



HM TREASURY

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# **SUSTAINABLE PUBLIC FINANCES**

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**Convergence Programme for the United Kingdom**

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

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**December 2003**

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# 1 INTRODUCTION

**1.1 The forecasts for the UK economy and public finances set out in this Programme show that the UK's public finances are robust and sustainable.** Strong economic fundamentals and decisive macroeconomic policy have left the UK better placed than in previous world slowdowns to maintain stability and ensure the public finances remain sustainable in the long term.

**1.2** Earlier this year, global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth, in particular in the euro area. Since then, as some key uncertainties have receded, international growth prospects have generally recovered, although this improvement has remained uneven across countries. In particular, activity in the euro area has remained subdued. Meanwhile, UK economic growth picked up strongly in the second and third quarters, as forecast in Budget 2003. This pick-up in activity is expected to continue into 2004, as the world recovery continues to gather momentum.

## The importance of sustainability

**1.3 Sustainable public finances are an essential prerequisite to achieving steady long-term economic growth.** There has been a shift towards more medium-term planning within fiscal frameworks by governments around the world, and a greater emphasis on the long term. This has been motivated mainly by countries both focusing on control over their short and medium-term fiscal positions and becoming increasingly aware of the importance of looking at the long term, in part so as to prepare for the common problem of an ageing population. The focus of the UK's attention has long been on fiscal sustainability, recognising that this helps create an environment conducive to sustained long-term economic growth and inter-generational fairness. The Government published, in December 2003, its second *Long-term public finance report*<sup>1</sup>. This report, produced annually, seeks to extend and complement existing analysis<sup>2</sup> and introduces additional indicators to assess long-term fiscal sustainability. Using these techniques, and a range of plausible assumptions, it is possible to build up a comprehensive picture of the long-term sustainability of the public finances in the light of expected future developments (as shown in Chapter 4).

**1.4** This regular annual Convergence Programme, "**Sustainable Public Finances**", updates the UK's 2002 Convergence Programme to reflect the latest Government forecasts for the economy and public finances, which are published in the Pre-Budget Report on 10 December 2003<sup>3</sup>. It is subject to the usual UK Parliamentary scrutiny and approval. This update also takes account of Budget 2003<sup>4</sup>, as well as taking account of the latest biennial Government spending review, completed in 2002<sup>5</sup>.

## Prudent interpretation

**1.5** The latest public finance projections show that the **UK continues to meet a prudent interpretation of the Stability and Growth Pact**, reflecting low debt and long-term fiscal sustainability, the need for public investment in the UK, and the economic cycle (**in keeping with the 2003 Broad Economic Policy Guidelines**).

<sup>1</sup> *Long-term public-finance report: an analysis of fiscal sustainability*, HM Treasury, December 2003

<sup>2</sup> In Annex A of the Economic and Fiscal Strategy Report (EFSR), which sets out 30-year public finance projections

<sup>3</sup> *Pre-Budget Report*, HM Treasury, December 2003

<sup>4</sup> *Budget 2003*, HM Treasury, April 2003

<sup>5</sup> *2002 Spending Review*, HM Treasury, July 2002

### The macroeconomic framework

**1.6** Chapter 2 of this report provides an outline of the UK Government's framework for monetary and fiscal policy and for public spending, which forms an integrated strategy for maintaining low debt, long-term fiscal sustainability, high and stable levels of growth and employment, and for minimising the adverse impact of external events:

- since its introduction in 1997, the **monetary policy framework in the UK** has consistently delivered inflation close to the Government's target and allowed the Bank of England's Monetary Policy Committee (MPC) to mitigate the impact of global events on the UK economy;
- the **fiscal policy framework in the UK** is delivering sustainable public finances, while supporting monetary policy over the cycle. The fiscal rules are set over the **economic cycle**. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand. The rules also work together to ensure **sustainable public finances in the long term**.
- the fiscal rules, which the Government is on track to meet, also promote capital investment and are the foundation of the UK Government's **public spending framework** which is delivering substantial resources to reform and modernise public services.

### Economic forecasts

**1.7** Chapter 3 provides updated forecasts for the UK economy in the period to 2006. The domestic stability delivered by the Government's macroeconomic frameworks has enabled the UK economy to cope well in a challenging global economic environment and UK demand and activity has strengthened as geo-political uncertainties have receded. Against a gradually improving global background, financial markets have more than made up the losses incurred over the first quarter of 2003. Many forward-looking survey and confidence measures have also improved considerably in recent months and manufacturing output has risen. Following growth of 0.2 per cent in the first quarter – the weakest for almost eleven years – GDP grew by 0.6 per cent in the second and by 0.7 per cent in third quarter of the year, broadly in line with the 2003 Budget forecast.

### Public finances

**1.8** Chapter 4 summarises the public sector finance projections and outlines how, in light of these projections, the UK continues to meet a prudent interpretation of the Stability and Growth Pact:

- **the economic cycle**. The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the impact of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began. The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year. The economy is projected to return to trend during 2005-06, meaning that over the whole cycle the average annual surplus on the current budget would be around an annual 0.2 per cent of GDP, equivalent to a margin or surplus in this cycle of £14 billion.

With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2008-09 is 0.1 per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on track to continue to meet the golden rule after the end of this economic cycle.

- **sustainability.** The UK Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle. General government gross debt is forecast to stabilise at 41.5 per cent (one of the lowest debt levels in the EU) by the end of the projection period.

While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. This updated Programme draws on an improved and updated analysis of long term fiscal sustainability published in the *Long term public finance report* December 2003. The report shows that, based on reasonable assumptions, the public finances are sustainable in the longer term, and that the UK is well placed to meet the challenges of an ageing population relative to many other countries.

- **public investment.** Sound public finances that are sustainable over the economic cycle are not only essential to ensure economic stability; they are also necessary to deliver the sustainable investment in public services required to deliver standards that meet public expectations. In keeping with the 2003 Broad Economic Policy Guidelines, this updated Programme also demonstrates the UK Government's commitment to address the historical under-investment in public services in the UK.

## Productivity and economic reform in Europe

**1.9** The Government is continuing to press for changes that will improve the flexibility of the European economy and so enhance its productivity performance. In the past, Europe has sometimes adopted economic strategies that were insufficiently responsive to changing economic circumstances, overly uniform, or too insular. The Government believes that the EU needs to be flexible, reforming, open, and globally orientated. In the context of globalisation, it needs to capitalise on the diversity of its economies and the Government will work for further progress at next spring's European Council on economic reform.

## Annex A & Annex B

**1.10** Annex A provides details of the differences in key indicators between this update of the Programme and the 2002 update. Annex B provides details of the financial impact of the 2003 Budget policy decisions, and subsequent announcements.

## Annex C Flexibility in the UK economy

**1.11** Annex C of this Convergence Programme is Annex C of the December Pre-Budget Report 2003 *Flexibility in the UK economy*. Reforms that promote flexibility and fairness are central to achieving the Government's goal to deliver high and stable levels of growth, with opportunity and rising living standards for all. Annex C explains the UK Government's approach of combining flexibility with fairness, and the action the Government has taken to boost flexibility in labour, product and capital markets since the April Budget 2003 and in the December Pre-Budget Report 2003.

**Box 1.1: Background to the 2003 update “Sustainable Public Finances”**

The Government has submitted programmes under the Stability and Growth Pact for each of the last five 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 the content and format of stability and convergence programmes<sup>6</sup>. This 2003 update reflects the Code of Conduct. The updated Programme is subject to the usual UK Parliamentary scrutiny and approval under Section 5 of the European Communities (Amendment) Act 1993.

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<sup>6</sup> *Opinion on the content and format of stability and convergence programmes*, EFC/ECFIN/404/01-REV 1

## 2

## POLICY FRAMEWORK &amp; 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;
- building a fairer society;
- delivering high quality public services; and
- protecting the environment.

**2.2** These objectives, and the elements through which the Government plans to meet them, 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 with a **prudent interpretation of the EU Stability and Growth Pact**.

**2.3** The macroeconomic framework is based on the principles of transparency, responsibility and accountability.<sup>1</sup> The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

**Long-term Sustainability and Flexibility****The importance of long-term sustainability...**

**2.4** While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability*. Many developed countries face significant challenges over the long term as a result of ageing populations. For example, the demand for health care is likely to rise as a result of the increased number of older people.

<sup>1</sup> Further details can be found in *Reforming Britain's economic and financial policy*, HM Treasury, 2002

**2.5** An improved and updated analysis of long-term fiscal sustainability is published alongside the Pre-Budget Report in the 2003 Long-term public finance report. The report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances, updating the illustrative long-term projections set out in Budget 2003. To provide a comprehensive and robust analysis, the report:

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

**2.6** The report shows that, based on reasonable assumptions, the public finances are sustainable in the longer term, and that the UK is well placed relative to other countries to meet the challenges of an ageing population. Chapter 4 of this report details the content of this report.

#### ...and flexibility

**2.7** In June 2003, the Government made an assessment of the five tests, which assess the economic case for joining the single currency, as set out in Box 2.4. The assessment set out a reform agenda of concrete and practical steps, including reforms at national, regional and local level to enhance flexibility of labour, capital and product markets in the UK. The Government announced it would publish six monthly flexibility reports, the first of which accompanies this Convergence programme.

### Monetary Policy

#### The monetary policy framework

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

- clear and precise objectives. While the primary objective of monetary policy is to deliver price stability, the adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's inflation target;
- 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
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system.

**2.9** These arrangements have removed the risk that short-term political factors could influence monetary policy and ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target.

**New inflation target**

**2.10** On 9 June 2003, the Chancellor announced that he intended to change the basis of the inflation target in the remit for the MPC. The 2003 Pre-Budget Report confirms that from today the operational target for monetary policy will switch to a target based on the harmonised index of consumer prices, which the National Statistician has named the Consumer Prices Index (CPI) for the UK. The Chancellor has written to the Governor of the Bank of England setting out the new remit. Attached to the letter is an annex explaining the new target, including the advantages of the CPI. In addition, the Office for National Statistics (ONS) has published a paper<sup>2</sup> setting out the technical and methodological basis of the CPI, the differences between the CPI and RPIX and the advantages of CPI for the purposes of setting monetary policy.

**2.11** As discussed in the ONS paper, the CPI is a better measure of inflation for the purposes of setting monetary policy, as it:

- better allows for the substitution of cheaper for more expensive goods and services within expenditure categories when relative prices change and so it is a more realistic characterisation of consumer behaviour;
- has a wider population coverage and is more consistent with national accounts principles of consumer expenditure, so it shares a coherence with other economic statistics and gives a better picture of spending patterns in the UK; and
- is the most comparable measure of inflation internationally and represents international best practice.

**2.12** The level of the new CPI inflation target is being set at 2 per cent and the switch to the new target will apply from 10 December. The new target is 0.5 percentage points below the previous RPIX-based target, reflecting differences in the way that CPI and RPIX inflation are measured. The level of the new target is set to be consistent with the old target in two years' time, the typical forecast horizon for monetary policy purposes.

**2.13** All other aspects of the monetary policy framework remain unchanged. If the rate of CPI inflation diverges by more than one percentage point above or below the target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected period of the deviation and how this approach meets the remit of the MPC.

**2.14** Benefits will continue to be uprated by the RPI, or derivative indices, as before. Recipients will continue to receive assistance with housing costs through the housing costs element of the RPI or through help for housing costs targeted at low-income households.<sup>3</sup> The Government will continue to issue gilts linked to the RPI measure of inflation.

<sup>2</sup> *The New Inflation Target: the Statistical Perspective*, ONS, December 2003.

<sup>3</sup> Housing Benefit, Council Tax Benefit and Income Support for Mortgage Interest are available to help low income households with housing costs.

**Box 2.1: The Consumer Prices Index**

The Consumer Prices Index (CPI) is a measure of the change in the level of prices charged for consumer goods and services. It is constructed on a common, or harmonised, basis for all EU Member States. The common European standard is known as the Harmonised Index of Consumer Prices (HICP) and the CPI is the UK's measure.

As with RPIX, the CPI is calculated by weighting prices according to the pattern of households' expenditure. Both indices are 'chain-linked', which means that the weights are adjusted annually to reflect changes in the pattern of consumers' expenditure. While the CPI is calculated from the same raw price data as the RPI and RPIX, there are a number of methodological and coverage differences between RPIX and CPI that lead to differences between the inflation rates, as described in the Office for National Statistics paper. These methodological differences can be broadly divided into two effects, the formula effect and the coverage effect.

The **formula effect** relates to the way the two indices aggregate individual prices within individual expenditure categories. The CPI uses a geometric mean and RPIX uses arithmetic means. The geometric mean is the approach used in most other countries, and as stated in the ONS paper, has some advantages over arithmetic means.

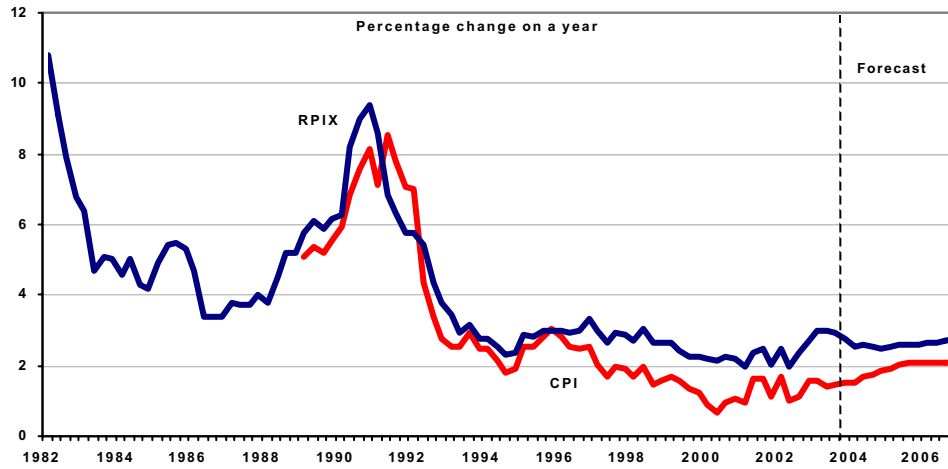
The **coverage effect** is due to the different coverage of the two indices and relates primarily to differences in population and expenditure coverage, and commodity measurement. The population coverage differences reflect the fact that the CPI is based on the purchasing patterns of all private households, including expenditure by foreign visitors, the richest households and the poorest pensioner households, all of which are excluded from the RPI. On expenditure coverage, the major difference is the exclusion of several components of housing costs from the CPI that are included in RPIX, including housing depreciation and council tax. The commodity measurement effect reflects different treatment of items such as insurance premiums.

Since 1997, the formula effect and the difference in coverage relating to housing costs have been the main reasons for the differences between CPI and RPIX inflation. The other coverage effects have tended to be negligible on average.

**2.15** The difference between CPI and RPIX inflation is expected to narrow markedly from 1.3 percentage points in October 2003 to ½ percentage point two years ahead, the typical forecast horizon for monetary policy purposes. Thereafter, the differential is expected to remain broadly stable, rising slightly above ½ percentage point in future years. With CPI inflation expected to remain at its target level of 2 per cent, RPIX inflation is expected to rise slightly above 2½ per cent depending on a range of economic factors and rounds up to 2¾ per cent in the Pre-Budget Report forecast.

**2.16** The exclusion of certain housing cost elements from the CPI does not mean that housing developments will not be an important factor in setting monetary policy or that house prices will be more volatile under a CPI-based target. Although the MPC will target CPI inflation, house prices are – and will continue to be – an important indicator in assessing macroeconomic developments for the purposes of setting monetary policy. Furthermore, as discussed in detail in the ONS paper published on 10 December 2003, Eurostat is currently undertaking a pilot study (in which the UK is participating) to assess the preferred means of incorporating a measure of housing costs into the CPI. The ONS is expected to take into account any internationally agreed future changes in the measurement of inflation.

Chart 2.1: CPI and RPIX<sup>1</sup>



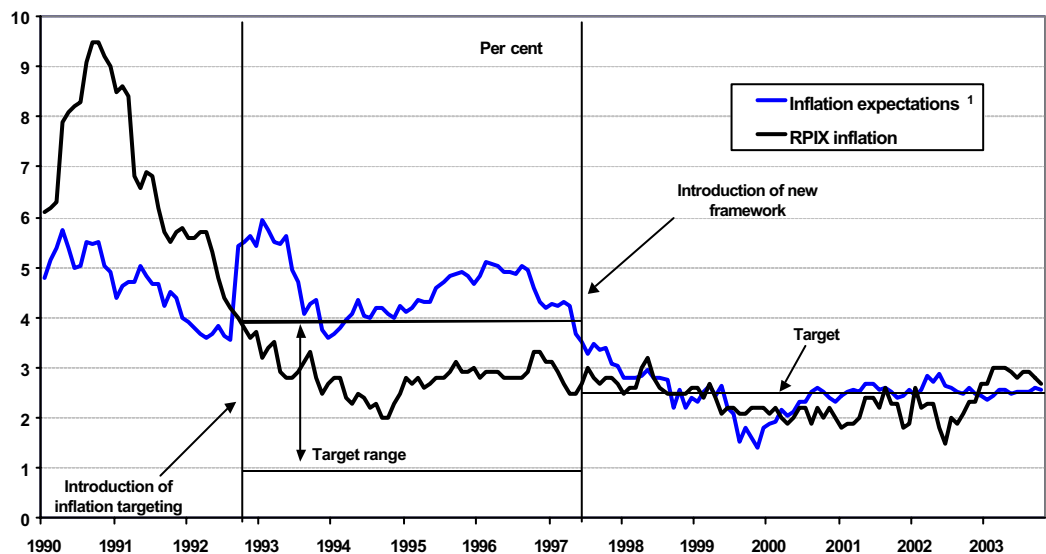
<sup>1</sup> Outturns until 2003Q3; forecasts for every second quarter from 2003Q4 to 2006Q4.

### The performance of the Monetary Policy Framework

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

- RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government’s target; and
- long-term inflation expectations, as measured by survey and financial markets data, show that expected inflation has remained close to the Government’s target, having fallen from over 4 per cent in 1997, demonstrating the framework has a high degree of credibility.

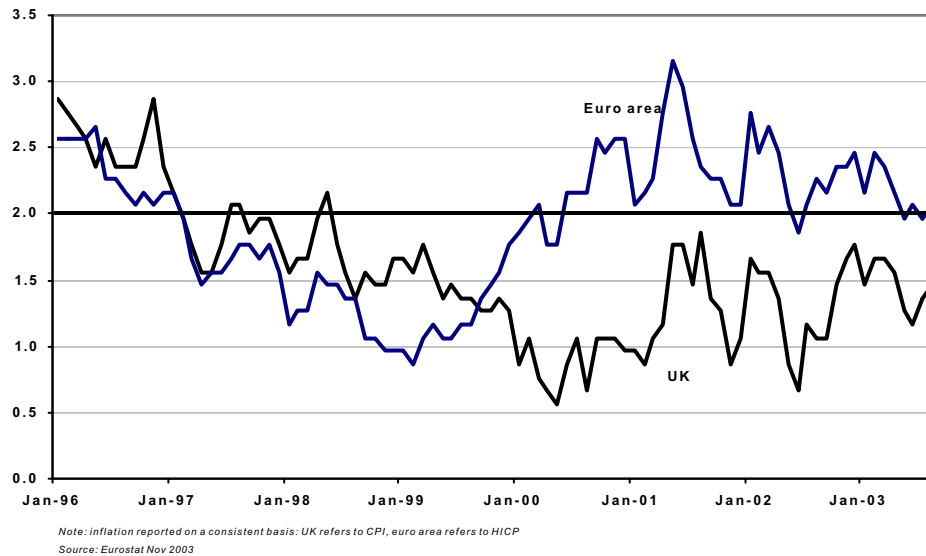
Chart 2.2: Inflation performance and expectations



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

**2.18** The framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped to keep output close to its trend level, while ensuring that inflation remained close to target. The MPC then increased interest rates in November 2003 in response to a strengthening global economy and a pick up in growth in the UK. Long-term 30 year interest rates are lower than in the US or the euro area, reducing the Government's debt interest payments and freeing up resources for investment in public services.

**Chart 2.3: UK and euro-area average inflation rates**



**2.19** Three-month interest rates currently stand at 3.88 per cent, reflecting a sustained reduction in both the level of inflation and inflation expectations in the UK since the monetary framework was established in 1997.

**Table 2.1: Inflation and long-term interest rates in 2003**

|                  | Inflation | Long term 30 year interest rates |
|------------------|-----------|----------------------------------|
| <b>UK</b>        | 1.4       | 4.9                              |
| <b>Euro area</b> | 2.0       | 5.1                              |

Note: inflation reported on a consistent basis: UK refers to CPI, euro area refers to HICP  
Source: Eurostat and Bloomberg

## Fiscal Policy

### The fiscal policy framework

**2.20** The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*<sup>4</sup> – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

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

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

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

**2.22** The fiscal rules ensure sound public finances in the medium term while allowing flexibility in two key respects:

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

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

<sup>4</sup> *Code for fiscal stability*, HM Treasury, 1998.

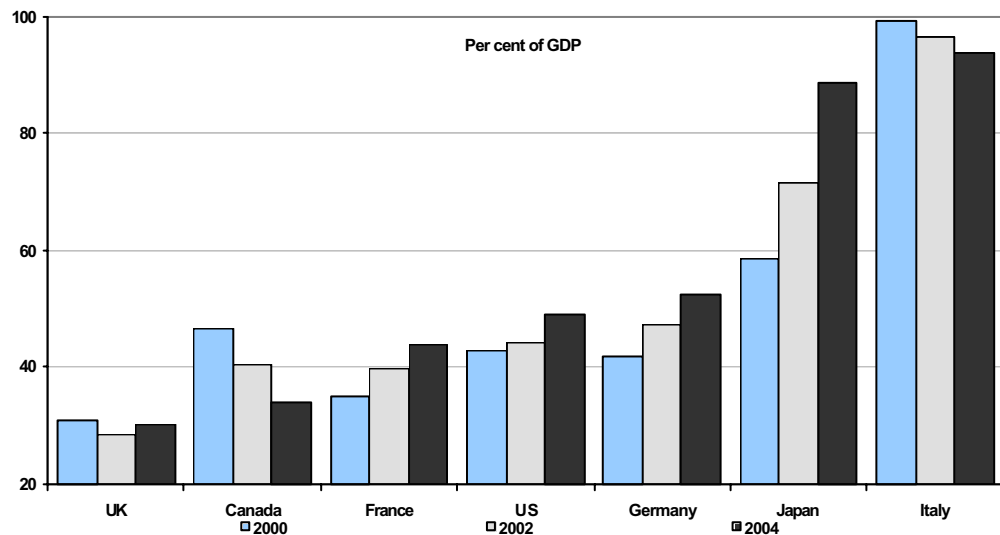
**2.24** In order to enhance the reporting of fiscal developments, the *End of year fiscal report* (EYFR) is an annual report and the 2003 EYFR is published alongside the 2003 Pre-Budget Report<sup>5</sup>. It compares forecasts and outturns of the public finances, identifying the possible reasons for differences. The EYFR helps to foster transparency by enhancing the Government's reporting and analysis of fiscal developments and ensures that UK is fully in line with international best practice, including the International Monetary Fund's Code of Good Practices on Fiscal Transparency.

### Fiscal Strategy and Sustainability

#### Sound and sustainable public finances

**2.25** The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by more than 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. Public sector net debt has also been reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.4 shows, the UK now has the lowest level of debt as a proportion of GDP in the G7, and Chart 2.5 shows the UK has the third lowest level in the EU.

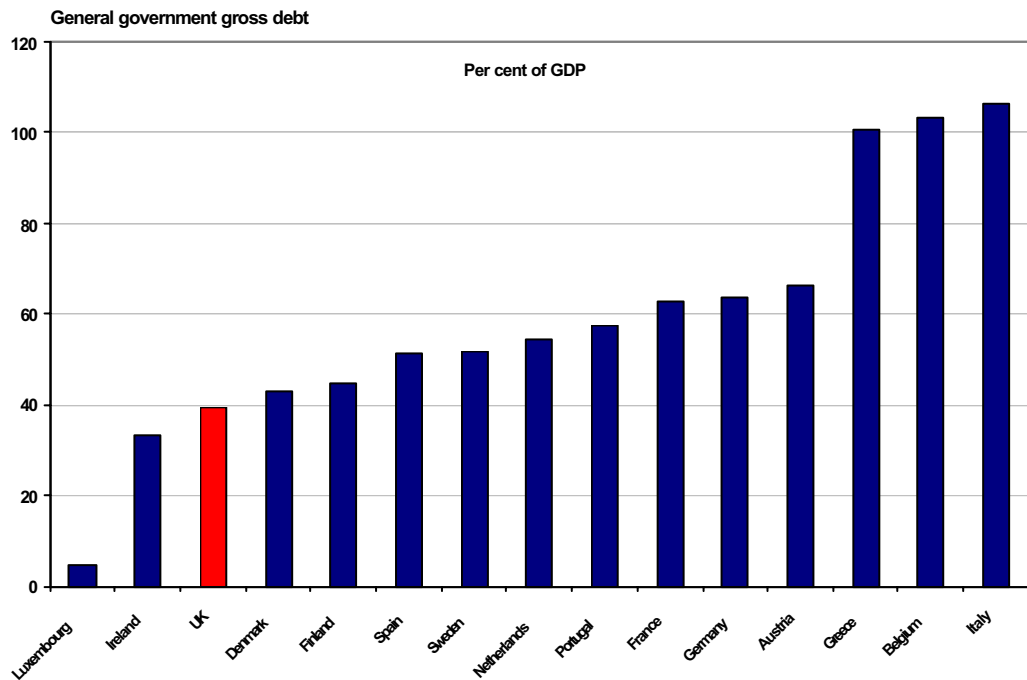
**Chart 2.4: OECD estimate of general government net financial liabilities for G7 countries**



**2.26** Low and stable debt levels combined with accumulated current budget surpluses over the course of the economic cycle, have allowed the full and symmetric operation of automatic stabilisers, helping to limit the impact of the global economic slowdown. Modest levels of borrowing over the forecast period reflect the sustained capital investment in public services and infrastructure. Higher investment spending is sustainable and fully consistent with the fiscal rules since debt remains at a stable and prudent level over the forecast period.

<sup>5</sup> *End of year fiscal report*, HM Treasury December 2003.

Chart 2.5: General government gross debt, 2003



## Fiscal balances

**2.27** Table 2.2 presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government remains on track to meet its strict fiscal rules over the economic cycle.

Table 2.2: Summary of public sector finances

|   | Per cent of GDP    |         |                     |         |  |      |      |
|---|--------------------|---------|---------------------|---------|--|------|------|
|   | Outturn<br>2002-03 | 2003-04 | Estimate<br>2004-05 | 2005-06 | Projections<br>2006-07 2007-08 2008-09 |      |      |
| <b>Fairness and prudence</b>                  |                    |         |                     |         |  |      |      |
| Surplus on current budget                     | -1.1               | -1.7    | -0.7                | -0.4    | 0.0                                    | 0.3  | 0.6  |
| Average surplus since 1999-2000               | 1.0                | 0.4     | 0.3                 | 0.2     | 0.1                                    | 0.2  | 0.2  |
| Cyclically-adjusted surplus on current budget | -0.6               | -0.8    | -0.1                | -0.1    | 0.0                                    | 0.3  | 0.6  |
| <b>Long-term sustainability</b>               |                    |         |                     |         |  |      |      |
| Public sector net debt <sup>1</sup>           | 30.9               | 32.8    | 33.8                | 34.6    | 35.1                                   | 35.4 | 35.5 |
| Core debt <sup>1</sup>                        | 31.2               | 32.2    | 32.6                | 33.2    | 33.7                                   | 34.1 | 34.3 |
| Net worth <sup>2</sup>                        | 24.3               | 21.5    | 19.4                | 16.2    | 16.0                                   | 14.8 | 14.4 |
| Primary balance                               | -0.5               | -1.7    | -0.9                | -0.7    | -0.4                                   | -0.3 | -0.1 |
| <b>Economic impact</b>                        |                    |         |                     |         |  |      |      |
| Net investment                                | 1.0                | 1.6     | 1.9                 | 2.0     | 2.1                                    | 2.2  | 2.2  |
| Public sector net borrowing (PSNB)            | 2.1                | 3.4     | 2.6                 | 2.4     | 2.1                                    | 1.9  | 1.7  |
| Cyclically-adjusted PSNB                      | 1.6                | 2.4     | 2.0                 | 2.2     | 2.0                                    | 1.9  | 1.7  |
| <b>Financing</b>                              |                    |         |                     |         |  |      |      |
| Central government net cash requirement       | 2.1                | 3.6     | 2.8                 | 2.6     | 2.5                                    | 2.1  | 1.8  |
| Public sector net cash requirement            | 2.1                | 3.6     | 2.6                 | 2.3     | 2.2                                    | 1.8  | 1.6  |
| <b>European commitments</b>                   |                    |         |                     |         |  |      |      |
| Treaty deficit <sup>3</sup>                   | 2.1                | 3.3     | 2.6                 | 2.4     | 2.1                                    | 2.0  | 1.8  |
| Cyclically-adjusted Treaty deficit            | 1.5                | 2.4     | 2.0                 | 2.2     | 2.1                                    | 2.0  | 1.8  |
| Treaty debt ratio <sup>4,1</sup>              | 37.9               | 39.3    | 40.2                | 40.8    | 41.1                                   | 41.4 | 41.5 |
| <i>Memo: Output gap</i>                       | -1.1               | -1.4    | -0.7                | -0.2    | 0.0                                    | 0.0  | 0.0  |

<sup>1</sup> At end March; GDP centred on end March.

<sup>2</sup> At end December; GDP centred on end December.

<sup>3</sup> General government net borrowing on a Maastricht basis.

<sup>4</sup> General government gross debt measures on a Maastricht basis.

**2.28** The Government supports a prudent interpretation of the Stability and Growth Pact as described in Box 2.2. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in the Pre-Budget Report, which show the Government on track to meet its fiscal rules over the cycle, low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with the prudent interpretation of the Pact. Box 2.3 also shows that the UK's public finances compare favourably to other G7 countries.

#### **Box 2.2: The Stability and Growth Pact**

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

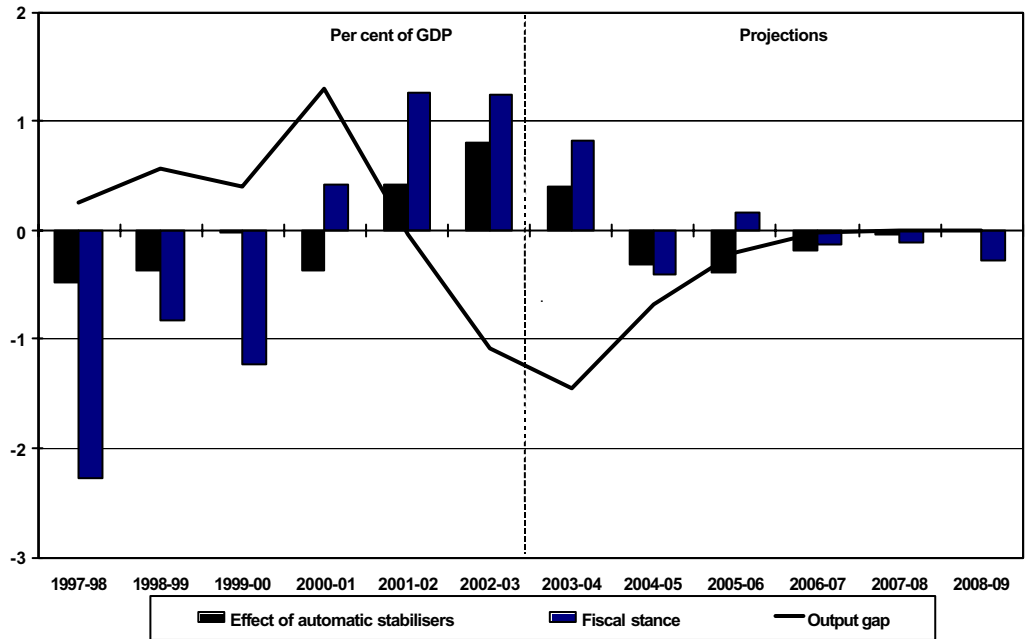
The Government supports a prudent interpretation of the Pact that builds on the Code of Conduct, agreed by Member States in June 2001 and in the report agreed by EU Finance Ministers on strengthening budgetary co-ordination in June 2003. A prudent interpretation would lock in long-term fiscal discipline and sustainability, enhancing credibility, while allowing the automatic stabilisers to smooth fluctuations in output, and allow appropriate increases in investment in public services. Specifically, it would take into account all the following factors in applying a country by country approach to assessments of compliance with the medium-term fiscal objective of 'close to balance or in surplus':

- the economic cycle - by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy. It is therefore welcome that the Council and Commission now focus on cyclically-adjusted fiscal balances when assessing the public finances, and ensure that policy is not operated in a pro-cyclical way;
- sustainability - low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of the sustainability of public finances should also take into account the long-term budgetary impact of ageing populations, such as that set out in the *Long-term public finance report*, published alongside the 2003 Pre-Budget Report; and
- public investment - against a background of sound public finances and economic stability, public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.

**2.29** While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.6 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.

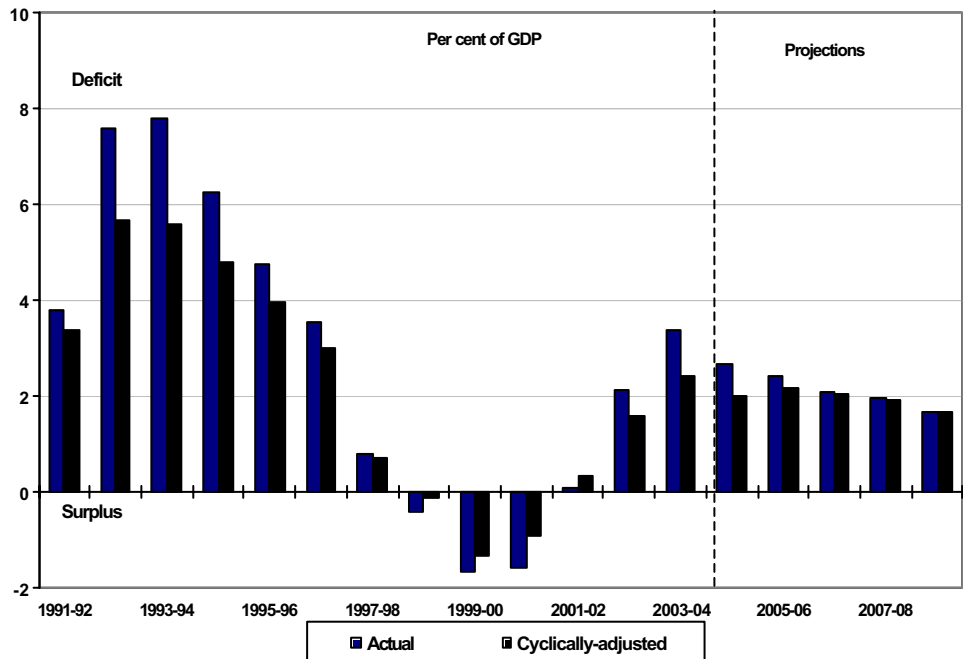
**2.30** During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy has moved below trend so the fiscal stance has eased, helping to maintain economic stability. Over the next few years, as the economy returns to trend, fiscal policy moves towards to a more neutral stance.

Chart 2.6: Fiscal policy supporting monetary policy



2.31 Modest levels of borrowing over the forecast period reflect sustained capital investment in public services, and is fully consistent with meeting the Government’s firm fiscal rules.

Chart 2.7: Public sector net borrowing



**Box 2.3: Public finances in the G7**

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

| Per cent of GDP                    | Estimate <sup>1</sup> |             | Projections |         |         |         |
|------------------------------------|-----------------------|-------------|-------------|---------|---------|---------|
|                                    | 2003-04               | 2004-05     | 2005-06     | 2006-07 | 2007-08 | 2008-09 |
| <b>United Kingdom</b>              |                       |             |             |         |         |         |
| Treaty deficit                     | 3.3                   | 2.6         | 2.4         | 2.1     | 2.0     | 1.8     |
| Cyclically-adjusted Treaty deficit | 2.4                   | 2.0         | 2.2         | 2.1     | 2.0     | 1.8     |
| Treaty debt                        | 39.3                  | 40.2        | 40.8        | 41.1    | 41.1    | 41.5    |
| Public sector net investment       | 1.6                   | 1.9         | 2.0         | 2.1     | 2.2     | 2.2     |
|                                    | <b>2003</b>           | <b>2004</b> | <b>2005</b> |         |         |         |
| <b>France</b>                      |                       |             |             |         |         |         |
| Treaty deficit                     | 4.2                   | 3.8         | 3.6         |         |         |         |
| Cyclically-adjusted Treaty deficit | 3.9                   | 3.3         | 3.2         |         |         |         |
| Treaty debt                        | 62.6                  | 64.3        | 65.6        |         |         |         |
| <b>Germany</b>                     |                       |             |             |         |         |         |
| Treaty deficit                     | 4.2                   | 3.9         | 3.4         |         |         |         |
| Cyclically-adjusted Treaty deficit | 3.5                   | 3.3         | 3.0         |         |         |         |
| Treaty debt                        | 63.8                  | 65.0        | 65.8        |         |         |         |
| <b>Italy</b>                       |                       |             |             |         |         |         |
| Treaty deficit                     | 2.6                   | 2.8         | 3.5         |         |         |         |
| Cyclically-adjusted Treaty deficit | 2.1                   | 2.3         | 3.2         |         |         |         |
| Treaty debt                        | 106.4                 | 106.1       | 106.1       |         |         |         |
| <b>Canada</b>                      |                       |             |             |         |         |         |
| Deficit                            | 1.0                   | 0.7         | 0.8         |         |         |         |
| Cyclically-adjusted deficit        | 1.1                   | 0.6         | 0.7         |         |         |         |
| Gross debt                         | 77.3                  | 74.8        |             |         |         |         |
| <b>Japan</b>                       |                       |             |             |         |         |         |
| Deficit                            | 7.4                   | 6.8         | 6.9         |         |         |         |
| Cyclically-adjusted deficit        | 6.9                   | 6.5         | 6.6         |         |         |         |
| Gross debt                         | 155.7                 | 164.1       |             |         |         |         |
| <b>USA</b>                         |                       |             |             |         |         |         |
| Deficit                            | 4.9                   | 5.1         | 4.9         |         |         |         |
| Cyclically-adjusted deficit        | 4.5                   | 5.1         | 5.0         |         |         |         |
| Gross debt                         | 63.8                  | 65.7        |             |         |         |         |
| <b>G7 average<sup>2</sup></b>      |                       |             |             |         |         |         |
| Deficit                            | 3.9                   | 3.7         | 3.6         |         |         |         |
| Cyclically-adjusted deficit        | 3.5                   | 3.3         | 3.4         |         |         |         |
| Gross debt                         | 81.2                  | 82.8        | 69.4        |         |         |         |

Source: data for EU countries excluding UK from European Commission autumn forecasts; non-EU countries from OECD; borrowing figures from OECD Economic Outlook 74 (preliminary version, November 2003), debt figures from OECD Economic Outlook 73 (June 2003). The fiscal aggregates forecast by the OECD are slightly different from those forecast by the European Commission, deficit refers to deficit on general government financial balance, gross debt to general government gross financial liabilities.

<sup>1</sup> The 2003-04 figures were projections in Budget 2003.

<sup>2</sup> Unweighted average (financial year figures used for UK)

### Forecasts vs Outturns

**2.32** Table 2.3 provides a summary of comparison of the year-ahead projections for main fiscal aggregates in Budget 2001 and Budget 2002 compared with the latest outturn information.

Table 2.3: Fiscal balances

| Per cent of GDP  | 2001-02                 |             |             | 2002-03                 |             |            |
|--|-------------------------|-------------|-------------|-------------------------|-------------|------------|
|  | Budget 2001<br>forecast | Outturn     | Difference  | Budget 2002<br>forecast | Outturn     | Difference |
| Surplus on current budget                                | 1.6                     | 0.9         | -0.7        | 0.3                     | -1.1        | -1.4       |
| Cyclically-adjusted surplus on current budget            | 1.2                     | 0.6         | -0.6        | 0.5                     | -0.6        | -1.0       |
| Public sector net borrowing                              | -0.5                    | 0.1         | 0.5         | 1.1                     | 2.1         | 1.1        |
| Cyclically-adjusted public sector net borrowing          | -0.1                    | 0.3         | 0.5         | 0.9                     | 1.6         | 0.7        |
| <i>Average difference in net borrowing since 1977-78</i> |                         |             | 1.0         |                         |             | 1.0        |
| <b>Public sector net debt</b>                            | <b>30.3</b>             | <b>30.2</b> | <b>-0.1</b> | <b>30.2</b>             | <b>30.8</b> | <b>0.7</b> |

**2.33** The outturn for the current budget was a surplus of 0.9 per cent of GDP in 2001-02 and a deficit of 1.1 per cent of GDP in 2002-03 compared to forecasts of surpluses of 1.6 and 0.3 per cent of GDP, respectively. The outturn for net borrowing was 0.1 per cent of GDP in 2001-02 and 2.1 per cent of GDP in 2002-03 compared to forecasts of a net repayment of 0.5 per cent of GDP in 2001-02 and net borrowing of 1.1 per cent in 2002-03. This 1.1 per cent difference between forecast and outturn is around the average difference over the last 25 years.

**2.34** A full account of public sector finances is given in Chapter 4. In summary:

- the average current budget since the start of the current economic cycle in 1999-2000 is projected to be positive throughout the projected period meeting the golden rule;
- the current budget returning to balance and moving back to balance by 2006-07 with a surplus thereafter;
- public sector net debt is projected to be low and stable throughout the next five years, at 35½ per cent, comfortably meeting the sustainable investment rule and, according to the OECD, the lowest in the G7; and
- 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).

### Releasing Resources for High-Quality Public Services

**2.35** The Government's goal is to build a stronger, more flexible economy and a fairer society. World-class public services are crucial to achieving this goal. A healthy and educated workforce, modern and reliable transport network, and adequate supply of affordable housing promote productivity and flexibility in the wider economy and help to ensure opportunity and security for all. The Government's commitment to continuous improvement in the public services through sustained investment and reform is contributing to a stronger and fairer economy, and is helping to ensure that taxpayers receive value for money from their investment.

**2.36** Sound public finances that are sustainable over the cycle are a prerequisite for sustainable investment in public services. The fiscal rules underpin the Government's public spending framework. The golden rule increases the efficiency of public spending by ensuring that public investment is not sacrificed to meet short-term current spending pressures. Departments are now given separate allocations for resource and capital spending to help ensure adherence to the rule. The sustainable investment rule sets the context for the Government's public investment targets and ensures that borrowing for investment is conducted in a responsible way.

**2002 Spending Review**

**2.37** The 2002 Spending Review set spending plans for the three years to 2005-06 and to 2007-08 for the NHS, consistent with the fiscal rules. Building on previous Spending Reviews, these spending plans are delivering substantial extra investment in key public service priorities, including:

- planned UK spending on the NHS increasing by an average of 7.1 per cent a year in real terms over the five years to 2007-08; and
- planned UK spending on education increasing by 6 per cent a year in real terms between 2002-03 and 2005-06.

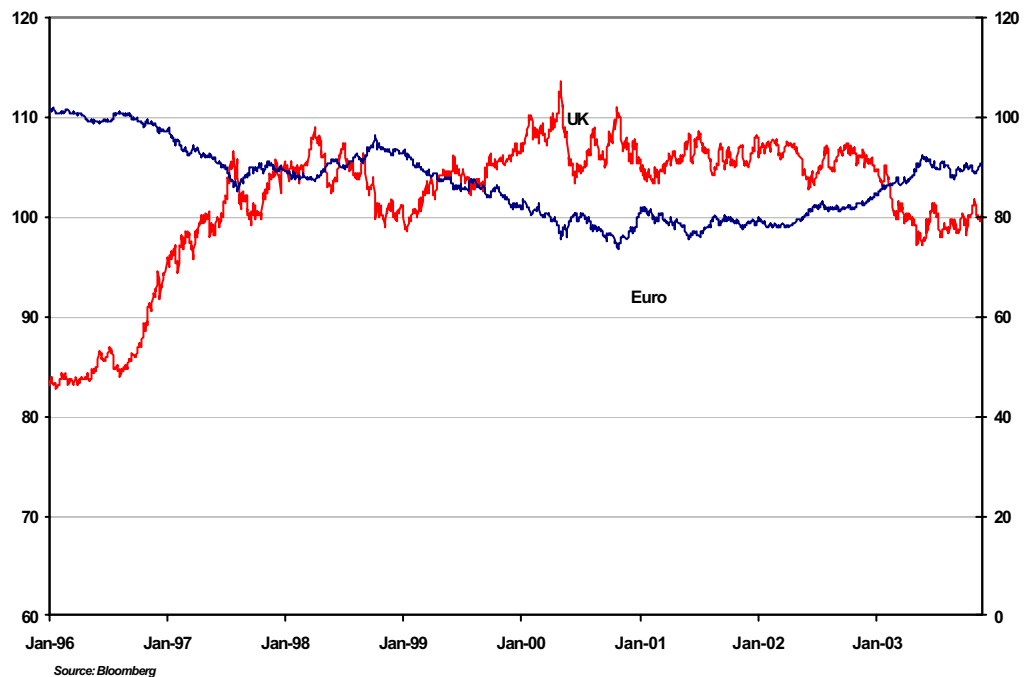
**2004 Spending Review**

**2.38** The 2004 Spending Review will set new spending plans that lock in the step change in funding delivered for key public services delivered in previous Spending Reviews. The Review will determine new departmental spending plans for 2006-07 and 2007-08 and a new set of Public Service Agreements. Departmental spending plans for 2005-06 determined in the 2002 Spending Review will not be changed. Increases in departmental plans above the 2005-06 baseline will be rigorously targeted where they will have the greatest impact on front line delivery, and settlements will be conditional on real efficiency savings being achieved by departments.

**Exchange Rate Stability**

**2.39** 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 2.8: Sterling and the euro effective exchange rate indices**



**2.40** 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 monetary and fiscal policy frameworks provide an anchor for achieving greater stability.

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

### **Economic and Monetary Union**

**UK policy 2.42** The Government's policy on membership of the single currency is set out in Box 2.4.

**Box 2.4: Government policy on EMU**

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

An assessment of the five tests was made in June 2003<sup>1</sup>. This concluded that, *“since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area.”* The assessment set out a reform agenda of concrete and practical steps, including:

- reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. The Government announced it would publish six monthly flexibility reports, the first of which is published as Annex C in the Pre-Budget Report;
- independent reviews, with interim reports published alongside this Pre-Budget Report, of mortgage finance and the supply of UK housing to examine their impact on economic stability;
- the publication of a draft referendum bill, published on 10 December 2003. The draft bill will allow for consultation over the details of a referendum if one were to be held; and
- the publication of the *Seventh report on euro preparations* on 18 November 2003, setting out the progress that has been made across the economy since June 2003. A further report will be published in spring 2004.

Work is also proceeding on a number of issues identified in the discussion paper *Fiscal stabilisation and EMU*<sup>2</sup>. This includes clarifying how a new fiscal stabilisation rule might work, the case for modernising the tax regulator powers, improving the understanding of the fiscal transmission mechanism, examining the case for strengthening automatic stabilisers and giving further consideration to the effectiveness of different fiscal instruments in stabilising the economy.

Budget 2004 will include a report on progress on the issues identified in the June 2003 assessment of the five tests, and will determine whether a further assessment of the five tests should be undertaken next year. If a further assessment were to conclude that the five tests had been met, the Government would put the issue before the British people in a referendum.

<sup>1</sup> *UK membership of the single currency: An assessment of the five economic tests*, HM Treasury, June 2003 (Cm 5776).

<sup>2</sup> Available on the Treasury's website at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

## Long-Term Economic Performance

**Flexibility ...** **2.43** The Government's economic objective is to build a strong economy and fair society, where there is opportunity and security for all. Reforms which promote flexibility and fairness are central to achieving this goal. Rapid technological progress and strong competition in global markets mean that the profitability and competitiveness of different industries and occupations are continually evolving. A flexible economy responds to such changes in economic conditions efficiently and quickly. Annex C of this Convergence Programme explains the UK Government's approach of combining flexibility with fairness, and the action the Government has taken to boost flexibility in labour, product and capital markets since April Budget 2003 and in the December Pre-Budget Report 2003.

**2.44** A high degree of flexibility minimises disruptions to output and employment and helps an economy to sustain high rates of productivity growth and employment. Flexible and dynamic markets are therefore a precondition for economic strength. Flexibility is especially important when a country needs to adjust to a country-specific shock within a monetary union, where monetary policy at a national level is not an option. The overall flexibility of the economy depends on the interaction of flexibility in the labour, capital and product markets.

**...and productivity** **2.45** Many of the important characteristics of a flexible economy are also key drivers of productivity growth. The ability to switch resources readily between firms and industries improves the economy's resilience in adverse market conditions and its capacity to develop and implement the technological advances and organisational changes that raise productivity and wages. The Government's overall strategy for promoting productivity and enterprise in the UK economy, through reforms which boost competition, enterprise, skills, innovation and investment is set out in the Pre-Budget Report.

**Economic reform in Europe** **2.46** The Government is continuing to press for changes that will improve the flexibility of the European economy and so enhance its productivity performance. In the past, Europe has sometimes adopted economic strategies that were insufficiently responsive to changing economic circumstances, overly uniform, or too insular. The Government believes that the EU needs to be flexible, reforming, open, and globally orientated. In the context of globalisation, it needs to capitalise on the diversity of its economies and the Government will work for further progress at next spring's European Council on economic reform.

## 3

## ECONOMIC OUTLOOK

**The World Economy**

**3.1** At the time of Budget 2003, economic activity in most major economies had slowed as geo-political uncertainties compounded existing vulnerabilities and led to significant falls in business and consumer confidence, increased volatility in financial markets and higher oil prices. As a result, the loss of momentum in global growth, which became apparent during autumn 2002, continued into early 2003. The Budget 2003 forecast assumed this would be a temporary slowing and, as expected, growth in several major economies has since strengthened as some key uncertainties have receded. Meanwhile, leading indicators – notably confidence measures and equity prices – have generally turned up across the G7.

**3.2** Growth in most G7 economies looks set to steadily improve during the course of 2004, though this acceleration is likely to be more pronounced in some economies than in others. Growth in the US appears to be increasing sharply and data from Japan suggest stronger growth than most forecasters expected. However, activity in parts of the euro area has been more subdued. During the first half of this year, euro area output stagnated. As a result, most forecasts for growth in the euro area have been revised down significantly since the spring.

**3.3** Although some key uncertainties surrounding the global economy have diminished, significant risks still remain. In particular, imbalances between the world's major economies pose the risk of sudden, sharp movements in exchange rates. For example, further sharp falls in the value of the US dollar would pose a significant threat to regions where recovery is dependent on trade with the US. A further downside risk comes from labour markets, which have remained weak in a number of G7 economies. In some economies, activity might also be held back if balance sheet adjustment has further to run. Finally, ongoing security concerns and the continued threat from terrorism pose a risk of renewed volatility and nervousness in international financial markets and falls in consumer and business confidence.

**3.4** There are also a number of upside risks. Stock building has generally remained modest by historical standards and a turnaround in the inventory cycle could provide a powerful short-term stimulus to growth. In addition, there are clear signs that business investment is picking up in some major economies; and in the past recoveries in capital spending have often tended to accelerate faster than generally expected.

**Prospects for UK Economic Growth**

**GDP Growth 3.5** The domestic stability delivered by the Government's macroeconomic frameworks has enabled the UK economy to cope well in a challenging global economic environment and UK demand and activity has strengthened as geo-political uncertainties have receded. Against a steadily improving global background, financial markets have more than made up the losses incurred over the first quarter of 2003. Many forward-looking survey and confidence measures have also improved considerably in recent months and manufacturing output has risen. Following growth of 0.2 per cent in the first quarter – the weakest for almost eleven years – GDP grew by 0.6 per cent in the second and by 0.7 per cent in the third quarter of the year, broadly in line with the Budget forecast.

**3.6** Extensive revisions to the UK national accounts were introduced by the Office for National Statistics (ONS) in the Blue Book 2003. These revisions reflect both methodological changes and new information on the economy. They mainly affect real volume measures with only small changes to nominal data. The overall effect of the revisions is that GDP growth since the mid-1990s is now stronger and relatively more balanced between expenditure components than previously estimated. In particular, household consumption growth is now estimated to have grown more slowly over the recent past, with business investment and net trade both stronger.

**Economic cycle  
and the output gap**

**3.7** Data revisions since Budget 2003 provide new information and point to a higher than previously thought trend rate of output growth over the past few years, but for the Pre-Budget Report the existing 2¾ per cent trend growth rate projection is retained. A deliberately cautious trend growth assumption ¼ percentage point below the neutral view continues to be used for the purposes of projecting the public finances.

**Box 3.1 : Revisions to national accounts and trend growth**

Substantial upward revisions to measured UK GDP data were introduced by the Office for National Statistics (ONS) in Blue Book 2003. This has the effect of boosting the estimated trend rate of growth between the adjudged on-trend points in the first half of 1997 and the third quarter of 2001. Over this period, the Blue Book 2003 data yield an annual trend rate of output growth of 2.9 per cent, revised up from the previous estimate of 2.6 per cent at the time of Budget 2003.

There have been no significant revisions over the same period to outturns for the trend growth rates of average hours worked or employment, so the increase in the trend rate of output growth is reflected in the productivity growth component. Therefore, the estimated growth rate of underlying trend output per hour between 1997 and 2001 has increased to 2.7 per cent, 0.3 percentage points higher than at Budget time.

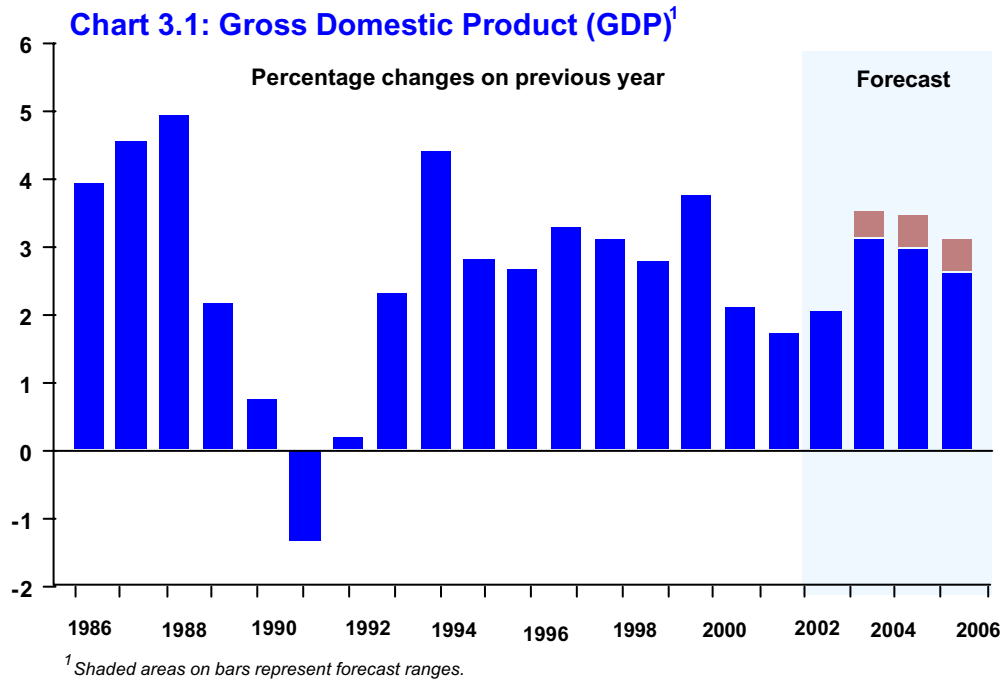
A mechanical application of the Treasury's trend growth methodology would project forward this trend productivity increase, which, with other trend growth components unchanged, would raise the trend output growth projection well above the existing 2¾ per cent neutral assumption. This would imply a negative output gap in mid-2003 in excess of the 1½ per cent gap estimated on the basis of the 2¾ per cent trend growth assumption. However, evidence and judgement suggest that a current negative output gap much wider than 1½ per cent of GDP would be implausible.

After considering the data and taking a cautious approach to projecting trend growth, the existing 2¾ per cent trend output growth projection is retained as the neutral judgement. However, the data revisions further increase confidence that the 2¾ per cent assumption is consistent with the economy's potential. More detail and explanation on the decomposition of trend growth can be found in Annex A of the Pre-Budget Report. As shown in the table below, the public finances projections will continue to be based on a lower cautious view of trend growth of 2½ per cent, as audited by the NAO, up to 2006-07 and 2¼ per cent for subsequent years, with the slowdown reflecting expected demographic trends.

**Table 3.1: Contributions to trend output growth**

|  | Estimated trend rates of growth, per cent per year |        |                            |                       |                           | Trend output |
|--|--|--------|----------------------------|-----------------------|---------------------------|--------------|
|  | Trend output per hour worked                       |        | Trend average hours worked | Trend employment rate | Population of working age |              |
|  | Underlying   | Actual |                            |                       |                           |              |
| <b>Over the recent past (1997H1 to 2001Q3)</b> |  |        |                            |                       |                           |              |
| Budget 2003                                    | 2.35   | 2.14   | -0.47                      | 0.43                  | 0.50                      | 2.61         |
| PBR 2003                                       | 2.65   | 2.44   | -0.47                      | 0.42                  | 0.54                      | 2.94         |
| <b>Projection</b>                              |  |        |                            |                       |                           |              |
| Budget 2003                                    | 2.35   | 2.25   | -0.10                      | 0.20                  | 0.50                      | 2¾           |
| PBR 2003                                       | 2.35   | 2.25   | -0.10                      | 0.20                  | 0.50                      | 2¾           |

**3.8** The size of the estimated negative output gap in the third quarter of 2003 – around 1½ per cent of GDP on the assumption of 2¾ per cent trend output growth – is the same as the forecast made at Budget time, despite data revisions for 2002. So the forecast path for GDP is also broadly unchanged, with the economy building on recent positive developments and accelerating through into 2004. GDP is now expected to grow by 2.1 per cent in 2003 as a whole, within the lower half of the Budget 2003 forecast range. In both 2004 and 2005, GDP is forecast to grow by 3 to 3½ per cent. Growth is expected to fall back to its trend rate by early 2006 as slack in the economy is taken up and output returns to its trend level. Relative to recent years, the forecast implies more balanced growth.

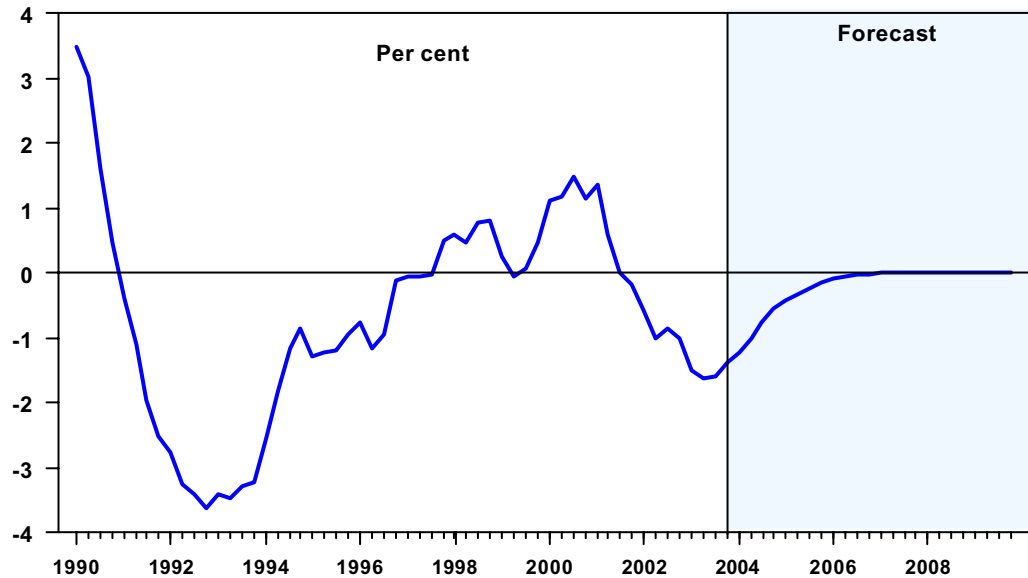


**Inflation 3.9** The Pre-Budget Report confirms that the operational target for monetary policy to apply from now on will be defined in terms of Consumer Prices Index (CPI) inflation, instead of RPIX inflation. Underlying inflation remains firmly in check. In October 2003, RPIX stood at 2.7 per cent. CPI inflation stood at 1.4 per cent, among the lowest in the EU.

**3.10** CPI inflation is forecast to remain a little below target in 2004 as existing slack in the economy continues to dampen domestically generated pricing pressures. However, inflation is expected to return to target from 2005 as the combined effects of the recent depreciation of sterling and the strengthening recovery in the world economy feed through to higher import prices.

**Table 3.2: Summary of forecast**

|                              | Forecast |      |         |         |         |
|------------------------------|----------|------|---------|---------|---------|
|                              | 2002     | 2003 | 2004    | 2005    | 2006    |
| GDP growth (per cent)        | 1¾       | 2    | 3 to 3½ | 3 to 3½ | 2½ to 3 |
| CPI inflation (per cent, Q4) | 1½       | 1½   | 1¾      | 2       | 2       |

Chart 3.2: The output gap<sup>1</sup>

<sup>1</sup> Actual output less trend output as a percentage of trend output (non-oil basis).

## Interest Rates

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

- RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government's target; and
- long-term inflation expectations, as measured by financial markets data, show that expected inflation has remained close to the Government's target, having fallen from over 4 per cent in 1997, demonstrating the framework has a high degree of credibility.

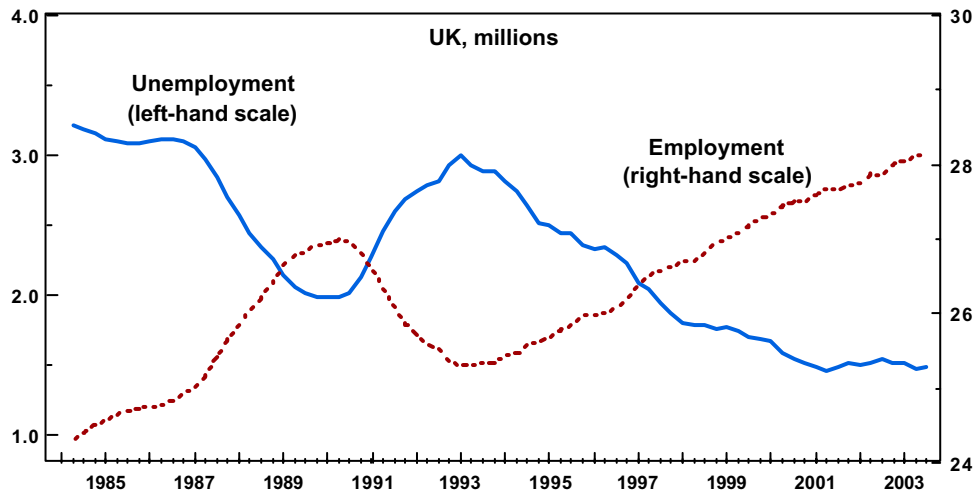
**3.12** The framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped to keep output close to its trend level, while ensuring that inflation remained close to target. The MPC then increased interest rates in November 2003 in response to a strengthening global economy and a pick up in growth in the UK. Long-term 30 year interest rates are lower than in the USA or the euro area, reducing the Government's debt interest payments and freeing up resources for investment in public services.

## Employment

**Employment 3.13** The UK labour market has remained resilient to shocks from global economic developments. The employment rate is close to record highs and unemployment rates have remained stable. The performance of the UK labour market provides evidence that the Government's supply-side reforms are creating a more dynamic and flexible labour market in the UK. The resilience of the UK labour market contrasts with many other industrialised countries where unemployment has risen.

**Unemployment 3.14** The unemployment rate, on the International Labour Organisation (ILO) definition, trended gently downwards over the year to the third quarter of 2003, while remaining broadly flat over the past two years or so. At 5.0 per cent, it remains the lowest among the G7 economies. Claimant count unemployment has also nudged down in recent months, following short-lived increases in the earlier months of the year. It has been below one million for over two and a half years and is now at its lowest level since 1975. In October, the claimant rate stood at just 3.0 per cent.

**Chart 3.3: LFS employment, unemployment and participation<sup>1</sup>**



<sup>1</sup> Labour Force Survey (age group 16 and over)

## Consumption

**3.15** Against a backdrop of low inflation, a strong labour market and a pick-up in GDP growth, household real disposable income growth should strengthen, and so consumption should continue to grow relatively robustly over the forecast horizon. Nevertheless, underlying consumption growth is expected to remain below rates seen since the mid-1990s as a result of moderating house price inflation and slower rises in households' wealth, together with a diminishing appetite for borrowing as consumers adjust to relatively high levels of debt. However, this outlook is particularly prone to both upside risks in the short term and downside risks more generally.

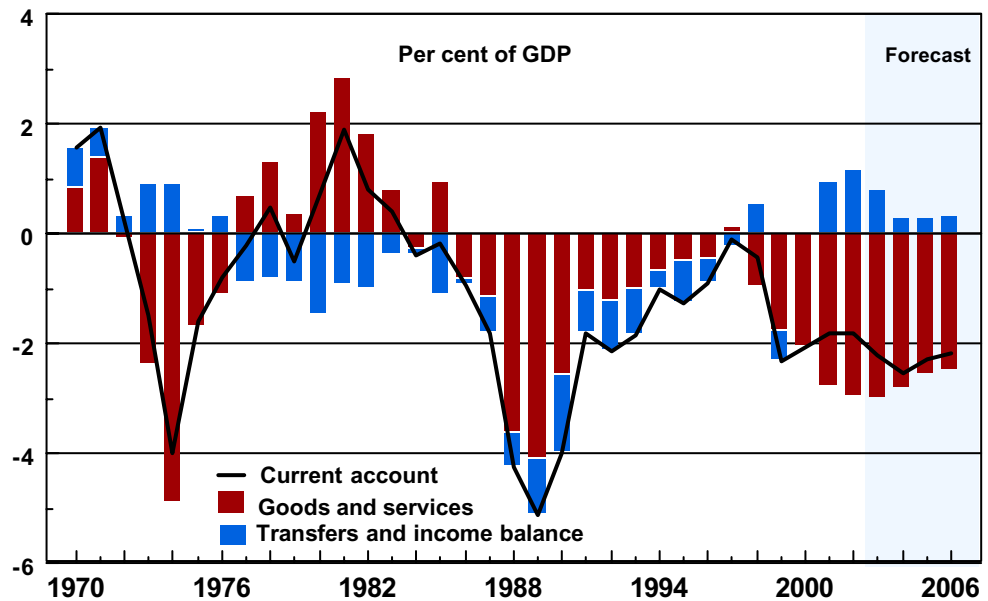
## Investment

**3.16** The latest national accounts revisions show that business investment has been stronger in recent years than previously estimated. However, despite the effects of recent revisions, business investment remained subdued in the early stages of the year, as forecast in Budget 2003. More recently, there have been tentative signs that a gradual business investment recovery is underway. In the year to the third quarter of 2003, it recorded its first – albeit marginal – positive annual growth rate since the end of 2001. Imports of capital goods appear to have flattened out during the summer months, while production of capital equipment has seen a modest rise over the past year or so.

**3.17** With corporate profitability having risen over the past year and company balance sheets far healthier than during the late 1990's ICT boom, businesses are well positioned to step up investment as the global recovery gathers pace into 2004. Business investment is forecast to rise by  $\frac{3}{4}$  per cent in 2003 as a whole, accelerating to between 3 to  $3\frac{1}{2}$  per cent in 2004 and to  $5\frac{1}{2}$  to  $6\frac{1}{4}$  per cent the year after.

## Trade and the Balance of Payments

Chart 3.4: Balance of payments current account



**3.18** The current account deficit over the first half of 2003 was broadly unchanged on a year earlier, although there was a sharp widening between the first and second quarters. A large surplus on investment income has continued partly to offset the trade deficit within the current account. In 2002, the UK had a record surplus on investment income of over £21 billion, while in the first six months of this year the income surplus was also up on a year earlier. A number of factors have maintained sizeable income surpluses over the recent past. Overseas investments by UK oil operators benefited from a period of relatively high world oil prices. The global downturn in financial services since 2000 has affected the UK's financial services industry, reducing profits earned by overseas banks and institutions with bases in the UK. While long-term structural factors should underpin income surpluses going forward, the forecast entails a moderation relative to recent years.

**3.19** Compared with last year, the UK trade deficit is expected to remain broadly flat in 2003 as a whole. The trade deficit is then expected to widen slightly over the forecast horizon, as UK import growth picks up around the same time as export growth, in response to strengthening business investment and brightening conditions in the manufacturing sector. Relative to GDP, the current account deficit is expected to remain modest compared to historical peaks, stabilising at around 2¼ per cent of GDP by the end of the forecast horizon.

## Summary of Economic Prospects

Table 3.3: Summary of economic prospects<sup>1</sup>

|   | Percentage changes on a year earlier unless otherwise stated |      |                       |              |              | Average errors from past forecasts <sup>3</sup> |
|---|--|------|-----------------------|--------------|--------------|---|
|   | 2002   | 2003 | Forecast <sup>2</sup> |              |              |   |
|   |  |      | 2004                  | 2005         | 2006         |   |
| <b>Output at chained volume measures</b>                                    |  |      |                       |              |              |   |
| Gross domestic product (GDP)  | 1½   | 2    | 3 to 3½               | 3 to 3½      | 2½ to 3      | ¾   |
| Manufacturing output  | -3½  | ¼    | 1¼ to 2¼              | 1¼ to 2¼     | 1¼ to 2¼     | 1¼  |
| <b>Expenditure components of GDP at chained volume measures<sup>4</sup></b> |  |      |                       |              |              |   |
| Domestic demand   | 3  | 2½   | 3¼ to 3¾              | 2¾ to 3¼     | 2¾ to 3¼     | ¾   |
| Household consumption <sup>5</sup>  | 3½   | 2½   | 2¼ to 2¾              | 2¼ to 2¾     | 2¼ to 2¾     | 1   |
| General government consumption  | 2½   | 3¼   | 2½                    | 2½           | 2½           | 1¼  |
| Fixed investment  | 1¼   | 2¼   | 6 to 6½               | 5½ to 6      | 4 to 4¾      | 1½  |
| Change in inventories <sup>6</sup>  | -¼   | 0    | ¼                     | 0            | 0 to ¼       | ¼   |
| Exports of goods and services   | -1   | -1½  | 5¼ to 5¾              | 7 to 7½      | 6¼ to 6¾     | 2¼  |
| Imports of goods and services   | 3¾   | ½    | 5¼ to 5¾              | 5¼ to 6¼     | 5¼ to 6¼     | 2   |
| <b>Balance of payments</b>  |  |      |                       |              |              |   |
| <b>current account</b>  |  |      |                       |              |              |   |
| £ billion   | -19  | -24½ | -29½                  | -28          | -28¼         | 7¼  |
| per cent of GDP   | -1¼  | -2¼  | -2½                   | -2¼          | -2¼          | ¾   |
| <b>Inflation</b>  |  |      |                       |              |              |   |
| CPI (Q4)  | 1½   | 1½   | 1¾                    | 2            | 2            | -   |
| RPIX (Q4)   | 2½   | 2¾   | 2½                    | 2½           | 2¾           | ¼   |
| Producer output prices (Q4) <sup>7</sup>                                    | 1  | 1½   | 2¼                    | 2            | 2            | 1¼  |
| GDP deflator at market prices   | 3¼   | 3    | 2½                    | 2½           | 2¾           | 1   |
| <b>Money GDP at market prices</b>   |  |      |                       |              |              |   |
| £ billion   | 1044   | 1096 | 1158 to 1164          | 1222 to 1234 | 1287 to 1306 | 10  |
| percentage change   | 5  | 5    | 5½ to 6               | 5½ to 6      | 5¼ to 5¾     | ¾   |

<sup>1</sup>The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2003, released by the Office for National Statistics on 30 September 2003, and output, income and expenditure data for the third quarter released on 26 November 2003.

<sup>2</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>3</sup>Average absolute errors for year-ahead projections made in autumn forecasts over the past ten years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2003.

<sup>4</sup>Further detail on the expenditure components of GDP is given in Table A9.

<sup>5</sup>Includes households and non-profit institutions serving households.

<sup>6</sup>Contribution to GDP growth, percentage points.

<sup>7</sup>Excluding excise duties.

# 4 OUTLOOK FOR THE PUBLIC FINANCES

**4.1** Over the past five 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 are based on prudent and cautious assumptions.

**4.2** Table 4.1 shows five-year projections for the current budget and public sector net debt, the key aggregates for assessing the performance against the golden rule and the sustainable investment rule respectively. Outturns and projections of other important measures of the public finances, including the Treaty deficit, both in actual and cyclically-adjusted terms, and Treaty debt, are also shown.

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

|  | Per cent of GDP |         |          |             |         |         |         |         |
|--|-----------------|---------|----------|-------------|---------|---------|---------|---------|
|  | Outturns        |         | Estimate | Projections |         |         |         |         |
|  | 2001-02         | 2002-03 | 2003-04  | 2004-05     | 2005-06 | 2006-07 | 2007-08 | 2008-09 |
| <b>Fairness and prudence</b>                           |                 |         |          |             |         |         |         |         |
| Surplus on current budget                              | 0.9             | -1.1    | -1.7     | -0.7        | -0.4    | 0.0     | 0.3     | 0.6     |
| Average surplus since 1999-2000                        | 1.7             | 1.0     | 0.4      | 0.3         | 0.2     | 0.1     | 0.2     | 0.2     |
| <u>Cyclically-adjusted surplus on current budget</u>   | 0.6             | -0.6    | -0.8     | -0.1        | -0.1    | 0.0     | 0.3     | 0.6     |
| <b>Long-term sustainability</b>                        |                 |         |          |             |         |         |         |         |
| Public sector net debt <sup>1</sup>                    | 30.2            | 30.9    | 32.8     | 33.8        | 34.6    | 35.1    | 35.4    | 35.5    |
| Core debt <sup>1</sup>                                 | 31.1            | 31.2    | 32.2     | 32.6        | 33.2    | 33.7    | 34.1    | 34.3    |
| Net worth <sup>2</sup>                                 | 24.9            | 24.3    | 21.5     | 19.4        | 16.2    | 16.0    | 14.8    | 14.4    |
| <u>Primary balance</u>                                 | 1.7             | -0.5    | -1.7     | -0.9        | -0.7    | -0.4    | -0.3    | -0.1    |
| <b>Economic impact</b>                                 |                 |         |          |             |         |         |         |         |
| Net investment   | 0.9             | 1.0     | 1.6      | 1.9         | 2.0     | 2.1     | 2.2     | 2.2     |
| Public sector net borrowing (PSNB)                     | 0.1             | 2.1     | 3.4      | 2.6         | 2.4     | 2.1     | 1.9     | 1.7     |
| <u>Cyclically-adjusted PSNB</u>                        | 0.3             | 1.6     | 2.4      | 2.0         | 2.2     | 2.0     | 1.9     | 1.7     |
| <b>Financing</b>                                       |                 |         |          |             |         |         |         |         |
| <u>Central government net cash requirement</u>         | 0.3             | 2.1     | 3.6      | 2.8         | 2.6     | 2.5     | 2.1     | 1.8     |
| <b>European commitments</b>                            |                 |         |          |             |         |         |         |         |
| <i>Treaty deficit</i> <sup>3</sup>                     | 0.0             | 2.1     | 3.3      | 2.6         | 2.4     | 2.1     | 2.0     | 1.8     |
| <i>Cyclically-adjusted Treaty deficit</i> <sup>3</sup> | 0.3             | 1.5     | 2.4      | 2.0         | 2.2     | 2.1     | 2.0     | 1.8     |
| <u>Treaty debt ratio</u> <sup>4</sup>                  | 37.9            | 37.9    | 39.3     | 40.2        | 40.8    | 41.1    | 41.4    | 41.5    |
| <u>Memo: Output gap</u>                                | 0.0             | -1.1    | -1.4     | -0.7        | -0.2    | 0.0     | 0.0     | 0.0     |

<sup>1</sup> At end March, GDP centred on end March.

<sup>2</sup> At end December GDP centred on end December.

<sup>3</sup> General government net borrowing on a Maastricht basis.

<sup>4</sup> General government gross debt on a Maastricht basis.

## Meeting the Fiscal Rules

**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 cost of paying for the public services they use and it is therefore an important indicator of inter-generational fairness.

**4.4** As explained in Chapter 3, the Government's provisional view is that the current economic cycle started in 1999-2000. Based on the assumptions used in these projections, the economy will next return to trend levels, ending the current cycle, in 2005-06. The projections show that the Government is on track to meet the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over the whole economic cycle of around 0.2 per cent of GDP, equivalent to a margin or surplus in this cycle of £14 billion. If the economic cycle were to have started in 1997-98, the average surplus on the current budget up to 2005-06 would be over 0.2 per cent of GDP. The cyclically-adjusted surplus, which allows underlying or structural trends in the indicators to be seen more clearly by removing the estimated effects of the economic cycle, shows a deficit from 2002-03 to 2005-06, but is close to balance in 2004-05 and 2005-06 before returning to balance in 2006-07.

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

**Sustainable investment rule**

**4.6** The sustainable investment rule is also comfortably met over the economic cycle. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and expenditure taken by the Government, including the decision to use the proceeds from the auction of spectrum licences to repay debt, reduced debt to around 30 per cent of GDP by the end of 2001-02. It is now projected to grow slowly, as the Government borrows modestly to fund increased investment in public services, stabilising at 35½ per cent at the end of the projected period - £64 billion below the 40 per cent level. The projections for core debt, which exclude the estimated impact of the economic cycle, increase more slowly to around 34 per cent of GDP.

**EU commitments**

**4.7** The projections contained in Table 4.1 show that the UK's public finances remain robust and sustainable. With net debt rising from 32.8 per cent in 2003-04 and forecast to stabilise at 35.5 per cent in 2008-09, and general government gross debt forecast to stabilise at 41.5 per cent (one of the lowest debt levels in the EU) by the end of the projection period, the Government is demonstrating its continued commitment to long-term sustainability. In keeping with the 2003 Broad Economic Policy Guidelines, the projections contained in Table 4.1 also demonstrate the Government's commitment to address the historical under-investment in public services in the United Kingdom. Public investment rises to 2.2 per cent of GDP by the end of the period. In cyclically-adjusted terms, both public sector net borrowing and general government net borrowing will be 2.4 per cent in 2003-04, falling to 1.7 per cent and 1.8 per cent respectively by the end of the projection period. Nominal general government net borrowing, on the Treaty definition, will be 3.3 per cent in 2003-04, falling to 2.6 per cent in 2004-05 and to 1.8 per cent by the end of the projection period.

**4.8** In the light of these projections the United Kingdom continues to meet a prudent interpretation of the Stability and Growth Pact, that reflects low debt and long-term fiscal sustainability, the need for public investment in the UK, and the economic cycle.

**Current and capital budgets**

**4.9** Table 4.2 provides more detail on the projections for the current and capital budgets for the public sector.

Table 4.2: Current and capital budgets

|                                  | Per cent of GDP    |                     |             |             |  |             |             |
|----------------------------------|--------------------|---------------------|-------------|-------------|--|-------------|-------------|
|                                  | Outturn<br>2002-03 | Estimate<br>2003-04 | 2004-05     | 2005-06     | Projections<br>2006-07 2007-08 2008-09 |             |             |
| <b>Current budget</b>            |                    |                     |             |             |  |             |             |
| Current receipts                 | 37.6               | 38.1                | 38.9        | 39.5        | 39.9                                   | 40.2        | 40.4        |
| <b>Current expenditure</b>       | <b>37.3</b>        | <b>38.5</b>         | <b>38.2</b> | <b>38.6</b> | <b>38.5</b>                            | <b>38.6</b> | <b>38.5</b> |
| Depreciation                     | 1.4                | 1.3                 | 1.3         | 1.3         | 1.3                                    | 1.3         | 1.3         |
| <b>Surplus on current budget</b> | <b>-1.1</b>        | <b>-1.7</b>         | <b>-0.7</b> | <b>-0.4</b> | <b>0.0</b>                             | <b>0.3</b>  | <b>0.6</b>  |
| <b>Capital budget</b>            |                    |                     |             |             |  |             |             |
| Gross investment                 | 2.8                | 3.3                 | 3.6         | 3.7         | 3.7                                    | 3.8         | 3.8         |
| Less asset sales                 | -0.4               | -0.3                | -0.3        | -0.3        | -0.3                                   | -0.3        | -0.3        |
| <b>Less depreciation</b>         | <b>-1.4</b>        | <b>-1.3</b>         | <b>-1.3</b> | <b>-1.3</b> | <b>-1.3</b>                            | <b>-1.3</b> | <b>-1.3</b> |
| Net investment                   | 1.0                | 1.6                 | 1.9         | 2.0         | 2.1                                    | 2.2         | 2.2         |
| <b>Net borrowing</b>             | <b>2.1</b>         | <b>3.4</b>          | <b>2.6</b>  | <b>2.4</b>  | <b>2.1</b>                             | <b>1.9</b>  | <b>1.7</b>  |

## Economic Assumptions

**4.10** 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 output growth of 2½ per cent a year up to 2006-07, ¼ percentage point lower than the Government's neutral view. The Government's neutral view of trend output growth is reduced to 2½ per cent in 2007-08 and 2008-09, and so, to maintain a cautious approach, an assumption of 2¼ per cent is used in the public finance projections, still ¼ percentage point lower than the Government's neutral view. The main economic assumptions are summarised in Table 4.3.

Table 4.3: Economic assumptions for the public finance projections

|  | Percentage changes on previous year |                               |                               |                               |  |                               |                               |
|--|-------------------------------------|-------------------------------|-------------------------------|-------------------------------|--|-------------------------------|-------------------------------|
|  | Outturn<br>2002-03                  | Estimate<br>2003-04           | 2004-05                       | 2005-06                       | Projections<br>2006-07 2007-08 2008-09 |                               |                               |
| Output (GDP)                             | 1 <sup>3</sup> / <sub>4</sub>       | 2 <sup>1</sup> / <sub>4</sub> | 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>4</sub> | 2 <sup>1</sup> / <sub>4</sub> |
| Prices                                   |                                     |                               |                               |                               |  |                               |                               |
| CPI                                      | 1 <sup>1</sup> / <sub>4</sub>       | 1 <sup>1</sup> / <sub>4</sub> | 1 <sup>3</sup> / <sub>4</sub> | 2                             | 2                                      | 2                             | 2                             |
| GDP deflator                             | 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> | 2 <sup>3</sup> / <sub>4</sub>          | 2 <sup>3</sup> / <sub>4</sub> | 2 <sup>3</sup> / <sub>4</sub> |
| RPI <sup>1</sup> (September)             | 1 <sup>1</sup> / <sub>2</sub>       | 3                             | 3 <sup>1</sup> / <sub>2</sub> | 3                             | 2 <sup>1</sup> / <sub>2</sub>          | 2 <sup>3</sup> / <sub>4</sub> | 2 <sup>3</sup> / <sub>4</sub> |
| Rossi <sup>2</sup> (September)           | 1 <sup>1</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> | 2 <sup>1</sup> / <sub>4</sub> |
| <b>Money GDP<sup>3</sup> (£ billion)</b> | <b>1055</b>                         | <b>1111</b>                   | <b>1174</b>                   | <b>1238</b>                   | <b>1304</b>                            | <b>1369</b>                   | <b>1436</b>                   |

<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.

**4.11** As detailed in Box 4.1, a number of key assumptions that underpin the public finance projections are independently audited by the Comptroller and Auditor General under a three-year rolling review to ensure that they remain reasonable and cautious. This prudent approach to fiscal policy builds an important 'safety margin' into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending.

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

|   |   |
|---|---|
| Privatisation proceeds <sup>1,6,11</sup>                    | Credit is taken only for proceeds from sales that have been announced.  |
| Trend GDP growth <sup>1,6,9</sup>                           | 2½ per cent a year to 2006-07 and 2¼ per cent in 2007-08 and 2008-09.   |
| UK claimant unemployment <sup>1,4,7,9</sup>                 | Rising slowly to 0.95 million in 2005-06, from recent levels of 0.93 million, consistent with the average of independent forecasts.   |
| Interest rates <sup>1,6,7,11</sup>                          | 3-month market rates change in line with market expectations (as of 27 November).   |
| Equity prices <sup>2,7,12</sup>                             | FTSE All-Share index rises from 2154 (close 27 November) in line with money GDP.  |
| VAT <sup>2,7,10,12</sup>                                    | Ratio of underlying VAT to consumption falls by 0.05 percentage points a year. Only the direct and preventative effects of the anti-fraud VAT strategy are included in the projections.         |
| Consistency of price indices <sup>2,7,12</sup>              | Projections of price indices used to project the public finances are consistent with CPI.   |
| 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>5,10</sup>                                  | \$24.9 a barrel in 2004, the average of independent forecasts, and then constant in real terms.   |
| Tobacco <sup>6,10,11</sup>                                  | The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For the 2003 Pre-Budget Report, a share of 18 per cent has been used in all forecasts. |
| Inland Revenue compliance enforcement package <sup>11</sup> | Only direct and some preventative effects 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 Pre-Budget 2000 Report, 8 November 2000 (HC959).

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

<sup>9</sup> Audit of Assumptions for the April 2002 Budget, 17 April 2002 (HC760).

<sup>10</sup> Audit of Assumptions for the 2002 Pre-Budget Report, 27 November 2002 (HC109).

<sup>11</sup> Audit of Assumptions for Budget 2003, 9 April 2003 (HC627).

<sup>12</sup> Audit of Assumptions for the 2003 Pre-Budget Report, 10 December 2003 (HC35).

## Forecast Differences and Risks

**4.12** The fiscal balances represent the difference between large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. Over the past 25 years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been a little over 1 per cent of GDP. These tend to grow as the forecast horizon lengthens. A full account of differences between the projections made in Budget 2001 and Budget 2002 and the subsequent outturns is provided in the Government's 2003 *End of year fiscal report*.

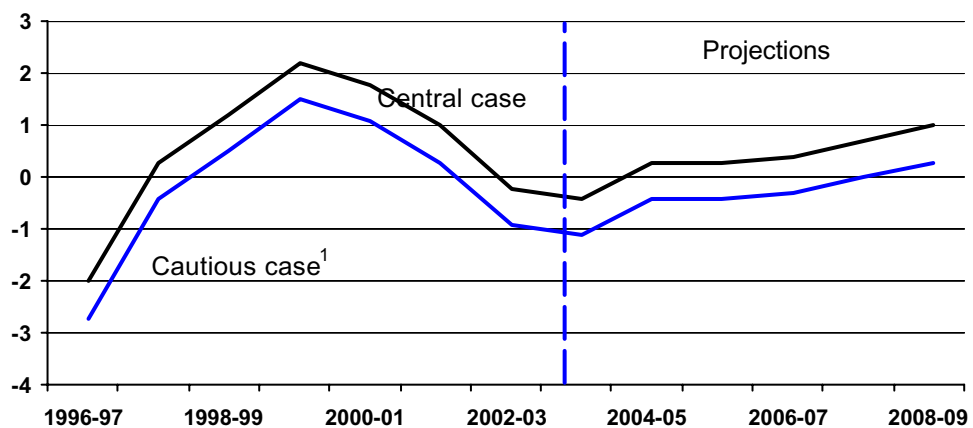
### The economic outlook

**4.13** Short-term fluctuations in the economy can have significant impacts on the public finances. As explained in Chapter 3, UK demand and activity have strengthened since early 2003 as geo-political uncertainties have receded. Global financial markets have made up considerable ground following sharp falls in 2002 and early 2003 and US GDP growth has rebounded strongly. In the UK, growth picked up strongly in the second and third quarters. The pick-up in activity is expected to be consolidated into 2004.

**4.14** However, there are also risks to the economic outlook. The uneven nature of the pick-up in global activity, the continued reliance on developments in the US and the relatively disappointing performance of the euro area, present a threat to the sustainability of this recovery over the medium term. These factors also mean that global activity is vulnerable to the possibility of faltering US domestic demand in the short term. On the upside, given the relatively swift turnaround in activity since the spring, the present world recovery may be stronger than currently anticipated.

**4.15** Projected differences in short-term growth forecasts may have only a temporary effect on public finances. However, changes in the estimated cyclical position of the economy in relation to its trend – the output gap – will have a permanent effect on prospects. For this reason, the Government has remained vigilant to the uncertainties inherent in forecasting the public finances and created a margin against unexpected events through the use of cautious, audited assumptions and in the cautious case. Combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, the Government can now draw on this margin to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full, while remaining on track to meet the fiscal rules.

**Chart 4.1: Cyclically-adjusted surplus on current budget**



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

## General Government Finances

4.16 Table 4.4 gives a breakdown of general government finances.

**Table 4.4: General government finances**

|   | Per cent of GDP    |             |                                |             |
|---|--------------------|-------------|--------------------------------|-------------|
|   | Outturn<br>2002-03 | 2003-04     | Projections<br>2004-05 2005-06 |             |
| Total current receipts                    | 37.3               | 37.7        | 38.5                           | 39.2        |
| Total current expenditure                 | 37.3               | 38.5        | 38.2                           | 38.6        |
| Depreciation                              | 0.9                | 0.9         | 0.9                            | 0.9         |
| <b>Surplus on current budget</b>          | <b>-0.9</b>        | <b>-1.6</b> | <b>-0.6</b>                    | <b>-0.3</b> |
| Net investment                            | 1.1                | 1.7         | 2.0                            | 2.2         |
| <b>Net borrowing<sup>1</sup></b>          | <b>2.1</b>         | <b>3.3</b>  | <b>2.6</b>                     | <b>2.4</b>  |
| Net interest payments                     | 1.0                | 1.0         | 1.1                            | 1.0         |
| <b>Primary balance</b>                    | <b>-1.1</b>        | <b>-2.3</b> | <b>-1.5</b>                    | <b>-1.4</b> |
| <i>Current receipts</i>                   |                    |             |                                |             |
| Taxes on income and wealth                | 13.6               | 13.3        | 13.9                           | 14.4        |
| Taxes on production and imports           | 13.5               | 13.6        | 13.6                           | 13.7        |
| Other current taxes                       | 1.9                | 1.9         | 2.0                            | 2.0         |
| Taxes on capital                          | 0.2                | 0.2         | 0.2                            | 0.2         |
| Social contributions                      | 6.0                | 6.7         | 6.7                            | 6.7         |
| Interest income                           | 1.1                | 1.0         | 1.0                            | 1.0         |
| Other                                     | 1.1                | 1.0         | 1.0                            | 1.0         |
| <b>Total current receipts</b>             | <b>37.3</b>        | <b>37.7</b> | <b>38.5</b>                    | <b>39.2</b> |
| <i>Current expenditure</i>                |                    |             |                                |             |
| Current expenditure on goods and services | 20.3               | 21.1        | 21.1                           | 21.4        |
| Net social benefits                       | 12.2               | 12.4        | 12.4                           | 12.3        |
| Net current grants                        | 2.2                | 2.1         | 1.9                            | 2.0         |
| Interest and dividends paid               | 2.0                | 2.0         | 2.1                            | 2.1         |
| Subsidies                                 | 0.6                | 0.8         | 0.7                            | 0.7         |
| AME margin                                | 0.0                | 0.0         | 0.0                            | 0.0         |
| <b>Total current expenditure</b>          | <b>37.3</b>        | <b>38.5</b> | <b>38.2</b>                    | <b>38.6</b> |
| <i>Capital expenditure</i>                |                    |             |                                |             |
| Gross domestic fixed capital formation    | 1.2                | 1.7         | 2.0                            | 2.0         |
| Other capital expenditure                 | -0.1               | 0.0         | 0.1                            | 0.1         |
| <b>Net investment</b>                     | <b>1.1</b>         | <b>1.7</b>  | <b>2.0</b>                     | <b>2.2</b>  |
| <b>Total expenditure</b>                  | <b>38.5</b>        | <b>40.2</b> | <b>40.3</b>                    | <b>40.7</b> |

Note: This table is derived from Pre-Budget Report table B21

<sup>1</sup> Although this is based on the ESA95 definition of general government net borrowing (GGNB), the forecasts are identical to GGNB calculated on a Maastricht definition.

## Receipts

4.17 The latest projections for general government receipts, contained in the Pre-Budget Report, are shown in Table 4.4.

4.18 Forecasts of public sector current receipts have been revised down in all years since Budget 2003. Table 4.5 breaks down the causes of these revisions between economic determinants audited by the National Audit Office (NAO), changes to the components of GDP, and other factors.

Table 4.5: Changes in public sector current receipts since Budget 2003

|   | £ billion           |               |  |               |               |
|---|---------------------|---------------|--|---------------|---------------|
|   | Estimate<br>2003-04 | 2004-05       | Projections<br>2005-06 2006-07 2007-08 |               |               |
| Effect on receipts of non-discretionary changes in:   |                     |               |  |               |               |
| Economic determinants audited by the NAO <sup>1</sup> | 1/2                 | 1 1/2         | 2                                      | 2             | 2 1/2         |
| of which:   |                     |               |  |               |               |
| Equity price assumption                               | 1/2                 | 1             | 1 1/2                                  | 1 1/2         | 1 1/2         |
| GDP components  | -4                  | -5 1/2        | -5 1/2                                 | -5            | -4            |
| of which:   |                     |               |  |               |               |
| Wages & salaries                                      | -3 1/2              | -4            | -4                                     | -3 1/2        | -3            |
| Consumers' expenditure                                | -1/2                | -1/2          | -1                                     | -1            | -1/2          |
| Other   | -2                  | -1/2          | -1                                     | 0             | 1             |
| <b>Total before discretionary changes</b>             | <b>-5 1/2</b>       | <b>-4 1/2</b> | <b>-4 1/2</b>                          | <b>-2 1/2</b> | <b>-1 1/2</b> |
| Discretionary changes                                 | 0                   | 0             | 0                                      | 1/2           | 1/2           |
| <b>Total change</b>                                   | <b>-5 1/2</b>       | <b>-4</b>     | <b>-4</b>                              | <b>-2</b>     | <b>0</b>      |

<sup>1</sup> Excludes the higher than expected VAT receipts, which is included in other changes, and extension of the VAT package, which is included in discretionary changes

**4.19** Changes in economic determinants audited by the NAO have increased public sector receipts by between £1½ billion and £2½ billion per year from 2004-05 onwards. This is largely a result of higher equity prices, which increase receipts from stamp duty, capital taxes, and corporation tax from life assurance companies. The NAO audited assumption on equity prices used in Budget 2003 meant that the projections only assumed equity prices would rise in line with money GDP from a starting level of 1778. However, since the Budget equity prices have actually risen by around 20 per cent.

**4.20** Offsetting the positive impact of the economic determinants audited by the NAO are changes to the composition of GDP. As explained in Chapter 3, growth in wages and salaries in 2003 has been lower than projected, reducing revenues from income tax and National Insurance Contributions (NICs) by around £3½ billion in 2003-04 and in future years. Lower than expected growth in consumers' expenditure has also had a negative impact on VAT and excise revenues, although despite this lower growth, VAT revenues in the first half of 2003-04 have been substantially above the levels projected in Budget 2003, partly reflecting caution in the NAO audited assumptions used to forecast VAT revenues.

**4.21** The remaining differences in the forecast of receipts can be explained by various factors including lower than expected levels of housing transactions, the reclassification of business rates paid by local authorities and lower than expected oil production. The reclassification of business rates paid by local authorities, which reduces receipts by around £1 billion per year, has no impact on the current budget or net borrowing as it is offset by an equivalent reduction in public expenditure.

## Expenditure

**4.22** Consistent with the longer-term expenditure planning horizon allowed by the fiscal rules, the Government has introduced a system of firm and fixed Departmental Expenditure Limits (DELs) for departmental spending stretching over three years, and reviewed every two. Departments now have certainty over their budgetary position for well over a year ahead, enabling them to plan and manage their programmes sensibly without the risk that crucial funding will be removed. Departments are also able to draw on their stock of end-year flexibility (EYF). EYF allows departments to carry forward resources not fully spent at the end of the year for use in future years, enabling them to plan their spending effectively and helping to avoid inefficient end-year surges in departmental spending.

**4.23** Expenditure items that are large, potentially volatile and demand-led – such as social security benefits and debt interest payments – are collectively known as Annually Managed Expenditure (AME). These items are subject to tough scrutiny twice a year as part of the Budget and Pre-Budget Report process to ensure that volatility in AME does not threaten fiscal stability. The Government recognises the uncertainties in planning public expenditure, allows for this through the DEL reserve and AME margin and remains vigilant to pressures and risks. Taken together, DEL and AME add up to Total Managed Expenditure (TME), the broadest measure of total public expenditure.

**Projections 4.24** The latest projections for general government expenditure, contained in the Pre-Budget Report, are included in Table 4.4. As shown in Chapter 2 the Government's spending plans are fully consistent with meeting its strict fiscal rules. In 2003-04 total spending is planned to rise by 6.9 per cent in real terms over the year as a whole relative to 2002-03, with DEL spending rising by 7.3 per cent and AME spending rising by 6.4 per cent. This year departments have chosen to draw down £2.5 billion of EYF so far to add to their authorised spending limits. The Government expects this net addition to spending to be offset by the end of the year by underspends elsewhere within DEL.

**4.25** Since September 2001, the Government has spent nearly £2 billion on the war in Afghanistan and to combat terrorism both domestically and abroad. In Budget 2003, the Government made a special contingency provision of £3 billion to meet the costs of the military conflict in Iraq and its other international obligations. Of that special reserve, £1 billion was allocated to the Ministry of Defence DEL in 2002-03 with the rest remaining unallocated. A further £1.3 billion of current spending has been charged against the special reserve in 2003-04. In this year's Pre-Budget Report, the Government carries forward the £2 billion unallocated special reserve into 2003-04 and adds a further £500m taking the total special reserve for this year to £2.5 billion. A further £300 million will be added in 2004-05 as a prudent allowance against continuing commitments. This will ensure that the Government is able to meet its international commitments in Iraq and elsewhere in the war against terrorism.

**Box 4.2: The Stability and Growth Pact**

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

The Government supports a prudent interpretation of the Pact that builds on the Code of Conduct, agreed by Member States in June 2001 and the report agreed by EU Finance Ministers on strengthening budgetary co-ordination in June 2003. A prudent interpretation would lock in long-term fiscal discipline and sustainability, enhancing credibility across the economic cycle, while allowing the automatic stabilisers to smooth fluctuations in output, and allow appropriate increases in investment in public services. Specifically, it would take into account all the following factors in applying a country by country approach to assessments of compliance with the medium-term fiscal objective of 'close to balance or in surplus':

- the economic cycle - by allowing automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy. It is therefore welcome that the Council and Commission now focus more on cyclically-adjusted fiscal balances when assessing the public finances, and hence recognise the importance of avoiding pro-cyclical fiscal policy;
- sustainability - low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilizers to operate, and providing a sound basis for investment in public services. Assessment of the sustainability of public finances should also take into account the long-term budgetary impact of ageing populations, such as that set out in the *Long-term public finance report*, published alongside the 2003 Pre-Budget Report; and
- public investment - against a background of sound public finances and economic stability and subject to the sustainable investment rule, public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.

**Taking Account of the Economic Cycle**

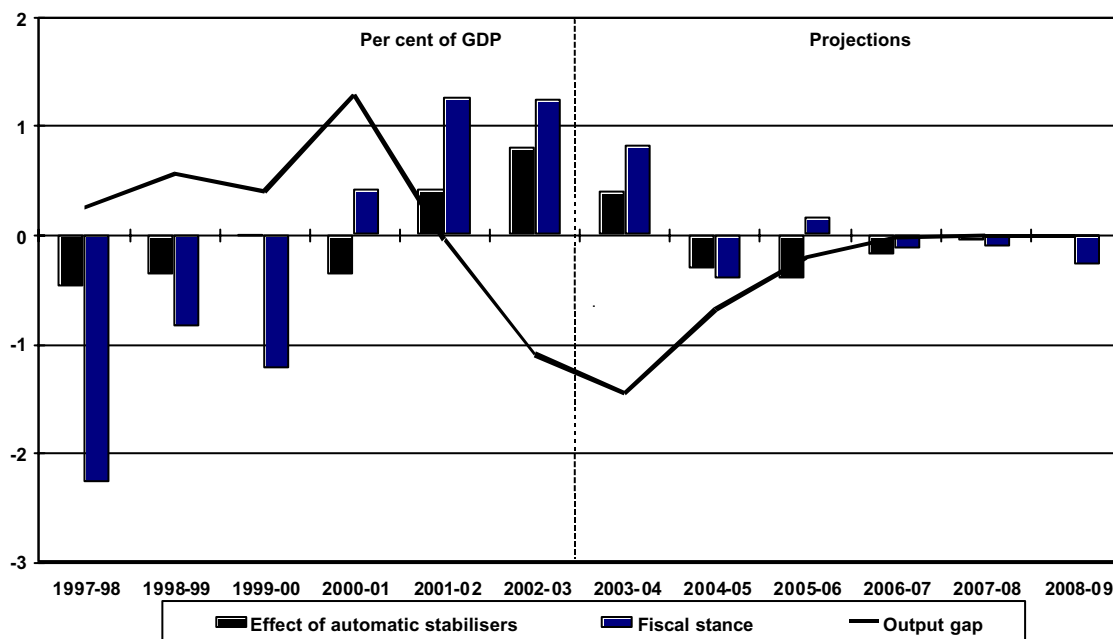
**4.26** As set out in Box 4.2, a key element of a prudent interpretation of the Stability and Growth Pact is that it takes account of the economic cycle. It is important to focus on cyclically-adjusted fiscal balances when assessing public finances and subsequent policy decisions.

**The automatic stabilisers**

**4.27** While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. By allowing the fiscal balances to vary between the years in line with the cyclical position of the economy, the automatic stabilisers are able to operate freely to help smooth the path of the economy in the face of variations in demand.

**4.28** Chart 4.2 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy. During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilizers. As the economy has moved below trend so the fiscal stance has eased, helping to maintain economic stability. Over the next few years, as the economy returns to trend, fiscal policy moves towards a more neutral stance.

Chart 4.2: Fiscal policy supporting monetary policy



**4.29** As noted earlier, in cyclically-adjusted terms, both public sector net borrowing and general government net borrowing will be 2.4 per cent in 2003-04, falling to 1.7 per cent and 1.8 per cent respectively by the end of the projection period. Nominal general government net borrowing, on the Treaty definition, will be 3.3 per cent in 2003-04, falling to 2.6 per cent in 2004-05 and to 1.8 per cent by the end of the projection period.

### Sustainability for the Long Term

**4.30** Long-term sustainability is a key element of a prudent interpretation of the Stability and Growth Pact. A key element of this prudent interpretation takes account of sustainability. The Government believes that sustainable public finances are a prerequisite to achieving stable long-term economic growth, which in turn is essential in guaranteeing that everybody shares in the growing prosperity of the country. The Government also seeks to ensure that spending and taxation impact fairly between generations.

**4.31** The projections contained in Table 4.1 show that the UK's public finances remain robust and sustainable. With net debt rising from 32.8 per cent in 2003-04 and forecast to stabilise at 35.5 per cent in 2008-09, and general government gross debt forecast to stabilise at 41.5 per cent (one of the lowest debt levels in the EU) by the end of the projection period, the Government is demonstrating its continued commitment to long-term sustainability.

**4.32** The UK's fiscal framework facilitates transparent, long-term decision-making in both the public and private sectors. The framework is guided by the *Code for fiscal stability*, which sets out a commitment to managing the public finances in the long-term interests of the UK. The objectives for fiscal policy and the Government's two fiscal rules, the golden rule and sustainable investment rule, reflect the Government's long-term focus and are discussed in Chapter 2 of this Report.

**4.33** To measure progress against the Government's commitment to its objectives and long-term interests, the *Code for fiscal stability* requires the publication of an Economic and Fiscal Strategy Report (EFSR) outlining the Government's long-term goals, strategy for the future, and how it is progressing in meeting its fiscal policy objectives.

**Illustrative long-term fiscal projections**

**4.34** Within the EFSR, the *Code* requires the Government to publish illustrative long-term fiscal projections, covering a horizon of at least 10 years. In practice a 30-year horizon has been chosen. These projections, which are based on a top-down assessment of long-term fiscal sustainability, are published in Annex A of the EFSR.

**4.35** In addition to the projections in Annex A of the EFSR, the Government published its first Long-term public finance report alongside the 2002 Pre-Budget Report. The 2003 *Long-term public finance report: fiscal sustainability with an ageing population*<sup>1</sup>, which follows the general structure of the 2002 report but also introduces a number of innovations and refinements, is published alongside the 2003 Pre-Budget Report. The Government is committed to continue to update and report on its assessments of long-term fiscal sustainability in the future.

**Long-term public finance report**

**4.36** The 2003 Long-term public finance report seeks to extend and complement the analysis in Annex A of the EFSR (which is updated in the report as well). To this end the report aims to provide:

- a comprehensive picture of the sustainability of the public finances over the long term based on a range of plausible assumptions;
- an indication of the degree of inter-generational fairness;
- better quality information to guide policy and enhance decision-making and planning by both the Government and individuals; and
- a framework for examining the effects of demography and other long-term trends on the public finances.

**4.37** As stated above, the Government already conducts a top-down assessment of long-term fiscal sustainability in Annex A of the EFSR. However, due to the modelling approach, these do not identify specific long-term spending trends. The 2003 *Long-term public finance report* builds on the analysis provided in last year's report. Last year's assessment of long-term fiscal sustainability was based on a number of approaches, including the top-down approach used for the illustrative long-term fiscal projections in Annex A of the EFSR, bottom-up projections and synthetic sustainability indicators, such as fiscal gaps. This year's Report extends the range of approaches to include the conventional national-accounts measures of debt and an accruals-based balance sheet.

**4.38** Using the different approaches to assessing long-term fiscal sustainability, in particular bottom-up projections, the intertemporal budget gap and fiscal gaps, and to a lesser extent the inter-generational balance gap as derived by generational accounting, it is possible to build up a comprehensive picture of the long-term sustainability of the public finances in the light of future developments.

**4.39** The 2003 *Long-term public finance report* confirms the findings of last year's report and other studies. It finds that, on the basis of current policies and a range of assumptions, the UK public finances are sustainable in the long term. In addition, the report concludes that the UK is in a strong position relative to other major economies to face the challenges ahead. The report also finds that there is a high degree of inter-generational fairness of current policies, compared to many other countries.

<sup>1</sup> 2003 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003.

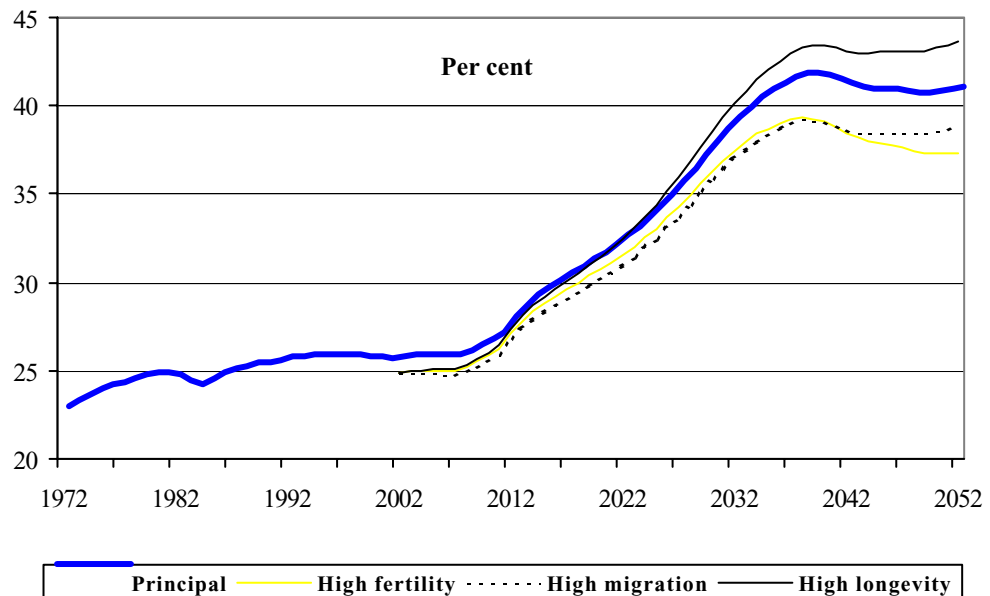
**Long-term challenges** 4.40 One of the most important future developments is the changing structure of the UK's population. The Government Actuary's Department (GAD) published 2001-based interim principal population projections in November 2002 that take account of the findings of the 2001 Census. GAD will publish its next set of projections, the 2002-based population projections, on 18 December 2003.

**Variant Population projections** 4.41 The 2002 *Long-term public finance report* was based on GAD's principal population projections. The 2003 report moves the analysis on by including GAD's variant population projections. In particular, the report includes GAD's high population variants, based on higher assumptions for longevity (life expectancy), fertility rates (the number of children per woman) and net migration rates compared with the principal population projections.

**Ageing population** 4.42 According to GAD's principal population projections, the UK's population will increase from 59 million in 2002 to 64 million by the mid 2030s, and then stabilise. GAD's high variant scenarios are projected to lead to larger population sizes in the future, with the high fertility variant peaking at around 69 million by 2050. In addition to the gradual rise in the number of people living in the UK, GAD's projections also show that the structure of the UK's population will change significantly over the coming decades. The most pronounced structural change will be the ageing of the population. The ageing of the population can be illustrated by the evolution of the demographic old-age dependency ratio. This ratio shows the number of people aged 65 years and over relative to the number of people aged between 16 and 64 years<sup>2</sup>.

4.43 Chart 4.3 shows that the demographic old-age dependency ratio has edged up slightly since the early 1970s, reaching around 25 per cent in 2002. The ageing process is expected to accelerate significantly after 2010, with the demographic old-age dependency ratio projected to rise to just above 40 per cent by 2040 in GAD's principal population projections. The trend is projected to be very similar in the variant population scenarios, with the increase projected to be most moderate in the high fertility variant, as the size of the working-age population will be boosted by an inflow of more young people in the coming decades.

**Chart 4.3: Old-age dependency ratio**



Source: Government Actuary's Department's 2001-based interim population projections and historical data.

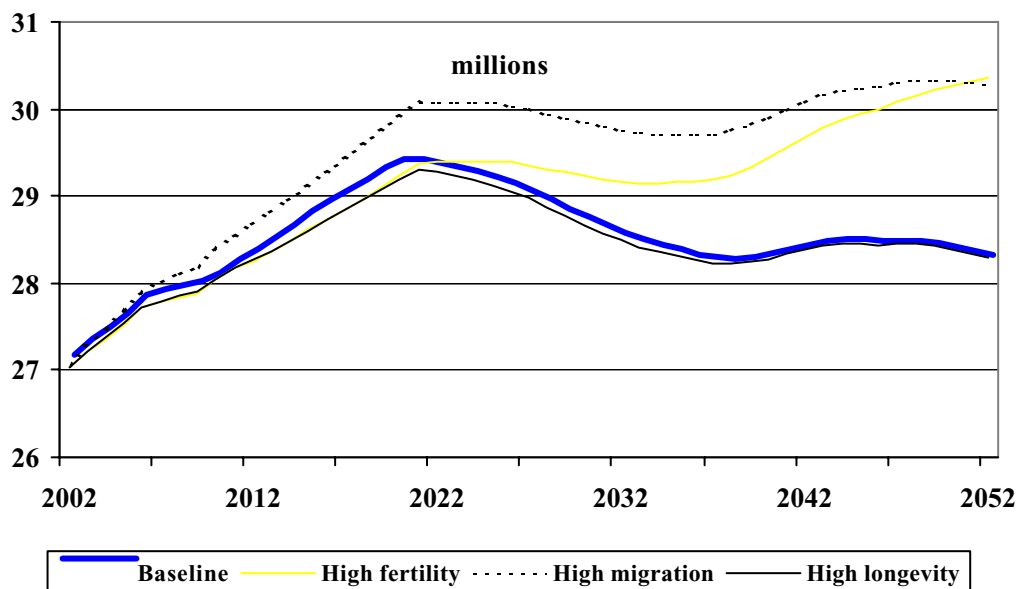
<sup>2</sup> The 2002 *Long-term public finance report* used the economic old-age dependency ratio to illustrate the ageing trend.

**Assumptions 4.44** Given the enormous uncertainties involved when conducting long-term projections, it is crucial to state clearly the assumptions used. The 2003 *Long-Term Public Finance Report* is consistent with the medium-term forecast presented in the 2003 Pre-Budget Report. Beyond the medium-term forecast period, the report is based on a range of plausible assumptions and provides sensitivity analysis to stress test the results. In addition to the assumptions regarding demographic trends, assumptions are needed for: policy, employment and productivity growth (and hence GDP growth), discount/debt interest rate, and spending and revenue profiles.

**4.45** The 2003 *Long-term public finance report* is based on the assumption of current policy, which has been interpreted as all policy already in place or announced in the 2003 Pre-Budget Report. Beyond the medium-term forecast period, spending and revenue, with a few exceptions, are entirely driven by demographic changes<sup>3</sup>.

**4.46** The employment rate of the working-age population is assumed to remain unchanged from 2008-09 onwards, the end of the medium-term forecast period. This means that changes in employment levels are entirely due to changes in the size of the working-age population. Chart 4.4 shows the likely evolution of employment over the coming decades, based on GAD's 2001-interim principal and variant population projections<sup>4</sup>. The report provides results based on these different population scenarios.

**Chart 4.4: UK employment in different population scenarios.**



Source: HM Treasury, based on Government Actuary's Department 2001-based interim population projections

**4.47** The productivity growth assumption used in the baseline scenario is 2 per cent per year. This is the average long-term productivity growth rate for the UK since the mid 1950s. It is also the neutral productivity assumption used in the Government's medium-term forecast. Tables 4.6 and 4.7 show average real GDP growth in the coming decades for the baseline scenario and based on the variant population projections.

<sup>3</sup> For more details on modelling and exceptions see Chapter 5 of 2003 *Long-term Public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003.

<sup>4</sup> The report's baseline projections are based on GAD's principal population projections.

**Table 4.6: Real GDP growth and its components in the baseline scenario (per cent)**

| Year            | 2012-13 to<br>2021-22 | 2022-23 to<br>2031-32 | 2032-33 to<br>2041-42 | 2042-43 to<br>2051-52 |
|-----------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Productivity    | 2                     | 2                     | 2                     | 2                     |
| Employment      | ½                     | -¼                    | 0                     | 0                     |
| <b>Real GDP</b> | <b>2 ½</b>            | <b>1 ¾</b>            | <b>2</b>              | <b>2</b>              |

**Table 4.7: Real GDP growth in the variant population projections (per cent)<sup>1</sup>**

| Year           | 2012-13 to<br>2021-22 | 2022-23 to<br>2031-32 | 2032-33 to<br>2041-42 | 2042-43 to<br>2051-52 |
|----------------|-----------------------|-----------------------|-----------------------|-----------------------|
| High Migration | 2 ½                   | 2                     | 2                     | 2                     |
| High Longevity | 2 ½                   | 1 ¾                   | 2                     | 2                     |
| High Fertility | 2 ½                   | 2                     | 2                     | 2 ¼                   |

<sup>1</sup>Productivity growth per year is 2 per cent for all variants.

**4.48** The intertemporal budget gap and fiscal gap approaches to assessing long-term fiscal sustainability require a real interest/discount rate assumption. Based on index-linked gilts, and consistent with the Government's Green Book, the report presents results based on real interest/discount rate assumptions of 2½ per cent, 3 per cent and 3½ per cent.

#### Spending projections

**4.49** Table 4.6 summarises the spending projections as presented in the 2003 *Long-term public finance report*<sup>5</sup>. The table shows that the changing demographic structure of the UK's population – and especially the ageing aspect – is projected to have only a limited impact on public spending over the coming decades. This contrasts with the findings in many other developed countries, where the spending pressures are much greater. Spending on education and pensions is projected to remain more or less stable as a share of GDP beyond the medium term. Health spending is projected to increase the most, rising to 9¾ per cent of GDP in 2052-53. As a result, total spending is projected to be slightly higher, as a share of GDP, than at the end of the medium term (2008-09). The substantial increase in spending between 2002-03 and 2012-13 largely reflects the Government's increased spending on public services in the medium-term projections, in particular, education and health as part of the 2002 Spending Review.

**Table 4.8: Spending projections (per cent of GDP)**

|                                   | 2002-03     | 2012-13     | 2022-23     | 2032-33     | 2042-43     | 2052-53     |
|-----------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Education                         | 5.1         | 5.5         | 5.3         | 5.5         | 5.4         | 5.4         |
| Pensions <sup>1</sup>             | 5.0         | 5.1         | 4.9         | 5.4         | 5.3         | 5.3         |
| Health <sup>2</sup>               | 6.5         | 8.2         | 8.5         | 9.3         | 9.7         | 9.7         |
| Long-term care <sup>3,4</sup>     | 0.9         | 1.1         | 1.1         | 1.1         | 1.1         | 1.1         |
| <b>Total age-related spending</b> | <b>17.5</b> | <b>19.8</b> | <b>19.7</b> | <b>21.2</b> | <b>21.4</b> | <b>21.5</b> |
| Other spending                    | 21.5        | 20.7        | 20.2        | 20.6        | 20.2        | 19.8        |
| <b>Total spending<sup>5</sup></b> | <b>38.9</b> | <b>40.5</b> | <b>39.9</b> | <b>41.8</b> | <b>41.7</b> | <b>41.3</b> |

<sup>1</sup> Defined as the sum of the Retirement pension, including the State Second Pension, Minimum Income Guarantee and Pension Credit, over 75 TV licences, and Christmas Bonus. <sup>2</sup> Gross NHS spending. <sup>3</sup> Compression of morbidity assumed. <sup>4</sup> Excluding long-term care provided within the NHS which is accounted for under Health (for which no compression of morbidity is assumed). <sup>5</sup> Total spending including gross investment but excluding interest and dividends payments.

<sup>5</sup> Note that the results presented in the 2003 *Long-term public finance report*, and reproduced here, are based on the general government public finances. The exceptions are the illustrative long-term fiscal projections, which cover the public sector.

**4.50** Education spending is projected to remain relatively stable over the coming decades, fluctuating around 5½ per cent of GDP. This reflects the fact that the number of people of education age (either in schools, higher education or further education) is projected to vary only slightly. The increase from 5.1 per cent in 2002-03 to 5.5 per cent in 2012-13 reflects the substantial increase in education spending announced in the 2002 Spending Review up to 2005-06. Education is projected to be marginally lower as a share of GDP over the coming decades than last year. This is entirely due to a reclassification within the projection model, with the difference now classified under other spending (which is correspondingly higher).

**4.51** Public pension spending is projected to remain stable over the next 50 years, fluctuating between 4.9 per cent and 5.4 per cent of GDP. As a share of GDP, public pension spending is projected to be highest around 2032-33, when the number of pensioners is projected to be increasing at its fastest rate as the 1960s baby-boom generation enters retirement. The pension projections are slightly higher than last year as a result of a revised projection methodology rather than policy changes<sup>6</sup>.

**4.52** Health spending (gross NHS) as a proportion of GDP is projected to rise from 6½ per cent in 2002-03 to around 9¾ per cent by 2052-53. Of this an increase of roughly 1½ percentage points of GDP by 2007-08 reflects the substantial increase in NHS spending announced in Budget 2002 in response to the Wanless Review. The further increase from 2008-09 is driven by demographic changes.

**4.53** The projections in the 2003 *Long-term public finance report* assume a compression of morbidity effect for long-term care. The assumption is based on past experience, which suggests that people can expect an increase in the number of years enjoyed in good health as life expectancy rises. This means that long-term care spending is held at around 1 per cent of GDP (the 2008-09 level) rather than rising to 1¾ per cent by 2052-53 as it would if compression of morbidity were not allowed for<sup>7</sup>.

**4.54** The gradual decline of other spending between 2002-03 and 2022-23 largely reflects the assumption that most non-pension social benefits (which represent nearly a third of other spending) will rise in line with prices after 2008-09, reducing their share in GDP. As stated above, other spending is projected to be marginally higher as a share of GDP than last year. This is due to a reclassification in the projection model.

#### Revenue projections

**4.55** Revenue is projected to remain fairly stable as a share of GDP over the coming decades. This contrasts with a projected decline in last year's projections. The difference is due to a modified modelling assumption for revenue from National Insurance Contributions<sup>8</sup>. Revenue, excluding interest and dividends received, is projected to rise from 37.6 per cent of GDP in 2002-03 to 39.4 per cent in 2012-13 and then remain more or less stable (39.3 per cent in 2052-53). These projections do not pick up all the potential developments on the revenue side that can be expected. In fact, there are several reasons why revenue may rise as a share of GDP without a change in policy. For example, the number of pensioners with significant pension entitlements is expected to increase over the coming decades. While contributions to pension schemes are exempt from taxation (up to generous limits), the future income stream that a funded pension generates is taxed. There is evidence that such policy could have a significant upward pressure on revenue in countries with well-established funded pension schemes<sup>9</sup>.

<sup>6</sup> See 2003 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003, page 60.

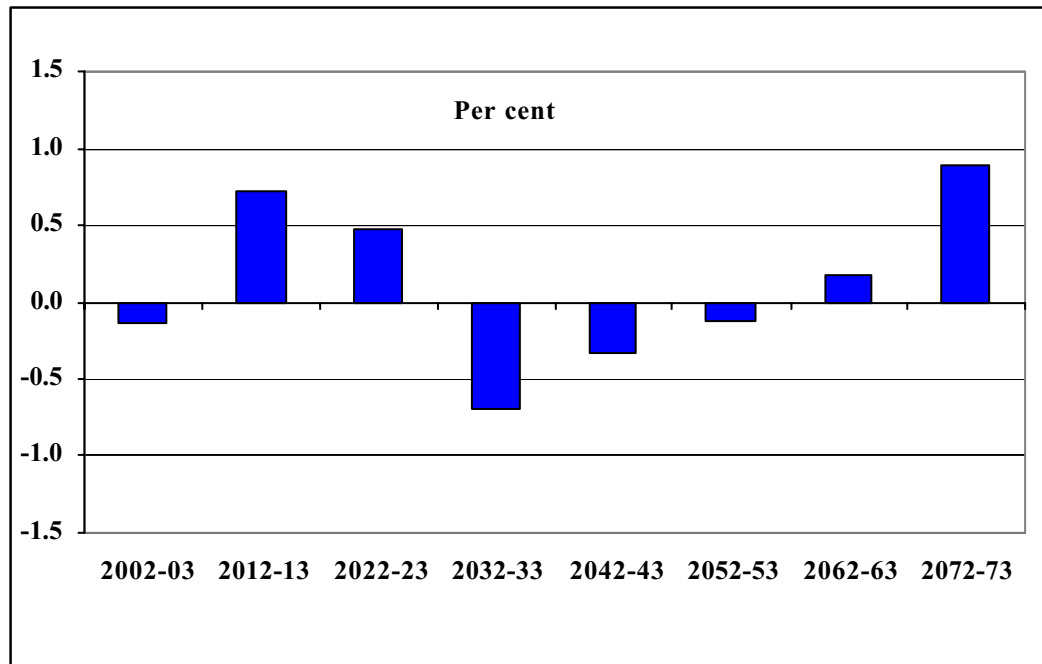
<sup>7</sup> Without this assumption, long-term care spending is projected to rise to around 1.7 per cent of GDP by 2052-53.

<sup>8</sup> See 2003 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003, Chapter 5.

<sup>9</sup> 2002 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, November 2002, pages 39 – 40.

**Primary balance 4.56** As a result of the projected spending and revenue trends, the general government primary balance is projected to move from a surplus equivalent to 0.7 per cent of GDP in 2012-13 into deficit by the late 2020s. Chart 4.5 shows that the projected deficit on the primary balance is most marked, as a share of GDP, in the 2030s, when spending pressures are projected to be greatest. However, the primary balance is projected to return to surplus after 70 years, reflecting the fact that the ageing process has run its course (the number of people aged 65 years and over is projected to decrease from 2060 onwards) and the continued relative decline of social security spending<sup>10</sup>.

**Chart 4.5: Primary balance as a share of GDP**



**Updated illustrative long-term fiscal projections 4.57** The 2003 *Long-term public finance report* provides an update of the illustrative long-term fiscal projections presented in Annex A of the 2003 EFSR based on the medium-term forecast presented in the 2003 Pre-Budget Report<sup>11</sup>. With the results of the updated illustrative long-term fiscal projections only marginally different from those presented in the 2003 EFSR, the conclusions drawn earlier remain valid: the UK's public finances are broadly sustainable over the long term. Consistent with meeting the golden rule, current consumption can grow slightly faster than GDP in the projections, providing the resources to meet future spending needs. Furthermore, public sector net investment can grow more or less in line with the economy without jeopardising the sustainable investment rule. Net debt is projected to remain below 40 per cent of GDP in the long term.

<sup>10</sup> To derive the primary balance, it is necessary to include interest and dividends received to the revenue projections. Interest and dividends received are assumed to remain constant as a share of GDP, at 1¼ per cent, from the end of the medium-term forecast onwards. Increases in social security spending are assumed to grow in line with prices.

<sup>11</sup> See 2003 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003, Chapter 6 for the assumptions used for the updated illustrative long-term fiscal projections.

**Intertemporal balance 4.58** The report also assesses the long-term sustainability of the public finances using a number of approaches, in particular the intertemporal budget gap/constraint and fiscal gaps. Using the bottom-up projections presented above, it is possible to calculate the intertemporal budget constraint (IBC)<sup>12</sup>. The IBC states that all current and future revenue streams should be sufficient to cover all current and future spending streams and today's debt. If current and future revenues are not sufficient to cover current and future spending, and current debt, then the extent of the imbalance is called the intertemporal budget gap (IBG). The IBG can be used to calculate the immediate and permanent change in the fiscal stance that is needed to meet the IBC, in other words ensure the long-term sustainability of the public finances. More generally though, even if the IBG points to an imbalance, it does not necessarily imply that fiscal action has to be taken. Over these very long time horizons, many policy levers are available and in general structural reforms, for example those that help to raise trend growth, will be important.

**4.59** Table 4.9 presents estimates of the intertemporal budget gap in the baseline scenario for the three discount rate assumptions. As can be seen whether revenue needs to rise (or spending to fall) depends entirely on the discount rate assumption. If a low discount rate is used, as could be justified by the low real interest rate on long-term UK government bonds, the condition for intertemporal balance is exceeded in the baseline scenario.

**Table 4.9: Intertemporal budget gaps<sup>1</sup>**

| (per cent of GDP)                         |     |   |     |
|---|-----|---|-----|
| Discount rate (per cent)                  | 2 ½ | 3 | 3 ½ |
| Baseline (2 per cent productivity growth) | -1¼ | ¼ | 1¼  |

<sup>1</sup> Tax increase (or decrease) in 2002-03 and a permanent, proportionate tax increase (or decrease) thereafter intertemporal balance. Rounded to the nearest quarter

**Fiscal gaps 4.60** The 2003 *Long-term public finance report* also uses fiscal gaps to assess the long-term sustainability of the public finances. The fiscal gap concept takes a sustainable debt to GDP ratio as a starting point for thinking about long-term fiscal sustainability. The fiscal gap measure represents the change in the primary balance needed to attain a particular debt target (assumed to be 40 per cent to be consistent with the Government's sustainable investment rule) at a particular point in time<sup>13</sup>. Table 4.10 shows the baseline scenario projections under a variety of assumptions regarding the debt interest rate.

**Table 4.10: Fiscal gaps<sup>1</sup> in baseline scenario with 2 per cent productivity growth**

| (per cent of GDP)        |     |    |     |
|--------------------------|-----|----|-----|
| Interest rate (per cent) | 2 ½ | 3  | 3 ½ |
| <b>Target year</b>       |     |    |     |
| 2022-23 <sup>2</sup>     | -1  | -¾ | -½  |
| 2032-33                  | -¼  | -¼ | 0   |
| 2042-43                  | 0   | ¼  | ¼   |
| 2052-53                  | 0   | ¼  | ½   |

<sup>1</sup> Change to primary balance needed to attain a particular debt level at target year. Rounded to nearest quarter percentage point.

<sup>12</sup> For more information on these measures, for example how they are derived, and their respective strengths and weaknesses see Chapters 3,4 and 6 of the 2003 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003.

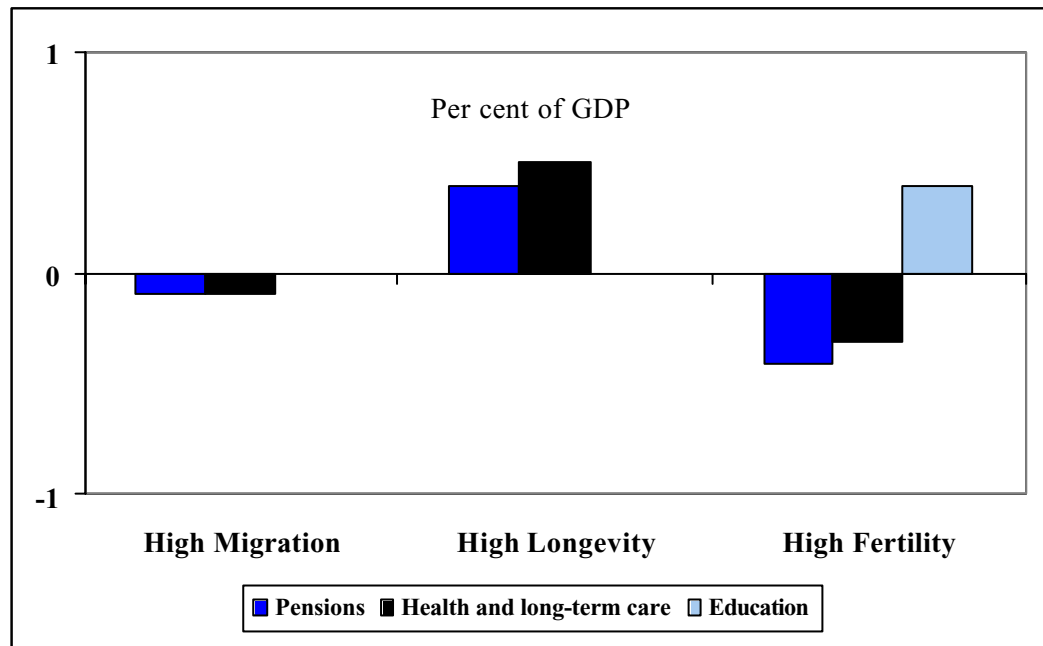
<sup>13</sup> Based on the fiscal gap concept, the report introduces a new indicator, which calculates the required change in the primary balance so that the net debt to GDP ratio *never* exceeds a certain limit. See 2003 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, December 2003, page 30 and pages 57-58.

**4.61** The results show that the UK public finances are in a strong long-term position. Table 4.10 shows that the Government could loosen its fiscal stance if it aimed for a net debt to GDP ratio of 40 per cent by 2022-23 or 2032-33. If the horizon were extended, the Government would have to tighten fiscal policy only marginally to ensure that net debt reaches 40 per cent of GDP by the target year.

**Spending based on variant population projections**

**4.62** The 2003 *Long-term public finance report* also presents spending projections based on the variant population scenarios. Chart 4.6 shows that the projections are robust to changes in demographic assumptions. The chart shows that spending as a share of GDP is projected to be more or less the same in the high migration variant as in the baseline projections. By contrast, age-related spending is projected to be higher in the high longevity scenario and lower in the high fertility scenario than in the baseline projections.

**Chart 4.6: Difference in age-related spending between baseline and variant population projections<sup>1</sup>**



<sup>1</sup> In 2052-53.

**4.63** As can be seen from Chart 4.4, employment is projected to be similar in the high longevity and principal population variants. GDP is therefore also projected to be similar over the coming decades (Tables 4.6 and 4.7). However, the high longevity variant projects that there will be more people above working age. As a result, pension, health and long-term care spending are projected to be around ½ percentage point higher than in the baseline projections. By contrast, education spending as a share of GDP remains unaffected by the change in the longevity assumption. In the high fertility variant, employment (and hence GDP) is projected to be substantially higher than in the baseline projections from around 2020 onwards due to an inflow of more young people into the labour force. This leads to a fall in pension, health and long-term care spending as a share of GDP even though they remain relatively stable in absolute terms. By contrast, education spending is projected to rise as a share of GDP, reflecting the fact that there are more people below working age in the high fertility than in the baseline projections.

**Summary 4.64** The 2003 *Long-term public finance report* assesses the long-term sustainability of the public finances using a series of fiscal sustainability indicators, including the intertemporal budget gap/constraint and fiscal gaps. The updated results confirm the findings of the 2002 report that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries to face future challenges. The 2003 report also shows that the future spending trends are robust to changes in the demographic assumptions.

**4.65** The *Long-term public finance report* along with the *End of year fiscal report* mark a major development of the UK's fiscal framework. In particular, they provide substantially more transparency and detailed analysis on both the distant future and the recent past.

## Public Investment

**4.66** As set out in Box 4.2, a prudent interpretation of the Stability and Growth Pact takes account of the important role of public investment. Against a background of sound public finances and economic stability, public investment contributes to the provision of high quality public services and can help to raise the overall productive potential of the economy.

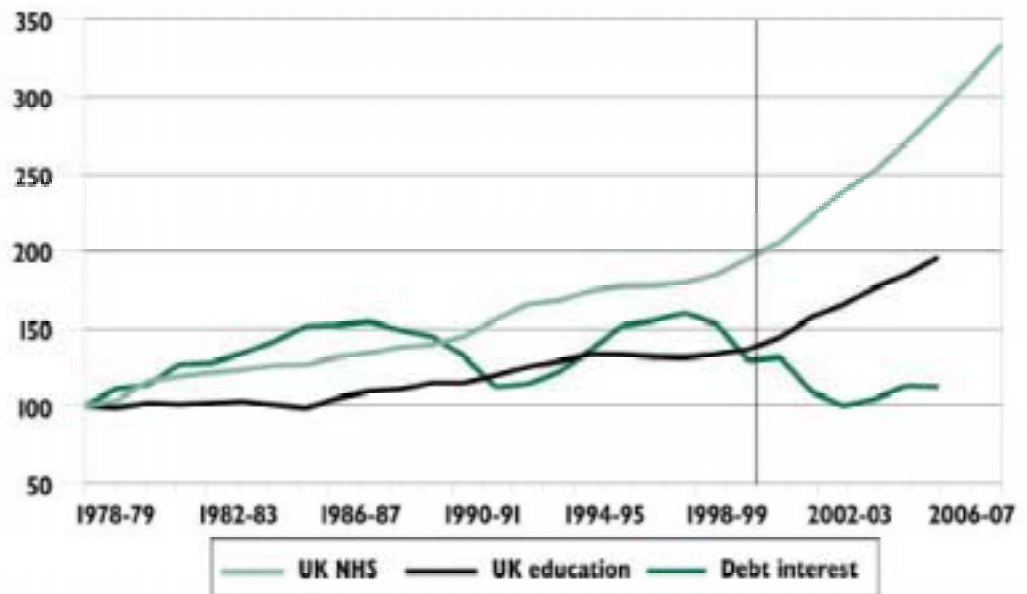
**4.67** The UK has historically invested less of its national income in key public services than comparable economies such as the US and many EU countries. OECD data show that throughout the 1970s, 1980s and 1990s, the UK spent a significantly lower share of its GDP on health than France, Germany and the US. In 1997, total health spending per capita in the UK was lower than in every other EU country except for Greece, Ireland, Portugal and Spain.<sup>14</sup> Spending on educational institutions as a proportion of GDP in the UK has also lagged behind that in the US and many EU countries.<sup>15</sup>

**4.68** In keeping with the 2003 Broad Economic Policy Guidelines, the projections contained in Table 4.1 demonstrate the Government's commitment to address the historical under-investment in public services in the United Kingdom. Public investment rises to 2.2 per cent of GDP by the end of the period.

**4.69** Extensive reform of the system for managing public expenditure, underpinned by the new fiscal framework, and prudent management of the economy and the public finances have enabled the Government to deliver a step change in resources for key public service priorities in the three Spending Reviews since 1998. After a period of relative stagnation in the mid-1990s, since the 1998 Comprehensive Spending Review health and education have benefited from significant and sustained real increases in investment. By 2006, public spending on education in the UK is set to be about 50 per cent higher in real terms than in 1997, and by 2008 spending on the UK NHS will be approximately 90 per cent higher in real terms than in 1997.

<sup>14</sup> *OECD Health Data 2003*. Total expenditure on health per capita, measured on a US dollar PPP basis.

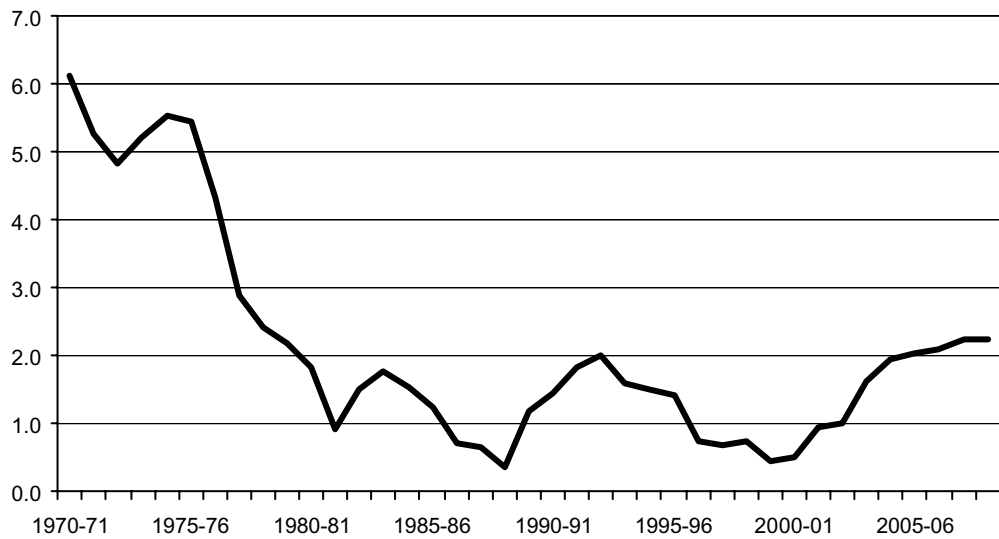
<sup>15</sup> *Education at a Glance*, OECD, 2003.

Chart 4.7: Long-term trends in spending on key public services<sup>1</sup>

<sup>1</sup> Real spending on UK NHS, UK education and central government debt interest related to 1978-79 = 100. Vertical line at 1998-00, the first year covered by the 1998 Comprehensive Spending Review.  
Source: HM Treasury.

**4.70** A prerequisite for delivering high quality public services is having the right public service infrastructure in place. In 1997-98, public sector net investment stood at just £5.6 billion, or (as shown in Chart 4.8) 0.7 per cent of GDP. Investment in public services had been on a declining trend since the mid-1970s, in part reflecting a budgeting system that encouraged short-termism and a bias towards spending on current pressures rather than on capital investment. The new fiscal framework, which removes the previous bias against capital investment, and the introduction of separate capital and resource budgeting for departments have helped reverse the declining trend in public sector net investment, which is now set to rise to 2 per cent of GDP by 2005-06. This substantial increase in investment is allowing departments to deal with inherited maintenance backlogs and establish the asset base necessary to deliver high quality public services. For example, substantial increases in NHS treatment capacity through additional hospital beds and treatment centers will continue to help reduce patient waiting times and improve health outcomes.

Chart 4.8: Public sector net investment (per cent of GDP)



4.71 Table 4.11 provides a breakdown of public sector capital expenditure from 2002-03 to 2005-06.

Table 4.11: Public sector capital expenditure

| £ billion   |                    |                     |             |             |
|---|--------------------|---------------------|-------------|-------------|
|   | Outturn<br>2002-03 | Estimate<br>2003-04 | Projections |             |
|   |                    |                     | 2004-05     | 2005-06     |
| Capital Budget DEL                                    | 21.3               | 24.6                | 26.7        | 29.0        |
| Locally-financed expenditure                          | 0.3                | 1.4                 | 2.4         | 2.3         |
| National Lottery                                      | 0.9                | 1.1                 | 1.0         | 0.8         |
| Public corporations' own-financed capital expenditure | 2.0                | 2.5                 | 2.6         | 2.5         |
| Other capital spending in AME                         | 0.6                | 2.9                 | 5.4         | 7.0         |
| AME margin  | 0.0                | 0.3                 | 0.0         | 0.0         |
| <b>Public sector gross investment<sup>1</sup></b>     | <b>25.1</b>        | <b>32.9</b>         | <b>38.2</b> | <b>41.6</b> |
| <i>Less depreciation</i>                              | 14.4               | 14.8                | 15.5        | 16.3        |
| <b>Public sector net investment</b>                   | <b>10.7</b>        | <b>18.0</b>         | <b>22.7</b> | <b>25.2</b> |
| Proceeds from the sale of fixed assets <sup>2</sup>   | 4.7                | 3.8                 | 3.8         | 3.8         |

<sup>1</sup> This and previous lines are all net of sales of fixed assets.  
<sup>2</sup> Projections of total receipts from the sale of fixed assets by public sector.

4.72 Table 4.12 shows general government debt repayments.

Table 4.12: General government debt repayments

|  | Per cent of GDP |             |         |         |
|--|-----------------|-------------|---------|---------|
|  | Outturn         | Projections |         |         |
|  | 2002-03         | 2003-04     | 2004-05 | 2005-06 |
| Net debt level <sup>1</sup>                  | 30.9            | 32.8        | 33.8    | 34.6    |
| Gross debt level (Maastricht definition)     | 37.9            | 39.3        | 40.2    | 40.8    |
| Change in gross debt                         | 0.0             | 1.4         | 0.8     | 0.6     |
| <b>Contributions to change in gross debt</b> |                 |             |         |         |
| Primary balance <sup>2</sup>                 | 1.1             | 2.3         | 1.5     | 1.4     |
| Interest payments <sup>2</sup>               | 1.0             | 1.0         | 1.1     | 1.0     |
| Nominal GDP growth                           | -1.8            | -2.1        | -2.3    | -2.2    |
| Other factors influencing the debt ratio     | -0.2            | 0.2         | 0.5     | 0.4     |
| <i>Memo: implicit interest rate on debt</i>  | 5.3             | 5.2         | 5.3     | 5.1     |

Note: This table is derived from Pre-Budget Report tables.

<sup>1</sup> Public sector net debt.

<sup>2</sup> Primary balance based on net interest payments for consistency with UK public sector definition. Interest payments given net of interest receipts.

4.73 Table 4.13 shows net borrowing by sub-sectors.

Table 4.13: Net borrowing by sub-sectors

|                                 | £ billion |             |         |         |
|---------------------------------|-----------|-------------|---------|---------|
|                                 | Outturn   | Projections |         |         |
|                                 | 2002-03   | 2003-04     | 2004-05 | 2005-06 |
| General government <sup>1</sup> | 21.7      | 37.2        | 30.7    | 29.9    |
| Central government              | 23.8      | 38.0        | 30.8    | 30.5    |
| Local authorities               | -2.1      | -0.9        | -0.1    | -0.6    |

<sup>1</sup> Although this is based on the ESA95 definition of general government net borrowing (GGNB), the projections are identical to GGNB

## Delivering High-Quality Public Services

4.74 The Government's long-term goal is to deliver efficient and responsive public services that meet public expectations throughout the country through sustained increases in investment and reform. Strong and dependable public services lay the foundations for a flexible, high productivity economy, supporting greater efficiency among businesses and adaptability within the workforce. They also promote opportunity and security for all, helping to tackle poverty and social exclusion and improving quality of life.

### 2002 Spending Review

4.75 The 2002 Spending Review set spending plans for 2003-04 to 2005-06 for public services other than the NHS, for which spending plans to 2007-08 were fixed in the 2002 Budget. Building on previous Spending Reviews, these spending plans allow for significant increases in key public services, including:

- planned UK spending on the NHS increasing by an average of 7.1 per cent a year in real terms over the five years to 2007-08; and
- planned UK spending on education increasing by 6.0 per cent a year in real terms between 2002-03 and 2005-06.

4.76 Combined with wide-ranging reform to improve public service productivity, increased investment is delivering improved results across a range of services.

**4.77** The Government has addressed historic underinvestment in the UK's public services as a prerequisite for improving their performance. The Government recognises that while UK public services perform well in some areas there is considerable scope for improvement in others. As well as providing the necessary resources, it is committed to implementing reforms to raise the productivity of the public services and thereby maximise their contribution to a flexible and productive wider economy. The Government's approach to meeting this public service productivity challenge<sup>16</sup> is underpinned by:

- clear long-term goals expressed as desired outcomes;
- greater devolution of decision-making to local service providers, combined with effective governance structures;
- improved information about performance; and
- better incentives for service providers to meet users' needs.

**4.78** Sound public finances that are sustainable over the economic cycle are not only essential to ensure economic stability; they are also necessary to deliver the sustainable investment in public services required to deliver standards that meet public expectations. The Government's fiscal rules, described in Chapter 2, are the foundation of the public spending framework, ensuring that the public finances are sustainable over the economic cycle and that spending and taxation impact fairly between generations. The rules have important consequences for the budgeting regime, removing the past discrimination against investment and ensuring that borrowing for investment is conducted in a responsible way.

#### **Box 4.3: Securing Good Health for the Whole Population**

Budget 2003 announced that Derek Wanless would provide an update on the long-term challenges in implementing the 'fully engaged' scenario set out in his 2002 report on long-term health trends, with a particular focus on the efficiency of cross-departmental work on preventative health and health inequalities.

The review will consider how public health spending decisions are taken and will examine how to ensure that they can be taken as cost-effectively and consistently as possible, in order to improve health outcomes through the efficient use of resources. Underpinning this work is a preliminary report outlining the main causes of mortality, morbidity and key risk factors amenable to public health interventions in England, including trends over time.

England performs poorly compared to other countries on some key measures of health outcomes and chronic disease such as coronary heart disease (CHD), cancer and particularly respiratory diseases. Chronic diseases such as CHD and cancer are also strongly related to lifestyle factors such as smoking, poor diet, high blood pressure, obesity, physical inactivity and alcohol.

In addition, a significant proportion of avoidable ill health is related to socio-economic deprivation. Mortality rates are much higher for lower socio-economic groups, and this is strongly linked to socio-economic differences in lifestyle factors, as well as to social and environmental factors such as poverty, lack of education, unemployment, and poor housing and access to health services. For example, it is estimated that half the difference in the numbers of people surviving to 70 years of age between the highest and lowest socio-economic groups is due to the higher prevalence of smoking in the lowest group.

The background report describing these health trends has been published on HM Treasury's<sup>17</sup> and the Department of Health's websites to provide a backdrop to the final report, *Securing Good Health for the Whole Population*, due in February 2004.

<sup>16</sup> See *Public Services: Meeting the productivity challenge*, HM Treasury, April 2003.

<sup>17</sup> [www.hm-treasury.gov.uk/wanless](http://www.hm-treasury.gov.uk/wanless).

**2004 Spending Review 4.79** The 2004 Spending Review will set new spending plans that lock in the step change in funding for key public services delivered in previous Spending Reviews. The baseline year for the Review will be 2005-06 and it will set new plans for 2006-07 and 2007-08 other than for the NHS, for which plans were set in Budget 2002. Departmental spending plans for 2005-06 determined in the 2002 Spending Review will not be changed. The Review will examine the effectiveness of existing programmes in delivering the Government's objectives. Additional funds above existing baselines will be targeted at front-line public service priorities on the basis of a rigorous assessment of where new resources will have the greatest impact on outcomes. Settlements will be conditional on the achievement of real efficiency gains by departments. In setting out the next steps in reform, the Review will in particular focus on increasing devolution to the front line, enabling public service providers to respond flexibly to local needs.

**4.80** In Budget 2003, the Government announced that it would investigate a number of key issues to make the best of funding allocated in the 2002 Spending Review and to prepare the ground for the 2004 Spending Review. These reviews are focusing on the drivers of performance and efficiency in the public services, to help ensure that the public receives value for money for its investment and enjoys consistently high and continuously improving standards.

#### **Box 4.4: Choice in education**

The Government is committed to widening the variety of choices in education to enable all pupils to learn the essential skills that best match their needs and interests. Reform must ensure that every pupil has real and effective choice options – which in the past were constrained by the existence of weak and failing schools.

As new investment increases capacity in schools – with more and better head teachers, teachers, assistants, IT equipment and buildings – effective choice is improving for everyone. The number of failing schools is now lower than ever before. However, the Government is committed to making greater progress in reducing the scale of underperformance in coasting schools. Plans for personalised learning will lead many schools to become more responsive to individual pupils' needs, supported where appropriate by workforce reform, curriculum flexibility, extended schools and better links to children's and other local services. The enterprise pilots that started in September 2003, following the Davies review of enterprise and education, provide a good example of different learning experiences and skills that can widen meaningful choice options in line with particular pupils' needs.

# A

## COMPARISON WITH 2002 PROJECTIONS

**Table A.1: Comparing GDP growth and inflation between 2002 and 2003 Pre-Budget Reports**

|                                 | Per cent of GDP |       |            |       |            |            |                |            |
|---------------------------------|-----------------|-------|------------|-------|------------|------------|----------------|------------|
|                                 | 2002            |       | 2003       |       | 2004       |            | 2005           |            |
|                                 | 2002            | 2003  | 2002       | 2003  | 2002       | 2003       | 2002           | 2003       |
| GDP growth                      | 1 1/2           | 1 3/4 | 2 1/2 to 3 | 2     | 3 to 3 1/2 | 3 to 3 1/2 | 2 3/4 to 3 1/4 | 3 to 3 1/2 |
| RPIX inflation <sup>1</sup>     | 2 1/2           | -     | 2 1/4      | -     | 2 1/2      | -          | 2 1/2          | -          |
| CPI inflation (Q4) <sup>1</sup> | -               | 1 1/2 | -          | 1 1/2 | -          | 1 3/4      | -              | 2          |

<sup>1</sup>RPIX was replaced by CPI as the inflation target in the 2003 Pre-Budget Report

**Table A.2: Comparing public sector finances between 2002 and 2003 Pre-Budget Reports**

|   | Per cent of GDP |      |         |      |         |      |         |      |         |      |         |      |
|---|-----------------|------|---------|------|---------|------|---------|------|---------|------|---------|------|
|   | 2002-03         |      | 2003-04 |      | 2004-05 |      | 2005-06 |      | 2006-07 |      | 2007-08 |      |
|   | 2002            | 2003 | 2002    | 2003 | 2002    | 2003 | 2002    | 2003 | 2002    | 2003 | 2002    | 2003 |
| Current receipts                              | 38.3            | 37.6 | 39.3    | 38.1 | 39.9    | 38.9 | 40.4    | 39.5 | 40.6    | 39.9 | 40.8    | 40.2 |
| Current expenditure (inc depreciation)        | 38.9            | 38.7 | 39.7    | 39.8 | 39.7    | 39.5 | 39.9    | 39.9 | 40.0    | 39.8 | 40.1    | 39.9 |
| Surplus on current budget                     | -0.5            | -1.1 | -0.4    | -1.7 | 0.2     | -0.7 | 0.4     | -0.4 | 0.6     | 0.0  | 0.7     | 0.3  |
| Net investment                                | 1.4             | 1.0  | 1.8     | 1.6  | 1.9     | 1.9  | 2.0     | 2.0  | 2.1     | 2.1  | 2.2     | 2.2  |
| Public sector net borrowing                   | 1.9             | 2.1  | 2.2     | 3.4  | 1.6     | 2.6  | 1.6     | 2.4  | 1.5     | 2.1  | 1.5     | 1.9  |
| Cyclically-adjusted surplus on current budget | 0.2             | -0.6 | 0.3     | -0.8 | 0.6     | -0.1 | 0.5     | -0.1 | 0.6     | 0.0  | 0.7     | 0.3  |
| Cyclically-adjusted PSNB                      | 1.2             | 1.6  | 1.5     | 2.4  | 1.3     | 2.0  | 1.5     | 2.2  | 1.5     | 2.0  | 1.5     | 1.9  |
| Treaty deficit <sup>1</sup>                   | 1.8             | 2.1  | 2.2     | 3.3  | 1.7     | 2.6  | 1.6     | 2.4  | 1.6     | 2.1  | 1.6     | 2.0  |
| Treaty debt ratio <sup>2</sup>                | 37.9            | 37.9 | 38.8    | 39.3 | 38.9    | 40.2 | 38.9    | 40.8 | 39.1    | 41.1 | 39.2    | 41.4 |

<sup>1</sup> General government net borrowing on a Maastricht basis.

<sup>2</sup> General government gross debt on a Maastricht basis.

**Table A.3: Comparing public sector finances between 2002 and 2003 Budgets**

|   | Per cent of GDP |      |         |      |         |      |         |      |         |      |
|---|-----------------|------|---------|------|---------|------|---------|------|---------|------|
|   | 2002-03         |      | 2003-04 |      | 2004-05 |      | 2005-06 |      | 2006-07 |      |
|   | 2002            | 2003 | 2002    | 2003 | 2002    | 2003 | 2002    | 2003 | 2002    | 2003 |
| Current receipts                              | 38.7            | 37.6 | 39.9    | 38.6 | 40.2    | 39.2 | 40.4    | 39.8 | 40.5    | 40.1 |
| Current expenditure (inc depreciation)        | 38.4            | 38.7 | 39.2    | 39.4 | 39.5    | 39.4 | 39.8    | 39.7 | 39.8    | 39.7 |
| Surplus on current budget                     | 0.3             | -1.1 | 0.6     | -0.8 | 0.8     | -0.1 | 0.6     | 0.2  | 0.7     | 0.4  |
| Net investment                                | 1.4             | 1.2  | 1.8     | 1.7  | 1.9     | 2.0  | 2.0     | 2.1  | 2.1     | 2.1  |
| Public sector net borrowing                   | 1.1             | 2.3  | 1.2     | 2.5  | 1.1     | 2.1  | 1.4     | 1.9  | 1.4     | 1.7  |
| Cyclically-adjusted surplus on current budget | 0.5             | -0.5 | 0.6     | 0.2  | 0.7     | 0.5  | 0.6     | 0.4  | 0.7     | 0.4  |
| Cyclically-adjusted PSNB                      | 0.9             | 1.7  | 1.2     | 1.5  | 1.2     | 1.5  | 1.4     | 1.7  | 1.4     | 1.7  |
| Treaty deficit <sup>1</sup>                   | 1.0             | 2.3  | 1.1     | 2.4  | 1.1     | 2.1  | 1.4     | 1.9  | 1.5     | 1.7  |
| Treaty debt ratio <sup>2</sup>                | 36.9            | 38.0 | 36.6    | 39.0 | 36.5    | 39.4 | 36.6    | 39.6 | 36.8    | 39.9 |

<sup>1</sup> General government net borrowing on a Maastricht basis.

<sup>2</sup> General government gross debt on a Maastricht basis.

# B

## THE FISCAL IMPACT OF BUDGET POLICY DECISIONS

Budget policy decisions Table B.1: Budget 2003 policy decisions

|   | £ million                   |                    |                    |
|---|-----------------------------|--------------------|--------------------|
|   | (+ve is an Exchequer yield) |                    |                    |
|   | 2003-04<br>indexed          | 2004-05<br>indexed | 2005-06<br>indexed |
| <b>MEETING THE PRODUCTIVITY CHALLENGE</b>                                       |                             |                    |                    |
| 100 per cent first year capital allowances for ICT                              | -5                          | -160               | +70                |
| VAT flat-rate scheme upper limit of £150,000                                    | -15                         | -15                | -15                |
| Revalorise VAT registration and deregistration thresholds                       | 0                           | 0                  | 0                  |
| VAT: simplify the treatment of business gifts                                   | *                           | -5                 | -5                 |
| VAT: electronically supplied services   | +20                         | +25                | +30                |
| Simplified import VAT accounting  | -5                          | -20                | -20                |
| Improvements to research and development tax credit                             | -20                         | -40                | -50                |
| Employment benefits: deregulatory measures                                      | -5                          | -5                 | -5                 |
| Reform of North Sea infrastructure taxation                                     | 0                           | -15                | -20                |
| Life companies: change to policyholder rate and apportionment of profits        | -25                         | -40                | -40                |
| <b>INCREASING EMPLOYMENT OPPORTUNITY FOR ALL</b>                                |                             |                    |                    |
| Income tax: indexation of starting and basic rate limits                        | 0                           | 0                  | 0                  |
| Housing benefit disregard   | 0                           | -45                | -45                |
| <b>BUILDING A FAIRER SOCIETY</b>  |                             |                    |                    |
| <b>Supporting families and pensioners</b>                                       |                             |                    |                    |
| Child Trust Fund  | -350                        | -230               | -235               |
| Tax exemption for foster carers   | 0                           | -5                 | -5                 |
| Income tax exemption for reimbursed homeworking costs                           | -5                          | -5                 | -5                 |
| Extend hospital downrating exemption to 52 weeks                                | -30                         | -15                | -15                |
| Indexation of the pension schemes earnings cap                                  | 0                           | 0                  | 0                  |
| £100 payment for older pensioners   | -180                        | -180               | -180               |
| <b>Protecting tax revenues<sup>1</sup></b>                                      |                             |                    |                    |
| Tackling avoidance using equity remuneration and creating a fairer society      | +110                        | +90                | +95                |
| Capital gains tax: anti-avoidance involving second-hand life assurance policies | 0                           | +30                | +30                |
| Capital gains tax: countering avoidance schemes through offshore trusts         | 0                           | +5                 | +5                 |
| Loan relationships: closing loopholes   | +25                         | +50                | +50                |
| Tackling avoidance through sale and repurchase agreements                       | +30                         | +50                | +50                |
| Income tax: avoidance through relevant discounted securities                    | +20                         | +20                | +20                |
| Service companies: closing loopholes used by domestic employees                 | +15                         | +15                | +15                |
| VAT anti-fraud measures   | +225                        | +230               | +235               |
| VAT on continuous supplies  | *                           | +15                | +15                |

Table B.1 (cont): Budget 2003 policy decisions

|   | £ million                   |                    |                    |
|---|-----------------------------|--------------------|--------------------|
|   | (+ve is an Exchequer yield) |                    |                    |
|   | 2003-04<br>indexed          | 2004-05<br>indexed | 2005-06<br>indexed |
| <b>Duties and other tax changes</b>                                   |                             |                    |                    |
| Treatment of options for the purposes of tax on chargeable gains      | 0                           | +20                | +40                |
| Inheritance tax: indexation of threshold                              | 0                           | 0                  | 0                  |
| Electronic payment for large employers                                | 0                           | +10                | +10                |
| Introduction of gross profits tax for bingo                           | -20                         | -25                | -20                |
| Amusement machines licensing duty: freeze of rates                    | -5                          | -5                 | -5                 |
| General betting duty: minor amendments                                | +5                          | +5                 | +5                 |
| Tobacco duties: revalorisation of rates                               | 0                           | 0                  | 0                  |
| Alcohol duties: revalorise beer and wine, freeze other rates          | -35                         | -35                | -30                |
| <b>PROTECTING THE ENVIRONMENT</b>                                     |                             |                    |                    |
| Landfill tax: £3 increases from 2005-06                               | 0                           | 0                  | +140               |
| Climate change levy: freeze   | -20                         | -20                | -20                |
| Aggregates levy: freeze rates   | -10                         | -10                | -10                |
| Enhanced capital allowances for water efficient technologies          | -20                         | -30                | -25                |
| Enhanced capital allowances for additional energy saving technologies | -5                          | -5                 | -10                |
| <b>Transport and the environment</b>                                  |                             |                    |                    |
| Company car tax: emissions level for minimum charge                   | 0                           | 0                  | +125               |
| Fuel duties: revalorisation of rates from 1 October                   | -300                        | 0                  | 0                  |
| Fuel duties: new duty rate for bioethanol from January 2005           | 0                           | -5                 | -30                |
| Fuel duties: increase rebated oils by 1p above revalorisation         | +95                         | +95                | +100               |
| Air passenger duties: freeze of rates                                 | -25                         | -25                | -30                |
| Changes to Vehicle Excise Duty  | +30                         | +30                | +35                |
| VAT: Revalorisation car fuel scale charges                            | 0                           | 0                  | 0                  |
| <b>OTHER POLICY DECISIONS</b>   |                             |                    |                    |
| Recycled revenues from landfill tax increases                         | 0                           | 0                  | -140               |
| <b>TOTAL BUDGET MEASURES</b>  | <b>-505</b>                 | <b>-250</b>        | <b>+110</b>        |
| <i>* Negligible</i>   |                             |                    |                    |
| <b>ADDITIONAL BUDGET POLICY DECISIONS</b>                             |                             |                    |                    |
| Resetting of the AME margin   | +805                        | -980               | -1,750             |

<sup>1</sup> In addition, there was a further package of measures to modernise stamp duty (set out in Table A2.1 of Budget 2003). The original yield set out in Budget 2002 tables (Table 1.2 and A.1) were updated, and a reduced yield (by £10 million in 2003-04, and £100 million in 2004-05) was included in Budget 2003 fiscal projections.

Pre-Budget Report policy decisions Table B.2: Estimated costs of 2003 Pre-Budget Report decisions and others announced since Budget 2003<sup>1</sup>

|   | (+ve is an Exchequer yield) |              |             |             |
|---|-----------------------------|--------------|-------------|-------------|
|   | 2003-04                     | 2004-05      | 2005-06     | 2006-07     |
| <b>Raising productivity in an enterprise economy</b>                |                             |              |             |             |
| Improvements to the VAT flat-rate scheme                            | 0                           | -10          | -25         | -30         |
| Improvements to R&D tax credit schemes                              | 0                           | -15          | -25         | -25         |
| Capital allowances: increases in the thresholds defining SMEs       | 0                           | -100         | -170        | -125        |
| Corporation tax reform: extension of relief for management expenses | 0                           | -20          | -35         | -25         |
| Corporation tax reform: transfer pricing and thin capitalisation    | 0                           | +25          | +40         | +25         |
| Interest and royalties directive                                    | 0                           | *            | *           | +5          |
| <b>Increasing employment opportunity for all</b>                    |                             |              |             |             |
| Housing benefit: social sector Pathfinders                          | 0                           | 0            | -15         | -30         |
| <b>Building a fairer society</b>                                    |                             |              |             |             |
| Child Tax Credit: increase above earnings commitment                | 0                           | -885         | -925        | -955        |
| Employer supported childcare  | 0                           | 0            | -20         | -25         |
| Working Tax Credit for first time parents                           | 0                           | -10          | -10         | -10         |
| State pension: deferral; lump sum and increments                    | 0                           | 0            | -10         | -25         |
| Modernising National Savings and Investments                        | 0                           | 0            | +5          | +5          |
| VAT: cultural bodies  | -20                         | -25          | -25         | -20         |
| <b>Protecting tax revenues</b>                                      |                             |              |             |             |
| Foreign earnings deduction for seafarers (FED)                      | 0                           | +20          | +50         | +40         |
| Reform of the Construction Industry Scheme                          | 0                           | +20          | +40         | +80         |
| Reform of the taxation of trusts                                    | 0                           | +40          | +105        | +100        |
| VAT: abusive grouping   | 0                           | +50          | +70         | +65         |
| VAT: partial exemption special methods                              | 0                           | +50          | +55         | +50         |
| VAT: assignment of bad debts  | +5                          | +20          | +20         | +20         |
| Tackling alcohol fraud  | 0                           | +5           | +10         | +175        |
| <b>Total Pre-Budget report measures</b>                             | <b>-15</b>                  | <b>-835</b>  | <b>-865</b> | <b>-705</b> |
| <b>Additional Pre-Budget Report policy decisions</b>                |                             |              |             |             |
| Total special reserve allocation                                    | -2500                       | -300         | 0           | 0           |
| <b>TOTAL POLICY DECISIONS</b>                                       | <b>-2515</b>                | <b>-1135</b> | <b>-865</b> | <b>-705</b> |
| Extension to VAT strategy <sup>2</sup>                              | -5                          | +165         | +210        | +290        |
| <b>TOTAL DISCRETIONARY MEASURES</b>                                 | <b>-2,520</b>               | <b>-970</b>  | <b>-655</b> | <b>-415</b> |

\* Negligible

<sup>1</sup> Costings shown relative to an indexed base.<sup>2</sup> Net of additional resources allocated to HM Customs and Excise

# C

## FLEXIBILITY IN THE UK ECONOMY

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**C1** Annex C of this updated Convergence Programme is Annex C of the December 2003 Pre-Budget Report.

**C1** The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Reforms which promote flexibility and fairness are central to achieving this goal. Rapid technological progress and strong competition in global markets mean that the profitability and competitiveness of different industries and occupations are continually evolving. A flexible economy responds to such changes in economic conditions efficiently and quickly. A high degree of flexibility minimises disruptions to output and employment and helps an economy to sustain high rates of productivity growth and employment. Flexible and dynamic markets are therefore a precondition for economic strength. Flexibility is especially important when a country needs to adjust to a country-specific shock within a monetary union, where monetary policy at a national level is not an option.

**C2** The Government is committed to advancing flexibility and fairness together by enabling individuals and firms to cope with and respond to change. By investing in education and training, it has helped to equip people to adapt to new and changing employment opportunities. The National Minimum Wage and reforms to the tax and benefit system help to cushion the impact of economic shocks on household incomes, while high-quality and responsive services such as Jobcentre Plus provide incentives and practical support to enable people to rapidly enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

**C3** In his statement to the House of Commons on 9 June 2003 on UK membership of the single currency,<sup>1</sup> the Chancellor gave a commitment to publish six-monthly reports on trends and progress in labour, product and capital markets. This document is the first of these six-monthly flexibility reports. It complements a range of other information which the Government produces on economic developments and structural policy reforms in both the UK and internationally, particularly across Europe. This report records progress on the Government's reforms of labour, product and capital markets, which promote flexibility and fairness.

**C4** This annex is divided into two sections:

- the first section explains the importance of a flexible economy and the Government's approach of combining flexibility with fairness; and
- the second section sets out the action the Government has taken to boost flexibility in labour, product and capital markets since Budget 2003 and in this Pre-Budget Report.

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<sup>1</sup> Available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

## WHY FLEXIBILITY MATTERS

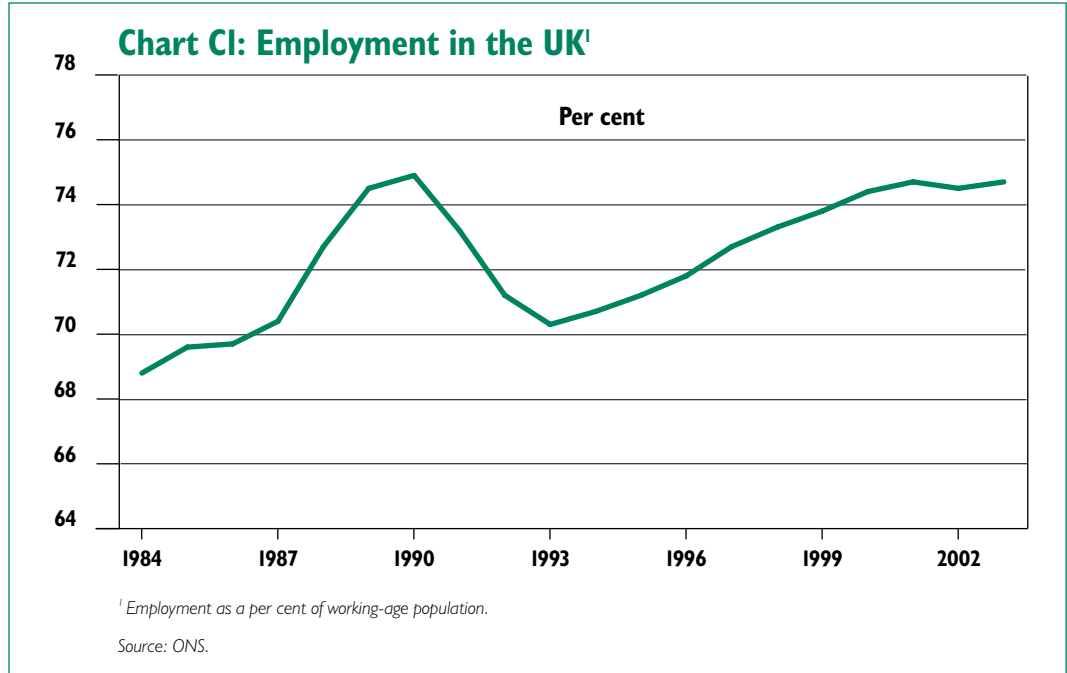
**Why flexibility is needed** **C5** Flexibility is the ability of firms and individuals to respond to economic change efficiently and quickly. Economic change can come in many different forms. Economic growth is driven by continual advances in technology that increase the efficiency with which existing goods and services can be produced and increase the range of goods and services that are provided. In addition, shifts in consumer demand for different products, the opening up of new markets, the emergence of new competitors and improvements or disruptions to the supply of natural resources all have important effects on the profitability of different firms and industries.

**C6** In recent years, advances in information and communications technology, the increased integration of emerging markets with the global economy and significant movements in the price of oil have been prominent developments affecting industry. However, individual firms and households may also be affected by more localised changes that affect particular industries or particular firms within an industry. In a global age, such changes are happening faster than in the past. As a result, the economy is continually undergoing a process of structural change, in which the amount of labour and capital required by some industries declines, freeing up resources that may be profitably used in the production of new goods and services.

**Characteristics of flexibility** **C7** Economic flexibility describes an economy's capacity to adjust to such changes. There are many different ways in which workers and firms can adjust to change. For firms, adjustment may involve altering prices or changing a product line. For a worker, adjustment may mean learning a new skill, accepting a lower wage increase, moving into a different job in the same firm or even changing employer. Adjustment is achieved by a combination of changes occurring in the labour, product and capital markets. This can be supplemented if necessary by complementary changes in the stance of monetary and fiscal policy. Flexibility is about minimising the costs of adjustment.

**C8** A flexible economy has the ability to adjust smoothly and rapidly, with movements in relative prices and quantities that enable the economy to maintain high levels of output and employment. However, stability at the macro-economic level may disguise considerable changes at a more disaggregated level. Between 1995 and 2003, UK employment grew by 2.2 million, but with marked differences in the rate of growth even at a broad level of industry aggregation.

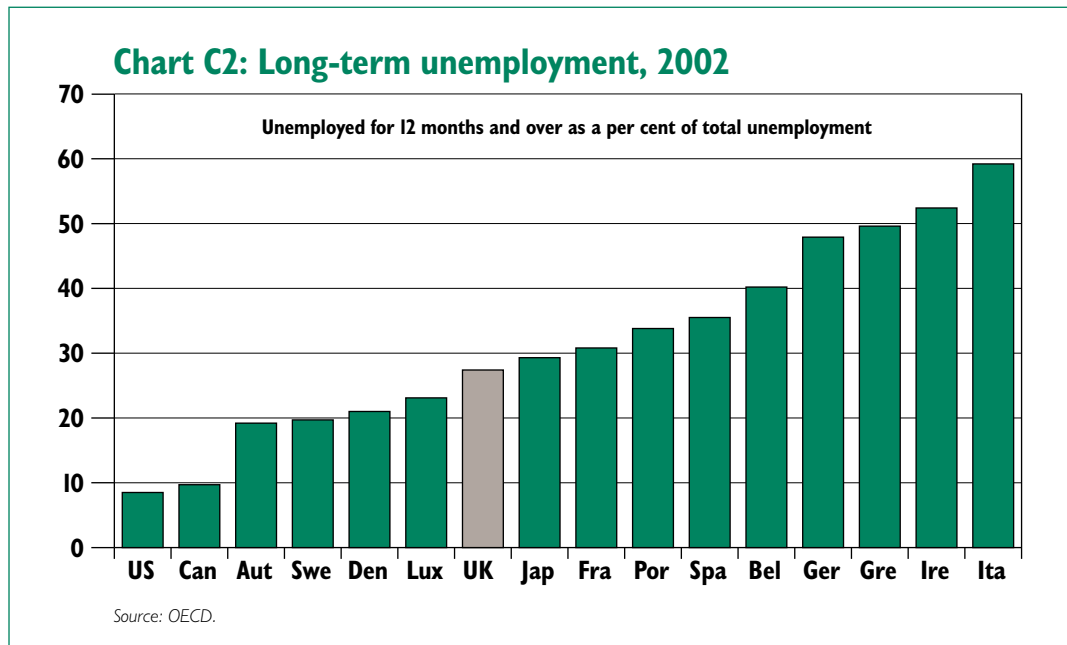
**C9** In an inflexible economy, weak adjustment capacity increases the likelihood that adjustment will be slower and more disruptive. In the worst case, output and employment may be permanently affected. This is a particular risk when the economy experiences substantial disruptions. For example, the 1991-92 recession led to the employment rate in the UK falling from 75 per cent in 1990 to around 70 per cent in 1993 and it was not until 2001 that it returned to its 1989 level, as shown in Chart C1. The effect was particularly acute for older male workers, many of whom were forced into involuntary early retirement. As a result, both personal incomes and national income were lower than they would have otherwise been.



**Flexibility and recent economic performance**

**C10** In recent years there have been striking differences in the performance of the leading industrial nations which appear to be associated with the overall flexibility of their economies. Between 1995 and 2002 labour productivity in the US grew by 2 per cent per annum on average, compared with 1.6 per cent in the UK and 1 per cent in the EU. While this partly reflects differences in the macroeconomic policy stance between countries, much of the difference appears to be more deep-seated, reflecting structural differences. The OECD estimates that the structural rate of unemployment in the euro area in 2003 is 8.1 per cent, compared with 5.2 per cent in the UK and 5.1 per cent in the US.

**C11** Chart C2 illustrates that the UK has lower rates of long-term unemployment compared to a number of other major European countries. This is partly as a result of the New Deal regime, which has been effective at reducing long-term unemployment. However, the chart shows that the rate of long-term unemployment in the UK still remains above the low levels achieved in the US and Canada.



**CI2** Policies that impact on labour, product and capital markets are an important determinant of the overall balance between flexibility and fairness in different economies. In the US, the minimum wage and Earned Income Tax Credit combined with low benefit replacement rates create a strong incentive for displaced labour to find new employment. In addition, relatively unrestrictive employment protection legislation has reduced the cost of providing employment and encouraged job creation. However, relatively ungenerous levels of out-of-work support mean that periods of unemployment can result in large reductions in family incomes. Well-developed capital markets in the US, including a vibrant venture capital market, have provided finance for business creation and expansion, and support an already strong entrepreneurial culture. These features have enabled the US to be at the forefront of developing and exploiting advances in information and communications technology (ICT). However, the US provides lower levels of publicly funded support to its citizens. For example, it does not have a national health insurance programme and 14 per cent of the population has no insurance coverage. The costs of health care are high and many Americans are at risk of being uninsured at some point in their lives.

**CI3** In Europe, labour market policy has placed greater emphasis on mitigating the effects of change. In many European countries relatively generous benefit systems help insure households against labour market shocks but at the same time reduce incentives for claimants to return to and progress in work, leading to relatively high structural levels of unemployment. These effects are to some extent mitigated by active labour market policies, especially in the Nordic countries. Furthermore, in some countries overly restrictive legislation governing conditions of employment has placed significant constraints on employers. The effect of these restrictions on overall flexibility is partially offset by high functional flexibility of the workforce as a result of effective workforce training programmes.

**CI4** Product market competition is more restricted in Europe than in the US, with some markets strongly segmented along national lines, particularly in utility and service industries. Similarly, capital market integration has been impeded by regulations that have restricted cross-border capital flows. EU Member States have committed themselves to a programme of economic reform to further promote the integration of European labour, product and capital markets. While there has been welcome progress in some areas – including modernisation of the EU's competition regime, steps towards liberalisation in markets such as energy and telecommunications, reform of the state aid regime, and increased employment – more work is required to deliver improved outcomes for the EU economy. As in previous years, the Government will publish a progress report on European economic reform ahead of the Spring European Council in March 2004.

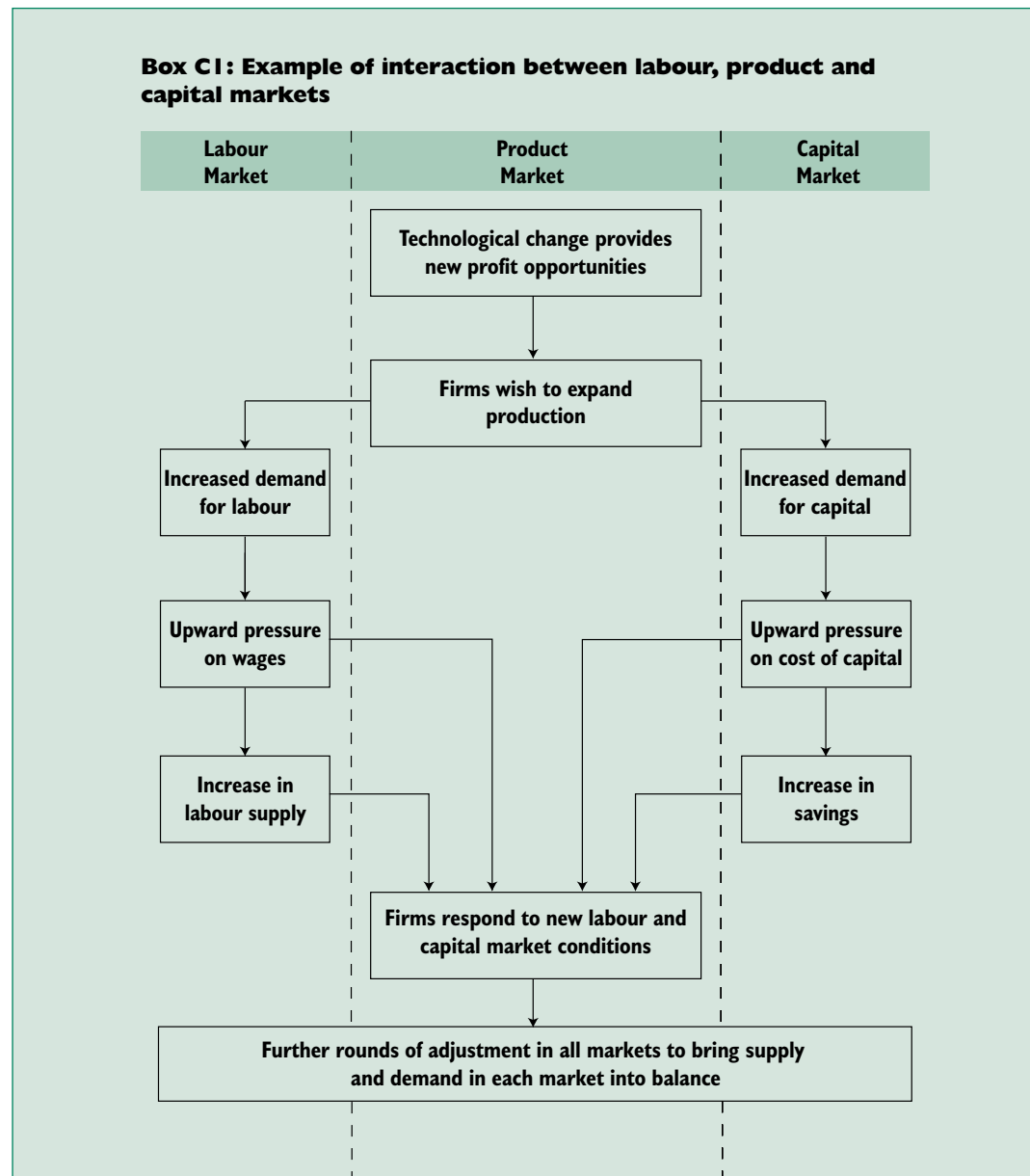
## **The UK's approach: combining flexibility and fairness**

**CI5** The Government's objective is to build a stronger, more enterprising economy and a fairer society, maintaining stability and ensuring rising living standards for all. This entails an approach to economic reform that advances flexibility and fairness together, combining the best features of the US and European systems. Investment in education and workforce skills help individuals adapt to change. Reforms to the tax and benefit system provide national guarantees through a National Minimum Wage and a national tax credit system that help to insure households against fluctuations in their incomes while at the same time strengthening incentives to participation in the labour market. The Welfare to Work strategy provides assistance with job search and training. The Government's approach to increasing employment for all is discussed in more detail in Chapter 4 of this Pre-Budget Report, and its strategy for building a fairer society is set out in Chapter 5. The Government's reforms to the competition regime encourage firms to respond quickly to changes in market conditions and help to ensure that key product markets work better for consumers. The Government has also

increased support for basic and applied research, encouraging innovation and helping businesses to harness the potential of new technologies. Policies such as the Savings Gateway, Child Trust Fund and ISAs have expanded access to capital markets and spread the benefits of saving and asset ownership. Investment in strong and flexible public services has helped to make them more efficient and responsive and extended opportunity and security for all.

### Flexibility in labour, product and capital markets

**C16** The overall flexibility of the economy depends on the interaction of flexibility in the labour, capital and product markets, as illustrated in Box C1. This interdependence implies that the overall flexibility of the economy depends on each market working as effectively as possible. The diagram illustrates how changes originating in the product market are transmitted to the labour and capital markets and back to the product market. Further rounds of adjustment and feedback will occur until the balance of supply and demand is restored in each market. Changes originating in labour and capital markets, for example, as a result of tax and benefit changes which affect labour supply or a change in risk aversion affecting the cost of capital, will similarly be transmitted to other markets, with the economy's overall adjustment reflecting the interactions between all three markets.



**Labour market flexibility C17** The performance of the labour market is central to the well being of the economy and society. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes. Backed up by policies which equip people to adjust rapidly to change and provide support for those who are not in employment, it implies an economy that is fairer, more competitive and more productive.

**C18** The key characteristics of a flexible labour market are that:

- wages adjust to maintain the balance between labour supply and labour demand;
- the labour force is equipped with transferable skills that employers require, enabling the rapid redeployment of labour within or between firms when labour demand changes;
- firms do not find it prohibitively costly to create employment or to vary it when needed;
- workers are able easily to commute or move residence in order to find employment;
- working patterns meet the needs of both employers and employees, increasing labour supply; and
- there is an institutional environment that encourages labour force participation, equips people to adapt rapidly to change and provides support for those without employment, enabling them to remain active participants in the labour market.

**C19** Chapter 4 of this Pre-Budget Report sets out the Government's overall strategy for ensuring employment opportunity for all. Achieving this aim requires a flexible labour market in which people are equipped to make effective and informed labour market choices. New measures introduced since Budget 2003 that promote flexibility and fairness in the UK labour market are summarised in the second section of this report.

**Product market flexibility C20** Product market flexibility relates to the ease with which firms are able to respond to changing market conditions. For individual firms or industries increased flexibility enables them to respond rapidly, allowing firms to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive market environment.

**C21** The main characteristics of a flexible product market are that:

- there is a competitive environment which rewards efficiency, discourages waste and provides firms with strong incentives to adapt the range and quality of their goods and services to provide their customers with good quality products at competitive prices;
- there is a strong capacity for innovation, enabling firms to develop and implement new processes and products ahead of their competitors;
- there are low barriers to entry which allow new firms to challenge incumbents creating incentives for innovation and efficiency; and

- a regulatory environment in which the constraints on business yield clear benefits to the wider economy and are not disproportionately costly in terms of their effect on firms' incentives to hire, train, innovate and invest.

**Capital market flexibility** **C22** Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively. Efficient capital markets ensure that businesses, entrepreneurs and innovators have ready access to the funds that they require in order to develop their ideas. Capital markets also play an important role in balancing the risks and returns of different uses of capital, screening out projects that have an unacceptably high level of risk.

**C23** Flexible capital markets can also play a role in underpinning flexibility in labour and product markets. They should, for example, allow individuals to borrow when necessary in order to enhance their education and skills, with beneficial effects on productivity and on the employability of the individuals concerned. In product markets, flexible access to finance should allow firms to reallocate resources efficiently and to invest as appropriate in new processes and products.

**C24** A flexible capital market can also promote fairness by enabling all individuals to take advantage of educational and business opportunities. However, government intervention may on occasions be required to ensure that information asymmetries do not lead to some individuals being unfairly denied access to capital markets.

**C25** The main characteristics of a flexible capital market are that:

- borrowers have a range of financing options available to them that allow them to access the capital they require at a competitive price and on competitive terms. This applies particularly to firms seeking capital for high risk projects, where efficient capital markets are best placed to price the risk appropriately;
- investors have the ability to hold a diversified portfolio of assets spread across regions and sectors, so that they can use income from these assets to insure against a fall in income that is specific to their own region and sector; and
- there is sufficient borrowing and lending capacity on credit markets to allow households and business to smooth fluctuations in income.

**Flexibility and the productivity challenge** **C26** Many of the important characteristics of a flexible economy are also key drivers of productivity growth. The ability to switch resources readily between firms and industries improves the economy's resilience in adverse market conditions and its capacity to develop and implement the technological advances and organisational changes that raise productivity and wages. Chapter 3 of this Pre-Budget Report sets out the Government's overall strategy for promoting productivity and enterprise in the UK economy through reforms which boost competition, enterprise, skills, innovation and investment. New measures introduced since Budget 2003 which promote product and capital market flexibility are summarised in the next section of this report.

## MEASURES TO PROMOTE FLEXIBILITY

**C27** This section of the report summarises the action the Government has taken since Budget 2003 and in this Pre-Budget Report to promote flexibility and fairness in the UK economy.

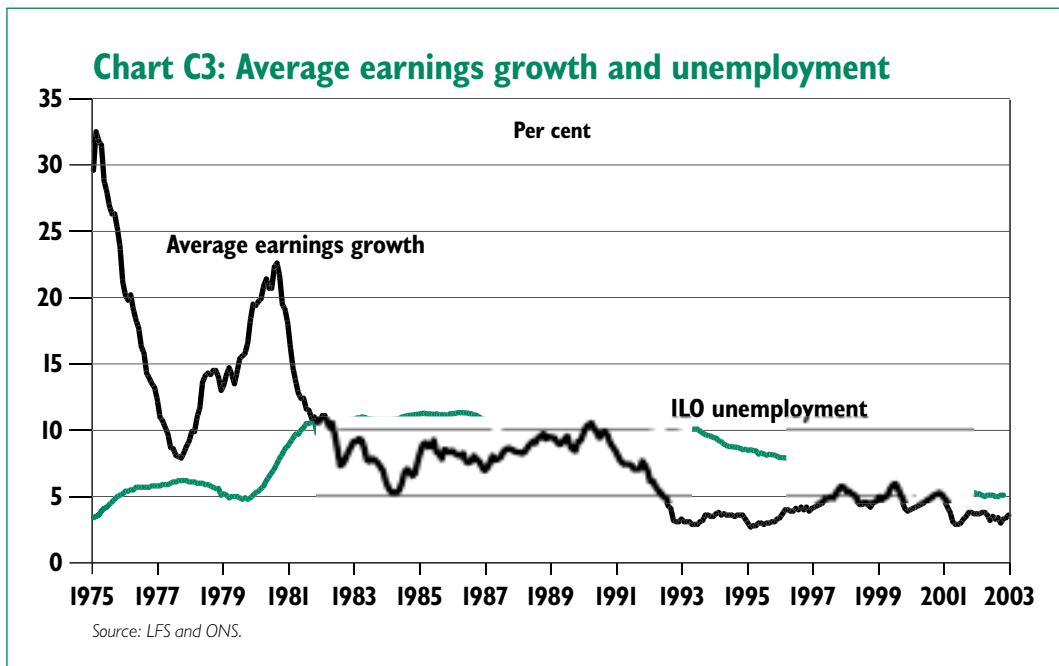
## Measures to promote flexibility and fairness in labour markets

**C28** The Government's long-term goal is employment opportunity for all – the modern definition of full employment. Its strategy involves maintaining macroeconomic stability and promoting an enterprising economy with a dynamic and flexible labour market in which people are able to make effective and informed labour market choices. The Government has introduced a range of measures to advance flexibility and fairness in the UK labour market.

### Enhancing wage flexibility

**C29** In the labour market, as in other markets, price adjustment is an important factor that ensures that the market mechanism functions effectively. Wage levels are a major determinant of the supply of and demand for labour. A dynamic and flexible labour market requires wages to respond flexibly to shocks and to imbalances between supply and demand, both at the aggregate and sectoral level.

**C30** Historically the UK has had to contend with accelerating wage inflation in the face of low levels of unemployment. However, as Chart C3 shows, in the most recent labour market upswing unemployment has fallen to historically low levels but the rate of wage growth has remained consistent with the inflation target and trend productivity growth of 2 per cent – a development consistent with the estimated fall in the structural unemployment rate since the early 1990s. This improvement in part reflects the successful reintegration of the long-term unemployed and marginalised groups into the labour market, which helps to ensure that the economy does not run into labour supply bottlenecks. This strategy is discussed later in this annex.



**C31** In an efficient labour market, wages should move to balance the supply of, and demand for, labour in regional and local labour markets. This process can be impeded by national pay agreements that fail to take account of local and regional conditions. The Government has amended the remits for the Pay Review Bodies to include a stronger local and regional dimension and is working with the rest of the public sector to increase the focus on respecting local pay conditions, side by side with UK-wide guarantees of a National Minimum Wage and the tax credit agenda.

**Allsopp Review C32** In light of the growing regional productivity and flexibility agenda, Christopher Allsopp was asked in February 2003 to undertake a review of statistics for economic policy-making and to produce a first report by the time of the Pre-Budget Report:

- the first report, described in more detail in Annex A, makes a number of recommendations **to improve the quality and availability of regional data**, including price and labour market data, to satisfy the growing demand for such data over the medium-term.

**Promoting geographic mobility C33** A labour force that is able to move within and between regions enhances labour market flexibility by enabling workers to move to available employment opportunities. In the UK geographic labour mobility is low compared to the US, as is the case elsewhere in Europe. The Government has been introducing a number of policies that aim to raise the ability and willingness of workers to commute or move location in order to find employment.

**C34** The current Housing Benefit system is complex and can reduce work incentives and create barriers to geographic mobility. The Government has announced a number of Housing Benefit reforms to address these problems, discussed in more detail in Chapter 4. These include the piloting of a new local housing allowance (LHA) for tenants in the private sector in nine Pathfinder areas. This will give recipients greater certainty as to their level of entitlement and so increase their ability to choose where to live. In this Pre-Budget Report the Government announces:

- the intention to begin **LHA Pathfinders in the social sector** as soon as practical.

**C35** The Government has introduced housing and planning reforms to increase housing supply and in turn make it easier for households to access employment opportunities wherever they occur. Analysis of the importance of housing market flexibility is provided in Box C2. The Deputy Prime Minister's Sustainable Communities statement in February 2003 detailed plans for a significant increase of 200,000 homes over and above existing plans by 2016. This will be backed by planning reforms to ensure local authorities make plans for at least ten years potential supply of housing, while prioritising brownfield development and driving up density. In this Pre-Budget Report, the Government:

- welcomes **the interim report of the Barker Review** on the factors affecting housing supply in the UK, discussed in more detail in Chapter 3, and looks forward to the final report in spring 2004;
- announces its intention to issue a consultation document on **tax transparent property investment trusts** at Budget 2004; and

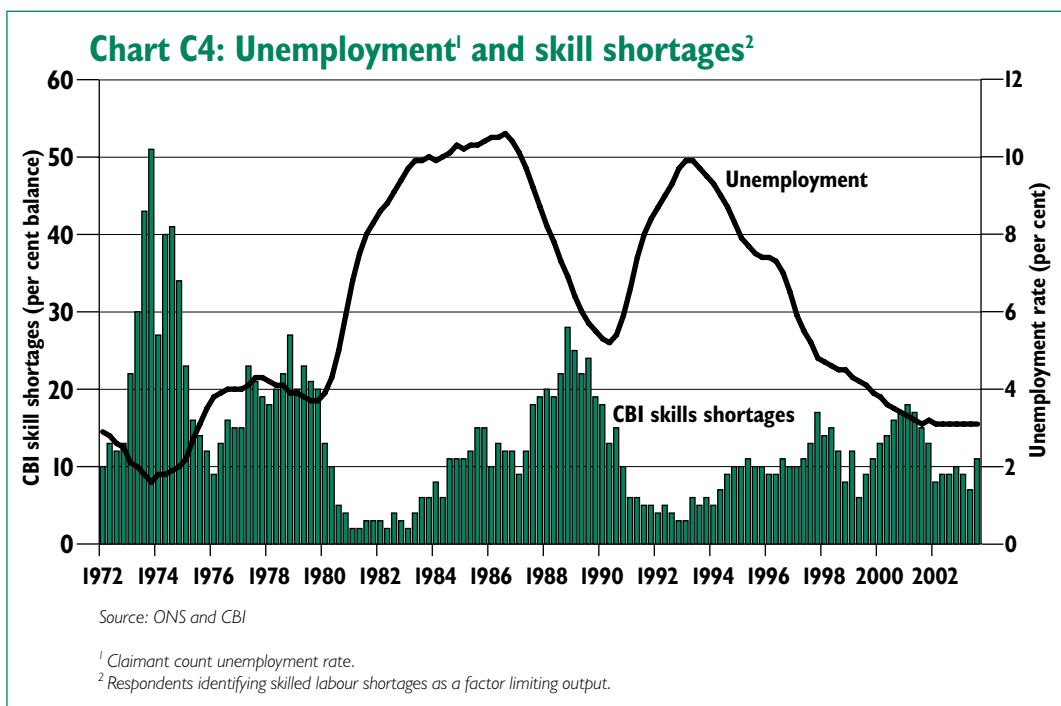
- welcomes **Professor David Miles' interim review of the supply and demand side factors limiting the development of the fixed rate mortgages** in the UK, discussed in detail in Chapter 2, and looks forward to the final report at the time of Budget 2004.

### Box C2: Housing and flexibility

A stable and flexible housing market is essential to a healthy economy as housing market imbalances are a potential brake on economic development. The cost and availability of housing influences the geographical distribution and mobility of the labour force and may affect capacity levels in local labour markets. Conditions in local labour markets affect firms' location decisions and hence an inefficient housing market may also constrain investment and production decisions, influencing the longer-term development of local economies. In addition, volatility in housing markets affects the wider economy through private consumption, since changes in housing wealth affect the level of household spending. As movements in housing wealth are strongly pro-cyclical, this link tends to amplify the economic cycle. Consequently reduced volatility in housing markets could further promote macroeconomic stability.

The Government is committed to a comprehensive programme of action to improve the functioning of the UK housing market and to ensure a better match between the supply and demand for housing. The objective is to reduce the extent to which housing considerations may constrain labour market adjustment. The Government's reform programme is discussed in detail in this Pre-Budget Report and summarised in this annex.

**Developing skills C36** The quantity and quality of skilled labour in an economy are important determinants of economic performance and productivity growth. Skilled workers adapt faster and more effectively to change. They increase the ability of a firm to update its practices and products at the rate demanded by changing markets, making the economy more flexible. Chart C4 illustrates that in the past skills shortages have acted as a significant constraint on economic growth. While shortages have been less acute in recent years, improving skills acquisition remains fundamental to the long-term health of the economy.



**C37** The Government is committed to further action to develop skills. This Pre-Budget Report sets out a number of steps the Government has taken to develop workforce skills and so enhance flexibility in the UK, discussed in more detail in Chapter 3:

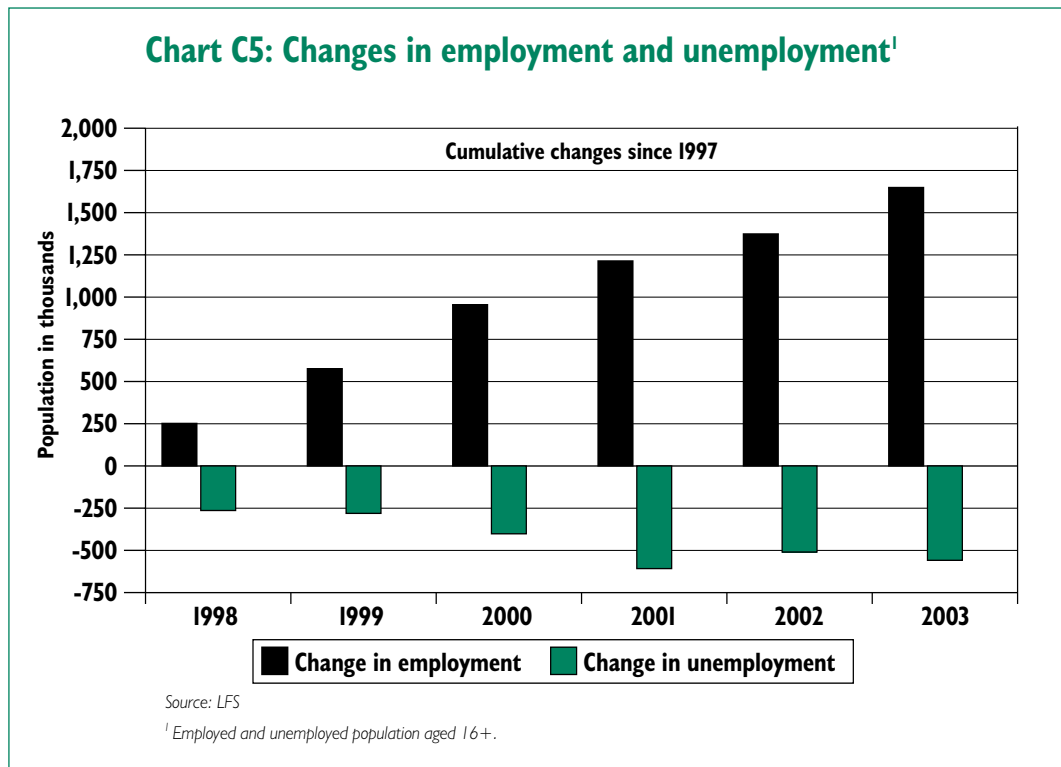
- the **extension of Employer Training pilots** to encourage skills training for a third year and to cover over a third of England;
- the publication of a **discussion paper on delivering incentives for membership bodies to provide workforce development**; and
- implementing measures announced in Budget 2003 to support the contribution migration makes to creating a skilled and flexible workforce, including changes to enhance the **Highly Skilled Migrant Programme**, and a new entitlement for international science and engineering students to work in the UK after graduation.

**Employment flexibility C38** Employment flexibility describes the provision of a range of working patterns that allow both employers and employees to find an arrangement that best meets their respective needs. Part-time and temporary work gives employers the flexibility to vary capacity levels and employees scope to balance their work and other responsibilities. Diverse patterns of employment can achieve a more efficient matching of labour demand and supply.

**C39** The UK labour market shows a significant degree of employment flexibility, with a high incidence of part-time work, a wide distribution of hours worked and widespread adoption of flexible working practices, all of which are primarily a result of employee choice. However, employment flexibility can be increased further. The Government is keen to promote diverse forms of employment including the take up of self-employment. It is currently introducing a number of measures to promote employment flexibility, discussed in more detail in Chapters 4 and 5:

- a Small Business Services Review of the **routes off benefits into self-employment**, to report in spring 2004;
- promoting the **provision of employer supported childcare**; and
- an increase in the returns from **deferring the state pension**, promoting choice for those who wish to extend their working lives.

**Improving labour market opportunities C40** Since 1997, unemployment in the UK has fallen to levels last seen in the 1970s, the number of people in jobs has risen by 1.7 million and the employment rate is the highest in the G7, as illustrated in Chart C5.



**C4I** While this performance is strong both by historical and international standards, not all groups have shared equally in the success. Employment opportunity for all means that everybody is given the right assistance and the right choices to return to the labour market while at the same time ensuring support for those that cannot work. Chapter 4 describes the measures the Government has introduced to provide opportunity and choice for all, including extensive programmes of support for those groups with special circumstances, such as the long-term unemployed, lone parents, partners of benefit claimants and sick and disabled people. The Government is also targeting support for people in disadvantaged areas and for ethnic minorities. In Chapter 4 of this Pre-Budget Report the Government announces further help for these groups:

- **enhanced help for lone parents**, increasing the number of work-focused interviews lone parents with children aged 14 or over are required to attend, and providing help with childcare costs in the week before starting work;
- **improving work incentives** in London by extending pilots of the £40 per week in-work credit to parents, including lone parents, who have been on certain benefits for a year or more;
- **extra support to help the unemployed**, by piloting mandatory short intensive work-focused courses at the six-month stage;
- an extension of eligibility for the **enhanced New Deal for partners**;
- **an extension of back to work help for those aged 60 and over and on the Pension Credit** by October 2004;
- **extra help for sick and disabled people**, enabling Jobcentre Plus personal advisers to provide additional voluntary support to Incapacity Benefit customers who want to return to work; and
- the existing Action Teams will be extended, two additional **Action Teams** will be introduced and Action Teams will have greater discretion to direct resources towards the most disadvantaged people.

## Measures to promote flexibility and fairness in product markets

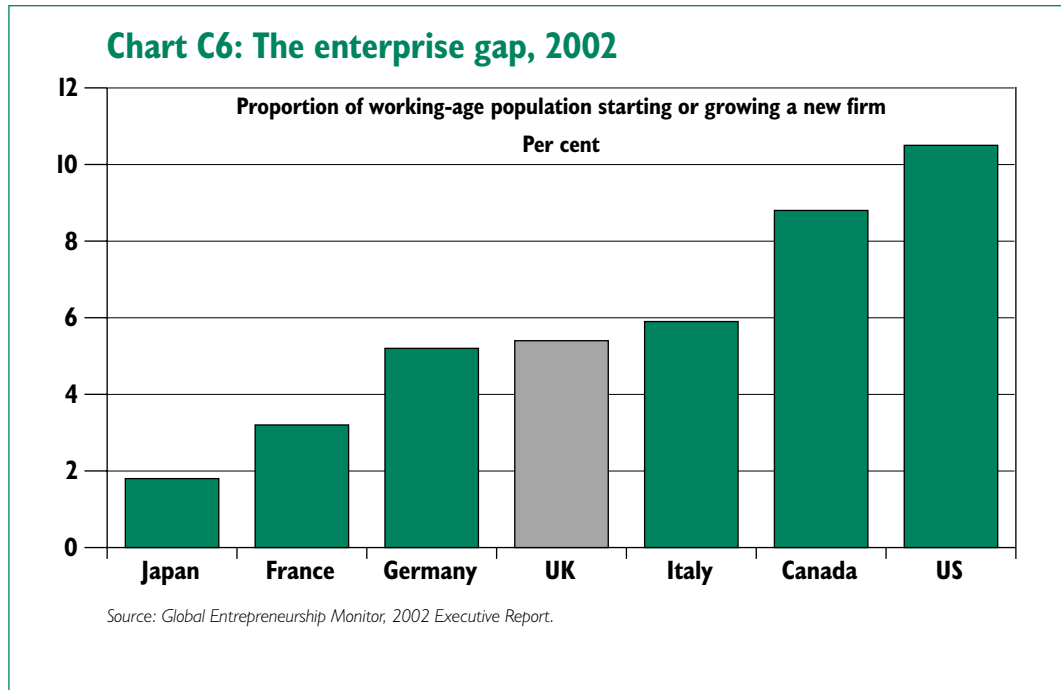
**C42** Chapter 3 of this Pre-Budget Report sets out the Government's programme of reform aimed at promoting flexibility and boosting productivity growth in the UK economy by focusing on measures which boost competition, enterprise, innovation, skills and investment.

**Competition C43** Competition boosts flexibility by providing incentives for firms to respond quickly to changes in market conditions, technology and costs. Competition increases the incentives for firms to adopt more efficient working methods and to develop new products and services that meet the changing demands of consumers. The Government is committed to promoting competition in the UK economy and has taken significant steps to ensure that the UK competition regime ranks among the best in the world. The Enterprise Act (2002) has given full independence to UK competition authorities and given the Office of Fair Trading (OFT) more proactive powers to investigate markets where competition may be restricted or distorted. Empowered consumers promote competition in markets by providing signals and incentives for firms to respond quickly. Since Budget 2003 the Government has taken further steps to enhance competition, empower consumers and promote flexibility, discussed in more detail in Chapter 3:

- an independent review into regulation of the **legal services market** aimed at promoting competition and innovation will report in December 2004;
- a review of the **Financial Services and Markets Act (FSMA)** including an assessment of its impact on competition; and
- measures to **improve competition in the supply of goods and services to the Government**.

**C44** Government is also introducing a number of measures to promote competition in specific markets, discussed in further detail in Chapter 3.

**Enterprise C45** The Government is committed to building an enterprise society in which people from all backgrounds can consider and act on opportunities for enterprise. A strong entrepreneurial culture means that the economy is better equipped to identify and develop the opportunities offered by new technologies, new products and new markets, and generate new sources of income when existing production techniques and products lose their competitiveness. Chart C6 illustrates that the entrepreneurial culture in the UK is not as highly developed as in the US and Canada, where a much higher proportion of the population is engaged in starting or growing new firms.



**C46** In this Pre-Budget Report the Government has taken the following new steps to promote enterprise in the UK economy, discussed in more detail in Chapter 3:

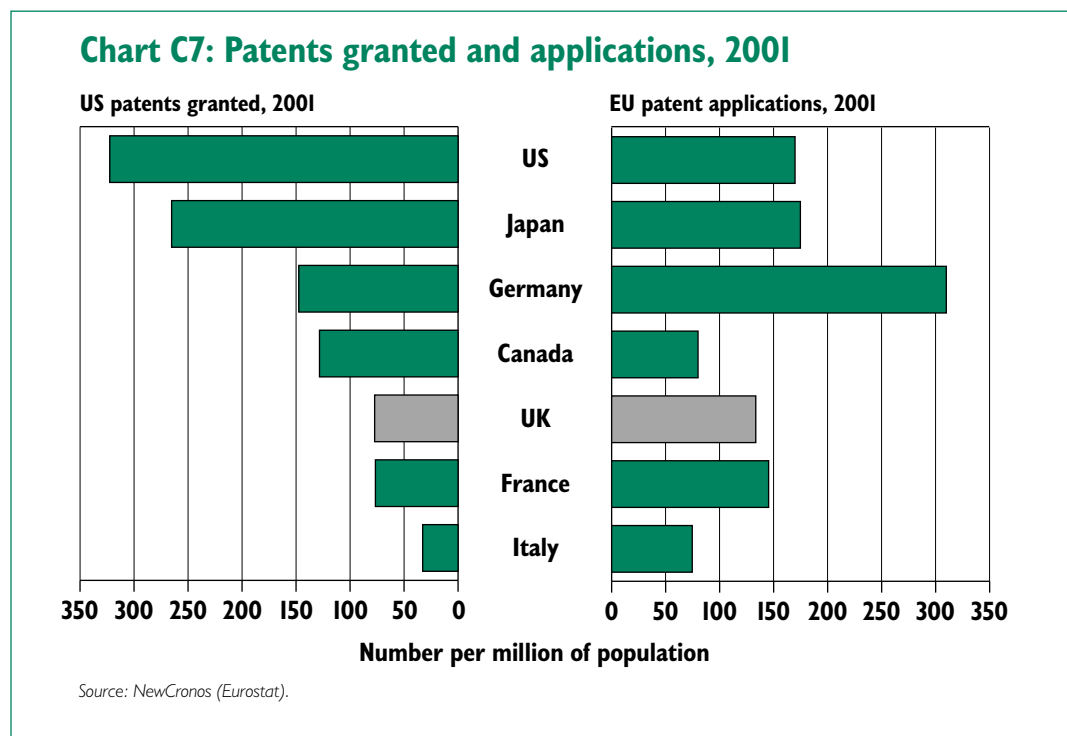
- the **launch of a new [businesslink.gov.uk](http://businesslink.gov.uk) website**, which will provide an online service for business advice;
- measures to support regional growth, **including details of the Local Authority Business Growth Incentives Scheme**, which will boost the role of local authorities in business growth;
- **reforms to reduce the regulatory burden on enterprise**, including the recent announcement of an increase in the statutory audit threshold to £5.6 million; and
- measures which will ensure **greater stability within the regulatory system** such as considering an extension of the common commencement date commitment for employment law to other areas of regulation, subject to the findings of the current DTI pilot.

**C47** The Government has introduced significant reforms to modernise the business tax system and promote enterprise and flexibility. The Government has already cut the main and small companies' rates of corporation tax from 33 and 23 per cent to just 30 and 19 per cent. It has also introduced a generous capital gains tax taper for business assets – so that the UK now has one of the most favourable Capital Gains Tax (CGT) regimes in the world. This Pre-Budget Report announces further measures, discussed in more detail in Chapter 3:

- **improvements to the VAT flat rate scheme**, including new lower rates, to enable more businesses to benefit fully from compliance savings; and
- a package of other **measures to improve the business tax system**.

**Science and Innovation C48** Through innovation business can harness the potential of new technologies and promote more efficient ways of working. Successful innovation extends the range of products that the economy can produce and reduces the costs of existing production methods. Both developments increase the productive potential of the economy and improve its resilience to global competition. However, the UK lags behind its major international competitors in some important aspects of innovation performance, for example, in terms of patents applied for and granted (Chart C7). The Government is pursuing various measures to promote innovation in the UK economy, discussed in more detail in Chapter 3. This Pre-Budget Report describes the steps the Government is taking including:

- a new, clearer and more accessible **R&D tax credit definition**; and
- the publication of the **Lambert Review of Business-University collaboration**.



**Investment C49** Investing in new technology and capital is important if firms are to respond to new opportunities in a competitive and entrepreneurial way. Where there are financial or structural barriers to new investment, firms' competitiveness will be constrained. In addition, investment in underlying infrastructure can help to facilitate flexibility in wider labour and product markets by making both labour and products more mobile. The Government has today announced the following steps to promote investment in the UK economy, discussed in more detail in Chapter 3:

- an increase in the **qualification thresholds for SMEs** to allow more businesses to benefit from higher first year capital allowances; and
- a proposed scheme for a **Business Premises Renovation Allowance**, subject to state aid approval.

**Planning reform C50** The Government is committed to reforming the planning system to make it more strategic, streamlined and flexible, helping to deliver the Government's objectives of increasing enterprise and productivity and promoting investment. Key measures will be introduced in the first Planning Bill for more than a decade, which is expected to receive Royal Assent by Spring 2004. The reforms include the abolition of county structure plans, the introduction of a more flexible local development plans system and legislation for Business Planning Zones to speed up development in disadvantaged areas. The Government will be issuing a revised planning policy statement on town centres in England, for consultation, which aims to encourage investment and growth in town centres. It is also undertaking reform of planning obligations, addressing potential delays in negotiated section 106 agreements by proposing a new optional planning charge which developers could choose to pay in place of a conventional negotiated agreement. The planning system is also one of the important factors considered by the Barker Review in its study of housing supply in the UK.

## Measures to promote flexibility and fairness in capital markets

**C51** Capital markets contribute to the flexibility of the economy by providing entrepreneurs and firms with the finance that they require to fund their activities. A flexible capital market ensures that finance is provided at the lowest price appropriate to the investment risk borne by the provider. Efficient capital markets enable individuals to smooth out fluctuations in their income by offering a wide range of saving vehicles and allowing individuals to borrow prudently against future income.

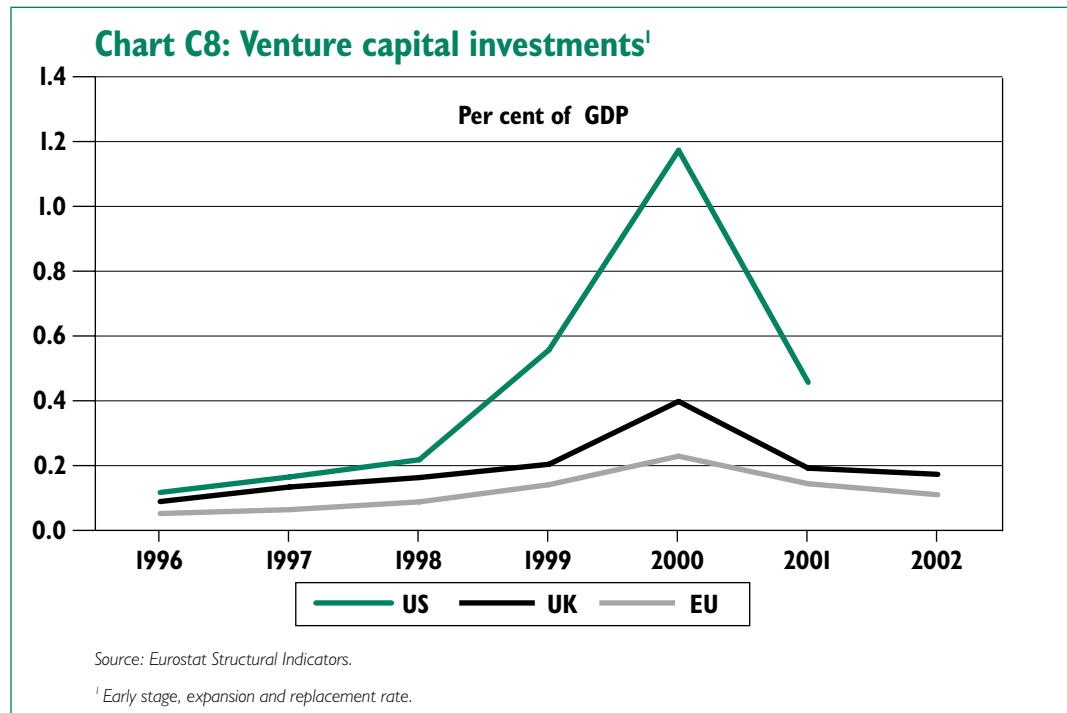
**Securities settlement C52** The ability of companies to raise capital in a cheap and flexible manner is important in allowing them to respond to market developments and to drive forward their efforts to raise their business performance. An important part of achieving cheap and flexible access to capital is having an efficient securities settlement system. Electronic settlement can bring cost savings for issuers and investors, and increase flexibility in the issuance of securities. In 1998 the Bank of England produced a Securities Settlement Priorities Review. In response to the review's final outstanding recommendation the Government:

- legislated in June 2003 to allow for the **electronic settlement of money market instruments, and migration of money market instruments** to an electronic settlement system was completed in October 2003.

**SME Finance C53** The ability to access external sources of finance is essential if small businesses are to take full advantage of the investment opportunities available to them. Access to funds enables entrepreneurs and innovators to develop their ideas, contributing to improvements in productivity and ensuring that resources get directed to where they can be most profitably employed. Chart C8 shows that the UK has a large venture capital market compared to European countries but a smaller market than the US. However, the Government believes there is more to do to promote access to finance for small business. The Government has published *Bridging the finance gap: next steps in improving access to growth capital for small businesses* alongside this Pre-Budget Report which announces:

- measures to overcome barriers to raising finance for small business, including a pathfinder round of **Enterprise Capital funds** and proposed enhancements to **Venture Capital Trusts and the Enterprise Investment Scheme**;

- launch of an independent **review of the Small Firms Loan Guarantee**; and
- a package of measures to enhance **small firms' awareness of the range of finance options** open to them.



### Investment and Corporate Governance

**C54** A good framework for investment decisions and corporate governance ensures that savings are put to their most effective use and reallocated on a timely basis. Improving transparency of market signals and enhancing institutional responsiveness to competitive pressure are key elements of flexibility. This helps to promote better company performance, higher returns to investors and a lower cost of capital. The Government has taken a series of steps to aid this process by promoting greater accountability and transparency in the links between investors and companies, which is discussed in further detail in Chapter 3 of this Pre-Budget Report. Most recently the Government has:

- endorsed the introduction of the **new Combined Code**, which was issued in July 2003 and takes effect for listed companies with reporting years beginning on or after 1 November 2003;
- introduced a bill, based on the **legislative recommendations of the Coordinating Group for Accounting and Audit (CGAA) and the Swift Review**, to enhance auditor independence and to strengthen financial reporting;
- engaged with the industry on key issues still outstanding from the **Myners review of institutional investment**; and
- worked on measures **to improve the competence of pension fund trustees**, to be included in the forthcoming Pensions bill.

**Sandler Review C55** Flexible capital markets provide an effective range of products for saving and investment to smooth consumption in response to fluctuations in income. In July 2002, a report for the Government by Ron Sandler recommended improvements in savings vehicles through the development of low-cost and risk-controlled stakeholder products. To take forward the agenda in the Sandler Report, the Government has:

- published a **response paper** in July 2003 in which it announced specifications for a simple set of low cost products;
- announced **that all Sandler stakeholder medium-term products and life insurance products** will be brought into the stocks and share components of ISAs from 2005; and
- worked to ensure that the **EU Investment Services Directive** takes account of product regulation as a middle way between full advice services and execution-only services.

**Capital Markets integration C56** Greater integration of international capital markets should make capital allocation more efficient. This will ensure savers get the best return on their money and are able to hold a diversified portfolio of assets while funds flow to firms offering the best investment opportunities thereby encouraging innovation. To this end the Government will continue to work towards the creation of an integrated EU capital market and greater integration of EU-US capital markets. Recent important steps in this direction have included:

- the adoption by the EU in July 2003 of the **Prospectus Directive**, which will enable companies to raise capital across the EU on the basis of a single prospectus; and
- the UK encouraging a more intensive **EU-US dialogue on financial services issues**, in particular to look beyond the short term to ensure that issues are dealt with before they become pressing concerns.

## CONCLUSIONS

**C57** The ability of economies to adjust flexibly to changes in technology and in market conditions has been an important characteristic of successful economies since the Industrial Revolution. It is especially true of the current era, in which rapid technological change and globalisation provide increased opportunities to dynamic and flexible economies, but have also increased the costs arising from inflexibility and slow adjustment. As was highlighted in the Treasury's economic assessment of the case for joining EMU, a high level of flexibility is especially important when a country needs to adjust to country-specific shocks within a monetary union, since a country-specific monetary policy response is not an option.

**C58** The Government recognises that it is important to ensure that the institutional and regulatory environment supports flexible adjustment in labour, product and capital markets, equipping the economy to respond to current and future opportunities and challenges. The Government also recognises that flexibility should be accompanied by policies that support individuals as they respond to change, so that flexibility is accompanied by fairness.

**C59** This report highlights a range of specific measures that the Government is undertaking in pursuit of these objectives. A review of progress on the Government's reform agenda will be published at the time of Budget 2004.