

Entrenching macroeconomic stability will be essential if Britain is to respond to the global economic challenges of the next decade. This chapter sets out the action the Government is taking to maintain macroeconomic stability and build on the progress made since 1997. The UK economy is currently experiencing its longest unbroken expansion since quarterly national accounts data began 50 years ago, with GDP now having grown for 49 consecutive quarters. And with inflation low and stable, interest rates set by the Monetary Policy Committee in order to meet the Government's symmetric inflation target, fiscal policy supporting monetary policy over the economic cycle, the UK weathered the international economic downturn, which began in 2001, better than many other industrialised countries. The global recovery has been gathering momentum during 2004, despite higher world oil prices. In the UK GDP has grown strongly over the past year with significant evidence of a rebalancing in the composition of demand. While a number of risks continue to surround the international outlook, sound macroeconomic fundamentals, recent strong and more broadly-based growth and continued expansion in the world economy point to a further period of relatively strong UK output growth. UK GDP is expected to grow by $3\frac{1}{4}$ per cent in 2004, in line with the Budget 2004 forecast. Growth of 3 to $3\frac{1}{2}$ per cent is forecast for 2005 as the remaining slack in the economy is absorbed before the output gap is closed in early 2006.

The interim forecast update of the projections for the public finances published in this Pre-Budget Report are broadly unchanged since the Budget 2004. Where there are changes, these are small and affect the short-term projections. The projections 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 including, by the end of the projection period, the cyclically-adjusted current budget in the cautious case; and
- public sector net debt is projected to remain low and stable over the forecast period, stabilising at a level well below the 40 per cent ceiling in the sustainable investment rule.

An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the *2004 Long-term public finance report*. The report confirms that on the basis of current policies, the public finances are sustainable in the longer term. In addition, the UK is in a strong position relative to many other countries to meet the challenges of an ageing population.

THE MACROECONOMIC FRAMEWORK

2.1 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.

2.2 In an increasingly integrated global economy, financial and economic instability in one region or country can be rapidly transmitted around the world. Flexible markets play an important role in dealing with these shocks, allowing the economy to adjust quickly and efficiently, with minimum impact on output and employment. A macroeconomic framework designed to maintain long-term stability is also key to allowing the economy to adjust smoothly to global shocks, an issue discussed further in Box 2.3.

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 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.

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

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 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.

Public spending framework **2.9** 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.

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

Box 2.1: Caution in the public finance projections

Forecasting the public finances inevitably involves a significant margin of uncertainty, particularly for the fiscal balances, which represent the differences between two very large aggregates. The Government's fiscal framework specifically recognises this uncertainty. The projections for the public finances are therefore based on cautious assumptions, including for trend growth, which help to build a margin against unexpected events.

These assumptions are audited by the NAO on a three-year rolling-review basis to ensure that they remain both reasonable and cautious. It is important that the assumptions remain reasonable as well as cautious, as excessive caution could distort the management of the public finances, particularly public spending. The NAO-audited assumptions include those for: privatisation proceeds; trend GDP growth; UK claimant unemployment; interest rates; equity prices; projecting the VAT gap; consistency of price indices; shares of labour income and profits in national income; funding; oil prices; and tobacco smuggling.

One of the key audited assumptions is that for the trend rate of GDP growth for the public finance projections, which is assumed to be $\frac{1}{4}$ of a percentage point below the neutral view. This means that the rate of economic growth used to forecast the public finances is the bottom end of the projection range. For example, in this Pre-Budget Report, the forecast for economic growth used in the public finance projections over the period 2005-06 to 2009-10 averages under $2\frac{1}{2}$ per cent, $\frac{1}{4}$ per cent below the central case, implying the level of GDP used in the public finance forecast is 1.4 per cent below the neutral view in 2009-10.

For the 2004 Pre-Budget Report, no assumptions were due for audit and the assumptions examined in previous audits have not been changed. A full description of the assumptions used in the 2004 Pre-Budget Report can be found in Annex B.

2.10 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding³ in 1997 established a framework for co-operation between these three bodies on financial stability.

2.11 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.

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

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 Government is committed to publishing six-monthly reports on trends and progress in increasing flexibility in the UK economy, the third of which is published as Annex C to this Pre-Budget Report.

As the Chancellor announced in Budget 2004: *"while the Government does not propose a euro assessment be initiated at the time of this Budget, the Treasury will again review progress at Budget time next year"*.

The Government continues to emphasise the need for a more prudent interpretation of the Stability and Growth Pact, as described in *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004. This 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 the 2004 *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.

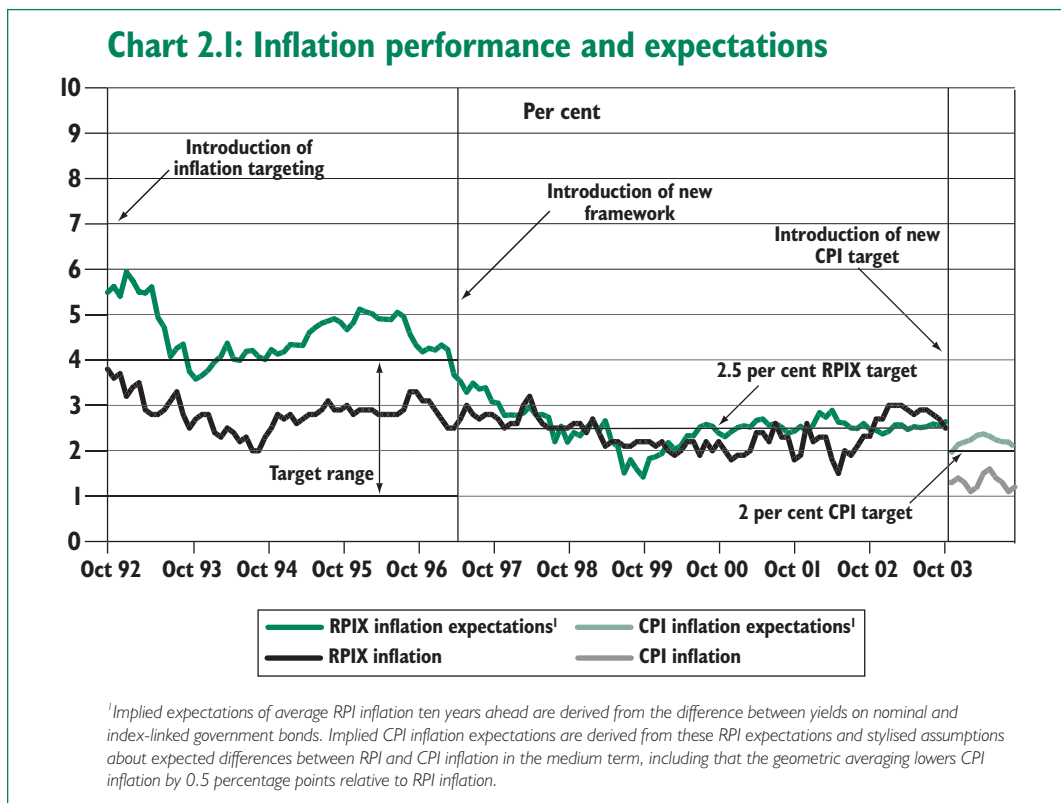
The Government also remains committed to the EU's Lisbon strategy on economic reform, launched in March 2000, and will continue to work with Member States and the EU institutions to build on progress so far and to accelerate the pace of reform, as discussed further in Chapter 3.

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 of 2.5 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 from a 2.5 per cent RPIX target to a 2 per cent CPI target – implied market expectations are that CPI inflation will be close to the 2 per cent target. CPI inflation has been within 1 percentage point of its target since its inception in December 2003.



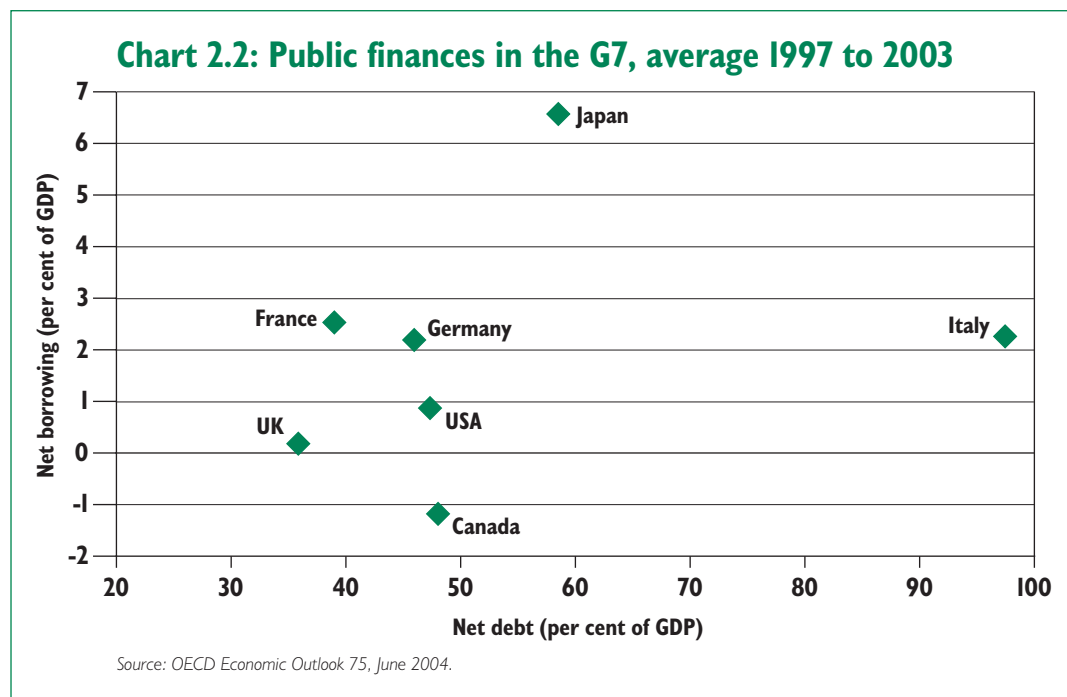
2.15 The monetary policy framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped 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 on five occasions since November 2003 to reach 4.75 per cent.

2.16 Long-term interest rates have remained at historically low levels and have averaged just under 5 per cent this year. 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. Ten-year forward rates, which abstract from cyclical influences, remain below those in the United States and the euro area. Ten-year forward rates have fallen marginally in the United Kingdom over the year from 4.7 per cent in March 2004 to 4.6 per cent in November 2004⁴ as they have in the United States and the euro area.

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

2.17 Since Budget 2004, the sterling effective exchange rate has depreciated by just under 3 per cent. Over a longer period, the effective exchange rate has been relatively stable. The volatility of sterling’s effective exchange rate has been around half that of the euro and just over a third of that of the US dollar since 1999.

Fiscal policy 2.18 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 around 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. In more recent years, fiscal policy supported monetary policy as the economy moved below trend: between 2000-01 and 2003-04, the fiscal stance eased by around 3 per cent of GDP. 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, since 1997 the UK’s public finances have compared favourably with other countries.



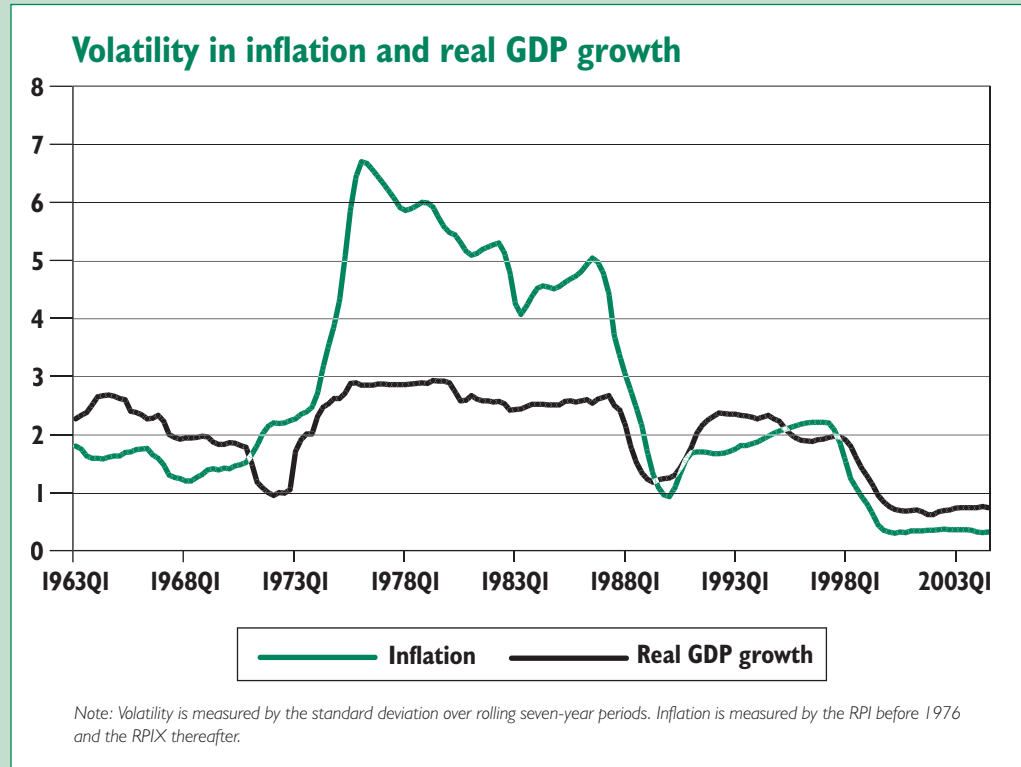
2004 Spending Review 2.18 The 2004 Spending Review set spending plans for the years 2005-06 to 2007-08, locking in the increased investment of previous spending reviews while providing for further investment in the most crucial areas of the public services. These plans provide for:

- 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 to rise from 2 per cent of GDP to 2½ per cent by 2007-08, 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 £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

2.19 The overall spending limits set in Budget 2004 and confirmed in the 2004 Spending Review remain sustainable and fully consistent with the fiscal rules.

Box 2.3: Increased stability in the UK economy

Economic stability allows consumers, firms and governments to plan effectively for the long term. The UK has experienced unprecedented macroeconomic stability in the past decade, with volatility in inflation and real GDP growth at its lowest levels since at least the early 1960s.



Long-term global economic challenges and opportunities for the UK, published alongside the Pre-Budget Report, examines how the increased integration of global product and capital markets, and the pressures of an ageing society, reinforce the need for a stable and sustainable macroeconomic framework. Closer economic integration increases the speed and magnitude of global economic shocks affecting the UK.

The UK's macroeconomic framework has performed well in the face of global economic shocks in recent years, including: the Asian economic crisis, the global equity price fall in 2001 and 2002, geopolitical uncertainty that followed the events of 11 September 2001 and the recent large rise in oil prices. A key factor has been the proactive response of monetary policy against a background of low inflation expectations, combined with a fiscal framework that allows fiscal policy to respond flexibly to the cycle and to support monetary policy. In particular, the Bank of England's Monetary Policy Committee took decisive action to cut short-term interest rates between February 2001 and July 2003, while maintaining long-term inflation expectations close to the inflation target.

The UK and many other countries also face the challenge of demographic change over the coming decades. The updated 2004 *Long-term public finance report*, published alongside the Pre-Budget Report, confirms that the UK fiscal position is sustainable in the long term on the basis of current policies. It also demonstrates that the UK remains in a strong position relative to many other developed countries to face the challenges of an ageing society.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.20 Over the past four years, many industrialised countries have suffered economic downturns, including the US and much of the euro area. More recently, the international economy has been affected by geopolitical uncertainty, rising oil prices, large current account imbalances and shifting exchange rates between the US, Asia and Europe. The UK has grown continuously throughout this period of global economic uncertainty, supported by monetary policy, and an easing of the fiscal stance and the full operation of the automatic stabilisers as the economy moved below trend. The UK continues its longest unbroken expansion since quarterly national accounts data began 50 years ago, with GDP now having grown for 49 consecutive quarters.

2.21 As many of the key uncertainties which had substantially dampened international activity receded in 2003, business and consumer confidence rose around the world and supported a solid resumption in world trade and output growth. Indeed, global growth is currently robust by historical standards, despite higher oil prices, which have been driven to record nominal highs in large part by exceptionally strong demand growth, although the real price of oil remains well below its peak. Against these positive international developments, UK GDP accelerated from mid-2003, and annual growth has now remained above trend for four consecutive quarters.

Table 2.1: Summary of world forecast

	Percentage change on a year earlier unless otherwise stated				
	Outturn	Forecasts			
	2003	2004	2005	2006	2007
<i>Major 7 countries¹</i>					
Real GDP	2¼	3½	3	2¼	2¼
Consumer price inflation ²	1½	3	2¼	1¼	1¼
World trade in goods and services	5	9½	8½	7¼	7¼
UK export markets ³	3¾	8¼	8	7¼	6¼

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.

2.22 The composition of UK GDP growth has already undergone a significant degree of rebalancing since the world economy began to pick up in the course of last year. Consumption growth has continued to moderate in response to increases in short-term interest rates. At the same time, the strong global environment has underpinned the pick-up in business investment seen over recent quarters.

2.23 In 2003 as a whole, UK GDP rose 2.2 per cent, in line with the Budget 2003 forecast. Quarterly growth moved above trend by the third quarter of 2003, for the first time in three years, and it continued at above trend rates through the first half of 2004. Preliminary data suggest that growth in the economy eased in the third quarter compared with the first half of the year, with GDP currently estimated to have risen by 0.4 per cent between the second and third quarters, up 3.1 per cent over the year, consistent with the Budget 2004 forecast.

Box 2.4: UK Presidencies of the G7/8 and EU

Long-term global economic challenges and opportunities for the UK, published today alongside the Pre-Budget Report, explains that the global economy is in the midst of a radical transformation, with far-reaching and fundamental changes in technology and trading patterns. The rapid growth of large emerging economies, in particular China and India, is shifting the balance of global economic activity. These changes have significant long-term implications for the world's economies. As part of its response the UK will tackle, through its leadership of the G7/8 and EU in 2005, the following key challenges:

- **international poverty reduction**, to ensure that all countries and regions of the world benefit from, and contribute to, increased global growth and prosperity. The Government will press for action from the international community in the key areas needed to meet the Millennium Development Goals (MDGs): increasing aid flows, including the implementation of the International Finance Facility (IFF); further debt relief; and ensuring fair trade for developing countries. The Commission for Africa, launched by the Prime Minister earlier this year, will report in the run-up to the July 2005 G8 Summit in Gleneagles;
- **structural economic reform**, to increase flexibility and improve the ability of developed countries to adjust quickly and efficiently to rapid economic changes. The Government will use the Presidencies to develop a global consensus on the actions necessary, in particular a renewed emphasis on boosting employment and growth across the developed world, including through more flexible labour, product and capital markets. Europe in particular must build on Wim Kok's report on the Mid-Term Review of Lisbon, and take concrete steps on regulatory reform and strengthen transatlantic economic integration;
- **trade**. Governments have a critical role to play in shaping global trends through multilateral action. Openness to free and fair trade and outward-looking internationalism will help boost competitiveness and strengthen the drivers of productivity, and the Government will push for further progress on the Doha trade negotiations during 2005, that recognises that developing countries can carefully design and sequence their own trade reform; and
- **climate change**. The UK Presidencies will support the drive to tackle climate change as a priority for all industrialised nations.

Economic prospects 2.24 Sound macroeconomic fundamentals, recent underlying growth at above trend rates, and continued expansion in the world economy, point to a further period of relatively strong growth in demand for UK output. Moreover, on the supply side, evidence of remaining slack in the economy supports the judgement that the economy has the potential for a period of further above trend growth in the short term, without risking inflationary pressures. UK GDP is expected to grow by 3¼ per cent in 2004, up from 2.2 per cent last year and 1.8 per cent in 2002, and unchanged since the 2002 Pre-Budget Report forecast. Annex A provides more information on the Treasury's recent economic forecasting performance.

2.25 Growth is forecast to remain within the 3 to 3½ per cent range for 2005 as a whole. However, the annual figures mask an underlying gradual slowing since the second half of 2003. By early 2006, the output gap is forecast to have closed and GDP growth is expected to be back to trend rates. In 2007, GDP growth is forecast to ease to 2¼ to 2¾ per cent in line with the trend projection.

2.26 Consumer Prices Index (CPI) inflation stood at 1.2 per cent in October. Going forward, CPI inflation is expected to rise gradually back to target by mid-2006, as upward pressure from import prices, accentuated by the recent depreciation of sterling, feeds through. The credibility of the Government’s monetary policy framework is also expected to contribute to returning inflation to target through anchoring inflation expectations.

Table 2.2: Summary of UK forecast

	Outturn	Forecast			
	2003	2004	2005	2006	2007
GDP growth (per cent)	2¼	3¼	3 to 3½	2½ to 3	2¼ to 2¾
CPI inflation (per cent, Q4)	1½	1¼	1¾	2	2

Composition of UK growth

2.27 GDP has grown strongly over the past year with significant evidence of a rebalancing in the composition of demand. Real private consumption has grown broadly in line with the expansion of the economy as a whole over the recent past, and is expected to rise by 3¼ per cent this year, broadly in line with GDP growth for the year. Thereafter, private consumption growth is forecast to be below GDP growth.

2.28 Business investment has strengthened significantly since early 2003, following what proved to be a relatively shallow decline in the face of weakness in the world economy. Business investment is expected to rise by 5¾ per cent this year, slightly stronger than forecast in Budget 2004. With profitability and corporate balance sheets having strengthened considerably, and demand still judged to be growing strongly, business investment is expected to continue to grow solidly over the forecast horizon, albeit at a slightly slower rate than this year.

2.29 With world trade growing at around 9½ per cent this year, there are also signs that improvements in external demand are beginning to feed through to UK exports, with goods export volumes up by over 4 per cent in the third quarter of 2004 on a year earlier. Export growth is expected to gather more momentum in coming quarters as the recent pick-up in external demand continues to filter through to UK exports. Moreover, the sterling Exchange Rate Index has depreciated by around 4 per cent since the summer, largely due to a fall in the pound’s value against the euro. This should also provide some additional impetus to export growth over the forecast horizon. Against the background of continued strong growth in UK export markets, goods and services export volumes are forecast to rise by 6½ to 7 per cent next year, building on growth of around 2¼ per cent this year.

Risks 2.30 Although the overall shape of the economic forecast is broadly unchanged from Budget time, the configuration of the surrounding risks and uncertainties has changed. In particular, high oil prices – if sustained – would tend to dampen growth, though to the extent that they reflect strong global demand, rather than supply-side or risk premia shocks, there are likely to be offsetting effects. Global developments remain a key influence on the UK outlook and challenging judgements will continue to be faced in setting monetary and fiscal policy. In the UK forecast, as has been the case in 2004, business investment could continue to surprise on the upside, and there may be headroom for stronger consumer spending.

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 has been forecast since Budget 2003.

RECENT FISCAL TRENDS AND OUTLOOK

2.32 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 2004 and in this Pre-Budget Report, in accordance with the *Code for fiscal stability*.

2.33 The forward-looking fiscal projections described in this section are complemented by the 2004 *End of year fiscal report*, published alongside this Pre-Budget Report, which provides detailed retrospective information on the public finances in 2002-03 and 2003-04.

Table 2.3: Fiscal balances compared with Budget 2004

	Outturn ¹ Estimate		Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Surplus on current budget (£ billion)							
Budget 2004	-21.3	-10.5	-5	0	4	9	
Effect of forecasting changes	0.2	-1.2	-1	1	-½	-1	
Effect of policy decisions since Budget 2004	0.0	-0.8	-½	0	-½	0	
PBR 2004	-21.1	-12.5	-7	1	4	9	12
Net borrowing (£ billion)							
Budget 2004	37.5	32.9	31	27	27	23	
Changes to current budget	-0.2	2.0	1½	-½	½	½	
Changes to net investment	-2.5	-0.7	1½	2	½	0	
PBR 2004	34.8	34.2	33	29	28	24	22
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2004	-1.0	-0.2	-0.2	0.0	0.3	0.7	
PBR 2004	-1.0	-0.4	-0.4	0.1	0.3	0.6	0.8
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2004	2.4	2.1	2.3	2.1	1.9	1.6	
PBR 2004	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Net debt (per cent of GDP)							
Budget 2004	33.2	34.4	35.3	35.9	36.3	36.4	
PBR 2004	32.9	34.3	35.4	36.2	36.8	37.0	37.1

Note: Figures may not sum due to rounding.

¹ The 2003-04 figures were estimates in Budget 2004.

2.34 The outturn for the current budget for 2003-04 is around £0.2 billion lower than the Budget 2004 estimate, while net borrowing is now around £2½ billion lower. Projections for the current budget are little changed compared with the projections set down in Budget 2004, as shown in Table 2.3. Where there are changes, these are small and affect the short-term projections; the situation in the medium term is broadly as set out in Budget 2004.

Estimate for 2004-05 2.35 Receipts from income tax, national insurance contributions and VAT have come in broadly as expected in Budget 2004. In 2004-05, the current budget is around £2 billion lower and net borrowing around £1½ billion higher than in Budget 2004, reflecting slower than expected growth in corporation tax revenues and the effect of discretionary measures, including the addition to the special reserve. In addition, the estimate of public sector net investment in 2004-05 is now lower than in Budget 2004, as described in Annex B.

2.36 Growth in receipts is likely to be stronger in the remainder of 2004-05 compared with the first seven months. In particular, the payment lags related to North Sea taxes, discussed in more detail below, means little of the additional revenue from higher oil prices has yet fed through to the monthly public finance data. On the other hand, growth in spending is likely to moderate as departments continue to adjust to the end-year flexibility arrangements and resource accounting, resulting in a flatter profile of spending through the year. In addition, the introduction of the Pension Credit in September 2003 will have increased the year on year growth rates in spending in the first half of 2004-05.

2.37 Table 2.4 explains the reasons for the change in public sector net borrowing. Before taking into account the discretionary measures announced in this Pre-Budget Report, the projections for the public finances are broadly unchanged from Budget 2004. Net borrowing is slightly higher in the short term compared to the Budget 2004 projections, but continues to fall back to the levels set out in Budget 2004 over the forecast horizon.

Table 2.4: Public sector net borrowing compared with Budget 2004

	Estimate ¹		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
Budget 2004	32.9	31	27	27	23
Changes since Budget 2004					
Effect of oil prices on oil taxes ²	-1.3	-1½	-1½	-1½	-1½
Corporation tax	3.2	3	1	½	½
Other forecasting changes ³	-1.3	1	1½	2	2
Total before discretionary measures	33.5	33	28	27	24
Discretionary measures	0.7	½	0	½	0
2004 Pre-Budget Report	34.2	33	29	28	24

Note: Figures may not sum due to rounding.

¹ The 2004-05 figures were projections in Budget 2004.

² Includes NAO-audited assumption and the effect of higher oil prices on demand for road fuels and road fuel duty.

³ Includes changes in the timing of investment, described in Annex B, other economic determinants (include GDP components) and fiscal forecasting changes.

Changes in receipts 2.38 While the outlook for the public finances is broadly unchanged since Budget 2004, there are changes in the composition of the public finances. Other than the oil price, none of the NAO-audited assumptions have significantly affected projections for the public finances. The direct effect of higher oil prices, including the offsetting effect from higher pump prices, which is expected to reduce receipts by around £½ billion compared to the Budget projections, is forecast to boost receipts by around £1½ billion.

2.39 This direct price effect does not include other effects that may offset the additional revenues from oil taxes. These operate through the economic forecast, and the projections for various components of GDP, and cannot therefore be identified separately in the economic forecast. An important factor in this Pre-Budget Report forecast is that the higher oil prices largely reflect increased global demand. Strong growth in the world economy is, as described above, helping to maintain strong growth in the UK economy.

2.40 However, while the effect of higher pump prices on demand is felt immediately, there are important lags in the payment of higher receipts from North Sea taxes. While the oil price has risen strongly in the second half of 2004, little of the additional revenue has been reflected in monthly cash receipts so far. Corporation tax payments are made quarterly and the final payments for this period will not be made until April 2005. Payment of petroleum revenue tax (PRT) follows a different pattern based on six month chargeable periods, with a system of monthly instalment payments. This means that PRT receipts to the end of October reflect tax due for the first half of 2004 and earlier periods, and are slightly lower than in 2003 because of lower oil production. The high oil prices in the second half of 2004 will have no impact on PRT receipts until March 2005.

2.41 Projections for receipts of income tax, national insurance contributions and VAT are little changed from Budget 2004. In the short term, receipts from corporation tax are projected to be lower than forecast. While receipts from corporation tax have grown strongly, and the growth in receipts from non-financial companies is broadly in line with expectations, the increase in receipts from financial companies has been lower than expected. A number of factors may explain this, including companies offsetting higher profits against past losses or capital allowances to a greater degree than expected following the period of weakness in international capital markets. As the forecast horizon extends, corporation tax from financial companies returns towards its Budget 2004 level.

Changes in spending

2.42 Forecast expenditure is broadly unchanged from Budget 2004. Projections for DEL up to 2007-08 are based on the 2004 Spending Review allocations, and projections for current AME expenditure is unchanged from Budget 2004. More detail on projections for spending is provided in Annex B.

Discretionary policy changes

2.43 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.

2.44 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 2004. This includes:

- a continuation of the freeze on the main road fuel duties, in response to the sustained volatility in the oil market;
- a ten-year strategy for childcare, setting out the Government's vision of affordable, flexible, high-quality childcare for all parents who need it;

- giving employers the opportunity to access free and flexibly delivered training for their low-skilled employees through a National Employer Training Programme; and
- action to protect tax revenues and modernise the tax system, including measures to combat tax fraud and avoidance.

2.45 In the 2002 Pre-Budget Report, the Government created a special reserve to meet the UK's international obligations. In this Pre-Budget Report, as a prudent allowance against continuing commitments, the Government is adding a further £520 million to the special reserve for 2004-05. Full details of the Government's spending and allocations for the military conflict in Iraq and on the war on terrorism at home and abroad are described in Chapter 6.

2.46 The Government is taking action to reduce pressures on council tax in 2005-06 by £1 billion by releasing an extra £125 million of resources for England alongside a reduction in ring fencing and other obligations and £512 million from departmental allocations. Full details are set out in Chapter 6.

2.47 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.

Box 2.5: The effect of oil prices on the UK's economy and public finances

While oil prices have risen strongly in 2004, as described in Annex A, their impact on the UK economy has so far been limited. Importantly, compared to other episodes of high prices, the real price of oil (the price adjusted for inflation) has remained below its peak. This, coupled with the sharp decline of energy intensity in developed economies since the 1970s, has resulted in a relatively muted impact. In addition, the UK remains a small net exporter of oil. Finally, the increase in oil prices reflects, in large part, strong global demand growth in 2004 whereas in previous periods oil prices rises were almost entirely attributable to supply-side shocks.

In the past, rising oil prices have often been accompanied by significant rises in inflation, which were compounded by a lack of clarity on the appropriate policy response. The Government's monetary policy framework has helped to keep inflation expectations anchored. As can be seen in Chart 2.1, inflation expectations have remained close to target over the last year, showing the credibility of the monetary policy framework.

Oil prices will also have an effect on the UK's public finances. Other things being equal, higher oil prices boost the tax take from petroleum revenue tax and North Sea corporation tax. There are, however, a number of offsetting effects that means the impact on the public finances as a whole will be limited. The scale of these offsetting effects, and in particular the effects that operate through the economic forecast, are extremely uncertain as they will depend on the response of individuals and businesses to rising prices. There will also be important timing effects, with any effects on inflation or the wider economy taking time to affect the public finances. The offsetting effects include those from:

- higher pump prices, which reduces demand for road fuels and therefore reduces revenues from fuel duties;
- any temporary increase in inflation, which increases the indexation of allowances and limits for income tax and national insurance contributions and raises the level of indexation of tax credits and social security benefits; and
- possible impacts on the wider economy. In particular, other things being equal, higher input prices may reduce companies profit margins, reducing their profitability and therefore reducing receipts of non-North Sea corporation tax. However, with part of the rise in oil prices being demand driven, the negative effects on non-oil producers and oil consumers need to be assessed alongside the offsetting impacts from strong growth in the world economy.

This suggests that care needs to be taken when considering estimates of the impact of higher oil prices on the public finances as a whole. This will be especially so if high oil prices are the result of increased demand, rather than purely a supply shock as often occurred in the past.

FISCAL POSITION AND MEDIUM-TERM PROSPECTS

2.48 Table 2.5 presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government is meeting its strict fiscal rules over the economic cycle.

Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Fairness and prudence							
Surplus on current budget	-1.9	-1.1	-0.6	0.0	0.3	0.6	0.8
Average surplus since 1999-2000	0.4	0.2	0.1	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	-1.0	-0.4	-0.4	0.1	0.3	0.6	0.8
Long-term sustainability							
Public sector net debt ¹	32.9	34.3	35.4	36.2	36.8	37.0	37.1
Core debt ¹	31.6	32.4	33.4	34.3	35.0	35.3	35.4
Net worth ²	22.0	19.6	17.1	16.5	15.4	15.5	14.8
Primary balance	-1.5	-1.3	-1.0	-0.5	-0.3	0.0	0.2
Economic impact							
Net investment	1.2	1.8	2.1	2.2	2.3	2.2	2.3
Public sector net borrowing (PSNB)	3.1	2.9	2.7	2.2	2.0	1.6	1.5
Cyclically-adjusted PSNB	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Financing							
Central government net cash requirement	3.5	3.4	2.9	2.5	2.1	1.7	1.8
Public sector net cash requirement	3.6	3.1	2.8	2.5	2.2	1.8	1.8
European commitments							
Treaty deficit ³	3.1	2.8	2.7	2.2	2.0	1.6	1.5
Cyclically-adjusted Treaty deficit	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Treaty debt ratio ^{1,4}	39.5	40.9	41.8	42.4	42.8	42.8	42.6
<i>Memo: Output gap</i>	-1.4	-0.8	-0.1	0.0	0.0	0.0	0.0

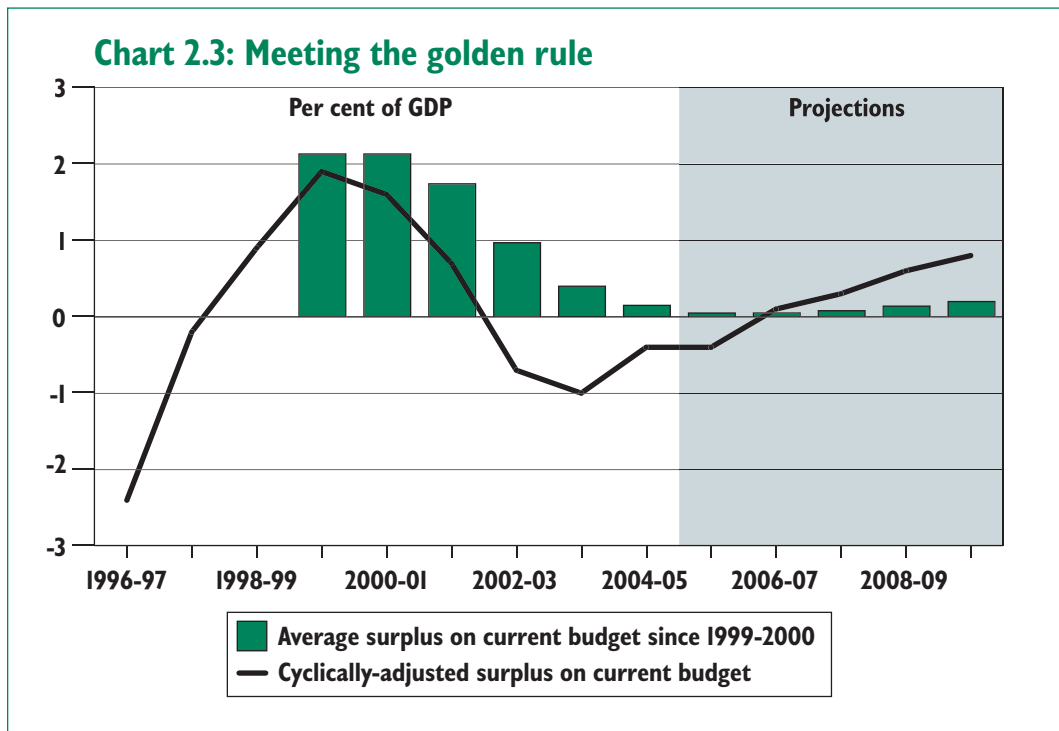
¹ At end March; GDP centred on end March.

² At end December; GDP centred on end December.

³ General government net borrowing on a Maastricht basis.

⁴ General government gross debt on a Maastricht basis.

Golden rule 2.49 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 inter-generational fairness. The current budget strengthens through the projection period, returning to balance in 2006-07 and showing a surplus of 0.8 per cent of GDP by 2009-10.



2.50 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.⁵

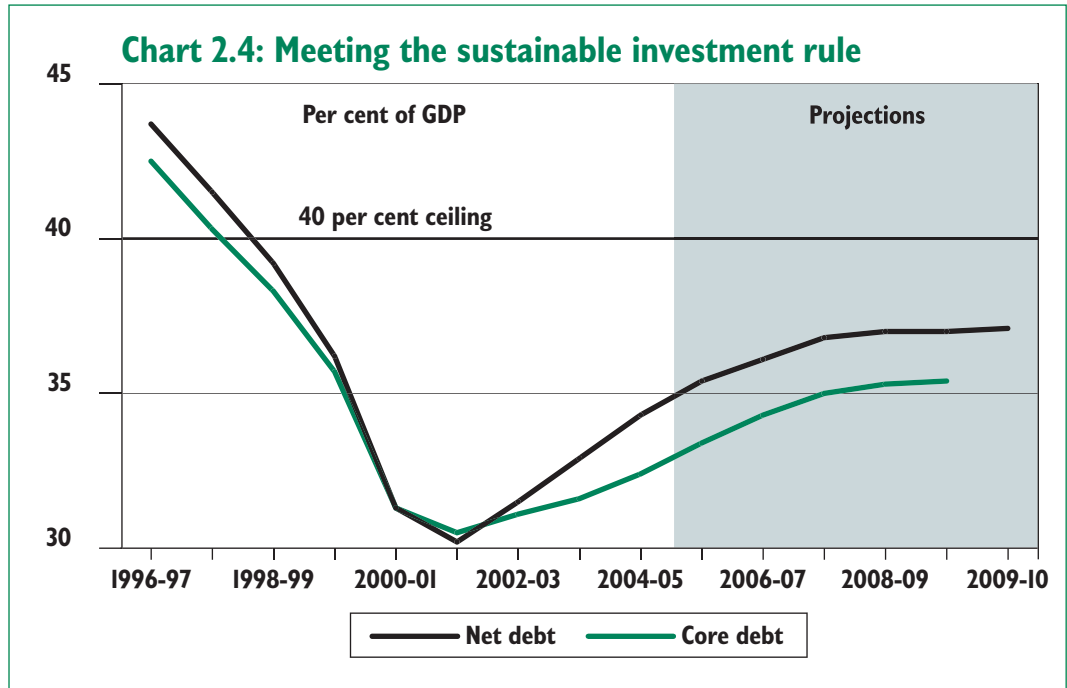
2.51 The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year of the projection period. The economy is projected to return to trend by early 2006, meaning that over the whole cycle the average surplus on the current budget would be 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.

2.52 With the economy assumed to be on trend from early 2006 onwards the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2009-10 is $\frac{1}{4}$ per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule after the end of this economic cycle.

Sustainable investment rule

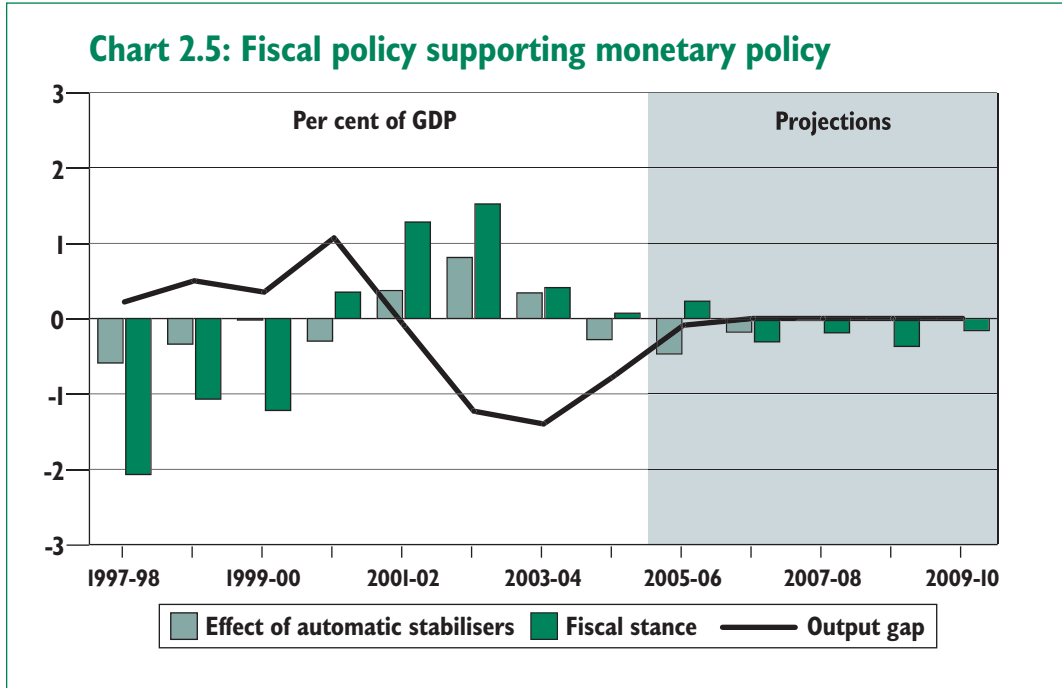
2.53 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector net debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP 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 and performance over past cycles is described in Budget 2000.



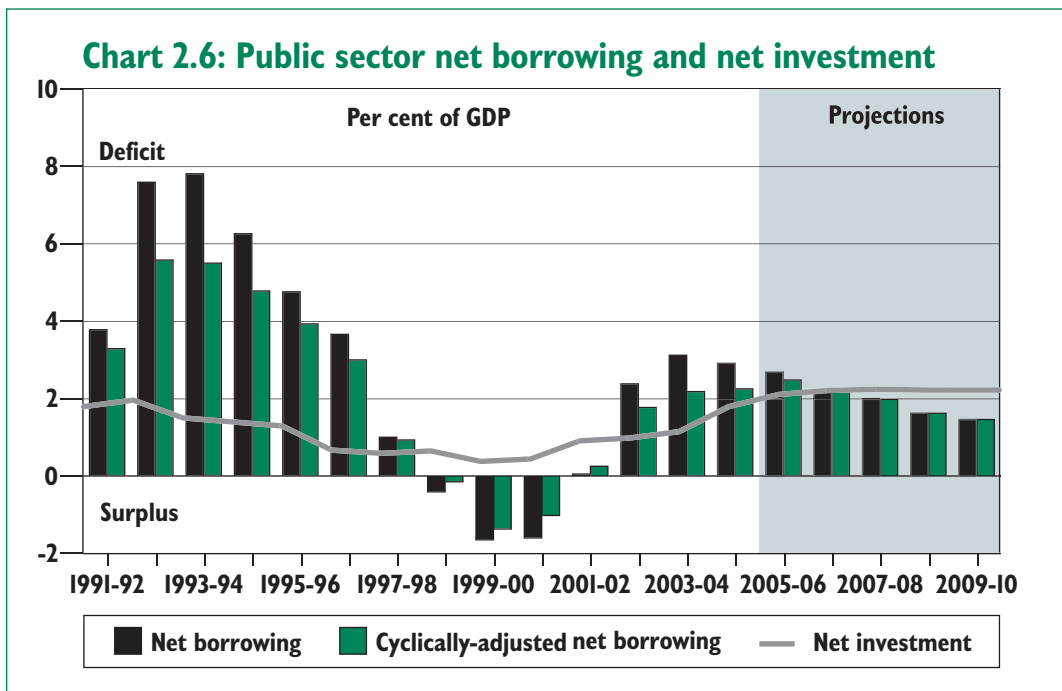
2.54 Chart 2.4 shows that, despite a sustained period of weakness in the world economy in 2001 and 2002, net debt is expected to remain low and stable, stabilising at around 37 per cent of GDP at the end of the projection period. Therefore, the Government comfortably meets its sustainable investment 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 35½ 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 intergenerational fairness that underpins the fiscal framework.

Economic impact 2.55 While the primary objective of fiscal policy is to ensure sound public finances, it 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). Chart 2.5 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.

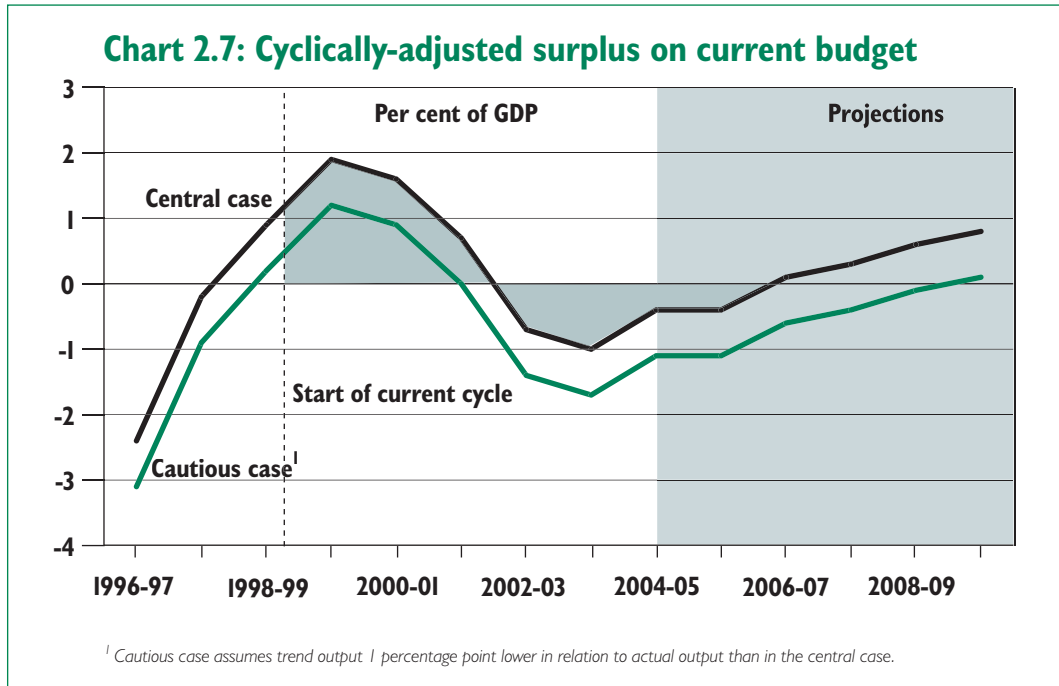


2.56 During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. More recently, fiscal policy has continued to support monetary policy in helping to deliver economic stability, through the automatic stabilisers and an easing of the fiscal stance when the economy moved below trend. Subsequently as the economy returns to trend the overall impact of fiscal policy moves back to a more neutral position.

2.57 The 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.



- Financing 2.58** The forecast for the central government net cash requirement for 2004-05 has been revised from £35.6 billion in Budget 2004 to £39.7 billion, an increase of £4.1 billion. It has been decided to meet this increased financing requirement by increasing gilt sales by £3.2 billion to £50.3 billion and by increasing the planned end financial-year Treasury bill stock by £1.0 billion to £18.5 billion. Full details and a revised financing table can be found in Annex B.
- European commitments 2.59** The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box 2.2 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 Pre-Budget Report, which show the Government is meeting 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 2.60** 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. As set out in Box 2.1, 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 $\frac{1}{4}$ percentage point lower than its neutral view.
- 2.61** 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.
- 2.62** The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. This was combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt. This has allowed the Government to safeguard the increase in investment in priority public services, allow the automatic stabilisers to work in full during the period of global economic uncertainty that began in 2000 and meet in full the UK's international commitments, while continuing to meet the fiscal rules.



2.63 The Government is, on the basis of cautious, independently audited assumptions, meeting the golden rule in the central case. However, in the cautious case, the average surplus on the current budget over the economic cycle 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 also moves back into surplus. 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

2.64 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 as set out in the *Code for fiscal stability*. Many developed countries face significant challenges over the long term as a result of ageing populations. For example, the demand for health and long-term care is likely to rise as a result of the increased number of older people.

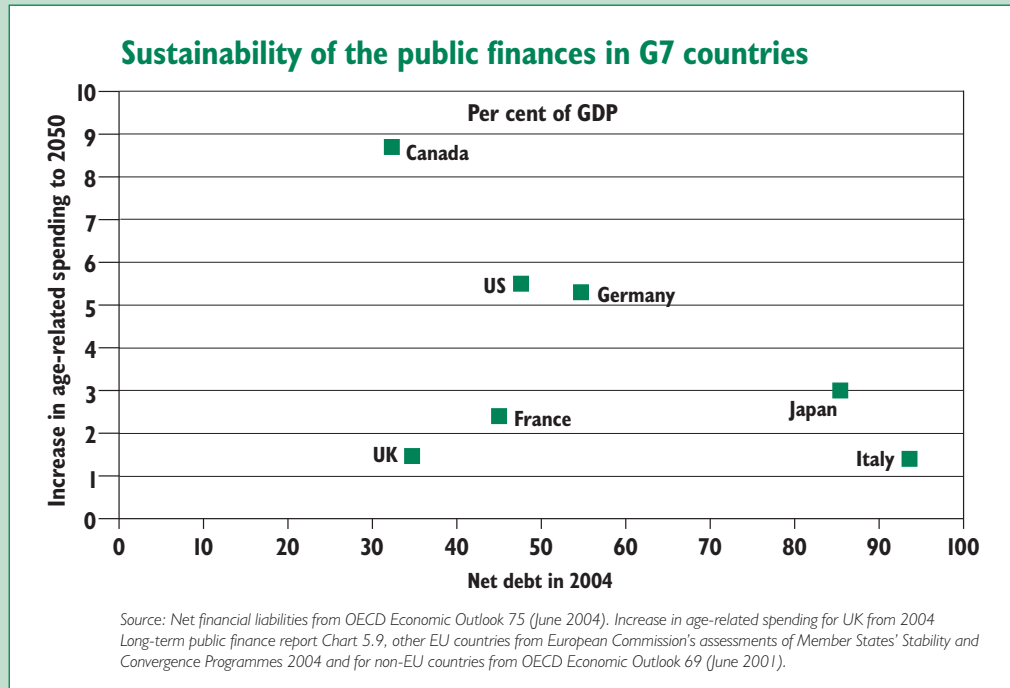
2.65 An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2004 *Long-term public finance report*. Based on the latest population projections the report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances, updating the illustrative long-term projections set out in Budget 2004. To provide a comprehensive and robust analysis, the report:

- shows performance against a wide range of indicators;
- includes analysis based on different population projections to test the robustness of the conclusions; and
- provides spending projections for education, health and pensions.

2.66 Using a range of sustainability indicators, including the intertemporal budget gap and fiscal gap, and based on current policies and reasonable assumptions, the report shows that the public finances are sustainable in the longer term. The UK is in a strong position relative to many other countries to meet the challenges of an ageing population.

Box 2.6: Long-term sustainability in the G7

The challenges posed by an ageing population vary considerably between countries. The chart below shows the relationship between the ratio of net debt to GDP and the projected increase in age-related spending over the period to 2050.



The chart shows that a number of countries face a large projected increase in age-related spending over the next 50 years or so, of up to around 9 per cent of GDP, primarily due to large increases in pension and health spending. Of those countries with relatively small projected increases in age-related spending, some have a high starting level of debt, which could prove a burden in the future. In contrast, the UK has one of the lowest debt to GDP ratios in the G7, and faces only a relatively small increase in age-related spending, illustrating that the UK is well placed to meet the long-term challenges of an ageing population.

A more detailed analysis of long-term trends and sustainability in different countries is presented in Chapter 5 of the 2004 Long-term public finance report.

