2 MAINTAINING MACROECONOMIC STABILITY

The UK economy is currently experiencing its longest unbroken expansion on record, with GDP now having grown for 54 consecutive quarters. The domestic stability delivered by the Government's macroeconomic framework, with volatility in the UK economy at historically low levels and the lowest in the G7, puts the UK in a strong position to respond to the global economic challenges of the next decade.

Overall economic developments since the 2005 Pre-Budget Report have been as forecast. Economic growth has gradually increased momentum through the latter stages of 2005 and into 2006. With the outturn for 2005 and the forecast for 2006 as expected at the time of the Pre-Budget Report, the UK economy remains well placed for a pick-up in growth to above trend rates later this year and into 2007, supported by the continuing domestic stability delivered by the Government's macroeconomic framework.

The Budget 2006 projections for the public finances are broadly in line with the 2005 Pre-Budget Report and show that the Government is meeting its strict fiscal rules:

- **the current budget shows an average surplus as a percentage of GDP over the current economic cycle, even using cautious assumptions, ensuring the Government is meeting the golden rule. Beyond the end of the current cycle, the current budget moves clearly into surplus; and**
- **public sector net debt is projected to remain low and stable over the forecast period, stabilising at a level below the 40 per cent ceiling set in the sustainable investment rule.**

THE MACROECONOMIC FRAMEWORK

2.1 The UK economy is currently experiencing its longest unbroken expansion since quarterly national accounts data began, with GDP now having grown for 54 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the global economic challenges of the next decade.

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

2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability.[1] The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term while allowing fiscal policy to support monetary policy over the economic cycle. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

[1] Further details can be found in *Reforming Britain's economic and financial policy,* Balls and O'Donnell (eds.), 2002.

Monetary policy framework

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

- clear and precise objectives. The primary objective of monetary policy is to deliver price stability. The adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target. **The Government reaffirms in Budget 2006 the target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI)**, which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC.

2.5 These arrangements have removed the risk that short-term political factors can influence monetary policy and ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target. The Chancellor today announces the appointment of David Blanchflower to the Bank of England's Monetary Policy Committee to succeed Stephen Nickell. This appointment will take effect on 1 June 2006.

Fiscal policy framework

2.6 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[2] – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

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

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

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

[2] *Code for fiscal stability*, HM Treasury, 1998.

Box 2.1: Developments in the fiscal framework

While the key steps in developing the fiscal policy framework were taken in 1997 and 1998, the framework has continued to be enhanced. In 1997, the Government set out its two fiscal rules and invited the National Audit Office (NAO) to perform the first ever audit of key assumptions underpinning the fiscal projections. In 1998, the key components of the fiscal framework and the underlying principles were brought together in the *Code for fiscal stability*. The Code set more extensive reporting requirements for governments than those set previously by the 1975 Industry Act. For example, the Code requires the publication of illustrative long-term fiscal projections, and of Pre-Budget Reports no less than three months prior to the Budget.

Developments in the fiscal framework since then have further developed the five key principles of fiscal management that were enshrined in the Code: transparency, stability, responsibility, fairness and efficiency.

The role of the NAO in ensuring that forecasts are transparent and responsible has developed since 1997. While the first audit covered five assumptions, additions in 1998 increased this to the 11 key assumptions listed in Chapter C. In 2000, the NAO were invited to conduct a three-year rolling review of the assumptions previously audited. The NAO now also audits 'spend to save' and 'spend to raise' spending packages, such as HMRC's direct tax compliance strategy audited alongside the Budget, where additional resources are specifically targeted at reducing expenditure or raising revenue. The most recent additional audit was introduced alongside the 2005 Pre-Budget Report, in which the NAO audited the Treasury's judgement that the previous economic cycle ended in 1997. In future, the NAO will be invited to audit the end date of the current and future cycles once the Treasury has made a firm judgement.

In 1999, the Government expanded the suite of fiscal indicators reported in each Budget and Pre-Budget Report, which allow for scrutiny of all aspects of fiscal policy on a consistent basis. These fiscal aggregates, including cyclically-adjusted balances, are reported in tables 2.5 and 2.6. In 2002, the Treasury started reporting on core debt, an indicator of the debt position after removing the impact of the economic cycle. In Budget 1999, the first illustrative long-term fiscal projections were published, reporting on intergenerational fairness and covering a 30-year horizon. The latest projection is in Annex A. Reporting on long-term issues was further enhanced in 2002 with the publication of the first *Long-term public finance report*. At the same time, backward-looking analysis of the Treasury's fiscal projections was enhanced with the introduction of the *End of year fiscal report*. Both reports have since been published annually alongside the Pre-Budget Report.

The IMF[a] describe the resulting UK fiscal framework as being "on the frontier of institutional development". Nevertheless, the Treasury keeps the framework under constant review to ensure it remains at the forefront of international best practice.

[a] IMF, Concluding Statement to the 2005 Article IV Mission to the UK.

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

- the rules are set over the economic cycle. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and

- the rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

Public spending framework

2.9 The fiscal rules underpin the Government's public spending framework. The golden rule states that, over the economic cycle, the Government will only borrow to invest. Departments are therefore given separate resource and capital allocations, which increases the efficiency of public spending as public investment is not crowded out by short-term current spending pressures. Departments are now given separate allocations for resource and capital spending to help ensure adherence to the rule. The sustainable investment rule sets the context for the Government's public investment targets and ensures that borrowing for investment is conducted in a responsible way.

Financial stability framework

2.10 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system. A framework for co-operation on financial stability between the three authorities was set out in a Memorandum of Understanding in 1997. These arrangements have proven to be a robust and effective framework for responding to financial stability risks. Building on experience, the authorities have continued to develop the response frameworks for managing both financial crises and operational disruption and have published an updated version of the Memorandum, incorporating these improvements.[3]

2.11 The Standing Committee on Financial Stability, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss individual cases and developments relevant to financial stability, focusing on risks deemed to have systemic consequences. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and coordinates the three authorities' response and contingency plans. In the event of a crisis, it would meet at short notice and is the principal forum for agreeing policy, and, where appropriate, co-ordinating and agreeing action between the three authorities. The Memorandum of Understanding between the three authorities defines the role of the Standing Committee in both financial crisis management and in responding to operational disruptions to the financial sector.

PERFORMANCE OF THE FRAMEWORK

2.12 The frameworks for monetary policy, fiscal policy and public spending provide a coherent strategy for maintaining high and stable levels of growth and employment, and for minimising the adverse impact of external events.

[3] Full text available at www.hm-treasury.gov.uk.

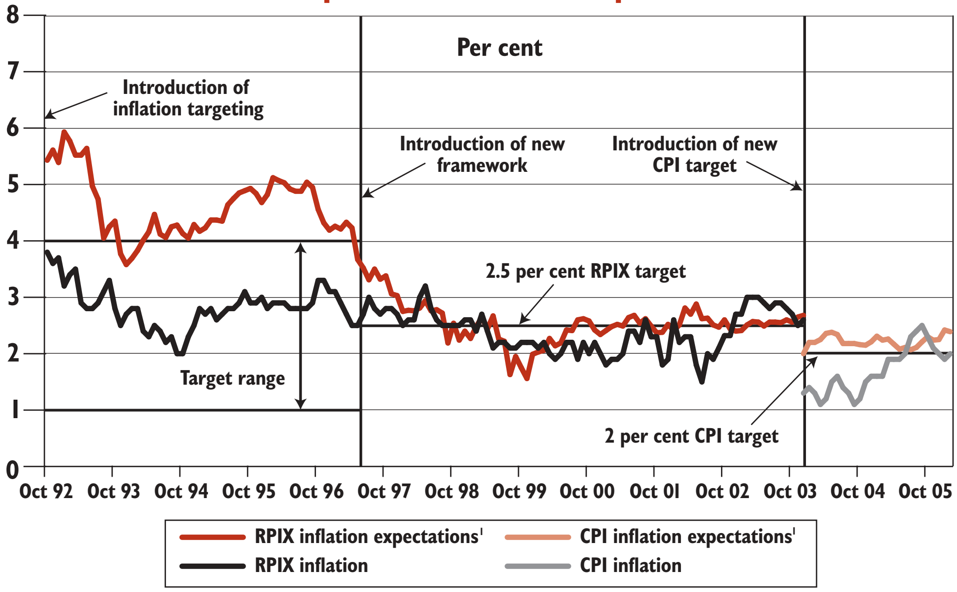
Monetary policy

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

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target value of 2½ per cent, the longest period of sustained low inflation for the last 30 years; and
- inflation expectations have remained close to target following the switch to a 2 per cent CPI target. CPI inflation has been within 1 percentage point of its target at all times since its inception in December 2003.

2.14 The monetary policy framework has given the MPC the flexibility to respond decisively to unexpected economic events over recent years. Consistent with its forward looking approach, the MPC cut interest rates by a ¼ percentage point in August 2005 responding to the slackening in the pressure of demand on supply. Since then, interest rates have remained unchanged reflecting the MPC's view that monetary policy settings are consistent with inflation remaining at target.

Chart 2.1: Inflation performance and expectations



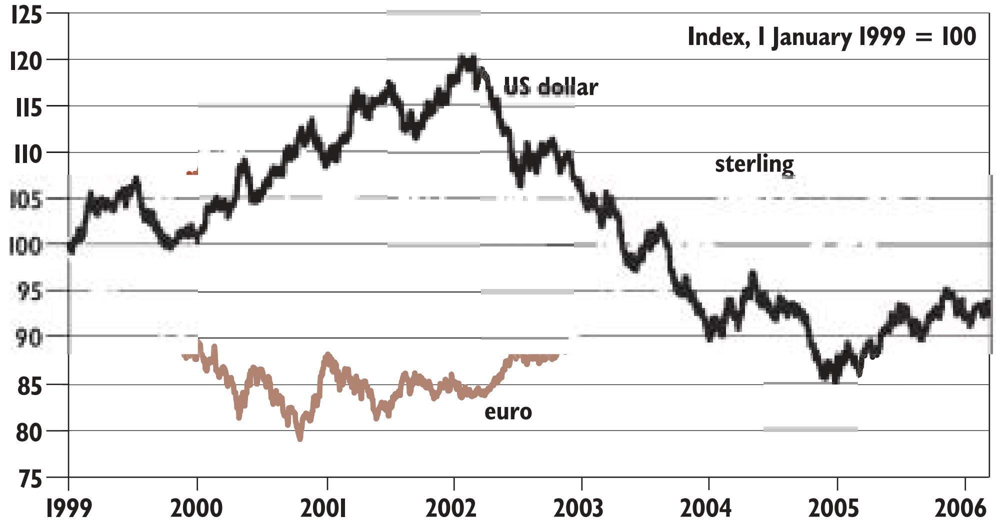
[1] Implied expectations of average RPI inflation ten years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI expectations and stylised assumptions about expected differences between RPI and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

2.15 Low inflation expectations and a period of entrenched macroeconomic stability have helped long-term interest rates remain at historically low levels. Low long-term interest rates reduce the Government's debt interest payments, free up resources for public services and help promote investment. Over the current economic cycle, long-term spot interest rates have averaged 5 per cent compared with an average of just over 9 per cent in the previous cycle. Ten-year spot rates have fallen by 0.6 percentage points to 4.1 per cent from March 2005 to February 2006, but have remained unchanged in the United States and have fallen only slightly in the euro area. Box 2.5 describes the fall in interest rates on ultra-long bonds at the beginning of 2006 and considers some of the potential causes.

2.16 Ten-year forward rates, which abstract from cyclical influences, are around 0.8 percentage points lower than those in the United States and very slightly above those in the euro area.[4] Ten-year forward rates have fallen in the UK over the last year from 4.7 per cent in March 2005 to 4.0 per cent in February 2006. This compares with a rate of 8 per cent in April 1997 before the introduction of the new macroeconomic framework.

2.17 Alongside the UK's macroeconomic stability in recent years, the effective exchange rate has also been relatively stable, as seen in Chart 2.2. The sterling effective exchange rate remains close to levels at Budget 2004, having remained within a narrow band of just over 3 per cent of its average level over the period. Since the introduction of the euro in 1999, the volatility of sterling's effective exchange rate has been under half that of the euro and around a third that of the US dollar.

Chart 2.2: Movements in leading effective exchange rate indices since 1999



Source: Bank of England.

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

Box 2.2: Causes of increased stability in the UK

Since the introduction of the Government's macroeconomic framework in 1997, the UK has experienced an unprecedented period of economic stability. Both relative to the rest of the post-World War II period, and relative to other G7 countries, economic volatility in the UK is low. As the IMF stated in December 2005, "macroeconomic stability in the United Kingdom remains remarkable".[a] There has been considerable debate on the causes of increased stability, both in the UK and across the developed world.

There is strong evidence to suggest that the Government's macroeconomic framework has contributed to increased stability by creating a more certain and predictable environment for private sector decision makers:

- **the credibility of monetary policy has increased since 1997. Inflation expectations have remained close to the inflation target (see Chart 2.1). Interest rate differentials between the UK and the US and Germany narrowed immediately after the announcement of the monetary policy framework in May 1997, as shown in the table, and have remained low or negative. Short-term interest rates have been low for the longest sustained period since the 1950s.**

Interest rate differentials following the introduction of the new macroeconomic framework

	Differential with UK forward rates[1]				
	Day before (2 May 1997)	Day after (7 May 1997)	3 months after (6 Aug 1997)	6 months after (6 Nov 1997)	18 months after (6 Nov 1998)
US	0.7	0.1	0.1	–0.1	–0.1
Germany	0.7	0.2	0.1	0.0	0.0

[1] UK 10-year forward rates less US/German rates.

Source: Bank of England.

- **the credibility of fiscal policy has increased since 1997. The Government's fiscal policy framework has restored sound public finances, and has supported monetary policy by allowing the automatic stabilisers to operate and discretionary action to be taken where appropriate (see Chart 2.6).**

The extent and intensity of economic shocks could also affect stability. The UK economy has maintained stability in the face of a number of shocks with economic consequences since 1997, including: a large rise and fall in equity prices, large rises in house prices and in oil prices, wars in Afghanistan and Iraq, terrorist attacks and major economic crises in Russia and East Asia. The UK has also had to adapt to an increasingly globalised economy, with growing trade and cross border investment altering the competitive environment.

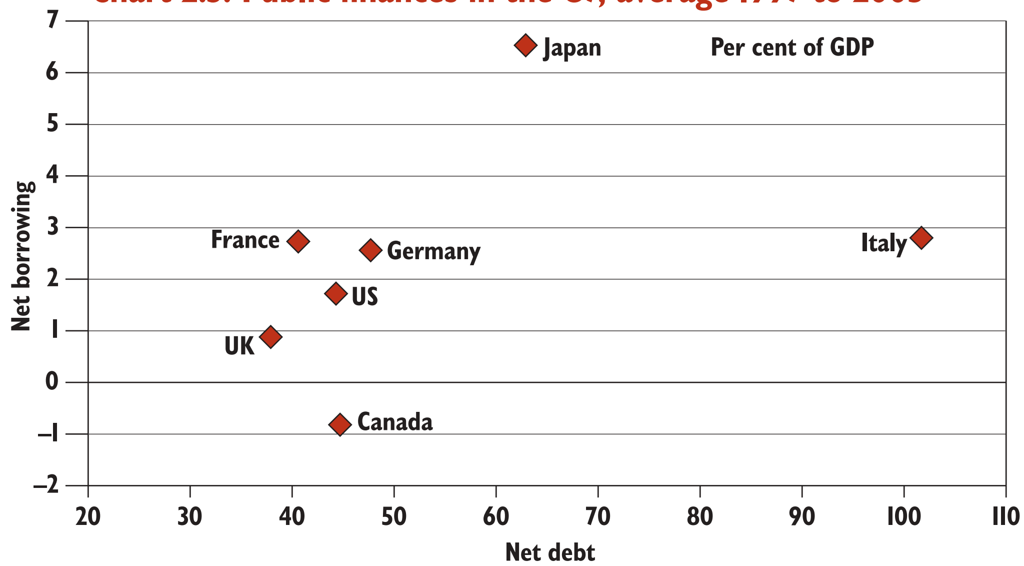
Structural changes and reforms have been taking place over many years which have also played an important role in increasing the UK economy's flexibility and resilience. They include, for example, reforms to competition policy legislation and reforms to encourage the economically inactive back to work, set out in more detail in Chapter 3 and Chapter 4.

[a] IMF, Concluding Statement to the 2005 Article IV Mission to the UK.

Fiscal policy

2.18 The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Public sector net debt was reduced from just under 44 per cent of GDP in 1996-97 to 35.0 per cent in 2004-05. Public sector net borrowing was reduced sharply from 1997-98 on, with surpluses over 1998-99 to 2000-01 when the economy was above trend. In more recent years, net borrowing has increased, allowing fiscal policy to support monetary policy as the economy moved below trend in 2001. As Chart 2.3 shows, since 1997 the UK's public finances compare favourably with other countries.

Chart 2.3: Public finances in the G7, average 1997 to 2005



Source: OECD Economic Outlook 78, December 2005.

2004 Spending Review

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

- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;
- public sector net investment rising to $2^1/_4$ per cent of GDP by 2007-08, compared with 0.5 per cent of GDP in 1999, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £21 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

Comprehensive Spending Review

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

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.21 The UK economy was resilient in the face of a number of challenges in 2005. After strong growth at above trend rates in late 2003 and through the first half of 2004, GDP growth decelerated from mid-2004 and has since remained at below trend rates in the face of sustained higher oil prices, weak demand in the euro area, and a slowing housing market.

2.22 In previous decades, such factors would have risked being accompanied by a recession. But based on the stability provided by the government's macroeconomic framework, UK GDP has now expanded for 54 consecutive quarters. On the basis of quarterly national accounts data, this is the longest unbroken expansion since records began 50 years ago. The current economic expansion has persisted for well over twice the duration of the previous period of unbroken growth.

2.23 Overall developments since the 2005 Pre-Budget Report have been as forecast with the economy strengthening as forecast. GDP rose by 0.6 per cent in the final quarter of 2005, remaining a little below trend although slightly stronger than in the second and third quarters and significantly above growth at the start of last year. In 2005 as a whole, UK GDP is currently estimated to have risen by 1¾ per cent, the tenth consecutive year of faster growth than the euro area.

Table 2.1: Summary of world forecast

	Percentage change on a year earlier unless otherwise stated			
	Outturn	Forecasts		
	2005	2006	2007	2008
Major 7 countries[1]:				
Real GDP	2½	2½	2½	2½
Consumer price inflation[2]	2½	2½	2¼	2½
Euro area:				
Real GDP	1½	1¾	2	2
World GDP	4½	4½	4½	4½
World trade in goods and services	7	7¾	7	6¾
UK export markets[3]	6¼	7½	6½	6

[1] *G7: US, Japan, Germany, UK, France, Italy and Canada.*
[2] *Per cent, Q4.*
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

2.24 Developments in the global economy have also been broadly as forecast in the 2005 Pre-Budget Report. World output growth in 2005 was driven by emerging Asia, particularly China, as well as by continued robust growth in the US. Oil prices have remained high since the autumn, while at the same time world growth is now estimated to have been slightly stronger than expected, largely reflecting the strength of underlying momentum in Asia.

2.25 World trade growth has also remained robust, despite having moderated compared with the four-year high reached in 2004. Asia has largely driven this growth, with the Asia-Pacific region contributing around 40 per cent to world trade growth over the past three years, in contrast to around 15 per cent from each of the US, the euro area and the rest of Europe. Asia accounts for just 15 per cent of UK export markets, whereas the euro area, which is growing more slowly, accounts for around half of the UK's export markets.

Economic prospects

2.26 The economy has already shown signs of gradually increasing momentum through the latter stages of 2005 and into 2006. The Government's macroeconomic framework has continued to deliver unprecedented stability, with inflation at target, despite the effects of higher oil prices. The economy remains well placed to see a renewed period of above trend growth from 2007 as factors temporarily subduing growth over the recent past abate.

2.27 Overall, the economic forecast is unchanged from the 2005 Pre-Budget Report. Following growth of $1^3/_4$ per cent in 2005, UK GDP is expected to grow by between 2 and $2^1/_2$ per cent this year, still slightly below trend rates, reflecting a number of temporary factors. Private consumption growth is expected to be restrained by continued household appetite for saving, subdued growth in labour incomes, and the residual effects of higher energy prices. Companies are likely to remain cautious about stepping up business investment in the face of high oil prices and high levels of gearing.

2.28 CPI inflation is expected to remain close to target, as inflation expectations remain firmly anchored, and energy prices exert slightly more upward pressure on inflation in 2006 than expected at the time of the Pre-Budget Report.

Table 2.2: Summary of UK forecast[1]

	Outturn	Forecast		
	2005	2006	2007	2008
GDP growth (per cent)	$1^3/_4$	2 to $2^1/_2$	$2^3/_4$ to $3^1/_4$	$2^3/_4$ to $3^1/_4$
CPI inflation (per cent, Q4)	$2^1/_4$	2	2	2

[1] *See footnote to Table B9 for explanation of forecast ranges.*

2.29 With the effects of previous oil price rises on spending and the recent adjustment in the household saving ratio receding, private consumption growth should firm a little further in 2007 and 2008, although rising at rates well below recent peaks and below growth in the economy as a whole. With adjustment to higher oil prices working through and corporate fundamentals generally supportive, there should be firmer growth in investment spending as demand accelerates in 2007. As a result, GDP growth is forecast to be above trend rates at between $2^3/_4$ and $3^1/_4$ per cent in both 2007 and 2008, with spare capacity being absorbed and the output gap closing in 2008-09, unchanged from the 2005 Pre-Budget Report judgement.

2.30 The Budget 2006 forecast implies further rebalancing of GDP growth going forward, with business investment accelerating and outpacing private consumption from the end of 2006. Private consumption growth is expected to be in line with GDP this year, but to fall below it thereafter. Net exports are forecast to make a neutral contribution to GDP growth, in contrast to the negative contribution in the years preceding 2005.

Risks

2.31 The set of risks surrounding the Budget 2006 economic outlook is similar to that surrounding the 2005 Pre-Budget Report forecast. The balance of risks has shifted a little, with domestic risks having receded, while global uncertainties have increased somewhat. Globalisation means that the UK economy shares increasingly in the risks affecting the world economy and means that domestic risks are harder to differentiate.

2.32 Uncertainty continues to surround the current output gap estimate given ongoing uncertainty as to whether the latest vintage of ONS data is correctly approximating the degree to which the economy has been growing below trend over the recent past. To the extent that the economy has been growing more (less) quickly than implied by existing data, then that would mean less (more) scope for above-trend growth over the forecast horizon.

2.33 The forecast for private consumption continues to be surrounded by both upside and downside risks. Unexpected weakness of average earnings growth would tend to undermine household expenditure, although it would be at least partly offset by the boost to employment from weakening labour costs. Private consumption growth also presents potential upside risks. With increasing evidence that the housing market has undergone a smooth realignment with some modest recent firming in house prices and with consumer confidence having firmed, household spending could accelerate more sharply than envisaged.

The economic cycle

2.34 As announced in July last year, the Treasury's judgement is that the current economic cycle began in the first half of 1997.[5] The Comptroller and Auditor General audited this judgement alongside the 2005 Pre-Budget Report and concluded that, though there were uncertainties, there are reasonable grounds to date the end date of the previous economic cycle to 1997 and that this would not reduce the extent of caution in making the fiscal projections. In the second half of 2001, the economy moved below trend with output remaining below its trend level since then. The economy is expected to return to trend in 2008-09.

Caution and the public finances

2.35 The end date of the economic cycle is one of a number of key assumptions that underpin the public finance projections which are independently audited by the Comptroller and Auditor General to ensure that they remain reasonable and cautious. A complete list of these assumptions is set out in Chapter C of the *Financial Statement and Budget Report* and further background is provided in Box 2.1. This prudent approach to fiscal policy builds an important safety margin into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending.

2.36 For this Budget, the Comptroller and Auditor General has audited the assumption for underlying trend growth used for the purpose of projecting the public finances, which is set a $^1/_4$ percentage point below the Government's neutral view. The review concluded that over the past four years the assumption has been reasonable and cautious, though other assumptions could have been adopted that would have introduced a greater degree of caution. Looking forward, the review concluded that the assumption currently remains reasonable and cautious but recommended that, because of the uncertainties involved in estimating trend growth rates, the Treasury kept its estimate under review.

2.37 The assumption for forecasting revenue from duty on tobacco, that the illicit market share is set at least at the latest published outturn level, would normally be due for review under the three-year rolling review. However, firm data for the illicit market share is currently only available for the first year of the rolling review period so that it is not possible to reach a conclusion for the three-year period as a whole. The Comptroller and Auditor General has therefore reviewed the evidence for 2003-04, concluding that the assumption had added caution to the fiscal projections in that year, and reviewed the issues that have arisen in producing an estimate for 2004-05. The Comptroller and Auditor General recommended areas of further analysis that HM Revenue and Customs will undertake over the next year and will be invited to conduct a full review at Budget 2007.

2.38 The Comptroller and Auditor General reviewed the yield from the Budget 2003 direct taxation compliance package and found that the projections of yield were reasonable and the method adopted to make adjustments to the projections in the light of outturn evidence was a helpful one to ensure caution.

2.39 The Comptroller and Auditor General also audited the conventions on short-term interest rates and privatisation proceeds. He concluded that the interest rate assumption methodology, that three-month forward interest rates will be based on market expectations, was a reasonable one and incorporates an element of caution through the risk premium embodied in the forward rates. Over the past three years, interest rate projections had been

[5] *Evidence on the UK economic cycle*, HM Treasury, July 2005.

higher than outturn more often than not and so had been cautious to this extent, on the basis that higher interest rates have a negative impact on the public finances. The review concluded that the convention on privatisation proceeds had led to no systematic forecasting errors over the review period and that for the future it remains reasonable and is based on being cautious. In view of potentially large future privatisation receipts, close attention should be paid to the profile of receipts included in the fiscal projections.

Box 2.3: Follow-up to the UK Presidencies of the G7/8 and EU

In 2005, the UK used its leadership of the G7/8 and the EU to address the challenges and opportunities of globalisation. The details were set out in the 2005 Pre-Budget Report. Building on these achievements, the UK will work closely with the G7/8, the EU, International Financial Institutions and other international partnerships, including emerging market economies, to promote global prosperity and economic stability, accelerate progress towards the Millennium Development Goals (MDGs), address the challenges of structural economic reform, resist protectionist pressures and promote free and fair trade, by:

- **ensuring early progress to deliver on the commitments made in 2005 to provide an extra $50 billion in aid each year, and ensuring that these commitments are transformed into concrete actions to help developing countries achieve the MDGs – including through the funding of ten-year plans to deliver free, universal primary education and health; resources to develop the capacity to trade; implementing the agreement for 100 per cent multilateral debt relief and pushing for further debt relief; launching a vaccination programme through the International Finance Facility for Immunisation; and agreeing a pilot scheme to accelerate the development of vaccines;**
- **strengthening the ability of EU and global institutions to respond to global challenges to economic stability – including through increasing the IMF's focus on credible, independent and persuasive surveillance and supporting the UN Secretary General in reforming the UN's institutional operations;**
- **promoting structural reform in the EU to build competitive, open, flexible and fair economies – by ensuring a free and open market in services and completing the single market in financial services; measurable regulatory reform, including reductions in administrative burdens and the exemption of SMEs from disproportionate rules; promoting effective competition policy; and effective monitoring of reforms to maintain momentum in the Lisbon agenda;**
- **securing sustainable, reliable and affordable energy sources by promoting transparent, open and competitive international energy markets – through working with the Russian G8 Presidency and G8 members to extend the principles of the recent G7 oil initiative to energy, and with EU partners to influence EU energy policy following the 2005 Hampton Court summit; and promoting investment in alternative sources of energy to support the international climate change and sustainable development agendas; and**
- **promoting a freer and fairer international trading system, in the face of increasing protectionist pressures – through an ambitious outcome to the Doha WTO Trade Round, which delivers substantial benefits to developing countries; enables poor countries to have the flexibility to decide their own trade reform and provides them with resources to build trade capacity; significantly increases agricultural market access; substantially reduces trade-distorting subsidies; eliminates all forms of agricultural export support; and provides greater opportunities for trade in industrial goods and services; as well as through further reform of the Common Agricultural Policy.**

RECENT FISCAL TRENDS AND OUTLOOK

2.40 Budget 2006 presents the Government's annual fiscal forecast and updates the 2005 Pre-Budget Report interim projections.[6]

2.41 The Budget 2006 projections are broadly in line with the 2005 Pre-Budget Report interim projections, locking in the Government's prudent stance. As projected in the Pre-Budget Report, receipts growth has been more robust in 2005-06 than would have been anticipated against a background of slower economic growth.

Estimate for 2005-06

2.42 Net taxes and national insurance contributions have strengthened through 2005-06, and are estimated to have grown by 7.6 per cent from the previous year, in line with the forecast in the Pre-Budget Report. Corporation tax continues to grow strongly, up 27 per cent on last year, and now estimated to be higher than at the Pre-Budget Report, boosted by strong corporate profitability, and by further growth in North Sea oil revenues. The buoyant financial services sector has also contributed to robust growth in income tax and national insurance contributions. Excise duties and VAT receipts are lower than expected, partly reflecting changes in consumers' spending patterns. Moderation in household spending has also reduced growth in consumption taxes.

2.43 The estimated 2005-06 outturn for the public sector current budget is a deficit of £11.4 billion compared with projected deficits of £10.6 billion and £5.7 billion in the 2005 Pre-Budget Report and Budget 2005 respectively. The current budget moves into surplus in 2007-08, a year earlier than expected at the time of the Pre-Budget Report. For public sector net borrowing the estimated 2005-06 outturn shows £37.1 billion, compared with £37 billion projected in the 2005 Pre-Budget Report and £31.9 billion projected in Budget 2005. While the current budget deficit in 2005-06 is £7.6 billion lower than in 2004-05, the reduction in net borrowing is more modest, reflecting the £5.0 billion increase in public sector net investment.

2.44 With economic growth having been slower over 2005, there was a notable shift in the estimated cyclically-adjusted balances in 2005-06. Cyclically-adjusted net borrowing is estimated to have fallen by around $^3/_4$ of a per cent of GDP to 2.4 per cent of GDP, while the cyclically-adjusted deficit on the current budget fell by 1 per cent of GDP to around $^1/_4$ per cent of GDP. On the basis of cautious, audited assumptions, the Government is meeting its strict fiscal rules over the economic cycle.

2.45 In making its fiscal projections, the Government distinguishes between non-discretionary factors which affect the public finances, such as changing consumption patterns affecting receipts and changes to the economic forecast, for example to GDP growth, and discretionary Budget measures. This chapter first outlines the non-discretionary changes which form the fiscal context for the Budget decisions.

Non-discretionary changes in receipts

2.46 As the economy returns to trend in 2008-09, stronger economic growth underpins continued growth in receipts over the projection period, although the rate of receipts growth is set to moderate in 2006-07, in part driven by higher than forecast capital expenditure in the North Sea, changes to the pattern of oil production and changes in the impact of the Government's measure to allow North Sea firms to defer first year capital allowances. In line with the rebalancing of economic growth going forward, the forecast for corporation tax is higher than at the Pre-Budget Report, boosted by the improved profitability of non-financial corporations as well as by higher oil prices. Higher equity prices also increase the forecast for capital taxes and stamp duties. Lower growth in average earnings and changes in the composition of consumer spending act to dampen some receipts. VAT and excise duties are particularly affected by changes in spending patterns as well as by losses from Missing Trader Intra-Community (MTIC) fraud.

[6] The Budget 2006 fiscal projections take account of the February outturns for receipts, spending and borrowing.

Table 2.3: Public sector net borrowing compared with the 2005 Pre-Budget Report

	£ billion					
	Estimate			Projections		
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
2005 PBR	**37.0**	**34**	**31**	**26**	**23**	**22**
Changes since the 2005 PBR						
Economic and other forecasting effects	0.2	1½	–1	–½	1	1½
Total before discretionary measures	**37.2**	**35**	**30**	**26**	**24**	**24**
Discretionary measures	**0.0**	**½**	**–½**	**–1**	**–½**	**0**
Budget 2006	**37.2**	**36**	**30**	**25**	**24**	**23**

Note: Totals may not sum due to rounding.

Non-discretionary changes in spending

2.47 The forecast for expenditure before discretionary measures is slightly above the forecast in Pre-Budget Report. Reclassification of the BBC into the public sector increases the expenditure forecast across the projection period, but is fiscally neutral as the impact is offset by increased receipts.

BUDGET DECISIONS

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

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

2.49 Against this backdrop, and building on steps already taken, Budget 2006 announces:

- a commitment to increase the child element of the Child Tax Credit in line with average earnings to the end of this Parliament;
- further payments into Child Trust Fund accounts at age 7 of £250 for all children, with £500 for children from lower-income families;
- £585 million of additional resources over 2006-07 and 2007-08 to provide further support for personalised learning in schools in England;
- an increase in the stamp duty land tax threshold to £125,000, exempting an additional 40,000 homebuyers each year;
- the introduction of Real Estate Investments Trusts to create greater flexibility for investors;
- measures to modernise the tax system, and to tackle tax fraud and avoidance; and
- the deferral of the inflation-based increase in main road fuel duties to 1 September 2006, in response to sustained volatility in oil prices.

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

MEDIUM-TERM FISCAL PROJECTIONS

2.51 Table 2.4 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2005 and in the 2005 Pre-Budget Report. It includes the impact of all Budget decisions in accordance with the *Code for fiscal stability*. Further detail is provided in Chapter C of the *Financial Statement and Budget Report*.

2.52 The revised outturn for 2004-05 shows the deficit on the current budget to be £0.9 billion lower than in the 2005 Pre-Budget Report, and £2.9 billion higher compared with Budget 2005. The outturn for net borrowing in 2004-05 is £0.9 billion higher than in the Pre-Budget Report, in line with an increase of £1.7 billion in net investment, and net borrowing is £5.3 billion higher than the estimate in Budget 2005.

Table 2.4: Fiscal balances compared with Budget 2005 and the 2005 Pre-Budget Report

	Outturn[1]	Estimate[2]			Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Surplus on current budget (£ billion)							
Budget 2005	**–16.1**	**–5.7**	**1**	**4**	**9**	**12**	–
Effect of revisions and forecasting changes	*–3.8*	*–4.2*	*–6½*	*–6½*	*–5*	*–3½*	–
Effect of discretionary changes	*0.0*	*–0.8*	*2*	*2½*	*2½*	*2*	–
2005 PBR	**–19.9**	**–10.6**	**–4**	**0**	**7**	**11**	**13**
Effect of revisions and forecasting changes	*0.9*	*–0.8*	*–2½*	*½*	*0*	*–1*	*–1½*
Effect of discretionary changes	*0.0*	*0.0*	*–½*	*½*	*1*	*½*	*½*
Budget 2006	**–19.0**	**–11.4**	**–7**	**1**	**7**	**10**	**12**
Net borrowing (£ billion)							
Budget 2005	**34.4**	**31.9**	**29**	**27**	**24**	**22**	–
Changes to current budget	*3.8*	*4.9*	*5*	*4*	*2½*	*1½*	–
Changes to net investment	*0.6*	*0.1*	*0*	*0*	*0*	*0*	–
2005 PBR	**38.8**	**37.0**	**34**	**31**	**26**	**23**	**22**
Changes to current budget	*–0.9*	*0.8*	*3*	*–1*	*–½*	*½*	*1*
Changes to net investment	*1.7*	*0.6*	*–½*	*–½*	*–½*	*–½*	*0*
Budget 2006	**39.7**	**37.1**	**36**	**30**	**25**	**24**	**23**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2005	–0.8	–0.3	0.1	0.3	0.6	0.8	–
2005 PBR	–1.3	–0.1	0.7	0.7	0.7	0.7	0.8
Budget 2006	**–1.3**	**–0.3**	**0.4**	**0.7**	**0.7**	**0.7**	**0.8**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2005	2.4	2.4	2.2	2.0	1.6	1.5	–
2005 PBR	2.9	2.2	1.6	1.6	1.6	1.5	1.4
Budget 2006	**3.0**	**2.4**	**1.9**	**1.6**	**1.6**	**1.6**	**1.5**
Net debt (per cent of GDP)							
Budget 2005	34.4	35.5	36.2	36.8	37.1	37.1	–
2005 PBR	34.7	36.5	37.4	37.9	38.2	38.2	38.2
Budget 2006	**35.0**	**36.7**	**37.9**	**38.4**	**38.5**	**38.6**	**38.6**

Note: Totals may not sum due to rounding.
[1] The 2004-05 figures were estimates in Budget 2005.
[2] The 2005-06 figures were projections in Budget 2005.

2.53 The estimated surplus on the current budget in 2005-06 is slightly lower than expected at the 2005 Pre-Budget Report, reflecting slightly higher expenditure. As receipts strengthen over the projection period, the current surplus rises in line with the 2005 Pre-Budget Report and Budget 2005 projections. Similarly, net borrowing is slightly higher in 2005-06, but reduces rapidly, coming back broadly into line with the projections of the 2005 Pre-Budget Report.

2.54 Table 2.4 also sets out the underlying structural position of the fiscal balances, adjusted for the impact of the economic cycle on the public finances.[7] Cyclically-adjusted, the current budget deficit and net borrowing are slightly higher in 2005-06 than projected in the Pre-Budget Report, partly because the output gap is now estimated to be slightly narrower than forecast. Over the period to 2008-09, cyclically-adjusted net borrowing remains at or below that projected in Budget 2005.

Box 2.4: Key successes of the UK fiscal framework

The UK fiscal framework was designed to address a number of challenges, discussed below. On each challenge clear progress has been made.

The first challenge was to ensure sound public finances and fairness within and between generations. Over the cycle from 1986-87 to 1997-98 the current budget was in deficit by an average of 1.9 per cent of GDP in each year, peaking at over 6 per cent in 1993-94. While the current economic cycle has not been completed, the Budget projections show that by 2008-09 the average surplus is expected to be 0.1 per cent of GDP. The largest deficit in any one year of this cycle, at 1.9 per cent of GDP, is equal to the average of the deficit over the previous economic cycle. Net debt as a percentage of GDP was 43.6 per cent in March 1997 compared with a projected 38.3 per cent at the end of the current cycle.

Current budget surplus (per cent of GDP)

Year of cycle	1	2	3	4	5	6	7	8	9	10	11	12	Average
1986-87 to 1997-98 cycle	–1.4	–0.3	1.7	1.4	0.4	–2.0	–5.6	–6.2	–4.8	–3.4	–2.8	–0.2	–1.9
1997-98 to 2008-09 cycle	–0.2	1.2	2.2	2.2	1.0	–1.2	–1.9	–1.6	–0.9[1]	–0.6[2]	0.1[2]	0.5[2]	0.1

[1] *Estimate for 2005-06.*

[2] *Projection for 2006-07 to 2008-09.*

Second, fiscal policy has supported monetary policy over the cycle. One way of demonstrating this is to compare the change in cyclically-adjusted net borrowing (the fiscal stance) with the evolution of the output gap. The economy moved above trend in the first half of 1997, and between 1996-97 and 2000-01 the fiscal stance was tightened by 4 percentage points of GDP. As the economy moved below trend in late 2001, the fiscal stance was relaxed by just under 3 percentage points of GDP between 2001-02 and 2004-05, as shown in Chart 2.6.

The third challenge in 1997 was to rebuild the public capital stock. The fiscal rules provided the framework within which an increase in public investment could take place while maintaining sound public finances. Since 1997-98 public sector net investment has increased from 0.6 per cent of GDP to an estimated 2.1 per cent in 2005-06, as illustrated in Chart 2.7. For the remainder of the cycle, public sector net investment is projected to remain at 2$^{1}/_{4}$ per cent of GDP, the longest period of sustained high public investment for 26 years.

[7] Details of the Treasury's approach to cyclical adjustment can be found in Annex A of the 2003 *End of year fiscal report*.

ADHERING TO PRINCIPLES

2.55 Table 2.5 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. The table indicates that, after allowing for non-discretionary changes to receipts and spending and taking into account the Budget decisions, the Government is meeting both of its strict fiscal rules.

Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate			Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Fairness and prudence							
Surplus on current budget	–1.6	–0.9	–0.6	0.1	0.5	0.7	0.8
Average surplus since 1997-98	0.2	0.1	0.0	0.0	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–1.3	–0.3	0.4	0.7	0.7	0.7	0.8
Long-term sustainability							
Public sector net debt[1]	35.0	36.4	37.5	38.1	38.3	38.4	38.4
Core debt[1]	34.3	35.2	35.4	35.5	35.7	35.9	36.0
Net worth[2]	29.0	26.0	24.8	23.3	22.9	22.9	22.8
Primary balance	–1.7	–1.3	–1.1	–0.5	–0.1	0.1	0.1
Economic impact							
Net investment	1.8	2.1	2.2	2.3	2.3	2.3	2.3
Public sector net borrowing (PSNB)	3.4	3.0	2.8	2.2	1.7	1.6	1.5
Cyclically-adjusted PSNB	3.0	2.4	1.9	1.6	1.6	1.6	1.5
Financing							
Central government net cash requirement	3.3	3.2	3.2	2.6	2.1	2.1	1.8
Public sector net cash requirement	3.3	3.0	2.9	2.4	1.8	1.8	1.5
European commitments							
Treaty deficit[3]	3.3	3.2	3.0	2.4	1.9	1.7	1.6
Cyclically-adjusted Treaty deficit[3]	2.9	2.5	2.0	1.8	1.7	1.7	1.7
Treaty debt ratio[4]	40.8	42.6	43.9	44.5	44.5	44.5	44.5
Memo: Output gap	*–0.4*	*–1.2*	*–1.4*	*–0.7*	*–0.1*	*0.0*	*0.0*

[1] *Debt at end March; GDP centred on end March.*
[2] *Estimate at end December; GDP centred on end December.*
[3] *General government net borrowing on a Maastricht basis.*
[4] *General government gross debt on a Maastricht basis.*

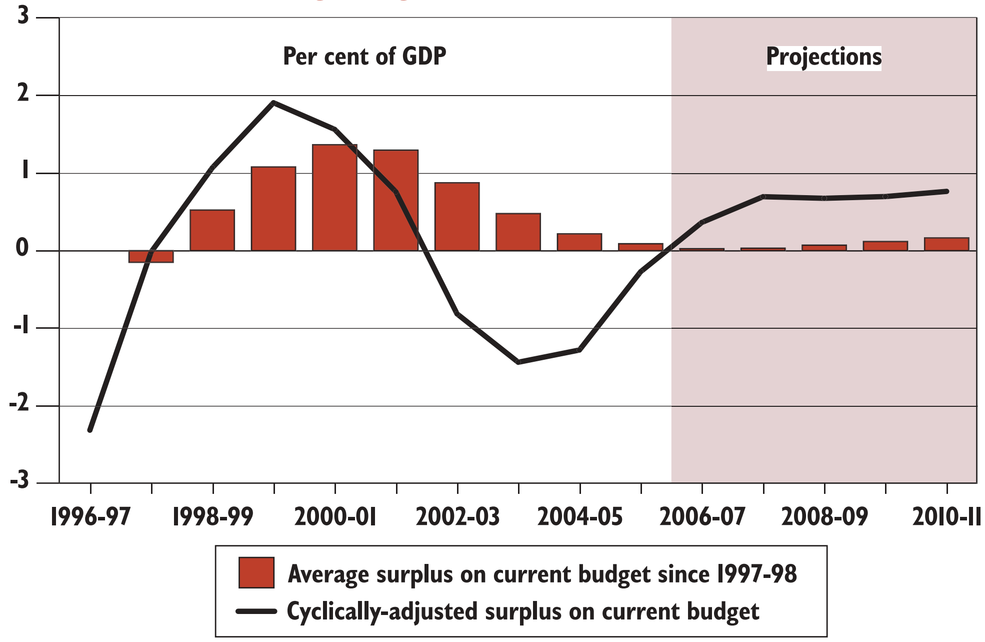
Golden rule

2.56 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of intergenerational fairness. The current budget strengthens through the projection period, returning to surplus in 2007-08 and showing a surplus of 0.8 per cent of GDP by 2010-11.

2.57 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.

2.58 The average surplus on the current budget since the start of the current cycle in 1997-98 is in balance or surplus in every year of the projection period. The economy is projected to return to trend in 2008-09, which means that the average annual surplus on the current budget would be 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £16 billion in this cycle, including the AME margin, the same as at the 2005 Pre-Budget Report.

Chart 2.4: Meeting the golden rule



Source: HM Treasury.

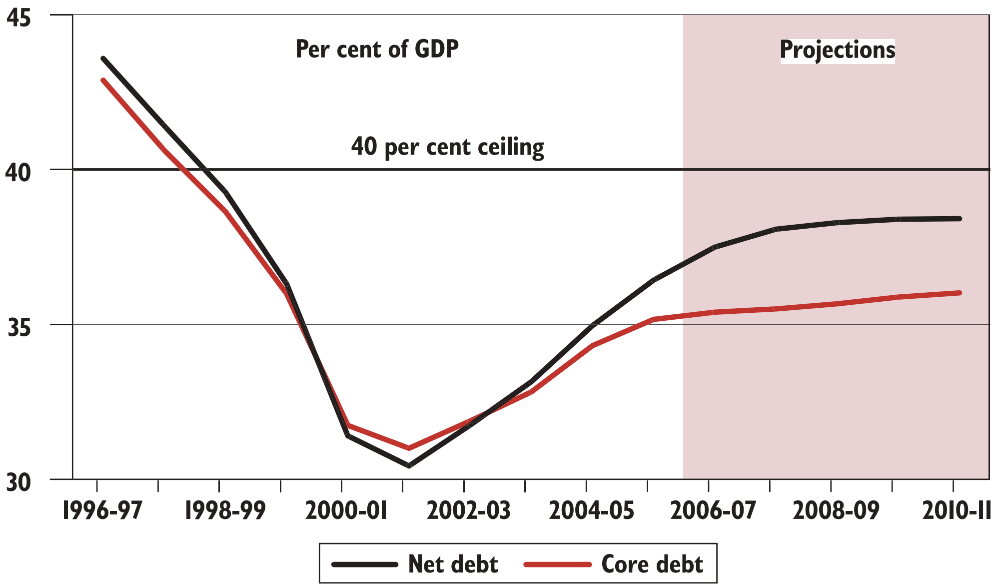
2.59 With the economy assumed to be on trend in 2008-09, Budget projections show, based on cautious assumptions, that the average surplus on the current budget over the period 2008-09 to 2010-11 is 0.7 per cent of GDP. At this early stage and based on cautious assumptions, for example for trend growth as explained in Box C2, the Government is therefore on course to meet the golden rule after the end of this economic cycle.

Sustainable investment rule

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

2.61 Chart 2.5 shows, that despite output being below trend since 2001, net debt is expected to stabilise at 38.4 per cent of GDP from 2009-10. Therefore the Government meets its sustainable investment rule while continuing to borrow to fund increased long-term capital investment in public services. Chart 2.5 also illustrates projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt rises only modestly from 35¼ per cent in 2005-06 to 36 per cent of GDP at the end of the projection period.

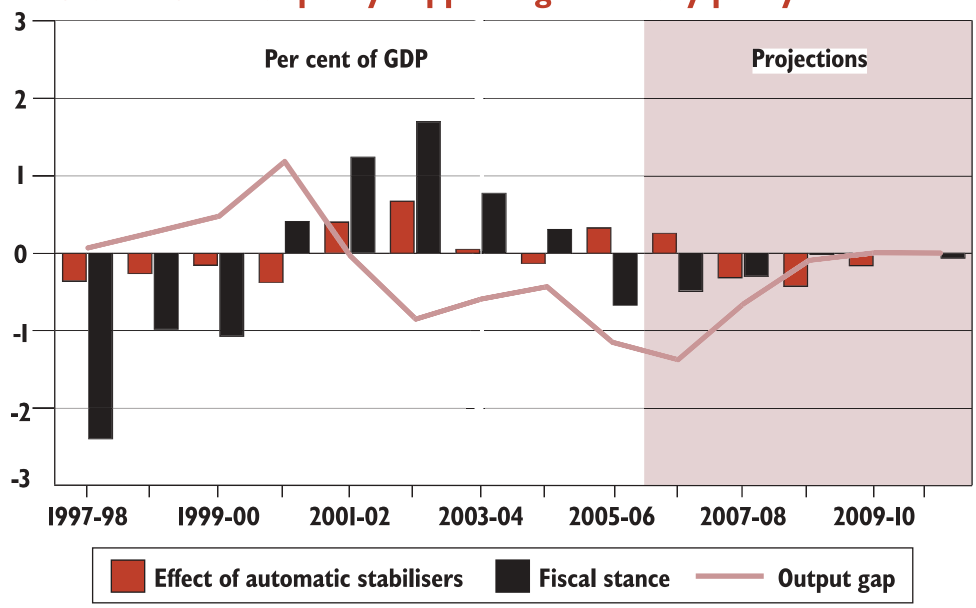
Chart 2.5: Meeting the sustainable investment rule



Source: ONS and HM Treasury.

Economic impact **2.62** While the primary objective of fiscal policy is to ensure sound public finances, fiscal policy also affects the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). These can be broken down into changes due to the effects of the automatic stabilisers and those due to the change in the fiscal stance, as illustrated in Chart 2.6.

Chart 2.6: Fiscal policy supporting monetary policy



Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, ie the difference between PSNB and the cyclically-adjusted PSNB. A negative number represents fiscal tightening.
Source: HM Treasury.

2.63 During the late 1990s, the fiscal stance and the automatic stabilisers tightened at a time when the economy was above trend. As the economy moved below trend in 2001, the automatic stabilisers and the fiscal stance supported the economy, with the degree of support moderating as the economy moved back towards trend in early 2004.

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

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

2.65 Between Budgets and Pre-Budget Reports, the fiscal stance can change as a result of a discretionary measure to:

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

2.66 Table 2.6 explains how these concepts relate to the projections in the Budget. It shows the changes in both the fiscal stance and the overall fiscal impact between Budget 2005, the 2005 Pre-Budget Report and Budget 2006. There was a significant tightening in the fiscal stance between Budget 2005 and the 2005 Pre-Budget Report due to a combination of discretionary policy action and non-discretionary factors. Budget 2006 locks in this tighter fiscal stance with a modest discretionary tightening in the medium term.

Table 2.6: The overall fiscal impact[1]

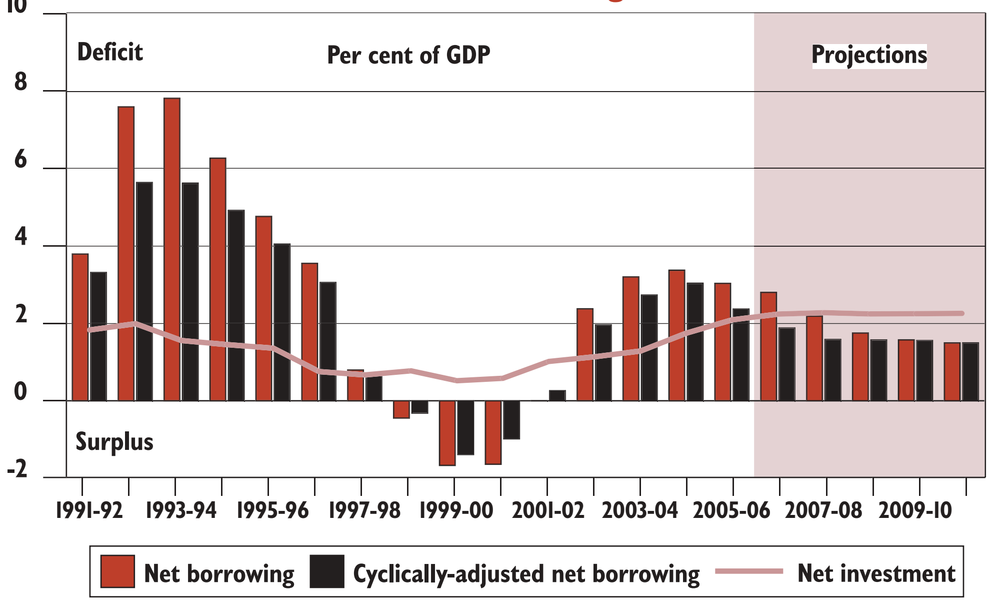
	Per cent of GDP						
	Outturn[2]	Estimate[3]	Projections				
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Change from Budget 2005 to the 2005 PBR							
Post Budget and PBR policy decisions	0.0	0.1	–0.1	–0.2	–0.2	–0.1	–
+							
non-discretionary factors	0.6	–0.2	–0.4	–0.2	0.1	0.2	–
=							
CHANGE IN FISCAL STANCE	0.6	–0.2	–0.6	–0.3	0.0	0.1	–
+							
automatic stabilisers	–0.2	0.6	1.0	0.6	0.2	0.0	–
=							
OVERALL FISCAL IMPACT	0.4	0.4	0.4	0.3	0.2	0.1	–
Change from the 2005 PBR to Budget 2006							
Budget measures	0.0	0.0	0.0	0.0	–0.1	0.0	0.0
+							
non-discretionary factors	0.1	0.1	0.3	0.0	0.0	0.0	0.1
=							
CHANGE IN FISCAL STANCE	0.1	0.1	0.3	–0.1	0.0	0.0	0.1
+							
automatic stabilisers	0.0	–0.1	–0.1	0.0	0.0	0.0	0.0
=							
OVERALL FISCAL IMPACT	0.1	0.0	0.2	–0.1	–0.1	0.0	0.1

[1] *All the numbers represent the impact of changes on public sector net borrowing. A negative number represents fiscal tightening.*

[2] *The 2004-05 figures were estimates in Budget 2005.*

[3] *The 2005-06 figures were projections in Budget 2005.*

Chart 2.7: Public sector net borrowing and net investment



Source: ONS and HM Treasury.

2.67 On average since 1997-98 public sector net investment has exceeded net borrowing, reflecting the average surplus on the current budget. This is projected to continue as the Government borrows to invest in public services while continuing to meet its strict fiscal rules. Chart 2.7 shows net borrowing falling to 1.5 per cent of GDP by the end of the projection period.

Financing

2.68 The forecast for the central government net cash requirement (CGNCR) for 2005-06 is £40.6 billion, a reduction of £2.7 billion from the 2005 Pre-Budget Report forecast.

2.69 The forecast for the CGNCR for 2006-07 is £41.2 billion. The financing requirement will be met by:

- gross gilt issuance of £63.0 billion;
- an increase in the Treasury bill stock of £2.0 billion by end March 2007; and
- a £3.1 billion planned reduction in the DMO's short-term financing position by end March 2007.

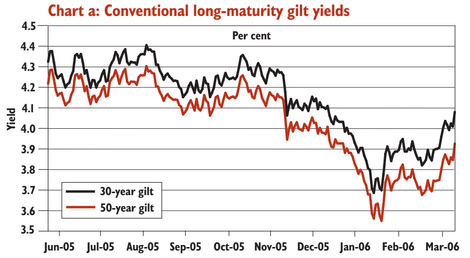
2.70 Full details and a revised financing table can be found in Chapter C. Box 2.5 considers the factors underlying the recent fall in gilt yields and the Government's weighting of its gilt issuance programme towards longer maturities in the last few years. **During 2006-07, the DMO will increase the amount of long-maturity and index-linked gilt issuance, with up to two-thirds of total issuance at long maturities.** Further details can be found in the *Debt and Reserves Management Report 2006-07* which has been published alongside the Budget.

Box 2.5: Low yields and the Government bond market

Long-term interest rates have fallen to low levels throughout the world with inflation-adjusted interest rates on 30-year government bonds falling below 2 per cent in some countries compared with around 3½ per cent in 2001. The UK government bond, or gilt, market has experienced particularly low yields on very long-maturity gilts (30- to 50-year maturities) with inflation-adjusted interest rates reaching lows of less than ½ per cent in January 2006 compared with over 2 per cent in 2001.

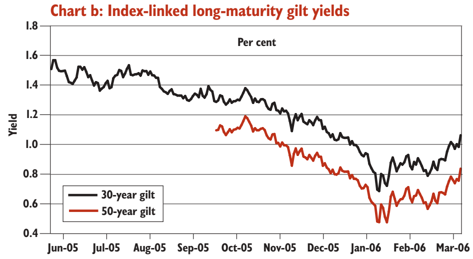
The charts below illustrate how yields on both long-maturity nominal ('conventional') and index-linked gilts have fallen between May 2005 and March 2006. Yields have recovered somewhat since January.

Chart a: Conventional long-maturity gilt yields



Source: Bloomberg.

Chart b: Index-linked long-maturity gilt yields



Source: Bloomberg.

The factors underlying the recent fall in gilt yields extend well beyond the gilt market itself. Understanding the likely future duration and scale of low yields raises questions about: whether the fall in global yields is temporary or likely to be sustained, which will depend on factors including the global savings rate and global credit conditions; the macroeconomic implications of pension fund demand for long-dated and inflation-linked assets; the behaviour of pension funds and other sources of demand in the current accounting and regulatory climate; and the implications for the Government's debt management policy and plans for financing through the gilts market. The Government is keeping these factors under continuous review.

In recent years pension funds have shifted increasingly from equities into long-dated and inflation-linked bonds and this trend is likely to continue in the medium term. The Government's debt management objective is to minimise cost subject to risk. In line with this objective, the Government has weighted its gilt issuance programme increasingly towards longer maturities over the last few years (from 28 per cent of total insurance in 2003-04 to 47 per cent in 2005-06) and has extended the yield curve to 50 years during 2005-06.

Further details of the Government's financing programme for 2006-07 can be found in the *Debt and Reserves Management Report 2006-07*, which was published alongside the Budget and is available on the Treasury's website at: www.hm-treasury.gov.uk.

European commitments

2.71 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box B2 and as reflected in reforms to the Pact agreed in March 2005. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in Budget 2006, which show the Government is meeting its fiscal rules over the cycle, maintaining low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with a prudent interpretation of the Pact.

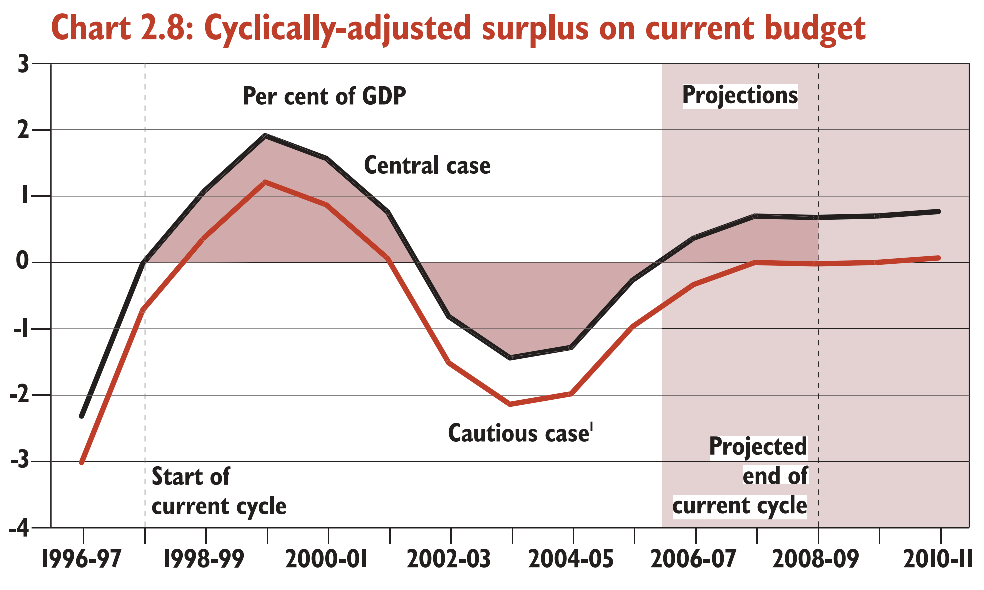
Dealing with uncertainty

2.72 Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The use of cautious assumptions audited by the NAO builds a safety margin into the public finance projections to guard against unexpected events. The degree of caution in the assumptions underpinning the public finance projections increases over the projection period. For example, Box C2 explains how the Government bases its public finance projections on a trend growth assumption that is a $^1/_4$ percentage point lower than its neutral view, to accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term. This implies that the level of GDP used in the public finance forecast is $1^1/_4$ per cent below the neutral view by 2010-11.

2.73 A second important source of potential error results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.8 illustrates the projections for this cautious case.

2.74 The Government is, on the basis of cautious, independently-audited assumptions, meeting the golden rule in the central case. In the cautious case, Chart 2.8 shows that the cyclically-adjusted surplus will be in balance at the end of the projection period.

Chart 2.8: Cyclically-adjusted surplus on current budget



[1] Cautious case assumes trend output 1 percentage point lower in relation to actual output than the central case.
Source: HM Treasury.

Box 2.6: Independence for statistics

Statistics make a crucial contribution to good government in a modern democracy: assisting in the formulation and evaluation of policies; the management of the services for which the government is responsible; encouraging and informing debate; and allowing people to judge whether government is delivering on its promises. Last November, the Chancellor announced to Parliament the Government's intention to legislate for independence in statistics. Alongside the Budget, the Government has published a consultation document outlining proposals for the further enhancement of the statistical system in the context of the planned legislation by:

- **entrenching independence in legislation;**
- **introducing a direct reporting and accountability to Parliament, rather than through Ministers;**
- **placing a statutory responsibility on a new independent governing board to assess and approve all National Statistics against the code of practice, also backed by statute;**
- **making key appointments to the board through open and fair competition; and**
- **removing the statistics office from Ministerial control by establishing it as a Non-Ministerial department, with special funding arrangements outside the normal Spending Review process.**

The Government welcomes the views of all stakeholders on the issues raised in the consultation document. Copies of the consultation document, *Independence for statistics*, can be obtained from the HM Treasury website at www.hm-treasury.gov.uk.

LONG-TERM FISCAL SUSTAINABILITY

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

2.76 An analysis of long-term fiscal sustainability is presented in Annex A. The analysis shows that given the projected profile for tax revenues and transfers, current public consumption can grow at around assumed GDP growth after the medium term while meeting the Government's golden rule. Public sector net investment can also grow broadly in line with the economy without jeopardising the sustainable investment rule.

2.77 These illustrative long-term fiscal projections yield similar conclusions to those presented in the Government's 2005 *Long-term public finance report*. Using a range of sustainability indicators, and based on current policies and reasonable assumptions, the report shows that the public finances are sustainable in the longer term.