2 MAINTAINING MACROECONOMIC STABILITY

The global economic recovery has gathered less momentum than forecast in Budget 2002. Slower growth in the US and continental Europe, concern over corporate accounting standards and developments in the Middle East have led to further falls on world equity markets and a rise in oil prices, compounding existing uncertainties over global economic prospects. Nonetheless, the economic stability delivered by the Government's macroeconomic framework has left the UK well placed to deal with the impact of global events:

- **the monetary policy framework is delivering low and stable inflation, while allowing the Bank of England's Monetary Policy Committee to respond to risks to the symmetrical inflation target; and**
- **the fiscal rules are delivering sound public finances so that the Government can let the automatic stabilisers operate freely, while meeting the rules over the economic cycle.**

International conditions continue to be a major influence on the UK economy and heightened global uncertainty presents risks to the forecast. UK GDP is forecast to grow by 1.6 per cent this year, below the Budget 2002 forecast, and by between 2½ to 3 per cent next year.

The Pre-Budget Report interim projections for the public finances show that the Government is firmly on track to meet its strict fiscal rules over the economic cycle, including in the cautious case:

- **the average current budget since the start of the present cycle in 1999-2000 is comfortably in surplus, ensuring the Government is on track to meet the golden rule, using cautious assumptions and in the cautious case;**
- **this is confirmed by the cyclically-adjusted current budget, which allows for the impact of the economic cycle and is in surplus in every year throughout the projection period; and**
- **public sector net debt is projected to be low and stable throughout the next five years, comfortably meeting the sustainable investment rule and, at 31 to 33 per cent of GDP, the lowest in the G7.**

In a period of global economic weakness and uncertainty, the use of cautious assumptions and the 'stress test' against the cautious case help to ensure that the public finances are sound and sustainable and that the Government is vigilant in the face of potential risks. In the short term, the automatic stabilisers are operating freely, as a cyclical shortfall in receipts this year and over the next two years helps to support monetary policy in maintaining economic stability while the economy is below trend. In the medium term, the public finances return towards the Budget 2002 profile as the economy returns to trend. In the long term, a new assessment published alongside this Pre-Budget Report shows that the UK is well placed to deal with future fiscal challenges, such as those arising from an ageing population, and that current policies impact fairly between generations.

THE MACROECONOMIC FRAMEWORK

2.1 Following a pronounced slowdown in 2001, growth in the world economy showed signs of strengthening earlier in the year. But the world economy has since faced a series of new challenges and risks. Concern over corporate accounting standards and other financial malpractices, and events in the Middle East, have led to further falls on international equity markets and a rise in oil prices, compounding uncertainty about the strength of global demand and hampering confidence and business investment across the industrialised world. In an integrated global economy, no country can remain fully immune to international developments. The role of the macroeconomic framework is to limit the impact of adverse developments on the economy so that the UK can maintain high and stable levels of growth and employment.

2.2 The macroeconomic framework is designed to secure and maintain long-term economic stability. Large fluctuations in output, employment and inflation create uncertainty for businesses, consumers and the public sector, and can hold back the economy's long-term growth potential. Stability helps businesses, individuals and the Government plan 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 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 two strict rules that guarantee sound public finances over the medium term. The fiscal rules are the foundation of the Government's public spending framework, which ensures long-term planning while putting in place incentives to increase the quality of public services and deliver specified outcomes. These coordinated policies work together in a coherent and integrated way.

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 Bank of England's Monetary Policy Committee (MPC) has responded to developments in the world economy, limiting the impact of global instability on the UK economy. The framework is based on four key principles:

- clear and precise objectives. The primary objective of monetary policy is to deliver price stability. The Government's single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's target of $2^1/_2$ per cent for the 12-month increase in the Retail Prices Index excluding mortgage interest payments (RPIX), which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings, and the 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 clear inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how this meets the MPC's remit.

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

Fiscal policy framework

2.6 The Government's fiscal policy framework is based on five key principles of fiscal management set out in the *Code for fiscal stability*[2] – transparency, stability, responsibility, fairness and efficiency. The Code, enshrined in legislation through the 1998 Finance Act, describes how these principles relate to the formulation and implementation of policy and requires the Government to state both its objectives and the fiscal rules through which policy is operated. The Government's fiscal policy objectives are:

[1] *Reforming Britain's economic and financial policy*, HM Treasury, 2002.

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

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

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

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

2.8 The fiscal rules promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects. First, the rules are set over the economic cycle, allowing the fiscal balances to vary between years in line with the cyclical position of the economy. This allows the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand. Second, the interaction of the two rules promotes capital investment while ensuring sustainable public finances over 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 for capital spending. The sustainable investment rule ensures that borrowing for investment is conducted in a responsible way.

2.9 The fiscal framework also recognises that projections of the current budget and net debt are subject to uncertainty. The average absolute difference between the year-ahead forecast of public sector net borrowing and the outturn has been around one per cent of GDP over the last ten years. Projections of the public finances are therefore based on deliberately prudent assumptions for key economic variables, including the trend rate of growth, the level of unemployment and equity prices. These assumptions are audited by the Comptroller and Auditor General under a three-year rolling review to ensure that they remain reasonable and cautious. This approach minimises the need for unexpected changes in the direction of taxation or spending.

End of year fiscal report

2.10 **In order to enhance its reporting of fiscal developments, a new *End of year fiscal report* is published for the first time alongside this Pre-Budget Report.** The Report provides detailed retrospective information on the public finances in 2000-01 and 2001-02, including their performance against the fiscal rules and against published forecasts and plans. The *End of year fiscal report* further enhances the Government's commitment to transparency in fiscal policy and brings the UK fully into line with international best practice. It supplements the historical and provisional outturn data published in Annex B of the Pre-Budget Report and in the Financial Statement and Budget Report in accordance with the *Code for fiscal stability*. It shows that the Government was firmly on track to meet its fiscal rules in 2000–01 and 2001–02 with strong surpluses on the current budget in both years and low and stable levels of public sector net debt.

Public spending framework

2.11 Sound public finances that are sustainable over the cycle are a prerequisite for sustainable investment in public services. The fiscal rules underpin the Government's public spending framework and have important consequences for the structure of the budgeting regime. The main elements of the framework are:

- firm and fixed three-year Departmental Expenditure Limits (DEL) to help departments to plan and manage resources with greater certainty over the medium term;

- Annually Managed Expenditure (AME) which includes those elements of spending that cannot reasonably be subjected to firm multi-year limits. DEL and AME sum to Total Managed Expenditure (TME);
- separate resource (current) and capital budgets, consistent with the distinction in the fiscal rules. Departments are required to manage these budgets separately, so helping to remove the bias against investment that was present in the previous planning regime;
- full end-year flexibility (EYF), which allows departments to carry forward underspends from one year to the next; and
- Public Service Agreements (PSAs) that commit departments to challenging outcome-focused targets and set out the public service improvements that increased spending will deliver.

2.12 The 2002 Spending Review established departmental spending plans and PSA targets for the three years to 2005-06, consistent with the firm overall limits for public spending set in Budget 2002. Chapter 6 provides further information on the 2002 Spending Review and on the Government's strategy for reforming public services.

Box 2.1: Macroeconomic frameworks in the new global economy

An increasingly integrated global economy offers substantial economic benefits, while also posing new challenges for macroeconomic policy. An analysis of the implications of globalisation for macroeconomic policy-making, *Macroeconomic frameworks in the new global economy*, is published alongside this Pre-Budget Report.

Increased access to global capital brings both new opportunities and greater international competition for investment capital, as investors are able to move their money from one country to another rapidly in response to economic news. As a result, policy credibility has become more important than in the past, and is more quickly rewarded by international capital markets. Conversely, weaker macroeconomic frameworks which lack credibility are now more quickly and severely punished. Credible macroeconomic frameworks that deliver stability are therefore essential to promote stability, and attract and retain domestic and foreign capital.

As economies become more open and integrated, potential sources of economic shocks are likely to widen and shocks themselves will be transmitted more rapidly. Macroeconomic policy frameworks must ensure that economies are sufficiently robust to cope with such shocks, while also allowing flexibility to respond in the most appropriate manner when shocks do occur.

Fixed rules, applied whatever the state of the economy or the nature of the shock, are unlikely to work in the modern global economy. Yet entirely discretionary approaches are equally inadequate, since the temptation for policymakers to respond to short-term pressures and to depart from long-term objectives can be too powerful.

A balanced approach lies in 'constrained discretion' – frameworks that constrain macroeconomic policy to meet clear long-term goals, but which allow policy to respond flexibly in the short term to a variety of shocks without damaging credibility. Frameworks based on constrained discretion need to be underpinned by clear and sound long-term policy objectives, pre-commitment through strong institutional arrangements and procedural rules, openness and transparency, and clear accountability. Countries which have a high degree of transparency and build up a track record of credibility over a long period of time will have greater freedom to implement discretionary responses to shocks, without undermining that credibility and putting stability at risk. The challenge for all countries is to manage the shocks that globalisation can bring, and to capture its benefits by enhancing credibility.

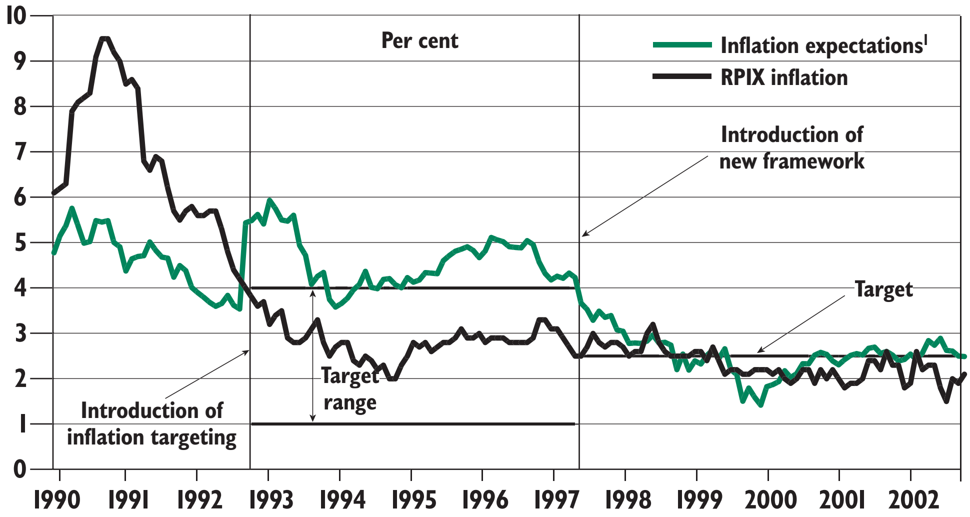
THE PERFORMANCE OF THE FRAMEWORK

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

Monetary strategy

2.14 The monetary policy framework has enhanced the credibility and transparency of economic policy-making and continues to deliver positive results. Since the framework was introduced, RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government's target and within the range outside of which an open letter would be triggered. Long-term inflation expectations, as measured by survey and financial markets data, show that inflation is expected to remain close to the Government's inflation target, having fallen from over four per cent in 1997.

Chart 2.1: Inflation performance and expectations



[1] *Ten-year ahead market inflation expectations.*

2.15 The framework has dealt successfully with unforeseen shocks. The MPC responded promptly and decisively to the global slowdown during 2001 and the events of 11 September by cutting interest rates seven times, and by a total of two percentage points, from six to four per cent. This decisive policy response helped to keep output close to its potential level throughout the year, while ensuring that inflation continued to remain close to target.

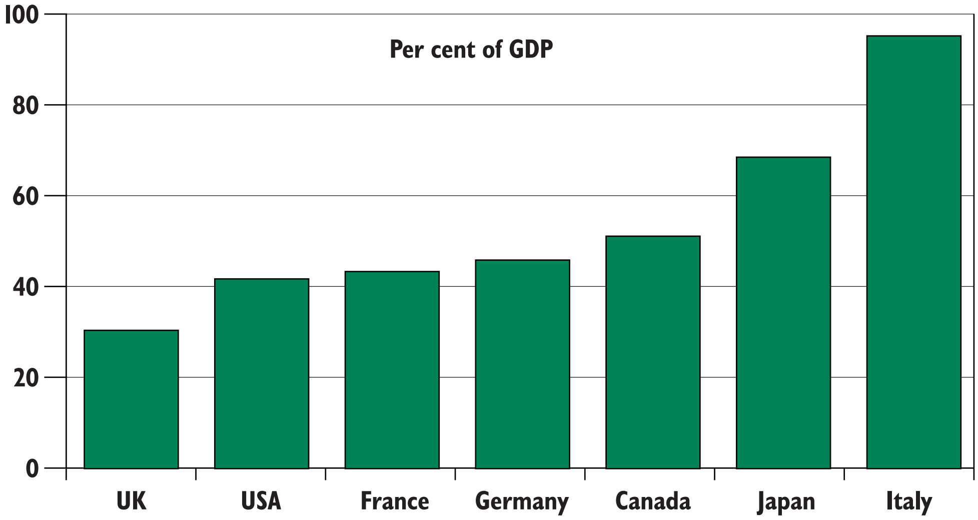
2.16 Since November 2001 the MPC has held official short-term interest rates at four per cent, as buoyant growth in domestic consumption and rising house prices have helped counteract the effect of slower growth in the world economy, weak investment growth and turbulence in foreign exchange and equity markets. Long-term interest rates are around their lowest levels for over 35 years, helping to restrict the size of debt interest payments and freeing up valuable resources for investment in public services. Market expectations reflect investor confidence that the monetary framework will continue to deliver inflation close to target.

Fiscal strategy

2.17 The public finances have been restored to a position of sustainability. As a result of tough decisions on taxation and spending, and with the benefits of greater economic stability, fiscal policy was tightened in structural terms by over 4 percentage points of GDP between 1996-97 and 2000-01, supporting monetary policy during a period when the economy was generally above trend.

2.18 These actions, including the use of the £22.5 billion proceeds from the auction of spectrum licences, have allowed the Government to repay more than £50 billion of debt since 1996-97. Public sector net debt has been reduced from 44 per cent of GDP in 1996-97 to under 31 per cent of GDP – lower than that in any other G7 economy. Low and stable debt levels, combined with accumulated current budget surpluses over the course of the economic cycle, have allowed the automatic stabilisers to operate fully, helping to limit the impact of the more recent global slowdown on the UK economy.

Chart 2.2: OECD projections of general government net financial liabilities for G7 countries, 2002



Source: OECD Economic Outlook June 2002.

2002 Spending Review

2.19 Significant investment in the reform and modernisation of public services has been delivered within this framework. The 2002 Spending Review[3] established departmental spending plans for the three years to 2005-06, and for the five years to 2007-08 for UK spending on the NHS, consistent with the firm overall 'envelope' set in Budget 2002 and within the Government's strict fiscal rules.

2.20 Total managed expenditure (TME) is set to rise by 4.3 per cent a year, on average, in real terms, over the Spending Review period. Within this, the Government has been able to devote additional resources to priority public services. Social security payments, tax credits and debt interest payments will account for just 23 per cent of the additional public spending planned over the next three years, compared with 57 per cent between 1991-92 and 1996-97. Debt interest payments have fallen by £7 billion since 1996-97, and are expected to have fallen by almost 4 per cent a year, on average, over the period 1996-97 to 2005-06, compared with an average annual increase of more than 6 per cent between 1991-92 and 1996-97. To address the legacy of under-investment in public services, public sector net investment, already planned to be almost three times higher this year than in 1997-98, is projected to rise still further to $2^1/_4$ per cent of GDP in 2007-08. Further details are set out in Chapter 6.

[3] *Opportunity and security for all: investing in an enterprising, fairer Britain*, HM Treasury, July 2002.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.21 During the first half of 2002, a recovery in world trade and industrial production provided clear evidence that a global economic recovery was underway. However, the immediate outlook for the world economy has weakened in more recent months as corporate accounting scandals, further falls on world equity markets, developments in the Middle East and rising oil prices have compounded existing uncertainty over world economic prospects. Consequently, the global economic recovery currently appears to have less momentum than was anticipated earlier in the year.

Table 2.1: Summary of world forecast

	Percentage changes on a year earlier				
	Outturn	Forecast			
	2001	2002	2003	2004	2005
Major 7 countries[1]					
Real GDP	½	1½	2¼	3	2¾
Consumer price inflation[2]	1½	1¾	1¼	1½	1½
World trade in goods and services	½	2	5½	8¾	7½
UK export markets[3]	1	1½	5	8	6½

[1] *G7: US, Japan, Germany, France, UK, Italy and Canada.*
[2] *Final quarter of each period. For UK, RPIX.*
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

2.22 In an integrated global economy, no country can remain immune to these developments, and the emergence of new challenges and risks has further affected already fragile business confidence across the industrialised world. As a result, and mirroring developments in most other major economies, the corporate sector in the UK has reduced investment spending, and the strengthening in activity has been weaker than forecast in Budget 2002.

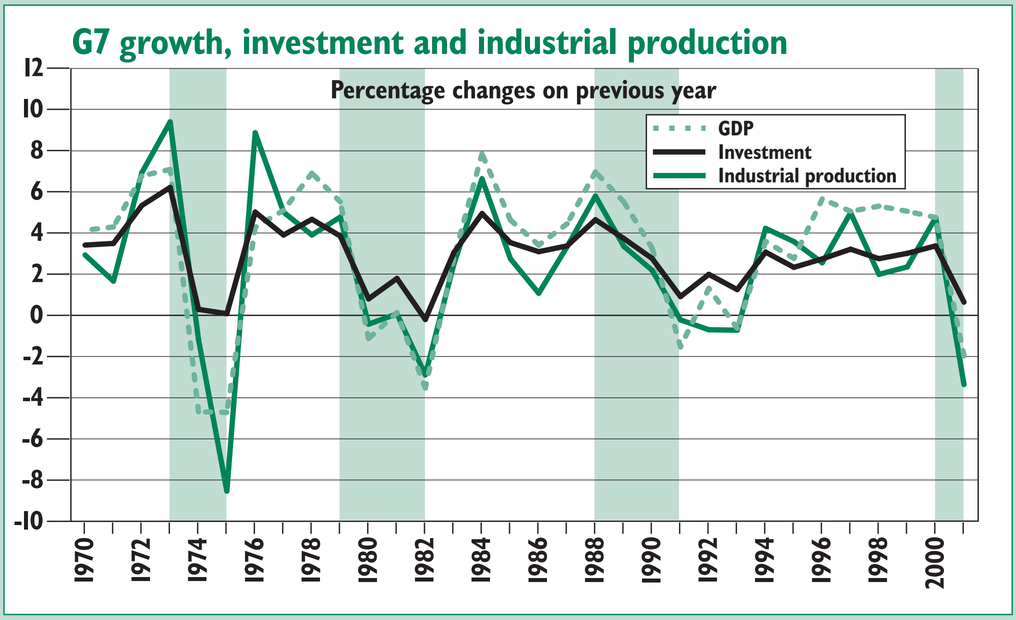
2.23 Nonetheless, UK GDP growth has strengthened since the beginning of this year, following the marked slowdown in the world economy in 2001. The Government's reforms to the macroeconomic framework are ensuring that the UK faces challenges in the global economy from a position of underlying strength, with low inflation and sound public finances. Historically low interest rates, a robust labour market, further gains in house prices and strong consumer confidence, have underpinned solid growth in household consumption and allowed the UK to maintain stability despite an uncertain global recovery. UK GDP rose by 0.8 per cent in the third quarter of 2002, to stand 1.8 per cent up on a year earlier.

Economic prospects

2.24 Table 2.2 summarises the outlook for UK growth and inflation. GDP growth for 2002 as a whole is now expected to be 1.6 per cent, below the Budget forecast. However, sound fundamentals mean that the UK economy is well placed to respond positively when the world economic recovery gathers momentum.

Box 2.2: Global economic slowdowns

During 2001 growth slowed significantly and simultaneously in the US, Europe and Asia for the first time for almost thirty years, and the world's three largest economies – the US, Germany and Japan – were all in recession.



A striking feature of the slowdown was that it was accompanied by falling investment and industrial production in nearly all of the major advanced economies. Industrial production in the G7 economies fell by 3.3 per cent in 2001 while whole-economy investment fell by two per cent. Both contracted more sharply than at any other time in the past 20 years.

World trade growth slipped from 12 per cent in 2000 to a near standstill in 2001 as a result of the synchronised slowdown in economic growth and the collapse in demand for highly traded investment goods. World trade picked up in the first half of 2002 and is expected to grow by two per cent over the year.

The global outlook in 2002 has been affected by fresh uncertainties that have prompted further falls in stock markets around the world and increases in oil prices. Like any other economy, the UK is not immune to these events. While on previous occasions, particularly in the mid-1970s, early 1980s and early 1990s, the UK has suffered more than its competitors from global turbulence and experienced more severe slowdowns, on this occasion the stability delivered by this Government's macroeconomic framework has allowed the UK economy to remain in a strong position.

While a number of major economies saw falls in output last year, the UK continued to grow, and at the fastest rate of all G7 economies. This year, amid new uncertainties and risks, the economy continues to experience the longest unbroken economic expansion on record. The resilience of the labour market also sets the UK apart from most other industrialised countries, many of which have seen unemployment rates rise significantly since the slowdown began in 2001. UK unemployment, at 5.3 per cent, is currently the lowest among the G7 economies for the first time since the 1950s.

2.25 The effects of continuing global uncertainty and equity price falls are expected to restrain UK GDP growth at slightly below-trend rates through to the middle of next year. Thereafter, GDP is expected to see a period of above-trend growth as recovery in the world economy becomes more firmly established and gathers pace, allowing slack in the UK economy to be taken up. Growth is forecast to rise to between $2^1/_2$ to 3 per cent next year and to reach 3 to $3^1/_2$ per cent in 2004, before returning to trend by the end of 2005.

Table 2.2: Summary of UK forecast

	Outturn	Forecast			
	2001	2002	2003	2004	2005
GDP growth (per cent)	2	$1^1/_2$	$2^1/_2$ to 3	3 to $3^1/_2$	$2^3/_4$ to $3^1/_4$
RPIX inflation (per cent, Q4)	2	$2^1/_2$	$2^1/_4$	$2^1/_2$	$2^1/_2$

2.26 Private investment, which has been particularly affected by uncertainties surrounding the global environment this year, is expected to pick up during 2003 as strengthening global demand, reduced uncertainty and improvements in corporate finances increase confidence and encourage the business sector to pursue more expansive investment strategies. Government investment is also forecast to expand further in 2003, as significant increases in resources are directed to priority public services, in accordance with the Government's plans and within the fiscal rules. A gathering in the pace of external demand growth from the middle of next year should also provide a renewed impetus to exports, with export growth expected to be above its long-run average in both 2004 and 2005. Higher demand for investment goods and rising external demand should help the manufacturing sector to build on the stabilisation in output seen through this year.

2.27 Growth in household consumption is forecast to be more moderate than in recent years as the delayed effects of stock market falls and weaker income growth take hold and the appetite for further increases in debt recedes. With stronger growth in investment and export demand, but weaker growth in private consumption, GDP growth is expected to become more balanced over the forecast period.

2.28 After moving back to target at the end of this year, RPIX inflation is expected to fall slightly below the Government's $2^1/_2$ per cent target next year with downward pressure from slack in the economy. It is forecast to return to target by 2004 as the effects of a pick-up in import prices and the economy accelerating back to trend work through.

Forecast risks

2.29 Heightened global uncertainty is reflected in upside and downside risks to the UK forecast. On the upside, the accommodating stance of fiscal and monetary policy in the US or a diminution of tensions in the Middle East could give rise to a stronger than anticipated recovery in global demand. Similarly, the Government's reforms to boost productivity have the potential to improve the trend rate of growth of the UK economy over the medium term.

2.30 Global downside risks include those of continued volatility in equity prices, a delayed recovery in business investment, renewed rises in oil prices, and the prospect of current account imbalances unwinding in a disorderly way. Domestic downside risks include the possibility of a sharp correction in house prices in the event of further steep growth, and the emergence of inflationary pressures in the labour market. Both monetary and fiscal policies must remain vigilant to these risks. Low and stable inflation improves the ability of the MPC to respond to risks to the symmetrical inflation target, while the Government will continue to base projections of the public finances on cautious assumptions, including for equity prices and trend growth, and to 'stress test' projections against the cautious case. This helps to ensure that the public finances remain sound, that fiscal policy can support monetary policy over the economic cycle and that the Government remains on track to meet its tough fiscal rules, while remaining vigilant in the face of potential risks.

Box 2.3: Government policy on EMU

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

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

The preliminary analysis supporting the five tests assessment – technical work needed to enable the assessment to be completed within two years of the start of the Parliament – is well underway. A number of supporting studies encompassing the preliminary and technical work will be published alongside the assessment.

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

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

The economic cycle

2.31 Since Budget 2000, the Government's provisional judgment has been that the economy completed a full, albeit short cycle between the first half of 1997 and mid-1999. The current economic cycle therefore began in mid-1999, with output moving slightly above trend in 2000 and the first half of 2001.

2.32 As more data becomes available there is still some doubt as to whether the economy was on trend or just close to trend in mid-1999, so the judgement that the present cycle started in mid-1999 rather than in the first half of 1997 remains provisional. Paragraph 2.51 shows that this judgement does not affect the fact that the Government remains firmly on track to meet its fiscal rules over the economic cycle. The average current budget since 1997-98 and since 1999-2000 remains comfortably in surplus in every year of the projection period.

Caution and the public finance projections

2.33 A prudent view of trend growth is one of several assumptions that are independently audited by the Comptroller and Auditor General under a three-year rolling review to ensure that they remain reasonable and cautious. A complete list of these assumptions is set out in Annex B. This cautious 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, economic or fiscal shocks will require unexpected changes in plans for taxation or spending.

2.34 For this Pre-Budget Report, the Comptroller and Auditor General has audited the assumptions relating to oil prices, anti-tobacco smuggling measures and VAT that underpin the public finances projections. All three were deemed to be reasonable and to incorporate caution.[4]

2.35 The Government is launching a comprehensive new strategy for tackling VAT fraud, avoidance and non-compliance, details of which are set out in Chapter 5 and in *Protecting indirect tax revenues*, published alongside the Pre-Budget Report. Consistent with previous cautious practice, the update to the relevant assumption which takes account of the direct and preventive impacts of this strategy, but not of the deterrent effects, has been audited by the Comptroller and Auditor General.

RECENT FISCAL TRENDS AND OUTLOOK

2.36 The public finance projections in the Pre-Budget Report have a different status to those produced at the time of the Budget. They represent an interim forecast update and not necessarily the outcome that the Government is seeking. The fiscal effects of firm decisions announced since Budget 2002 and in this Pre-Budget Report have been incorporated into the fiscal projections in accordance with the requirements of the *Code for fiscal stability*.

2.37 Since Budget 2002, the immediate outlook for the world economy has weakened as concern over corporate accounting standards and events in the Middle East have led to further falls on world equity markets and a rise in oil prices, compounding uncertainty over world economic prospects. Even under cautious assumptions, disciplined management of the public finances means that the Government can allow the automatic stabilisers to operate in full during this period, while remaining on track to meet the fiscal rules over the cycle, including in the cautious case. Full details of changes in taxation and expenditure since the Budget are set out in Annex B.

[4] *Audit of Assumptions for the 2002 Pre-Budget Report*, National Audit Office, November 2002.

Table 2.3: Fiscal balances compared with Budget 2002

	Outturn	Projections				
	2001–02	**2002–03**	**2003–04**	**2004–05**	**2005–06**	**2006–07**
Surplus on current budget (£ billion)						
Budget 2002	**10.6**	**3.2**	**7**	**9**	**7**	**9**
Effect of forecasting changes	–3.0	–7.9	–12	–7	–3	–1
of which: effect of automatic stabilisers	*–0.6*	*–5.8*	*–9*	*–5*	*–1*	*0*
effect of other non-discretionary factors	*–2.4*	*–2.1*	*–4*	*–2*	*–2*	*–1*
Effect of policy decisions since Budget 2002	—	–1.0	1	0	1	1
PBR 2002	**7.7**	**–5.7**	**–5**	**3**	**5**	**8**
Net borrowing (£ billion)						
Budget 2002	**1.3**	**11.2**	**13**	**13**	**17**	**18**
Effect of forecasting changes	–0.2	7.8	12	6	2	1
of which: effect of automatic stabilisers	*0.6*	*5.8*	*9*	*5*	*1*	*0*
effect of other non-discretionary factors	*–0.8*	*2.0*	*4*	*2*	*1*	*1*
Effect of policy decisions since Budget 2002	—	1.0	–1	0	–1	–1
PBR 2002	**1.2**	**20.1**	**24**	**19**	**19**	**19**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2002[1]	1.0	0.5	0.6	0.7	0.6	0.7
PBR 2002	**0.7**	**0.2**	**0.3**	**0.6**	**0.5**	**0.6**
Cyclically-adjusted public sector net borrowing (per cent of GDP)						
Budget 2002[1]	0.2	0.9	1.2	1.2	1.4	1.4
PBR 2002	**0.2**	**1.2**	**1.5**	**1.3**	**1.5**	**1.5**
Net debt (per cent of GDP)						
Budget 2002[1]	30.4	30.2	30.4	30.4	30.7	31.0
PBR 2002	**30.4**	**31.0**	**32.1**	**32.4**	**32.6**	**32.7**

Note: Figures may not sum due to rounding.
[1] The 2001-02 figures were estimates in Budget 2002.

2.38 Table 2.3 compares the medium-term projections for the current budget, net debt and net borrowing with those produced in Budget 2002. The impact of the automatic stabilisers, other non-discretionary factors and policy decisions since Budget 2002 are described later in this section.

2.39 The current budget surplus in 2001-02 stood at £7.7 billion, almost £3 billion lower than the estimate published in Budget 2002. At £1.2 billion, the outturn for public sector net borrowing in 2001-02 was very close to the Budget estimate.

2.40 Looking forward, the projections for the current budget and net borrowing are temporarily weaker than projected at the time of the Budget, largely reflecting the cyclical impact of the automatic stabilisers on receipts. A deficit on the current budget of £5.7 billion is now expected for 2002-03, while public sector net borrowing is expected to be £20.1 billion. In the medium term, the projections return towards the Budget profile as the economy returns to trend.

2.41 Table 2.3 also sets out estimates of the underlying structural position of the fiscal balances, adjusted for the estimated impact of the economic cycle. On this basis, the projections for the current budget and for net borrowing remain close to the Budget 2002 profile. A cyclically-adjusted surplus on the current budget of 0.2 per cent of GDP is expected in 2002-03, while net borrowing is expected to be equivalent to 1.2 per cent of GDP. In structural terms, the current budget is in surplus in each year of the projection period.

2.42 Table 2.4 sets out the impact on the current budget of changes since Budget 2002 attributable to the operation of the automatic stabilisers, other non-discretionary factors and policy decisions since Budget 2002. The impact of the different factors on public sector net borrowing is very similar, as the projections for public sector net investment are little changed.

Table 2.4: Factors behind changes to the current budget since Budget 2002

£ billion			Projections		
	2002-03	2003-04	2004-05	2005-06	2006-07
Automatic stabilisers	–5.8	–9	–5	–1	0
Other non-discretionary factors	–2.1	–4	–2	–2	–1
Policy decisions since Budget 2002	–1.0	1	0	1	1
Total change	**–8.9**	**–12**	**–6**	**–2**	**–1**

Note: Figures may not sum due to rounding. A positive number reflects a higher current surplus.

2.43 The table shows that the automatic stabilisers account for £5.8 billion of the change in the current budget in 2002-03, and £9 billion in 2003-04. The change in the automatic stabilisers declines over the forecast period as the economy returns to trend. These estimates of the changes in the size of the automatic stabilisers are based on the average impact of changes in the output gap on the public finances over previous cycles.[5] They reflect both the direct impact of changes in GDP and its components, and other factors that are determinants of tax receipts, including changes in asset prices, to the extent that they have been related to changes in the output gap in the past.

Changes in receipts

2.44 The changes to the projections of the current budget mostly reflect updated projections of receipts which are expected to be weaker this year and over the next two years. Table 2.5 decomposes the changes to the projections of receipts into NAO-audited assumptions, financial company profits and other economic and forecasting effects. Each of these contributes – to differing extents – both to the change in the automatic stabilisers and to other non-discretionary factors. Table 2.5 shows that the difference in receipts is larger in 2003-04 than in 2002-03, reflecting the delayed impact of weaker growth and further falls in equity prices during this year. The factors are explained in more detail in Annex B. They include:

- the impact of the NAO-audited assumptions, particularly on equity prices which are 25 per cent lower throughout the forecast period than assumed in Budget 2002, affecting capital taxes, stamp duty on equities and corporation tax. The audited assumption requires equity prices to rise from existing levels in line with money GDP, reducing receipts by £3½ to £4 billion in every year from 2003-04 relative to the Budget 2002 projections. Applying this cautious assumption will tend to affect the non-discretionary factors shown in Table 2.4 throughout the forecast;
- revisions to the tobacco and VAT assumptions, that partly offset the impact of lower equity prices, and impact as non-discretionary factors. The revisions have been audited by the NAO to ensure they remain reasonable and cautious;
- financial company profits, which have continued to be affected by the current downturn in international capital markets and global economic uncertainty, but are expected to return to trend in the medium term, and therefore have only a temporary impact on the forecast; and

[5] *Fiscal policy, public finances and the cycle*, HM Treasury, 1999.

- other economic and forecasting effects, which are weaker than in the Budget this year and next as the economy remains below trend, but become positive in the medium term, partly as a result of changes to the composition of GDP. This is explained in more detail on a tax-by-tax basis in Annex B.

Table 2.5: Changes in current receipts since Budget 2002

£ billion			Projections		
	2002–03	2003–04	2004–05	2005–06	2006–07
Effect on receipts of changes in:					
Assumptions audited by the NAO	**0**	**–3½**	**–3**	**–2½**	**–1½**
of which: Equity prices	*–1*	*–3½*	*–4*	*–4*	*–4*
Revised tobacco and VAT assumptions	*0*	*½*	*1½*	*2*	*2*
Financial company profits	**–5**	**–5**	**–3½**	**–1½**	**–1**
Other economic and forecasting effects[1]	**–2½**	**–3½**	**½**	**2**	**2½**
Total before policy changes	**–8**	**–12**	**–6**	**–2**	**0**
Policy decisions since Budget 2002 affecting receipts	½	½	½	½	1
Total change	**–7½**	**–11½**	**–5½**	**–1½**	**½**

Note: Figures may not sum due to rounding.

[1] *Excluding assumptions audited by the NAO.*

2.45 Heightened global uncertainties present risks to the projections for the public finances, underlining the need for vigilance and for caution in projecting the fiscal balances. By basing its projections on cautious assumptions, independently audited by the NAO, and by 'stress-testing' these projections against the cautious case, the Government is ensuring that the public finances remain sound, that fiscal policy can support monetary policy over the economic cycle and that the fiscal rules continue to be met.

Changes in spending

2.46 Projections for DEL up to the end of 2005-06 are based on the 2002 Spending Review allocations, adjusted to take account of changes to certain public sector pension schemes and some other classification changes between DEL and AME which have no impact on overall public spending. Projections for expenditure on AME programmes are higher than those made at the time of the 2002 Spending Review, largely due to an increased forecast of payments made under the coal health compensation scheme and projected investment in London Underground to be delivered through the Public-Private Partnership. These are partly offset by lower projections for social security spending, reflecting a downward revision to the inflation forecast since Budget 2002. In line with the convention adopted in previous Pre-Budget Reports, changes to the forecast for AME programmes have been offset in the AME margin.

Discretionary policy changes

2.47 In considering the impact of additional discretionary policy changes on the fiscal position, the Government has taken into account the following factors:

- the importance of ensuring the fiscal rules are met over the cycle;
- its broader, medium-term objectives for fiscal policy, including the need to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- the need to ensure that fiscal policy supports monetary policy.

Box 2.4: Public finances in the EU and the US

The global economic slowdown has had a significant impact on fiscal positions across the industrialised world.

The table below shows that budget deficits in the EU and the US this year and next year are now expected to be greater than anticipated earlier in the year. In 2002, the OECD estimates that this is mostly explained by increases in cyclically-adjusted net borrowing. In 2003, the impact of the automatic stabilisers also explains part of the increases, except in Germany.

Revisions to forecasts for general government net borrowing

	General government net borrowing (per cent of GDP) 2002		2003	
	June 2002	November 2002	June 2002	November 2002
Germany	2.8	3.7	2.1	3.3
France	2.0	2.7	1.8	2.9
Italy	1.4	2.3	1.3	2.1
Euro area	1.5	2.2	1.2	2.1
United States	1.0	3.1	0.7	3.0
	Cyclically-adjusted general government net borrowing (per cent of GDP) 2002		**2003**	
	June 2002	**November 2002**	**June 2002**	**November 2002**
Germany	1.5	2.7	1.1	2.3
France	1.8	2.5	1.8	2.6
Italy	0.4	1.6	0.5	1.2
Euro area	0.7	1.6	0.7	1.4
United States	0.7	2.7	0.5	2.5

Source: OECD.

The Pre-Budget Report forecast for UK general government net borrowing (the Treaty deficit) is set out in Table 2.6. While general government net borrowing is forecast to be about one percentage point higher in 2002-03 and 2003-04 compared with the Budget 2002 forecast, in cyclically-adjusted terms the increase is 0.3 percentage points in both years. The developments have to be seen in the context of the overall sustainability of the public finances. Table 2.6 also sets out the forecast for UK general government gross debt (Treaty debt), which is one of the lowest in the EU.

2.48 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all firm decisions announced in this Pre-Budget Report or since Budget 2002, including the abolition of North Sea Royalty payments and further measures to tackle tax avoidance and establish a modern and fair tax system. To ensure that resources are available to meet the UK's defence and overseas needs in the fight against global terrorism, this Pre-Budget Report also makes available an additional provision of £1 billion this year to be held in a special reserve. The fiscal impact of these and other measures is set out in Table B4, which shows that policy measures announced since Budget 2002 cost the Exchequer £1 billion in 2002-03, but yield £0.6, £0.4 and £0.5 billion in the following three years. The projections do not take account of measures proposed in this Pre-Budget Report for consultation prior to Budget 2003, including increases in the standard rate of landfill tax, or other proposals where final decisions have yet to be taken. Decisions on such measures will be taken in the Budget, and along with revised forecasts for the economy and the public finances, will impact on the final Budget forecast.

Fiscal position and medium-term prospects

2.49 Table 2.6 presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government remains on track to meet its strict fiscal rules over the economic cycle.

Table 2.6: Summary of public sector finances

	Per cent of GDP						
	Outturn[1]	Projections					
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Fairness and prudence							
Surplus on current budget	0.8	–0.5	–0.4	0.2	0.4	0.6	0.7
Average surplus since 1999-00	1.7	1.2	0.8	0.7	0.7	0.7	0.7
Cyclically-adjusted surplus on current budget	0.7	0.2	0.3	0.6	0.5	0.6	0.7
Long-term sustainability							
Public sector net debt	30.4	31.0	32.1	32.4	32.6	32.7	33.0
Core debt	30.3	30.3	30.6	30.6	30.8	31.0	31.3
Public sector net worth[2]	26.5	26.7	22.2	20.6	19.5	19.0	17.9
Primary balance	1.7	–0.3	–0.6	0.0	0.0	0.1	0.0
Economic impact							
Public sector net investment	0.9	1.4	1.8	1.9	2.0	2.1	2.2
Public sector net borrowing (PSNB)	0.1	1.9	2.2	1.6	1.6	1.5	1.5
Cyclically-adjusted PSNB	0.2	1.2	1.5	1.3	1.5	1.5	1.5
Financing							
Central government net cash requirement	0.3	1.8	2.8	1.9	1.7	1.9	1.6
European commitments							
Treaty deficit[3]	0.2	1.8	2.2	1.7	1.6	1.6	1.6
Cyclically-adjusted Treaty deficit[3]	0.2	1.1	1.4	1.3	1.5	1.6	1.6
Treaty debt ratio[4]	38.2	37.9	38.8	38.9	38.9	39.1	39.2
Memo: Output gap	–0.3	–1.3	–1.0	–0.3	0.0	0.0	0.0

[1] *The 2001–02 figures were estimates in Budget 2002.*
[2] *At end-December; GDP centred on end-December.*
[3] *General government net borrowing on a Maastricht basis.*
[4] *General government gross debt.*

Golden rule

2.50 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 is therefore an important indicator of inter-generational fairness. Lower receipts in the short term mean that a current budget deficit of 0.5 per cent of GDP is now expected this year. The deficit is projected to narrow slightly to 0.4 per cent of GDP in 2003-04, before the current budget is restored to surplus from 2004-05, as the economy and financial company profits return towards trend. Strong surpluses on the current budget are projected by the end of the period.

2.51 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the impact of the automatic stabilisers. Progress against the rule is measured by the average surplus on the current budget since the cycle began. The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is comfortably positive throughout the forecast period by at least 0.7 per cent of GDP. On this basis, the Government is firmly on track to meet the golden rule. This is confirmed by the surpluses on the current budget in cyclically-adjusted terms in every year of the projection period. Were the current economic cycle thought to have begun in 1997-98 rather than in 1999-2000, the average currrent budget since the start of the cycle would also be in surplus in each year of the projection period.

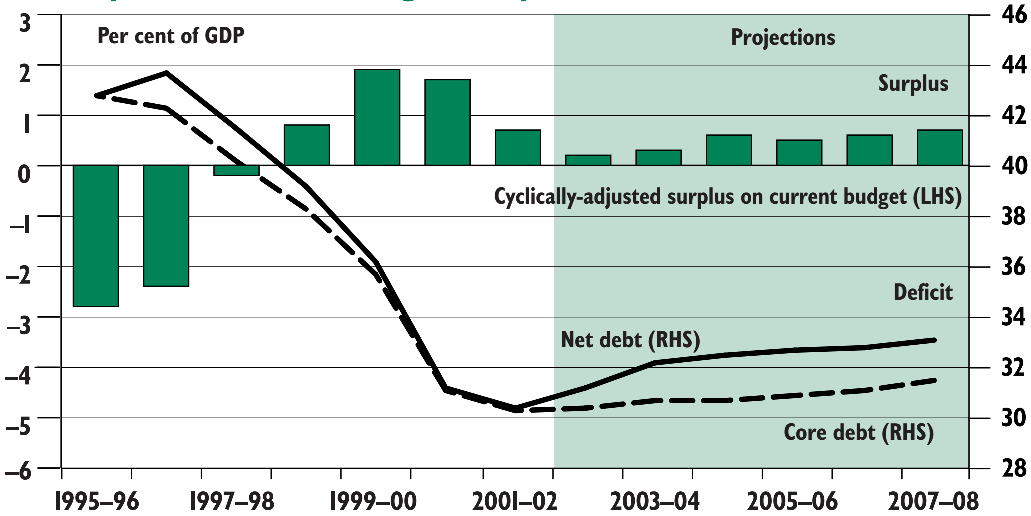
Sustainable investment rule

2.52 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector debt at a low and sustainable level – other things being equal, net debt should be held below 40 per cent of GDP.

2.53 The Pre-Budget Report projections show that, despite continued weakness in the world economy, net debt is expected to remain low and stable, rising slightly from 31 per cent to stabilise around 33 per cent of GDP over the forecast period, comfortably meeting the sustainable investment rule by remaining well below 40 per cent. As a result of sound public finances and greater economic stability, the Government can therefore deliver the significant investment in public services announced in the 2002 Spending Review, while continuing to maintain a buffer against unexpected economic events and wider global instability. Having fallen by £7 billion since 1996-97 to their lowest level as a per cent of GDP since the First World War, debt interest payments are also expected to remain low, ensuring that resources can be directed toward improving front-line public services.

2.54 Chart 2.3 shows the projected net debt ratio and cyclically-adjusted current surplus. It demonstrates that the Government comfortably met the golden rule and the sustainable investment rule over the economic cycle which began in the first half of 1997 and is thought to have come to an end in mid-1999, and that the Government remains on track to meet these firm fiscal rules over the present economic cycle.

Chart 2.3: Meeting the fiscal rules – cyclically-adjusted surplus on current budget and public sector net debt



2.55 Chart 2.3 also illustrates the Pre-Budget Report projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt is estimated in accordance with the methodology published alongside Budget 2002.[6] Economic stability has meant that levels of core debt have been very similar to total net debt over recent years, and a similar relationship is expected over the forecast period. Core debt is projected to rise slowly to just over 31 per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key principle of inter-generational fairness with underpins the fiscal framework.

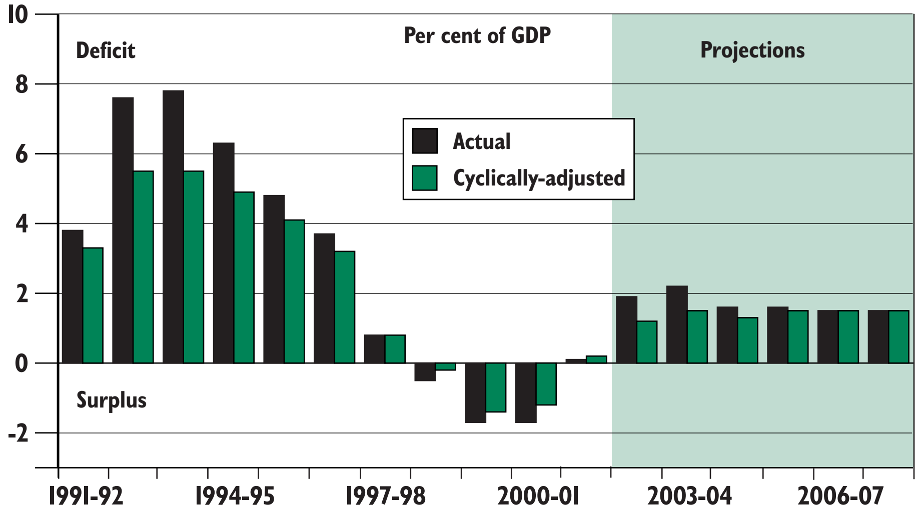
[6] *Core debt – an approach to monitoring the sustainable investment rule*, HM Treasury, April 2002.

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

Economic impact

2.57 While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.4 sets out the interim projections for actual and cyclically-adjusted net borrowing.

Chart 2.4: Public sector net borrowing – actual and cyclically-adjusted



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

Financing

2.59 As a result of the new projections for the fiscal balances, the forecast for the central government net cash requirement for 2002-03 has been revised from £13.5 billion to £18.7 billion, an increase of £5.2 billion. Accordingly, it has been decided to meet the increase financing requirement by:

- increasing gilt sales by £3.8 billion to £26.2 billion; and
- increasing the run down of the Debt Management Office's net cash position by £1.2 billion, to £6.6 billion.

2.60 Full details and a revised financing table can be found in Annex B.

European commitments

2.61 The Pre-Budget Report projections comfortably meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (three per cent of GDP) throughout the projection period. The projections are consistent with the Government's prudent interpretation of the Stability and Growth Pact, which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). Based on cautious assumptions and consistent with the Government's fiscal rules, the cyclically-adjusted Treaty deficit is projected to remain at or below 1.6 per cent of GDP throughout the projection period. General government gross debt, the Treaty measure, remains consistently well below the 60 per cent reference value, ensuring the public finances are sustainable.

Box 2.5: The Stability and Growth Pact

The Stability and Growth Pact was finalised at the European Council in June 1997 to ensure that EU member states maintain sound and sustainable government finances through the medium-term budgetary objective of "close to balance or in surplus".

Fiscal sustainability is a pre-condition for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy coordination as set out in the EU Treaty. Building on the Code of Conduct, agreed by member states in June 2001, the Government supports a prudent interpretation of the Stability and Growth Pact which takes into account the following factors:

- **the economic cycle – allowing automatic stabilisers to operate fully and symmetrically over the cycle will ensure that fiscal policy supports monetary policy in smoothing economic fluctuations. It is therefore important to focus on cyclically-adjusted fiscal balances when assessing public finances and subsequent policy decisions;**
- **sustainability – low debt levels enhance the sustainability of the public finances, allow more room for the operation of the automatic stabilisers, and provide a sound basis for investment in public services and reforms to encourage productivity, employment and fairness. In considering the sustainability of public finances, it is necessary to examine the budgetary impact of an ageing population and, where possible, generational accounts. The *Long-term public finance report*, published alongside this Pre-Budget Report, presents such an assessment; and**
- **public investment – against a background of sound public finances and economic stability, public investment contributes to the provision of high quality public services and can help to raise the overall productive potential of the economy. The 2002 Spending Review set new plans to increase public sector net investment in the UK to 2 per cent of GDP by 2005-06 – a five-fold increase compared to 1997–98 – while meeting the fiscal rules and maintaining low levels of debt.**

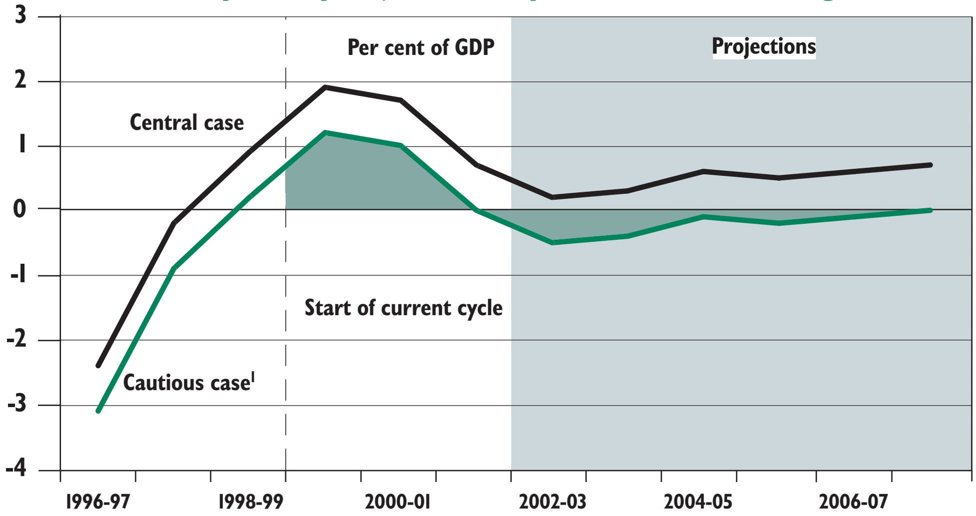
A prudent interpretation of the Pact will lock in longer-term fiscal discipline and sustainability, enhancing credibility, while allowing the automatic stabilisers to smooth fluctuations in output, and enabling appropriate increases in investment in public services.

Dealing with uncertainty

2.62 Fiscal balances represent the difference between two large aggregates, and forecasts of them are inevitably subject to wide margins of error. The use of cautious assumptions audited by the NAO builds an allowance into the public finance projections to guard against unexpected events. To accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is $^1/_4$ percentage point lower than its neutral view.

2.63 A second important source of potential error results from misjudging the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections 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. This margin for error is particularly important given continued global uncertainties and risks to the forecast. Chart 2.5 illustrates the Pre-Budget Report projection for this cautious case.

Chart 2.5: Cyclically-adjusted surplus on current budget



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

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

LONG-TERM FISCAL SUSTAINABILITY

2.65 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.*

2.66 **A new analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report**[7]. The report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances. It updates the illustrative long-term fiscal projections set out in Budget 2002[8] and confirms the findings of the Budget projections.

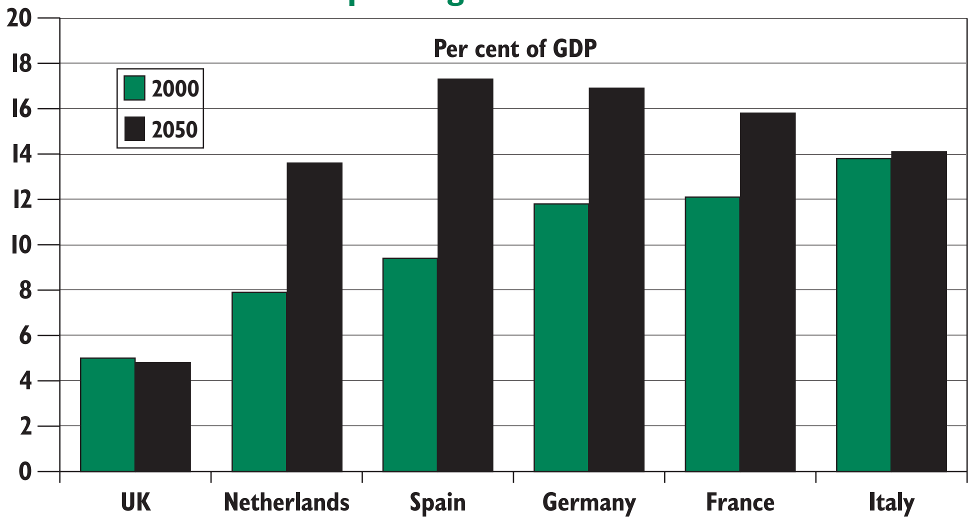
[7] *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, November 2002.

[8] *Illustrative long-term fiscal projections*, Annex A of the Economic and Fiscal Strategy Report, Budget 2002.

2.67 Based on reasonable assumptions, the report shows that the public finances are sustainable in the longer term, and that current policies impact fairly between generations. Given the projected profiles for tax revenues and transfers, current consumption can grow slightly faster than GDP growth in the long term while still meeting the golden rule. Public sector net investment can grow close to the economy's growth rate over the 30-year projection period without jeopardising the sustainable investment rule, and the net debt to GDP ratio is projected to remain below 40 per cent.

2.68 The report also shows that the changing demographic structure of the UK's population is expected to have only a limited impact on the public finances over the coming decades. This is in contrast with many other developed countries, in which spending pressures arising from an ageing population are much greater. Chart 2.6 illustrates that, on the assumption of unchanged policies, UK public spending on pensions is projected to remain fairly constant as a proportion of GDP, in contrast to the substantial increases expected in many other EU countries.

Chart 2.6: Pension spending in selected EU countries



Note: UK figures are taken from Chart 6.5 of the Long-term public finances report *and are for 2001-02 and 2051-52 respectively.*
Sources: Table 3.5, EPC Working Group on Ageing (2001) and HM Treasury.

2.69 The report presents a series of additional indicators, including generational accounts, fiscal gaps and projections of spending on education, pensions, health and long-term care – together, about half of all public spending. These indicators confirm the overall result that that UK fiscal position is sustainable in the long term and that the UK is in a strong position relative to many other developed countries. They also demonstrate that there is a high degree of inter-generational fairness, particularly when account is taken of announced increases in public investment which will benefit both current and future generations.