2 MAINTAINING MACROECONOMIC STABILITY

The UK economy is currently experiencing its longest unbroken expansion on record, with GDP now having grown for 57 consecutive quarters.

Growth of the UK economy since Budget 2006 has been higher than forecast, with slightly above-trend growth narrowing the output gap. Domestically, growth has been driven by higher than expected business investment. Externally, the recovery in the euro area has boosted export growth. Together, these developments have further helped to rebalance UK economic growth.

The 2006 Pre-Budget Report projections for the public finances 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.**

An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2006 *Long-term public finance report*. The report confirms that on the basis of current policies the public finances are sustainable in the long term.

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 57 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.

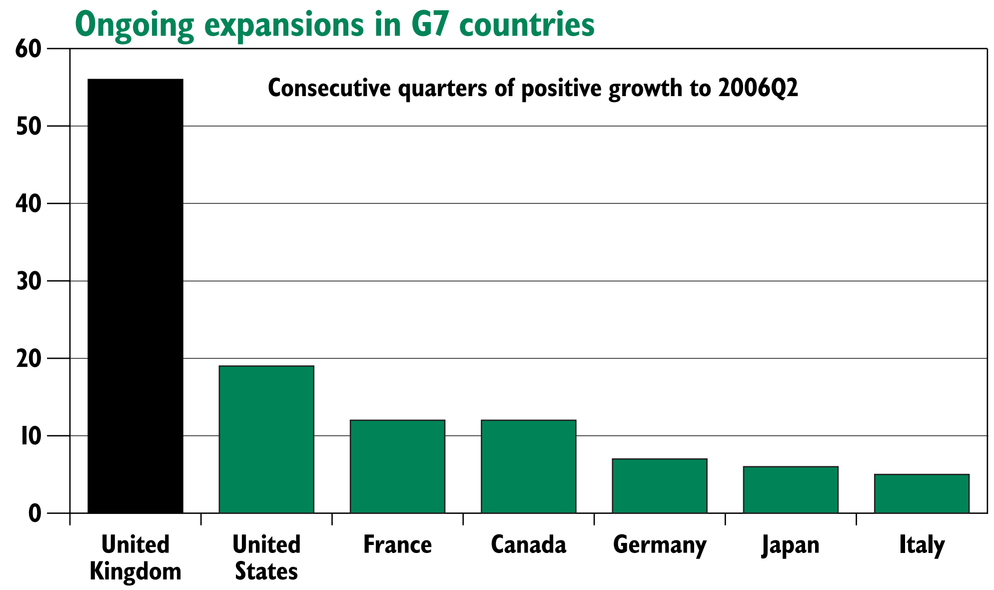
2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability.[1] The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over 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

Box 2.1: Economic stability

The Government's macroeconomic framework is delivering economic stability, with both sustained growth and low inflation. Stability promotes economic performance through:

- **establishing domestic resilience and enabling policy flexibility in the face of economic shocks;**
- **giving firms and individuals the best macroeconomic environment in which to make decisions about the allocation of resources; and**
- **avoiding the erosion of human and physical capital that is associated with volatile swings in output.**



Source: OECD Economic Outlook 79.

The UK economy has now expanded in 57 consecutive quarters, an unprecedented period of unbroken growth since the quarterly National Accounts began. This prolonged expansion is not only without precedent in the post-war history of the UK, but is also the longest on post-war record for any G7 economy and the longest ongoing expansion of any OECD country.

It will be at least nine years before the UK's current expansion could be eclipsed by another G7 country. The next longest ongoing expansion in a G7 economy is in the US, where growth has been unbroken for just under five years. This compares with the UK where there have been positive rates of growth for over 14 years.

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 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.

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.

2.8 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

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

- 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 The framework for co-operation on financial stability between the Bank of England, the Financial Services Authority (FSA) and HM Treasury is set out in the 2006 Memorandum of Understanding.[3] The Memorandum of Understanding between the three authorities defines the roles and responsibilities of the three authorities in maintaining financial stability, and for financial crisis management and in responding to operational disruptions to the financial sector.

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 to the financial system. 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, coordinating and agreeing action between the three authorities.

[3] The 2006 Memorandum updates the version published in 1997.

Box 2.2: Independence for statistics

Following the commitment made by the Chancellor in November 2005, and a full public consultation, the Government has introduced to Parliament in this session legislation for the reform of the UK statistical system.

This will build on earlier reforms, helping to reinforce the quality and integrity of statistics produced in government, supporting the Government's agenda for better public services, and contributing to long-term stability in the UK economy.

The bill, introduced on 21 November 2006, will establish an independent Statistics Board, responsible for promoting and safeguarding the quality and comprehensiveness of all official statistics, wherever produced in government. As part of this, the Board will have a statutory duty to set professional standards in a code of practice, and to assess independently all National Statistics against this code.

The Board will also replace Ministers as the top layer of governance for the Office for National Statistics. The Board will be independent of ministerial control, established as a Non-Ministerial Department, with special funding arrangements outside the normal Spending Review process. Following decisions by Northern Ireland, Scotland and Wales to participate in the new arrangements, the full benefits of the legislation will be realised, strengthening the statistical system for users across the UK.

Further details of the Government's proposals, including the Government's public consultation document, the Government's response to the consultation, as well as the bill and associated documentation, can be found on the HM Treasury website at www.hm-treasury.gov.uk.

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.

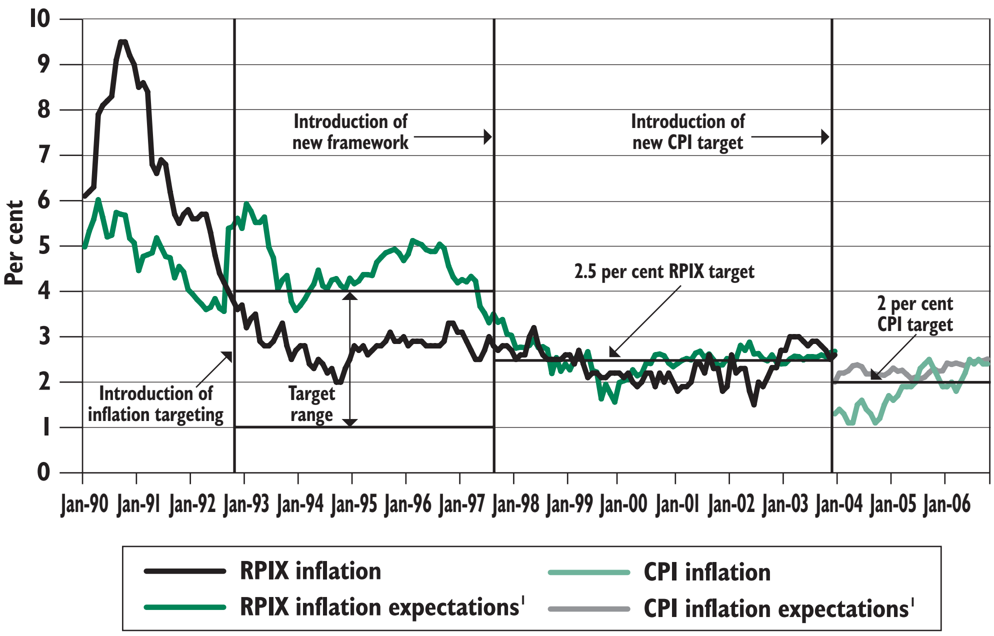
Monetary policy

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 rate of increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target value of $2^1/_2$ 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 $^1/_4$ percentage point in August 2005, responding to the slackening in the pressure of demand on supply. This year, as growth has strengthened and measured inflation has moved above target, the MPC has acted by raising the official Bank rate by 25 basis points in August and November.

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.

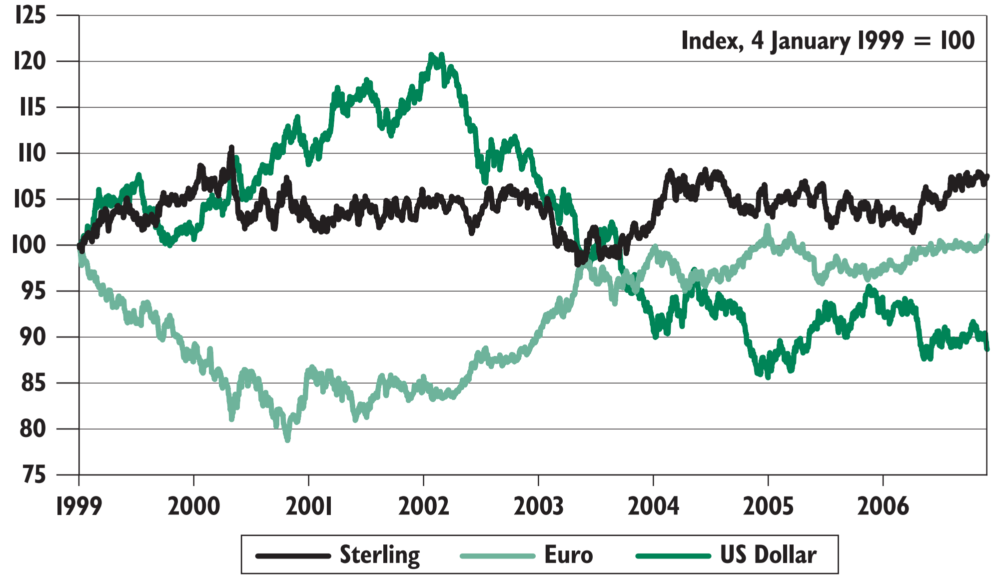
2.15 Low inflation expectations and a period of entrenched macroeconomic stability have helped long-term interest rates remain at historically low levels. Low long-term interest rates reduce the Government's debt interest payments, free up resources for public services and help promote investment. Over 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.

2.16 Ten-year forward rates, which abstract from cyclical influences, are around 0.9 percentage points lower than those in the United States and slightly above those in the euro area.[4] Ten-year forward rates in November 2006, at 4.1 per cent, are at the same rate as a year earlier. 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 under $3^1/_2$ 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 quarter of that of the US dollar.

[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.

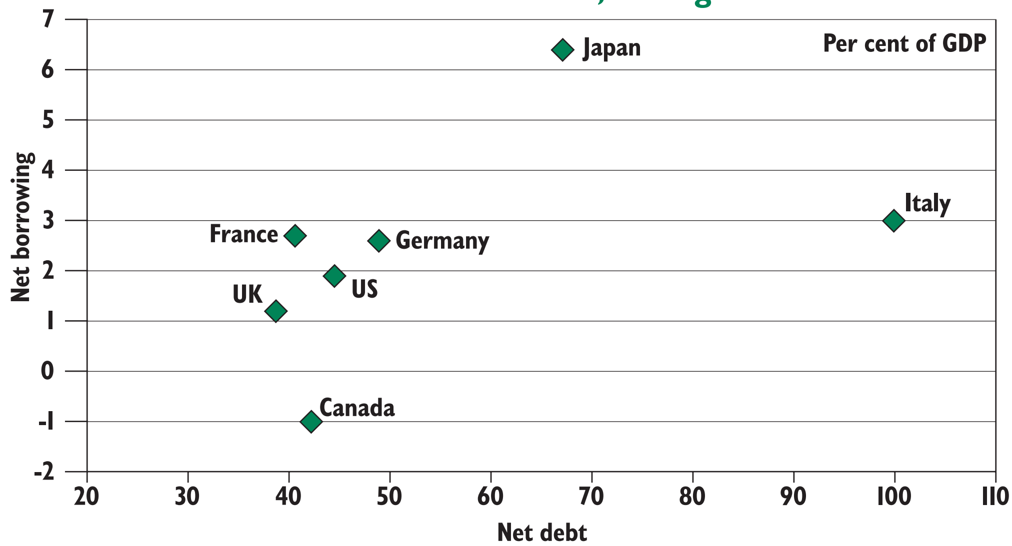
Chart 2.2: Movements in leading effective exchange rate indices since 1999



Source: Bank of England.

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 just over 30 per cent in 2001-02, creating room for an historically unprecedented rise in public sector net investment, which has risen as a share of GDP in six successive years. 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. Net borrowing increased to allow fiscal policy to support monetary policy as the economy moved below trend in 2001, but remained low and stable. Even at its peak during this cycle, borrowing as a share of the economy stayed well below half the rates of the late 1990s. 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 2006



Source: OECD Economic Outlook 79, June 2006

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 2¼ per cent of GDP from 2006-07 onwards, 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 Government's macroeconomic framework has continued to deliver an unprecedented period of sustained economic growth with low inflation. UK GDP has now expanded in 57 consecutive quarters, the longest unbroken expansion since quarterly National Accounts began in 1955, and the longest ongoing expansion among all OECD countries.

2.22 UK GDP growth has been stronger than expected at the time of Budget 2006. GDP has expanded by 0.7 per cent in each of the last four quarters. There has been a greater degree of rebalancing of growth than estimated at Budget 2006. Investment has been growing faster than GDP since the middle of 2005, while private consumption has been growing slightly slower. In particular, business investment in the third quarter of 2006 was up 7 per cent on a year earlier. There has been some rebalancing on the output side of the economy too, where ongoing service sector growth has been supported by some recovery in the manufacturing sector. Finally, there has been some rebalancing between domestic and external sources of demand, supported by the strengthening in euro area growth this year.

Table 2.1: Summary of world forecast

	Percentage change on a year earlier unless otherwise stated				
	Outturn	Forecasts			
	2005	2006	2007	2008	2009
World GDP	4 3/4	5	4 3/4	4 1/2	4 1/2
Major 7 countries[1]					
Real GDP	2 1/2	2 3/4	2 1/4	2 1/2	2 1/2
Consumer price inflation[2]	2 1/2	2 1/2	2 1/4	2	2
Euro area GDP	1 1/2	2 1/2	2	2 1/4	2 1/4
World trade in goods and services	7 1/4	8 3/4	7 1/2	7 1/2	7
UK export markets[3]	5 3/4	7 3/4	6 1/2	6 1/4	6 1/4

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

[2] *Per cent, Q4.*

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

2.23 The world economy is now in its third consecutive year of growth of around 5 per cent. Continued buoyancy in emerging markets, particularly in Asia, is expected to sustain global growth at similar rates in 2007. Since 2003, world growth has been driven by the US and Asia, particularly China. Through 2006, growth in the US has moderated, largely due to lower residential investment. This has been offset by a broadening of the recovery in the euro area, an improvement in growth in Japan and continued momentum in the rest of Asia and other emerging economies.

2.24 World trade has recovered strongly, with growth rising from zero in 2001 to 10 per cent in 2004. Following a 7 1/4 per cent increase in 2005, it is expected to grow by 8 3/4 per cent in 2006 and 7 1/2 per cent in 2007. Growth in world trade has been heavily orientated towards Asia.

Economic prospects

2.25 Given the new evidence published since Budget 2006, the Treasury has reviewed the underpinning assumptions for its post-2006 neutral trend output growth assumption, which it has revised to continue at 2 3/4 per cent a year, consistent with the neutral rate since 2001.

2.26 Since Budget 2006, many external institutions, including the OECD, National Institute of Economic and Social Research, Oxford Economics and Goldman Sachs, have revised up their estimates of the UK's trend rate of output growth in the post-2006 period. The Treasury's 2 3/4 per cent neutral trend output growth estimate for the post-2006 period lies within the range of these external estimates, cited in Box A4. The Treasury's cautious trend output growth assumption of 2 1/2 per cent, used for the purposes of projecting the public finances, is materially below the comparable range of external estimates. The National Audit Office has audited this change to the post-2006 cautious trend growth assumption and has concluded, in light of external forecasts and other information, that the revised assumption is reasonable and cautious.

2.27 With growth in recent years having been stronger and more balanced than was evident at the time of Budget 2006, and that pattern having continued in 2006, the Pre-Budget Report economic forecast is for growth to continue at close-to-trend rates throughout the forecast horizon, to 2009. The output gap is currently estimated to be around -1/4 per cent and is expected to close early in 2007.

2.28 Growth in 2006 is expected to be 2 3/4 per cent, above the Budget 2006 forecast range. Growth in 2007 as a whole is forecast to reach 2 3/4 to 3 1/4 per cent, in line with the Budget forecast, reflecting above-trend growth in the second half of 2006 and early 2007. The recent momentum of business investment in particular is expected to carry through into 2007, and private sector business surveys point to strong output growth in the near term. Favourable supply-side conditions, with subdued growth in earnings and unit wage costs, should also support GDP growth next year. With the output gap closing early in 2007, and in the absence of clear evidence that momentum in the economy will carry output above trend during 2007, the Pre-Budget Report forecast is for growth to be close to trend in the second half of 2007 and to remain at $2^1/_2$ to 3 per cent in 2008 and 2009.

2.29 The rebalancing of growth that has taken place since the beginning of 2005 is expected to continue. Private consumption is forecast to grow at slightly slower rates than the overall economy, reflecting the effect of higher than expected inflation on real incomes, the effect of recent interest rate increases and a higher propensity to save. Business investment gathered momentum in the first three quarters of 2006, growing by $5^1/_4$ per cent on a year earlier, significantly above the Budget forecast range for the year as a whole of 1 to $1^1/_2$ per cent. The outlook for business investment is positive. Profitability is expected to remain strong and the cost of capital to remain low by historical standards. Net trade made a neutral contribution to GDP growth in 2005 and is expected to make a small negative contribution in 2006. With solid underlying export growth and somewhat slower import growth, the impact of net trade on GDP growth is expected to be broadly neutral from 2007.

2.30 CPI inflation is expected to remain above target into the first half of 2007, before quickly returning to target, with monetary policy keeping inflation expectations firmly anchored. The impact of higher food and energy prices, particularly domestic utility tariffs, discussed in Box A6, is expected to unwind during 2007 without having fed through to second-round inflationary pressures. The lack of evidence of any second-round effects on other prices supports the view that the recent rise in inflation will be temporary. It is notable that producers of energy-intensive manufactured goods have passed very little of the rise in input prices on to customers, absorbing the impact in margins. Similarly, average earnings growth has remained subdued. The absence of second-round effects reflects the credibility of the Government's monetary policy framework in successfully anchoring inflation expectations.

Table 2.2: Summary of UK forecast[1]

	Outturn	Forecasts			
	2005	2006	2007	2008	2009
GDP growth (per cent)	$1^3/_4$	$2^3/_4$	$2^3/_4$ to $3^1/_4$	$2^1/_2$ to 3	$2^1/_2$ to 3
CPI inflation (per cent, Q4)	$2^1/_4$	$2^1/_2$	2	2	2

[1] *See footnote to Table A10 for explanation of forecast ranges.*

Risks **2.31** Risks to the 2006 Pre-Budget Report economic outlook are broadly balanced, both globally and domestically.

2.32 The key uncertainty identified in Budget 2006 concerned the tension between cyclical indicators of the degree of slack in the economy and the output gap implied by the trend growth arithmetic. Following National Accounts revisions, particularly those published in the 2006 Blue Book, the coherence between the latest output gap estimate and the cyclical indicators has improved, but considerable uncertainty remains over the extent to which official population and labour supply data adequately measure migration flows. If inflows have been higher than measured, it may imply a greater degree of slack in the economy or more scope for growth.

2.33 Domestic risks are broadly balanced across the components of demand, with potential downside risks to the private consumption forecast, but significant upside risks to business investment growth. Surveys of consumers' saving intentions suggest that the pick-up in the household saving ratio over the past year could continue and exceed the Pre-Budget

Report forecast. Offsetting that, developments in the housing market have been somewhat stronger than expected and could be associated with higher consumption growth. In recent months, survey indicators of manufacturing activity have moderated somewhat, although forward-looking indicators of manufacturing export orders remain strong.

2.34 Despite business investment growth having been revised up in the Pre-Budget Report forecast, there are still significant upside risks. In particular, corporate profitability remains strong, as explained in Box A9, and financing conditions remain benign. Both factors could support stronger growth in business investment while data revisions, including the incorporation of own-account software investment by ONS in summer 2007 (see Box A8), could affect measured business investment growth.

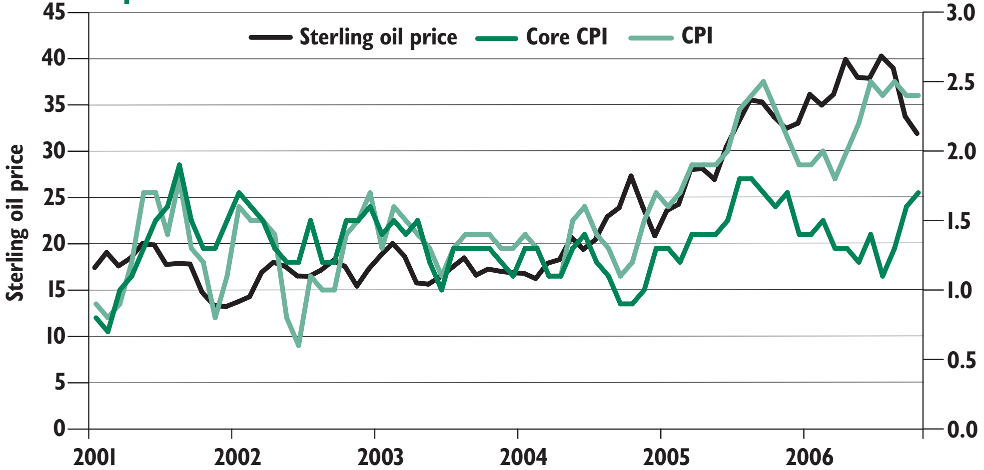
2.35 With CPI inflation currently above target, largely driven by the temporary impact of higher energy and food prices, as outlined in Box 2.3, there is a risk to the forecast from rising inflation expectations and second-round effects on inflation. However, monetary policy has kept inflation expectations firmly anchored and earnings growth has remained subdued.

Box 2.3: The effect of oil prices on the UK economy and public finances

Oil prices have increased sharply since 2004, driven partly by demand from emerging markets. Higher oil prices have adverse effects on the supply side, dampening output and demand and leading to higher consumer inflation. Demand is weakened through the erosion of consumers' purchasing power due to higher fuel costs and added pressure on businesses' profit margins in response to higher production costs.

Whether higher oil prices lead to a temporary increase in consumer inflation or a more sustained rise depends on the extent of second round effects in wages and costs in response to the original increase in oil prices. The initial impact of higher oil prices led to an increase in CPI, which reached 2.5 per cent in June and August this year, with some additional impetus from higher food prices. However, core inflation[a] has remained below 2 per cent, in line with the average of recent years. This is consistent with the lack of evidence of any second-round effects from higher energy and food prices in the UK. However, it is important to remain vigilant. As the Chancellor stated earlier this year in his letter to the Pay Review Bodies, *"It will be important to ensure that public sector pay increases do not contribute to inflationary pressures in the economy going forwards. To do so would risk converting a temporary increase in inflation into a permanent increase. The Pay Review Bodies should therefore continue to base their pay settlements on the achievement of the inflation target of 2 per cent"*.

Impact of oil on headline and core inflation



Oil prices also affect the UK's public finances. While higher oil prices have a positive effect on tax revenues from petroleum revenue tax and North Sea corporation tax, there are a number of offsetting effects that limit the overall impact on the public finances. The scale and timing of these effects is extremely uncertain, as they depend on the responses of individuals and businesses to rising prices. The offsetting effects include:

- **any temporary increase in inflation, which increases the indexation of allowances and limits for income tax and national insurance contributions and of indexation of tax credits and social security benefits. Higher inflation also increases the costs of servicing indexed-linked bonds;**
- **higher petrol pump prices, which reduces the demand for road fuels and therefore reduces revenues from fuel duties; and**
- **possible impacts on the wider economy, for example, if higher input prices reduce companies' profit margins, receipts from non-North Sea corporation tax will fall.**

[a] *Measures of core inflation exclude certain items from the CPI basket whose price effects might be considered to be temporary and/or volatile, for example, energy prices and seasonal food prices.*

Caution and the public finances

2.36 For this Pre-Budget Report, the Comptroller and Auditor General audited the change to the Treasury's post-2006 cautious trend output growth assumption used for the public finances forecasts, which it has revised to continue at $2^1/_2$ per cent a year. The Comptroller and Auditor General found that the Treasury's revised underlying growth rate assumption is below the range of external forecasts of the long term growth rate. It is also at or below the average of external forecasters' medium term growth projections. The review concluded that on this basis the revised Treasury assumption is reasonable and cautious.

2.37 The Comptroller and Auditor General audited the Treasury's equity price assumption and found that the assumption of linking equity price growth to that of money GDP has a theoretical and hence reasonable basis, though in practice, the relationship is unlikely to be valid at all times. The review also concluded that for the 2003 to 2006 period, the assumption proved to be a cautious one for most of the projections of the public finances made in the three years, as outturn equity prices exceeded the Treasury's forecasts.

2.38 The Comptroller and Auditor General also audited the assumption on the consistency of the price indices used to project the public finances with the CPI, which is used in the definition of the inflation target. The review confirmed that over the period 2003 to 2006 the series were, and that for the future they remain, consistent with each other and with the CPI.

Box 2.4: The UK's international and European objectives

In both a global and a European context, there is a need to address the challenges of structural economic reform, resist protectionist pressures and promote free trade. The UK is working 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, tackle unfairness and deliver social justice, and promote environmental stewardship, by:

- **pushing for progress on the commitments made in 2005 by donors to provide an extra $50 billion in aid each year to help achieve the Millennium Development Goals; promoting debt relief for a wider group of countries than the heavily indebted poor countries who have received 100 per cent multilateral debt relief; establishing a $4 billion vaccination programme through the International Finance Facility for Immunisation and catalysing the development of new vaccines through a pilot Advanced Market Commitment scheme;**
- **strengthening the ability of EU and global institutions to respond to global challenges to economic stability – including increasing the IMF's focus on credible and independent surveillance, reforming the IMF's governance and supporting reform of the UN's institutional operations;**
- **promoting structural reform in the EU through the further development of a competitive Single Market equipped for the changing global environment; reform of the EU budget through the fundamental review and improved financial management; radical Common Agricultural Policy reform; measurable reductions in EU administrative burdens, and greater use of a risk-based approach to regulation; and monitoring progress on Lisbon agenda reforms;**
- **ensuring sustainable, reliable and affordable energy sources by promoting transparent and open international energy markets – building on the 2005 Hampton Court summit agenda with EU partners and continuing work on extending the principles of the G7 oil initiative to gas;**
- **building a global consensus, in line with the conclusions of the Stern Review, on the need to stabilise greenhouse gas concentrations and fostering an international response to the threat of climate change by effectively pricing carbon through a global carbon market; promoting investment in low-carbon technologies worldwide; promoting European and international energy efficiency standards; and assisting developing countries to adapt to climate change; and**
- **promoting external openness and a freer and fairer international trading system, in the face of rising protectionism – using the last window of opportunity to deliver an ambitious and pro-development outcome to the Doha Development Round, which increases market access in agriculture, industrial goods and services, ends export subsidies and substantially reduces all trade-distorting domestic support. The Government is also pressing for concrete and credible Aid for Trade financing to help poor countries build their capacity to trade.**

RECENT FISCAL TRENDS AND OUTLOOK

2.39 The public finance projections in the Pre-Budget Report have a different status from 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 projections for the public finances presented below include the effects of firm decisions announced since Budget 2006 and in this Pre-Budget Report, in accordance with the *Code for fiscal stability*.

2.40 The forward-looking fiscal projections described in this section are complemented by the 2006 *End of year fiscal report*, published alongside this Pre-Budget Report, which provides detailed retrospective information on the public finances in 2004-05 and 2005-06.

Table 2.3: Fiscal balances compared with Budget 2006

	Outturn[1]	Estimate[2]			Projections		
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Surplus on current budget (£ billion)							
Budget 2006	**–11.4**	**–7.1**	**1**	**7**	**10**	**12**	
Effect of forecasting changes	–3.7	–1.0	–5	–5½	–5	–4	
Effect of policy decisions since Budget 2006	0.0	0.2	2	2½	2	2	
PBR 2006	**–15.1**	**–7.9**	**–1**	**4**	**7**	**10**	**14**
Net borrowing (£ billion)							
Budget 2006	**37.1**	**35.8**	**30**	**25**	**24**	**23**	
Changes to current budget	3.7	0.8	3	3	3	1½	
Changes to net investment	–3.3	0.1	–1	–½	–1	–1	
PBR 2006	**37.5**	**36.8**	**31**	**27**	**26**	**24**	**22**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2006	–0.3	0.4	0.7	0.7	0.7	0.8	
PBR 2006	**–1.0**	**–0.4**	**–0.1**	**0.3**	**0.5**	**0.6**	**0.8**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2006	2.4	1.9	1.6	1.6	1.6	1.5	
PBR 2006	**2.8**	**2.6**	**2.2**	**1.9**	**1.7**	**1.5**	**1.3**
Net debt (per cent of GDP)							
Budget 2006	36.4	37.5	38.1	38.3	38.4	38.4	
PBR 2006	**36.4**	**37.5**	**38.2**	**38.6**	**38.7**	**38.7**	**38.5**

Note: Figures may not sum due to rounding.

[1] *The 2005-06 figures were estimates in Budget 2006.*

[2] *The 2006-07 figures were projections in Budget 2006.*

Outturn for 2005-06

2.41 The outturn for the current budget for 2005-06 is around £3.7 billion lower than the Budget 2006 estimate, while net borrowing is now around £0.4 billion higher. Further details are given in Annex B.

2.42 As Table 2.3 shows, the main fiscal aggregates are broadly in line with the forecast at Budget time. Where there are differences between the Pre-Budget Report projections for the current budget and net borrowing and those in Budget 2006, these are largely due to areas unrelated to the strength of the economy, most notably lower receipts from North Sea oil revenues, as well as some higher spending as a result of high oil prices feeding through to domestic inflation. These are shown in Table 2.4, and discussed in more detail below.

Estimate for 2006-07

2.43 The estimates for net borrowing in 2006-07, of 2.8 per cent of GDP, and for the current surplus, of a deficit of 0.6 per cent, remain unchanged from Budget 2006. This represents a fall from 2005-06 to 2006-07 in the current budget deficit of around £7.2 billion. Net borrowing also fell, but due to the rise in net investment the reduction was lower, down by £0.7 billion compared with 2005-06.

2.44 In contrast to the main aggregates, the cyclically-adjusted measures for this year and next have changed since Budget 2006. These changes follow upward revisions to the estimates of economic growth during the past three years and stronger growth, which have directly fed through to the profile of the output gap. Cyclically-adjusted net borrowing is on a declining trend and by 2009-10 returns close to the levels set out in the Budget, and then falls below Budget projections, reaching 1.3 per cent of GDP at the end of the projection period. As discussed in Annex A, there remain considerable uncertainties about the current estimate of the output gap, so precise estimates of cyclically-adjusted balances should be treated with caution.

2.45 The receipts forecast for 2006-07 is slightly higher than at Budget time. National insurance contributions and taxes on wages and salaries are unchanged from Budget 2006, as record levels of employment are offset by lower than expected average earnings growth. Other income tax receipts are higher than expected. Capital taxes and stamp duties have been boosted by the rise in the equity market. Receipts are now expected to grow by 6.6 per cent for the year as a whole, in line with outturns for the first seven months of 2006-07.

2.46 Central government spending for the first seven months of 2006-07 has shown strong growth over the corresponding period in the previous year. Overall public current expenditure is higher by £1.4 billion in 2006-07 and by £2.4 billion in 2007-08 compared with Budget 2006. Growth is expected to moderate over the rest of the year partly due to changes in the timing of grant payments, explained further in Annex B.

Table 2.4: Public sector net borrowing compared with Budget 2006

	Estimate [1]	Projections			
	2006-07	2007-08	2008-09	2009-10	2010-11
Budget 2006 (£ billion)	**35.8**	**30**	**25**	**24**	**23**
Changes since Budget 2006					
North Sea revenues	–0.1	3	2	1	1
Impact of higher 2006 inflation on tax & expenditure[2]	0.9	1½	1½	1½	1½
Other tax and expenditure changes	0.4	–½	1	1½	1
Total before discretionary measures	**36.9**	**33**	**30**	**28**	**27**
Discretionary measures	**–0.2**	**–2**	**–2½**	**–2**	**–2**
2006 Pre-Budget Report	**36.8**	**31**	**27**	**26**	**24**

Note: Figures may not sum due to rounding.

[1] The 2006-07 figures were projections in Budget 2006.

[2] This assumes that spending changes continue throughout the projection period.

Changes in receipts

2.47 A reduction in expected North Sea oil revenues accounts for almost all of the decline in forecast receipts, before discretionary measures, compared with Budget 2006. As discussed in Box B2, the lower forecast is due to higher capital investment in the North Sea, increased operating expenditure, lower than anticipated production and a stronger dollar-sterling exchange rate.

2.48 Other changes in receipts are much less significant. Projected revenues from consumption taxes are slightly lower than at the Budget. Moderate rates of consumption growth and a change in the composition of spending result in modest growth in VAT receipts. Higher levels of employment have a positive impact on receipts over the forecast period. Including discretionary measures, the current receipts forecast is in line with that at Budget 2006.

Changes in spending

2.49 The forecast for expenditure before discretionary measures is slightly higher than at the time of the Budget for 2006-07 and 2007-08. Projections for Departmental Expenditure Limits (DEL) up to 2007-08 are based on 2004 Spending Review allocations. Projections for Annually Managed Expenditure (AME) are higher for this year and next. This is in part due to the impact of higher inflation on the cost of servicing indexed-linked bonds and on indexed-linked social security benefits, as shown in Table 2.4.

Discretionary policy changes

2.50 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 strict 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.

2.51 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all decisions announced in this Pre-Budget Report or since Budget 2006. This includes:

- an increase in air passenger duty with effect from 1 February 2007, as part of further steps to tackle the global challenges of climate change, in recognition of the environmental costs of flying;
- a further £130 million direct to schools in England in 2007-08, including to support personalised teaching and extended services; and
- action to protect tax revenues and further modernise the tax system, including a number of measures to tackle tax avoidance.

2.52 The fiscal impact of these and other measures is set out in Annex B. As usual, the projections do not take account of measures proposed in this Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken.

FISCAL POSITION AND MEDIUM-TERM PROSPECTS

2.53 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. It illustrates the Goverment's performance against its fiscal rules, and shows that the Goverment is meeting its strict fiscal rules over the economic cycle.

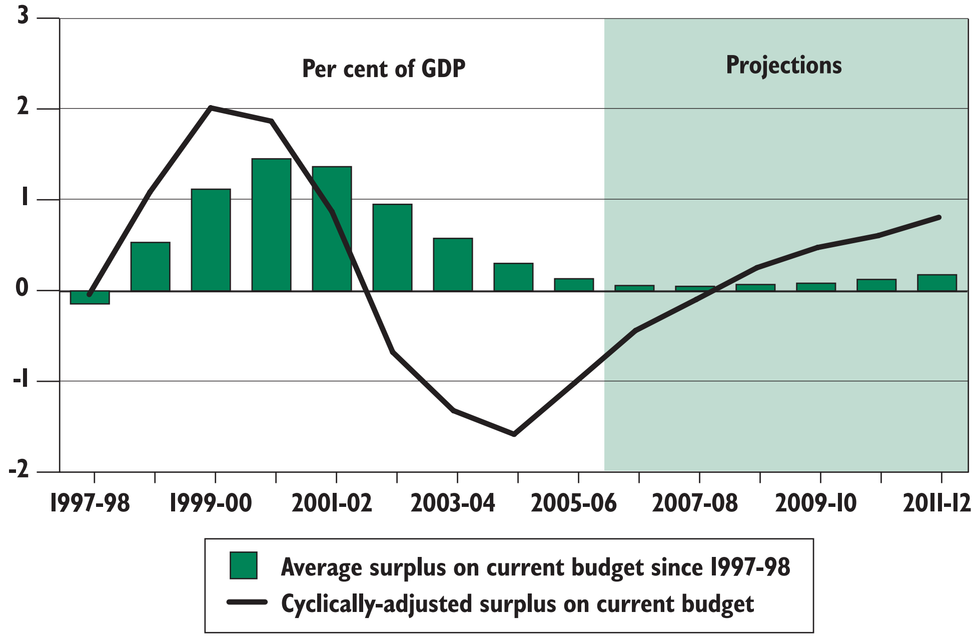
Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate[1]			Projections		
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Fairness and prudence							
Surplus on current budget	–1.2	–0.6	–0.1	0.3	0.5	0.6	0.8
Average surplus since 1997-98	0.1	0.1	0.0	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–1.0	–0.4	–0.1	0.3	0.5	0.6	0.8
Long-term sustainability							
Public sector net debt[1]	36.4	37.5	38.2	38.6	38.7	38.7	38.5
Core debt[1]	35.8	36.7	37.4	37.8	38.0	38.0	37.8
Net worth[2]	27.0	25.7	24.9	24.9	24.6	24.6	24.6
Primary balance	–1.4	–1.1	–0.6	–0.2	0.0	0.1	0.3
Economic impact							
Net investment	1.8	2.2	2.2	2.2	2.2	2.2	2.2
Public sector net borrowing (PSNB)	3.0	2.8	2.3	1.9	1.7	1.5	1.3
Cyclically-adjusted PSNB	2.8	2.6	2.2	1.9	1.7	1.5	1.3
Financing							
Central government net cash requirement	3.2	3.2	2.5	2.1	2.1	1.8	1.9
Public sector net cash requirement	3.2	2.9	2.4	2.0	2.0	1.6	1.7
European commitments							
Treaty deficit[3]	2.8	2.7	2.2	1.9	1.7	1.5	1.3
Cyclically-adjusted Treaty deficit[3]	2.6	2.5	2.2	1.9	1.7	1.5	1.3
Treaty debt ratio[4]	42.7	43.7	44.1	44.2	44.2	44.0	43.6
Memo: Output gap	–0.4	–0.2	0.0	0.0	0.0	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 **2.54** 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 2008-09 and showing a surplus of 0.8 per cent of GDP in 2011-12.

Chart 2.4: Meeting the golden rule



Source: HM Treasury.

2.55 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 in 1997-98.[5]

2.56 The average surplus on the current budget since the start of the current cycle in 1997-98 is positive in every year of the projection period. The economy is projected to return to trend in early 2007 which means that the average annual surplus on the current budget over the whole cycle 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 £8 billion in this cycle, including the AME margin.

2.57 With the economy assumed to return to trend in early 2007, the projections show that the current budget moves into surplus in 2008-09, with the surplus rising to 0.8 per cent of GDP by 2011-12. At this early stage and based on cautious assumptions, the Government is on course to meet the golden rule after the end of this economic cycle.

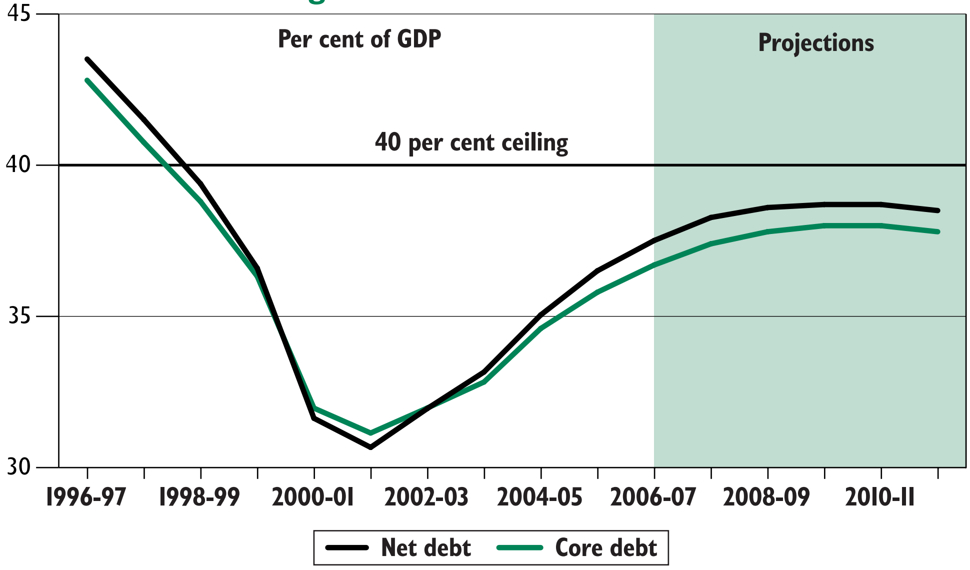
Sustainable investment rule

2.58 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.

[5] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002.

2.59 Chart 2.5 shows that, despite output being below trend since 2001 and the addition of finance leases, net debt remains below 40 per cent throughout the projection period, and starts to decline, reaching 38.5 per cent of GDP by the end of the projection period. 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 36.7 per cent in 2006-07 to 37.8 per cent of GDP at the end of the projection period.

Chart 2.5: Meeting the sustainable investment rule

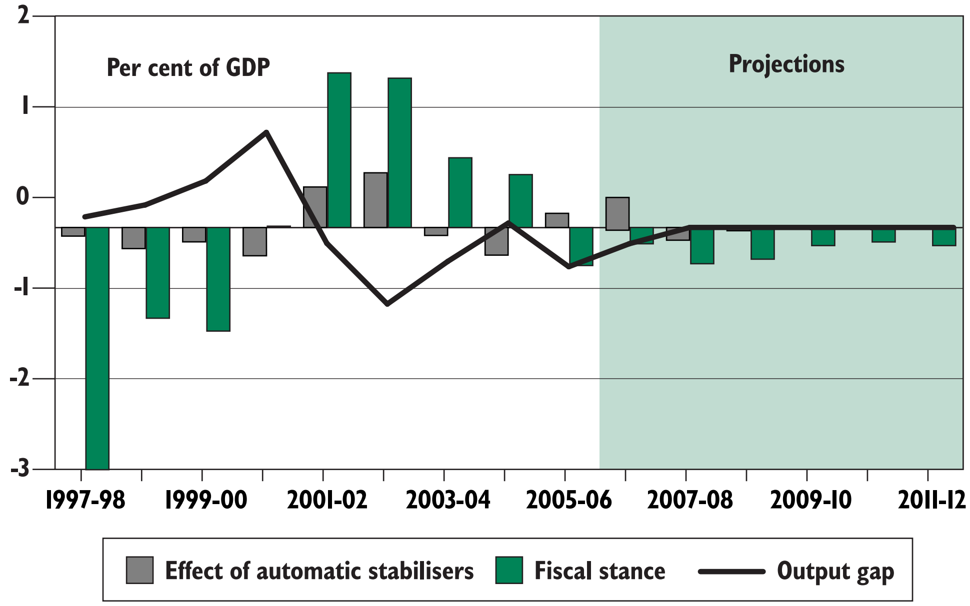


Source: ONS and HM Treasury.

Economic impact

2.60 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

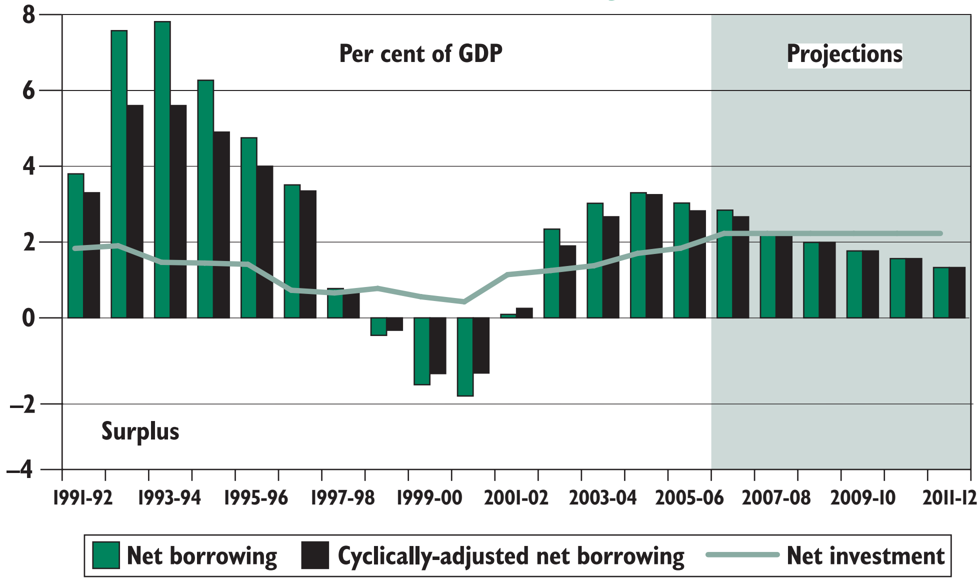


Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, i.e. the difference between PSNB and the cyclically-adjusted PSNB.

Source: HM Treasury.

2.61 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 economy approaching trend levels, fiscal policy in 2006-07 is expected to be slightly tighter, and further moderate fiscal tightening is forecast over the projection period.

Chart 2.7: Public sector net borrowing and net investment



Source: ONS and HM Treasury.

2.62 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 1.3 per cent of GDP by the end of the projection period.

Financing

2.63 The forecast for the central government net cash requirement for 2006-07 is unchanged from that at Budget time. The forecast for the central government net financing requirement for 2006-07 has been revised from £65.0 billion in Budget 2006 to £59.0 billion, a decrease of £6.0 billion. It has been decided to meet this lower financing requirement by decreasing gilt sales by £0.5 billion to £62.5 billion and by decreasing the planned end financial year Treasury bill stock by £5.5 billion to £15.6 billion. Further details and a revised financing table can be found in Annex B.

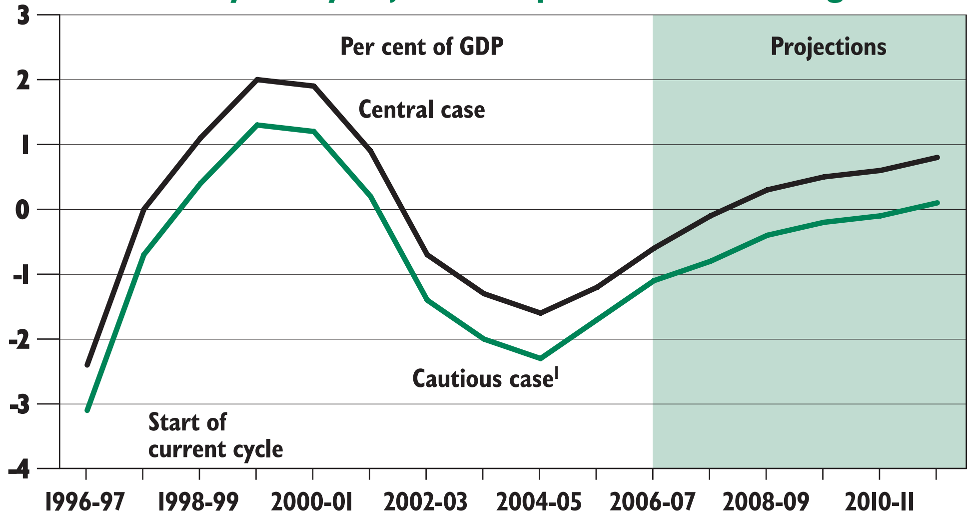
European commitments

2.64 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box A1 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 this Pre-Budget Report, 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

2.65 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. 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 a $^{1}/_{4}$ percentage point lower than its neutral view.

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.

2.66 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.

2.67 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 balance will be in surplus at the end of the projection period.

LONG-TERM FISCAL SUSTAINABILITY

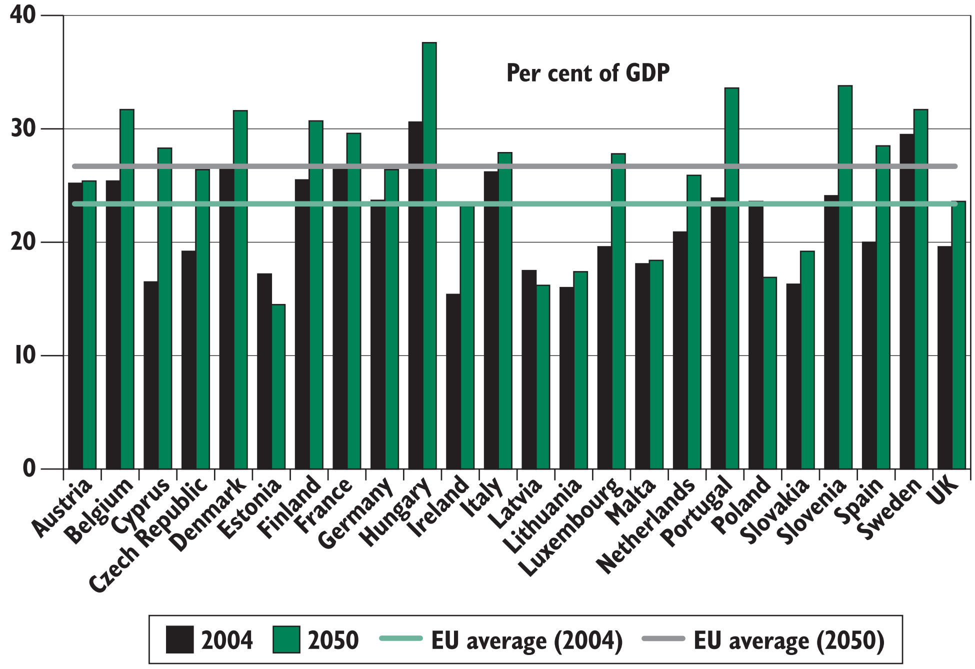
2.68 While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects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

2.69 An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2006 *Long-term public finance report*. Based on the latest population projections the report provides a comprehensive analysis of long-term economic and demographic developments and their potential impact on the public finances. The 2006 *Long-term public finance report* concludes that the public finances remain sustainable over the long term. Box 2.5 provides more information on fiscal challenges in EU Member States.

Box 2.5: Age-related spending in EU countries

Many European countries face significant challenges from ageing populations. In February 2006, the European Union's Economic Policy Committee published age-related expenditure projections for the 25 Member States for the period 2004 to 2050.[a] The projections cover pensions, health care, long-term care, education, unemployment transfers and, in some cases, social contributions. The chart shows that age-related spending in the UK is projected to rise only moderately over the next five decades - in contrast with substantial projected increases in some other countries - and that it will be similar in 2050 to the EU average now.

Age-related spending in EU countries[1]



[1]Projections for the Czech Republic, Cyprus, Estonia, France and Hungary do not include long-term care. Projections for Greece are not shown as they do not include pension projections.
Source: Economic Policy Committee and European Commission, February 2006.

[a] *The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)*, Economic Policy Committee and European Commission, February 2006.