

Convergence Programme for the United Kingdom: submitted in line with the Stability and Growth Pact

December 2008



HM TREASURY



HM TREASURY

Convergence Programme for the
United Kingdom:
submitted in line with the Stability
and Growth Pact

December 2008

© Crown copyright 2008

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Where we have identified any third party copyright material you will need to obtain permission from the copyright holders concerned.

For any other use of this material please write to Office of Public Sector Information, Information Policy Team, Kew, Richmond, Surrey TW9 4DU or e-mail: licensing@opsi.gov.uk

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

Printed on at least 75% recycled paper.
When you have finished with it please recycle it again.

ISBN 978-1-84532-547-8
PU667

Contents

		Page
Chapter 1	Introduction	2
Chapter 2	Economic outlook	6
Chapter 3	Overall policy framework, institutions and objectives	18
Chapter 4	Outlook for the public finances	35
Chapter 5	Sustainability of public finances	62
Chapter 6	Quality of public finances	69
Annex A	The fiscal impact of budget policy decisions	81
Annex B	Supplementary information	83
Annex C	Structural reform measures	89

1

Introduction

1.1 The Government has submitted programmes under the Stability and Growth Pact for each of the last ten 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).

1.2 This regular annual Convergence Programme updates the UK's 2007 Convergence Programme to reflect the latest Government forecasts for the economy and the public finances, which were published in the Pre-Budget Report on 24 November 2008¹. The public finance projections in the Pre-Budget Report have a different status to those included in the Budget – they are an interim forecast update. This update therefore also takes account of Budget 2008². The updated Programme is subject to the usual UK Parliamentary scrutiny and approval under Section 5 of the European Communities (Amendment) Act 1993.

Facing global challenges

1.3 The Government's long-term goal is to secure and maintain macroeconomic stability, in order to promote a strong economy and achieve its objective of a fair society where there is security and opportunity for all.

1.4 Chapter 2 outlines how over the last year major shocks have hit the economies of every country in the world. While commodity prices have recently eased, the credit shock has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. The current economic and fiscal climate is exceptionally challenging. While economic prospects are subject to significant uncertainty, it is clear that the UK, like many advanced economies has moved into recession.

1.5 The UK economy has slowed as credit conditions tightened and high food and energy prices squeezed household incomes and company profits. The combined effects of these shocks has been to push the UK economy into recession and inflation to a 16-year high. Due to lower commodity prices, inflation has started to ease, but growth is forecast to be negative in 2009. From the second half of 2009, the economy is forecast to begin to recover, with growth picking up further in 2010 and 2011.

1.6 The macroeconomic framework introduced in 1997, means that the UK is facing these shocks from a solid foundation. Credible medium-term objectives and mechanisms for short-term flexibility mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective commitments to low inflation and sound public finances.

¹ 2008 Pre-Budget Report, HM Treasury, November 2008

² Budget 2008, HM Treasury, March 2008

Policy Response

1.7 Chapters 3 and 4 outline in detail the Government's and the Bank of England's response to the global shocks.

1.8 The Bank of England has reduced interest rates to a 50-year low, providing monetary policy support to the economy.

1.9 The Government's immediate priority is to continue to support the economy through these difficult times. A starting point of low public debt, and action being taken to ensure sound public finances over the medium term, provide flexibility for fiscal policy to support the economy now, acting to support monetary policy. The 2008 Pre-Budget Report announced that the Government will support families and businesses, including by:

- temporarily reducing the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and
- bringing forward £3bn of capital spending from 2010-11 to 2008-09 and 2009-10, the years when the impact of the shock is likely to be the strongest.

1.10 Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. The 2008 Pre-Budget Report therefore, set out plans for a sustained fiscal consolidation from 2010-11, when the economy is expected to be recovering and able to support a reduction in borrowing.

The case for a concerted international fiscal response

1.11 The case for concerted fiscal action has been endorsed by the leaders of the G20 countries. On 15 November 2008 they declared that they:

- had agreed to work together to restore global growth; and
- would *"use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability"*.

1.12 The combined effect of coherent actions taken across countries will be more effective than each country acting alone. Decisive concerted action by the world's leading economies will also provide a strong signal to the private sector of the willingness of governments to act effectively together. An effective international response does not mean that all countries should take identical actions. Instead, fiscal actions need to be tailored to the situation of each country, taking account of existing levels of public debt.

The macroeconomic framework

1.13 The Government's macroeconomic framework has been designed to ensure that policymakers have the flexibility to respond appropriately to shocks.

1.14 The Government's fiscal policy objectives remain unchanged:

- 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 automatic stabilisers to help smooth the path of the economy

1.15 To achieve its objectives, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full. Consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once global shocks have worked their way through the economy in full.

1.16 Chapter 3 contains a detailed discussion of the UK's macroeconomic framework.

Public Finances

1.17 Developments in the economy and financial markets since the 2007 Convergence Programme have significant implications for the public finance projections. Table 1.A provides a summary of the 2008 Pre-Budget Report projections for key fiscal aggregates, which are discussed more fully in Chapter 4.

Table 1.A: Summary of fiscal projections

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Public sector net borrowing (PSNB)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Total change since Budget	0.0	2.4	5.5	4.8	3.7	2.8	-
Impact of discretionary measures on PSNB ¹	0.0	0.6	1.1	-0.3	-0.9	-1.3	-1.6
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Public sector net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net debt ²	36.3	41.2	48.2	52.9	55.6	57.1	57.4

¹ Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13 and 2013-14.
² Debt at end March; GDP centred on end March; excluding financial sector interventions.

1.18 The fiscal projections set out in the 2008 Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

1.19 Public sector net borrowing (PSNB) increases from 2.6 per cent of GDP in 2007-08 to 8.0 per cent in 2009-10, reflecting the impact of the economic downturn on receipts, in particular from the financial and housing sectors, the effect of the automatic stabilisers and the action the Government is taking to support the economy. Of this around 1.1 per cent of GDP is as a result of discretionary action to support the economy. PSNB then declines to 2.9 per cent of GDP by 2013-14 as the economy recovers and the Government takes action to ensure the sustainability of the public finances.

1.20 Public sector net debt (PSND) increases over the forecast period, in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years, then begins to stabilise at just over 57 per cent by 2013-14.

Sustainability for the long term

1.21 The analysis in chapters 3 and 4 sets out how the Government will ensure sustainability in the medium term. In addition, the Government must also ensure that fiscal policy is sustainable

in the long term. Chapter 5 discusses some of the socio-economic challenges facing the public finances in the long term, including demographic changes.

Quality of public finances

1.22 Over the last ten years, record levels of investment coupled with reform have generated real and enduring improvements in Britain's schools, hospitals and other public services. The Government will maintain high levels of investment, reprioritise spending to support the economy through the downturn and take forward an ambitious extension of its plans to increase value for money. More details are contained within Chapter 6.

Stability and Growth Pact

1.23 European economies have all been affected by the unprecedented global economic shocks, and several European member states are already in recession. Fiscal policy has an important role to play in these exceptional circumstances. The 2005 revision of the Pact allows better account to be taken of cyclical conditions, and places greater emphasis on improved flexibility in exceptional circumstances. The Government welcomed these reforms and has since emphasised the importance of applying the additional economic judgement the revisions allow.

1.24 The Government's objectives of smoothing the path of the economy in the short term while ensuring sound public finances over the medium term are consistent with the October European Council Conclusions, which confirmed that the Stability and Growth Pact should be applied in a manner that reflects current exceptional economic circumstances. The objectives are also consistent with the Commission's 26 November Communication, "A European Economic Recovery Plan". This recognises that a budgetary expansion, which may lead some Member States to breach the 3% GDP deficit reference value, is justified in these extraordinary circumstances. It further states that corrective action will have to be taken in time frames consistent with the recovery of the economy.

Economic reform in Europe

1.25 The Government set out progress against key elements of the UK's comprehensive programme of structural reform, including measures being taken in the areas covered by the UK's country-specific recommendations prepared by the Council of the European Union, in the 2008 UK National Reform Programme³. The main reform actions are summarised in Annex C, taken from the 2008 National Reform Programme and updated to take into account the announcements made in the 2008 Pre-Budget Report.

Annex A & Annex B

1.26 Annex A provides details of the financial impact of the 2008 Pre-Budget Report and Budget 2008 policy decisions. Annex B provides supplementary information.

³ *Lisbon Strategy for Jobs and Growth: UK National Reform Programme*, HM Government, September 2008

2

Economic outlook

Global economic shocks

2.1 Between the summer of 2007 and summer 2008, the world economy progressively suffered from the unprecedented confluence of two major economic shocks. The global financial markets shock was triggered in July 2007. What began as a disruption to the functioning of specific credit and money markets has spread and intensified to the extent that all financial markets have been affected and financial institutions and financial systems around the world have been put under severe pressure. As a result, credit conditions facing households and companies have tightened very significantly. The availability of credit has been restricted, the terms on lending tightened, and the price of private credit has soared relative to official policy rates and government borrowing costs, factors that have caused growth in advanced and emerging economies to slow significantly.

2.2 The effect of restricted credit on household and company spending was exacerbated by a surge in global commodity prices in the first half of 2008 that put strong upward pressure on food and energy prices around the world. Stresses in financial markets intensified dramatically in September and October, with a number of large and small financial institutions across a broad range of advanced and emerging economies receiving government support, in conjunction with unprecedented generalised support for banking systems across the world. As output growth has slowed in response to these shocks, commodity prices have fallen sharply, thereby removing one of the factors detracting from world growth prospects.

The world economy

2.3 Global economic prospects have been hit hard since summer 2007, and particularly since Budget 2008. The credit shock described above caused credit conditions to tighten across advanced economies and growth to slow. The surge in commodity prices in the first half of 2008 lifted inflation, squeezing real incomes and pushing many advanced economies into recession. The escalation of the global banking crisis in recent months has increased uncertainty over prospects for growth in advanced economies and the risk of contagion to emerging markets. But the global financial policy response has limited the downside risks from systemic banking collapse, and an increasing number of countries have eased monetary policy and announced fiscal stimulus measures. At the same time, lower commodity prices should provide support for real incomes next year.

2.4 Against the backdrop of major economic shocks, world growth is forecast to have slowed to 3½ per cent in 2008 and to fall to just 2 per cent in 2009. That would represent a serious slowdown from the 4¾ per cent expansion in 2007, reflecting slower domestic demand growth in advanced economies and weaker trade growth around the world. Growth across the G7 economies is forecast to have slowed to 1 per cent this year, and to turn negative in 2009, the first year of contraction since 1982. Many advanced economies are already experiencing falling output, with the euro area and Japan in recession.

2.5 The outlook for world trade has deteriorated in line with world growth prospects, exacerbated by the effect of the global financial crisis on the availability of trade finance. UK export markets are expected to grow more slowly than world trade as advanced economies, particularly the euro area and US, make up a larger proportion of UK export markets.

Table 2.A: The World Economy

	Percentage change on a year earlier, unless otherwise stated				
	2007	2008	Forecast		
			2009	2010	2011
World GDP	4¾	3½	2	3¾	4½
<i>Major 7 countries</i> ¹ :					
Real GDP	2¼	1	-¾	1½	2½
Consumer price inflation ²	3	2¾	1¼	2	2
Euro area GDP	2¾	1	-1	1	1¾
World trade in goods and services	7	5¼	2	4¼	7
UK export markets ³	6½	3¾	½	3¼	6

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.

2.6 Inflation, which picked up in the first half of 2008 following the surge in commodity prices, is expected to moderate quickly towards the end of the year. G7 inflation is forecast to hit an 8-year low of 1¼ per cent by late 2009. The inflation outlook for emerging economies is less clear, as many currencies have depreciated rapidly and a number of monetary policy frameworks are not yet well established.

2.7 Receding inflation risks in the G7 countries have provided greater scope for monetary easing. On 8 October, six major central banks, including the Federal Reserve, European Central Bank (ECB) and Bank of England, announced a coordinated ½ percentage point interest rate cut. Subsequently, the Federal Funds rate was cut further to 1 per cent, down from a peak of 5¼ per cent prior to the onset of the global credit shock, and official interest rates have been reduced to 2½ per cent in the euro area, 0.3 per cent in Japan and 2 per cent in the UK.

Prospects for UK economic growth

Recent developments

2.8 In 2006 and 2007, GDP grew by 2¾ and 3 per cent respectively. Reflecting the impact on the economy of the major shocks it has faced, growth has slowed progressively as credit conditions tightened and real incomes were squeezed by high commodity prices. Quarterly GDP growth in the first half of 2007 averaged 0.8 per cent, before slowing progressively to average 0.6 per cent in the second half and 0.1 per cent in the first half of 2008. In the third quarter, GDP contracted by 0.5 per cent, the first fall in output since 1992, with negative growth across most sectors of the economy. The distribution sector experienced the largest contraction, consistent with discretionary spending having been held back as consumer sentiment weakened and real incomes were squeezed.

2.9 Private sector business surveys weakened further in October, suggesting that output in the final quarter of 2008 is likely to fall again, placing the UK economy in technical recession. Surveys of purchasing managers compiled by the Chartered Institute of Purchasing and Supply indicate that output growth in the manufacturing, construction and services sectors was very

weak. Similarly, the Economic Sentiment Indicator compiled by the European Commission fell to its lowest level since 1991.

2.10 In common with experience across the world, UK inflation increased during 2008 as the surge in global commodity prices fed through to retail prices of food, petrol and diesel, and household energy bills. In the UK, CPI inflation increased from 2.2 per cent in December 2007 to a peak of 5.2 per cent by September 2008 before falling back to 4.5 per cent in October. Movements in prices of goods that are most closely linked to global commodity prices accounted for virtually all of the increase: food price inflation increased from 6 per cent in December to a peak of 14½ per cent in August; petrol and diesel price inflation increased from 17 per cent to a peak of 26 per cent in July; and household energy price inflation increased from -7 per cent to 39 per cent in October.

2.11 Since the onset of the global credit shock in summer 2007, the Monetary Policy Committee (MPC) of the Bank of England has cut Bank Rate by a cumulative 2¾ percentage points, from 5¾ per cent to 3 per cent. On 8 October, the MPC cut rates by ½ a percentage point as part of a globally coordinated interest rate cut, and then on 6 November it reduced Bank Rate by a further 1½ percentage points to 3 per cent. This was followed by a further cut of 1 percentage point on 4 December to 2 per cent, the lowest rate since 1951. With inflationary pressures easing and weaker near-term UK growth prospects, financial markets have increasingly come to expect further monetary policy easing. This trend has been evidenced by the lowering of external forecasters' expectations of Bank Rate by the middle of 2009 to around 1½ per cent.

Trend growth

2.12 As with other aspects of economic forecasting, recent economic shocks, in particular the global financial crisis, have generated uncertainties over prospects for trend output, the assessment of which plays a central role in the Treasury's approach to forecasting. There are a number of channels through which the global credit and commodity price shocks could reduce the level of trend output. In light of commodity price developments since July 2008, credit related channels are the most likely to have persistent effects to trend output. Table 2.B presents estimates of trend output growth and its decomposition to the second half of 2006, and the Treasury's projections thereafter. For the 2008 Pre-Budget Report, to take account of the likely negative effect of the credit shock on trend output, a phased reduction to the trend level of productivity (and therefore the trend level of output) of about 4 per cent has been assumed over the two years from mid-2007, a period consistent with the credit conditions assumption that underpins the economic forecast more generally. This adjustment is within the range of external estimates of the impact of the shocks to credit and energy markets on medium-term potential output, though it is a key forecasting judgement around which there is very considerable uncertainty. The Treasury will continue to keep its trend output assumptions under review.

Table 2.B: Contributions to trend output growth^{1,2}

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked ^{3, 4}		Trend average hours worked ⁴	Trend employment rate ⁴	Adult population ⁵	Trend output
	Underlying (1)	Unadjusted (2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1						
Budget 2008	2.12	1.93	-0.11	0.37	0.26	2.46
Latest data	2.13	1.95	-0.11	0.36	0.26	2.47
Over the recent past						
1997H1 to 2001Q3						
Budget 2008	2.86	2.61	-0.45	0.49	0.51	3.17
Latest data	3.12	2.87	-0.46	0.50	0.52	3.45
2001Q3 to 2006H2						
Budget 2008	2.26	2.21	-0.31	0.09	0.75	2.76
Latest data	2.12	2.07	-0.26	0.11	0.75	2.68
Projection⁶						
2006H2 onwards						
Budget 2008	2.25	2.30	-0.25	-0.1	0.8	2¾
PBR 2008 ⁷	2.25	2.30	-0.25	-0.1	0.8	2¾
Level effect: 2007Q3 to 2009Q3⁸	-4	-4	0	0	0	-4

¹ Treasury analysis based on judgement that 1986Q2, 1997H1, 2001Q3 and 2006H2 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components forward.

² Interim projections between Budget 2002 and PBR 2007 are provided in an expanded table in 'Budget 2008: the economy and public finances - supplementary material'.

³ The underlying trend rate is the unadjusted trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant. Column (1) = column (2) + (1-a).column (4), where a is the ratio of new to average worker productivity levels. The figure is consistent with this ratio being of the order of 50 per cent.

⁴ The decomposition makes allowances for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than

⁵ UK resident household basis. Population aged 16 and over.

⁶ Neutral case assumptions for trend from 2006H2.

⁷ Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006H2 are anchored.

⁸ Adjustment to trend growth reflecting a phased reduction to the level of trend output of around 4 per cent between mid-2007 and mid-2009.

Economic cycle and the output gap

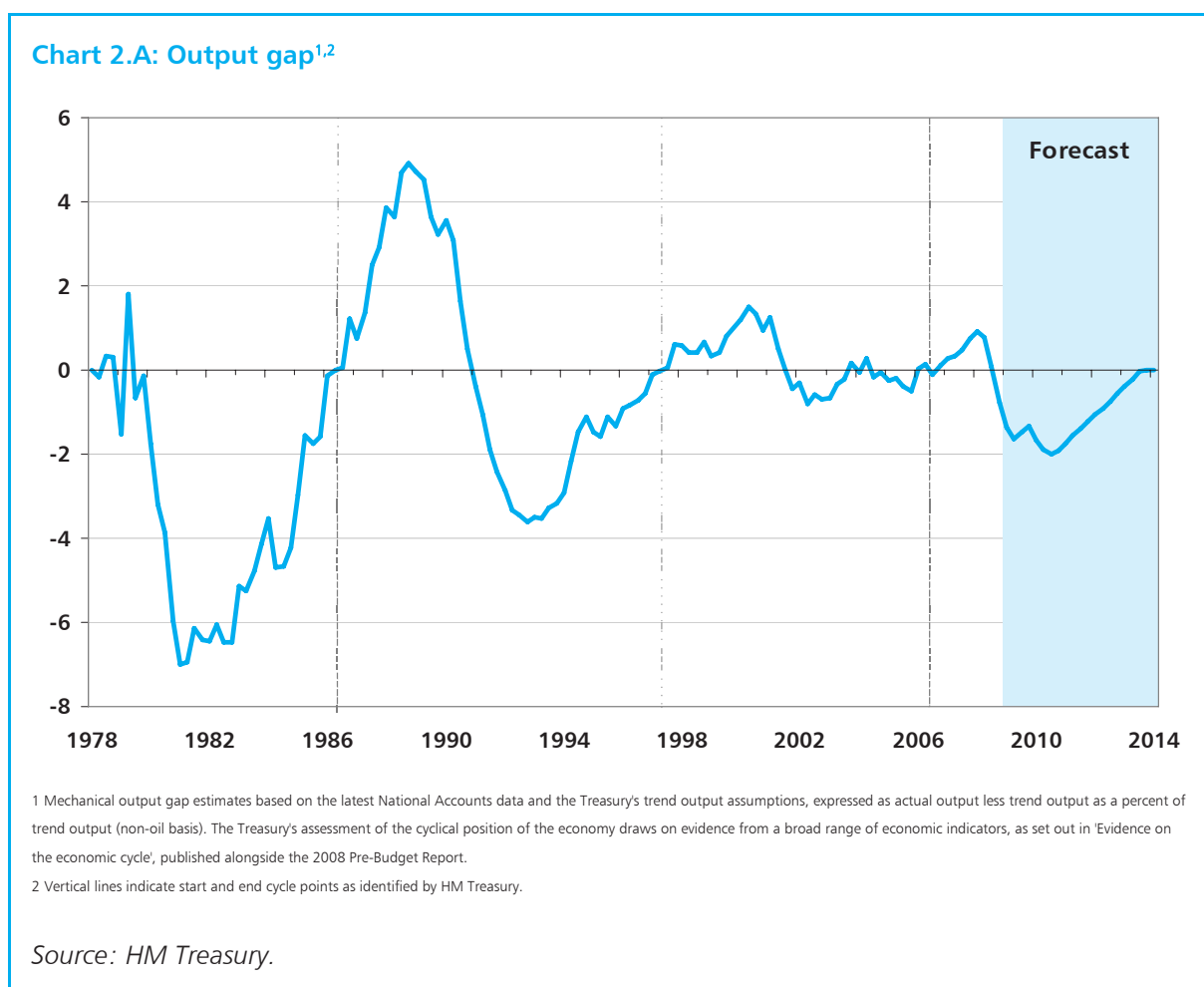
2.13 The 2008 Blue Book revisions to recent National Accounts data were relatively small, with non-oil GVA growth in both 2006 and 2007, of 3 per cent, still estimated to have been at an above-trend rate. Since the beginning of 2008, growth has slowed to below-trend rates of 0.3 per cent and 0.0 per cent in the first two quarters of the year, before falling to -0.5 per cent in the third quarter. Taken together with the 2008 Pre-Budget Report assumptions on trend output, this would imply that the economy was recently operating close to trend, with an output gap of around zero in the third quarter of 2008.

2.14 Evidence from the broad range of cyclical indicators monitored by the Treasury continues to support the Budget 2008 assessment that the economy passed up through trend during the second half of 2006, marking the end of the economic cycle judged to have started in the first half of 1997.

2.15 The Comptroller and Auditor General has audited this judgement. Taking all the evidence available as a whole, he judged that it is reasonable to conclude currently that the second half of 2006 marked the end date of the most recently completed economic cycle, and recommended, given the uncertainties in dating economic cycles, including looking ahead and the impact new data might have in the future, that the Treasury keep this assessment under review.

2.16 The cyclical indicators suggest the economy remained above trend during 2007 before falling back towards trend during the first half of 2008.

2.17 The Treasury's forecasting judgements on the impact of the credit shock on trend output are subject to significant uncertainty. This has implications for assessing the balance between cyclical demand and potential supply, and hence prospective inflationary pressures and the labour market implications of the economic downturn. In terms of cyclical pressures, signals conveyed by the Bank's Regional Agents and the BCC and CBI quarterly business surveys do not deliver a clear picture of the degree of slack that has been generated by slowing growth over the past year. The evidence from the cyclical indicators is in general supportive of the assessment that the economy was recently operating close to trend, but clear uncertainties remain.



Prospects for credit conditions

2.18 As was the case at Budget 2008, the key forecasting assumption underpinning the 2008 Pre-Budget Report forecast concerns prospects for the unwinding of tight credit conditions and normalisation of banking and financial markets. As set out above, conditions in global markets deteriorated dramatically in September and October. Following unprecedented global policy action in recent weeks, money markets have stabilised and the risk of systemic failure of the global financial system looks to have receded, but global credit markets have remained severely strained with stock markets falling sharply and some markets remaining closed.

2.19 Despite extensive government support for financial systems worldwide, it will take time for conditions to normalise, and recent experience is likely to mean that 'normal' credit conditions

will be materially less accommodative than they were in the years to mid-2007. The 2008 Pre-Budget Report forecast is therefore conditioned on the assumption that credit conditions will remain tight in 2008, and ease slowly through 2009 before stabilising in 2010 at a level where risk is more appropriately priced. This assumption is consistent with a view that the value of underlying property collateral will have stopped falling around the end of 2009 and that lower policy interest rates and funding costs will enable banks to lend profitably, bolstering their capital positions. These developments should allow lenders to return to a normal process of intermediating funds from savers to borrowers, while pricing risk competitively, but more warily, so as to avoid the mistakes of recent years. The Government's comprehensive package of measures to support the banking system should limit the downside risks to this assumption, enhancing prospects for credit conditions to ease over the coming year.

GDP growth forecast

2.20 Lower commodity prices and easing inflation are set to support real incomes in 2009, sterling has depreciated, and monetary and fiscal policy have both been eased to support the economy through the downturn. Together these factors lay the foundations for recovery. Uncertainty remains over how effectively the global financial crisis can be resolved and therefore how soon the financial system can resume its normal function of intermediating funds from savers to borrowers, in order efficiently to finance investment, house purchase and consumption and spread concentrations of risk.

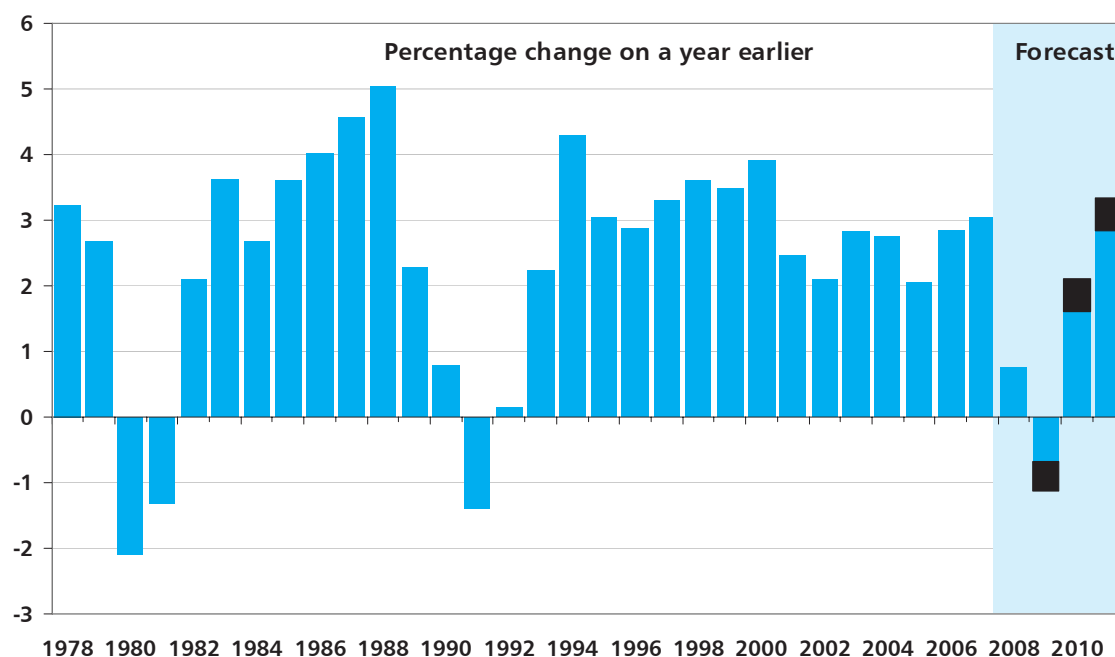
2.21 Having slowed progressively over the past year, GDP is forecast to fall by a $\frac{1}{4}$ per cent on a year earlier in the second half of 2008, leaving output in 2008 as a whole up $\frac{3}{4}$ per cent on a year earlier. The recession is forecast to continue into the first half of 2009, before GDP growth begins to recover in the second half of the year as credit conditions start to ease and the boost to real incomes from lower commodity prices, the stimulus from monetary and fiscal policy, and the effects of sterling's depreciation, take hold.

2.22 Growth in 2009 as a whole is forecast to be negative, at $-1\frac{1}{4}$ to $-\frac{3}{4}$ per cent. The effect of fiscal stimulus, particularly the temporary cut in the VAT rate and bringing forward of public investment to 2008-09 and 2009-10, in addition to other measures, is assumed to reduce the extent of the downturn by around $\frac{1}{2}$ a percentage point. The UK also has relatively powerful automatic stabilisers, which will operate in full to support the economy.

2.23 Credit conditions are assumed to settle at a new norm in 2010, such that the process of efficient credit allocation is restored and the UK's flexible markets can adjust more effectively to changed economic circumstances. As lagged effects feed through, including from fiscal and monetary stimulus and from the depreciation of sterling, growth is expected to pick up progressively through 2010 and 2011 to a little above trend rates. Experience of past recoveries points to the possibility that, once recovery has taken hold, growth could continue at strong rates for a number of years as spare capacity is brought back into productive use. For example, GDP growth averaged $3\frac{1}{4}$ per cent a year in the five years from 1982 and again in the five years from 1993.

2.24 Chart 2.B shows the evolution of GDP. Table B.9 in Annex B compares the 2008 Pre-Budget Report GDP growth forecast with that of Budget 2008.

Chart 2.B: Gross Domestic Product (GDP)¹



¹ Shaded areas on bars represent forecast ranges.

Source: HM Treasury

Inflation

2.25 CPI inflation fell from 5.2 per cent in September to 4.5 per cent in October, suggesting September marked the peak. Global commodity prices have fallen sharply since the summer, which should feed through to consumer prices for petrol, food and household energy with varying lags. Energy prices contributed more than 2 percentage points to CPI inflation in September 2008, which means that even if energy prices were to remain unchanged from that level, by September 2009 they would subtract around 1 percentage point from the annual rate of inflation. In addition, with output contracting there is a degree of spare capacity opening up that will progressively reduce domestically generated inflationary pressure.

2.26 Commodity price developments and the emergence of a negative output gap would suggest that inflation will decline rapidly from above 5 per cent to reach the target rate by the middle of 2009, although the pass-through from sterling's depreciation will exert upward pressure. In addition, the temporary reduction of the VAT rate from 17½ per cent to 15 per cent from December 2008 is expected to put further downward pressure on inflation as businesses pass the cut through to prices. The forecast assumes that due to the competitive nature of the UK retail sector, especially during the coming downturn, the majority of the VAT rate cut will be passed through to consumer prices, but that prices will be reduced progressively rather than immediately. This is in line with international evidence. As a result, these factors mean that CPI inflation is forecast to fall below 1 per cent in the second half of 2009.

2.27 Unlike the initial cut in the VAT rate, the subsequent pre-announced increase back to 17½ per cent will be anticipated by businesses and consumers, so the forecast assumes that businesses will smooth the pass-through of this change during the normal process of reviewing prices as other costs and demand factors evolve. Inflation is forecast to move a little above the

2 per cent inflation target following the reversal of the VAT rate cut and as the lagged effects of sterling depreciation on import prices continue to feed through, before returning to target in 2011 as the still negative output gap exerts downward pressure.

Employment

2.28 Strong output growth in 2007 fed through to strong employment growth, with employment rising by more than 100,000 a quarter from the second quarter of 2007 to the first quarter of 2008. As output growth has slowed, employment flattened in the second quarter and fell by around 100,000 in the third quarter.

2.29 Unemployment has begun to increase, with the Labour Force Survey (LFS) measure of the unemployment rate rising from 5¼ per cent to 5¾ per cent over recent months. The more timely claimant count measure has risen by 186,000 since the start of the year, though from a very low level: January 2008 was the first time since mid-1975 that the claimant count had fallen below 800,000.

Consumption

2.30 Real household disposable income is estimated to have been flat in 2007, as negative growth in non-wage income, particularly net interest and dividend payments, offset the impact of strong employment growth on total wages and salaries. Sluggish real disposable income growth continued in the first half of 2008, as the commodity-price related pick-up in inflation squeezed real incomes further. The effects of lower commodity prices and the temporary cut in the rate of VAT should support real income growth in 2009, which is forecast to pick up to ½ to 1 per cent. As the recovery takes hold from 2010, a strengthening labour market is expected to take over as the main driver of real income growth as inflation returns to close to target and the effects of fiscal stimulus recede.

2.31 Private consumption grew by 3 per cent in 2007, in line with GDP growth as a whole. Consumer spending continued to grow strongly in the first quarter of 2008 before contracting slightly in the second quarter. The breakdown of consumer spending in the second quarter shows clearly how the global economic shocks impacted UK consumers, with spending on housing and transport-related durable goods falling by around 5 per cent on the previous quarter, while spending on discretionary services like recreation and restaurants was down by around 3 per cent.

2.32 Consumer spending is forecast to decline in 2009, reflecting various factors. Apprehension over labour market prospects and increased saving from the very low level of 2008 are likely to put downward pressure on consumer spending. The temporary cut in the rate of VAT, by boosting real purchasing power as it is passed through to lower prices and by incentivising purchases before the lower rate reverses, is expected to increase the volume of spending relative to the level that would have prevailed in the absence of such a cut. The forecast assumes that around half of the increase in real purchasing power will feed through to an increased volume of spending and half to the adjustment of household finances.

2.33 As real incomes recover further and credit conditions normalise, consumer spending is forecast to grow by 1¼ to 1¾ per cent in 2010, and then to continue to grow at rates slightly below that of the whole economy as households continue to adjust their finances. This pattern of growth, with a gradual rise in the household saving ratio, will support the rebalancing of demand in the UK from domestic to external sources.

Investment

2.34 Business investment grew strongly between 2005 and 2007, by more than 4 per cent a year in 2005 and 2006 and almost 10 per cent in 2007, a pattern consistent with the economy having passed up through trend in the second half of 2006. In the first half of 2008, business investment contracted by 1 per cent on a year earlier as uncertainty over demand prospects increased. The contraction was broadly based across sectors.

2.35 With company finances under pressure, near-term demand prospects weakening and credit conditions remaining tight, business investment is set to contract relatively sharply in 2008 and 2009. In keeping with the strongly cyclical nature of investment, after falling 1 per cent in 2008 and $7\frac{3}{4}$ to $8\frac{1}{4}$ per cent in 2009, business investment is forecast to begin recovering in 2010 as credit conditions normalise and demand uncertainties recede, and to grow strongly in 2011.

2.36 Between 2000 and 2007, investment in dwellings increased from around $2\frac{3}{4}$ per cent to 4 per cent of GDP in nominal terms, with around half of the rise accounted for by strong growth in house prices. As such, while real activity has been relatively strong, growing by $8\frac{1}{2}$ per cent in 2006 and 5 per cent in 2007, the UK has not witnessed the kind of housing construction boom that took place in some countries, notably the US, Ireland and Spain.

2.37 Prospects for housing investment have been adversely affected by the impact of the global credit shock on the UK housing market. After contracting $7\frac{3}{4}$ per cent on a year earlier in the first half of 2008, investment is forecast to fall $9\frac{1}{2}$ per cent in 2008 as a whole and by a further 11 to $11\frac{1}{2}$ per cent in 2009. However, with the fundamental drivers of demand for housing – principally the rate of household formation – still in place, and credit conditions assumed to settle at a new norm, housing investment is expected to recover from later in 2010.

Trade and the balance of payments

2.38 Annual growth in recorded exports and imports of goods and services has been distorted by activity related to missing trader intra-community fraud (MTIC), which significantly inflated the value of measured goods trade in the first half of 2006. Since the second half of 2006, Government measures to tackle MTIC fraud have led to a sharp fall in estimated MTIC-related activity, to a low level.¹ The economic forecast abstracts from MTIC effects by making a neutral assumption that the adjustment for MTIC-related activity remains constant throughout the forecast at the latest quarterly estimate, and that trade grows in line with underlying determinants.

2.39 Growth in the measured volume of goods and services exports, excluding the MTIC adjustment, is estimated to have eased from 8 per cent in 2006 to $1\frac{1}{4}$ per cent in 2007. It seems possible that this exaggerates the extent of the genuine slowdown between those years, reflecting difficulties in applying the MTIC adjustment. With MTIC-related activity estimated to have been stable for more than a year, growth rates in the first half of 2008 should be subject to somewhat reduced uncertainty. On current estimates, the volume of exports of goods and services grew $2\frac{1}{2}$ per cent on a year earlier in the first half of the year.

2.40 In the near term, prospects for UK export growth are likely to be dictated by the downturn in key export markets, notably the euro area, so that export growth is likely to be weak in 2008

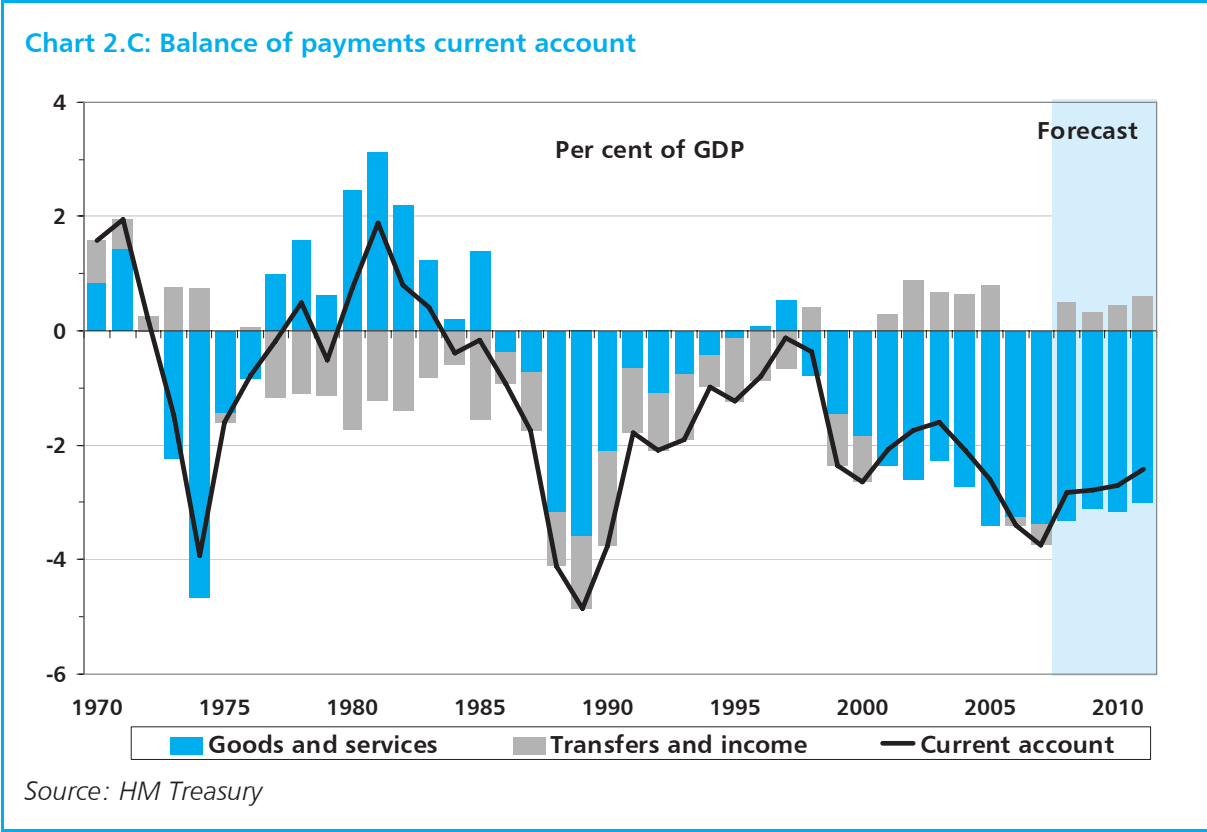
¹ In view of the inevitable measurement difficulties involved in adjusting for MTIC-related activity, the ONS continues to advise in its monthly trade releases that comparisons of trade volumes and prices “should be treated with a great deal of caution”. Consistent with the view set out in paragraph B.77 of Budget 2008, it remains hard to reconcile the trade data for 2006 and 2007 with evidence from private business surveys and domestic demand growth in the UK’s main trading partners.

and 2009 despite the support from sterling's depreciation. The forecast for UK export market growth in 2009 has been revised down by almost 6 percentage points since Budget 2008 to ½ a per cent. Export volumes growth in 2009 is forecast to be 0 to ½ per cent, but as growth in the UK's export markets recovers and the effects from sterling gradually encourage more companies to pursue export opportunities, growth is forecast to pick up in 2010 and further in 2011.

2.41 Growth in the measured volume of goods and services imports, excluding the MTIC adjustment, shows a similar pattern to exports, with strong growth in 2006, of 6¾ per cent, followed by slower growth of 3½ per cent in 2007. In the first half of 2008, the volume of goods imports grew by 2¼ per cent on a year earlier, having fallen on a quarterly basis since the final quarter of 2007. By contrast, the volume of services imports grew by 6 per cent on a year earlier following strong quarterly growth in the first quarter of 2008.

2.42 With consumer spending and business investment forecast to contract in 2009, the volume of imports is also expected to fall. In line with the recovery in domestic demand from 2010, but tempered by the effect of sterling's depreciation on consumers' incentives to substitute domestically produced goods for imports, import volumes growth is forecast to pick up from 2010.

2.43 Overall, the UK's current account deficit was 3¾ per cent of GDP in 2007. After temporarily narrowing to 1½ per cent in the first quarter of 2008, it returned to 3 per cent of GDP in the second quarter. The balance of domestic demand growth in the UK and overseas, supported by the effects of sterling's depreciation, should lead to the current account deficit narrowing in the second half of 2008 and 2009. The balance is forecast to remain broadly stable thereafter, with 2007 expected to have marked the peak for the current account deficit.



Independent forecasters

2.44 Since Budget 2008, the average of independent forecasts for GDP growth in 2008 has been revised down from 1.7 per cent to 0.9 per cent, close to the 2008 Pre-Budget Report forecast. With independent forecasters expecting contractions in private consumption and investment in 2009, forecasts for GDP growth next year have been revised down progressively and significantly, from 1.9 per cent at the time of Budget 2008 to -0.9 per cent. Since August 2008, this downward trend has quickened as the independent average has fallen from 0.9 per cent to -0.9 per cent. Following the pick-up in inflation this year, forecasts for CPI inflation in the final quarter of 2008 have risen to 4.5 per cent. However, inflation is expected to fall back over the coming year, moving below target by the end of 2009. The average of independent forecasts for 2010 and 2011 show inflation at or close to target.

2.45 Among external forecasters that produce medium-term growth forecasts, expectations are for a relatively sluggish recovery in 2010 and 2011, with the independent average somewhat below the Pre-Budget Report forecast ranges for those years at 1.2 and 2.4 per cent respectively. Illustrating the uncertainty surrounding the timing and strength of the recovery, the range of independent growth forecasts for 2010 is over 1 percentage point wider than that for 2009 despite there being a smaller number of forecasters in the sample.

Summary of economic prospects

Table 2.C: Summary of economic prospects¹

	Percentage change on a year earlier, unless otherwise stated					Average errors from past forecasts ⁵
	2007	Forecast ^{2,3,4}				
		2008	2009	2010	2011	
Output at constant market prices						
Gross domestic product (GDP)	3	¾	-1¼ to -¾	1½ to 2	2¾ to 3¼	¾
Manufacturing output	¾	-1¼	-3¼ to -2¾	1 to 1½	1¾ to 2¼	1¼
Expenditure components of GDP at constant market prices						
Domestic demand	3¾	¾	-2 to -1½	1½ to 2	2½ to 3	1
Household consumption ⁶	3	1½	-1½ to -1	1¼ to 1¾	2¼ to 2¾	1
General government consumption	1¾	2¾	2¾	1	0	1
Fixed investment	7	-4½	-8¼ to -7¾	2¼ to 2¾	6½ to 7	2¾
Change in inventories ⁷	¼	0	-¼ to 0	0	0	¼
Exports of goods and services ⁸	-4½	¾	¼ to ¾	3¼ to 3¾	5¼ to 5¾	3
Imports of goods and services ⁸	-1¾	½	-2½ to -2	2½ to 3	4 to 4½	2¾
Exports of goods and services (excluding MTC)	1¼	¾	0 to ½	3¼ to 3¾	5¼ to 5¾	-
Imports of goods and services (excluding MTC)	3½	½	-2¾ to -2¼	2½ to 3	4 to 4½	-
Balance of payments current account						
£ billion	-52½	-41¾	-41	-41½	-39¼	12¼
Per cent of GDP	-3¾	-2¾	-2¾	-2¾	-2½	¾
Inflation						
CPI (Q4)	2	¾	½	2¼	2	-
Producer output prices (Q4) ⁹	4	6	2	2½	2	1¼
GDP deflator at market prices	2¾	3½	1¾	2½	2¾	½
Money GDP at market prices						
£ billion	1401	1461	1469 to 1477	1529 to 1545	1615 to 1640	12
Percentage change	6	4¼	½ to 1	4 to 4½	5½ to 6	¾

¹ The forecast is consistent with the preliminary estimate data for the third quarter of 2008, released by the Office for National Statistics on 24 October 2008.

² All growth rates in tables throughout this Annex are rounded to the nearest ¼ percentage point.

³ As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2¼ per cent. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as their basis for projecting the public finances, which is a ¼ percentage point below the neutral assumption.

⁴ 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.

⁵ Average absolute errors for year-ahead projections made in autumn forecasts over the past 10 years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2009.

⁶ Includes households and non-profit institutions serving households.

⁷ Contribution to GDP growth, percentage points.

⁸ Figures upto and including 2008 are distorted by MTC.

⁹ Excluding excise duties.

3

Overall policy framework, institutions and objectives

Objectives of economic policy

3.1 The Government's objective is to build a strong economy and a fair society, where there is opportunity and security for all. Key elements in the Government's long-term economic strategy are:

- maintaining macroeconomic stability;
- ensuring financial stability;
- supporting business and raising the sustainable rate of productivity growth;
- providing employment opportunity for all;
- ensuring fairness;
- improving public services; and
- addressing environmental challenges.

3.2 These objectives are consistent with the objectives of the European Community as set out in Article 2 of the Treaty. They are also consistent with the Lisbon Strategy, the Integrated Guidelines, and with a prudent interpretation of the EU Stability and Growth Pact.

3.3 As outlined in detail in the previous chapter, over the past year major shocks have hit the economies of every country in the world. While commodity prices have recently eased, the credit shock has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. These developments mean economic prospects are subject to exceptional uncertainty, but it is clear that the UK, like many advanced economies, has moved into recession.

3.4 The Government's macroeconomic framework has been designed to ensure that policymakers have the flexibility to respond appropriately to shocks. Transparency and a commitment to medium-term goals mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective objectives of low inflation and sound public finances over the medium term.

3.5 The economic downturn caused by these major economic shocks will have a large and persistent impact on the public finances. In the face of such adverse developments, it is important to focus on the purpose of the fiscal framework – to support economic growth by delivering economic stability – and to ensure that fiscal policy decisions are appropriate to achieve this.

3.6 The Government's objectives for fiscal policy in the face of these shocks remain unchanged:

- 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.

3.7 In order to ensure sound public finances over the medium term, fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked their way through the economy in full. A starting point of low public debt and the action the Government is taking to ensure fiscal sustainability over the medium term mean borrowing can be allowed to rise to enable the Government to support families and businesses in the short term, including through discretionary action.

Policy response to exceptional circumstances

3.8 The Government's immediate priority is to continue to support the economy through these difficult times and support needs to be tailored to the particular problems that the economy is facing. Supporting the economy in its recovery from these exceptional events will benefit not only current but also future generations.

3.9 The Bank of England has reduced interest rates to a 50-year low, providing monetary policy support to the economy. Responsible and sustainable management of the public finances requires stabilising the financial sector and supporting the long-term growth of the economy. This means allowing borrowing to increase in the short term, but ensuring a sustainable path for the public finances in the medium term, in addition to the measures the Government has undertaken to maintain financial stability and protect depositors, which are outlined in Box 3.A.

Box 3.A: Ensuring financial stability

Since July 2007, the global economy has experienced levels of financial instability not seen for generations. The causes of this instability are varied and global. They include both macroeconomic factors, such as global financial imbalances, and microeconomic factors, such as the failure of banks to manage financial risk. The trigger for the instability was the downturn in the US housing market, the 'subprime' end of which was a feature of many of the financial products that had been created in recent years. The instability grew steadily, peaking in the weeks following the collapse of Lehman Brothers, a US investment bank, in September 2008.

The Government's objectives for addressing these threats to the financial system have been consistent, and focused around the need to:

- support stability and restore confidence in the financial system;
- protect depositors' money; and
- safeguard the interests of taxpayers.

In September 2008, the crisis intensified and it became clear that not just individual institutions but the entire banking system was at risk of collapse. That would have had devastating consequences for UK households and businesses. The Government therefore intervened decisively to prevent systemic collapse. First, to address concerns about liquidity, at least £200 billion was made available to the Bank of England's existing Special Liquidity Scheme. Second, to address concerns about solvency, at least £50 billion was committed to a Bank Recapitalisation Fund. Third, to address concerns about funding, a credit guarantee scheme was established. These measures and their likely impact on the public finances are discussed in more detail in Chapter 4.

Other governments around the world have followed with similar steps and market reactions have been generally positive. However, markets remain fragile and volatile. The Government remains committed to taking action to meet its objectives.

Looking to the future, and given the global nature of this instability, the Government's international priorities include:

- as the 2009 Chair of the G20, making rapid progress on priority issues for the future of the international financial regulatory system;
- ensuring that the EU learns the lessons from the crisis, in particular regarding supervision and deposit protection arrangements for banks operating across borders; and
- reviewing the long-term opportunities and challenges for the UK's crown dependencies and overseas territories as financial centres.

Within the UK, the Government's immediate priorities include:

- continuing to monitor the financial system to ensure it is able to support the wider economy, including through appropriate levels of lending to businesses and households;
- strengthening the Banking Bill to enhance the Authorities' ability to deal with banking group holding companies and the insolvency of investment firms; and
- introducing measures to facilitate the raising of equity capital.

Fiscal policy response

3.10 In current economic circumstances, it is more important than usual for fiscal policy to play a role in supporting economic activity. In general, monetary policy is the primary tool for managing demand in the economy, while fiscal policy supports monetary policy through the automatic stabilisers, helping to smooth the path of the economy. However, while there have been encouraging signs that monetary easing is being passed through to interest rates paid by households and businesses, it is likely that monetary policy may be less effective than normal in stimulating economic activity at present, in particular due to constraints on the availability of credit. Given this, fiscal policy should play a more active, complementary role because it is able to support growth, and people's incomes and purchasing power, directly. In this way, fiscal policy can support monetary policy to limit the extent and duration of the downturn.

3.11 The case for a concerted international response to the current downturn is set out in *The case for a concerted international fiscal response*¹, published alongside the 2008 Pre-Budget Report, and summarised in the box below.

Box 3.B: The case for a concerted international fiscal response

The case for concerted fiscal action has been endorsed by the leaders of the G20 countries. On 15 November they declared that they:

- had agreed to work together to restore global growth; and
- would "use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability".

A simple, but nonetheless powerful, argument for concerted fiscal action is that this is a global crisis, and therefore requires a global solution. The combined effect of coherent actions taken across countries will be more effective than each country acting alone. In open economies, such as the UK, a proportion of any stimulus will be spent on imports. A concerted stimulus among major trading partners would increase trade flows in both directions.

Decisive concerted action by the world's leading economies will also provide a strong signal to the private sector of the willingness of governments to act effectively together. This should raise the private sector's expectations of the economic outlook, and help to reduce the risk of an adverse feedback between low expectations, cautious spending and weak outcomes.

An effective international response does not mean that all countries should take identical actions. Instead, fiscal actions need to be tailored to the situation of each country, taking account of existing levels of public debt.

However, the effectiveness of international fiscal actions will be enhanced if they are concerted, and conform to the "timely, targeted and temporary" principles described in Chapter 4.

¹ *The case for a concerted international fiscal response*, HM Treasury, November 2008

3.12 The 2008 Pre-Budget Report announced that the Government will support families and businesses, including by:

- temporarily reducing the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and
- bringing forward £3bn of capital spending from 2010-11 to 2008-09 and 2009-10, the years when the impact of the shock is likely to be the strongest.

3.13 Further support announced for pensioners, families with children and all taxpayers with modest and middle incomes, including those affected by the removal of the 10 pence starting rate of tax in Budget 2007, and to support businesses, will also help to mitigate the impact of the economic downturn. Further detail on these measures is set out in Chapter 4.

3.14 Discretionary action of £16 billion will deliver a fiscal stimulus package of around 1 per cent of GDP in total in 2009-10, in addition to the support provided by measures in 2008-09. A number of advanced economies have announced fiscal support packages of similar magnitude in recent months.

3.15 The economic forecast has made realistic assumptions – informed by the experience of other changes in VAT both in the UK and abroad – on the extent to which a cut in VAT is passed on in the form of lower prices. The forecast assumes that, over time, the majority of the reduction in VAT will be passed on to consumers through lower prices, and that households will spend around half of the increase in real disposable income that results. The increase in public investment will deliver a direct increase in economic activity. Overall, GDP growth in 2009 is forecast to be around ½ a percentage point higher than it would be in the absence of the discretionary action that the Government has taken.

Ensuring medium-term sustainability

3.16 By acting quickly and decisively to provide support to the economy when it needs it most, fiscal action – working alongside monetary policy – can help to reduce the impact on individuals and households of the financial markets shock and the risk of a deeper or more prolonged recession. This action will be financed by borrowing in the short term.

3.17 Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. Fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked through the economy in full. The 2008 Pre-Budget Report set out measures which put the public finances on a path to achieve a balanced cyclically-adjusted current budget and a declining debt to GDP ratio by 2015-16.

3.18 A full account of the 2008 Pre-Budget Report projections for the public sector finances is given in Chapter 4, and summarised in Table 1.A. In summary:

- public sector net borrowing (PSNB) increases from 2.6 per cent of GDP in 2007-08 to 8.0 per cent in 2009-10, reflecting the impact of the economic downturn on receipts, in particular from the financial and housing sectors, the effect of the automatic stabilisers and the action the Government is taking to support the economy. Of this around 1.1 per cent of GDP is as a result of discretionary action to support the economy.

- PSNB then declines to 2.9 per cent of GDP by 2013-14 as the economy recovers and the Government takes action to ensure the sustainability of the public finances. In 2013-14, the action the Government is taking reduces net borrowing by 1.6 per cent of GDP; and
- Public sector net debt (PSND) increases over the forecast period, in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years, then begins to stabilise at just over 57 per cent by the end of the forecast period.

The Macroeconomic framework

3.19 The Government's macroeconomic framework, introduced in 1997, was designed to maintain macroeconomic stability. Stability helps individuals, businesses and the Government to plan effectively for the long term, improving the quantity and quality of investment in physical and human capital, and helping to increase productivity.

3.20 The role of the macroeconomic framework in supporting strong and stable economic performance over the past decade has been acknowledged by international institutions, such as the IMF¹, as providing a strong foundation to weather global challenges.

3.21 The Government remains committed to this framework and the objectives enshrined within it. However, in the face of exceptional global economic challenges, it is important to consider the way that the framework is implemented, to ensure it continues to deliver the Government's objectives of stability, growth and employment.

Monetary policy framework

3.22 The primary objective of monetary policy is to deliver price stability. The monetary policy framework introduced in 1997 provides full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times.

3.23 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.

Performance of the framework

3.24 Since its introduction in 1997, the monetary policy framework has successfully delivered inflation that has been low and stable by historical and international standards:

- CPI inflation has averaged 2.3 per cent since CPI was made the operational target for monetary policy in December 2003, closely in line with the 2 per cent target;
- on average, the UK has had one of the lowest inflation rates in the G7 so far this decade. This compares with the period from 1980 to 1997 when UK inflation was the second highest of all G7 economies; and
- UK long-term interest rates have averaged 5.1 per cent since 1997 compared with an average of just over 9 per cent in the previous decade.

¹ 2008 IMF Article IV Consultation Concluding Statement of the Mission to the United Kingdom

Response to economic shocks

3.25 Macroeconomic policymakers are currently facing difficult challenges in responding to the global credit and commodity price shocks. In these challenging economic circumstances, the monetary policy framework remains the right approach. Its design gives the independent MPC the means to deliver price stability while avoiding unnecessary volatility in output.

The Government stands firmly behind the 2 per cent inflation target, and will continue to support the MPC in the forward-looking decisions it takes to ensure that inflation returns to target.

3.26 The primary objective of monetary policy is to deliver price stability. However, the monetary policy framework takes into account that the economy can suffer from external events or temporary difficulties. The remit for the MPC recognises that “the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances,” and that “attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output.”

3.27 The remit² for the MPC states that if inflation deviates by more than one percentage point above or below the target, the Governor of the Bank of England must explain in an open letter 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. The open letter system is an integral part of the macroeconomic framework. Open letters are published on the Bank of England and HM Treasury websites. The transparency and accountability provided by the open letter system allow the MPC the flexibility to deliver the inflation target while avoiding unnecessary volatility in output.

3.28 Since Budget 2008, the Governor of the Bank of England has written open letters to the Chancellor as inflation moved more than 1 per cent above target. As the Governor stated in his September letter, this rise in inflation followed “sharp, largely unanticipated, increases in the price of energy and food, reflecting developments in the global balance of demand and supply for these commodities.” In the November Inflation Report, the projection was for inflation to fall back “rapidly in the near term, as the contribution from food and energy diminishes”.

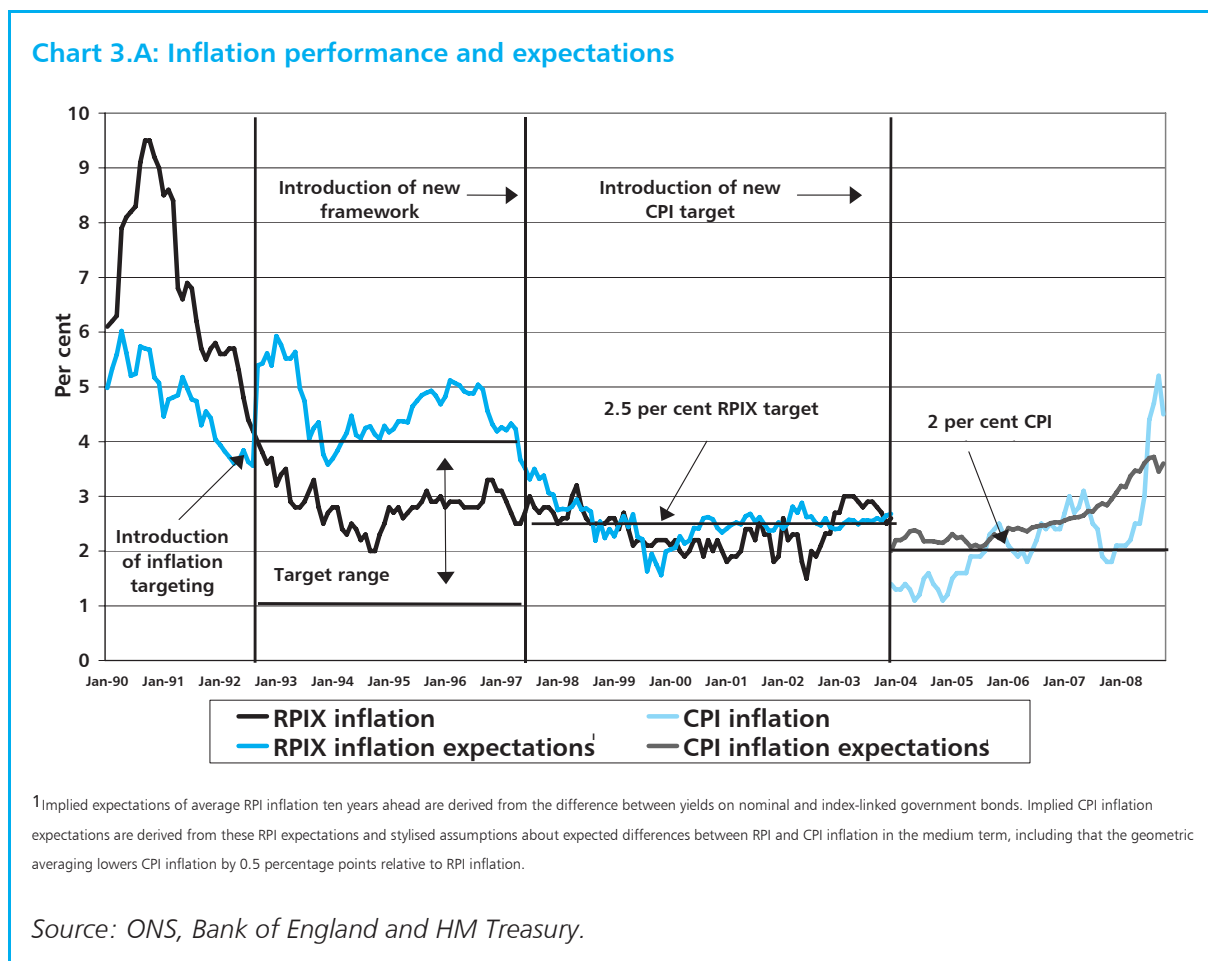
3.29 Responding to the intensifying global financial crisis, the MPC called a special meeting in October 2008, where the Committee decided to cut the policy rate by ½ a percentage point in a coordinated global action that involved six major central banks, including the Federal Reserve in the US and the European Central Bank. In November, the Bank of England reduced the policy rate by a further 1½ percentage points to 3 per cent, stating that “the risks to inflation have shifted decisively to the downside”. In December, the Bank of England reduced the policy rate again by 1 percentage point to 2 per cent.

3.30 Inflation expectations appear to have remained anchored, testament to the credibility that the monetary policy framework has built since 1997. Survey measures of shorter-term inflation expectations have tended to move up in step with actual inflation, and while many of these measures have been elevated over the recent past, they have fallen back recently. The latest monthly surveys from GfK and YouGov/Citigroup showed a marked decline in inflation expectations – the October YouGov/Citigroup survey reported that the measure of household expectations for five to ten years ahead fell to its lowest level since the survey began in November 2005. Financial market-derived measures of inflation expectations can be affected by

² www.bankofengland.co.uk

other market developments, and have been more difficult to interpret given recent market volatility. However, these data do not appear to point to a de-anchoring of expectations from the inflation target.

3.31 Throughout this period of above-target inflation, average earnings growth has remained stable and subdued showing that, despite a temporary increase in inflation, wage-setting behaviour remains consistent with achieving the inflation target.



Developments in the monetary policy framework

3.32 In June 2008, the Chancellor announced further details of reforms to the MPC appointments process. These changes, by injecting more openness and transparency into the process, demonstrate the Government’s commitment to ensure that the monetary policy framework remains at the forefront of international best practice. The changes include a commitment to advertise vacancies for the Governor and Deputy Governors of the Bank of England and external members of the MPC, consistent with the principles of open competition. The Chancellor announced on 10 December that the Queen had approved the appointment of Paul Tucker as the next Deputy Governor for Financial Stability. This followed an open competition and was the first appointment to follow the new process.

3.33 These changes build on the reforms the Government has already made to the process for MPC appointments, as outlined in the UK’s 2007 Convergence Programme.

Fiscal policy framework

3.34 Recognising that “the conduct of fiscal policy has a critical influence on economic stability”,³ a new fiscal framework was outlined in the *Code for fiscal stability* (“the Code”), published alongside Budget 1998 and subsequently underpinned by legislation. The Code specifies five principles that underpin the formulation and implementation of fiscal policy: transparency, stability, responsibility, fairness and efficiency.

3.35 To increase the transparency and accountability of fiscal decision making, the Code requires the Government to set out in each Budget its fiscal policy objectives and the rules by which it intends to operate fiscal policy. The fiscal framework was designed to ensure that the Government has the flexibility to respond appropriately to shocks. The Code provides flexibility for the Government to either change its rules or depart from them on a temporary basis to ensure that at all times they are appropriate to deliver the Government’s fiscal policy objectives, including when economic circumstances change significantly. To ensure transparency, the Code requires the Government to state clearly the reasons for any change.

Fiscal policy objectives

3.36 Since 1997, the Government has had two clear and consistent objectives for fiscal policy:

- 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 automatic stabilisers to help smooth the path of the economy.

3.37 Over the past cycle, these fiscal policy objectives were implemented through two fiscal rules, against which the performance of fiscal policy can be judged:

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

Performance of the fiscal framework over the last economic cycle

3.38 As these rules were measured over the course of the economic cycle, the judgement that the cycle ended in the second half of 2006⁴ makes it timely to review performance against them and their success in delivering the Government’s fiscal policy objectives.

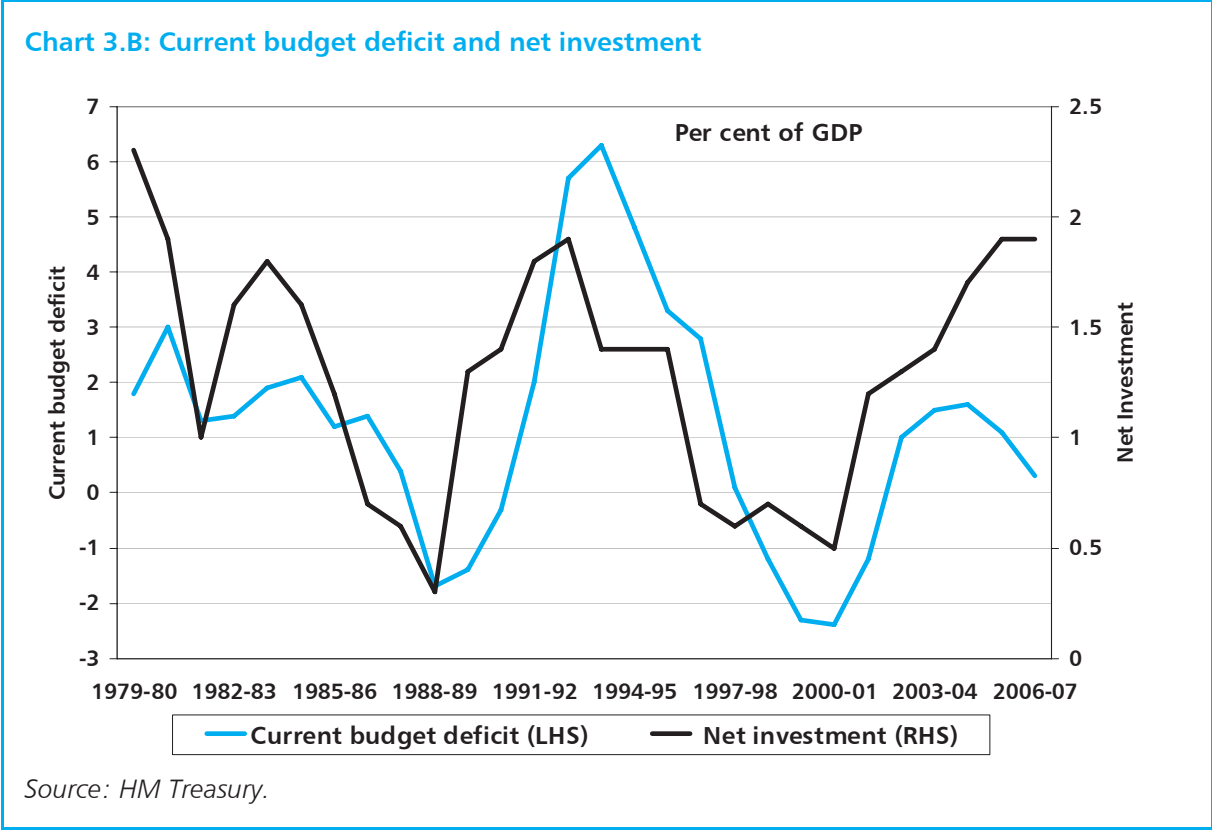
Supporting investment

3.39 The golden rule was measured by the average annual surplus on the current budget as a percentage of GDP. The golden rule was met over the economic cycle that started in 1997, with an average surplus on the current budget of 0.1 per cent of GDP.

³ The Code for Fiscal Stability, HM Treasury, November 1998.

⁴ See Chapter 2 for more detail on the end of the economic cycle

3.40 One of the key achievements of the fiscal framework has been to address the bias against capital spending that existed in the past and previous underinvestment in public services. Historically, it has been extremely rare for public investment to continue to grow during periods of fiscal consolidation, and prior to the introduction of the framework it had not happened for 40 years. The effectiveness of the golden rule is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment in Chart 3.B. Public sector net investment as a share of GDP has increased significantly, having risen from 0.6 per cent in 1997-98 to 2.1 per cent in 2007-08.

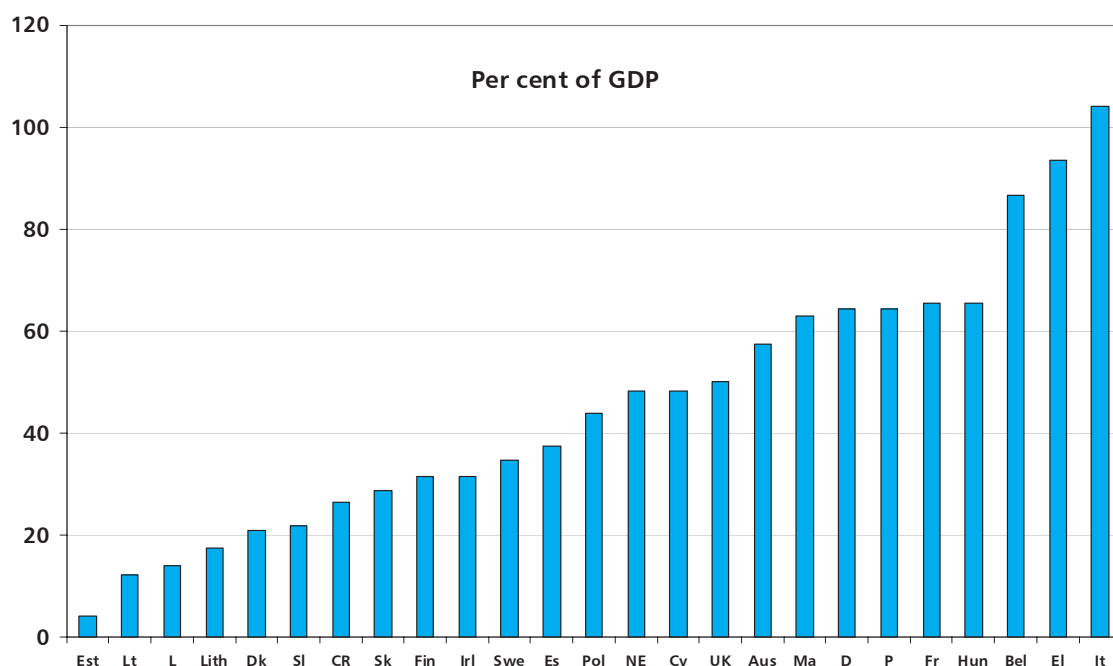


Maintaining a sustainable level of debt

3.41 The sustainable investment rule stated that ‘public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level’. The sustainable investment rule stated that ‘public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level’. In Budget 1998, the Government announced that it would maintain net debt below 40 per cent of GDP over the course of the cycle. In Budget 2003, the Government strengthened this commitment, stating that to meet the rule with confidence, net debt would be maintained below 40 per cent of GDP in each and every year of the then current cycle.

3.42 The sustainable investment rule was met over the previous economic cycle. Net debt was reduced from 42.5 per cent of GDP at the end of 1996-97 to 36.0 per cent in 2006-07, and was maintained below 40 per cent of GDP on average over the cycle. The Government also met its additional commitment to maintain net debt below 40 per cent of GDP in each and every year from 2003-04 to 2006-07. According to latest IMF and OECD data, in 2007, UK net debt was lower as a percentage of GDP than all G7 countries, with the exception of Canada.

Chart 3.C: General government gross debt, 2008



Source: European Commission Autumn Forecast 2008

Supporting economic stability

3.43 A key consideration in the design of the fiscal rules was that fiscal policy should support monetary policy, in particular through allowing the full operation of the automatic stabilisers. In doing so, fiscal policy can help to support economic stability, reducing volatility in economic output and supporting the delivery of low and stable inflation and lower interest rates.

3.44 Compared to previous cycles, the introduction of the fiscal framework has helped to ensure that fiscal policy has acted in support of economic stability. During the period from 1997 to 2003, when the economy operated above trend until 2001 and then below trend during the global slowdown from 2001 to 2003, fiscal policy played a significant role in smoothing the path of the economy. Fiscal policy tightened to reduce demand in the economy while it was operating above trend and loosened to support demand, both through the operation of the automatic stabilisers and changes to the fiscal stance, as the economy moved below trend in 2001. Between 2004 and 2007, when the economy was operating close to trend, the degree of fiscal support moderated.

Responding to current circumstances

3.45 The Government's objectives for fiscal policy in the face of current economic circumstances – to help smooth the path of the economy in the short term, and ensure sustainability over the medium term – remain unchanged. The fiscal rules set for the last economic cycle were met, delivering the Government's objectives. However, applying the rules in these circumstances would not be consistent with achieving the Government's objectives for fiscal policy at a time when it needs to act with monetary policy to support the economy. Three key aspects of the current situation mean that seeking to meet the golden rule and the sustainable investment rule in the face of these shocks would not be appropriate:

- given the distinctive nature of the current global financial crisis, particularly the impact it has had on the monetary transmission mechanism, fiscal policy will need to play a more significant role in the year ahead in helping to support demand within the economy;
- the current economic cycle is projected to be unusual, with the up-phase interrupted by two major global economic shocks. This implies that aiming to balance the current budget on average over the cycle would require damagingly pro-cyclical fiscal policy; and
- the large and persistent impact of these shocks on the public finances mean policy must adjust over a period of time to avoid short-term pro-cyclical tightening. The right approach is to allow public debt to rise to absorb the shock and allow fiscal policy to support the economy, until adjustment has been completed and debt is set on a declining path as a proportion of GDP.

3.46 Supporting the economy in its recovery from these exceptional events will benefit not only current but also future generations. Responsible and sustainable management of the public finances therefore requires stabilising the financial sector and supporting the long-term growth of the economy. This means allowing borrowing to increase in the short term, but ensuring a sustainable path for the public finances in the medium term, in addition to the measures the Government has undertaken to maintain financial stability and protect depositors.

A new fiscal operating rule

3.47 So, to achieve its objectives, and as provided for in the *Code for fiscal stability*, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full. Consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

3.48 The fiscal projections set out in the 2008 Pre-Budget Report, and reported in Chapter 4, are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

Delivering the fiscal policy objectives

3.49 To ensure fiscal policy supports monetary policy and helps to smooth the path of the economy, the temporary operating rule:

- is designed to accommodate an increase in borrowing to support the economy in the short term; and
- is measured on a cyclically-adjusted basis, to allow the automatic stabilisers to operate in full at all times and avoid a sharp, pro-cyclical fiscal tightening.

3.50 Over the medium term, to ensure sound public finances and that taxation and spending impact fairly within and between generations, the temporary operating rule will:

- ensure that in the medium term borrowing is low and debt is stable and falling as a proportion of GDP;
- continue to protect capital spending and ensure that the public finances are in a position to deliver intergenerational fairness over the medium term; and
- ensure the Government remains on course to deliver sound public finances in the medium term, through a sustained improvement in the underlying position of the public finances.

Dealing with uncertainty

3.51 There is considerable uncertainty over the path of the economy and the public finances in the short term, and over the persistence of the economic shocks. Setting a rule focussed on steady improvement in the public finances allows the Government flexibility to cope with that uncertainty, while constraining fiscal policy to deliver sound public finances over the medium term.

The fiscal rules in the future

3.52 The fiscal projections in the 2008 Pre-Budget Report show how the Government intends to achieve its objectives in the medium term. In advance of the public finances reaching cyclically-adjusted current balance, the Government will set out how it will apply the fiscal framework in future to continue to deliver those objectives.

3.53 *The Government's fiscal framework*⁵ provides further detail on the performance of the fiscal policy framework over the past cycle, along with the design and implementation of the new fiscal operating rules.

⁵ *The Government's fiscal framework*, HM Treasury, November 2008.

Box 3.C: The impact on net debt of action to maintain financial stability and protect depositors

The independent Office for National Statistics will determine how measures to maintain financial stability and protect depositors are classified within the National Accounts, in consultation with Eurostat and statistical offices in other member states to ensure consistent interpretation of international statistical guidance.

As any extra liabilities that may become classified to the public sector through these interventions will be mostly temporary and backed by significant financial assets, they do not reflect future calls on the taxpayer. The long-term impact on the public finances, and any burden on future generations, would be determined by any eventual economic profit or loss incurred on the interventions. **As a result, consistent with the treatment of Northern Rock announced in Budget 2008, while the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on public sector net debt both including and excluding the impact of those interventions.**

The Government will base its fiscal policy, and measurement of its fiscal rules, on aggregates that exclude that impact. Any economic profit or loss on interventions will be included in both measures (and so within the fiscal rules) when that profit or loss crystallises for central government. Chapter 4 sets out in more detail the likely impact of the measures to maintain financial stability and protect depositors on the public finances.

Wider institutional context

Caution and transparency in the public finance projections

3.54 The use of assumptions audited by the independent National Audit Office (NAO) is designed to add caution into the public finance projections. Details of these assumptions are outlined in Chapter 4.

3.55 The trend rate of GDP growth is assumed to be $\frac{1}{4}$ per cent below the neutral view, which means that the rate of economic growth on which the public finances projections are based is the lower end of the forecast range.

3.56 The *2008 End of year fiscal report*⁶ (EYFR) is published alongside the 2008 Pre-Budget Report. The EYFR underlines the Government's commitment to transparency in fiscal policy by providing detailed retrospective information on the public finances in 2006-07 and 2007-08, including an explanation for differences between forecasts and outturn in those years.

Cyclical adjustment

3.57 The temporary operating rule is measured on a cyclically-adjusted basis. To ensure transparency, the Government is publishing alongside the Pre-Budget Report updated estimates of the effects of the economic cycle on the public finances,⁷ which suggest that the Treasury's existing cyclical-adjustment coefficients should remain unchanged. In addition, in the interests of

⁶ *2008 End of Year Fiscal Report*, HM Treasury, November 2008

⁷ *Public finances and the cycle: Treasury Economic Working Paper No.5*, HM Treasury, November 2008.

transparency and accountability, [the Government will invite the National Audit Office to review the Treasury's approach to cyclical adjustment.](#)

Public spending framework

3.58 The fiscal framework underpins the public spending framework. The recent period of strong growth in public spending was necessary to correct for previous under-investment in public services. Over the past ten years, public investment and reform of public service delivery have together generated real improvements in the quality of public services. Going forward, public spending must continue to be set at levels that ensure sustainability and protect intergenerational fairness. Faced with major global economic shocks, the Government's aim when setting its public spending plans is to support the economy in the short term and continue to improve public services, while ensuring fiscal sustainability over the medium term. More detail on the public spending framework and public spending plans is contained in Chapter 6.

Stability and Growth Pact

3.59 The introduction of the SGP in the late 1990s represented a major step forward in recognising the importance of long-term budgetary discipline and as a framework for coordination by Member States of their fiscal policies. The UK has supported the principle of a strong SGP, recognising that fiscal sustainability is a prerequisite for macroeconomic stability, and that collective fiscal co-ordination is desirable within an integrated economic community, and essential for a successful monetary union. However, in the past, the operation of the SGP highlighted a number of issues that needed to be addressed.

3.60 The reforms to the Pact agreed in March 2005 rightly place a greater focus on the avoidance of pro-cyclical policies, on improved flexibility in "exceptional circumstances", and on achieving low debt levels and thereby enhancing the long-term sustainability of public finances. The Government continues to work closely with Member States and EU institutions, as the success of the reforms will depend on how they are implemented. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

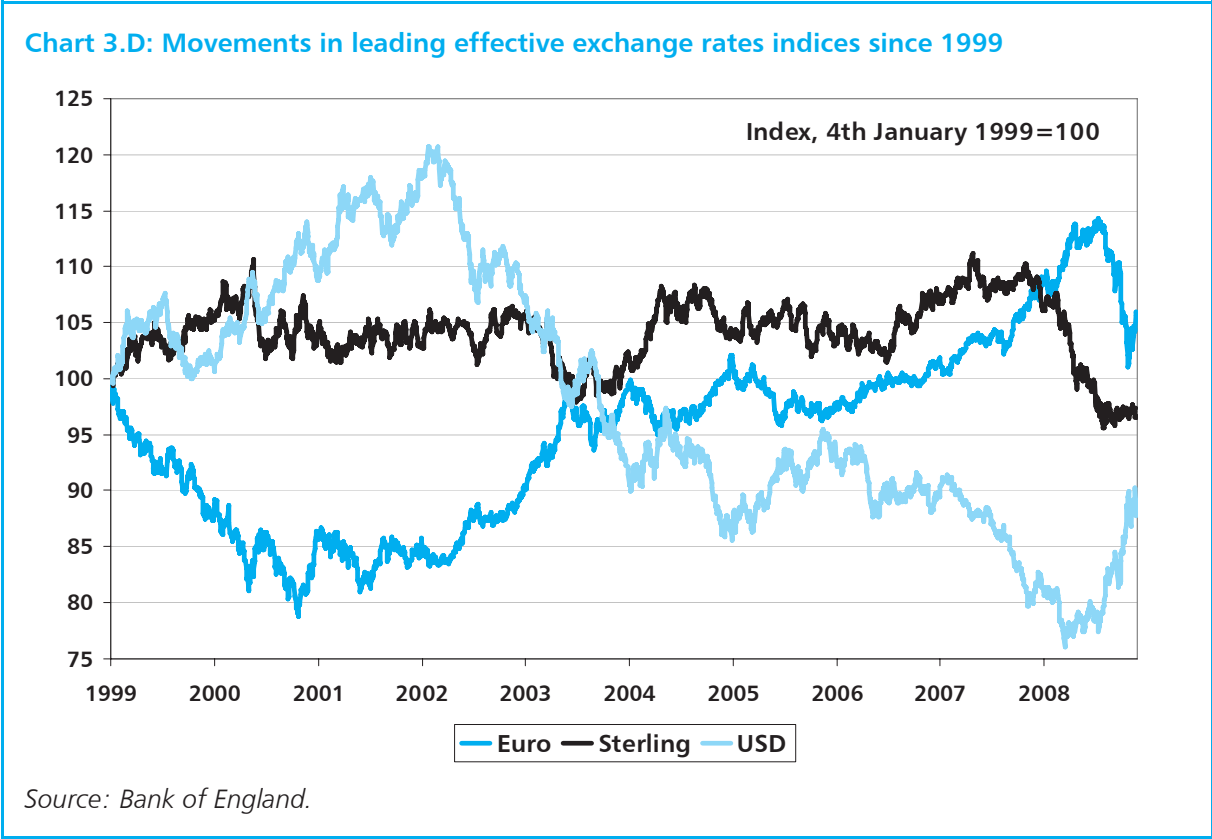
3.61 The UK Government continues to emphasise the need for a prudent interpretation of the SGP. A prudent interpretation takes into account:

- the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy, so providing the flexibility to take the right decisions over the cycle. Given the distinctive nature of the current global financial crisis, particularly the impact it has had on the monetary transmission mechanism, fiscal policy will need to play a more significant role in the year ahead in helping to support demand within the economy;
- sustainability – taking into account that low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations; and
- public investment – recognising that public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.

3.62 European economies have all been affected by the unprecedented global economic shocks, and several European member states are already in recession.⁸ Fiscal policy has an important role to play in these exceptional circumstances. The Government’s objectives of smoothing the path of the economy in the short term while ensuring sound public finances over the medium term are consistent with the October European Council Conclusions, which confirmed that the Stability and Growth Pact should be applied in a manner that reflects current exceptional economic circumstances. The objectives are also consistent with the Commission’s 26 November Communication, *A European Economic Recovery Plan*⁹. This recognises that a budgetary expansion, which may lead some Member States to breach the 3 per cent of GDP deficit reference value, is justified in these extraordinary circumstances. It further states that corrective action will have to be taken in time frames consistent with the recovery of the economy.

Exchange rate stability

3.63 The combination of financial sector fragility and increasing risk premia demanded on sterling assets, UK growth prospects being revised down and expectations of substantial further monetary policy easing over the coming year has been associated with significant depreciation of sterling. Overall, the sterling exchange rate index has declined by over 20 per cent since its peak in the summer of 2007. The Government’s objective is for a stable and competitive exchange rate in the medium term, consistent with meeting the inflation target.



⁸ European Commission Economic Forecast Autumn 2008, European Commission, November 2008.
⁹ Communication from the Commission to the European Council, *A European Economic Recovery Plan*, November 2008

Economic and monetary union

3.64 The Government's policy on membership of the single currency is set out in Box 3.D.

Box 3.D: Government policy on EMU

The Government's policy on membership of the single currency was set out by the previous Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor is the national economic interest and whether, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous. An assessment of the five economic tests was published in June 2003. This concluded that: "since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area."

As part of the policy of 'prepare and decide', the Government coordinates appropriate euro preparations across the UK economy. The Government also supports business in dealing with the euro as a foreign currency.

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the June 2003 assessment, the latest progress report on which was made at Budget 2008. While the Government did not propose initiating a euro assessment at the time of Budget 2008, the Treasury will again review the situation at Budget time next year, as required by the Chancellor's June 2003 statement.

4

Outlook for the public finances

4.1 This chapter sets out interim projections for the public finances. It includes:

- five-year projections of the current budget, the cyclically-adjusted current budget, public sector net borrowing and public sector net debt, the key aggregates for assessing performance against the fiscal framework and the impact of fiscal policy on the economy; and
- detailed analyses of the outlook for government receipts and expenditure.

Economic and policy context

Impact of the economic downturn

4.2 The global credit and commodity price shocks have adversely affected economic growth and the financial and property markets in the UK, as they have around the world. These developments also have significant implications for the public finances:

- lower economic growth acts to significantly reduce tax receipts, in particular from income tax, VAT and corporation tax due to lower incomes, consumption and profits;
- the financial crisis additionally affects the tax take from the financial sector, which over recent years has generated about 25 per cent of corporation tax revenue. Earnings and bonuses in that sector are also affected, reducing income tax receipts;
- sharp falls in house and share prices reduce capital gains tax and stamp duty receipts;
- the automatic stabilisers are working to support the economy, increasing spending on social security benefits; and
- higher than expected inflation since Budget 2008 has resulted in higher social security expenditure, reduced tax receipts (due to higher allowances) in 2009-10, and increased the cost of servicing index-linked gilts in 2008-09. These pressures moderate significantly over the projection period, as inflation is expected to fall sharply next year.

4.3 While economic growth is expected to pick-up progressively through 2010 and 2011 to a little above trend rates, total economic growth over the forecast period is lower than forecast at Budget 2008. Consistent with a rebalancing of the economy, the recovery is expected to be led by investment and exports, sectors that tend to provide less tax receipts than consumption. Furthermore, it is expected that the financial and housing market shocks will have an additional, persistent effect on the public finances. More details are provided in Box 4.C.

Fiscal policy response

4.4 As set out in Chapter 3, the Government's immediate priority is to support the economy through these difficult times. The 2008 Pre-Budget Report announced that the Government will support families and businesses, including by:

- temporarily reducing the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and
- bringing forward £3bn of capital spending from 2010-11 to 2008-09 and 2009-10, the years when the impact of the shock is likely to be the strongest.

4.5 Further support announced for pensioners, families with children and all taxpayers with modest and middle incomes, including those affected by the removal of the 10 pence starting rate of tax in Budget 2007, and to support businesses, will also help to mitigate the impact of the economic downturn.

4.6 Discretionary action of £16 billion will deliver a fiscal stimulus package of around 1 per cent of GDP in total in 2009-10, in addition to the support provided by measures in 2008-09. A number of advanced economies have announced fiscal support packages of similar magnitude in recent months.

Delivering fiscal support

4.7 For fiscal support to help stabilise the economy effectively it should be:

- timely – it needs to have a swift impact. This requires both that the policy change can be implemented quickly, and that it has a rapid impact on behaviour;
- temporary – to maximise its immediate impact and protect medium-term fiscal sustainability. If action is not taken to maintain sound public finances, there is a risk that higher long-term interest rates will outweigh its stimulus effect; and
- targeted – it is important that the support boosts spending, to maximise the impact on economic activity.

Choice of levers

4.8 The Government has therefore chosen to take fiscal action that meets these criteria. A reduction in the rate of VAT has been chosen as the main lever for the fiscal action as this change can be implemented rapidly (timely), will impact immediately on the purchasing decisions of firms and individuals to boost spending (targeted) and is reversible (temporary). A temporary reduction in the rate of VAT will lower prices for households and should provide help immediately, when they need it most. It will also incentivise them to bring forward the purchase of goods, which will help support firms and the people they employ as the economy slows.

4.9 Furthermore, bringing forward valuable public investment also pursues these aims by impacting directly on economic activity in the UK (targeted), in particular supporting the construction sector, which is expected to be disproportionately affected by the economic downturn. In order to ensure that increased public spending acts as an effective economic stimulus, the Government has taken the decision to bring forward existing spending programmes, which can support the economy quickly (timely), rather than initiate new projects, which can take considerable time. As the spending plans are being brought forward, the boost to spending is offset in later years (temporary).

4.10 In addition, the measures the Government is bringing forward to benefit those on low and middle incomes, detailed in Table A.2. in Annex A, helps to boost spending as these households tend to have a higher propensity to increase consumption in response to an increase in income.

The benefits of support

4.11 The precise economic impact of the VAT measure depends on a number of factors, including the extent to which the reduction in prices is passed through to consumers, the extent to which temporarily lower prices stimulate a greater volume of spending, and the amount that is spent on domestically produced goods and services rather than imports. The reduction in the VAT rate is expected to support families' and businesses' finances and spending power in the short term:

- in Britain's competitive retail sector, it is expected that the majority of the VAT reduction will be passed on to consumers through lower prices, increasing the purchasing power of families and individuals;
- where households choose to use this increased purchasing power to increase consumption, it will support growth now, contributing to the profits of businesses and helping to support employment; and
- where it is saved, it will help households to adjust their finances.

4.12 The economic forecast has made realistic assumptions – informed by the experience of other changes in VAT both in the UK and abroad – on the extent to which a cut in VAT is passed on in the form of lower prices. The forecast assumes that, over time, the majority of the reduction in VAT will be passed on to consumers through lower prices, and that households will spend around half of the increase in real disposable income that results. The increase in public investment will deliver a direct increase in economic activity. Overall, GDP growth in 2009 is forecast to be around $\frac{1}{2}$ a percentage point higher than it would be in the absence of the discretionary action that the Government has taken.

Ensuring sustainability

4.13 Fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked through the economy in full. The 2008 Pre-Budget Report set out measures which put the public finances on a path to achieve a balanced cyclically-adjusted current budget and a declining debt to GDP ratio by 2015-16.

4.14 These measures are a combination of adjustments to both taxation and spending, implemented at a time when the economy is forecast to be recovering and able to support fiscal consolidation. These measures include:

- the income tax personal allowance will be restricted for those with incomes over £100,000 – the 2 per cent of people with the highest incomes - from April 2010, when the economy is forecast to be growing
- a new additional higher rate of income tax of 45 per cent (and 37.5 per cent for dividend income) will be introduced for those with incomes above £150,000 from April 2011;
- the employee, employer and self-employed rates of National Insurance Contributions will increase by 0.5 per cent from April 2011, when economic growth is forecast to be above trend rates and real incomes are growing strongly

4.15 Alcohol and tobacco duties will be increased to offset the effects of the temporary reduction in VAT. Maintaining these increases after December 2009 will further support fiscal consolidation.

4.16 The 2008 Pre-Budget Report also announced a £5bn increase in the Government's Value for Money target in 2010-11, with consequential adjustments in departmental resource budgets to be announced at Budget 2009. Further details also provided in Chapter 6.

Public spending

4.17 The Pre-Budget Report announced action to bring forward £3 billion of capital spending to support the economy, increasing capital budgets for 2008-09 and 2009-10. In turn, this means that capital budgets in 2010-11 can be set at a lower level, with total capital DEL budgets over the entire Comprehensive Spending Review (CSR) period being no higher as a result.

4.18 The 2008 Pre-Budget Report fiscal projections are based on an assumption of average growth in current spending of 1.2 per cent a year in real terms over 2011-12, 2012-13 and 2013-14. Net investment moves to 1.8 per cent of GDP by 2013-14, still three times higher as a proportion of GDP than in 1997-98. Taken together these assumptions mean Total Managed Expenditure (TME) growing by 1.1 per cent per year in real terms on average over 2011-12, 2012-13 and 2013-14.

Projections for the public finances

4.19 Table 4.A presents the key fiscal aggregates based on the five themes of fiscal consolidation, economic impact, sustainability, financing and European commitments; while Table 4.B compares the projections for net borrowing, the current balance, net investment and net debt with those published in Budget 2008.

4.20 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all firm decisions announced in this 2008 Pre-Budget Report or since Budget 2008. These measures and their fiscal impacts are set out in Table A.2 in Annex A.

4.21 Consistent with the *Code for fiscal stability*, the projections do not take account of decisions where the impact cannot yet be quantified or of measures where consultation is proposed in the Pre-Budget Report, or where final decisions have yet to be taken.

Public finance projections

Table 4.A: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Fiscal consolidation							
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Consolidation in the cyclically-adjusted current budget ¹	-	-	-	1.0	1.2	0.7	0.6
Economic impact							
Net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net borrowing (PSNB)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Cyclically-adjusted PSNB	2.9	5.3	7.2	5.6	4.3	3.5	2.8
Sustainability							
Public sector net debt ^{2,3}	36.3	41.2	48.2	52.9	55.6	57.1	57.4
Core debt ^{2,3}	36.5	41.3	47.5	51.0	52.8	53.9	54.2
Net worth ⁴	28.8	23.5	16.6	12.9	10.6	9.1	8.7
Primary balance	-1.0	-3.6	-6.7	-4.7	-3.0	-1.6	-0.5
Financing							
Central government net cash requirement	2.3	10.5	8.5	6.9	5.9	4.6	3.7
Public sector net cash requirement ³	1.5	4.8	8.9	6.9	5.7	4.3	3.4
European commitments							
Treaty deficit ⁵	2.8	5.4	8.1	7.0	5.6	4.4	3.3
Cyclically-adjusted Treaty deficit ⁵	3.1	5.4	7.3	5.8	4.5	3.8	3.1
Treaty debt ratio ⁶	43.2	52.9	60.5	65.1	67.5	68.6	68.5
Memo: Output gap	0.6	-0.3	-1.5	-1.9	-1.3	-0.7	-0.1
¹ Change in the cyclically-adjusted surplus on the previous year.							
² Debt at end March; GDP centred on end March.							
³ Excluding financial sector interventions.							
⁴ Estimate at end December; GDP centred on end December.							
⁵ General government net borrowing on a Maastricht basis.							
⁶ General government gross debt measures on a Maastricht basis.							

Table 4.B: Fiscal balances compared with Budget 2008

	Outturn ¹	Estimate ²	Projections			
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Net borrowing (£ billion)						
Budget 2008	36.4	42.5	38	32	27	23
Changes to current budget	-1.2	31.6	74	77	65	56
Changes to net investment	1.4	3.5	5 ½	-4	-5 ½	-8
2008 Pre-Budget Report	36.6	77.6	118	105	87	70
Surplus on current budget (£ billion)						
Budget 2008	-7.9	-9.6	-4	4	11	18
Effect of revisions and forecasting change:	1.2	-23.3	-61	-78	-75	-72
Effect of discretionary changes ³	0.0	-8.3	-13	1	10	16
2008 Pre-Budget Report	-6.7	-41.2	-78	-73	-54	-37
Net investment (£ billion)						
Budget 2008	28.5	32.9	35	37	38	41
Effect of revisions and forecasting change:	1.4	2.5	2 ½	- ½	-2	-1 ½
Effect of discretionary changes ³	0.0	1.0	3 ½	-3 ½	-4	-6 ½
2008 Pre-Budget Report	29.9	36.5	40	33	33	33
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2008	-0.7	-0.5	0.1	0.5	0.8	1.0
2008 Pre-Budget Report	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2008	2.7	2.7	2.2	1.8	1.5	1.2
2008 Pre-Budget Report	2.9	5.3	7.2	5.6	4.3	3.5
Net debt (per cent of GDP)⁴						
Budget 2008	37.1	38.5	39.4	39.8	39.7	39.3
2008 Pre-Budget Report	36.3	41.2	48.2	52.9	55.6	57.1

Note: Totals may not sum due to rounding.

¹ The 2007-08 figures were estimates in Budget 2008

² The 2008-09 figures were projections in Budget 2008

³ Including changes in forecasting assumptions on spending growth in 2011-12 and 2012-13

⁴ Debt at end March; GDP centred on end March; excluding financial sector interventions.

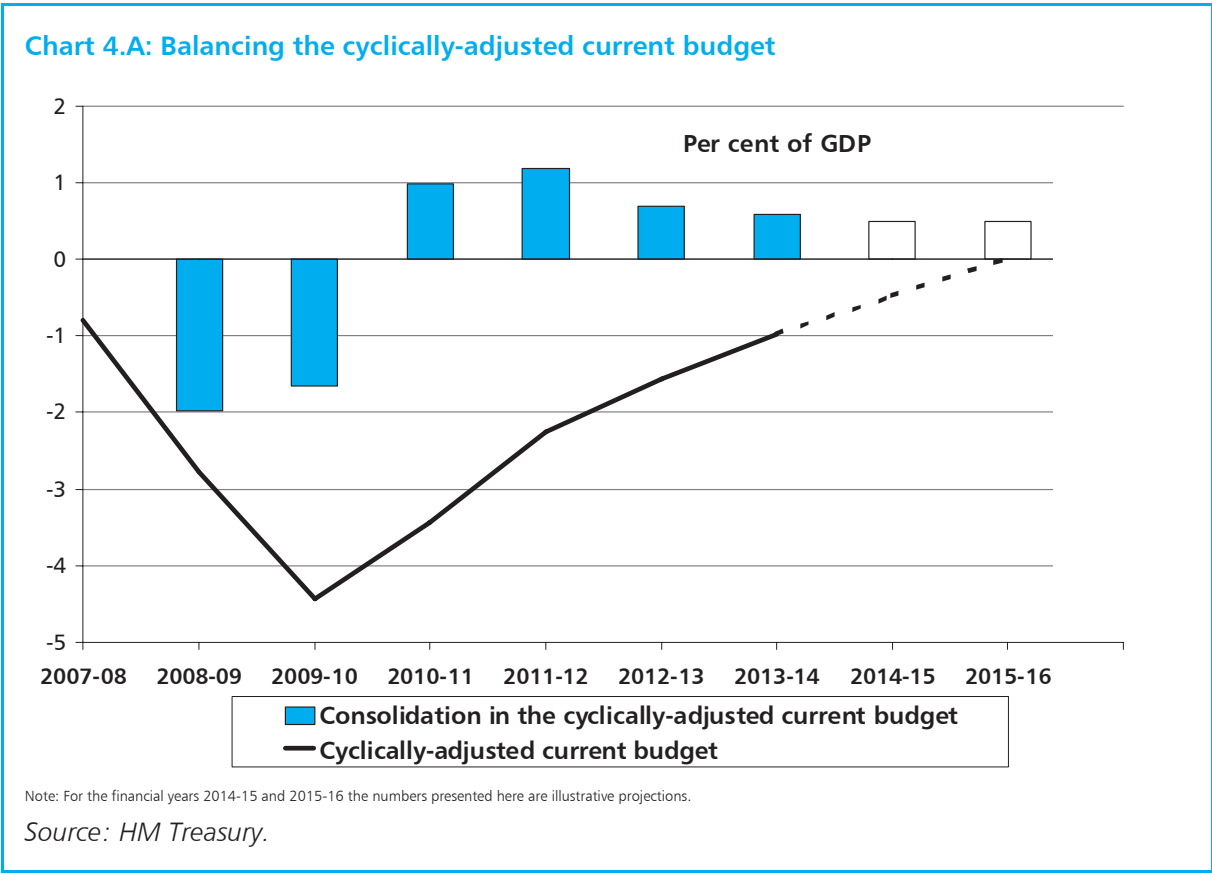
4.22 Table 4.A shows that both the deficit on the current budget and public sector net borrowing (PSNB) are projected to increase significantly in 2009-10. This reflects the impact of the economic downturn on tax receipts, including from the financial and housing markets. It also reflects the action that the Government is taking to support the economy and mitigate the impact of the economic shocks on businesses and individuals. Table 4.B shows that discretionary support is most significant in 2009-10, acting to reduce the impact of the economic shock when it is expected to be at its strongest. PSNB peaks at 8.0 per cent of GDP in 2009-10. Of this, the discretionary fiscal action the Government is taking to support the economy accounts for 1.1 per cent of GDP, of which around 0.2 per cent of GDP is capital spending. In total, borrowing for capital investment accounts for 2.7 per cent of GDP in 2009-10. Therefore, excluding borrowing for investment and discretionary action, net borrowing in 2009-10 would be 4.4 per cent of GDP.

4.23 In later years, borrowing declines as a result of the recovery of the economy and the Government's action to ensure the sustainability of the public finances, but remains higher than forecast at Budget 2008 because of the persistent effects of the downturn on the level of growth and on the financial and housing sectors in particular. Total public sector net borrowing falls to 2.9 per cent of GDP by the end of the forecast period, reflecting the action the Government is taking to ensure the sustainability of the public finances over the medium term, including through the tightening in discretionary spending set out earlier in this chapter and reflected in Table 4.B. The improvement in the public finances from 2010-11 is shown in Table

4.A, with both PSNB and the deficit on the current budget declining from that year, including in cyclically-adjusted terms.

Balancing the cyclically-adjusted current budget

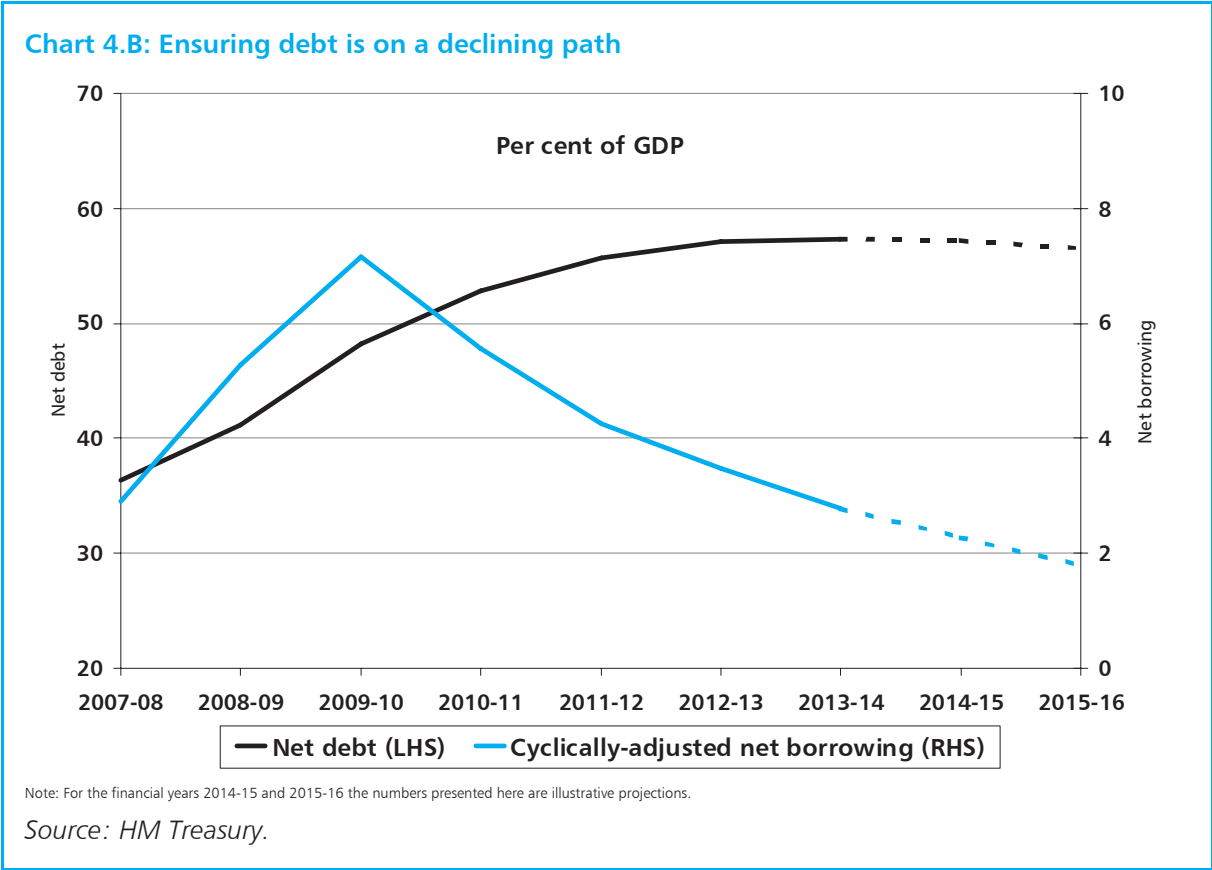
4.24 The 2008 Pre-Budget Report put the public finances on a path to achieve a balanced cyclically-adjusted current budget by 2015-16. The bars on Chart 4.A show the planned fiscal consolidation in each financial year of the projection period. They show that the Pre-Budget Report fiscal projections entail a planned consolidation in the cyclically-adjusted current budget of over 0.5 per cent of GDP in each of the financial years from 2010-11 to 2013-14. As a result of this sustained consolidation, the cyclically-adjusted current deficit is projected to decrease from 4.4 per cent in 2009-10 to 1.0 per cent in 2013-14. A further adjustment of ½ a per cent of GDP per year in 2014-15 and 2015-16 would eliminate the deficit on the current budget by 2015-16. Therefore the fiscal projections set out in the 2008 Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a proportion of GDP by 2015-16 when the global shocks will have worked through the economy in full. This is consistent with the Government’s temporary operating rule.



Declining net debt to GDP ratio

4.25 The Government reduced net debt as a proportion of GDP over the previous economic cycle – public sector net debt fell from 42.5 per cent GDP in 1996-97 to 36.0 per cent in 2006-07. Holding public debt at a prudent level in normal times allows space for debt to rise to accommodate shocks when they happen. The large and persistent impact of the financial markets shock in particular on the public finances means policy must adjust over a period of time, to avoid a short-term pro-cyclical tightening. This requires public debt to rise to absorb the shock and allow fiscal policy to support the economy, until adjustment has been completed and debt is set on a declining path as a proportion of GDP. Table 4.A shows that, as a result of the impact of the economic downturn on borrowing, public sector net debt is forecast to increase over the projection period and stabilise at just over 57 per cent of GDP in 2013-14.

4.26 The 2008 Pre-Budget Report put the public finances on a path that will ensure that the level of public debt will fall as a proportion of GDP in the medium term, once the global shocks have worked their way through the economy in full. Chart 4.B shows that cyclically-adjusted PSNB is projected to decline from 2009-10, as a result of the planned fiscal consolidation, standing at 2.8 per cent at the end of the projection period in 2013-14. The chart also shows illustrative projections based on a further improvement of ½ a per cent of GDP per year in the cyclically-adjusted current budget and assume that public sector net investment is held constant at 1.8 per cent of GDP. The illustrative projections show that, under these assumptions, cyclically-adjusted PSNB will continue to fall and the public debt to GDP ratio will be declining in 2015-16, once the global shocks have worked their way through the economy in full. This is consistent with the Government’s temporary operating rule.



Net investment

4.27 Public sector net investment has increased rapidly in recent years from 1¼ per cent of GDP in 2003-04 to 2 per cent of GDP in 2007-08. As a result of decisions taken in the 2008 Pre-Budget Report, net investment will increase to 2¾ per cent in 2009-10 before moving back to 1.8 per cent of GDP in 2013-14.

Contingent liabilities

4.28 Fiscal aggregates published by Government, such as net debt and net worth, reflect public sector liabilities that have been accrued in the past and are certain to require future transfers to meet the obligations. In addition, there are provisions or contingent liabilities that may have to be met in the future but where the timing or existence of the liability is not certain, these include for example nuclear decommissioning liabilities. The Government considers these types of liabilities in the sustainability analysis published in the *Long-term public finance report*¹. For

¹ Long term public finance report, HM Treasury, March 2008

example, the report publishes estimates of net liabilities, which include provisions and are based on dry run Whole of Government Accounts (WGA). When WGA are published for the year 2009-10, contingent liabilities will be disclosed as a note to the accounts. However, measures of contingent liability are subject to significant uncertainties, which limits the extent to which they can be used to determine fiscal policy in the short run.

Impact of financial stability measures on the public finances projections

4.29 The impact on the public finances of the measures the Government undertook to maintain financial stability and protect depositors is discussed in Box 4.A.

Box 4.A: Impact of financial stability measures on the public finances projections

As set out in Chapter 3, the main public finance projections exclude the impact of recent support measures for the financial sector, as these are exceptional and mostly temporary. This is an extension of the approach adopted in Budget 2008 to exclude Northern Rock from net debt. The independent Office for National Statistics (ONS) has yet to rule on how some of the transactions should be scored and issued a special background note on 16 October 2008 (Financial Support for the banking industry: classification issues). These classification decisions will take some time as a large volume of detailed information and legal documents will need to be examined before definitive rulings can be made. ONS are also in consultation with Eurostat (the Statistical Office of the European Union) and statistical offices in other member states to ensure consistent interpretation of international statistical guidance. The measures are as follows:

Northern Rock: The projections are consistent with the company's Business Plan published after Budget 2008 and assume a reduction in both the size of its balance sheet and in the loan from the Government, which was projected in Budget 2008 to remain at £14 billion from end 2008-09.

Special Liquidity Scheme (SLS): The scheme was introduced in April 2008, and extended in October 2008, to provide liquidity support from the Bank of England to the banking system. The Government is lending Treasury bills to the Bank of England to run the scheme. The classification of the scheme is a matter for the ONS, and until there is a ruling, it has been assumed that there will be no impact on PSND as the transaction is back-to-back stock lending (for a fee) and therefore no debt is regarded as having been issued.

Bradford & Bingley: The company was taken into public ownership in September 2008 and restructured. This has added £18.2 billion to Central Government Net Cash Requirement (CGNCR) through transactions associated with transfer of retail deposits to Abbey. £14.2 billion of this represents the assumption by Government of a loan from the Bank of England to cover the liabilities borne by the Financial Services Compensation Scheme (FSCS) and the remaining £4 billion is Government compensation for deposits above the FSCS depositor compensation limit. In addition there is a further £5.7 billion for the provision of a working capital facility. The company is currently producing a business plan, and the exact size of the working capital will be finalised as a part of that process. Although ONS announced on 14 November 2008 the classification of Bradford & Bingley to the public sector they have not yet been able to publish relevant data so no allowance can be made for including the debt of remainder of the company on the Government's balance sheet.

Kaupthing Singer & Friedlander (KSF) and Heritable: These were taken into public ownership in October 2008 and restructured. This has added £3.6 billion to CGNCR through transactions associated with transfer of retail deposits to ING Direct. £3 billion of this represents a Government loan to cover the liabilities borne by the FSCS.

Landsbanki (Icesave accounts): Transactions are taking place to compensate retail depositors in this account. These are expected to add around £4.5 billion to CGNCR. £3.8 billion of this represents Government refinancing of Bank of England loans to cover the liabilities borne by the FSCS and the Icelandic Depositors' and Investors' Guarantee Fund (ICS).

Bank Recapitalisation Fund: The Chancellor made a statement on 18 November 2008 detailing how future applications to the scheme would be dealt with from those banks which may seek to negotiate a substantively new proposal or new agreement with HM Treasury about the terms of any recapitalisation. Given the banks have agreed to raise capital, and the Government has given a commitment to support this, the 2008 Pre-Budget Report projections assume that the Government will acquire preference shares, and underwrite the issuance of ordinary shares, in Royal Bank of Scotland Group, Lloyds and HBOS at the terms set out in the statement on 13 October 2008, at a total cost of £37 billion, in 2008-09. In line with the NAO audited assumption (on privatisation proceeds) no disposal of these shares has been assumed over the entire projection period. However the impact on debt interest payments is largely offset by return on the preference shares.

Credit Guarantee Scheme (CGS): This scheme was introduced in October 2008. It is an insurance contract to repay new senior bank debt should the participating bank default. ONS have indicated that generally guarantees are contingent liabilities of Government and so do not score in the accounts unless the guarantee was called. No transactions from the CGS have been recorded in the 2008 Pre-Budget Report projections.

Projections for the Treaty measures of debt and deficit

4.30 The UK entered the Excessive Deficit Procedure following a Council Decision in July 2008 based on the Budget 2008 forecasts. Since Budget 2008, the nature of the global financial market shock has broadened and intensified, and global economic prospects have been hit hard. Table 4.A shows the Treaty measures of debt and deficit used for the purposes of the Excessive Deficit Procedure – Article 104 of the Treaty. The 2008 Pre-Budget Report projections meet the EU Treaty reference value for general government gross debt (60 per cent of GDP) in 2008-09, but rise above it in subsequent years. The treaty deficit in 2007-08 was 2.8 per cent of GDP. The deficit is expected to rise to 8.1 per cent of GDP in 2009-10. The treaty deficit is then expected to fall to 3.3 per cent of GDP in 2013-14.

4.31 European economies have all been affected by the unprecedented global economic shocks, and several European member states are already in recession.² Fiscal policy has an important role to play in these exceptional circumstances. The Government's objectives of smoothing the path of the economy in the short term while ensuring sound public finances over the medium term are consistent with the October European Council Conclusions, which confirmed that the Stability and Growth Pact should be applied in a manner that reflects current exceptional economic circumstances.³ The objectives are also consistent with the Commission's 26 November Communication, "A European Economic Recovery Plan"⁴. This recognises that a budgetary expansion, which may lead some Member States to breach the 3% GDP deficit reference value, is justified in these extraordinary circumstances. It further states that corrective action will have to be taken in time frames consistent with the recovery of the economy.

² European Commission Economic Forecast Autumn 2008, European Commission, November 2008.

³ www.consilium.europa.eu

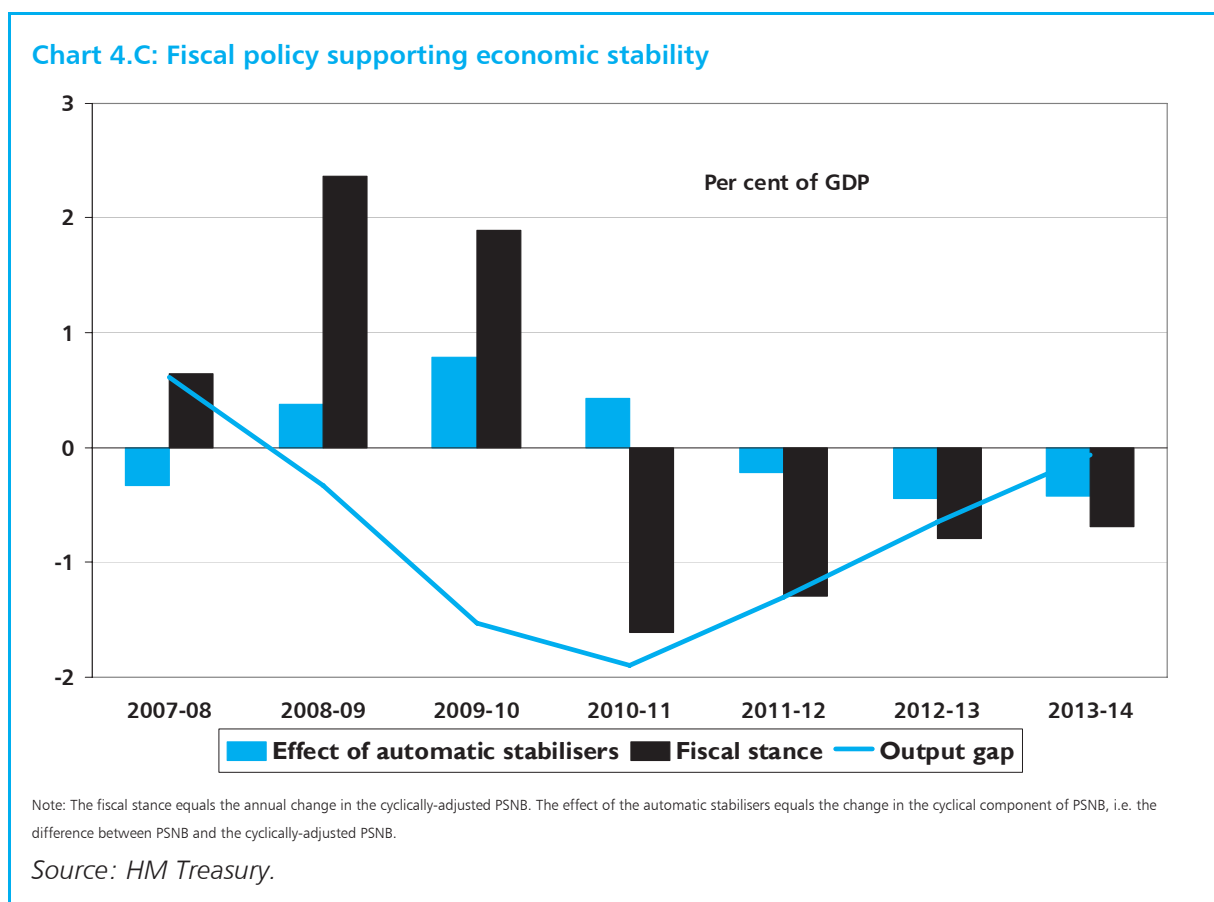
⁴ Communication from the Commission to the European Council, *A European Economic Recovery Plan*, November 2008

Economic impact of fiscal policy

4.32 The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing. The overall impact of fiscal policy on the economy is made up of changes in:

- the automatic stabilisers – that part of the change in PSNB resulting from cyclical movements in the economy; and
- the fiscal stance – that part of the change in PSNB that is not a result of cyclical movements in the economy (as measured by changes in cyclically-adjusted PSNB).

4.33 Chart 4.C shows the economic impact of planned fiscal policy over the forecast period. It shows that both the automatic stabilisers and the fiscal stance act to provide a considerable degree of support to the economy in 2008-09 and 2009-10, during the economic downturn. From 2010-11 the fiscal stance tightens to fund a reduction in borrowing at a time when the economy is expected to be recovering and able to support the fiscal consolidation.



Forecast assumptions

Key assumptions

4.34 This section sets out the key assumptions on which the fiscal projections are based:

- the economy follows the path described in Chapter 2. The fiscal projections continue to be based on the assumption that trend output growth will be $\frac{1}{4}$ percentage point lower than the Government's neutral view, which is designed to add caution;
- there are no tax or spending policy changes beyond those announced in or before the 2008 Pre-Budget Report. Rates, thresholds and limits, including for 2008-09,

increase in line with projected indexation or announced policy. Consistent with the *Code for fiscal stability*, the forecast does not take account of measures proposed in the Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken;

- Departmental Expenditure Limits (DEL) to 2010-11 are adjusted as set out earlier in the chapter, in order to bring forward spending to support the economy and help to ensure fiscal consolidation in the medium term;
- total Annually Managed Expenditure (AME) programmes to 2010-11 have been forecast consistent with the economic assumptions and policy decisions in the 2008 Pre-Budget Report;
- public sector current expenditure is projected to grow at 1.2 per cent on average in real terms from 2011-12 to 2013-14; and
- net investment is projected to move to 1.8 per cent of GDP in 2013-14.

4.35 The main domestic economic assumptions are summarised in Table 4.C.

Table 4.C: Economic assumptions for the public finances projections

	Percentage changes on previous year unless otherwise specified						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Output (GDP)	3	- ¼	- ½	2	3	3	3
Prices							
CPI	2 ¼	3 ¾	1	2	2	2	2
GDP deflator	3	3 ¼	1 ½	2 ¾	2 ¾	2 ¾	2 ¾
RPI ¹ (September)	4	5	-2 ¼	2 ½	4	3 ½	3
Rossi ² (September)	2 ¼	6 ¼	0	1 ¾	2 ½	2 ½	2 ½
Money GDP ³ (£ billion)	1,421	1,463	1,480	1,549	1,638	1,735	1,836

¹ Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year. Unless a fall is specifically allowed for in statute, tax parameters and benefit levels depending on the negative RPI value for 2009 are assumed to remain unchanged from their previous values.

² RPI excluding housing costs, used for uprating certain social security benefits.

³ Not seasonally adjusted.

The use of NAO audited assumptions

4.36 The key assumptions underlying the fiscal projections are audited by the independent National Audit Office (NAO) under the three-year rolling review process. This is designed to add caution into the public finance projections. Details of the audited assumptions are given in Box 4.B. The trend rate of GDP growth is assumed to be ¼ per cent below the neutral view, which means that the rate of economic growth on which the public finances projections are based is the lower end of the forecast range, as set out in Table 4.C.

4.37 For Budget 2008, the Comptroller and Auditor General audited the assumption relating to unemployment, which requires projections to be based on outside forecasts when these are higher than recent outturns. He concluded that the assumption proved to be cautious in the later part of the Rolling Review period since Budget 2005, though in the earlier part actual unemployment in the initial parts of the projections exceeded the level projected by outside forecasters. He concluded that the assumption draws on a wide range of external views of the future and is a reasonable one to have used and to continue to use. No other assumptions were due for review in Budget 2008.

4.38 For the 2008 Pre-Budget Report, the Comptroller and Auditor General audited the Treasury's judgement that the end date of the previous economic cycle was in the second half of 2006. Taking all the evidence as a whole, he judged that it is reasonable to conclude that the second half of 2006 marked the end date of the most recently completed economic cycle, which

was judged to have started in the first half of 1997. The Comptroller and Auditor General recommended, given the uncertainties in dating the economic cycles, including looking ahead and the impact new data might have in the future, that the Treasury keep this assessment under review. The NAO will be asked to audit the end date of the current and future cycles once the Treasury has made a firm judgement.

4.39 The Comptroller and Auditor General also audited the oil price assumption used for the Treasury's public finance projections. The report concluded that the convention was cautious over the past three years, is designed to provide caution in the future, and remains a reasonable assumption to use going forward. No other assumptions were due for review in the 2008 Pre-Budget Report.

Box 4.B: Key assumptions underlying the fiscal projections audited by the National Audit Office (NAO) ^a

Trend GDP growth ^c	2½ per cent a year to 2014.
Dating of the cycle ^f	The previous economic cycle, which began in the first half of 1997, ended in the second half of 2006.
Composition of GDP ^d	Shares of labour income and profits in national income are broadly constant in the medium term.
Consistency of price indices ^c	Projections of price indices used to project the public finances are consistent with CPI.
Oil prices ^f	\$60.1 a barrel in 2009, the average for the month to 19 November, and then constant in real terms. This is lower than the \$71.8 average of independent forecasts for 2009.
Equity prices ^c	FTSE All-share index rises from 1998 (close 19 November) in line with money GDP.
VAT ^d	The underlying VAT gap will rise by 0.5 percentage points per year from the estimated outturn for the current year.
Tobacco ^d	The underlying level of duty paid consumption of cigarettes will be set at least three per cent per year lower than the estimated outturn for the current year.
UK claimant unemployment ^{e, g}	Rising from recent levels of 0.98 million to 1.41 million at the end of 2009, and to 1.55 million at the end of 2010, based on the average of independent forecasts.
Interest rates ^b	3-month market rates change in line with market expectations (as of 13 November).
Funding ^d	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Privatisation proceeds ^b	Credit is taken only for proceeds from sales that have been announced.

^a For details of all NAO audits before Budget 2006, see the 2005 Pre-Budget Report, 5 December 2005 (HC 707).

^b Audit of Assumptions for Budget 2006, 22 March 2006 (HC 937).

^c Audit of Assumptions for the 2006 Pre-Budget Report, 6 December 2006 (HC 125).

^d Audit of Assumptions for Budget 2007, 21 March 2007 (HC 393).

^e Audit of Assumptions for Budget 2008, 12 March 2008 (HC 345).

^f Audit of Assumptions for the 2008 Pre-Budget Report, 24 November 2008 (HC 1150).

^g Seasonally-adjusted UK claimant unemployment. This is a cautious assumption based on the average of external forecasts and is not the Treasury's economic forecast.

Forecast differences and risks

4.40 Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been around 1 per cent of GDP. This difference tends to grow as the forecast horizon lengthens. The fiscal balances represent the difference between two large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. This is particularly the case at times such as now when the economy has been subject to significant shocks and there is increased uncertainty about its future path. The uncertainty surrounding economic prospects at the current time, therefore implies greater than usual risks surrounding the public finance projections.

4.41 The 2008 *End of year fiscal report*¹ (EYFR) is published alongside the Pre-Budget Report. The EYFR underlines the Government's commitment to transparency in fiscal policy by providing detailed retrospective information on the public finances in 2006-07 and 2007-08, including an explanation for differences between forecasts and outturn in those years.

Risks and uncertainty

4.42 Economic forecasting inevitably involves judgement about the uncertain path of future events. Given the current context, of shocks that are likely to affect supply potential as well as demand and substantial macroeconomic and financial policy responses, the 2008 Pre-Budget Report forecast involves an even greater reliance on judgement.

4.43 As was the case at the last Budget and Pre-Budget Report, the key forecast judgement relates to the intensity and duration of the global tightening in credit conditions faced by households and companies. The forecast assumes that, with financial institutions having received significant support from governments around the world, credit conditions should ease over the coming year and return to a new norm from early 2010. The extent of government support and very low level of policy interest rates suggest there is an upside risk to this assumed path of credit conditions, with the possibility that the banking system is able to restore the efficiency of its financial intermediation operation more quickly. Against that, the experience of the past six months, when conditions appeared to be stabilising before deteriorating dramatically in September and October, underlines the significant downside risks that remain.

4.44 There are uncertainties over the degree to which monetary and fiscal policy easing will support activity. In terms of monetary easing, there have been some encouraging signs that it will filter through to households and companies, though there remain clear risks over how long the availability of credit will remain restricted and the extent to which households and companies will want to increase borrowing in an uncertain economic environment, and when outstanding household borrowing is historically high.

4.45 In terms of the fiscal stimulus, the key economic risks stem from the degree to which the lower VAT rate is passed through to consumer prices and the extent to which temporarily lower prices stimulate a greater volume of spending. It has been assumed that over time the majority of the VAT rate cut will be passed through to consumer prices. While this suggests a risk to consumer spending from lower pass-through, that would be tempered by the upside risk to corporate profits and perhaps therefore employment if companies were to retain more of the temporary VAT rate cut. With respect to stimulating spending, the forecast assumes that approximately half of the increase in real purchasing power translates into an increased volume of spending, with the remainder used by households to bolster their finances. There are clearly upside and downside risks to this assumption, particularly those related to developments in

¹ 2008 *End of Year Fiscal Report*, HM Treasury, November 2008

credit conditions. If credit conditions ease more rapidly than assumed, households will have greater scope to bring forward spending to capitalise on the temporarily lower rate of VAT.

4.46 From spring 2008 until recently, the risk to inflation was tilted to the upside, with commodity prices reaching record highs in the summer. As commodity prices have fallen sharply and growth has slowed, pressures on inflation have eased. While the depreciation of sterling means there are residual upside risks to inflation from import prices, it seems clear that inflation is set to fall sharply over the coming year. Further downward pressure on inflation will come as the cut in the VAT rate is progressively passed through to prices.

4.47 The uncertainty surrounding economic prospects in turn implies greater than usual risks surrounding the public finance projections. The projections are based on the recovery in economic growth set out above, and a pick up in financial sector profits and asset prices beginning in early 2010. Downside risks to the public finance projections include that the economic downturn is sharper or longer than expected, the economic recovery is slower than expected or that the contraction in the financial sector or the adjustment in the housing market are more protracted. If, however, the substantial stimulus from monetary and fiscal policy, sterling's depreciation and lower commodity prices, takes hold sooner than forecast, the public finance projections would be subject to upside risks.

General government finances

4.48 Table 4.D gives a breakdown of general government finances. General government transactions by economic category

	£ billion			
	Outturn	Estimate	Projections	
	2007-08	2008-09	2009-10	2010-11
Current receipts				
Taxes on income and wealth	207.7	203.0	192.4	206.8
Taxes on production and imports	176.0	174.8	170.4	188.4
Other current taxes	31.9	33.3	34.7	36.5
Taxes on capital	3.9	3.1	2.4	2.0
Compulsory social contributions	95.5	98.4	101.0	106.0
Gross operating surplus	12.9	13.6	14.5	15.5
Rent and other current transfers	1.6	2.0	2.0	2.1
Interest and dividends from private sector and abroad	7.4	6.8	7.0	7.5
Interest and dividends from public sector	1.9	1.5	1.4	1.4
Total current receipts	539.0	536.5	525.7	566.3
Current expenditure				
Current expenditure on goods and services	300.7	320.4	334.3	346.4
Subsidies	9.8	11.5	11.8	11.2
Net social benefits	157.3	168.9	179.9	185.3
Net current grants abroad	-0.3	-3.7	-3.2	-1.3
Other current grants	37.7	38.9	42.2	43.6
Interest and dividends paid	30.6	31.4	27.0	40.6
AME margin	0.0	0.0	0.9	1.8
Total current expenditure	535.8	567.3	593.0	627.5
Depreciation	12.9	13.6	14.5	15.5
Surplus on current budget	-9.7	-44.5	-81.8	-76.7
Capital expenditure				
Gross domestic fixed capital formation	27.9	32.5	35.2	33.6
Less depreciation	-12.9	-13.6	-14.5	-15.5
Increase in inventories	0.0	0.0	0.0	0.0
Capital grants (net) within public sector	2.4	0.5	0.4	0.5
Capital grants to private sector	13.8	16.8	18.5	14.4
Capital grants from private sector	-1.3	-1.2	-1.3	-1.1
AME margin	0.0	0.0	0.1	0.2
Net investment	29.9	34.9	38.4	32.1
Net borrowing¹	39.7	79.5	120.2	108.8
<i>of which:</i>				
Central government net borrowing	39.2	75.3	116.4	106.5
Local authority net borrowing	0.5	4.2	3.8	2.2
Gross debt (Maastricht basis)				
Central government	555.3	713.3	834.3	947.5
Local government	59.1	60.5	61.5	60.2

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

4.49 The Eurostat definition of total revenues and expenditure used in Table 2 of *the Guidelines on the format and content of Stability and Convergence Programmes* differs from that used in the public finance projections outlined in this Convergence Programme. Both the UK projections and Eurostat classifications are ESA95 compatible. The differing total revenue and expenditure data is due to differing treatments of ESA95 components. For example, public sector pension contributions are included as receipts in the Eurostat definition, but are subtracted from the net social benefits in the UK projections definition. Both classifications produce the same figures for the Treaty deficit and for all other fiscal aggregates.

Developments on the revenue side

4.50 The latest projections for general government receipts, contained in the 2008 Pre-Budget Report, are shown in Table 4.D.

4.51 With the impact of the global credit and commodity shocks slowing the economy rapidly, receipts growth in the first part of 2008-09 was weak. Net taxes and national insurance contributions (NICs) were up just 1.8 per cent year-on-year in the first seven months of 2008-09. With the economy having entered a downturn, receipts growth on a year earlier is likely to turn negative over the remainder of 2008-09. Receipts are expected to weaken further in 2009-10 with net taxes and NICs projected to fall by 3.3 per cent on 2008-09.

Changes in total receipts since Budget 2008

4.52 Lower levels of output across the economy act to significantly reduce tax receipts, in particular from income tax, NICs, VAT and corporation tax due to lower incomes, consumption and profits. With income tax and NICs accounting for around 45 per cent of total receipts, lower labour income results in a shortfall in receipts in 2009-10 of £16 billion, compared with Budget 2008 forecast. By 2010-11, lower consumer spending and profits of industrial and commercial companies reduce receipts by £4½ billion and £7½ billion respectively. Total economic growth over the forecast period is lower than assumed in Budget 2008. Coupled with a recovery led by investment and exports, which is likely to generate less receipts than a consumer-led rebound, a substantial element of the receipts shortfall due to economic factors persists.

4.53 Box 4.C looks at the impact of the financial and housing sectors on the public finances. The intensification of the global financial crisis since Budget 2008 will significantly reduce receipts from the financial sector. The impact on corporation tax, income tax and VAT from the financial sector is likely to reduce receipts by £7½ billion in 2008-09 and by around £10 billion in 2009-10, relative to the Budget 2008 forecast. The Budget had assumed that the negative impact on receipts from financial sector disruption would be at its greatest in 2008-09 before the sector picked up as credit conditions normalised in mid-2009. Consistent with the assumption underlying the 2008 Pre-Budget Report economic forecast that credit conditions will ease only slowly through 2009 and stabilise in 2010, no rebound in financial sector profits and City bonuses is assumed in 2009. Thereafter, activity in the sector recovers but remains lower than assumed in earlier Budgets and Pre-Budget Reports.

Box 4.C: The impact of the financial and housing sectors on the public finances

The global credit shock has particularly affected the financial and housing sectors in the UK – both of which are typically a significant source of tax receipts. Financial company corporation tax has accounted for around 25 per cent of overall corporation tax, and the sector provides significant amounts of income tax and NICs on salaries and bonuses. The housing sector provides revenue directly through stamp duty, inheritance tax and capital gains tax and indirectly through the VAT collected on housing-related consumption.

In recent years, the financial and housing sectors saw rapid growth in activity and asset values. This growth was reflected in receipts from taxes linked to the two sectors². In 2002-03, financial and housing sector receipts were equivalent to 3 per cent of GDP. By 2007-08, these receipts had increased to 4¼ per cent of GDP. The rise in housing and financial sector receipts from 2002-03 to 2007-08 accounted for half of the increase in total current receipts over this period.

Consistent with the economic forecast, the public finance projections assume a sharp drop in receipts from the housing and financial sectors in the next two years and then a recovery in the medium term.

However, over the forecast horizon the sectors do not recover to the levels of activity, and associated receipts, experienced in 2007-08. Receipts from the two sectors are predicted to decline from 4¼ per cent of GDP in 2007-08 to 2¾ per cent in 2009-10, before rising to 3½ per cent of GDP in 2013-14.

4.54 Equity prices have fallen sharply since Budget 2008. The public finances forecast uses a NAO audited assumption for equity prices, which assumes that prices will rise in line with money GDP from their current level. Equity prices are around 35 per cent lower than assumed in the Budget throughout the forecast horizon. Equity prices have a direct impact on stamp duty on shares, onshore corporation tax, and with a lag, capital gains tax and inheritance tax. Receipts driven by equity prices are expected to be £1 billion lower in 2008-09 and around £3½ billion a year lower in 2009-10 and thereafter.

4.55 Residential and commercial property markets have also been affected by the global credit shock. The availability of property finance has declined rapidly, impacting on both house prices and transactions. Allied with a continued drop in commercial property prices, stamp duty land tax has fallen sharply in 2008-09. The public finance forecasts have used external forecasts, from the Treasury's published *Comparison of independent forecasts*³ as the basis for the Treasury's assumptions. The average of independent forecasts is for house prices to fall by 20 per cent in the two years to the end of 2009. Coupled with continued weakness in property transactions and a lagged impact on receipts of capital gains tax and inheritance tax, housing-related receipts are likely to be £7 billion lower in 2009-10, relative to the Budget 2008 forecast. With the level of house prices lower throughout the forecast than assumed in the Budget, a sizeable element of the shortfall persists.

² These revenues include receipts from financial sector corporation tax, financial sector PAYE and NICs, Capital Gains Tax, Inheritance Tax and stamp duties

³ *Comparison of independent forecasts*, HM Treasury

Table 4.D: Current receipts

	£ billion			Changes since Budget 2008 (£ billion)		
	Outturn 2007-08	Estimate 2008-09	Projection 2009-10	Outturn 2007-08	Estimate 2008-09	Projection 2009-10
HM Revenue and Customs						
Income tax (gross of tax credits)	151.9	156.7	151.2	-3.7	-3.5	-19.9
Income tax credits	-4.4	-5.5	-6.0	0.2	-0.3	-0.5
National insurance contributions	100.4	97.7	100.8	3.0	-6.9	-7.1
Value added tax	80.6	82.6	72.6	0.1	-1.2	-16.3
Corporation tax ¹	46.9	45.5	42.4	-0.1	-6.4	-13.9
Corporation tax credits ²	-0.6	-0.6	-0.7	0.0	0.0	0.0
Petroleum revenue tax	1.7	2.6	1.5	0.0	0.9	-0.3
Fuel duties	24.9	25.1	26.2	0.0	-0.7	-0.9
Capital gains tax	5.3	4.9	2.4	0.5	-0.1	-1.8
Inheritance tax	3.8	3.1	2.4	-0.1	-0.1	-0.7
Stamp duties	14.1	8.3	6.9	-0.2	-5.2	-8.3
Tobacco duties	8.1	8.2	8.2	0.0	0.6	0.4
Spirits duties	2.4	2.3	2.5	0.1	0.0	0.2
Wine duties	2.6	2.8	2.9	0.1	-0.2	-0.2
Beer and cider duties	3.3	3.4	3.3	0.0	-0.1	-0.3
Betting and gaming duties	1.5	1.5	1.4	0.0	0.0	0.0
Air passenger duty	2.0	1.9	1.9	0.0	-0.1	-0.5
Insurance premium tax	2.3	2.3	2.5	0.0	-0.1	0.0
Landfill tax	0.9	0.9	1.2	0.0	-0.2	-0.1
Climate change levy	0.7	0.7	0.7	0.0	0.0	0.0
Aggregates levy	0.3	0.4	0.3	0.0	-0.1	-0.1
Customs duties and levies	2.5	2.6	2.8	0.0	0.1	0.2
Total HMRC	451.2	447.1	427.5	0.0	-23.4	-69.9
Vehicle excise duties	5.4	5.8	6.0	-0.2	-0.4	-1.1
Business rates	21.4	23.5	24.6	-0.4	-0.3	-0.2
Council tax ³	23.2	24.6	25.7	-0.5	-0.3	-0.4
Other taxes and royalties ⁴	14.6	15.7	15.9	-0.1	-0.1	-0.9
Net taxes and NICs⁵	515.9	516.6	499.6	-1.2	-24.4	-72.5
Accruals adjustments on taxes	1.0	-3.1	2.5	-0.4	-5.1	0.0
Less own resources contribution to EC budget	-5.0	-4.3	-4.8	0.0	0.4	0.2
Less PC corporation tax payments	-0.3	-0.2	-0.2	-0.1	0.0	0.0
Tax credits adjustment ⁶	0.6	0.7	0.7	0.0	0.0	0.0
Interest and dividends	8.3	7.7	8.1	0.4	0.7	1.1
Other receipts ⁷	27.0	28.0	29.5	-1.1	-1.4	-1.6
Current receipts	547.5	545.5	535.5	-2.4	-29.8	-72.7
<i>Memo:</i>						
North Sea revenues ⁸	7.8	13.2	8.7	0.1	3.3	-1.1

¹ National Accounts measure, gross of enhanced and payable tax credits.

² Includes enhanced company tax credits.

³ Council tax increases are determined annually by local authorities, not by the Government. As in previous years, council tax figures are projections based on assumptions and are not Government forecasts.

⁴ Includes VAT refunds and money paid into the National Lottery Distribution Fund.

⁵ Includes VAT and 'traditional own resources' contributions to EC budget.

⁶ Tax credits which are scored as negative tax in the calculation of NTNIC but expenditure in the National Accounts.

⁷ Includes gross operating surplus, rent and business rate payments by local authorities.

⁸ Consists of North Sea corporation tax and petroleum revenue tax.

Tax-by-tax analysis

4.56 Table 4.E contains the 2008 Pre-Budget Report projections for receipts and the changes in these projections from Budget 2008.

Income tax and national insurance contributions

4.57 Cash receipts of income tax and NICs in 2008-09 are expected to be £10.4 billion below the Budget projection, of which around £2.7 billion relates to the £600 rise in the personal allowance announced in May. With the labour market already slowing and earnings growth subdued, growth in PAYE and NIC receipts from wages and salaries in the first seven months of 2008-09 has been weaker than assumed in the Budget forecast. Receipts from sectors such as the financial sector, construction, retail and manufacturing have been particularly weak. The year-on-year drop assumed in income tax, NICs and capital gains tax receipts over the remainder of 2008-09 reflects a continuation of recent trends and a projected sharp reduction in receipts from financial sector bonuses.

4.58 Receipts of PAYE and NIC are forecast to remain weak in 2009-10, reflecting the response of the labour market to the contraction in the economy in late 2008 and early 2009. Overall labour income is only expected to rise by 2½ per cent in 2009-10. With credit conditions only assumed to ease slowly in 2009, receipts from financial sector bonuses are not expected to recover in 2009-10. In addition, there is a sharp drop in tax on savings income in 2009-10, related to the recent base rate reductions and a decline in self assessment receipts. The latter will be affected by weaker growth in self-employment income, and a drop in savings income and dividends.

4.59 Income tax and NIC receipts recover from 2010-11 as the economy picks up momentum and the financial sector recovers. However, receipts remain significantly lower than in the Budget 2008 projection.

Non-North Sea corporation tax

4.60 Non-North Sea corporation tax has historically been one of the more cyclical of taxes with receipts expected to fall by almost 15 per cent in 2008-09, due to the downturn in the economy and the financial sectors. With profits in the financial sector forecast to fall by 14 per cent, financial sector corporation tax in 2008-09 is likely to be around 35 per cent down on 2007-08. Profits from industrial and commercial companies are forecast to fall by ½ per cent in 2008 with corporation tax from the larger companies who pay quarterly instalments projected to be down around 10 per cent in 2008-09.

4.61 Onshore corporation tax receipts are not expected to recover in 2009-10. Financial sector profits are assumed to remain flat, while other non-oil profits are expected to fall a further 2¼ per cent. From 2010-11, profits in the financial sector are forecast to increase from very low levels, growing at above-trend growth rates of 14 per cent per year, consistent with the sector recovering but activity remaining lower than assumed in earlier Budgets and Pre-Budget Reports. Onshore corporation tax increases as a proportion of GDP, but remains well below the Budget 2008 projection. This reflects lower projected levels of economic output throughout the forecast period resulting in lower profit levels for non-financial firms, while the contribution of the financial sector to overall activity is likely to be smaller than previously envisaged.

North Sea revenues

4.62 North Sea revenues in 2008-09 are expected to be £3.3 billion above the Budget 2008 forecast, reflecting the rapid rise in both oil and gas prices up to July. Since then, oil prices have fallen back sharply, but are likely to still average just over \$100 a barrel in 2008 as a whole, well above the \$83.8 a barrel assumed in the Budget 2008 forecast. There are a number of offsets

that limit the overall impact of high oil prices on the public finances and mean that there is no significant windfall to the government. Temporarily higher inflation will push up the indexation of tax thresholds and benefits and increase the cost of servicing index-linked gilts, whilst increased costs will reduce tax yields by squeezing the profit margins in the remainder of the economy and any drop in the demand for fuel will reduce fuel duties.

4.63 The projections of North Sea revenues for 2009 and beyond use the NAO audited oil price assumption. This is either the average of independent forecasts for the year ahead, or if lower, the average of the past month's oil price in nominal dollar terms, as is the case with this forecast. This gives an oil price of \$60.1 a barrel for 2009, which is the key driver of the projected 33 per cent fall in North Sea revenues in 2009-10. The depreciation of sterling against the dollar means that the drop in the oil price in sterling terms is less steep than in dollar terms. This helps limit the downward revision in North Sea revenues in 2009-10 since the Budget to £1.1 billion.

Capital gains tax and inheritance tax

4.64 Receipts from capital gains tax (CGT) are expected to halve between 2007-08 and 2009-10, reflecting the sensitivity of CGT to equity price changes. Such a fall would not be unprecedented, as receipts fell by 50 per cent between 2001-02 and 2002-03, reflecting the dotcom-related drop in equity prices. CGT is particularly volatile because financial assets account for around two-thirds of chargeable gains and it is charged on the gain rather than the whole disposal price. With CGT paid in the financial year following the year in which the gains were realised, the main impact from lower equity prices will not be felt until 2009-10. CGT receipts will also be affected by the downturn in the property market.

4.65 Declines in asset prices will also affect inheritance tax, which is particularly affected by developments in the property market. Housing accounts for around 50 per cent of assets in estates notified for probate. The lagged response of inheritance tax to the drops in both equity and house prices in 2008 is expected to reduce receipts by £0.7 billion in 2009-10, relative to the Budget 2008 forecast.

Stamp duties

4.66 Total stamp duty is expected to fall by over 40 per cent in 2008-09. The sharp drop in stamp duty land tax is from a combination of falls in house prices, the commercial property market and in particular that residential property transactions in 2008-09 are likely to be less than half their 2007-08 level. Stamp duty on shares has also been adversely affected by the steep drop in equity prices. With much of the drop occurring through the autumn, substantial year-on-year falls in stamp duty on shares are likely over the remainder of 2008-09.

4.67 A further decline in stamp duties is likely in 2009-10. The average of independent forecasts is for a fall in house prices of just over 20 per cent in the two years to the end of 2009. In addition, property transactions are likely to remain low given that credit conditions are only expected to ease slowly through 2009. Thereafter, the economy and the housing market are expected to pick up, with house prices assumed to grow by 6 per cent per year broadly in line with long term average growth in house prices, but stamp duty receipts remain well below Budget 2008 projections. This reflects lower house and equity prices throughout the forecast.

VAT receipts

4.68 Year-on-year growth in cash receipts of VAT in the first seven months of 2008-09 was 4.3 per cent, stronger than the overall growth in receipts, partly reflecting one-off factors and that nominal consumer expenditure held up in the early part of the year. With growing evidence of weaker consumer spending, VAT receipts are expected to slow over the remainder of the

financial year. The reduction in VAT from 17½ per cent to 15 per cent at the start of December will reduce cash receipts of VAT by around £1.9 billion in 2008-09. Some of the VAT relating to the last four months of 2008-09 will be paid in the first few months of 2009-10 and accrue back to 2008-09.

4.69 With the VAT rate at 15 per cent until the end of December 2009, receipts are expected to be over 12 per cent lower in 2009-10 than in 2008-09. The sharp fall in VAT receipts in 2009-10 also reflects the impact of economic developments on the VAT base. Consumer spending which accounts for around two-thirds of the total VAT base is expected to decline in real terms in 2009, although the reduction in the VAT rate partly ameliorates this. In nominal terms, consumer spending is expected to grow by just 0.7 per cent in 2009. The VAT base will also be affected by the financial sector crisis. While financial sector businesses do not charge VAT on final products they cannot claim back the VAT incurred from buying other business inputs to produce these exempt products. These partially-exempt businesses thus incur 'stuck VAT' and this is likely to be affected by the downturn in the sector.

4.70 Beyond 2009-10, growth in the VAT base is held back by consumer spending growing at rates slightly below that of the whole economy, as households adjust their finances. In addition, the forecast assumes a 0.5 percentage point rise per year in the underlying VAT gap (the difference between the theoretical tax liability and actual receipts), in line with the NAO audited assumption.

Developments on the expenditure side

4.71 The spending projections cover the whole of the public sector, using the National Accounts aggregate Total Managed Expenditure (TME). For fiscal aggregates purposes, TME is split into national accounts components covering public sector current expenditure, public sector net investment and depreciation. For budgeting and other purposes, TME is split into Departmental Expenditure Limits (DEL - firm three-year limits for departments' programme expenditure) and Annually Managed Expenditure (AME - expenditure items that are large, potentially volatile and demand-led, such as social security benefits and debt interest payments, and so not easily subject to firm multi-year limits). Departments have separate resource budgets, for current and capital expenditure.

4.72 AME 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, it 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 public expenditure.

Changes in Total Managed Expenditure since Budget 2008

4.73 The provisional outturn for TME in 2007-08 was £2.3 billion lower than estimated in Budget 2008. Current expenditure was lower by £3.8 billion, mainly due to larger than expected departmental underspends. Public sector net investment was higher by £1.4 billion mainly due to a reclassification of Ministry of Defence (MoD) expenditure from current to capital expenditure.

4.74 TME for 2008-09 is estimated to be around £5.3 billion higher than at Budget 2008 and then higher over the forecast period, mainly due to increased spending on social security benefits, and increased forecasts of local authority self-financed expenditure. The reasons for changes in TME are explained in more detail in the projections of individual DEL and AME components.

Table 4.E: Total Managed Expenditure 2007-08 to 2010-11

	£ billion			
	Outturn 2007-08	Estimate 2008-09	Projections 2009-10 2010-11	
CURRENT EXPENDITURE				
Resource Departmental Expenditure Limits	310.0	325.3	339.2	350.0
<i>of which:</i>				
Near-cash Departmental Expenditure Limits	288.7	304.4	317.3	326.5
Non-cash	21.4	20.9	21.9	23.5
Resource Annually Managed Expenditure	226.3	242.6	254.5	278.2
<i>of which:</i>				
Social security benefits ¹	138.8	149.2	159.6	164.0
Tax credits ¹	17.1	19.5	20.6	20.4
Net public service pensions ²	2.3	2.9	3.8	3.9
National Lottery	0.9	1.0	0.8	0.8
BBC domestic services	3.3	3.5	3.6	3.7
Other departmental expenditure	2.6	2.1	2.2	1.6
Net expenditure transfers to EC institutions ³	5.4	3.8	5.3	7.1
Locally-financed expenditure ⁴	24.4	26.1	26.8	28.3
Central government gross debt interest	29.9	30.8	26.6	40.0
AME margin	0.0	0.0	0.9	1.8
Accounting adjustments	1.6	3.8	4.4	6.4
Public sector current expenditure	536.4	568.0	593.7	628.2
CAPITAL EXPENDITURE				
Capital Departmental Expenditure Limits	44.1	48.8	53.8	50.1
Capital Annually Managed Expenditure	3.6	6.3	6.3	3.5
<i>of which:</i>				
National Lottery	0.8	0.7	0.9	0.8
Locally-financed expenditure ⁴	3.6	5.3	4.6	3.5
Public corporations' own-financed capital expenditure	5.9	6.4	7.1	6.0
Other capital expenditure	-1.2	-0.4	0.5	0.6
AME margin	0.0	0.0	0.1	0.2
Accounting adjustments	-5.4	-5.6	-6.8	-7.6
Public sector gross investment	47.7	55.1	60.1	53.6
Less public sector depreciation	-17.8	-18.7	-19.7	-20.9
Public sector net investment	29.9	36.5	40.4	32.7
TOTAL MANAGED EXPENDITURE⁵	584.1	623.1	653.8	681.8
<i>of which:</i>				
Departmental Expenditure Limits	343.5	362.1	380.6	386.8
Annually Managed Expenditure	240.6	261.0	273.1	295.0

¹ For 2007-08 to 2008-09, child allowances in Income Support and Jobseekers' Allowance have been included in the tax credits line and excluded from the social security benefits line.

² Net public service pensions expenditure is reported on a National Accounts basis.

³ AME spending component only. Total net payments to EC institutions also include receipts scored in DEL, VAT based contributions which score as negative receipts and some payments which have no effect on the UK public sector in the National Accounts. Latest estimates for total net payments, which exclude the UK's contribution to the cost of EU aid to non-Member States (which is attributed to the aid programme), and the UK's net contribution to the EC Budget, which includes this aid, are (in £ billion):

	2007-08	2008-09	2009-10	2010-11
Net payments to EC institutions	3.5	1.2	3.2	5.7
Net contribution to EC Budget	4.2	2.0	4.0	6.5

⁴ This expenditure is mainly financed by council tax revenues. See footnote to Table 4.E for an explanation of how the council tax projections are derived.

⁵ Total Managed Expenditure is equal to the sum of public sector current expenditure, public sector net investment, and public sector depreciation.

DEL and AME analysis

4.75 The detailed allocation of DEL is shown in Table 4.G. The departmental groupings have been updated to reflect the machinery of government changes announced in October 2008, and outturn years restated on the basis of current departmental responsibilities.

Table 4.F: Departmental Expenditure Limits - resource and capital budgets

	Outturn 2007-08	Estimate 2008-09	Plans 2009-10	2010-11
Resource DEL¹				
Children, Schools and Families	44.9	46.9	49.2	51.9
Health	88.4	94.0	99.9	106.3
of which: NHS England	86.4	92.5	98.3	104.6
Transport	6.8	6.4	6.4	6.6
Innovation, Universities and Skills	15.5	16.4	17.2	18.2
CLG Communities	4.2	4.4	4.5	4.6
CLG Local Government	22.8	24.7	25.6	26.4
Home Office	8.5	9.0	9.4	9.6
Justice	8.8	9.5	9.4	9.4
Law Officers' Departments	0.7	0.7	0.7	0.7
Defence	35.8	37.3	35.2	36.7
Foreign and Commonwealth Office	1.9	2.0	1.6	1.6
International Development	4.5	4.9	5.5	6.4
Energy and Climate Change	0.6	0.9	1.0	1.1
Business, Enterprise and Regulatory Reform	1.8	1.6	1.5	1.4
Environment, Food and Rural Affairs	2.7	2.7	2.8	2.8
Culture, Media and Sport	1.6	1.6	1.7	1.8
Work and Pensions	8.1	8.0	8.2	7.9
Scotland	23.8	24.6	25.4	26.5
Wales	12.3	13.0	13.5	14.2
Northern Ireland Executive	7.7	8.1	8.4	8.8
Northern Ireland Office	1.3	1.2	1.2	1.2
Chancellor's Departments	4.8	4.8	4.6	4.5
Cabinet Office	1.8	2.1	2.2	2.4
Independent Bodies	0.8	0.9	0.8	0.9
Moderisation Funding	0.0	0.4	0.4	0.1
Reserve	0.0	0.5	2.8	2.9
Allowance for shortfall	0.0	-1.2	0.0	0.0
Additional Value for Money savings	0.0	0.0	0.0	-5.0
Total resource DEL	310.0	325.3	339.2	350.0
Capital DEL^{1,2}				
Children, Schools and Families	5.2	6.0	7.2	6.8
Health	3.8	4.7	5.6	4.8
of which: NHS England	3.6	4.6	5.4	4.7
Transport	7.1	7.3	8.3	7.4
Innovation, Universities and Skills	2.1	2.2	2.5	1.8
CLG Communities	6.1	7.4	8.4	6.0
CLG Local Government	0.0	0.2	0.1	0.1
Home Office	0.7	0.9	0.8	0.8
Justice	0.8	0.9	0.8	0.7
Law Officers' Departments	0.0	0.0	0.0	0.0
Defence	7.9	8.0	8.2	8.9
Foreign and Commonwealth Office	0.2	0.2	0.2	0.2
International Development	0.7	0.9	1.4	1.6
Energy and Climate Change	1.5	1.7	1.7	1.8
Business, Enterprise and Regulatory Reform	0.0	0.0	0.0	0.0
Environment, Food and Rural Affairs	0.6	0.6	0.7	0.6
Culture, Media and Sport	0.5	1.0	0.4	0.6
Work and Pensions	0.1	0.1	0.1	0.1
Scotland	3.6	3.3	3.3	3.5
Wales	1.5	1.6	1.7	1.8
Northern Ireland Executive	1.0	1.0	1.1	1.1
Northern Ireland Office	0.0	0.1	0.1	0.1
Chancellor's Departments	0.3	0.3	0.3	0.3
Cabinet Office	0.3	0.4	0.4	0.4
Independent Bodies	0.1	0.1	0.1	0.0
Reserve	0.0	0.8	0.6	0.8
Allowance for shortfall	0.0	-0.6	0.0	0.0
Total capital DEL	44.1	48.8	53.8	50.1
Depreciation	10.7	12.0	12.3	13.3
Total Departmental Expenditure Limits	343.5	362.1	380.6	386.8
Total Education spending³	77.8	83.0	87.7	90.4

¹ Figures for the Departments for Business, Enterprise and Regulatory Reform, Environment, Food and Rural Affairs, and Energy and Climate Change are provisional.

² The 2010-11 capital figures reflect changes including updating Department of Health's capital plans to a level consistent with the latest planned spend and adjustments to Devolved Administrations DEL plans in line with the normal application of the Barnett formula, as set out in paragraph B.85.

³ The definition of education is now more closely aligned to the UN's Classification of the Functions of Government, including education not definable by level. The total DCSF budget, although reprofiled to bring forward capital spending, is unchanged over the 2008-09 to 2010-11 period. Projections also reflect updated information in respect of Devolved Administration and Local Authority spending plans.

AME

4.76 AME spending is forecast on the basis of the economic assumptions set out in Table 4.C. and the NAO audited assumptions set out in Box 4.B. The main changes to these assumptions since Budget 2008 that affect AME are changes to RPI and Rossi inflation, which affect benefit and public sector pensions upratings, and a higher NAO audited assumption for unemployment.

AME margin

4.77 The AME margin has been reset at £1 billion and £2 billion for the years 2009-10 and 2010-11 respectively.

Social security benefits

4.78 Forecasts for social security expenditure have been increased since Budget 2008, due to the impact of the economic downturn, measures announced in the 2008 Pre-Budget Report, and higher inflation outturns for September 2008, which have increased the level of benefits for 2009-10. Apart from the basic state pension, which is increased by 2.5 per cent when this is higher than RPI inflation, benefit levels in 2010, which depend on the negative RPI value for September 2009, are assumed for the purposes of these forecasts to remain unchanged from their previous level. The higher projection of claimant count unemployment from the NAO audited assumption, have also contributed to higher social security spending from 2009-10 onwards, and higher projections of several benefit caseloads have contributed to the increase in for 2009-10 onwards.

Tax credits

4.79 The forecast for expenditure on Child and Working Tax credits has increased since the Budget 2008, reflecting the impact of the economic downturn. The revised projection incorporates revisions in line with higher than expected in-work entitlement, due to changes in the composition of the population in receipt of tax credits, and lower than expected growth in earnings among those in receipt of tax credits.

Central Government debt interest

4.80 Forecasts for central government gross debt interest payments have been revised in the light of latest economic determinant assumptions. With the exception of 2009-10, the projections for central government gross debt interest payments over the 2007 Comprehensive Spending Review period have increased since Budget 2008. A rise in forecast RPI inflation for 2008-09 has increased the debt interest payments on index-linked gilts. Forecast market interest rates have fallen since Budget 2008, which has the effect of reducing debt interest payment costs. However, these reductions are more than offset by the effects of higher borrowing in 2008-09 and 2010-11. The decrease in forecast debt interest payments for 2009-10 is due to a combination of lower forecast inflation and market interest rates.

Future spending growth

4.81 The Government is determined to support the economy in the short term and continue to improve and invest in public services in the years ahead. To secure the improvements and investment within a framework that delivers sustainable public finances over the medium term, [the 2008 Pre-Budget Report therefore also sets assumptions for spending growth in the period from 2011-12 onwards:](#)

- total spending will grow by 1.1 per cent a year in real terms over the years 2011-12 to 2013-14 ;

- current spending will grow by 1.3 per cent in 2011- 12, 1.2 per cent in 2012-13 and 1.1 per cent in 2013-2014; and
- public sector net investment will remain at historically high levels moving to 1.8 per cent of GDP by 2013-14.

5

Sustainability of public finances

Sustainability for the long term

5.1 The analysis in chapters 3 and 4 sets out how set out how fiscal policy will ensure that the public finances are on a sustainable path in the medium term. In addition, the Government must also ensure that fiscal policy is sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects for long-term growth. It would also be inconsistent with the principles for fiscal management set out in the *Code for fiscal stability*.

5.2 Future generations not only benefit from higher long-term economic growth but also from investment in public services made today. Debt therefore plays an important role in ensuring inter-generational fairness by spreading the costs of investment over generations that benefit. It is, however, important for inter-generational fairness to ensure that the burden on future generations is not excessive, because this would itself have detrimental impacts on long-term growth.

5.3 With this in mind, the Government's temporary operating rule will ensure a declining path for the level of public sector debt. There is no unique level of public debt, or debt-to-GDP ratio, that represents a prudent and sustainable level. In deciding what the right level of debt is, the Government therefore has to weigh up a number of factors. These include the need for investment, the intergenerational impact of spending and revenues and prospects for the long-term growth of the economy. In the past, evaluation of these different factors led the Government to conclude that over the previous cycle debt should be kept below 40 per cent of GDP.

5.4 The challenges facing the UK, and the rest of the world, today are very different. While the UK economy no longer suffers from the impacts of underinvestment it saw in 1997, it faces exceptional economic challenges brought on by the credit and commodity price shocks. Supporting the economy in its recovery from these exceptional events will benefit not only current but also future generations. Responsible and sustainable management of the public finances therefore requires stabilising the financial sector and supporting the long-term growth of the economy. This means allowing borrowing to increase in the short term, but ensuring a sustainable path for the public finances in the medium term, in addition to the measures the Government has undertaken to maintain financial stability and protect depositors. The long-term impact on the public finances, and any burden on future generations, of any extra liabilities which may become classified to the public sector through these financial sector interventions will be determined by any eventual economic profit or loss incurred.

5.5 The Government is in a position to use debt to smooth the path of the economy because debt levels were low by both historical and international standards when the global economic

shocks occurred. This highlights the importance of being prepared to deal with the challenges facing the economy, including those that may arise in the more distant future such as demographic change.

5.6 In the next decade the UK will begin to see the impacts of an ageing population, while further challenges lie ahead with the retirement of the 1960s baby boomers in the 2020s. The 2008 *Long-term public finance report*¹ (LTPFR) provided a full assessment of the impact this will have on the public finances. The analysis showed that, while age-related spending is relatively low by international standards and projected to remain so, demographic change will put pressure on the public finances in the coming decades. To ensure long-term fiscal sustainability it is therefore vital to prepare for these events once the impact of the recent economic shocks has subsided, so the 2008 Pre-Budget Report sets fiscal policy to ensure that public debt is returned to a declining path once the global shocks have worked their way through the economy in full.

5.7 Since 2002, the Government has published the *Long-term public finance report* on a regular basis,² with the intention of providing a comprehensive analysis of long-term socio-economic and demographic developments, and their likely impact on the public finances. The next *Long-term public finance report* will be published in 2009.

Long-term socio-economic and other trends

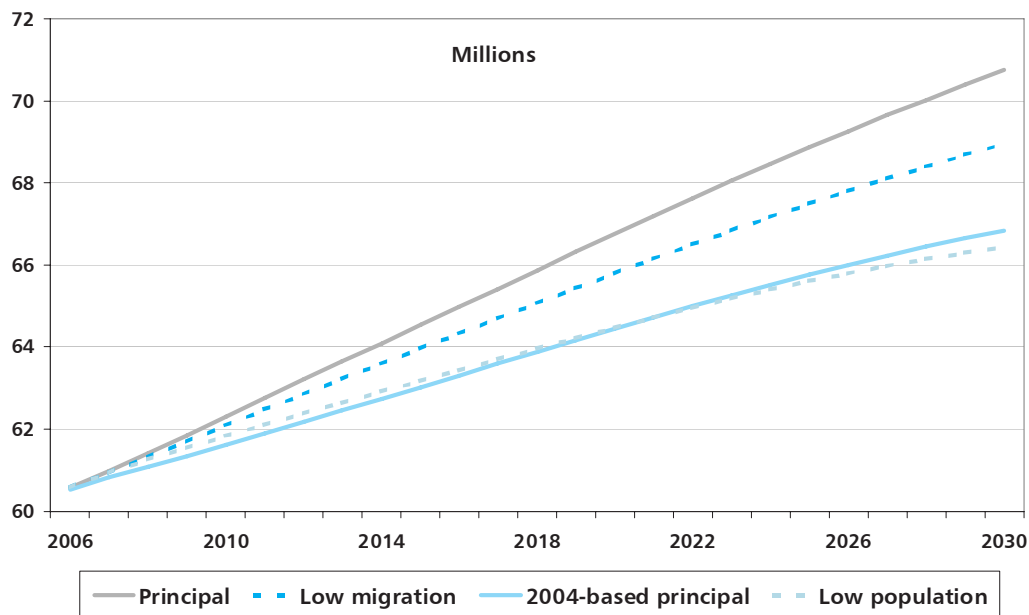
5.8 The Office for National Statistics (ONS) published its latest population projections in October 2007. These projections are based on a mid-year population estimate for 2006 and on a new set of assumptions regarding the key three vital statistics, namely fertility, net migration and life expectancy. The projections illustrate the demographic changes likely to affect the UK in the future if current trends continue.

5.9 The structure of the UK population is projected to change significantly over the coming decades. The principal projections show that the UK's population will increase from about 61 million in 2006 to close to 67 million by 2020 and to over 70 million by 2030. Chart 5.A shows the projected increase for a selection of population variants and for comparison also shows the previous (2004-based) population projections.

¹ 2008 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, March 2008. The analysis in the LTPFR is based on projections from Budget 2008

² See, for example, the 2008 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, March 2008.

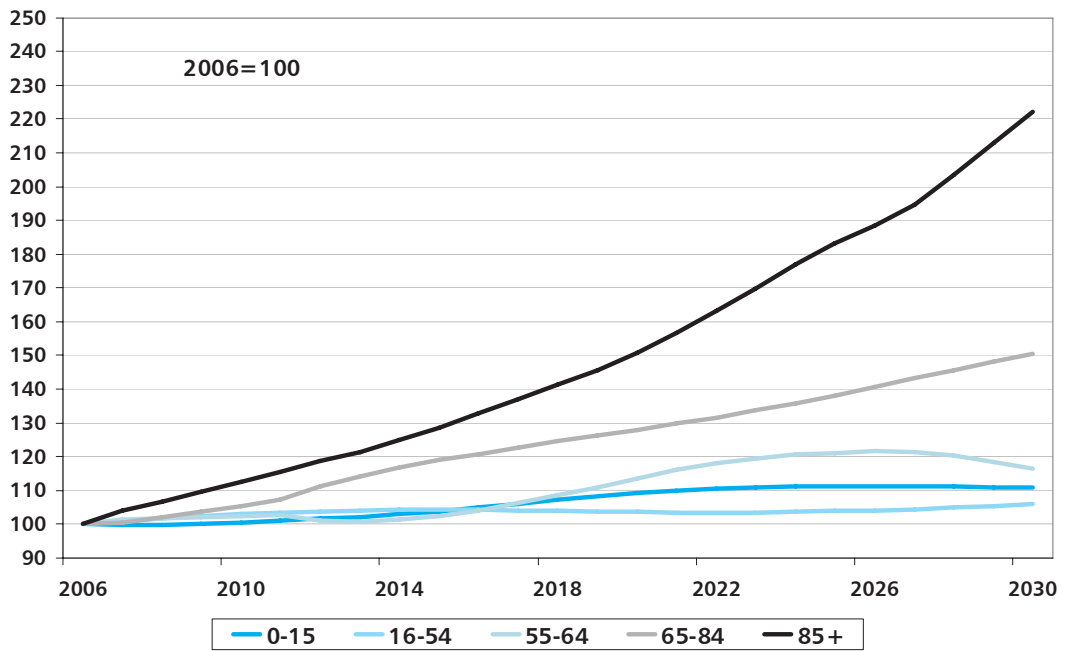
Chart 5.A: Total UK population projections



Source: Office for National Statistics and Government Actuary's Department.

5.10 The age structure of the population will also change significantly as the projected growth rates of different age groups vary significantly. The younger working-age population is projected to remain relatively stable over the period up to 2030. The number of children is set to increase gradually by around 10 per cent while the 55-64 year olds show a rise of around 20 per cent over the same period. Older age-groups will see relatively more significant increases: the 56-84 year olds will have grown by over 50 per cent, and the 85+ group will have grown by around 50 per cent by 2020 and more than doubled by the 2030s. It should be noted that this group is relatively small to begin with and the rapid growth of this cohort should be interpreted within that context.

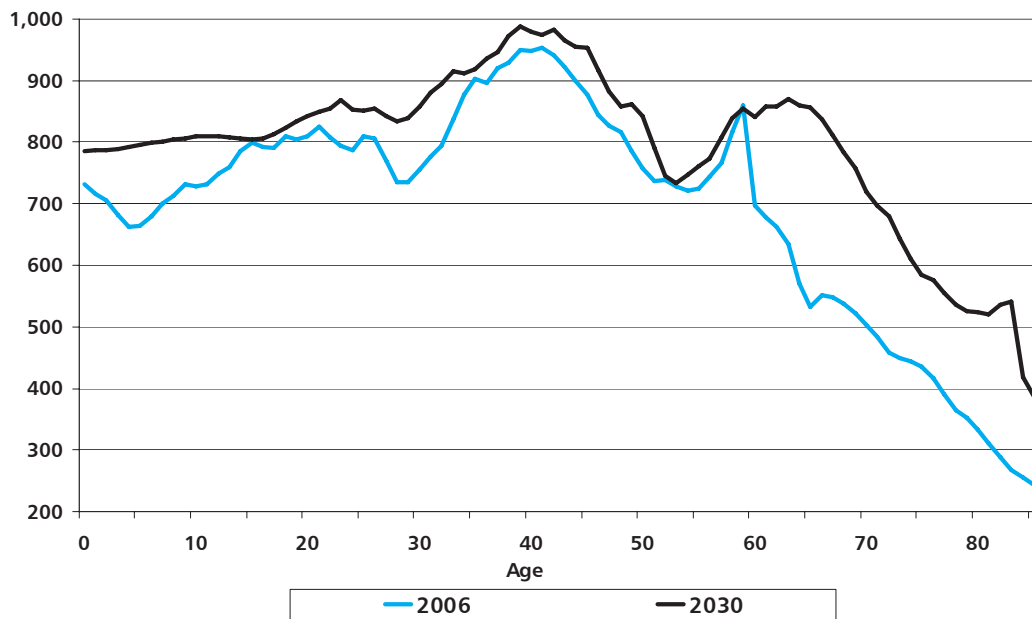
Chart 5.B: Population indices by age group



Source: Office for National Statistics.

5.11 The projected change in the age structure is likely to create its own opportunities and challenges, which the UK will have to deal with in the decades ahead. To illustrate the challenge by 2030, chart 5.C below shows the age distribution in 2006 versus the projected distribution in 2030. The two most prominent features for the 2006 distribution are the spike around the 60-year age group and the much larger hump around the 40-year group. The former represents the immediate post-war baby boom, the latter the more sustained and pronounced second baby boom of the 1960s. By 2030, those currently in their forties will be in their mid sixties and are represented by the second bulge of the 2030 distribution. There will be a new bulge of 40-year olds, which is the result of increased fertility rates in the last decade as well as relatively high net migration of people in their thirties over the coming decade.

Chart 5.C: UK Population by age



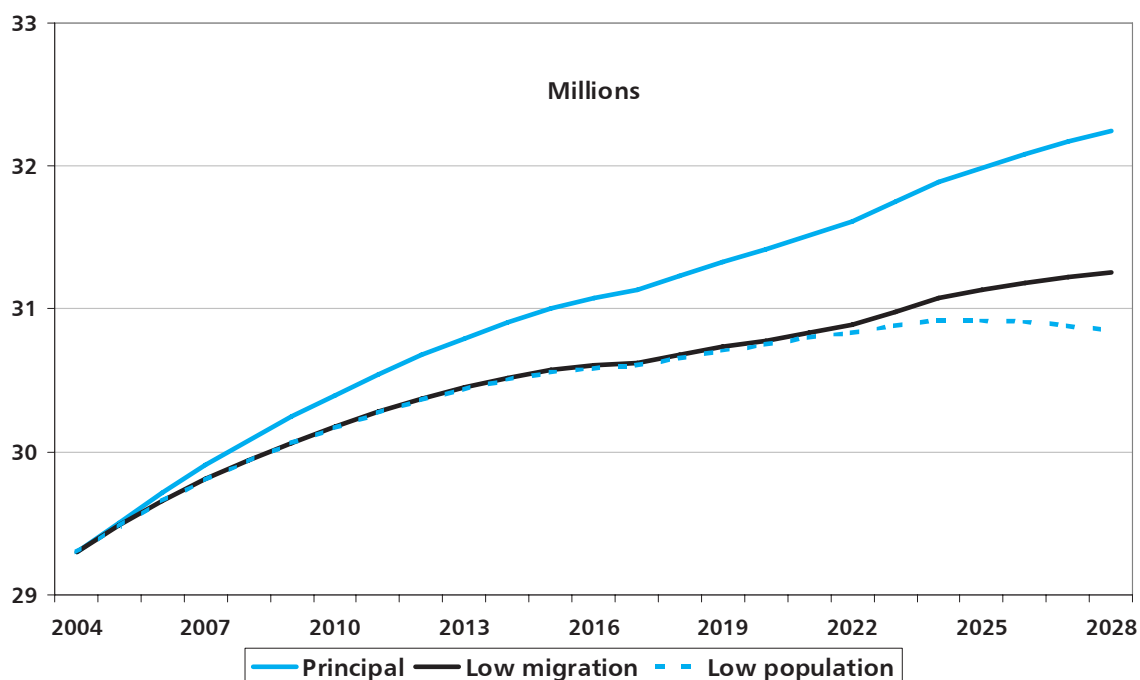
Source: Office for National Statistics.

5.12 Females of the immediate post-war baby boom are now leaving the labour force and entering state pension age, with males following within the next few years. The cohorts of the second baby boom are currently at their prime in the labour market but will reach state pension age in the late 2020s to the early 2030s. The *2008 Long-term public finance report* provided a detailed analysis on how employment might evolve over the coming decades. Using the cohort method of projecting employment trends and ONS' 2006-based principal population projections, the report projected that in spite of the forthcoming retirement of large cohorts, as explained above, employment will continue to contribute to real GDP growth.

5.13 Chart 5.D shows projections of employment, based on the principal and a number of variant projections discussed above for the UK over the next 20 years, where employment is defined across the age group 16 years to 69 years. Using the same methodology as in the *2006 Long-term public finance report*³, the new principal projections indicate that employment will continue to rise over the coming decades reaching over 32 million in 2030, which is nearly 3 million higher than employment levels in 2008. By 2057, employment is projected to be close to 35 million, over 5 million higher than in 2008 in the principal projections. The smallest increase is projected by the low population variant, in which employment is projected to increase by less than 1 million throughout the projection period.

³ *Long-term public finance report*, HM Treasury, 2006

Chart 5.D: UK employment projections



Source: HM Treasury.

5.14 Previous *Long-term public finance reports* assumed that employment would have a neutral effect on trend growth over the long term. However, the 2008 *Long-term public finance report* showed that employment growth derived from the latest population projections, positively contributes to trend growth. Based on this, the report therefore projected GDP growth of 2¼ to 2½ per cent per year over the coming decades.⁴

5.15 The 2008 *Long-term public finance report* showed that demographic change is likely to put upward pressure on spending as the demand for health care, long-term care and state pensions will increase with the ageing of the population. In addition, the projected increase in the number of children puts pressure on education spending. Demographic change also implies that revenue, as share of GDP, is projected to increase, although it is projected to remain below spending. This could put pressure on the public finances and to ensure long-term fiscal sustainability it is essential to prepare for these events. The 2008 Pre-Budget Report set out how fiscal policy will ensure that the public finances are on a sustainable path in the medium term and therefore prepare for the possible challenges facing the economy in the long term.

Comparison with the Economic Policy Committee's (EPC) projections

5.16 The long-term projections presented in the 2008 *Long-term public finance report* are based on assumptions that differ in a number of ways from the commonly agreed assumptions used by the Economic Policy Committee (EPC). The key differences in the underlying data used in the

⁴ For detail on the assumptions underlying these projections see *Long-term public finance report: an analysis of sustainability*, HM Treasury, March 2008

two sets of projections are explained in the 2006 *Convergence Programme for the United Kingdom*, Chapter 5, Box 5.5.⁵

5.17 As well as different assumptions, the EPC's budgetary projections also use different modelling and projection methodologies for health, long-term care and education expenditures.⁶ For the pension projections, the same methodologies are used for both sets of projections (though using different underlying assumptions, as explained above).

⁵ See the 2006 *Convergence Programme for the United Kingdom submitted in line with the stability and growth pact*, HM Treasury, December 2006, chapter 5 Sustainability of public finances, Box 5.5, page 62.

⁶ See The 2005 projections of age-related expenditure (2004-2050) for the EU-25 Member States: underlying assumptions and projection methodologies, European Union Economic Policy Committee, November 2005, for a full explanation of the assumptions and methodologies agreed by the EPC.

6

Quality of public finances

6.1 Over the last ten years, record levels of investment coupled with reform have generated real and enduring improvements in Britain's schools, hospitals and other public services. The Government will maintain high levels of investment, reprioritise spending to support the economy through the downturn and take forward an ambitious extension of its plans to increase value for money.

Progress over the last decade

Sustained investment in public services

6.2 Since 1997, the economy has grown by nearly 3 per cent a year on average and in real terms. Thanks to this economic growth, and increasingly ambitious targets for efficiency savings, the Government has been able to focus resources on priority areas of Britain's public services such as health, education and transport. Since 1997:

- total public spending has increased by 42 per cent in real terms, compared to an increase of 15 per cent in the previous decade;
- spending on the National Health Service (NHS) has doubled in real terms;
- spending in education is today nearly 60 per cent higher, and, as a proportion of GDP, has risen from 4.6 per cent in 1997-98 to 5.5 per cent in 2007-08;
- spending on transport has increased by over 70 per cent in real terms; and
- spending on public order and safety has increased by 50 per cent in real terms.

Long term capital investment

6.3 The fiscal framework put in place in 1997 has also protected capital spending, reversing a legacy of underfunding and enabling the Government to build new schools, hospitals and transport infrastructure. Public sector net investment as a share of GDP has increased significantly, having risen from a low of 0.6 per cent in 1997-98 to 2.1 per cent in 2007-08. As a result:

- total capital investment in education has risen from £1.7 billion in 1998-99 to £7.2 billion in 2007-08, annual average real growth of 14 per cent;
- total capital investment in housing and community amenities has risen from £2.6 billion in 1998-99, to £9 billion in 2007-08, annual average real growth of 12 per cent;
- total capital investment in transport has risen from £2.9 billion in 1998-99, to £11.4 billion in 2007-08, annual average real growth of 13 per cent;
- total capital investment in the NHS has risen from £0.8 billion in 1998-99, to £3.6 billion in 2007-08, annual average real growth of 10 per cent; and

- total capital investment by local authorities has risen from £6.7 billion in 1998-99 to £18.3 billion in 2007-08, annual average real growth of 8 per cent.

Public service reforms

6.4 The Government has matched rising public investment since 1997 with significant new reforms to modernise Britain's public services:

- during the first stage of reform, the Government introduced stronger performance management, with stretching Public Service Agreements (PSAs) setting priorities for delivery, the introduction of tough minimum standards and enhanced inspectorates to tackle poor performance across services; and
- the second stage of reform saw greater incentives for continuous innovation and improvement, encouraging diversity of provision, increasing competition and ultimately putting more power into the hands of service users.

6.5 The Government recognises that services must continue to improve further if they are to be consistently world class. As set out in the recent publication, *Excellence and Fairness: achieving world class public services*,¹ the next stage of the reform will drive improvement and increase value for money by:

- further empowering users so they can hold public services to account and participate more fully in shaping the services they receive;
- giving professionals and public sector workers the power and responsibility to innovate and drive up performance; and
- ensuring a more strategic leadership role for central Government.

6.6 The Government's new performance management framework announced at the 2007 Comprehensive Spending Review (CSR) is key in supporting delivery of improved outcomes and driving forward the vision for public service improvement set out in *Excellence and Fairness*. It is based around a streamlined set of 30 PSAs, which articulate the Government's highest priority outcomes for citizens and span departmental boundaries, setting out a shared vision and providing strategic leadership for collaboration and new professionalism at all levels in the delivery system. Progress in delivering outcomes will be reported in the lead Department's Annual Performance Reports for 2008.

Improvements in outcomes

6.7 As a result of this increased investment and reform, Britain's public services have significantly improved. For example:

- the NHS will meet its ambition of a 20 per cent reduction in mortality rates of cancer patients aged under 75 by 2010 and has already achieved the target of a 40 per cent reduction in mortality rates of heart disease patients aged under 75 by 2010;
- in the last decade, the number of operations have increased by over 1 million and there are now 2.9 million more emergency and elective admissions each year;
- in 1997, over 280,000 patients were waiting over 6 months for an inpatient appointment. By the end of this year, virtually no one will wait longer than 18 weeks from being referred by their GP until the start of treatment;

¹ *Excellence & Fairness, Achieving world class public services*, 2008

- since peaking in 1995, crime has reduced by 35 per cent, bringing the chance of being a victim of crime to the lowest ever level;
- over 64 per cent of 15 year olds now achieve 5 or more good GCSEs or equivalent, up from 45 per cent in 1997; and
- the 800 Jobcentre Plus offices that have been created since 2001 have acted as the cornerstone of the Government welfare to work policy, dealing with benefit claims and employment advice in one place.

Supporting the economy though the downturn

6.8 Building on the record level of investment in public services achieved since 1997, a wide range of government services are now playing their part in supporting the economy. For example:

- in September 2008, the Prime Minister announced £1 billion from the private and public sectors, including additional spending through the Warm Front programme, to provide help with energy saving and heating for households facing high energy bills;
- Communities and Local Government (CLG) has brought forward a £1 billion housing package to help first time buyers get onto the housing ladder, help homeowners in difficulty and support the construction industry;
- the Government announced in October that it would set aside £100 million from the European Social Fund (ESF) and the Department for Innovation, Universities and Skills (DIUS) to provide integrated employment and skills support for those facing redundancy. The 2008 Pre-Budget Report announced that the total funding available from the ESF is now £158 million, and that this will be matched on the skills side by £79 million of Next Steps advice service and Train to Gain funds;
- the Department for Business, Enterprise and Regulatory Reform (BERR) is providing ongoing finance for face-to-face advice on debt problems, with new provisions for Debt Relief Orders from April 2009 to reduce the costs of bankruptcy for the poorest;
- the Working Neighbourhoods Fund is promoting employment and enterprise in 65 areas with significant levels of unemployment, inactivity and deprivation. This fund will support local authorities to create local solutions to local problems including by providing careers and interview advice, information about flexible working and childcare, and advice on starting a business; and
- the Regional Development Agencies (RDAs) are supporting the most vulnerable sectors by reprioritising business support networks, assisting business with the efficient use of resources, and delivering bespoke sector support packages. For example, One North East is now investing £6 million per annum to strengthen and grow the region's manufacturing sector, including bespoke support for over 600 businesses and skills development for over 2,000 individuals, safeguarding around 1,000 jobs.

Fiscal stimulus

6.9 In the face of continuing global uncertainty, the Government is now taking further action to support the economy through the downturn. As set out in Chapter 4, to provide a fiscal stimulus to the economy, [the 2008 Pre-Budget Report announced that £3 billion of capital spending from 2010-11 would be brought forward into 2009-10 and 2008-09](#). This additional spending

during the downturn will support a number of different industries and jobs across the country. In order to ensure that the spending has maximum economic impact the Government has brought forward a package that is:

- timely – focused on projects that can be brought forward in the time available;
- targeted – focused on supporting the domestic UK economy; and
- temporary – focused on bringing forward spending in a sustainable way.

6.10 The package includes:

- [£700 million to advance the Department for Transport's \(DfT\) existing plans to increase capacity on the motorways and other critical highways, and to accelerate the delivery of up to 200 new carriages on the rail network](#), helping Government to deliver on its targets to relieve congestion on the road network, reduce crowding on the railways and move towards a sustainable transport system;
- [£775 million of housing and regeneration investment brought forward to help offset the impact of economic shocks on priority programmes](#), including £250 million on Decent Homes programmes to fund improvements and improve energy efficiency in 25,000 council homes, £150 million on social rented housing to deliver up to 2,000 more social rented homes and reduce the number of households in temporary accommodation, £175 million for major repairs to council housing stock, and £100 million to support key regeneration and housing infrastructure projects. The RDAs will also consider the scope for bringing forward up to £100 million nationally to provide a fiscal stimulus to regional and national economic development;
- [£800 million brought forward in the priority schools capital programmes, providing opportunities for small businesses locally and allowing schools and children to benefit early from important projects](#). In particular, the additional capital spending in 2009-10 will fund accelerated renewal of the primary school estate and boost local authority capital funds for modernising school infrastructure. This could bring forward the adaptation of 2,000 secondary classrooms for to improve personalised learning, energy-saving measures in around 140 secondary schools, the building of kitchens in 300 primary schools, and the conversion of rooms for mother-and-baby groups and other community uses in 800 primary schools;
- [£442 million to accelerate support for around 25 capital projects to improve Further Education infrastructure and around 50 projects to improve facilities at Higher Education Institutions](#), and to bring forward development of scientific research facilities and improvements to university research infrastructure;
- [£50 million of investment brought forward, and £100 million of additional funding, for the Warm Front programme](#). This means 60,000 homes will benefit more quickly from energy efficiency and heating measures, helping people heat their homes affordably during difficult economic times;
- [£100 million to advance the upgrading of up to 600 GP surgeries to training practices](#), creating opportunities for small firms and targeting funding to those areas that have historically had a lower provision of doctors;
- [£20 million of investment on flood defences brought forward](#), delivering earlier protection for over 27,000 homes, and [£5 million of improvements to the British Waterways network infrastructure](#);

- £20 million to improve the estates of the Serious Organised Crime Agency and the National Police Improvement Agency, developing and installing high technology systems and enhancing intelligence gathering against serious organised crime. This enables the redeployment of posts out of London a year earlier than planned, in line with the Lyons relocation policy; and
- in the case of devolved areas of spending, the devolved administrations will be able to reprofile spending in line with the Barnett formula in the normal way.

6.11 The Government also announced a number of other spending measures to support individuals and business through the downturn including:

- additional help for small and medium enterprises facing credit constraints through a new Small Business Finance Scheme to support up to £1 billion of bank lending;
- the extension of the Mortgage Rescue scheme, to include cover for second charge lending, and the Support for Mortgage Interest scheme for homeowners who lose their jobs. Additionally there will be increased funding to ensure people in financial difficulties can access free and impartial debt advice; and
- £1.3 billion to increase the help Jobcentre Plus gives to those out of work and looking for a job, ensuring that they continue to get the dedicated and personal support they need to move rapidly back into work. There will also be increased provision for those facing redundancy through an expansion of the Rapid Response Service (RRS), to cover short-term as well as long-term redundancies, offering a range of on-site support such as retraining and job-matching.

A relentless focus on value for money

Overdelivery of the 2004 SR Efficiency Programme

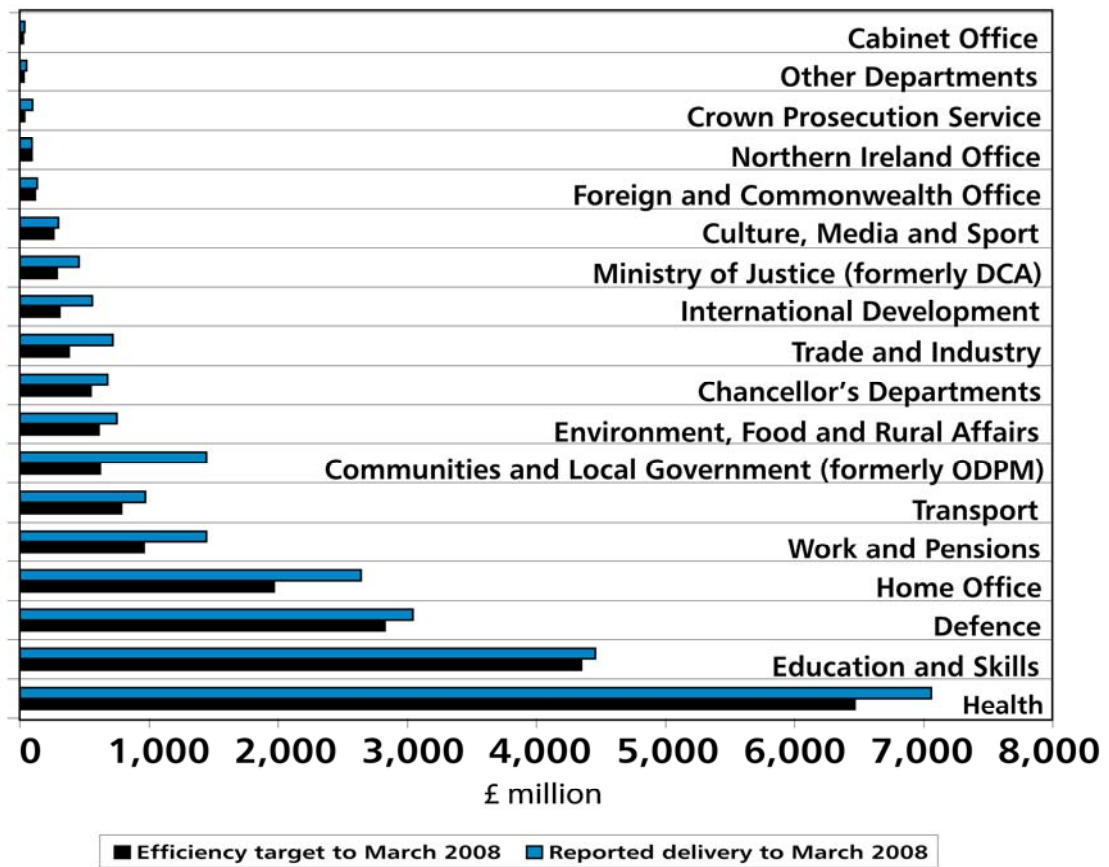
6.12 As part of the 2004 Spending Review, the Government set stretching efficiency targets for departments to deliver by March 2008 as recommended by Sir Peter Gershon in *Releasing Resources to the Front Line – Independent Review of Public Sector Efficiency*². The 2008 Pre-Budget Report announced significant over-delivery against each efficiency target set in 2004. In particular, the Government announced:

- over £26.5 billion of efficiency savings³, substantially exceeding the target of £21.5 billion set in 2004. Further details on departmental efficiency savings can be found in Chart 6.A;
- over 86,700 net workforce reductions, significantly over-delivering against the target of 70,600 net workforce reductions and allowing the Government to employ more front-line professionals such as doctors, nurses, teachers and police officers; and
- over 17,100 staff relocated out of London and the South East by June 2008, putting the Government on track to deliver the Lyons relocation target to move 20,000 posts by 2010.

² Sir Peter Gershon, *Releasing Resources to the Front Line – Independent Review of Public Sector Efficiency*, July 2004.

³ Departments have classified all efficiency gains as "Final," the most robust measurement classification as set out in HMT Measurement Guidance

Chart 6.A: Departments' efficiency savings (agreed target and reported delivery)



Source: HM Treasury.

2007 CSR targets

6.13 The 2007 CSR went further and agreed a more ambitious value for money programme, which will deliver savings worth £30 billion by 2010-11. By using the capability developed within departments over the previous three years it has been possible to require all gains to be cash-releasing and reported net of costs. Departments are in the process of delivering these savings and will report on progress in their Autumn Performance Reports. Examples of Departments' plans to deliver the 2007 CSR value for money targets are set in box 6.A below.

Box 6.A: Delivering the 2007 CSR value for money targets

The public sector has been actively engaged in identifying value for money savings over the CSR period. For example:

- local government will achieve £4.9 billion of annual net cash-releasing efficiency savings by 2010-11 through - business process improvements and collaboration initiatives, which could deliver up to £1.8 billion by 2010-11; smarter procurement, which could deliver up to £2.8 billion by 2010-11; and better asset management which could deliver up to £300 million by 2010-11;
- HM Revenue and Customs transformation programme is expected to save over £190 million through more efficient property management. A further saving of £57 million is expected as more customers use online services;
- the Ministry of Defence (MOD) plans to achieve £31 million of savings by reducing non-operational energy consumption by at least 15 per cent, also reducing the Department's carbon footprint. MOD also expects to reduce its civilian workforce by some 10 per cent over the period 2008 to 2011, yielding a further £25 million per annum saving for each of the remaining Spending Review years;
- HM Court Service plans to make over £140 million of savings through modernising processes and making use of new technology. There will be significant improvements in the way in which caseloads are managed, increased electronic links with other agencies and better access to services; and
- the Department of Health announced agreement on 19th November 2008 to a new Pharmaceutical Price Regulation Scheme (PPRS), including a price cut of 3.9 per cent in the first year of the new agreement with a further price cut of 1.9 per cent with the introduction of generic substitution in January 2010. This deal is expected to deliver savings in the UK of around £350 million in 2009-10, and approximately £550 million per year thereafter.

The Operational Efficiency Programme

6.14 As the next stage in the Government's rolling programme of value for money improvements, Budget 2008 launched the Operational Efficiency Programme (OEP) to examine opportunities for further efficiency savings in five cross-cutting areas. The five OEP workstrands are: back office and information technology, collaborative procurement, asset management, property and local incentives and empowerment. Although the Operational Efficiency Programme is due to report at Budget 2009, significant progress has already been achieved and the 2008 Pre-Budget Report announced a number of emerging findings for each one of the five workstrands.

6.15 In the first OEP workstrand, a programme of work led by Martin Read, former Chief Executive of Logica has identified substantial annual savings from 2010-11 onwards through greater efficiencies in back office operations including human resources, finance, estate, security, marketing, travel and legal services.

6.16 In the second OEP workstrand, a programme of work led by Martin Jay, Chairman of Invensys, has identified substantial additional annual savings from 2010-11 onwards through actions such as improving compliance on centrally negotiated deals and optimising the complex and fragmented public sector buying landscape.

6.17 As part of the third OEP workstrand which is focused on asset management and sales, Gerry Grimstone, Chairman of Standard Life, will work with departments and the Shareholder Executive to take forward studies on a range of assets (see box 6.B), reporting progress at Budget 2009. These studies will look into ways of using different public sector assets more efficiently, including the potential for alternative business models, commercialisation, new market opportunities and where appropriate transfer of ownership.

6.18 On property, the fourth OEP workstrand, Lord Carter of Coles, is leading work to examine the efficiency savings that could be achieved across the UK's public sector property holdings, which have an estimated book value of around £370 billion. He will be focusing on some of the larger holdings in areas such as health, local government, defence and justice. Work will also link in with Baroness Ford's review on the release of surplus land for housing. Lord Carter will develop a series of recommendations for Budget 2009 that will incentivise more efficient public sector management of property assets.

6.19 As identified in *Excellence and Fairness*, innovation at the front line is key to delivering customer-focused public services and driving value for money. Parts of the public sector are already enabling this kind of innovation. Operation QUEST, for example, empowers front-line staff in the police service to reform everyday working practices, cutting out wasteful processes to focus on meeting citizens' needs. As a result, Norfolk Constabulary realised £3 million savings (of which £500,000 is cash-releasing) through improved efficiency and effectiveness, and customer confidence and satisfaction increased from 86 per cent to 97 per cent. The Government is determined to ensure that this sort of innovation and reform is the norm across the public services, and therefore the 2008 Pre-Budget Report announced that:

- the Chief Secretary to the Treasury has appointed Sir Michael Bichard, Executive Director of the Institute for Government, to lead the local incentives and empowerment workstrand of the Operational Efficiency Programme, to analyse how best to facilitate front-line innovation, reporting by Budget 2009;
- the Government will empower and support front-line staff to drive bottom up innovation, with a new efficiency award for public servants on the frontline who have reformed public services and delivered greater value for money; and
- to provide the space to innovate, the Better Regulation Website is being redesigned to make it even easier for citizens, businesses and frontline staff to suggest ways to reduce bureaucratic burdens.

Box 6.B: Operational Efficiency Programme – Asset strand

Gerry Grimstone is heading the asset strand of the Operational Efficiency Programme (OEP), and will be working with departments, agencies, and the Shareholder Executive to consider, for a number of Government assets, the potential for alternative business models, commercialisation, new market opportunities and, where appropriate, alternatives to public ownership. The work includes:

- a review of British Waterways' model for managing its canal-side property portfolio which will assess how best public value might be delivered from these assets in the medium term;
- options for the Queen Elizabeth II conference centre, after a recent study concluded there was no public policy rationale for the Government to own it;
- a strategic review into the future business model of the Ordnance Survey, that will take into account its role as a public sector information provider, together with providing value for money for the tax payers;
- work with the Land Registry to explore ways to improve its operating framework;
- widening the scope of study of capacity requirements at the Dartford Crossing to include the potential to realise value for the taxpayer and, in addition, continuing to explore options for the commercialisation of other transport assets;
- a study to explore the potential benefits of alternative future models for the Royal Mint; and
- reviews of the Met Office, Oil & Pipeline Agency, and Defence Storage & Distribution Agency examining alternative business models.

Departments are also working to achieve efficiencies on other Government assets:

- The Ministry of Defence will shortly publish its response to a recent consultation on its plans to release and share parts of its electromagnetic spectrum holdings, with the release process for initial spectrum bands beginning in Spring 2009;
- the Government continues to explore options for realizing value from its stake in Urenco;
- a study of the Forestry Commission's portfolio in England is being launched in parallel to examine options for delivery of public value from the estate in the long term; and
- a major redevelopment by Covent Garden Market Authority will aim to put it on a sustainable financial footing, enabling the Government to achieve its long term objective of disengagement.

In addition it was concluded in October not to pursue a sale of the Tote in light of current market conditions, and that it should be retained in public ownership for the medium term, to be brought to the market when conditions are likely to deliver value for the tax payer and the racing industry.

The Public Value Programme

6.20 In Budget 2008, the Government also launched the Public Value Programme (PVP), to look at all major areas of public spending in order to identify smarter ways of doing business and taking wider policy decisions. The PVP will inform the Government's value for money frameworks for 2010-11 and for the post-CSR period.

6.21 The 2008 Pre-Budget Report announced that the Public Value Programme has already identified key reforms that will deliver savings and efficiency improvements in 2010-11 and in the next Spending Review period. Key reforms include:

- improvements to NHS estate utilisation which will reduce the need for new hospital space by up to £3 billion, and save up to £100 million per annum of estate costs over the next spending period. In addition, the Department of Health will introduce new models for providing primary care estate by enabling Primary Care Trusts to extend Local Improvement Finance Trust (LIFT) public-private partnerships to the management of their entire estate;
- the Ministry of Justice (MoJ) will increase its use of competition to improve efficiency and effectiveness in the National Offender Management Service (NOMS). Specifically this will mean that all new build prisons are to be built and managed by the private sector over the next three years; five commercially let contracts will be competed by 2010-11 to new NOMS specification standards with bids invited from the public, private and third sectors; high cost or under performing prisons will be identified against the new NOMS standard specifications and failure to improve will lead to services being contracted out without a public sector bid. Further details on the NOMS competition programme will be published in the NOMS Agency Corporate and Business Plan in January 2009;
- the Policing Green Paper contains proposals which relate to increasing, over time, the productivity of the police workforce, including by supporting forces in streamlining working practices. Similar work in other sectors, and also by some police forces, has delivered productivity increases of 15 per cent. The 2008 Pre-Budget Report announced that this will be worth around £1 billion, equivalent to increasing the size of the police service by around 20,000 officers. The plans will be reinforced by a targeted inspection, in 2010, of the police workforce, to ensure resources are being deployed to maximum effect, and continued roll-out of Operation QUEST, a programme of frontline improvement work that has already delivered substantial successes, such as increasing customer satisfaction to over 90 per cent;
- the Highways Agency has been investigating how it can go further to deliver efficiencies over the CSR period. The Highways Agency will seek to double the efficiency savings it aims to deliver, which could potentially save an additional £150 million by 2010-11. The Government will continue to consider where it can go further over the longer term, and will provide a further update at Budget 2009; and
- DIUS will take further steps to drive forward the Leitch reforms and move to a more demand-led system for skills, and will ensure that subsidies are targeted on raising demand in the most economically valuable areas.

6.22 The Public Value Programme will continue to focus on the scope for additional value for money across all major areas of spending policy, with further investigation in the following key areas:

- all PCTs have submitted to Strategic Health Authorities their draft five year strategic commissioning plans to improve local health care. As PCTs enhance their commissioning skills towards world class standards over the next year they will develop their strategic and financial plans to ensure they unlock cashable value for money improvements across the £70 billion of commissioned health services. [Budget 2009 will set out the projected value for money impact of World Class Commissioning. Budget 2009 will also report on the scope to increase efficiency further in the hospital sector through the tariff prices paid by PCTs and progress on extending pricing to new areas of the health service;](#)
- [DCSF is assessing the value for money of: Building Schools for the Future \(BSF\), childcare and teaching assistants.](#) Building on the success to date of BSF and Academies, the PVP will inform decisions on the cost effective delivery of key strategic objectives through the schools capital programmes, including the roll-out of Waves 7 to 15 of BSF. On teaching assistants, the PVP is assessing their deployment, and impact on educational outcomes. The PVP has also developed the evidence-base on how best to deliver the Government's long-term childcare objectives. The value for money evidence demonstrates that providing a level of free provision for the most deprived 2 year olds, in line with the Prime Minister's commitment, is likely to have a greater positive impact on child outcomes than extending the number of free hours of childcare available to 3 and 4 year olds beyond the 15 hours per week they will receive by 2010-11;
- [MoJ will continue to consider the scope for value for money improvements within legal aid procurement;](#)
- following its successful pilot on the M42, [the Government will announce in the New Year the conclusions of its work to investigate where hard shoulder running should be rolled out more widely on the motorway network in preference to motorway widening.](#) Initial results suggest that hard shoulder running schemes can be delivered on average around 40 per cent cheaper than the equivalent motorway widening schemes. [The Department for Transport will also assess how best to provide transport funding to local authorities so that it continues to be targeted to areas of greatest need;](#)
- [MoD is developing work on value for money reforms, building on existing work being taken forward in the Defence Acquisition Change Programme.](#) This will further improve the MOD's commercial capability and will ensure better commercial value for money by changing the terms of the MOD's relationship with industry;
- [CLG's forthcoming regeneration framework will improve the efficiency of regeneration spending,](#) including strengthening accountability for delivering improvements in economic growth and employment, providing clear regional prioritisation of capital investment and strengthening local co-ordination;
- in the context of wider work on energy saving and rising activity to help low income households, [the new Department for Energy and Climate Change \(DECC\) is considering how to maximise value from the Warm Front programme;](#)
- [the Department for International Development will build on its current work to improve the effectiveness of its aid, by analysing key aspects of its spending on health and education to identify opportunities to improve its effectiveness in future.](#)

The initial findings of this work, focused on education spending, will be reported in Budget 2009;

- The RDAs are playing a vital role supporting those regions in dealing with the economic downturn and laying the foundations for future economic growth. [The Government will work with the RDAs to maintain and where possible increase the value realised from the Single Pot Funding](#); and
- [the Student Loans Company, working with the Department for Innovation, Universities and Skills \(DIUS\), is undertaking a review to establish the extent of income-related fraud within the student support system, with a particular focus on fraudulent grant claims](#). Depending on the outcome, DIUS will work with the SLC to implement measures to reduce the level of fraud and ensure that financial support to students goes only to those that are genuinely entitled to it.

6.23 These initiatives all show that there is considerable scope to go further on value for money. So, at this time of global economy uncertainty, and with the need to ensure our public finances are sustainable over the medium term, the Government believes it is right to do more. Building on our record of delivery - and as a result of the new announcements on the OEP and PVP programmes set out above - [the 2008 Pre-Budget Report announced that the existing cross-Government value for money target for 2010-11 will increase from £30 billion to £35 billion, releasing £5 billion of additional recoverable savings in 2010-11](#). Savings which can be achieved by individual departments will be set out, and 2010-11 allocations adjusted accordingly, at Budget 2009, alongside the final report from the Operational Efficiency Programme. The Barnett formula will be applied as usual to the devolved administrations' budgets when reductions to departments' budgets are announced.

6.24 To ensure that the Government continues to deliver high quality public services in a way that represents value for money in the next Spending Review period, the Government will broaden and deepen work to drive efficiency from 2011-12 onwards, in particular by driving forward the Operational Efficiency Programme and the Public Value Programme. In addition to early announcements set out in paragraphs 6.14-6.19, Budget 2009 will announce the final conclusions of the OEP's work in all five workstrands, identifying further savings for the next SR period. In addition to this, the PVP will continue working on a range of specific areas to explore whether further savings can be achieved in the next spending review, as set out in paragraph 6.22. By releasing these efficiency savings the Government will be able to guarantee that front-line public services will continue to grow and improve in the years ahead.

Future spending growth

6.25 The Government is determined to support the economy in the short term and continue to protect its public service priorities in the years ahead. To secure the improvements and investment within a framework that delivers sustainable public finance over the medium term, [the Pre Budget Report therefore set assumptions for spending growth in the period from 2011-12 onwards](#):

- total spending will grow by 1.1 per cent a year in real terms over the years 2011-12 to 2013-14 ;
- current spending will grow by 1.3 per cent in 2011- 12, 1.2 per cent in 2012-13 and 1.1 per cent in 2013-2014; and
- public sector net investment will remain at historically high levels moving to 1.8 per cent of GDP by 2013-14.

A The fiscal impact of budget policy decisions

Table A.1: Budget March 2008 policy decisions

		(+ve is an Exchequer yield)			£ million
		2008-09	2009-10	2010-11	2008-09
		indexed	indexed	indexed	non-indexed
Modernising the tax system					
1	Charities: gift aid transitional rate	-60	-105	-120	-60
2	Enterprise management incentive	-10	-10	-10	-10
3	Enterprise investment scheme: increase in investor limit	0	-5	-5	0
4	Remittance basis: foreign dividend tax rate	0	+15	+10	0
5	Extension of the dividend tax credit	0	*	-20	0
6	Corporation tax: treatment of unclaimed assets	+90	-15	-15	+90
7	North Sea fiscal regime modernisation	-25	-25	-20	-25
8	VAT: staff hire concession	0	+150	+125	0
9	VAT: reduced rate for smoking cessation products	-10	-15	-15	-10
10	Stamp duty land tax: removal of lease duty rule from residential property	-5	-5	-5	-5
11	Review of powers: penalties	0	0	+10	0
<i>Simplification</i>					
12	Corporation tax: reform of associated companies rules	0	*	-5	0
13	Capital allowances: write-off of small pools	0	-25	-15	0
14	VAT: revalorisation of registration and deregistration thresholds	0	0	0	-5
15	VAT: option to tax exempt land and property	-25	-5	-5	-25
16	VAT: extension of the exemption for fund management	+5	+15	+15	+10
Fairness and opportunity for all					
17	Increase child element of Child Tax Credit by £50 a year	0	-340	-350	0
18	Increase first child rate of Child Benefit to £20 a week	0	-210	-170	0
19	Pilots of new approaches to tackling child poverty	-10	-35	-80	-10
20	Child Benefit disregard for Housing Benefit and Council Tax Benefit	0	-180	-350	0
21	Age related payments: £50 payment to over 60s households and a further £50 to over 80s households	-575	0	0	-575
22	Welfare to work: reassessment of work capability for incapacity benefit claimants	0	0	-10	0
23	Income tax: indexation of savings and basic rate limits	0	0	0	-810
Duties changes					
24	Tobacco duties: indexation	0	0	0	+35
25	Alcohol duties: increases in rates	+400	+505	+625	+600
26	Amusement machine license duty: indexation	0	0	0	+5
Protecting the environment					
27	Increase in value of landfill communities fund	*	*	*	-5
28	Landfill tax: reform of waste exemption	0	*	+20	0
29	Extension of land remediation relief	0	-10	-20	0
30	Extension of enhanced capital allowances	*	*	-5	*
31	Road fuel duties	-550	0	+270	-550
32	Rebated oils duties	-10	0	+5	-10
33	Biofuels: removal of the duty differential	0	0	+550	0
34	Biofuels: reduced rate for off-road biofuel use	*	+5	+10	*
35	Vehicle excise duty: new rates, bands and first year charge	0	+465	+735	0
36	Vehicle excise duty: reduced rate for cleanest vans	-5	-15	-15	-5
37	Company car tax thresholds	0	-5	+80	0
38	Fuel benefit charge: revalorisation	*	+10	+25	*
39	Fuel scale charge: revalorisation and realignment	*	*	*	+15
40	Capital allowances: business cars	-10	+40	+75	-10
41	Aviation duty	0	0	+40	0
Protecting tax revenues					
42	Disclosure regime: user identification	0	+10	+20	0
43	Disguising interest	+55	+120	+105	+55
44	Controlled foreign companies	+150	+150	+100	+150
45	Intangible assets regime	0	+10	+15	0
46	North Sea oil and gas: abuse of management expenses rules	+140	+175	+175	+140
47	Double taxation treaties	+200	+40	+30	+200
48	Life insurance: taxation of interest	+25	+35	+35	+25
49	Sideway loss relief	+25	+40	+15	+25
50	Unauthorised Unit Trusts: payments on account	+50	0	0	+50
51	Stamp duty land tax: alternative finance	+5	*	*	+5
52	Stamp duty land tax: group relief	+10	+10	+10	+10
TOTAL POLICY DECISIONS		-140	+790	+1,865	-700

Table A.2: Estimated costs for 2008 Pre-Budget Report policy decisions and others announced since Budget 2008¹

	£ million			
	2008-09	2009-10	2010-11	2011-12
Measures announced since Budget 2008²				
Personal allowance and basic rate limit changes for 2008-09	-2,650	-270	+90	0
September housing package: spending measures	-200	-665	+865	0
SDLT holiday for residential homes	-130	-150	0	0
Local Housing Allowance: cap benefit at 5 bedroom rate	0	+5	+15	+15
Class 3 NICs: Pensions Bill amendment	0	+230	+10	+10
Supporting the economy and ensuring sustainability of public finances				
VAT rate reduction	-3,800	-8,600	0	0
Alcohol duties: increase in rates	+160	+640	+645	+675
Tobacco duties: increase in rates	+115	+340	+360	+365
Capital spending brought forward	-365	-2,545	+2,910	0
Indexation of personal allowance and basic rate limit	0	-2,930	-3,310	-3,270
£130 increase in personal allowance in 2009-10 and 2010-11	0	-630	-770	-100
Freeze basic rate limit in 2011-12	0	0	0	+180
Restrict personal allowance by half from £100,000 and to zero from £140,000 from 2010-	0	0	+830	+1,320
Additional higher income tax rate of 45% above £150,000 and raise trust rate to 45% from	0	0	0	+670
Align the NICs primary threshold with personal allowance in 2011-12	0	0	0	-1,610
Increase main employee NICs rate by 0.5% from 2011-12	0	0	0	+2,050
Increase additional employee NICs rate by 0.5% from 2011-12	0	0	0	+440
Increase employer NICs rate by 0.5% from 2011-12	0	0	0	+2,650
Increase main self-employed rate of NICs by 0.5% from 2011-12	0	0	0	+170
Increase additional self-employed NICs rate by 0.5% from 2011-12	0	0	0	+80
Public spending: additional value for money savings	0	0	+5,000	+5,000
Supporting business				
Foreign profits	0	+75	+25	-275
Loss carry back: temporary extension	-10	-175	-20	+15
Small Companies Rate of corporation tax: defer increase to April 2010	0	-20	-460	-130
Rates on empty property: temporary exemption	0	-185	+10	0
Backdated business rates bills	-80	-55	+25	+20
Income shifting: defer action	0	-25	-260	-200
Insurance claims equalisation reserves	-15	-35	-35	-35
Helping people fairly				
Child benefit: bring forward uprating from April 2009 to January 2009	-170	0	0	0
Child element of Child Tax Credit: bring forward £25 increase from 2010 to April 2009	0	-190	0	0
DWP Job Centre Plus funding ⁴	0	-400	-400	0
Uprating of pension credit above indexation	0	-260	-300	-310
Additional payment to pensioners and others	-900	0	0	0
Freeze pension lifetime and annual allowance from 2011-12 for 5 years	+25	+100	+200	+400
Index housing benefit disregard in tax credits	0	-5	-5	-5
Support for mortgage interest	-30	-15	0	0
Further support for debt advice	-5	-10	-5	0
Protecting revenues				
Change of Accounting Practice Regulations	0	+10	+15	+15
Enhance tax avoidance disclosure regime	0	+10	+15	+10
Delivering on environmental goals				
Air passenger duty	0	-60	-160	-50
Vehicle excise duty - cars and vans	0	-465	-515	-545
Vehicle excise duty - heavy goods vehicles	0	-10	-10	-10
Fuel duty	-180	0	0	0
Additional spending on Warm Front	-50	-50	0	0
Capital allowances: business cars	0	+10	+10	+5
Other policy decisions				
Addition to DEL reserve	-1,000	0	0	0
TOTAL POLICY DECISIONS	-9,285	-16,330	+4,775	+7,550
Memo: Resetting AVE margin	0	-1,000	-2,000	-2,000

¹ Costings shown relative to an indexed base.

² Costings reflect Pre-Budget Report economic forecast and assumptions.

³ Yield increases due to lagged effects of self-assessment. For 2011-12 onwards, yield is £670 million / £1650 million / £1600 million.

⁴ The remainder of the employment package totalling £1.3 billion announced in PBR is funded from DWP End of Year flexibility.

B

Supplementary information

Table B.1: Macroeconomic Prospects ¹

	£bn	Percentage change on a year earlier unless otherwise stated				
		2007	2008	Forecast ^{2,3,4}		
				2009	2010	2011
Real GDP		3	$\frac{3}{4}$	-1 $\frac{1}{4}$ to - $\frac{3}{4}$	1 $\frac{1}{2}$ to 2	2 $\frac{3}{4}$ to 3 $\frac{1}{4}$
Nominal GDP	1401	6	4 $\frac{1}{4}$	$\frac{1}{2}$ to 1	4 to 4 $\frac{1}{2}$	5 $\frac{1}{2}$ to 6
<i>Expenditure components of GDP at market prices⁵</i>						
Private consumption expenditure ⁶		3	1 $\frac{1}{2}$	-1 $\frac{1}{2}$ to -1	1 $\frac{1}{4}$ to 1 $\frac{3}{4}$	2 $\frac{1}{4}$ to 2 $\frac{3}{4}$
Government consumption expenditure		1 $\frac{3}{4}$	2 $\frac{3}{4}$		2 $\frac{3}{4}$	1
Gross fixed capital formation ⁷		7	-4 $\frac{1}{2}$	-8 $\frac{1}{4}$ to -7 $\frac{3}{4}$	2 $\frac{1}{4}$ to 2 $\frac{3}{4}$	6 $\frac{1}{2}$ to 7
Changes in inventories and net acquisition of valuables ⁸		$\frac{1}{4}$	0	- $\frac{1}{4}$ to 0	0	0
Exports of goods and services ⁹		-4 $\frac{1}{2}$	$\frac{3}{4}$	$\frac{1}{4}$ to $\frac{3}{4}$	3 $\frac{1}{4}$ to 3 $\frac{3}{4}$	5 $\frac{1}{4}$ to 5 $\frac{3}{4}$
Imports of goods and services ⁹		-1 $\frac{3}{4}$	$\frac{1}{2}$	-2 $\frac{1}{2}$ to -2	2 $\frac{1}{2}$ to 3	4 to 4 $\frac{1}{2}$
<i>Exports of goods and services (excluding MTIC)</i>		1 $\frac{1}{4}$	$\frac{3}{4}$	0 to $\frac{1}{2}$	3 $\frac{1}{4}$ to 3 $\frac{3}{4}$	5 $\frac{1}{4}$ to 5 $\frac{3}{4}$
<i>Imports of goods and services (excluding MTIC)</i>		3 $\frac{1}{2}$	$\frac{1}{2}$	-2 $\frac{3}{4}$ to -2 $\frac{1}{4}$	2 $\frac{1}{2}$ to 3	4 to 4 $\frac{1}{2}$
<i>Contributions¹⁰ to real GDP growth¹¹</i>						
Final domestic demand ¹²		3 $\frac{3}{4}$	$\frac{3}{4}$	-2 to -1 $\frac{1}{2}$	1 $\frac{1}{2}$ to 2	2 $\frac{1}{2}$ to 3
Changes in inventories and net acquisitions of valuables		$\frac{1}{4}$	0	- $\frac{1}{4}$	0	0
Net trade		- $\frac{3}{4}$	0	$\frac{3}{4}$	$\frac{1}{4}$	$\frac{1}{4}$

¹ The forecast is consistent with the preliminary estimate data for the third quarter of 2008, released by the Office for National Statistics on 24 October 2008.

² All growth rates in this table are rounded to the nearest $\frac{1}{4}$ percentage point.

³ As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2 $\frac{3}{4}$ per cent. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as their basis for projecting the public finances, which is a $\frac{1}{4}$ percentage point below the neutral assumption.

⁴ 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.

⁵ Further detail on the expenditure components of GDP is given in Table A10 of the 2008 Pre-Budget Report.

⁶ Household consumption under UK definition. Includes households and non-profit institutions serving households.

⁷ Fixed investment under UK definition.

⁸ Change in inventories under UK definition. Contribution to GDP growth, percentage points.

⁹ Figures up to and including 2008 are distorted by MTIC.

¹⁰ Based on central case. For the purpose of projecting public finances, forecasts are based on the bottom of the GDP forecast range.

¹¹ Components may not sum to total due to rounding and omission of transfer costs of land and existing buildings and the statistical discrepancy.

¹² Equals the sum of private consumption, gross fixed capital formation and government consumption under UK definition.

Table B.2: Real GDP growth

	2007-08	2008-09	2009-10	Per cent			
				2010-11	2011-12	2012-13	2013-14
Real GDP growth	3	- 1/4	- 1/2	2	3	3	3

Note: GDP growth as used for public finance projections. These figures represent the lower end of the projection range as presented in the Government's economic forecast, adjusted from calendar years to financial years. The economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2 3/4 per cent to the end of 2006 and 2 1/2 per cent thereafter. The figures at the lower end of the ranges are consistent with the deliberately cautious assumptions of trend growth used as the basis for projecting the public finances, which is 1/4 percentage point below the neutral assumption.

Table B.3: Change in gross debt ratio

	2007-08	2008-09	2009-10	Per cent of GDP			
				2010-11	2011-12	2012-13	2013-14
Change in gross debt ratio ¹	0.9	9.6	7.6	4.5	2.5	1.1	-0.1

¹ General government gross debt measure on a Maastricht basis.

Table B.4: General government interest and dividends paid

	2007-08	2008-09	2009-10	Per cent of GDP			
				2010-11	2011-12	2012-13	2013-14
General government interest and dividends paid	2.2	2.1	1.8	2.6	2.9	3.0	3.1

Note: GDP growth as used for public finance projections

Table B.5: General government primary balance

	2007-08	2008-09	2009-10	Per cent of GDP			
				2010-11	2011-12	2012-13	2013-14
Primary balance ¹	0.6	3.3	6.3	4.4	2.6	1.3	0.2

¹ General government net borrowing less interest expenditure.

Table B.6: Stock-flow adjustments

	2007-08	2008-09	2009-10	Per cent of GDP			
				2010-11	2011-12	2012-13	2013-14
Stock-flow adjustment ¹	0.0	5.5	0.1	0.2	0.5	0.5	0.4

¹ General government net borrowing less interest expenditure.

Table B.7: Cyclical budget components

	2007-08	2008-09	2009-10	Per cent of GDP			
				2010-11	2011-12	2012-13	2013-14
Cyclical budgetary component ¹	-0.3	0.0	0.8	1.3	1.0	0.6	0.2

¹ General government net borrowing less interest expenditure.
¹ Treaty deficit less cyclically-adjusted Treaty deficit.

Table B.8: Cyclically-adjusted primary balance

	2007-08	2008-09	2009-10	Per cent of GDP			
				2010-11	2011-12	2012-13	2013-14
Cyclically-adjusted primary balance ¹	0.9	3.2	5.5	3.1	1.6	0.8	0.0

¹ General government net borrowing less interest expenditure.
¹ General government net borrowing less interest paid less cyclical budgetary component.

Table B.9: GDP Growth forecasts at the 2008 Pre-Budget Report and Budget 2008

		Per cent of GDP			
		Forecast			
		2008	2009	2010	2011
GDP growth	2008 PreBudget Report	3/4	-1 1/4 to -3/4	1 1/2 to 2	2 3/4 to 3 1/4
	Budget 2008	1 3/4 to 2 1/4	2 1/4 to 2 3/4	2 1/2 to 3	-

Table B.10: Private consumption deflator

	Level	Percentage change on a year earlier				
	2007	2007	2008	2009	2010	2011
Private consumption deflator ¹	109¾	2	4¼	1¾	3	2¾

¹ Q4.

Table B.11: Export deflator (goods and services)

	Percentage change on a year earlier				
	2007	2008	2009	2010	2011
Export price deflator ¹ (goods and services)	2½	10¼	2¼	2¾	1¼

¹ Average value indices.

Table B.12: Import deflator (goods and services)

	Percentage change on a year earlier				
	2007	2008	2009	2010	2011
Import price deflator ¹ (goods and services)	1	9½	4¼	3¾	2¼

¹ Average value indices.

Table B.13: Balance on goods and services

	Per cent of GDP				
	2007	2008	2009	2010	2011
Balance on goods and services	-3½	-3¼	-3	-3¼	-3

Table B.14: Balance of primary incomes and transfers

	Per cent of GDP				
	2007	2008	2009	2010	2011
Balance of primary income and transfers	-¼	½	¼	½	½

Table B.15: Net lending/ net borrowing of the private sector

	Per cent of GDP				
	2007	2008	2009	2010	2011
Net lending of the private sector ¹	-1	1¼	5	5	3½

¹ Mid-points of forecast ranges

Table B.16: Implicit interest rates on debt

	Per cent of GDP						
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Implicit interest rate on debt ¹	5.3	5.1	3.5	4.5	4.8	4.7	4.7

¹ Interest expenditure expressed as per cent of gross debt in previous year.

Table B.17: Net borrowing by sub-sector

	Outturn 2007-08	Estimate 2008-09
Net Borrowing (£ billion)		
Central Government	39.2	75.3
Local Authority	0.5	4.2
Net Borrowing (% GDP)		
Central Government	2.8	5.1
Local Authority	0.0	0.3

Table B.18: Comparing GDP growth and inflation between 2006 and 2007 PBR

	Percentage change on a year earlier				
	2007	2008	2009	2010	2011
Gross domestic product					
PBR 2007	3	2 to 2½	2½ to 3	2½ to 3	-
PBR 2008	3	¾	-1¼ to -¾	1½ to 2	2¾ to 3¼
CPI inflation (per cent, Q4)					
PBR 2007	2	2	2	2	-
PBR 2008	2	3¾	½	2¼	2

Table B.19: Comparing public sector finances between 2007 and 2008 PBR

	Per cent of GDP					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Current receipts						
PBR 2007	39.2	39.5	39.7	39.9	40.0	40.2
PBR 2008	38.5	37.3	36.2	37.2	37.9	38.3
Current expenditure						
PBR 2007	38.5	38.5	38.2	38.1	37.9	37.8
PBR 2008	37.8	38.8	40.1	40.6	39.9	39.1
Surplus on current budget						
PBR 2007	-0.6	-0.3	0.2	0.6	0.8	1.1
PBR 2008	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2
Net Investment						
PBR 2007	2.1	2.2	2.2	2.3	2.3	2.3
PBR 2008	2.1	2.5	2.7	2.1	2.0	1.9
Public sector net borrowing (PSNB)						
PBR 2007	2.7	2.5	2.0	1.7	1.5	1.3
PBR 2008	2.6	5.3	8.0	6.8	5.3	4.1
Cyclically-adjusted surplus on current budget						
PBR 2007	-0.7	-0.2	0.3	0.6	0.8	1.1
PBR 2008	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6
Cyclically-adjusted PSNB						
PBR 2007	2.8	2.4	1.9	1.7	1.5	1.3
PBR 2008	2.9	5.3	7.2	5.6	4.3	3.5
Treaty deficit ¹						
PBR 2007	2.9	2.8	2.4	2.1	1.8	1.6
PBR 2008	2.8	5.4	8.1	7.0	5.6	4.4
Treaty debt ratio ²						
PBR 2007	43.9	44.8	45.1	45.3	45.2	44.9
PBR 2008	43.2	52.9	60.5	65.1	67.5	68.6

¹ General government net borrowing on a Maastricht basis.

² General government gross debt on a Maastricht basis.

Table B.20: Comparing public sector finances between 2007 and 2008 Budgets

	Per cent of GDP				
	2007-08	2008-09	2009-10	2010-11	2011-12
Current					
Budget 2007	40.1	40.4	40.4	40.4	40.4
Budget 2008	39.1	39.0	39.2	39.7	39.7
Current					
Budget 2007	39.1	38.9	38.7	38.5	38.3
Budget 2008	38.4	38.4	38.2	38.1	37.8
Surplus on current					
Budget 2007	-0.3	0.2	0.4	0.6	0.8
Budget 2008	-0.6	-0.7	-0.2	0.3	0.6
Net Investment					
Budget 2007	2.1	2.2	2.2	2.2	2.2
Budget 2008	2.0	2.2	2.2	2.3	2.2
Public sector net borrowing					
Budget 2007	2.4	2.0	1.8	1.6	1.4
Budget 2008	2.6	2.9	2.5	2.0	1.6
Cyclically-adjusted surplus on current					
Budget 2007	-0.3	0.2	0.4	0.6	0.8
Budget 2008	-0.7	-0.5	0.1	0.5	0.8
Cyclically-adjusted					
Budget 2007	2.4	2.0	1.8	1.6	1.4
Budget 2008	2.7	2.7	2.2	1.8	1.5
Treaty deficit ¹					
Budget 2007	2.5	2.1	1.9	1.7	1.5
Budget 2008	2.8	3.2	2.8	2.3	1.9
Treaty debt ratio ²					
Budget 2007	44.3	44.4	44.5	44.4	44.1
Budget 2008	43.8	46.1	46.9	47.2	47.0

¹ General government net borrowing on a Maastricht basis.

² General government gross debt on a Maastricht basis.



Structural reform measures

6.26 The Government set out progress against key elements of the UK's comprehensive programme of structural reform, including measures being taken in the areas covered by the UK's country-specific recommendations prepared by the Council of the European Union, in the 2008 UK National Reform Programme. The main reform actions are summarised in the box below, taken from the 2008 National Reform Programme and updated to take into account the announcements made in the 2008 Pre-Budget Report

Box C.1: Addressing the UK's country-specific recommendation and *points to watch*: summary of measures

<p>Implement recent plans to substantially improve skill-levels and establish as integrated approach to employment and skills in order to improve productivity and increase opportunities for the disadvantaged</p>	<ul style="list-style-type: none"> • Integrated employment and skills support for those facing redundancy using £158m of European Social Fund funds with a matched £79m of existing Train to Gain and Next Steps advice service funds to provide a more tailored and flexible training offer, working with regional and local partners • UK Commission for Employment and Skills operational in April 2008 • Consultation on a new right for workers to request time to train in June 2008 • Trial aspects of an integrated employment and skills service between 2008 and 2009, including: new screening process for literacy, numeracy, language and employability skills' new Adult Advancement and Careers Service (AACS); Skills Health Check; and Skills Accounts for benefit customers • Suite of robust operational targets for Jobcentre Plus and Learning and Skills Council set in 2009, to underpin the Government objective of delivering sustainable employment and progress for all • Skills Funding Agency fully operational from 2010 • Integrated employment and skills system fully operational by 2010-11 • Full participation of all 16 year-olds by 2013 and all 17 year-olds by 2015
<p>Progressively increase housing supply in order to meet medium-term demand pressures</p>	<ul style="list-style-type: none"> • Government target to deliver 240,000 net additional homes per year by 2016 in order to more effectively match supply with £20 billion by 2010-11 for housing investment in England • Integrate the Regional Economic Strategy (RES) and Regional Spatial Strategy (RSS) by Spring 2010 • Commitment to achieve delivery of 200,000 new homes on surplus public sector land by 2016. Budget 2007 announced that sites have been identified with potential for 70,000 new homes

Ensure progress towards the UK's R&D intensity target through full implementation of the recent review of R&D and innovation policy, particularly taking fuller account of the specific needs of the services sector

- Measures aimed at further boosting UK research and innovation performance (including in the services sector), with associated timetables for their implementation, were set out in the *Innovation Nation* White Paper and in the Government response to the Lord Sainsbury Review of UK science and research policies, both published in March 2008
- The Government published an Annual Innovation Report in December 2008 setting out progress made in delivering on these commitments.

ISBN 1-84532-547-8



9 781845 325473