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# **MAINTAINING ECONOMIC STABILITY**

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## **Convergence Programme for the United Kingdom**

**Submitted in line with the Stability and Growth Pact**

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December 2001



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# 1

## INTRODUCTION

1.1 Current world economic conditions pose significant challenges for policymakers. The Government's reforms to the macroeconomic framework leave the UK better placed than on previous occasions to cope with instability in the global economy and to continue to steer a course of stability.

### The macroeconomic framework

1.2 The **monetary policy framework** is delivering low and stable inflation and is enabling the Bank of England's Monetary Policy Committee (MPC) to respond quickly to risks to the symmetrical inflation target. The **fiscal policy framework** is delivering sound public finances over the medium term, while supporting monetary policy over the cycle. The fiscal rules are set over the cycle and the automatic stabilisers are allowed to operate fully, which lets fiscal policy smooth the path of the economy in the face of slower growth. The fiscal rules are also the foundation of the Government's **public spending framework**, which is delivering **sustainable investment** in public services.

1.3 Low inflation prospects have enabled the MPC to react pre-emptively to the global economic slowdown, cutting interest rates to their lowest level since 1964. Tough decisions on taxation and spending taken by the Government over the past four years to repay debt mean that fiscal policy is able to support monetary policy in maintaining economic stability as the economy temporarily moves below trend.

1.4 This report, "Maintaining Economic Stability", updates the UK's 2000 Convergence Programme to reflect the latest Government forecasts for the economy and public finances, which were published in the Pre-Budget Report on 27 November 2001.<sup>1</sup> The public finance projections in the Pre-Budget Report have a different status to those included in the Budget – they present an interim forecast update and do not necessarily represent the outcome the Government is seeking. This update therefore also takes account of Budget 2001.<sup>2</sup>

### Macroeconomic stability

1.5 The Government's economic goal is to deliver long-term economic stability, ensuring that the fiscal rules are met and inflation remains low. Chapter 2 describes how the Government is working to achieve this goal, maintaining stability in testing economic times. In an integrated global economy, no country can fully insulate itself from international economic events. But as a result of the steps the Government has taken, and the platform of stability it has created, the UK economy is now better placed than on previous occasions to continue to steer a course of economic stability.

1.6 Chapter 2 provides a brief outline of how the macroeconomic framework that the Government has put in place is helping to maintain economic stability. Since the framework reforms were introduced, the economy has experienced a period of stable and steady growth, inflation has remained very close to target and interest rates are low. At the same time, a healthy and sustainable position for the public finances has been achieved.

1.7 The public finance projections easily meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period. The projections are consistent with a prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty).

<sup>1</sup> Pre-Budget Report, HM Treasury, November 2001. Available at [http://www.hm-treasury.gov.uk/Pre\\_Budget\\_Report/prebud\\_pbr01/prebud\\_pbr01\\_index.cfm](http://www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr01/prebud_pbr01_index.cfm)

<sup>2</sup> Budget 2001, HM Treasury, March 2001. Available at [http://www.hm-treasury.gov.uk/Budget/Budget\\_2001/bud\\_bud01\\_index.cfm](http://www.hm-treasury.gov.uk/Budget/Budget_2001/bud_bud01_index.cfm)

**Productivity and employment** 1.8 Productivity growth, alongside higher levels of employment, is a key route to delivering greater economic prosperity. The productivity performance of the UK economy has historically been weak, creating a substantial productivity gap between the UK and other advanced industrial economies. In difficult economic times, it is more important than ever that reforms are introduced to close the productivity gap. To build a stronger economy and fairer society, employment opportunity must be extended to all groups and areas in the country.

**Economic Reform in Europe** 1.9 The Government is committed to raising employment and productivity across Europe through economic reform. At the Lisbon European Council in spring 2000, Europe's leaders committed themselves to an ambitious ten-year strategy for reform. The vision agreed at Lisbon is of a dynamic, job-creating Europe that delivers on both economic and social objectives to become the leading knowledge-based economy in the world. The Government will publish a White Paper on economic reform in Europe for the Spanish presidency.

**Economic Forecasts** 1.10 Chapter 3 provides updated forecasts for the UK economy in the period to 2004. Sound economic fundamentals are enabling the fiscal and monetary frameworks to respond to the global slowdown. Together the two arms of policy are working together to maintain economic stability and a return to stronger and more balanced growth from the middle of 2002. UK GDP is forecast to grow by  $2\frac{1}{4}$  per cent in 2001, the bottom end of the Budget 2001 forecast range, and by between 2 and  $2\frac{1}{2}$  per cent in 2002.

**Public finances** 1.11 The public finance projections show that, despite the world economic slowdown, the fiscal position remains sound, existing public spending plans are fully affordable, and the UK is better able than in the past to deal with the ups and downs of the global economy. In the short term, temporarily lower tax receipts compared with the Budget profile mean that fiscal policy is supporting monetary policy in maintaining economic stability. The Government also remains on track to meet both its fiscal rules over the cycle, including in the cautious case. Chapter 4 summarises the latest Government projections for the public finances, including:

- five-year ahead projections of the current budget surplus and public sector net debt, the key aggregates for assessing performance against the Government's fiscal rules;
- projections of public sector net borrowing, general government net borrowing and general government gross debt;
- consistent projections of the cyclically adjusted fiscal balances;
- detail on general government receipts and expenditure, and public investment;
- features of public services reform; and
- information on the long-term sustainability of the public finances.

**Annexes** 1.12 Annex A provides details of the differences in key indicators between this update of the programme and the 2000 update. Annex B provides details of the financial impact of the 2001 Budget measures, and subsequent announcements.

**Box 1.1 Background to the 2001 update: “Maintaining Economic Stability”**

The Government has submitted programmes under the Stability and Growth Pact for each of the last three years. The Stability and Growth Pact requires Member States to provide information on economic developments in their country, for the purposes of the multilateral surveillance procedure under Articles 99 and 104 of the EU Treaty (ex Articles 103 and 104c). The UK is required to present the following information in its Convergence Programme:

- information on the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit, the expected path for the general government debt ratio, the medium-term monetary policy objectives, and the relationship of those to price and exchange rate stability;
- the main assumptions about expected economic developments and important economic variables;
- a description of budgetary and other economic policy measures being taken, or proposed, to achieve the objectives of the programme; and
- an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

In July 2001 the ECOFIN Council agreed an updated Code of Conduct on content and format of Stability and Convergence Programmes.<sup>3</sup> This 2001 update reflects the Code of Conduct alongside the Government’s obligations to the UK Parliament under Section 5 of the European Communities (Amendment) Act 1993.

<sup>3</sup> Opinion on the content and format of stability and convergence programmes, EFC/ECFIN/404/01-REV 1. Available at <http://register.consilium.eu.int/pdf/en/01/st10/10522en1.pdf>



# 2

## POLICY FRAMEWORK & OBJECTIVES

### Objectives of Economic Policy

**2.1** The Government's central economic objective is to raise the rate of sustainable growth and achieve rising prosperity through creating economic and employment opportunity for all. The key elements of the Government's economic strategy are:

- maintaining macroeconomic stability;
- meeting the productivity challenge;
- increasing employment opportunity for all;
- ensuring fairness for families and communities;
- delivering high quality public services; and
- protecting the environment.

**2.2** This objective, and the elements through which the Government plans to meet it, are consistent with the objectives of the European Community as set out in Article 2 of the Treaty. They are also consistent with the Broad Economic Policy Guidelines of the Member States and the Community and a prudent interpretation of the EU Stability and Growth Pact.

### Maintaining Macroeconomic Stability

#### The importance of stability

**2.3** In an increasingly integrated global economy, no country can be insulated from the impact of current world developments. The world economy is slowing more now than at any time over the past two decades, while the terrorist attacks of 11 September have intensified uncertainty, delaying the world recovery and adding to the risks to global growth. For the first time since 1974, growth has slowed significantly in almost every region of the world. As one of the most open of the major economies, and a leading international financial centre, this external environment poses challenges for the UK economy.

**2.4** The Government's role is to ensure that macroeconomic policy is able to react to adverse developments so that the UK can maintain high and stable levels of growth and employment. Economic stability helps businesses, people and the Government to plan effectively for the long term.

**2.5** Since 1997, the Government has put in place a new open and transparent framework for macroeconomic policy, defining clear policy objectives and a division of responsibility, which gives proper accountability. During this period, the economy has experienced a period of stability and steady growth, averaging 2.6 per cent on an annual basis since the second quarter of 1997.

**2.6** Through pre-emptive action, steady and stable growth is now being accompanied by low inflation, low interest rates, low unemployment and sound and sustainable public finances. This has enabled the Government to raise investment in Britain's key public services on a sustainable basis.

## Monetary Policy

### The monetary policy framework

**2.7** The monetary policy framework has helped to keep inflation close to the Government's target and is based on:

- clear and precise objectives. The goal of monetary policy, price stability, is defined in terms of a symmetric inflation target. This means that outcomes below target are treated as seriously as those above target, eliminating incentives for the MPC to drive inflation below target at the cost of lost output and employment;
- full operational independence for the MPC in setting interest rates to meet its target of 2½ per cent for the 12 month increase in the Retail Prices Index excluding mortgage interest payments (RPIX), which applies at all times;
- openness, transparency and accountability which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings and publication of the Bank of England's quarterly Inflation Report; and
- flexibility and credibility. Because monetary policy is based on a credible framework the MPC can use discretion in deciding how quickly to react to external events or temporary difficulties beyond its control. This discretion is constrained by the inflation target and an 'Open Letter' system, under which, 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 length of time before inflation will return to target and how this meets the MPC's remit.

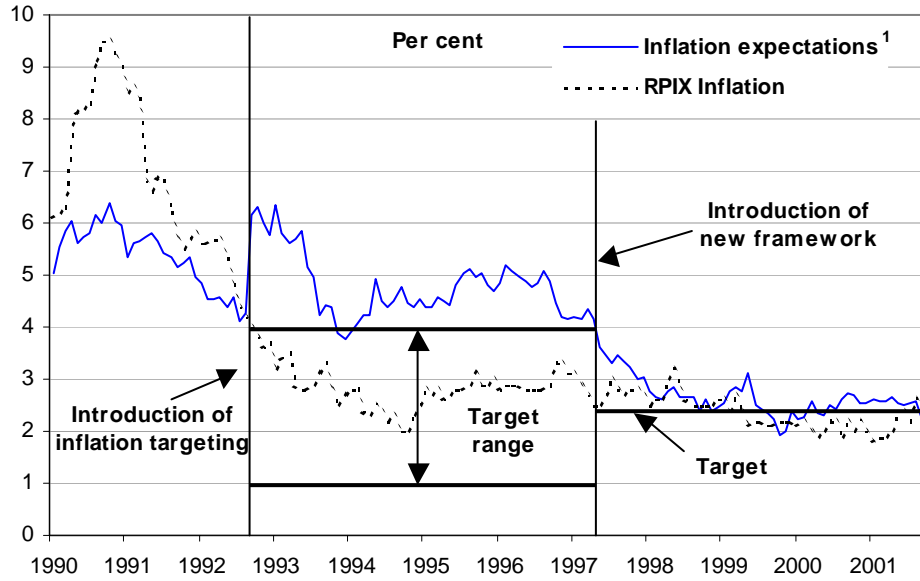
### Benefits of the monetary policy framework

**2.8** By enhancing the transparency and credibility of policy-making, the monetary policy framework has already delivered positive results. RPIX inflation has averaged 2.4 per cent since May 1997 - very close to the Government's 2½ per cent target - and market inflation expectations suggest that low inflation is expected to continue: this has been achieved with less output and employment volatility than in the past.

**2.9** The MPC has changed interest rates quickly in either direction in response to threats to economic stability. Beginning in February 2001, the MPC saw the need to reduce interest rates. It also responded in a timely and considered manner to the uncertainty generated by the attacks on the US, demonstrating the flexibility of the framework by acting swiftly to reduce interest rates in order to support UK consumer and business confidence. Since then, rates have been cut on two further occasions and they are now at their lowest level since 1964.

**2.10** These actions have reinforced the credibility of the monetary policy framework. This is demonstrated in the behaviour of inflation expectations, shown in Chart 2.1. Although inflation fell to levels close to 3 per cent annually in the years prior to 1997, when a target range of 1 to 4 per cent was in force, inflation expectations remained consistently outside this target range. Inflation expectations only fell to the target after the introduction of the new framework in 1997 and they have remained close to target since then. This credibility allows the MPC to react flexibly and to take account of the potential impact of global events on the UK economy without markets doubting its determination to meet the inflation target.

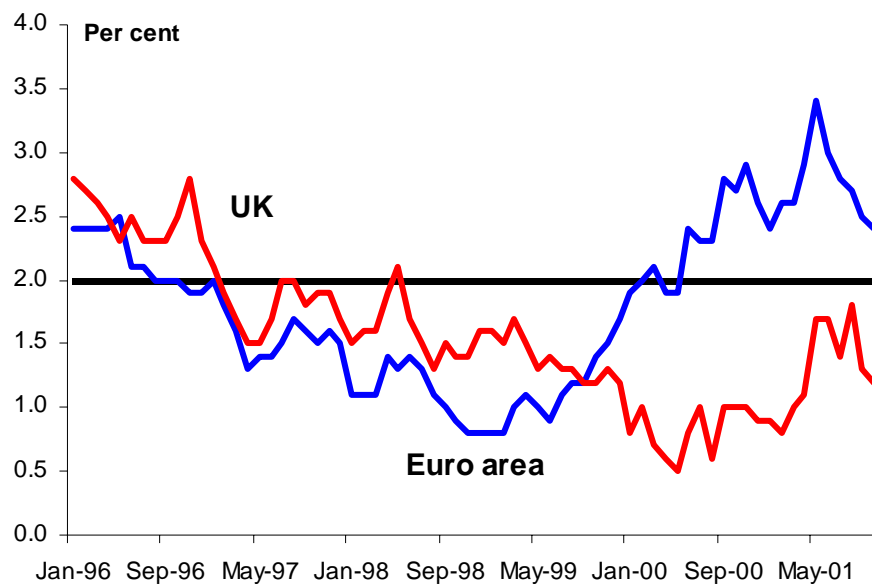
Chart 2.1: Inflation performance and expectations



<sup>1</sup> Ten year ahead market inflation expectations.

**HICP 2.11** Due to differences in coverage and methodology, the HICP index differs from RPIX. The HICP measure of inflation currently stands at around 1.0 percentage point below RPIX inflation. However, divergence between the two measures due to differences in coverage varies through time, leaving a more persistent differential due to methodology of around 0.5 percentage points.<sup>4</sup> Measured on an HICP basis, the UK inflation rate is below the euro area average, and is comfortably within the ECB’s definition of price stability, of an annual increase in inflation of up to 2 per cent (Chart 2.2).

Chart 2.2: UK and euro-area average HICP inflation rates



Source: Eurostat

<sup>4</sup> See “The harmonised index of consumer prices (HICP): some factual information” HM Treasury, November 1998.

**2.12** Official short-term interest rates currently stand at 4 per cent, reflecting a sustained reduction in both the level of inflation and inflation expectations in the UK. UK long-term interest rates have fallen to around their lowest levels for over 40 years.

**Table 2.1: HICP inflation and long-term interest rates in 2001**

	HICP inflation	Long-term interest rates
<b>UK</b>	1.2	4.9
<b>EU15</b>	2.2	4.8
<b>Euro area</b>	2.4	4.8

*Source: Eurostat October 2001.*

**Box 2.1: Coordination of monetary and fiscal policy**

Over the past four years, the Government has implemented important reforms to the macroeconomic framework. Based on principles of transparency, responsibility and credibility, the framework establishes a platform of economic stability for the long term. Further detail is set out in the book: "Reforming Britain's Economic and Financial Policy".<sup>5</sup>

The roles of monetary and fiscal policy are clearly defined. The Government sets the symmetric inflation target for the MPC to achieve. Fiscal policy is guided by rules to ensure sustainability without limiting its ability to support monetary policy in delivering economic stability as the foundation of high and stable levels of growth and employment. One of the two key objectives of fiscal policy is over the short term to support monetary policy and, in particular, to allow the automatic stabilisers to play their role in smoothing the path of the economy.

Co-ordination is further enhanced by clearly defined objectives and transparent procedures. The MPC and the Government (in setting fiscal policy) are each aware of what the other is trying to achieve and how the other will react to their policy decisions. This process is assisted by the presence of a representative from HM Treasury at MPC meetings who is able to provide detailed information on fiscal policy.

A substantial fiscal tightening in 1997-98 and 1998-99 supported monetary policy when output was above its trend level, while also eliminating the large structural deficit. The fiscal tightening continued in 1999-2000, at a time when inflationary pressures were mounting. It has now left the public finances well placed to play their part in cushioning the effects of the global economic slowdown. Debt levels are stable and low, and strong surpluses on the current budget over the past two years provide room for manoeuvre within the fiscal rules over the remainder of the economic cycle.

<sup>5</sup> "Reforming Britain's Economic and Financial Policy", HM Treasury, published by Palgrave, December 2001.

## Fiscal Policy

### The fiscal policy framework

**2.13** Reforms to the monetary policy framework have been accompanied by a parallel set of reforms to fiscal policy, ensuring that high standards of transparency, responsibility and accountability apply to fiscal policy decisions. Box 2.1 sets out how the two arms of policy work in a co-ordinated way to deliver economic stability, with the objectives of both monetary and fiscal policy set by the Government.

**2.14** The Code for Fiscal Stability sets out five key principles of fiscal management that are at the heart of the framework: transparency, stability, responsibility, fairness and efficiency. The Code sets out how these principles relate to the formulation and implementation of fiscal policy in practice and requires the Government to state its objectives for fiscal policy based on these principles.

**2.15** The Government's objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly both within and across generations; and
- over the short term, to support monetary policy; and, in particular, to allow the automatic stabilisers to play their role in smoothing the path of the economy.

### Fiscal rules

**2.16** These objectives are implemented through the Government's two fiscal rules, against which the performance of fiscal policy can be judged:

- **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 equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

**2.17** The rules are both set over the cycle to allow Public Sector Net Borrowing (PSNB) to vary between years, in keeping with the cyclical position of the economy.<sup>6</sup> Box 2.2 sets out how this enables the automatic stabilisers to operate freely over the cycle.

**2.18** The golden rule distinguishes between current spending, which benefits the current generation, and capital spending, which benefits both current and future generations. By allowing the current generation to borrow to fund only capital spending, with current spending met by current receipts, the golden rule helps to match the costs and benefits of public spending over time – consistent with the Government's objective of generational equity. The golden rule also enhances the efficiency of government spending because it means that growth enhancing public investment is not sacrificed for current spending. The sustainable investment rule complements this by ensuring that borrowing for public investment is conducted in a responsible way.

<sup>6</sup> PSNB is defined as the sum of current spending, including depreciation and net investment, less total revenues. The Treaty definition of the deficit measures general government net borrowing, which is equivalent to PSNB minus borrowing by public corporations and excluding financial transactions.

**Box 2.2: Taking account of the cycle: the automatic stabilisers**

Several features of the tax and spending regime help to stabilise the economy over the economic cycle. As the economy strengthens, incomes tend to rise, resulting in higher income and corporation tax receipts. At the same time, lower unemployment rates reduce social security spending. As the economy weakens, the opposite effects occur. This means that government borrowing tends to fall when growth is relatively high, and rises when growth is relatively low. These 'automatic' effects help to reduce volatility in output over the cycle, by boosting aggregate demand when the economy is below trend, and reducing aggregate demand when the economy is above trend.

The Government's objectives for fiscal policy are to ensure sound public finances, while allowing the automatic stabilisers to operate over the cycle. This permits fiscal policy to support monetary policy in smoothing the path of the economy in the face of variations in demand, and explains why the fiscal rules are set over the economic cycle. For the golden rule, it means the surpluses in the current budget in periods of stronger growth can offset deficits in periods of weaker growth, helping to stabilise the economy. Public debt will tend to rise as a proportion of GDP during periods of weaker growth, and fall as a proportion of GDP during periods of stronger growth.

The strength of the automatic stabilisers depends on the characteristics of the tax and spending regime, such as the progressivity of taxes, as well as the composition of changes in demand in the economy. Their impact can be seen by examining the difference between actual public sector net borrowing (PSNB) and the cyclically-adjusted PSNB position. Attempting to balance the current budget at all times would significantly increase swings in output over the economic cycle, damaging economic stability.

**Caution and the public finance projections**

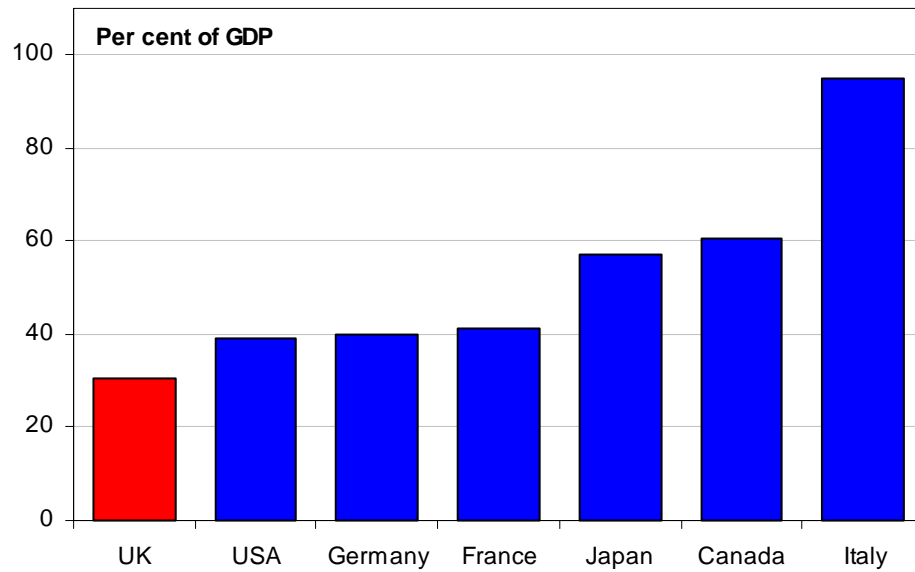
**2.19** The fiscal framework also recognises that budgetary projections inevitably involve a considerable element of uncertainty. Projections of the public finances are therefore based deliberately on prudent assumptions for key economic variables, including the trend rate of growth in the economy. These assumptions are audited by the independent National Audit Office under a three-year rolling review which ensures they remain both reasonable and cautious. A deliberately cautious approach builds in a safety margin against unexpected events and minimises the need for unexpected changes in direction in taxation or spending.

**2.20** As a further measure of caution, the Government takes account of possible misjudgements about the position of the economy in the cycle, by publishing a more cautious scenario for the cyclical position of the economy in which the level of trend output is 1 percentage point lower than on the central view (see Chapter 4: Outlook for the Public Finances).

**Fiscal Strategy and Prospects****Sound public finances**

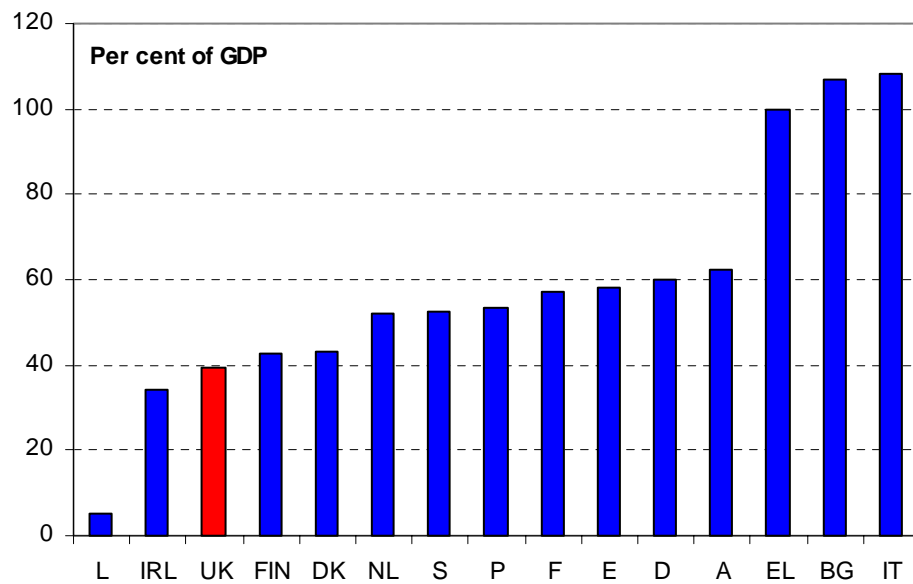
**2.21** Within this framework, the Government has taken a number of important steps over the past four years to restore the public finances to a sustainable position. These have included working within the previous Government's spending plans for the first two years, further fiscal consolidation through a series of tax changes, and using the proceeds of the auction of spectrum licences to pay back debt. As a result of these decisions, and with the benefits of greater economic stability, over £50 billion of debt has been repaid since 1996-97 when public sector net debt stood at 44 per cent of GDP and there was an overall budget deficit of £28 billion. The current level of net debt is 31 per cent of GDP, the lowest of all the G7 countries and, on the Treaty measure of gross debt, one of the lowest in the EU. This is illustrated by Charts 2.3 and 2.4.

**Chart 2.3: OECD projections of general government net financial liabilities for G7 countries, 2001**



Source: OECD Economic Outlook June 2001

**Chart 2.4: General government gross debt, 2001**



Source: European Commission Autumn 2001 forecasts

**Delivering resources to priorities**

**2.22** The improvement in the public finances and strong economic fundamentals have enabled the Government to release new resources for investment in public services, while remaining well within the two fiscal rules. Among the areas in which the Government has made savings are:

- lower growth in spending on social security, through cutting the cost of worklessness (due primarily to lower unemployment); and
- reduced debt interest payments resulting from lower levels of debt (reflecting the proceeds of the spectrum licence auction) and lower interest rates from improved credibility.

**2.23** As a result, changes in social security benefits and debt interest payments are expected to account for 18 per cent of the change in Total Managed Expenditure (TME) in the period 2000-01 to 2003-04, compared to 42 per cent in the period to 1978-79 to 1996-97.

**Protecting investment**

**2.24** Low levels of public debt, together with the protection provided to government investment by the golden rule, are allowing significant increases in investment. Net investment is forecast to more than double to 1.7 per cent by 2003-04, addressing years of neglect in public infrastructure, while public sector net debt is projected to remain stable at 31 per cent of GDP.

**Taking account of the cycle**

**2.25** Sound public finances also mean that the Government can allow fiscal policy to support monetary policy in cushioning the impact of the economic cycle. The overall impact of fiscal policy on the economy can be assessed by looking at changes in Public Sector Net Borrowing (PSNB). PSNB is expected to show a small deficit of 0.3 per cent of GDP in 2001-02. The public finance projections show that fiscal policy is supporting monetary policy in 2001 and 2002 as lower levels of receipts compared with the Budget will support demand as the economy moves temporarily below trend.

**2.26** Fiscal balances in actual and cyclically-adjusted terms are shown in Table 2.2. On a cyclically-adjusted basis, a current budget surplus of 1 per cent of GDP is expected in 2001-02, and net borrowing is expected to be equivalent to 0.3 per cent of GDP. The cyclically-adjusted balances are weaker in the following two years than previously forecast, but revert to close to the Budget profile by 2004-05. The underlying position therefore remains strong.

**Table 2.2: Fiscal balances**

	Per cent of GDP					
	Outturn	Projections				
		2000-01	2001-02	2002-03	2003-04	2004-05
<b>Fairness and prudence</b>						
Surplus on current budget	2.6	1.0	0.3	0.4	0.6	0.7
Cyclically-adjusted surplus on current budget	2.3	1.0	0.3	0.3	0.5	0.7
<b>Economic impact</b>						
Public sector net borrowing (PSNB)	-2.0	0.3	1.1	1.3	1.2	1.1
Cyclically-adjusted PSNB	-1.6	0.3	1.1	1.4	1.2	1.1
<b>European commitments</b>						
Treaty deficit <sup>1</sup>	-2.0	0.2	1.1	1.3	1.1	1.0
Cyclically-adjusted Treaty deficit <sup>1</sup>	-1.7	0.3	1.0	1.3	1.1	1.0

<sup>1</sup> General government net borrowing on an ESA95 basis.

**2.27** Public sector net borrowing is projected to peak in 2003-04. The Government is planning to borrow modestly to fund increased investment in the country's capital stock. In the coming year, rising public spending including investment spending will support monetary policy. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level.

#### Public sector finances

**2.28** A full summary of public sector finances is given in Chapter 4:

- the profile of the current budget balance shows that the Government is well on track to meet the golden rule over the projection period, with the average surplus on the current budget from 1999-2000 expected to be at least 1 per cent of GDP throughout the next five years;
- public sector net debt is projected to remain at 31 per cent of GDP throughout the projection period;
- net borrowing is projected to move into modest deficit, consistent with the sustainable investment rule as net investment increases over the next three years;
- the general government projections easily meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period;
- the projections are consistent with a prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty).<sup>7</sup>

#### Public Services

**2.29** The Government's long-term goal is to deliver world-class public services through investment and reforms to ensure that taxpayers receive real value for money. Through its action to maintain macroeconomic stability and ensure that the fiscal rules are met, it has delivered significant and sustained increases in the resources available to strengthen Britain's public services.

**2.30** By maintaining economic stability and sound public finances in challenging economic times, the Government is now laying the foundations for further sustainable increases in public spending and investment. It will expand opportunity through high standards of education, ensure the National Health Service (NHS) provides high quality care on the basis of clinical need and not ability to pay, deliver an efficient and sustainable transport system, and promote secure and prosperous communities.

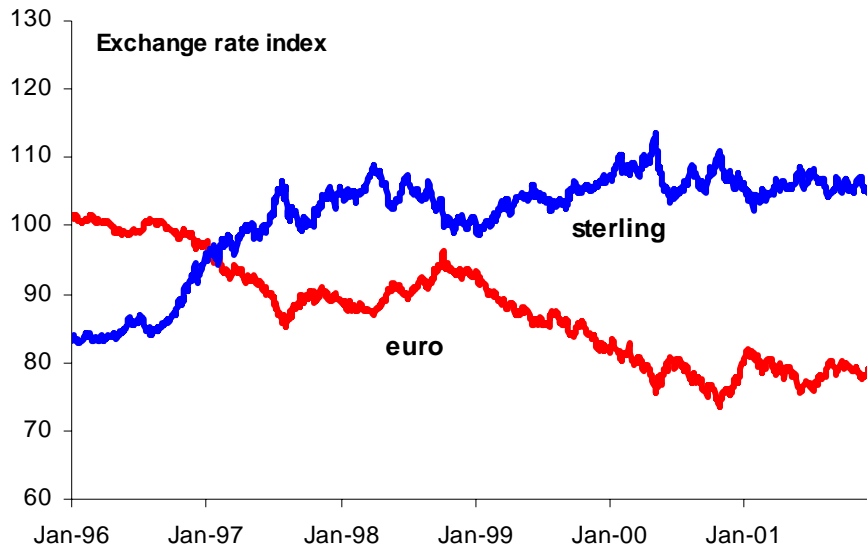
**2.31** The delivery of high quality public services depends not only on how much the Government spends but also on how effectively it spends it. Public Service Agreements (PSAs) were introduced following the 1998 Comprehensive Spending Review. PSA targets set out, for each department, the key outcomes that the Government is committed to achieve - including better health, educational attainment, and crime reduction - rather than the inputs which make them possible. By linking funding to the delivery of service improvements, key reforms and modernisation, they are central to the Government's strategy for improving public services. PSA targets are also an important input to the Spending Review process: funding is agreed in advance for the target period, so that departments have certainty that the resources will be available to ensure delivery and can plan accordingly.

<sup>7</sup> The concluding statement of the December 2001 IMF Article IV mission on the UK stated that "In terms of prudence, cyclically-adjusted overall deficits of about 1 per cent of GDP over the medium term would not compromise the strong underlying fiscal position achieved in the late 1990s, as highlighted by the projected stability of the public debt ratio at the modest level of 31 per cent of GDP". Similarly the OECD 2001 Economic Survey of the UK concluded that "the fiscal projections are sufficiently prudent".

## Exchange Rate Stability

**2.32** The Government believes that exchange rate stability can only be achieved on the basis of sound economic fundamentals, in particular, low and stable inflation, steady and sustainable growth and sound public finances. The exchange rate should therefore be seen as the outcome of all other economic policies.

**Chart 2.5: Sterling and the euro effective exchange rate indices**



Source: IMF

**2.33** Previous UK experience has shown that an exchange rate target without these fundamentals in place can be counter-productive and lead to less, not more, stability in the medium term. The Government intends to achieve exchange rate stability over the medium term through its policies for achieving greater economic stability. The new monetary and fiscal policy frameworks provide an anchor for achieving greater stability.

**2.34** A summary of UK trade and balance of payments is provided in Chapter 3.

## Economic and Monetary Union

### UK policy

**2.35** The Government's policy on membership of the single currency remains as 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 underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous. See Box 2.3 for more detail.

**Box 2.3: Government policy on EMU**

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

In June 2001, the Chancellor explained that, before the assessment of the five tests is started, the Treasury would continue to undertake necessary preliminary and technical work to inform it. The scope of this work was set out in the original October 1997 assessment. This preliminary and technical work includes:

- the cyclical behaviour of the UK economy relative to the Euro-area and their relative responses to economic shocks;
- the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work;
- the impact of the single currency on the cost and availability of capital, macroeconomic stability, the stability of the real effective exchange rate and the location, quality and quantity of investment;
- the effect of the single currency on financial services, including the changes that have occurred in this sector in the UK and the Euro-area since 1997; and
- the impact of the single currency on trade, competition, productivity and employment.

More detail was published in the Treasury paper, "Preliminary and technical work to prepare for the assessment of the five tests for UK membership of the single currency".<sup>8</sup>

The Government is actively helping UK businesses prepare for working with the euro. At the same time, preparations for possible UK entry continue under the outline National Changeover Plan. Further information is available in the Treasury's Fifth Report on Euro Preparations (see [www.euro.gov.uk](http://www.euro.gov.uk)).

**Economic Reform**

**2.36** Productivity growth, alongside higher levels of employment, is a key route to delivering greater economic prosperity. The productivity performance of the UK economy has historically been weak, creating a substantial productivity gap between the UK and other advanced industrial economies. In difficult economic times, it is more important than ever that reforms are introduced to close the productivity gap. The Government is therefore continuing to take action to achieve its long-term economic goal of raising Britain's productivity performance to deliver rising living standards for all. To build a stronger economy and fairer society, employment opportunity must be extended to all groups and areas in the country.

<sup>8</sup> Available at [http://www.hm-treasury.gov.uk/mediastore/otherfiles/p119\\_01.pdf](http://www.hm-treasury.gov.uk/mediastore/otherfiles/p119_01.pdf)

### Economic reform Europe

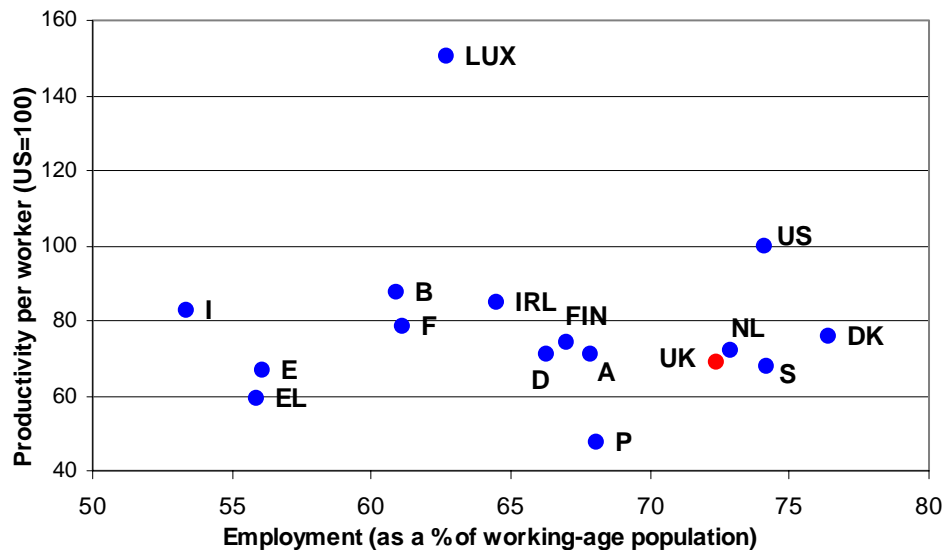
**2.37** The Government is committed to raising employment and productivity across Europe through economic reform. At the Lisbon European Council in spring 2000, Europe's leaders committed themselves to an ambitious ten-year strategy for reform. The vision agreed at Lisbon is of a dynamic, job-creating Europe that delivers on both economic and social objectives to become the leading knowledge-based economy in the world. Recognising the UK's interdependence with other EU countries, and in close co-operation with its European partners, the Government has been at the forefront of developing this new policy framework. The next step is to build on the progress made at Lisbon by:

- opening up European networks, including gas, electricity and telecoms;
- cutting the cost of investment capital, including liberalisation of financial services;
- promoting more open trade, both within the EU and with the rest of the world;
- ensuring more competition and lower prices and removing unnecessary or over-burdensome regulation, in particular through modernisation of state aids;
- creating more jobs through labour mobility and labour market reforms; and
- establishing a real stimulus to innovation, including development of patents and e-Europe.

**2.38** The Government will publish a White Paper on economic reform in Europe for the Spanish presidency.

**2.39** Chart 2.6 below illustrates that EU countries face different starting points in the challenge to achieve high levels of both productivity and employment. For the UK, it is clear that emphasis should be placed on achieving improved productivity performance, while maintaining high levels of employment.

**Chart 2.6: Employment rates and productivity levels in the EU, 2000**



Source: Eurostat, OECD Employment Outlook

**Employment** 2.40 To achieve its goal of full employment in every UK region, the Government is pursuing a comprehensive strategy to deliver employment opportunity for all - the modern definition of full employment. Macroeconomic stability is a prerequisite for achieving this aim, but it is not enough to secure job opportunities for all. The Government has introduced radical reforms of the tax and benefit system and active labour market policies to achieve this aim. In an uncertain global economic environment, it must be supported by flexible working practices and by responsive employment policies to ensure that the labour market is able to adapt without generating higher structural unemployment.

2.41 To advance its long-term goal the Government is therefore also implementing a broad-based microeconomic strategy designed to address structural weaknesses in the labour market and ensure that individuals throughout the country are able to compete effectively for jobs. The main elements of this strategy are:

- Welfare to Work policies that help unemployed people search and compete effectively for jobs, and help re-attach the long-term unemployed and economically inactive to the labour market;
- reforms to make work pay. Unemployed people are understandably reluctant to take up work if it makes them worse off, or not much better off. The introduction of the Working Families' Tax Credit (WFTC) and reforms to national insurance contributions (NICS) and income tax have increased the returns to working compared with remaining on welfare. Alongside the minimum wage, these reforms mean that the Government can guarantee a minimum income in employment for all individuals; and
- help with the return to work, by removing barriers to work and ensuring that people are financially secure when moving from welfare to work.

**Productivity** 2.42 The productivity performance of the UK economy has historically been weak. A legacy of macroeconomic instability and microeconomic failures has inhibited productivity growth and created a substantial productivity gap between the UK and many other advanced industrial economies.

2.43 The Government is implementing a comprehensive strategy for delivering stronger productivity growth and closing the productivity gap. The Government's strategy addresses issues at the regional, national and international levels and involves stakeholders from across all sectors of the economy.

2.44 The Government believes that the productivity gap can only be tackled over the long term. The UK economy registered an above-trend productivity performance during 2000, with output per worker rising by 2.3 per cent across the economy as a whole and by 5.8 per cent in manufacturing. The tendency of firms to retain labour despite weaker external demand has driven a cyclical slowdown in productivity growth during 2001. However, the continued strength of UK economic fundamentals should support a resumption of stronger productivity gains beyond the near term.

**2.45** The Government's approach to improving the UK's long-term productivity performance rests on two pillars: delivering macroeconomic stability to enable firms and individuals to invest for the long term, and implementing microeconomic reforms to remove the barriers which prevent markets from functioning efficiently. These microeconomic reforms address historic weaknesses in five areas that affect the rate of productivity growth:

- strengthening competition to encourage firms to innovate, reduce costs and provide better quality goods and services to the consumer;
- promoting enterprise and innovation to unlock the potential of new technologies and working practices, supporting entrepreneurship, risk-taking and management in all communities across the country;
- improving the skills base to maximise the contribution of human capital to growth;
- encouraging investment to improve the UK's stock of physical capital in every sector and industry; and
- working directly to improve public services productivity.

**2.46** Government has an important role to play in creating the right environment and incentives to facilitate productivity growth within the private sector and to improve public sector productivity. However, the productivity gap cannot be closed without a wider effort across the economy as whole. The Government is therefore committed to working alongside business, trade unions and other stakeholders to raise productivity across all sectors of the UK economy.

# 3

## ECONOMIC OUTLOOK

### The World Economy

**3.1** For the first time since 1974, there has been a significant and simultaneous slowdown of growth in the US, Europe and Japan, with sharp declines in world trade growth, investment, industrial production and stock markets. The terrorist attacks of 11 September have added to the downward momentum in world activity, and are expected to delay the global recovery. UK export markets are now forecast to grow by just 1 per cent this year.

**3.2** Short-term prospects across the G7 and Europe depend heavily on private consumption, which has been the main driver of recent growth. Weakening labour market conditions and the possibility of further equity price falls present downside risks to consumer confidence, while the current weakness of business sentiment could also prove more prolonged than expected. However, the decisive response by policy-makers in the US and Europe is expected to support a recovery which gathers pace from mid-2002, though the policy loosening witnessed this year might stimulate a world recovery which is either stronger, or begins earlier, than expected. The PBR projections for the world economy used in this Convergence Programme are broadly consistent with the Commission's Autumn forecasts.

### Prospects for UK Economic Growth

**3.3** The UK economy has been affected by the global slowdown, but GDP growth has remained relatively robust, with record levels of employment, strong real disposable income growth, low interest rates and housing market gains all continuing to support consumer spending. However, weaker external demand and heightened economic uncertainty have contributed to a contraction in business investment, and net trade is expected to exert a significant drag on GDP growth in the near term. The terrorist attacks of 11 September have had a further negative effect on UK business sentiment and, to a lesser extent, consumer confidence.

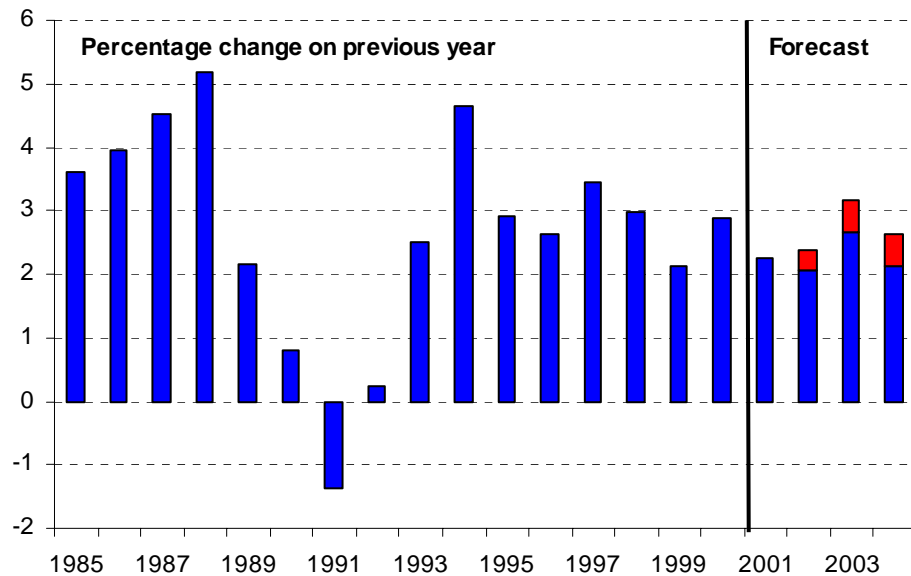
**3.4** Nonetheless, the UK is now in a better position than on previous occasions to cope with turbulence in the world economy. Subdued inflationary pressures have enabled the Monetary Policy Committee to take decisive action to sustain domestic demand, while fiscal policy is supporting monetary policy in maintaining stable economic growth.

**GDP growth 3.5** GDP growth is estimated to have been 0.5 per cent in the third quarter of 2001.<sup>9</sup> The short-term outlook has weakened since 11 September, and a period of below trend growth is expected to lead to a small negative output gap opening up around the turn of the year. Household consumption growth is expected to moderate to rates more consistent with its longer-term determinants, while business surveys indicate weak near-term investment intentions. Further ahead, stronger and more balanced growth is expected to resume in the UK from the middle of 2002 as the world economic recovery gathers pace.

**3.6** Projections for GDP growth from 2002 are presented as ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges represent the Government's neutral case view of economic prospects, anchored around an assumption of 2½ per cent a year for the trend rate of output growth from the start of 2002. Projections for the public finances are based on the low end of the ranges, consistent with a deliberately cautious assumption of 2¼ per cent a year trend growth.

<sup>9</sup> Output, income and expenditure data released by the Office for National Statistics on 22 November 2001.

Chart 3.1: Gross Domestic Product (GDP)



<sup>1</sup> Areas shaded red on bars represent forecast ranges.

**Inflation 3.7** RPIX inflation picked up during the course of 2001, but has averaged slightly below the Government's 2½ per cent target. The modest increase has, to an extent, reflected temporary factors, including a sharp pick-up in seasonal food prices earlier in the year and increased retail meat prices. Broader upward pressure has stemmed from goods prices, and buoyant retail sales growth appears to have taken some of the pressure off retailers' margins.

**3.8** Price pressures further back in the supply chain have eased during the year, with falling oil and non-oil commodity prices and weaker world prices for a wide range of goods. RPIX inflation is forecast to remain below target next year as weaker price pressures in the supply chain feed through into retail prices. The small positive output gap forecast to emerge in 2003, coupled with upward pressure on non-oil import prices from the anticipated pick-up in world growth, should bring RPIX inflation back to target by the end of 2003.

**3.9** However, domestic price pressures could prove stronger than currently assessed. The recent pick-up in unit wage cost growth could prove more persistent than expected, and buoyancy in consumer spending might encourage retailers further to rebuild margins.

**3.10** The outlook for UK inflation is also affected by the considerable uncertainties surrounding the external environment. Domestic inflationary pressures could well remain more subdued if the world downturn proves more protracted than expected, while a sharper than expected global recovery would apply upward pressure to imported inflation.

Table 3.1: Summary of forecast

	2000	Forecast			
		2001	2002	2003	2004
GDP growth (per cent)	3	2¼	2 to 2½	2¾ to 3¼	2¼ to 2¾
RPIX inflation (per cent, Q4)	2	2¼	2¼	2½	2½

### Cyclical Position

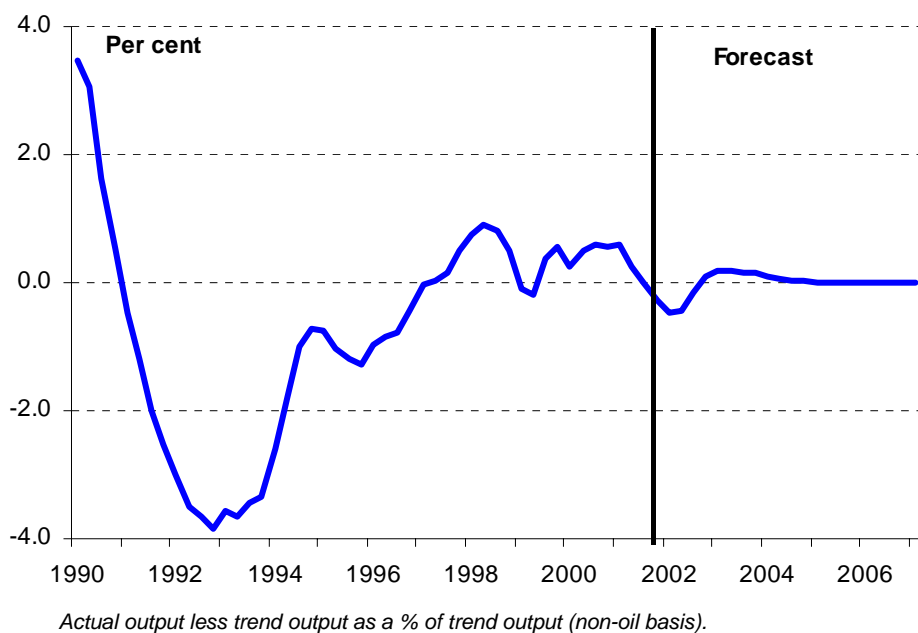
#### Economic cycle and the output gap

**3.11** In Budget 2001, the economy was assessed to have been at or close to trend in the first half of 1997 and again around mid-1999. Since then, most survey measures of capacity and labour utilisation have moved slightly above their long-run averages. A pick-up in average earnings growth earlier this year also suggested that the economy was operating slightly above potential, and ILO unemployment had fallen somewhat below most estimates of the NAIRU.<sup>10</sup>

**3.12** However, the economy is currently judged to be operating close to potential. Having continued to grow in the first half of the year, employment flattened over the summer as the effects of the world economic slowdown reached the UK. Headline average earnings growth has fallen back to 4½ per cent, and business survey indicators suggest that capacity constraints have diminished. Although the short-term outlook has weakened, growth is expected to move temporarily above its trend rate from the middle of 2002 so that the negative output gap closes by the end of the year. With inflation forecast to be slightly below target throughout 2002, there is room for the economy to operate slightly above potential during 2003.

**3.13** For the purposes of assessing performance against the fiscal rules, the provisional judgement remains that a small cycle may have been completed by mid-1999 when the current cycle is assumed to begin.

Chart 3.2: The Output Gap



<sup>10</sup> Non-accelerating inflation rate of unemployment.

### Interest Rates

**3.14** Inflation has remained lower for longer than at any time since the 1960s, allowing the Monetary Policy Committee to cut interest rates during the course of the year, to levels not seen since 1964. Monetary policy decisions since 11 September appear to have provided support to households' confidence in their own finances, reducing the risk of a sharp slowdown in consumer spending and cushioning the impact of weaker external demand.

**3.15** These actions have reinforced the credibility of the monetary policy framework. Although inflation fell to levels close to 3 per cent annually in the years prior to 1997, when a target range of 1 to 4 per cent was in force, inflation expectations remained consistently outside this target range. Inflation expectations only fell to the target after the introduction of the new framework in 1997, and they have remained close to target since then.

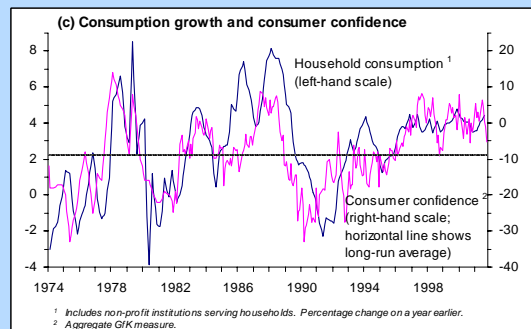
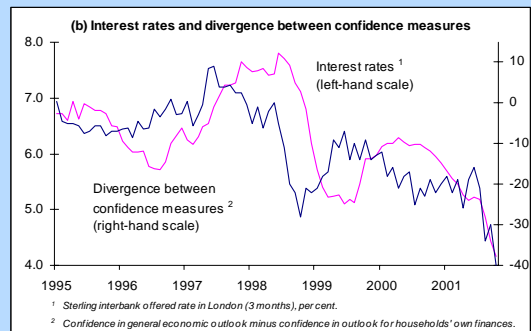
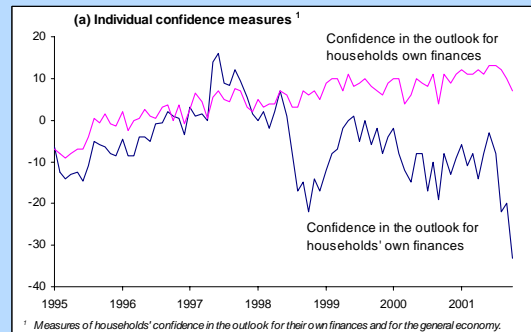
### Box 3.1: Consumer confidence and the prospects for consumer spending

Consumer confidence in the UK started the year close to record levels according to the aggregate GfK indicator.<sup>11</sup> Confidence has fallen back in recent months, as world economic prospects have deteriorated, but still exceeds its long-run average. Despite falling consumer confidence, household consumption has continued to grow rapidly during 2001.

Recent movements in the aggregate consumer confidence measure have masked significant divergences between some of its individual components (Chart a). In particular, while confidence in the general economic outlook has fallen significantly below its long-run average, households' confidence in their own financial position has held up strongly. A similar pattern emerged during 1998, when global financial instability prompted a sharp downturn in confidence in the general outlook for the UK economy.

As in 1998, the MPC has responded to the more uncertain outlook by cutting interest rates. The divergence between the two confidence measures during both these periods suggests that pre-emptive monetary policy action can sustain confidence in household finances during temporary periods of heightened economic uncertainty (Chart b).

Over longer periods, consumption growth tends not to be divorced from aggregate consumer confidence (Chart c). The recent weakening of confidence is therefore expected to contribute to a moderation of household consumption growth to rates more consistent with its longer-term determinants. On the other hand, further support to household finances should flow from the recent easing of monetary policy, helping to offset the effect of falling confidence on consumption in the short term and reducing the likelihood of a sharper slowdown in consumer spending.



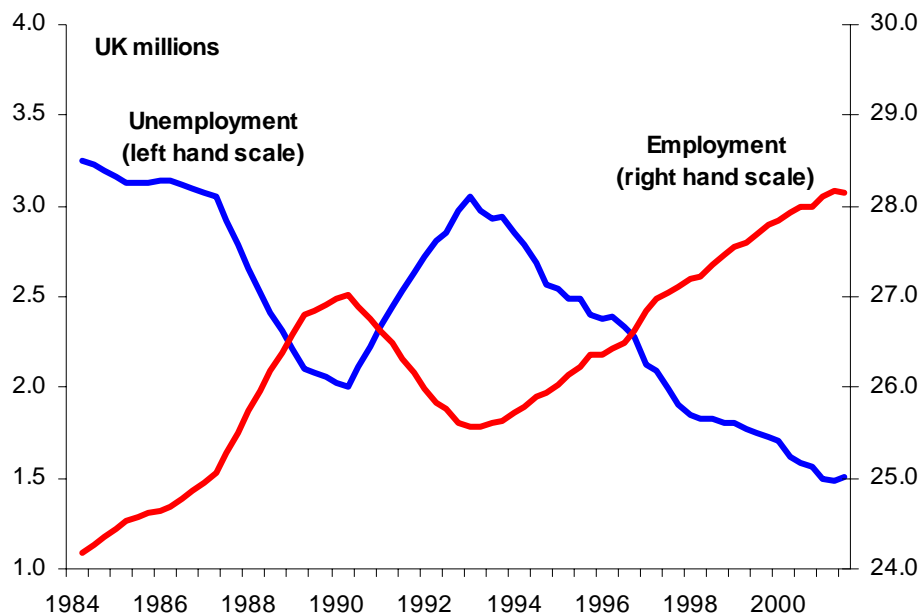
<sup>11</sup> Consumer confidence indicators published by Martin Hamblin GfK (Gesellschaft für Konsumforschung), on behalf of the European Commission. This box is consistent with data published prior to 27 November 2001.

## Employment

**Employment 3.16** Employment levelled off over the summer but, in the third quarter of 2001, the Labour Force Survey measure was up by almost 160,000 on a year earlier. It is now over 1.2 million higher than in spring 1997. The employment rate has remained close to its historic high of 75 per cent during 2001, a level last reached in spring 1990 at the peak of the economic cycle. Historically high employment rates are now being achieved with the economy operating very close to potential, highlighting the marked improvement in labour market performance in recent years.

**Unemployment 3.17** Recent ILO unemployment rates have been at their lowest since the 1970s, though the rate moved back above 5 per cent in the three months to September. Headline average earnings growth has fallen back to 4½ per cent, and unemployment is now judged to be only slightly below the NAIRU.

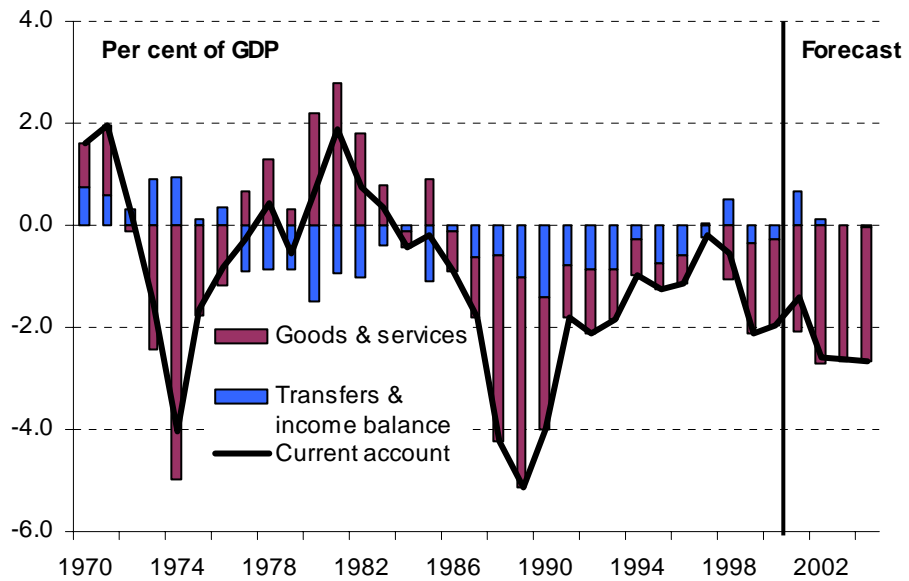
**Chart 3.3: LFS employment and unemployment**



## Trade and the Balance of Payments

**3.18** The pattern of UK trade has been heavily affected as world demand, particularly for highly traded ICT goods, has weakened. UK exports contracted during the second and third quarters of the year as external demand weakened, but the impact on the trade deficit has been offset by lower imports. Latest figures show that the current account deficit narrowed slightly in 2000. It is now forecast to narrow a bit further in 2001, with an unusually strong investment income balance more than accounting for the narrowing.

Chart 3.4: Balance of Payments current account



**3.19** Although the anticipated G7 recovery should contribute to accelerating export volumes from the middle of 2002, import volumes are expected to pick up more strongly as domestic business investment and manufacturing output recover. The current account deficit is expected to widen next year, and to level off at around 2¾ per cent of GDP thereafter.

## Summary of Economic Prospects

**Table 3.2: Summary of economic prospects**

	2000	Forecast <sup>1</sup>			
		2001	2002	2003	2004
<b>Output at constant market prices</b>					
GDP growth (per cent)	3	2¼	2 to 2½	2¼ to 3¼	2¼ to 2¾
Manufacturing output growth (per cent)	1¾	-1¾	-¾ to -½	2¼ to 2¾	1¾ to 2¼
<b>Money GDP at market prices</b>					
£ billion	943	988	1032 to 1036	1086 to 1095	1137 to 1151
percentage change	4¾	4¾	4½ to 4¾	5¼ to 5¾	4¾ to 5¼
<b>Balance of payments current account</b>					
£ billion	-18½	-14	-26¾	-28¾	-30½
per cent of GDP	-2	-1½	-2½	-2¾	-2¾
<b>Inflation</b>					
		<b>Percentage change on a year earlier</b>			
RPIX (Q4)	2	2¼	2¼	2½	2½
Producer output prices (Q4) <sup>2</sup>	1¾	0	¾	2	2¼
GDP deflator at market prices	1¾	2¼	2½	2½	2½
<b>Expenditure components of GDP at constant market prices <sup>3</sup></b>					
Domestic demand	3½	3	2¾ to 3¼	2¾ to 3¼	2¼ to 2¾
Household consumption <sup>4</sup>	4	4	2¾ to 3	2¼ to 2¾	2 to 2½
General government consumption	1½	3	4¾	2	2
Fixed investment	4¾	1	2 to 2¼	4¾ to 5¼	2¾ to 3¼
Change in inventories <sup>5</sup>	-¼	-½	0	¼	0
Export of goods and services	10¼	¾	¼ to ½	6¾ to 7¼	6 to 6½
Imports of goods and services	10¾	2½	2¾ to 3	6¼ to 6¾	5½ to 6
<b>Percentage point contribution to GDP growth</b>					
Domestic demand	4	3½	3 to 3¼	2¾ to 3¼	2¼ to 2¾
Change in inventories	-¼	-½	0	¼	0
External balance of goods and services	-¾	-¾	-1	-¼	-¼

<sup>1</sup> The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2001, released by the Office for National Statistics on 25 September 2001, and output, income and expenditure data for the third quarter released on 22 November.

<sup>2</sup> Excluding excise duties.

<sup>3</sup> The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

<sup>4</sup> Includes households and non-profit institutions serving households.

<sup>5</sup> Contribution to GDP growth, percentage points.

# 4

## OUTLOOK FOR THE PUBLIC FINANCES

**4.1** Over the past four and a half years, the Government has laid the foundations for long-term economic stability. Extensive reforms to the frameworks for monetary and fiscal policy have established a platform of stability with low inflation, low interest rates, low unemployment and sound and sustainable public finances, as discussed in Chapter 2. This section sets out projections for the public finances, which continue to be based on the prudent and cautious assumption of 2¼ per cent annual trend growth.

**Table 4.1: Summary of public sector finances**

	Per cent of GDP							
	Outturns			Projections				
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
<b>Fairness and prudence</b>								
Surplus on current budget	2.3	2.6	1.0	0.3	0.4	0.6	0.7	0.7
Average surplus since 1999-2000	2.3	2.5	2.0	1.6	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	2.0	2.3	1.0	0.3	0.3	0.5	0.7	0.7
<b>Long-term sustainability</b>								
Public sector net debt	36.4	31.2	30.7	30.6	31.0	31.1	31.1	31.1
Net worth	14.7	19.5	21.6	21.2	20.8	20.3	19.8	19.5
Primary balance	4.1	4.1	1.6	0.6	0.5	0.7	0.7	0.6
<b>Economic impact</b>								
Net investment	0.5	0.7	1.3	1.4	1.7	1.8	1.8	1.8
Public sector net borrowing (PSNB)	-1.8	-2.0	0.3	1.1	1.3	1.2	1.1	1.1
Cyclically-adjusted PSNB	-1.5	-1.6	0.3	1.1	1.4	1.2	1.1	1.1
<b>Financing</b>								
Central government net cash requirement	-1.0	-3.7	0.6	1.3	1.7	1.3	1.2	1.3
<b>European commitments</b>								
Treaty deficit <sup>1</sup>	-1.7	-2.0	0.2	1.1	1.3	1.1	1.0	1.0
Cyclically-adjusted Treaty deficit <sup>1</sup>	-1.4	-1.7	0.3	1.0	1.3	1.1	1.0	1.0
Treaty debt ratio <sup>2</sup>	43.1	39.9	38.1	37.2	37.0	36.8	36.6	36.3
<b>Memo: Output gap</b>	<b>0.3</b>	<b>0.6</b>	<b>-0.1</b>	<b>-0.1</b>	<b>0.2</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

<sup>1</sup> General government net borrowing on an ESA95 basis.

<sup>2</sup> General government gross debt.

### Current Balance and Net Borrowing

**4.2** Table 4.1 shows six-year projections of the current budget surplus and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule respectively. Outturns and projections of other important measures of the public finances, including net borrowing and net worth, are also shown. In a change to Budget 2001, the presentation includes the impact of the windfall tax and associated spending.

**Golden rule 4.3** The surplus on the current budget represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the costs of paying for the public services they use and is therefore an important indicator of the generational fairness of the finances.

4.4 The projections show that the Government remains on track to meet the golden rule over the forecast period, with the average surplus on the current budget from 1999-00 projected to be at least 1.1 per cent of GDP throughout the next five years. The surplus on the current budget was equivalent to 2½ per cent of GDP in 2000-01. The surpluses are projected to fall temporarily over the short term, mainly reflecting weaker growth, the impact of the audited assumptions, and weaker financial company profits (these are discussed in more detail below). Over the medium term, stronger economic growth and a return in financial company profits to a cautious view of their long term trend will push the current surplus back to close to their Budget 2001 levels.

#### Sustainable investment rule

4.5 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public debt at a low and sustainable level. The projections show that net debt is expected to remain at 31 per cent of GDP throughout the forecast period and well below 40 per cent. The Government is therefore firmly on track to meet the sustainable investment rule while also freeing up resources for investment in priority public services and maintaining a cushion against further unexpected events.

4.6 Table 4.2 provides more detail on the projections for the current and capital budgets. The table shows the current surplus and net borrowing, both including and excluding windfall tax and associated spending.

**Table 4.2: Current and capital budgets**

	Per cent of GDP						
	Outturn		Projections				
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
<b>Current budget</b>							
Current receipts	40.0	39.2	38.8	39.1	39.3	39.4	39.3
Current expenditure	36.1	36.8	37.2	37.4	37.4	37.4	37.3
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget (excluding WTAS <sup>1</sup> )	2.7	1.1	0.3	0.4	0.6	0.7	0.7
<b>Surplus on current budget</b>	<b>2.6</b>	<b>1.0</b>	<b>0.3</b>	<b>0.4</b>	<b>0.6</b>	<b>0.7</b>	<b>0.7</b>
<b>Capital budget</b>							
Gross investment	2.5	3.0	3.1	3.4	3.4	3.4	3.4
less asset sales	-0.5	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3
less depreciation	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Net investment	0.7	1.3	1.4	1.7	1.8	1.8	1.8
Net borrowing (excluding WTAS <sup>1</sup> )	-2.1	0.1	1.1	1.3	1.2	1.1	1.1
<b>Net borrowing</b>	<b>-2.0</b>	<b>0.3</b>	<b>1.1</b>	<b>1.3</b>	<b>1.2</b>	<b>1.1</b>	<b>1.1</b>
<b>Public sector net debt - end year</b>	<b>31.2</b>	<b>30.7</b>	<b>30.6</b>	<b>31.0</b>	<b>31.1</b>	<b>31.1</b>	<b>31.1</b>
<i>Memos:</i>							
Treaty deficit <sup>2</sup>	-2.0	0.2	1.1	1.3	1.1	1.0	1.0
Treaty debt ratio <sup>3</sup>	39.9	38.1	37.2	37.0	36.8	36.6	36.3

<sup>1</sup> Windfall tax receipts and associated spending.

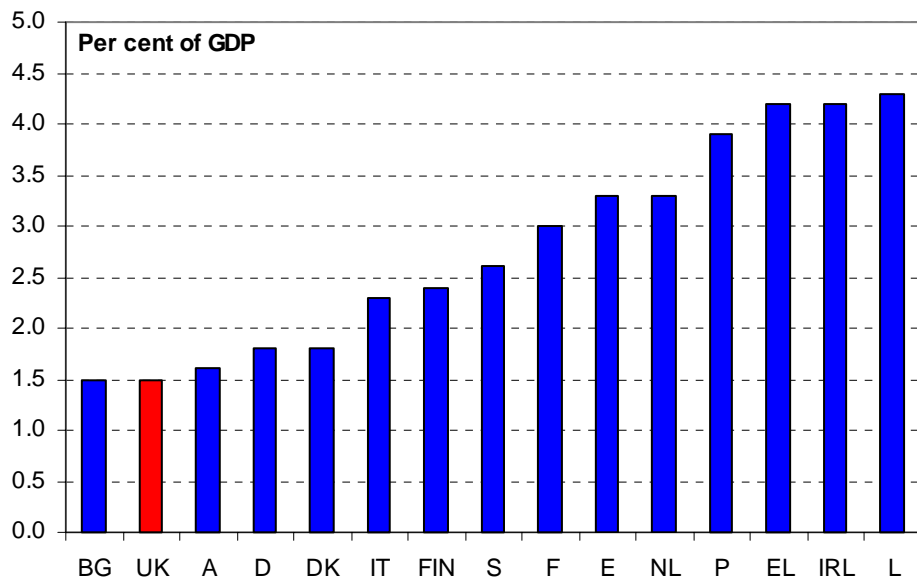
<sup>2</sup> General government net borrowing on an ESA95 basis.

<sup>3</sup> General government gross debt.

**Public investment 4.7** Net borrowing is equal to net investment minus the surplus on the current budget. Public sector net investment is projected to be approximately 1.3 per cent of GDP in 2001-02, implying net borrowing of 0.3 per cent of GDP. The ratio of net investment to GDP is projected to increase steadily to 1.8 per cent of GDP in 2004-05 and remain at that level thereafter. The rapid growth of net investment will result in modest levels of net borrowing over the remainder of the period, consistent with meeting the sustainable investment rule.

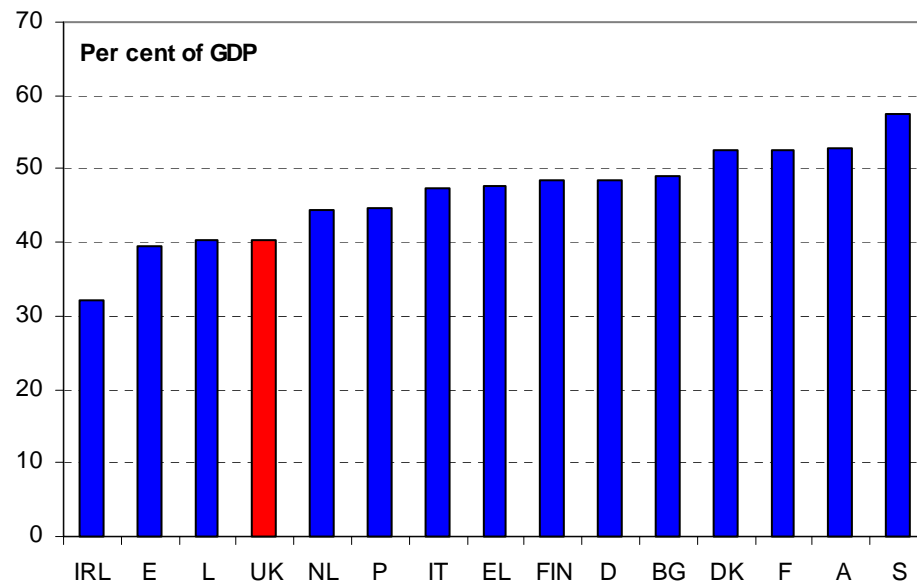
**4.8** The importance of this approach is illustrated by Charts 4.1 and 4.2 which set out comparative levels of general government net investment and general government total expenditure within the EU.

**Chart 4.1: General government net investment, 2001**



Source: European Commission Autumn 2001 forecasts

**Chart 4.2: General government total expenditure, 2001**



Source: European Commission Autumn 2001 forecasts

**EU commitments** 4.9 The projections easily meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period. The projections are consistent with a prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty).

4.10 Based on cautious assumptions and consistent with the Government's fiscal rules, the cyclically-adjusted Treaty deficit is projected to increase to 1.3 per cent of GDP in 2003-04 before returning to a deficit of 1 per cent at the end of the forecast period. This is consistent with meeting the objective of the Stability and Growth Pact of achieving a budgetary position close to balance or in surplus over the medium term, taking into account prudent borrowing for investment as specified in the EU Treaty.

### Cyclical Adjustment and Sensitivities

4.11 The Government takes care to distinguish between cyclical and structural changes to the public finances. This helps the Government to allow the automatic stabilisers to operate in full, so that they can play their role in smoothing the path of the economy, as described in Chapter 2 Box 2.2. Table 4.1 shows estimates of the cyclically-adjusted current budget and net borrowing as a per cent of GDP.

4.12 The cyclically-adjusted current budget has moved from a deficit of over 2 per cent of GDP in 1996-97 to a surplus of over 2 per cent of GDP in 2000-01. Although the surpluses are projected to be smaller in 2001-02 and 2002-03, they return towards Budget 2001 levels by 2004-05. Similarly, cyclically-adjusted net borrowing of 3 per cent of GDP in 1996-97 has moved to a net repayment of around 1½ per cent in 2000-01 before returning to a modest deficit over the short and medium term, consistent with the sustainable investment rule.

**Caution and forecast risks** 4.13 The public finance projections are deliberately based on cautious assumptions for key economic variables, including the trend rate of growth of the economy in the medium term. These are audited by the independent National Audit Office (NAO)<sup>12</sup> to ensure they remain both reasonable and cautious. Details of these assumptions are given in Box 4.1. An asymmetric approach to fiscal policy, which is in contrast to the symmetric approach taken to monetary policy, is particularly important to build in a safety margin against unexpected events. It gives greater certainty that, over the medium term, the Government is planning to spend only what it can afford on existing tax plans.

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<sup>12</sup> The NAO is accountable to Parliament and totally independent of Government. The Head of the NAO certifies the accounts of all Government departments and a wide range of other public sector bodies, and has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which Departments and other bodies have used their resources.

**Box 4.1: Key assumptions audited by the NAO**

Privatisation proceeds <sup>1,6</sup>	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth <sup>1,6</sup>	2¼ per cent a year.
UK claimant unemployment <sup>1,4,7</sup>	Rising slowly to 1.14 million in 2003-04, from recent levels of 0.95 million, consistent with the average of independent forecasts.
Interest rates <sup>1,6,7</sup>	3-month market rates change in line with market expectations (as of 19 November).
Equity prices <sup>2,7</sup>	FT-All share index rises from 2579 (close 19 November) in line with money GDP.
VAT <sup>2,7</sup>	Ratio of VAT to consumption falls by 0.05 percentage points a year.
GDP deflator and RPI <sup>2,7</sup>	Projections of price indices used to plan public expenditure are consistent with RPIX.
Composition of GDP <sup>3,8</sup>	Shares of labour income and profits in national income are broadly constant in the medium term.
Funding <sup>3,8</sup>	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Oil prices <sup>5</sup>	\$22.90 a barrel in 2002, the average of independent forecasts, and then constant in real terms.
Anti-tobacco smuggling measures <sup>6</sup>	Only direct effects, including deterrent effects of fiscal marks, are allowed for.

<sup>1</sup> *Audit of Assumptions for the July 1997 Budget Projections, 19 June 1997 (HC3693)*

<sup>2</sup> *Audit of Assumptions for the Pre-Budget Report, 25 November 1997 (HC361)*

<sup>3</sup> *Audit of Assumptions for the Budget, 19 March 1998 (HC616)*

<sup>4</sup> *Audit of the Unemployment Assumption for the March 1999 Budget Projections, 9 March 1999 (HC294)*

<sup>5</sup> *Audit of the Oil Price Assumption for the Pre-Budget Report, November 1999 (HC873)*

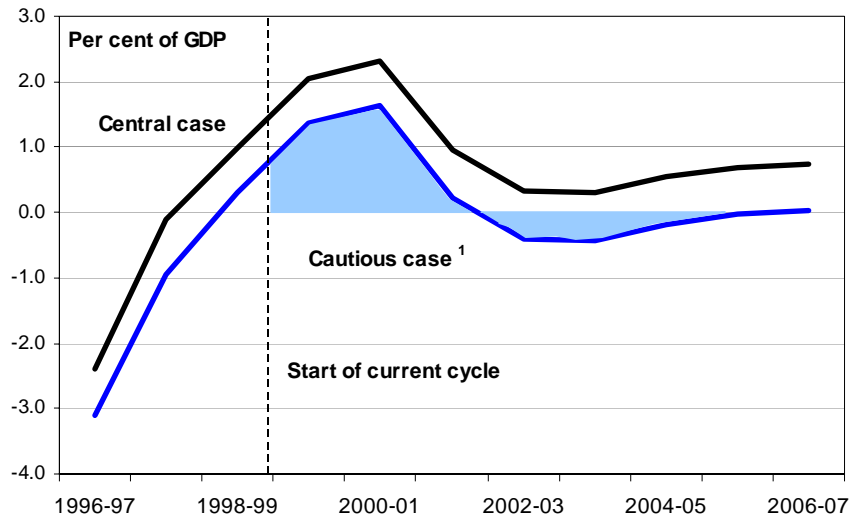
<sup>6</sup> *Audit of Assumptions for the March 2000 Budget, 21 March 2000 (HC348)*

<sup>7</sup> *Audit of Assumptions for the November 2000 Pre-Budget Report (HC959)*

<sup>8</sup> *Audit of Assumptions for the March 2001 Budget, 7 March 2001 (HC304)*

**4.14** Nonetheless, fiscal balances represent the difference between two large aggregates and forecasts of them are inevitably subject to wide margins of error. The cautious assumptions audited by the NAO, including the trend growth assumption, take account of possible misjudgement about the trend growth of the economy in the medium term. A second important source of potential error results from misjudgement about the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be 1 percentage point lower than on the central case. Chart 4.3 illustrates the interim forecast for this cautious case.

Chart 4.3: Cyclically-adjusted surplus on current budget



<sup>1</sup> Cautious case assumes trend output 1 percentage point lower in relation to actual output than in the central case.

**4.15** The chart shows that the cyclically-adjusted current budget in the cautious case was in a strong surplus in 1999-00, the start of the current cycle and again in 2000-01. It is then projected to move into deficit in 2001-02, before heading back into surplus by 2006-07. The cyclically-adjusted current budget remains in surplus on average in the cautious case meeting the 'stress test' of the golden rule. The Government therefore remains on track to meet the golden rule over the cycle, including in the cautious case. The fact that the margin for error has narrowed since Budget 2001 but that the projections meet the fiscal rules demonstrates the importance of taking a prudent approach to fiscal policy.

## General Government Finances

4.16 Table 4.3 gives a breakdown of general government finances.

**Table 4.3: General government finances**

	Per cent of GDP			
	Outturn	Projections		
	2000-01	2001-02	2002-03	2003-04
Total current receipts	39.7	38.9	38.5	38.8
Total current expenditure	36.1	36.8	37.2	37.4
Depreciation	0.8	0.8	0.8	0.8
<b>Surplus on current budget</b>	<b>2.8</b>	<b>1.3</b>	<b>0.5</b>	<b>0.6</b>
Net investment	0.8	1.5	1.6	1.9
<b>Net borrowing</b>	<b>-2.0</b>	<b>0.2</b>	<b>1.1</b>	<b>1.3</b>
Net interest payments	1.5	1.1	1.0	0.9
<b>Primary balance</b>	<b>3.5</b>	<b>0.9</b>	<b>-0.1</b>	<b>-0.3</b>
<b>Current Receipts</b>				
Taxes on income and wealth	15.1	14.6	14.6	14.8
Taxes on production and imports	13.8	13.7	13.6	13.6
Other current taxes	1.8	1.8	1.8	1.9
Taxes on capital	0.2	0.2	0.2	0.2
Social contributions	6.5	6.4	6.2	6.2
Interest Income	1.3	1.2	1.1	1.2
Other	1.0	1.0	1.0	1.0
<b>Total current receipts</b>	<b>39.7</b>	<b>38.9</b>	<b>38.5</b>	<b>38.8</b>
<b>Current Expenditure</b>				
Current expenditure on goods and services	18.6	19.3	19.7	19.8
Net social benefits	12.0	12.3	12.1	12.1
Net current grants	2.8	2.2	2.1	2.1
Interest and dividends paid	0.6	0.8	0.7	0.7
Subsidies	2.2	2.2	2.6	2.7
<b>Total current expenditure</b>	<b>36.1</b>	<b>36.8</b>	<b>37.2</b>	<b>37.4</b>
<b>Capital Expenditure</b>				
Gross domestic fixed capital formation	1.2	1.5	1.8	1.9
Other capital expenditure	0.4	0.8	0.6	0.8
<b>Total capital expenditure</b>	<b>1.6</b>	<b>2.3</b>	<b>2.4</b>	<b>2.7</b>
<b>Total expenditures</b>	<b>37.7</b>	<b>39.1</b>	<b>39.6</b>	<b>40.1</b>

*This table is derived from Pre-Budget Report table B21.*

## General Government Receipts

4.17 Total current receipts are projected to rise by just over 2<sup>1</sup>/<sub>4</sub> per cent this year, and by just over 3<sup>3</sup>/<sub>4</sub> per cent in 2002-03. This compares with projected money GDP of 4<sup>1</sup>/<sub>2</sub> per cent this year, and just over 4<sup>3</sup>/<sub>4</sub> per cent in 2002-03.

**4.18** Based on the cautious audited assumptions, however, receipts are expected to grow at a slower rate than forecast in Budget 2001 in the short term. The forecast for receipts has been revised down by £7 billion in 2001-02 and by £10 billion in 2002-03. In the medium term, receipts are expected to recover to the Budget profile. Table 4.4 below decomposes the change in the forecast of receipts into its component factors.

**Table 4.4: Factors behind changes to receipts since Budget 2001**

£ billion	Projections				
	2001-02	2002-03	2003-04	2004-05	2005-06
GDP	-1	-2	0	½	1
Audited assumptions	-1½	-4½	-3½	-2½	-2½
<i>of which:</i>					
<i>Interest rate</i>	-1	-2	-1	0	0
<i>Equity price</i>	-1	-2	-2	-2	-2
<i>Other</i>	0	-½	-½	-½	-½
Financial company profits	-3	-2½	0	1	2
Other factors	-2	-1	½	½	½
<b>Total change</b>	<b>-7</b>	<b>-10</b>	<b>-3</b>	<b>-½</b>	<b>1</b>

<sup>1</sup> Figures may not sum due to rounding.

**4.19** Slower GDP growth will reduce tax receipts by about £1 billion in 2001-02 and £2 billion in 2002-03 compared with Budget 2001. Although economic growth in 2003 is expected to be higher than in Budget 2001, the cumulative effect on levels of the main tax bases (wages and salaries, industrial and commercial company profits and consumers' expenditure) is such that the effect on tax receipts in 2003-04 is still negative. However, the impact of the economic forecast means that receipts are expected to be slightly higher at the end of the projection period, consistent with a higher level of money GDP. The main taxes affected by these changes are income tax, corporation tax and VAT.

**4.20** Changes to some of the other assumptions have large effects on tax receipts. In particular, equity price levels are important determinants of capital taxes, stamp duty and corporation tax, mainly because of the effect on the capital gains of life insurance companies. The audited assumption that underpins the current projections is that equity prices increase in line with money GDP from the existing level of the FT - All Share Index - in this case 2579. Compared with the Budget 2001 assumption of 3007 for the end of 2001, this means that equity prices are about 14 per cent lower in the current forecast. This reduces receipts by around £2 billion from 2002-03 onwards, due to the lags in the payments of capital taxes.

**4.21** Changes in other assumptions audited by the NAO also have a significant impact on receipts, particularly in the early years. Lower market expectations of 3-month market interest rates than in Budget 2001 has an impact on income tax deducted at source from bank and building society interest payments and, with a lag, on the extra tax paid on interest income by higher rate taxpayers. It also has a large impact on non-tax receipts of the public sector, such as interest receipts. Much of the change in the 'other audited assumptions' line of Table 4.4 is explained by oil prices, which are \$1.7 a barrel lower than at the time of Budget 2001, reducing receipts by about £½ billion a year throughout the period.

**4.22** Corporation tax receipts in 2001-02 are expected to be £4½ billion lower than in the Budget projections. Some of this reflects changes in the tax paid by industrial and commercial companies, largely due to changes in the economy. This element is included in the GDP line of Table 4.4. However, much of the fall in receipts is due to a fall in the taxable profits of financial companies. This is not directly reflected in forecasts for GDP. The ‘financial companies’ line in Table 4.4 shows the impact on the fiscal balances of the reduction in corporation tax receipts due to the lower assumption about financial company profits. This excludes life insurance companies, whose profits forecast is based on equity prices. The ‘financial companies’ line also includes falls in income tax because of changes stemming from lower bonuses paid by financial companies to their employees.

### General Government Expenditure

**4.23** Consistent with the Government’s new frameworks for monetary and fiscal policy, the Government divides spending into:

- Departmental Expenditure Limits (DEL), which are set for all government departments over three years. Each DEL provides the department with a solid basis for planning their own costs effectively. Separate budgets are set for resource (current) and capital spending, removing the bias against investment inherent in the previous planning regime; and
- Annually Managed Expenditure (AME), which covers those elements of spending which cannot reasonably be subject to firm multi-year limits and are instead subject to tough annual scrutiny as part of the Budget process.

**Projections 4.24** The latest projections for public expenditure, contained in the Pre-Budget Report, are included in Table 4.3.

**4.25** Compared with the 2000 Convergence Programme projections, Total Managed Expenditure (TME) is lower in 2001-02, similar in 2002-03, and less than £2 billion higher in 2003-04. Changes to GDP projections mean that spending is unchanged as a percentage of GDP in both 2002-03 and 2003-04.

**4.26** The Government is allocating substantial additional resources to key public services. Projections for DEL up to the end of 2003-04 are based on the 2000 Spending Review allocations, including the targeted additions announced in Budget 2001 and the additional £1 billion for the UK National Health Service in 2002-03 announced in the Pre-Budget Report. This leads to significant increases in current spending on goods and services, which is projected to increase from around 18½ per cent of GDP in 2000-01 to 20 per cent in 2003-04.

**4.27** Net social transfer payments are projected to increase as a share of GDP in 2001-02, mainly because of the effects of previous discretionary measures giving extra help to families with children and pensioners. Transfer payments to the unemployed have been falling in recent years, but are now projected to increase from 2002-03 onwards as a result of the audited assumption used about unemployment levels (see Box 4.1). Other current expenditure includes current grants to bodies outside general government, and the main reason for the increase in this category is higher grants to education and training institutions, as part of 2000 Spending Review increases on education spending.

**4.28** The marked improvements in the health of the public finances since 1996-97 and the benefits of economic stability have led to a significant reduction in debt interest payments in recent years. The Government’s decision to use the receipts from mobile phone companies for the use of the electromagnetic spectrum to reduce debt leads to a £1 billion saving in debt interest payments every year. As a result of all these savings, debt interest payments are projected to fall to just over 2 per cent of GDP, the lowest since 1915.

## Public Sector Investment

**Capital expenditure** 4.29 Both gross domestic fixed capital formation and capital grants are expected to increase rapidly over the next three years, in line with the Government's commitment to address neglect in the public infrastructure. Public sector net investment is set to almost double to 1.3 per cent of GDP in 2001-02 and is forecast to increase steadily over the next three years before levelling at around 1.8 per cent of GDP from 2004-05 onwards.

4.30 Table 4.5 provides a breakdown of public sector capital expenditure. In addition, the Government continues to use the Private Finance Initiative (PFI) and Public Private Partnerships (PPPs) to support its capital investment programme, in areas as diverse as education, hospitals, defence, IT, and property management.

**Table 4.5: Public sector capital expenditure**

	£ billion			
	Outturn	Estimate	Projections	
	2000-01	2001-02	2002-03	2003-04
CG spending and LA support in DEL	10.4	15.6	19.2	23.6
Locally-financed spending	1.9	1.9	1.9	1.8
National Lottery	1.1	1.1	1.2	1.3
Public corporations <sup>1</sup>	4.6	4.8	4.6	4.3
Other capital spending in AME	1.0	2.6	1.5	1.6
Allocation of reserve and AME margin	0.0	0.0	0.3	0.5
<b>Public sector gross investment<sup>2</sup></b>	<b>19.0</b>	<b>26.0</b>	<b>28.8</b>	<b>33.2</b>
Less depreciation	12.7	13.2	14.0	14.6
<b>Public sector net investment<sup>2</sup></b>	<b>6.3</b>	<b>12.9</b>	<b>14.8</b>	<b>18.6</b>
Proceeds from the sale of fixed assets <sup>3</sup>	4.5	3.8	3.8	3.8

<sup>1</sup> Public corporations' capital expenditure is partly within DEL and partly within AME.

<sup>2</sup> This and previous lines are all net of sales of fixed assets.

<sup>3</sup> Projections of total receipts from the sale of fixed assets by public sector. These receipts are taken into account in arriving at public sector gross and net investment, which are net of sales of fixed assets.

**Table 4.6: General government debt repayments**

	Per cent of GDP			
	Outturn	Projections		
	2000-01	2001-02	2002-03	2003-04
Net debt level <sup>1</sup>	31.2	30.7	30.6	31.0
Gross debt level	39.9	38.1	37.2	37.0
Change in gross debt	-3.2	-1.8	-0.9	-0.2
	<b>Contributions to change in gross debt</b>			
Primary balance	-3.5	-0.9	0.1	0.3
Interest payments	1.5	1.1	1.0	0.9
Nominal GDP growth	-1.8	-1.7	-1.7	-1.8
Other factors influencing the debt ratio	0.6	-0.3	-0.3	0.4
<i>p.m.</i> implicit interest rate on debt	7.0	5.9	5.6	5.8

<sup>1</sup> Public Sector Net Debt

*This table is derived from Pre-Budget Report tables.*

**4.31** Sound public finances and greater economic stability mean that debt interest payments as a proportion of GDP are projected to be lower in each of the three years from 2001-02 to 2003-04 than at any time since 1915. The public sector primary balance is equal to net borrowing excluding net debt interest payments - thus abstracting from the implications of past fiscal deficits. If real interest rates exceed trend GDP growth, a primary surplus is required to stabilise the net debt ratio. The primary balance is projected to be in surplus by 1½ per cent of GDP in 2001-02. Surpluses of between ½ per cent and ¾ per cent of GDP are projected over the next five years.

**4.32** Table 4.7 shows net borrowing by sub-sectors.

**Table 4.7: Net borrowing by sub-sectors**

	Per cent of GDP			
	Outturn	Projections		
	2000-01	2001-02	2002-03	2003-04
General Government	-2.1	0.2	1.1	1.3
Central Government	-2.0	0.1	1.0	1.1
Local Government	-0.1	0.1	0.1	0.1

*This table is derived from Pre-Budget Report table B21.*

## Public Service Reform

**4.33** The Government's long-term goal is to deliver world-class public services through investment and reforms to ensure that taxpayers receive real value for money. Through its action to maintain macroeconomic stability and ensure that the fiscal rules are met, it has delivered significant and sustained increases in the resources available to strengthen Britain's public services.

**4.34** By maintaining economic stability and sound public finances in challenging economic times, the Government is now laying the foundations for further sustainable increases in public spending and investment. It will expand opportunity through high standards of education, ensure the National Health Service (NHS) provides high quality care on the basis of clinical need and not ability to pay, deliver an efficient and sustainable transport system, and promote secure and prosperous communities. The Pre-Budget Report sets out:

- the Government's framework for public spending and how it is delivering real improvements in public service delivery;
- how the Government's approach has freed up additional resources for key public service priorities;
- an additional £1 billion for the National Health Service in the UK in 2002-03;
- the developments to the public spending framework being introduced as part of the 2002 Spending Review;
- the Government's wider goals and priorities for the 2002 Spending Review; and
- cross-cutting reviews in the 2002 Spending Review to find coordinated solutions to cross-departmental challenges.

**4.35** Furthermore, each department is committed, through Public Service Agreements (PSAs) to achieve specific performance targets. First published after the 1998 CSR, PSAs have since been developed further, and are monitored on a quarterly basis by a Cabinet level committee. The Government has promised to give progress reports against targets annually.

**4.36** The plans set out in the CSR were extended to 2003-04 in the 2000 Spending Review that reported in July 2000. New PSAs also form an integral part of the new settlement, with targets that are more focussed on outcomes. Additionally, Service Delivery Agreements (SDAs) have been established to complement and underpin the PSAs, providing more detail on how priorities will be delivered efficiently and effectively. For further detail, see "Planning Sustainable Public Spending – Lessons from Previous Policy Experience".<sup>13</sup>

## Economic Assumptions

**4.37** The fiscal projections assume that the economy follows the path described in Chapter 3. In the interests of caution, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend growth of 2¼ per cent a year, the lower end of the GDP growth ranges in Chapter 3. The main economic assumptions are summarised in Table 4.8.

<sup>13</sup> "Planning Sustainable Public Spending: Lessons from Previous Policy Experience", HM Treasury, November 2000. Available from: <http://www.hm-treasury.gov.uk>

**Table 4.8: Economic assumptions for the public finances**

	Percentage changes on previous year						
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Output (GDP)	2 <sup>3</sup> / <sub>4</sub>	2	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>
Prices							
RPIX	2	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>
GDP deflator	1 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>
RPI <sup>1</sup> (September)	3 <sup>1</sup> / <sub>4</sub>	1 <sup>3</sup> / <sub>4</sub>	2	3 <sup>1</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>
Rossi (Spetember) <sup>2</sup>	1 <sup>1</sup> / <sub>2</sub>	1 <sup>3</sup> / <sub>4</sub>	2	2	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>
Money GDP <sup>3</sup> (£ billion)	955	998	1046	1099	1150	1205	1263

<sup>1</sup> Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.

<sup>2</sup> RPI excluding housing costs, used for uprating certain social security benefits.

<sup>3</sup> Not seasonally adjusted.

## Long-term Public Finances

**4.38** When setting fiscal policy the Government has to ensure that its decisions provide stable public finances in the short and medium term. However, the Government also has to ensure that its policy decisions are consistent with a sustainable long-term framework. As such the Government is aware of the need to examine and plan for the long-term effects that the changing demographic profile in the UK will have for taxation and spending plans.

**4.39** The study presented in this section formed an integral part of the 2001 Economic and Fiscal Strategy Report (EFSR), published in conjunction with the March 2001 Budget. With the Code for Fiscal Stability requiring the Government to publish illustrative long-term projections covering a period of at least 10 years as part of the annual EFSR, the Government will present updated studies at the time of future budgets, taking into account new policy announcements as well as the latest information on demographic, economic, spending and revenue trends.

### Demographic trends

**4.40** Like most other EU and OECD countries, the UK will face a major demographic challenge in the decades ahead from an ageing population. Whereas only one in seven people in the UK were aged 65 or over in 1980, that share had risen to nearly one in six in 2000 and is predicted to rise to around one in five by 2020. Over the same period, life expectancy at birth will have risen from 70.2 years in 1980 to 77.8 years in 2020 for males, and from 76.2 years to 82.5 years for females. Average and median ages will also rise markedly.

**4.41** However, the ageing of the population in the UK is expected to be less pronounced than in most other western European countries and is predicted to have a manageable impact on the UK public finances. Nonetheless, the issue cannot be ignored. The reduced proportion of the population of traditional working age and the greater demand for services for the aged will both have implications for government revenue and spending. The assumptions and methodology underpinning the Government's long-term fiscal projections are detailed in Box 4.2.

**Box 4.2: Assumptions Underlying Long-term Fiscal Projections**

The Treasury's model for long-term fiscal projections examines the sustainability of the public finances by determining at what rate current consumption - such as current spending on health, education and transport - can grow while still allowing the Government to meet its fiscal rules. To achieve this, the Treasury projects the evolution of taxation, transfer payments and capital consumption (depreciation) in the coming decades on the basis of prudent and cautious assumptions. With total current spending (by assumption) held constant from 2006-07 onwards, the difference then indicates the financial resources available for current consumption. The projections are intended to show the impact of extending the current policy setting forward. A number of assumptions are made to approximate current policy from a modelling perspective.

Consistent with the approach to projecting the public finances in the short and medium term, the key economic assumptions used represent a cautious case. Crucially, the long-term rate of economic growth used in these projections is lower than the Government's neutral projection of trend economic growth. This is due to the use of cautious assumptions for both productivity and labour force growth, with the former and latter assumed to stabilise some  $\frac{1}{4}$  and  $\frac{1}{2}$  percentage points respectively below the rates used in the neutral projection of trend growth. For example, higher short-term productivity growth may reflect 'catch-up' effects and female participation rates cannot be expected to continue to grow forever.

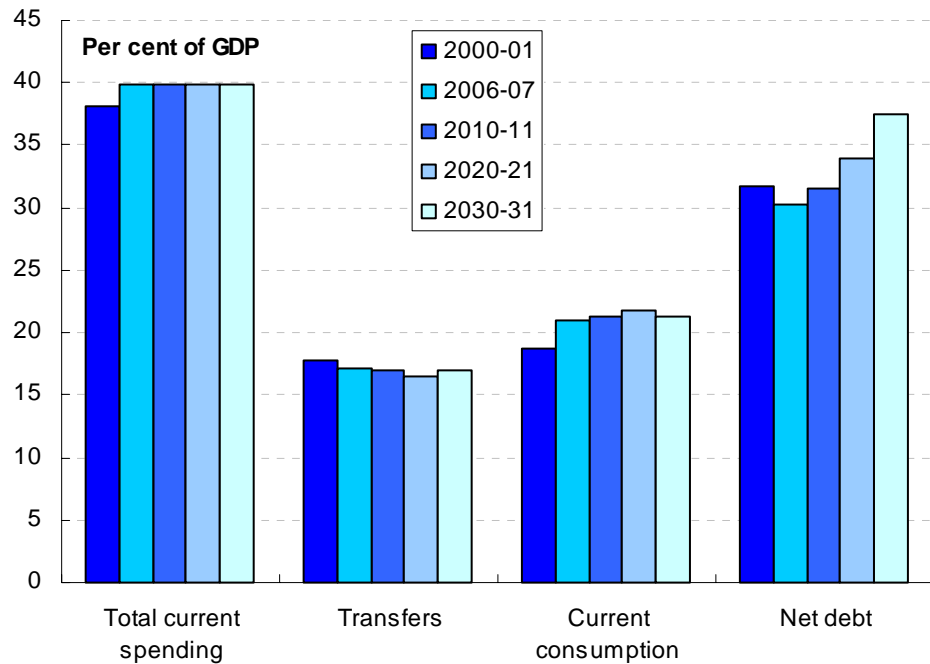
Tax revenues are subject to a number of influences in both the short and long term and their long-term implications are difficult to project. For this reason, for the 2001 long-term illustrative projections, the key tax assumption used is to project total current receipts as a constant share of GDP from 2006-07 onwards (beyond the medium-term projection) without making assumptions about the source of that revenue.

The main spending assumptions relate to transfers and capital consumption. Transfers are made up of three separate components, social security transfers (calculated in conjunction with the then Department of Social Security), interest payments and other transfers. The projections of social security transfers took into account the then current social security framework. The calculation of interest payments required assumptions both about interest rates and the level of investment. We modelled interest rates using market expectations and the existing spread of financial assets to which those rates apply. The amount of net investment in GDP was assumed to remain constant from 2005-06 to 2030-31.

The capital consumption data were calculated based on the forward profile for investment. This provided information on additions to the capital stock. The consumption of both the existing stock of assets and these new additions was then calculated on the assumption that future public sector asset lives are broadly similar to those evident in the past.

**Projections 4.42** Using the assumptions outlined in Box 4.2, the baseline illustrative projections show that public-sector current consumption can grow at a markedly faster rate - at an average of  $2\frac{1}{2}$  per cent a year between 2001-01 and 2030-31 - than the assumed average real GDP growth rate of 2 per cent while still meeting the Government's fiscal rules. The growth rate of real current consumption can exceed that of real GDP as a result of the declining trend for transfers as a share of GDP until around 2020-21. In other words, until then there is a reallocation of financial resources away from funding transfers to funding current consumption. This is mainly due to the decline in social security spending as a share of GDP but also partly due to a fall in debt interest payments as a share of GDP in the medium term.

Chart 4.4: Baseline long-term public finance projections



*Total current spending equals receipts from 2006-07 onwards.*

**4.43** The projected changes in net debt emphasise the importance of ensuring sound public finances in the short term to prepare for future developments. On current projections, net debt falls to around 30 per cent of GDP in 2006-07, a rate well below the 40 per cent level defined as consistent with meeting the sustainable investment rule. However, this downward trend is not projected to continue into the future. Rather, net debt is projected to rise gradually to 37½ per cent of GDP in 2030-31 given the long-term growth and investment assumptions.

**4.44** In an alternative scenario, it was assumed that social security spending would grow a little more slowly than in the baseline scenario. Specifically it was assumed that social security spending as a percentage of GDP would be 8.2 per cent by 2030-31; 1 percentage point lower than the baseline scenario by the end of the projection period. As in most other industrialised countries, social security spending rose sharply between the early 1970s and the early 1990s when it peaked at around 12 per cent of GDP. Since then social security's share has gradually fallen, giving the alternative scenario some plausibility. As a result of this alternative assumption, public-sector current consumption can grow at an average 2¾ per cent a year for 30 years while still meeting the fiscal rules.

**4.45** The set of long-term projections presented in the EFSR in conjunction with Budget 2001 shows that the UK's public finances are broadly sustainable in the long term. The general conclusion of the projections has been supported by work undertaken by the National Institute of Economic and Social Research (NIESR) for HM Treasury. The Institute's set of generational accounts for the UK suggests only a modest generational imbalance and a broadly sustainable position<sup>14</sup>. By contrast, many other countries are faced with marked generational imbalances<sup>15</sup>.

<sup>14</sup> Generational Accounting in the UK by Robert Cardarelli, James Sefton and Laurence Kotlikoff (2000).

<sup>15</sup> Generational Accounting Around the World edited by Alan Auerbach, Laurence Kotlikoff and Willi Leibfritz (1999).

**Uncertainties and  
policy responses**

**4.46** Despite the relatively favourable position, there is no room for complacency, not least because of the high degree of uncertainty involved in producing long-term projections. Even though the demographic and economic assumptions are reasonable and cautious, a wide range of unforeseeable developments might take place over the projection period. For example, a different demographic profile (perhaps due to changing mortality and/or migration trends) could have an impact on the demand for social security, health and education services. Moreover, the Government is facing uncertainty regarding the cost of a number of other expenditures such as nuclear decommissioning.

**4.47** It is for this reason that the Government has put in place policy measures designed to offset the impact of an ageing population on revenue and spending flows. Policies in this direction include, *inter alia*, the future increase in the retirement age for women, reforming the welfare system and modernising public-sector service provision, and assisting people to provide for retirement incomes for themselves. These developments will all play an important role in ensuring sustainable public finances in the long term.

**Future work – the  
Code for Fiscal  
Stability**

**4.48** The Government will continue to examine the potential impact of both the ageing of the population and other long-term effects. This reflects the high degree of uncertainty surrounding long-term analysis of fiscal trends and the fact that small changes in economic and policy variables can have significant effects over long time frames. As part of its Code for Fiscal Stability, the Government will therefore present revised projections in the 2002 Budget (and subsequent Budgets) that will take into account the latest assumptions and policy initiatives.

# A

## COMPARISON WITH 2000 PROJECTIONS

**A1** The main differences between this report and the 2000 update have been discussed in Chapters 3 and 4. As illustrated by Table A.1 below, GDP growth is expected to be lower this year than predicted at the time of the 2000 Pre-Budget Report, while inflation is expected to return to its 2½ per cent target in 2003-04

**Table A.1: Comparing GDP growth and inflation between 2000 and 2001 Pre-Budget Reports**

	Percentage change on previous year							
	2000-01		2001-02		2002-03		2003-04	
	2000	2001	2000	2001	2000	2001	2000	2001
GDP growth	3	3	2 <sup>1</sup> / <sub>4</sub> -2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub> -2 <sup>3</sup> / <sub>4</sub>	2-2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>4</sub> -2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub> -2 <sup>3</sup> / <sub>4</sub>
RPIX inflation	2 <sup>1</sup> / <sub>4</sub>	2	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>

**A2** Table A.2 sets out the differences between the two programmes in relation to the public finances. Outturns for the current budget surplus and Public Sector Net Borrowing (PSNB) were stronger than expected in 2000-01. In 2001-02, PSNB is expected to be 0.3 per cent of GDP, larger than projected a year ago. In line with the Government's commitment to strengthen the public infrastructure, public investment is forecast to increase steadily, reaching 1.8 per cent of GDP by 2004-05.

**Table A.2: Comparing public sector finances between 2000 and 2001 Pre-Budget Reports**

	Per cent of GDP									
	2000-01		2001-02		2002-03		2003-04		2004-05	
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001
Current receipts	40.0	40.0	40.2	39.2	40.0	38.8	39.6	39.1	39.6	39.3
Current expenditure	36.8	36.1	37.1	36.8	37.2	37.2	37.4	37.4	37.4	37.4
Surplus on current budget	1.7	2.6	1.5	1.0	1.2	0.3	0.7	0.4	0.7	0.6
Net investment	0.7	0.7	1.1	1.3	1.4	1.4	1.7	1.7	1.8	1.8
Public sector net borrowing	-0.9	-2.0	-0.5	0.3	0.2	1.1	0.9	1.3	1.0	1.2
Cyclically-adjusted surplus on current budget <sup>1</sup>	1.5	2.3	1.4	1.0	1.1	0.3	0.6	0.3	0.7	0.5
Cyclically adjusted PSNB <sup>1</sup>	-0.8	-1.6	-0.3	0.3	0.3	1.1	1.1	1.4	1.1	1.2
Treaty deficit <sup>2</sup>	-1.1	-2.0	-0.6	0.2	0.1	1.1	0.9	1.3	1.0	1.1
Treaty debt ratio <sup>3</sup>	40.1	39.9	37.7	38.1	36.1	37.2	35.6	37.0	35.5	36.8

Figures include Windfall tax receipts and associated spending and are on an ESA 95 basis.

<sup>1</sup> PBR 2000 figures exclude Windfall tax and associated spending.

<sup>2</sup> General government net borrowing.

<sup>3</sup> General government gross debt.

**A3** The improvements in current surplus and PSNB in 2000-01 are also apparent on a cyclically-adjusted basis.

**A4** Public finance projections in the PBR are interim forecasts, and do not necessarily represent the outcome the Government is seeking. The interim forecast shows that the current budget surpluses are projected to fall temporarily over the short term, mainly reflecting the effects of weaker growth, the impact of the audited assumptions, and weaker financial company profits (these are discussed in more detail in Chapter 4). Over the medium term, stronger economic growth and a return in financial company profits to a cautious view of their long term trend will push the current surplus back towards Budget 2001 levels. Table A.3 sets out the differences in relation to the public finances between Budget 2000 and Budget 2001.

**Table A.3: Comparing public sector finances between 2000 and 2001 Budgets**

	Per cent of GDP									
	2000-01		2001-02		2002-03		2003-04		2004-05	
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001
Current receipts	39.7	40.5	39.9	40.2	39.8	40.1	39.4	39.8	39.3	39.9
Current expenditure	36.8	36.6	36.9	37.1	37.1	37.3	37.2	37.5	37.2	37.5
Surplus on current budget	1.4	2.4	1.5	1.6	1.2	1.3	0.8	0.8	0.7	0.8
Net investment	0.9	0.8	1.2	1.1	1.5	1.5	1.8	1.7	1.8	1.8
Public sector net borrowing	-0.5	-1.6	-0.3	-0.5	0.3	0.2	1.0	0.9	1.1	1
Cyclically-adjusted surplus on current budget	1.3	2.1	1.3	1.4	1.0	1.1	0.7	0.6	0.7	0.7
Cyclically adjusted PSNB	-0.5	-1.4	-0.3	-0.3	0.5	0.3	1.1	1.1	1.1	1.1
Treaty deficit <sup>1</sup>	-0.6	-1.7	-0.3	-0.5	0.3	0.1	1.1	0.9	1.2	0.9
Treaty debt <sup>2</sup>	42.0	40.6	40.2	37.6	39.1	36.1	38.9	35.7	38.7	35.6

Figures exclude Windfall tax receipts and associated spending and are on an ESA 95 basis.

<sup>1</sup> General government net borrowing.

<sup>2</sup> General government gross debt.

# B

## THE FISCAL IMPACT OF BUDGET MEASURES

**B1** Chapters 2 and 4 set out details of the Government's fiscal framework and the public finance projections. In making additional discretionary policy changes, the Government takes into account:

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

**B2** Within these strict constraints, the Government has been able to release additional resources in Budget 2001 and subsequently. Table B.1 below shows the financial implications of measures announced in the 2001 Budget:

### Budget Measures

**Table B.1: Budget 2001 measures**

	+ve is an Exchequer		
	yield		£ million
	2001-02	2002-03	2003-04
<b>PBR 2000 CONSULTATION MEASURES</b>			
1 Enterprise Management Incentives: expansion	-10	-15	-20
2 Abolition of withholding tax on intra-UK corporate interest	-250	-25	*
3 General betting duty: reform by January 2002	-45	-145	-100
4 Over index aged income allowances by £240 from April 2003	0	0	-120
5 Authorised mileage rates	0	-5	-5
<i>Fuel Duty</i>			
6 Ultra-low sulphur petrol: cut duty by 2p	-445	-470	-465
7 Ultra-low sulphur diesel: cut duty by 3p	-610	-620	-625
8 Abolition of higher rate on higher octane unleaded petrol (including lead replacement petrol)	-85	-80	-65
9 Road fuel gases: cut duty by 6p per kg	*	-5	-5
10 Biodiesel: cut duty by 20p from Royal Assent 2002	0	-10	-15
<i>Vehicle Excise Duty</i>			
11 Increase threshold for reduced VED rates for private and light goods vehicles tax class to 1549cc from November 2000	-430	-270	-250
12 Introduction of reformed VED system for lorries	-105	-310	-310
13 Abolition of VED for tractors	-15	-15	-15
<b>Total: PBR 2000 consultation measures (tax and AME)</b>	<b>-1995</b>	<b>-1970</b>	<b>-1995</b>
<b>MEETING THE PRODUCTIVITY CHALLENGE</b>			
14 All-employee share ownership plan: stamp duty exemption on purchase of shares from trust	*	*	-5
15 EIS/VCTs/CVS: enhancement	-5	-5	-5
16 Films: extension of 100 per cent write-off for production costs	0	*	-50
17 Improved flexibility of close company foreign capital gains rules	*	-10	-10

	+ve is an Exchequer yield		
	2001-02	2002-03	2003-04
<b>INCREASING EMPLOYMENT OPPORTUNITY FOR ALL</b>			
18			
Income tax: over-indexation of starting rate band by £300 from £1520 to £1880	-750	-950	-950
19 Income tax: indexation of basic rate limit	0	0	0
<b>PROTECTING THE ENVIRONMENT</b>			
41 VAT: revalorisation of fuel scale charges	0	0	0
42 Unleaded petrol: cut duty by 2p from 7 March 2001 to 14 June 2001	-15	0	0
<i>Vehicle Excise Duty</i>			
43 Freeze car VED for one year	-85	-85	-85
<i>Urban regeneration</i>			
44 VAT: extend scope of reduced rate on conversion of residential dwellings	-25	-35	-35
45 VAT: reduced rate on renovations of homes empty for 3 or more years	-5	-5	-5
46 Enhanced tax relief for cleaning contaminated sites	-15	-35	-40
<b>FAIRNESS FOR FAMILIES AND COMMUNITIES</b>			
<i>Supporting families with children</i>			
20 Increase Children's Tax Credit by £1.50 to £10 from April 2001	-230	-310	-310
21 Increase Children's Tax Credit by a further £10 for families in the year of a child's birth from April 2002	0	-170	-250
22 Increase Working Families' Tax Credit (WFTC) basic credit by £5 from June 2001	-165	-300	-315
23 Increase WFTC childcare tax credit limit from June 2001 to £135 for child care costs for one child and £200 for two or more	-5	-15	-15
24 Increase Income Support and Jobseeker's Allowance child premia by £1.50 from October 2001	-120	-245	-250
<i>Maternity package</i>			
25 Raise flat rate Statutory Maternity Pay and Maternity Allowance to £75 from April 2002 and £100 from April 2003	0	-45	-205
26 Extend Statutory Maternity Pay and Maternity Allowance from 18 to 26 weeks from April 2003	0	0	-160
27 Small Employer Relief: expand eligibility from April 2002	0	-30	-30
28 Increase Sure Start Maternity Grant by £200 from April 2002	0	-40	-40
29 Introduce two weeks paid paternity leave from April 2003	0	0	-50
30 Introduce paid adoption leave for one parent from April 2003	0	0	-5
<i>Duties and other tax changes</i>			
31 Alcohol: freeze duties	-90	-90	-90
32 Tobacco: revalorise duties	0	0	0
33 Inheritance tax: index threshold	0	0	0
34 VAT: modernising relief on vehicles adapted for people with disabilities	-10	-10	-10
35 VAT: reduced rate on children's car seats	-5	-5	-5
36 VAT: modernising relief for young children's clothing and footwear	-20	-20	-20
37 VAT: refund scheme for national museums and galleries	-10	-15	-15
38			
Increase in de minimis limit for business gifts for business taxes and VAT	-15	-15	-15
39 Life insurance policies: policyholder information	*	*	10
40 Controlled foreign companies	0	20	20
<b>Total: new Budget measures (tax and AME)</b>	<b>-1570</b>	<b>-2415</b>	<b>-2940</b>
<b>Total: Budget measures (tax and AME)</b>	<b>-3565</b>	<b>-4385</b>	<b>-4935</b>
<b>ADDITIONAL BUDGET POLICY DECISIONS</b>			
<i>Additions to DEL</i>			
Education	-290	-330	-380
Health	-360	-355	-290
Fighting crime and drugs	-70	-110	-155
Carrying forward of DEL and underspend	-1000	0	0
Additions to Capital Modernisation Fund	-60	0	0
Change to AME margin	1730	1580	1610
<b>TOTAL: BUDGET POLICY DECISIONS</b>	<b>-3615</b>	<b>-3600</b>	<b>-4150</b>
* Negligible			

**B3** Table B.2 below sets out the effect of the measures announced in the November 2001 Pre-Budget Report on the fiscal projections.

**Pre-Budget Report  
measures**

**Table B.2: Pre-Budget Report 2001 measures**

	+ve is an Exchequer yield			£ million
	2001-02	2002-03	2003-04	2004-05
<b>Measures announced since Budget 2001</b>				
Change CGT business assets taper relief	0	-10	-20	-40
Forex and Corporate Debt - measures introduced in July 2001	90	160	150	150
Remove Crown's preferential right to recover unpaid taxes	0	-35	-70	-70
Removal of automatic VAT fines for small businesses	*	*	*	*
Winter fuel payments increased to £200 for 2001-02	-435	0	0	0
<b>Total measures announced since Budget 2001</b>	<b>-345</b>	<b>115</b>	<b>60</b>	<b>40</b>
<b>Measures announced in the Pre-Budget Report 2001</b>				
Increase limit for EMI to £30 million	0	-25	-30	-40
VAT: reform of annual accounting system	0	*	*	*
Implementation of VAT flat rate scheme for small businesses	0	-25	-25	-25
Freeze of Class 2 NICs rates	0	-5	-5	-5
Introduction of Pension Credit	0	0	-975	-2025
Guaranteed increase to basic state pension	0	0	-225	-225
Disability measures	0	-30	-65	-70
Winter fuel payments increased to £200 for 2002-03 and beyond	0	-435	-440	-445
Reform of Pools Betting Duty	0	-5	-5	-5
Green Fuels Challenge - pilot schemes	0	*	*	*
Aggregates levy - special arrangements in Northern Ireland	0	-10	-10	-10
<b>Total Pre-Budget Report measures</b>	<b>0</b>	<b>-535</b>	<b>-1780</b>	<b>-2850</b>
<b>Additional PBR policy decisions</b>				
Additional health spending in Del	0	-1000	0	0
Reallocation from AME	0	1000	0	0

\* Negligible