

International developments remain a key influence on the UK economy. Last year, concern over corporate accounting scandals and events in the Middle East brought uncertainty and volatility to equity and oil prices. This year, geo-political risks, particularly surrounding hostilities in Iraq, have compounded global uncertainties and further restrained global economic activity, particularly in the Euro-area. Nonetheless, the economic stability delivered by the Government's macroeconomic framework has left the UK well placed to deal with the impact of global events:

- the monetary policy framework is delivering low and stable inflation, while allowing the Bank of England's Monetary Policy Committee to respond to risks generated by weakness in the world economy; and
- the fiscal rules are delivering sound public finances and allowing the automatic stabilisers to operate freely to support monetary policy.

The immediate outlook for the world economy is now weaker than anticipated at the time of the Pre-Budget Report and prospects for the major economies, in particular the Euro-area, have been revised downwards. Growth is forecast to accelerate from the second half of 2003 and into 2004 as international uncertainty eases. UK GDP is forecast to grow by between 2 and 2½ per cent this year, and between 3 and 3½ per cent in 2004 and 2005, as the economy returns to trend.

The projections for the public finances show that the Government is firmly on track to meet its strict fiscal rules over the economic cycle, including in the cautious case, and while meeting its international and public spending commitments:

- the average current budget since the start of the current cycle in 1999-2000 is comfortably in surplus, ensuring the Government remains on track to meet the golden rule, using cautious assumptions and in the cautious case; and
- public sector net debt is projected to be low and stable throughout the next five years, stabilising at just under 34 per cent of GDP by the end of the projection period. This comfortably meets the sustainable investment rule and gives the UK the lowest level of debt as a proportion of national income in the G7.

In the short term, the operation of the automatic stabilisers means that fiscal policy is supporting monetary policy in maintaining economic stability as the economy remains below trend. In the medium term, the public finances return towards the Budget 2002 profile as economic growth strengthens. The use of cautious assumptions and the 'stress test' against the cautious case help to ensure that the public finances are sound and sustainable, despite continued international uncertainty and global economic weakness.

THE MACROECONOMIC FRAMEWORK

2.1 Compared with the Pre-Budget Report, economic growth is now expected to be weaker in the world's major economies, particularly in the Euro-area. Last year, concern over corporate accounting scandals and events in the Middle East brought uncertainty and volatility to equity and oil prices, and this has continued into 2003. Geo-political risks, most of all those surrounding the hostilities in Iraq, have compounded existing uncertainties. International developments continue to be a key influence on the outlook for the UK economy, and persistent uncertainty and subdued global growth have prompted falls in consumer confidence and further deferred business investment plans. The macroeconomic framework limits the impact of adverse global developments on the economy so that the UK can maintain high and stable levels of growth and employment.

2.2 The macroeconomic framework is designed to maintain long-term economic stability. Large fluctuations in output, employment and inflation add to uncertainty for businesses, 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.

2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability¹. The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by two strict rules that ensure sound public finances over the medium term. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

Box 2.1: Government policy on EMU

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

The Government is committed to publishing a comprehensive and rigorous assessment of the five tests within two years of the start of this Parliament. If a decision to recommend joining is taken by the Government, it will be put to a vote in Parliament and then to a referendum of the British people.

The Government's preliminary and technical analysis supporting the five tests assessment and comprising 18 supporting studies will be published alongside the assessment.

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

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

¹ Further details can be found in *Reforming Britain's economic and financial policy*, HM Treasury, 2002.

Monetary policy framework 2.4 Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target and allowed the Bank of England's Monetary Policy Committee (MPC) to mitigate the impact of global uncertainty on the UK economy. The framework is based on four key principles:

- clear and precise objectives. While the primary objective of monetary policy is to deliver price stability, the adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's inflation target. **The Government is reaffirming in Budget 2003 the target of 2½ per cent for the 12 month increase in the Retail Prices Index excluding mortgage payments (RPIX)**, which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings, and 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 this meets the remit of the MPC.

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

Fiscal policy framework 2.6 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*² – 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.

2.7 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.

²The code for fiscal stability, HM Treasury, November 1998.

2.8 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.

**Public spending
framework**

2.9 The fiscal policy framework also takes account of uncertainty that is inherent in projections of the public finances. The fiscal projections are based on cautious assumptions for key economic variables, including the trend rate of growth, equity prices and the level of unemployment. This cautious approach builds a safety margin into the public finances and minimises the need for unexpected changes in taxation or spending. The assumptions are audited by the Comptroller and Auditor General as part of a three-year rolling review to ensure that they remain reasonable and cautious.

2.10 To enhance the reporting of past fiscal developments, a new *End of year fiscal report* was published for the first time alongside the 2002 Pre-Budget Report. The report provides detailed retrospective information on the public finances in 2000-01 and 2001-02, supplementing the information already published under the *Code for fiscal stability* and bringing the UK into line with international best practice.

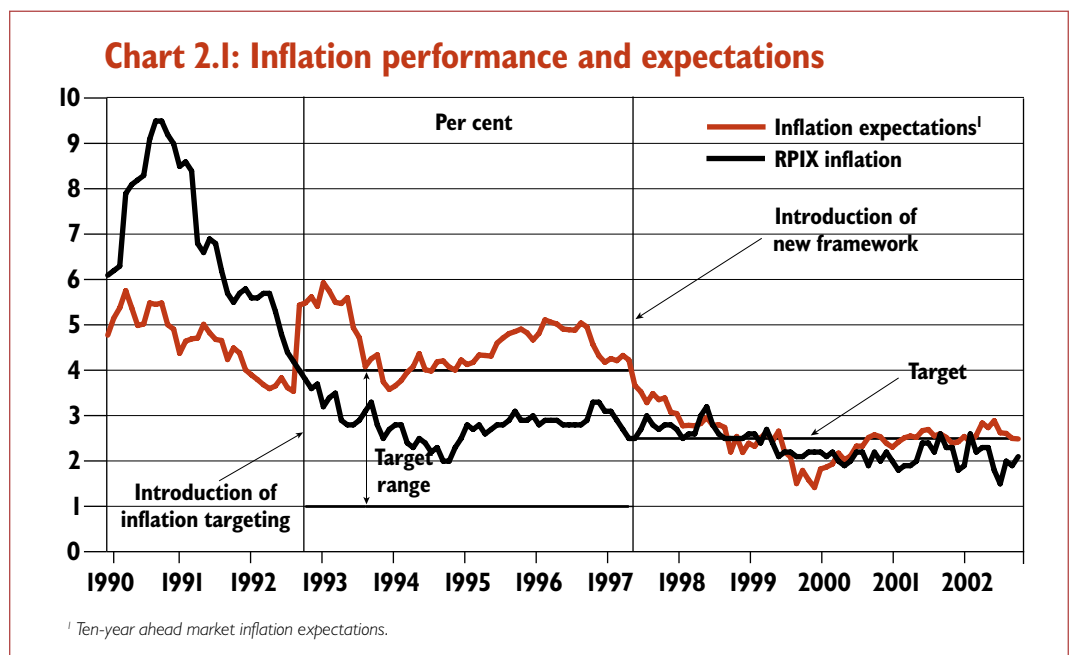
2.11 Sound public finances are a prerequisite for sustainable investment in public services. The fiscal rules underpin the Government's public spending framework and have important consequences for the structure of the budgeting regime. The golden rule increases the efficiency of public spending by ensuring that growth-enhancing 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. Full details of the public spending framework are set out in Chapter 6, which also provides information on the resources made available for public services in the 2002 Spending Review and on the Government's strategy for reforming public services.

THE PERFORMANCE OF THE FRAMEWORK

Monetary strategy 2.12 The Government's frameworks for monetary policy, fiscal policy and public spending form a coherent strategy for maintaining high and stable levels of growth and employment, and for minimising the harmful impact of external events.

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

- RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government's target; and
- long-term inflation expectations, as measured by survey and financial markets data, show that inflation is expected to remain close to the Government's target, having fallen from over 4 per cent in 1997.



2.14 The framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates by a total of two percentage points. Interest rates were then left at historically low levels for over a year, before a further reduction in February 2003. This helped to keep output close to its trend level, while ensuring that inflation remained close to target. Long-term interest rates are around their lowest levels for over 35 years, reducing the Government's debt interest payments and freeing up resources for investment in public services.

Fiscal strategy 2.15 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 more than 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. Public sector net debt has also been reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03 – the lowest level of debt as a proportion of national income in the G7.

2002 Spending Review 2.16 Significant investment in the reform and modernisation of public services has been delivered within this framework. The 2002 Spending Review established departmental spending plans for the three years to 2005-06, and for the five years to 2007-08 for UK spending on the NHS, consistent with the Government's strict fiscal rules. To deliver the largest ever sustained spending growth in the history of the NHS, while meeting the fiscal rules and other priorities, Budget 2002 raised national insurance contributions (NICs) by one per cent for employees, employers and the self employed on all earnings above the NICs threshold from April 2003, and froze the income tax personal allowance for those aged under 65 in 2003-04.

2.17 Total Managed Expenditure (TME) is set to rise by 4.3 per cent a year, on average, in real terms between 2002-03 and 2005-06. Within this, the Government has been able to devote additional resources to priority public services:

- over the three years to 2005-06, planned spending on education is set to grow by 5.7 per cent a year in real terms and on transport by 8.3 per cent. Over the five years to 2007-08, planned spending on health is set to grow by 7.2 per cent a year in real terms;
- social security payments, tax credits and debt interest payments will account for just 23 per cent of the additional public spending planned over the next three years, compared with 57 per cent between 1991-92 and 1996-97;
- debt interest payments are expected to have fallen by almost 7 per cent a year, on average in real terms, over the period 1996-97 to 2002-03, compared with an average annual increase of more than 7 per cent in real terms between 1991-92 and 1996-97; and
- to address the legacy of under-investment in public services, public sector net investment, already expected to be almost three times higher in 2003-04 than in 1997-98, is projected to rise still further to 2¹/₄ per cent of GDP in 2007-08.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments 2.18 Global economic conditions have remained challenging since the 2002 Pre-Budget Report and prospects for the world's major economies, in particular the Euro-area, have been revised downwards. Last year, concern over accounting scandals and tensions in the Middle East brought uncertainty and volatility to equity and oil prices, and this has continued into 2003. Geo-political risks, particularly surrounding hostilities in Iraq, have compounded existing uncertainties. Although oil prices have now fallen back, they have recently been at their highest level for around two and a half years and global equity markets and exchange rates have seen further turbulence since the time of the Pre-Budget Report.

2.19 International uncertainty remains a key influence on UK economic prospects. Ongoing global uncertainty, combined with an already sluggish global recovery, has kept business confidence in the UK subdued and discouraged firms from bringing deferred investment projects back on stream. Nonetheless, the Government's macroeconomic framework has continued to perform well against these global challenges and risks. Inflation has remained close to target, allowing the MPC to reduce interest rates to their lowest level in almost fifty years. Fiscal policy has continued to complement monetary policy in supporting growth.

2.20 While a number of the world's major economies were in recession in 2001, the UK economy has continued to grow throughout the recent period of protracted global uncertainty. The UK is currently experiencing its longest unbroken period of economic expansion since quarterly records began almost fifty years ago, with GDP having increased for 42 consecutive quarters.

Economic prospects 2.21 Growth slowed across the G7 economies in the final months of 2002, as expected. However, since the turn of the year, geo-political risks and volatility in equity markets prompted further sharp falls in consumer confidence and weaker than expected household consumption in most of the major economies. With business confidence remaining at low levels and further evidence that firms are continuing to defer investment decisions, global economic activity in the first few months of 2003 is now forecast to be weaker than anticipated at the time of the Pre-Budget Report. Growth is expected to strengthen from the middle of 2003 as uncertainty dissipates and the recovery in the US gathers pace.

Table 2.1: The world economy

	Percentage changes on a year earlier			
	2002	Forecast		
		2003	2004	2005
<i>Major 7 countries¹</i>				
Real GDP	1½	1¾	2¾	3
Consumer price inflation ²	1¾	1¼	1½	1½
<i>Euro-area</i>				
Real GDP	¾	1	2¼	2¾
World trade in goods and services	2½	4¾	8½	7¾
UK export markets ³	1¾	4¼	7½	7

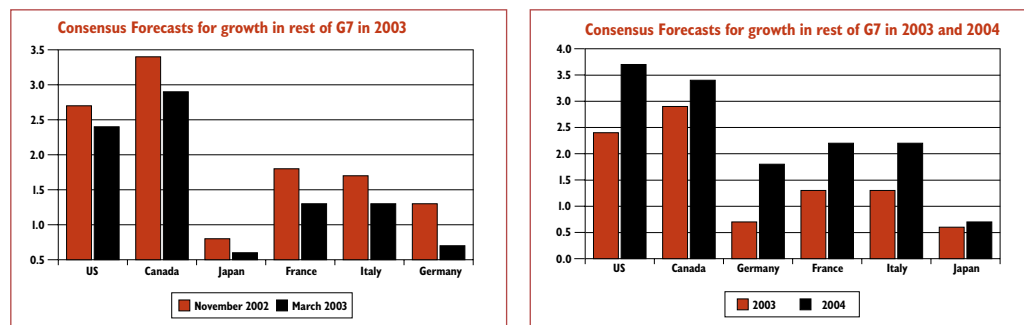
¹ G7: US, Japan, Germany, France, UK, Italy and Canada.

² Final quarter of each period. For UK, RPIX.

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

2.22 Chart 2.2 shows that, since the time of the Pre-Budget Report, Consensus Forecasts have revised down their projections for GDP growth during 2003 in each of the G7 economies, and especially in the Euro-area. However, the latest consensus forecasts also reveal that growth is expected to recover throughout the G7 during 2004, as global uncertainties ease from the second half of this year.

Chart 2.2: Independent forecasts for G7 growth



Source: Consensus Economics Inc.

2.23 Ongoing global uncertainty is expected to continue to subdue demand in key UK export markets and hold back business investment in the near term. UK GDP is expected to grow by between 2 to 2½ per cent this year. Growth is expected to accelerate in the second half of 2003 and into 2004, as international uncertainty eases and an anticipated gathering in the pace of the global economic recovery feeds through to the domestic economy. GDP is therefore forecast to increase by 3 to 3½ per cent both next year and the year after, with the economy returning to trend by the end of 2005.

2.24 RPIX inflation is expected to remain a little above the Government's target over the next few months, temporarily boosted by housing cost effects. Thereafter, inflation is forecast to ease back as these temporary factors unwind and slack in the economy puts downward pressure on domestic prices.

Table 2.2: Summary of UK forecast

	2002	Forecast		
		2003	2004	2005
GDP growth (per cent)	1¾	2 to 2½	3 to 3½	3 to 3½
RPIX inflation (per cent, Q4)	2½	2¾	2½	2½

2.25 International developments have also affected the recent pattern of economic growth. Global uncertainty has undermined business confidence and external demand, while a robust labour market, allied with strong house price rises, has given support to private consumption. Growth is expected to become more balanced over the forecast horizon as deferred business investment comes back on stream, exports pick up in response to stronger global demand, and private consumption growth moderates towards sustainable rates.

Forecast risks 2.26 There are both upside and downside risks to the economic outlook. On the upside, the various uncertainties currently affecting the global economy could dissipate more quickly, and confidence recover more sharply than anticipated. This would, in turn, help support a stronger than expected improvement in UK economic prospects.

2.27 A period of prolonged uncertainty, accompanied by continued volatility in financial markets, weaker equity prices and higher oil prices poses the clearest downside risk to G7 activity. The Government will remain vigilant in the face of these risks. The public finance projections will continue to be based on cautious assumptions, including for equity prices and the trend rate of growth, and 'stress tested' against the cautious case, which builds in a margin against shocks and unexpected events. The Government remains on track to meet its strict fiscal rules over the economic cycle, including in the cautious case.

The economic cycle 2.28 Since Budget 2000, the Government's provisional judgment has been that the economy completed a full, albeit short cycle between the first half of 1997 and mid-1999. The current economic cycle therefore began in mid-1999, with output moving slightly above trend in 2000 and the first half of 2001. This judgement does not affect the fact that the Government remains firmly on track to meet its fiscal rules over the economic cycle. The average current budget since 1999-2000 and since 1997-98 remains comfortably in surplus in every year of the projection period.

Caution and the public finances **2.29** The Comptroller and Auditor General independently audits 12 key assumptions that underpin the public finances projections on a three-year rolling programme to ensure that they remain reasonable and cautious. A complete list of these assumptions is set out in Chapter C of the *Financial Statement and Budget Report*. For Budget 2003, the existing assumptions relating to privatisation proceeds and interest rates have been audited; as set out in Chapter C, the tobacco assumption has been revised to reflect recent trends in smuggling and the success of HM Customs and Excise strategy. All were deemed to be reasonable and to have demonstrated or incorporate caution³.

2.30 As described in Chapter 5, Budget 2003 launches a new compliance and enforcement package for direct tax and national insurance contributions. An additional £66 million is being provided to the Inland Revenue over the next three years to support implementation of the package. The package is expected to produce £1.6 billion in total additional revenue over the next 3 years, but in line with the Government's cautious approach to the public finances a lower figure of under £1.4 billion over three years, with the annual figure rising to just over £0.6 billion in 2005-06, has been included in the forecast. The Comptroller and Auditor General has audited the projections and concluded that they are based on a reasonable approach and incorporate caution.

Box 2.2: Equity prices and the public finances

The projections for the public finances are based on the cautious assumption that equity prices rise from their current levels in line with projected growth in money GDP.

The equity price assumption which underpins the Budget 2003 projections is based on the 28 March 2003 level of the FT All-Share index, which, at 1778, is 9 per cent lower than that used in the 2002 Pre-Budget Report projections. This affects receipts from capital taxes, corporation tax and stamp duty, and reduces total receipts by just under £1 billion in each year compared with the Pre-Budget Report projections. The impact on receipts of the recent stock market increases over the past week have therefore not been incorporated into the forecast published today.

The Treasury's methodology for estimating the impact of the economic cycle on the public finances is based on the average impact of the output gap on the fiscal aggregates over previous cycles. This would only capture the effect of equity prices on the public finances to the degree that movements in equity prices have been associated with past economic cycles. To the extent that this is not the case, recent falls in equity prices will not be captured in estimates of the automatic stabilisers.

Equity prices are heavily influenced by expectations about the future, making them volatile and prone to 'bubbles' and periods of over-correction. The consensus among market analysts is that equity prices are currently suppressed by unduly harsh risk premia associated with global instability, and the average of recent independent forecasts¹ suggests that equity prices will rise by 20 per cent over the coming year. This would generate a £1 billion increase in total receipts this year relative to the Budget projections.

Nonetheless, consistent with its prudent approach to managing the public finances, and in the interests of stable and robust fiscal planning, the Government continues to base its projections on a deliberately cautious equity price assumption.

¹ Based on a panel of independent organisations forecasting the year-ahead level of the FTSE 100 index in March 2003.

³ *Audit of Assumptions for Budget 2003*, National Audit Office, April 2003 (HC 627).

RECENT FISCAL TRENDS AND OUTLOOK

2.31 Budget 2003 presents the Government's annual fiscal forecast and updates the 2002 Pre-Budget Report interim projections which showed weaker receipts this year and over the next two years, primarily due to cyclical or otherwise temporary factors.

2.32 Continued weakness and uncertainty in the world economy and the £3 billion contingency provision to meet the full cost of the UK's military obligations in Iraq affected the fiscal balances last year. The estimated 2002-03 outturn for the public sector current budget shows a deficit of £11.7 billion, compared with a projected deficit of £5.7 billion in the 2002 Pre-Budget Report and a surplus of £3.2 billion in Budget 2002. For public sector net borrowing, the estimated 2002-03 outturn is £24.0 billion, compared with a projection of £20.1 billion in the Pre-Budget Report and of £11.2 billion in Budget 2002. However, disciplined management of the public finances means that the Government can allow the automatic stabilisers to operate during this period of global economic weakness, while remaining on track to meet the fiscal rules over the economic cycle, including in the cautious case.

2.33 Table 2.3 shows the projections for public sector net borrowing compared with those in the 2002 Pre-Budget Report. It disaggregates the changes into those attributable to the automatic stabilisers, other non-discretionary factors and discretionary measures, which include the Budget decisions set out in paragraphs 2.42 to 2.44 below.

Table 2.3: Public sector net borrowing compared with the 2002 Pre-Budget Report

£ billion	Estimate ¹		Projections			
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
PBR 2002	20.1	24	19	19	19	20
Effect of automatic stabilisers	-1.1	2	3	1	0	0
Effect of other non-discretionary factors	3.1	1	1	1	1	1
Discretionary measures ²	1.9	0	1	2	1	1
<i>of which: policy measures since PBR 2002</i>	<i>2.0</i>	<i>0</i>	<i>0</i>	<i>0</i>	<i>-1</i>	<i>-1</i>
<i>resetting the AME margin</i>	<i>-0.1</i>	<i>-1</i>	<i>1</i>	<i>2</i>	<i>2</i>	<i>2</i>
Budget 2003	24.0	27	24	23	22	22

Note: Figures may not sum due to rounding.

¹ The 2002-03 figures were projections in PBR 2002.

² This includes the £2 billion added since the Pre-Budget Report to make the contingency provision for the UK's military commitments in Iraq £3 billion in 2002-03. The allocation of resources between years will be reviewed in the light of developments.

2.34 The automatic stabilisers explain over half of the change in borrowing in 2003-04 and 2004-05. As the economy returns to trend over the medium term, so the effect of the automatic stabilisers declines. Other non-discretionary factors will capture a variety of influences on the public finances, including some temporary factors that are not picked up by the Treasury's methodology for cyclical adjustment described below, and the forecast revenue effects of the Inland Revenue compliance and enforcement package. From 2004-05, discretionary measures increase the level of borrowing, primarily as a result of the Government's decision to reset the AME margin to ensure that the public spending projections include a prudent and cautious safety margin against unexpected events. The discretionary measures line also includes the additional £2 billion added to the contingency provision in 2002-03 since the Pre-Budget Report.

2.35 The Treasury's methodology for estimating the impact of the economic cycle on the public finances is based on the average impact of changes in the output gap on the public finances over previous cycles. This means that the impact of changes in equity prices, social security payments and financial company profits are only attributed to the automatic stabilisers to the degree that changes in these have been associated with the output gap in the past. To the extent that this economic cycle differs from previous ones, temporary changes in the public finances may be ascribed to other non-discretionary effects rather than the automatic stabilisers.

2.36 An alternative disaggregation of the factors underlying the change in public sector net borrowing is shown in Table 2.4. Changes associated with the assumptions audited by the NAO help to reduce projections of net borrowing. This is primarily the result of the new assumption for anti-tobacco smuggling measures and the Inland Revenue compliance and enforcement package, partly offset by lower equity prices as described in Box 2.5. Other economic and forecasting effects includes the impact of the cycle on net borrowing to the extent that these cyclical factors are not associated with the NAO assumptions or financial company profits.

Table 2.4: Public sector net borrowing compared with the 2002 Pre-Budget Report

£ billion	Estimate ¹	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
PBR 2002	20.1	24	19	19	19	20
Assumptions audited by the NAO	0.0	-1	-1	-1	-2	-2
<i>of which: equity price assumption</i>	<i>0.0</i>	<i>0</i>	<i>1</i>	<i>1</i>	<i>1</i>	<i>1</i>
<i>tobacco assumption</i>	<i>0.0</i>	<i>0</i>	<i>-1</i>	<i>-1</i>	<i>-1</i>	<i>-1</i>
<i>Inland Revenue package</i>	<i>0.0</i>	<i>0</i>	<i>-1</i>	<i>-1</i>	<i>-1</i>	<i>-1</i>
Financial company profits	0.0	1	1	0	0	0
Other economic and forecasting effects	2.0	3	4	4	3	3
Total before discretionary measures	2.0	3	4	2	0	-1
Discretionary measures²	1.9	0	1	2	1	1
<i>of which: policy measures since PBR 2002</i>	<i>2.0</i>	<i>0</i>	<i>0</i>	<i>0</i>	<i>-1</i>	<i>-1</i>
<i>resetting the AME margin</i>	<i>-0.1</i>	<i>-1</i>	<i>1</i>	<i>2</i>	<i>2</i>	<i>2</i>
Budget 2003	24.0	27	24	23	22	22

Note: Figures may not sum due to rounding.

¹ The 2002-03 figures were projections in PBR 2002.

² This includes the £2 billion added since the Pre-Budget Report to make the contingency provision for the UK's military commitments in Iraq £3 billion in 2002-03. The allocation of resources between years will be reviewed in the light of developments.

Non-discretionary changes in receipts **2.37** Receipts are now expected to be £10.1 billion lower in 2002-03 compared with the Budget 2002 projection, and £2.7 billion lower than projected in the 2002 Pre-Budget Report. The change between Budget 2002 and the 2002 Pre-Budget Report reflects the impact of falls in equity prices and weaker financial company profits. The decline in overall receipts since the Pre-Budget Report is largely due to lower than expected receipts from income tax and national insurance contributions.

2.38 Receipts in 2003-04 are projected to be below the levels forecast in Budget 2002, and slightly lower than those in the 2002 Pre-Budget Report. Over the medium term, receipts steadily return to the levels forecast in Budget 2002. Chapter C of the Financial Statement and Budget Report provides further detail on changes to the forecast of receipts.

Non-discretionary changes in spending **2.39** The estimated outturn for Total Managed Expenditure (TME) in 2002-03 is £1.2 billion higher than projected in the 2002 Pre-Budget Report. For Departmental Expenditure Limits (DEL), the estimated outturn is £2.7 billion higher than projected in the 2002 Pre-Budget Report and Annually Managed Expenditure (AME) is expected to be £1.5 billion lower.

2.40 In subsequent years, AME is higher than forecast in the 2002 Pre-Budget Report as social security payments increase and towards the end of the projection period debt interest payments rise. Local authority self-financed expenditure is also higher at the end of the projection period, though this has a broadly neutral impact on the fiscal balances as it is matched by higher council tax receipts, which reflect the convention that projections for council tax are based on recent years' increases. AME is also projected to rise as a result of the Government's decision to reset the AME margin.

BUDGET DECISIONS

2.41 The Budget is the definitive statement of the Government's desired fiscal policy settings. In making its Budget decisions the Government has considered:

- the need to ensure that, over the economic cycle, the Government will continue to meet its strict fiscal rules;
- its fiscal policy objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- how fiscal policy can best support monetary policy over the economic cycle.

2.42 Within this disciplined framework, Budget 2003 shows the Government can meet its public spending commitments and announces further decisions to build a Britain of economic strength and social justice, including:

- a package of reforms to promote flexibility in labour, product and capital markets, including measures to promote enterprise, innovation and skills, and support to help people find and succeed in work;
- further steps to advance flexibility and fairness together, with a new Child Trust Fund to spread the benefits of asset ownership to all and further support for pensioners; and
- reforms to tackle avoidance and advance fairness in the tax system, to ensure that everyone contributes fairly to the public services from which they benefit.

2.43 Table 1.2 lists the key Budget policy decisions and their impact on the public finances. Further details are set out in Chapter A of the *Financial Statement and Budget Report*.

2.44 As described in Chapter 6, the Government has made a special contingency provision of £3 billion to ensure that resources are available to cover the full cost of the UK's military obligations in Iraq. The full amount of the provision has been allocated to 2002-03, though it is not yet clear when these costs will fall. In the light of this uncertainty and to protect committed investment while responding prudently to heightened global risks, the Government has decided to make no further allocations from the Capital Modernisation Fund (CMF). Instead unallocated CMF funding will contribute to the rebuilding of the AME margin to ensure that the public spending projections include a prudent and cautious safety margin against unexpected events. Resetting the AME margin to £1, £2 and £3 billion for the years 2003-04, 2004-05 and 2005-06, in accordance with usual practice, increases projections for TME by £1 billion in 2004-05 and by £1.8 billion in 2005-06, compared with those made in the 2002 Pre-Budget Report.

MEDIUM TERM FISCAL PROJECTIONS

2.45 Table 2.5 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2002 and in the 2002 Pre-Budget Report. Changes in the fiscal balances are disaggregated into those explained by discretionary measures and those due to forecasting changes. It includes the impact of all Budget decisions in accordance with the *Code for fiscal stability*. Consistent with the presentation in the Pre-Budget Report, the table includes the impact of the windfall tax and associated spending. Further detail is provided in Chapter C of the *Financial Statement and Budget Report*.

2.46 The revised outturn for 2001-02 shows the current surplus to be £0.7 billion lower than forecast in Budget 2002 and £2.3 billion higher than in the 2002 Pre-Budget Report. The figures for public sector net borrowing are around £1½ billion lower than in both Budget 2002 and the 2002 Pre-Budget Report.

2.47 The projections for the current budget and net borrowing, which includes the £3 billion contingency provision to cover the full cost of the UK's military obligations in Iraq, show a slight deterioration in the near-term position compared with the 2002 Pre-Budget Report. Over the medium term, as the economy returns to trend, the projections move back towards the path described in Budget 2002. This slight deterioration in the short-term fiscal position leads to a modest increase in net debt which stabilises at just under 34 per cent of GDP by the end of the period, well below 40 per cent of GDP.

Table 2.5: Fiscal balances compared with Budget 2002

	Outturn Estimate ¹		Projections				
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Surplus on current budget (£ billion)							
Budget 2002	10.6	3.2	7	9	7	9	-
Effect of forecasting changes	-3.0	-7.9	-12	-7	-3	-1	
of which: effect of automatic stabilisers	-0.6	-5.8	-9	-5	-1	0	
effect of other non-discretionary factors	-2.4	-2.1	-4	-2	-2	-1	
Effect of policy measures	0.0	-1.0	1	0	1	1	
PBR 2002	7.7	-5.7	-5	3	5	8	10
Effect of forecasting changes	2.3	-4.1	-4	-3	-1	-1	0
of which: effect of automatic stabilisers	0.5	1.1	-2	-3	-1	0	0
effect of other non-discretionary factors	1.8	-5.2	-2	0	0	-1	0
Effect of Budget measures	0.0	-1.9	0	-1	-1	-1	-1
Budget 2003	9.9	-11.7	-8	-1	2	6	9
Net borrowing (£ billion)							
Budget 2002	1.3	11.2	13	13	17	18	-
PBR 2002							
Effect of forecasting changes	-0.2	7.8	12	6	2	1	
of which: effect of automatic stabilisers	0.6	5.8	9	5	1	0	
effect of other non-discretionary factors	-0.8	2.0	4	2	1	1	
Effect of policy measures	0.0	1.0	-1	0	-1	-1	
PBR 2002	1.2	20.1	24	19	19	19	20
Effect of forecasting changes	-1.5	2.0	3	4	3	1	1
of which: effect of automatic stabilisers	-0.5	-1.1	2	3	1	0	0
effect of other non-discretionary factors	-1.0	3.1	1	1	1	1	1
Effect of Budget measures	0.0	1.9	0	1	2	1	1
Budget 2003	-0.4	24.0	27	24	23	22	22
Public sector net debt (per cent of GDP)							
Budget 2002 ²	30.4	30.2	30.4	30.4	30.7	31.0	-
PBR 2002	30.4	31.0	32.1	32.4	32.6	32.7	33.0
Budget 2003	30.2	30.9	32.2	32.7	33.2	33.5	33.8

Note: Figures may not sum due to rounding.

¹ The 2002-03 figures were projections in Budget 2002 and PBR 2002.

² The 2001-02 figures were an estimate in Budget 2002.

2.48 Table 2.6 sets out the underlying structural position of the fiscal balances, adjusted for the impact of the economic cycle on the public finances. Cyclically-adjusted, the current budget and net borrowing remain close to the levels projected in Budget 2002 and the 2002 Pre-Budget Report over the medium term. In 2002-03, which includes the £3 billion contingency provision to meet the full cost of the UK's military obligations in Iraq, cyclically-adjusted net borrowing increases by $\frac{1}{2}$ per cent of GDP compared to the 2002 Pre-Budget Report, and the cyclically-adjusted current budget falls by around $\frac{3}{4}$ per cent of GDP, leading to a deficit of $\frac{1}{2}$ per cent in that year.

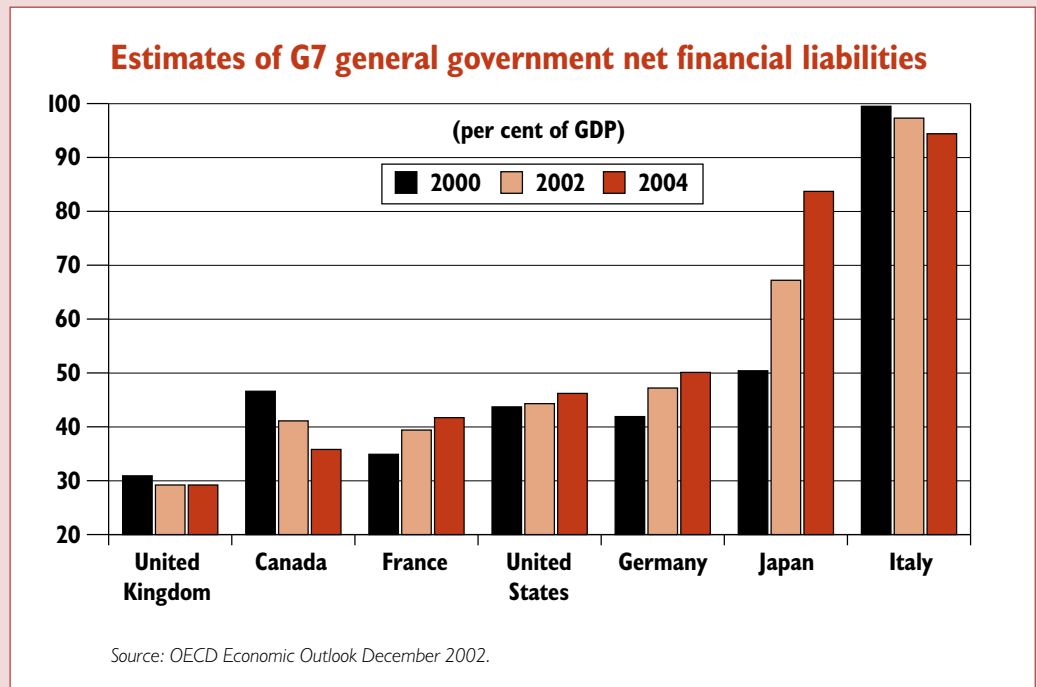
Table 2.6: Cyclically-adjusted fiscal balances

	Outturn Estimate ¹		Projections				
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Surplus on current budget (per cent of GDP)							
Budget 2002	1.0	0.5	0.6	0.7	0.6	0.7	–
PBR 2002	0.7	0.2	0.3	0.6	0.5	0.6	0.7
Budget 2003	0.9	–0.5	0.2	0.5	0.4	0.4	0.6
Net borrowing (per cent of GDP)							
Budget 2002	0.2	0.9	1.2	1.2	1.4	1.4	–
PBR 2002	0.2	1.2	1.5	1.3	1.5	1.5	1.5
Budget 2003	0.1	1.7	1.5	1.5	1.7	1.7	1.6

¹The 2002-03 figures were projections in Budget 2002 and PBR 2002.

Box 2.3: International public finances

The global economic slowdown has had a significant impact on public finances throughout the world and many of the G7 economies have experienced rising debt ratios since 2000, and are expected to see further rises in the coming years. As shown in the chart below, the UK now has the lowest debt-to-GDP ratio in the G7.



Public sector net debt in the UK has fallen from nearly 44 per cent of GDP in 1996-97 to around 32 per cent in 2003-04. Low and stable debt levels have allowed fiscal policy to support monetary policy in limiting the impact of recent global weakness on the UK economy without threatening the long-term sustainability of the public finances.

Projections for borrowing have also been revised in the light of the recent weakness in the global economy. The table below shows how the European Commission forecasts for the 2003 general government net lending have been revised since spring 2002.

Forecasts for general government net lending for 2003

Per cent of GDP	Date of forecast		Change
	Spring 2002	Spring 2003	
Italy	-1.3	-2.3	-1.0
France	-1.8	-3.7	-1.9
US	-0.9	-4.8	-3.9
Germany	-2.1	-3.4	-1.3
Japan	-6.1	-7.0	-0.9

Source: European Commission Forecasts Spring 2002 and Spring 2003.

ADHERING TO PRINCIPLES

2.49 Table 2.7 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. The table indicates that, after allowing for non-discretionary changes to receipts and spending and taking into account the Budget decisions, the Government remains on track to meet both fiscal rules.

Table 2.7: Summary of public sector finances

	Per cent of GDP						
	Outturn Estimate ¹		Projections				
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Fairness and prudence							
Surplus on current budget	1.0	-1.1	-0.8	-0.1	0.2	0.4	0.6
Average surplus since 1999-00	1.8	1.1	0.7	0.6	0.5	0.5	0.5
Cyclically-adjusted surplus on current budget	0.9	-0.5	0.2	0.5	0.4	0.4	0.6
Long-term sustainability							
Public sector net debt	30.2	30.9	32.2	32.7	33.2	33.5	33.8
Core debt	30.3	30.4	30.9	30.9	31.2	31.6	32.0
Public sector net worth ²	26.2	22.9	21.7	20.0	18.5	18.0	17.0
Primary balance	1.8	-0.6	-0.8	-0.4	-0.3	-0.1	-0.1
Economic impact							
Public sector net investment	1.0	1.2	1.7	2.0	2.1	2.1	2.2
Public sector net borrowing (PSNB)	0.0	2.3	2.5	2.1	1.9	1.7	1.6
Cyclically-adjusted PSNB	0.1	1.7	1.5	1.5	1.7	1.7	1.6
Financing							
Central government net cash requirement	0.3	2.0	3.2	2.4	2.1	2.2	1.9
Public sector net cash requirement	0.3	2.1	2.9	2.3	1.9	2.0	1.7
European commitments							
Treaty deficit ³	0.0	2.3	2.4	2.1	1.9	1.7	1.7
Cyclically-adjusted Treaty deficit	0.1	1.7	1.5	1.4	1.7	1.7	1.7
Treaty debt ratio ⁴	37.9	38.0	39.0	39.4	39.6	39.9	40.1
<i>Memo: Output gap</i>	-0.2	-1.1	-1.4	-0.7	-0.1	0.0	0.0

¹ The 2002-03 figures were projections in Budget 2002 and PBR 2002.

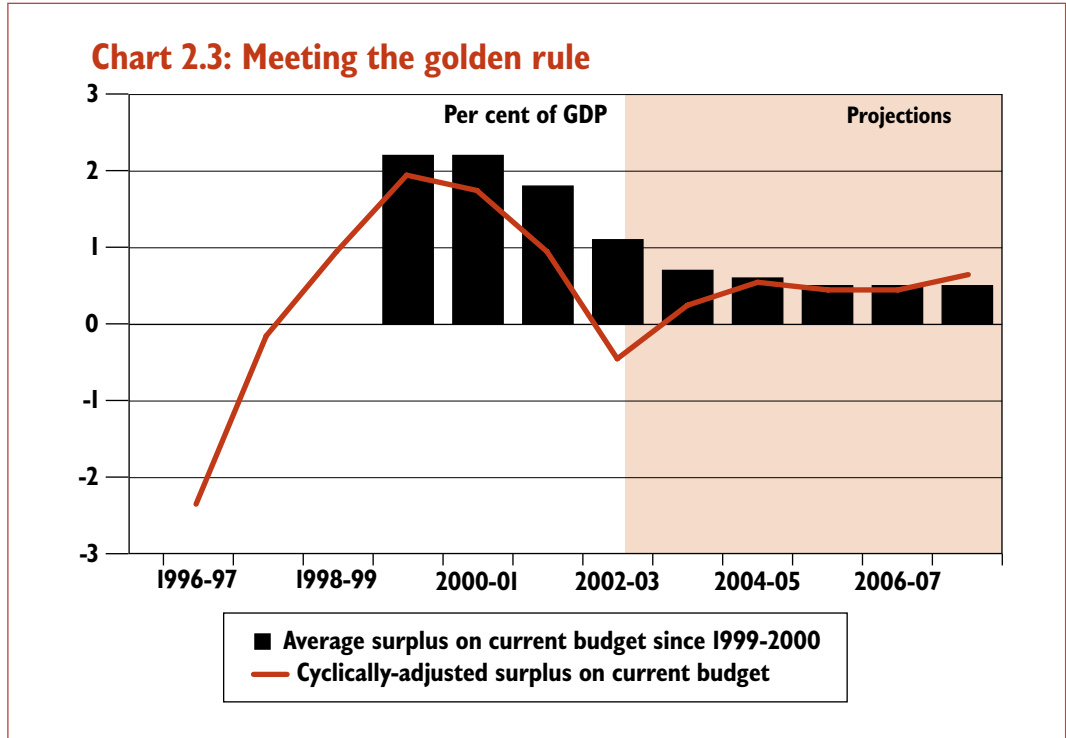
² At end-December; GDP centred on end-December.

³ General government net borrowing.

⁴ General government gross debt.

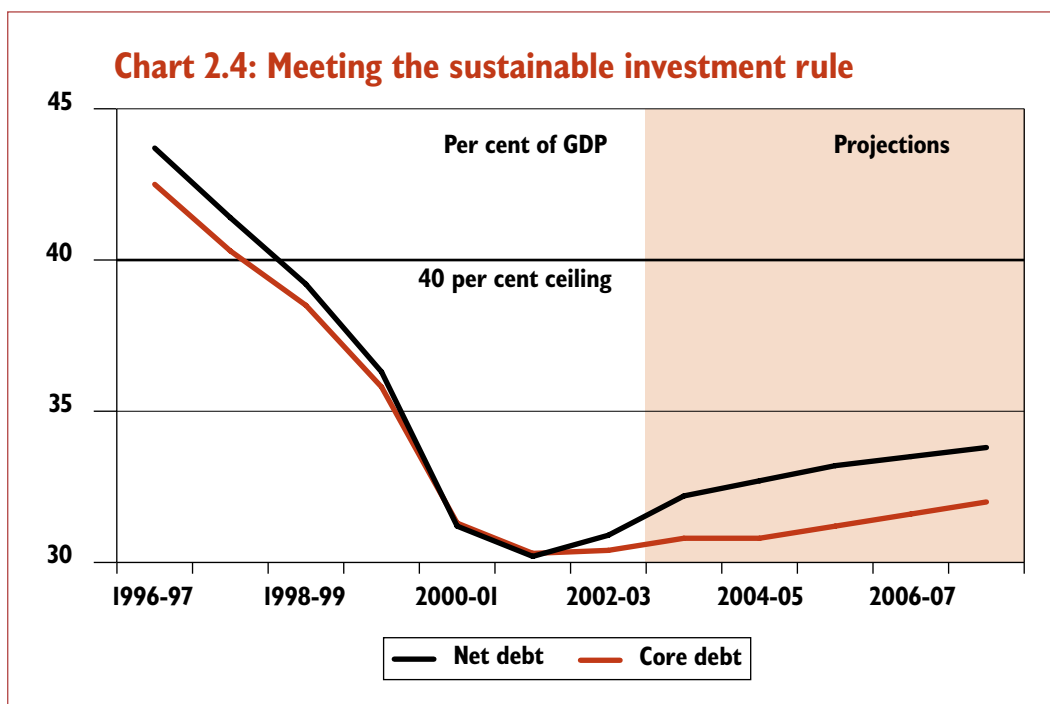
Golden rule 2.50 The current budget is the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and is therefore an important indicator of inter-generational fairness. Lower receipts and higher spending mean that the estimated outturn for 2002-03 is a current budget deficit of 1.1 per cent of GDP. The deficit is projected to fall to 0.8 per cent of GDP in 2003-04 before the current budget approaches balance in 2004-05. Strong surpluses on the current budget are projected by the end of the period.

2.51 The golden rule is set and assessed over the economic cycle. Chart 2.3 shows that the Government is comfortably on track to meet the golden rule. The average surplus on the current budget since 1999-2000, which is the Government's provisional judgement on the start of the current cycle, is comfortably positive throughout the forecast period by at least 0.5 per cent of GDP.



Sustainable investment rule 2.52 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector 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.

2.53 Chart 2.4 shows that, despite sustained weakness in the world economy, net debt is expected to remain low and stable, rising slightly from 31 per cent to stabilise just under 34 per cent of GDP over the forecast period. This comfortably meets the sustainable investment rule by remaining well below 40 per cent.



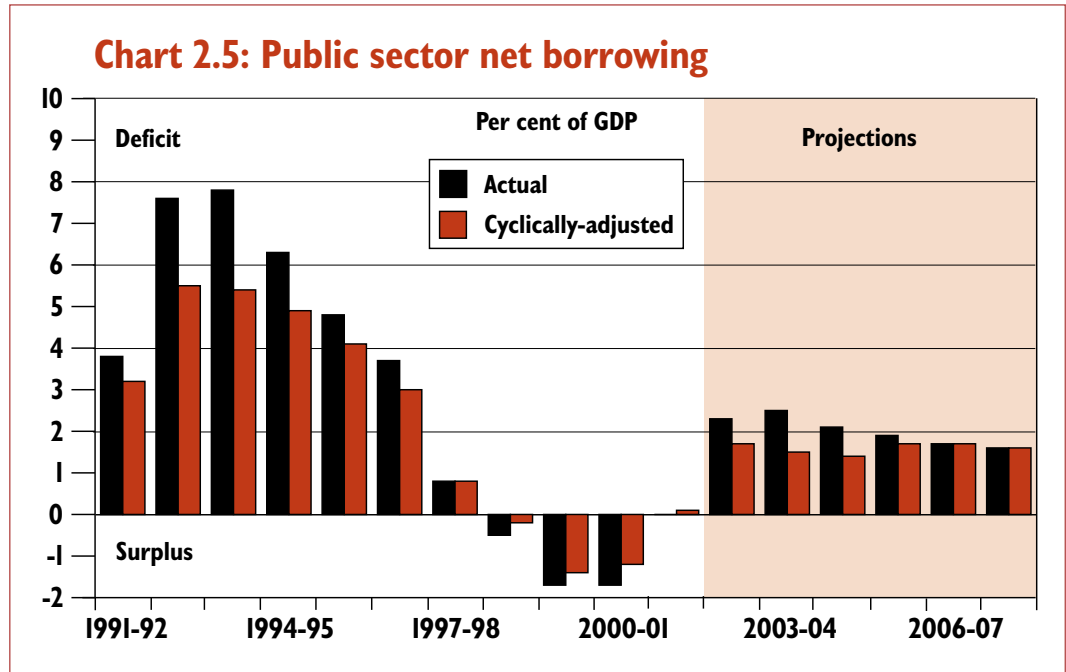
2.54 Sound public finances and greater economic stability have allowed the Government to increase investment in public services while maintaining a margin against unexpected economic events. Debt interest payments were around £7 billion lower in 2002-03 compared with 1996-97, freeing up resources to improve frontline public services. Public sector net investment, already planned to be around three times higher in 2003-04 than in 1997-98, is projected to rise still further to 2¼ per cent of GDP in 2007-08

2.55 Alongside net debt, Chart 2.3 also illustrates projected core debt which, excludes the estimated impact of the economic cycle on public sector net debt⁴. Underlying economic stability means that, in recent years, the levels of core debt and net debt have been very similar. Looking ahead, core debt is projected to rise slowly to 32 per cent of GDP, as a result of modest and prudent borrowing to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the principle of inter-generational fairness which underpins the fiscal framework.

2.56 Net worth, the difference between the total assets and liabilities of the Government, provides a further measure of fiscal sustainability, and is expected to decline gently over the projection period. At present net worth is not used as a key indicator, mainly because of the difficulties involved in measuring government assets and liabilities accurately.

Economic impact 2.57 While the primary objective of fiscal policy is to ensure sound public finances over the medium term, fiscal policy also plays an important role, supporting monetary policy in delivering economic stability over the cycle. The impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB), projections for which are set out in Chart 2.5.

⁴An explanation of the methodology was published alongside Budget 2002 in *Core debt: an approach to monitoring the sustainable investment rule*, HM Treasury, April 2002.



2.58 Modest levels of borrowing over the forecast period reflect sustained capital investment in priority public services. In addition to the operation of the automatic stabilisers over the short term, rising public spending, including investment, will support monetary policy as the economy remains below trend. Increased public investment is sustainable and fully consistent with the fiscal rules as net debt remains at a stable and prudent level over the forecast period.

2.59 The overall impact of fiscal policy on the economy is made up of changes in:

- the fiscal stance – that part of the change in PSNB resulting from changes in cyclically-adjusted PSNB; and
- the automatic stabilisers – that part of the change in PSNB resulting from cyclical movements in the economy.

2.60 Between Budgets, the fiscal stance can change as a result of a discretionary measure to:

- achieve a desired change in the fiscal stance; or
- accommodate or offset the impact of non-discretionary factors (non-cyclical or structural changes to tax receipts or public spending).

2.61 Table 2.8 explains how these concepts relate to the projections in the Budget. It shows the changes in both the fiscal stance and the overall fiscal impact between Budget 2002 and the 2002 Pre-Budget Report, and the changes since the Pre-Budget Report.

Table 2.8: The overall fiscal impact

	Percentage points of GDP						
	Outturn	Estimate ¹	Projections				
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Change from Budget 2002 to PBR 2002							
Post Budget and PBR policy decisions	0.0	0.1	-0.1	0.0	0.0	0.0	-
+							
non-discretionary factors	-0.1	0.2	0.3	0.2	0.1	0.1	-
=							
CHANGE IN FISCAL STANCE	-0.1	0.3	0.3	0.1	0.1	0.1	-
+							
automatic stabilisers	0.1	0.6	0.8	0.4	0.1	0.0	-
=							
OVERALL FISCAL IMPACT	0.0	0.9	1.1	0.5	0.2	0.1	-
Change from PBR 2002 to Budget 2003							
Budget measures	0.0	0.2	0.0	0.1	0.1	0.1	0.1
+							
non-discretionary factors	-0.1	0.3	0.1	0.1	0.1	0.1	0.0
=							
CHANGE IN FISCAL STANCE	-0.1	0.5	0.1	0.2	0.2	0.2	0.1
+							
automatic stabilisers	0.0	-0.1	0.1	0.2	0.1	0.0	0.0
=							
OVERALL FISCAL IMPACT	-0.2	0.3	0.2	0.4	0.3	0.2	0.1

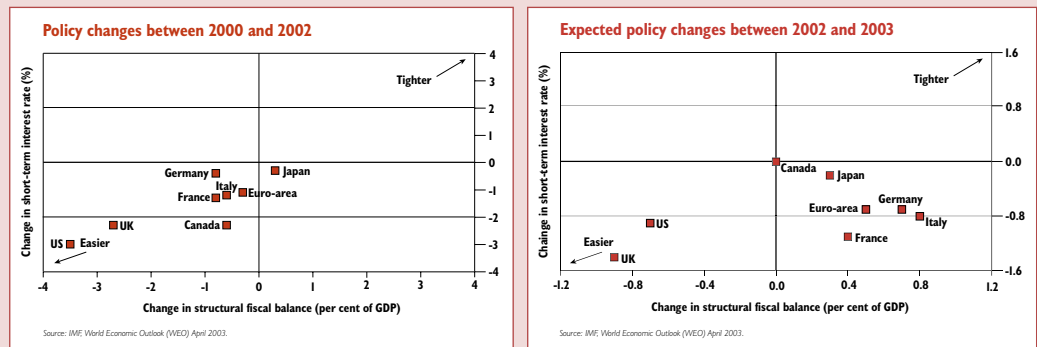
¹The 2002-03 figures were projections in Budget 2002 and PBR 2002.

2.62 Table 2.8 shows that, particularly in 2002-03 and 2003-04, fiscal policy is supporting monetary policy as the economy continues below trend. Over the medium term, the effect of the automatic stabilisers decreases as the economy returns to trend. However, the degree of caution in the assumptions underpinning the public finance projections increases over the projection period, and the actual outcomes and the effects on the economy may not necessarily reflect the projections, especially in later years.

2.63 GDP growth in 2002 was slightly higher than forecast at the time of the 2002 Pre-Budget Report and the output gap was consequently smaller. For 2002-03, the Treasury's methodology for cyclical adjustment therefore attributes less of the change in net borrowing between Budget 2002 and Budget 2003 to the automatic stabilisers. Nonetheless, fiscal policy supported monetary policy in maintaining macroeconomic stability in 2002-03.

Box 2.4: Monetary and fiscal policy in the G7 economies

During 2001 growth slowed significantly and simultaneously in the US, Europe and Asia for the first time for almost thirty years and the world's three largest economies – the US, Germany and Japan – were all in recession. For the US and the Euro-area the slowdown brought to an end a period of continuous growth stretching back to the beginning of 1993. While growth slowed in the UK, it continued and the UK has now experienced the longest unbroken economic expansion since quarterly records began.



In recent years, decisive action by policy-makers, particularly in the aftermath of the events of 11 September 2001, has prevented a more severe global slowdown. The charts show that, between 2000 and 2002, all of the G7 economies except Japan benefited from a coordinated easing of monetary and fiscal policy. It also highlights that the scale of the easing was more significant in the US and the UK.

The charts also show that, against a backdrop of continued global uncertainty, monetary and fiscal policy is expected to continue supporting growth in the US and the UK during 2003. By contrast, a further expected easing of monetary policy within the Euro-area is expected to be partially offset by planned fiscal tightening in some countries.

Financing 2.64 The provisional Debt Management Report 2003-04 (DMR) was published on 20 March 2003 in advance of the Budget and in compliance with the *Code for fiscal stability*. It included a provisional financing remit for 2003-04. The forecast for the financing requirement was based on the 2002 Pre-Budget Report projection for the central government net cash requirement (CGNCR) in 2003-04. In the DMR, it was announced that a provisional net financing requirement of £49.8 billion for 2003-04 would be met by gross gilts issuance of £40.0 billion and a £9.8 billion adjustment in the net short-term debt position.

2.65 The Budget forecast for the CGNCR for 2002-03 is £21.4 billion, £2.7 billion higher than forecast at the time of the 2002 Pre-Budget Report. The forecast for the CGNCR in 2003-04 is £35.3 billion. This means that the net financing requirement, which includes £21.1 billion of redemptions, is now £54.8 billion. In line with the contingencies outlined in the DMR, these changes have been accommodated by increasing gross gilts issuance by £7.4 billion to £47.4 billion and decreasing the unwind of the Debt Management Office's net cash position by £2.4 billion to £4.2 billion. The difference between CGNCR and PSNB in 2003-04 is partly the result of cash and accrual implications of the NICs measures announced in Budget 2002, which increase accrued receipts by more than cash receipts – reducing PSNB by more than CGNCR. Full details and a revised financing table can be found in Chapter C of the *Financial Statement and Budget Report*.

European commitments **2.66** The Budget 2003 projections meet both 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, described in Box 2.4.

Box 2.4: The Stability and Growth Pact

The Stability and Growth Pact is intended to ensure that EU Member States maintain sound public finances through the budgetary objective of 'close to balance or in surplus' over the medium term. Fiscal sustainability is a prerequisite for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy coordination as set out in the EU Treaty.

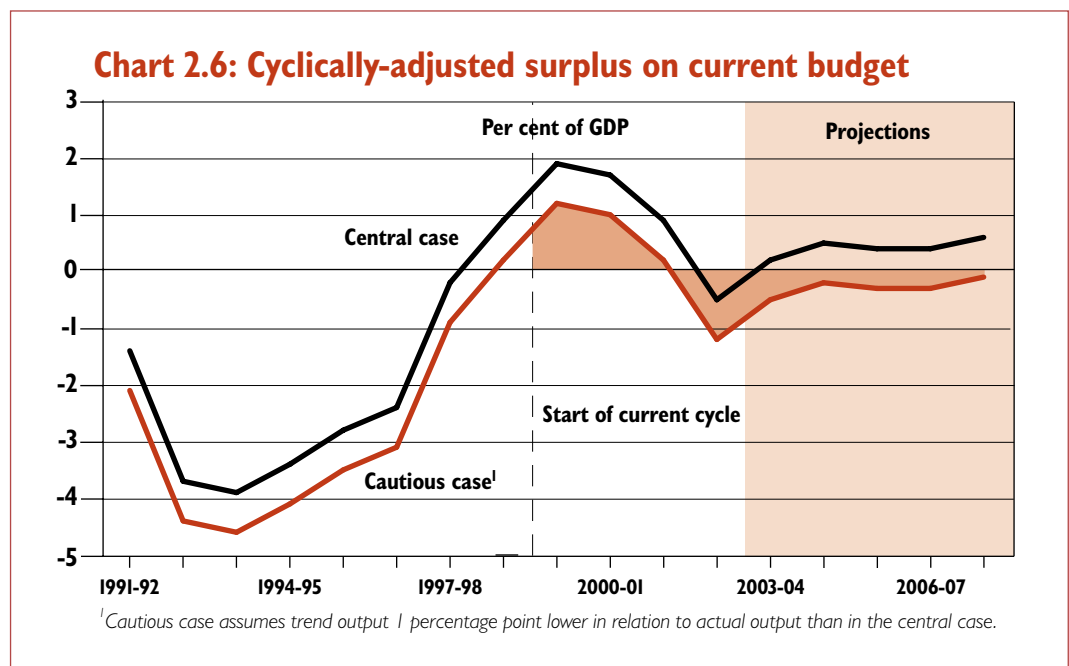
Building on the Code of Conduct, agreed by Member States in June 2001, the Government supports a prudent interpretation of the Pact. A prudent interpretation would lock in long-term fiscal discipline and sustainability, enhancing credibility, while allowing the automatic stabilisers to smooth fluctuations in output, and allow appropriate increases in investment in public services. Specifically, it would take into account the following factors:

- **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. It is therefore important to focus on cyclically-adjusted fiscal balances when assessing the public finances;
- **sustainability** – 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 the sustainability of public finances should also take into account the long-term budgetary impact of ageing populations, such as that set out in Annex A and in the Government's *Long-term public finance report*, published alongside the 2002 Pre-Budget Report; and
- **public investment** – against a background of sound public finances and economic stability, public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy. The 2002 Spending Review set new plans to increase public sector net investment in the UK to 2 per cent of GDP by 2005-06 – a five-fold increase compared with 1997-98 – and the projections in this Budget assume a further increase to 2¼ per cent of GDP by 2007-08. These plans are fully consistent with the fiscal rules and with the maintenance of low levels of debt.

In March 2003, the European Council fully endorsed a report agreed by EU Finance Ministers on strengthening budgetary co-ordination. The report emphasised the importance of taking into account the economic cycle, long-term sustainability, and the quality of public investment in assessing the state of public finances. It also stressed the need to apply a country-by-country approach to assessments of compliance with the medium-term fiscal objective of 'close to balance or in surplus'. This is in line with key aspects of the Government's prudent interpretation of the Stability and Growth Pact.

Dealing with uncertainty 2.67 The fiscal balances represent the difference between two large aggregates and forecasts of them are subject to wide margins of error. The use of cautious assumptions, audited by the Comptroller and Auditor General, builds an allowance into the public finances projections to guard against unexpected events. To accommodate potential errors arising from misjudgements about the trend rate of growth in the economy, the Government bases its public finance projections on a trend growth assumption that is $\frac{1}{4}$ percentage point lower than its neutral view.

2.68 A second important source of potential error results from misjudging the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections are 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. Chart 2.6 illustrates the forecast in this ‘cautious case’.



2.69 The chart shows that the cyclically-adjusted current budget in the cautious case was in strong surplus in 1999-2000, which on the Government’s provisional judgement is the start of the current economic cycle, and in 2000-01. It is projected to move into deficit before returning towards balance by the end of the forecast period. The average cyclically-adjusted current budget is in surplus in the cautious case over the current economic cycle, meeting the ‘stress test’ of the golden rule. The Government is therefore on track to meet the golden rule over the economic cycle, including in the cautious case.

Long-term fiscal sustainability

2.70 While a key objective of fiscal policy is to ensure sound public finances over the 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. This would also be inconsistent with the principles of fiscal management set out in the *Code for fiscal stability*.

2.71 An analysis of long-term fiscal sustainability is presented in Annex A. The analysis shows that, based on current policies, current consumption – spending on items such as health and education – can grow at a slightly faster rate than real GDP over the next 30 years, ensuring that resources are available to meet potential future spending pressures, such as those arising from an ageing population, while still meeting the fiscal rules. Public sector net investment can also grow broadly in line with the economy without jeopardising the sustainable investment rule.

2.72 This conclusion concurs with the detailed findings of the *Long-term public finance report*⁵, published alongside the 2002 Pre-Budget Report. The Government will continue to update and report on its assessment of long-term fiscal sustainability in future Budgets and through regular publication of the *Long-term public finance report*.

MACROECONOMIC STABILITY AND THE HOUSING MARKET

2.73 Strong cycles in the housing market have been a striking feature of the UK economy over the past three decades. This volatility has affected the wider economy through private consumption, as household spending is closely linked to changes in housing wealth. Reducing volatility in the housing market will therefore promote macroeconomic stability.

2.74 A number of structural features explain high levels of housing market volatility in the UK compared to other European countries, and the strong link to consumption:

- the responsiveness of housing supply to demand pressures is particularly low in the UK. Since 1960, the UK has invested a lower proportion of its national income in housing than any other EU country. A weak supply response is largely responsible for the strong upward trend in real house prices in the UK and tends to accentuate house price volatility;
- the high level of mortgage debt and dominance of variable rate mortgages combine to explain households' interest rate sensitivity and the strong link between the housing market and consumption in the UK; and
- high levels of owner occupation, as compared to private or social renting, and the ability of households to withdraw equity from housing adds to the impact of changes in housing wealth on consumption.

2.75 The effect the housing market has on macroeconomic stability could be much more significant should the UK join EMU. The housing market forms an important part of the monetary transmission mechanism – the means by which interest rates affect the wider economy. This is the subject of a supporting study to the assessment of the five economic tests.

⁵ *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, November 2002.

2.76 The Government has recognised that reforms are needed to help increase the supply of housing, particularly affordable housing, and reduce volatility and promote stability in the wider economy. Reforms already announced include:

- the Deputy Prime Minister's proposals for significant development in four growth areas in the South-East, new regional housing bodies to better coordinate funding at the regional level and action in areas facing a surplus of housing, all backed by an additional £1.1 billion a year by 2005-06 to support a substantial increase in affordable housing; and
- making the planning system work more quickly, predictably and effectively by speeding-up the processing of applications, a commitment for local authorities to deliver planned increases in housing numbers, with intervention if necessary, committing to build at higher densities than the past, statutory timetables for called-in applications and £350 million extra for planning authorities over the next 3 years.

2.77 The weak responsiveness of new housing supply to rising house prices is a complex problem. In the light of its reforms to the planning system, the Government has therefore asked Kate Barker to conduct a review of issues affecting housing supply in the UK – in particular to look at the role of competition, capacity and finance of the house-building industry, and possible fiscal instruments, and the interaction of these factors with the planning system and sustainable development objectives. This review would complement the work of the Sustainable Home Ownership Taskforce announced by the Deputy Prime Minister on 18 March this year.

2.78 Building on the reforms already announced to deliver a step change in planning policy, further significant changes in the planning, supply and finance of housing will be required to address both demand and supply in the housing market to tackle market failures, significantly increase the responsiveness of supply to demand, and reduce national and regional price volatility. This includes requiring new Regional Spatial Strategies to take account of volatility in the housing market and promote macro-economic stability as part of delivering sustainable development; tough and credible measures, including intervention, where local authorities are not delivering housing numbers in high demand areas; and exploring whether, in the medium term, achieving our objectives will require a system of binding local plans. The Government's proposals are outlined in more detail in Chapter 3.

2.79 The share of variable rate mortgages in the UK is markedly higher than in many other countries. The Chancellor has asked Professor David Miles to undertake a review of the supply and demand side factors limiting the development of the fixed rate mortgage market in the UK. The review will establish why the share of fixed-rate mortgages is so low compared to the United States and many other EU countries, and examine whether there has been any market failure that has held back the market for fixed and long-term fixed-rate mortgages. It will make an interim report in autumn 2003 before reporting in full by Budget 2004.

