2 MAINTAINING MACROECONOMIC STABILITY

The UK economy is currently experiencing its longest unbroken expansion on record, with GDP now having grown for 58 consecutive quarters. Over the past ten years, the Government's macroeconomic framework has delivered more stability in terms of GDP growth and inflation rates than in any decade since the war. This historically low volatility puts the UK in a strong position to respond to the global economic challenges of the next decade.

Overall economic developments are as forecast at the Pre-Budget Report. The UK economy grew by $2\frac{3}{4}$ per cent in 2006, as forecast in the Pre-Budget Report. The rebalancing of domestic demand gathered pace during 2006, with business investment ending the year growing at the fastest rate for eight years. Following five consecutive quarters of above-trend growth, the UK economy is estimated to have ended 2006 operating close to its trend level, although there remains evidence of some slack in the labour market. The Budget 2007 economic forecast is little changed from that of the Pre-Budget Report. GDP is forecast to grow by $2\frac{3}{4}$ to $3\frac{1}{4}$ per cent in 2007. With the economy expected to have returned to trend early in 2007, growth is expected to remain close to trend levels of $2\frac{1}{2}$ to 3 per cent. CPI inflation is expected to return to target in the second half of 2007.

The Budget 2007 projections for the public finances show that the Government is meeting its strict fiscal rules:

- **the current budget shows an average surplus as a percentage of GDP over the current economic cycle ensuring the Government is meeting the golden rule. Beyond the end of the current cycle, the current budget moves clearly into surplus; and**
- **public sector net debt is projected to remain low and stable over the forecast period, stabilising below 39 per cent, below the 40 per cent ceiling set in the sustainable investment rule.**

THE MACROECONOMIC FRAMEWORK

2.1 The UK economy is currently experiencing its longest unbroken expansion since quarterly National Accounts data began, with GDP now having grown for 58 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the challenges of the next decade.

2.2 The Government's macroeconomic framework is designed to maintain long-term economic stability. Large fluctuations in output, employment and inflation add to uncertainty for firms, consumers and the public sector, and can reduce the economy's long-term growth potential. Stability allows businesses, individuals and the Government to plan more effectively for the long term, improving the quality and quantity of investment in physical and human capital and helping to raise productivity.

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

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

Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

Monetary policy framework

2.4 Since its introduction just under a decade ago, the monetary policy framework has successfully delivered low and stable inflation, and has kept inflation expectations firmly anchored to the Government's target. The framework is based on four key principles:

- clear and precise objectives. The primary objective of monetary policy is to deliver price stability. The adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target. **The Government reaffirms in Budget 2007 the target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI),** which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC.

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

Fiscal policy framework

2.6 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[2] – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

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

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

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

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

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

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

Public spending framework

2.9 The fiscal rules underpin the Government's public spending framework. The golden rule states that, over the economic cycle, the Government will only borrow to invest. Departments are therefore given separate resource and capital allocations, which increases the efficiency of public spending as public investment is not crowded out by short-term current spending pressures. Departments are now given separate allocations for resource and capital spending to help ensure adherence to the rule. The sustainable investment rule sets the context for the Government's public investment targets and ensures that borrowing for investment is conducted in a responsible way.

Financial stability framework

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

2.11 The Standing Committee on Financial Stability, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss individual cases and developments relevant to financial stability, focusing on risks to the financial system. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and coordinates the three authorities' response and contingency plans. In the event of a crisis, it would meet at short notice and is the principal forum for agreeing policy, and, where appropriate, coordinating and agreeing action between the three authorities.

[3] The 2006 Memorandum updates the version published in 1997 and the full text is available at www.hm-treasury.gov.uk.

PERFORMANCE OF THE FRAMEWORK

2.12 The frameworks for monetary policy, fiscal policy and public spending provide a coherent strategy for maintaining high and stable levels of growth and employment, and for minimising the adverse impact of external events.

2.13 The UK's macroeconomic policy framework continues to deliver unprecedented growth and stability. GDP in the UK has now expanded for 58 consecutive quarters, the longest unbroken expansion since quarterly National Accounts began more than half a century ago. Over the past 10 years, the UK has enjoyed more stability in terms of GDP growth and inflation than in any decade since the war. Despite recent energy and food-related price rises, discussed below, inflation, on the RPI measure, has remained within a range of $^3/_4$ to $4^3/_4$ per cent over the past 10 years, compared with a range of 1 to 11 per cent in the 1990s, $2^1/_2$ to 22 per cent in the 1980s and 5 to 27 per cent in the 1970s.

2.14 The success of the framework in delivering low inflation has been widely recognised. As the IMF recently emphasised, "macroeconomic policies have contributed to growth and stability". The IMF also added that, as a result of these foundations, "growth of real GDP per capita was higher and less volatile than in any other G7 country".

Monetary policy

2.15 The monetary policy framework has improved the credibility of policy making and continues to deliver clear benefits, as discussed in Box 2.1.

2.16 The monetary policy framework has given the MPC the flexibility to respond decisively to unexpected economic events over recent years. Consistent with its forward-looking approach, the MPC has increased interest rates three times since August 2006. This pre-emptive action has helped to ensure that inflation is forecast to return to around target in the second half of 2007.

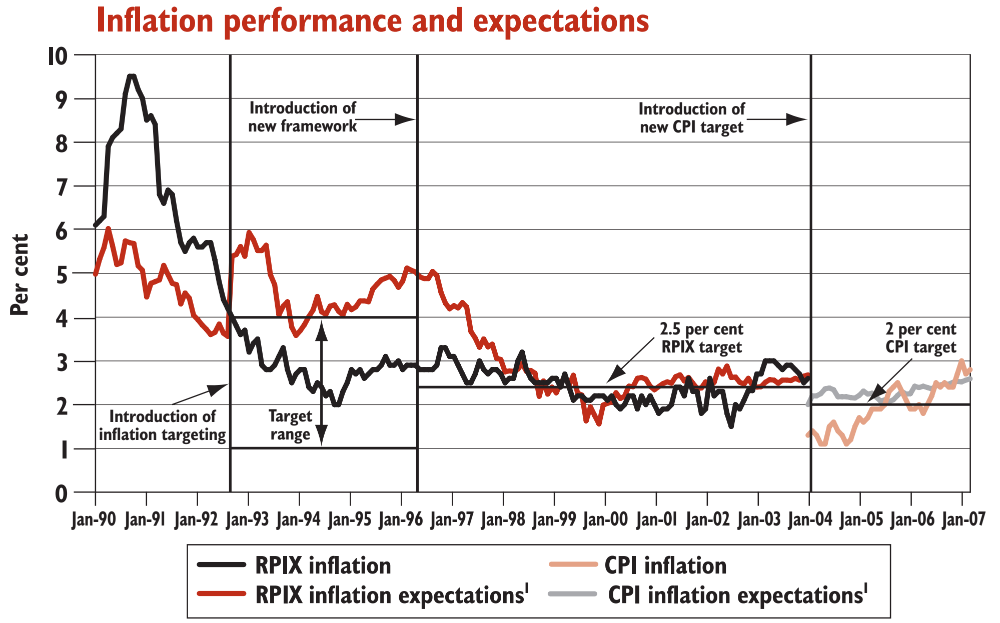
2.17 Low inflation expectations and a period of entrenched macroeconomic stability have helped long-term interest rates remain at historically low levels. Low long-term interest rates reduce the Government's debt interest payments, free up resources for public services and help promote investment. Over the current economic cycle, long-term spot interest rates have averaged 5 per cent compared with an average of just over 9 per cent in the previous cycle.

2.18 Ten-year forward rates, which abstract from cyclical influences, are around 0.7 percentage points lower than those in the United States and very slightly above those in the euro area.[4] Ten-year forward rates in February 2007, at 4.2 per cent, are at the same level as at Budget 2006. This compares with a rate of 8 per cent in April 1997 before the introduction of the new macroeconomic framework.

[4] Ten-year forward rates are market expectations, formed today, of short rates in ten years' time. They are less affected by short-term factors, such as the current cyclical position of the economy, than spot rates and are therefore a better basis for making international comparisons when cyclical conditions differ.

Box 2.1: The monetary policy framework ten years on

The Government's monetary policy framework will mark its first decade in May 2007, and has ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target.



[1] Implied expectations of average RPI inflation ten years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI expectations and stylised assumptions about expected differences between RPI and CPI inflation in the medium term, including that the geometric averaging lowers CPI inflation by 0.5 percentage points relative to RPI inflation.
Source: ONS, Bank of England and HM Treasury.

Since the new framework was introduced:

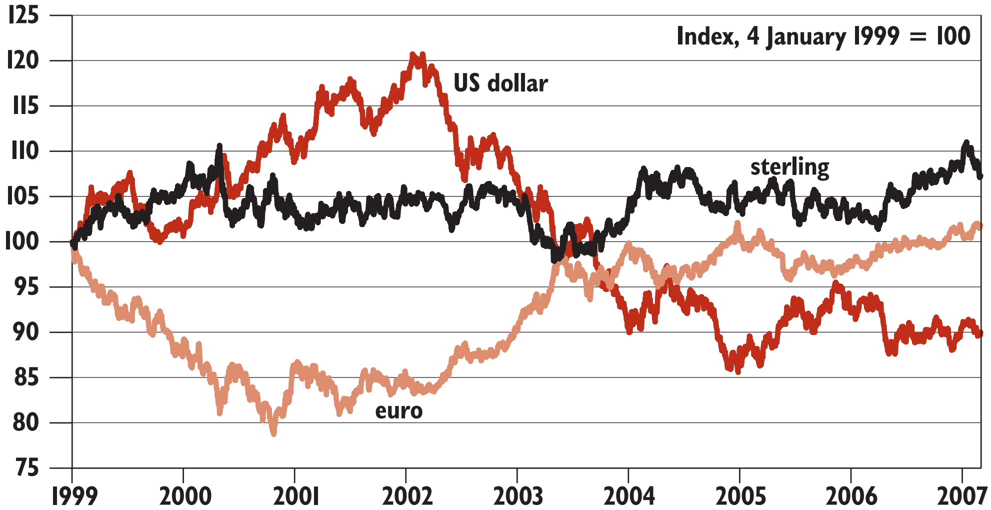
- **the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target value of 2½ per cent, the longest period of sustained low inflation for the past 30 years; and**
- **inflation expectations have remained close to target following the switch to a 2 per cent CPI target. CPI inflation has been within 1 percentage point of its target at all times since its inception in December 2003.**

In the past decade, only Japan, which suffered a prolonged period of deflation, has had lower average inflation than the UK among the G7 economies. This contrasts sharply with the decade preceding 1997, when the UK had the highest inflation rate in the G7, bar Italy.

While previously low inflation in the UK has only been achieved through high interest rates, the entrenched credibility of the macroeconomic framework has allowed low interest rates to coincide with low inflation; both UK interest rates and inflation since 1997 have averaged less than half that recorded over the previous two decades. Low and stable interest rates have also given the MPC the flexibility to deal with shocks, helping to ensure low inflation has also been accompanied by strong and stable growth throughout the past decade.

2.19 Alongside the UK's macroeconomic stability in recent years, the effective exchange rate has also been relatively stable, as seen in Chart 2.1. The sterling effective exchange rate remains close to levels at Budget 2004. Since the introduction of the euro in 1999, the volatility of sterling's effective exchange rate has been under half that of the euro and around a quarter of that of the US dollar.

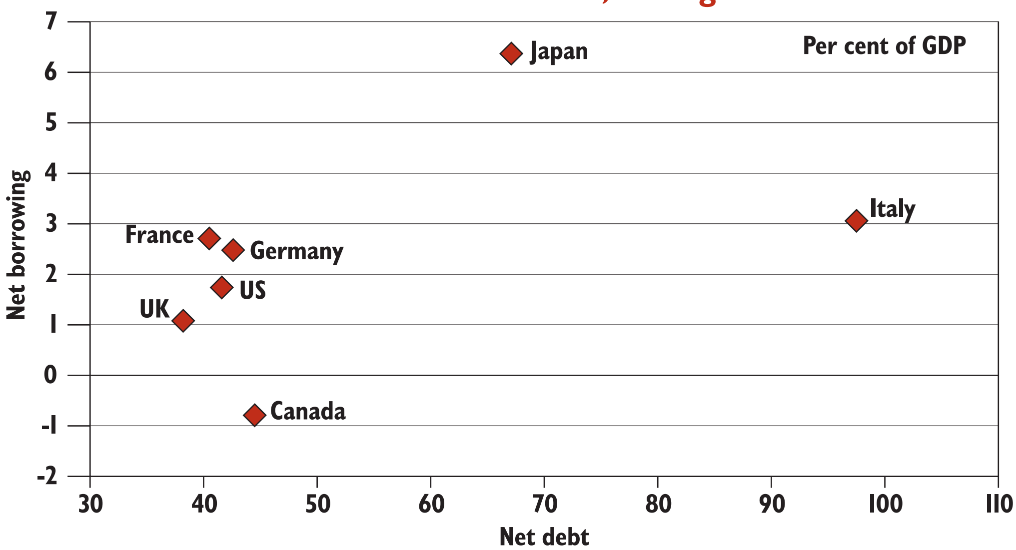
Chart 2.1: Movements in leading effective exchange rate indices since 1999



Source: Bank of England.

Fiscal policy **2.20** The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Public sector net debt was reduced from just under 44 per cent of GDP in 1996-97 to 35 per cent in 2004-05. Public sector net borrowing was reduced sharply from 1997-98 on, with surpluses over 1998-99 to 2000-01 when the economy was above trend. As the economy moved below trend in 2001, net borrowing increased, reaching 3.3 per cent of GDP in 2004-05, allowing fiscal policy to support monetary policy. This is in contrast to the position in the previous cycle when borrowing peaked at 7.8 per cent of GDP. As Chart 2.2 shows, since 1997 the UK's public finances compare favourably with other countries.

Chart 2.2: Public finances in the G7, average 1997 to 2006

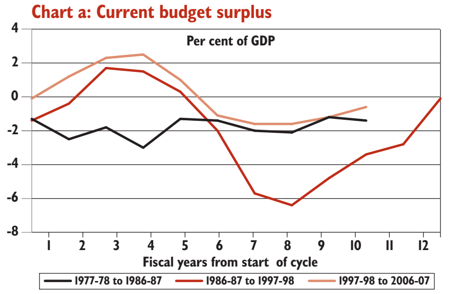


Source: OECD Economic Outlook 80, December 2006.

Box 2.2: Achievements of fiscal policy

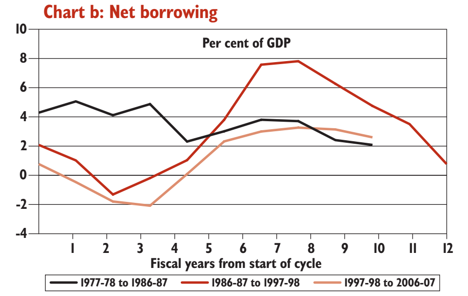
The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability* – transparency, stability, responsibility, fairness and efficiency.

Chart a: Current budget surplus



Source: HM Treasury.

Chart b: Net borrowing



Source: HM Treasury.

In the last decade, the introduction of strict fiscal rules and clear objectives for fiscal policy have put the public finances on a more sound and sustainable footing than in previous economic cycles. The golden rule is being met in this cycle with a surplus of 0.1 per cent of GDP, in contrast to the last cycle's average deficit of 2.0 per cent of GDP, and the 1977-78 to 1986-87 cycle's average deficit of 1.8 per cent of GDP. Debt has remained at low and sustainable levels, while at the same time public sector net investment is now over three times higher as a share of the economy than it was in 1997-98. Public sector net borrowing has remained low and stable over the current cycle, averaging 1.1 per cent of GDP, compared with an average of 3.1 per cent of GDP over the cycle from 1986-87 to 1997-98 and 3.6 per cent from 1977-78 to 1986-87.

Responsible management of public finances, in line with the Government's objectives, has enabled fiscal policy to effectively support monetary policy over the current cycle. The IMF noted in March this year, that in the UK "shocks, such as the global downturn of 2000-03 and the increase in oil prices during 2004-06, were managed with good policy responses", and noted "the shallowness of the UK growth slowdown during the last global downturn".[a]

The credibility of the framework has been established not only by the performance of the key fiscal aggregates, but also by the enhanced transparency introduced by the *Code for fiscal stability*. This includes the publication of illustrative long-term projections and the requirement for the Government to invite the National Audit Office (NAO) to audit the key assumptions underpinning the fiscal projections. These have been developed further with the annual publication of the *Long-term public finance report*, the *End of year fiscal report*, providing backward-looking analysis of the Treasury's fiscal projections, and the extension of NAO audits to 12 key assumptions from five at the first audit.

2004 Spending Review

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

- current spending to increase by an annual average of 3.3 per cent in real terms between 2004-05 and 2007-08;
- public sector net investment rising to 2 per cent of GDP by 2007-08, compared with $^1/_2$ per cent of GDP in 1997-98, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £21 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

Comprehensive Spending Review

2.22 The overall spending limits set in Budget 2004 and confirmed in the 2004 Spending Review remain sustainable and fully consistent with the fiscal rules. Building on these firm foundations, the 2007 Comprehensive Spending Review (CSR) provides the opportunity for a fundamental and long-term review of the Government's priorities and expenditure, ensuring the UK is equipped to meet the challenges of the decade ahead. This Budget confirms the firm overall spending limits for the CSR years, 2008-09, 2009-10 and 2010-11, which ensure that the Government meets its strict fiscal rules while allowing it to increase total public spending by an average of 2 per cent per year in real terms with:

- current spending increasing by an average of 1.9 per cent per year in real terms; and
- net investment rising to $2^1/_4$ per cent of GDP compared with $^1/_2$ per cent of GDP in 1997-98, locking in the step change in investment over the past decade.

2.23 The 2007 CSR will report later this year, setting a full set of departmental spending plans for 2008-09, 2009-10 and 2010-11. Chapter 6 provides further details of the programme of analytical work the Government is conducting in preparation for the 2007 CSR.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

2.24 As forecast at the time of the Pre-Budget Report, the UK economy grew by $2^3/_4$ per cent in 2006. Having expanded at a rate of 0.7 per cent for four consecutive quarters, GDP growth picked up slightly to 0.8 per cent in the fourth quarter of 2006.

Recent economic developments

2.25 The world economy grew at a faster rate in 2006 than at any time since 1990, with GDP growth of 5 per cent, reflecting a pick-up in G7 activity and continued strength in emerging markets. Global growth is expected to slow slightly in 2007, though to remain high by historical standards at $4^3/_4$ per cent. World trade growth has recovered strongly over the past five years, rising from zero growth in 2001 to $9^3/_4$ per cent in 2006. A modest slowdown in world trade growth is expected in 2007.

Table 2.1: Summary of world forecast

	Percentage change on a year earlier, unless otherwise stated			
		Forecasts		
	2006	2007	2008	2009
World GDP	5	4¾	4¾	4½
Major 7 countries[1]:				
Real GDP	2¾	2½	2½	2½
Consumer price inflation[2]	1½	2	2	2
Euro area GDP	2¾	2¼	2¼	2¼
World trade in goods and services	9¾	7¾	7½	7
UK export markets[3]	8½	7	6½	6¼

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

[2] *Per cent, Q4.*

[3] *Other countries' imports of goods and services weighted according to the importance of imports from the UK in those countries' total imports.*

Economic prospects

2.26 The latest estimates of GDP and non-oil GVA growth to the fourth quarter of 2006 are consistent with the 2006 Pre-Budget Report forecast. The Budget 2007 GDP growth forecast is unchanged from the Pre-Budget Report: the small negative output gap is expected to have closed early in 2007 and growth is forecast to continue at close-to-trend rates throughout the forecast horizon. This implies GDP growth of 2¾ to 3¼ per cent in 2007, and 2½ to 3 per cent a year thereafter.

2.27 The rebalancing of domestic demand already evident during 2006 is expected to continue to a somewhat greater degree than was envisaged in the 2006 Pre-Budget Report forecast. Latest estimates of business investment in the second half of 2006 show particularly strong growth, which surprised on the upside, and some of that momentum is expected to carry through into 2007. Private consumption growth is expected to moderate as recent increases in interest rates feed through to disposable income growth and households' desire to save. The contribution of net trade to GDP growth is expected to remain slightly negative in 2007, but to be neutral thereafter.

2.28 The pick-up in headline inflation over the past year has mainly been attributable to energy and food prices, rather than domestic cyclical pressures, factors that are expected to unwind during 2007. By far the largest contributor to the rise in inflation during 2006 was energy prices, particularly domestic gas and electricity prices. At the time of the 2006 Pre-Budget Report, developments in wholesale gas prices pointed to energy prices stabilising, with their contribution to inflation falling during 2007. Since the Pre-Budget Report, a number of major energy providers have announced significant cuts in utility tariffs that imply the contribution of energy prices to inflation is likely to turn negative by the middle of 2007. Unless harvests prove worse during 2007 than in 2006, when the unusually hot summer pushed food prices higher, the contribution of food prices to overall inflation should also fall.

2.29 As a result of these expected energy and food-related price developments, CPI inflation is likely to fall quite sharply from its current level, returning to around target in the second half of 2007.

2.30 Inflation expectations remain anchored to the inflation target and earnings growth has remained subdued, suggesting there have been no second-round effects from the recent above-target rates of inflation, although this risk has not yet subsided.

2.31 Leading forecasters expect the UK's record of strong and stable growth to be maintained going forward, with the credibility of the monetary policy framework keeping inflation expectations firmly anchored. For example, the IMF has recently revised up its forecast for UK GDP growth in 2007 to 2.9 per cent, fully consistent with the Budget 2007 forecast.[5]

Table 2.2: Summary of UK forecast[1]

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

[1] *See footnote to Table B9 for explanation of forecast ranges.*

Risks **2.32** Risks to the Budget 2007 economic forecast appear balanced, given broadly offsetting developments since the 2006 Pre-Budget Report.

2.33 A key risk to the UK economic forecast remains the uncertainties over labour market data, and the possibility that if growth in the working-age population has been greater than officially recorded, there may be a greater degree of slack in the economy and thus more scope for growth.

2.34 In terms of the components of demand, despite strong growth in consumption at the end of 2006, forecast quarterly consumption growth rates in 2007 have been revised down from the 2006 Pre-Budget Report to reflect developments in interest rates and saving intentions. Risks to the forecast are therefore balanced between the upside risk from recent momentum and the downside risk that developments in households' finances will have a larger than expected impact on consumer spending. Business investment ended 2006 with even more momentum than was expected at the time of the Pre-Budget Report. To the extent that internal and external financing conditions remain supportive, and firms' margins recover as input cost pressures ease, there is again scope for investment growth to exceed expectations.

2.35 With inflation expected to remain above target during the first half of 2007, the risk remains that higher rates of actual inflation could feed through to inflation expectations and earnings growth. However, the evidence so far suggests that monetary policy has kept inflation expectations anchored to the inflation target and, while wage settlements growth has picked up a little, there has been no discernable impact on earnings growth.

2.36 Growth in the final quarter of 2006 was strong in most of the world's major economies, including the UK, suggesting there is more momentum in these economies, particularly in the euro area, than was apparent at the time of the Pre-Budget Report. Additionally, the strength of growth in Asia, particularly China and India, surprised forecasters once more in 2006, and could do so again in 2007.

2.37 Episodes of financial market volatility, such as that experienced in late February and early March this year, represent a further global risk to the outlook. Large and rapid fluctuations in the value of financial assets, possibly reflecting investors' changing attitudes to risk, can have an impact on global growth. These risks may be mitigated to some extent by the development of deeper and more diversified capital markets, and improvements in macroeconomic policy frameworks. In recent years, emerging markets, which tend to be particularly sensitive to developments in global financial markets, have generally improved macroeconomic fundamentals and significantly increased holdings of foreign currency reserves.

[5] *United Kingdom: Staff Report for the 2006 Article IV Consultation*, IMF, March 2007.

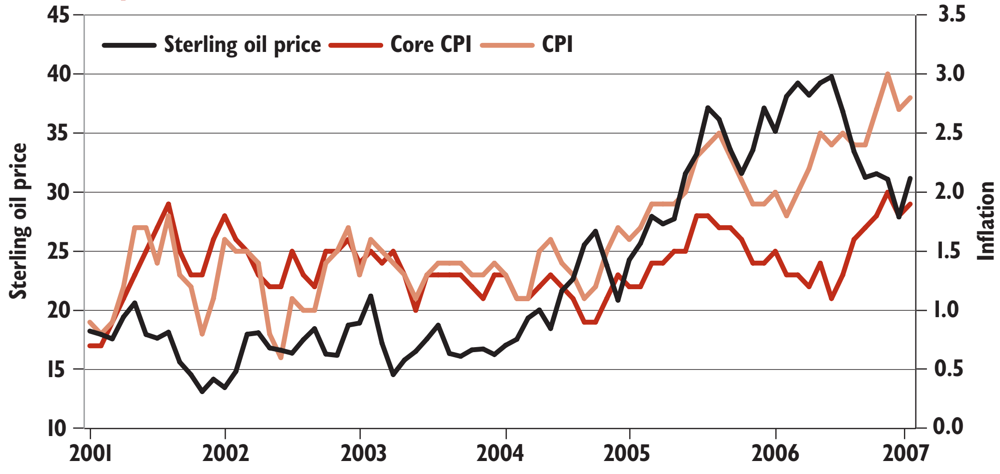
Box 2.3: Inflation and pay

Since the introduction of the new monetary policy framework in 1997, the UK has experienced the longest period of sustained low inflation since the late 1960s. Over the recent past, inflation has been subjected to temporary, unforeseen shocks: increases in energy prices, driven by developments in the oil and wholesale gas markets, have fed through to higher utility prices; and increases in food prices, resulting from exceptionally hot summer weather and global factors. Against this background, CPI inflation rose through 2006, reaching 3 per cent in December, but was lower at 2.8 per cent in February 2007.

But in contrast to previous decades, the credibility of the UK's monetary policy framework has kept inflation expectations anchored and earnings growth has remained subdued. Once temporary, volatile factors have been stripped out, 'core' inflation has been at or below 2 per cent. Measures of core inflation exclude items with volatile price effects, including energy prices and seasonal food prices. These measures of underlying inflation in the economy are a better reflection of the balance of pressures of demand and supply and thus more relevant for the horizon over which pay settlements are determined. The chart below shows that, while headline inflation has risen in tandem with oil prices over the past year, core inflation has remained much more subdued, at rates close to its average over the past five years. Moreover, wholesale energy prices have already fallen and the effect of food price rises is expected to unwind in 2007. As energy price induced pressures recede, inflation is expected to return to target within the year. The latest average of independent forecasts suggests CPI inflation is expected to return to around its 2 per cent target in the second half of 2007, consistent with the Budget forecast.

As inflation returns to around target in the second half of 2007 it is important that the Government continues to be vigilant and disciplined in the fight against inflation. An important part of this means ensuring pay settlements continue to be consistent with the Government's inflation target of 2 per cent, as set out in Chapter 6. Demonstrating this commitment to combining discipline with fairness in pay the Chancellor announced in Parliament on 1 March 2007 that the overall headline settlements for public sector workforces covered by Pay Review Bodies are to be less than the 2 per cent inflation target, averaging 1.9 per cent, in 2007-08. The overall package of settlements provides a sustainable, affordable set of pay awards that helps contribute to low inflation and economic stability.

Impact of oil on headline and core inflation



Source: Bloomberg and HM Treasury.

The economic cycle

2.38 As announced in July 2005, the Treasury's judgement is that the current economic cycle began in the first half of 1997.[6] The Comptroller and Auditor General audited this judgement alongside the 2005 Pre-Budget Report and concluded that, though there were uncertainties, there are reasonable grounds to date the end date of the previous economic cycle to 1997 and that this would not reduce the extent of caution in making the fiscal projections. The economy is expected to have returned to trend early in 2007.

Caution and the public finances

2.39 The Comptroller and Auditor General reviewed the yield from the Budget 2004 compliance package for direct tax and national insurance contributions and found that the estimated yield from the package was greater than the Treasury's revised forecasts of yield, and that on this basis the forecasts were therefore cautious.

2.40 The Comptroller and Auditor General has also audited the assumptions for forecasting VAT revenues. He concluded that the use of the VAT gap assumption had resulted in forecasts that were cautious in three of the four years of the rolling review period since Budget 2003, and cautious over the period as a whole. The Comptroller and Auditor General was not able to draw a conclusion on the reasonableness of the allowance made in VAT forecasts for the impact of the 2002 VAT compliance strategy because of difficulties in identifying the separate contributions of the underlying trend in the VAT gap, the compliance strategy and the impact of legislative measures on VAT receipts.

2.41 As explained in Chapter C, a new NAO-audited assumption has been used in Budget 2007 for the purposes of projecting VAT receipts. This revised assumption is set out in Box C1. The Comptroller and Auditor General has audited the revised assumption and concluded that it is a reasonable one for the purposes of forecasting future VAT revenues and that it will be cautious to the extent that historical trends in the VAT gap are a good indicator of future trends.

2.42 Under the rolling review, for Budget 2007 the Comptroller and Auditor General has audited the assumptions relating to debt financing and factor income shares. The review concluded that the calculations of debt interest payments were consistent with forecasts of the government's net financing requirement and with its debt financing policy. For factor income shares the assumptions were reasonable and continue to be so for the future.

2.43 The assumption for forecasting revenue from duty on tobacco, that the illicit market share is set at least at the latest published outturn level, has been audited by the Comptroller and Auditor General under the rolling review process for the period since Budget 2003. However, due to the absence of firm data for the illicit market share for 2005-06 and 2006-07, it is not possible to reach a conclusion for the rolling review period as a whole. The Comptroller and Auditor General has therefore reviewed the evidence for 2003-04 and 2004-05, concluding that the assumption proved cautious in those years.

2.44 As explained in Chapter C, because of the difficulties involved in making estimates of the illicit market share, a new NAO-audited assumption has been used for the purposes of forecasting tobacco revenues in Budget 2007. This revised assumption is set out in Box C1. The Comptroller and Auditor General has audited the revised assumption and concluded that it is a reasonable one and, though there are a number of uncertainties as to how cautious the assumption will be in practice, it introduces an element of caution into the forecasts.

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[6] *Evidence on the UK economic cycle*, HM Treasury, July 2005.

Box 2.4: The UK's international and European objectives

In both a global and a European context, there is a need to address the challenges of structural economic reform, resist protectionist pressures and promote free trade. The UK is working closely with the G7/8, the EU, International Financial Institutions and other international partnerships, including emerging market economies, to promote global prosperity and economic stability, tackle unfairness and deliver social justice, and promote environmental stewardship, by:

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

RECENT FISCAL TRENDS AND OUTLOOK

2.45 Budget 2007 presents the Government's annual fiscal forecast and updates the 2006 Pre-Budget Report interim projections.[7]

2.46 In making its fiscal projections, the Government distinguishes between non-discretionary factors which affect the public finances, such as changing consumption patterns affecting receipts and changes to the economic forecast, for example to GDP growth, and discretionary Budget measures. This chapter first outlines the non-discretionary changes which form the fiscal context for the Budget decisions.

Non-discretionary changes in receipts

2.47 The lower forecast for North Sea revenues throughout the projection period more than explains the increase in net borrowing from 2007-08 onwards. North Sea revenue forecasts have been reduced as a result of sterling's appreciation against the dollar, lower oil prices, lower production and higher investment in the North Sea since the Pre-Budget Report. The forecast for total current receipts excluding North Sea revenues has increased since the Pre-Budget Report, driven by higher income tax and national insurance contributions, increased growth in VAT receipts, higher stamp and capital taxes. Some of this improvement over the projection period is offset by lower than expected corporation tax receipts.

Non-discretionary changes in spending

2.48 The forecast for expenditure before discretionary measures is slightly above the forecast in the Pre-Budget Report. Spending is slightly higher as a result of resetting the AME margin, as well as the impact of inflation on the costs of servicing government debt.

2.49 Overall, when compared with the 2006 Pre-Budget Report interim projections, the Budget 2007 projections show slightly higher forecasts for net borrowing, more than accounted for by revisions to the forecast for North Sea oil revenues. The overall impact of changes to other receipts and expenditure is to reduce net borrowing over the projection period. The estimate for borrowing in 2006-07 is revised down from the Pre-Budget Report, as in this year the reduction in borrowing from other tax and expenditure changes outweighs the increase in borrowing from North Sea revenue changes.

Table 2.3: Public sector net borrowing compared with the 2006 Pre-Budget Report

	Outturn		Estimate	Projections				
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
2006 Pre-Budget Report (£ billion)	**39.2**	**37.5**	**36.8**	**31**	**27**	**26**	**24**	**22**
Changes since the 2006 PBR								
North Sea revenues	0	0	1.3	2½	2½	2½	2	1½
Other tax and expenditure changes	–0.1	0.3	–3.1	–1	0	0	–½	½
Total before discretionary measures	**39.1**	**37.8**	**35.0**	**33**	**30**	**28**	**26**	**24**
Discretionary measures	**0**	**0**	**0.0**	**½**	**–½**	**0**	**–½**	**–½**
Budget 2007	**39.1**	**37.8**	**35.0**	**34**	**30**	**28**	**26**	**24**

Note: Figures may not sum due to rounding.

[7] The Budget 2007 fiscal projections take account of the February outturns for receipts, spending and borrowing.

Estimate for 2006-07

2.50 Net taxes and national insurance contributions are estimated to have grown by 6.3 per cent from the previous year. Excluding North Sea revenues, total current receipts growth is estimated to have been above that in the Pre-Budget Report forecast. Income tax and national insurance contributions are growing strongly, boosted by financial sector bonuses and the impact of anti-avoidance measures. VAT receipts have strengthened considerably, underpinned by the success of measures to reduce fraud and by the increase in consumption growth compared with 2005. Capital and stamp duties are also higher than expected. Stronger than expected revenues in these areas are offset by changes to corporation tax receipts and North Sea revenues.

2.51 The estimated outturn for the public sector current budget is a deficit of £9.5 billion compared with projected deficits of £7.9 billion and £7.1 billion in 2006 Pre-Budget Report and Budget 2006 respectively. The current budget moves into surplus in 2008-09, in line with the projections in the 2006 Pre-Budget Report. For public sector net borrowing the estimated 2006-07 outturn is £35.0 billion, lower than the estimates of £36.8 billion projected in the 2006 Pre-Budget Report and £35.8 billion projected in Budget 2006.

2.52 The cyclically-adjusted deficit on the current surplus fell by approximately $^1/_2$ per cent of GDP from 2005-06 to 2006-07. Cyclically-adjusted net borrowing fell by less, around $^1/_4$ per cent of GDP, reflecting increased spending on public investment. The estimate of cyclically-adjusted net borrowing for 2006-07 is slightly lower, at 2.5 per cent of GDP, than at the Pre-Budget Report, while the cyclically-adjusted deficit on the current balance is slightly higher. On the basis of cautious, audited assumptions, the Government is meeting its strict fiscal rules over the economic cycle.

BUDGET DECISIONS

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

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

2.54 Against this backdrop, and building on steps already taken, Budget 2007 announces:

- reforms to simplify the tax system, to provide help for pensioners, support for families and make work pay, including:
  - removing the 10 pence starting rate of tax and cutting the basic rate of income tax from 22 pence to 20 pence from April 2008;
  - increasing the upper earnings limit for national insurance and fully aligning it with the point at which taxpayers start to pay the higher rate of income tax, raising the aligned upper earnings limit and basic rate limit by £800 a year above indexation in April 2009:
  - increasing further the child element of the Child Tax Credit by £150 per year above earnings indexation in April 2008; and

- increasing the threshold for Working Tax Credit by £1,200 to £6,420; raising the withdrawal rate on tax credits by 2 per cent to 39 per cent and increasing the weekly rate of Child Benefit for the eldest child to £20 in April 2010.

- a major package of reforms to the corporate tax system, including reducing the headline corporate tax rate from 30 per cent to 28 per cent from April 2008, simplifying capital allowances, further enhancing research and development tax credits, and increasing the small companies rate to tackle individuals incorporating to minimise tax;
- restricting tax relief available on empty commercial properties, to encourage the supply of office, retail and industrial premises;
- further reforms to modernise the tax system, and a number of measures to tackle tax fraud and avoidance;
- taking further steps to tackle the global challenge of climate change including an increase in fuel duty rates from 1 October 2007, reforms to Vehicle Excise Duty and measures to improve the energy efficiency of homes.

2.55 Table 1.2 lists the key Budget policy decisions and their impact on the public finances, including resetting the AME margin. Further details are set out in Chapter A of the *Financial Statement and Budget Report.*

MEDIUM-TERM FISCAL PROJECTIONS

2.56 Table 2.4 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2006 and in the 2006 Pre-Budget Report. It includes the impact of all Budget decisions in accordance with the *Code for fiscal stability*. Further detail is provided in Chapter C of the *Financial Statement and Budget Report*.

2.57 The revised outturn for 2005-06 shows the deficit on the current budget to be £0.1 billion lower than in the 2006 Pre-Budget Report, and £3.6 billion higher compared with Budget 2006. The outturn for net borrowing in 2005-06 is £0.2 billion higher than in the Pre-Budget Report, accounted for by the increase of £0.3 billion in net investment. Net borrowing for 2005-06 is £0.7 billion higher than the estimate in Budget 2006.

Table 2.4: Fiscal balances compared with Budget 2006 and the 2006 Pre-Budget Report

	Outturn[1]	Estimate[2]	Projections				
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Surplus on current budget (£ billion)							
Budget 2006	**–11.4**	**–7.1**	**1**	**7**	**10**	**12**	**–**
Effect of forecasting changes	*–3.7*	*–1.0*	*–5*	*–5½*	*–5*	*–4*	*–*
Effect of discretionary changes	*0.0*	*0.2*	*2*	*2½*	*2*	*2*	*–*
PBR 2006	**–15.1**	**–7.9**	**–1**	**4**	**7**	**10**	**14**
Effect of forecasting changes	*0.1*	*–1.6*	*–2½*	*–1½*	*–1½*	*–1½*	*–2*
Effect of policy decisions since PBR 2006	*0.0*	*0.0*	*–½*	*½*	*0*	*½*	*½*
Budget 2007	**–15.0**	**–9.5**	**–4**	**3**	**6**	**9**	**13**
Net borrowing (£ billion)							
Budget 2006	**37.1**	**35.8**	**30**	**25**	**24**	**23**	**–**
Changes to current budget	*3.7*	*0.8*	*3*	*3*	*3*	*1½*	*–*
Changes to net investment	*–3.3*	*0.1*	*–1*	*–½*	*–1*	*–1*	*–*
PBR 2006	**37.5**	**36.8**	**31**	**27**	**26**	**24**	**22**
Changes to current budget	*–0.1*	*1.6*	*3*	*1½*	*1½*	*1*	*1½*
Changes to net investment	*0.3*	*–3.4*	*–½*	*1*	*1*	*0*	*0*
Budget 2007	**37.8**	**35.0**	**34**	**30**	**28**	**26**	**24**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2006	–0.3	0.4	0.7	0.7	0.7	0.8	–
PBR 2006	–1.0	–0.4	–0.1	0.3	0.5	0.6	0.8
Budget 2007	**–1.0**	**–0.5**	**–0.3**	**0.2**	**0.4**	**0.6**	**0.8**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2006	2.4	1.9	1.6	1.6	1.6	1.5	–
PBR 2006	2.8	2.6	2.2	1.9	1.7	1.5	1.3
Budget 2007	**2.8**	**2.5**	**2.4**	**2.0**	**1.8**	**1.6**	**1.4**
Net debt (per cent of GDP)							
Budget 2006	36.4	37.5	38.1	38.3	38.4	38.4	–
PBR 2006	36.4	37.5	38.2	38.6	38.7	38.7	38.5
Budget 2007	**36.5**	**37.2**	**38.2**	**38.5**	**38.8**	**38.8**	**38.6**

Note: Totals may not sum due to rounding.
[1] The 2005-06 figures were estimates in Budget 2006.
[2] The 2006-07 figures were projections in Budget 2006.

2.58 The estimated surplus on the current budget in 2006-07 is lower than expected at the 2006 Pre-Budget Report. The current surplus remains slightly below that forecast at the 2006 Pre-Budget Report, driven by lower than expected North Sea revenues, but by 2010-11, the difference narrows, so that as a percentage of GDP, the current surplus is unchanged compared with the Pre-Budget Report. The estimate for net borrowing in 2006-07 is lower by £1.8 billion, and in future years the projections for borrowing are slightly higher than expected at the Pre-Budget Report.

2.59 Table 2.4 also sets out the underlying structural position of the fiscal balances, adjusted for the impact of the economic cycle on the public finances.[8] Cyclically-adjusted net borrowing is lower in 2006-07 than estimated in the Pre-Budget Report, and then slightly higher out to the end of the projection period. The cyclically-adjusted current budget deficit is slightly higher in 2006-07, but by 2010-11 is back in line with the projections made at the 2006 Pre-Budget Report.

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

ADHERING TO PRINCIPLES

2.60 Table 2.5 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. The table indicates that, after allowing for non-discretionary changes to receipts and spending and taking into account the Budget decisions, the Government is meeting both of its strict fiscal rules.

Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Fairness and prudence							
Surplus on current budget	–1.2	–0.7	–0.3	0.2	0.4	0.6	0.8
Average surplus since 1997-98	0.2	0.1	0.0	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–1.0	–0.5	–0.3	0.2	0.4	0.6	0.8
Long-term sustainability							
Public sector net debt[1]	36.5	37.2	38.2	38.5	38.8	38.8	38.6
Core debt[1]	35.8	36.4	37.4	37.7	38.0	38.1	38.0
Net worth[2]	27.0	25.7	24.9	24.9	24.5	24.4	24.4
Primary balance	–1.4	–1.0	–0.8	–0.5	–0.3	0.0	0.2
Economic impact							
Net investment	1.8	2.0	2.1	2.2	2.2	2.2	2.2
Public sector net borrowing (PSNB)	3.0	2.7	2.4	2.0	1.8	1.6	1.4
Cyclically-adjusted PSNB	2.8	2.5	2.4	2.0	1.8	1.6	1.4
Financing							
Central government net cash requirement	3.3	2.8	2.7	2.0	2.2	1.8	1.8
Public sector net cash requirement	3.2	2.6	2.6	1.9	2.1	1.6	1.7
European commitments							
Treaty deficit[3]	2.9	2.8	2.5	2.1	1.9	1.7	1.5
Cyclically-adjusted Treaty deficit[3]	2.7	2.6	2.5	2.1	1.9	1.7	1.5
Treaty debt ratio[4]	42.7	43.5	44.3	44.4	44.5	44.4	44.1
Memo: Output gap	*–0.5*	*–0.2*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*

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

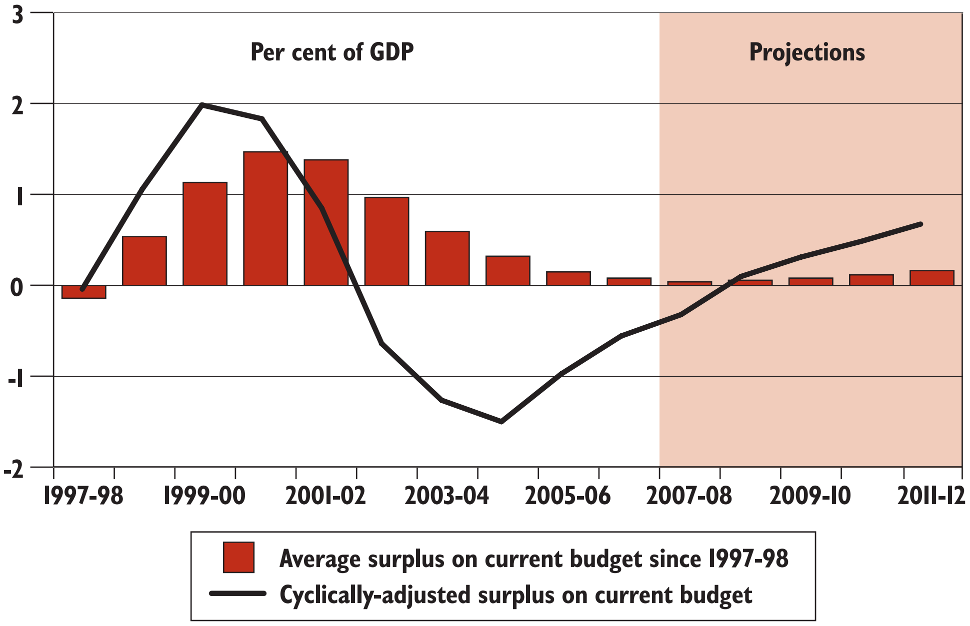
Golden rule

2.61 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of intergenerational fairness. The current budget strengthens through the projection period, returning to surplus in 2008-09 and showing a surplus of 0.8 per cent of GDP by 2011-12, as expected at the Pre-Budget Report.

2.62 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.

2.63 The average surplus on the current budget since the start of the current cycle in 1997-98 is in balance or surplus in every year of the projection period. The economy is expected to have returned to trend early in 2007. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £11 billion in this cycle, higher than at the 2006 Pre-Budget Report.

Chart 2.3: Meeting the golden rule



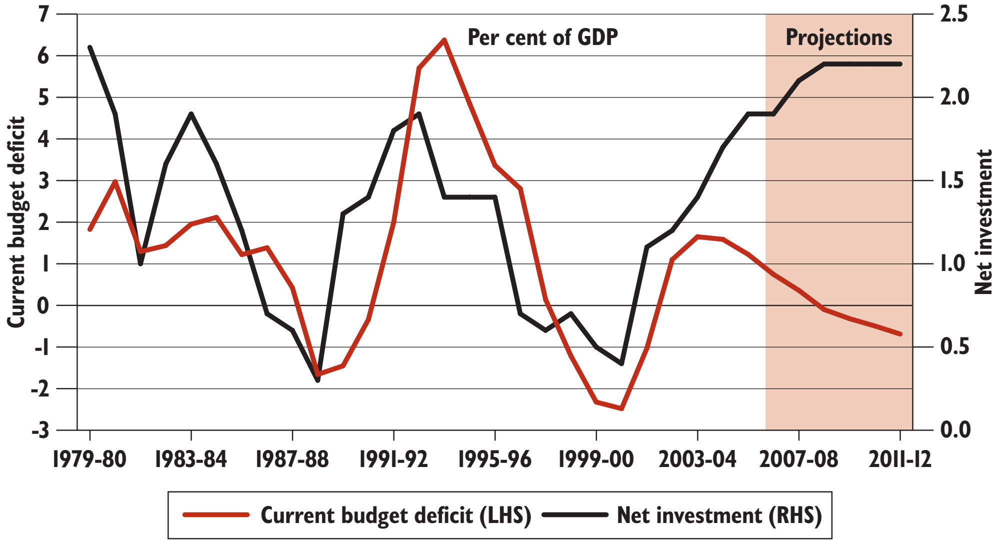
Source: HM Treasury.

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

Box 2.5: Borrowing for investment

The fiscal framework is designed to remove the bias against capital spending by making a distinction between capital and current spending. Historically, it has been extremely rare for public investment to grow during periods of fiscal consolidation, and prior to the introduction of the macroeconomic framework, it had not happened for 40 years. The effectiveness of the golden rule in eliminating this historic bias against capital spending is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment illustrated in the chart. As the chart shows, this pattern of reducing borrowing while maintaining net investment will continue in the coming years.

Current budget deficit and net investment



Source: HM Treasury.

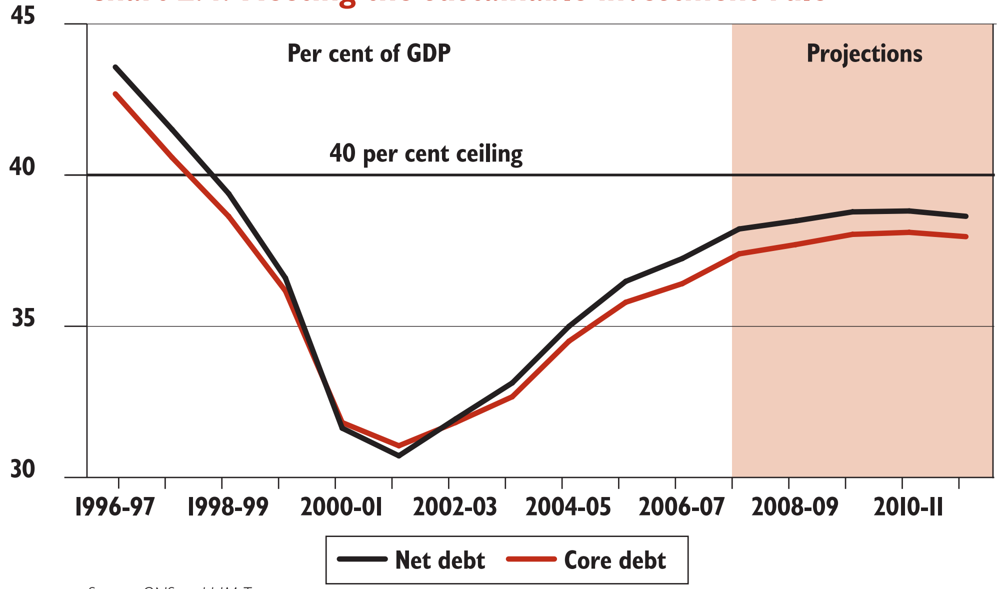
Public sector net investment is now over three times higher as a share of the economy than it was in 1997-98, having risen from less than ¾ per cent to 2 per cent of GDP this year. As a result of this sustained increase, public investment in priority areas has grown significantly: annual average real growth in capital budgets from 2000-01 to 2007-08 will be 23 per cent in the NHS, 14 per cent in education and 19 per cent in transport. The Government's strategy for public investment is discussed in more detail in Chapter 6.

Sustainable investment rule

2.65 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector net debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

2.66 Chart 2.4 shows that despite output being generally below trend since 2001, net debt remains below 39 per cent of GDP, and starts to decline at the end of the projection period, reaching 38.6 per cent in 2011-12. Therefore the Government meets its sustainable investment rule while continuing to borrow to fund increased long-term capital investment in public services. Chart 2.4 also illustrates projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt.

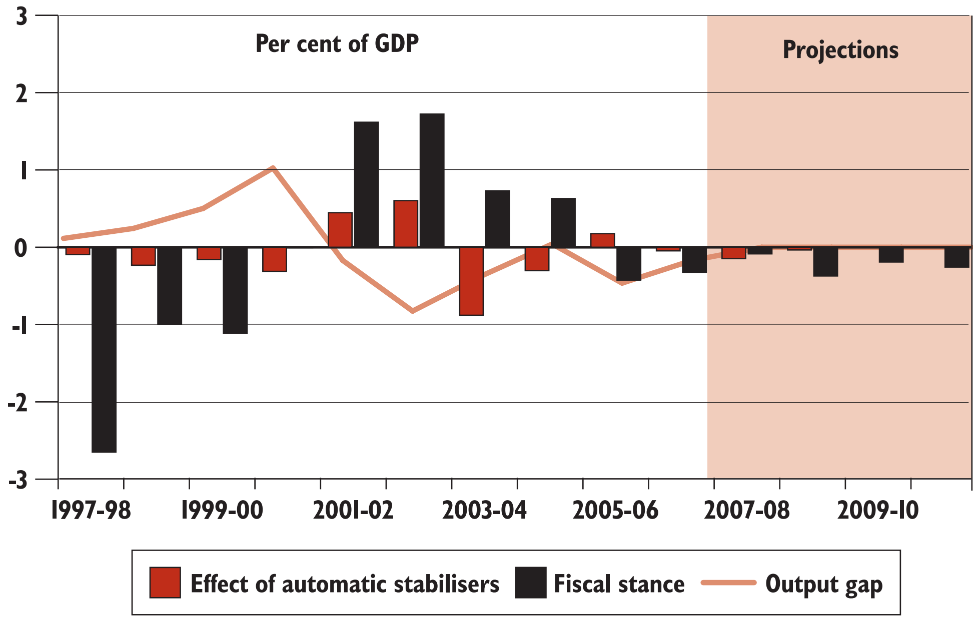
Chart 2.4: Meeting the sustainable investment rule



Source: ONS and HM Treasury.

Economic impact **2.67** While the primary objective of fiscal policy is to ensure sound public finances, fiscal policy also affects the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). These can be broken down into changes due to the effects of the automatic stabilisers and those due to the change in the fiscal stance, as illustrated in Chart 2.5.

Chart 2.5: Fiscal policy supporting monetary policy



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

2.68 As shown in Chart 2.5, during the late 1990s, the fiscal stance and the automatic stabilisers tightened at a time when the economy was above trend. As the economy moved below trend in 2001, the automatic stabilisers and the fiscal stance supported the economy, with the degree of support moderating as the economy moved back towards trend in early 2004. With the economy approaching trend levels in 2006-07, borrowing is lower compared with 2005-06, so that fiscal policy is slightly tighter.

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

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

2.70 Between Budgets and Pre-Budget Reports, the fiscal stance can change as a result of a discretionary measure to:

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

2.71 Table 2.6 explains how these concepts relate to the projections in the Budget. It shows the changes in both the fiscal stance and the overall fiscal impact between the 2006 Pre-Budget Report and Budget 2007. In Budget 2007 discretionary changes are broadly neutral across the projection period. With borrowing lower in 2006-07 than expected in the Pre-Budget Report, there is a tightening in the fiscal stance in 2006-07 compared with the Pre-Budget Report. As discussed above, non-discretionary changes, driven by North Sea revenues, account for the relative fiscal loosening over the projection period compared with the 2006 Pre-Budget Report.

Table 2.6: The overall fiscal impact[1]

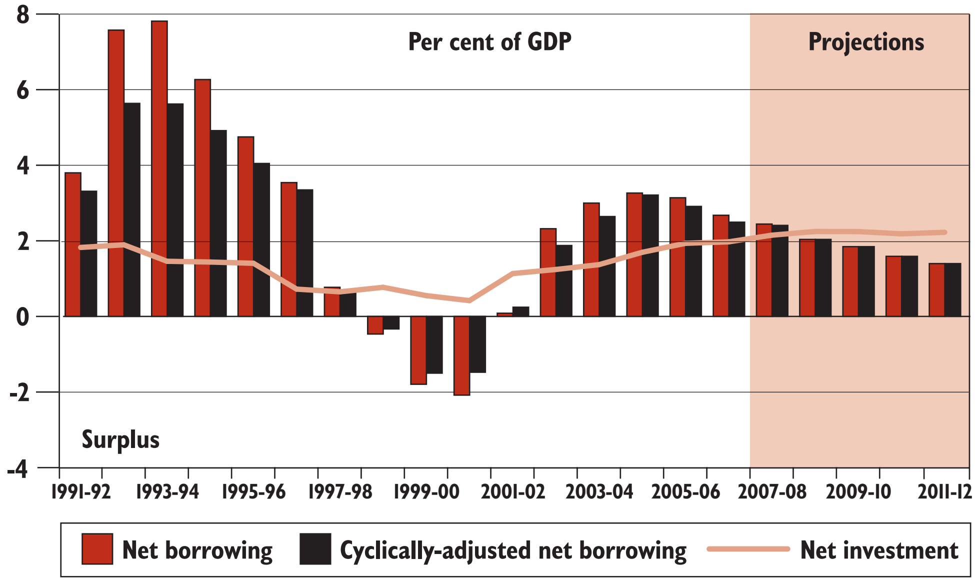
	Per cent of GDP						
	Outturn[2]	Estimate[3]	Projections				
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Change from 2006 PBR to Budget 2007							
Budget measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
+							
non-discretionary factors	0.0	–0.1	0.1	0.2	0.2	0.1	0.1
=							
CHANGE IN FISCAL STANCE	0.0	–0.1	0.2	0.2	0.2	0.1	0.1
+							
automatic stabilisers	0.0	0.0	0.0	0.0	0.0	0.0	0.0
=							
OVERALL FISCAL IMPACT	0.0	–0.1	0.2	0.2	0.2	0.1	0.1

[1] *All the numbers represent the impact of changes on public sector net borrowing. A negative number represents a fiscal tightening.*

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

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

Chart 2.6: Public sector net borrowing and net investment



Source: ONS and HM Treasury.

2.72 On average since 1997-98 public sector net investment has exceeded net borrowing, reflecting the average surplus on the current budget. This is projected to continue as the Government borrows to invest in public services while continuing to meet its strict fiscal rules. Chart 2.6 shows net borrowing falling to 1.4 per cent of GDP by the end of the projection period.

Financing

2.73 The forecast for the central government net cash requirement (CGNCR) for 2006-07 is £37.0 billion, a decrease of £4.2 billion from the 2006 Pre-Budget Report forecast of £41.2 billion.

2.74 The forecast for the CGNCR for 2007-08 is £37.6 billion. Gross gilt redemptions are £29.2 billion and National Savings and Investments' net contribution to financing is estimated to be £2.8 billion. The net financing requirement for 2007-08 is forecast to be £59.8 billion. The net financing requirement will be met by:

- gross gilt issuance of £58.4 billion; and
- an increase in the Treasury bill stock to £17.0 billion.

2.75 Full details and a revised financing table can be found in Chapter C. Box 2.6 considers the factors underlying low gilt yields and the Government's weighting of its gilt issuance programme towards longer maturities in the last few years. In 2007-08, approximately two-thirds of total issuance is forecast to be in long maturity and index-linked gilts. Further details can be found in the *Debt and reserves management report 2007-08* which is published alongside the Budget.

European commitments

2.76 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box B1 and as reflected in reforms to the Pact agreed in March 2005. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in Budget 2007, which show the Government is meeting its fiscal rules over the cycle, maintaining low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with a prudent interpretation of the Pact.

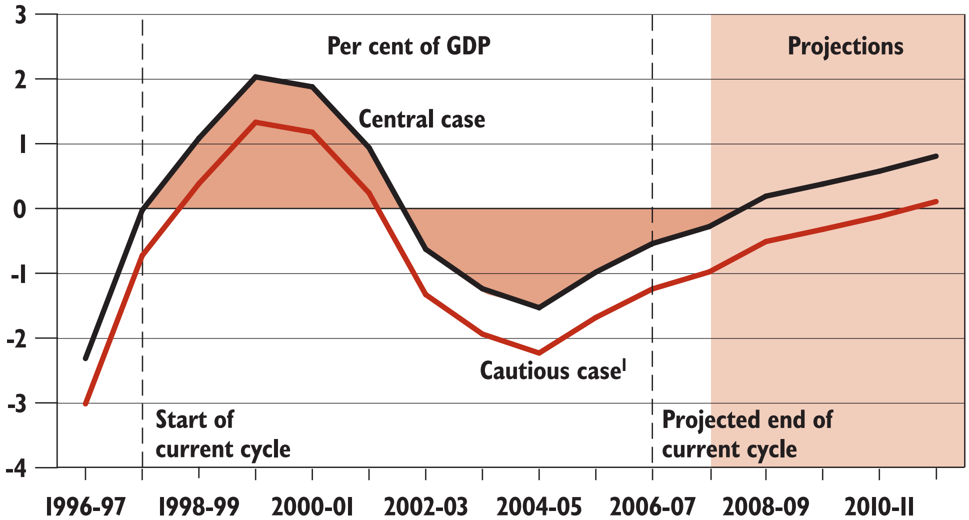
Dealing with uncertainty

2.77 Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The use of cautious assumptions audited by the NAO builds a safety margin into the public finance projections to guard against unexpected events. The degree of caution in the assumptions underpinning the public finance projections increases over the projection period. The Government bases its public finance projections on a trend growth assumption that is a $^1/_4$ percentage point lower than its neutral view, to accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term. This implies that the level of GDP used in the public finance forecast is $1^1/_4$ per cent below the neutral view by 2011-12.

2.78 A second important source of potential error results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.7 illustrates the projections for this cautious case.

2.79 The Government is, on the basis of cautious, independently-audited assumptions, meeting the golden rule in the central case. In the cautious case, Chart 2.7 shows that the cyclically-adjusted balance will be in surplus at the end of the projection period.

Chart 2.7: Cyclically-adjusted surplus on current budget

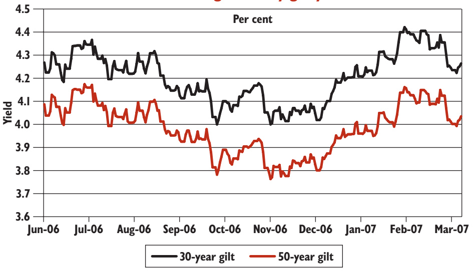


[1] Cautious case assumes trend output one percentage point lower in relation to actual output than the central case.
Source: HM Treasury.

Box 2.6: Low yields and the government bond market

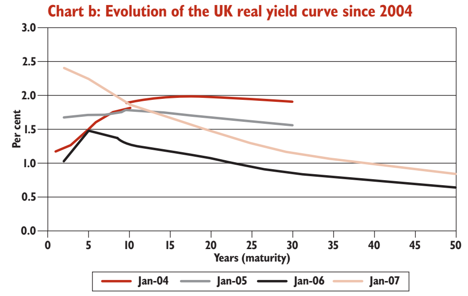
Following the drop in interest rates at long maturities to very low levels in January last year, yields have risen but remain at close to historic lows (Chart a). This reflects, in part, a global phenomenon associated with the success of central banks around the world in maintaining low inflation, but also reflects trends in global saving and investment. However, unlike the yield curve in the United States and the euro-area, the UK yield curve has been inverted for most of the past decade, suggesting a sustained UK-specific influence on long conventional and real gilt yields over and above that exerted by global influences (Chart b).

Chart a: Conventional long-maturity gilt yields



Source: Bloomberg.

Chart b: Evolution of the UK real yield curve since 2004



Source: Office for National Statistics.

One possible reason for the inversion of the yield curve is the rising demand from defined-benefit pension schemes for long-dated bonds.[1] Over the past decade, pension schemes have gradually shifted the composition of their portfolios from equities to bonds and fixed-income assets. Underlying the increased attractiveness of long-dated and index-linked bonds for pension funds' portfolios are a number of factors including:

- **the growing maturity of pension schemes both due to ageing of schemes' members and in some cases to the closure of defined benefit schemes to new entrants and/or restrictions on the acquisition of new rights for existing members;**
- **the cumulative effect of regulation over a long period of time, designed to provide more protection to scheme members which made pension fund liabilities a more explicit liability;**
- **a better understanding of risks (including their measurement) and a decrease in the risk tolerance of both trustees and corporate sponsors; and**
- **the implementation of new accounting standards which highlighted risks that were not apparent in the previous system and encouraged pension funds to invest in liability-matching assets, such as bonds, in order to offset balance sheet volatility.**

These factors are likely to underpin sustained demand for long conventional and index-linked gilts from defined-benefit pension schemes in the medium term. The Government's debt management objective is to minimise cost subject to risk. In line with this objective, the Government has weighted its gilt issuance programme increasingly towards longer maturities over the past few years (from 28 per cent of total issuance in 2003-04 to 59 per cent in 2006-07) and has extended the yield curve to 50 years. Further details of the Government's financing programme for 2007-08 can be found in the *Debt and reserves management report 2007-08*, which is published alongside the Budget and is available on the Treasury's website at: www.hm-treasury.gov.uk.

[1]Although there are also important non-pension related sources of demand for long-dated and index-linked gilts.

Box 2.7: Independence for statistics

Following the commitment made by the Chancellor in November 2005, and a full public consultation, the Government has introduced to Parliament this session legislation for the reform of the UK statistical system. This will build on earlier reforms, helping to reinforce the quality and integrity of statistics produced in government, supporting the Government's agenda for better public services, and contributing to long-term stability in the UK economy.

Following its introduction on 21 November 2006 and its passage through the House of Commons, the Bill entered the House of Lords on 14 March 2007. The Bill will establish an independent Statistics Board, reporting directly to Parliament, responsible for promoting and safeguarding the quality and comprehensiveness of all official statistics, wherever produced in government. The Board will have a statutory duty to set professional standards in a Code of Practice, and to assess independently all National Statistics against this Code. The Board will also replace Ministers as the top layer of governance for the Office for National Statistics.

As the Financial Secretary to the Treasury announced during the Bill's Second Reading in the Commons on 8 January 2007, the Government intends that the new system will be up and running by Spring 2008, and is therefore working to ensure a smooth transition to the new system. A key part of this will be the early appointment of a Chair of the Board, to enable preparatory work to begin on the transition to the new system, including on how the Board's statutory functions might operate in practice.

Also, in order to assist planning and provide funding certainty, the Government has announced a budget of £1.2 billion for the next five years for the new Statistics Board, which will allow the Board to be established and to deliver on its new functions, together with a high quality Census in 2011.

Further details of the Government's proposals, including the Bill and associated documentation, can be found on the HM Treasury website at http://www.hm-treasury.gov.uk.

LONG-TERM FISCAL SUSTAINABILITY

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

2.81 An analysis of long-term fiscal sustainability is presented in Annex A. The analysis shows that given assumptions regarding tax revenues and the projected profile for transfers, current public consumption can grow at around assumed GDP growth after the medium term while meeting the Government's golden rule. Public sector net investment can also grow broadly in line with the economy without jeopardising the sustainable investment rule.

2.82 These illustrative long-term fiscal projections yield similar conclusions to those presented in the Government's 2006 *Long-term public finance report*. Using a range of sustainability indicators, and based on current policies and reasonable assumptions, the report shows that the public finances are sustainable in the longer term.