2 MAINTAINING MACROECONOMIC STABILITY

Sound economic fundamentals and the Government's macroeconomic framework ensured the UK economy was able to steer a course of stability in the face of the slowdown in the world economy in 2001:

- **the monetary policy framework is delivering low and stable inflation, which enabled the Monetary Policy Committee to respond to weaker global growth;**
- **by meeting the fiscal rules over the cycle, fiscal policy has supported monetary policy as slower growth led to a temporary slowdown in government receipts.**

Growth in the UK is expected to gather pace and become more balanced in 2002, underpinned by a global economic recovery. Budget 2002 locks in economic stability for the future:

- **based on cautious assumptions, the Government remains on track to meet both its strict fiscal rules over the cycle, including in the cautious case; and**
- **the fiscal stance this year and over the next two years is at least as tight as in the Pre-Budget Report: compared with the Pre-Budget Report, there is a small fiscal tightening this year and next.**

Consistent with meeting the fiscal rules, Budget 2002:

- **implements a comprehensive Budget package to promote enterprise and work and to tackle child poverty and takes action to close loopholes in the tax system and protect the revenue base;**
- **adds £4 billion to DEL in 2003–04 and sets firm overall limits for public spending for the period of the 2002 Spending Review;**
- **within this envelope, delivers substantial increases in resources over five years to reform the NHS and improve standards of health care;**
- **raises national insurance contributions (NICs) paid by employers, employees and the self-employed by one per cent on all earnings, including above the NICs threshold, from April 2003; and**
- **freezes the NICs threshold and income tax personal allowance for those aged under 65 in 2003–04.**

As a result of these measures, Budget 2002 maintains the conditions for economic stability, continuing the Government's prudent approach to managing the public finances, while releasing substantial resources for the Government's priorities.

THE MACROECONOMIC FRAMEWORK

2.1 The Government's reforms to the macroeconomic framework ensured that the UK was well placed to respond to the slowdown in world growth during 2001. From a platform of low inflation and fiscal discipline, the UK was able to maintain steady and stable growth in the face of faltering global demand and rising economic uncertainty.

2.2 The macroeconomic framework is designed to maintain long-term economic stability. Large and unpredictable fluctuations in output, employment and inflation impose significant economic and social costs and can hold back the economy's long-term growth potential. Stability helps businesses, individuals and the Government to plan effectively for the long term, improving the quantity and quality of long-term investment in physical and human capital, and helping to raise levels of productivity.

2.3 The framework is built on a set of clear principles based on transparency, accountability and responsibility.[1] The increasing interdependence of the world economy means that the Government must address the causes of domestic and international instability, minimising the risk and impact of disruption from external events. The different components of the framework are working in an integrated way to maintain macroeconomic stability.

The monetary policy framework

2.4 Since its introduction in 1997, the monetary policy framework has helped to keep inflation close to the Government's target and has achieved a high degree of credibility. As a result, the Bank of England's Monetary Policy Committee (MPC) was able to respond pre-emptively to the global slowdown, limiting the impact of world events on the UK economy. The principles of the framework are:

- full operational independence for the MPC in setting interest rates to meet the Government's inflation target. **The Government is reaffirming in Budget 2002 the target of $2^1/_2$ per cent for the 12 month increase in the Retail Prices Index excluding mortgage interest payments (RPIX)**, which applies at all times.
- clear and precise objectives. The primary objective of monetary policy is price stability, while the symmetry in the Government's inflation target ensures that outcomes below target are treated as seriously as outcomes above target. Monetary policy therefore helps to support the Government's wider economic policy objective of high and stable levels of growth and employment;
- 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, embedded in 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 set out in an open letter to the Chancellor the reasons for the deviation, what action the MPC proposes to take, how long it will be before inflation returns to target and how this meets the MPC's remit.

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

The fiscal policy framework

2.6 The reforms to the monetary policy framework have been accompanied by a parallel set of reforms to fiscal policy, ensuring that the highest standards of transparency, responsibility and accountability apply to fiscal policy decisions.

[1] Further detail can be found in: *Reforming Britain's Economic and Financial Policy*, HM Treasury, (2002).

2.7 *The Code for Fiscal Stability* sets out the five key principles of fiscal management which are at the heart of the framework – transparency, stability, responsibility, fairness and efficiency. The Code also requires the Government to state its objectives and fiscal rules through which it operates fiscal policy based on these principles. The Government's key objectives are:

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

2.8 These objectives are implemented through the Government's two fiscal rules, against which the performance of fiscal policy can be judged:

- **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.

2.9 These fiscal rules promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects:

- the rules are set over the cycle, allowing fiscal balances to vary between years in line with the cyclical position of the economy; and
- the interaction of the two rules promotes capital investment while ensuring sustainable public finances in the longer term. The golden rule requires the current budget to be in balance or surplus on average over the cycle, allowing the Government to borrow only for capital spending. The sustainable investment rule limits government borrowing to a stable and prudent level.

2.10 The fiscal framework also recognises that projections of the current budget and net debt inevitably involve a considerable element of uncertainty. Projections of the public finances are therefore deliberately based on prudent assumptions for key economic variables. These assumptions, which include the trend rate of growth, the level of unemployment, and oil and equity prices, are audited by the National Audit Office (NAO) under a three-year rolling review to ensure they remain both reasonable and cautious. This minimises the need for unexpected changes in direction in taxation or spending.

End of Year Fiscal Report

2.11 Reporting on the performance of the public finances against the fiscal rules and published projections is an important element of a transparent fiscal policy – one of the principles of fiscal management set out in the *Code for Fiscal Stability*. In accordance with this principle and the requirements of the Code, Chapter C of the Financial Statement and Budget Report (FSBR) includes provisional outturn information for 2001-02, an analysis of the outturn for 2000-01, as well as other historical data. **In order to further enhance its reporting of fiscal developments, the Government intends to publish End of Year Fiscal Reports to provide more retrospective information on the public finances, including their performance against the fiscal rules and published forecasts and plans**. The first Report will be published alongside the Pre-Budget Report later this year and will cover the two years 2000–01 and 2001–02.

Box 2.1: Informing households about tax and spending decisions

The Government is committed to ensuring that households are fully informed about tax and spending decisions. Taxpayers have a right to know how their money is being used and the public services they can expect in return. The Government has taken a number of steps to improve access to information about Budget decisions, including:

- **the release of all published documentation on the Internet shortly after completion of the Chancellor's statement to Parliament, ensuring that this information is easy to find and use. Almost 200,000 separate copies of documents were viewed this way following the November 2001 Pre-Budget Report, while a quarter of a million pages were viewed by visitors to the site in the first week of December 2001 alone; and**
- **the production of a summary leaflet presenting the main decisions taken in Budgets and Pre-Budget Reports and a breakdown of government spending and revenue. The leaflet is available free of charge from the Treasury and is published on the Internet. Copies of the leaflet are also distributed nationwide through libraries, educational establishments, citizens advice bureaus, Jobcentres, NHS hospitals, GPs' surgeries, and other organisations.**

The Government will continue to explore the most effective means of disseminating information, including the distribution of a leaflet to households.

The public spending framework

2.12 Sound public finances are a pre-requisite for sustainable investment in public services. The fiscal rules are the foundation of the spending framework and have important consequences for the structure of the budgeting regime. The main elements of the framework are:

- three-year Departmental Expenditure Limits (DEL) to help departments plan and manage resources more effectively over the medium term. The 2002 Spending Review will establish new departmental annual spending plans up to and including 2005-06 and within the firm overall spending limits announced in this Budget;
- Annually Managed Expenditure (AME) which covers those elements of spending which cannot reasonably be subject to firm multi-year limits. DEL and AME sum to Total Managed Expenditure (TME);
- separate resource (current) and capital budgets for each department, consistent with the distinction in the fiscal rules. Departments are required to manage their resource and capital budgets separately, removing the historical bias against investment; and
- Public Service Agreements (PSAs) through which each department is committed to deliver challenging outcome-focused targets.

2.13 The Government's public spending framework and priorities for the 2002 Spending Review are described in more detail in Chapter 6.

THE PERFORMANCE OF THE FRAMEWORK

2.14 The Government's framework for monetary and fiscal policy and for public spending form an integrated strategy for maintaining high and stable levels of growth and employment, and for minimising the impact of external events.

Monetary strategy

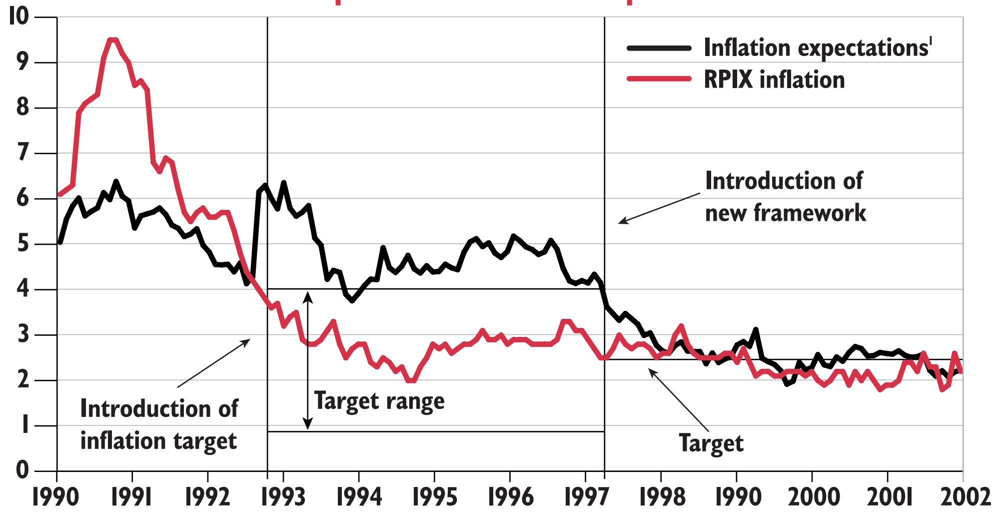
2.15 The monetary policy framework has helped to enhance the credibility of economic policy-making and is delivering tangible results:

- RPIX inflation has averaged 2.4 per cent since May 1997 – close to the Government's target – and has fluctuated in the narrow range of 1.8 to 3.2 per cent;
- long-term inflation expectations in financial markets remain in line with the Government's target, having fallen from over 4 per cent between 1994 and early 1997 to 2½ per cent by mid-1998;
- official short-term interest rates have been much less volatile since 1997, remaining in a narrow band of between 4 and 7.5 per cent; and
- long-term interest rates are around their lowest levels for over 35 years, helping to reduce the Government's debt interest payments and free-up more resources for investment in public services.

2.16 The monetary policy framework has proved successful in reacting to unforeseen shocks. The MPC responded to the global slowdown during 2001 by cutting interest rates seven times, and by 2 percentage points altogether, from 6 per cent to 4 per cent. This pre-emptive action helped to ensure that activity remained strong throughout the year.

2.17 More recently, interest rates have been held at 4 per cent since November 2001, as weak external demand has been balanced by buoyant consumption. Uncertainty over prospects for the world economy and the timing of any rebalancing between domestic and external demand have prompted the MPC to avoid policy changes while the outlook for inflation is so close to target.

Chart 2.1: Inflation performance and expectations



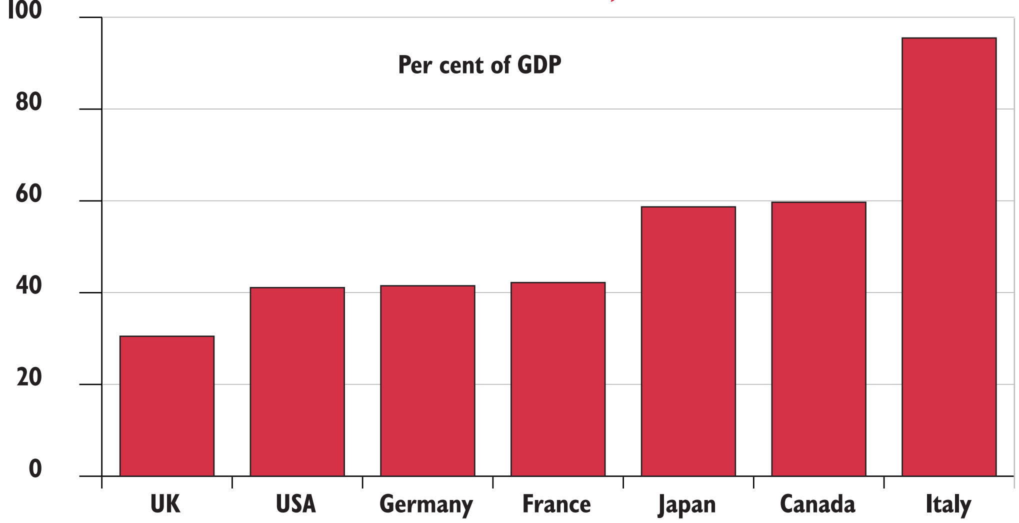
[1] Ten year ahead market inflation expectations

Fiscal strategy

2.18 On fiscal policy, the Government has taken a number of important steps over the past five years to restore the public finances to a sustainable position. These have included working within the previous Government's spending plans for the first two years, further fiscal consolidation through a series of tax changes, and using the proceeds from the auction of spectrum licences to reduce net debt. As a result of these decisions, and with the benefits of greater economic stability, fiscal policy was tightened in structural terms by $4^1/_2$ percentage points of GDP between 1996–97 and 2000–01, supporting monetary policy at a time when the economy was generally above trend.

2.19 The Government has also repaid over £50 billion of debt. In total, public sector net debt has been reduced from 44 per cent of GDP to under 31 per cent, the lowest of any G7 country. This is illustrated by Chart 2.2 which shows OECD estimates for 2001.

Chart 2.2: OECD estimates of general government net financial liabilities for G7 countries, 2001



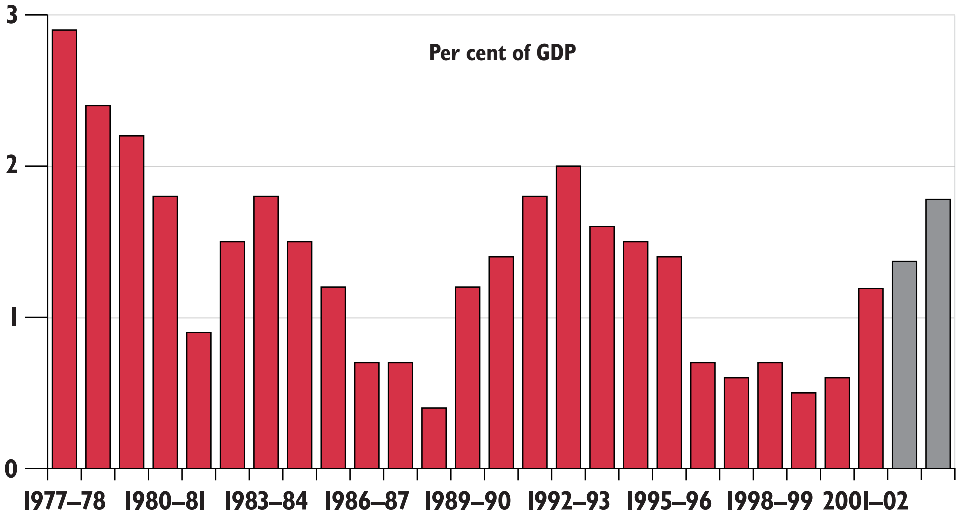
Source: OECD Economic Outlook December 2001

2.20 Low and stable debt levels, and strong surpluses on the current budget, left the public finances well placed to support monetary policy in limiting the impact of the global slowdown in 2001. Lower unemployment and sound public finances have also enabled the Government to release substantial new resources for priority public services, as a result of significant savings from:

- reduced debt interest payments, which are expected to be nearly £12 billion lower in real terms in 2002–03 than in 1997–98 as a result of net debt repayments and lower interest rates; and
- lower growth in spending on social security. Spending on benefits for the unemployed is forecast to be nearly £5 billion lower in 2002–03 than in 1996–97 in real terms.

2.21 As part of this strategy, the Government is addressing the historic under-investment in Britain's public infrastructure. The decline in public investment is illustrated in Chart 2.3 which shows that the level of public sector net investment fell from 2.9 per cent of GDP in 1977–78 to under 1 per cent in the second half of the 1990s. Although a significant part of the decline was the result of privatisation and asset sales, the chart demonstrates that levels of investment have fallen to historically low levels. Chapter 6 describes the steps the Government is taking to reverse this under-investment. Net investment is projected to more than double between 2000–01 and 2003–04.

Chart 2.3: Public sector net investment



Box 2.2: EMU and EMU preparations

The Government's policy on membership of the single currency remains as set out by the Chancellor in his statement to Parliament in October 1997. The determining factor underpinning any Government decision is the national economic interest and whether the economic case for joining is clear and unambiguous.

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

In June 2001, the Chancellor explained that the Treasury would undertake necessary preliminary and technical work before the assessment of the five tests is started. The scope of this work was set out in the original October 1997 assessment and includes:

- **the cyclical behaviour of the UK economy relative to the euro area and their relative responses to economic shocks;**
- **the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work;**
- **the impact of the single currency on the cost and availability of capital, macroeconomic stability, the stability of the real effective exchange rate and the location, quality and quantity of investment;**
- **the effect of the single currency on financial services, including the changes that have occurred in this sector in the UK and the euro area since 1997; and**
- **the impact of the single currency on trade, competition, productivity and employment.**

Further detail was set out in the Treasury paper, *Preliminary and technical work to prepare for the assessment of the five tests for UK membership of the single currency*.

The Government is also continuing work on EMU preparations. On 1 January 2002, the twelve countries of the euro area introduced euro cash. On 28 February 2002, national currencies ceased to be legal tender. The Government welcomes reports from euro area countries and the European Commission that the changeover went smoothly, and the Treasury has been gathering information on the exercise. This supports a number of elements of the Government's policy towards EMU preparations: the public sector can play a key leading role; early planning helps to ensure a smooth changeover and to reduce costs; and the illustrative timetable for a UK changeover remains a sound planning assumption.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.22 Last year economic growth slowed simultaneously and significantly in the US, Europe and Japan. World trade growth, investment, industrial production and stock markets all declined sharply and demand for ICT-related products collapsed. The events of 11 September heightened uncertainty and further weakened business confidence across the world.

Table 2.1: The world economy

	Percentage change on a year earlier, unless otherwise stated			
		Forecast		
	2001	2002	2003	2004
Major 7 countries[1]				
Real GDP	1	$1^1/_2$	$2^3/_4$	$2^1/_2$
Consumer price inflation[2]	$1^1/_2$	$1^1/_2$	$1^1/_2$	$1^1/_2$
World trade in goods and services	0	$2^1/_4$	$8^1/_2$	$7^1/_4$
UK export markets[3]	$-^1/_4$	$1^3/_4$	$7^3/_4$	6

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

[2] *Per cent,Q4. For UK, RPIX.*

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

2.23 In contrast to previous periods of faltering global demand and rising economic uncertainty, the Goverment's macroeconomic framework coped well. Robust consumer demand played a key role in supporting economic growth, underpinned by a series of interest rate cuts by the MPC. Fiscal policy supported monetary policy in sustaining demand over the course of the year. Growth in the UK was 2.2 per cent during 2001, in line with the Pre-Budget Report projection and the lower end of the Budget 2001 forecast range.

Economic prospects

2.24 The risks to the global economic outlook associated with the events of 11 September have now clearly diminished, and prospects for G7 activity this year are stronger than at the time of the Pre-Budget Report. In the US – which is expected to lead a global recovery – strong household consumption and some rebuilding of stocks are projected to underpin growth during the first half of 2002. A more broad-based global recovery is expected to gather pace from the middle of the year with business investment and world trade strengthening and monetary policy returning to a more neutral stance.

Table 2.2: Summary of UK forecast

		Forecast		
	2001	2002	2003	2004
GDP growth (per cent)	$2^1/_4$	2 to $2^1/_2$	3 to $3^1/_2$	$2^1/_2$ to 3
RPIX inflation (per cent, Q4)	2	$2^1/_4$	$2^1/_2$	$2^1/_2$

2.25 Table 2.2 summarises the outlook for UK growth and inflation. GDP is expected to grow by between 2 and $2^1/_2$ per cent in 2002, strengthening to between 3 and $3^1/_2$ per cent in 2003, before returning to a trend of $2^3/_4$ per cent in 2004. Growth is also expected to become more balanced in 2002. Household spending is forecast to moderate to sustainable growth rates while stronger external demand should support a recovery in business investment and exports. This should also boost UK manufacturing output from the second half of this year, while strengthening demand for ICT-related products is expected to stimulate a revival in high-technology sectors.

2.26 The UK continues to experience the longest period of sustained low inflation since the 1960s. Annual RPIX inflation averaged 2.1 per cent in 2001, unchanged from 2000 and a little below the Government's target of 2.5 per cent. Looking ahead, subdued input price pressures should continue to exert a downward influence on RPIX during 2002. Rising prices for commodities and imported goods, and a small positive output gap, are expected to bring inflation back up to target by mid 2003.

2.27 Nonetheless, the projected pick-up in UK growth remains heavily dependent on the global economic outlook. A faltering world recovery, for example, would have knock-on effects to confidence and activity in the UK. Conversely, the scale of the policy loosening during 2001 could yet lead to a much stronger than anticipated G7 recovery this year. With interest rates at historically low levels there also remains a risk that household consumption in the UK will moderate more gradually than forecast, boosting activity in the short term but raising the likelihood of a sharper correction at some point in the future. But, with sound public finances and low inflation, the UK remains well placed to respond if any of these risks materialise.

The trend rate of growth of the economy

2.28 The trend rate of growth of the economy is the rate at which output can increase over the medium term without placing upward or downward pressure on inflation. Over the short term, the actual level of output tends to cycle around the trend level of output. The estimate of the difference between actual and trend output, or output gap, is an indicator of inflationary pressure.

Economic cycle

2.29 Based on business survey indicators of capacity and labour utilisation and other labour market indicators, the economy was judged in the Pre-Budget Report to have completed a small cycle between the first half of 1997 and mid-1999, before moving slightly above trend in 2000 and the first half of 2001. The latest available evidence suggests that the impact of weaker global growth has since brought the economy back to trend in the third quarter of 2001, completing a further half-cycle. On this basis, trend output growth is estimated to have been a little below 2¾ per cent a year since the first half of 1997.

2.30 Given the closeness of output to trend throughout the period since 1997, possible measurement errors and the prospect of further data revisions, it remains difficult to judge the cyclical path of the economy with certainty. However, for the purposes of assessing performance against the fiscal rules, the provisional judgement remains that a small cycle may have been completed by mid-1999 when the current cycle is assumed to have begun.

Prospects for trend growth

2.31 The Government's latest assessment of the prospects for trend growth is set out in the Budget paper, *Trend growth: recent developments and prospects*. This builds on the approach used in the Government's previous analysis[2] by decomposing trend output growth into its component elements. For the first time the methodology also distinguishes the impact of trends in average hours worked.

2.32 The Government's assessment, which is summarised in Chapter B of the Financial Statement and Budget Report (FSBR), concludes that a neutral view of the prospects for trend output growth is 2¾ per cent a year. This is in line with a number of independent organisations, including the IMF. The small upward revision in the Government's estimate results from a modest increase to the estimated impact of net migration on the working age population, and a small increase in the contribution to trend growth from the employment rate. Importantly, the neutral estimate of labour productivity growth continues to be based on past trends. The Government is maintaining its approach of not making any allowance for possible productivity improvements resulting from the Government's wide range of policies designed to raise the economy's growth potential, until this has demonstrably been achieved.

[2] *Trend growth – prospects and implications for policy*, HM Treasury, November 1999.

Caution and the public finances

2.33 Looking forward over the projection period, the public finances continue to be based on a deliberately cautious assumption for trend output growth that is $\frac{1}{4}$ percentage point lower than the Government's neutral view. Box 2.3 explains the importance of basing projections of the public finances on the prudent assumption of $2\frac{1}{2}$ per cent. The assumption has been audited by the NAO, as required by the *Code for Fiscal Stability*. The Comptroller and Auditor General has concluded that the assumption is reasonable and cautious.[3]

Box 2.3: Trend growth and fiscal policy

Measures of trend growth play an important role in the conduct of macroeconomic policy. Accurate estimates of trend growth are necessary to:

- **ensure that the public finances are placed on a sound and sustainable footing by taking account of the temporary impact of the economic cycle and by providing a robust assessment of the structural prospects for the public finances in the medium term; and**
- **provide an estimate of the spare capacity in the economy so that fiscal policy can play a role in supporting monetary policy through the economic cycle.**

In the past, optimistic expectations about the potential or trend growth of the economy led to inappropriate policy decisions and added to instability. In order to take account of this forecast risk, the Government deliberately uses a cautious assumption for trend growth for the public finance projections that is $\frac{1}{4}$ percentage point lower than its neutral view. Increasing the fiscal trend growth assumption from $2\frac{1}{4}$ to $2\frac{1}{2}$ per cent a year in step with the increase in the neutral view from $2\frac{1}{2}$ to $2\frac{3}{4}$ per cent will maintain the same $\frac{1}{4}$ percentage point margin of caution as previous projections, while ensuring that the public finance projections also remain reasonable and appropriately cautious, improving medium-term planning of public spending.

RECENT FISCAL TRENDS AND OUTLOOK

2.34 Budget 2002 is the first definitive forecast since Budget 2001. It updates the Pre-Budget Report interim projections which showed a significant but temporary fall in receipts during 2001–02 and 2002–03.

2.35 The provisional 2001-02 outturn for the public sector current budget shows a surplus of £10.6 billion, compared with a projection of £16 billion at the time of Budget 2001 and £$10\frac{1}{4}$ billion in the Pre-Budget Report. For public sector net borrowing, the provisional 2001–02 outturn is £1.3 billion, compared with a projected net repayment of £5 billion in Budget 2001 and net borrowing of £$2\frac{1}{2}$ billion in the Pre-Budget Report. Despite the impact of the temporary shortfall in receipts on the fiscal balances, the sound fiscal position means that the Government has been able to let fiscal policy support monetary policy as the economy moved below trend, while still remaining on track to meet the fiscal rules over the cycle.

Non discretionary changes – receipts

2.36 Receipts are now expected to be £7.6 billion lower in 2001-02 than forecast in Budget 2001, close to the Pre-Budget Report forecast. This reflects the impact of weaker world growth, lower equity prices and a deterioration in financial companies' profits. Since the Pre-Budget Report, outturn data for corporation tax and NICs in 2001–02 has been lower than projected, although outturns for income tax have been higher.

[3] *Audit of Assumptions for the 2002 Budget*, April 2002, (HC760).

2.37 The projection for receipts remains significantly lower in 2002-03 than in the Budget 2001 forecast, in line with the Pre-Budget Report update. In the medium term, and based on cautious audited assumptions, receipts recover to a higher level than projected in Budget 2001. The effect of the $^{1}/_{4}$ point revision to the trend growth assumption is set out in Table 2.5. Its impact cumulates over the projection period, increasing the overall level of receipts by £5 billion in 2006-07. Since the Pre-Budget Report, the impact of the other audited assumptions has had a broadly neutral impact over the forecast horizon, slightly weaker equity prices and oil prices (based on the average price over three months) are offset by the effect of higher interest rate expectations on receipts. Chapter C of the FSBR analyses the forecasting changes in more detail.

Non-discretionary changes – spending

2.38 On spending, the estimated outturn for TME in 2001–02 is £1.6 billion lower than forecast in Budget 2001 and £1.5 billion lower than in the Pre-Budget Report. While firm outturn information for DEL is not yet available, the estimate is for a small underspend of £0.7 billion in 2001–02 against the Pre-Budget Report plan. The lower estimate for TME therefore also reflects changes to the forecast for AME.

2.39 Expenditure on social security benefits and debt interest payments is expected to be almost £1 billion lower in 2001-02 than forecast in Budget 2001 and £2$^{3}/_{4}$ billion lower in 2002-03. Table 2.3 decomposes the changes into those arising from social security expenditure and those arising from lower debt interest payments. It excludes the impact of Pre-Budget Report measures and Budget 2002 policy decisions on social security. The table shows that the benefits of economic stability, lower unemployment and sound public finances are leading to a structural improvement in public spending, which is freeing up resources for the Government's priorities.

Table 2.3: Savings in Annually Managed Expenditure since Budget 2001 due to social security and debt interest before policy decisions

	£ billion		
	2001–02	2002–03	2003–04
Change from Budget 2001			
Social security benefits[1]	–0.3	–0.1	–0.6
Central government debt interest[2]	–0.6	–2.6	–0.3
Of which, changes since PBR 2001			
Social security benefits[1]	*–0.4*	*–0.5*	*–0.6*
Central government debt interest	*0.0*	*–0.3*	*0.0*

[1] *Excluding PBR measures and Budget policy decisions on social security benefits.*

[2] *Excluding reclassifications.*

2.40 The savings shown in Table 2.3 include further non-discretionary improvements in addition to those identified in the Pre-Budget Report forecast. In particular, social security benefits are forecast to be significantly lower in 2002-03 and 2003-04 as a result of lower outturn data and the audited assumption on unemployment. Chapter C of the FSBR analyses the Budget forecast for AME in further detail.

BUDGET DECISIONS

2.41 The Budget is the definitive statement of the Government's desired fiscal policy settings. In making its Budget decisions, based on the structural position of the public finances, the Government has considered:

- the need to ensure that, over the economic cycle, the Government will continue to meet its tough fiscal rules;
- its fiscal policy objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and across generations; and

- how fiscal policy can best support monetary policy over the economic cycle.

2.42 After taking account of these objectives, the Budget:

- **introduces a package of measures to encourage enterprise,** by rewarding innovation and supporting business growth and development, and reducing regulation and compliance costs;
- **takes further steps to promote employment,** improving work incentives for people on low incomes, and targeting further assistance on those groups and regions facing the most serious barriers to work;
- **introduces new measures to tackle child poverty,** supporting families with children in recognition of the costs and responsibilities that come with parenthood;
- **takes action to protect the government's revenue base and close down loopholes in the tax system,** tackling tax fraud and avoidance, and promoting fairness;
- **adds an additional £4 billion to Departmental Expenditure Limits** in 2003–04 and **sets firm overall spending limits** for the three-year period of the 2002 Spending Review up to 2005–06, allowing:
    - **current spending,** excluding spending on health, to increase by $2^1/_2$ per cent a year in real terms in 2004-05 and 2005-06. Current spending will rise in total by an average of 3.3 per cent a year in real terms over the same period; and
    - **public sector net investment** to rise from its 1.8 per cent of GDP target in 2003–04 to 2 per cent of GDP by 2005–06, continuing to address the legacy of under-investment in Britain's public infrastructure while meeting the sustainable investment rule.
- within the overall envelope for public spending, and in response to the recommendations of the Wanless Review of long-term health trends, delivers substantial increases in investment to place the National Health Service (NHS)[4] on a sustainable long-term financial footing and ensure that resources are available for reform. The Budget provides for **7.4 per cent average annual real terms growth in UK NHS spending over the five years to 2007–08, and 7.5 per cent growth in England.**

2.43 After allowing for non-discretionary changes to receipts and spending, and taking into account the Budget decisions – including significant increases in resources for the National Health Service – the Government remains on track to meet its strict fiscal rules, including in the cautious case. In order to ensure sound public finances over the medium-term:

- from April 2003, there will be an **additional one per cent national insurance contribution (NIC) by employers, employees and the self-employed on all earnings above the NICs threshold**. This is in addition to existing rates of contribution below the upper earnings limit for employees and the upper profits limit for the self-employed. These limits will be increased in line with inflation in 2003–04; and
- **the income tax personal allowance for those aged under 65 and the NICs threshold will be frozen** in 2003–04.

[4] The convention in the fiscal projections for public spending after 2005-06, prior to plans being set in the 2004 Spending Review, is set out in paragraph C22 of the FSBR. Looking further ahead, Annex A of the EFSR presents illustrative long-term fiscal projections which show that the fiscal position is sustainable in the long term, based on cautious and prudent assumptions.

2.44 Table 2.4 sets out the impact of these decisions on the fiscal balances compared with the Pre-Budget Report. The impact of Budget measures, additional policy decisions and the spending review envelope, combined with forecasting changes, leaves the current balance unchanged in 2002–03, increases the surplus in the following two years by £3 billion and £2 billion and reduces it slightly in 2005–06. Additionally, in the light of sustained low levels of net debt, the Government has decided to increase modestly net borrowing in the medium term to fund much needed investment in public infrastructure. In taking these decisions, the Government is ensuring that it remains firmly on track to meet its strict fiscal rules, including in the cautious case. A full explanation of the firm spending limits within which the 2002 Spending Review will be completed is provided in Chapter 6. Budget measures and additional policy decisions are set out in Chapter A of the FSBR.

Table 2.4: Budget policy decisions and spending review additions[1]

	Projections			
£ billion	**2002–03**	**2003–04**	**2004–05**	**2005–06**
Surplus on current budget				
PBR 2001	**3**	**4**	**7**	**8**
Change between PBR and Budget	0	3	2	–1
of which:				
Forecasting changes	*1*	*1*	*2½*	*4½*
Budget measures on tax and AME	*–1*	*6*	*7½*	*8½*
Additional Budget policy decision on DEL	–	*–3½*	–	–
Reset AME margin	*0*	*–½*	–	–
Spending additions in SR2002 period (current)	–	–	*–8*	*–14*
Budget 2002	**3**	**7**	**9**	**7**
Net borrowing				
PBR 2001	**12**	**15**	**13**	**13**
Change between PBR and Budget	–1	–1½	–½	4
of which:				
Changes to the current budget	*0*	*–3*	*–2*	*1*
Additional Budget policy decision on DEL	–	*½*	–	–
Forecasting changes to net investment	*–½*	*½*	–	–
Spending additions in SR2002 period (net investment)	–	–	*2*	*3*
Budget 2002	**11**	**13**	**13**	**17**

[1] *Figures may not sum to totals due to rounding.*

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 2001 and the Pre-Budget Report. Changes in the fiscal balances are decomposed into those explained by policy measures and those due to forecasting changes, including the revision to the underlying trend growth assumption. 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 FSBR.

2.46 The revised outturn for 2000–01 shows the current surplus to be £½ billion lower, and net borrowing £1 billion higher, than estimated in Budget 2001. The revisions since the Pre-Budget Report return the provisional outturn to levels close to the Budget forecast and mainly reflect upward revisions to spending.

Table 2.5: Fiscal aggregates compared with Budget 2001[1]

	Outturn[2]		Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Fiscal balances[3]							
Surplus on current budget (£ billion)							
Budget 2001	**22.3**	**16**	**14**	**8**	**9**	**9**	**–**
Effect of forecasting changes	2.8	–5.2	–11	–3	0	2	–
Effect of policy measures	–	–0.3	0	–2	–3	–3	–
PBR 2001	**25.1**	**10.3**	**3**	**4**	**7**	**8**	**9**
Effect of forecasting changes	–3.5	0.3	1	1	2	5	7
of which: revision to trend growth assumption	–	–	*1*	*2*	*3*	*4*	*5*
Budget policy decisions/SR2002 additions[4]	–	–	–1	2	0	–6	–8
Budget 2002	**21.6**	**10.6**	**3**	**7**	**9**	**7**	**9**
Net borrowing (£ billion)							
Budget 2001	**–15.0**	**–5**	**2**	**10**	**11**	**12**	**–**
Effect of forecasting changes	–3.8	5.2	11	3	0	–2	–
Effect of PBR policy measures	–	2.0	–1	1	3	3	–
PBR 2001	**–18.8**	**2.5**	**12**	**15**	**13**	**13**	**13**
Effect of forecasting changes	2.9	–1.2	–1	–1	–2	–5	–7
of which: revision to trend growth assumption	–	–	*–1*	*–2*	*–3*	*–4*	*–5*
Budget policy decisions/SR2002 additions[4]	–	–	0	–1	2	9	13
Budget 2002	**–15.9**	**1.3**	**11**	**13**	**13**	**17**	**18**
Net debt (per cent of GDP)							
Budget 2001	31.8	30.3	29.6	29.7	29.9	30.0	–
PBR 2001	31.2	30.7	30.6	31.0	31.1	31.1	31.1
Budget 2002	**31.3**	**30.4**	**30.2**	**30.4**	**30.4**	**30.7**	**31.0**

[1] *Including windfall tax receipts and associated spending.*

[2] *The 2000–01 figures were estimates in Budget 2001. The 2001-02 figures were projections in Budget 2001 and PBR 2001.*

[3] *Figures may not sum to totals due to rounding.*

[4] *The convention for public spending after 2005-06 is set out in paragraph C22.*

2.47 The headline figures for the current budget and net borrowing are in line with the Pre-Budget Report projections in 2001-02 and 2002-03. The combined impact of Budget decisions and forecasting changes, including to the trend growth assumption, mean that the projections return to a path similar to that in Budget 2001 over 2003-04 and 2004-05. Further out, the increase in public investment will lead to moderately higher net borrowing, fully consistent with the fiscal rules since net debt remains at or below 31 per cent throughout the next five years, well below 40 per cent.

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. The cyclically-adjusted current surplus for 2001-02 is estimated to be 1 per cent of GDP, the same as the Pre-Budget Report forecast and slightly below the Budget 2001 forecast of 1.2 per cent. On a cyclically-adjusted basis, net borrowing is now expected to equal 0.2 per cent of GDP, compared with a small net repayment of 0.1 per cent forecast in Budget 2001 and net borrowing of 0.3 per cent in the Pre-Budget Report.

Table 2.6: Cyclically-adjusted fiscal balances

	Per cent of GDP						
	Outturn[1]			Projections			
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Surplus on current budget							
Budget 2001	2.0	1.2	1.0	0.6	0.7	0.7	–
PBR 2001	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Budget 2002	**1.8**	**1.0**	**0.5**	**0.6**	**0.7**	**0.6**	**0.7**
Net borrowing							
Budget 2001	-1.3	-0.1	0.4	1.1	1.1	1.1	–
PBR 2001	-1.6	0.3	1.1	1.4	1.2	1.1	1.1
Budget 2002	**-1.2**	**0.2**	**0.9**	**1.2**	**1.2**	**1.4**	**1.4**

[1] *The 2000-01 figures were estimates in Budget 2001. The 2001-02 figures were projections in Budget 2001 and PBR 2001.*

Fiscal stance

2.49 In both 2002–03 and 2003–04, cyclically-adjusted net borrowing is projected to be 0.2 per cent of GDP lower than in the Pre-Budget Report. It returns to its Pre-Budget Report level in 2004–05. The fiscal stance this year and over the next two years is therefore at least as tight as projected in November. Compared with the Pre–Budget Report, there is a small fiscal tightening this year and next as growth gathers pace during 2002 and the economy returns to trend. This is illustrated in Table 2.8.

ADHERING TO PRINCIPLES

2.50 Table 2.7 presents a summary of the key fiscal aggregates based on the five themes of fairness and prudence, 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.

Golden rule

2.51 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 intergenerational fairness. The table shows that the estimated surplus on the current budget was 1.1 per cent of GDP in 2001-02. It is then projected to fall to 0.3 per cent in 2002-03, including as a result of temporarily weaker tax receipts, before levelling at around 0.7 per cent of GDP for the remainder of the forecast period.

Table 2.7: Summary of public sector finances[1]

	Per cent of GDP						
	Outturn			Projections			
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Fairness and prudence							
Surplus on current budget	2.3	1.1	0.3	0.6	0.8	0.6	0.7
Average surplus since 1999-2000	2.3	1.9	1.5	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	1.8	1.0	0.5	0.6	0.7	0.6	0.7
Long-term sustainability							
Public sector net debt	31.3	30.4	30.2	30.4	30.4	30.7	31.0
Core debt[2]	31.0	30.2	29.9	30.1	30.2	30.5	30.8
Net worth	19.5	20.8	21.4	21.4	21.0	20.3	20.1
Primary balance	3.8	1.7	0.6	0.5	0.4	0.1	0.0
Economic impact							
Net investment	0.6	1.2	1.4	1.8	1.9	2.0	2.1
Public sector net borrowing (PSNB)	-1.7	0.1	1.1	1.2	1.1	1.4	1.4
Cyclically-adjusted PSNB	-1.2	0.2	0.9	1.2	1.2	1.4	1.4
Financing							
Central government net cash requirement	-3.7	0.3	1.3	1.6	1.4	1.7	1.9
European commitments							
Treaty deficit[3]	-1.7	0.2	1.0	1.1	1.1	1.4	1.5
Cyclically-adjusted treaty deficit[3]	-1.2	0.3	0.8	1.1	1.2	1.4	1.5
Treaty debt ratio[4]	40.1	38.0	36.9	36.6	36.5	36.6	36.8
Memo: Output gap	0.8	-0.2	-0.2	0.1	0.0	0.0	0.0

[1] *Including windfall tax receipts and associated spending.*

[2] *See box 2.4 for an explanation of core debt.*

[3] *General government net borrowing.*

[4] *General government gross debt.*

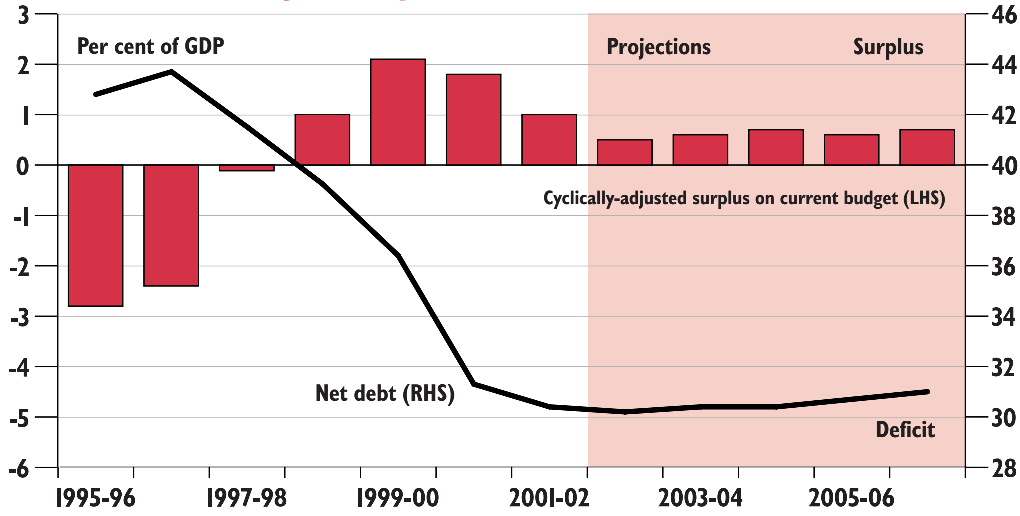
2.52 On a cyclically-adjusted basis, the current budget remains in surplus throughout the projection period. The average surplus since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, also stays positive, remaining over 1 per cent over the next five years. On this basis, the Government is on track to meet the golden rule.

Sustainable investment rule

2.53 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public debt at a low and sustainable level. The Budget projections show that, even after the decision moderately to increase net investment in the medium term, net debt is expected to rise slightly to 31 per cent of GDP through the forecast period – comfortably meeting the sustainable investment rule, and well below 40 per cent. As a result of sound public finances and greater economic stability, the Government can increase investment in the public capital stock while maintaining a buffer against unexpected events. Debt interest payments also remain low. They are projected to be lower in 2002-03 than at any time since the First World War, releasing a greater proportion of public spending to frontline public services.

2.54 Chart 2.4 illustrates the low net debt ratio and the projected cyclically-adjusted current budget surpluses. It demonstrates that the Government met its fiscal rules over the economic cycle completed between the first half of 1997 and mid-1999, and is on track to meet them throughout the forecast period.

Chart 2.4: Meeting the fiscal rules – cyclically adjusted surplus on current budget and public sector net debt



2.55 A further measure of the sustainability of the Government's fiscal position is net worth – the difference between the total assets and liabilities of the Government. Net worth is projected to remain broadly stable throughout the forecast period. This is because the Government is investing to enhance the public sector capital stock while maintaining debt at a prudent level.

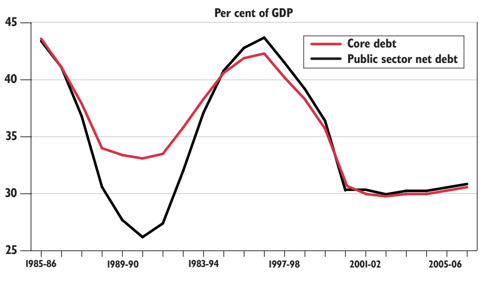
Box 2.4: Core debt

A key aspect of the fiscal framework is that both fiscal rules – the golden rule and the sustainable investment rule – are set over the economic cycle. This promotes economic stability by allowing the automatic stabilisers to operate freely. Setting the rules over the cycle also permits fiscal policy to support monetary policy in smoothing the path of the economy in the face of variations in demand.

Forecasts of the public finances since the 1998 Pre-Budget Report have included cyclically-adjusted figures for current budget surplus and public sector net borrowing to illustrate the impact of the cycle on these key fiscal balances. To increase the transparency of the framework the Treasury will, from this Budget on, also publish figures for a new measure of net debt excluding cyclical fluctuations – core debt. Estimates of core debt will be updated in future Budget and Pre-Budget Report forecasts according to a transparent methodology set out in a technical paper published alongside this Budget.

Core debt is estimated at 31 per cent of GDP in 2000-01, very similar to the value for total debt of 31.3 per cent. The chart below shows that the difference between core and total debt has been slight in recent years, reflecting stability in the economy as a whole. However, the measures diverge more widely further back due to differences between actual and cyclically adjusted deficits, when the economy was significantly away from trend as in the late 1980s.

Public sector net debt and core debt



Core and total net debt (per cent of GDP, end of year)

	Core Debt	Total Debt
1990-91	33.1	26.2
1997-98	40.2	41.5
1998-99	38.3	39.2
1999-00	35.7	36.4
2000-01	31.0	31.3
2006-07*	30.8	31.0

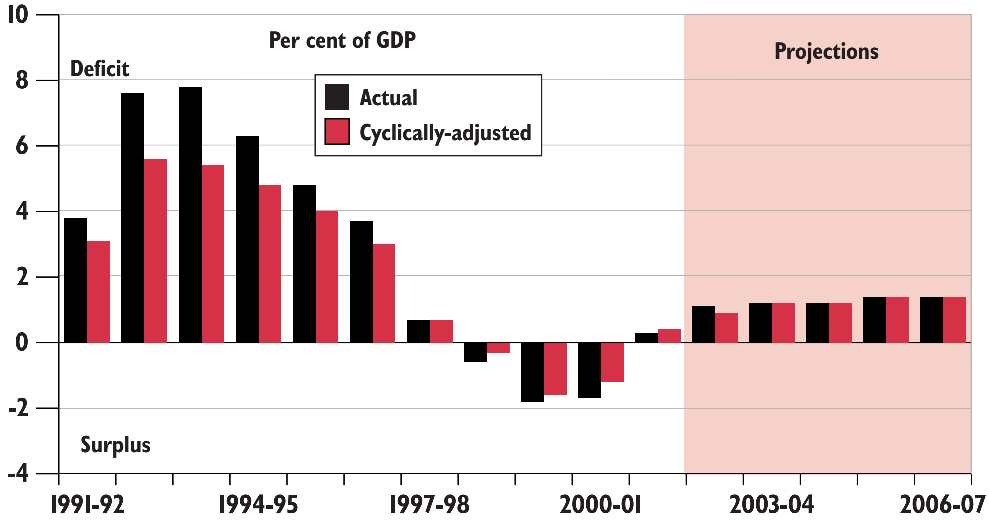
* Projection

The publication of core debt figures increases the transparency of the fiscal framework and assists analysis of performance against the sustainable investment rule, when the economy may be away from trend. Core debt also provides the Government with a tool for monitoring the evolution of debt accumulated as a result of new investment in public services while complying strictly with its firm fiscal rules. The Budget projections show that core debt will rise slowly to 31 per cent of GDP, as the Government borrows modestly to fund increased investment in priority public services, consistent with the fiscal rules.

Economic impact

2.56 While the primary objective of fiscal policy is to ensure sound public finances, fiscal policy 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). The projection for net borrowing is shown in Chart 2.5 which sets out actual and cyclically-adjusted figures as a percentage of GDP. The chart shows the projected move from surplus into deficit over the medium term. The Government has decided to increase net borrowing modestly to fund increased investment in the country's capital stock. These increases 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, well below 40 per cent of GDP.

Chart 2.5: Public sector net borrowing – actual and cyclically-adjusted



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

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

2.58 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).

2.59 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 2001 and the 2001 Pre-Budget Report, and the changes since the Pre-Budget Report.

Table 2.8: The overall fiscal impact

	Percentage points of GDP					
	Outturn	Projections				
	2001–02	2002–03	2003–04	2004–05	2005–06	2006-07
Change from Budget 2001 to PBR 2001						
Post Budget and PBR measures	0.0	0.0	0.2	0.2	0.2	–
+						
non-discretionary factors	0.4	0.6	0.1	–0.1	–0.2	–
=						
CHANGE IN FISCAL STANCE	0.4	0.7	0.3	0.2	0.1	–
+						
automatic stabilisers	0.3	0.3	0.1	0.1	0.0	–
=						
OVERALL FISCAL IMPACT	0.7	1.0	0.4	0.2	0.1	–
Change from PBR 2001 to Budget 2002						
Budget policy decisions[1]	0.0	0.0	–0.1	0.2	0.7	1.0
+						
non-discretionary factors	–0.1	–0.2	–0.1	–0.2	–0.4	–0.6
=						
CHANGE IN FISCAL STANCE	–0.1	**–0.2**	**–0.2**	**–0.1**	0.3	0.4
+						
automatic stabilisers	0.0	0.1	0.1	0.0	0.0	0.0
=						
OVERALL FISCAL IMPACT	–0.1	–0.1	–0.2	0.0	0.3	0.4

[1] *Includes convention for public spending after 2005–06 set out in paragraph C22.*

2.60 In 2001–02, as the economy moved below trend, the overall impact of fiscal policy was to support monetary policy by a further 0.7 per cent of GDP between Budget 2001 and the Pre-Budget Report. This occurred mainly because of the impact of slower global growth and weaker equity prices on receipts. As noted in the Pre-Budget Report, the estimates of the cyclically-adjusted fiscal balances understate the extent to which the reduction in receipts is temporary and can be attributed to the automatic stabilisers.[5]

2.61 The table shows that, compared with the Pre-Budget Report, the combined impact of Budget measures and non-discretionary factors results in a small tightening in the fiscal stance in 2002–03 and 2003–04. Fiscal policy is therefore supporting monetary policy as growth gathers pace during the course of 2002 and the economy returns to trend.

2.62 Based on cautious audited assumptions, the total impact of Budget decisions, including the effect of increased net investment on net borrowing, more than offsets the projected non-discretionary improvements to the public finances from 2005–06. However, the amount of caution from the audited assumptions rises over the projection period and therefore the outcome of fiscal policy and its impact on the economy will not necessarily reflect these projections. Nonetheless, within the context of sound public finances, and consistent with meeting the fiscal rules, increases in public consumption and investment, in part offset through increases in general taxation and NICs, will contribute to more balanced growth in the medium term.

[5] See paragraph 2.47 of the 2001 Pre-Budget Report, HM Treasury. The Treasury's methodology for cyclically-adjusting budget balances is set out in: *Fiscal policy: public finances and the cycle*, March 1999.

Financing

2.63 The Debt and Reserves Management Report 2002–03 (DRMR) was published on 14 March 2002, in advance of the Budget due to the requirements of the *Code for Fiscal Stability*. The forecast for the financing requirement was based on the Pre-Budget Report projection for the central government net cash requirement (CGNCR) in 2002–03. In the DRMR it was announced that the provisional net financing requirement of £32.3 billion for 2002–03 would be met by gross gilts issuance of £23 billion and a £9.3 billion adjustment in the net short-term debt position.

2.64 The CGNCR outturn for 2001–02 is £2.9 billion, £3.4 billion lower than forecast in the Pre–Budget Report. The forecast for the CGNCR for 2002–03 is now £13.5 billion. Revisions to the projected level of redemptions and the Debt Manangement Office's cash balance at the Bank of England mean that the net financing requirement for 2002-03 is £32.1 billion. In line with the contingencies outlined in the DRMR, these changes have been accommodated by reducing gross gilt sales by £0.6 billion to £22.4 billion. The total adjustment in net short term debt remains at £9.7 billion. Full details and a revised financing table can be found in Chapter C of the FSBR.

European commitments

2.65 The Budget 2002 projections easily meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period. The projections are consistent with the Government's prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). Based on cautious assumptions and consistent with the Government's fiscal rules, the cyclically-adjusted Treaty deficit is projected to increase to 1.4 per cent of GDP by the end of the projection period as the Government borrows modestly to fund increased investment in the public capital stock. The increases in investment will boost the productive capacity of the economy and will not put macroeconomic stability at risk. General government gross debt remains well below 60 per cent, ensuring the public finances are sustainable.

Box 2.5: The Stability and Growth Pact

The Stability and Growth Pact was finalised at the European Council in June 1997 to ensure that EU Member States safeguard sound and sustainable government finances through the medium-term budgetary objective of "close to balance or surplus." Fiscal sustainability is a precondition for macroeconomic stability and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy co-ordination 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 that takes into account:

- **the economic cycle: by allowing the automatic stabilisers to operate symmetrically over the cycle, fiscal policy can support monetary policy in smoothing economic fluctuations in the face of variations in demand. Focusing on cyclically-adjusted fiscal balances is therefore important when assessing the appropriateness of budgetary policies;**
- **sustainability: low debt levels enhance the sustainability of the public finances, give more room for manoeuvre to allow the automatic stabilisers to operate and provide a sound basis for investment in priority public services or reforms to promote productivity, employment and fairness. Any assessment of the sustainability of public finances also needs to take account of the budgetary impact of ageing populations and, where possible, generational accounts (see Annex A); and**
- **public investment: in the context of sound public finances and economic stability, public investment not only raises welfare through the provision of high quality public services, but can also help raise the overall productive potential of the economy. However, after historic under-investment, the UK currently has the lowest level of public investment of any major EU country. The Government is committed to delivering rapid growth in investment so as to renew and modernise the capital stock. Budget 2002 sets new spending limits for the 2002 Spending Review which allow for a further rise in public sector net investment to 2 per cent of GDP by 2005-06, consistent with meeting the fiscal rules and maintaining low levels of debt.**

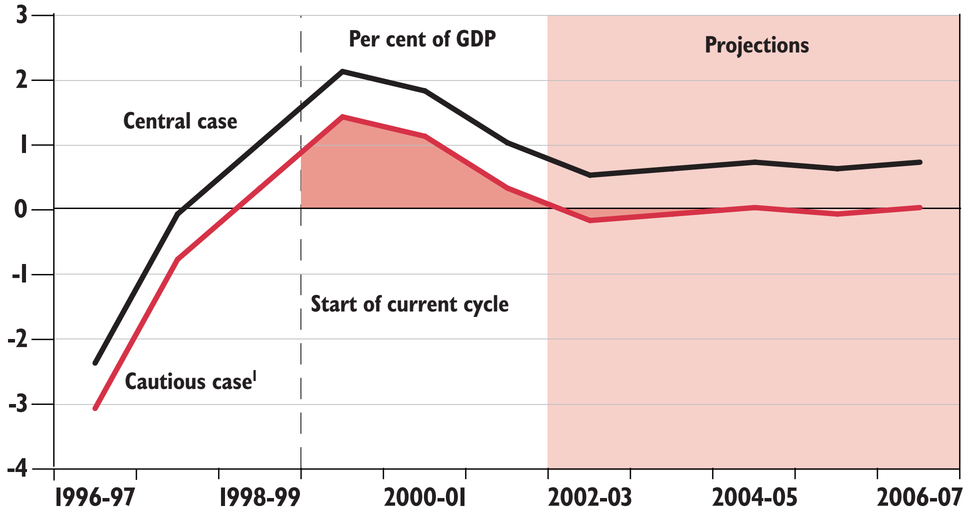
A prudent interpretation of the Pact will lock in longer term fiscal discipline and sustainability, enhancing credibility, while allowing appropriate flexibility over the economic cycle to increase public investment in priority public services.

Dealing with uncertainty

2.66 As fiscal balances represent the difference between two large aggregates, forecasts of them are inevitably subject to wide margins of error. The cautious assumptions audited by the NAO, including the trend growth assumption, take account of possible misjudgements about the trend growth of the economy in the medium term. The importance of accommodating this error source explains why the Government continues to base its public finance projections on a trend growth assumption $^{1}/_{4}$ percentage point lower than its neutral view.

2.67 A second 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 1 percentage point lower than on the central case. Chart 2.6 illustrates the forecast for this cautious case.

Chart 2.6: Cyclically-adjusted surplus on current budget



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

2.68 The chart shows that the cyclically-adjusted current surplus in the cautious case remained in strong surplus in 1999–00, the start of the current cycle, and again in 2000–01. It is then projected to move towards balance in 2001–02, and into a small deficit in 2002–03, before returning broadly to balance for the remainder of the projection period. The cyclically-adjusted current budget remains in surplus on average in the cautious case, meeting the 'stress test' of the golden rule. The Government therefore remains on track to meet the golden rule over the cycle, including in the cautious case. Meeting the cautious case and maintaining the $^{1}/_{4}$ point margin of caution in the trend growth assumption underpinning the fiscal projections increases the probability of meeting the fiscal rules and also maintains the buffer against fiscal risks.

Long-term fiscal projections

2.69 The Government must ensure that its short and medium-term fiscal policy decisions are consistent with long-term fiscal sustainability. Failure to do so could not only have detrimental effects on long-term economic growth, but would be inconsistent with the principles of fiscal management set out in the *Code for Fiscal Stability*. Annex A presents illustrative long-term fiscal projections for the UK which show that the fiscal position is sustainable in the long term, with net debt projected to remain below 40 per cent of GDP.