2 MAINTAINING MACROECONOMIC STABILITY

The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges that have faced the world economy over recent years. While many of the world's major economies have experienced recession, the UK grew continuously throughout the global downturn that began in 2001. The UK is the only G7 economy not to have experienced at least one quarterly contraction in output over the last three years, with GDP now having grown for 46 consecutive quarters, which, on the basis of quarterly national accounts' data, is the longest sustained expansion on record.

UK GDP rose 0.9 per cent in the fourth quarter of 2003, the fastest rate for over three and a half years. For 2003 as a whole, GDP rose by 2.3 per cent, consistent with the Budget 2003 forecast of 2 to 2½ per cent and slightly above the 2003 Pre-Budget Report estimate of 2.1 per cent. GDP is expected to grow by 3 to 3½ per cent in both 2004 and 2005 before returning to a trend of 2½ to 3 per cent in 2006.

The Budget 2004 projections for the public finances are little changed from the 2003 Pre-Budget Report, and show that the Government is on track to meet its strict fiscal rules:

- **the current budget since the start of the current economic cycle in 1999-2000 shows an average annual surplus up to 2005-06 of 0.1 per cent of GDP and the Government is therefore on track to meet the golden rule on the basis of cautious assumptions. There is a margin against the golden rule of £11 billion in this cycle, including the Annually Managed Expenditure (AME) margin. The current budget returns to balance by 2006-07, and the cyclically-adjusted current budget in the cautious case moves back to balance by the end of the projection period; and**
- **public sector net debt is projected to remain low and stable over the next five years, stabilising at just under 36½ per cent of GDP – £53 billion below the 40 per cent ceiling set in the sustainable investment rule.**

Budget 2004 sets firm overall spending limits for the 2004 Spending Review period, allowing:

- **current spending to increase by an average 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumption for trend economic growth and consistent with the nominal growth rates set out in Budget 2003 and the 2003 Pre-Budget Report. Final plans for Department Expenditure Limits (DEL) and AME will be set in the Spending Review; and**
- **public sector net investment to rise from 2 per cent of GDP to 2¼ per cent of GDP by 2007-08 to continue to address historic under-investment in Britain's infrastructure.**

The growth rate of both overall spending and departmental spending will be lower in the 2004 Spending Review than in the 2002 Spending Review. However, building on the progress made in correcting historic under-investment, and with administration costs frozen in nominal terms and planned efficiency gains, the Government expects to match the pace of growth in front line public services achieved in the last Spending Review.

THE MACROECONOMIC FRAMEWORK

2.1 The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges that have faced the world economy over recent years. While many of the world's major economies have experienced recession, the UK grew continuously throughout the global downturn that began in 2001. The UK is the only G7 economy not to have experienced at least one quarterly contraction in output over the last three years, with GDP now having grown for forty-six consecutive quarters – the longest unbroken expansion since quarterly records began five decades ago.

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.

Monetary policy framework

2.4 Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target and allowed the Bank of England's Monetary Policy Committee (MPC) to mitigate the impact of global events on the UK economy. The framework is based on four key principles:

- clear and precise objectives. While 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 MPC in setting interest rates to meet the Government's inflation target. **The Government reaffirms in Budget 2004 the target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI),** which applies at all times;

- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and

- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC

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

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 could influence monetary policy and ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target.

Box 2.1: The new inflation target

On 10 December 2003, the Pre-Budget Report confirmed that the inflation target would with immediate effect switch to a measure based on the harmonised index of consumer prices, which the National Statistician named the Consumer Prices Index (CPI) for the UK. This improves the quality of the UK inflation target and also helps ensure inflation expectations in the UK remain in line with those in the euro area.

The new inflation target is 2 per cent for the 12-month increase in the CPI. The rate for the new target is ½ a percentage point lower than the previous target of 2½ per cent for the 12-month increase in Retail Prices Index excluding mortgage interest payments (RPIX) because of differences in the way that CPI and RPIX inflation are measured. The level of the new target was set to be consistent with the old target in two years' time, the typical forecast horizon for monetary policy purposes, and broadly in line with the expected long-run difference between the CPI and RPIX measures arising from differences between their formulae.

The move to a target for inflation based on the CPI measure of inflation has a number of distinct advantages over the RPIX measure for monetary policy purposes.[a] In particular, the CPI:

- **better allows for the substitution of cheaper for more expensive goods and services within expenditure categories when relative prices change and so may be considered a more realistic depiction of consumer behaviour;**
- **has a wider population coverage and is more consistent with national accounts principles of consumer expenditure, so it shares a coherence with other economic statistics and gives a better picture of spending patterns in the UK; and**
- **is a more comparable measure of inflation internationally and represents international best practice. The CPI measure of inflation is also consistent with the Harmonised Index of Consumer Prices (HICP) which is the European Central Bank's (ECB) preferred measure of inflation and the measure used to judge whether the ECB has met its objective of achieving price stability. The adoption of the CPI will therefore enable a more direct comparison between inflation rates in the United Kingdom and the euro area.**

[a] Further detail can be found in the ONS article 'The New Inflation Target: The Statistical Perspective', Economic Trends, January 2004

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

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

- 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 ensure sound public finances in the medium term while allowing flexibility in two key respects:

- the rules are set over the economic cycle. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and
- the rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

2.9 The fiscal policy framework also takes account of uncertainty that is inherent in projections of the public finances. The fiscal projections are based on cautious assumptions for key economic variables, including the trend rate of growth, oil prices and the level of unemployment. This cautious approach builds a safety margin into the public finances and minimises the need for unexpected changes in taxation or spending. The assumptions are audited by the Comptroller and Auditor General as part of a three-year rolling review to ensure that they remain reasonable and cautious.

Public spending framework

2.10 The fiscal rules underpin the Government's public spending framework. The golden rule increases the efficiency of public spending by ensuring that public investment is not sacrificed to meet 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. Full details of the public spending framework are set out in Chapter 6.

Box 2.2: 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, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous.

An assessment of the five economic tests was published in June 2003. This concluded that: *"since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area."* The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment. The Budget reports on progress. This includes:

- switching the symmetric inflation target to one measured by the Consumer Prices Index (CPI). This will improve the quality of the UK inflation target and will help ensure inflation expectations in the UK remain in line with those in the euro area. Further detail is provided in Box 2.1;
- the publication of the draft euro referendum bill on 10 December 2003. The draft bill allows for consultation over the details of a referendum if one were to be held;
- reforms to address both supply and demand in the housing market and macroeconomic stabilisation by implementing a programme of change to increase supply and responsiveness of the housing market as recommended in the Barker review and, on the demand side, responding to the Miles review on the mortgage market. Further detail is provided in Box 2.9; and
- reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. Boxes 3.2 and 4.1 provide further detail. The Government is committed to publishing six-monthly reports on trends and progress in increasing flexibility in the UK economy. The second flexibility report is published alongside the Budget today.

The Government issues six-monthly reports on euro preparations. The seventh report in November 2003 set out the progress that has been made across the economy since June 2003. In addition, the Government is continuing to discuss the proposals set out in the discussion paper *Fiscal Stabilisation and EMU*. On the Stability and Growth Pact, the Government continues to emphasise the need for a more prudent interpretation of the Pact as described in Box 2.6 and is today publishing *The Stability and Growth Pact: A Discussion Paper,* which assesses the performance of the Pact against the principles of credibility, flexibility and legitimacy and considers how a prudent interpretation helps the Pact better to achieve its objectives. The Government also remains committed to the EU's Lisbon strategy on economic reform, launched in March 2000, and will continue to work with Member States and the EU institutions to build on progress so far and to accelerate the pace of reform in order to meet the Lisbon challenge.

While the Government does not propose a euro assessment be initiated at the time of this Budget, the Treasury will again review the situation at Budget time next year.

Financial stability framework

2.11 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding[3] in 1997 established a framework for co-operation between these three bodies on financial stability. The Bank of England is responsible for the stability of the financial system as a whole, including the payments infrastructure. The FSA is responsible for the authorisation and supervision of financial institutions including banks, for supervising financial markets and securities clearing and settlement systems, and for regulatory policy. The Treasury has responsibility for the overall institutional structure of regulation and the legislation that governs it.

2.12 A Standing Committee, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss financial stability, focusing on risks deemed to have systemic consequences. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and coordinates the three authorities' contingency plans. In the event of a crisis, it would meet at short notice and co-ordinate any necessary action by the authorities.

THE PERFORMANCE OF THE FRAMEWORK

2.13 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

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

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target value of 2½ per cent; and
- inflation expectations have been close to target – market expectations are that CPI inflation will be close to the 2 per cent target.

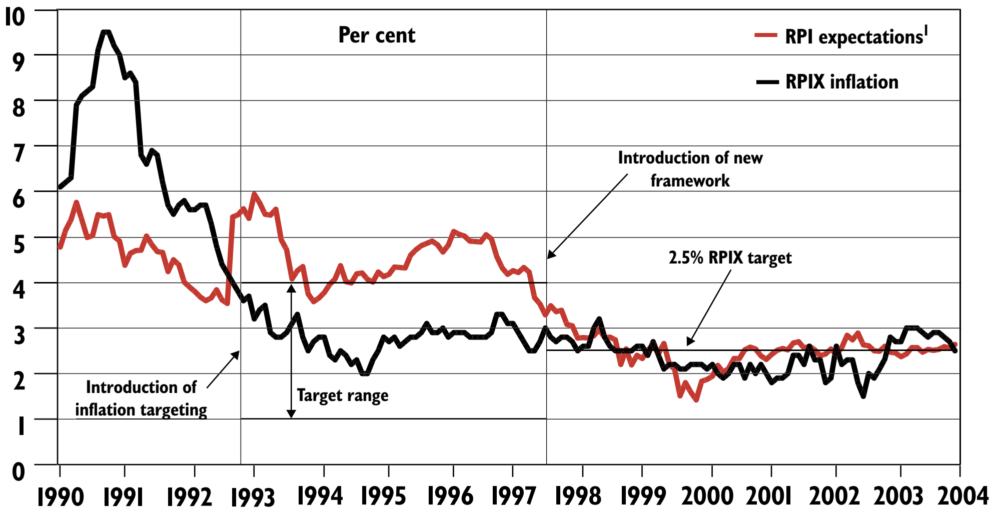
2.15 The framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped to keep output relatively close to its trend level, while ensuring that inflation remained close to target. Consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation as growth strengthens the MPC has raised interest rates twice in recent months by ¼ percentage point in November 2003 and February 2004.

2.16 Despite increasing during the year, the average long-term, ten-year interest rate in the UK was around 4½ per cent in 2003, the lowest average annual rate in over 40 years. Low long-term rates reduce the Government's debt interest payments, free up resources for public services and help to promote investment throughout the economy. UK long-term, ten-year forward interest rates[4] remain below the equivalent rates in the euro area and the US, as they have done for the past five years.

[3] Full text available at on the Treasury website www.hm-treasury.gov.uk.

[4] Source: www.bankofengland.co.uk and Bank of England.

Chart 2.1: Inflation performance and expectations



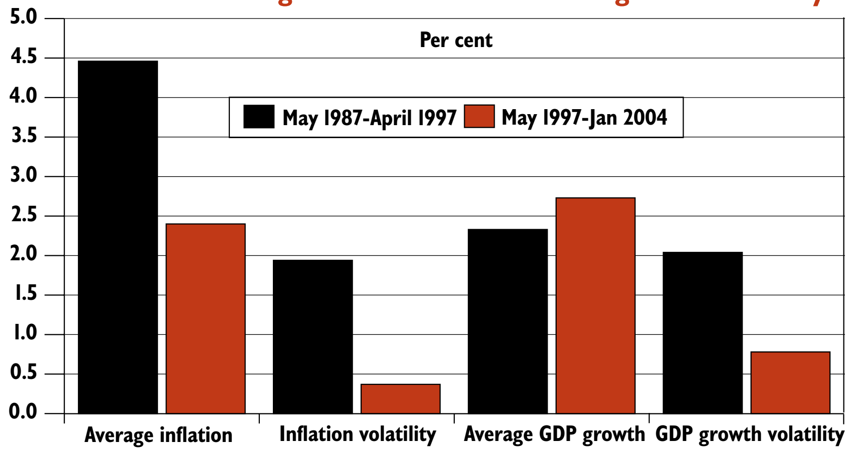
[1] Ten year ahead market inflation expectations.

Fiscal policy **2.17** The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by more than 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. Public sector net debt was also reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.2 shows, in 2003 the UK's net debt was the lowest in the G7.

Box 2.3: The benefits of inflation targeting with central bank independence

In May 1997, the Chancellor gave the Bank of England full operational independence with the Monetary Policy Committee being set a single, symmetrical, point inflation target.

Chart a: UK GDP growth and inflation: averages and volatility[a]

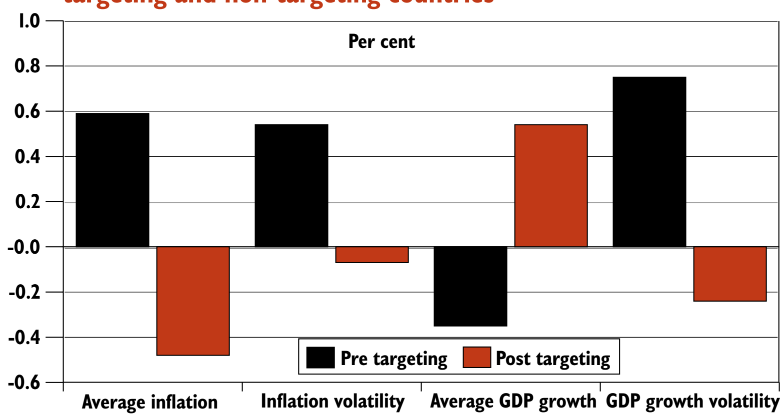


[a] Inflation is measured on the RPIX basis. Inflation and GDP growth volatility are measured by standard deviations.

The arrangements for monetary policy introduced in 1997 were designed to enhance credibility. The chart above shows that since May 1997, average inflation, the volatility of inflation and the volatility of output growth have all fallen in the UK relative to the previous 10 years, without any adverse effects on output growth. Furthermore since May 1997, the UK has had the lowest volatility of inflation and output growth of all the G7 countries.

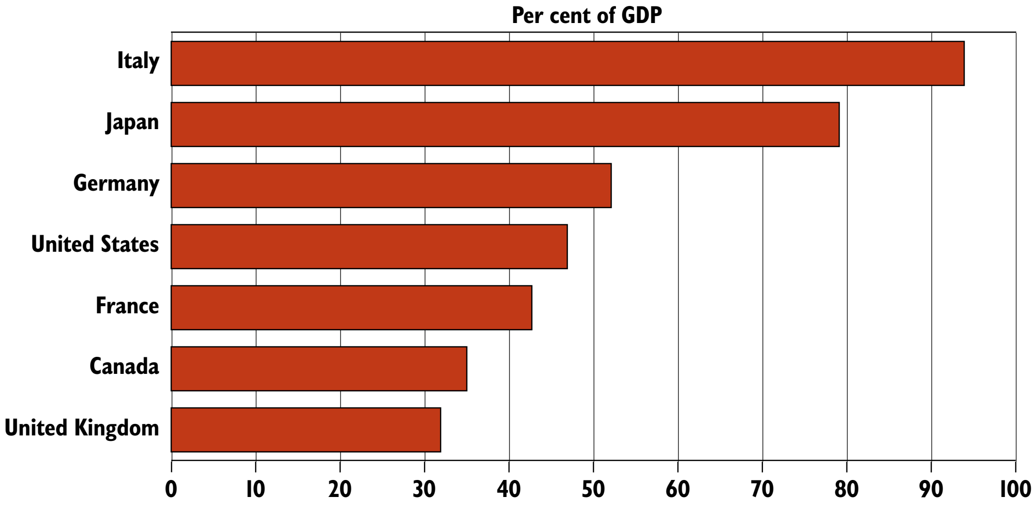
Other OECD countries that have adopted explicit inflation targets with independent central banks have also shown an improved performance. The chart below shows that before inflation targeting these countries had experienced relatively high average inflation, high inflation volatility, high output growth volatility and low output growth. After these changes, performance improved, not only compared to their past histories, but also with respect to the group of countries that have not adopted inflation targets. However, in many of the inflation-targeting countries, including the UK, the monetary policy reforms were also accompanied by reforms in other areas such as fiscal policy and so the improvements could partly reflect these wider reforms.

Chart b: Difference in performance between inflation targeting and non-targeting countries[a]



[a] Inflation and GDP growth volatility are measured by standard deviations.
Note: The inflation targeters are the UK, New Zealand, Australia and Sweden. The non-targeters are the US, Japan, France, Germany, Italy, the Netherlands, Portugal, Ireland, Austria, Belgium, Denmark and Greece. For the inflation targeters, the pre targeting period is the ten year period before inflation targets were implemented. For the countries that do not target inflation, the pre targetting period reflects the median date of the change in monetary policy regimes in the inflation targeters.

Chart 2.2: Net financial liabilities in the G7 in 2003



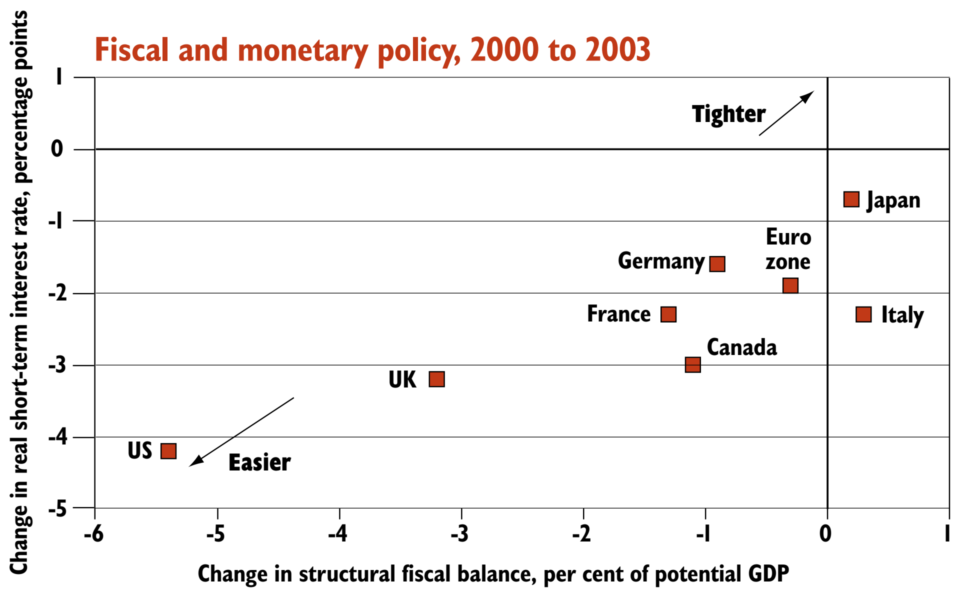
Source: OECD Economic Outlook 74. December 2003.

2002 Spending Review

2.18 The 2002 Spending Review set spending plans for the years 2003-04 to 2005-06 for the public services other than the NHS, for which spending plans to 2007-08 were fixed in the 2002 Budget. Continuing the trend set in previous Spending Reviews, these spending plans allowed for significant increases in investment for the key public services, with resources focused on health, education, transport, criminal justice and housing. The overall spending limits set in Budget 2002 and confirmed in the 2002 Spending Review remain sustainable and fully consistent with the fiscal rules.

Box 2.4: Global downturn – the response of monetary and fiscal policy in G7 economies

While world economic growth is now strengthening, the global slowdown that began in 2001 resulted in many of the world's major economies, including the US, Japan, Italy and Germany, moving into recession. In the UK, the Bank of England's Monetary Policy Committee took decisive action to cut short-term interest rates, while inflation expectations remained close to target. At the same time, fiscal policy was able to support monetary policy, underpinned by strong and sustainable public finances. The UK experienced unbroken growth throughout this period. The chart shows how fiscal policy supported monetary policy in the US and UK from 2000 to 2003, while monetary and fiscal policy were less responsive in many other countries.



Source: Calculated from OECD Economic Outlook No 74 December 2003.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.19 The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges that have faced the world economy over recent years. As described in Box 2.4, while many of the world's major economies have experienced recession, the UK grew continuously throughout the global downturn that began in 2001. Indeed, the UK is the only G7 economy not to have experienced at least one quarterly contraction in output over the past three years, with GDP now having grown for 46 consecutive quarters which, on the basis of quarterly national accounts' data, is the longest sustained expansion on record.

2.20 In early 2003, geo-political and other uncertainties weighed heavily on international growth prospects, and global activity remained weak. However, growth in several major economies had already picked up by the middle of last year and, as expected at the time of the Pre-Budget Report, activity has continued to strengthen across the world's major economies. As geo-political and other uncertainties have receded, global demand has strengthened and most major international financial markets have seen valuations rise back to around the levels of spring or summer 2002.

Table 2.1: The world economy

	Percentage change on a year earlier unless otherwise stated			
		Forecasts		
	2003	2004	2005	2006
Major 7 countries[1]				
Real GDP	2¼	3¼	3	2¾
Consumer price inflation[2]	1½	1½	1¾	1¾
Euro-area				
Real GDP	½	1¾	2¾	2½
World trade in goods and services	4¼	7¾	8	7¼
UK export markets[3]	3¾	6¼	7¼	6¾

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

2.21 UK GDP rose 0.9 per cent in the fourth quarter of 2003, the fastest rate for over three and a half years and following growth of 0.8 per cent in the third quarter. For 2003 as a whole, GDP rose by 2.3 per cent, consistent with the Budget 2003 forecast of 2 to 2½ per cent and a little above the 2003 Pre-Budget Report estimate of 2.1 per cent.

Economic prospects

2.22 Economic developments and prospects remain much as envisaged in the 2003 Pre-Budget Report. As at that time, the recent pick-up in activity seen over the latter half of 2003 is expected to be consolidated through 2004 and into 2005. As demand continues to accelerate into 2004, GDP is forecast to grow by 3 to 3½ per cent both this year and in 2005. The output gap is forecast to close by early 2006 and GDP growth is forecast to moderate thereafter, with the economy projected to remain at trend. The 2004 Budget forecast for GDP growth is therefore the same as in the 2003 Budget and Pre-Budget Reports in every year of the current projection period.

Table 2.2: Summary of UK forecast

		Forecast		
	2003	2004	2005	2006
GDP growth (per cent)	2¼	3 to 3½	3 to 3½	2½ to 3
CPI inflation (per cent, Q4)	1½	1¾	2	2

2.23 The forecast for CPI inflation is also broadly unchanged compared with the 2003 Pre-Budget Report. Inflation is expected to remain a little below its symmetrical 2 per cent target in 2004 as existing slack in the economy continues to subdue domestically generated pricing pressures. However, inflation is expected to return to target by mid-2005 as the lagged effects of sterling's depreciation against the euro since 2002, combined with the effects – already evident in commodity prices – of the strengthening synchronised recovery in the world economy, feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

2.24 Business investment shows signs of having increased in recent months, following a prolonged period of weakness during which global uncertainty reduced companies' appetite to undertake capital expenditure. Survey evidence indicates investment intentions have risen sharply in recent months, and business investment is forecast to pick up through this year as the global recovery gathers pace.

2.25 Tentative signs of improved international prospects feeding through to higher external demand have also emerged. Although the sterling exchange rate index has strengthened a little since last December's Pre-Budget Report, this mainly reflects further rises in sterling's exchange rate with the US dollar. Sterling has been relatively more stable against the euro, but remains significantly weaker in relation to it than for most of the first four years of the euro's existence. Recent exchange rate developments are discussed in more detail in Box B6.

2.26 Export growth is expected to pick up more significantly through 2004 and 2005 as external demand continues to accelerate. The weakening of sterling against the euro should provide a boost to export volumes as euro area GDP growth picks up and the lags between exchange rates and trade flows work through.

2.27 At the same time, private consumption growth is forecast to moderate and remain comfortably below the rates seen for much of the period since the mid-1990s. As investment and exports pick up, the composition of demand is projected to become more balanced than in recent years.

Risks

2.28 Risks, both on the upside and downside, have changed little since the time of the 2003 Pre-Budget Report. A number of ongoing risks and uncertainties to the world economy would, if realised, influence the UK economy. In particular, the US dollar has continued to decline against some other major currencies in recent months. So far, this has been an orderly depreciation, accompanied by improving financial conditions and strengthening growth, but given continued large global imbalances, much sharper movements in major exchange rates cannot be ruled out. This highlights the urgent need for policy makers to push ahead with the structural reforms that will ensure a more broadly-based and sustainable global recovery over the medium term, minimising the risk of a disorderly unwinding of global trade positions.

2.29 A further downside risk comes from the potential rebuilding of balance sheets. Significant progress has been made in rebuilding household and corporate balance sheets across several major economies since the recession of 2001. However, this process may not be complete and could resume once the stimulus from policy begins to fade. Another downside risk comes from the continued threat of international terrorism.

2.30 In the UK, downside risks continue to be associated with the outlook for consumer spending. While the forecast allows for a moderation in the growth of private consumption, expenditure could undergo a sharper than expected correction if, for example, house prices were to decline significantly or the world economy were to suffer a negative shock. On the upside, the pick-up in growth seen since early 2003 could prove stronger than expected in the short-term. In particular, business investment has, in the past, tended to surprise on the upside once into an upswing, and private sector capital expenditure could once more prove stronger than forecast over the projection period. Similarly, private consumption could again prove to have more near-term momentum than envisaged in the Budget forecast, although this would raise the risk of a sharp correction in the opposite direction further out.

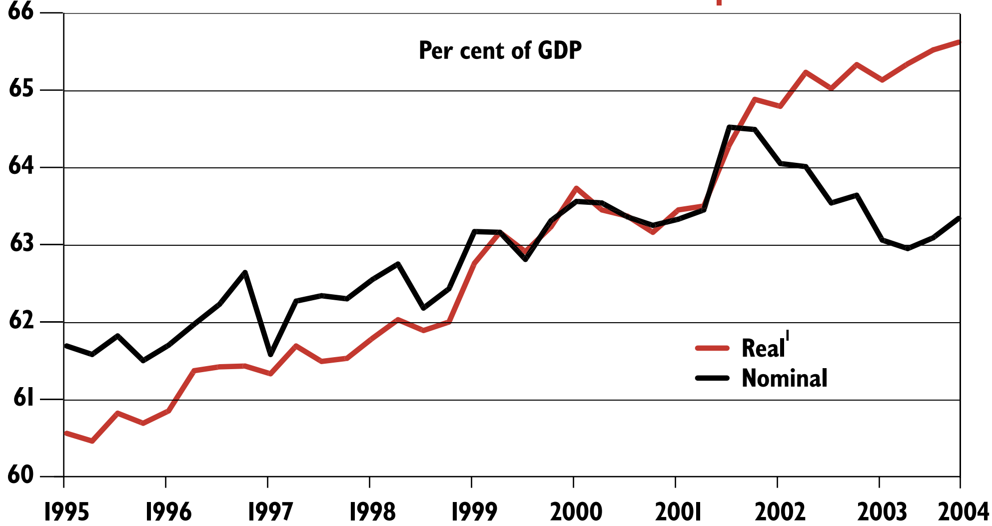
The economic cycle

2.31 On the basis of the Government's provisional judgement on the dating of the current and past economic cycles, the economy completed a full, though short, cycle between the first half of 1997 and mid-1999. The current economic cycle began in mid-1999 when actual output moved above the trend level. In the second half of 2001, the economy moved below trend with actual output remaining below the trend level since then. The economy is expected to return to trend by early 2006 as forecast in the 2003 Pre-Budget Report.

Box 2.5: The sustainability of household consumption

Growth of real household consumption moderated in 2003, increasing by 2.8 per cent, its slowest annual rate since 1995. Moreover, much of the growth in household consumption volumes over the past year appears to have been spurred by strong competition exerting downward pressures on prices in parts of the retail and service sectors: in nominal terms, private consumption in 2003 grew by 4.4 per cent, its slowest since 1949, and its share in GDP fell by more than in any year since 1977. This further supports the evidence set out in the 2003 Pre-Budget Report that since the mid-1990s the data in nominal terms indicate growth in private consumption has been more sustainable than the real measures suggest. However, it also suggests that, independent of the temporary effects of the global uncertainties prevailing earlier in 2003, households' expenditure patterns have gradually begun to adjust to relatively high levels of indebtedness and weaker growth in real incomes compared with recent years.

Ratio of real and nominal household consumption to GDP



[1] *Ratio of household consumption to GDP in chained volume measures.*

Nonetheless, as international uncertainties have receded, growth in real consumer spending has picked up from its low in early 2003 and revealed more momentum than previously expected, with growth of 1 per cent or more in each of the past three quarters. This unexpected momentum has been accompanied by continued growth in household borrowing at historically high rates. In the three months to January 2004, the stock of household debt was up by just over 13 per cent on a year earlier.

Although the ratio of household debt to income has climbed to historically high levels, this needs to be viewed alongside developments in household assets. The ratio of household debt to total net wealth is currently estimated to be no higher than it was in 1995. Moreover, more than three quarters of the increase in household mortgage debt since early 2000 has been matched by the build-up of household holdings of money and deposits. This is consistent both with the view that much of mortgage equity withdrawal (MEW) over this period has been saved rather than used to finance spending, and with the relatively stable saving ratio in recent years. It also suggests that the risk of a moderation in house price inflation and sharply lower MEW leading to faltering consumer spending growth should not be overstated. In any case, despite strong increases in MEW, households' equity in housing has continued to build up. Equity is estimated recently to have risen to almost four fifths of house values, which is high by historical standards. This reduces the likelihood of MEW coming rapidly to an end.

NAO audited assumptions

2.32 A number of key assumptions that underpin the public finance projections 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 Chapter C of the *Financial Statement and Budget Report* (FSBR). This prudent approach to fiscal policy builds an important 'safety margin' into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending.

2.33 Under the rolling review, for Budget 2003 the Comptroller and Auditor General has audited the assumptions relating to factor income shares and government financing. In both cases the review concluded that the assumptions were reasonable and continue to be so for the future.

2.34 As described in Chapter 5, Budget 2004 announces a new compliance and enforcement package for direct taxes and national insurance contributions. Consistent with previous practice, the estimates of the extra revenue delivered by the package include the direct and preventive effects of the package and made no allowances for indirect effects. Therefore, while the package is expected to produce an additional £2 billion in revenue over the next three years, in line with the Government's cautious approach to the public finances, a lower figure of £1.7 billion has been included in the public finances projections. The Comptroller and Auditor General has audited the approach adopted to estimate the revenue benefits of the package and concluded that, though there are uncertainties in the estimates of the benefits, it is reasonable and incorporates caution.

2.35 As explained in Chapter C, in the light of the volatility in the observed ratio of VAT to consumption, a new approach to project VAT receipts has been used for the projections in Budget 2004. This is a more comprehensive approach to model the tax base than the old one, and uses an assumption on the VAT gap. The Comptroller and Auditor General has also completed the audit of the assumption on the VAT gap used to project VAT receipts. In his report, the Comptroller and Auditor General has concluded that the assumption has features that introduce caution in the projections for VAT and is reasonable.

RECENT FISCAL TRENDS AND OUTLOOK

2.36 Budget 2004 presents the Government's annual fiscal forecast and updates the 2003 Pre-Budget Report interim projections.

2.37 The Pre-Budget Report interim projections showed weaker receipts as a result of lower than expected growth in certain GDP components and higher than expected spending, including that arising from the UK's international commitments. The Budget 2004 public finance projections show little change compared with the Pre-Budget Report as trends in receipts and spending have turned out largely as expected.

2.38 The estimated 2003-04 outturn for the public sector current budget shows a deficit of £21.3 billion compared with projected deficits of £19.3 billion and £8.4 billion in the 2003 Pre-Budget Report and Budget 2003 respectively. For public sector net borrowing, the estimated 2003-04 outturn is £37.5 billion, compared with £37.4 billion projected in the 2003 Pre-Budget Report and £27.3 billion projected in Budget 2003. On the basis of cautious, audited assumptions, the Government remains on course to meet its fiscal rules over the economic cycle.

2.39 Table 2.3 shows projections for public sector net borrowing compared with those presented in the 2003 Pre-Budget Report. It disaggregates the difference into those relating to the assumptions audited by the NAO, changes in GDP components and other forecasting effects. It also shows the discretionary measures, including the decision to reset the Annually

Managed Expenditure (AME) margin. If the Government had not decided to rebuild this cautious safety margin in AME, medium-term projections for net borrowing would have been lower and the surplus on the current budget higher than shown in the 2003 Pre-Budget Report.

Table 2.3: Public sector net borrowing compared with the 2003 Pre-Budget Report

£ billion	Estimate[1]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
PBR 2003	**37.4**	**31**	**30**	**27**	**27**	**24**
Assumptions audited by the NAO	**–0.2**	**–1**	**–1½**	**–2**	**–2**	**–1½**
of which:						
VAT forecasting assumption	0.0	½	0	–½	–1	–1
equity prices	0.0	–½	–1	–1	–1	–1
GDP components	**0.3**	**–½**	**–1**	**–1**	**–1**	**–½**
of which:						
consumers expenditure	0.0	–½	–½	–½	–½	0
Other forecasting effects	**0.0**	**2**	**2½**	**2½**	**2**	**½**
of which:						
receipts	0.6	1½	2	2	2	2
expenditure	–0.7	½	½	0	–½	–1½
Total before discretionary measures	**37.5**	**32**	**30**	**27**	**26**	**22**
Discretionary measures[2]	0.0	1½	1	½	½	½
of which:						
resetting the AME margin	0.3	1	2	2	2	2
Inland Revenue compliance package	0.0	0	–½	–1	–1	–1
Budget 2004	**37.5**	**33**	**31**	**27**	**27**	**23**

Note: Figures may not sum due to rounding.
[1] The 2003-04 figures were estimates in PBR 2003.
[2] Includes measures announced since the 2003 Pre-Budget Report.

2.40 Changes associated with assumptions audited by the NAO have reduced net borrowing. The new approach for forecasting VAT, which is based on a more detailed model of the VAT base and an audited assumption on the VAT gap, which the NAO have concluded incorporates caution, has increased projected receipts by up to £1½ billion. In addition, higher equity prices are expected to increase receipts from corporation tax, capital taxes and stamp duty.

2.41 Differences between the 2003 Pre-Budget Report and Budget 2004 projections for individual components of GDP have reduced net borrowing. This is mainly due to higher levels of consumers' expenditure, which increases projections for VAT receipts, related to information from the latest national accounts' data for 2003. Other forecasting effects for receipts are the result of revisions to NHS gross operating surpluses, though this is matched by changes in receipts and therefore is fiscally neutral; lower than projected receipts of council tax, which is also fiscally neutral; and recent trends in incorporations. The expenditure forecasting effects are mainly related to AME, discussed below, and the revenue neutral switch with NHS gross operating surplus.

Non-discretionary changes in receipts

2.42 Table 2.4 shows how projections for specific receipts and spending items have affected net borrowing since the 2003 Pre-Budget Report. Projections for receipts from income tax, national insurance contributions and non-north sea corporation tax taken together are lower in 2003-04, a result of temporarily higher capital allowances and corporation tax repayments, but over the medium term, are broadly unchanged from the 2003 Pre-Budget Report. Recent data show that underlying receipts are increasing in line with the 2003 Pre-Budget Report projections, with financial companies' profits and income tax receipts from bonuses both increasing as expected.

2.43 Receipts from VAT are greater than expected this year, and in future years are increased by higher consumers' expenditure and the new audited assumption. Projections for excise duties and vehicle excise duty (VED) are lower as a result of a lower projection for RPI inflation and a lower estimated outturn this year respectively.

Non-discretionary changes in spending

2.44 The estimated outturn for Total Managed Expenditure (TME) in 2003-04 is £0.5 billion higher than projected in the 2003 Pre-Budget Report. The estimated outturn for 2003-04 Departmental Expenditure Limits (DEL) is £1 billion lower than projected in the 2003 Pre-Budget Report.

2.45 Projections for AME are, as shown in Table 2.4, higher in the short term compared to the 2003 Pre-Budget Report projections, though they remain broadly unchanged over the medium term. In the short term, the effect of a re-profiling of Child and Working Tax Credit payment schedules has increased expenditure. In addition, there is higher spending in the early years from changes in the timing of payments of the UK's contributions to the EU. AME is also affected by changes to local authority self-financed expenditure, which are fiscally neutral and related to lower council tax receipts discussed above.

Table 2.4: Changes in projections of public sector net borrowing since the 2003 Pre-Budget Report

£ billion	Estimate[1]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
PBR 2003	**37.4**	**31**	**30**	**27**	**27**	**24**
Changes before discretionary measures	**0.1**	½	–½	–½	–1	–1½
of which:						
Income tax, NICs and non-North Sea CT	0.6	1½	½	0	½	0
VAT	–0.7	–½	–1	–1½	–2	–2
Excise duties and VED	0.1	½	½	½	½	½
AME[2]	0.9	½	0	0	0	0
Other	–0.7	–1½	0	½	½	0
Total before discretionary measures	**37.5**	**32**	**30**	**27**	**26**	**22**
Discretionary measures[3]	0.0	1½	1	½	½	½
of which:						
resetting the AME Margin	0.3	1	2	2	2	2
Inland Revenue compliance package	0.0	0	–½	–1	–1	–1
Budget 2004	**37.5**	**33**	**31**	**27**	**27**	**23**

Note: Figures may not sum due to rounding.
[1] *The 2003-04 figures were estimates in PBR 2003.*
[2] *Resource AME.*
[3] *Includes measures announced since the 2003 Pre-Budget Report.*

BUDGET DECISIONS

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

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

2.47 Within this disciplined framework, Budget 2004 shows the Government can meet its public spending commitments and announces further decisions to create a Britain of stability and strength, including:

- a £100 payment to pensioner households with someone aged 70 or over to help with their council tax bills;
- a package of measures to help protect tax revenues for the benefit of all taxpayers. The Inland Revenue has been provided with additional resources to support a new compliance and enforcement package as described in Chapter 5;
- Budget 2004 sets firm overall spending limits for the 2004 Spending Review period, allowing:
  - current spending to increase by an average 2.5 per cent in real terms in 2006-07 and 2007-08, in line with the cautious assumption for trend economic growth and consistent with the nominal growth rates set out in Budget 2003 and the 2003 Pre-Budget Report. Final plans for DEL and AME will be set in the Spending Review;
  - public sector net investment to rise from 2 per cent of GDP to $2^1/_4$ per cent of GDP by 2007-08 to continue to address historic under-investment in Britain's infrastructure; and
- the growth rate of both overall spending (TME) and departmental spending (DEL) will be lower in the 2004 Spending Review than in the 2002 Spending Review. However, building on the progress made in correcting historic under-investment, and with administration costs frozen in nominal terms and planned efficiency gains, the Government expects to match the pace of growth in front line public services achieved in the last Spending Review.

2.48 Table 1.2 lists the key Budget policy decisions and their impact on the public finances. Further details are set out in Chapter A of the FSBR.

2.49 The Government has also decided to reset the AME margin to £1 billion and £2 billion for the years 2004-05 and 2005-06, in accordance with usual practice. This increases projections for TME by the same amount, and ensures that the public spending projections include a prudent and cautious safety margin against unexpected events. The resetting of the AME margin transfers around £3 billion to an explicit public spending safety margin and maintains the same overall caution in the projections as a whole.

MEDIUM-TERM FISCAL PROJECTIONS

2.50 Table 2.5 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2003 and in the 2003 Pre-Budget Report. Changes in the fiscal balances are disaggregated into those attributable to revisions or forecasting changes and discretionary measures. It includes the impact of all Budget decisions in accordance with the *Code for fiscal stability.* Consistent with the presentation in the Pre-Budget Report, the table includes the impact of the windfall tax and associated spending. Further detail is provided in Chapter C of the FSBR.

2.51 The revised outturn for 2002-03 shows the deficit on the current budget to be £0.5 billion higher than in Budget 2003, and £0.4 billion higher than in the 2003 Pre-Budget Report. The outturn for net borrowing is £1.1 billion lower than shown in Budget 2003, and £0.4 billion higher than in the 2003 Pre-Budget Report.

Table 2.5: Fiscal balances compared with Budget 2003 and the 2003 Pre-Budget Report

	Outturn[1]	Estimate[2]			Projections		
	2002-03	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**
Surplus on current budget (£ billion)							
Budget 2003	**–11.7**	**–8.4**	**–1**	**2**	**6**	**9**	**–**
Effect of forecasting changes:							
Receipts[3]	–0.5	–5.5	–4	–4	–3	–1	–
Current expenditure[4]	0.4	–2.9	–2	–2	–3	–3	–
Effect of discretionary changes[5]	0.0	–2.5	–1	–1	0	0	–
PBR 2003	**–11.8**	**–19.3**	**–8**	**–5**	**0**	**4**	**8**
Effect of revisions and forecasting changes:							
Receipts[3]	–0.4	–1.3	–2	–1	0	0	1
Current expenditure[4]	–0.1	–0.6	1	1	1	1	1
Effect of discretionary changes[5]	0.0	0.0	–1	–1	–1	–1	0
Budget 2004	**–12.3**	**–21.3**	**–11**	**–5**	**0**	**4**	**9**
Net borrowing (£ billion)							
Budget 2003	**24.0**	**27.3**	**24**	**23**	**22**	**22**	**–**
Changes to current budget	0.1	10.9	7	7	6	4	–
Forecasting changes in net investment	–1.5	-0.9	0	0	0	0	–
Discretionary changes to net investment	0	0	0	0	0	0	–
PBR 2003	**22.5**	**37.4**	**31**	**30**	**27**	**27**	**24**
Changes to current budget	0.5	1.9	2	1	0	0	–1
Forecasting changes in net investment	–0.1	–1.8	0	0	0	0	0
Discretionary changes to net investment	0.0	0.0	0	0	0	0	0
Budget 2004	**22.9**	**37.5**	**33**	**31**	**27**	**27**	**23**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2003	–0.5	0.2	0.5	0.4	0.4	0.6	–
PBR 2003	–0.6	–0.8	–0.1	–0.1	0.0	0.3	0.6
Budget 2004	**–0.6**	**–1.0**	**–0.2**	**–0.2**	**0.0**	**0.3**	**0.7**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2003	1.7	1.5	1.5	1.7	1.7	1.6	–
PBR 2003	1.6	2.4	2.0	2.2	2.0	1.9	1.7
Budget 2004	**1.6**	**2.4**	**2.1**	**2.3**	**2.1**	**1.9**	**1.6**
Net debt (per cent of GDP)							
Budget 2003	30.9	32.2	32.7	33.2	33.5	33.8	–
PBR 2003	30.9	32.8	33.8	34.6	35.1	35.4	35.5
Budget 2004	**30.8**	**33.2**	**34.4**	**35.3**	**35.9**	**36.3**	**36.4**

[1] *The 2002-03 figures were estimates in Budget 2003.*
[2] *The 2003-04 figures were projections in Budget 2003.*
[3] *Further details given in table C7.*
[4] *Includes depreciation.*
[5] *Includes measures announced since the 2003 Pre-Budget Report.*

2.52 Short-term projections for the surplus on the current budget are slightly lower, and net borrowing slightly higher compared to the 2003 Pre-Budget Report reflecting lower receipts and a reprofiling of expenditure. As receipts strengthen over the projection period, so the main fiscal aggregates return to the levels projected in the 2003 Pre-Budget Report. Debt is forecast to rise to just under $36\frac{1}{2}$ per cent of GDP by the end of the projection period. The revision to debt also includes the impact of fully reflecting the Blue Book 2003 changes to the classification of business rates, which increases the public sector net cash requirement by around £1 billion a year.

2.53 Table 2.5 also sets out the underlying structural position of the fiscal balances, adjusted for the impact of the economic cycle on the public finances.[5] Cyclically-adjusted, the current budget and net borrowing are little changed from the 2003 Pre-Budget Report projections. Compared to Budget 2003, cyclically-adjusted net borrowing is higher, and the surplus on the current budget lower, in the near term. Towards the end of the projection period, they return towards the levels shown in Budget 2003.

Box 2.6: The Stability and Growth Pact

The Stability and Growth Pact is intended to ensure that EU Member States maintain sound public finances. Fiscal sustainability is a prerequisite for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy coordination.

The Government supports a prudent interpretation of the Pact that builds on the Code of Conduct, agreed by Member States in June 2001[a] and the March 2003 ECOFIN conclusions agreed by Finance Ministers on strengthening budgetary coordination. A prudent interpretation would lock in long-term fiscal discipline and sustainability, enhancing credibility across the economic cycle, while allowing the automatic stabilisers to smooth fluctuations in output, and allow appropriate increases in investment in public services. Specifically, it would take into account:

- **the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy;**
- **sustainability – low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations, such as that set out in Annex A and in the 2003 *Long-term public finance report*; and**
- **public investment – public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.**

The Government is today publishing *The Stability and Growth Pact: A Discussion Paper.* This assesses the performance of the Pact against the principles of credibilty, flexibility and legitimacy and considers how a prudent interpretation helps the Pact better to achieve its objectives. The issue is not one of fundamental overhaul or Treaty change, but evolution. There are signs that the implementation of the Pact is evolving towards a more prudent interpretation. Over the past two years the Council has approved: a greater focus on cyclical adjustment; a recognition that the automatic stabilisers should be allowed to operate symmetrically over the cycle; a greater focus on long-run sustainability, including the impact of ageing populations; a greater emphasis on debt reduction in highly indebted countries; and greater attention to the quality of public finances.

[a] The Code of Conduct on the content and format of Stability and Convergence Programmes was agreed as an EFC Opinion, endorsed by ECOFIN in October 1998 and revised in June 2001. Available at www.europa.eu.int

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

ADHERING TO PRINCIPLES

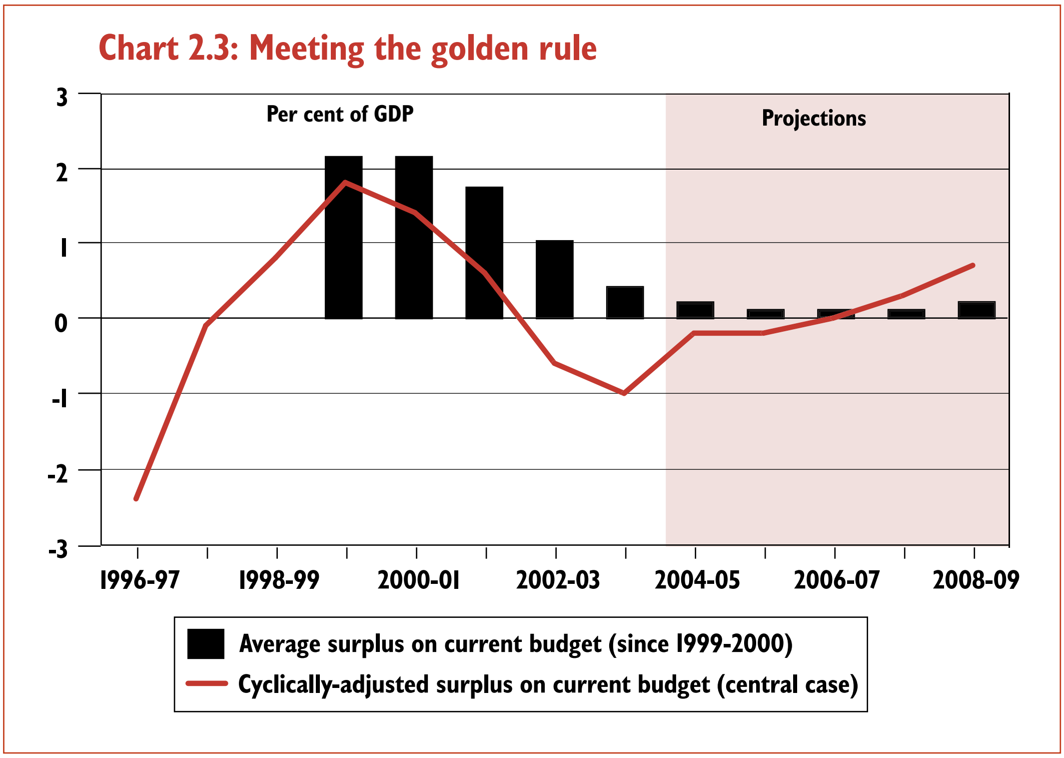
2.54 Table 2.6 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. The table indicates that, after allowing for non-discretionary changes to receipts and spending and taking into account the Budget decisions, the Government remains on track to meet both fiscal rules.

Table 2.6: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate[1]	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Fairness and prudence							
Surplus on current budget	–1.2	–1.9	–0.9	–0.4	0.0	0.3	0.7
Average surplus since 1999-2000	1.0	0.4	0.2	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–0.6	–1.0	–0.2	–0.2	0.0	0.3	0.7
Long-term sustainability							
Public sector net debt[1]	30.8	33.2	34.4	35.3	35.9	36.3	36.4
Core debt[1]	30.8	32.2	32.9	33.7	34.3	34.8	34.9
Net worth[2]	24.3	22.0	19.6	17.1	16.5	15.4	15.5
Primary balance	–0.6	–1.7	–1.1	–0.8	–0.5	–0.2	–0.1
Economic impact							
Net investment	1.0	1.5	1.9	2.0	2.1	2.2	2.2
Public sector net borrowing (PSNB)	2.2	3.4	2.8	2.5	2.1	1.9	1.6
Cyclically-adjusted PSNB	1.6	2.4	2.1	2.3	2.1	1.9	1.6
Financing							
Central government net cash requirement	2.1	3.8	3.0	2.6	2.4	1.9	1.6
Public sector net cash requirement	2.1	3.9	2.9	2.5	2.3	1.9	1.6
European commitments							
Treaty deficit[3]	2.1	3.2	2.6	2.4	2.0	1.9	1.6
Cyclically-adjusted Treaty deficit[3]	1.5	2.3	1.9	2.2	2.0	1.9	1.6
Treaty debt ratio[4]	37.9	39.8	40.9	41.5	41.9	42.2	42.1
Memo: Output gap	–1.2	–1.4	–0.8	–0.1	0.0	0.0	0.0

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

Golden rule **2.55** 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 and additional spending in the short term means that the deficit on the current budget is forecast to be 1.9 per cent of GDP this year, falling to 0.9 per cent next year and moving back to balance in 2006-07, and showing a surplus of 0.6 per cent of GDP by the end of the projection period.



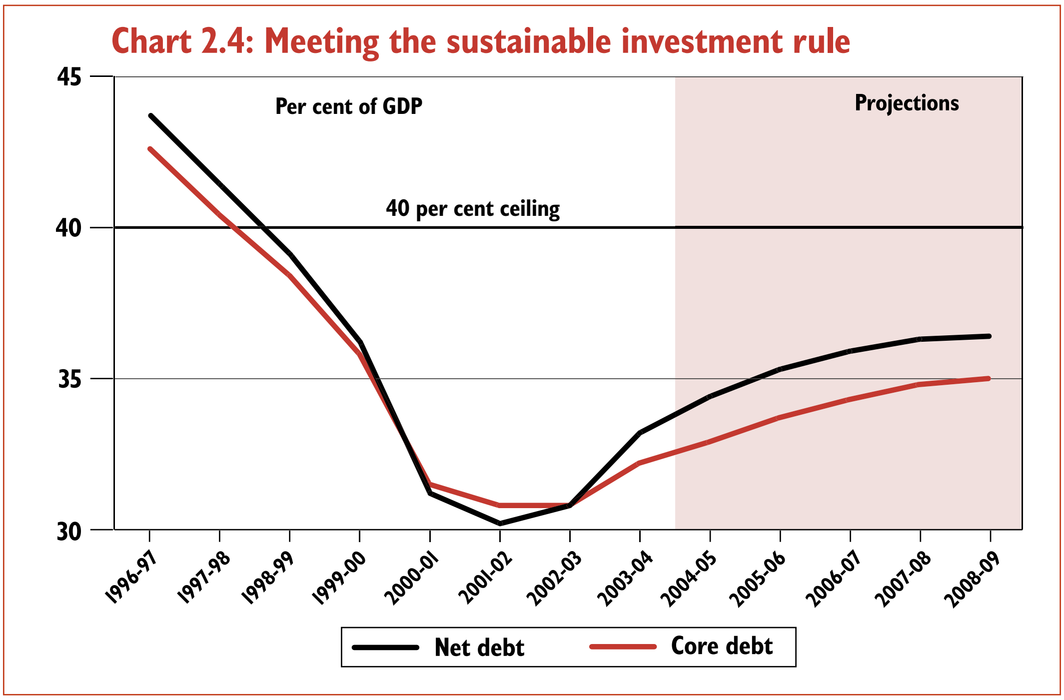
2.56 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.[6] 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 positive in every year of the projection period. The economy is projected to return to trend by early 2006, meaning that over the whole cycle the average surplus on the current budget would be around an annual 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is on track to meet the golden rule and there is a margin against the golden rule of £11 billion in this cycle, including the AME margin. If the economic cycle were assumed to have started in 1997-98, the average surplus on the current budget up to 2005-06 would be 0.2 per cent of GDP.

2.57 The economy is projected to return to trend by early 2006. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2008-09 is 0.1 per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on track to continue 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.

[6] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002 and performance over past cycles is described in Budget 2000.



2.59 Chart 2.4 shows that, despite sustained weakness in the world economy, net debt is expected to remain low and stable, rising from 31 per cent to stabilise at just under 36½ per cent at the end of the projection period – £53 billion below the 40 per cent level. Therefore, the Government comfortably meets its sustainable investment rule. Chart 2.4 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 projected to rise to around 35 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 objective of inter-generational fairness that underpins the fiscal framework.

Box 2.7: Public finances in the G7

The table below compares the projections presented in Budget 2004 with those for other G7 countries, as forecast by the European Commission or the OECD. While care needs to be taken when comparing numbers internationally, the UK performs well: gross debt is the lowest in the G7 and the deficit is below the average for the G7 as a whole.

Public finances in the G7

Per cent of GDP	Estimate[a]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
United Kingdom						
Treaty deficit	3.2	2.6	2.4	2.0	1.9	1.6
Cyclically-adjusted Treaty deficit	2.3	1.9	2.2	2.0	1.9	1.6
Treaty debt	39.8	40.9	41.5	41.9	42.2	42.1
Public sector net investment	1.5	1.9	2.0	2.1	2.2	2.2
	2003	**2004**	**2005**			
France						
Treaty deficit	4.2	3.8	3.6			
Cyclically-adjusted Treaty deficit	3.9	3.3	3.2			
Treaty debt	62.6	64.3	65.6			
Germany						
Treaty deficit	4.2	3.9	3.4			
Cyclically-adjusted Treaty deficit	3.5	3.3	3.0			
Treaty debt	63.8	65.0	65.8			
Italy						
Treaty deficit	2.6	2.8	3.5			
Cyclically-adjusted Treaty deficit	2.1	2.3	3.2			
Treaty debt	106.4	106.1	106.1			
Canada						
Deficit	–1.0	–0.7	–0.8			
Cyclically-adjusted deficit	–1.1	–0.6	–0.7			
Gross debt	75.6	73.6	70.8			
Japan						
Deficit	7.4	6.8	6.9			
Cyclically-adjusted deficit	6.9	6.5	6.6			
Gross debt	154.6	161.2	167.2			
USA						
Deficit	4.9	5.1	4.9			
Cyclically-adjusted deficit	4.5	5.1	5.0			
Gross debt	63.4	66.0	68.5			
G7 average[b]						
Deficit	3.7	3.5	3.4			
Cyclically-adjusted deficit	3.2	3.1	3.2			
Gross debt	80.9	82.5	83.7			

Source: data for EU countries excluding UK from European Commission autumn forecasts; non-EU countries from OECD Economic Outlook 74 (December 2003). The fiscal aggregates forecast by the OECD are slightly different from those forecast by the European Commission, deficit refers to deficit on general government financial balance, gross debt to general government gross financial liabilities.

[a] The 2003-04 figures were estimates in Budget 2003.

[b] Unweighted average (financial year figures used for UK)

Economic impact

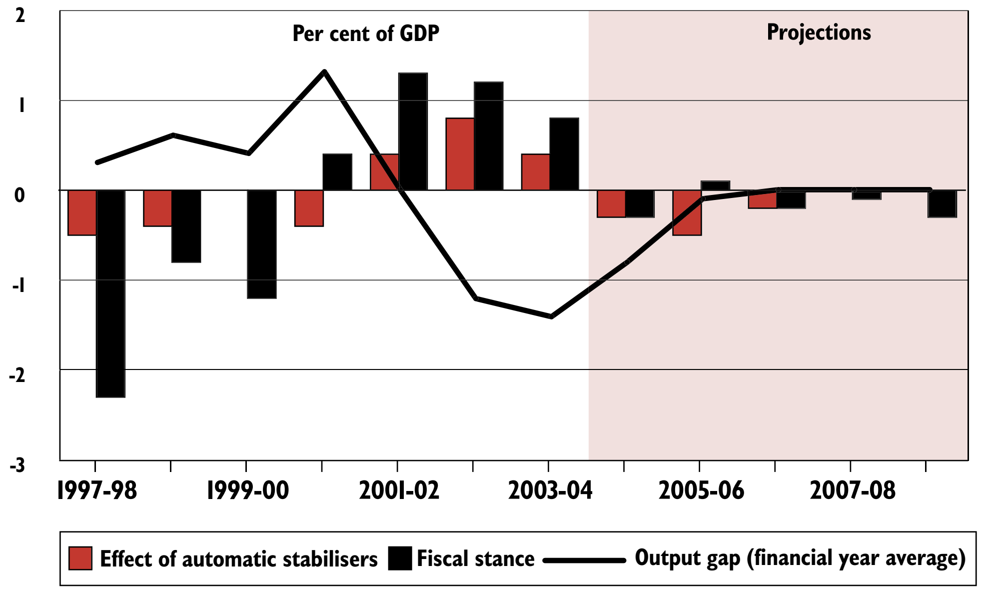
2.60 While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB).

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

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

2.62 Chart 2.5 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy. During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy has moved below trend so the fiscal stance has eased, helping to maintain economic stability. Over the next few years, as the economy returns to trend, fiscal policy moves towards a more neutral stance.

Chart 2.5: Fiscal policy supporting monetary policy



2.63 Between Budgets, the fiscal stance can change as a result of a discretionary measure to:

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

2.64 Table 2.7 explains how these concepts relate to the projections in the Budget. It shows the changes in both the fiscal stance and the overall fiscal impact between Budget 2003 and the 2003 Pre-Budget Report, and the changes since the Pre-Budget Report.

Table 2.7: The overall fiscal impact

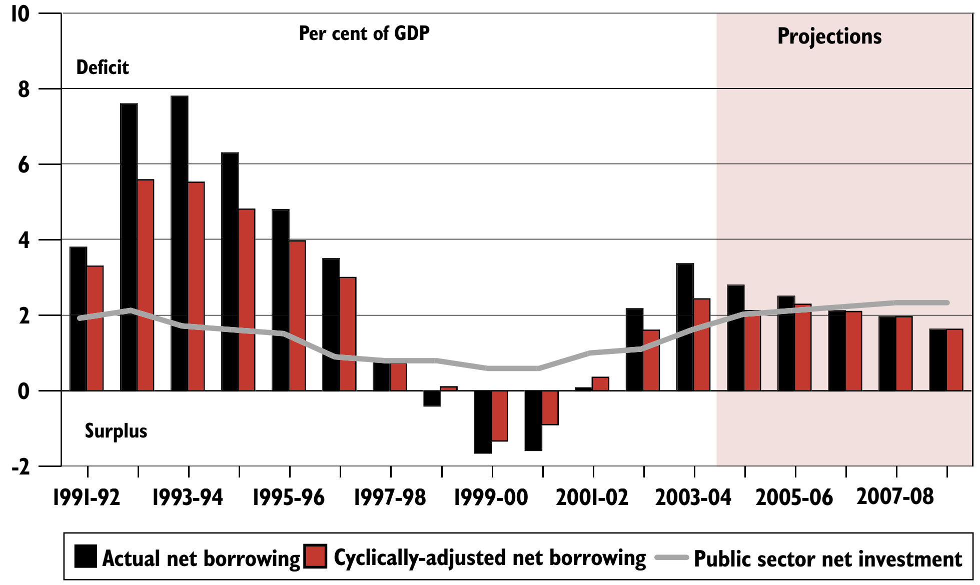
	Percentage points of GDP						
	Outurn	Estimate[1]	Projections				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Change from Budget 2003 to PBR 2003							
Post Budget and PBR policy decisions	0.0	0.0	0.0	0.0	0.0	0.0	–
+							
non-discretionary factors	–0.1	0.9	0.6	0.5	0.4	0.3	–
=							
CHANGE IN FISCAL STANCE	–0.1	0.9	0.6	0.5	0.4	0.3	–
+							
automatic stabilisers	–0.1	0.0	0.0	0.1	0.0	0.0	–
=							
OVERALL FISCAL IMPACT	–0.1	0.9	0.6	0.5	0.4	0.3	–
Change from PBR 2003 to Budget 2004							
Budget measures	0.0	0.0	0.1	0.1	0.0	0.1	0.0
+							
non-discretionary factors	0.0	0.0	0.0	0.0	0.0	–0.1	–0.1
=							
CHANGE IN FISCAL STANCE	0.0	0.0	0.1	0.1	0.0	0.0	–0.1
+							
automatic stabilisers	0.0	0.0	0.0	0.0	0.0	0.0	0.0
=							
OVERALL FISCAL IMPACT	0.0	0.0	0.2	0.0	0.0	0.0	–0.1

[1] *The 2003-04 figures were projections in Budget 2003.*

2.65 With the path of the output gap little different from Budget 2003 and the 2003 Pre-Budget Report, the Treasury's methodology for cyclical adjustment attributes almost all of the change in the net borrowing to non-discretionary factors. Table 2.7 therefore shows that, relative to Budget 2003, the fiscal stance has eased. Relative to the 2003 Pre-Budget Report, the fiscal stance is broadly unchanged. However, the degree of caution in the assumptions underpinning the public finance projections increases over the projection period, and the actual outcomes and the effects on the economy may not necessarily be reflected in the projections, especially in later years.

2.66 Modest levels of borrowing over the forecast period reflect sustained capital investment in public services, as shown in Chart 2.6, and is fully consistent with meeting the Government's firm fiscal rules.

Chart 2.6: Public sector net borrowing and net investment



Financing **2.67** The forecast for the central government net cash requirement (CGNCR) for 2003-04 is £42.3 billion, an increase of £1.8 billion from the 2003 Pre-Budget Report forecast. Allowing for a £0.2 billion increase in the sterling offset from the issuance of foreign currency debt for the financing of the Official Reserves and a £0.7 billion increase in the forecast net contribution from National Savings & Investments (NS&I) means that the net financing requirement for 2003-04 is now expected to be £58.0 billion, an increase of £0.9 billion from the 2003 Pre-Budget Report forecast. The increased financing requirement is being met by a £0.1 billion revision to the forecast level of gilt sales and a £0.8 billion increase in the forecast level of short-term debt at end March 2004.

2.68 The forecast for the CGNCR for 2004-05 is £35.6 billion. With gilt redemptions of £14.7 billion, and an estimated forecast net contribution from NS&I of £2.0 billion, the forecast net financing requirement for 2004-05 is £48.3 billion. The financing requirement will be met by:

- gross gilts issuance of £48.0 billion; and
- a £0.3 billion increase in the net short-term debt position.

2.69 Full details and a revised financing table can be found in Chapter C. Further details can be found in the *Debt and Reserves Management Report 2004-05,* which is published alongside Budget 2004.

European commitments **2.70** The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box 2.6 and *The Stability and Growth Pact: A Discussion Paper,* published alongside Budget 2004. 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 Budget, which show the Government on track to meet its fiscal rules over the cycle, low debt and sustainable public finances, combined with sustainable increases in public sector net investment, are fully consistent with the prudent interpretation of the Pact.

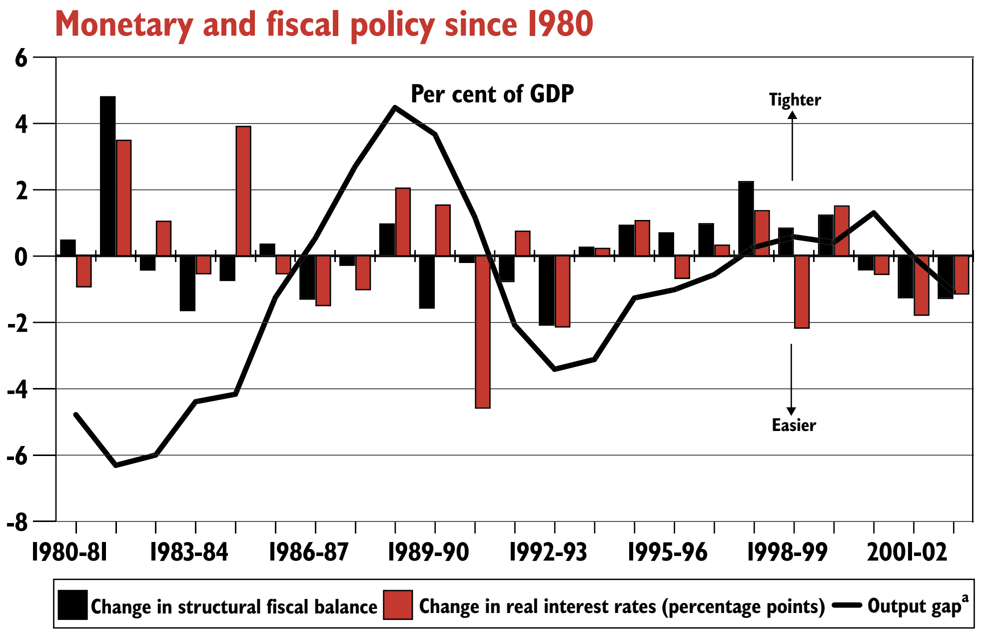
Dealing with uncertainty

2.71 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 margin 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.

Box 2.8: Fiscal policy and monetary policy in the UK

The UK's macroeconomic framework is designed to promote economic stability. In recent years fiscal and monetary policy have worked together to support economic growth during a period of economic uncertainty. From the top of the economic cycle in 2000-01 to 2002-03, when the economy was below trend, real interest rates fell by around 3 percentage points and fiscal policy eased by around 2.5 per cent of GDP.

The chart below shows how the fiscal stance and monetary policy have moved in relation to the output gap over time. Since the late 1990s, both fiscal and monetary policy have tended to be counter-cyclical and forward looking. The chart also shows, however, that monetary and fiscal policy have not always worked in such a coherent, counter-cyclical

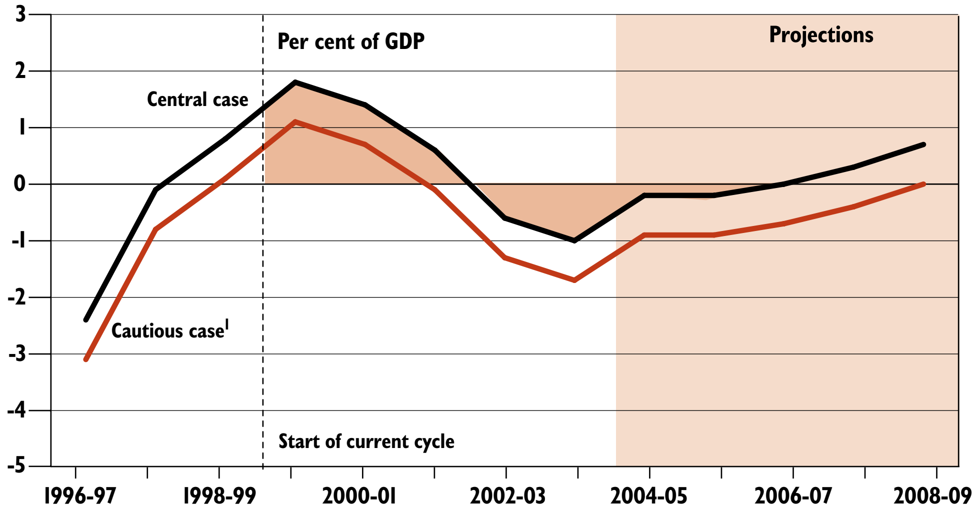


[a] *Financial year average.*

2.72 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 2.7 illustrates the Pre-Budget Report projection for this cautious case.

2.73 The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. Combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, the Government can now draw on this margin to safeguard the increase in investment in priority public services, reset the AME margin to ensure that the public spending projections include a cautious safety margin, and allow the automatic stabilisers to work in full following a period of global economic uncertainty, while remaining on track to meet the fiscal rules.

Chart 2.7: 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.

2.74 The Government is, on the basis of cautious, independently audited assumptions, on track to meet the golden rule in the central case. However, in the cautious case, the average surplus on the current budget in the cautious case is no longer positive as the Government draws on its safety margin against unexpected events. The projections show that this margin is being rebuilt at the end of the projection period as the current budget moves into surplus and the cyclically-adjusted surplus in the cautious case moves back to balance. In the meantime, the Government will remain vigilant to the risks and continue to base projections of the public finances on cautious assumptions.

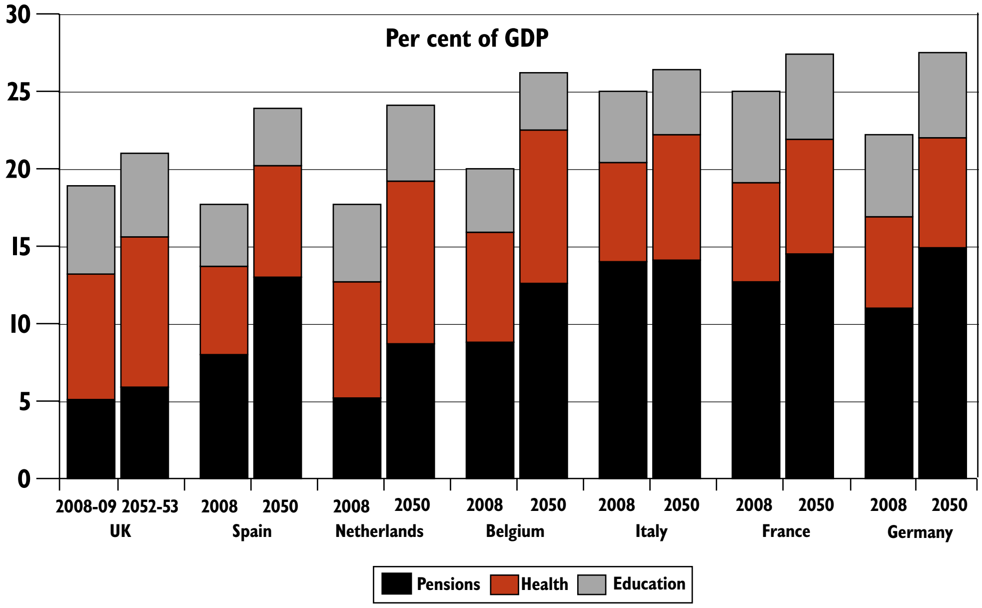
LONG-TERM FISCAL SUSTAINABILITY

2.75 To safeguard long-term economic growth and ensure inter-generational fairness it is important that Budget decisions are consistent with long-term sustainability of the public finances. Failure to do so would be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability*.

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

2.77 These illustrative long-term fiscal projections yield similar conclusions to those presented in the Government's 2003 *Long-term public finance report*, published alongside the 2003 Pre-Budget Report. The report demonstrates that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries to face the challenges ahead. Chart 2.8 shows the projected development of age-related spending over the coming decades in selected EU countries. It shows that age-related spending in the UK is projected to rise only moderately over the next five decades, even when including the latest projections on state pension spending.

Chart 2.8: Age-related spending in selected EU countries



[1] For UK spending in 2008-09 and 2052-53 based on health and education projections presented in 2003 Long-term public finance report and latest pension projections, for other countries spending in 2008 and 2050 based on national and EPC projections. Comparisons of projections need to be treated with caution as some include the cost of long-term care within health projections, and may not fully reflect latest policy changes.
Sources: HM Treasury 2003, Department for Work and Pensions 2004 and European Commission's assessments of Member States' Stability and Convergence Programmes 2004.

2.78 Alternative projections can be generated on a wide range of assumptions and policy scenarios, including uprating pension increases in line with earnings growth rather than inflation. For example, based on GAD projections[7], it can be calculated that spending on the basic state pension, state earnings related pension scheme and the state second pension would rise to around 7 per cent of GDP by 2050 with earnings uprating, around 3 percentage points higher than under current policy.

2.79 However, notwithstanding the use of prudent and cautious assumptions, a wide range of unforeseen developments could arise over the projection period. The Government will therefore continue to update and report on its assessments of long-term fiscal sustainability, both through regular publication of the *Long-term public finance report* alongside the Pre-Budget Report and through the illustrative long-term fiscal projections presented with each Budget, to ensure that all fiscal policy decisions are set within a sustainable, long-term framework.

MACROECONOMIC STABILITY AND THE HOUSING MARKET

2.80 The housing market in the UK has often been associated with instability in the economy as a whole. Pronounced cycles in the housing market have been a notable feature of the UK economy over the past three decades and have affected the wider economy through private consumption. Housing is a key asset for households and household spending is closely associated with changes in housing wealth. Reducing volatility in the housing market will therefore help promote macroeconomic stability.

[7] Based on data from the *Quinquennial Review of the National Insurance Fund*, Government Actuary's Department, 2003.

2.81 A number of structural features may contribute to the high levels of housing market volatility in the UK compared to other European countries, and could explain the strong link to consumption:

- the low responsiveness of housing supply to demand in the UK, which has contributed to the strong rise in real house prices in the UK and tends to increase house price volatility;
- the dominance of variable rate mortgages and high level of mortgage debt combine to explain both households' sensitivity to interest rate changes and the strong link between the housing market and consumption in the UK; and
- high levels of owner occupation, as compared to renting, and the ability of households to withdraw equity from housing adds to the impact of changes in housing wealth on consumption.

2.82 The unique characteristics of the housing market expose households to many inter-related risks. Demand for housing changes over people's lifetimes but trading up or down is costly and the timing of moves involves price risk. Since houses are also usually bought with mortgage finance, this entails interest rate risk. Furthermore, the ability to service interest payments, cover the costs of moving and meet maintenance costs depend on the households' future income stream, which is also uncertain. Importantly, the risks associated with house prices, interest rates and incomes have tended to be positively related, compounding the potential impact of shocks on consumption.

Box 2.9: Stability, the housing market and EMU

The Government is committed to a comprehensive programme to improve the functioning of the housing market. Building on the reforms to deliver a step change in planning policy, the Government is undertaking further significant changes in the planning system, supply of housing and housing finance to tackle market failures, increase the responsiveness of supply to demand and reduce national and regional price volatility. These measures are beneficial in their own right to improve the stability and flexibility of the UK housing market and wider economy, but will also help to increase the housing market's compatibility with the euro area, encouraging greater convergence over time.

The June 2003 assessment of the five economic tests for UK membership of EMU concluded that distinct supply and demand features of the UK housing market mean that both the relationship between house prices and household consumption, and the underlying rate of real house price growth, are stronger in the UK than in the euro area. The structure of the UK mortgage market is such that UK households are more sensitive to interest rates, which has implications for the transmission of monetary policy.

The Government is implementing quickly and decisively past reforms to housing supply and going further to address both supply and demand in the housing market and macroeconomic stabilisation more generally. In particular:

- **Kate Barker's final report on the factors affecting housing supply published today sets out a challenging set of reforms to improve the functioning of the housing market to increase housing supply. The Government accepts the need for a substantial increase in development over time, and the need for reform, and intends to implement a programme of change as recommended in the review to the planning system and to the delivery of development. Chapter 3 sets out how it intends to take this forward; and**
- **the Government commissioned David Miles to review the mortgage market to consider why, unlike in many other developed economies, very little mortgage debt in the UK is at longer-term fixed interest rates. David Miles' final report on the UK mortgage market, published on 12 March 2004, makes recommendations on how the market can be helped to work better for consumers in a number of areas. A summary of the report and the Government's response is set out below.**

2.83 The Government has recognised that reforms in the housing market are needed to reduce volatility and promote stability in the wider economy. At the time of Budget 2003, the Chancellor asked David Miles to review the mortgage market in the UK, to consider why, unlike in many other developed economies, very little mortgage debt in the UK is at longer-term fixed interest rates. The final report was published on 12 March 2004 and is summarised in Box 2.10.

2.84 The Government welcomes David Miles' analysis of the strengths of the UK mortgage market, the areas for reform and his recommendations for action. The Government endorses his conclusion that urgent reform is desirable to make the market work better for consumers in a number of areas. A number of his recommendations are addressed to the Government and it will consider and consult on them as proposed by the Review. A number of recommendations are addressed to the FSA, which has in train reforms in the mortgage market, which will move to statutory regulation on 31 October 2004. The Chancellor has asked the FSA to consider and report on the further reforms proposed by David Miles.

2.85 At the time of Budget 2003, the Chancellor, with the Deputy Prime Minister, also commissioned Kate Barker to analyse the issues surrounding housing supply in the UK. Details of the final report of the Barker Review are presented in Chapter 3.

Box 2.10: The Miles Review of the UK mortgage market

The interim report of the Miles Review, published in December 2003, found that while many borrowers can benefit from longer-term fixed-rate mortgages, few choose these products – overwhelmingly, mortgages in the UK are either at variable rates or at rates fixed for around two years. The interim report presented evidence on the key factors limiting the take-up of mortgages at longer-term rates of interest:

- when choosing between mortgages, many borrowers attach great weight to the level of initial monthly repayments. Consideration of where interest rates might move in the future, and what this implies for affordability, seems to play a far smaller role. Many households find it difficult to assess these risks and the type of advice and information they receive does not help them as much as it could;
- the structure of mortgage pricing generates cross-subsidisation from many existing borrowers, a significant proportion of whom are paying standard variable rates, to new borrowers taking out discounted variable and short-term fixed-rate mortgages. This creates unfairness and makes the market less transparent than it could be. It plays to a tendency of many borrowers to focus on the initial monthly payments on a mortgage and it makes medium-term and longer-term fixed-rate mortgages appear expensive; and
- there are also a number of potential legislative and regulatory barriers that might affect the cost effective funding of longer-term fixed-rate lending and the way in which early redemption charges are structured.

The Review's final report, published on 12 March 2004, makes recommendations to the FSA and associated bodies, and to the Government on how the mortgage market in the UK can be helped to work better. The recommendations are based on evidence presented both in the interim report and the final report and fall broadly into two groups: those that are aimed at improving the advice and information that borrowers receive and at creating a fairer and more transparent pricing structure, and those that are aimed at helping lenders fund mortgages and handle risk in the most cost effective way. The recommendations include measures to:

- improve the information and advice available to consumers so they can make well-informed decisions about mortgage products;
- make the pricing of mortgages in the UK more transparent, fairer and sustainable, including the recommendation that lenders make their full range of mortgage products available to all borrowers;
- remove obstacles to the development of alternative forms of protection from nominal payment uncertainty; and
- enable cost-effective long-term lending, including recommendations to consider changes that would affect the wholesale markets.

The report concludes that, although there are great strengths in the UK housing finance system, if acted upon the recommendations have the potential to change the UK mortgage market and make it work better. This will be to the benefit of borrowers, lenders, other financial intermediaries and the savers whose funds are channelled through the market.