2 Maintaining macroeconomic stability

The world economy is facing a more challenging environment than was apparent at the time of the 2007 Pre-Budget Report, with continued disruption in global financial markets. The UK is well placed to meet these challenges thanks to the resilience and stability engendered by the Government's macroeconomic framework and a decade of reform promoting open and flexible labour, product and capital markets.

In 2007 the UK economy continued to perform strongly, growing 3 per cent on a year earlier, the fastest growth rate among the G7 economies. Inflation returned to close to target in the second half of 2007. Employment growth picked up during the year, with employment reaching a record high of almost 29½ million; unemployment continued to fall, and the claimant count reached a 32-year low.

Despite the impact of financial market disruption on the public finances, the Budget 2008 projections show that the Government is meeting its strict fiscal rules:

- **the current budget shows an average surplus as a percentage of GDP over the economic cycle which began in 1997-98, ensuring the Government is meeting the golden rule. The current budget moves clearly into surplus from 2010-11 onwards; and**
- **public sector net debt is projected to remain low and stable over the forecast period, stabilising below the 40 per cent ceiling set in the sustainable investment rule.**

The reclassification of Northern Rock to the public sector will bring its assets and liabilities temporarily into the public finances. In line with the *Code for Fiscal Stability*, while Northern Rock remains in the public sector the Government will measure performance against the sustainable investment rule using figures excluding its impact.

An updated analysis of long-term fiscal sustainability is published alongside this Budget in the 2008 *Long-term public finance report*. This report confirms that the Government will be in a position to meet its fiscal rules in the long term, ensuring that the long-term public finances remain sustainable.

2.1 The Government's macroeconomic framework is designed to maintain long-term economic stability. The monetary policy framework seeks to ensure low and stable inflation. The fiscal policy framework seeks to maintain sound public finances in the medium term, while allowing fiscal policy, and in particular the automatic stabilisers, to help smooth the path of the economy. Both parts of the framework work together in an integrated way to support growth and stability, providing the flexibility to respond to changes in the economic environment, and the context for ongoing policy reforms to address future strategic challenges.[1]

[1] For the Government's updated analysis of the strategic challenges facing the economy see *UK economy: analysis of long-term performance and strategic challenges*, HM Treasury, March 2008

REVIEW OF MAIN DEVELOPMENTS

2.2 In July 2007 problems related to the US sub-prime mortgage market triggered disruption in global financial markets which has spread swiftly across countries and markets. In the 2007 Pre-Budget Report, the forecast for growth in 2008 was reduced by ½ percentage point compared with the Budget 2007 forecast, on the assumption that there would be some feed-through from financial market disruption to tighter credit conditions and to household and company spending in the short term. Adjustments were made to the fiscal projections to reflect the impact on receipts from the financial sector. Given the uncertainties, this adjustment was in line with the Government's prudent approach to fiscal management, and as the detailed analysis of the fiscal position below shows, proved to be a reasonable adjustment for 2007-08.

2.3 The fiscal policy response at the time of the 2007 Pre-Budget Report was to accommodate the impact of financial market disruption, with modest discretionary fiscal loosening in 2007-08 and 2008-09, followed by fiscal policy tightening in the medium term. This was in line with the Government's objectives for fiscal policy, of ensuring sustainable public finances in the medium term and smoothing the path of the economy in the short term.

2.4 Since then, the disruption in financial markets has continued. Concerted action by the world's major central banks has helped somewhat to ease pressures in money markets, but conditions in credit markets deteriorated and a number of markets remain effectively closed. There has been further evidence of developments in financial markets feeding through to tighter credit conditions facing households and companies. The Budget 2008 forecast assumes the negative impact on growth from these developments will be somewhat larger and more prolonged than expected in the 2007 Pre-Budget Report.

2.5 Inflation is currently close to target, but significant increases in global agricultural commodity and energy prices are expected to lift inflation in the short term. In addition, the recent depreciation of sterling will exert continued upward pressure on prices. As a result, inflation is expected to pick up in the near term, before falling back by the end of 2008, returning to target in 2009 and remaining on target thereafter.

2.6 The Budget 2008 public finance estimates show the deficit on the current budget in 2007-08 to be in line with the 2007 Pre-Budget Report projections. The estimated outturns for borrowing and debt in 2007-08 are lower than expected at the Pre-Budget Report, with debt just over 1 per cent of GDP lower than the Budget 2007 projection. This comes in the context of low and stable borrowing delivered by the fiscal framework, and a reduction in debt over the cycle from 41.3 per cent in 1997-98 to 36.6 per cent in 2006-07.

2.7 The public finance projections from 2008-09 onwards are affected by the continuation of financial market disruption, by lower asset prices, with global stock markets lower, and by the impact of tighter credit conditions. The expected short-term increase in inflation and social security payments also increase spending. As a result, there is an increase in borrowing concentrated in the years in which tighter credit conditions are assumed to have their largest negative impact on the economy. This increase in borrowing supports economic stability, in line with one of the key purposes of the fiscal framework. The Government is also taking action in Budget 2008 to maintain sound public finances in the medium term. On the basis of cautious forecast assumptions, outlined in more detail below, the Government is meeting its strict fiscal rules throughout the projection period.

THE MACROECONOMIC FRAMEWORK

2.8 The design of the macroeconomic framework introduced in 1997 recognises that the discretion necessary for effective economic policy – short-term flexibility to meet credible long-term goals – is possible only within an institutional framework that constrains the government to deliver clearly defined long-term policy objectives with maximum openness and transparency.

2.9 The monetary policy framework seeks to deliver low and stable inflation by ensuring that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target. The *Code for fiscal stability* sets out a clear framework and set of obligations constraining how Government conducts fiscal policy, including the requirement for the Government to set out its fiscal policy objectives and the rules through which policy will be operated.[2] The fiscal rules are also the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes.

2.10 Both the monetary and fiscal policy frameworks allow for action in the face of economic shocks while safeguarding the Government's commitment to long-term stability. These frameworks have ensured low interest rates, low inflation and allowed the UK to be the only major economy to have achieved continuous positive growth over the past decade. This strong performance was achieved despite several significant economic shocks, including the Asian crisis of 1997, the Long-Term Capital Management hedge fund collapse and Russian debt crisis of 1998, the bursting of the dotcom bubble in 2000, and the impact of the terrorist attacks of 11 September 2001 and the sustained increase in oil prices since 2002.

2.11 A decade after the introduction of the macroeconomic framework, and following continued reforms to promote flexible and open product, labour and capital markets, there is clear evidence that the UK economy is more resilient than in the past, as illustrated in Box 2.1 and discussed in Box B4 in Chapter B. The benefits have been seen in much enhanced macroeconomic stability, as noted by the IMF: "Wide-ranging structural reforms over the past two-and-a-half decades have increased the economy's openness and flexibility, paving the way for reaping important benefits from globalization. Macroeconomic policies have contributed to growth and stability, encouraging households and businesses to plan for the long term and positioning the economy well to respond to shocks."[3]

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

[3] From the latest IMF staff report on the UK economy: *United Kingdom Article IV Staff Report*, International Monetary Fund, March 2007.

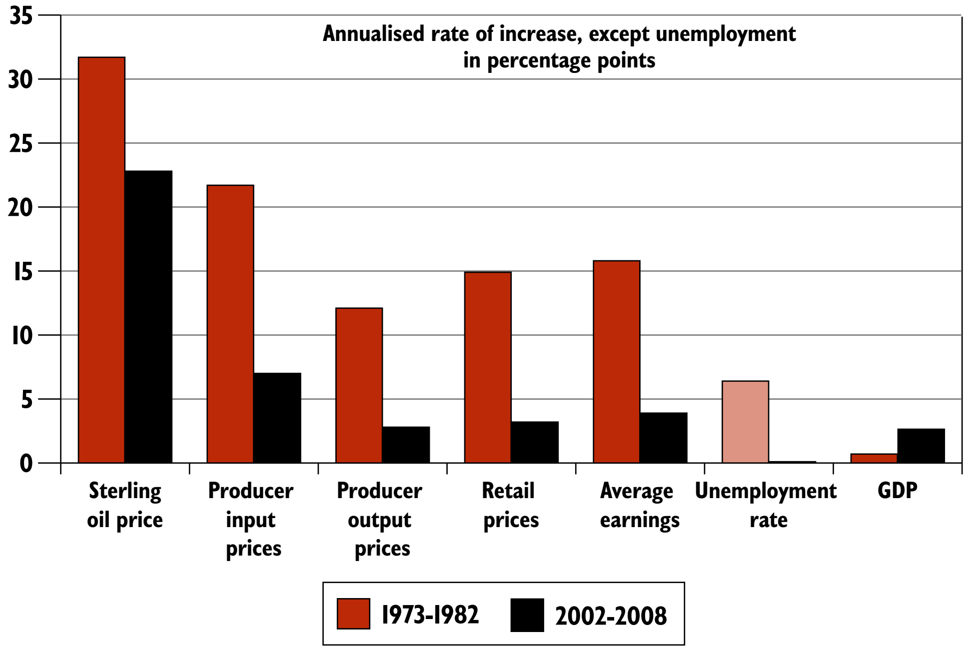
Box 2.1: The macroeconomic framework, market flexibility and macroeconomic stability

Since 2002, the sterling price of crude oil has more than trebled, significantly increasing energy costs for UK businesses and consumers. Despite this, inflation has remained close to target and growth strong and stable. Comparing the six years to January 2008 with the nine years to January 1982, a period spanning the two oil price shocks of the 1970s, demonstrates how improvements in the flexibility of UK product and labour markets and the operation of monetary and fiscal policy has helped to improve macroeconomic performance.

In the nine years to 1982, sterling oil prices increased at an annualised rate of 32 per cent, lifting producer input prices at a rate of 22 per cent. That increase generated 12 per cent increases in producer output prices, 14 per cent increases in retail prices, and finally 15 per cent increases in average earnings. Reflecting the product and labour market rigidities of the late 1970s, unemployment increased to more than 10 per cent, GDP growth averaged less than 1 per cent and contracted sharply in both 1974-75 and 1980-81.

By contrast, in the six years to 2008, while the rise in oil prices has been almost as fast, at an annualised rate of 23 per cent, measures of inflation at the various stages of the production process point to producers and retailers absorbing cost increases in margins: the annualised rate of producer input price inflation has been 7 per cent, of producer output price inflation 3 per cent, of RPI inflation 3 per cent and of CPI inflation 2 per cent. Improved labour market flexibility has meant that despite higher fuel and energy costs, average earnings growth has remained subdued and unemployment low and stable. Against this backdrop, GDP growth has continued uninterrupted at an annualised rate of 2¾ per cent.

Rising oil prices and the effect on inflation, the labour market and growth



Source: ONS and Ecowin.

MONETARY POLICY FRAMEWORK AND PERFORMANCE

2.12 The monetary policy framework is based on four key principles:

- clear and precise objectives. The primary objective of monetary policy is to deliver price stability. The adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target. **The Government reaffirms in Budget 2008 the target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times**;
- openness, transparency and accountability which are enhanced through publication of minutes of MPC meetings and quarterly Inflation Reports; and
- credibility and flexibility to allow the MPC to decide how to react to events, within the constraints of the inflation target and the open letter system.

Performance of the monetary policy framework

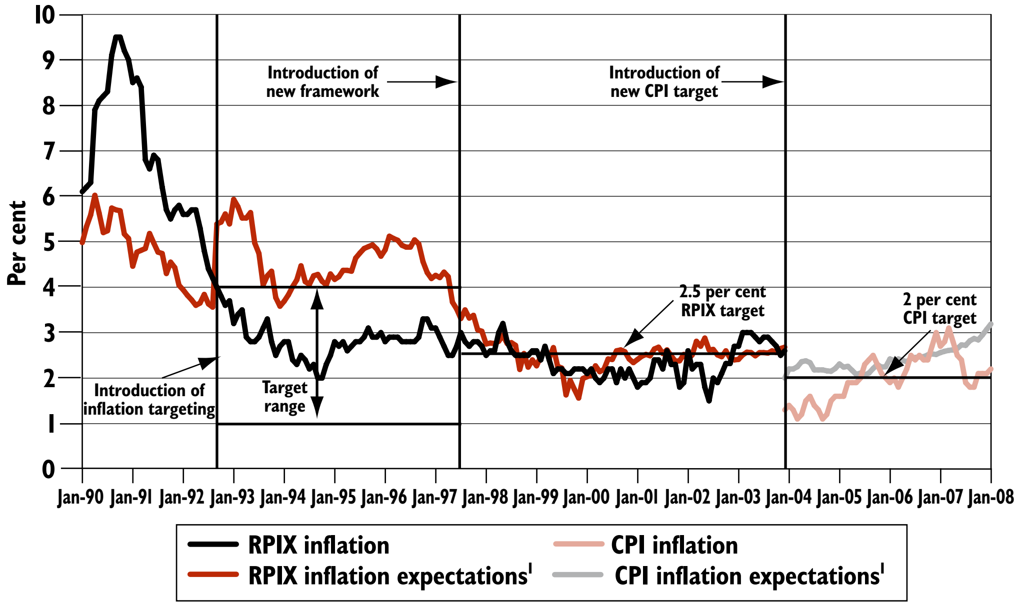
2.13 Since its introduction in 1997, the monetary policy framework has successfully delivered the longest sustained period of low and stable inflation for around fifty years as well as one of the lowest inflation rates in the G7. The Treasury Select Committee recently noted that "the Monetary Policy Committee deserves a significant amount of credit for ensuring that inflation over the last decade has been both lower, and less volatile, than in preceding decades".[4] Under the Government's monetary policy framework:

- CPI inflation has averaged 2 per cent since CPI was made the operational target for monetary policy in December 2003, exactly in line with target;
- UK inflation has been the second lowest in the G7 so far this decade, with only Japan – where there has been a protracted period of deflation – having lower inflation on average. 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 per cent compared with an average of just over 9 per cent in the previous economic cycle.

2.14 With growth above trend for much of 2006 and 2007, the MPC raised Bank Rate by 1¼ percentage points between August 2006 and July 2007. As the disruption in global financial markets took hold in the second half of 2007, and its effect on credit conditions became clearer, the MPC cut Bank Rate by a ¼ percentage point in both December 2007 and February 2008 to the current level of 5¼ per cent. In the press release accompanying its decision in February, the MPC highlighted how "The Committee needs to balance the risk that a sharp slowing in activity pulls inflation below the target in the medium term against the risk that elevated inflation expectations keep inflation above target".[5]

[4] *The Monetary Policy Committee of the Bank of England: ten years on*, Treasury Select Committee, September 2007.
[5] *News release: Bank of England reduces Bank Rate by 0.25 percentage points to 5.25 per cent*, Bank of England, February 2008.

Chart 2.1: Inflation performance and expectations



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

Source: ONS, Bank of England and HM Treasury.

Developments in the monetary policy framework

2.15 In January 2008, the Chancellor announced further details of reforms to the MPC appointments process. The Government will, as far as is possible, publish a timetable for external MPC appointments before a vacancy becomes available and announce details of who it has decided to appoint in sufficient time to allow pre-commencement hearings by the Treasury Select Committee. Reappointed members will undergo a pre-commencement hearing in the same way that new members will, ensuring that all members are subject to regular Parliamentary scrutiny.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

2.16 The UK economy continued to perform strongly in 2007, growing 3 per cent on a year earlier, the fastest growth rate among the G7 economies. Inflation returned to close to target from mid-2007, and at 2.2 per cent in January 2008 was lower than in the US or the euro area. Annual growth in employment picked up during the year, from around 50,000 during the first half to almost 250,000 during the second half, with employment reaching a record high of almost 29½ million. Unemployment continued to fall, and the claimant count reached a 32-year low. The flexibility and resilience of the UK economy over the past decade provides a solid platform from which to face the economic shocks presented by the continued disruption in global financial markets and the increase in commodity prices.

World economy

2.17 World GDP growth is expected to slow from 4¾ per cent in 2007 to 4 per cent in 2008, with growth forecast to moderate more among advanced than emerging economies. UK export markets growth is forecast to slow, reflecting relative weakness in the euro area and US, which together account for around two-thirds of UK export demand.

Credit conditions

2.18 At the time of the 2007 Pre-Budget Report, the disruption in financial markets was in its early stages and its likely impact on credit conditions facing households and companies was highly uncertain. With only limited evidence available at that time, the forecast assumed some feed-through to tighter credit conditions and hence to household and company spending in the short term. Since then there has been further evidence of developments in financial markets feeding through to tighter credit conditions facing households and companies.

Broader monetary conditions

2.19 During 2008 and early 2009, when the negative effect of tighter credit conditions on output are assumed to be largest, underlying monetary conditions are set to be supportive. Sterling has depreciated since the 2007 Pre-Budget Report, which is forecast to boost export growth in 2008 and 2009. The Bank of England has reduced interest rates by ½ a percentage point since early December 2007, and markets expect some further easing over the coming year. To the extent that these expectations are realised interest rates should support growth from the end of this year. It is, however, possible that the pass-through of interest rate changes will be more muted while the period of disruption in financial markets persists.

2.20 On the assumption that credit conditions start easing during the second half of 2008 and normalise by mid-2009, annual growth is expected to pick up from the first half of 2009. Once financial markets begin to function normally again, the forecast assumes that the natural adjustment processes of a well-functioning market economy will take further hold, helping to sustain output growth at or slightly above trend rates. The recent strength of employment growth, and continuing absence of wage pressures, suggests the labour market will continue to support the economy through 2008 and beyond. GDP growth is forecast to slow from 3 per cent in 2007 to 1¾ to 2¼ per cent in 2008, before picking up to 2¼ to 2¾ per cent in 2009 and 2½ to 3 per cent in 2010.

Rebalancing of demand

2.21 Reflecting credit conditions facing households and companies, growth of consumer spending and business investment are forecast to slow in 2008, and to pick up in 2009 and 2010. Consumer spending growth is expected to remain slightly below whole economy GDP growth, as domestic demand continues to rebalance. With sterling having depreciated by around 7 per cent since the 2007 Pre-Budget Report, the conditions are in place for external demand to contribute more positively to GDP growth over the forecast horizon.

Table 2.1: Summary of UK forecast[1]

		Forecasts		
	2007	2008	2009	2010
GDP growth (per cent)	3	1¾ to 2¼	2¼ to 2¾	2½ to 3
CPI inflation (per cent, Q4)	2	2½	2	2

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

Inflation

2.22 Inflation is currently close to target, but significant increases in global agricultural commodity and energy prices are expected to lift inflation in the short term. In addition, the recent depreciation of sterling will exert continued upward pressure on prices. Reflecting the flexibility of UK product and labour markets, similar cost shocks in 2005 and 2006 were largely absorbed by producers in margins, or offset by pressing down on other costs, including wages. Inflation is forecast to fall back to 2½ per cent by the end of 2008, returning to target in 2009 and remaining on target thereafter.

Box 2.2: Inflation, macroeconomic stability and pay

Since the introduction of the new monetary policy framework in 1997, the UK economy has experienced the longest period of sustained low inflation since the 1960s. Low inflation is a key part of the macroeconomic stability that has provided the platform for record employment levels and higher investment, productivity and economic growth.

Recently, inflation has been subject to temporary shocks: increases in energy prices, driven by developments in the oil and wholesale gas markets, and higher food prices, which have been affected by a number of global factors including poor harvests affecting supplies and higher demand from emerging markets and from biofuels. Stripping out some of the short-term influences, underlying 'core' inflation (excluding energy and seasonal food) has remained low and generally under 2 per cent (1.8 per cent in January). The pressures from higher energy and food prices are expected to raise headline inflation over the near term. But consensus forecasts for oil prices in 2008 show analysts expect prices to fall, and in line with the assessment of the UN's Food & Agricultural Organisation,[a] food prices are also expected to moderate this year. As these cost pressures recede, the Budget forecast is for inflation to return to target in 2009, consistent with the March average of independent forecasts.[b] Further analysis of inflation is included in Chapter B.

The stability and credibility of the UK's monetary policy framework has so far contributed to keeping earnings growth across the economy stable and subdued. Nevertheless, there remains a risk of second-round effects of temporarily higher inflation feeding through to higher average earnings growth. It is therefore important that pay settlements are consistent with the achievement of the Government's inflation target of 2 per cent because settlements based on a temporary pick up in inflation would risk converting a temporary increase in inflation into a permanent increase.

To deliver continuing stability, the Government will seek to maintain discipline in pay setting and agree multi-year pay settlements where appropriate. The Government's public sector pay policy therefore supports wider economic stability through:

- **focusing on the labour market conditions of workforces, particularly their recruitment and retention position, with multi-year settlements where appropriate;**
- **delivering settlements that are affordable and value for money; and**
- **delivering settlements consistent with achievement of the inflation target of 2 per cent.**

[a] *OECD – FAO Agricultural Outlook 2007-2016*, OECD-FAO, 2007.
[b] *Forecasts for the UK economy: A comparison of independent forecasts*, HM Treasury, 12 March 2008.

Property markets

2.23 Annual house price inflation has slowed, from above 10 per cent in August 2007 to around 2½ per cent in February 2008, and commercial property prices in the UK have fallen. In addition, the effective closure of markets for securitised assets has put added strain on banks' funding positions. This could affect house price inflation in coming months, and seems likely to reduce the volume of activity in property markets.

The economic cycle

2.24 Evidence from the cyclical indicators monitored by the Treasury, and the latest National Accounts data, suggest that the economy passed up through trend in the second half of 2006. The small positive output gap at the beginning of 2008 is forecast to turn negative during 2008, to stand at around ½ a per cent in the first half of 2009. With output judged to be close to trend at the end of 2007, growth forecast to slow to below trend rates in 2008 and 2009, and prospective National Accounts revisions, it remains too soon to assess whether the second half of 2006 marks the end of the economic cycle that is judged to have started in the first half of 1997.

Risks

2.25 The Budget 2008 economic forecast is made against the backdrop of considerable uncertainty related to the continued disruption in global financial markets and its potential impact on the global and domestic economy. Assessing the likely response of banks and other credit issuers to developments in financial markets, and of companies and households to developments in credit conditions, represents the principal forecast uncertainty.

2.26 While the impact of tighter credit conditions caused by the continued disruption in global financial markets represents a risk to growth in all economies, that risk is clearly greater in the US, where falling house prices impact on the markets for some financial market instruments. The increasing complexity and interconnectedness of markets has meant that developments in one market can easily be transmitted to others, as shown by the ongoing financial market disruption. This creates new challenges mitigating financial stability risks and protecting consumers, and in ensuring the UK economy has the flexibility to respond to such developments. Box 2.3 outlines the action the Government is taking forward at an international level to address these challenges.

2.27 For world trade, risks to the multilateral trading system remain, especially from the proliferation of bilateral and regional trade agreements and, increasingly, from protectionist trade policies. A firm stance against protectionism can help to ensure that trade continues to improve living standards across advanced and emerging economies.

2.28 While the US current account deficit has started to decline, this has not yet been accompanied by a reduction of the large surpluses of some Asian countries. There remains a risk of disorderly unwinding of global imbalances, with the economic costs such a process would entail. To reduce this risk it is important that major world economies allow a continued rebalancing of demand and flexibility in their exchange rates.

2.29 In the UK, there are upside risks from the weaker exchange rate providing support for export growth and from the strength of the labour market, which could support income growth and consumer spending by more than has been assumed. Recent private business survey indicators suggest that the economy may have carried more momentum into 2008 than the forecast assumes. There are clear downside risks to growth if credit conditions were to deteriorate further, raising the price of and limiting access to finance for companies and households by more or for longer than has been assumed.

2.30 Since the 2007 Pre-Budget Report, commercial property prices in the UK have fallen, annual house price growth has slowed and the volume of property transactions has declined. While this is expected to impact directly on residential investment and the approximately one-third of business investment that comprises buildings and structures, further unanticipated adjustment in the commercial or residential property markets could present risks to the forecasts for business investment or private consumption through effects on confidence or the value of collateral.

Box 2.3: Promoting a stable and prosperous world economy

Disruption in global financial markets has re-emphasised the need for effective global cooperation to address the shared challenges of an increasingly integrated world economy. The UK is playing its full part at EU and international level to promote global prosperity and economic stability by:

- **pursuing reform of the international financial institutions in order to minimise the risks to global economic stability, and strengthen their effectiveness, credibility and legitimacy. The UK is seeking to strengthen the roles of the IMF and Financial Stability Forum to provide a better early warning system for financial system risks. The UK will also seek to improve dialogue on these issues among major economies, including emerging markets, as G20 chair in 2009;**
- **working actively with industry, the Financial Services Authority, the Bank of England and counterparts across the world to understand the causes of the continued disruption to global financial markets, and deliver appropriate actions at EU and international level to strengthen the stability and resilience of markets. The Financial Stability Forum will report to the G7 in April on the underlying causes of the ongoing market turbulence and propose international responses;**
- **continuing to make a strong case for open markets and resist protectionist pressures. This includes working through the WTO to achieve an ambitious and pro-development outcome to the Doha Development Agenda, while ensuring the capacity of poorer countries to trade. The Government is engaging fully with work in the IMF and OECD to develop best practice guidelines for sovereign wealth funds;**
- **promoting economic reform across the EU through the Lisbon Strategy to sustain high levels of growth and social cohesion in Member States. The UK will also pursue reform of the EU budget so that the EU is better equipped to meet the challenges of the 21st century;**
- **ensuring sustainable, reliable and affordable energy supplies by promoting open, transparent and competitive energy markets, through the EU and international fora;**
- **supporting new global negotiations to tackle climate change beyond 2012 by taking forward the Bali Action plan with the aim of agreement by December 2009. Supporting that process, the Government will continue to push for a cost-effective international response to climate change, a global carbon market, and financial assistance for adaptation by developing countries; and**
- **pursuing policies and measures that: promote sustainable economic growth in developing countries, accelerate progress towards the Millennium Development Goals, improve international aid effectiveness, and ensure debt sustainability and implementation of agreed debt relief initiatives.**

FISCAL POLICY FRAMEWORK

2.31 Prior to the introduction of the macroeconomic framework in 1997, fiscal policy contributed to instability with high and volatile borrowing that often amplified rather than reduced the fluctuations of the economic cycle. Fiscal policy decisions were made in the context of an imprecise and changing set of objectives. A clear and tightly defined fiscal policy framework was introduced in 1997, with the *Code for fiscal stability,* underpinned by legislation, setting out key principles for fiscal management, new reporting requirements and a role for the National Audit Office providing independent audit of key assumptions behind the public finances forecast. The Code requires the Government to state clearly its fiscal policy objectives and the rules through which policy will be operated, increasing the transparency and accountability of fiscal decision making.

2.32 The Government's fiscal policy objectives are:

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

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

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

2.34 Boxes 2.4 and 2.6 provide more detail on the purpose of the fiscal rules and how they work together to achieve the Government's fiscal objectives. Box 2.5 illustrates the success of the rules in ensuring sustained increases in public sector net investment.

PERFORMANCE OF THE FISCAL POLICY FRAMEWORK

2.35 Since 1997, fiscal policy has resulted in low and stable borrowing, in contrast to previous UK experience. In the 1986-87 to 1997-98 economic cycle, net borrowing reached nearly 8 per cent of GDP, and averaged 3.1 per cent of GDP. During the economic cycle which began in 1997-98, net borrowing has averaged 1.0 per cent of GDP and at its peak reached just 3.3 per cent of GDP. The fiscal framework has successfully supported economic stability by allowing the automatic stabilisers to operate, as illustrated by Chart 2.5. The fiscal framework has also protected an historically unprecedented increase in public sector net investment, while net debt has been maintained at a low and sustainable level.

2.36 Table 2.2 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. The table shows that, after allowing for non-discretionary changes to receipts and spending and taking into account the Budget decisions, the Government is meeting both of its strict fiscal rules. Details of the recent fiscal trends and outlook that underpin these projections are set out later in the chapter.

Table 2.2: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Fairness and prudence							
Surplus on current budget	–0.3	–0.6	–0.7	–0.2	0.3	0.6	1.0
Average surplus since 1997-98	0.1	0.1	0.0	0.0	0.0	0.1	0.1
Cyclically-adjusted surplus on current budget	–0.3	–0.7	–0.5	0.1	0.5	0.8	1.0
Long-term sustainability							
Public sector net debt[1]	36.6	37.1	38.5	39.4	39.8	39.7	39.3
Core debt[1]	35.9	36.6	37.7	38.4	38.6	38.5	38.2
Net worth[2]	26.0	25.3	23.7	22.2	21.3	20.7	20.9
Primary balance	–0.6	–0.9	–1.3	-0.9	–0.3	0.1	0.4
Economic impact							
Net investment	1.9	2.0	2.2	2.2	2.3	2.2	2.3
Public sector net borrowing (PSNB)	2.3	2.6	2.9	2.5	2.0	1.6	1.3
Cyclically-adjusted PSNB	2.2	2.7	2.7	2.2	1.8	1.5	1.2
Financing							
Central government net cash requirement	2.8	2.7	4.0	3.2	2.5	2.3	1.8
Public sector net cash requirement	2.7	2.3	2.8	2.9	2.1	1.9	1.4
European commitments							
Treaty deficit[3]	2.6	2.8	3.2	2.8	2.3	1.9	1.6
Cyclically-adjusted Treaty deficit[3]	2.5	3.0	3.0	2.5	2.1	1.8	1.5
Treaty debt ratio[4]	43.3	43.8	46.1	46.9	47.2	47.0	46.6
Memo: Output gap	*0.0*	*0.3*	*–0.5*	*–0.4*	*–0.3*	*–0.1*	*0.0*

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

Box 2.4: Purpose of the golden rule

The golden rule, that over the economic cycle the Government will borrow only to invest and not to fund current spending, is designed to work alongside the sustainable investment rule to:

- **protect intergenerational fairness. It ensures that current generations pay for the public services that they consume, rather than funding consumption through borrowing that will have to be repaid by future generations; and**
- **eliminate the bias against capital spending. The rule draws a distinction between current and capital spending, recognising that both have important roles to play in the provision of public services and that decisions on all spending must be considered on a value for money basis. The success of the rule in eliminating this bias is assessed in Box 2.5.**

A key feature of the golden rule is that it is measured over the economic cycle - rather than every year – to allow fiscal policy the flexibility to respond in support of monetary policy to accommodate shocks and smooth the path of the economy.

The automatic stabilisers are a feature of the tax and spending system that serve to dampen the impact of shocks on output. As the economy strengthens incomes tend to rise resulting in, for example, higher income and corporation tax receipts and lower social security spending. The budget balance will therefore tend to rise when output is above trend and fall when it is below. These movements support monetary policy by dampening economic cycles without putting at risk the long-term sustainability of fiscal policy.

The economic impact of fiscal policy will also be determined by other non-discretionary factors: for example, a decline in tax revenues caused by a fall in asset prices, in the face of an economic shock, would be a non-discretionary fiscal loosening that acts to support the economy.

Against the backdrop of continued financial market disruption, fiscal policy in Budget 2008 supports the economy with the automatic stabilisers and other non-discretionary changes having the greatest positive impact while the economy is below trend. By the end of the projection period, borrowing returns to its Budget 2007 levels, as the economy returns to trend.

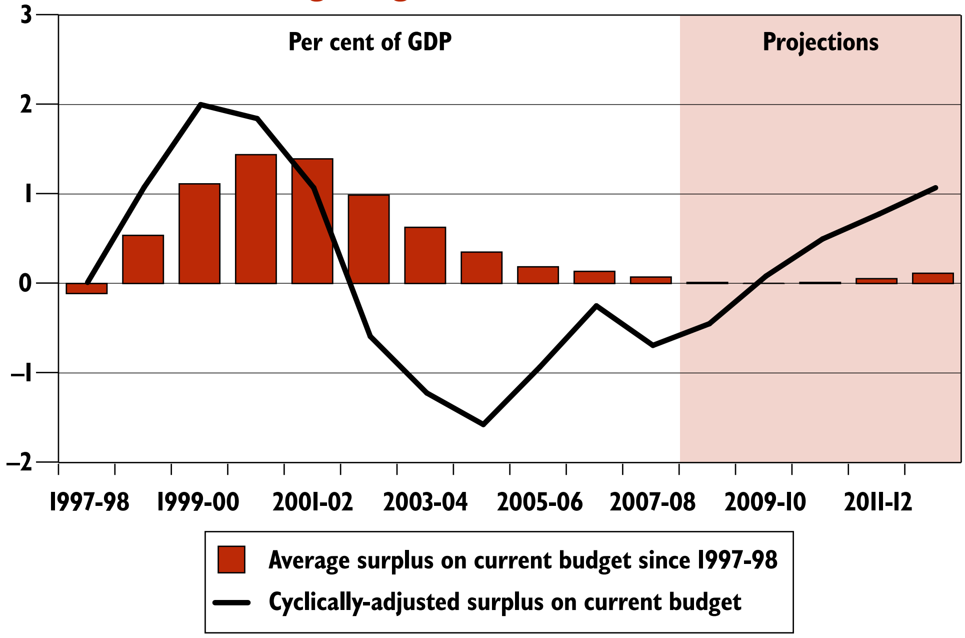
Golden rule

2.37 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of intergenerational fairness. The golden rule allows early and forward-looking action in fiscal policy. The current budget strengthens through the projection period, returning to surplus in 2010-11, showing a surplus of 1.0 per cent of GDP by 2012-13.

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

2.39 The golden rule is met over the economic cycle which began in 1997-98. Fiscal policy accommodates the impact on the public finances of continued disruption in global financial markets, reducing the surplus on the current budget in the early years of the forecast. The current balance reaches surplus in 2010-11 and returns towards the Pre-Budget Report forecast by 2012-13, ensuring that the Government is on track to meet the golden rule in the next cycle.

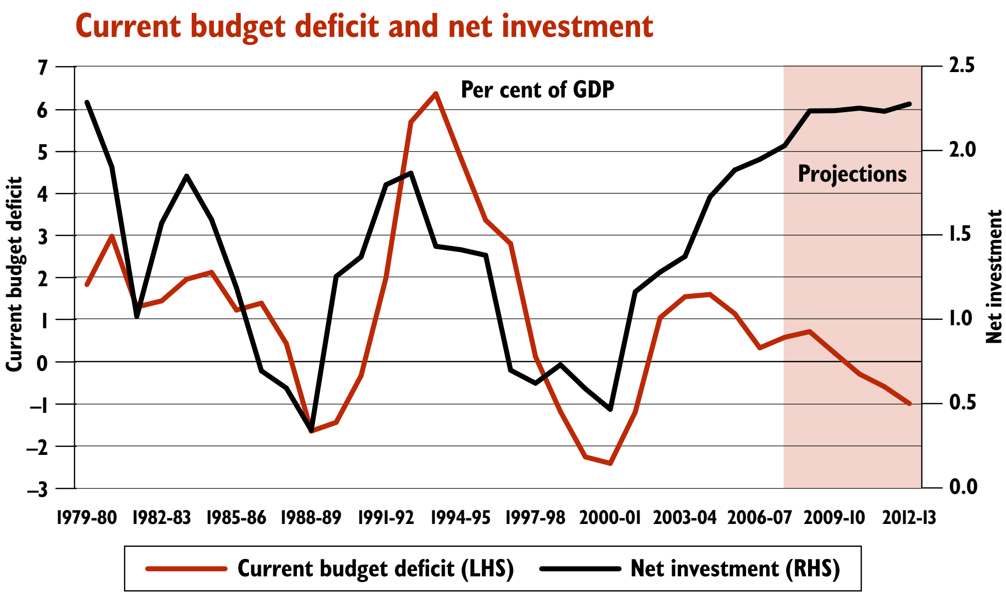
Chart 2.2: Meeting the golden rule



Source: HM Treasury.

Box 2.5: Protecting investment

The fiscal framework is designed to remove the bias against capital spending by making a distinction between capital and current spending. Historically, it has been extremely rare for public investment to grow during periods of fiscal consolidation, and prior to the introduction of the macroeconomic framework, it had not happened for 40 years. The effectiveness of the golden rule in eliminating this historic bias against capital spending is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment illustrated in the chart below. As the chart shows, this pattern of reducing borrowing while maintaining net investment will continue in the coming years. Public sector net investment is now over three times higher as a share of the economy than it was in 1997-98, having risen from 0.6 per cent to 2 per cent of GDP this year.



Source: HM Treasury.

Sustainable investment rule

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

2.41 Net debt in 2007-08 is ½ per cent of GDP lower, at 37.1 per cent of GDP, than expected at the 2007 Pre-Budget Report and around 1 per cent lower than expected at Budget 2007. In the later years of the projection period, net debt is higher than at the 2007 Pre-Budget Report as fiscal policy supports monetary policy and the Government fulfils its commitment to protecting the sustained rises in public sector investment. Chart 2.3 shows that net debt remains below 40 per cent of GDP, and starts to decline at the end of the projection period reaching 39.3 per cent in 2012-13. Therefore the Government meets its sustainable investment rule while continuing to borrow to fund increased long-term capital investment in public services. Chart 2.3 also illustrates projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt.

Box 2.6: Purpose of the sustainable investment rule

The sustainable investment rule is designed to work with the golden rule, described in Box 2.4, to achieve two key objectives:

- **to protect intergenerational fairness. The level of public debt represents the costs imposed by past decisions on future taxpayers, and maintaining it at a stable and prudent level ensures those costs remain fair. Imposing a limit on net debt recognises that future generations will have to forego current spending to service the debt that today's taxpayers incur. Borrowing for investment is compatible with intergenerational fairness as it allows a better match of the costs and benefits of large long-lived capital projects; and**
- **to ensure the sustainability of public finances. The sustainable investment rule requires debt to be held at a stable and prudent level. Maintaining net debt at a prudent level protects against the costs of high levels of public debt – including increased exposure to shocks like interest rate changes, a risk premium on interest rates, and efficiency losses due to the higher tax rates needed to service debt for a given level of public spending.**

To put these objectives into operation, the Government chose to assess performance using a public sector net debt (PSND) measure, which the independent Office for National Statistics publish every month. Net debt, which subtracts the value of liquid financial assets from the gross debt measure, was chosen as this is a fairer reflection of the government's immediate solvency. The value of other financial assets is not netted off in the net debt measure. Instead of general government debt, which just measures the liabilities of central and local government, the fiscal framework uses a public sector debt measure, as this adds in the debt of public corporations, capturing more fully the liabilities which will accrue to future taxpayers.

The purpose of the sustainable investment rule, to protect intergenerational fairness and ensure sound public finances, provides the context for measurement decisions. The impact of Northern Rock on public sector net debt provides a good example. Northern Rock is temporarily in public ownership and its liabilities are fully backed by other financial assets held by the company, and therefore its impact on PSND does not reflect future calls on the taxpayer or affect sustainability. PSND does not take account of temporary ownership or net off all financial assets. As the sustainable investment rule aims to capture the burden of debt that will fall on future taxpayers, it would not be appropriate to include the liabilities of Northern Rock in the measure of performance against the rule. The *Code for fiscal stability* provides for such circumstances. The Government remains committed to best practice fiscal reporting, and to improving the assessment of fairness and sustainability where further opportunities arise, maintaining the integrity of the constraints set by the fiscal framework.

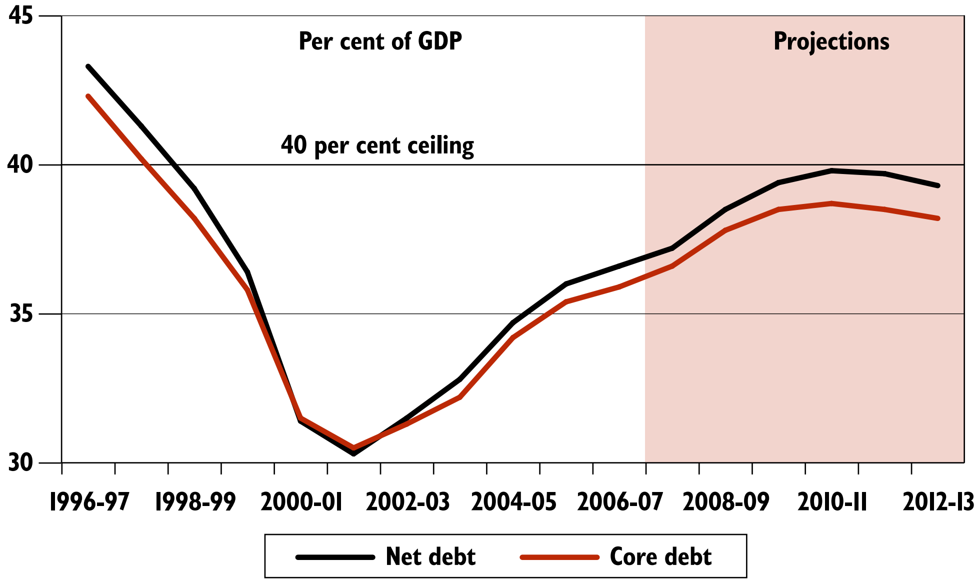
Northern Rock and the sustainable investment rule

2.42 The Office for National Statistics (ONS) announced on 7 February 2008 its intention to classify Northern Rock as a public corporation with effect from 9 October 2007. This will increase public sector net debt (PSND) by the company's gross liabilities to the private sector net of its liquid assets. The ONS have not yet completed the work required to compile an estimate of the change.

2.43 The Government will report on PSND both including and excluding Northern Rock in any future Budgets and Pre-Budget Reports in which the company remains classified as a public corporation. As set out in Box 2.6, the sustainable investment rule ensures sound public finances and fairness by protecting future generations from bearing the costs of debt incurred by this generation. Northern Rock is temporarily in public ownership and its liabilities are fully backed by other financial assets held by the company, and therefore its impact on PSND does not reflect future calls on the taxpayer. For the purpose of measuring performance against the sustainable investment rule, the Government will use a measure of PSND excluding Northern Rock's assets and liabilities.

2.44 The *Code for fiscal stability* provides for such circumstances. While Northern Rock remains in temporary public ownership, operating at arms length from Government, the Treasury will provide financing to the company and continue to provide guarantee arrangements where appropriate. It will continue to record a contingent liability for these arrangements. Any economic profit or loss will be included within both measures of PSND (and thus within the sustainable investment rule) when that profit or loss crystallises for central government.

Chart 2.3: Meeting the sustainable investment rule



Source: ONS and HM Treasury.

Financing

The forecast for the central government net cash requirement (CGNCR) for 2007-08 is £37.7 billion, an increase of £0.4 billion from the 2007 Pre-Budget Report forecast of £37.3 billion. The projection for the CGNCR in 2008-09 is £59.3 billion, including the impact of refinancing the Bank of England's loan to Northern Rock. Following the decision to take Northern Rock into a period of temporary public ownership, the Government will during 2008-09 replace the Bank of England's loan to Northern Rock with direct Treasury funding, in order to comply with restrictions in the Treaty Establishing the European Community on central bank financing of government undertakings. Given that under current arrangements the Treasury has indemnified the Bank of England in the event it is unable to recover its full loan, this refinancing does not change the Government's economic exposure. The loan will remain secured against the assets of the company. The net amount outstanding of the Treasury loan as at 31 March 2009 is currently projected to be £14 billion, but this amount is subject to revision and will be updated at the 2008 Pre-Budget Report.

2.45 Gross gilt redemptions are £17.3 billion and National Savings and Investments' net contribution to financing is estimated to be £4.0 billion. The net financing requirement in 2008-09 also includes the impact of the partial repayment in 2007-08 of £6 billion of the Ways and Means Advance from the Bank of England. The forecast for the net financing requirement in 2008-09 is £78.8 billion. The Government's decision to repay up to £7 billion of the remaining balance of its Ways and Means Advance is not reflected in the net financing requirement in 2008-09 but is included as a planned change in the short-term debt level. The financing requirement will be met by:

- gross gilt issuance of £80.0 billion;
- an increase in the Treasury bill stock of £5.8 billion to £22.0 billion.

2.46 Full details and a revised financing table can be found in Chapter C. Further details can be found in the *Debt and reserves management report 2008-09* which is published alongside the Budget.

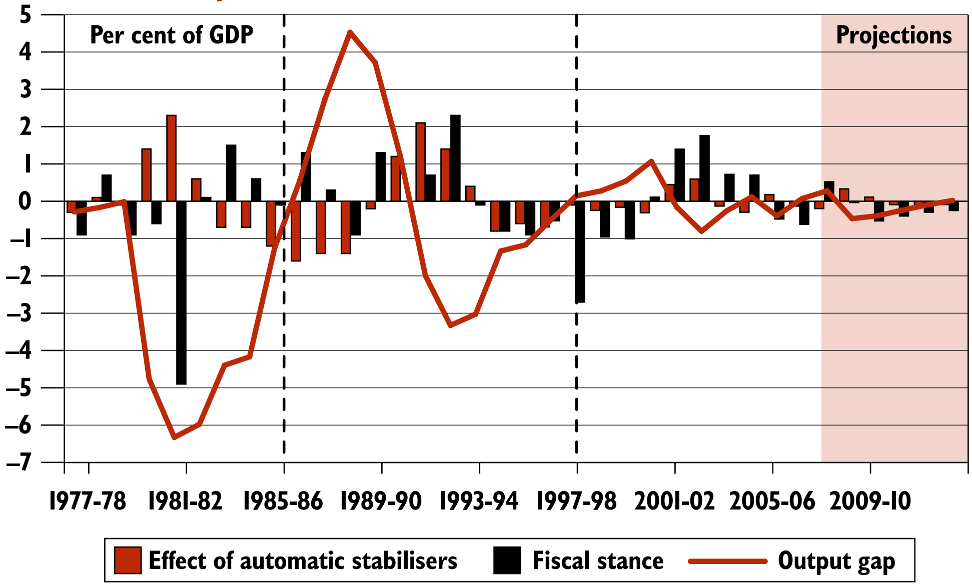
European commitments

2.47 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box B3 and as reflected in reforms to the Pact agreed in March 2005. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in Budget 2008, which show the Government is meeting its fiscal rules over the cycle, maintaining low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with a prudent interpretation of the Pact.

Economic impact

2.48 While the primary objective of fiscal policy is to ensure sound public finances, fiscal policy also affects the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). This measure captures the net effect of changes in the Government's spending and receipts on economic activity.

Chart 2.4: Fiscal policy supporting monetary policy over recent economic cycles



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

2.49 Before 1997 fiscal policy contributed to instability with high and volatile borrowing that often amplified rather than reduced the fluctuations of the economic cycle. Since the introduction of the fiscal rules, fiscal policy has supported economic stability, as shown in Chart 2.4. During the late 1990s, fiscal policy tightened at a time when the economy was above trend. As the economy moved below trend in 2001, fiscal policy, both via the automatic stabilisers and the fiscal stance, supported the economy, with the degree of support moderating as the economy moved back towards trend.

2.50 The fiscal policy setting in Budget 2008 continues to support economic stability in 2007-08 and 2008-09, in line with the economy moving below trend. PSNB then begins to fall, in the context of a pick up in growth as the economy returns to trend.

2.51 Table 2.3 separates out the overall impact of fiscal policy since Budget 2007 on the economy into 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).

2.52 The fiscal stance can be further split into:

- discretionary changes – Budget or other policy changes affecting borrowing; and
- non-discretionary changes – other changes in borrowing resulting for example from shocks in the economy that are not captured by cyclical adjustments, or

from structural changes to tax receipts or public spending that the government chooses not to offset.

2.53 Table 2.3 shows that the overall fiscal impact of changes since Budget 2007 support growth throughout the projection period. Non-discretionary factors play a major role, as the Government accommodates the changes to tax receipts and public spending that result from the impact of the continued disruption in financial markets. Discretionary policy measures in the 2007 Pre-Budget Report and Budget 2008 are neutral in the short term followed by a modest tightening, partially offsetting the stimulus coming from non-discretionary factors, underpinning sustainable public finances as the economy moves back towards trend.

Table 2.3: The overall fiscal impact[1]

	Per cent of GDP					
	Outturn[2]	Estimate[3]	Projections			
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Changes from Budget 2007 to Budget 2008						
Budget changes	0.0	0.0	0.0	-0.1	–0.1	–0.2
+						
non-discretionary factors	–0.3	0.3	0.7	0.4	0.4	0.3
=						
change in fiscal stance	–0.3	0.4	0.7	0.4	0.2	0.1
+						
automatic stabilisers	–0.1	–0.2	0.2	0.3	0.2	0.1
=						
overall fiscal impact	–0.4	0.2	0.9	0.7	0.4	0.2

[1] *All numbers represent the impact of changes on PSNB, so that a positive number represents fiscal loosening compared with Budget 2007.*
[2] *The 2006-07 figures were estimates in Budget 2007.*
[3] *The 2007-08 figures were projections in Budget 2007.*

Taking account of uncertainty

2.54 Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The Budget 2008 economic forecast is made against the backdrop of considerable uncertainty related to the continued disruption in global financial markets.

Cautious assumptions

2.55 The use of cautious assumptions audited by the NAO builds a safety margin into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending. A complete list of these assumptions is set out in Chapter C of the Financial Statement and Budget Report.

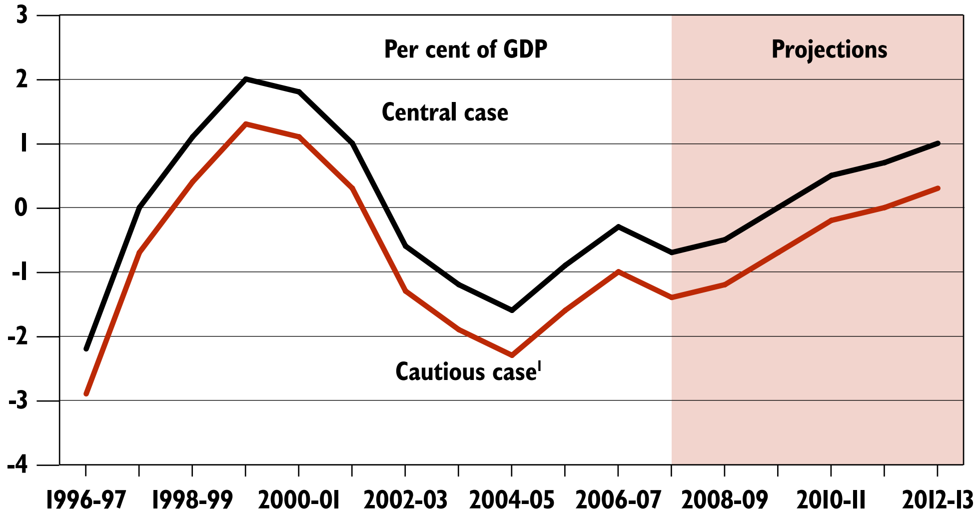
2.56 For Budget 2008, the Comptroller and Auditor General has audited the assumption relating to unemployment, which requires projections to be based on outside forecasts. He concluded that the assumption proved to be cautious in the later part of the Rolling Review period since Budget 2005, though in 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.

2.57 The degree of caution in the assumptions underpinning the public finance projections increases over the projection period. For example, the Government bases its public finance projections on a trend growth assumption that is a ¼ percentage point lower than its neutral view, to accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term. This implies that the level of GDP used in the public finance forecast is 1¼ per cent below the neutral view by 2012-13.

The cautious case **2.58** A second important source of potential error results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.5 illustrates the projections for this cautious case.

2.59 The Government is, on the basis of cautious, independently-audited assumptions, meeting the golden rule in the central case. In the cautious case, Chart 2.5 shows that the cyclically-adjusted balance will be in surplus at the end of the projection period.

Chart 2.5: Cyclically-adjusted surplus on current budget



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

Source: HM Treasury.

RECENT FISCAL TRENDS AND OUTLOOK

2.60 Budget 2008 presents the Government's annual fiscal forecast and updates the 2007 Pre-Budget Report interim projections.

Outturn for 2006-07 **2.61** The revised outturn for 2006-07 shows the deficit on the current budget to be £0.4 billion lower than in the 2007 Pre-Budget Report, and £5.2 billion lower compared with Budget 2007. With net investment lower by £0.5 billion, the outturn for net borrowing in 2006-07 is £1.0 billion lower than in the Pre-Budget Report. Net borrowing is £4.9 billion lower than the estimate in Budget 2007.

Estimate for 2007-08 **2.62** The Budget 2008 estimates of key fiscal aggregates are in line with the 2007 Pre-Budget Report projections:

- the estimated outturn for the public sector current budget is a deficit of £7.9 billion, in line with the projected deficit of £8.3 billion in the 2007 Pre-Budget Report. It is higher than the Budget 2007 projection of a £4.3 billion deficit, which was made prior to the onset of financial market disruption in July 2007;

- for public sector net borrowing the estimated 2007-08 outturn is £36.4 billion, slightly lower than the estimate of £38.0 billion projected in the 2007 Pre-Budget Report. Borrowing is slightly higher than the estimate of £33.7 billion projected in Budget 2007;
- public sector net investment in 2007-08 is lower, at £28.5 billion, than projections in the 2007 Pre-Budget Report and Budget 2007 of £29.7 billion and £29.4 billion respectively; and
- the estimated outturn for public sector net debt in 2007-08 is 37.1 per cent of GDP. This is ½ per cent of GDP lower than expected at the 2007 Pre-Budget Report, and just over 1 per cent of GDP lower than the Budget 2007 projection.

2.63 The cyclically-adjusted fiscal aggregates for 2007-08 are largely unchanged compared with the Pre-Budget Report estimates. Cyclically-adjusted net borrowing for 2007-08 is 2.7 per cent of GDP, compared with 2.8 per cent at the Pre-Budget Report. The cyclically-adjusted deficit on the current balance is the same, at 0.7 per cent of GDP, as at the Pre-Budget Report.

Non-discretionary changes in receipts from 2008–09 onwards

2.64 While the continued disruption in financial markets is expected to affect GDP growth in 2008 and 2009 somewhat more than was forecast in the Pre-Budget Report, financial market developments are expected to have a more significant impact on particular areas of receipts from 2008-09 onwards. For example, the slow down in house price inflation and the effective closure of the mortgage-backed securities market is expected to feed through to fewer property transactions and to reduce expected stamp duty land tax receipts. As equity prices in the audited assumption are around 14 per cent lower than at the time of the Pre-Budget Report, forecast stamp taxes on shares are reduced. Lower equity prices also impact on projected corporation tax, capital gains tax and inheritance tax receipts.

2.65 The forecast for VAT and excise duties has been revised down compared to the 2007 Pre-Budget Report, partly due to a change in the composition of spending towards zero-rated and lower rate goods, reflecting developments in food and energy inflation in 2008-09 and in line with the ongoing rebalancing of the UK economy away from domestic consumption. North Sea revenues are broadly in line with expectations, with higher oil prices offset by higher expenditure and lower production.

Non-discretionary changes in spending from 2008-09

2.66 Social security spending and interest payments on index-linked gilts will be affected by higher forecasts for inflation. Forecasts for social security benefits and tax credits are also affected by an increase in the expected number of births over the projection period.

Forecasting assumptions

2.67 The Budget 2008 fiscal projections are based on an assumption of growth in current spending of 1.8 per cent per year in real terms over 2011-12 and 2012-13. The assumption for capital spending keeps net investment at 2¼ per cent of GDP in 2011-12 and 2012-13. Taken together these prudent assumptions mean Total Managed Expenditure (TME) grows by 1.9 per cent per year over 2011-12 and 2012-13

Budget decisions

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

- the need to ensure that, over the economic cycle, the Government will continue to meet its strict fiscal rules;

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

Discretionary changes

2.69 Against this backdrop, the discretionary fiscal measures set out in Chapter 1 allow for a fiscal policy stance that protects economic stability in the short term, and takes action to maintain sound public finances in the medium term. Budget changes are fiscally neutral in 2008-09 and 2009-10. As the economy returns to trend, discretionary tightening reduces the deficit in later years of the projection period.

Medium-term fiscal projections

Estimates for 2008-09 onwards

2.70 Taking both non-discretionary factors and policy decisions together, the Budget 2008 estimates of key fiscal aggregates for 2008-09 onwards are as follows:

- with some receipts and areas of spending affected by the impact of the ongoing disruption in financial markets, the deficit on the current budget increases in 2008-09. Even with fiscal policy supporting the economy in the near term, the current budget moves into surplus in 2010-11. The surplus strengthens over the projection period, and returns to levels broadly in line with the 2007 Pre-Budget Report projections by 2012-13;
- similarly, net borrowing in 2007-08 is broadly in line with projections in the 2007 Pre-Budget Report, then rises in 2008-09. Net borrowing falls from 2008-09 year-on-year and by 2012-13 is, at £23 billion, also back in line with projections at the Pre-Budget Report; and
- net investment rises so that by 2010-11 it reaches £37 billion, more than accounting for borrowing (£32 billion).

2.71 The cyclically-adjusted current balance improves across the projection period, falling from a deficit of 1.6 per cent of GDP in 2004-05, and moving into surplus from 2009-10. Cyclically-adjusted net borrowing falls year-on-year from 2008-09.

2.72 Cyclical adjustment cannot take account of non-cyclical temporary shocks to the public finances, nor cyclical shocks with different impacts than those experienced across the 30 year period over which the cyclical adjustment factors are calculated. Therefore to the extent that cyclical adjustment is not taking account of the impact of financial market disruption, structural PSNB may be lower than these Budget projections suggest.

2.73 Table 2.4 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2007 and in the 2007 Pre-Budget Report. It includes the impact of all Budget decisions in accordance with the *Code for fiscal stability*. Further detail is provided in Chapter C of the Financial Statement and Budget Report.

Table 2.4: Fiscal balances compared with Budget 2007 and the 2007 Pre–Budget Report

	Outturn[1]	Estimate[2]	Projections				
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Surplus on current budget (£ billion)							
Budget 2007	**–9.5**	**–4.3**	**3**	**6**	**9**	**13**	
Effect of revisions and forecasting changes	4.7	–3.6	–6½	–4	–1½	–1	
Effect of discretionary changes	0.0	–0.4	–½	1	1½	1½	
2007 Pre–Budget Report	**–4.7**	**–8.3**	**–4**	**3**	**9**	**14**	**20**
Effect of revisions and forecasting changes[3]	0.5	0.4	–5½	–7½	–6½	–5	–3½
Effect of discretionary changes	0.0	0.0	0	1	2	2½	2½
Budget 2008	**–4.3**	**–7.9**	**–10**	**–4**	**4**	**11**	**18**
Net borrowing (£ billion)							
Budget 2007	**35.0**	**33.7**	**30**	**28**	**26**	**24**	
Changes to current budget	–4.7	4.0	7	2½	0	–1	
Changes to net investment	0.8	0.4	0	0	2	2	
2007 Pre–Budget Report	**31.0**	**38.0**	**36**	**31**	**28**	**25**	**23**
Changes to current budget	–0.5	–0.4	5½	7	5	2½	1
Changes to net investment	–0.5	–1.2	½	½	0	0	–1
Budget 2008	**30.1**	**36.4**	**43**	**38**	**32**	**27**	**23**
Cyclically–adjusted surplus on current budget (per cent of GDP)							
Budget 2007	–0.5	–0.3	0.2	0.4	0.6	0.8	
2007 Pre–Budget Report	–0.2	–0.7	–0.2	0.3	0.6	0.8	1.1
Budget 2008	**–0.3**	**–0.7**	**–0.5**	**0.1**	**0.5**	**0.8**	**1.0**
Cyclically–adjusted net borrowing (per cent of GDP)							
Budget 2007	2.5	2.4	2.0	1.8	1.6	1.4	
2007 Pre–Budget Report	2.2	2.8	2.4	1.9	1.7	1.5	1.3
Budget 2008	**2.2**	**2.7**	**2.7**	**2.2**	**1.8**	**1.5**	**1.2**
Net debt (per cent of GDP)							
Budget 2007	37.2	38.2	38.5	38.8	38.8	38.6	
2007 Pre–Budget Report	36.7	37.6	38.4	38.8	38.9	38.8	38.6
Budget 2008	**36.6**	**37.1**	**38.5**	**39.4**	**39.8**	**39.7**	**39.3**

Note: Totals may not sum due to rounding.
[1] The 2006–07 figures were estimates in Budget 2007.
[2] The 2007–08 figures were projections in Budget 2007.
[3] Including changes to forecasting assumptions on spending growth in 2011-12 and 2012-13

LONG-TERM FISCAL SUSTAINABILITY

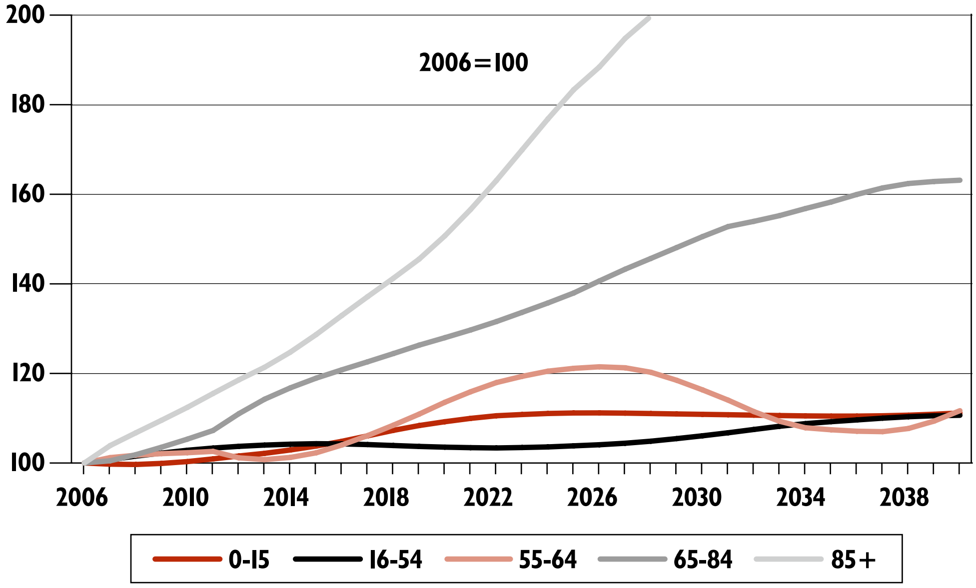
2.74 The primary objective of fiscal policy is to ensure sound public finances. The above analysis sets out how medium-term sustainability is protected by the golden rule and the sustainable investment rule. In addition, the Government must also ensure that policy decisions are fiscally sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with potential detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management set out in the *Code for fiscal stability*.

2.75 A comprehensive assessment of long-term fiscal sustainability is published alongside Budget 2008 in the 2008 *Long-term public finance report*.[6] The report makes an assessment of long-term fiscal sustainability in the light of the challenges arising from projected demographic change over the coming decades. The 2007 Comprehensive Spending Review and *The UK economy: analysis of long-term performance and strategic challenges*, published alongside the Budget, identify additional long-term socio-economic challenges that are likely to have profound effects both on Britain's society and economy over the next decade.[7] These trends are also likely to affect the public finances in the long term through their impacts on both public spending and revenues. This section summarizes the main analysis and conclusions presented in the 2008 *Long-term public finance report*, focusing on the next 30 years.

Latest UK population projections

2.76 The latest official UK population projections were produced by the ONS and published in October 2007. While highly uncertain, the new projections show the size of the UK's population increasing significantly from 60 million today to 67 million by 2020 and around 72 million by the mid 2030s. The population structure is also projected to change substantially, with the ageing of the UK population being one of the key socio-economic challenges that the UK, alongside other developed countries, will face over the coming decades. For example, the 85+ age group is projected to more than triple in size over the next 30 years, while the 0-15 years and 16-54 years age groups grow at a significantly lower rate. Chart 2.6 shows this wide variation between the projected changes in size of different age groups.

Chart 2.6: Population indices by age group



Source: ONS, 2006-based principal population projections.

Taking account of uncertainty

2.77 Any long-term projection is subject to a high degree of uncertainty and the ONS therefore produces a wide range of variants around the principal projections, using alternative fertility, life expectancy and migration assumptions. The variants differ markedly from the principal projections in terms of the projected size and structure of the UK population in the coming decades. To ensure a robust approach to assessing the long-term sustainability of the public finances, the 2008 *Long-term Public Finance Report* therefore includes sensitivity

[6] 2008 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, March 2008.

[7] *2007 Pre Budget Report and Comprehensive Spending Review*, HM Treasury, October 2007. *The UK economy: analysis of long-term performance and strategic challenges*, HM Treasury, March 2008.

analysis based on a selection of population variants. The different variants have different impacts on the long-term public finances and it is therefore important to monitor how the population develops and prepare for a wide range of potential outcomes.

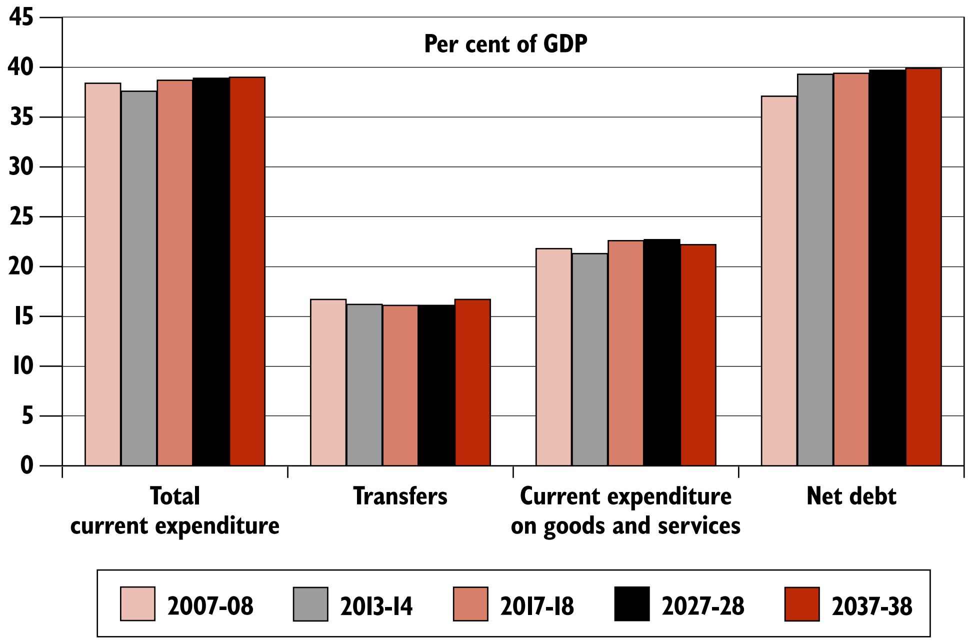
Assessment of fiscal sustainability

2.78 The Government's assessment of long-term fiscal sustainability, published in the 2008 *Long-term Public Finance Report,* is made using three complementary approaches.[8] One of these approaches imposes high-level constraints on the fiscal aggregates by assuming that the Government will meet its two fiscal rules. It then shows by how much current expenditure and net investment will be able to grow, given certain assumptions regarding government revenues, transfer payments and capital depreciation.

Illustrative projections

2.79 The results of this analysis are given by the illustrative fiscal projections in Chart 2.7, which shows first that current public consumption can grow at around the same annual rate as GDP after the medium term while meeting the Government's golden rule; second that public sector net investment can continue to grow at around its current rate, and more or less in line with projected economic growth, without jeopardising the sustainable investment rule; and third, the net debt to GDP ratio is projected to remain below 40 per cent by the end of the 30-year projection period.

Chart 2.7: Illustrative long-term fiscal projections



Source: HM Treasury.

2.80 As set out in the 2008 *Long-term Public Finance Report,* the illustrative long-term fiscal projections complement analysis of how demographic change could affect future spending and revenue, based on current policies and in the absence of any high-level fiscal constraints. These show that total spending, as a share of GDP, is projected to increase to around 43¼ per cent over the next three decades. Spending on health and state pensions are projected to increase the most as result of demographic change, while spending on education is

[8] The three modelling approaches used are historic indicators that illustrate the current position of the public finances, bottom-up projections based on the unconstrained evolution of spending and revenues and top-down projections of the public finances with constraints based on the Government's two fiscal rules. For further explanation of these different modelling approaches and detail on the assumptions on which they are based see the 2008 *Long-term public finance report: fiscal sustainability with an ageing population*, HM Treasury, March 2008, Chapter 3.

projected to increase as a result of demographic changes. The report also shows that revenue is projected to increase as a share of GDP, albeit at a lower rate. Sensitivity analysis based on different population variants illustrate that the different projected demographic structures will affect the rate at which both spending and revenue will change and therefore highlight the importance of monitoring population trends.

2.81 As is widely recognised, there will be a number of challenges arising from demographic change over the coming decades – such as the ageing of the population. While these developments will have profound socio-economic impacts, the analysis published in the 2008 *Long-term Public Finance Report* focuses on the effect that it could have on the public finances. A wide-ranging assessment of the current fiscal position as well as potential future pressures on the public finances shows that the UK is well placed to deal with the challenges arising from demographic change over the coming decades. The Government will continue to be in a position to meet its fiscal rules in the long term, ensuring that the long-term public finances remain sustainable. The UK will therefore be well placed to deal with the potential fiscal impacts arising from other long-term trends.