Analysing UK Fiscal Policy

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EXECUTIVE SUMMARY

The Government has taken significant steps to strengthen the framework for fiscal policy since taking office. Fiscal policy is now directed firmly towards maintaining sound public finances over the medium term, based on strict rules. Where possible it supports monetary policy over the economic cycle. This approach, together with the new monetary policy framework, provides the platform of stability necessary for achieving the Government's central economic goal of high and sustainable levels of growth and employment.

High quality external scrutiny of the conduct of fiscal policy plays a key role in ensuring that the benefits of the new framework are delivered fully. This paper aims to help understanding by providing a guide to analysing fiscal policy under the new framework.

It is important to understand the role each fiscal aggregate plays in analysis of policy. Using an inappropriate aggregate can result in misleading conclusions. For example, while the public sector net cash requirement is a good measure of the public sector's financing needs, it is not the best measure of the impact of fiscal policy on the economy or the long-term sustainability of fiscal policy.

The paper focuses on decisions regarding the key fiscal policy aggregates, rather than decisions about individual spending or taxation policies, important though these are.

In addition to meeting the Government's key microeconomic objectives, decisions taken in the Budget on taxation and spending – and the balance between them – reflect the Government's key fiscal policy objectives of:

- over the medium term, ensuring sound public finances and that spending and taxation impact fairly both within and across generations. In practice this requires that:
  - the Government meets its key taxation and spending priorities while avoiding an unsustainable and damaging rise in the burden of public debt; and
  - those generations who benefit from public spending also meet, as far as possible, the costs of the services they consume; and
- over the short term, supporting monetary policy, where possible, by:
  - allowing the automatic stabilisers to play their role in smoothing the path of the economy in the face of variations in demand; and
  - where prudent and sensible, providing further support to monetary policy through changes in the fiscal stance.

The new fiscal framework has been designed carefully to deliver these objectives. Central to the framework are five principles of fiscal management:

- **transparency** in the setting of fiscal policy objectives, the implementation of fiscal policy and the publication of the public accounts;
- **stability** in the fiscal policy-making process and in the way fiscal policy impacts on the economy;
- **responsibility** in the management of the public finances;
- **fairness**, including between generations; and
- **efficiency** in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.

These principles were enshrined in the Finance Act 1998 and in the *Code for Fiscal Stability*, approved by the House of Commons in December 1998. The Code explains how these principles are to be reflected in the formulation and implementation of fiscal policy.

The Government has specified two key fiscal rules that accord with these principles. These are:

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

The fiscal rules provide benchmarks against which the performance of fiscal policy can be judged. The Government will meet the golden rule if, on average over a complete economic cycle, the current budget is in balance or surplus. The Government also believes that, other things equal, a modest reduction in net public sector debt to below 40 per cent of GDP over the economic cycle is desirable.

The Government recognises that the composition of the Budget can have an important bearing on its economic effect over both the short and long-term. However, as a first approximation, and in the absence of a significant compositional shift in taxation and spending in the Budget, the key indicator for assessing the overall fiscal impact is the **change in public sector net borrowing** (PSNB). Fiscal policy adds to demand when there is an increase in PSNB and subtracts from demand when PSNB falls.

The overall fiscal impact is therefore made up of changes in:

- that part of PSNB resulting from cyclical movements in the economy, ie through the operation of **the automatic stabilisers**; and
- that part of PSNB resulting from changes in **the fiscal stance** (which is equivalent to changes in cyclically-adjusted or structural PSNB).

The Budget projections of cyclically-adjusted PSNB indicate the extent to which the Government is planning to undertake a **discretionary tightening or loosening of the fiscal stance**. This tightening or loosening may come about due to one or both of:

- a discretionary Budget measure to achieve the desired change in the fiscal stance; and
- a Budget decision to accommodate or offset the impact of non-discretionary factors that are expected to affect the fiscal stance.

These concepts help to explain the process by which decisions are made in the Budget. A judgement is reached about the appropriate fiscal stance given the need to meet the fiscal rules. This judgement also takes into account the need to ensure, as far as possible, that the overall fiscal impact supports monetary policy through the economic cycle. The Government then implements discretionary Budget measures to the extent that they are necessary to deliver the appropriate fiscal stance, taking into account the impact of non-discretionary factors which change the baseline fiscal projections (including pipeline measures).

In setting fiscal policy, the Government takes a deliberately cautious approach. This has to balance the costs of potentially underachieving the fiscal rules against those associated with running an unduly restrictive fiscal policy stance. It also recognises that some adjustment of the fiscal stance is possible within the cycle, if actual outturns and updated projections suggest the Government is no longer likely to meet its objectives.

This prudent approach is implemented, among other things, by adopting a cautious assumption about the economy's trend growth rate. The Government's economic policies are designed to raise this growth rate beyond the level assumed for fiscal policy purposes. For the purposes of fiscal planning, however, it would not be prudent to take credit for any success of these policies until firm evidence emerges. This approach ensures the risks of costly policy reversals are minimised.

Under the *Code for Fiscal Stability*, the Government is committed to publishing a Pre-Budget Report (PBR) at least three months prior to the Budget. One of the roles of the PBR is to increase transparency, which it does in two key ways. First, it provides an opportunity for the Government to consult the public on specific policy initiatives under consideration for the forthcoming Budget. Second, it presents an update on the outlook for the economy and the public finances, taking into account economic and other developments since the Budget.

It is important to note that the public finance projections contained in the PBR present an interim forecast update. The PBR projections do not necessarily represent the outcome the Government is seeking. They have a quite different status to the projections contained in the Economic and Fiscal Strategy Report (EFSR) and Financial Statement and Budget Report (FSBR) at Budget time. The figures presented are preliminary and the projections are subject to change in the period before the Budget. Forecast errors can be large, even in the near term. A further assessment is made at Budget time before decisions are taken to ensure the fiscal rules are met.

Updated fiscal projections will be presented in the Pre-Budget Report to be published on 9 November 1999. However, applying this approach to the Budget 99 projections shows:

- the Government was well placed to meet its medium-term objectives – the fiscal rules were on track to be met over the current cycle on both projections of the *surplus on current budget* and *public sector net debt*. The prudence of the Government's medium-term plans was also reflected in *public sector net worth* which was forecast to rise slightly following years of marked decline.

- following several years of necessary tightening of the fiscal stance to restore sound public finances, the decisions taken in Budget 99 were projected to lock in this tightening by leaving the fiscal stance virtually unchanged over the forecast period (that is, cyclically-adjusted PSNB was projected to remain broadly constant). Actual PSNB was projected to rise a little into 1999-2000, so that the automatic stabilisers could play their role in supporting monetary policy. This decision was taken against a backdrop of a slowing domestic economy following weaker world growth.

I Introduction

I.1 The Government has taken significant steps to strengthen the framework for fiscal policy since taking office. Fiscal policy is now directed firmly towards maintaining sound public finances over the medium term, based on strict rules. Where possible it supports monetary policy over the economic cycle. This approach, together with the new monetary policy framework, provides the platform of stability necessary for achieving the Government's central economic goal of high and sustainable levels of growth and employment.

I.2 High quality external scrutiny of the conduct of fiscal policy plays a key role in ensuring that the benefits of the new framework are delivered fully. This paper aims to help understanding by providing a guide to analysing fiscal policy under the new framework. The paper focuses on decisions regarding the key fiscal policy aggregates, rather than decisions about individual spending or taxation policies, important though these are.

I.3 The paper begins by outlining briefly the objectives of fiscal policy and the institutional framework that has been designed to deliver them. Subsequent sections discuss the key fiscal policy aggregates, how fiscal policy operates within the new framework and how careful assessment of the key aggregates – combined with more detailed analysis – can help form an accurate picture of developments in the public finances and their impact on the economy both over the short and long term. This year's Budget, Budget 99, is used to illustrate the points made. A glossary of fiscal policy concepts is at Annex A; Annex B provides the arithmetic behind the fiscal indicators; Annex C describes improvements by the ONS in the reporting of fiscal aggregates; and Annex D lists a number of papers produced by the Treasury which explain the new macroeconomic framework.

2 The objectives of fiscal policy

2.1 On arrival in office in 1997 the Government was faced with a large structural fiscal deficit, low net investment, rising public debt and falling public sector net worth[1]. Urgent action was needed. This situation had come about in part as a result of a lack of clear and transparent fiscal objectives, together with fiscal reporting that did not permit full and effective public and Parliamentary scrutiny. The Government therefore took steps to implement a new framework for fiscal policy – one that complements the Government's significant reforms to the monetary policy framework.

2.2 The objectives for fiscal policy set by the Government under the new regime are based on an assessment of what fiscal policy can realistically achieve over both the short and long term, and how this relates to the Government's wider policy goals and functions. Among the core functions of government is the provision of high quality public goods and services and financial and other assistance to those most in need. In providing and financing these activities, the Government must ensure that its actions are consistent with the maintenance of economic stability, both in the short term and beyond. Stability promotes the long-term investment and planning necessary for sustaining high levels of growth and employment.

2.3 Given the central importance of economic stability, the key objectives of the Government's fiscal policy are:

- over the medium term, ensuring sound public finances and that spending and taxation impact fairly both within and across generations. In practice this requires that:
  - the Government meets its key taxation and spending priorities while avoiding an unsustainable and damaging rise in the burden of public debt; and
  - those generations who benefit from public spending also meet, as far as possible, the costs of the services they consume; and
- over the short term, supporting monetary policy, where possible, by:
  - allowing the automatic stabilisers to play their role in smoothing the path of the economy in the face of variations in demand; and
  - where prudent and sensible, providing further support to monetary policy through changes in the fiscal stance. For example, it is likely to be more appropriate to change the fiscal stance in this context if the economy is projected to be some way from trend.

2.4 The medium and short-term objectives are linked. For example, the scope for, and likely success of, using fiscal policy to support monetary policy during a downswing in the economic cycle is likely to depend on the soundness of the medium-term fiscal position. Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended.

2.5 The interaction of fiscal policy with monetary policy is also affected by the power of the automatic stabilisers (see Box 2.1).

[1] These terms are defined more precisely later in the paper and in Annex A.

Box 2.1: The automatic stabilisers

Several features of the tax and spending regime act to stabilise the economy over the economic cycle. As the economy strengthens, incomes and expenditure tend to rise, resulting in higher tax receipts, while falling unemployment reduces social security spending. As the economy weakens, the opposite effect occurs. So government borrowing will be relatively low when the economy is operating above trend and relatively high when the economy is below trend. This "automatic" fiscal effect helps to reduce the swings in output over the economic cycle, by boosting aggregate demand when the economy is below trend, and reducing aggregate demand when the economy is above trend. The impact of the automatic stabilisers can be seen by examining the difference between actual public sector net borrowing (PSNB) figures and the cyclically-adjusted PSNB position.

The automatic stabilisers have a significant impact on the public finances. Treasury estimates† suggest that, after two years, a 1 per cent increase in output relative to trend will lead to:

- an increase in the ratio of the surplus on the current budget to GDP of just under 3/4 percentage point; and
- a decrease in the ratio of PSNB to GDP of just under 3/4 percentage point.

This means that the ratios of the current budget and PSNB to GDP fluctuate over the economic cycle, even if the fiscal stance remains unchanged throughout. For example, if a cycle entailed a range for the output gap of ±2 per cent - encompassing a range for growth of, say, between 1 and 4 per cent - the PSNB to GDP ratio will vary (with opposite sign) by ±1½ per cent. If the automatic stabilisers were overridden, the consequences would be considerably greater instability in output and employment.

The strength of the automatic stabilisers depends on the characteristics of the taxation and spending regime, for example the progressivity of taxes. Altering those characteristics would, therefore, have implications for the degree of stabilisation provided and should be taken into account when making changes to the taxation or spending regime. Moreover, when assessing the extent to which the fiscal policy framework is supporting monetary policy, the strength of the automatic stabilisers should be considered.

†*See Fiscal Policy: Public Finances and the Cycle, HM Treasury, March 1999.*

3 THE FRAMEWORK FOR FISCAL POLICY

3.1 The new framework for fiscal policy has been designed carefully to deliver the fiscal policy objectives discussed in section 2. Central to the framework are five principles of fiscal management:

- **transparency** in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts;
- **stability** in the fiscal policy-making process and in the way fiscal policy impacts on the economy;
- **responsibility** in the management of the public finances;
- **fairness**, including between generations; and
- **efficiency** in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.

3.2 These principles were enshrined in the Finance Act 1998 and in the *Code for Fiscal Stability*, approved by the House of Commons in December 1998. The Code explains how these principles are to be reflected in the formulation and implementation of fiscal policy in practice. For example, consistent with the principle of transparency, the Code sets out explicit requirements for the setting and explaining of fiscal policy objectives and for reporting developments in the public finances, eg the requirement on the Government to publish the Economic and Fiscal Strategy Report and a list of the minimum information it must contain.

3.3 The Government has specified two key fiscal rules that accord with these principles. These are:

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

3.4 The fiscal rules provide benchmarks against which the performance of fiscal policy can be judged. The Government will meet the golden rule if on average over a complete economic cycle the current budget is in balance or surplus. The Government also believes that, other things equal, a modest reduction in net public sector debt to below 40 per cent of GDP over the economic cycle is desirable.

Box 3.1: The fiscal rules – the importance of prudence and transparency

Under the previous framework insufficient attention was paid to the impact of the economic cycle on the public finances. Consequently, the fiscal surpluses recorded at the end of the 1980s were interpreted incorrectly as representing an improvement in the structural position of the public finances. Fiscal policy was relaxed at a time when the opposite response would have been more appropriate. When the economy eventually returned to trend, the position of the public finances deteriorated rapidly, resulting in a sharp rise in the public debt burden between 1990-91 and 1996-97.

The Government is determined to avoid a repetition of these past errors. The main lessons have therefore been taken on board in the formulation of the new policy framework. Particularly important are:

- **a prudent approach – it is important to adjust for the economic cycle and to build in a margin for uncertainty; and**
- **openness and transparency – in the new fiscal framework two strict fiscal rules are clearly defined, in line with the medium-term objectives of fiscal policy. The framework also embodies a new, more open set of reporting requirements to allow effective evaluation of policy against objectives.**

Box 3.2: A new public spending framework

To support the new fiscal framework, the Government has implemented a new regime for planning and controlling spending. The previous framework had encouraged short-term planning and discriminated against spending on investment. Its primary focus was on controlling the *quantity* of spending, with insufficient emphasis given to controlling the *quality and effectiveness* of current and capital spending.

The new spending regime addresses these issues. Under the new framework, three-year plans have been set for all the main government departments through Departmental Expenditure Limits (DEL). These limits provide departments with a solid basis for planning and a strong incentive to manage their own costs effectively. Where expenditure cannot reasonably be subject to multi-year limits, it is subject to tough annual scrutiny as part of the Budget process and is contained under the heading of Annually Managed Expenditure (AME).

Within DEL and AME – which together equate to Total Managed Expenditure (TME) – current and capital expenditures are planned and managed separately, consistent with the distinction in the fiscal rules. This removes the bias against investment inherent under the previous planning regime.

Each department is also committed through new Public Service Agreements (PSAs) to testing performance and efficiency targets for the modernisation of public services. PSAs, which were first published last December in "Public Services for the Future: Modernisation, Reform, Accountability" (Cm 4181), set out the key results the public can expect in return for the investment it is making in public services. The Government has promised to give progress reports against the targets annually.

New mechanisms are being put in place to deliver these targets and existing ones are being strengthened. Performance overall is being closely monitored by a Cabinet Committee, PSX. The Government has also appointed an advisory group of outside experts, the Public Services Productivity Panel, which is working with departments to help improve performance. Good business management is essential, with PSAs backed up at all levels by clear ownership and accountability, rigorous performance review and reinforcement and incentives. The Government is determined to improve performance across the public sector, in particular to raise standards to those of the best where there are variations in performance within and between services.

4 IMPLEMENTING FISCAL POLICY IN PRACTICE

The key fiscal aggregates

4.1 Two important features of the new fiscal policy framework are a high level of transparency in fiscal reporting combined with greater emphasis on fiscal aggregates with economic meaning. This contrasts with the previous framework in which the public sector net cash requirement (formerly the PSBR) was the primary focus of policy decision-making, notwithstanding the fact that it is an inadequate measure of the economic impact or sustainability of fiscal policy.

4.2 A further major shortcoming of the various public sector net cash requirement targets adopted was that they created a bias against capital spending. Current and capital spending could be offset against each other, making capital projects – where the benefits appear only in the future – an easy target when it became necessary to tighten the fiscal stance. This bias contributed to considerable under-investment in public assets.

4.3 Under the new framework a variety of fiscal aggregates are now reported regularly by the Government, some of which take on particular importance. Annex C provides some details of improvements to the Public Sector Finances *First Release* which will bring monthly fiscal reporting into line with the fiscal aggregates which play key roles in the new framework.

4.4 Each fiscal aggregate is usually reported in both nominal terms and as a proportion of GDP, the latter providing a better indicator of trends since it allows for the impact of inflation and real growth in the economy. In addition, many of the indicators are also reported in cyclically-adjusted terms, ie they are adjusted for the estimated impact of the economic cycle so that the underlying or structural trend can be seen more easily.

4.5 Each of these aggregates has a role to play in analysis of policy. Understanding the differences between fiscal aggregates is essential to form an accurate picture of developments in the public finances and their impact on the economy. It is important to use the right aggregate – or combination of aggregates – for the task at hand. Table 4.1 provides a brief guide to the appropriate indicators to use.

Table 4.1: Using the key fiscal aggregates

Issue under examination	Appropriate fiscal measure									Other information		
	Surplus on current budget over the cycle	Public sector net debt	PSNB	Cyclically-adjusted PSNB	Net worth	Primary balance	General government financial deficit	General government gross debt	Central government net cash requirement	Generational accounts	Long-term fiscal projections	Composition of spending and revenue
Medium-term fiscal policy objectives:												
Ensuring fiscal policy is prudent, ie consistent with sustainability	✓	✓			✓	✓				✓	✓	
Fairness of fiscal policy across generations	✓									✓		
Short-term fiscal policy objectives:												
Fiscal stance				✓								✓
Overall fiscal impact			✓									✓
Other objectives:												
Consistency with European commitments							✓	✓				
Government's financing requirement									✓			

Using the key fiscal aggregates

4.6 Section 2 set out the medium and short-term objectives of fiscal policy. This section discusses how the various fiscal aggregates can be used to assess progress against those objectives.

Analysing progress against the medium-term fiscal policy objectives

4.7 Ensuring that the public finances remain sound is the primary objective of fiscal policy. In this respect **public sector net debt** is a key indicator under the Government's new framework. It is the measure of debt against which the sustainable investment rule is assessed. The golden rule, discussed below, also plays a major role in keeping borrowing levels consistent with a prudent net debt ratio because the current budget is a major driver of PSNB. Several other fiscal indicators such as **net worth, the primary balance** and **long-term fiscal projections** also have a role to play in assessing the long-term sustainability of the public finances (see Box 4.1).

4.8 A further medium-term objective is to ensure that, as far as possible, those generations who benefit from public spending also meet the costs of the services they consume. This is part of the rationale behind the golden rule, whereby the Government is committed, over the economic cycle, to borrow only to invest and not to fund current spending. The key indicator of progress against this rule is the **average current budget over the economic cycle**. The current budget represents the difference between current receipts and current expenditure including depreciation. The golden rule is met when the average current budget over the economic cycle is in balance or surplus.

Box 4.1: Measures of fiscal sustainability

Net debt versus gross debt

Public debt figures can be defined either in gross or net terms. Gross figures capture the total amount of the Government's financial liabilities whereas net figures subtract from this figure the value of liquid financial assets. Net debt is used in the Government's framework since it provides a fairer reflection of the Government's immediate solvency. The Maastricht measure of debt, which is comparable across EU Member States, is based on gross general government debt.

Primary balance

The primary balance is PSNB excluding net debt interest payments. It represents the fiscal position excluding the impact of past deficits. It is possible to calculate the primary balance required to stabilise the ratio of net debt to GDP over the long term at different levels. A large primary balance is required if debt is high or if the interest rate is well above the growth rate[†].

Net worth[††]

Public sector net worth measures the difference between the total assets, including non-financial assets (such as roads), and liabilities of the Government. It represents the approximate stock counterpart to the current balance, and links appropriately with the golden rule. Changes in net worth provide an indication of the extent to which the net assets of the public sector are changing. However, many Government assets and liabilities are difficult to measure accurately. The estimates of tangible assets, for example, are dependent on broad assumptions which may not be appropriate in every case. This is why public sector net debt continues to play an important role in the fiscal policy framework.

The Office for National Statistics (ONS) is currently in the process of improving the quality of balance sheets by taking advantage of new data from the introduction of resource accounts for central government departments. These developments, which are reported in an article in November 1999 *Economic Trends*, may allow net worth to play a greater role in the fiscal framework in the future.

Prospective net worth

Prospective net worth provides a forward-looking measure of the Government's net asset position. It represents current net worth plus the discounted value of all future spending and receipts that the Government will face as a result of its current policies. In practice, many of these future cash flows are particularly difficult to measure. However, it can be argued that including estimates of some of the more "lumpy" items – such as unfunded pension liabilities – may provide useful information on the wider sustainability of the Government's fiscal position.

Long-term fiscal projections

Illustrative long-term fiscal projections, published with the Economic and Fiscal Strategy Report each year in accordance with the *Code for Fiscal Stability*, also help to assess the sustainability of the public finances. They examine the effects of demographics and other influences on long-term spending and taxation. The first set of long-term projections, published in the 1999 EFSR, suggested that the UK's future public finances are on a broadly sustainable path.

[†]The formula to calculate the primary balance required to stabilise the net debt ratio is given in Annex B.

[††]Net worth was previously referred to as net wealth. However, due to the changes to the presentation of the national accounts as a result of ESA 95, it is now called net worth.

4.9 **Generational accounts** can also provide an indication of the fairness of policy across generations. They provide a means, on the basis of maintaining current policies, of comparing the net burden of taxation and transfer payments on present generations with that faced by future generations. The Treasury last year supported a study by the National Institute for Economic and Social Research to produce and publish the first set of generational accounts for the UK[3].

Analysing the short-term fiscal policy stance

4.10 While the primary objective of fiscal policy is to ensure the medium-term sustainability of the public finances and fairness between generations, fiscal policy can also play a short-term role in supporting monetary policy. It is for this reason that the two fiscal rules are set over the economic cycle – it allows public sector net borrowing (PSNB) to vary between years, in keeping with the cyclical position of the economy.

4.11 The Government recognises that the composition of the Budget can have an important bearing on its economic effect over both the short and long term. However, as a first approximation, and in the absence of a significant compositional shift in taxation and spending in the Budget, the key indicator for assessing the overall fiscal impact is **the change in public sector net borrowing**. PSNB differs from the surplus on the current budget because it includes net investment. Government investment spending will have an impact on economic activity and so should be included when assessing the economic impact of fiscal policy.

4.12 The overall fiscal impact is therefore made up of changes in:

- that part of PSNB resulting from cyclical movements in the economy, ie through the operation of **the automatic stabilisers**; and
- that part of PSNB resulting from changes in **the fiscal stance** (which is equivalent to changes in cyclically-adjusted or structural PSNB).

4.13 The fiscal stance can change as a result of:

- **discretionary Budget measures**: for example, a decision at Budget time to reduce tax rates will have the effect, other things equal, of increasing cyclically-adjusted PSNB. Similarly, a decision to raise Government expenditure will increase cyclically-adjusted PSNB. The opposite would occur following an increase in tax rates or a reduction in public spending.
- **non-discretionary factors**: for example, a rise in the price of oil will, other things equal, reduce cyclically-adjusted PSNB, through an increase in North Sea tax receipts. Other developments that can result in unplanned changes in cyclically-adjusted PSNB include changes in spending habits. For example, a reduction in demand for tobacco will reduce the tax take for given increases in GDP.

4.14 Information about these non-discretionary factors will be available to the Government when making Budget decisions. A key policy issue is whether to accommodate their expected effects or whether to augment or offset their impact through Budget measures. In this way, the Government can determine the **expected** or desired fiscal stance.

4.15 The future is uncertain so, as events unfold, the **actual** fiscal stance that evolves may differ from that expected at the time of the Budget. For example, an intended tightening of the

[3] Cardarelli, R. Sefton, J. and Kotlikoff, L. *Generational accounting in the UK*, November 1998, paper presented to NIESR conference on Financing the Welfare State, December 1998.

fiscal stance may be transformed into an unexpected loosening due to an unanticipated decline in revenue that is unrelated to the economic cycle (eg due to a fall in the effective rate of VAT). Factors like this need to be taken into account when analysing the evolution of the fiscal stance.

4.16 The **absolute** fiscal stance is given by the change in cyclically-adjusted PSNB during the period covered by the Budget projections. However, it is also appropriate to analyse the change in the fiscal stance between Budgets. This analysis reveals the extent to which the fiscal stance is tightening or loosening **relative** to the previous Budget projections. It is possible, for example, for the fiscal stance to be tightened in relative terms, while continuing to loosen in absolute terms.

Box 4.2: Key elements in determining the overall fiscal impact

Discretionary Budget measures to change the fiscal stance

+

effects of all **non-discretionary factors** which have, or which are expected, to alter the fiscal stance

=

the change in **the fiscal stance**

+

the effect of the **automatic stabilisers** stemming from the cyclical position of the economy relative to trend

=

the change in the **overall fiscal impact** (measured as a first order approximation by the total change in PSNB)

4.17 The Budget projections of cyclically-adjusted PSNB indicate the extent to which the Government is planning to undertake a **discretionary tightening or loosening of the fiscal stance**. This tightening or loosening may come about due to one or both of:

- a discretionary Budget measure to achieve the desired change in the fiscal stance; and
- a Budget decision to accommodate or offset the impact of non-discretionary factors that are expected to affect the fiscal stance.

4.18 In a cyclical downturn, provided that there was no threat to the sustainability of the fiscal position, policy would be set to accommodate an increase in PSNB. This will allow the automatic stabilisers to support monetary policy in the "below trend" phase of the cycle with a positive overall fiscal impact on demand. It would generally be inappropriate in such circumstances to offset the automatic stabilisers by tightening the structural fiscal position to prevent a rise in borrowing, since this could be destabilising for the economy and act against the interests of monetary policy.

4.19 Box 4.3 gives some examples of how changes in the public finances can be interpreted using these concepts.

Box 4.3: Explaining changes in the public finances – some examples

Scenario 1: Budget economic projections show the economy moving below trend. Budget projects unchanged cyclically-adjusted PSNB over coming year but actual PSNB is projected to rise.

- **Fiscal policy is acting to support monetary policy by allowing the automatic stabilisers to play their role. The overall fiscal impact on demand is positive in the short-term. However, the fiscal stance remains unchanged.**

Scenario 2: Budget economic projections show the economy moving well below trend. Budget projects a rise in cyclically-adjusted PSNB over coming year due exclusively to a Budget decision to reduce tax rates or increase spending. Actual PSNB is forecast to rise over and above the increase in cyclically-adjusted PSNB.

- **Fiscal policy is acting to support monetary policy by allowing the automatic stabilisers to play their role as the economy goes below trend. Fiscal policy provides additional support by supplementing the operation of the automatic stabilisers with a discretionary loosening in the fiscal stance. This leads to a positive overall impact on demand in excess of that provided by the automatic stabilisers.**

Scenario 3: Budget economic projections show the economy remaining on trend. However fiscal projections show an increase in the effective tax rate over the coming year, leading to a reduction in cyclically-adjusted PSNB. Government takes Budget decisions to lower revenue from other sources or raise spending to offset this, thus leaving cyclically-adjusted PSNB unchanged over the coming year.

- **This is an example of a projected non-discretionary tightening of the fiscal stance. To offset this tightening, discretionary Budget measures are taken so as to leave the fiscal stance unchanged.**

How fiscal policy decisions are made in the Budget

4.20 The Budget presents a definitive statement of the Government's desired fiscal settings given the information it has to hand.

4.21 At each Budget, two key issues are considered before decisions are made about any changes to the aggregate fiscal policy settings:

- what outcomes for the key fiscal aggregates are required to ensure that, over the economic cycle, the Government meets its fiscal rules and thus its broader medium-term fiscal objectives; and

- what path for the key fiscal aggregates best ensures that, over the economic cycle, fiscal policy supports monetary policy in dampening fluctuations in the economy to help stabilise activity.

Establishing a path for the key aggregates consistent with meeting the fiscal rules

4.22 The Government is committed to meeting its fiscal rules. But projections of the public finances necessarily involve a significant element of uncertainty and the Government needs to take this into account in setting policy. For example, public revenue and spending projections depend heavily on economic growth and on assumptions made about the position of the economy in relation to its long-term trend. Deviations from what is assumed carry significant consequences for the fiscal balances. In addition, projections of particular tax revenues and spending are subject to specific risks and uncertainties.

4.23 Accordingly, in setting fiscal policy, the Government takes a deliberately cautious approach. This has to balance the costs of potentially underachieving the fiscal rules against those associated with running an unduly restrictive fiscal policy stance. It also recognises that some adjustment of the fiscal stance is possible within the cycle, if actual outturns and updated projections suggest the Government is no longer likely to meet its objectives.

4.24 This prudent approach is implemented, among other things, by adopting a cautious assumption about the economy's trend growth rate. The Government's economic policies are designed to raise this growth rate beyond the level assumed for fiscal policy purposes. For the purposes of fiscal planning, however, it would not be prudent to take credit for any success of these policies until firm evidence emerges. This approach ensures the risks of costly policy reversals are minimised.

Box 4.4: Ensuring caution in the public finances projections – the role of the NAO

The fiscal projections presented by the Government are based on deliberately cautious assumptions. This helps to ensure that policy is set in the UK's long-term interests and that policy credibility is high. The role of the National Audit Office (NAO) is to examine specified key assumptions and conventions underlying the forecasts of the public finances. The opinion of the NAO on assumptions and conventions used in Budget 99 and earlier can be found in four NAO reports: Cm 3693 (July 1997) and, as House of Commons papers, HC361 (November 1997), HC 616 (March 1998) and HC294 (March 1999).

As part of the Government's commitment to ensuring prudent public finance projections, and in accordance with the NAO's statutory requirement under the Finance Act 1998 and the *Code for Fiscal Stability*, the Chancellor recently asked the NAO to audit a more prudent oil price assumption for use in forecasting North Sea oil revenues. Their November 1999 report (HC 873) endorsed this new assumption as reasonable.

The assumptions and conventions that have been audited cover, amongst other matters, privatisation proceeds and the key determinants of tax revenues and unemployment and debt interest, important components of public expenditure within AME.

Perhaps the most important audited assumption is that for trend growth. When the Government entered office, it decided to adopt a cautious estimate of the trend growth rate, 2¼ per cent a year, for public finance projections. This view was endorsed by the NAO at the time as reasonable. The Government will continue to make its public finance projections on the basis of a 2¼ per cent trend growth assumption.

Dealing with pipeline measures

4.25 When forming a view on the desired fiscal stance, the Government takes into account all pipeline measures. These are measures announced in previous Budgets, yet to come into effect, but which nevertheless will have an impact on the fiscal position. Pipeline measures are included in the baseline projections and are therefore included when decisions are made over the policy action required to bring those projections into line with desired outcomes. The fiscal indicators published in the EFSR, FSBR and PBR all include the full effects of these pipeline measures.

4.26 An example of such a pipeline measure is the decision in the March 1998 Budget to introduce the Working Families Tax Credit (WFTC) as part of the Government's package of measures to make work pay. While the announcement of this policy was made in March 1998, the WFTC did not come into effect until October 1999. Accordingly, its effect on the fiscal position did not begin until then, with the full effect not coming in until 2000-01. The numbers presented in the Budget 99 projections included the full effects of the introduction of the WFTC.

Arriving at the Budget decision

4.27 At Budget time a judgement is reached about the appropriate fiscal stance given the need to meet the fiscal rules. This judgement also takes into account the need to ensure, insofar as possible, that the overall fiscal impact supports monetary policy through the economic cycle. The Government then implements discretionary Budget measures to the extent that they are necessary to deliver the appropriate fiscal stance, taking into account the impact of non-discretionary factors which change the baseline fiscal projections (including pipeline measures).

Keeping the Monetary Policy Committee informed

4.28 One of the objectives of fiscal policy is to support the operation of monetary policy, so it is essential, to ensure proper coordination of fiscal and monetary policy, that the Monetary Policy Committee (MPC) are fully informed of the Government's approach to fiscal policy. The Treasury representative on the MPC (who speaks at the meetings but does not have a vote) provides an important conduit through which this communication takes place.

4.29 In accordance with the overall policy of transparency, the MPC minutes always make clear when the Committee has been briefed about fiscal developments in advance of information becoming publicly available.

The role of the Pre-Budget Report

4.30 Under the *Code for Fiscal Stability*, the Government is committed to publishing a Pre-Budget Report (PBR) at least three months prior to the Budget. One of the roles of the PBR is to increase transparency, which it does in two key ways. First, it provides an opportunity for the Government to consult the public on specific policy initiatives under consideration for the forthcoming Budget. Second, it presents an update on the outlook for the economy and the public finances, taking into account economic and other developments since the Budget.

4.31 It is important to note that the public finance projections contained in the PBR present an interim forecast update. The PBR projections do not necessarily represent the outcome the Government is seeking. They have a quite different status to the projections contained in the EFSR and FSBR at Budget time. The figures presented are preliminary and the projections are subject to change in the period before the Budget. Forecast errors can be large, even in the near term. A further assessment is made at Budget time before decisions are taken to ensure the fiscal rules are met.

4.32 The status of the PBR projections carries implications for the way in which deviations from the Budget projections are interpreted. For example:

- If *tax revenue* appears likely to turn out lower than expected as a result of an unexpected fall in the effective tax rate, other things equal, the surplus on the current budget will be forecast to be smaller than that expected in the Budget (equivalently PSNB and public sector net debt will be forecast to be higher). If the PBR forecast is confirmed ahead of the subsequent Budget, decisions will be taken to ensure that the Government continues to meet its fiscal objectives. This may result, for example, in changes in taxation policy to offset the unexpected loss of revenue. Alternatively, no change (or limited change) may be necessary if changes in revenue are matched by an equivalent and offsetting unexpected change in spending.

- If expenditure on *Annually Managed Expenditure (AME)* appears likely to turn out lower than projected at the time of the Budget, the forecast "savings" will be reflected in a higher AME margin, rather than in a higher surplus on the current budget (or lower PSNB). On the other hand, if expenditure on AME items appears likely to be higher than expected in the Budget, the AME margin will be drawn down. Any additional projected spending necessary beyond that allowed for by the AME margin will be reflected in a reduction in the surplus on the current budget and higher PSNB. If the PBR projections are validated ahead of the subsequent Budget, decisions will be taken at that time to ensure that fiscal policy settings remain consistent with the Government's rules and objectives.

- Limited variation is expected in expenditure on *Departmental Expenditure Limits (DEL)* given the enforcement of strict multi-year plans. In the first instance, unexpected pressures on DEL are expected to be resolved by reprioritising DEL expenditure. One exception is that any underspend in one year can be carried over to subsequent years.

5 Analysing the impact and performance of fiscal policy – an example

5.1 This section illustrates in practical terms how the fiscal indicators discussed in Section 4 can be used to form an impression of the state of the public finances and their impact on the economy. It reproduces figures from Budget 99 and presents them in the format that will be used for the updated fiscal projections in the 1999 PBR.

Interpreting Budget 99

5.2 Table 5.1 below shows how the fiscal position can be analysed. The analysis uses the indicators and approach discussed above and is organised around five key themes: fairness and prudence, sustainability, economic impact, financing and meeting European commitments.

Table 5.1: Summary of public sector finances – Budget 99 projections[1]

	Per cent of GDP							
	Outturns		Estimate	Projections				
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Fairness and prudence								
Surplus on current budget	–3.0	–0.6	0.5	0.3	0.4	0.8	0.9	1.0
Cyclically-adjusted surplus on current budget	–2.4	–0.7	0.2	0.6	1.0	1.1	0.9	1.0
Average surplus since 1997-98	–	–0.6	–0.1	0.0	0.1	0.3	0.4	0.5
Long-term sustainability								
Public sector net debt[2]	44.3	42.5	40.6	39.4	38.2	36.8	35.6	34.6
Net worth[2]	18.1	14.7	13.8	15.2	16.6	17.6	18.3	19.1
Primary balance	–0.6	2.0	3.1	2.2	2.3	2.3	2.0	1.8
Economic impact								
Net investment	0.7	0.5	0.4	0.6	0.8	1.0	1.2	1.4
Public sector net borrowing (PSNB)	3.7	1.1	–0.1	0.3	0.4	0.1	0.3	0.4
Cyclically-adjusted PSNB	3.1	1.1	0.1	0.0	–0.2	–0.1	0.3	0.4
Financing								
Central government net cash requirement	3.3	0.4	–0.3	0.7	0.7	0.3	0.4	0.6
European commitments								
Maastricht deficit[3]	3.9	0.6	–0.6	0.3	0.2	0.2	0.1	0.3
Maastricht debt ratio[4]	53.6	49.6	47.6	46.6	45.3	43.5	42.2	41.0
Memo: output gap	*–0.6*	*0.5*	*0.2*	*–1.0*	*–0.6*	*–0.1*	*0.0*	*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 ESA79 basis. The Maastricht definition does not exclude the windfall tax and associated spending.*

[4] *General government gross debt.*

Fairness and prudence

5.3 The position on the current budget has improved markedly since 1996-97 when there was a deficit of 3 per cent of GDP, to stand at a small surplus of ½ per cent of GDP in 1998-99. The 3 per cent deficit inherited by the Government, which had been preceded by even bigger deficits, meant that there had previously been borrowing over the cycle to finance current spending as well as borrowing for investment. As well as being imprudent, this meant that future generations were being required to pay for services consumed by the previous generation of taxpayers. Fiscal policy is now operating in a more prudent manner and one that is fairer between generations – the Government is no longer borrowing to finance current spending, which means that, as far as possible, those taxpayers who benefit from current spending also bear its costs.

5.4 As discussed earlier, simply looking at the surplus on the current budget can be misleading when trying to assess the underlying position. The cyclically-adjusted surplus on the current budget presented in Table 5.1 demonstrates that the improvement in the position of the current balance has been structural, rather than merely a result of cyclical developments.

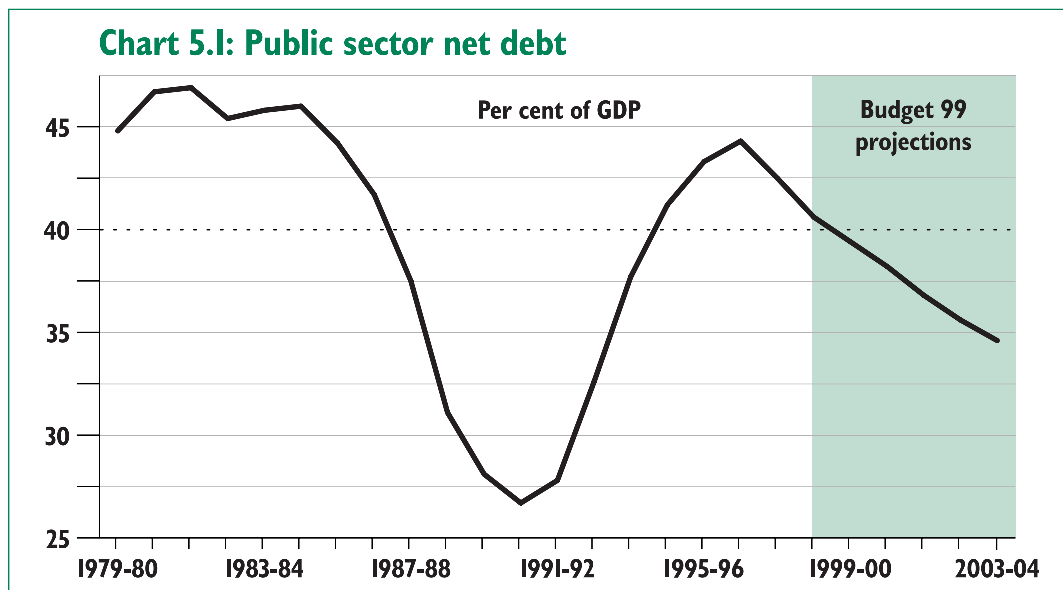
5.5 The golden rule not only tries to ensure fairness between generations, but also contributes to a prudent approach to the public finances. Current spending and revenue are the most significant drivers of trends in PSNB. Hence, achieving the golden rule plays a major part in keeping borrowing to levels consistent with a prudent and sustainable net debt ratio. In this way, the golden rule and the sustainable investment rule work together to deliver sound public finances.

5.6 Through a full economic cycle the economy will move above and below its trend growth path. It is therefore to be expected that the actual current budget surplus will vary between years. For this reason the golden rule is set over the cycle, not for each year. The key indicator to judge whether the Government is on track to meet the golden rule is the average surplus on the current budget over the whole cycle. On the basis of the Budget 99 numbers, the Government was on track to meet the golden rule over this cycle.

Sustainability

5.7 The projections set out in Table 5.1 showed that substantial progress has been made in reducing the public sector net debt ratio since 1996-97. The Budget 99 fiscal projections saw net debt remaining below 40 per cent of GDP in the future. The projections for net worth also pointed to a sustainable fiscal position. Having fallen from over 70 per cent of GDP in 1990-91 to under 14 per cent in 1998-99, largely as a result of large deficits on the current budget, a steady recovery from then on was projected to around 19 per cent of GDP by 2003-04.

Chart 5.1: Public sector net debt



5.8 The primary balance has also shown a substantial improvement since 1996-97, from approximate balance to a surplus of around 2½ per cent of GDP over the period covered by the projections. This is consistent with the projected decline in net debt as a proportion of GDP.

5.9 Not included in here, but published with the Economic and Fiscal Strategy Report each year, are illustrative long-term fiscal projections which also help to assess the long-term

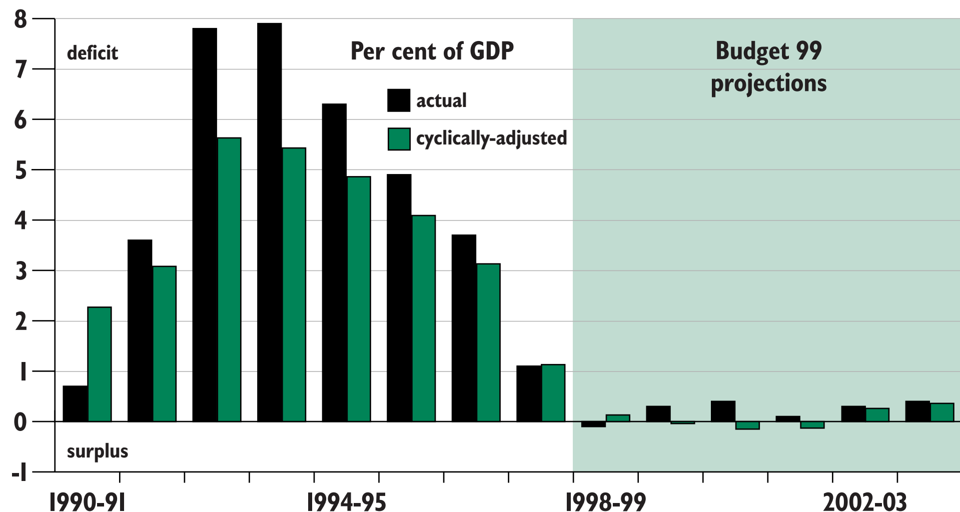
sustainability of the public finances by projecting the key fiscal aggregates over a longer time period. The first set of long-term projections, published in the March 1999 EFSR, showed that over the next 30 years the UK's public finances are broadly sustainable.

Economic impact

5.10 As discussed in Section 4, the overall fiscal impact can be approximated by the change in PSNB.

5.11 Table 5.1 shows that actual PSNB fell from 3.7 per cent of GDP in 1996-97 to zero by 1998-99. Some of the fall in PSNB since 1996-97 can be attributed to a strengthening economy. However, there was a significant fall in cyclically-adjusted PSNB. Between 1996-97 and 1998-99 this fell by 3 per cent, ie over this period there was a tightening of the fiscal stance of 3 per cent of GDP. This supported monetary policy during a period when the economy was operating above trend and helped interest rates to fall to their lowest levels for 30 years.

Chart 5.2: Public sector net borrowing – actual and cyclically-adjusted[1]



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

5.12 Moving into 1999-2000, the fiscal stance was projected to remain broadly unchanged, as shown by cyclically-adjusted PSNB. However the overall fiscal impact was expected to be positive, with support for monetary policy coming through the operation of the automatic stabilisers as shown by the projected small increase in PSNB.

5.13 The table also shows a projected near doubling in net investment as a proportion of GDP over the Comprehensive Spending Review period, which ends in 2001-02, and a projected increase beyond that. With the net debt ratio falling, borrowing remaining low and the current budget in surplus, the projected rise in investment was clearly sustainable.

Financing

5.14 As noted in Section 4, the public sector net cash requirement (formerly known as the PSBR) represents the public sector's short-term net cash financing requirement. This net cash measure no longer plays a significant role in the fiscal policy framework as it is not the best measure of the sustainability or economic impact of fiscal policy. However, it is still used to calculate the Government's debt issuance, since debt management operations necessarily involve cash financing.

5.15 The central government net cash requirement represents the level of central government net cash financing. The Government finances its net cash requirement plus maturing debt and any net finance required for the foreign exchange reserves though the issuance of debt, which includes gilts sales, National Savings products, Treasury bills and other short-term cash management instruments. For the projection period, the central government net cash requirement was projected to remain well below 1 per cent of GDP.

5.16 Based on the projections in Budget 99, the Government aimed to issue debt in 1999-2000 to meet a financing requirement of £21 billion, which was based on a forecast for the central government net cash requirement of £6.2 billion, plus gilt redemptions of £14.8 billion, and net financing for the official reserves of £2.4 billion, less the unwinding of expected excess gilt sales of £2.3 billion in 1998-99. This financing requirement of £21 billion in 1999-2000 was to be met through a remit to the Debt Management Office (DMO) for gilt sales of £17.3 billion, a remit to National Savings of net financing of £0.1 billion, plus additional net sales of £3.6 billion of Treasury bills and other short term cash management instruments.

European commitments

5.17 The Stability and Growth Pact, agreed in Amsterdam in 1997, strengthens and clarifies the excessive deficits procedure outlined in Article 104 of the Amsterdam Treaty. Key requirements of the Stability and Growth Pact are:

- a medium-term budgetary objective of close to balance or surplus; and
- that excessive deficits should be avoided. In particular, if the deficit (defined as general government financial deficit, the "Maastricht deficit") exceeds 3 per cent of GDP Member States may be fined, although as an 'Out' the UK cannot be fined.

5.18 In 1996-97, this deficit exceeded the 3 per cent ceiling by a large margin. However, since then, the Maastricht deficit has been brought into surplus, and is forecast to remain broadly close to balance. This progress was acknowledged in ECOFIN's 1999 Opinion on the UK Convergence Programme which stated that: *"[ECOFIN] notes with approval that the public finances are projected to be close to balance in underlying terms over the programme period thus fulfilling the requirements of the Stability and Growth Pact."*

Comparing Budget 99 with previous projections

5.19 Fiscal policy is normally set once a year at the time of the Budget. In order to compare the change in the fiscal stance, it is usually appropriate to compare the latest Budget with the previous Budget. This allows assessment of how the fiscal stance has changed, and in what direction policy is moving.

5.20 In the example below, the projections in Budget 99 are compared with those in the 1998 EFSR. This is the most appropriate comparison because the EFSR announced the fiscal envelope under which the Comprehensive Spending Review decisions were made and represents the previous point where fiscal policy was changed.

Table 5.2: Analysing the change in policy stance since the 1998 EFSR[1]

	Outturns		Estimate	Projections				
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Public sector net borrowing (PSNB) (£ billion)								
EFSR 1998 PSNB (ESA 95 basis)	28	8	3	4	2	2	3	2
Forecasting changes	–	1	–4	–2	–1	–5	–4	–2
of which effect of spending changes[2]	–	*0*	*–3*	*–6*	*–5*	*–7*	*–5*	*–3*
of which effect of taxation changes[2]	–	*1*	*–1*	*4*	*4*	*2*	*1*	*1*
Budget measures	–	–	–	1	1	4	4	4
Budget 99 PSNB	28	9	–1	3	3	1	3	4
Cyclically-adjusted PSNB (% GDP)								
EFSR 1998 cyclically-adjusted PSNB[3] (ESA 95)	3.2	1.0	0.4	0.1	–0.2	–0.2	–0.1	–0.2
Budget 99 cyclically-adjusted PSNB	3.1	1.1	0.1	0.0	–0.2	–0.1	0.3	0.4

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

[2] *Figures given show the impact on PSNB. Therefore a positive number means higher borrowing and a negative number means lower borrowing. Negative numbers for spending therefore mean lower spending. Positive numbers for tax receipts mean lower receipts.*

[3] *EFSR 1998 figures using the updated methodology used in Budget 99 – see Fiscal Policy: Public Finances and the Cycle, HM Treasury, March 1999.*

5.21 Comparing the PSNB profiles in the 1998 EFSR and Budget 99 shows that there was little change in the fiscal stance in Budget 99, after allowing for the effects of the introduction of ESA 95[4]. However, to achieve this unchanged fiscal stance did not imply that policy itself was inactive. Since the 1998 EFSR, both the PBR and preliminary projections prepared before Budget 99 showed that while tax receipts were lower than expected, this was more than offset by lower spending, particularly on social security and debt interest payments. Table 5.3 provides a breakdown of the changes in the public finances forecast between the November 98 PBR and Budget 99. At the time of the Budget, the projections for the public finances showed that, over the coming three years, tax receipts were projected to be £8 billion lower, with spending also projected to be £18 billion lower. Overall, over these three years, PSNB looked to be around £10 billion lower, which would have meant a significant negative overall fiscal impact on demand.

5.22 If this situation had been left unchanged, there would have been an unwelcome tightening of the fiscal stance. Given the projections showed the Government was on track to meet its fiscal rules it was decided in the Budget to offset this tightening through a £6 billion package of tax and spending measures. These discretionary measures helped to offset the unintended structural fiscal tightening which was projected to occur. Without this action, the impact of the automatic stabilisers would have been overriden, at a time when the economy was moving below trend, and fiscal policy might not have supported monetary policy.

[4] The new European System of Accounts (ESA 95) was introduced in September 1998, between the 1998 EFSR and Budget 1999. ESA 95 is being adopted throughout the European Union and will make international comparison easier. The basic concepts have remained the same, but the main aggregates were all affected to some extent by the comparison changes. Full description of the changes can be found in the ONS publication *National Account Concepts, Sources and Methods (ESA 95)*, HMSO, 1998.

Table 5.3: Changes to the public finances projections (over the coming three years) between the 1998 PBR and Budget 99[1]

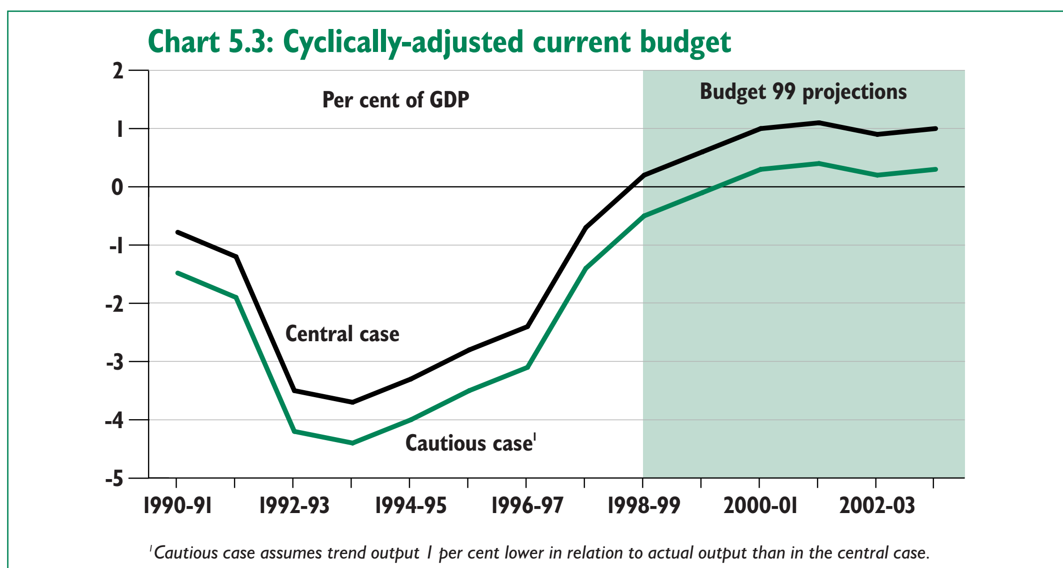
	£ billion
Projected non-discretionary reduction in tax receipts	
VAT	3
Corporation tax	2
Tobacco receipts	2½
National Insurance Contributions	1½
Other	–1
Total	**8**
Projected non-discretionary change in spending	
Debt interest	–4
Net public service pensions	–1
Social security	–2
Reduced AME margins	–7½
Other, including accounting adjustments	–3½
Total	**–18**
Total non-discretionary changes	**–10**
Budget measures	**6**
Change in net borrowing	**–4**

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

The cautious case

5.23 The previous section explained that the Government takes a deliberately cautious approach in setting fiscal policy to ensure it meets its fiscal objectives. Projections of the public finances necessarily involve a significant element of uncertainty and are therefore based on deliberately cautious assumptions audited by the National Audit Office. *Ex ante*, these projections include a small surplus on the current budget to provide a safety margin over that which would strictly be necessary to meet the golden rule.

Chart 5.3: Cyclically-adjusted current budget



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

5.24 The Government publishes an additional projection based on a more cautious case in which trend output is assumed to be 1 per cent lower than in the main projection. This scenario models the implications of assuming that a greater proportion of the projected surplus on the current budget results from the cyclical strength of the economy. Chart 5.3 shows that even under the more cautious case the Government would still remain on track to meet the fiscal rules.

6 CONCLUSION

6.1 The new fiscal policy framework, with its emphasis on transparency, means that there is a wide range of relevant fiscal policy information reported in the Budget and supporting documents. Understanding which pieces of information are appropriate for each purpose is crucial to forming an accurate impression of developments in the public finances, both in terms of the short-term impact of fiscal policy on the economy and the soundness of fiscal policy settings over the medium term.

6.2 The 1999 PBR will provide the Government's latest projections for both the economy and the public finances. As outlined in Section 4, these will not necessarily represent the Government's view of desired outcomes. While the PBR projections will be used as a basis for policy planning in the lead up to the Budget, it is the Budget itself in which any desired changes to fiscal policy will be undertaken.

A GLOSSARY OF FISCAL POLICY TERMS

Annex A: Glossary of fiscal policy terms

Actual - (see *unadjusted*).

Annually Managed Expenditure (AME) - spending that is managed on an annual basis. AME represents around half of Total Managed Expenditure (TME), and includes programmes such as social security benefits and debt interest payments that are subject to volatilities that make them difficult to budget for sensibly over a three-year horizon (the period covered by Departmental Expenditure Limits (DEL)).

AME margin - a provision for uncertainty in the forecast of AME components. It represents an unallocated margin built into the total forecast of AME spending.

Automatic stabilisers - various features of the tax and spending regime which act to stabilise the economy. As the economy strengthens, private incomes and expenditure tend to rise, resulting in higher tax receipts, while falling unemployment reduces social security spending. As the economy weakens, the opposite effect occurs. So government borrowing will tend to be relatively low when the economy is operating above trend and relatively high when the economy is below trend. This helps to reduce the swings in output over the economic cycle.

Average surplus on current budget - the average of the differences between current receipts and current expenditure including depreciation in each year of the cycle. The golden rule is met when the average surplus as a proportion of GDP over the economic cycle is in balance or surplus.

Balance sheet - a statement of asset and liabilities. Balance sheets can be constructed for public sector in a similar manner to those for companies. The difference between assets and liabilities shows the net asset position of the public sector (see *net worth*).

Balanced budget - a situation where total Government revenue is approximately equal to total spending. This contrasts with the golden rule, whereby the Government seeks to balance the current component of the budget over the economic cycle while permitting borrowing to fund capital spending (within prudent limits defined by the sustainable investment rule).

Baseline projection - refers to the outlook for the public finances based on an assumption of unchanged policy (including pipeline measures). A baseline projection provides an indication of the extent of policy changes necessary to meet the Government's fiscal objectives.

Capital expenditure - (see *net investment* and *gross investment*)

Cautious case - an additional public finance projection published by the Government under which trend output is assumed to be 1 per cent lower than in the central projection. This scenario models the implications of assuming that a greater proportion of the projected surplus on the current budget is due to the cyclical strength of the economy.

Central government - comprises predominantly government departments as well as other bodies subject to ministerial or departmental control, and extra-budgetary funds and accounts controlled by departments.

Central government net cash requirement (CGNCR) - equal to net borrowing by central government, plus financial transactions. This is a cash measure of central government's short-term net financing requirement (after refinancing of maturing debt).

Code for Fiscal Stability - statement of the broad parameters of the fiscal framework issued pursuant to the Finance Act 1998. Approved by Parliament in December 1998, the purpose of the Code is to improve the conduct of fiscal policy by specifying the principles that guide the formulation and implementation of fiscal policy and strengthening the reporting requirements on Government. The Code does this by requiring the Government to commit to, among other things, five principles of fiscal management, more transparent financial reporting and the use of best practice accounting methods.

Comprehensive Spending Review (CSR) - the Comprehensive Spending Review, completed in July 1998, set out new departmental spending plans for the medium term, to cover the remaining three years of the current Parliament, from 1999-2000 to 2001-02. These spending plans were arrived at after a root and branch examination of public sector expenditure to ensure that Departmental spending contributes effectively to meeting the Government's objectives.

Current budget - the difference between current revenue and current expenditure including depreciation. A current budget which is positive is termed a current surplus and that which is negative, a current deficit.

Current expenditure - spending on items that are 'consumed' in the year of purchase (as opposed to investment which is 'consumed' in future years), such as public sector salaries and transfers.

Current revenue (also termed current receipts) - revenue relating to activities in the current year, comprising mainly direct and indirect taxes, but also including social security contributions, interest, dividends, capital taxes and profits from trading activities. Proceeds from the sale of assets are not included.

Cyclical adjustment - the method of adjusting public finance indicators by subtracting an estimate of the impact of the economic cycle so that the underlying or structural trend can be seen more easily. This is particularly important when assessing fiscal prospects. The economic cycle can have a large short-term impact on the public finances through the operation of the automatic stabilisers. Experience has shown that in the past serious policy errors can occur if purely cyclical - and thus temporary - improvements in the public finances are treated as though they represented structural improvements. The *Code for Fiscal Stability* commits the Government to publishing cyclically-adjusted fiscal indicators.

Debt Management Report - one of the four annual documents required under the *Code for Fiscal Stability* (see also the *Pre-Budget Report (PBR)*, the *Financial Statement and Budget Report (FSBR)*, and the *Economic and Fiscal Strategy Report (EFSR))*. The Debt Management Report reviews developments in debt management over the past financial year, and sets out the details of the UK Government's borrowing programme for the forthcoming financial year.

Departmental Expenditure Limits (DEL) - multi-year spending plans for Government departments fixed in cash terms and representing around half of Total Managed Expenditure (TME). The present DELs were set in the 1998 Comprehensive Spending Review. Within DEL, current and capital spending are planned and managed separately to reduce any bias against spending on investment.

Depreciation - a measure of the reduction in the value of an asset over its life. Depreciation can be thought of as the consumption of capital and is a component of the current budget.

Direct taxation - taxes levied on income and wealth, for example income tax, corporation tax, and inheritance tax.

Discretionary measures - measures taken by the Government, usually at the time of the Budget, to alter the fiscal stance (eg additional expenditure).

Discretionary change in the fiscal stance - changes in the fiscal stance that occur through one or both of (i) discretionary Budget measures to achieve the desired change in the fiscal stance (eg additional expenditure); (ii) a decision to accommodate or offset the impact of non-discretionary factors that are expected to alter the fiscal stance.

Economic and Fiscal Strategy Report (EFSR) - one of the four annual documents required under the *Code for Fiscal Stability* (see also the *Pre-Budget Report (PBR)*, the *Financial Statement and Budget Report (FSBR)*, and the *Debt Management Report)*. Published each year with the FSBR at the time of the Budget, the EFSR sets out the Government's long-term economic and fiscal strategy and objectives.

Economic cycle - output has both a trend and cyclical component. Trend growth is a function of employment and advances in labour productivity. But over the shorter term the economy is likely to move through periods above and below the trend growth path - the resulting movements in output give rise to the economic cycle.

Excessive deficit - first defined in the Maastricht (European Communities) Treaty. Compliance with budgetary discipline is examined in relation to reference values of 3 per cent of GDP for the general government financial deficit and 60 per cent for general government gross debt. In practice, with certain exceptions, a deficit of more than 3 per cent of GDP is regarded as excessive.

Financial Statement and Budget Report (FSBR) - one of the four annual documents required under the Code for Fiscal Stability (see also the *Pre-Budget Report (PBR),* the *Economic and Fiscal Strategy Report (ESFR),* and the *Debt Management Report)*. Published each year with the EFSR at the time of the Budget, the FSBR sets out the Budget measures, and presents the economic background to the Budget and the fiscal position.

Fiscal code - (see *Code for Fiscal Stability*.)

Fiscal drag - the tendency for tax receipts as a percentage of GDP to increase over time. This is due to the progressive nature of the tax system, whereby the average tax rate increases the more income is earned. Nominal fiscal drag occurs when inflation pushes incomes up; real fiscal drag occurs when wages rise faster than inflation due to productivity growth.

Fiscal framework - the framework within which the Government operates fiscal and debt management policy. The framework is underpinned by the *Code for Fiscal Stability*.

Fiscal indicator - indicators used to assess fiscal policy. There are a variety of indicators or aggregates, such as the surplus on the current budget, PSNB, net debt and net worth, each of which can be helpful in analysing the impact, sustainability or generational fairness of fiscal policy.

Fiscal loosening - the term used to describe the fiscal stance when structural (cyclically-adjusted) PSNB is rising.

Fiscal policy - the combination of spending and tax policies which the Government uses to promote fairness and sustainability in the public finances and stability for the economy.

Fiscal principles - the five principles of transparency, stability, responsibility, fairness, and efficiency enshrined in the Finance Act 1998 and the *Code for Fiscal Stability*. The Code explains how these principles are to be reflected in the formulation and implementation of fiscal policy.

Fiscal stance - the term used to describe the change in structural (cyclically-adjusted) PSNB.

Fiscal tightening - the term used to describe the fiscal stance when structural (cyclically-adjusted) PSNB is falling.

General government - a measure of government incorporating both central government and local authorities.

General government financial deficit - (see *Maastricht Deficit.*)

Generational accounts - provide a comparison of the net burden of tax and transfer payments on present and future generations, assuming current policies are maintained.

Generational fairness - the principle that those generations who benefit from current spending should meet the cost. The golden rule helps promote fairness between generations by drawing a distinction between current and capital spending, recognising that current spending should not be paid for by future generations, while worthwhile public capital spending provides benefits in future years, and need not be paid for out of current receipts.

Golden rule - one of the Government's two fiscal rules (see also the *sustainable investment rule*). States that, on average over the economic cycle, the Government will borrow only to invest and not to fund current spending.

Gross investment - total expenditure on capital goods, before taking into account depreciation.

Indirect taxation - taxes levied on expenditure, such as excise duties or VAT.

Investment - (see *net investment*).

Liquid financial assets - assets which can be redeemed readily for cash, eg bank deposits.

Local authorities - public authorities of limited geographical scope, having power to raise funds by certain forms of local taxation.

Long term - often taken to mean at least ten years ahead, and a period in which economic cycles cease to be relevant to policy analysis.

Long-term fiscal projections - projections of the public finances for a period of 10 years or more. Under the *Code for Fiscal Stability* the Government is required to publish illustrative long-term fiscal projections each year in the Economic and Fiscal Strategy Report. These projections incorporate the effects of demographic trends and other influences on long-term spending and taxation levels.

Maastricht deficit - also known as the general government financial deficit, this is equivalent to public sector net borrowing less borrowing by public corporations and excluding financial transactions. It therefore measures general government net borrowing. Described as the "Maastricht deficit" as it is the measure of government borrowing used for the purposes of the Stability and Growth Pact.

Medium term - often taken to mean at least three to ten years ahead.

Monetary policy - the tool of macroeconomic policy operated by the Bank of England's Monetary Policy Committee that seeks to achieve the Government's inflation target by influencing aggregate demand through movements in interest rates.

Net debt - gross debt minus liquid financial assets. Public sector net debt, expressed as a percentage of GDP, is the key indicator by which progress against the sustainable investment rule is measured.

Net investment - gross spending on investment less depreciation. It measures the extent to which public spending is adding to the country's stock of physical capital.

Net worth - the difference between total assets and liabilities (including debt) held by the Government. It represents a more comprehensive measure of the overall worth position of the Government than net debt, as it includes non-financial assets (such as roads). The stock equivalent of the surplus on current budget (although also affected by revaluations), changes in net worth reflect the extent to which the net assets of the public sector are changing.

Neutral fiscal stance - the term used to describe the fiscal stance when structural (cyclically-adjusted) PSNB is unchanged.

Nominal variable - one from which the effects of inflation have not been excluded. (See *real variable*.)

Overall fiscal impact - a term used to describe the change in actual PSNB. The overall fiscal impact is the sum of the change in the fiscal stance plus the effect of the automatic stabilisers stemming from the cyclical position of the economy.

Pipeline measures - measures announced in previous Budgets, yet to come into effect, but which nevertheless will have an impact on the fiscal position. Pipeline measures are included in the baseline projections. Therefore they are taken account of when decisions are made about the discretionary Budget measures required to bring those projections into line with desired outcomes. The fiscal indicators published in the EFSR, FSBR and PBR include the full effects of pipeline measures.

Policy mix - the combination of fiscal and monetary policy settings at any given time.

Pre-Budget Report (PBR) - one of the four annual documents required under the *Code for Fiscal Stability* (see also the *Financial Statement and Budget Report (FSBR)*, the *Economic and Fiscal Strategy Report (ESFR)*, and the *Debt Management Report*). Published at least three months prior to the Budget (usually in the preceding November), the PBR provides a progress report on what has been achieved so far, updates forecasts on the economy and the public finances, and sets out the direction of Government policy and further measures that are under consideration in the run up to the next Budget, for information and consultation purposes.

Primary balance - PSNB excluding net debt interest payments. It measures the current fiscal position excluding the interest costs of accumulated net debt from previous years, and is used to assess whether current policy is consistent with stabilising the ratio of net debt to national income, given assumptions about future interest rates and economic growth.

Prospective net worth - a forward-looking measure of the Government's net assets, it represents net worth plus the discounted value of all future spending and receipts that the Government will face as a result of its current policies. In practice these future cash flows are difficult to measure.

Public corporations - publicly owned and controlled organisations which manage publicly owned industries.

Public sector - the widest measure of Government incorporating central government, local authorities and public corporations. The fiscal rules apply to the whole public sector because responsibility for borrowing by public corporations could fall ultimately on the taxpayer, and needs to be managed along with other elements of public borrowing. Focussing on the whole of the public sector removes incentives to reclassify activities to avoid constraints on borrowing.

Public sector net borrowing (PSNB) - the sum of current spending (including depreciation) and net investment, less total revenues.

Public sector net cash requirement (PSNCR) - formerly known as the PSBR, and equal to PSNB plus financing requirements that come from financial transactions (eg net asset sales, lending to the private sector and abroad, and accruals adjustments). This is a cash measure of the public sector's short-term net financing requirement (after refinancing of maturing debt). It is not the best measure of the sustainability or economic impact of fiscal policy and no longer plays a significant role in the policy framework.

Public sector net debt (PSND) - (see *net debt*).

Real variable - one that is adjusted to remove the impact of inflation. For example, projections suggest that between 1998-99 and 1999-2000, current spending in real terms will rise from £305.8 to £313 billion, an increase of 2¼ per cent. However, in nominal terms, the projections suggest that current expenditure will have risen from £313.5 to £328.9 billion over the same period, an increase of 5 per cent. The difference is explained by inflation. Examining real variables is useful since it provides a better indication of the resources actually consumed.

Short term - often taken to mean the next one to two years.

Sound public finances - (see *sustainability*)

Structural - (see *cyclically-adjusted*)

Surplus on current budget - the difference between current revenue and current spending including depreciation.

Sustainability - at a basic level, fiscal policy can be said to be sustainable if the Government can maintain indefinitely its current spending and taxation policies while continuing to meet its debt interest obligations. The costs to the British economy of fiscal policy becoming unsustainable would be extremely large, justifying a prudent approach.

Sustainable investment rule - the second of the Government's two fiscal rules (see also the *golden rule*), the sustainable investment rule states that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. The Government believes that, other things equal, it is desirable that public sector net debt be reduced to below 40 per cent of GDP over the economic cycle.

Total Managed Expenditure - the sum of Annually Managed Expenditure and Departmental Expenditure Limits. Or equivalently, total current and capital spending by the public sector.

Transfers - a form of government expenditure, such as unemployment benefits, which involves a transfer of money from taxpayers to benefit recipients, as opposed to a payment for a good or service.

Unadjusted - a fiscal indicator which has not been adjusted to take into account the effect of the economic cycle. Also referred to as actual.

B THE FISCAL ARITHMETIC

This Annex describes how each of the key fiscal indicators is defined. It also provides a brief explanation of the cyclical adjustment methodology used by the Treasury and the arithmetic underlying the relationship between the public sector primary balance and the net debt ratio.

Acronyms:

CB = Surplus on current budget
CACB = Cyclically-adjusted current budget
CR = Current revenue
CE = Current expenditure
D = Depreciation
PSNW = Public sector net worth
PSND = Public sector net debt
PSGD = Public sector gross debt
PSNB = Public sector net borrowing
CAPSNB = Cyclically-adjusted PSNB
PSNCR = Public sector net cash requirement
PSNI = Public sector net investment
PSPB = Public sector primary balance
GDP = Gross domestic product
GDPT = Trend gross domestic product
OG = Output gap
t = time period (1 year)

Flow measures:

$$CB_t = CR_t - CE_t - D_t$$

$$PSNB_t = - CB_t + PSNI_t$$

$$PSNCR_t = PSNB_t + \text{financial transactions}_t$$ [1]

$$PSPB_t = - PSNB_t + \text{net debt interest payments}_t$$

Stock measures:

$$PSNW_t = PSNW_{t-1} + CB_t + \text{net asset revaluations}_t$$

$$PSND_t = PSND_{t-1} + PSNCR_t + \text{balancing item}_t$$ [2]

$$PSGD_t = PSGD_{t-1} + \text{new debt issued}_t - \text{debt redeemed}_t$$

Each aggregate above can be expressed as a proportion of GDP (and it is often more sensible to do so, as it takes account of the impact of inflation and real growth in the economy).

[1] Financial transactions includes net lending to the private sector and the rest of the world, net acquisition of UK company securities, accounts receivable and payable, adjustment for interests on gilts, and other financial transactions.
[2] The balancing item includes: the capital uplift on index-linked gilts, fluctuations in exchange rates which affect the sterling value of the official reserves, and an amount to cover the discrepancy caused when gilts are issued at discount or premia, which means that the level of debt changes by the nominal value of gilts issued whereas the net cash requirement is financed by the actual cash amount received.

Cyclical adjustment

In addition, each of the flow balances can be adjusted to illustrate the underlying or structural position (which excludes the impact of the economic cycle)[3]. For example, the Treasury calculates the cyclically-adjusted current budget as a percentage of GDP as:

$$CACB_t/GDP_t = CB_t/GDP_t - 0.4 * OG_t - 0.3 * OG_{t-1}$$

whereas cyclically-adjusted PSNB equals:

$$CAPSNB_t/GDP_t = PSNB_t/GDP_t + 0.4 * OG_t + 0.3 * OG_{t-1}$$

where:

$$OG_t = ((GDP_t - GDPT_t)/GDPT_t)*100$$

The public sector primary balance and the net debt ratio

It is possible to calculate the public sector primary balance (as a proportion of GDP) required to stabilise the net public debt ratio at a given target level using the following formula:

$$\frac{PSPB}{GDP} = (r - g) * \left(\frac{PSND}{GDP}\right)^{Target}$$

where:

r = the real interest rate

g = the real economic growth rate

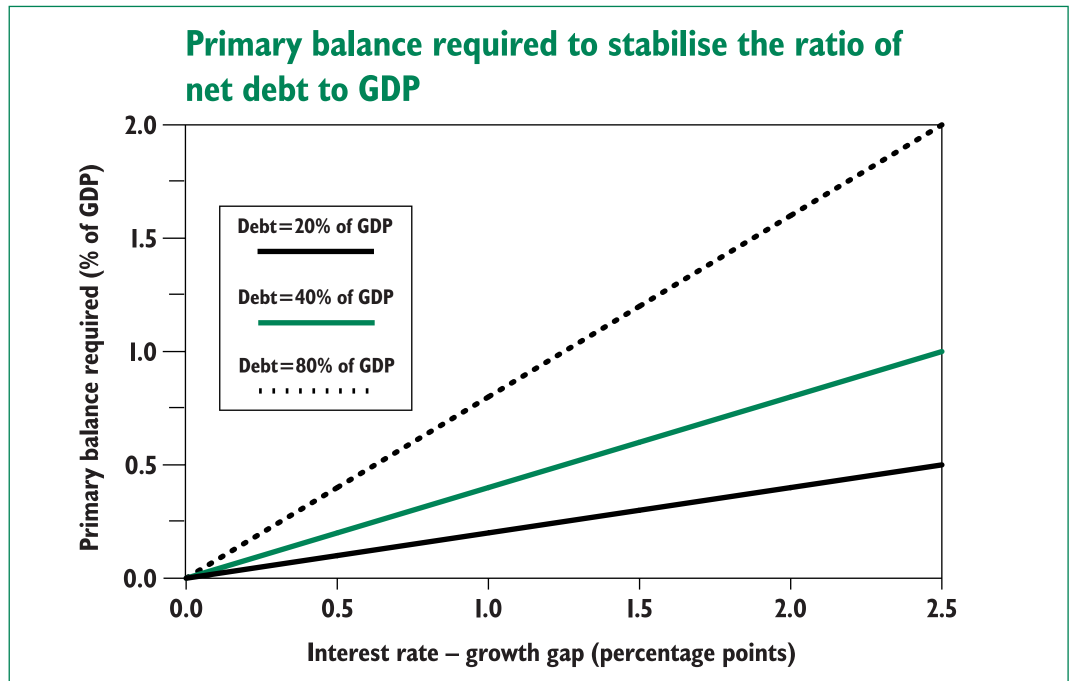
Table A1 shows the PSPB (as a per cent of GDP) required to stabilise the net public debt ratio at 40 per cent under different rates of growth and different real interest rates. It shows that, all else remaining equal, a higher primary balance is required when growth is lower and when interest rates are higher.

Table A1: Public sector primary balance (PSPB) required to stabilise net public debt at 40% of GDP

Real growth rate (g), %	2.5	2.0	2.5	2·0
Real interest rate (r), %	2.5	2.5	4.0	4·0
Difference (r–g)	0.0	0.5	1.5	2·0
PSPB required (as % GDP):	**0.0**	**0.2**	**0.6**	**0·8**

[3]The methodology for the cyclical adjustment of the public finances is descibed in more detail in *Public Finances and the Cycle*, HM Treasury, March 1999.

The chart shows the primary balance required to stabilise the net debt ratio at 20, 40 and 80 per cent of GDP, based on different gaps between the real interest rate and the real growth rate.



IMPROVEMENTS TO MONTHLY PUBLIC FINANCE STATISTICS

Significant improvements are in hand for the reporting of public finance statistics by the Office for National Statistics (ONS)[1]. From 18 November 1999, for the first time, monthly figures for the public sector surplus on current budget will be presented in the Public Sector Finances *First Release*. The improvement means that the key measures needed to assess progress against the Government's fiscal framework will all be published together on a monthly and timely basis. This will aid scrutiny of the Government's fiscal policy.

Monthly estimates will thus be available for:

- the **public sector surplus on current budget,** the key measure for assessing progress against the golden rule;
- **public sector net debt,** the key measure for assessing progress against the sustainable investment rule; and
- **public sector net borrowing,** a measure of the overall fiscal impact of policy on the economy and the starting point for analysis of the fiscal stance.

The surplus on current budget is defined as net saving, plus receipts from capital taxes, in line with national accounts under ESA95. ESA95 also defines net borrowing, using the term 'net lending' when borrowing is negative. From March 2000 general government net borrowing on an ESA95 basis (included in the *First Release*) will be reported to the European Commission under the requirements of the Maastricht Treaty. Public finance statistics in the UK continue to be in the lead of international developments. They play an important role in providing analysts and the public with information to assess Government performance.

An example of how the key table in the regular *First Release* will look, but which here excludes any figures, is shown below.

In addition, there will be a new summary of monthly central government receipts and expenditure on a national accounts basis, as defined by ESA95. This new summary will show the central government transactions which help determine the surplus on current budget and net borrowing. These are: taxes on production, taxes on income and wealth, other taxes, social contributions, interest and dividend receipts, the total of other receipts, interest payments, net social benefits paid, the total of other current expenditure, gross investment and depreciation. This will enable users to see the components of monthly central government net borrowing more clearly than was previously possible, and so help improve understanding of recent trends.

For the public sector as a whole, the release will also include, for the first time, monthly estimates of net investment.

Public Sector

	October		*April-October*		*Difference*
	1999	**1998**	**1999-00**	**1998-99**	
			£billion		
Surplus on current budget[1]	–	–	–	–	–
Net borrowing[2]	–	–	–	–	–
Net debt[3]	–	–	–	–	–
Net debt (% annual GDP)[3]	–	–	–	–	–

[1] From national accounts under ESA95; net saving plus receipt of capital taxes.

[2] As defined in national accounts under ESA95. Sometimes called the 'deficit'.

[3] Net debt at the end of the month.

[1] The Public Sector Finances *First Release* is issued jointly by the ONS and HM Treasury. More information can be found on the internet at http://www.ons.gov.uk

D Recent treasury macroeconomic policy papers

The Inflation Target and Remit for the Monetary Policy Committee: background notes, June 1997

Fiscal Policy: Lessons From the Last Economic Cycle, November 1997

The Public Sector Balance Sheet, December 1997

Stability and Investment for the Long Term, 1998 Economic and Fiscal Strategy Report, June 1998

Fiscal Policy: Current and Capital Spending, June 1998

Delivering Economic Stability: Lessons from Macroeconomic Policy Experience, November 1998

The Code for Fiscal Stability, November 1998

Fiscal Policy: a New Framework for Public Investment, December 1998

Fiscal Policy: Public Finances and the Cycle, March 1999

The New Monetary Policy Framework, October 1999

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