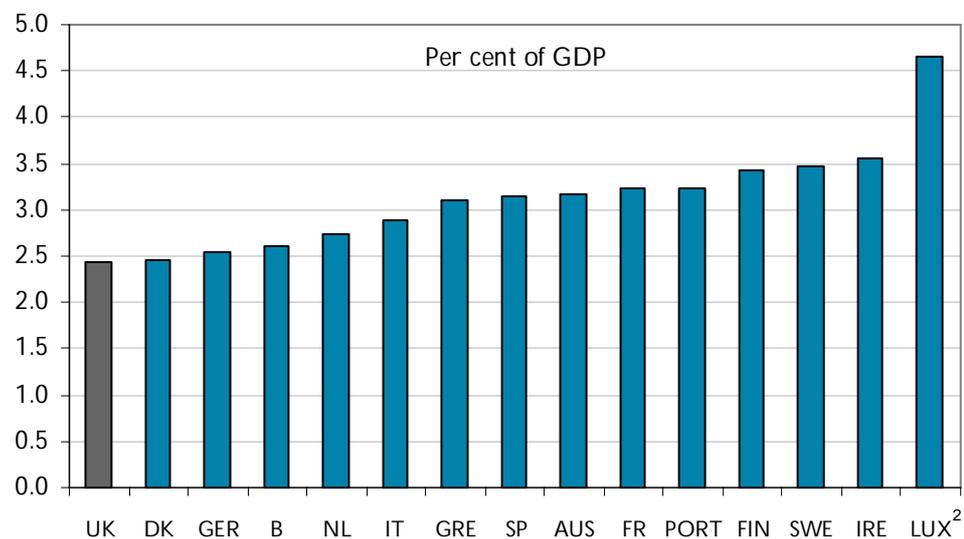
6.7 The third key element of the Government’s prudent interpretation of the Stability and Growth Pact involves taking account of the important role of public investment (see Box 4.3).

Investment in public assets

6.8 The UK has historically invested less of its national income in key public services than comparable economies such as the US and many EU countries. OECD data show that throughout the 1970s, 1980s and 1990s, the UK spent a significantly lower share of its GDP on health than France, Germany and the US. Against this background, in its 2005 Economic survey of the United Kingdom, the OECD stated that, “For decades under investment in public infrastructure was an easy option for constraining public outlays. The government’s first fiscal rule, the so called “golden rule”, distinguishes between capital and current spending, and has helped to avoid such short term expediency. Indeed, the share of government investment in GDP has risen, and there are plans for it to rise further. Nevertheless, even after it rises to just under 2½ per cent of GDP next year, it still remains relatively modest compared with many other OECD countries and may be inadequate to correct years of neglect.”¹

6.9 Chart 6.2 shows UK public investment in comparison with other European countries.

Chart 6.2: Public investment, 1971 to 2007¹



¹ Figures for 2005, 2006 and 2007 are forecasts.

² Data for Luxembourg is only available for the period 1991 to 2007.

Source: European Commission, Autumn 2005 forecasts

¹ Economic survey of the United Kingdom, OECD, 2005

6.10 The underlying strength of the public finances has enabled the Government to tackle the legacy of under-investment in the nation's infrastructure. Investment makes a crucial contribution to long-term economic growth, and public capital plays a significant role. Public sector capital underpins both public service delivery and private sector activity, contributing to the productivity and flexibility of the economy. The Government's reforms to the public spending framework have helped to address the institutional disincentives against public investment and improve the framework within which investment decisions are taken:

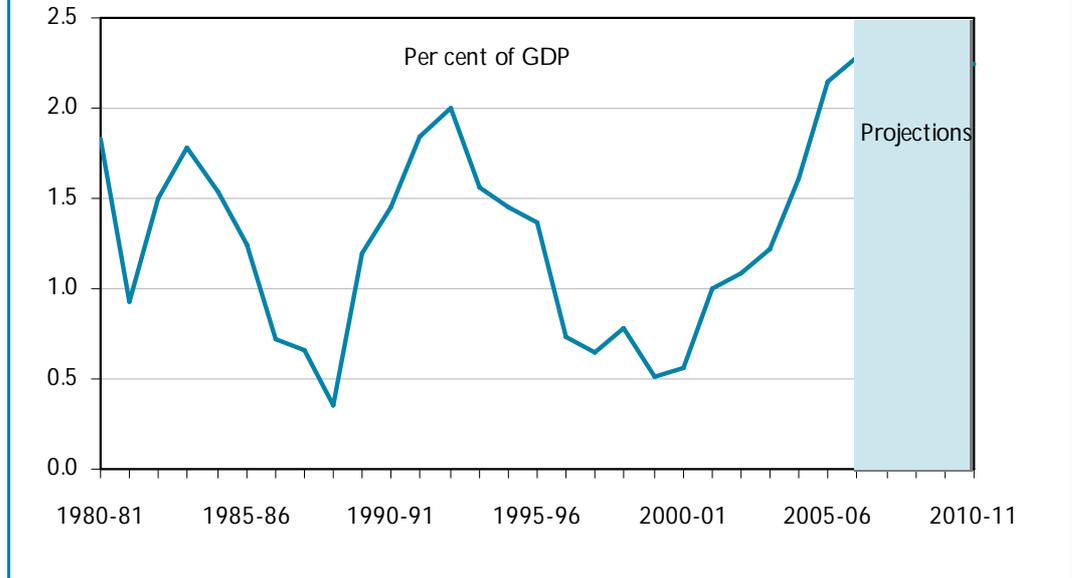
- fiscal rules and departmental budgeting which distinguish clearly between current and capital expenditure;
- medium-term budgeting for departments with full end year flexibility, which supports the management of longer-term investment projects; and
- improved investment appraisal and asset management procedures, supported by the establishment of the Office of Government Commerce in 2000 and the publication of the first National Assets Register in 1997 (updated in 2001), which for the first time anywhere in the world provided government and the public with a complete picture of the country's assets.

Borrowing for investment

6.11 Consistent with both the Broad Economic Policy Guidelines and the UK's Lisbon National Reform Programme, the projections contained in Table 4.1 demonstrate the Government's commitment to address this historical under-investment. The increases in public investment are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level, below 40 per cent of GDP. The fiscal rules, 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.

6.12 Chart 6.3 shows that public sector net investment is now over three times higher as a share of the economy than it was in 1997-98, having risen from less than $\frac{3}{4}$ per cent to $2\frac{1}{4}$ per cent of GDP this year. Net investment is now at its highest level for 26 years, and has never before risen as a share of the economy in six successive years. As a result of this sustained increase, public investment in priority areas has grown significantly: annual average real growth in capital budgets from 1999-2000 to 2007-08 will be 25 per cent in the NHS, 19 per cent in education and 15 per cent in transport.

Chart 6.3: Public sector net investment



6.13 Table 6.1 provides a breakdown of public service capital expenditure from 2004-05 to 2007-08.

Table 6.1: Public sector capital expenditure

	£ billion			
	Outturn 2004-05	Estimate 2005-06	Projections 2006-07 2007-08	
Capital Budget DEL	25.4	29.1	32.0	35.2
Locally-financed expenditure	1.9	2.3	2.3	2.4
National Lottery	1.1	0.9	0.9	0.8
Public corporations' own-financed capital expenditure	2.5	2.8	2.7	2.8
Other capital spending in AME	3.0	6.9	7.4	7.2
AME margin	0.0	0.0	0.6	0.4
Public sector gross investment¹	33.8	42.0	45.9	48.7
<i>Less depreciation</i>	14.9	15.7	16.6	17.5
Public sector net investment	18.9	26.3	29.3	31.1
Proceeds from the sale of fixed assets ²	6.2	6.1	6.1	6.1

¹ This and previous lines are all net of sales of fixed assets.

² Projections of total receipts from the sale of fixed assets by public sector.

2007 COMPREHENSIVE SPENDING REVIEW

6.14 Over the last decade the Government has delivered a strong economy and sound public finances at the same time as sustained increases in resources for public services, leading to significant improvements in outcomes. Looking forward, there are new opportunities and challenges that need to be addressed in order to secure these benefits for the decade to come. To ensure Britain is fully equipped to meet these long-

term challenges, on 19 July 2005 the Chief Secretary to the Treasury announced a second Comprehensive Spending Review (CSR) reporting in 2007.

6.15 A decade on from the first Comprehensive Spending Review, the 2007 CSR will represent a fundamental review of the Government's priorities and expenditure. It will cover departmental allocations for 2008-09, 2009-10 and 2010-11, with allocations for 2007-08 held to the agreed figures already announced at the 2004 Spending Review. To provide a rigorous analytical framework for these departmental allocations, the Government will be taking forward a programme of work over the next year and a half involving:

- an assessment of what the sustained increases in spending and reforms to public service delivery have achieved since the first CSR, to inform the setting of new objectives for the decade ahead;
- an examination of the key long-term trends and challenges that will shape the next decade – including demographic and socio-economic change, globalisation, climate and environmental change, global insecurity and technological change – together with an assessment of how public services will need to respond;
- to release the resources needed to address these challenges, and to continue to secure maximum value for money from public spending over the CSR period, a set of zero-based reviews of departments' baseline expenditure to assess its effectiveness in delivering the Government's long-term objectives; together with
- further development of the efficiency programme, building on the crosscutting areas identified in the Gershon Review, to embed and extend ongoing efficiency savings into departmental expenditure planning.

6.16 The 1998 CSR and subsequent spending reviews in 2000, 2002 and 2004 established the Government's overarching priorities for the long term: sustainable growth and employment; fairness and opportunity; modern and effective public services; a secure and fair world. To support their delivery these high-level objectives have been translated into a set of detailed, outcome-focussed Public Service Agreements. The CSR presents an opportunity to take stock of the performance of public services against these objectives, and set new ambitions for the decade ahead.

6.17 Britain will only succeed in the modern global economy if the Government plans and invests not just for the next few years but for the long term. The CSR will therefore be informed by a detailed assessment of the long-term trends and challenges that will shape public services over the next decade, including:

- demographic change and the rapid increase in the old age dependency ratio as the 'baby boom' generation reaches retirement age;
- the intensification of cross-border economic competition as the balance of international economic activity shifts toward rapidly growing emerging markets such as China and India;
- the acceleration in the pace of innovation and technological diffusion and a continued increase in the knowledge intensity of goods and services;
- continued global uncertainty with ongoing threats of international terrorism and global conflict; and

- increasing pressures on natural resources and global climate from rapid economic and population growth in the developing world and sustained demand for fossil fuels in advanced economies.

6.18 These trends will have fundamental and far-reaching implications for public services and will require innovative policy responses, coordination of activity across departmental boundaries and sustained investment in key areas. The Government will report on these public spending challenges in 2006.

6.19 To release the resources needed to address these future challenges and meet new priorities in the years ahead, the CSR will embed value for money in departmental planning through two interrelated strands of work:

- a set of zero-based reviews of departments' baseline expenditure to assess its effectiveness in delivering the Government's long-term objectives. Whereas past spending reviews have traditionally focused on allocating incremental increases in expenditure, the process of setting new long-term objectives provides an important opportunity – with many past objectives achieved and supporting programmes and spending potentially available for reallocation – for a more fundamental review of the balance and pattern of expenditure across departments.
- these zero-based reviews will be complemented by a rolling forward of the Government's efficiency programme over the CSR period, with a particular emphasis on the cross-cutting areas in the public sector where greater efficiencies can be realised through further integration of functions, sharing of best practice or benchmarking across organisations.

6.20 As part of its focus on securing maximum value for money from public spending over the CSR period, the Government will be working to ensure that public sector pay is set at levels that are fair, comparable with the wider economy wherever possible, and at sustainable levels that do not cause inflationary pressures. The Government has taken steps to deliver a consistent approach across the public sector to pay decisions and a greater awareness of the impact these can have on effective public service delivery.

6.21 As described above, since 1997 the Government has taken steps to reverse the legacy of under-investment in public sector assets and bring public investment back onto a sustainable footing. The priority over this period has been to address the most urgent investment backlogs in public services. The UK now faces a new set of challenges that require long-term commitments from the Government. Recognising that future public investment decisions should be based on a detailed assessment of both the current state of the asset stock and the long-term investment needs of the country, the Government will be giving a renewed focus to capital in the run-up to the CSR.

6.22 In 2004 the public sector held a total of £766 billion of non-financial assets. The size, quality and fitness-for-purpose of the existing capital stock have a key impact on the quality of public services. Consequently, building on the recommendations of the Lyons Review of asset management, the CSR will place a particular focus on the condition and management of the underlying asset stock as a basis for future capital allocations. In the run-up to the CSR, departments will be required to prepare asset management strategies which:

- review the current state and condition of their asset stock, including an assessment of what the increases in public investment since 1997 have achieved and what remaining investment backlogs are impacting on service delivery;

- take a zero-based approach to investment decisions, analysing capital budgets to identify plans for the disposal of assets that are no longer required, the level of investment needed to sustain present service delivery, and what additional investment is needed to expand the coverage or functionality of the asset base; and
- align future investment plans with departments' overall strategic and policy objectives.

REFORMING THE DELIVERY OF PUBLIC SERVICES

6.23 Recognising that increased resources alone are not enough to transform the performance of public services, the Government has established an ambitious programme of reform designed to raise standards of service, reduce inequalities and increase user satisfaction. Strengthening accountability is an important element of this reform programme, as it ensures that those responsible for delivering public services are responsive to the needs and preferences of the individuals and communities they serve. The successful implementation of this ambitious reform programme is driven by the Government, front-line professionals, communities and individuals, and includes:

- *setting clear goals and establishing national standards*, to raise performance and increase accountability;
- *increasing front-line freedoms and flexibilities*, to give front-line professionals greater operational autonomy and support to provide services that meet their users' needs;
- *promoting engagement with the citizen and the community* – including in the design, delivery and governance of public services – to strengthen local accountability and deliver more responsive services; and
- *empowering users* to promote high standards and personalised services, which meet their diverse needs and preferences, including by exercising choice.

Clear goals and national standards

6.24 Outcome-oriented targets and incentives for achievement, supported by high quality regulation and inspection regimes are the primary levers that the Government has used to improve performance and enforce minimum standards across public services. Since their introduction in the 1998 CSR, Public Service Agreements (PSAs) have been central to this approach, setting national goals with unprecedented levels of transparency. As set out in the 2004 Spending Review, PSAs will continue to focus on the Government's highest priority outcomes, within which service providers are given freedom and flexibility to decide how best they should be delivered. As these outcomes are achieved the PSA targets will, where appropriate, become national standards.

6.25 This strategy of investment and reform has delivered significant improvements in the outcomes achieved across public services. Increased resources for the National Health Service have helped save over 160,000 lives from 1996 to 2004 as a result of reductions to mortality rates from cancer and circulatory diseases among people aged under 75. In education, provisional results for 2005 show the biggest year-on-year increase in the proportion achieving five good GCSEs for a decade, with some of the biggest improvements seen in areas of significant deprivation and a history of low achievement. And the risk of being a victim of crime is now the lowest recorded by the British Crime Survey since it began in 1981.

6.26 The Government is determined to build on these firm foundations, driving further improvements to public services to deliver a stronger economy, a fairer society and a more secure world. Looking forward, there are new opportunities and challenges the country must address in the decade ahead, including: demographic change and the rapid increase in the old age dependency ratio; an acceleration in the pace of innovation and technological change; globalisation and the emergence of rapidly industrialising economies such as India and China; global uncertainty with ongoing threats from international terrorism and global conflicts; and further pressures on natural resources together with greater risks from climate change.

