2 Delivering macroeconomic stability

The Government's forward looking macroeconomic framework is continuing to deliver economic stability:

- **the monetary policy framework is delivering low and stable inflation which has meant that long-term interest rates are around their lowest level for 35 years;**
- **the fiscal policy framework has restored the public finances to a healthy and sustainable position: a surplus on public sector net borrowing of £16.4 billion is now estimated for 2000–01.**

Budget 2001 locks in economic stability for the future. This chapter shows that:

- **Budget 2001 locks in the tough fiscal stance set out in Budget 2000 and the Pre-Budget Report;**
- **fiscal outturns have been better than expected, largely reflecting non-discretionary, structural improvements to the public finances which feed through into future years, enabling:**
  - **new resources to be released to priority areas, while maintaining a long-term sustainable fiscal position even when world economic prospects are less certain;**
- **Budget 2001 measures include:**
  - **targeted tax cuts for productivity, work, savings and families;**
  - **an additional £2⅓ billion over the next three years for education and health, and to tackle drugs and crime;**
- **the fiscal stance including Budget measures is at least as tight as set out in Budget 2000 and the Pre-Budget Report throughout the next five years;**
- **the Government is on track to meet its firm fiscal rules, including in the cautious case.**

By continuing to deliver economic stability, Budget 2001 underpins the 2000 Spending Review settlement while allocating more resources to improve public services, growth, standards of living and prosperity for all.

THE MACROECONOMIC FRAMEWORK

2.1 The Government's central economic objective is to raise the economy's trend rate of growth, and achieve rising prosperity, through creating economic and employment opportunities for all.

2.2 Large fluctuations in output, employment, inflation and interest rates create uncertainty for businesses and consumers alike. They impose significant costs on the economy and society and can hold back the economy's long-term growth potential. The Government has been determined to avoid the sort of volatility which characterised the cycles of boom and bust of the past. That is why it has put in place a new macroeconomic framework to deliver economic stability – to help businesses and people, as well as Government, plan for the long term.

2.3 The framework is built on a set of clear principles based on transparency, accountability and responsibility and sets down a platform of economic stability for the long term. The monetary policy framework based on an operationally independent Bank of

England seeks to secure low and stable inflation, while the fiscal policy framework is underpinned by two fiscal rules that are designed to deliver sound public finances. A long-term public spending framework provides for better planning of government spending and places a greater focus on the quality of public service provision and the outcomes achieved.

The monetary policy framework

2.4 Since its creation at the start of this Government's period of office, the monetary policy framework has helped to keep inflation close to the Government's target and has enjoyed a high degree of credibility. This has been for a number of reasons:

- objectives are clear and precise. 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. In this way monetary policy helps to support the Government's wider economic policy objective of high and stable levels of growth and employment;
- the Bank of England's Monetary Policy Committee (MPC) has full operational independence and is responsible for setting interest rates to meet the Government's inflation target. The Government has reaffirmed in this Budget 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;
- the framework promotes openness, transparency and accountability through the publication of MPC members' voting records, prompt reporting of minutes of the monthly MPC meetings and the Bank of England's quarterly *Inflation Report;* and
- the 'Open Letter' system, whereby 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 why inflation has deviated from target, what action the MPC intends to take to get it back to target, how long it will be before inflation returns to target and how this meets the MPC's remit as set out by the Chancellor.

2.5 The new 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. The two arms of policy work in a coordinated way to deliver economic stability.

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 equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

2.9 The fiscal rules promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects. First, the rules are set over the economic cycle, allowing fiscal balances to vary between years in keeping with the cyclical position of the economy. This allows the automatic stabilisers to operate freely to dampen the effects of the economic cycle, boosting aggregate demand when the economy is below trend, and reducing aggregate demand when it is above trend.

2.10 Second, the interaction of the two rules promotes capital investment while ensuring the sustainability of the public finances in the longer term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only for capital spending. The sustainable investment rule limits government borrowing to a stable and prudent level: other things equal, lower than 40 per cent of GDP.

2.11 The fiscal framework has enhanced the credibility of the Government's fiscal policy and has promoted a constituency of support for stability-orientated policies, enabling and encouraging people and businesses to plan for the long term.

2.12 As set out in the 2000 EFSR, the Government is committed to ensuring that households are fully informed about tax and spending decisions and in due course intends to amend the *Code for Fiscal Stability* to guarantee this. It is considering the most effective way to take this forward, including the distribution to households of a leaflet.

The public spending framework

2.13 Across the public sector, planning for the long term and increasing capital investment have been supported by the new public spending framework. The key elements are:

- three-year spending allocations for departments (Departmental Expenditure Limits – DELs) providing departments with greater certainty and flexibility over their budgets and thereby enabling improved planning and management of resources over the medium term;
- Annually Managed Expenditure (AME) which covers those elements of spending which cannot reasonably be subject to firm multi-year limits and are instead subject to tough annual scrutiny as part of the Budget process. 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 bias against investment which was present in the previous planning regime. These are reinforced by Departmental Investment Strategies, published in November 2000, which show departments' plans for investment over the next three years;
- new Public Service Agreements (PSAs) through which each department is committed to deliver challenging outcome-focused targets; and

- Resource Accounting and Budgeting, which measures the full economic costs of government activity and provides better information and incentives for public sector managers.

2.14 The 2000 Spending Review set DEL allocations for the three years to 2003–04. The next Spending Review will take place in 2002.

Box 2.1: Promoting international stability

The crises in emerging markets in the 1990s brought to light fundamental weaknesses in the architecture of the international financial system and highlighted the need for new measures to promote stability at the international level in parallel to the reforms to the UK's macroeconomic framework. These crises demonstrated the need for governments to pursue transparent, consistent and credible macroeconomic policies. At the international level, these crises underlined the need for enhanced international surveillance, greater international cooperation in financial regulation and a new framework for managing crises.

To address these challenges, the G7 Finance Ministers pledged in October 1998 to create a new international financial architecture for an integrated global economy. The UK Government has played a leading role in taking forward this ambitious reform agenda, building on the structural changes introduced domestically. In the past three years, there has been substantial progress in a number of important areas, including:

- **a new framework of codes and standards to act as benchmarks against which countries can assess their performance and improve their economic and financial policy frameworks;**
- **a new model of cooperation in global financial regulation – the Financial Stability Forum – was established in 1999 to bring together the IMF, World Bank and key regulatory authorities with the objective of tackling areas of vulnerability in the international financial system;**
- **a new framework of partnership for crisis prevention and resolution between the private and public sectors which will help ensure that all parties which benefit from the international financial system play their part in maintaining its stability. The private sector has been involved in the handling of a number of recent crises, including those in Ukraine, Pakistan, Ecuador, Turkey, and Argentina; and**
- **a new mechanism for informal dialogue between systemically important economies – the G20 – was also established in 1999 to provide a forum for broader discussion and co-operation on key economic and financial issues.**

Taken together, these changes have laid the foundation of a new international financial system fit for the 21st century which will enable all countries to participate in the new global economy and share in rising prosperity.

PERFORMANCE OF THE FRAMEWORK

Monetary strategy

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

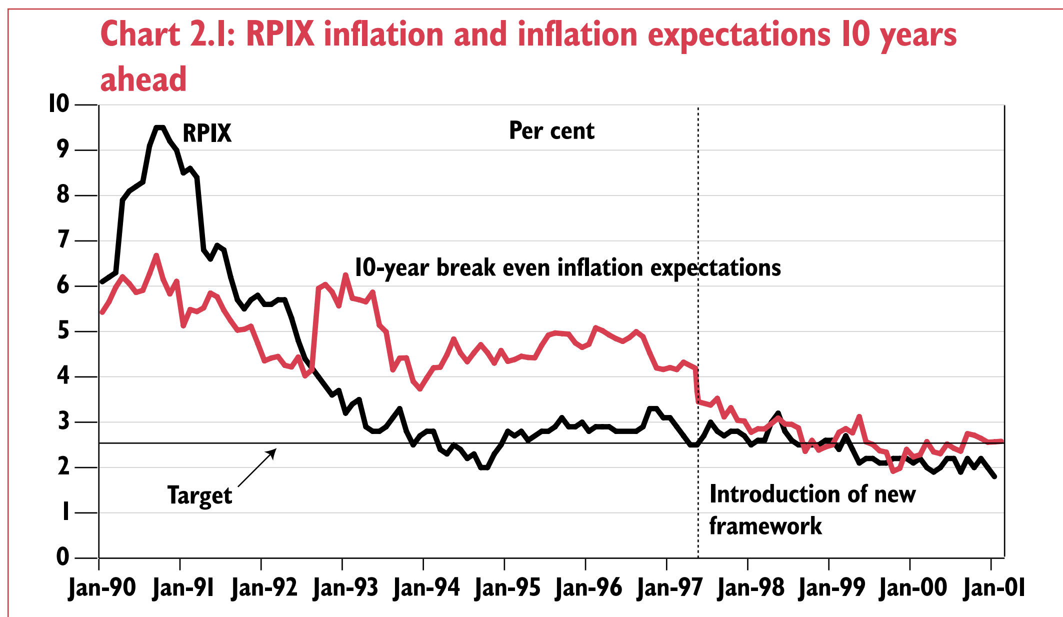
- RPIX inflation has averaged 2.4 per cent since May 1997 almost exactly in line with the Government's target and has fluctuated in the narrow range of 1.8 to 3.2 per cent;
- long-term inflation expectations in financial markets remain in line with the Government's target (see Chart 2.1) having fallen from over 4 per cent between 1994 and early 1997 to 2½ per cent by mid-1998;

- official interest rates have been much less volatile since 1997, remaining in a narrow band of between 5 and 7.5 per cent; and
- low and stable inflation has meant that long-term interest rates are around their lowest levels for over 35 years and this is helping to reduce the Government's debt interest payments.

2.16 The monetary framework is designed to be able to cope with unforeseen shocks and to leave room for pre-emptive policy responses. For example, the MPC reacted to events in East Asia in 1998 by reducing interest rates by $1^1/_4$ percentage points between October and December 1998. This helped to cushion the UK economy against potential adverse consequences with growth moderating slightly from 2.6 per cent in 1998 to 2.3 per cent in 1999. When activity recovered strongly and inflationary pressures became more evident the MPC also reacted pre-emptively, raising interest rates by 1 percentage point between Autumn 1999 and early 2000.

2.17 More recently interest rates have been cut, by 25 basis points on 8 February 2001 to $5^3/_4$ per cent. The MPC's decision reflected concerns, as expressed in the February Inflation Report, that: "In the Committee's judgment, the risks to growth and inflation are presently clearly on the downside, stemming in particular from the risk of a deeper or more prolonged slowdown in the United States."

Chart 2.1: RPIX inflation and inflation expectations 10 years ahead



Fiscal strategy

2.18 Since 1997, the public finances have been transformed and returned to a sustainable position. The Government took tough and immediate action to reduce the £28 billion deficit it inherited. It worked within the previous Government's spending plans for its first two years and made a number of difficult tax decisions, including continuing, until the November 1999 Pre-Budget Report announcement, to raise fuel duties by more than inflation under the escalator introduced by the previous Government.

2.19 By adopting a prudent and responsible approach to fiscal policy, a cumulative structural fiscal tightening of $4^1/_2$ percentage points of GDP between 1996–97 and 2000–01 restored the public finances to a sustainable position. Fiscal policy was also supporting monetary policy when the economy was above trend.

2.20 Budget 2000 locked in the fiscal tightening of Budget 99 and set a firm spending envelope for the three years covered by the 2000 Spending Review, ensuring that the Government remained on track to meet its fiscal rules while releasing new resources for key public services. This enabled significant increases in real current spending and a more than doubling of net investment by 2003–04. Net investment is projected to rise to 1.8 per cent of GDP by the end of the projection period. Thereafter, it will be set within this ceiling as a share of GDP, consistent with the net debt to GDP ratio remaining below 40 per cent in the medium term.

2.21 The 2000 Spending Review settlement provided a detailed breakdown of spending plans for the next three years, consistent with the spending limits announced in Budget 2000. Within that envelope, the Government was able to release additional resources to priority public services as a result of prudent management of the economy and public finances. Savings have been made in a number of areas, including:

- lower growth in spending on social security, through cutting the cost of worklessness; and
- reduced debt interest payments resulting from lower interest rate expectations and the debt repayment following the auction of radio spectrum licences.

2.22 As a result, changes in social security benefits and debt interest payments are expected to account for only 16 per cent of the change in TME in the period 2000–01 to 2003–04. This compares to 42 per cent in the period 1978–79 to 1996–97. Table 2.1 illustrates this and includes the impact of Budget policy decisions. A greater share of resources are available for priority public services.

Table 2.1: Changes in Total Managed Expenditure accounted for by social security benefits and debt interest payments

	1978–79 to 1996-97	1996-97 to 2003-04	2000-01 to 2003-04
Social security benefits[1]	33%	23%	19%
Central government debt interest payments	9%	–3%	–3%

[1] *For the purpose of comparison, social security includes Working Families' Tax Credit and Disabled Person's Tax Credit.*

2.23 The additional resources released by the Spending Review settlement will have an important impact on the productivity and sustainable growth of the economy. The Government is redressing historically low levels of public investment through a strategic programme of renewal and modernisation of the country's capital stock, including:

- a Ten Year Plan for transport, doubling investment in transport infrastructure in the Spending Review period with a balanced package of investment in high quality public transport and targeted improvements to the road network;
- an increase in capital expenditure on health by over £1.2 billion between 2000–01 and 2003–04, a 39 per cent rise in real terms;
- increased capital investment in schools amounting to £7.8 billion over 2000–01 to 2003–04.

Box 2.2: EMU and EMU preparations

The Government's policy on membership of the single currency remains as set out by the Chancellor of the Exchequer in his statement to the House of Commons in October 1997, and restated by the Prime Minister in February 1999. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous.

The Government has set out five economic tests which must be met before any decision to join can be made. In 1997, the Government's statement made clear that it would not start another assessment of the five tests until early in the next Parliament. The Government has said that the assesment will be produced within two years of the start of the next Parliament. The assessment will be comprehensive and rigorous. On the basis of the assessment, the Government will take a decision on whether the five tests have been met. The Government believes that, if a decision to recommend joining is taken by the Government, it should be put to a vote in Parliament and then to a referendum of the British people. The referendum would only occur if the five tests were met and the Government had made a decision to recommend joining.

The Government is committed to ensuring that the UK retains a genuine option to join a successful single currency. Over the past three years, the Government has worked intensively with the business community, wider public sector and voluntary groups both to ensure that the necessary preparations were in place to deal with the euro from 1 January 1999, and to take forward detailed planning work for possible UK entry, if that is what Government, Parliament and the people decide.

The Government has produced a range of resources to help firms understand the impact which the single currency may have on their business. These resources include a website, business-to-business case studies and factsheets covering core business euro information. The Government has also carried out surveys and works with 12 Regional Euro Forums to provide help at the local level. It also prepares regular progress reports on euro preparations.

The Treasury published the second Outline National Changeover Plan in March 2000. The plan, which was drawn up in consultation with business, the voluntary sector and the public sector, sets out the planning assumptions for a possible changeover to the euro. The public sector has given a clear signal of its commitment to prepare, undertaking targeted investment as part of the ongoing modernisation of public sector systems.

2.24 The Pre-Budget Report in November took further steps towards achieving the Government's goals of raising productivity performance to deliver stronger sustainable growth, while ensuring that all can share in rising prosperity. It also contained an affordable and carefully targeted package of announcements and proposals to help motorists and improve the competitiveness of the UK's transport sector. The interim fiscal forecast in the Pre-Budget Report showed that the fiscal stance, including measures, was at least as tight as set out in Budget 2000.

2.25 The challenge for Budget 2001 is not only to continue to deliver macroeconomic stability by ensuring that the Government locks in the tough fiscal stance set out in Budget 2000 and the Pre-Budget Report, but that it also puts in place policies to boost productivity and employment, while tackling child and pensioner poverty.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.26 GDP increased by 3 per cent in 2000, as forecast in the Pre-Budget Report. Preliminary estimates showed a rise of just 0.3 per cent in the fourth quarter though, excluding erratic falls in oil and gas output, growth remained much closer to trend. Domestic demand remained buoyant in 2000, reflecting strong growth in household consumption, while lower growth of business investment was partly offset by the pick-up in general government investment. Healthy export volume growth contributed to a stronger net trade performance than in previous years, but import volume growth remained strong. Manufacturing output growth was the fastest for six years, but continued to lag behind the expansion in services.

2.27 The labour market has continued to perform well. Labour Force Survey (LFS) employment increased by a further 225 thousand during 2000 and unemployment reached its lowest level since the 1970s, ending the year at 5.3 per cent on the International Labour Organisation measure. While official data suggest that the employment rate may be stabilising at an historically high level, still buoyant survey indicators and vacancies suggest that labour demand is robust. Despite evidence of skills shortages, wage growth and unit wage costs remain largely in check. Underlying earnings growth (excluding bonuses) remains very close to the 4½ per cent rate that would be consistent with the inflation target with trend medium-term productivity growth of 2 per cent a year.

2.28 Price and cost pressures remain subdued. A fall in oil prices from their autumn peak, combined with moderating domestic price pressures, helped RPIX inflation edge to a low of 1.8 per cent in January. The rise in productivity growth, to 2¼ per cent for the year as a whole, contributed to benign domestic cost pressures, as did a further compression of producer and retail margins.

Economic prospects

2.29 Overall UK growth prospects are unchanged since the Pre-Budget report, with GDP forecast to rise by 2¼ to 2¾ per cent in 2001 and later years. However, recent global developments signal a changed composition of demand in the short term. Table 2.2 summarises the outlook for growth and inflation.

Table 2.2: Summary of forecast

	Outturn		Forecast	
	2000	**2001**	**2002**	**2003**
GDP growth (per cent)	3	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
RPIX inflation (per cent, Q4)	2	2	2½	2½

2.30 Global economic growth moderated considerably in the second half of 2000, driven by a sharper than anticipated slowdown in the US. Combined with renewed weakness in Japan, G7 growth is expected to fall to 2 per cent in 2001, much weaker than in the Pre-Budget Report. Despite marked improvements in survey indicators, export volume growth is forecast to slow much more markedly during the course of 2001 than expected at the time of the Pre-Budget Report, reflecting weaker growth in UK markets overall. Net trade is now expected to reduce GDP growth by 1 percentage point in 2001 and 2002.

2.31 The deterioration in the global outlook does not yet appear to have impacted adversely on business optimism. Consumer confidence also remains at very high levels, which is expected to drive a 3¼ to 3½ per cent increase in household consumption in 2001, with a gradual moderation thereafter. Government spending will make a strong contribution to growth, with public consumption forecast to rise by 4¼ per cent. Domestic demand overall is expected to rise by 3¼ to 3½ per cent in 2001, easing to more sustainable rates in later years, but with greater short-term momentum offsetting the weaker trade outlook.

2.32 RPIX inflation is expected to rise back gradually to its 2½ per cent target by spring 2002 reflecting upward pressure from non-oil import prices and a declining negative contribution from changes in margins. Earnings growth has edged up in recent months, and domestic costs may exert further upward pressure before the output gap closes. The more prolonged undershoot of target mainly reflects the lower starting point for the projection and a smaller contribution from indirect taxes.

2.33 Downside risks to the outlook have sharpened since November, mainly reflecting risks to US growth. A harder than expected landing for the US economy, would imply a stronger direct trade impact, though possibly partly offset by adjustments in world exchange rates. Falling equity prices, or a more general loss of confidence, could lead to a more rapid, and possibly deeper, adjustment in UK private demand. But despite the recent deterioration, private sector financial imbalances remain modest compared to the past, and also current US experience. Overall balance sheet health provides a cushion against adverse external events, and policy is well placed to respond proactively given sound public finances and low inflation.

TREND GROWTH

2.34 The trend growth rate of the economy provides a measure of the growth in the supply capacity of the economy, or 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 the risk of inflation. In addition, the public finances appear stronger when the economy is operating above trend, and weaker when the economy is below trend. Therefore, accurately measuring trend growth is important in order to judge inflationary pressures in the economy and to enable policy makers to take the cycle into account when making fiscal policy decisions.

2.35 Based on business survey indicators of capacity and labour utilisation, the economy was judged to be at or close to trend in the first half of 1997 and again around mid-1999. Since then, most survey measures of capacity and labour utilisation have moved slightly above their long run averages suggesting that the economy was slightly above trend at the end of 2000. Trend output growth is estimated to be just over 2½ per cent per year. This assessment of the probable shape of the UK economic cycle since 1997 – moving above trend in 1997 and 1998 followed by a small deviation below trend in early 1999 – is broadly unchanged from the Pre-Budget Report and Budget 2000.

Economic cycle

2.36 Given the closeness of output to trend throughout 1997 to 1999, possible measurement errors and the prospect of further data revisions, it remains difficult to conclude for certain that the UK economy has completed a full, albeit short and shallow, economic cycle between the first half of 1997 and mid-1999. For the purposes of the Budget and the assessment of performance against the fiscal rules, the provisional judgement remains that a cycle may have been completed by mid-1999 when the current cycle is assumed to begin.

Prospects for trend growth

2.37 Looking ahead, the mid-points of the Budget 2001 forecast ranges are again anchored on the neutral assumption of trend output growth rising by 2½ per cent a year. This is based on productivity growth around its long-run historical average of 2 per cent. In comparison a number of independent organisations explicitly take a more favourable central view of trend growth in the near future, with estimates between 2¾ and 3 per cent. These are, in part, based on the view that the UK is well placed to achieve a significantly stronger productivity performance than the neutral 2½ per cent assumption underlying the Budget 2001 forecast.

2.38 There is a clear upside potential for trend growth to be higher in the future due to higher productivity growth. The more favourable views of trend growth and productivity partly reflect a period of 'catch up', with businesses striving to secure further productivity improvements in order to restore profitability and also to avoid wage pressures in a tight labour market. Moreover, 'capital deepening' through Information and Communication Technology (ICT) investment and related diffusion of know-how may contribute to an increase in UK productivity, as it has in the US since the mid-1990s. But while the evidence shows UK firms are well placed to emulate US productivity performance, Budget 2001 makes only a small allowance for upside productivity potential within the upper limits of the forecast ranges.

Caution and the public finance projections

2.39 Looking forward over the projection period, while the economic forecast is based on a neutral estimate of 2½ per cent a year trend growth, the public finance projections in this Budget continue to be based on the deliberately prudent and cautious trend growth assumption of 2¼ per cent a year, as audited by the NAO. This is because the Government is determined not to repeat the mistakes of the past by assuming a potential improvement in trend growth before this has demonstrably been achieved and audited.

2.40 The prudent and cautious view about trend growth is one of several assumptions audited by the NAO under the three year rolling review established in Budget 2000, which ensures they remain reasonable and cautious. A full list is set out in Chapter C of the FSBR. For Budget 2001, the Comptroller and Auditor General has audited the assumptions relating to the composition of GDP and debt funding. He has concluded in both cases that it is reasonable to continue to use the assumption as a basis for the fiscal projections.[1]

FISCAL DEVELOPMENTS AND OUTLOOK

2.41 Budget 2001 is the first definitive forecast since Budget 2000, which set the envelope for spending allocations to 2003–04. The forecast reflects the significant structural improvement in the health of the public finances over the past year which has enabled new resources to be released to the Government's priorities while ensuring fiscal discipline is maintained.

2.42 A surplus on current budget of £23.1 billion is now estimated for 2000–01 compared with a forecast of £14 billion at the time of Budget 2000. A similar improvement is expected for public sector net borrowing (PSNB). A net repayment of £16.4 billion is estimated for 2000–01, compared with a projected net repayment of £6 billion at the time of Budget 2000. These surpluses are also higher than expected at the time of the Pre-Budget Report.

2.43 It is important to distinguish between cyclical and structural components of a fiscal improvement. Based on the Treasury's methodology for cyclical adjustment, it is clear that the improvement over the past year largely appears to have been structural.[2] The stronger than expected fiscal tightening for 2000–01 will continue to impact on activity and inflation in the coming year.

2.44 Since 1996–97, the cumulative changes to structural public sector net borrowing add up to a fiscal tightening of 4½ percentage points of GDP. Over the same period, net debt has declined by over 12 percentage points. Fiscal policy has supported monetary policy by reducing inflationary pressures when the economy has been above trend.

[1] See *Audit of Assumptions for the March 2001 Budget*, March 2001 (HC304).
[2] See *Fiscal Policy: Public Finances and the Cycle*, HM Treasury, March 1999.

2.45 In making its fiscal projections, the Government distinguishes between non-discretionary factors which affect the public finances, such as changing consumption patterns affecting tax receipts and changes to the economic forecast, for example to GDP growth, and discretionary Budget measures. Further detail on this distinction is set out in *Analysing UK fiscal policy*.[3] This chapter first outlines the non-discretionary changes which, together with the 2000 Spending Review and the Pre-Budget Report, form the fiscal context for Budget decisions.

Non-discretionary changes – receipts

2.46 Receipts are now expected to be stronger in 2000–01 than expected at the time of Budget 2000. Full details of all tax and spending changes are included in Chapter C of the FSBR. Higher than expected receipts arise from:

- higher outturns for 1999–2000 than expected at the time of Budget 2000. This has raised the forecast base, affecting the profile in future years;
- increased receipts in 2000–01, notably higher income tax receipts from higher wages and employment; and
- greater than expected proceeds from the auction of radio spectrum licences.

2.47 The upward revisions in this forecast include further improvements on top of those identified in the Pre-Budget Report interim forecast. Since November, the forecast for income tax receipts for 2000–01 has been revised upwards by over £3 billion, reflecting buoyant Self-Assessment and PAYE receipts, which largely carry forward into future years. The structural improvement in income tax receipts stemming from higher wages and employment is analysed further in Chapter C.

Non-discretionary changes – spending

2.48 The estimated outturn for AME for 2000-01 is significantly lower than forecast in Budget 2000. Before taking into account discretionary changes since Budget 2000, there are also significant savings through the forecast period. Expenditure on social security benefits and debt interest payments is expected to be over £2 billion lower in 2000–01 than forecast in Budget 2000 and nearly £6 billion lower in 2001–02. Table 2.3 decomposes the savings into those arising from lower social security expenditure and those arising from lower debt interest payments. It shows that the benefits of economic stability, lower unemployment and sound public finances are leading to a structural improvement in government spending, which is freeing up resources in the future for the Government's priorities.

Table 2.3: Savings in Annually Managed Expenditure (AME) since Budget 2000 due to social security and debt interest before policy decisions

	£ billion			
	2000–01	2001–02	2002–03	2003–04
Change from Budget 2000				
Social security benefits[1]	–0.9	–1.9	–2.3	–2.9
Central Government debt interest	–1.2	–4.0	–2.5	–2.2
Of which, changes since PBR2000:				
Social security benefits[1]	*0.1*	*–0.2*	*–0.4*	*0.0*
Central Government debt interest	*–0.4*	*–1.5*	*–0.6*	*–0.4*

[1] *Excluding PBR measures and Budget policy decisions.*

[3] HM Treasury, November 1999.

2.49 Table 2.3 shows that these savings include further non-discretionary improvements in addition to those identified in the Pre-Budget Report forecast. In particular, debt interest payments are forecast to be £1½ billion lower in 2001–02 than expected at the time of the Pre-Budget Report as a result of lower inflation and lower interest rate expectations, and £½ billion lower thereafter as a result of lower interest rate expectations.

2.50 The Government will make a final judgement about the underspend on DEL for 2000–01 once more information on the outturn is available. Its preliminary judgement is that there is a £1 billion underspend in 2000–01.

Summary of changes since Pre-Budget Report

2.51 New information since the Pre-Budget Report on the DEL underspend and other non-discretionary improvements to receipts and spending have substantially improved the estimated fiscal balances for 2000–01 since November. Receipts are now estimated to be around £3 billion higher and current spending about £1 billion lower. The Government has also decided to use the £2½ billion savings in 2000–01 allocated to the AME margin in the Pre-Budget Report to pay down net debt. The total effect on the current budget is to increase the surplus by about £6½ billion, a significant proportion of which feeds through into future years (see Table 2.4).

BUDGET DECISIONS

2.52 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 meet its tough fiscal rules;
- its broader medium term fiscal objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and across generations; and
- the path that best ensures that fiscal policy supports monetary policy over the cycle.

2.53 Within this disciplined framework, which is designed to continue to deliver economic stability, the better than expected performance of the public finances in 2000–01, which is expected to persist into the future, has enabled additional discretionary changes to promote growth and opportunity for all, including:

- targeted tax cuts for productivity, work, savings and families. A full explanation of Budget measures is given in the FSBR; and
- an additional £2⅓ billion over the next three years to boost education and health, and to tackle drugs and crime.

2.54 In addition, in light of the improved forecast, the Government has drawn down the savings in AME beginning in 2001–02 that were allocated to the AME margin at the time of the Pre-Budget Report. This frees up resources for the implementation of the Pre-Budget Report consultation measures. As in previous Budgets, the AME margin is being reset to £1, £2 and £3 billion for the next three years (from 2001–02).

2.55 Also in accordance with previous practice, the Government has decided to carry forward from 2000–01 to 2001–02 the underspend on DEL of £1 billion to the Reserve to cover departments' End Year Flexibility.

MEDIUM TERM FISCAL PROJECTIONS

2.56 Table 2.4 compares the projections for the surplus on current budget and public sector net borrowing with those in Budget 2000 and last November's Pre-Budget Report. Changes are divided into those resulting from discretionary policy measures and those resulting from revisions and forecasting changes. It includes the impact of all Budget decisions in accordance with the *Code for Fiscal Stability*. A more detailed breakdown is given in Table C6.

2.57 The table distinguishes between the headline figures and the underlying structural position, which includes adjustments for the economic cycle. This is necessary because the Government takes care not to treat cyclical improvements to the public finances as structural improvements.

2.58 The cyclically-adjusted current surplus for 2000-01 is projected to equal 2.1 per cent of GDP, up on the Budget forecast of 1.3 per cent. Looking at PSNB on a cyclically–adjusted basis, a surplus of 1.4 per cent is now estimated for 2000–01, up on the Budget 2000 forecast of 0.5 per cent. In each year of the forecast period, the fiscal stance – defined as cyclically-adjusted PSNB – is projected to be at least as tight as set out in Budget 2000 and the Pre-Budget Report. Fiscal policy is supporting monetary policy in controlling inflation. Budget 2001 locks in the tough fiscal stance set out in Budget 2000 and the Pre-Budget Report.

Table 2.4: Fiscal balances comparison with Budget 2000 and PBR 2000[1]

	Outturn[2]	Estimate			Projections		
	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06
Fiscal balances (£ billion)							
Surplus on current budget							
Budget 2000	**17.1**	**14**	**16**	**13**	**8**	**8**	**–**
PBR/SR 2000 revision/forecasting changes	2.3	2.7	4	5	4	5	–
PBR/SR 2000 policy measures	–	–0.3	–3	–4	–4	–4	–
PBR 2000	**19.4**	**16.6**	**16**	**14**	**8**	**8**	**8**
Revision/forecasting changes	–0.1	6.5	3	4	4	5	5
Budget policy decisions	–	–	–3	–3	–4	–4	–4
Of which: Change to AME margin	–	–	2	2	2	2	2
PBR consultation measures	–	–	–2	–2	–2	–2	–2
New measures	–	–	–2	–3	–3	–4	–4
Budget 2001	**19.2**	**23.1**	**17**	**15**	**8**	**9**	**9**
Net borrowing							
Budget 2000	**–11.9**	**–6**	**–5**	**3**	**11**	**13**	**–**
PBR/SR 2000 revision/forecasting changes	–4.5	–4.4	–4	–6	–5	–5	–
PBR/SR 2000 policy measures	–	0.8	3	4	4	4	–
PBR 2000	**–16.4**	**–10.1**	**–6**	**1**	**10**	**12**	**13**
Revision/forecasting changes	0.4	–6.3	–4	–4	–4	–5	–5
Budget policy decisions	–	–	4	4	4	4	4
Of which: Change to AME margin	–	–	–2	–2	–2	–2	–2
PBR consultation measures	–	–	2	2	2	2	2
New measures	–	–	3	3	4	4	4
Budget 2001	**–16.0**	**–16.4**	**–6**	**1**	**10**	**11**	**12**
Cyclically-adjusted budget balances (per cent of GDP)							
Cyclically-adjusted surplus on current budget							
Budget 2000	1.8	1.3	1.3	1.0	0.7	0.7	–
PBR 2000	1.9	1.5	1.4	1.1	0.6	0.7	0.7
Budget 2001	**1.9**	**2.1**	**1.4**	**1.1**	**0.6**	**0.7**	**0.7**
Cyclically-adjusted net borrowing							
Budget 2000	–1.2	–0.5	–0.3	0.5	1.1	1.1	–
PBR 2000	–1.6	–0.8	–0.3	0.3	1.1	1.1	1.1
Budget 2001	**–1.6**	**–1.4**	**–0.3**	**0.3**	**1.1**	**1.1**	**1.1**

[1] *Excluding windfall tax receipts and associated spending.*
[2] *The 1999–2000 figures were estimates in Budget 2000.*
NB. Figures may not sum due to rounding.

ADHERING TO PRINCIPLES

2.59 Table 2.5 presents a summary of the key fiscal aggregates focused around five themes: fairness and prudence, sustainability, economic impact, financing and European commitments.

Table 2.5: Summary of public sector finances[1]

	Per cent of GDP						
	Outturn	Estimate			Projections		
	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06
Fairness and prudence							
Surplus on current budget	2.1	2.4	1.7	1.4	0.8	0.8	0.8
Average surplus since 1999–2000	2.1	2.3	2.1	1.9	1.7	1.5	1.4
Cyclically-adjusted surplus on current budget	1.9	2.1	1.4	1.1	0.6	0.7	0.7
Long-term sustainability							
Public sector net debt[2]	36.8	31.8	30.3	29.6	29.7	29.9	30.0
Net worth[2]	17.4	18.8	21.3	21.6	21.4	21.0	20.4
Primary balance	4.2	4.0	2.5	1.7	0.8	0.7	0.6
Economic impact							
Net investment[2]	0.4	0.8	1.1	1.5	1.7	1.8	1.8
Public sector net borrowing (PSNB)	–1.8	–1.7	–0.6	0.1	0.9	1.0	1.0
Cyclically-adjusted PSNB	–1.6	–1.4	–0.3	0.3	1.1	1.1	1.1
Financing							
Central government net cash requirement[2]	–1.0	–3.5	0.0	0.5	1.5	1.4	1.4
European commitments							
Treaty deficit[3]	–1.7	–1.7	–0.5	0.1	0.9	0.9	1.0
Treaty debt ratio[4]	43.7	40.6	37.6	36.1	35.7	35.6	35.6
Memo: Output gap	0.2	0.6	0.5	0.3	0.2	0.1	0.0

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

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

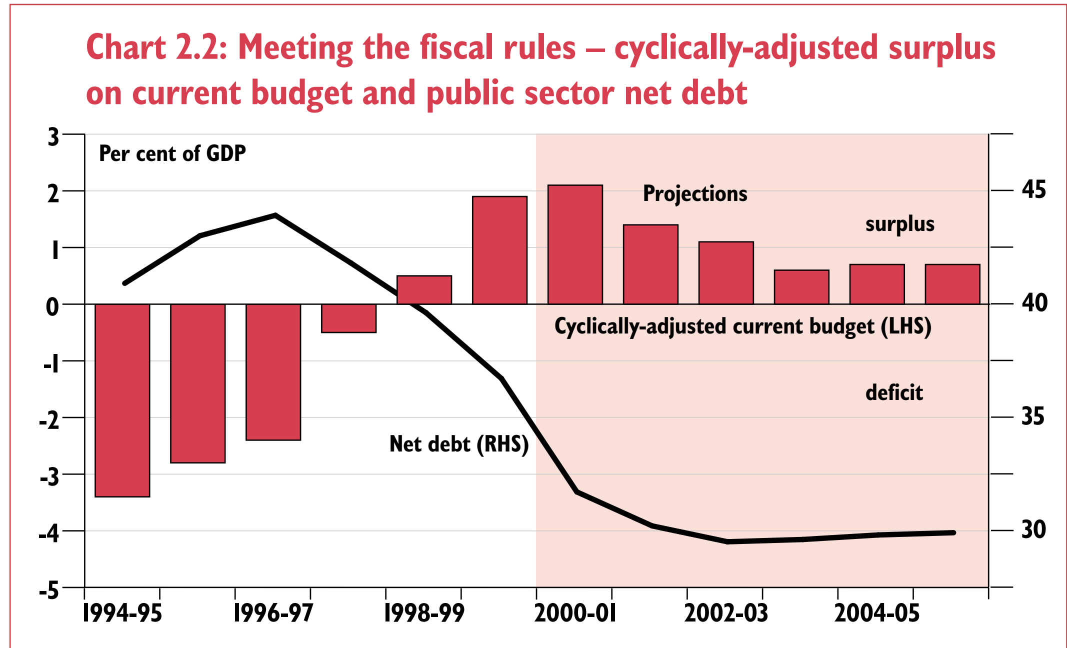
[3] *General government net borrowing on an ESA95 basis. The Treaty definition includes the windfall tax and associated spending.*

[4] *General government gross debt.*

Golden rule

2.60 Table 2.5 indicates that, after allowing for non-discretionary changes to receipts and spending and after releasing additional resources, the Government remains on track to meet both fiscal rules. The surplus on current budget represents the difference between current receipts and current expenditure, including depreciation. The surplus on current budget is estimated to equal 2.4 per cent of GDP in 2000–01. It is then projected to decline to 0.8 per cent over the forecast period, largely because of the increased current spending provided by the 2000 Spending Review, as well as measures announced in Budget 2001 and the Pre-Budget Report.

2.61 On a cyclically-adjusted basis, the surplus on current budget remains positive throughout the forecast 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 above 1 per cent over the next five years. On this basis, the Government is on track to meet the golden rule.



Sustainable investment rule

2.62 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This depends on maintaining public debt at a low and sustainable level. The Budget 2001 forecast shows that net debt continues to fall more sharply than predicted. With the benefits of sound public finances, lower interest rate expectations, lower inflation and the proceeds from the radio spectrum licence auction, the public sector net debt ratio is estimated to fall to below 32 per cent of GDP in 2000–01, and thereafter to fall further to 30 per cent or lower.

2.63 In every year of the forecast period net debt is also lower than the PBR forecast, reflecting lower than expected net borrowing in the current year. The Government is therefore firmly on track to meet the sustainable investment rule with net debt held at a stable and prudent level, well below 40 per cent.

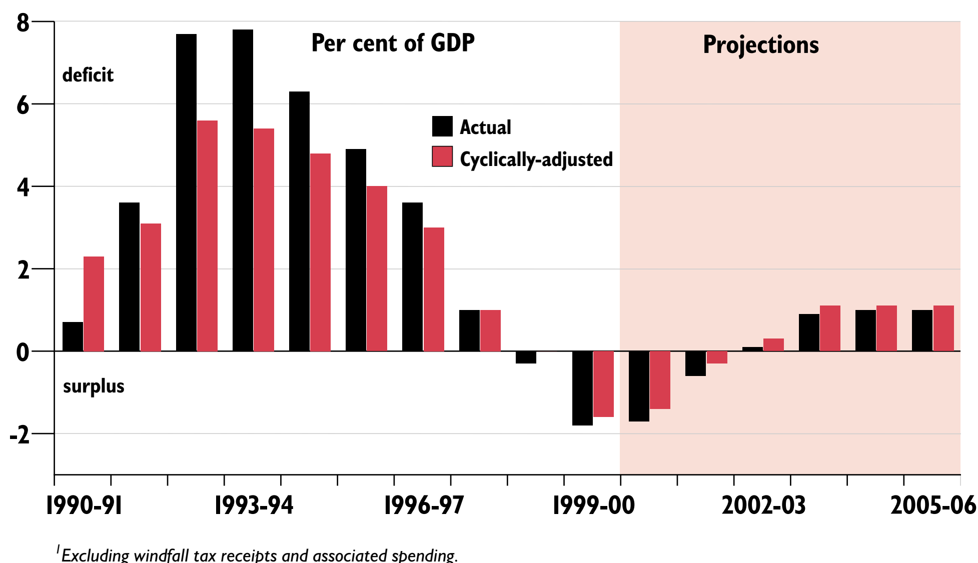
2.64 Chart 2.2 illustrates the falling net debt ratio, as well the cyclically-adjusted current budget remaining in surplus. It shows that the Government met its fiscal rules over the economic cycle that was probably completed between mid-1997 and mid-1999, and that it is on track to meet them in every year up to 2005–06.

2.65 Another 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 rise to over 21 per cent by 2001–02, thereafter remaining broadly stable.

Economic impact

2.66 While the key objective for fiscal policy is to ensure sound public finances, fiscal policy also impacts on the economy and plays a role in supporting monetary policy over the cycle. The key indicator for assessing the overall fiscal impact is the change in PSNB. The forecast for net borrowing is set out in Chart 2.3 which shows the actual and cyclically-adjusted figures as a percentage of GDP. The chart shows the projected move from surplus into deficit over the medium term. This is because the Government is planning to borrow modestly to fund its increased investment in the country's capital stock. This is fully consistent with the Government's long-term approach and with the fiscal rules, since net debt is being held at a stable and prudent level.

Chart 2.3: Public sector net borrowing – actual and cyclically-adjusted[1]



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

2.67 The overall fiscal impact 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.

2.68 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).

2.69 Table 2.6 explains how these concepts relate to the projections in the Budget. It shows the change in both the fiscal stance and the overall fiscal impact relative to the projections in Budget 2000, which set the envelope for the 2000 Spending Review allocations of departmental spending until 2003–04.

Table 2.6: The overall fiscal impact – change from Budget 2000

	Percentage points of GDP				
	Estimate	Projections			
	2000–01	2001–02	2002–03	2003–04	2004–05
Budget policy decisions	0.0	0.4	0.3	0.4	0.3
+					
PBR/SR 2000 measures	0.2	0.3	0.4	0.4	0.4
+					
non-discretionary factors	–1.1	–0.7	–0.8	–0.7	–0.8
=					
CHANGE IN FISCAL STANCE	**–0.9**	**0.0**	**–0.1**	**0.0**	**–0.1**
+					
automatic stabilisers	–0.1	–0.1	–0.1	–0.1	–0.1
=					
OVERALL FISCAL IMPACT	–1.0	–0.1	–0.2	–0.1	–0.2

2.70 In 2000–01 there was a significant tightening of the fiscal stance relative to that anticipated at the time of Budget 2000. This occurred as a result of buoyant tax receipts and lower than expected spending. As a result of higher growth than expected, the automatic stabilisers have also operated to a slightly greater extent than forecast. In total, the overall fiscal impact was greater than expected a year ago by an amount equivalent to 1.0 per cent of GDP.

2.71 The non-discretionary improvement persists through the forecast period (reflecting in part the structural improvement to the tax base discussed in Chapter C). Discretionary measures announced in the Budget, combined with decisions taken in the 2000 Spending Review and in the Pre-Budget Report offset this. The fiscal stance in Budget 2001 is therefore at least as tight as set out in last year's Budget. In addition, the automatic stabilisers are projected to operate to a greater extent throughout the forecast period than projected at the time of the last Budget. Overall therefore, fiscal policy will continue to support monetary policy as the economy remains above trend.

Financing

2.72 A revised Gilts Remit was published on 12 June 2000 in the light of the better than expected outcome from the auction of radio spectrum licences. Gross gilts issuance was fixed at £10 billion for the remainder of the financial year. This represented a reduction of £2.2 billion from the original remit issued in March 2000. Additionally, the contingencies outlined in the Debt Management Report 2000–01 were exercised. It was decided that the surplus should be used to reduce net debt. In the Pre-Budget Report, the forecast for the Central Government Net Cash Requirement (CGNCR) was revised from –£4.9 billion to –£28.2 billion. Additionally, further decisions were made regarding the composition of the reduction in net debt. It was also announced that the Debt Management Office would be holding a net short term cash surplus which they would unwind over the next three financial years.

2.73 The forecast for the CGNCR in 2001–02 is £0.3 billion. In order to add to the financing requirement and maintain the level of gross issuance, the Government has decided to pre-finance foreign currency debt due in 2003. In addition, the Government forecasts that it will purchase £1 billion of gilts through secondary market buy-backs. Both of these measures help increase the financing requirement and this will help to address the current liquidity problems in the gilts market. Gross gilt sales are planned to be £13.5 billion in 2001–02. Details of the debt management plans for 2001–02, including the remits for the Debt Management Office and National Savings are published today in the Debt and Reserves Management Report 2001-02.

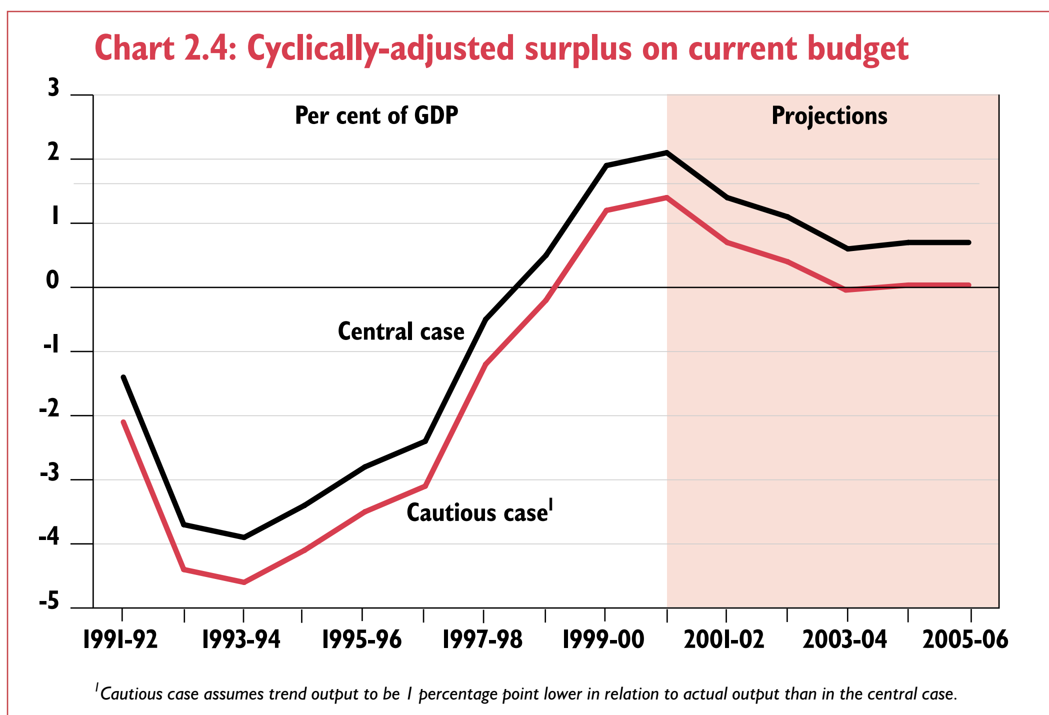
European commitments

2.74 The Treaty provides reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP). The Budget 2001 projections are consistent with these Treaty requirements and are in line with the Stability and Growth Pact. Gross debt is projected to fall to 37.6 per cent in 2001–02 and then to nearly 35 per cent by the end of the forecast period, well below the relevant value. Consistent with the Government's fiscal rules, the general government financial balance moves into a small deficit in the medium term reflecting the impact of increased investment in priority public services announced in the 2000 Spending Review. It remains well within the 3 per cent reference value.

Dealing with uncertainty

2.75 Projections of public finances necessarily involve a considerable degree of uncertainty. In particular, public revenue and spending projections depend heavily on forecasts of economic growth and, in particular, on assumptions about where the economy is in relation to trend at a given point in time. The health of public finances can quickly deteriorate if most of the strength turns out to be cyclical and if the economy slows to below trend over the forecast horizon. This could result in the need for significant and costly changes in the direction of fiscal policy.

2.76 To counter this risk and avoid potential disruptions to policy arising from other economic or fiscal shocks, the Government stress tests its projections against a cautious case in which the level of trend output is assumed to be 1 percentage point lower than in the



central case. This is illustrated in Chart 2.4. Even on this basis, the Government is on track to meet the golden rule over the economic cycle.

2.77 This increases the probability of meeting the fiscal rules and also creates a buffer against fiscal risks. By creating a safety margin, it minimises the need for unexpected changes of direction and so allows a smoother path for public spending.

LONG TERM FISCAL PROJECTIONS

2.78 It is important that the Government ensures that its short term fiscal policy decisions are consistent with long-term fiscal sustainability. Failure to do so could have detrimental effects on long-term economic growth. Illustrative long term projections are presented in Annex A of the EFSR. They show that the fiscal position is sustainable in the long term, with net debt to GDP projected to remain below 40 per cent.

2.79 The projections, which are based on prudent and cautious assumptions, show that current public consumption can grow faster than real GDP, while public net investment can be sustained at around $1^3/_4$ per cent of GDP without jeopardising the fiscal rules. The high degree of uncertainty surrounding the projections indicates that there is no scope for complacency.

CONCLUSION

2.80 The impact of introducing a new and comprehensive macroeconomic framework since 1997 is helping to sustain macroeconomic stability and enhanced economic performance. The sound fiscal position, sustainable into the medium and long term, coupled with a credible and effective framework for monetary policy, are creating an environment where the private sector can take decisions with more confidence and where the necessary improvements in public services can be afforded.

2.81 The challenge remains, however, to move to a significantly higher level of sustainable growth, the benefits of which are widely spread through the domestic economy, and which allow the UK to play a full part in maintaining a healthy world economy. Improving productivity is central to achieving this aim. The next chapter outlines measures the Government is taking to close the productivity gap.