



HM TREASURY

# Convergence Programme for the United Kingdom:

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submitted in line with the Stability and  
Growth Pact

**January** 2010





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# 1

## Introduction

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**1.1** The Government has submitted programmes under the Stability and Growth Pact for each of the last eleven 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 121 and 126 of the EU Treaty (ex Articles 99 and 104).

**1.2** This regular annual Convergence Programme updates the UK's 2008 Convergence Programme, based on data and Government forecasts for the economy and the public finances that were published in the Pre-Budget Report on 9 December 2009.<sup>1</sup> 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 2009.<sup>2</sup> 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** As set out in Chapter 2, in 2008 the global economy entered the most severe and synchronised recession since the Great Depression. By the end of the year, both advanced and emerging market economies were contracting – in many cases at rates not seen in the post-war period. In the UK, output in 2009 fell more sharply than expected at the time of the *2008 Convergence Programme for the United Kingdom*. However, timely and effective action by governments around the world has helped to avoid a significantly worse outcome and there are tentative signs of recovery in the global and UK economies.

### Policy response

**1.4** 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.

**1.5** As set out in Chapter 3, responding to the exceptional risks that the financial crisis has posed to UK economic stability, the Government has taken action to deliver a coherent and comprehensive package of support to the economy, and businesses and individuals within it.

**1.6** A starting point of low public debt and the action that the Government is taking to ensure fiscal sustainability over the medium term, enables the Government to continue to provide support to the economy, where it is needed, through the downturn and in the early stages of recovery, in particular, policies to ensure well-functioning financial markets are crucial to the future of the economy. Bank Rate is at a historically low level of 0.5 per cent and is expected to continue to provide an ongoing and powerful stimulus throughout 2010.

**1.7** However, as the economy and financial markets recover after an exceptional period of risk and uncertainty, the role for macroeconomic policy will change. Based on its assessment of

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<sup>1</sup> *2009 Pre-Budget Report*, HM Treasury, December 2009.

<sup>2</sup> *Budget 2009*, HM Treasury, April 2009.

economic conditions and prospects, the Government's actions will move from supporting activity in the downturn to setting policy to provide the conditions for future growth.

## Fiscal policy

**1.8** Setting a credible consolidation path to ensure sustainable public finances is a key element of the Government's macroeconomic strategy, and is essential for economic stability and the long-term health of the economy. Chapter 4 sets out the Government's plans for fiscal consolidation.

**1.9** As confidence in recovery grows and financial sector conditions normalise, the economy's reliance on fiscal support will diminish. This will allow fiscal support to be withdrawn, gradually at first, so as not to harm recovery.

**1.10** Over the medium term, the Government's fiscal plans will reduce public sector net borrowing as a share of GDP to 5.5 per cent by 2013-14. They put the public finances on a path to ensure that public sector net debt is falling as a share of GDP by 2015-16. In total, measures announced since the 2008 Pre-Budget Report will reduce borrowing by £57 billion in 2013-14.

## The fiscal framework

**1.11** The Government's objectives for fiscal policy 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.

**1.12** Chapter 3 outlines The Fiscal Responsibility Bill, announced alongside the 2009 Pre-Budget Report, which will enshrine the Government's fiscal consolidation plans in legislation. The Bill requires the Government to set out at all times a statutory fiscal plan for delivering sound public finances, to be approved by Parliament, and places a binding duty on the Government to meet that plan.

**1.13** Furthermore, the Bill sets out the Government's first legislative fiscal plan, the Fiscal Consolidation Plan (FCP). The FCP extends from 2009-10 to 2015-16 and incorporates the 2009 Pre-Budget Report fiscal judgment by requiring that the Government:

- halves public sector net borrowing as a share of GDP over four years from its forecast peak in 2009-10. The Government is setting a target, in secondary legislation enabled by the Bill, for borrowing to be 5.5 per cent of GDP or less in 2013-14;
- reduce borrowing as a share of GDP in each and every year from 2009-10 to 2015-16; and
- ensure that public sector net debt is falling as a share of GDP in 2015-16.

**1.14** This is a significant reform in the way that the Government is held to account for delivering its fiscal plans, giving Parliament a clear, central role in both setting and monitoring the Government's fiscal plans. These are binding targets that cannot be changed except through new primary legislation. This demonstrates the Government's commitment to delivering consolidation, and the importance it places upon action to ensure sound public finances in the medium term.



## Outlook for the public finances

1.15 The financial crisis has had a profound and persistent impact on the public finances. Table 1.A provides a summary of the 2009 Pre-Budget Report projections for key fiscal aggregates, which are discussed more fully in Chapters 4 and 5.

**Table 1.A: Summary of fiscal projections**

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Public sector net borrowing (PSNB)	6.6	12.6	12.0	9.1	7.1	5.5	4.4
Total change since Budget 2009	0.4	0.2	0.1	0.0	-0.1	0.0	
Impact of discretionary measures on PSNB <sup>1</sup>	0.0	0.0	0.3	0.3	0.1	0.0	-0.2
Cyclically-adjusted PSNB	5.7	9.0	8.0	5.8	4.5	3.6	3.1
Surplus on current budget	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Public sector net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
Public sector net debt <sup>2</sup>	44.0	55.6	65.4	71.7	75.4	77.1	77.7
Treaty deficit <sup>3</sup>	6.9	12.6	12.0	9.1	7.3	5.7	4.6
Treaty debt ratio <sup>4</sup>	55.5	72.9	82.1	88.0	90.9	91.6	91.2

Note: All measures are presented on the basis which excludes the temporary effect of financial interventions.

<sup>1</sup> Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13, 2013-14 and 2014-15.

<sup>2</sup> Debt at end March; GDP centred on end March.

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

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

1.16 Public sector net borrowing is projected to fall in each year of the forecast period, from a peak of 12.6 per cent in 2009-10 to 4.4 per cent by 2014-15, as a result of economic recovery and the Government's action to ensure the sustainability of the public finances. Public sector net borrowing reaches 5.5 per cent of GDP in 2013-14, as forecast at the 2009 Budget, more than halving the 2009-10 level of the deficit over four years.

1.17 Public sector net debt, excluding the temporary effect of financial interventions, is projected to rise over the forecast period to 77.7 per cent of GDP by 2014-15. The plans set out in the 2009 Pre-Budget Report are consistent with net debt falling as a share of GDP in 2015-16.

## Sustainability of public finances

1.18 The analysis in Chapters 3, 4 and 5 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 6 discusses the challenges that are likely to be particularly important to the UK's long-term economic and fiscal performance.

## Quality of public finances

1.19 Since 1997, record levels of investment matched by reform enabled the Government to achieve lasting improvements in Britain's public services. The 2009 Pre-Budget Report announced new efficiencies and reforms across the public sector. More details are contained within Chapter 7.

## Stability and Growth Pact

1.20 EU leaders have agreed that the flexibility provided for in the Stability and Growth Pact should be used, and that fiscal consolidation should be undertaken in line with economic recovery. Under the excessive deficit procedure of the Stability and Growth Pact, to which 20 EU member states are now subject, the EU's Economic and Financial Affairs Council has recommended that the UK brings its Treaty deficit below the 3 per cent reference value by 2014-15, with an average annual fiscal effort of 1.75 per cent of GDP from 2010-11.

**1.21** As shown in Table 1.A, the Treaty deficit is projected to be 4.6 per cent of GDP in 2014-15. Given its assessment of the economic and fiscal outlook, the Government's fiscal judgement is based on moving from supporting activity in the recession to delivering a sustained fiscal consolidation. This will ensure sound public finances, creating space for continued support to the economy during the early stages of recovery.

**1.22** The pace of consolidation recognises the uncertainty around prospects for the public finances given the exceptional nature and strength of the global downturn, the need to support the economy through the early stages of recovery and the need to deliver sustainable public finances.

**1.23** The focus of the Government's fiscal policy shifts toward consolidation in 2011-12, when the economy should be better placed to support a more rapid tightening because:

- GDP growth is forecast to pick up to an above trend rate of 3½ per cent in 2011;
- market expectations are for Bank Rate to remain at 0.5 per cent until the second-half of 2010, then to rise moderately, while remaining below 4 per cent by the end of 2012. While still at relatively low levels by historical standards, this implies that there would be greater space for the MPC to use interest rates to support demand by 2011-12; and
- as financial market conditions improve and the monetary policy transmission mechanism becomes more effective, the low Bank Rate expected by the market will provide an ongoing and powerful stimulus to spending by businesses and individuals and reduce the economy's reliance on fiscal support.

**1.24** The Government has set out fiscal consolidation plans that are consistent with debt returning to lower levels. These plans will ensure the public finances are on a sustainable path, which in turn will promote long-term economic growth. It will also ensure the public finances are able to manage any unexpected economic shocks in future.

## **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 2009 UK National Reform Programme.<sup>3</sup> The main reform actions are summarised in Annex C, taken from the 2009 National Reform Programme and updated to take into account the announcements made in the 2009 Pre-Budget Report.

## **Annex A and Annex B**

**1.26** Annex A provides details of the financial impact of the 2009 Pre-Budget Report and Budget 2009 policy decisions. Annex B provides supplementary information.

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<sup>3</sup> [http://www.hm-treasury.gov.uk/int\\_lisbonstrategy\\_jobs.htm](http://www.hm-treasury.gov.uk/int_lisbonstrategy_jobs.htm)

# 2

## Economic outlook

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2.1 All data included in this chapter are correct at the time of the 2009 Pre-Budget Report.

### Global economic shocks

2.2 In 2008 the global economy entered the most severe and synchronised recession since the Great Depression in the 1930s. By the end of the year, output and trade in both advanced and emerging market economies were contracting – in many cases at rates not seen in the post-war period. The high degree of synchronisation in the downturn reflects a global economy that has become more interconnected over the past two decades, with the process of globalization leading to a significant increase in the importance of financial and trade linkages between countries.

### The world economy

2.3 There are now emerging signs of recovery in the world economy. Confidence has increased and demand for consumer durables has stabilised. Manufacturing new orders have started to increase again in many countries although they remain at very low levels. Industrial production has picked up by more than 5 per cent from its trough in March and world trade volumes recovered in the second half of 2009.

2.4 Global financial conditions have improved markedly alongside the better outlook for the world economy. Global stock markets have risen by around 30 per cent since Budget 2009, helping to reinforce business confidence, while spreads on corporate debt in advanced countries have narrowed. Access to funding markets has also improved; in the US, average monthly corporate debt issuance in the last three months has more than doubled compared with the end of 2008. In emerging markets the third quarter of 2009 saw the second largest level of bond issuance on record and, despite recent events related to Dubai World, conditions remain much better.

2.5 Notwithstanding this improvement in financial conditions, bank lending to the private sector has remained weak in the advanced economies, reflecting both supply and demand. The Senior Loan Officers' Survey in the US and the euro area show that banks' willingness to lend is only gradually improving from low levels. The demand for new loans from businesses and households in both the US and euro area remains weak.

2.6 The turnaround in the world economy has raised commodity prices. Following increased volatility in 2008, oil prices fell to around \$46 a barrel at the start of 2009, but have since risen to around \$75-80 a barrel. Increases have not been confined to oil – food and metal prices have also risen significantly in response to increased demand from Asia, and in particular China.

2.7 Labour markets have deteriorated across advanced economies and in a number of the smaller emerging market economies. However, the depth of the deterioration has differed significantly. In the US, the unemployment rate has more than doubled during the crisis to 10 per cent, while in the EU and Japan, the unemployment rate has risen by only 2.5 and 1.3 percentage points respectively since the start of 2008. Aside from differences in labour market

structure, some of the differences in experience can be explained by the introduction of employment subsidies in countries such as Germany and Japan.

**Table 2.A: The world economy**

	Percentage change on a year earlier, unless otherwise stated				
	2008	2009	Forecast		
			2010	2011	2012
World GDP at purchasing power parity	3¼	-1	3¼	4¼	4¼
<i>Major 7 countries<sup>1</sup>:</i>					
Real GDP	¼	-3½	1¾	3	3¼
Consumer price inflation <sup>2</sup>	1¾	¼	1¼	1½	1¾
Euro area GDP	½	-4	1¼	2¼	2½
World trade in goods and services	3	-12¼	2½	5½	7¼
UK export markets <sup>3</sup>	2¼	-11¼	2½	4	6¼

<sup>1</sup> G7: US, Japan, Germany, UK, France, Italy and Canada.

<sup>2</sup> Per cent, Q4.

<sup>3</sup> Other countries' imports of goods and services weighted according to the importance of imports from the UK in those countries' total imports.

**2.8** Given the opposing factors of a severe global downturn and an unprecedented international policy response, prospects for the world economy remain uncertain. Although by less than at Budget 2009, the world economy is still forecast to contract by 1 per cent in 2009. The contraction has been most severe among the advanced economies and although the second half of 2009 is likely to see an improvement, G7 GDP is forecast to contract by 3½ per cent in 2009. As the policy stimuli announced earlier this year by advanced and emerging market economies feeds through fully, the world economy is forecast to grow by 3¼ per cent in 2010, before rising to 4¼ per cent in 2011 and 2012.

**2.9** The outlook for inflation among the G7 economies remains weak. Large output gaps in several economies are expected to weigh down on inflation, despite the forecast recovery in demand in 2010. Inflation in the G7 is forecast to slow to ¼ per cent in 2009 before rising to 1½ per cent in 2011.

## Prospects for UK economic growth

### Recent developments

**2.10** Along with other leading economies, the UK entered recession in the first half of 2008. The intensification of the global financial crisis following the collapse of Lehman Brothers in September 2008 led to a collapse in confidence and a further reduction in the availability of credit. As a result, output fell sharply in the final quarter of 2008 and following data revisions by the Office of National Statistics, the fall in output was greater than anticipated at Budget 2009.

**2.11** The deterioration in global economic demand at the end of 2008 triggered an involuntary build up in stocks, which firms unwound rapidly towards the end of the year, depressing growth. As confidence declined, output contracted by 2.5 per cent over the first quarter of 2009, the largest quarterly fall in over forty years.

**2.12** Since then, the pace of decline has eased, in line with the Budget 2009 forecast, as the substantial macroeconomic stimulus in place has increasingly taken hold.

**2.13** A broad range of economic data suggests activity has stabilised in recent months. Business optimism indicators have picked up, the level of employment rose in the third quarter of 2009 and house price indicators have consistently shown monthly gains. Surveys of purchasing managers compiled by the Chartered Institute of Purchasing and Supply (PMI) have also picked up in recent months, indicative of output recovery.

**2.14** Consumer price inflation has fallen back from its peak of 5.2 per cent in September 2008, as forecast at Budget 2009. However, the decline in inflation has been less than expected due to higher oil prices and greater than expected pass-through from sterling's depreciation to goods with a high import content. CPI inflation rose to 1.5 per cent in October.

**2.15** Substantial monetary policy support is in place. Market expectations are for Bank Rate to remain at the historically low, expansionary rate of 0.5 per cent until the second half of 2010 and the MPC is expected to complete its £200 billion programme of asset purchases by the end of January 2010. As a result, monetary policy is expected to continue to provide an on-going and powerful stimulus to spending by businesses and individuals throughout 2010, as the lagged effects of policy action feed through and improving financial conditions strengthen the monetary policy transmission mechanism. Improved transmission should, all else equal, mean that more loans are available and mortgage holders and borrowers will face lower effective interest rates. This should allow monetary policy to continue to support the economy as fiscal policy moves to consolidation.

**2.16** While the lower Bank Rate has reduced the absolute price of bank loans faced by households and companies, the spread between rates for new lending to households and small and medium sized companies over policy rates has widened and the availability of credit remains restricted. However, the latest Bank of England *Credit Conditions Survey* suggests some increase in credit availability to corporates is expected over the next three months.

## Trend growth

**2.17** As set out in the 2008 Pre-Budget Report and Budget 2009, the global financial shock has significantly increased the uncertainties surrounding the prospects for trend output. In principle, the shock could affect trend output in a number of ways. For example, a higher cost of credit may impact on the trend level of output by reducing the sustainable level of capital, while the reduction in the supply of credit more generally may impair the role of the financial sector in efficiently allocating resources and spreading risk.

**2.18** In light of a potentially weaker outlook for net migration, Budget 2009 also assumed a downward adjustment to the population component of trend output of around ½ per cent between mid-2007 and mid-2010, bringing the net migration assumption for these years into line with the assumptions underpinning the ONS' 2006-based low migration variant.

**2.19** Official and administrative migration data released since Budget 2009 support the possibility of a slowdown in net migration inflows. ONS estimates indicate that net migration into the UK fell by 70,000 to 163,000 in 2008, broadly in line with the level of net migration implied by the adjusted trend population assumptions. National Insurance numbers allocated to non-UK nationals and the number of approved applications to the Worker Registration Scheme have also fallen back sharply. The ONS' latest 2008-based population projections, published on 21 October, assume slightly weaker net migration than the previous 2006-based projections. However, the ONS' principal projection for net migration remains slightly stronger than that implied by the Treasury's trend population projection.

**2.20** Table 2.B sets out the 2009 Pre-Budget Report assumptions for trend output. Consistent with Budget 2009, the 2009 Pre-Budget Report assumes a phased reduction to the level of trend output of around 5 per cent between mid-2007 and mid-2010. Beyond mid-2010 the growth rate of trend output is assumed to return to 2¾ per cent, in line with the rate observed

over the half-cycle between 2001Q3 and 2006H2. The downward adjustment to trend output of around 5 per cent is broadly in line with recent external estimates, as well as analysis of the impact of previous financial crises (see Box 2.A). Nevertheless, the size and timing of the adjustment to trend output remain subject to significant uncertainty.

**Table 2.B: Contributions to trend output growth<sup>1,2</sup>**

	Estimated trend rates of growth, per cent per annum, unless otherwise stated					
	Trend output per hour worked <sup>3,4</sup>		Trend average hours worked <sup>4</sup>	Trend employment rate <sup>4</sup>	Population <sup>5</sup>	Trend output
	Underlying (1)	Unadjusted (2)	(3)	(4)	(5)	(6)
<b>1986Q2 to 1997H1</b>						
Budget 2009	2.13	1.95	-0.11	0.36	0.26	<b>2.47</b>
Latest data	2.13	1.95	-0.11	0.36	0.26	<b>2.47</b>
<b>Over the recent past</b>						
<b>1997H1 to 2001Q3</b>						
Budget 2009	3.12	2.87	-0.46	0.50	0.52	<b>3.45</b>
Latest data	3.12	2.88	-0.46	0.50	0.52	<b>3.45</b>
<b>2001Q3 to 2006H2</b>						
Budget 2009	2.12	2.07	-0.26	0.11	0.75	<b>2.68</b>
Latest data	2.23	2.18	-0.26	0.11	0.75	<b>2.80</b>
<b>Projection<sup>6</sup></b>						
<b>2006H2 onwards</b>						
Budget 2009	2.25	2.3	-0.25	-0.10	0.80	<b>2¾</b>
Level effect from 2007Q3 to 2010Q3 <sup>7</sup>	-4½	-4½	0	0	-½	<b>-5</b>
PBR 2009 <sup>8,9</sup>	2.23	2.3	-0.20	-0.15	0.80	<b>2¾</b>
Level effect from 2007Q3 to 2010Q3 <sup>7,8</sup>	-4½	-4½	0	0	-½	<b>-5</b>

<sup>1</sup> 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 going forward.

Full data definitions and sources are set out in Annex A of 'Trend growth: new evidence and prospects', HM Treasury, December 2006.

<sup>2</sup> Interim projections between Budget 2002 and the 2008 Pre-Budget Report are set out in 'Budget 2008: the economy and public finances - supplementary material' and the 2008 Pre-Budget Report.

<sup>3</sup> 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 figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.

<sup>4</sup> 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 that can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that average hours worked lag output by just one quarter, though this lag is harder to support by econometric evidence.

<sup>5</sup> UK resident household basis (LFS). Population aged 16 and over.

<sup>6</sup> Neutral case assumptions for trend from 2006H2.

<sup>7</sup> Adjustment reflecting a phased reduction to the level of trend output of around 5 per cent between mid-2007 and mid-2010.

<sup>8</sup> Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006H2 are anchored.

<sup>9</sup> Within the trend growth projection, small offsetting adjustments have been made to the projections of the individual components of trend growth for the 2009 Pre-Budget Report. In particular, the assumed decline in trend average hours has been adjusted up marginally from -0.25 per cent to -0.2 per cent in light of evidence pointing to a slowing in the pace of reduction in average hours prior to the downturn. An offsetting downward adjustment has been made to the trend employment rate projection from -0.1 per cent to -0.15 per cent per annum.

### Box 2.A: Impact of the financial crisis on trend output

Consistent with Budget 2009, the 2009 Pre-Budget Report assumed a downward adjustment to the economy's trend level of output in light of the global financial shock. For the 2009 Pre-Budget Report, the level of trend output is gradually adjusted from the middle of 2007 so that it is around 5 per cent lower from the middle of 2010 than the level implied by the Budget 2008 assumption.

This adjustment is comparable to the range of recent external estimates. In their latest Economic Review, NIESR<sup>1</sup> present estimates of the impact of the financial crisis on the UK's sustainable level of output of 3 to 5 per cent, while scenarios published by the European Commission point to an impact on EU potential output of up to 4½ per cent.<sup>2</sup> Similarly, the OECD's latest Economic Outlook assumes an average trend output adjustment of 3½ per cent across the OECD.<sup>3</sup> The 2009 Pre-Budget Report trend output adjustment is also broadly in line with the average output loss from previous financial crises reported in recent analysis by the IMF, based on the application of the IMF's methodology to UK data.<sup>4</sup> It is also consistent with a number of previous episodes, including the period following the 'Nordic' financial crises in the early 1990s, with a downward adjustment to the level of trend output before reverting to the economies' pre-crisis trend growth rates (see Box A.3 of the 2009 Pre-Budget report for more detail).

## Output gap

**2.21** The output gap is the difference between actual output and the assumed trend end level of output in the economy. Taken together with the 2009 Pre-Budget Report trend output assumptions, the latest National Accounts data imply a significant negative output gap opened up in 2009, reaching over –6 per cent in the third quarter of 2009.

**2.22** Evidence from the cyclical indicators monitored by the Treasury suggests the economy fell below trend during the second half of 2008. Survey evidence also suggests the degree of spare capacity subsequently increased markedly towards the end of 2008 and the beginning of 2009. However, there is uncertainty about the current estimate of the output gap. Some survey indicators suggest a moderation in the degree of spare capacity over the third quarter of 2009. The differences in the degree of slack implied by these alternative approaches reflect the significant uncertainties over the size of the total impact of the financial crisis on trend output; and measurement issues associated with survey indicators and National Accounts data.

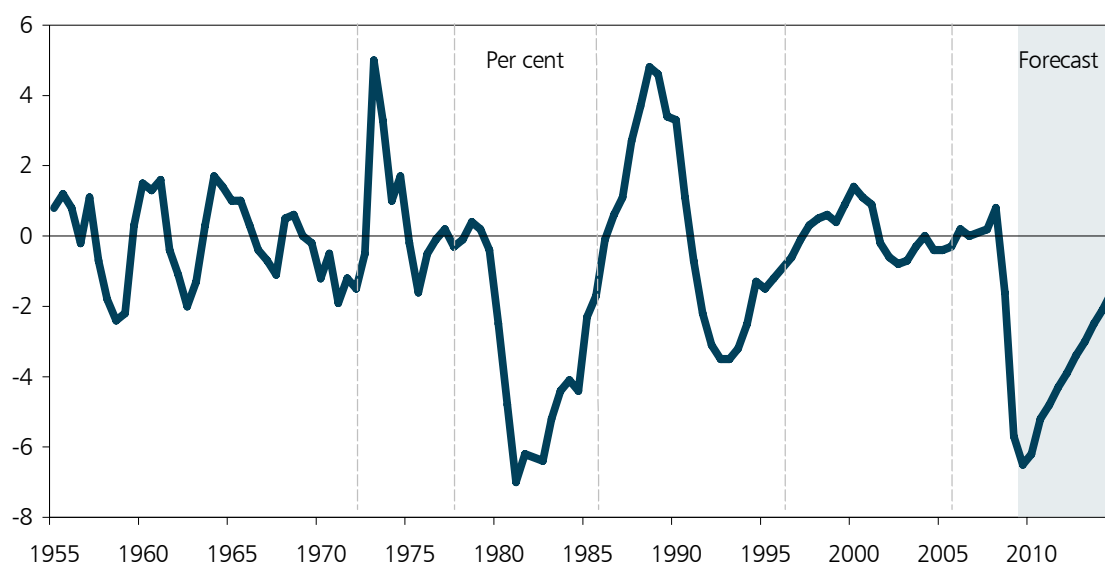
<sup>1</sup> *Long-term scarring from the financial crisis*, Barrell, R. in NIESR Economic Review, Vol.210, October 2009

<sup>2</sup> *Impact of the current economic and financial crisis on potential output*, European Commission, European Economy Occasional Paper No.49, June 2009.

<sup>3</sup> *OECD Economic Outlook No. 86 (Preliminary edition)*, OECD, November 2009.

<sup>4</sup> *World Economic Outlook October 2009: Sustaining the Recovery*, IMF, October 2009.

**Chart 2.A: The Output Gap<sup>1,2</sup>**



<sup>1</sup> Mechanical output gap estimates on a semi-annual basis, based on the latest National Accounts data and expressed as actual output less trend output as a percent of trend output (non-oil basis). Estimates post-1972 based on Treasury's assessment of on-trend points using a broad range of economic indicators as set out in 'Evidence on the economic cycle', published alongside the 2008 Pre-Budget Report. Estimates prior to 1972 derived using a Hodrick-Prescott filter as sufficient data from the cyclical indicators monitored by the Treasury are not available to assess on-trend points for this period.

<sup>2</sup> Vertical lines indicate start and end-cycle points as identified by HM Treasury.

Source: HM Treasury.

## GDP growth forecast

**2.23** The rate of decline in GDP slowed in the second and third quarters of 2009, in line with the Budget 2009 forecast, but the contraction of 2.5 per cent in the first quarter was much larger than expected. The 2009 Pre-Budget Report economic forecast is for GDP to contract by 4¾ per cent over the year in 2009, larger than the 3½ per cent forecast at Budget 2009. However, given signs of stabilisation in recent economic data, growth is expected to return by the end of the year.

**2.24** GDP growth is forecast to pick up through 2010 and 2011, as credit conditions continue to ease and the continuing and lagged effects of the significant monetary policy support and the depreciation of sterling take hold.

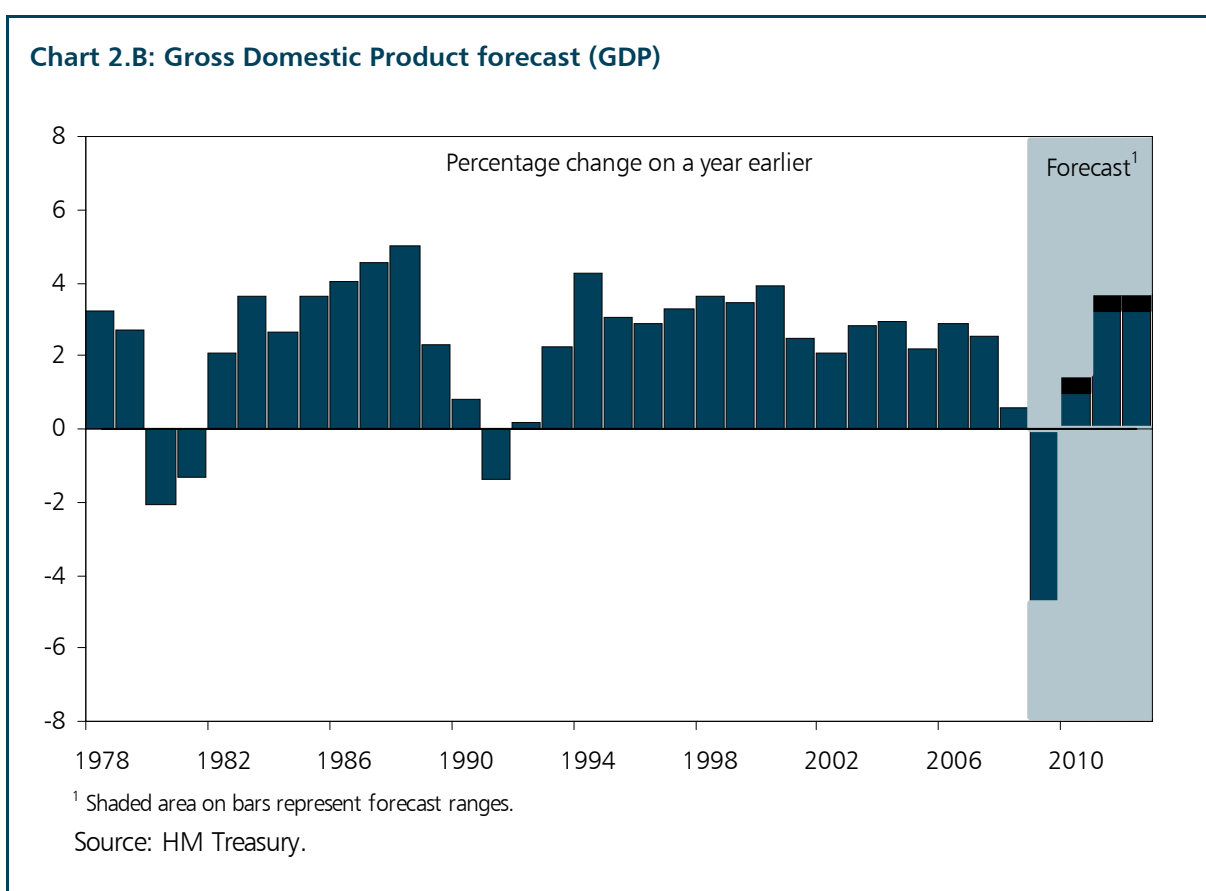


**Table 2.C: Summary of forecast**

	Forecast				
	2008	2009	2010	2011	2012
<b>GDP growth (per cent)<sup>1</sup></b>					
Upper end of forecast range			1½	3¼	3¼
<b>Economic forecast</b>	½	-4¼	1¼	3½	3½
Forecast underpinning public finance projections			1	3¼	3¼
<b>CPI inflation (per cent, Q4)</b>	<b>4</b>	<b>2</b>	<b>1¼</b>	<b>1½</b>	<b>2</b>

<sup>1</sup> See footnote to Table A9 for explanation of different growth assumptions.

**2.25** As discussed at Budget 2009, it is usual for GDP growth to pick up in a recovery as spare capacity is brought back into productive use. For example, as Chart 2.B shows, GDP growth was strong in the five years from 1982 and again in the five years from 1993, averaging 3¼ per cent a year. Indeed, the rate at which the output gap is assumed to close over the projection period is comparable to the rate observed following the recession of the early 1990s, and slightly slower than the rate observed following the recession of the early 1980s.



## Inflation

**2.26** CPI inflation is expected to continue to rise in the near term, as the pre-announced reversal of the cut in the VAT rate back to 17.5 per cent in January 2010 will be anticipated by businesses, and fuel prices are expected to remain above the lows of early 2009. The forecast assumes that businesses will smooth the pass-through of the reversal of the VAT rate cut, with inflation peaking in early 2010.

**2.27** After these temporary upward pressures have passed, inflation is forecast to fall through 2010 and in 2011, moving well below target, as the large negative output gap exerts downward pressure on prices. Reflecting this large degree of spare capacity, subdued earnings growth is also expected to exert downward pressure on inflation. As the economy recovers, with

the economy growing at above-trend rates, increases in capacity utilization will place upward pressure on inflation with CPI inflation rising back to target by the end of 2012.

## Labour market

**2.28** Demand for labour weakened through the second half of 2008 and into 2009, as firms sought to cut costs. Flexibility within the labour market, coupled with measures to support firms' cash flow, may have limited job losses through the recession (the relative performance of the UK labour market in this recession is discussed in more detail in Box A.4 of the 2009 Pre-Budget Report). However, as output fell sharply in early 2009, redundancies rose to around 300,000 per quarter, employment fell back and the ILO unemployment rate increased to 7.8 per cent. More recently, increases in ILO unemployment have eased substantially: in the third quarter of 2009, ILO unemployment rose by 30,000 – well below the rise seen during the first half of the year – to just under 2.5 million. Similarly, following the record monthly increase seen in February 2009, increases in the claimant count have moderated, averaging less than 19,000 per month in the three months to October, when the number of unemployed claimants rose to 1.64 million.

**2.29** Average earnings growth has slowed markedly over the past year and pay settlements have eased. Private sector earnings growth on a year earlier (excluding bonus payments) has fallen from around 3¾ per cent in mid-2008 to 1½ per cent in the three months to September 2009 – the lowest rate on record. Initially the slowdown was driven by weaker pay drift, but through 2009 around one-third of pay settlements have been at zero, weighing down on nominal earnings growth.

**2.30** Although firms are no longer laying employees off in substantial numbers, vacancies have not increased from the lows recorded in recent months. Moreover, firms continue to expand part-time employment rather than full-time contracts. Private business surveys of employment intentions – such as those produced by Manpower and the British Chambers of Commerce – suggest that employers are likely to remain tentative in the near term.

**2.31** The claimant count is forecast to continue to rise, peaking at about 1¾ million around the middle of 2010 with the lag between output and employment much shorter than before. As the economic recovery takes hold, employment is forecast to rise and unemployment to fall. While a recession can put upward pressure on the structural rate of unemployment, evidence from the OECD<sup>1</sup> indicates that this is less likely to persist in countries with flexible product and labour markets such as the UK. The investment in employment support since 1997, coupled with additional funding put in place through the current downturn, has maintained off-flow rates from the claimant count above those seen in the previous recession. Taking all these factors into account, the claimant count is projected to fall back to around 1½ million by the end of 2012.

## Consumption

**2.32** Consumer spending growth fell from 2.1 per cent in 2007 to 1 per cent in 2008, with consumption falling sharply towards the end of 2008. Household consumption fell by almost 2½ per cent in the first half of 2009, as discretionary expenditure declined. The consumption of durable goods recovered in the second quarter after falling slightly at the beginning of 2009. Sales may have been supported, to an increasing degree, by the reduction in the standard rate of VAT and by the Government's car scrappage scheme. Retail sales, which make up around a third of total consumption, have been resilient and grew 3.4 per cent in volume terms in the year to October.

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<sup>1</sup> OECD *Economic Outlook No.86*, OECD, November 2009.

**2.33** Household consumption stabilised in the third quarter of 2009 and, following recoveries in consumer confidence and household expectations of future income, this stabilisation is likely to be sustained.

**2.34** Consumption is forecast to contract over 2009 as a whole. However, it is assumed that households will bring forward some consumption from 2010 to 2009 as a result of the lower relative prices associated with the reversion of the temporary cut in the standard rate of VAT. Consumer spending then strengthens later in 2010 as credit conditions ease and lower effective interest rates support household spending. Consumer spending is then forecast to grow at a rate closer to that of overall GDP and greater than that of real household disposable income in 2011 and 2012. As a result the saving ratio is forecast to fall back to under 7 per cent by 2012.

## **Companies and investment**

**2.35** Companies finance investment internally, using the cash flow generated by their operations, or externally, either through bank lending or by issuing equity or debt to investors. In aggregate, firms' gross operating surplus has declined during the recession following falls in demand, although it continues to exceed the level of investment, and, in aggregate, firms' financial balances continue to be far stronger than in the early 1990s recession. In recent months, net funds raised by UK companies have been very volatile, although several general trends have emerged. In line with previous recessions, net lending growth to private non-financial companies has fallen and in recent quarters the net flow of lending has turned negative. The observed weakness in lending to companies partly reflects weaker demand for bank lending by UK companies as investment intentions have been scaled down in the face of uncertain demand.

**2.36** Credit availability also remains a factor, as seen in recent surveys from the CBI. The Bank of England Agents' summary in November also reported that while some firms felt that the availability of credit had eased, there was a perception by some – particularly amongst smaller firms and those linked to the construction and property sectors – that credit was hard to access at any price.

**2.37** Net debt and equity issuance rose significantly in the first half of 2009 compared with the year before. The move away from bank lending towards capital market finance can be explained in part by the constrained availability of bank credit and tighter lending conditions to companies, as discussed above. Survey evidence from the Bank of England's Regional Agents Survey and the most recent Deloitte survey of Chief Finance Officers also suggested it may reflect a desire to restructure balance sheets rather than to finance investment as companies have used the proceeds from capital issuance to pay down existing bank debt.

**2.38** Business investment has fallen very sharply since the start of the recession. As uncertainty over the global economic outlook increased and confidence collapsed, business investment fell by 10¼ per cent in the second quarter of 2009, taking the annual rate of decline to a record low of 21¾ per cent. The pace of contraction slowed markedly in the third quarter of this year. This is consistent with the latest evidence from private business surveys that suggest stabilisation in the near term.

**2.39** Reflecting the sharp fall in investment at the start of the year, business investment is forecast to contract by 18 per cent in 2009. Falls in business investment are likely to moderate going forward, aided by government measures to support investment such as the temporary enhanced first-year capital allowance introduced in Budget 2009. Investment is forecast to stabilise in 2010 as credit conditions ease and uncertainty over demand continues to subside. As the outlook for demand improves, investment growth is forecast to pick up strongly, to 10 per cent in 2011 and 12 per cent in 2012, as firms take up new opportunities in the rebalancing economy.

## Trade and the balance of payments

**2.40** UK export volumes were severely affected by the sharp contraction in global export demand. As global demand for UK goods and financial services continued to decline, the volume of UK exports fell by 7 per cent in the first quarter of 2009, the largest quarterly contraction on record. Consistent with the crisis in world financial activity, over two thirds of the fall in nominal exports of services in the first half of 2009 was due to declining exports from the financial services sector.

**2.41** The pace of decline in export volumes started to ease in the second quarter of this year as the global economy stabilised. Growth in goods export volumes returned in the third quarter, bolstered by a pick up in demand in some of the UK's largest export destinations, such as the US and euro area, which together constitute about two thirds of the UK's export markets.

**2.42** Export volume growth is forecast to pick up progressively through the forecast horizon as the US and economies in the EU strengthen and world trade demand recovers. As the full impact of sterling's depreciation takes effect and UK businesses take advantage of new export opportunities and a strengthening recovery in world trade, export growth is expected to rise into 2011 and 2012.

**2.43** Import volumes declined by 0.8 per cent over the year as a whole in 2008. As with exports, the pace of quarterly decline in import volumes increased further in the first quarter of 2009, in part due to a large contraction in inventories and investment demand. The rate of decline then eased and in the third quarter of 2009 import volumes rose by 1.3 per cent.

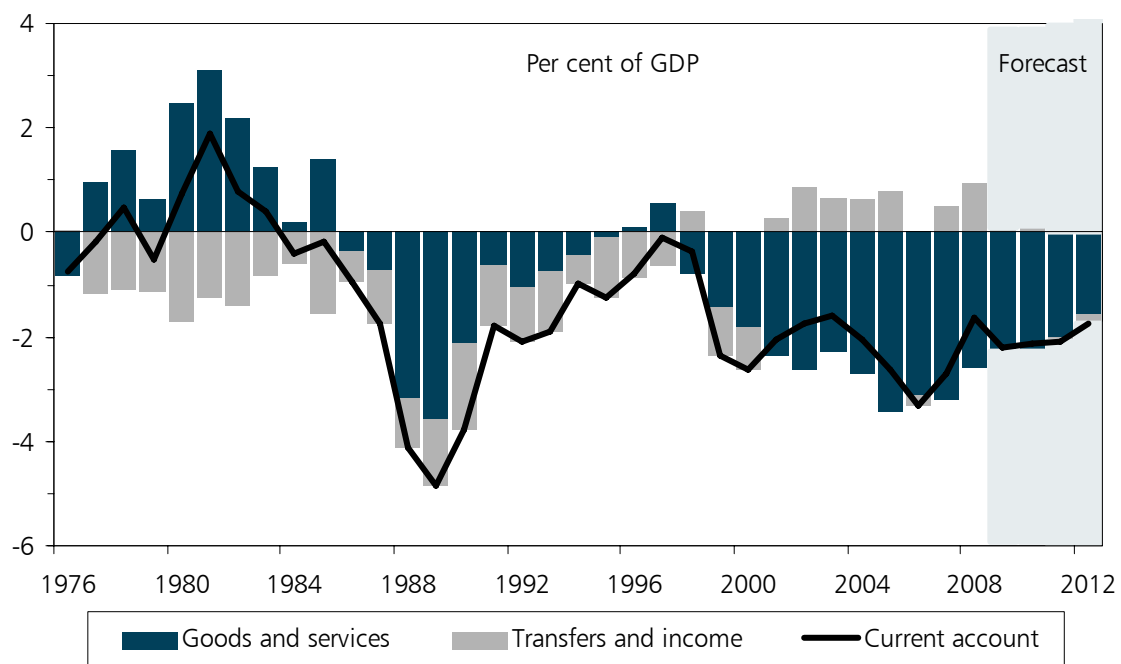
**2.44** Import volumes are expected to remain relatively subdued into 2010, as higher import prices encourage UK consumers to switch to domestically produced goods and services. As UK demand and investment in particular recover, growth in import volumes is forecast to rise from 2011.

**2.45** Having subtracted from growth in 2007, net trade contributed positively in 2008 and in the first two quarters of 2009, reflecting greater falls in imports relative to export volumes. In the third quarter, the nominal net exports deficit declined, but in real terms it rose as relatively weaker export volumes were outweighed by imports, so that net trade subtracted from the quarterly change in output.

**2.46** Net trade is forecast to continue contributing to growth throughout the forecast horizon, as the depreciation of sterling and recovery in the global economy support the rebalancing of UK domestic and external demand. In line with the Budget forecast, the contribution to GDP growth from net trade is forecast to be  $\frac{1}{2}$  per cent in each year from 2010 to 2012, in contrast to the negative contribution on average from 2000 to 2007.

**2.47** In 2008, the UK current account deficit narrowed for the second consecutive year, from  $2\frac{3}{4}$  per cent of GDP in 2007 to  $1\frac{3}{4}$  per cent. More recently, the overall balance has been volatile, demonstrating the considerable uncertainty in the underlying trend due to flows related to the financial services sector. The current account deficit is forecast to narrow gradually from  $2\frac{1}{4}$  per cent in 2009 to  $1\frac{3}{4}$  per cent of GDP in 2012.

**Chart 2.C: Balance of payments current account**



Source: HM Treasury

## Independent forecasters

**2.48** Since Budget 2009, the average of independent forecasts for GDP growth in 2009 has been revised down by over a percentage point, from -3.4 per cent to -4.5 per cent. This largely reflects much weaker than expected growth in the first quarter of the year. Prior to the first estimate, the consensus forecast for growth in the quarter, as polled by Bloomberg, was -1.5 per cent; the latest estimate points to a fall of 2.5 per cent.<sup>1</sup> On the other hand, revisions to 2010 growth have tended to be positive.

**2.49** The average of independent forecasts for growth in 2010, at 1.3 per cent, is in line with the Pre-Budget Report forecast. This represents a 1 percentage point increase in the average since Budget. In terms of components, private consumption has moved from -0.4 per cent at Budget 2009 to 0.2 per cent in December, also within the 2009 Pre-Budget Report forecast range.

**2.50** However, there is less consensus on the expected strength of the medium-term recovery and the composition of demand. The average of independent forecasts for growth in 2011 and 2012 within November's *Forecasts for the UK economy*,<sup>2</sup> stood at 2 per cent and 2.3 per cent respectively, with the forecast range in 2011 at 0.9-3.5 per cent. The National Institute of Economic and Social Research's (NIESR) autumn Economic Review forecast growth in 2011 of 1.5 per cent, within which private consumption contracted slightly, and net trade contributed +1.4 per cent to growth. The latest Goldman Sachs forecast also assumes a significant boost from net trade in 2011, at around 0.8 per cent, and growth for the year of 3.4 per cent.

**2.51** Inflation has been higher than market expectations in four out of the past seven months, and forecasts for CPI inflation in the final quarter of 2009 have been revised up by 1.1

<sup>1</sup> Latest forecast as of 9<sup>th</sup> December 2009.

<sup>2</sup> [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

percentage points since Budget to 1.8 per cent. This is in line with changes to the inflation forecast: the Pre-Budget Report CPI inflation forecast for the final quarter of 2009 is 1 percentage point higher than the Budget forecast. The average of independent forecasts is for CPI inflation to be at 1.8 per cent in the final quarter 2010. The broad range of forecasts for 2010, spanning 2.6 percentage points, illustrates the uncertainty surrounding current forecasts.

## Summary of forecast issues and risks

**2.52** Given the severity of the recent financial crisis and the depth of the resultant recession, the 2009 Pre-Budget Report economic forecast is subject to significant uncertainty and a number of key risks that are discussed in this section.

### Actual and trend output

**2.53** As in Budget 2009, the forecast assumes a phased reduction to the level of trend output of around 5 per cent between mid-2007 and mid-2010. This judgement is subject to significant uncertainty that is unlikely to be resolved for some time, given the difficulties in assessing the level of trend output in real time. A different adjustment period would change trend output and the shape of the output gap profile. Further uncertainties arise from the possibility of additional temporary supply constraints. For example, temporary financing constraints may limit trend output in the near term.

**2.54** This compounds the uncertainties over the future path of inflation because the output gap will typically drive the prospects for inflation. The change in the output gap may also have a bearing on inflationary pressure as the economy grows at above trend rates to close the output gap. The responsiveness of prices to both the level and change in the output gap is another uncertainty over the outlook for inflation.

### The global recovery

**2.55** The rebalancing of UK demand in the forecast involves a move away from government and consumer demand, towards investment and the external sector. As in the recovery following the 1990s recession, the depreciation of sterling should help, giving a competitive edge to UK exporters in international markets as well as to UK producers who compete domestically with imports.

**2.56** A sustained UK recovery underpinned by a positive contribution from net trade rests on a strong recovery in the global economy. There are now emerging signs that the global economy is recovering and that confidence has improved, partly due to the global policy stimulus but also a pick up in domestic demand in emerging economies. In the medium term, the recovery will depend heavily on domestic and international policy choices in countries across the world. There is a risk that these policy choices prove incompatible, such as attempts to support domestic economies by installing barriers to trade and investment. So far the G20 has been successful in preventing a resurgence in protectionist measures. It will be important to remain vigilant to this risk so global trade and investment flows continue to promote global growth in the future.

**2.57** Similarly, policy choices at the national level that prove to be incompatible internationally may lead to further global imbalances, and as such pose a downside risk to global growth. The G20 framework for strong, sustainable and balanced growth, announced at the Pittsburgh G20 summit, mitigates some of this risk as it promotes coordination of international policy choices.

### Credit conditions in the recovery

**2.58** Credit plays an important role in the economy. In financing investment it promotes the future growth potential of the economy, by increasing the effectiveness with which resources are allocated to their most efficient uses.

**2.59** Following the disruption in global financial markets triggered in July 2007, credit conditions faced by households and companies tightened, as the price of risk was reassessed and confidence plummeted. Conditions tightened further in 2008 and at the start of 2009 as banks and other lenders sought to rebuild their balance sheets and tighten their lending terms while the shadow banking system collapsed.

**2.60** In recessions associated with financial crisis, it is usual for the recovery in lending growth to lag the recovery in GDP growth. The Bank of England's June *Financial Stability Report* showed that in the aftermath of a credit crisis, real credit growth typically does not return until several quarters after the resumption in GDP growth. However, while limited lending growth need not prevent the economy from recovering it could limit the pace of recovery.

**2.61** The global macroeconomic policy stimulus and financial sector interventions have been successful in largely removing the immediate possibility of another financial stability event, as seen in the reduction in risk premia across financial markets. Together with similar domestic measures introduced by the Government and the Bank of England – discussed in detail in the 2009 Pre-Budget Report – these have helped to ease credit conditions faced by households and companies.

**2.62** Credit conditions are expected to recover into 2010 and 2011 and so support the recovery. In recent months, asset prices have risen sharply and this has prompted some commentators to warn of a possible asset-price bubble. However, these increases have only partially reversed the sharp declines in asset prices experienced during the global financial crisis. They largely reflect a normalisation from the extreme levels of risk aversion seen at that time, together with the direct impact of global policy actions, notably private-sector asset purchases, and improved private-sector confidence in the economic outlook. That said, as the recent *Reforming Financial Markets* White Paper<sup>3</sup> explained, the Government believes international policymakers should consider ways to take more account of asset-prices and wider financial imbalances in setting policy. The Government is currently discussing these issues with the Bank of England, the FSA and international partners (see Box 3.B).

## The speed and extent of private sector deleveraging

**2.63** The forecast is for an orderly rebalancing of the economy over the forecast horizon between net lending in the public and private sector, with a smaller balance of payments deficit reflecting rebalancing between domestic and external demand.

**2.64** Over the past decade, borrowing by the household sector was high even though the consumption share in GDP was broadly stable. This reflected the fact that borrowing was principally used to finance house purchases and the acquisition of other assets. As the recession took hold, demand fell markedly, credit conditions worsened and both the demand and supply of household credit fell. Household net lending moved from a deficit of around 5 per cent of GDP at the start of 2008 to a surplus of around  $\frac{3}{4}$  per cent in the second quarter of 2009.

**2.65** Falls in asset prices, including housing, along with a weaker and more uncertain outlook for income, mean the ratio of net assets to income in the household sector is now lower than households might have desired previously. A significant adjustment has already begun with the household saving ratio rising sharply in the first half of 2009.

**2.66** The saving ratio is expected to rise further in 2010 as households continue to rebuild their balance sheets, before settling to a rate closer to long-run averages. A risk is that the household sector cuts consumption more aggressively to achieve a much larger increase in the saving ratio

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<sup>3</sup> *Reforming Financial Markets*, HM Treasury, July 2009

and drive a more rapid adjustment in net assets. This could undermine aggregate demand and wider confidence in the recovery.

**2.67** Some companies have markedly increased leverage, although this is largely concentrated in particular sectors of the economy such as real estate and finance. Unlike in the early 1990s, the corporate sector appears well-placed to support the rebalancing of the economy. In aggregate, the corporate sector entered the recession in a relatively healthy financial position, which suggests it can reduce its leverage without holding back business investment.

**2.68** The decisive actions taken by the Government and the Bank of England in response to the crisis have reduced uncertainty and boosted confidence. The substantial macroeconomic stimulus that remains in place is expected to smooth the likely pace of deleveraging in the household and corporate sectors, as low interest rates have reduced the debt burden and the extent to which households and corporates need to pay down their debt. Easier credit conditions should also support spending, which combined with the comparatively stronger labour market performance in this recession, should help smooth the adjustment in household consumption.



## Summary of economic prospects

Table 2.D: Summary of economic prospects<sup>1</sup>

	Percentage change on a year earlier, unless otherwise stated					Average errors from past forecasts <sup>5</sup>
	2008	Forecast <sup>2, 3, 4</sup>				
		2009	2010	2011	2012	2010
<b>Output at constant market prices</b>						
Gross domestic product (GDP)	½	-4¾	1 to 1½	3¼ to 3¾	3¼ to 3¾	¾
Manufacturing output	-2¾	-10¾	1½ to 2	3½ to 4	3½ to 4	1¾
<b>Expenditure components of GDP at constant market prices<sup>6</sup></b>						
Domestic demand	¼	-5¼	¾ to 1¼	2¾ to 3¼	2¾ to 3¼	¾
Household consumption <sup>7</sup>	1	-3	0 to ½	2¾ to 3¼	2¾ to 3¼	1¼
General government consumption	2½	2	1¼	-1½	-2	¾
Fixed investment	-3¼	-14¼	-2 to -1½	4¼ to 4¾	8½ to 9	2¾
Change in inventories <sup>8</sup>	-½	-1¼	¾	½	0	¼
Exports of goods and services <sup>9</sup>	1	-10¾	2 to 2½	4½ to 5	5 to 5½	3
Imports of goods and services <sup>9</sup>	-¾	-12½	½ to 1	1¾ to 2¼	2¾ to 3¼	3
<i>Exports of goods and services (ex. MTIC)</i>	1	-10¾	2 to 2½	4½ to 5	5 to 5½	-
<i>Imports of goods and services (ex. MTIC)</i>	-¾	-12½	½ to 1	1¾ to 2¼	2¾ to 3¼	-
<b>Balance of payments current account</b>						
£ billion	-23½	-31	-31	-32	-28¾	11½
Per cent of GDP	-1¾	-2¼	-2¼	-2	-1¾	¾
<b>Inflation</b>						
CPI (Q4)	4	2	1¾	1½	2	¾
Producer output prices (Q4) <sup>10</sup>	5½	1½	1	1¼	2	1¼
GDP deflator at market prices	3	1½	2¾	1½	2¼	½
<b>Money GDP at market prices</b>						
£ billion	1448	1400	1454 to 1460	1525 to 1539	1611 to 1633	13
Percentage change	3½	-3¼	3¾ to 4¼	5 to 5½	5½ to 6	1

<sup>1</sup> The forecast is consistent with output, income and expenditure data for the third quarter of 2009, released by the Office for National Statistics on 25 November 2009.

<sup>2</sup> All growth rates in this table are rounded to the nearest ¼ percentage point.

<sup>3</sup> 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 trend output. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances, which is a ¼ percentage point below the neutral assumption.

<sup>4</sup> The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

<sup>5</sup> Average absolute errors for current year and 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 2010. The CPI average has been derived from only five years of data.

<sup>6</sup> Further detail on the expenditure components of GDP is given in Table 1.12.

<sup>7</sup> Includes households and non-profit institutions serving households.

<sup>8</sup> Contribution to GDP growth, percentage points.

<sup>9</sup> Figures up to and including 2009 are distorted by MTIC.

<sup>10</sup> Excluding excise duties.



# 3

## Overall policy framework, institutions and objectives

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### 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 3 of the EU 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, global shocks have precipitated the most severe and synchronised global recession since the Great Depression, leading to a sharper fall in UK output at the start of this year than was expected at the time of the *2008 Convergence Programme for the United Kingdom*.<sup>1</sup> However, timely and effective action by governments around the world has helped to avoid a significantly worse outcome and there are tentative signs of recovery in the world and UK economies.

### Policy response to exceptional circumstances

3.4 Responding to the exceptional risks that the financial crisis has posed to UK economic stability, the Government has taken action to deliver a coherent and comprehensive package of support to the economy, and businesses and individuals within it.

3.5 First, the Government has undertaken major interventions to reinforce the stability of the financial system, to increase confidence and banks' capacity to lend and, in turn, to support the recovery of the economy.

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<sup>1</sup> [www.hm-treasury.gov.uk/d/ukconvergenceplan\\_181208.pdf](http://www.hm-treasury.gov.uk/d/ukconvergenceplan_181208.pdf)

**3.6** Second, a substantial macroeconomic stimulus has been put in place to help the economy through the recovery:

- the Government is delivering fiscal support worth 5 per cent of GDP in 2009-10 from the measures announced since the 2008 Pre-Budget Report, and the operation of the automatic stabilisers;
- Bank Rate was reduced from 5 per cent in September 2008 to 0.5 per cent in March 2009, its lowest level in the Bank of England's history; and
- in March 2009, the Government authorised the Bank of England to use the Asset Purchase Facility for monetary policy purposes, to raise nominal spending and thereby support demand. As of 3 December, the Bank's purchases of gilts and private sector assets amounted to £185 billion.

**3.7** Third, targeted support has been provided to help those businesses and individuals who need it most, including measures to provide temporary support through the downturn for jobs, home-owners and businesses facing cash-flow problems.

**3.8** The Government's action has been successful in averting the more severe downside risks to the economy, and has limited the severity of the downturn and its impact on businesses and individuals. In particular, evidence suggests that employment has held up relative to the 1990s recession and a smaller proportion of firms have gone into liquidation, reflecting action that the Government has taken to promote labour market flexibility since 1997 and to support jobs and businesses with cash-flow problems during the downturn. Box 3.A provides more detail.

### Box 3.A: The role of Government interventions in limiting the impact of the recession

It is difficult to quantify the precise impact of recent measures implemented by the Government and the Bank of England to mitigate the substantial economic risks posed by the financial crisis, and the full impact of some interventions will not be realised for some time. However, while risks remain, there are positive signs that they are supporting the economy and that timely and effective policy action has assisted the UK economy in avoiding a significantly worse outcome.

First, reflecting the Government's action to address system-wide risks and support the flow of lending, there has been a general improvement in financial conditions:

- the LIBOR/OIS spread, which measures the risk premium in inter-bank lending, has fallen substantially from an average of more than 200 basis points in October 2008 to an average of 19 basis points in November 2009;
- equity prices have risen significantly, with the FTSE All-share index up almost 50 per cent since early March;
- 5-year Credit Default Swap spreads for the five largest UK banks, which provide an indication of the perceived risk of lending to banks, fell by nearly 55 per cent between their peak in March and December 2009; and
- an increasing amount of unsecured bank debt has been issued outside of the Government's Credit Guarantee Scheme, suggesting improved appetite among investors to fund banks.

Second, expectations of the economic outlook have improved:

- external forecasts for economic growth have improved since the start of the year: in April 2009 the average of external forecasts predicted GDP growth in 2010 of 0.3 per cent, as of December the average forecast has risen to 1.3 per cent.

Third, there are indications that Government action may have mitigated the impact of the recession on jobs, homeowners and businesses. This has helped break the potential negative feedback loops of falling employment, lower asset values and lower lending that could have worsened the recession:

- the UK's flexible labour market and the additional £5 billion set aside for Jobcentre Plus and employment programmes have helped to ensure that the labour market has performed relatively well in the current recession – for every 1 per cent decline in output, employment has fallen by just  $\frac{1}{3}$  of a per cent compared with  $1\frac{1}{3}$  per cent in the 1990s recession;
- the rate of company insolvencies remains well below its peak in the 1990s recession, at 0.9 per cent of all those on the active register in the third quarter of 2009, compared with a peak of 2.6 per cent in the earlier recession. This may in part be due to measures to support businesses announced in January 2009 and Budget 2009; and
- there has also been a smaller than expected rise in mortgage repossessions. The Council of Mortgage Lenders (CML) has revised down its forecast for repossessions in 2009 by 27,000. The CML is now forecasting 48,000 repossessions in 2009, compared with over 75,500 in 1991.

## Providing the conditions for future growth

**3.9** A starting point of low public debt and the action that the Government is taking to ensure fiscal sustainability over the medium term enables the Government to continue to provide support to the economy, where it is needed, through the downturn and in the early stages of recovery. However, as the economy and financial markets recover after a period of exceptional risk and uncertainty, the role for macroeconomic policy will change. Based on its assessment of economic conditions and prospects, the Government's actions will move from supporting activity in the downturn to setting policy to provide the conditions for future growth.

**3.10** Much of the support that the Government has put in place is time-limited, designed to assist businesses and individuals during a period when financial markets have not been functioning properly. Over time, financial markets should continue to normalise and the economy's reliance on Government support should diminish. Unwinding this support will allow markets to once again take up their role in providing incentives for growth and ensuring the efficient allocation of resources. Some targeted measures will continue to be important to support businesses and households and prevent more persistent effects from the downturn.

**3.11** As the recovery takes hold and economic growth becomes self-sustaining, this policy transition will assist future growth by ensuring sound public finances. Sustainable public finances are essential to macroeconomic stability and the long-term health of the economy.

**3.12** The Government can help to ensure a smooth transition in the future, providing on-going support during the early stages of recovery and minimising any disruption to economic activity.

### Interactions between policy interventions

**3.13** There are close interactions between the policy interventions – financial, fiscal and monetary – supporting the economy. The Government will take these interactions into full account as it makes the policy transition.

### Financial sector interventions

**3.14** Financial stability and well-functioning financial markets are key to a sustainable economic recovery. A well-functioning and well-regulated financial system will promote productive investment and the efficient pricing of risk, supporting future economic growth and stability. The Government will continue to provide support for as long as necessary to ensure a stable and effective financial system, and will establish a strengthened regulatory and supervisory framework.

**3.15** As financial conditions improve, the sector's dependence on government support will gradually reduce. This transition will need to be carefully managed. As the economy recovers and confidence in the financial sector grows, the Government expects and will actively encourage the private sector to cease accessing government support. In deciding when to withdraw from specific financial sector interventions, the Government will take into account the robustness of the economic recovery and resilience of the financial sector, as well as intervention-specific criteria such as usage of the scheme, impact on market confidence, distortions in competition and taxpayers' interests.

### Monetary policy

**3.16** Substantial monetary policy support is in place. Market expectations are for Bank Rate to remain at the historically low, expansionary rate of 0.5 per cent until the second half of 2010 and the MPC is expected to complete its £200 billion programme of asset purchases by the end

of January 2010.<sup>2</sup> As a result, monetary policy is expected to continue to provide an on-going and powerful stimulus to spending by businesses and individuals throughout 2010, as the lagged effects of policy action feed through and improving financial conditions strengthen the monetary policy transmission mechanism. Improved transmission should, all else equal, mean that more loans are available and mortgage holders and borrowers will face lower effective interest rates. This should allow monetary policy to continue to support the economy as fiscal policy shifts to consolidation.

## Fiscal policy

**3.17** Sustainable public finances are essential to macroeconomic stability and the long-term health of the economy. As confidence in recovery grows and financial sector conditions normalise, the economy's reliance on fiscal support will diminish. This will allow fiscal support to be withdrawn, gradually at first, so as not to harm recovery.

**3.18** As set out in detail in Chapter 4, over the medium term, the Government's fiscal plans will reduce public sector net borrowing as a share of GDP to 5.5 per cent by 2013-14. They put the public finances on a path to ensure that public sector net debt is falling as a share of GDP by 2015-16. In total, measures announced since the 2008 Pre-Budget Report will reduce borrowing by £57 billion in 2013-14.

**3.19** This clear plan to ensure the sustainability of the public finances underpins continued fiscal support to the economy now. The Pre-Budget Report forecasts a return to economic growth by the end of the year and a gradual pick-up in growth through 2010 and 2011. However, significant risks and uncertainties remain, so it will be important not to withdraw fiscal support too quickly. The Government therefore judges that a gradual transition for fiscal policy, from supporting activity in the recession to supporting the conditions for growth in the recovery, is appropriate. Exceptional and time-limited measures to increase economic demand, introduced to support the economy when it was at its weakest, will no longer be needed. But the Government will continue to provide fiscal support to the economy in 2010-11, during the early stages of recovery. This support will be provided through the automatic stabilisers, worth 4 per cent of GDP in 2010-11, planned increases in government spending and targeted support, where it is needed, to prevent more persistent effects from the downturn. Growth in public sector current expenditure then reduces from 2011-12, in order to ensure sustainable public finances.

## Support for new sources of growth

**3.20** The economic recovery is forecast to be shaped by a rebalancing of domestic and external demand. As the economy recovers, firms will be able to invest in new opportunities and take advantage of the competitiveness boost provided by the depreciation of sterling. Net exports and investment are expected to be more significant drivers of growth than in the recent past.

**3.21** Fiscal consolidation will support investment and the rebalancing of growth, by helping to maintain low long-term interest rates and a stable macroeconomic environment; while the action the Government is taking to restore the flow of credit should help support business investment and enable companies to take advantage of new export opportunities.

**3.22** Rebalancing must also take place at an international level. G20 Leaders have agreed to adopt the policies needed to lay the foundation for strong, sustainable and balanced growth and the Government has also set out the need for an EU Compact for Jobs and Growth.

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<sup>2</sup> The exchange of letters between the Chancellor and the Governor is available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

## Ensuring long-term financial stability

**3.23** The financial system plays a crucial role in all modern economies, affecting the lives of every individual and business. It is the core mechanism by which resources are allocated through the economy, channelling funds from savers to creditworthy borrowers, and thereby supporting productivity, jobs and growth.

### Financial sector interventions

**3.24** Over the past 18 months, the Government has carried out a series of interventions in the financial system, aimed at tackling problems at individual institutions, addressing system-wide instability and getting credit flowing through the economy once more.

### Strengthening the regulatory framework

**3.25** The Government is establishing a new regulatory and supervisory framework, to ensure that banks operate in a manner that promotes greater stability in future and which also protects and ensures a fair deal for customers. Over time, prudential regulatory standards will be strengthened, including improving the quantity and quality of bank capital, requiring the financial system to operate at lower levels of leverage and significantly tightening standards of liquidity regulation. The transition from support to a newly strengthened regulatory framework will need to be carefully managed. In particular, the implementation of these standards must be appropriately phased over time so as to avoid constraining prudent lending by banks and impeding the pace of recovery. Box 3.B examines the role for macro-prudential regulation in addressing potentially harmful inter-linkages between the financial sector and the real economy.



### Box 3.B: Macro-prudential regulation

Though financial markets are vital for the efficient matching of saving and investment, they can also serve to magnify the amplitude of the economic cycle. For example, rising asset prices can increase collateral and facilitate borrowing and may encourage risk taking. Indeed, the recent financial crisis, triggering the most severe global economic recession since the 1930s, clearly demonstrates the close ties between the financial sector and the broader economy. However, as the Government's recent White Paper *Reforming financial markets*<sup>3</sup> explained, there are various 'macro-prudential' tools that have the potential to mitigate these trends in the future:

- **macro-prudential surveillance:** The recent crisis highlights the limitations of a regulatory approach that focuses on monitoring individual institutions, as complex interdependencies and joint exposures have meant that even previously sound institutions experienced serious difficulties. The Financial Services Bill establishes a statutory Council for Financial Stability to monitor systemic risks more closely and coordinate the Authorities' response to these risks. This will be complemented at the EU level with the establishment of the European Systemic Risk Board and internationally by the joint IMF-FSB early warning exercise;
- **counter-cyclical tools:** *Reforming financial markets* identified a number of regulatory tools that might be useful for dampening the cyclicity of the financial sector. Examples include counter-cyclical capital buffers, through-the-cycle expected-loss provisioning, adjusting regulatory capital risk weights and loan-to-value limits. A recent discussion paper by the Bank of England on *The Role of Macro-prudential Policy*<sup>4</sup> analyses these issues in more detail. The Government is working closely with the FSA, the Bank and international partners to assess the merits of different policy options; and
- **monetary policy:** Some have argued that monetary policy should be used to 'lean against' rapid growth in asset prices and financial imbalances. However, giving the Bank of England additional monetary-policy objectives could create policy tensions that undermine the framework's credibility and put at risk the Monetary Policy Committee's (MPC) successful record in delivering low inflation. Interest rates may also be an inappropriate instrument for targeting asset-price bubbles. The MPC's remit gives it a good deal of flexibility to respond to developments in financial markets to the extent that they influence future inflation trends.

## The Government's macroeconomic framework

### Monetary policy framework

**3.26** 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) to meet the Government's target of a 2 per cent annual rise in the Consumer Prices Index (CPI), which applies at all times. The Chancellor announced the creation of the Asset Purchase Facility (APF) on 19 January, and authorised its use for monetary policy purposes on 3 March.

<sup>3</sup> *Reforming Financial Markets*, HM Treasury, July 2009.

<sup>4</sup> *The Role of Macro-prudential Policy*, Bank of England Discussion Paper, 21 November 2009.

**3.27** The objectives of the monetary policy framework have not changed with the use of the APF for monetary policy purposes. 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.

### **Monetary policy action**

**3.28** Monetary policy has been an important element of the overall support provided to the economy. In response to the exceptional circumstances during the past year, the MPC has kept Bank Rate at 0.5 per cent since March, and continued with its programme of asset purchases financed by the issuance of central bank reserves. In May, the MPC extended its programme of asset purchases to £125 billion. At the request of the MPC, the Chancellor authorised an increase in the upper limit of the APF to £175 billion in August, and then to £200 billion on 5 November 2009. The MPC is expected to complete its planned schedule of asset purchases by the end of January. The Bank of England is also consulting on whether the liquidity of secondary corporate debt markets could be further improved if it were to sell as well as buy corporate bonds in its APF portfolio.

### **The impact of MPC action**

**3.29** It is likely that the effects on output of the reduction in Bank Rate since October 2008 and from the asset purchases are still feeding through to the economy, given the normal lags in the monetary policy transmission mechanism, and the impairment of this mechanism due to the impact of the global financial crisis. As financial market conditions continue to improve, the actions taken by the MPC will continue to provide a powerful stimulus to spending by businesses and individuals.

**3.30** There is considerable uncertainty about the strength and pace with which the impacts of APF are feeding through to the economy, particularly as it is not possible to know what would have happened in its absence. However, a number of developments are consistent with its expected effects. As noted in the minutes of the October MPC meeting, although the counterfactual is hard to identify, the strength of broad money growth relative to nominal GDP is consistent with the asset purchase programme boosting M4 growth. Corporate bond and gilt yields fell significantly following the announcement of the APF's use for monetary policy purposes in March, with the decline in corporate bond yields exceeding the fall in gilt yields. Issuance of bonds by UK non-financial companies rose sharply in the first half of 2009, reflecting the lower cost of bond finance. Equity prices have risen by around 50 per cent since early March.

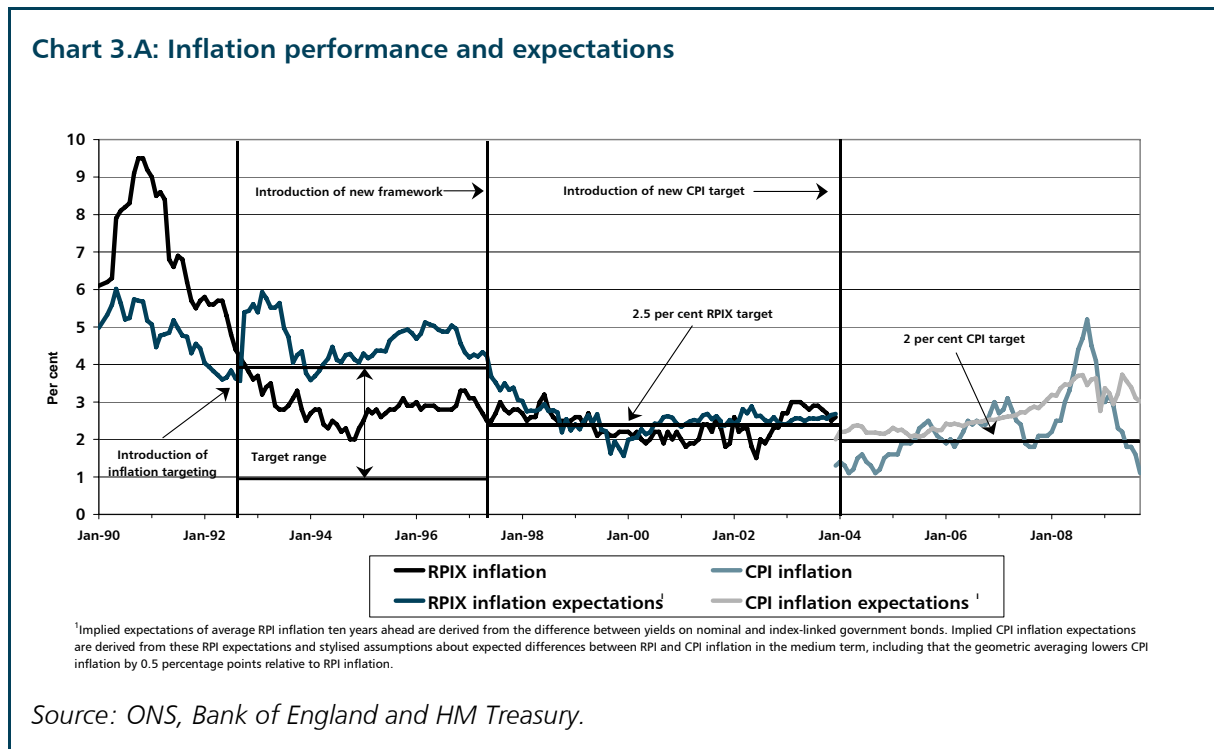
**3.31** CPI inflation has fallen since its peak in September 2008, troughing in September 2009. Inflation has since increased to 1.5 per cent in October and the November Inflation Report stated that CPI inflation is likely to rise sharply above the 2 per cent target in the near term.<sup>5</sup> The MPC's remit, as restated in the Chancellor's letter to the Governor of the Bank of England on 22 April, allows it to look through short-term movements in inflation such as the forecast increase above its 2 per cent target resulting from the reversal of last year's reduction in VAT. The Bank of England's November Inflation Report projected that spare capacity in the economy would continue to apply downward pressure to inflation over the medium term.

**3.32** Despite the volatility in actual inflation, inflation expectations have remained anchored, demonstrating the credibility that the monetary policy framework has built since 1997. As inflation has fallen from its peak of 5.2 per cent in September 2008 to 1.1 per cent a year later, market inflation expectations have moved within a much smaller range, moderating slightly over

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<sup>5</sup> See [www.bankofengland.co.uk](http://www.bankofengland.co.uk)

recent months. This is also reflected in survey expectations: the YouGov/Citigroup survey measure of household expectations for five to ten years ahead has moved within a narrow range of 0.5 percentage points over the past year. Financial market-derived measures of inflation expectations, as shown in Chart 3.A., can be affected by other market developments, including changes in market estimates of the wedge between RPI and CPI, and have been more difficult to interpret given recent financial market volatility. Although these measures are currently above the 2 per cent target, they do not appear to point to a significant de-anchoring of expectations.



### Monetary policy during the recovery

**3.33** The Government will continue to support the Bank of England in the forward-looking decisions it takes to meet the inflation target. As the economy strengthens, it will be appropriate and necessary to tighten monetary conditions. The MPC will determine the timing and pace of the transition towards more normal monetary policy settings, based on their assessment of the policy stance required to meet the inflation target. Within this, the MPC will determine the appropriate combination of raising Bank Rate and the sale of assets.

**3.34** The MPC will decide the scale and timing of any asset sales, but the Bank of England will consult closely with the Debt Management Office to minimise disruption to the gilt market. In his letter to the Chancellor of 17 February, the Governor said that the MPC would have due regard for the impact of those sales on the Government’s debt management operations.

### Fiscal policy framework

**3.35** The Government’s objectives for fiscal policy 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.

**3.36** The financial crisis and global downturn have had a profound and persistent impact on the public finances, resulting in a significant increase in Government borrowing and, as a result,

debt. Responding to these developments, in line with its fiscal objectives, the Government's fiscal strategy has been to:

- base policy decisions on a realistic fiscal forecast, based on a range of assumptions, some of which are designed to provide caution to allow for uncertainty;
- set out a credible plan for delivering a sustained consolidation over the medium term, to ensure sound public finances and create space in the short term for continued fiscal support. This consolidation will take place over a timeframe consistent with economic recovery and growth; and
- ensure that the fiscal policy framework is set to deliver the Government's fiscal policy objectives given the outlook for the public finances and the economy, allowing the flexibility for fiscal policy to respond appropriately while remaining committed to clear long-term goals.

**3.37** As the economy emerges from recession, and exceptional levels of uncertainty recede, the Pre-Budget Report announced a new Fiscal Responsibility Bill, which will strengthen the fiscal framework, established in 1997, to underpin a sustained period of consolidation. As set out in more detail Chapter 4, the Government has set fiscal plans that show borrowing is more than halved as a share of the economy to 5.5 per cent of GDP in 2013-14 and falls year-on-year across the forecast period. These plans are consistent with debt falling as a per cent of GDP in 2015-16. [The Fiscal Responsibility Bill announced alongside the Pre-Budget Report will enshrine these consolidation plans in legislation.](#) This is a significant reform in the way that the Government is held to account for delivering its fiscal plans, giving Parliament a clear role in the setting and monitoring of medium-term fiscal plans.

### **Role of the fiscal framework**

**3.38** The design and operation of the fiscal framework need to evolve in response to changing economic circumstances, in order to continue to ensure delivery of the Government's fiscal policy objectives. The temporary operating rule, set in the 2008 Pre-Budget Report, was designed to allow significant flexibility in the operation of fiscal policy during the recession. It facilitated an effective and necessary response to the downturn, while signalling a clear commitment to fiscal sustainability over the medium term.

**3.39** With economic conditions beginning to normalise and the economy forecast to emerge from recession by the end of the year, the Government believes it is now appropriate to strengthen the fiscal framework. This is in line with moves that other governments around the world are also seeking to take. The IMF has set out that the strengthening of medium-term fiscal frameworks, including through fiscal responsibility laws, should help to support the fiscal adjustment that will be necessary in most economies following the financial crisis.<sup>6</sup>

### **Fiscal Responsibility Bill**

**3.40** As a result, the Government is introducing a Fiscal Responsibility Bill to Parliament. The Bill requires the Government to set out at all times a statutory fiscal plan for delivering sound public finances, to be approved by Parliament, and places a binding duty on the Government to meet that plan. It also enables the Government to add further duties to the Fiscal Consolidation Plan through secondary legislation.

**3.41** The legislation gives Parliament a clear, central role in both setting and monitoring the Government's fiscal plans. In particular, Parliament must approve fiscal plans before they

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<sup>6</sup> *A strategy for normalising fiscal and monetary policies in advanced economies*, International Monetary Fund staff position note, 22 September 2009.

become law. This is a significant enhancement to Parliament's current role in setting medium-term fiscal policy, giving it a new opportunity to scrutinise the Government's plans. Further, the Government must report to Parliament on progress and compliance at each Budget and Pre-Budget Report. If its legislative fiscal plans are not achieved, the Government must set out why they were not met. The Government would then set out actions to remedy the situation. Combined, these provisions represent a significant evolution of the extent to which Parliament can hold the Government to account for its fiscal policy.

**3.42** The Government will publish an updated *Code for Fiscal Stability*, setting out the requirements the Government must meet in the publication of its fiscal plans and projections, in the New Year.

### **Fiscal Consolidation Plan**

**3.43** The Bill sets out the Government's first legislative fiscal plan, the Fiscal Consolidation Plan (FCP). The FCP extends from 2009-10 to 2015-16 and incorporates the 2009 Pre-Budget Report fiscal judgment by requiring that the Government:

- halves public sector net borrowing as a share of GDP over four years from its forecast peak in 2009-10. The Government is setting a target, in secondary legislation enabled by the Bill, for borrowing to be 5.5 per cent of GDP or less in 2013-14;
- reduce borrowing as a share of GDP in each and every year from 2009-10 to 2015-16; and
- ensure that public sector net debt is falling as a share of GDP in 2015-16.

**3.44** These are binding targets that cannot be changed except with the approval of Parliament through new legislation. This demonstrates the Government's commitment to delivering consolidation, and the importance it places upon action to ensure sound public finances in the medium term.

**3.45** Debt is a key indicator of the sustainability of the public finances. The Fiscal Consolidation Plan targets debt and the main measure of the deficit – public sector net borrowing. It is the overall level of borrowing which determines the path of debt. Targeting this simple measure of borrowing enhances certainty on the scale of adjustment the Government is undertaking. The Government will continue to consider cyclically-adjusted measures of the public finances as a key indicator of the fiscal position. But given uncertainties over the structural position of the public finances at present, and the need to set clear and simple targets to which it can be held to account, deficit targets under the Fiscal Consolidation Plan will not be cyclically-adjusted.

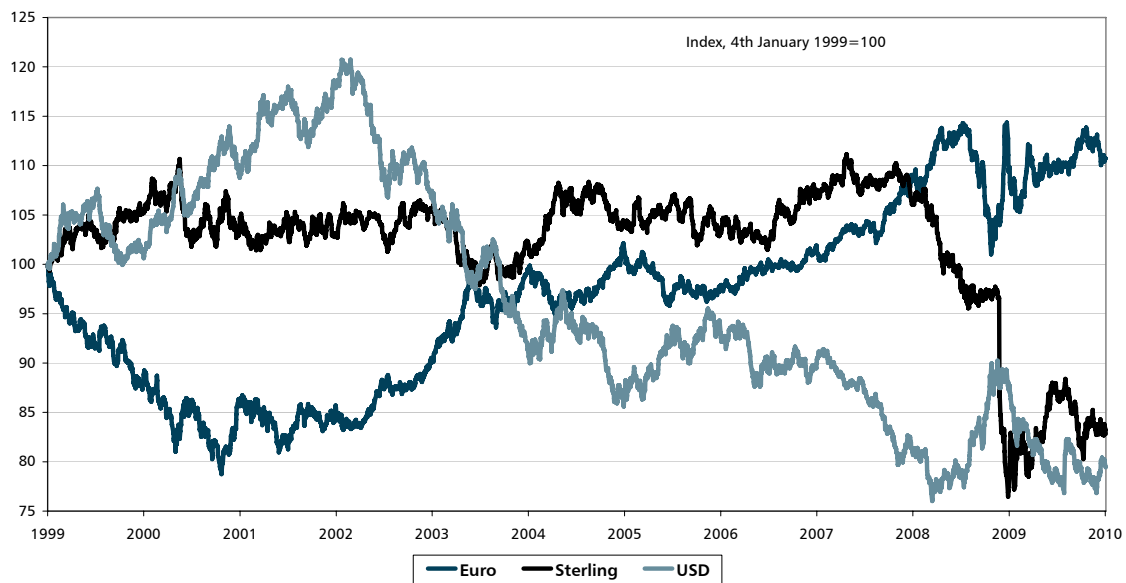
**3.46** The Fiscal Consolidation Plan will target a measure of net borrowing (PSNB ex) that excludes the temporary effects of financial interventions, but that will account for any permanent costs to the taxpayer. The independent Office for National Statistics will report on this measure alongside the Pre-Budget Report and further information on the measure is provided in Annex B. It is consistent with the current measure of public sector net debt excluding the temporary effect of the financial interventions (PSND ex).

### **Exchange rate stability**

**3.47** As of 4 Jan 2010, sterling has depreciated by 24 per cent since the disruption to global financial markets began in July 2007. But it has appreciated by 9 per cent since its trough in December 2008. The depreciation of sterling since mid-2007 is expected to contribute towards a rebalancing of demand in the UK. That depreciation has been associated with a wide range of factors, including monetary easing and disruption in the financial sector. The Government's

objective is for a stable and competitive exchange rate in the medium term, consistent with meeting the inflation target.

**Chart 3.B: Movements in leading effective exchange rates indices since 1999**



Source: Bank of England.

## Economic and monetary union

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

### Box 3.C: Government policy on EMU

The Government's policy on membership of the single currency was set out by the former 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: *"a clear and unambiguous case for UK membership of EMU has not at the present time been made"*.

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment of the five economic tests. Budget 2009 set out progress on the Government's reform agenda, including continued efforts to maintain the flexibility of labour, capital and product markets in the UK.

In his statement to the House of Commons on 9 June 2003, the former Chancellor committed the Government to an annual review of progress. The Government did not propose a euro assessment to be initiated at the time of the 2009 Budget. The Treasury will again review the situation in Budget 2010, as required by the Chancellor's June 2003 statement.

# 4

## Fiscal policy

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### Fiscal policy objectives and strategy

4.1 The Government's objectives for fiscal policy 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.

4.2 The financial crisis and global downturn have had a profound and persistent impact on the public finances, resulting in a significant increase in Government borrowing and, as a result, debt. Responding to these developments, in line with its fiscal objectives, the Government's fiscal strategy has been to:

- base policy decisions on a realistic fiscal forecast, based on a range of assumptions, some of which are designed to provide caution to allow for uncertainty;
- set out a credible plan for delivering a sustained consolidation over the medium term, to ensure sound public finances and create space in the short term for continued fiscal support. This consolidation will take place over a timeframe consistent with economic recovery and growth; and
- ensure that the fiscal policy framework is set to deliver the Government's fiscal policy objectives given the outlook for the public finances and the economy, allowing the flexibility for fiscal policy to respond appropriately while remaining committed to clear long-term goals.

4.3 The Government judges that this strategy remains appropriate in light of developments since Budget and continuing uncertainty:

- the Government will continue to base its fiscal projections on cautious assumptions. In particular, for the 2009 Pre-Budget Report, the assumptions on the VAT gap and claimant count unemployment;
- while there are signs of stabilisation in the economy and the Government's judgement on the economic outlook remains unchanged, risks remain. The Government judges that the pace of consolidation set in Budget 2009 remains appropriate; and
- as the economy emerges from recession, and exceptional levels of uncertainty recede, the Pre-Budget Report announced a new Fiscal Responsibility Bill, which will strengthen the fiscal framework, established in 1997, to underpin a sustained period of consolidation.

# Overview of fiscal developments

**Table 4.A: Summary of fiscal projections**

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Public sector net borrowing (PSNB)	6.6	12.6	12.0	9.1	7.1	5.5	4.4
Total change since Budget 2009	0.4	0.2	0.1	0.0	-0.1	0.0	
Impact of discretionary measures on PSNB <sup>1</sup>	0.0	0.0	0.3	0.3	0.1	0.0	-0.2
Cyclically-adjusted PSNB	5.7	9.0	8.0	5.8	4.5	3.6	3.1
Surplus on current budget	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Public sector net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
Public sector net debt <sup>2</sup>	44.0	55.6	65.4	71.7	75.4	77.1	77.7
Treaty deficit <sup>3</sup>	6.9	12.6	12.0	9.1	7.3	5.7	4.6
Treaty debt ratio <sup>4</sup>	55.5	72.9	82.1	88.0	90.9	91.6	91.2

Note: All measures are presented on the basis which excludes the temporary effect of financial interventions.

<sup>1</sup> Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13, 2013-14 and 2014-15.

<sup>2</sup> Debt at end March; GDP centred on end March.

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

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

**4.4** Chapter 2 set out the economic forecast presented in the 2009 Pre-Budget Report. Despite weaker than expected economic growth in the first part of the year, the Pre-Budget Report forecast of borrowing in 2009-10 is broadly unchanged from the 2009 Budget at 12.6 per cent of GDP. This reflects the caution in the Budget forecast, in particular in relation to VAT and stamp duties. With a wider output gap in 2009-10 and similar levels of borrowing, the estimate of cyclically-adjusted net borrowing is 0.8 per cent lower than assumed at Budget, at 9.0 per cent of GDP in 2009-10. This would suggest the structural position of the public finances has deteriorated less than forecast at Budget, though this assessment is dependent on economic assumptions about the output gap and trend growth.

**4.5** The 2009 Pre-Budget Report set out measures that maintain the overall Budget consolidation path. Although the Pre-Budget Report measures amount to a modest net loosening over the period, together with the consolidation measures announced in the 2008 Pre-Budget Report and Budget 2009, measures in the 2009 Pre-Budget Report reduce borrowing by £57 billion in 2013-14. This is supported by a cyclical reduction in borrowing as the economy returns to growth and receipts recover.

**4.6** EU leaders have agreed that the flexibility provided for in the Stability and Growth Pact should be used, and that fiscal consolidation should be undertaken in line with economic recovery. Under the excessive deficit procedure of the Stability and Growth Pact, to which 20 EU member states are now subject, the EU's Economic and Financial Affairs Council has recommended that the UK brings its Treaty deficit below the 3 per cent reference value by 2014-15, with an average annual fiscal effort of 1.75 per cent of GDP from 2010-11. The Treaty debt and deficit projections are shown in Table 4.A.

## Fiscal policy: supporting recovery while ensuring sustainability

**4.7** Given its assessment of the economic and fiscal outlook, the Government's fiscal judgement is based on moving from supporting activity in the recession to delivering a sustained fiscal consolidation. This will ensure sound public finances, creating space for continued support to the economy during the early stages of recovery. Actions to reduce borrowing and to support growth are mutually reinforcing: sound public finances are necessary for sustainable economic growth, which will in turn help reduce borrowing over the medium term.



## Exceptional and temporary fiscal stimulus

**4.8** Discretionary fiscal stimulus was introduced to provide support when the economy was weakest. In particular, it was necessary for fiscal policy to support the economy during a period when financial markets were impaired, private sector demand was credit-constrained and the effectiveness of the monetary policy transmission mechanism was reduced.

**4.9** The 2008 Pre-Budget Report announced a fiscal stimulus amounting to around 1 per cent of GDP in 2009-10. This included:

- a temporary reduction in the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and
- bringing forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10, to provide temporary support, targeted on areas where it would have maximum impact.

**4.10** The fiscal stimulus is complemented by the full operation of the automatic stabilisers and targeted support for those most affected by the downturn. Together, through these channels, fiscal support totals 5 per cent of GDP in 2009-10.

**4.11** This fiscal support has helped to limit the severity of the downturn and its impact on businesses and individuals. The Government estimates that, as a result of the direct impact of the fiscal stimulus announced in the 2008 Pre-Budget Report, GDP growth in 2009 will be around ½ percentage point higher than it would otherwise have been. In particular, evidence suggests a smaller proportion of firms have gone into liquidation and employment has held up relative to the 1990s recession.

**4.12** Fiscal stimulus was time limited to increase its impact during the downturn and support sustainable public finances over the medium term. The VAT reduction was designed to be temporary, and will expire on 31 December 2009. This reversal is an important part of the effectiveness of VAT as an instrument for fiscal stimulus, as it encourages consumers to bring forward spending at the end of 2009.

## Supporting recovery

**4.13** Tightening fiscal policy too quickly could undermine recovery and thereby result in a deterioration in the fiscal position. The Government will therefore ensure that fiscal policy continues to provide support to businesses and individuals during the early stages of recovery, when it is most at risk, while ensuring sound public finances over the medium term. Overall, Government borrowing of 12.0 per cent of GDP will continue to support the level of economic activity in 2010-11. In particular:

- the automatic stabilisers will continue to provide fiscal support worth 4 per cent of GDP in 2010-11;
- despite a period of negative RPI inflation this year, the cash and real terms value of tax credits and benefits will increase in April 2010 (including an increase in the basic state pension of 2.5 per cent), which will provide an effective real terms increase to transfer payments of over £4 billion, relative to the September RPI normally used for indexation;
- overall, planned increases in government spending will continue to support demand, with Total Managed Expenditure rising by £11 billion in real terms in 2010-11; and

- targeted interventions are providing support to businesses and individuals, including through funding to help the unemployed, action to support businesses with their cash flow and support for pensioners and low-income families with children.

## Action to ensure sound public finances

**4.14** The focus of the Government's fiscal policy shifts toward consolidation in 2011-12, when the economy should be better placed to support a more rapid tightening because:

- GDP growth is forecast to pick up to an above trend rate of 3½ per cent in 2011;
- market expectations are for Bank Rate to remain at 0.5 per cent until the second-half of 2010, then to rise moderately, while remaining below 4 per cent by the end of 2012. While still at relatively low levels by historical standards, this implies that there would be greater space for the MPC to use interest rates to support demand by 2011-12; and
- as financial market conditions improve and the monetary policy transmission mechanism becomes more effective, the low Bank Rate expected by the market will provide an ongoing and powerful stimulus to spending by businesses and individuals and reduce the economy's reliance on fiscal support.

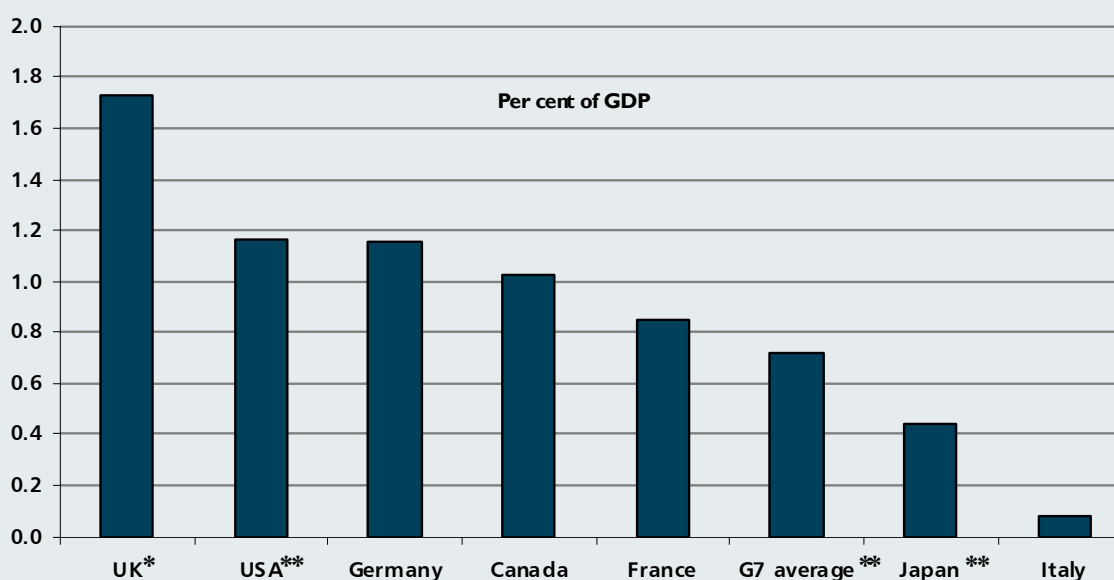
**4.15** At Budget the Government took a judgement on the appropriate pace of fiscal consolidation, which recognised the uncertainty around prospects for the public finances given the exceptional nature and strength of the global downturn, the need to support the economy through the early stages of the recovery and the need to deliver sustainable public finances. Further information on the composition and pace of adjustment is provided in Box 4.A.

#### Box 4.A: Composition and pace of adjustment

The Government's fiscal consolidation plan is based on announced tax increases, revised spending plans and support for growth. In total, consolidation measures announced to date in the 2009 Pre-Budget Report, Budget 2009 and the 2008 Pre-Budget Report will reduce borrowing by £57 billion in 2013-14. Of this, around two-thirds derives from changes to spending plans, while around one-third is driven by tax increases. This approach conforms with research by the IMF, which suggests that spending restraint is more likely to generate lasting fiscal consolidation and better economic performance. In particular, the IMF has noted that *"expenditure restraint brings about longer lasting and larger adjustment episodes, which are more successful in achieving a debt stabilizing fiscal position. Expenditure reduction demonstrates a firmer commitment to feasible and substantial consolidation, and may trigger lower interest rates and boost private demand."*<sup>1</sup>

With monetary policy better able to manage aggregate demand as financial conditions normalise and GDP growth forecast to grow at above trend rates from 2011, the economy is expected to be able to support a reduction in public borrowing, though it will be important not to withdraw fiscal support too quickly. The annual pace of consolidation set out in the 2009 Pre-Budget Report is faster than the pace of deficit reduction forecast by the IMF for all other G7 economies in the period up to 2014, reflecting the size of the deficit and the Government's commitment to addressing it. The average pace of consolidation over the 2009-10 to 2013-14 period, albeit from a higher level, is comparable to the speed at which the deficit was reduced during the period of consolidation in the 1990s, when growth averaged 3¼ per cent a year for 5 years from 1993.

Chart 4.A: Projected annual average fall in borrowing 2010-2014



Note: For the G7 average and countries other than the UK, the projected annual average fall in borrowing is as forecast by the IMF on a calendar year basis.

\* 2009 Pre-Budget Report financial year forecast of PSNB from 2009-10 to 2013-14.

\*\* For the countries indicated, deficit is forecast to peak in 2009, so pace of consolidation for these countries and the G7 average is taken over 2009 to 2014.

Source: HM Treasury and IMF: *The State of Public Finances Cross-Country Fiscal Monitor*, November 2009.

**4.16** Although the Pre-Budget Report measures amount to a modest discretionary loosening over the period, borrowing is reduced to 5.5 per cent of GDP in 2013-14 as forecast at the Budget.

**4.17** The 2009 Pre-Budget Report announced that the Government will take the following measures to support consolidation and reinforce the fairness of the tax system:

- an additional 0.5 per cent increase in the employee, employer and self-employed rates of national insurance contributions (NICs) from April 2011, alongside an increase in the point at which individuals start to pay NICs to protect 15 million people on incomes below £20,000;
- the point at which individuals start to pay the higher rate of income tax will be frozen in 2012-13; and
- the restriction of pensions tax relief from April 2011 will apply to those with gross incomes of £150,000 and over, where gross income incorporates all pension contributions, including those funded by an employer. This will be subject to an income floor, so that individuals with pre-tax incomes (excluding employer pension contributions) of less than £130,000 will be unaffected.

**4.18** These measures ensure that fiscal consolidation is broad-based, with those on high incomes making the greatest contribution. The rise in the NICs primary threshold protects those on low incomes, meaning an employee with income below £20,000 paying the standard employee rate of NICs will pay less NICs in April 2011.

## Public spending

**4.19** As set out in Budget 2009, spending growth will reduce from 2011-12 onwards in order to ensure sustainable public finances over the medium term. The 2009 Pre-Budget Report announced that public sector current expenditure<sup>1</sup> will grow by an average of 0.8 per cent a year in real terms between 2011-12 and 2014-15. In line with Budget 2009, public sector net investment will move to 1¼ per cent of GDP by 2013-14 and remain at that level in 2014-15.

**4.20** Chapter 7 contains more detail on the savings and efficiencies, across the public sector, that were announced in the 2009 Pre-Budget Report.

## Overall impact

**4.21** Overall, the projection set out for public sector net borrowing is broadly the same as the Budget in each year from 2011-12 to 2013-14, and falls to 4.4 per cent of GDP in 2014-15.

## Halving the deficit

**4.22** Over the medium term, borrowing is projected to fall markedly. Government consolidation measures announced in and since the 2008 Pre-Budget Report are supported by a cyclical reduction in borrowing as the economy returns to growth and receipts recover.

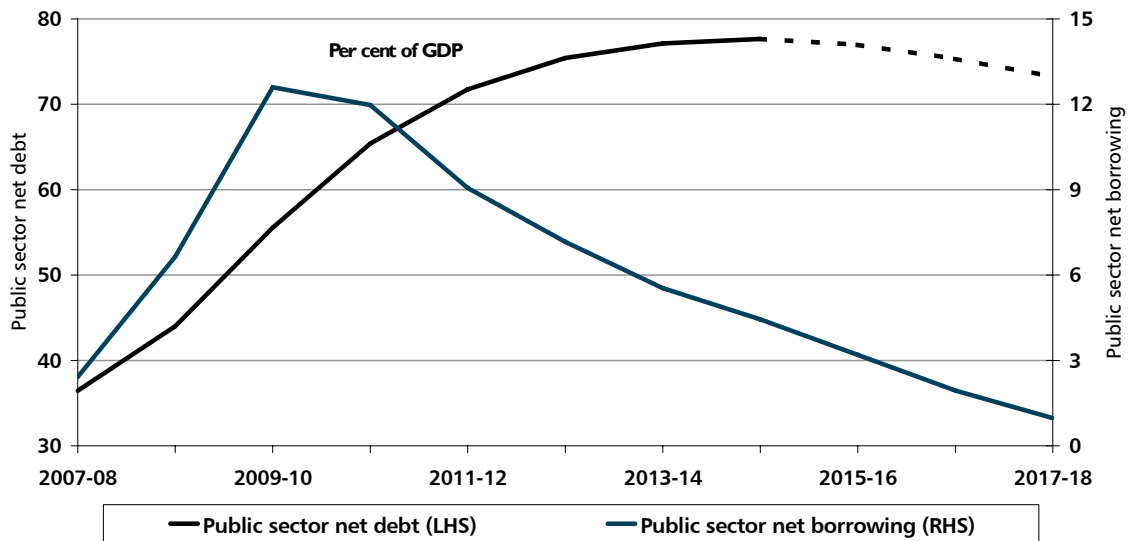
**4.23** Based on cautious assumptions, public sector net borrowing is projected to fall from 12.6 per cent of GDP in 2009-10 to 5.5 per cent in 2013-14. This reduction represents a more than halving of the deficit as a share of GDP over this period. PSNB then falls further to 4.4 per cent of GDP in 2014-15.

## Declining net debt to GDP ratio

**4.24** The measure of public sector net debt (PSND) used for fiscal policy is around 3 percentage points of GDP lower than at Budget. This reflects new treatment of the net losses from financial interventions, as set out in Chapter 5. This reduces the level of PSND across the forecast horizon, but does not affect the path.

**4.25** Public sector net debt increases over the projection period, in particular in 2009-10 and 2010-11, reflecting the high level of borrowing supporting the economy in those years. The public finances remain on a path consistent with ensuring that the level of PSND will fall as a proportion of GDP over the medium term. Chart 4.B shows forecasts to 2014-15 and illustrative projections thereafter. These are based on a further improvement of 0.7 per cent of GDP a year in the cyclically-adjusted current budget, equivalent to the average improvement over the 2009-10 to 2014-15 period. Public sector net investment is assumed to be held constant at 1¼ per cent of GDP. The illustrative projections show that, under these assumptions, debt will peak in 2014-15 and will fall in the following year. The 2009 Long-term public finance report provides illustrative projections for debt based on the firm fiscal consolidation plans set out to 2014-15 and stylised assumptions thereafter.<sup>2</sup>

**Chart 4.B: Meeting the Fiscal Consolidation Plan**



Note: For the financial years 2015-16 to 2017-18 the numbers presented here are illustrative projections.  
Source: HM Treasury.

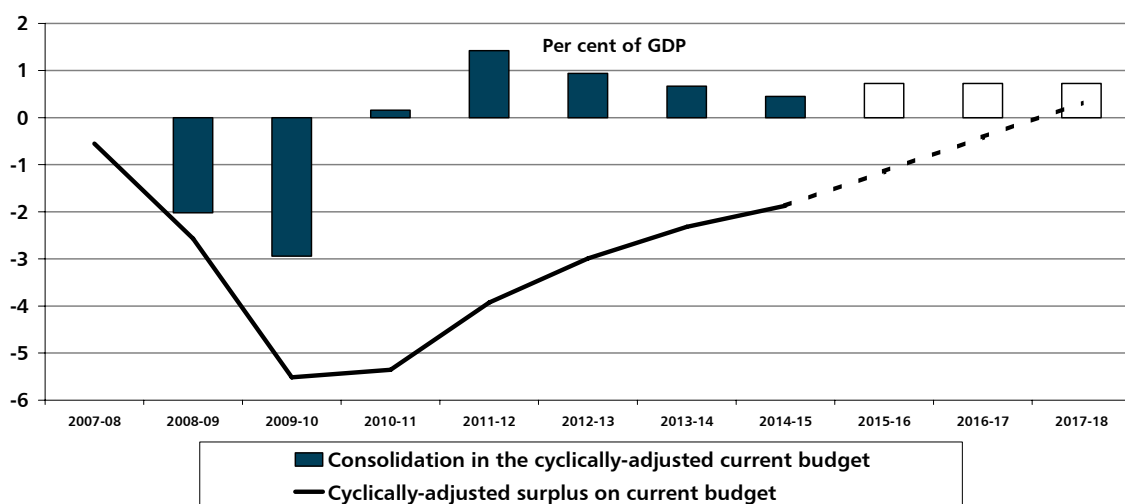
### Fiscal Responsibility Bill

4.26 Chapter 3 sets out detail on the Fiscal Responsibility Bill announced alongside the 2009 Pre-Budget Report, which will enshrine the Government’s fiscal consolidation plans in legislation.

### Balancing the cyclically-adjusted current budget

4.27 The cyclically-adjusted current deficit falls from 5.5 per cent in 2009-10 to 1.9 per cent in 2014-15, an average improvement of 0.7 per cent a year. Chart 4.C shows that a further illustrative improvement of 0.7 per cent a year from 2015-16, in line with this average, would eliminate the deficit on the cyclically-adjusted current budget by 2017-18.

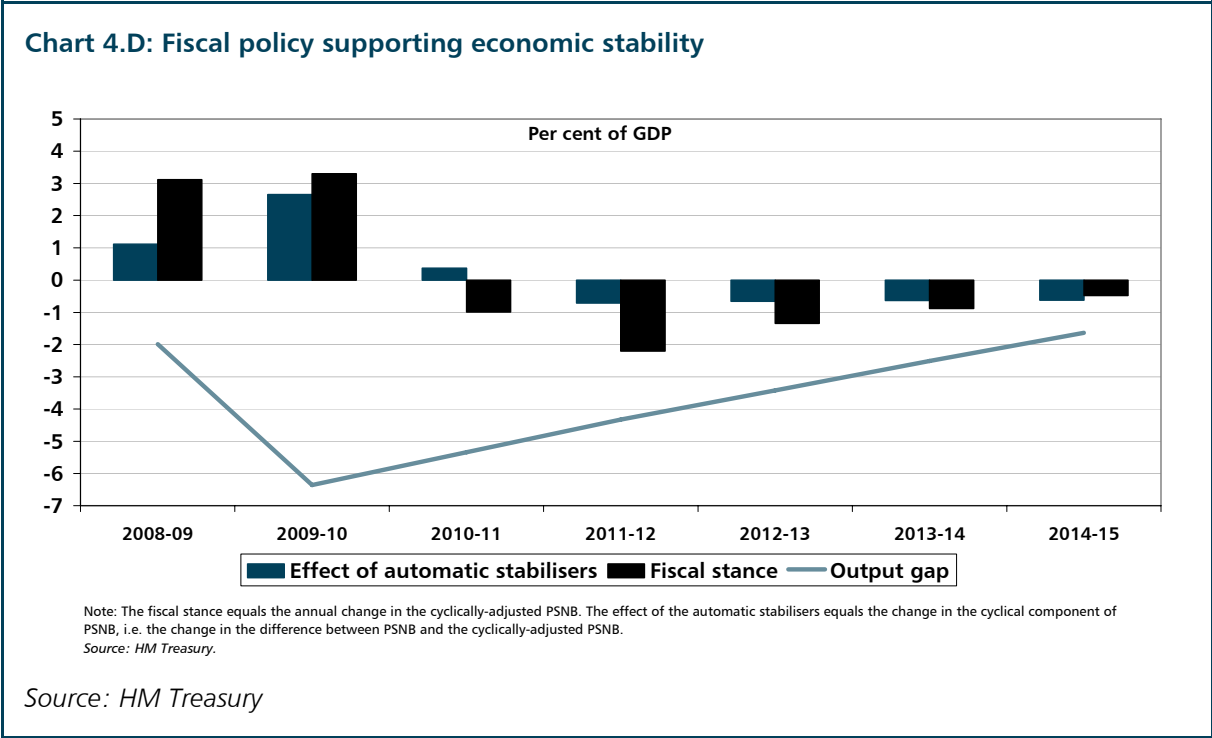
**Chart 4.C: Balancing the cyclically-adjusted current budget**



Note: For the financial years 2015-16 to 2017-18 the numbers presented here are illustrative projections.  
Source: HM Treasury.

### Economic impact

4.28 The overall impact of fiscal policy on the economy can be assessed by examining the change in public sector net borrowing. Chart 4.D shows that both the automatic stabilisers and the fiscal stance are acting to provide a considerable degree of support to the economy in 2008-09 and 2009-10, during the economic downturn. In 2011-12, the fiscal stance is tightening to deliver a reduction in borrowing at a time by which the economy is forecast to be recovering and able to support fiscal consolidation, while the effect of the automatic stabilisers remains positive in 2010-11, reflecting the lagged impact of the downturn on spending and receipts.







# 5

## Outlook for public finances

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5.1 This chapter explains the latest public finance outturns and projections in more detail.<sup>1</sup>

### The fiscal outlook

#### The impact of the global downturn

5.2 The financial crisis has had a profound and persistent impact on the public finances. It has resulted in a significant increase in borrowing relative to pre-crisis levels, which can be broken down into two categories:

- *temporary and cyclical borrowing*: the recession has caused a temporary increase in borrowing, due to lower tax receipts and higher government spending as the Government allows the automatic stabilisers to operate to support the economy. The temporary discretionary measures that the Government has implemented to provide fiscal support to the economy also have a short-term impact on borrowing; and
- *structural impacts*: the financial crisis has also had a more persistent impact on the public finances, due to its downward impact on the trend level of output in the economy, which has been assumed to be 5 per cent, a permanent loss of tax receipts from the financial and housing sectors and the projected rebalancing of economic activity, which will result in less tax-rich growth in the recovery. The fiscal consolidation that the Government has planned over the medium term is necessary to address these persistent effects.

5.3 The 2009 *End of year fiscal report*,<sup>2</sup> published alongside the Pre-Budget Report, provides a detailed analysis of the underlying reasons for the differences between the Budget 2008 forecasts for the public finances and outturn in 2008-09. This shows that the forecast differences were driven by the impact of the deterioration of the economy on tax receipts, the impact of the financial crisis on tax receipts from the financial and housing sectors, and the discretionary fiscal action taken by the Government to support the economy through the downturn. The US has experienced forecast differences of a comparable size to the UK, reflecting the similarities in the effects of the global financial crisis in both economies.

### Measures of the public finances

5.4 The Pre-Budget Report presented information on the public finances on two different bases:

- **including the temporary effects of financial interventions**. These measures include the temporary and exceptional effects from, for example, the inclusion of the balance sheets and operations of banks classified to the public sector; and
- **excluding the temporary effects of financial interventions**. These measures remove the temporary effects of financial interventions on the fiscal aggregates. As fees and losses are realised for central government, and so can be reliably included in the fiscal projections, they will score in these measures.

**5.5** In Budget 2009, a third basis was used to represent a provision for potential net losses from the financial interventions. This was necessary because of the considerable uncertainty at that time. As uncertainty has receded the Government is moving the treatment of financial interventions into line with the fiscal aggregates reported by the ONS, so this basis is no longer needed.

**5.6** The long-term impact of the financial interventions on the taxpayer and the sustainability of the public finances will be determined by the eventual net profit or loss on these interventions. The Government will therefore base its assessment of the fiscal position on measures which account for these permanent effects and which exclude any temporary effects of assets or liabilities incurred as a result of the interventions. Therefore, fiscal aggregates in this Chapter are presented on the basis that excludes the temporary effect of financial interventions, unless otherwise stated.

**5.7** Consistent with this approach, the 2009 Pre-Budget Report established a measure of Public Sector Net Borrowing that excludes the temporary effects of the financial interventions (PSNB ex). The components of net borrowing will also be measured on this basis. This measure is consistent with the parallel measure of Public Sector Net Debt (PSND ex) announced at Budget 2008, which the ONS publish in outturn. The ONS published PSNB ex in their monthly Statistical Bulletin on the public sector finances in December and have also published a technical note on its derivation.<sup>3</sup>

**5.8** Since the Budget, the exceptional financial market and economic uncertainty has receded and the Asset Protection Scheme policy agreement has been finalised. The risks to the taxpayer have been reduced. The 2009 Pre-Budget Report replaced the Budget 2009 provision for financial sector losses with a new treatment that books a paper loss on the shareholdings of the publicly owned banks using National Accounts methodology. This new treatment is set out in detail in Box 5.D.

## Forecast assumptions

### Key assumptions

**5.9** 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 2009 Pre-Budget Report. Rates, thresholds and limits, including for 2009-10, 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 2009 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 to reflect the cost of the policy decisions listed in Table 5.D;
- total Annually Managed Expenditure (AME) programmes to 2010-11 have been forecast consistent with the economic assumptions and policy decisions in the 2009 Pre-Budget Report;

- public sector current expenditure (excluding the additional time-limited resource expenditure announced in the 2009 Pre-Budget Report) is projected to grow at 0.8 per cent per year on average in real terms from 2011-12 to 2014-15; and
- public sector net investment is projected to move to 1¼ per cent of GDP in 2013-14.

**5.10** The estimates for 2009-10 are based on all available data within the Treasury and other government departments involved in producing tax and spending forecasts.

**Table 5.A: Economic assumptions for the public finance projections**

	Percentage changes on previous year unless otherwise specified						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Output (GDP)	-1 ¼	-3 ½	2	3 ¼	3 ¼	3 ¼	3 ¼
Prices							
CPI	3 ¾	2 ¼	2	1 ½	1 ¾	2	2
GDP deflator	2 ½	2	2 ¼	1 ½	2 ½	2 ¾	2 ¾
RPI <sup>1</sup> (September)	5	-1 ½	3	3 ¼	3 ¼	3 ¼	3
Rossi <sup>2</sup> (September)	6 ¼	1 ¾	3	1 ½	2	2 ¼	2 ½
Nominal GDP <sup>3</sup>	1435	1409	1472	1544	1635	1735	1841

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

<sup>2</sup> RPI excluding housing costs

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

## Caution in the public finances forecast

**5.11** Recognising the uncertainties surrounding the economic forecast and fiscal projections, the fiscal projections reflect a realistic view of the position of the public finances by incorporating some cautious assumptions. Overall, the forecast implies that the tax burden is broadly flat in the medium term, over 1 per cent below its level in 2007-08. The 2009 Pre-Budget Report projections are based on:

- a 5 per cent downward adjustment to the economy's trend (or potential) level of output in light of the global financial shock, consistent with the Budget 2009 forecast;
- the forecast for economic rebalancing, away from consumption and to investment and exports, which are less tax-rich sectors;
- the assumption that the financial sector expands from 2010-11 but profits as a share of GDP only return to the 20-year average by 2014-15, meaning that in 2014-15 the level of receipts from the sector remains below its 2007-08 level; and
- the NAO-audited assumptions, in particular on the VAT gap and claimant count unemployment, which build caution into the medium-term forecast. Further details on the NAO-audited assumptions are set out below.

## The use of NAO-audited assumptions

**5.12** The use of assumptions audited by the National Audit Office (NAO) under the three-year rolling review process is designed to add caution to the public finances projections. Details of the audited assumptions are given in Box 5.A. 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 2.C.

## Equity price assumption

**5.13** For the 2009 Pre-Budget Report, the Comptroller and Auditor General has audited the Treasury's assumption for equity prices used for the purposes of projecting the public finances. He concluded that the Treasury's approach for modelling equity prices based on the growth of nominal GDP is simple, transparent and based in economic theory, but that the assumption did not perform well over the rolling review period as a whole, as it did not capture the major movements in UK equity prices following upheavals in the global financial system and stock markets. As a result, the assumption resulted in over-prediction of tax receipts associated with equity prices, though these were a small percentage of overall government receipts. However, he also concluded that there is no case for adopting an alternative methodology on the basis that there is no obviously superior methodology. He recommended that the Treasury make an assessment of formal methods to allow for uncertainty in its equity price projections.

## Consistency of price indices

**5.14** The Comptroller and Auditor General also audited the consistency of price indices assumption used for the Treasury's public finance projections. The report concluded that the Treasury ensured consistency between the CPI, RPI, Rossi index and the GDP deflator over the rolling review period. The report also noted that the same approach as for the rolling review period has been used for the 2009 Pre-Budget Report forecast, and concluded that the projected series are consistent with each other on this basis.

#### Box 5.A: Key assumptions audited by the NAO<sup>4</sup>

Trend GDP growth <sup>5</sup>	2½ per cent a year to 2014. A downward adjustment of around 5 per cent has been made to the level of trend output, phased in between mid-2007 and mid-2010.
Dating of the cycle <sup>6</sup>	The previous economic cycle, which began in the first half of 1997, ended in the second half of 2006.
Composition of GDP <sup>7</sup>	Shares of labour income and profits in national income are broadly constant in the medium term.
Consistency of price indices <sup>8</sup>	Projections of price indices used to project the public finances are consistent with CPI.
Oil prices <sup>6</sup>	\$72.7 a barrel in 2010, the average for the three months to 26 November, and then constant in real terms. This is lower than the \$73.3 average of independent forecasts for 2010.
Equity prices <sup>8</sup>	FTSE All-share index rises from 2718 (close 2 December) in line with nominal GDP.
VAT <sup>7</sup>	The underlying VAT gap will rise by 0.5 percentage points per year from the estimated outturn for the current year.
Tobacco <sup>4</sup>	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 <sup>9,10</sup>	Projections are based on the average of independent forecasts. Under that convention, the most recent data result in a projection of the UK claimant unemployment rising from recent levels of 1.64 million to 1.72 million at the end of 2009, and to 1.91 million at the end of 2010.
Interest rates <sup>5</sup>	3-month market rates change in line with market expectations (as of 26 November).
Funding <sup>7</sup>	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Privatisation proceeds <sup>5</sup>	Credit is taken only for proceeds from sales that have been announced.
Cyclical adjustment methodology <sup>5</sup>	Estimates of the final balances adjusted for the effects of the economic cycle are produced in line with the ready-reckoner set out in <i>Public finances and the cycle</i> , Treasury Working Paper No. 5, 2008.

## Projections for the public finances

5.15 Table 5.B provides full projections for the key fiscal aggregates from the 2009 Pre-Budget Report. Fiscal aggregates presented exclude the temporary effect of financial interventions, unless otherwise stated.

**5.16** The Government will base its assessment of the fiscal position on measures that account for the permanent effects of its interventions in the financial sector and which exclude any temporary effects of liabilities incurred as a result of the interventions. The treatment of net losses from the financial interventions in the fiscal projections is described further in Box 5.D.

**Table 5.B: Summary of public sector finances**

	Per cent of GDP						
	Outturn Estimate		Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
<b>Fiscal stance</b>							
Public sector net borrowing (PSNB)	6.6	12.6	12.0	9.1	7.1	5.5	4.4
Cyclically-adjusted PSNB	5.7	9.0	8.0	5.8	4.5	3.6	3.1
Surplus on current budget	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Cyclically-adjusted surplus on current budget	-2.6	-5.5	-5.4	-3.9	-3.0	-2.3	-1.9
Net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
<b>Sustainability</b>							
Public sector net debt <sup>1</sup>	44.0	55.6	65.4	71.7	75.4	77.1	77.7
Core debt <sup>1</sup>	42.8	50.8	57.1	60.7	62.4	63.0	63.0
Net worth <sup>2</sup>	22.4	17.3	6.6	0.4	-3.6	-6.2	-7.2
Primary balance	-4.9	-10.7	-9.2	-6.0	-3.9	-2.3	-1.1
<b>Financing</b>							
Central government net cash requirement	11.3	15.8	11.8	9.5	7.2	5.8	4.4
Public sector net cash requirement	4.2	13.5	12.3	9.7	7.5	6.1	4.6
<b>Stability and Growth Pact</b>							
Treaty deficit <sup>3</sup>	6.9	12.6	12.0	9.1	7.3	5.7	4.6
Cyclically-adjusted Treaty deficit <sup>3</sup>	5.9	9.0	8.1	5.9	4.7	3.7	3.2
Treaty debt ratio <sup>4</sup>	55.5	72.9	82.1	88.0	90.9	91.6	91.2
Memo: Output gap	-2.0	-6.4	-5.3	-4.3	-3.4	-2.5	-1.6

*Note: All measures are shown on the basis which excludes the temporary effect of financial interventions, except net worth and the aggregates shown in the Financing and Stability and Growth Pact sections.*

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

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

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

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

## Public sector net borrowing

**5.17** Public sector net borrowing is projected to fall in each year of the forecast period, from 12.0 per cent in 2010-11 to 4.4 per cent by 2014-15, as a result of economic recovery and the Government's action to ensure the sustainability of the public finances. This measure of PSNB is on the basis that excludes the temporary effects of financial interventions and captures the permanent effect on the taxpayer. It therefore captures the impact of capital grants to public sector banks in outturn for 2008-09 and 2009-10, and fees associated with the financial interventions. A full breakdown of these factors is presented later in the Chapter.

## Current budget

**5.18** The current budget is also presented on the basis that excludes the temporary effects of financial interventions. The Pre-Budget Report projections show that the current budget is in deficit throughout the forecast period, peaking at 9.3 per cent of GDP in 2010-11, and then falling to 3.2 per cent by 2014-15. The cyclically-adjusted current budget, which removes the estimated effect of the economic cycle, falls from a deficit of 5.4 per cent of GDP in 2010-11 to 1.9 per cent in 2014-15.

## Net investment

**5.19** Net investment rose to 3.5 per cent of GDP in 2009-10 and 2.7 per cent of GDP in 2010-11. Net investment will move to 1¼ per cent of GDP by 2013-14. In 2008-09 and 2009-10, net investment is increased by capital grants to public sector banks associated with the financial interventions.

## Net debt-to-GDP ratio

**5.20** Public sector net debt, excluding the temporary effect of financial interventions, is projected to rise over the forecast period to 77.7 per cent of GDP by 2014-15. The projections for core debt, which excludes the estimated impact of the economic cycle, are expected to rise to 63.0 per cent in 2014-15.

## Stability and Growth Pact

**5.21** Table 5.B shows the Treaty measures of debt and deficit used for the purposes of the Excessive Deficit Procedure – Article 126 of the EU Treaty. The Treaty deficit is projected to fall from 12.0 per cent of GDP in 2010-11 to 4.6 per cent in 2014-15. Treaty debt is forecast to rise from 82.1 per cent of GDP in 2010-11 88.0 per cent of GDP in 2011-12, before stabilising at around 91 per cent of GDP from 2012-13.

## Contingent liabilities

**5.22** Fiscal aggregates published by the 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. Measures based on Generally Accepted Accounting Practice (GAAP) take into account the extent to which past transactions have already committed future funding flows, such as nuclear decommissioning or public sector pensions. The Government has announced that it will publish a GAAP-based balance sheet as part of its move towards publishing Whole of Government Accounts (WGA) for 2009-10. 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.

## Net worth

**5.23** Public sector tangible and financial assets net of financial liabilities can be calculated to provide an estimated measure of net worth. Because capital spending adds to assets and current spending does not, this measure is the approximate stock counterpart of the current budget. On this measure net worth is projected to become negative in the medium term as current borrowing continues. This borrowing reduces net worth, as it is not offset by an increase in the Government's existing assets. As such measures include liabilities accrued to date that will have to be met in the future, but do not take account of future government revenues, the concept of net worth is not comprehensive. Net worth is not used as a key indicator of the public finances, mainly as a result of the difficulties involved in accurately measuring many government assets and liabilities. The estimates of values of tangible assets are subject to wide margins of error because they depend on broad assumptions, for example about asset lives, which may not be appropriate in all cases.

## Financing

5.24 The central government net cash requirement (CGNCR) is projected to be around 11.8 per cent of GDP in 2010-11 and is expected to fall steadily to 4.4 per cent in 2014-15 as net borrowing falls. The impact on the CGNCR of financial interventions is included in Table 5.P.

## Changes to the fiscal balances

5.25 Table 5.C compares the latest estimates for the main fiscal balances with those in Budget 2009.

**Table 5.C: Fiscal balances compared with Budget 2009**

	Outturn <sup>1</sup>	Estimate <sup>2</sup>	Projections			
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
<b>Net borrowing (£ billion)</b>						
<b>Budget 2009</b>	<b>90.0</b>	<b>175.4</b>	<b>173</b>	<b>140</b>	<b>118</b>	<b>97</b>
<b>2009 Pre-Budget Report</b>	<b>95.4</b>	<b>177.6</b>	<b>176</b>	<b>140</b>	<b>117</b>	<b>96</b>
Difference	5.5	2.2	3.0	-0.5	-0.7	-0.6
<i>of which:</i>						
Changes to current budget	-2.2	-3.5	- ½	- ½	- ½	- ½
Changes to net investment	7.7	5.7	3 ½	0	0	0
<i>of which:</i>						
Effect of revisions and forecasting changes	5.4	2.6	- ½	-4 ½	-2 ½	0
Effect of 2009 PBR policy decisions	0.0	-0.4	1	-3 ½	-5	-6
Effect of other discretionary changes <sup>3</sup>	0.0	0.0	2 ½	7 ½	7	5
<b>Surplus on current budget (£ billion)</b>						
<b>Budget 2009</b>	<b>-52.3</b>	<b>-131.6</b>	<b>-137</b>	<b>-111</b>	<b>-91</b>	<b>-74</b>
Effect of revisions and forecasting changes	2.2	3.1	3	4 ½	2 ½	- ½
Effect of 2009 PBR policy decisions	0.0	0.3	-1	3 ½	5	6
Effect of other discretionary changes <sup>3</sup>	0.0	0.0	-1 ½	-7 ½	-7	-5
<b>2009 Pre-Budget Report</b>	<b>-50.1</b>	<b>-128.1</b>	<b>-137</b>	<b>-111</b>	<b>-91</b>	<b>-74</b>
<b>Net investment (£ billion)</b>						
<b>Budget 2009</b>	<b>37.7</b>	<b>43.8</b>	<b>36</b>	<b>29</b>	<b>26</b>	<b>22</b>
Effect of revisions and forecasting changes	7.7	5.6	2 ½	0	0	0
Effect of 2009 PBR policy decisions	0.0	0.1	0	0	0	0
Effect of other discretionary changes <sup>3</sup>	0.0	0.0	1	0	0	0
<b>2009 Pre-Budget Report</b>	<b>45.3</b>	<b>49.5</b>	<b>39</b>	<b>29</b>	<b>26</b>	<b>22</b>
<b>Cyclically-adjusted surplus on current budget (per cent of GDP)</b>						
Budget 2009	-3.1	-6.7	-6.4	-4.9	-3.9	-3.2
<b>2009 Pre-Budget Report</b>	<b>-2.6</b>	<b>-5.5</b>	<b>-5.4</b>	<b>-3.9</b>	<b>-3.0</b>	<b>-2.3</b>
<b>Cyclically-adjusted net borrowing (per cent of GDP)</b>						
Budget 2009	5.7	9.8	8.9	6.8	5.5	4.5
<b>2009 Pre-Budget Report</b>	<b>5.7</b>	<b>9.0</b>	<b>8.0</b>	<b>5.8</b>	<b>4.5</b>	<b>3.6</b>
<b>Net debt (per cent of GDP)<sup>4</sup></b>						
Budget 2009	43.0	55.4	65.0	70.9	74.5	76.2
<b>2009 Pre-Budget Report</b>	<b>44.0</b>	<b>55.6</b>	<b>65.4</b>	<b>71.7</b>	<b>75.4</b>	<b>77.1</b>

Note: Totals may not sum due to rounding.

Note: Budget 2009 aggregates, except for net debt, were on the basis which includes the temporary effects of financial interventions. All 2009 Pre-Budget Report aggregates are on the basis which excludes the temporary effects. In 2008-09 and 2009-10 some of the changes since Budget 2009 are therefore due to the different bases.

<sup>1</sup> The 2008-09 figures were estimates in Budget 2009.

<sup>2</sup> The 2009-10 figures were projections in Budget 2009.

<sup>3</sup> Including changes to forecasting assumptions on spending growth in 2011-12, 2012-13 and 2013-14.

<sup>4</sup> Debt at end March; GDP centred on end March.

## Changes to 2008-09

5.26 The outturn for net borrowing in 2008-09 was £95.4 billion, £5.5 billion higher than the Budget 2009 estimate of £90.0 billion. Since Budget, revisions to outturn based on latest data for local authority, public corporation and central government spending have reduced borrowing by around £5 billion. More than offsetting this are additions of around £10 billion,



relating to the inclusion of capital grants to public sector banks and other transactions in PSNB ex, set out in detail in Table 5.N.

### Changes to 2009-10

**5.27** Net borrowing in 2009-10 is expected to be £177.6 billion, broadly unchanged from the Budget 2009 forecast of £175.4 billion.

**5.28** The new treatment of financial interventions in PSNB ex raises expected borrowing in 2009-10 by around £2 billion compared to Budget 2009, as set out in detail in Table 5.N, with capital grants to public sector banks offset by fees paid by public sector banks to the Government and other transactions.

**5.29** The underlying Pre-Budget Report forecast for borrowing in 2009-10 is very close to that at the Budget. With weaker than expected economic growth in the first part of the year this may reflect the caution in the Budget fiscal forecast. The fiscal projections use the low end of the GDP forecast range. The NAO-audited assumptions on the VAT gap and equity prices also built in caution to the forecast, and the housing market has been stronger than expected since Budget. This is reflected in higher receipts from VAT and stamp duties than expected at the Budget.

**5.30** The deeper than forecast recession has resulted in a wider than previously estimated output gap in 2009-10, which with similar levels of borrowing has lowered the level of cyclically-adjusted net borrowing compared to Budget. Cyclically-adjusted PSNB is 9.0 per cent of GDP in 2009-10 compared to 9.8 per cent at the Budget.

### Changes to 2010-11

**5.31** In the medium term, the Pre-Budget Report forecast for borrowing and debt is very close to the projections made at the time of the Budget, even though the recession has been deeper than expected. Based on cautious assumptions, borrowing is projected to more than halve from 12.6 per cent of GDP this year to 5.5 in 2013-14 and 4.4 per cent in 2014-15, driven by the economic recovery and the consolidation measures announced in the 2008 Pre-Budget Report and Budget 2009. Cyclically-adjusted borrowing is lower than at Budget across the medium-term forecast.

**5.32** Debt is forecast to peak at 77.7 per cent of GDP. This is lower than the forecast of debt used for fiscal policy at the Budget, reflecting the reduction in the provision for losses from the financial interventions, explained in Box 5.D.

### Risks and uncertainties

**5.33** While there are signs that the economy and financial markets are stabilising, both the economy forecast and public finance projections remain subject to a significant degree of uncertainty, in particular:

- the economic growth path is a key driver of borrowing and debt over the forecast period;
- the path of interest rates and inflation over the forecast period are also sources of significant uncertainties for the public finance projections; and
- the outlook for the financial sector, which has been an important source of tax receipts in the UK, is another key uncertainty in the fiscal forecast.

**5.34** Estimates of cyclically-adjusted borrowing, in particular, are subject to considerable uncertainty in current circumstances:

- there are significant uncertainties around the cyclical position of the economy, as discussed further in Chapter 2. These uncertainties are important, since the judgement reached around the impact of the global economic shocks on trend growth is key to estimating the persistent impact of the shocks on the public finances; and
- since the Treasury's cyclical-adjustment methodology is calculated using data over full economic cycles, it may not fully pick up any disproportionate impacts on receipts and spending arising during recessions.

**5.35** 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 the 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. The uncertainty surrounding economic prospects at the current time therefore implies greater than usual risks surrounding the public finance projections.

**5.36** The 2009 *End of year fiscal report* (EYFR) is published alongside the 2009 Pre-Budget Report.<sup>11</sup> The EYFR underlines the Government's commitment to transparency in fiscal policy by providing detailed retrospective information on the public finances in 2007-08 and 2008-09, including an explanation of differences between forecasts and outturn in those years. To ensure consistency between forecast and outturn, the EYFR reports on a National Accounts basis, so some aggregates for 2008-09 are different from those reported in this Chapter because of the introduction of PSNB ex. The information set out in the EYFR supplements the historical and provisional outturn data published in this Chapter.

**5.37** As set out above, recognising the uncertainties surrounding the public finances, the fiscal projections reflect a realistic view of the position of the public finances by incorporating some cautious assumptions.

## Pre-Budget Report policy decisions

**5.38** 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 the 2009 Pre-Budget Report or since Budget 2009. The fiscal impacts of these measures are set out in Table 5.D.

**5.39** Expenditure measures affecting AME and DEL in 2009-10 have been added to total AME and total DEL, respectively.

**5.40** 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 2009 Pre-Budget Report, or where final decisions have yet to be taken.

## Calculating the cost

**5.41** The Pre-Budget Report projections for the public finances take full account of all the measures announced in the 2009 Pre-Budget Report and previous Budgets and Pre-Budget Reports. This is achieved through detailed modelling of the direct effect on receipts of individual measures, including their microeconomic behavioural effects where significant, and through the use of macroeconomic models which are able to estimate the indirect impact of the Pre-Budget Report package of measures as a whole. The detailed models tend to only consider the impact of a measure on the tax base the measure is being applied to, or closely related tax bases. The indirect impacts on other tax bases and the impact on economic growth are generally captured

through the macroeconomic models. The costings shown in Table 5.D are consistent with those produced using the detailed tax models.

**5.42** The calculation of the expected effect of changes in duty rate on consumer demand for excise goods assumes that any change in duty is passed on in full to consumers. Where the effect of one tax change is affected by implementation of others, the measures are normally costed in the order in which they appear in Table 5.D.

**5.43** The costings show the Exchequer impacts of the measures against a baseline that assumes allowances, thresholds and specific tax rates will be increased in line with either the appropriate price index or any pre-commitments (measures announced in previous Budgets or Pre-Budget Reports that are or were due to come into effect). As such they give an indicator of the impact of the decisions made in the current Pre-Budget Report.

**5.44** Unless allowances, thresholds and specific tax rates have been pre-announced, the indexed baseline assumes the following:

- income tax and National Insurance allowances and thresholds (excluding the higher rate limit and the income above which the income tax personal allowance will be restricted); the child element and disabled and severely disabled child elements of the Child Tax Credit, the single person, couple, lone parent, 30 hour 50 plus, disabled and severely disabled worker elements of the Working Tax Credit; inheritance tax nil-rate band allowance threshold; business rates and the capital gains tax annual exempt amount all increase in line with the change in the Retail Price Index (RPI) in the year to the September prior to the respective Budget or Pre-Budget Report;
- the climate change and aggregates levy and the vehicle excise duty, amusement machine licence duty, air passenger duty, fuel, tobacco and alcohol duties all rise in line with the projected annual change in the RPI in the year to the third quarter following the respective Budget or Pre-Budget Report; and
- VAT thresholds and gaming duty bands rise in line with the change in the RPI in the year to the December prior to the respective Budget.

**5.45** With the exception of business rates, when indexation rates are negative, the indexed baseline assumes allowances, thresholds and specific tax rates are held constant. The indexed baseline also takes account of statutory rounding rules.

**5.46** The yields of measures that close tax avoidance loopholes or tackle tax fraud represent the estimated direct Exchequer effect of the measures with the existing level of avoidance activity.

**Table 5.D: Estimated costs for 2009 Pre-Budget Report policy decisions and others announced since Budget 2009<sup>1</sup>**

	Head	£ million				
		2009-10	2010-11	2011-12	2012-13	
<b>Measures announced since Budget 2009<sup>2</sup></b>						
Stamp Duty - Exemption for company buybacks of shares of overseas branches	Tax	0	-5	-5	-5	
Financial products avoidance	Tax	+50	+100	+100	+50	
Pensions tax: anti-forestalling rules	Tax	-30	-40	0	0	
Digital Britain: Landline Duty	Tax	0	+90	+175	+175	
Childcare: employer supported childcare tax relief <sup>3</sup>	Tax/Spend	0	0	-	-	
Gurkhas: removal of 1997 cut-off	Spend	-70	-240	-	-	
Cold Weather Payments	Spend	-20	0	0	0	
Funding for <i>Building Britain's Future</i>	Spend	-35	+35	0	0	
<b>Measures announced at Pre-Budget Report 2009</b>						
<b>Ensuring Sustainability of the Public finances</b>						
Freeze NICs Higher Rate Threshold in 2012-13	Tax	0	0	0	+400	
Increase NICs Primary Threshold by £570 in 2011-12	Tax	0	0	-1,480	-1,500	
Increase employer NICs rate by 0.5% from 2011-12	Tax	0	0	+2,350	+2,470	
Increase main employee and self-employed NICs rate by 0.5 per cent from 2011-12	Tax	0	0	+1,970	+2,080	
Increase additional employee and self-employed NICs rate by 0.5 per cent from 2011-12	Tax	0	0	+320	+340	
Pensions tax: updated income definition	Tax	-10	-40	0	+500	
Freeze Inheritance Tax Threshold in 2010-11	Tax	0	+80	+170	+190	
Bank payroll tax	Tax	+550	0	0	0	
Salary sacrifice: workplace canteens	Tax	0	0	+110	+110	
Pensions auto-enrolment: slower introduction <sup>4</sup>	Tax	0	0	0	+100	
<b>Protecting Revenues</b>						
Insurance Premium Tax: avoidance	Tax	+5	+10	+10	+10	
Index linked gilts	Tax	0	+40	+65	+40	
Substantial donors to charity: replacement of anti-avoidance legislation	Tax	0	-10	-10	-10	
<b>Supporting Business</b>						
Rates on empty property: temporary exemption	Tax	0	-135	+10	0	
Small Companies Rate of corporation tax: defer increase to April 2011	Tax	0	-10	-380	-110	
Patent Box from April 2013 <sup>5</sup>	Tax	0	0	0	0	
Bingo Duty: reduce to 20%	Tax	0	-5	-10	-10	
Seafarer's earning deduction	Tax	0	0	-5	-5	
Venture Capital Schemes: State Aid changes	Tax	0	0	-20	-30	
Strategic Investment Fund addition <sup>6</sup>	Spend	0	-110	-	-	
<b>Protecting the Environment</b>						
Climate change levy: reduction of relief from 2011-12	Tax	0	0	+50	+50	
Fuel Benefit Charge: increase multiplier	Tax	0	+50	+45	+45	
Company Car Tax: extend bands from 2012-13	Tax	0	0	0	+120	
Biofuels Duty Differential: limited extension	Tax	0	-10	-10	0	
Electric vehicles: tax relief	Tax	0	-5	-5	neg	
Warm Front and Greener Boiler Incentive <sup>7</sup>	Spend	0	-85	0	0	
<b>Helping People Fairly<sup>8</sup></b>						
Tax relief for travel expenses	Tax	0	+35	+85	+85	
Extension of free school meals	Spend	0	-140	-	-	
Benefits uprating	Spend	0	-700	-	-	
Local authority guideline rents <sup>9</sup>	Spend	0	-115	-	0	
Money Guidance rollout in 2010/11	Spend	0	-10	0	0	
Working Tax Credits: extension to over 65s from April 2010	Spend	0	-5	-	-	
Tackling benefit error	Spend	0	95	-	-	
Housing benefit: managing gains from Local Housing Allowance from 2011	Spend	0	-40	-	-	
Support for Mortgage Interest <sup>10</sup>	Spend	-25	-70	0	0	
<b>TOTAL POLICY DECISIONS</b>			<b>+415</b>	<b>-1,240</b>	<b>+3,535</b>	<b>+5,095</b>
Reserve: support for military operations	Spend	0	-2,500	0	0	
<i>Memo: Increase to public sector current expenditure</i>	Spend	0	0	-7,700	-6,900	

<sup>1</sup> -Included within the current spending growth assumption for 2011-12 onwards.

<sup>2</sup> Costings shown relative to an indexed base.

<sup>3</sup> Costings reflect Pre-Budget Report economic forecast and assumptions.

<sup>4</sup> Employer supported childcare tax relief measure used to fund expansion of free childcare for 2 year olds.

<sup>5</sup> In 2013-14 the yield is £0.7 billion, in 2014-15 the yield is £1.6 billion.

<sup>6</sup> The costs of this measure will rise to £1.3 bn in steady state.

<sup>7</sup> The total addition to the Strategic Investment Fund at the PBR is £210m in 2010-11, including Barnett consequentials for non-reprioritising funding. £100m of this is funded through reprioritisation.

<sup>8</sup> Total funding for Warm Front and the Greener Boiler Incentive is £215m in 2010-11, including Barnett consequentials for non-reprioritising funding. £130m of this is funded through reprioritisation.

<sup>9</sup> Employment support package costing £45 million in 2009-10 and £355 million in 2010-11 funded by DWP underspend.

<sup>10</sup> Total support for Local Authority Guideline rents is £170m in 2010-11. £55m of this is funded through reprioritisation.

<sup>11</sup> Total support for Mortgage Interest in 2009-10 is £70m, including Barnett consequentials for non-reprioritised funding. £45m, of this is funded through reprioritisation.

**5.47** These estimates are shown on a National Accounts basis. The National Accounts basis aims to recognise tax when the tax liability accrues irrespective of when the tax is received by the Exchequer. However, some taxes are accounted for when the Exchequer actually receives the tax,

reflecting the difficulty in determining the period to which the tax liability relates. Examples of such taxes are corporation tax, self-assessment income tax, stamp duty land tax, inheritance tax and capital gains tax. This approach is consistent with other government publications.

## Receipts

**5.48** This section analyses the projections for tax receipts in detail. It begins by looking at the main determinants of changes in the overall projections since Budget 2009, before looking at changes in the projections of individual tax receipts. Finally it provides updated forecasts for the tax-GDP ratio.

### Changes in total receipts since Budget 2009

**5.49** Table 5.E shows outturns for cash receipts in the first seven months of 2009-10 and estimated receipts for the remainder of the year, along with percentage changes over the corresponding period in 2008-09. These growth rates can vary considerably across the year, partly because of the rules governing payment of each tax and the various time lags.

**5.50** Economic growth in the early part of 2009 was weaker than expected in Budget 2009. However, overall receipts growth in 2009-10 to date has been close to expectations in the Budget 2009 forecast. Receipts from stamp duties and VAT for the year-to-date in 2009-10 have been higher than expected. In part this is likely to be due to the caution in the Budget forecast assumptions on equity prices and the VAT gap, and higher property prices and transactions than expected at Budget. Income tax and NICs receipts have been weaker than expected in the year-to-date, which is likely to reflect lower earnings growth than expected at the Budget. For 2009-10 as a whole, overall receipts are expected to be £2.1 billion higher than in the Budget 2009 projection.

**Table 5.E: 2009-10 Net taxes and national insurance contributions**

	£ billion			Percentage change on 2008-09		
	Outturn <sup>1</sup>	Estimates		Outturn <sup>1</sup>	Estimates	
	Apr-Oct	Nov-Mar	Full year	Apr-Oct	Nov-Mar	Full year
<b>HM Revenue &amp; Customs</b>						
Income tax, NICs and capital gains tax <sup>2</sup>	130.3	101.1	231.4	-7.0	-10.1	-8.4
Value added tax	41.0	26.2	67.2	-19.7	-4.3	-14.3
Corporation tax <sup>2</sup>	21.6	11.8	33.4	-30.1	-3.3	-22.5
Petroleum revenue tax	0.5	0.7	1.2	-72.7	-6.5	-52.9
Fuel duties	15.4	11.0	26.4	6.5	8.1	7.1
Inheritance tax	1.4	0.8	2.2	-26.1	-13.6	-22.1
Stamp duties	4.3	3.1	7.4	-23.7	31.6	-7.2
Tobacco duties	5.2	3.6	8.8	9.5	3.1	6.8
Alcohol duties	5.2	3.8	9.0	8.7	3.0	6.2
Other Customs duties and levies	5.9	4.1	10.0	-4.9	0.0	-2.8
<b>Total HMRC</b>	<b>230.7</b>	<b>166.3</b>	<b>397.0</b>	<b>-11.8</b>	<b>-6.4</b>	<b>-9.6</b>
Vehicle excise duties	3.4	2.3	5.7	-0.1	6.3	2.4
Business rates	16.5	7.2	23.7	2.0	6.0	3.2
Council tax	16.7	8.1	24.8	2.4	1.1	1.9
Other taxes and royalties	8.2	8.1	16.4	-10.8	25.1	4.0
<b>Net taxes and NICs</b>	<b>275.6</b>	<b>192.0</b>	<b>467.6</b>	<b>-10.1</b>	<b>-4.5</b>	<b>-7.9</b>

<sup>1</sup> Provisional.

<sup>2</sup> Net of tax credits scored as negative tax in net taxes and national insurance contributions.

**5.51** Receipts growth is expected to be less weak in the remaining months of 2009-10 than in the first seven months. In part this is a consequence of policy measures such as VAT returning to 17.5 per cent at the end of the year. It also reflects the strengthening path of the economy over the course of 2009-10, with growth expected to return by the end of the year.

**5.52** Changes to the medium-term receipts forecast since Budget are driven primarily by changes to the inflation forecast and by the recovery in asset markets. In the medium term, the Pre-Budget Report forecast of the level of nominal GDP is lower than at Budget because CPI inflation is forecast to be below target for longer than previously expected. This results in a lower level of labour income, which generates around 45 per cent of total receipts through income tax and NICs. This drives a reduction in income tax and NICs receipts compared to Budget. This is partly offset by higher expected receipts from stamp and capital taxes, reflecting the strength in equity and property markets since Budget, and in higher North Sea receipts reflecting the increase since Budget in the NAO oil price assumption.

## Tax-by-tax analysis

### Income tax and NICs

**5.53** Cash receipts of income tax and NICs in 2009-10 are expected to be £3.0 billion below the Budget 2009 forecast with the shortfall more than explained by lower PAYE and NIC receipts. Although the decline in employment has not been as steep relative to output as in previous recessions, earnings growth has slowed sharply. Receipts have been particularly weak in the manufacturing and construction sectors, and there have also been sustained falls in the retail, financial and business service sectors.

**5.54** Receipts are expected to remain weak over the remainder of the year. Financial sector bonuses are expected to decline in 2009-10 by around 25 per cent to a level of around £5 billion reflecting the fall in financial sector profits, a greater proportion of awards deferred in line with the FSA code on remuneration, and the impact of the bank payroll tax announced in the 2009 Pre-Budget Report. Self assessment receipts are also expected to decline sharply, reflecting lower self-employment income and falls in both savings and dividend income. While tax on

savings income has held up better than expected in 2009-10, it is still likely to have fallen by over a third from the previous year.

**5.55** Receipts of income tax and NICs are expected to rise but will be held back by continued subdued earnings growth. The 2010-11 forecast allows for the Budget 2009 measure for an additional 50 per cent rate of income tax on incomes above £150,000. With CPI inflation expected to fall well below target in 2011 given the large degree of spare capacity in the economy, earnings growth is expected to remain subdued for longer than in the Budget 2009 forecast. The Pre-Budget Report projections assume that growth in wages and salaries reaches 5½ per cent in the medium-term, below the growth rate of nominal GDP. This leaves income tax and NICs lower than in the Budget forecast over the rest of the forecast horizon.

### Box 5.B: Impact of NAO-audited assumptions on the fiscal forecast

The National Audit Office (NAO) audited assumptions are designed to add caution to the public finances forecast. Box 5.A sets out details of all the NAO assumptions. This box illustrates how NAO-audited assumptions affect the 2009 Pre-Budget Report forecast.

**Trend rate of GDP growth:** The trend rate 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. The economy forecast is also based on a rebalancing of the economy towards growth in corporate incomes, investment and exports. This growth is less tax-rich than growth in wages and salaries and in consumption. On the income side, profits growth is less tax-rich than wages and salaries growth. From 2010-11 onwards, growth in both wages and salaries and in consumption is below the overall nominal growth in the economy.

**Equity and oil prices:** The NAO-audited assumption on equity prices is that the FTSE All-share index rises in line with nominal GDP from its current level. For the oil price the NAO-audited assumption is based on the average price over the past three months, which is then held flat in real terms over the forecast. This means the oil price remains at between \$72–77 per barrel over the forecast period.

**VAT gap:** The NAO-audited assumption is that the underlying VAT gap (the difference between recorded VAT receipts and the theoretical tax liability) increases by 0.5 percentage points per year from the latest estimated outturn. With firms' cash flows under pressure due to the downturn, there was a rise in VAT debts, pushing up the VAT gap in 2008-09. While the growth in VAT debts has slowed during 2009-10, much of the higher downturn-related VAT gap is locked in by the NAO-audited assumption through the medium-term forecast. This provides considerable caution, as with the economy projected to recover over the forecast period, it is likely that the VAT gap will actually fall, which would increase VAT receipts.

**Claimant count unemployment:** The NAO-audited assumption on the claimant count rises to 1.94m by the end of 2011, which is the average of independent forecasts in the November comparison published by HM Treasury, and then remains flat through the rest of the forecast period. HM Treasury's projection, published for the first time in the 2009 Pre-Budget Report, is that claimant count unemployment will fall to  $1\frac{1}{4}$  m by the end of 2014. This provides caution within the public expenditure projections.

#### Claimant count unemployment: NAO assumption and HMT projection (millions)

	2008	2009	2010	2011	2012	2013	2014
NAO Assumption (Q4)	1.09	1.72	1.91	1.94	1.94	1.94	1.94
HMT Projection (Q4)	1.09	$1\frac{3}{4}$	$1\frac{3}{4}$	$1\frac{1}{2}$	$1\frac{1}{2}$	$1\frac{1}{4}$	$1\frac{1}{4}$



**Table 5.F: Current receipts**

	£ billion			Changes since Budget 2009 (£ billion)		
	Outturn	Estimate	Projection	Outturn	Estimate	Projection
	2008-09	2009-10	2010-11	2008-09	2009-10	2010-11
<b>HM Revenue and Customs</b>						
Income tax (gross of tax credits)	153.5	140.4	144.7	0.9	-0.1	0.0
Income tax credits	-5.6	-6.2	-6.5	0.1	0.0	-0.3
National insurance contributions <sup>1</sup>	96.9	94.8	98.1	0.4	-2.9	-1.5
Value added tax	78.4	67.2	74.2	0.0	3.5	0.8
Corporation tax <sup>2</sup>	43.7	34.1	40.9	0.3	-0.6	1.6
Corporation tax credits <sup>3</sup>	-0.6	-0.7	-0.8	0.0	0.0	0.0
Petroleum revenue tax	2.6	1.2	1.6	0.0	0.1	0.4
Fuel duties	24.6	26.4	28.0	0.0	-0.2	-0.1
Capital gains tax	7.8	2.5	2.6	0.0	0.2	0.9
Inheritance tax	2.8	2.2	2.3	0.0	0.0	0.4
Stamp duties	8.0	7.4	9.3	0.0	2.5	2.6
Tobacco duties	8.2	8.8	8.9	0.0	0.5	0.6
Spirits duties	2.4	2.6	2.6	0.0	0.0	0.0
Wine duties	2.7	2.9	3.0	0.0	0.2	0.3
Beer and cider duties	3.4	3.5	3.5	0.0	0.1	0.1
Betting and gaming duties	1.5	1.4	1.4	0.0	0.0	-0.1
Air passenger duty	1.9	1.9	2.3	0.0	0.1	0.1
Insurance premium tax	2.3	2.3	2.3	0.0	-0.2	-0.2
Landfill tax	1.0	0.9	1.2	0.0	-0.1	-0.1
Climate change levy	0.7	0.7	0.7	0.0	0.0	0.0
Aggregates levy	0.3	0.3	0.3	0.0	0.0	0.0
Customs duties and levies	2.7	2.6	2.5	0.0	-0.1	-0.2
<b>Total HMRC</b>	<b>439.1</b>	<b>397.0</b>	<b>423.1</b>	<b>1.7</b>	<b>2.8</b>	<b>5.3</b>
Vehicle excise duties	5.6	5.7	6.1	0.0	0.1	-0.1
Business rates	22.9	23.7	24.6	0.1	-0.2	0.0
Council tax <sup>4</sup>	24.4	24.8	25.8	0.0	-0.1	-0.1
Other taxes and royalties <sup>5</sup>	15.7	16.4	19.2	0.4	-0.4	0.3
<b>Net taxes and NICs<sup>6</sup></b>	<b>507.7</b>	<b>467.6</b>	<b>498.8</b>	<b>2.3</b>	<b>2.2</b>	<b>5.5</b>
Accruals adjustments on taxes	-4.2	1.3	1.7	0.2	1.0	-1.2
Less own resources contribution to EC budget	-5.1	-3.7	-4.6	0.1	0.4	0.2
Less PC corporation tax payments	-0.2	-0.2	-0.2	0.0	0.0	0.0
Tax credits adjustment <sup>7</sup>	0.6	0.7	0.8	0.0	0.0	0.0
Interest and dividends	7.0	4.4	4.7	-0.5	-1.2	-1.6
Other receipts <sup>8</sup>	26.7	28.1	29.2	-0.4	-0.3	-1.0
<b>Current receipts</b>	<b>532.4</b>	<b>498.1</b>	<b>530.3</b>	<b>1.7</b>	<b>2.1</b>	<b>1.8</b>
Memo:						
North Sea revenues <sup>9</sup>	12.9	7.0	8.4	0.0	0.1	1.8

<sup>1</sup> Includes Bank Payroll Tax

<sup>2</sup> National Accounts measure, gross of enhanced and payable tax credits.

<sup>3</sup> Includes enhanced company tax credits.

<sup>4</sup> 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.

<sup>5</sup> Includes VAT refunds and money paid into the National Lottery Distribution Fund.

<sup>6</sup> Includes VAT and 'traditional own resources' contributions to EC budget.

<sup>7</sup> Tax credits which are scored as negative tax in the calculation of NTNIC but expenditure in the National Accounts.

<sup>8</sup> Includes gross operating surplus, rent and business rate payments by local authorities.

<sup>9</sup> Consists of North Sea corporation tax and petroleum revenue tax.

## Non-North Sea corporation tax

**5.56** Non-North Sea corporation tax is one of the most cyclical taxes and receipts are expected to fall by around 15 per cent in 2009-10, with revenue from the financial sector around a third of its 2006-07 peak, at just £3¼ billion out of a total of £28¼ billion. The 2009-10 decline is driven not only by a decline in profits for both the financial and non-financial sectors, but also

reflects the introduction of a first year capital allowance of 40 per cent for 2009-10 along with the impact of higher repayments as firms carry back losses to relieve against earlier liabilities. Overall, it is higher than expected repayments that are the key factor behind the £0.6 billion lower estimate for non-North Sea corporation tax in 2009-10.

**5.57** Receipts from non-North Sea corporation tax are forecast to recover in 2010-11.

Repayments in 2010-11 are expected to fall back as firms return to profit but also because loss-making firms can only carry back losses against recently paid tax for one year. Payments should also increase, driven by stronger forecast profits and a decrease in deductions as the enhanced capital allowances scheme draws to a close. Profits in the financial sector are expected to start to recover in 2010 from their depressed 2009 level. The Pre-Budget Report projections assume that taxable financial sector profits grow by 10 per cent in 2010-11 and 2011-12, before returning to rates of 7 per cent in each year. This is based on the assumption that profits as a percentage of GDP only return to close to the 20-year average in 2014-15. This leaves corporation tax from the sector below its 2007-08 level, even by 2014-15.

**5.58** Receipts from the non-oil, non-financial sector should benefit from continuing profit growth from 2010-11 onwards, reflecting sustained economic growth. However, with a smaller contribution of the financial sector to overall activity than envisaged prior to the crisis, non-North Sea corporation tax as a proportion of GDP remains well below the recent peak of 2.9 per cent.

### North Sea revenues

**5.59** North Sea revenues in 2009-10 are expected to be around £6 billion lower than in 2008-09. Oil prices, which averaged almost \$100 a barrel in 2008, are likely to average around \$62 a barrel in 2009. The sharp rise and subsequent fall in oil prices in 2008 meant that the first two corporation tax instalment payments on 2008 profits were much stronger than the final payment in January 2009. Instalment payments on 2009 profits are likely to be more even. This contributed to the sharp year-on-year decline of corporation tax in the first part of 2009-10, but is a key reason why the annual decline should be less strong over the remainder of the year.

**5.60** Compared with the Budget forecast, oil prices are likely to be around \$15 a barrel higher in 2009. However, North Sea revenues are expected to be just £0.1 billion above the Budget forecast for 2009-10. Higher oil prices have been offset by a combination of higher than expected operating and capital expenditure, weak gas prices and production over the summer and the appreciation of sterling against the dollar which has meant that the rise in oil prices in sterling terms has been more modest. From 2010, the forecast uses the NAO-audited assumption on oil prices. Based on the average of the past three months, oil prices are expected to be \$72.7 a barrel in 2010 and then constant in real terms. With oil prices over \$20 a barrel higher than in the Budget forecast from 2010 onwards and gas prices assumed to move back in line with oil prices, North Sea revenues are expected to be between £1¾ billion and £2½ billion higher than in Budget 2009 over the rest of the forecast period.

### Capital gains tax and inheritance tax

**5.61** Capital gains tax (CGT) is expected to fall from £7.8 billion in 2008-09 to £2.5 billion in 2009-10. CGT is paid in the final quarter of the financial year following the year in which the gains were realised. With financial assets accounting for the majority of chargeable gains, a sizeable element of the fall in receipts results from the sharp drop in equity prices through 2008-09. The year-on-year drop is accentuated by particularly strong receipts in 2008-09, reflecting investors rearranging their affairs ahead of the abolition of taper relief when the CGT regime was reformed in the 2007 Pre-Budget Report. The expected drop in CGT is one reason why the decline in income tax, NICs and CGT is greater in the remaining months of the financial year than in the first seven months of 2009-10 in Table 5.G. The stabilisation of the housing market

and higher equity prices have led to upward revisions to receipts from both CGT and inheritance tax from 2010-11 onwards.

## Stamp duties

**5.62** Stamp duty both on property and shares has been particularly affected by the financial crisis. Stamp duty in 2009-10 is expected to be around half of its 2007-08 level. However, the decline in stamp duty in 2009-10 is less than that assumed in the Budget forecast, reflecting the stabilisation in the housing market. House prices have recorded monthly rises, while property transactions have rebounded more strongly than assumed in the Budget, although they remain historically low. Stamp duty on shares has also benefited from higher equity prices and volumes since the start of this financial year.

**5.63** Year-on-year growth in stamp duty is likely to turn positive over the remainder of 2009-10 given the annual comparison will be against the low point for both property transactions and equity prices. In 2010-11, the stamp duty land tax forecast is based on the average of independent forecasts for house prices which assumes broadly stable prices in the year to the final quarter of 2010. Thereafter, stamp duty land tax continues to rise as house prices grow at around 5 per cent per year consistent with the average growth of real house prices over the last thirty years and transactions return to a level consistent with the historical average duration of ownership.

## VAT

**5.64** Cash receipts of VAT are expected to fall by 14 per cent in 2009-10, reflecting the temporary reduction in VAT from 17½ per cent to 15 per cent, the impact of the fall in economic activity on the VAT base and repayments relating to the judicial ruling in Fleming/Condé Nast on the three year time limit for reclaiming overdeclared or underclaimed VAT for tax periods before May 1997. However, the drop in receipts this year is not expected to be as steep as forecast at Budget 2009. Receipts are expected to be around £3.5 billion higher, principally because unauthorised VAT debt has not grown as quickly as was assumed in the Budget and litigation repayments made in the first half of the financial year were not as high as had been forecast.

**5.65** Higher than expected receipts in 2009-10 also reflect stronger consumer durable spending than anticipated. Durable spending, which is mainly standard rated, picked up in the second quarter and is likely to have risen further in the third quarter helped by the temporary reduction in VAT, the car scrappage scheme and low interest rates. Ahead of the Budget, the economic downturn and restrictive credit conditions had led to a rise in unauthorised VAT debt. This pushed up the VAT gap (the difference between the theoretical tax liability and actual receipts). The Budget forecast allowed for a further significant rise in the VAT gap on the assumption that VAT debt would continue to rise sharply into 2009-10. However, the growth in VAT debt has slowed in the first half of the financial year. The related document *Measuring Tax Gaps 2009* describes the VAT gap for 2008-09 and the methodology used to calculate the estimate including the impact of debt.

**5.66** VAT receipts are expected to recover in 2010-11 reflecting the ending of the temporary reduction in the standard rate of VAT. However, there will be an offset from higher repayments relating to the Fleming judicial ruling than in 2009-10. The forecast also assumes that growth in VAT receipts will be held back by the rebalancing of demand in the economy, which will lead to nominal consumer spending growing by less than overall growth in the economy. In addition, the NAO-audited assumption on the VAT gap requires at least a 0.5 percentage point rise in the underlying VAT gap each year. This builds considerable caution into the forecast because with the economy recovering, it might be expected that new VAT debt would fall, which would reduce the VAT gap.

## Excise duties

**5.67** Fuel duties in 2009-10 are expected to be £0.2 billion below the Budget 2009 projection. Relative to the Budget, a deeper downturn in the first half of 2009 and a higher oil price negatively affected fuel duty receipts. With fuel duty charged on a per litre basis, higher pump prices would reduce demand and hence receipts. With oil prices over \$20 a barrel higher from 2010 onwards, higher oil prices take around £0.7 billion per year off fuel duty receipts.

**5.68** Alcohol and tobacco receipts in 2009-10 are expected to be £0.3 billion and £0.5 billion higher respectively than assumed in the Budget forecast. Spending has held up better than anticipated in the Budget. In particular duty paid consumption of tobacco may have been boosted by the weakness of sterling against the euro, which would make cross-border shopping or illicit behaviour less attractive.

## Council tax

**5.69** Council tax increases are determined annually by local authorities, not by the Government. The council tax projections are based on stylised assumptions and are not Government forecasts. The council tax figures for 2010-11 onwards are based on the arithmetic average of council tax increases over the past three years. Since changes to council tax are broadly balanced by changes to locally financed expenditure, they have little material impact on the current balance or on net borrowing.

## Other taxes and royalties

**5.70** Around three-quarters of the other taxes and royalties component of Table 5.F is VAT refunds to central and local government. The temporary reduction in the VAT rate has lowered these refunds so far this year. Year-on-year growth over the remainder of the year is likely to be much stronger reflecting that the annual comparison in the final three months will reflect refunds at 17½ per cent relative to 15 per cent a year earlier. VAT refunds also score as public expenditure and thus have no effect on net borrowing.

## Tax-GDP ratio

**5.71** Table 5.G shows projections of receipts from major taxes as a percentage of GDP, and Table 5.H sets out projections of the overall tax-GDP ratio, based on net taxes and national insurance contributions.

**Table 5.G: Current receipts as a proportion of GDP**

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Income tax (gross of tax credits)	10.7	10.0	9.8	10.2	10.6	10.8	11.0
National insurance contributions <sup>1</sup>	6.8	6.7	6.7	6.9	6.9	7.0	7.0
Non-North Sea corporation tax <sup>2</sup>	2.3	2.0	2.3	2.4	2.5	2.4	2.4
Tax credits <sup>3</sup>	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
North Sea revenues <sup>4</sup>	0.9	0.5	0.6	0.6	0.6	0.5	0.4
Value added tax	5.5	4.8	5.0	5.3	5.2	5.1	5.0
Excise duties <sup>5</sup>	2.9	3.1	3.1	3.1	3.1	3.0	2.9
Other taxes and royalties <sup>6</sup>	6.8	6.6	6.8	6.9	6.9	6.9	6.9
<b>Net taxes and NICs<sup>7</sup></b>	<b>35.4</b>	<b>33.2</b>	<b>33.9</b>	<b>34.9</b>	<b>35.3</b>	<b>35.3</b>	<b>35.3</b>
Accruals adjustments on taxes	-0.3	0.1	0.1	0.2	0.3	0.2	0.2
Less EU transfers	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Other receipts <sup>8</sup>	2.4	2.3	2.3	2.5	2.5	2.6	2.5
<b>Current receipts</b>	<b>37.1</b>	<b>35.3</b>	<b>36.0</b>	<b>37.3</b>	<b>37.7</b>	<b>37.8</b>	<b>37.7</b>

<sup>1</sup> Includes Bank Payroll Tax

<sup>2</sup> National Accounts measure, gross of enhanced and payable tax credits.

<sup>3</sup> Tax credits scored as negative tax in net taxes and national insurance contributions.

<sup>4</sup> Includes petroleum revenue tax and North Sea corporation tax.

<sup>5</sup> Fuel, alcohol and tobacco duties.

<sup>6</sup> Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.

<sup>7</sup> Includes VAT and 'own resources' contributions to EC budget; cash basis.

<sup>8</sup> Mainly gross operating surplus and rent.

**Table 5.H: Net taxes and national insurance contributions<sup>1</sup>**

	Per cent of GDP						
	Outturn <sup>2</sup>	Estimate <sup>3</sup>	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Budget 2009	35.1	33.0	33.8	34.7	35.1	35.3	-
<b>2009 Pre-Budget Report</b>	<b>35.4</b>	<b>33.2</b>	<b>33.9</b>	<b>34.9</b>	<b>35.3</b>	<b>35.3</b>	<b>35.3</b>

<sup>1</sup> Cash basis. Uses OECD definition of tax credits scored as negative tax.

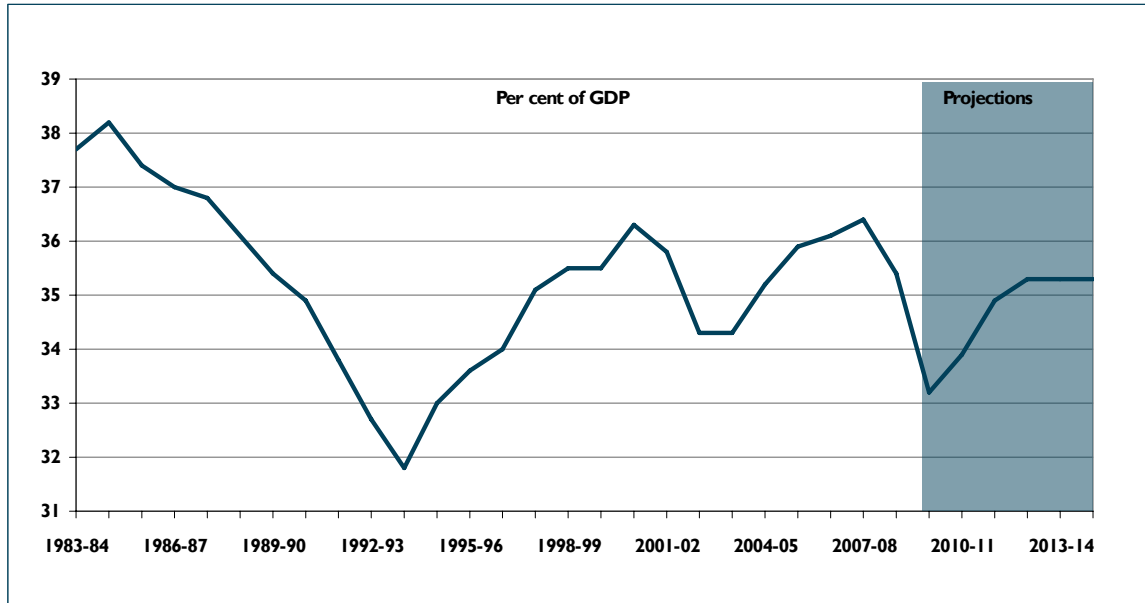
<sup>2</sup> The 2008-09 figures were estimates in Budget 2009.

<sup>3</sup> The 2009-10 figures were projections in Budget 2009.

**5.72** The tax-GDP ratio is similar to the Budget 2009 projection throughout the projection period. The tax-GDP ratio falls by over 2 percentage points in 2009-10 reflecting the effect of the downturn, the further decline in receipts from the financial and housing sectors and policy measures for fiscal support such as the temporary reduction in the standard rate of VAT. While the tax-GDP ratio remains above its early 1990s low, the decline in the ratio of just over 3 percentage points since the last on-trend point in 2006-07 is similar in scale to the fall recorded between 1990-91 and 1993-94.

**5.73** The ending of the temporary reduction in VAT will push up the tax-GDP ratio in 2010-11. Growth picking up to above-trend rates and the impact of the government's fiscal consolidation measures, lead the tax-GDP ratio to rise further in 2011-12. However, the forecasting judgments on the rebalancing of demand in the economy, a lower contribution to receipts from the financial sector than expected prior to the crisis and the NAO-audited assumptions all constrain the overall level of the tax-GDP ratio.

Chart 5.A: Tax-GDP ratio<sup>1</sup>



<sup>1</sup>Net taxes and NICs as defined in Table 5.E.

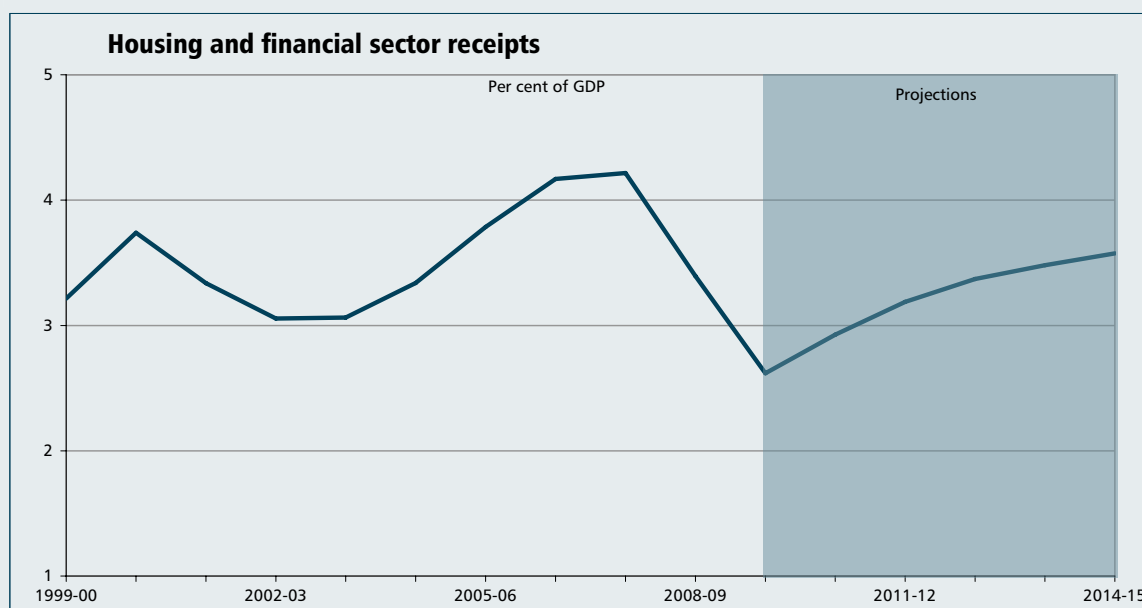
### Box 5.C: Impact of the financial and housing sectors on the public finances

The financial crisis and global downturn has particularly affected the financial and housing sectors in the UK, which are sectors that have been a particularly important source of tax receipts.

Financial company corporation tax has in the past 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.<sup>1</sup>

In recent years before the financial crisis, 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 sectors. 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.

In recent months there are signs that the economy is stabilising and that financial conditions are improving. However receipts from the financial sector are expected to fall further in 2009-10 compared to 2008-09 due to further falls in the profits of the financial sector. Receipts are then expected to recover but 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 to 2½ per cent of GDP in 2009-10, before rising to 3½ per cent of GDP in 2014-15, as these sectors see a cyclical recovery.



<sup>1</sup>These revenues include receipts from financial sector corporation tax, financial sector PAYE and NICs, Capital Gains Tax, Inheritance Tax and stamp duties.

## Public expenditure

**5.74** This section looks in detail at the projections for public expenditure. It includes provisional outturns for 2008-09, the latest estimates for 2009-10 and public expenditure plans for 2010-11 to 2014-15. The spending projections cover the whole of the public sector, using the National Accounts aggregate Total Managed Expenditure (TME).

## Total managed expenditure

**5.75** A breakdown of TME up to 2010-11 is provided in Table 5.K. For fiscal aggregate 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 DEL (firm three-year limits for departments' programme expenditure), and AME (which is large, volatile and demand-led, and is therefore not easily subject to firm multi-year limits). Changes to TME since Budget in the period until the end of the current spending review are set out in Table 5.L.

**5.76** The 2009 Pre-Budget Report confirms that overall departmental spending in 2010-11 will be maintained as planned to help support the economy through recovery. But, as set out in Budget 2009, spending growth will reduce from 2011-12 onwards in order to ensure sustainable public finances over the medium term. As set out in Chapter 4, the 2009 Pre-Budget Report announced that self-employed, employer and employee rates of national insurance contributions will rise by an additional 0.5 per cent from April 2011. As a result, the 2009 Pre-Budget Report announced that public sector current expenditure<sup>12</sup> will grow by an average of 0.8 per cent a year in real terms between 2011-12 and 2014-15. In line with Budget 2009, public sector net investment will move to 1¼ per cent of GDP by 2013-14 and remain at that level in 2014-15

## AME forecast

**5.77** AME spending is forecast on the basis of the economic assumptions set out in Table 5.A and the NAO-audited assumptions set out in Box 5.A. The main changes to these assumptions since Budget 2009 that affect the AME forecast are a lower NAO-audited assumption for unemployment, changes to RPI and Rossi inflation, which affect benefit and public service pension upratings, and changes to gilt rates which affect debt interest.

**5.78** The AME forecasts include two elements – the AME margin and the forecast of social security spending based on the NAO claimant count assumption – which provide elements of caution to mitigate against the risks of additional spending from movements in inflation and interest rates. As shown in Box 5.B, the NAO claimant count assumption builds in caution, because it assumes that claimant count unemployment does not fall from 2011 onwards. This provides caution in the public expenditure projections.



Table 5.I: Current and capital budgets

	£ billion						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
<b>Current budget</b>							
Current receipts	532.4	498.1	530	576	617	656	694
Current expenditure	563.8	607.0	647	666	686	707	729
Depreciation	18.7	19.2	20	21	22	23	24
<b>Surplus on current budget</b>	<b>-50.1</b>	<b>-128.1</b>	<b>-137</b>	<b>-111</b>	<b>-91</b>	<b>-74</b>	<b>-59</b>
<b>Capital budget</b>							
Gross investment <sup>1</sup>	64.0	68.7	60	50	48	45	47
Less depreciation	-18.7	-19.2	-20	-21	-22	-23	-24
Net investment	45.3	49.5	39	29	26	22	23
<b>Net borrowing</b>	<b>95.4</b>	<b>177.6</b>	<b>176</b>	<b>140</b>	<b>117</b>	<b>96</b>	<b>82</b>
<b>Public sector net debt - end year<sup>2</sup></b>	<b>618.8</b>	<b>798.9</b>	<b>986</b>	<b>1139</b>	<b>1270</b>	<b>1379</b>	<b>1473</b>
Memos:							
Treaty deficit <sup>3</sup>	97.8	177.9	177	141	119	98	84
Treaty debt <sup>4</sup>	796.9	1027.0	1209	1359	1485	1589	1679

Note: Measures of current budget, public sector net borrowing and public sector net debt are presented on the basis which excludes the temporary effect of financial interventions.

<sup>1</sup> Net of asset sales; for a breakdown see Table 2.3 in 2009 Pre-Budget Report: the economy and public finances - supplementary material.

<sup>2</sup> Debt at end March.

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

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

Table 5.J: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
<b>Current budget</b>							
Current receipts	37.1	35.3	36.0	37.3	37.7	37.8	37.7
Current expenditure	39.3	43.1	44.0	43.1	41.9	40.7	39.6
Depreciation	1.3	1.4	1.4	1.4	1.3	1.3	1.3
<b>Surplus on current budget</b>	<b>-3.5</b>	<b>-9.1</b>	<b>-9.3</b>	<b>-7.2</b>	<b>-5.6</b>	<b>-4.3</b>	<b>-3.2</b>
<b>Capital budget</b>							
Gross investment <sup>1</sup>	4.5	4.9	4.0	3.3	2.9	2.6	2.6
Less depreciation	-1.3	-1.4	-1.4	-1.4	-1.3	-1.3	-1.3
Net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
<b>Net borrowing</b>	<b>6.6</b>	<b>12.6</b>	<b>12.0</b>	<b>9.1</b>	<b>7.1</b>	<b>5.5</b>	<b>4.4</b>
<b>Public sector net debt - end year<sup>2</sup></b>	<b>44.0</b>	<b>55.6</b>	<b>65.4</b>	<b>71.7</b>	<b>75.4</b>	<b>77.1</b>	<b>77.7</b>
Memos:							
Treaty deficit <sup>3</sup>	6.9	12.6	12.0	9.1	7.3	5.7	4.6
Treaty debt ratio <sup>4</sup>	55.5	72.9	82.1	88.0	90.9	91.6	91.2

Note: Measures of current budget, public sector net borrowing and public sector net debt are presented on the basis which excludes the temporary effect of financial interventions.

<sup>1</sup> Net of asset sales; for a breakdown see Table 2.3 in 2009 Pre-Budget Report: the economy and public finances - supplementary material.

<sup>2</sup> Debt at end March; GDP centred on end March.

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

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

**Table 5.K: Total Managed Expenditure 2008-09 to 2010-11**

	£ billion		
	Outturn 2008-09	Estimate 2009-10	Projections 2010-11
<b>CURRENT EXPENDITURE</b>			
<b>Resource Departmental Expenditure Limits</b>	<b>321.2</b>	<b>342.2</b>	<b>353.4</b>
<i>of which:</i>			
Near-cash Departmental Expenditure Limits	301.6	319.5	329.8
Non-cash	19.5	22.7	23.6
<b>Resource Annually Managed Expenditure</b>	<b>242.7</b>	<b>264.8</b>	<b>293.6</b>
<i>of which:</i>			
Social security benefits <sup>1</sup>	149.8	163.8	169.5
Tax credits <sup>1</sup>	19.8	22.1	22.8
Net public service pensions <sup>2</sup>	3.3	4.1	4.8
National Lottery	1.0	0.9	0.9
BBC domestic services	3.4	3.5	3.7
Other departmental expenditure	0.9	-0.4	2.0
Net expenditure transfers to EC institutions <sup>3</sup>	3.1	6.6	7.4
Locally-financed expenditure <sup>4</sup>	26.8	27.0	28.3
Central government gross debt interest	30.5	30.7	44.4
AME margin	0.0	0.9	1.8
Accounting adjustments	4.0	5.4	8.1
<b>Public sector current expenditure</b>	<b>563.8</b>	<b>607.0</b>	<b>647.1</b>
<b>CAPITAL EXPENDITURE</b>			
<b>Capital Departmental Expenditure Limits</b>	<b>48.1</b>	<b>56.6</b>	<b>52.7</b>
<b>Capital Annually Managed Expenditure</b>	<b>15.9</b>	<b>12.1</b>	<b>6.8</b>
<i>of which:</i>			
National Lottery	0.5	1.0	0.9
Locally-financed expenditure	7.4	5.8	4.7
Public corporations' own-financed capital expenditure	6.8	7.1	7.4
Central government grants to public sector banks <sup>4</sup>	9.9	3.0	0.0
Other capital expenditure	-0.4	1.4	1.4
AME margin	0.0	0.0	0.0
Accounting adjustments	-8.4	-6.2	-7.5
<b>Public sector gross investment</b>	<b>64.0</b>	<b>68.7</b>	<b>59.5</b>
Less public sector depreciation	-18.7	-19.2	-20.1
<b>Public sector net investment</b>	<b>45.3</b>	<b>49.5</b>	<b>39.5</b>
<b>TOTAL MANAGED EXPENDITURE<sup>5</sup></b>	<b>627.8</b>	<b>675.7</b>	<b>706.6</b>
<i>of which:</i>			
Departmental Expenditure Limits	357.7	385.9	392.7
Annually Managed Expenditure	270.1	289.9	313.9

<sup>1</sup> For 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.

<sup>2</sup> Net public service pensions expenditure is reported on a National Accounts basis.

<sup>3</sup> 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 other costs attributed to Departmental DELs, and the UK's net contribution to the EC Budget, which includes these attributed costs, are (in £ billion):

	2008-09	2009-10	2010-11
Net payments to EC institutions	2.3	3.9	5.1
Net contribution to EC Budget	3.0	4.8	6.0

<sup>4</sup> Included in PSNB, previously excluded under PSNB. See further details in Table 5.N.

<sup>5</sup> Total Managed Expenditure is equal to the sum of public sector current expenditure, public sector net investment, and public sector depreciation, on a basis which excludes temporary effects of financial interventions.

**Table 5.L: Changes to Total Managed Expenditure since the Budget 2009**

	£ billion		
	Outturn 2008-09	Estimate 2009-10	Projections 2010-11
<b>CURRENT EXPENDITURE</b>			
<b>Resource Departmental Expenditure Limits</b>	<b>-3.1</b>	<b>0.1</b>	<b>1.2</b>
<i>of which:</i>			
Near-cash Departmental Expenditure Limits	-1.4	-0.4	1.0
Non-cash	-1.7	0.5	0.2
<b>Resource Annually Managed Expenditure</b>	<b>2.5</b>	<b>-1.1</b>	<b>1.1</b>
<i>of which:</i>			
Social security benefits	-0.3	-0.9	-1.4
Tax credits	0.0	0.5	1.0
Net public service pensions	0.3	0.0	0.2
National Lottery	0.1	0.0	0.1
BBC domestic services	0.0	0.0	0.0
Other departmental expenditure	0.1	-2.8	0.3
Net expenditure transfers to EC institutions	0.0	0.9	-0.5
Locally-financed expenditure	-0.6	-0.9	-0.2
Central government gross debt interest	0.1	3.5	1.5
AME margin	0.0	0.0	0.0
Accounting adjustments	2.9	-1.5	0.2
<b>Public sector current expenditure</b>	<b>-0.6</b>	<b>-1.0</b>	<b>2.2</b>
<b>CAPITAL EXPENDITURE</b>			
<b>Capital Departmental Expenditure Limits</b>	<b>-0.2</b>	<b>-1.1</b>	<b>1.1</b>
<b>Capital Annually Managed Expenditure</b>	<b>8.0</b>	<b>6.4</b>	<b>1.5</b>
<i>of which:</i>			
National Lottery	-0.1	0.0	0.0
Locally-financed expenditure	2.9	1.4	0.8
Public corporations' own-financed capital expenditure	-0.4	-0.3	-0.2
Central government grants to public sector banks <sup>4</sup>	9.9	3.0	0.0
Other capital expenditure	-0.8	-0.1	0.5
AME margin	0.0	-0.1	-0.2
Accounting adjustments	-3.6	2.4	0.6
<b>Public sector gross investment</b>	<b>7.8</b>	<b>5.3</b>	<b>2.7</b>
Less public sector depreciation	-0.1	0.4	0.6
<b>Public sector net investment</b>	<b>7.7</b>	<b>5.7</b>	<b>3.3</b>
<b>TOTAL MANAGED EXPENDITURE</b>	<b>7.1</b>	<b>4.3</b>	<b>4.9</b>
<i>of which:</i>			
Departmental Expenditure Limits	-3.0	-1.5	2.2
Annually Managed Expenditure	10.2	5.7	2.7

## AME

### Social security benefits

**5.79** The forecast for social security expenditure is lower than at Budget 2009, primarily driven by decreases in the NAO-audited assumptions for claimant count unemployment since the Budget reflecting the better than expected performance of the labour market. The assumption uses the average of independent forecasts of claimant count, which is 1.94m at end of 2011, and is then held constant through the forecast period. This has a direct impact on forecasts for Jobseeker's Allowance, Housing Benefit and Council Tax Benefit in particular. As set out in Box 5.B, the Treasury's projection is that the claimant count will fall to 1¼m in 2014.

## Tax credits

**5.80** The forecast growth in tax credits spending is driven largely by uprating of the rates and thresholds in line with the Government's indexation policy. This forecast has increased since Budget 2009. The changes reflect revised economic assumptions for RPI inflation and average earnings, and updated estimates relating both to the current level of expenditure on in-work families claiming tax credits and the ongoing impact of the economic downturn on recipients. There are expected to be fewer out of work families than forecast at Budget 2009, reflecting revisions to the claimant count assumption, but falls in income among those in work, which can lead to increased entitlements, are expected to be more numerous. The changes also reflect a growing number of claims for Working Tax Credit by people without children, and the Budget 2006 commitment to index the child element of Child Tax Credit with earnings for the duration of this Parliament.

## Public service pensions

**5.81** Net public service pensions are measured on a National Accounts basis, and report benefits paid less contributions received by central government pay-as-you-go public service pension schemes. Forecast expenditure in 2010-11 reflects actuarial advice on the rate and level at which benefits are expected to come into payment, the rate of future employer and employee contributions and the latest information relating to scheme demographics. Payments to pensioners are expected to increase because of increases in the number of pensioners. Net public service pensions expenditure remains relatively unchanged in 2009-10 compared to Budget 2009, whilst higher than expected pension payments increases net expenditure in 2010-11 compared to the Budget forecast.

## National lottery

**5.82** The National Lottery figures reflect the latest view on timing of drawdown by distributing bodies. The 2009-10 estimates are broadly unchanged from Budget 2009. The forecasts for 2009-10 and 2010-11 are consistent with the latest information from the distributions funds, and projected revenues from ticket sales.

## Other departmental expenditure

**5.83** The large changes to other departmental current and capital expenditure in 2009-10 reflect fees received to date during 2009-10, in respect of the Asset Protection Scheme, the Credit Guarantee Scheme, and underwriting fees for the issuance of shares in Banks temporarily in the public sector. The figures for central government grants to public sector banks in 2008-09 and 2009-10 are newly included in the public finance aggregates, on the basis that excludes the temporary effects of financial institutions. Previously these would have been neutral within the public sector. Increases in other capital expenditure in 2010-11 are primarily due to increases in net lending to public corporations.

## EU contributions

**5.84** Net expenditure transfers to EU Institutions, which consist of Gross National Income (GNI) based contributions less the UK abatement, are unchanged in 2008-09, higher in 2009-10 and lower in 2010-11 than was estimated at the time of the 2009 Budget. The main factors are the use of later information on the size of the EC Budget for 2009 and the possible level of the 2010 EC Budget, and the level of UK payments to these Budgets, changes in UK GNI-based contributions resulting from the use of latest economic assumptions and other changes resulting from new information from the European Commission.

## Locally financed expenditure

**5.85** Locally financed expenditure mainly consists of local authority self-financed expenditure (LASFE) and Scottish spending financed by local taxation. LASFE is the local authority spending financed by local authorities' own sources of net income, other than central government support. The main determinant of the LASFE forecast is council tax. The council tax projections used to derive current LASFE are based on stylised assumptions, which are not government forecasts, and are mirrored in the projections for council tax included in current receipts, so that these assumptions have no material effect on the fiscal aggregates. The current forecast also reflects historical information on movements in reserves, interest receipts and debt repayment. Capital LASFE reflects forecasts on the level of capital expenditure financed by the use of capital receipts, revenue sources of capital finance, private sector contributions and self-financed borrowing. Capital LASFE is net of local authority asset sales.

**5.86** The reductions in current LASFE since Budget 2009 mainly reflect the impact of lower forecast use of reserves to finance current spending and higher use of revenue to finance capital expenditure. Capital LASFE grows, reflecting higher capital expenditure financed from revenue, a forecast reduction in local authority asset sales (that net-off capital spend) and the one-off transfer of Salford's housing stock in 2008-09.

## CG debt interest

**5.87** The projections for central government gross debt interest payments have been revised in the light of the latest assumptions for the economic determinants. The level of debt interest rises in line with the developments in borrowing and the expected path of key determinants. The increases in debt interest payments since Budget 2009 are due to higher forecast RPI inflation, which has increased the expected uplift accruing on index-linked gilts, and also because market expectations of interest rates have risen since Budget 2009.

## PC capital expenditure

**5.88** Public corporations' own-financed capital expenditure (PCOFCE) measures the total amount of public corporations' net capital expenditure, less the amount of this spending that is financed by central government departments, which is already included in DEL and elsewhere in AME. PCOFCE is lower, due to greater lending from central government, which offsets any increases in PC net capital expenditure.

## AME margin

**5.89** The figures for the AME margin shown in Table 5.K above are as set in Budget 2009, but with the figures reduced as necessary to accommodate forecast increases in spending.

## Accounting adjustments

**5.90** The accounting adjustments reconcile the budgeting aggregates DEL and AME with the National Accounts definition of TME, removing items that score in DEL or AME but not in TME, and adding in items included in TME but not in DEL or AME. A breakdown of these accounting adjustments is given in the 2009 Pre-Budget Report: the economy and public finances – supplementary material. Changes to the current and capital accounting adjustments since Budget 2009 include a lower estimate of the amount of defence capital spending that is classified as 'single use military equipment', which is treated as current spending in the National Accounts. This spending is in capital DEL budgets, but is then switched out of capital and into current spending in the national accounting adjustments. Other changes to accounting adjustments reflect lower forecasts for VAT refunds and the imputed subsidy for the Housing Revenue Account (HRA), both of which are offset in current receipts.

**Table 5.M: Departmental Expenditure Limits – resource and capital budgets**

	Outturn	Estimate	Plans
	2008-09	2009-10	2010-11
<b>Resource DEL</b>			
Children, Schools and Families	46.8	49.2	51.3
Health	92.3	100.1	104.0
of which: NHS England	90.7	98.4	102.3
Transport	5.7	6.4	6.4
CLG Communities	4.2	4.5	4.5
CLG Local Government	24.7	25.6	26.3
Business, Innovation and Skills	18.0	19.1	19.2
Home Office	9.2	9.6	9.8
Justice	9.1	9.6	9.4
Law Officers' Departments	0.7	0.7	0.7
Defence	36.7	38.9	36.7
Foreign and Commonwealth Office	2.1	2.1	1.6
International Development	4.8	5.4	6.2
Energy and Climate Change	0.4	1.1	1.1
Environment, Food and Rural Affairs	2.6	2.7	2.7
Culture, Media and Sport	1.6	1.7	1.7
Work and Pensions	8.0	8.9	9.8
Scotland	24.6	25.6	26.1
Wales	12.9	13.6	14.0
Northern Ireland Executive	8.0	8.4	8.7
Northern Ireland Office	1.3	1.2	1.2
Chancellor's Departments	4.5	4.4	4.2
Cabinet Office	2.1	2.3	2.4
Independent Bodies	0.8	0.9	1.0
Modernisation Funding	0.0	0.3	0.2
Reserve	0.0	0.4	4.0
Allowance for shortfall	0.0	-0.6	0.0
<b>Total resource DEL</b>	<b>321.2</b>	<b>342.2</b>	<b>353.4</b>
<b>Capital DEL</b>			
Children, Schools and Families	5.5	7.4	6.7
Health	4.4	5.4	4.7
of which: NHS England	4.2	5.3	4.6
Transport	7.2	8.0	7.3
CLG Communities	7.1	9.1	6.4
CLG Local Government	0.1	0.2	0.1
Business, Innovation and Skills	2.1	3.0	2.3
Home Office	0.8	0.8	0.8
Justice	0.9	0.9	0.7
Law Officers' Departments	0.0	0.0	0.0
Defence	8.7	9.0	8.8
Foreign and Commonwealth Office	0.2	0.2	0.2
International Development	0.9	1.4	1.6
Energy and Climate Change	1.7	2.1	2.0
Environment, Food and Rural Affairs	0.6	0.7	0.6
Culture, Media and Sport	0.9	0.5	0.6
Work and Pensions	0.1	0.3	0.3
Scotland	3.3	4.0	3.2
Wales	1.6	1.7	1.8
Northern Ireland Executive	1.2	1.1	1.1
Northern Ireland Office	0.1	0.1	0.1
Chancellor's Departments	0.3	0.4	0.2
Cabinet Office	0.4	0.4	0.4
Independent Bodies	0.0	0.1	0.1
Reserve	0.0	0.8	2.8
Allowance for shortfall	0.0	-0.8	0.0
<b>Total capital DEL</b>	<b>48.1</b>	<b>56.6</b>	<b>52.7</b>
<b>Depreciation</b>	<b>11.6</b>	<b>13.0</b>	<b>13.5</b>
<b>Total Departmental Expenditure Limits</b>	<b>357.7</b>	<b>385.9</b>	<b>392.7</b>
<b>Total Education spending<sup>1</sup></b>	<b>81.4</b>	<b>88.0</b>	<b>89.2</b>

<sup>1</sup> Education spending is defined according to the UN's Classification of the Functions of Government. Projections include spending by departments, Devolved Administrations and local authorities. Changes since Budget 2009 reflect updated departmental and Devolved Administration budgets.

## DEL

**5.91** The detailed allocation of DEL is shown in Table 5.M. The departmental groupings have been updated to reflect the machinery of government changes announced in June 2009, and outturn years restated on the basis of current departmental responsibilities. In line with previous practice, resource and capital DEL for 2009-10 reflect the latest available information and include an allowance for shortfall reflecting likely underspends against departmental provisions.

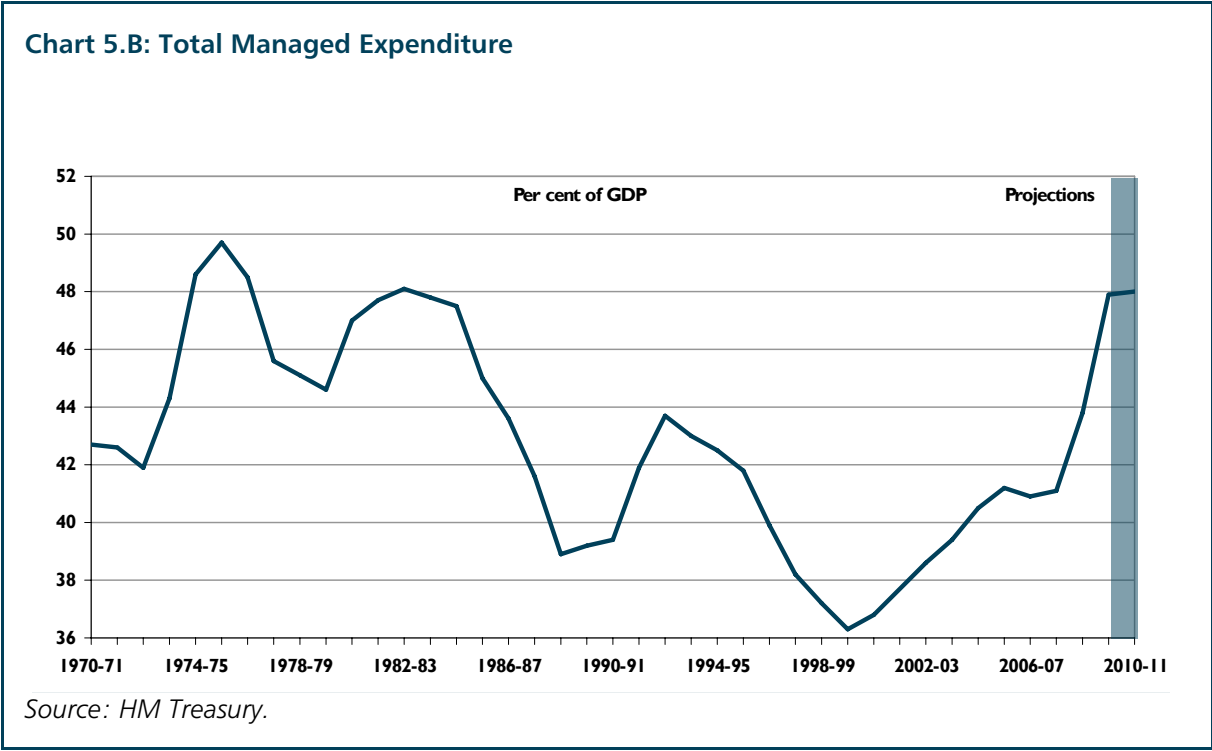
**5.92** Final outturn spending for total DEL in 2008-09 was £357.7 billion, £3.0 billion below Budget 2009 forecast. Within this total underspend, capital DEL was £0.2 billion lower than

forecast, near-cash resource DEL was £1.4 billion lower than forecast, and non-cash resource DEL was £1.7 billion lower than forecast. The 2008-09 capital DEL outturn includes £0.4 billion of accelerated investment planned for that year and announced within the 2008 Pre-Budget Report capital fiscal stimulus package. The near-cash resource DEL underspend reflected larger than expected underspending by a number of departments, most notably a £1.3 billion underspend by the Department of Health (DH), which mainly reflects the planned surplus in the NHS, the result of improving financial management. The unspent capital DEL largely relates to provision for contingency for the Olympic Delivery Authority.

**5.93** There have been a number of changes to DEL budgets since Budget 2009. These mostly reflect:

- reprioritisation measures to fund new spending policies from within existing budgets, including £350 million transferred from the Department for Transport (DfT) to the Department of Communities and Local Government (CLG) to fund the Social Housing Package announced in *Building Britain's Future*;
- an addition to the Reserve of £2.5 billion in 2010-11 to provide an adequate contingency for the cost of Military Operations in 2010-11;
- an additional £130 million in 2009-10 for Department for Children, Schools and Families (DCSF) through access to End of Year Flexibility to fund the Building Schools for the Future and academies programmes; and
- adjustments to the resource and capital budgets for a number of departments following changes in International Financial Reporting Standards.

**5.94** The latest figures also include classification and budgetary changes, which have no impact on National Accounts definitions or TME.



## Central Government spending in 2009-10

**5.95** Monthly spending information is only available for central government. The provisional outturn for current expenditure in the first seven months of 2009-10 is 6 per cent higher than in the corresponding period in 2008-09. Growth is lower in the year to date than the Pre-Budget Report estimate for the year as a whole, as a result of lower debt interest spending.

**5.96** Debt interest payments for the year to date are 23.4 per cent lower than the same period last year, largely because of the effect of lower RPI inflation on the accruing uplift on index-linked gilts. The cumulative year-on-year decline will diminish later in the year as the RPI inflation rate for the relevant period (three or eight months previously depending on the gilt prospectus) rises.

**5.97** Provisional outturn data for net social benefit expenditure for the first seven months of 2009-10 show growth of 10.1 per cent over the same period in 2008-09, as a continued result of the economic downturn. Net social benefit expenditure is estimated to grow at a lower rate for the year as a whole in the Pre-Budget forecast, due to the NAO-audited assumption for unemployment projecting slower growth in the second half of 2009.

**5.98** Other current expenditure is 7.2 per cent higher for the year to date, compared to the relevant period a year ago. This is slightly lower than the Pre-Budget Report estimate of 7.6 per cent growth for the year as a whole.

## Financial interventions

### Classification in National Accounts

**5.99** Following 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 independent Office for National Statistics (ONS) issued comprehensive documentation on 6 November 2009 describing how measures to maintain financial stability and support the effective functioning of the financial sector should be classified in National Accounts and included in outturn data.

### Treatment in the public finances

**5.100** The long-term impact of the financial interventions on the sustainability of public finances will be determined by the eventual net profit or loss on these interventions, which will represent the permanent impact on the taxpayer. The Government will therefore base its assessment of the fiscal position on measures that account for these permanent effects and which exclude any temporary effects of liabilities incurred as a result of the interventions. The treatment of net losses from the financial interventions in the fiscal projections is described further in Box 5.D.

### Public sector net borrowing

**5.101** As set out at the start of this Chapter, and consistent with this approach, the 2009 Pre-Budget Report uses a measure of net borrowing and its components that excludes the temporary effects of the financial interventions (PSNB ex). As set out in Chapter 3, the Fiscal Consolidation Plan will target this measure of borrowing. This measure is consistent with the parallel measure of PSND ex announced at Budget 2008, which the ONS report in outturn. The ONS will also report PSNB ex in outturn and are today publishing a technical note on its derivation.

**5.102** PSNB ex will exclude in outturn the temporary effects of financial interventions such as the gross operating surpluses of banks while they are temporarily in the public sector. Once the ONS have included data for RBS and LBG in the Public Sector Finances data these flows have the



potential to be large and volatile. However, PSNB ex will capture in outturn the permanent effects to the taxpayer of the financial interventions such as:

- the fee income and any loss payments associated with interventions such as the Asset Protection Scheme and the Credit Guarantee Scheme;
- any interest payments from public sector banks to the Government and the interest flows associated with interventions, including the Asset Purchase Facility;
- any paper losses on the acquisition of equity or injection of capital in public sector banks; and
- any final indemnity payments on interventions such as the Special Liquidity Scheme and Asset Purchase Facility.

**5.103** Table 5.N sets out the impact in detail from 2008-09 to 2010-11. This shows:

- transactions between the banks and the private sector are excluded. These are currently small as the ONS has not yet included RBS and Lloyds in the National Accounts measure of PSNB. The net interest income of the Bank of England Asset Purchase Facility Fund (BEAPFF) is also excluded. The Government has indemnified the Bank of England with respect to any losses that may materialise on the Fund's operations and this would score in PSNB ex;
- public sector banks transactions with Government are included in PSNB ex, this currently includes fees paid to the Government by RBS and Lloyds related to recapitalisations and the APS. Any losses on the APS would also be included in this line;
- on a National Accounts basis the difference between the purchase price for equity injections into public sector banks and the market price of the equity on the day of purchase is included in PSNB ex as a capital grant. Other equity injections include funding for Northern Rock; and
- the Government's support for depositors in Bradford and Bingley over the FSCS depositor compensation limit is also included in PSNB ex as a capital grant.

**5.104** The projections in this Chapter do not include any estimate of fee or dividend income from the interventions. Payments and receipts associated with interventions are only included in estimated outturn and in the Budget projections where these have already been made, or a firm announcement has been made of a future transaction. The additional borrowing to finance these payments gives rise to an increase in the Government's debt interest costs, which is included in the projections in this Chapter. Net interest flows are included in the projections.

**5.105** Consistent with National Accounts, a number of transactions relating to the financial interventions will not affect any measure of PSNB because they take the form of financial transactions, such as loans or share purchases, which do not constitute borrowing (as one financial asset is being exchanged for another), or they are offset by recoveries imputed in the National Accounts, such as for liabilities borne by the FSCS. This means that the cash receipts from the sale of shares in public sector banks will not score in PSNB ex as they will be classified as financial transactions. The sale of shares will be reflected in lower debt once the banks are reclassified to the private sector.

**Table 5.N: Financial interventions – impact on PSNB**

	£ billion				
	Outturn	Estimate	Projections		
	2008-09	2009-10	2010-11	2011-12	
<b>PSNB including temporary effects of financial interventions</b>	<b>84.7</b>	<b>170.4</b>	<b>170</b>	<b>136</b>	
<b>Temporary effects excluded from PSNB ex:</b>					
Public sector banks and Bank of England Schemes: transactions with the private sector <sup>1</sup>	0.8	5.5	6	4	
<b>Included in PSNB ex:</b>					
Public sector banks: transactions with government <sup>2</sup>	0.0	-3.8	0	0	
Equity injections: acquisition of shares <sup>3</sup>	6.1	4.2	0	0	
Other equity injections	0.0	1.4	0	0	
Depositor compensation	3.8	0.0	0	0	
<b>PSNB excluding temporary effects of financial interventions</b>	<b>95.4</b>	<b>177.6</b>	<b>176</b>	<b>140</b>	
	Percentage of GDP				
PSNB including temporary effects of financial interventions	5.9	12.1	11.6	8.8	
PSNB excluding temporary effects of financial interventions	6.6	12.6	12.0	9.1	

<sup>1</sup> Illustrative projections for the purposes of the public finances only. Do not represent the Governments' view on the future profits of public sector banks or the net interest income of the Asset Purchase Facility.

<sup>2</sup> This includes fees for outturn. No fee payments are included in the projection.

<sup>3</sup> Provisional estimate for 2009-10.

#### **Box 5.D: The net fiscal cost of financial sector interventions**

At Budget 2009 the Government provisionally estimated that potential losses from the financial interventions might lie within a range of £20 billion to £50 billion. The estimate was set out as a range because of the significant uncertainty over potential outcomes from the interventions at that point. The high end of this range was adopted for fiscal policy purposes as a cautious judgement. It was used to create a measure of PSND including unrealised losses from the financial interventions. This measure was not on a National Accounts basis and was not reported by the ONS.

Exceptional financial market and economic uncertainty has receded since the Budget and, as set out in the Pre-Budget Report, significant changes to the APS policy agreement mean the risks to the taxpayer have reduced. Taking these changes into account, the eventual fiscal cost will be determined by a number of factors:

- the eventual net profit or loss on the recapitalisations of RBS and Lloyds. This will depend on the eventual sale price achieved compared to the purchase price. One way to value this is on the basis of current market prices which would point to a cost of £14 billion, net of the value of the Government's RBS dividend access share. The Government will also have received a total of £0.7 billion in underwriting fees, and this year will receive a £0.3 billion fee for the RBS contingent capital guarantee;
- net payouts under the APS scheme. Based on due diligence of APS assets and the outlook for asset prices and the economy, the central expectation is that net losses on the insured pool of assets will not exceed the revised £60 billion first loss that will fall to RBS. Under the APS the Government will receive fees of £2.5 billion from Lloyds and at least £2.5 billion from RBS; and
- the aggregate costs for all other interventions are expected to be close to zero overall once fees and other income are taken into account. They have been designed to minimise exposure and fair value fees are charged.

At current market prices the net cost of these components would total £8 billion. Any eventual profit or loss will only be realised on the sale of the shares.

#### **Treatment in the public finances and for fiscal policy purposes**

With the Government's exposure now focused on its share holdings and with uncertainty having receded since Budget, it is appropriate to remove the £50 billion provision and move the treatment of financial interventions into line with fiscal aggregates defined on a National Accounts basis and reported by the ONS:

- National Accounts scores a capital grant if the purchase price for equity exceeds the market price on the day of purchase. The value of these capital grants for the purchase of RBS and LBG shares in 2008-09 is £6 billion and in 2009-10 will be around £4 billion, net of the value of the dividend access share. The value in 2009-10 will depend on the share prices on the day of the transactions. These figures will then be fixed as at the day of purchase and will not move subsequently as share prices change in the market; and
- the value of fees to be received this year and so included in the 2009-10 projections totals over £4 billion, but fee receipts estimated to be of a similar value across the forecast period are excluded from the forecast.

As set out in Tables 5.R and 5.S the equity injections related to the acquisition of shares will increase the measures of net borrowing and net debt excluding the temporary effect of the

financial interventions by around £10 billion over two years, representing on a National Accounts basis the treatment of potential losses from the interventions.

## Impact on Public Sector Net Debt

**5.106** Since September 2008 the ONS has published estimates of public sector net debt both including and excluding financial interventions (initially only the impact of Northern Rock) in the monthly Public Sector Finance statistical bulletin. Table 5.O shows the composition of the difference between PSND including financial interventions and PSND excluding the temporary effects of financial interventions.

**Table 5.O: Financial interventions - impact on PSND**

	£ billion			
	Outturn	Estimate	Projections	
	2008-09	2009-10	2010-11	2011-12
<b>PSND including temporary effects of financial interventions</b>	<b>742.4</b>	<b>941.6</b>	<b>1118</b>	<b>1264</b>
<b>Temporary effects excluded from PSND ex:</b>				
Bank balance sheets <sup>1</sup>	122	130	126	122
Depositor compensation	9	10	10	10
Bank of England Schemes	2	15	10	6
<b>Included in PSND ex:</b>				
Equity injections: acquisition of shares <sup>2</sup>	6	10	10	10
Other equity injections	0	1	1	1
Depositor compensation	4	4	4	4
Public sector banks: transactions with government <sup>3</sup>	0	-3	-3	-3
<b>PSND excluding temporary effects of financial interventions</b>	<b>618.8</b>	<b>798.9</b>	<b>986</b>	<b>1139</b>
	<b>Percentage of GDP</b>			
<b>PSND including temporary effects of financial interventions</b>	<b>52.8</b>	<b>65.5</b>	<b>74.2</b>	<b>79.7</b>
<b>PSND excluding temporary effects of financial interventions</b>	<b>44.0</b>	<b>56.7</b>	<b>67.0</b>	<b>73.7</b>

<sup>1</sup> RBS and Lloyds Banking Group cannot be included until ONS have calculated their specific contributions, this is consistent with ONS' treatment in Public Sector Finances.

<sup>2</sup> Provisional estimate for 2009-10.

<sup>3</sup> No fee payments are included in the projection.

**5.107** The main contributions to PSND from financial interventions are:

- the total liabilities, net of liquid assets, of the balance sheets of Northern Rock and Bradford & Bingley (B&B). ONS have not yet been able to calculate the impact of RBS and Lloyds' balance sheets on PSND;
- depositor compensation paid out by the FSCS and Treasury in respect of deposits with Kaupthing Singer & Friedlander (KSF), Heritable, Landsbanki, Dunfermline Building Society and London Scottish Bank which has yet to be recovered from the administrators of those institutions; and
- the BEAPFF is a monetary policy instrument which is also excluded from the measures excluding the temporary effects of financial interventions. As at the end of September 2009, the scheme had added some £17 billion to the National Accounts measure of PSND, mainly from gilts which for PSND are valued at face value and this was lower than the market price paid.

**5.108** General government gross debt (GGGD), the Maastricht Treaty debt definition, is affected by all of the cash flows that impact on the CGNCR, whether or not they cross the public sector boundary. Thus the Government's purchases of equity in RBS and Lloyds Banking Group are included in GGGD even though these are classified by the ONS as intra-public sector transactions.

**Table 5.P: Financial interventions - impact on CGNCR**

	£ billion			
	Outturn	Estimate	Projections	
	2008-09	2009-10	2010-11	2011-12
<b>Net effect of financial interventions</b>	<b>84.0</b>	<b>44.0</b>	<b>-4.5</b>	<b>-3.2</b>
<i>transactions which also affect net borrowing</i>				
Equity injections: acquisition of shares	6.1	4.2	0.0	0.0
Other equity injections	0.0	1.4	0.0	0.0
Depositor compensation	3.8	0.0	0.0	0.0
Public sector banks: transactions with government <sup>1</sup>	-0.4	-2.8	0.0	0.0
<i>financial transactions which do not affect net borrowing</i>				
Loans	20.6	15.0	-4.6	-3.3
Equity injections (net acquisition of shares at market price)	30.8	25.2	0.0	0.0
Depositor compensation	23.1	1.1	0.1	0.0

<sup>1</sup> No fee payments are included in the projection.

## Impact on Central Government Net Cash Requirement

5.109 Cash payments associated with the financial interventions increase the CGNCR in the year in which they are made. The transactions which also affect net borrowing in Table 5.P are discussed earlier in this section. The transactions which directly affect the CGNCR include:

- the cash components of loan advances and capital injections into public sector banks; and
- the component of depositor compensation paid below the FSCS limit.

## Net cash requirement

5.110 Table 5.Q presents projections of the net cash requirement by sub-sector, giving details of financial transactions that do not affect net borrowing (the change in the sector's net financial indebtedness) but do affect its financing requirement.

**Table 5.Q: Public sector net cash requirement**

	£ billion				£ billion			
	2009-10				2010-11			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
<b>Net borrowing ex</b>	<b>170.7</b>	<b>6.9</b>	<b>0.0</b>	<b>177.6</b>	<b>171.7</b>	<b>5.0</b>	<b>-0.4</b>	<b>176.3</b>
Financial interventions impact	0.0	0.0	-7.2	-7.2	0.0	0.0	-6.0	-6.0
<b>Net borrowing</b>	<b>170.7</b>	<b>6.9</b>	<b>-7.2</b>	<b>170.4</b>	<b>171.7</b>	<b>5.0</b>	<b>-6.4</b>	<b>170.3</b>
<i>Financial transactions</i>								
Net lending to private sector and abroad	4.9	0.1	-0.2	4.8	5.7	0.1	-0.2	5.6
Cash expenditure on company securities	26.0	-0.5	-24.7	0.8	1.0	-0.7	0.7	1.0
Accounts receivable/payable	2.6	0.2	0.3	3.1	2.0	0.2	0.3	2.5
Adjustment for interest on gilts	1.6	0.0	0.0	1.6	-4.4	0.0	0.0	-4.4
Miscellaneous financial transactions	16.2	1.8	-6.8	11.2	-4.7	0.0	-5.4	-10.0
Own account net cash requirement	222.1	8.5	-38.7	192.0	171.3	4.6	-11.0	164.9
Net lending within the public sector	1.2	-0.8	-0.5	0.0	2.7	-2.2	-0.5	0.0
<b>Net cash requirement<sup>1</sup></b>	<b>223.3</b>	<b>7.8</b>	<b>-39.1</b>	<b>192.0</b>	<b>174.0</b>	<b>2.4</b>	<b>-11.5</b>	<b>164.9</b>

Note: Including the effect of financial interventions except where stated.

<sup>1</sup> Market and overseas borrowing for local government and public corporation sectors.

5.111 The central government net cash requirement (CGNCR) for 2009-10 is now projected to be £2.5 billion higher than at Budget 2009, largely reflecting changes to the financial transactions. In order to derive the CGNCR it is necessary to use public sector net borrowing on a National Accounts basis, including the temporary effects of financial interventions. CG net

borrowing is little changed from the Budget projection, though its composition is different with higher debt interest payments largely driven by higher inflation being offset by other changes. The changes to the financial transactions are as follows:

- net lending to the private sector and abroad is £0.6 billion lower at £4.9 billion largely as a result of a lower requirement for support for PFI projects;
- cash expenditure on company securities is £9.1 billion higher at £26.0 billion, the result of changes to the terms of the Asset Protection Scheme (APS) and the redemption of the preference shares in RBS and LBG earlier in the year. The latter reduced the net cash requirement by £2.2 billion as the Government's holding of LBG preference shares were only partially replaced by ordinary shares bought in the Open Offer. Under the APS the Government will make an equity injection of £25.5 billion into RBS, £9.5 billion higher than had been assumed in the Budget, and of £5.9 billion into LBG, which had not been assumed in the Budget. It is projected that some £4.0 billion of the £25.5 billion payment for unquoted RBS equity will count as a capital grant and so falls within CG net borrowing;
- accounts receivable/payable are £2.0 billion higher than at Budget, the result of changes to the projected tax accrual for 2009-10 which will not be received in cash in the financial year and to the timing of cash expenditures relative to their accrued equivalents. It is also assumed that the RBS fees totalling £1 billion may not be paid in cash;
- the adjustment for interest on gilts is £3.4 billion lower at £1.6 billion, largely because inflation as it affects index-linked gilts is now projected to be higher than at the Budget. This change offsets the increase to CGNB resulting from a higher debt interest accrual on the index-linked gilts;
- miscellaneous financial transactions are £2.5 billion lower at £16.2 billion, the result of slightly lower projections of the new lending required to support the restructuring of Northern Rock and providing working capital facilities to Bradford & Bingley; and
- net lending within the public sector is £0.7 billion lower at £1.2 billion, the result of lower expected lending to local authorities.

# Financing requirement

Table 5.R: Financing requirement forecast

	£ billion	
	2009-10 April 2009 Original Remit	2009-10 December 2009 Pre-Budget Report
<b>Central government net cash requirement</b>	<b>220.8</b>	<b>223.3</b>
Gilt redemptions	16.6	16.6
Financing for the Asset Purchase Facility	-1.0	-1.0
Financing for the Official Reserves <sup>1</sup>	2.0	4.0
Buy-backs <sup>2</sup>	0.0	0.1
Planned short-term financing adjustment <sup>3</sup>	-0.6	-0.6
<b>Gross financing requirement</b>	<b>237.8</b>	<b>242.4</b>
Less Assumed net contribution from NS&I	0.0	-0.5
<b>Net financing requirement</b>	<b>237.8</b>	<b>242.9</b>
<i>Financed by:</i>		
<b>1. Debt issuance by the Debt Management Office</b>		
Treasury bills	21.6	21.6
Gilts	220.0	225.1
<b>2. Other planned changes in short-term debt<sup>4</sup></b>		
Changes in Ways & Means <sup>5</sup>	-3.8	-3.8
<b>3. Unanticipated changes in short-term cash position<sup>6</sup></b>		
	<b>0.0</b>	<b>0.0</b>
<b>Total financing</b>	<b>237.8</b>	<b>242.9</b>
<b>Short-term debt levels at end of financial year</b>		
Treasury bill stock in market hands <sup>7</sup>	65.6	65.6
Ways & Means	0.4	0.4
DMO net cash position	0.5	0.5

<sup>1</sup> This figure reflects an additional £2 billion of sterling financing for the Official Reserves in addition to the £2 billion announced at Budget 2009.

<sup>2</sup> Purchases of "rump" gilts which are older, small gilts, declared as such by the DMO and in which Gilt-edged Market Makers (GEMMs) are not required to make two-way markets. The Government will not sell further amounts of such gilts to the market but the DMO is prepared, when asked by a GEMM, to make a price to purchase such gilts.

<sup>3</sup> To accommodate changes to the current year's financing requirement resulting from: (i) publication of the previous year's outturn CGNCR; (ii) an increase in the DMO's cash position at the Bank of England; and / or (iii) carry over of unanticipated changes to the cash position from the previous year.

<sup>4</sup> Total planned changes to short-term debt are the sum of: (i) the planned short-term financing adjustment; (ii) Treasury bill sales; and (iii) changes to the level of the Ways & Means advance.

<sup>5</sup> Reflects the Government's decision to repay £3.8 billion of the remaining balance of the Ways and Means Advance in 2009-10. The Government repaid £3.2 billion in 2008-09.

<sup>6</sup> A negative (positive) number indicates an addition to (reduction in) the financing requirement for the following financial year.

<sup>7</sup> The DMO has operational flexibility to vary the end-financial year stock subject to its operational requirements in 2009-10.

5.112 In line with the updated fiscal forecasts, the revised financing arithmetic for 2009-10 is shown in Table 5.R. The central government net cash requirement (CGNCR) is now forecast to be £223.3 billion, an increase of £2.5 billion from the Budget 2009 forecast. There has been an increase in the net financing requirement (NFR) for 2009-10 of £5.1 billion from Budget 2009, so that the NFR is now forecast to be £242.9 billion compared with £237.8 billion at Budget. The increase in the NFR is the net effect of:

- an increase in the CGNCR of £2.5 billion from the Budget 2009 forecast;
- a reduction in the forecast net contribution to financing of £0.5 billion in 2009-10 from National Savings and Investments (NS&I); and
- an increase of £2.0 billion in the financing for the Official Reserves.

5.113 In order to meet the increase in the NFR, the Debt Management Office's (DMO's) remit has been revised. Gross gilt issuance is projected to increase by £5.1 billion to £225.1 billion. The projected increase in the Treasury bill stock is unchanged at £21.6 billion.

5.114 Gross gilt issuance is expected to be split as follows:

- short-maturity gilt issuance is expected to be £74.2 billion (or 33 per cent of total issuance);
- medium-maturity gilt issuance is expected to be £70.1 billion (or 31 per cent of total issuance); and
- long-maturity and index-linked gilt issuance is expected to be £80.8 billion (or 36 per cent of total issuance).

**5.115** Auctions will remain the Government's primary method by which to issue gilts. The Government will continue to use supplementary methods – syndication, mini-tenders and the post-auction 'top up' facility – to issue gilts in the remainder of 2009-10. It is anticipated that:

- £184.1 billion (82 per cent of total issuance) will be issued by pre-announced auctions;
- £30 billion (13 per cent of total issuance) will be issued by syndication; and
- £11 billion (5 per cent of total issuance) will be issued by mini-tenders.

**5.116** Details of changes to the financing arithmetic and a revised financing table for 2009-10 together with information on the progress of gilts sales so far this year against the DMO's financing remit can be found on the DMO's website.<sup>1</sup>



# 6

## Sustainability of public finances

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### Fiscal sustainability beyond the medium term

6.1 The analysis in Chapters 3 and 4 sets out how fiscal policy will ensure that public finances are on a sustainable path in the medium term. This chapter provides analysis of long-term trends and associated challenges facing the UK, based on Government's *2009 Long-term public finances report*.<sup>1</sup>

### Long-term trends and challenges

6.2 *The UK economy: analysis of long-term performance and strategic challenges*,<sup>2</sup> identifies the challenges that are likely to be particularly important to the UK's long-term economic performance as:

- demographic change;
- environmental change; and
- globalisation, technological change and global uncertainty.

### Demographic change

6.3 In the coming decades, the proportion of elderly people is likely to increase substantially. The old-age dependency ratio, calculated by dividing the number of people aged 65 and above by the number of people aged 16 to 64, is set to increase from around 1 in 4 to nearly 1 in 2 in 2060. This trend is common across most developed countries and is the result of a combination of factors, including increases in life expectancy, low fertility rates and the ageing of two large cohorts born in the 1940s and 1960s. While UK demographic developments compare favourably with those of other countries,<sup>3</sup> they are likely to have a direct impact on the public finances through greater pressures on age-related expenditure such as state pensions or health care. Demographic developments are also likely to have implications for the relative size of the workforce and therefore on economic growth, thereby indirectly affecting the public finances.

### Environmental change

6.4 To ensure economic growth that is sustainable in the long-term, it is crucial to be aware of the potential impacts of economic activity on the natural environment and the resources on which long-term growth depends. The impact of climate change is already being felt in the UK and worldwide and, without action, the UK can expect to face economic costs over the next few decades through damage to national infrastructure from severe weather events. The UK supports a goal of reducing developed countries' greenhouse gas emissions by 80 per cent by 2050 and is leading efforts to secure a global deal to tackle climate change at the UN Climate Change Summit in Copenhagen in December 2009. Policy action to reduce emissions is likely to have economic implications as the increasing cost of emissions will drive significant investments in energy saving and low-carbon technologies, while the need to adapt to some inevitable warming could require major changes to energy, transport and infrastructure. However, the indirect pressure this could potentially have on the public finances through affecting economic growth is likely to be modest.

## Globalisation, technological change and global uncertainty

**6.5** The UK economy needs to remain flexible to exploit the new opportunities as well as respond to the challenges further globalisation will bring. Technological change drives productivity improvements and is therefore integral to long-term economic growth. Globalisation and technological change are mutually reinforcing trends: new technology allows transactions to take place across longer distances and can lead to the integration of global markets; globalisation in turn encourages the diffusion of technological advances, which itself encourages innovation. By enhancing growth, these trends can underpin long-term fiscal sustainability, but they can also affect the public finances directly, for example, through effects on tax bases, such as corporation tax. In the short term, these trends can contribute to global uncertainty. As the financial crisis has shown, they allow shocks to spread rapidly around the global economy. This presents significant challenges to all countries and underlines the importance of international cooperation. However, in the long term, these trends should support economic rebalancing in the UK and around the world.

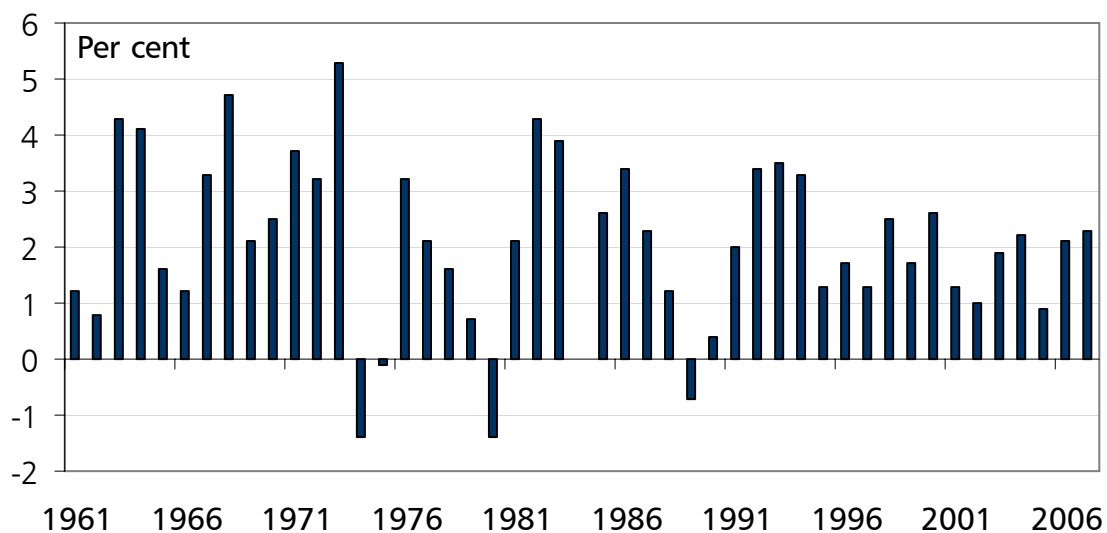
## Long-term economic growth

**6.6** Projections for economic growth in the long-term are largely determined by productivity growth and changes in the size of workforce. Future productivity growth is likely to be underpinned by technological change and globalisation, both of which will be increasingly influenced by environmental developments. The size of expected workforce is influenced by current population structure as well as life expectancy, fertility rates and migration rates. The UK is one of the few European economies where the size of the workforce is projected to increase over the coming decades.

## Productivity

**6.7** In real terms, the UK economy has grown on average by around 2 ½ per cent over the past fifty years. The main driver of this has been growth in productivity, which can be defined as the increase in the output of each unit of labour input in the economy. Chart 6.A shows productivity growth in the past 50 years. Although it has fluctuated substantially, on average, productivity has grown by around 2 per cent over this horizon.

Chart 6.A: Productivity growth (output per worker)



Source: Office for National Statistics

**6.8** The Government's framework for increasing productivity growth has been based on seeking to secure and maintain macroeconomic stability, so as to ensure businesses and individuals have the required certainty to make long-term investment decisions; and undertaking microeconomic reforms to tackle market failures around the drivers of productivity. The drivers of productivity are:

- **competition** – encouraging the adoption of innovative business practices and increased business efficiency;
- **enterprise and entrepreneurship** – strengthening the UK's enterprise culture;
- **science and innovation** – ensuring that the UK capitalises on the creation of new knowledge and its translation into new goods and services;
- **skills** – supporting the development of a more flexible, responsive and productive workforce; and
- **investment** – enhancing the stock of physical capital and ensuring its efficient utilisation.

**6.9** The central projection for long-term economic growth used makes the reasonable assumption that productivity will continue to grow at its historic long-term trend, which as shown above was on average around 2 per cent per year. However, this is of course not guaranteed, and it will continue to be important that the right conditions are maintained for the UK economy to take advantage of opportunities that arise.

## Employment and workforce growth

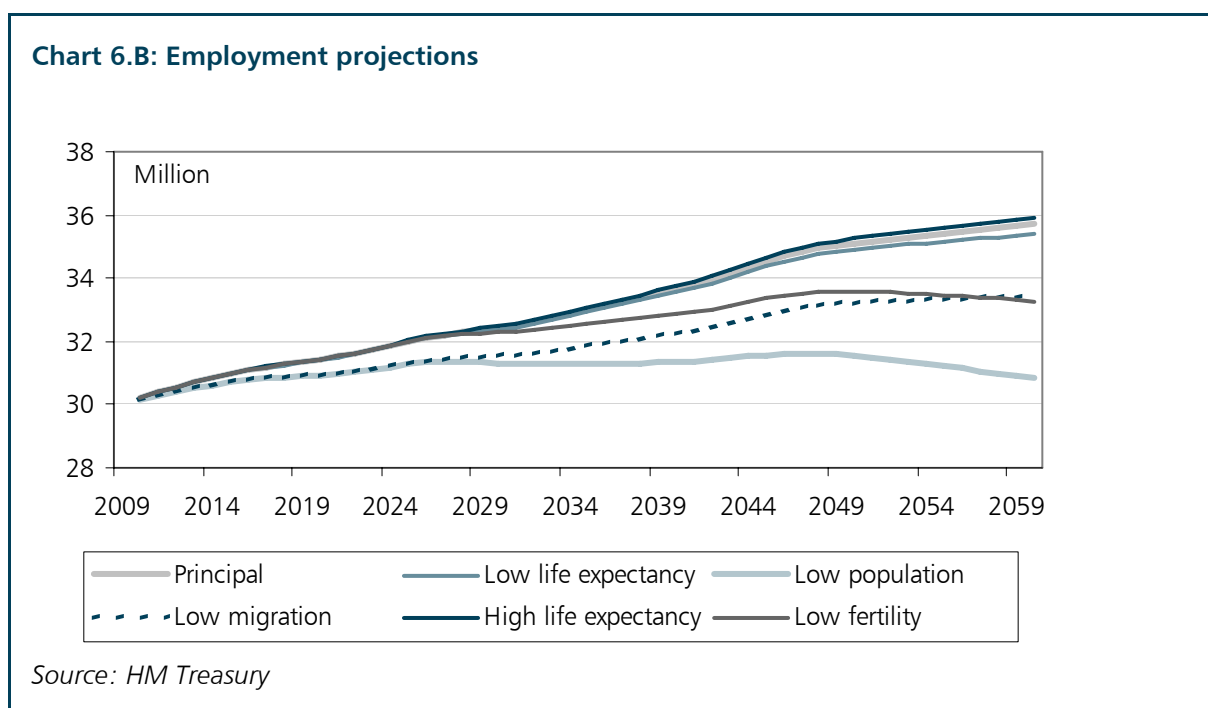
**6.10** Demographic change has implications for the size of the workforce. The Office for National Statistics (ONS) regularly publishes population projections and latest figures show that the workforce in the UK is likely to continue growing, as the number of people of working age continues to grow.<sup>4</sup> In addition to the size of workforce, trends in labour participation will also affect total employment. To capture both the change in size of workforce and developments in

participation rates, HM Treasury uses its 'cohort model', which is explained in detail in the 2005 Long-term public finance report.

**6.11** The ONS population projections are used as the main input to the cohort model. Employment levels can then be projected by using these estimates and taking into account the impact of an ageing workforce on overall participation. Chart 6.B shows the results of this analysis for different population variants. It is apparent that, notwithstanding demographic change, under most of the population variants employment is set to continue to grow. This is also the case for population variants that project a lower number of workers compared with the principal variant, as shown in the low migration and low population variants

**6.12** The projected increase in the size of the workforce is set to contribute to economic growth in the coming decades. This contrasts with developments in many other European countries, where the workforce is projected to shrink, with potentially negative impacts on GDP growth. Comparisons of population trends in EU countries show that the UK is one of only seven Member States that is set to see an increase in its working-age population (aged 15-64) whereas others are projected to see a decline.<sup>5</sup>

**6.13** Assuming a 2 per cent productivity growth and employment growth as projected under the principal population variant, the economy is likely to grow at a rate between 2 ¼ and 2 ½ per cent in the long term. At this rate of growth, the economy would double in size within the next thirty years, while per capita real GDP would increase by over two thirds.



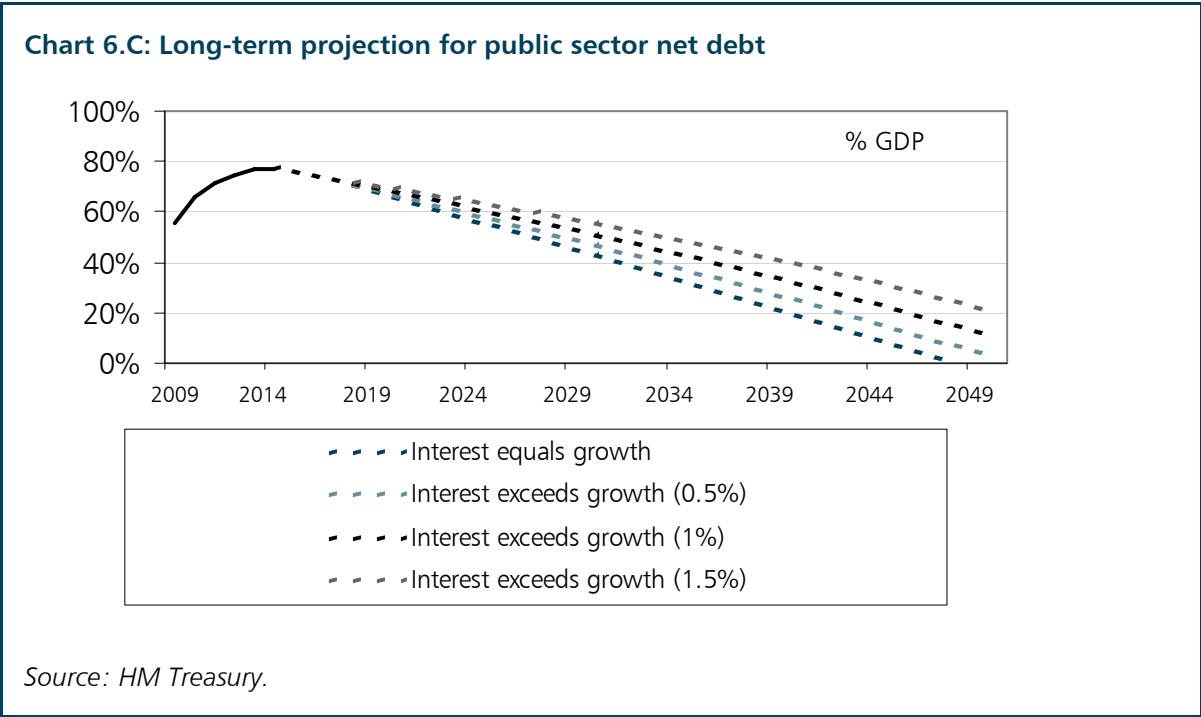
## Long-term fiscal projections

**6.14** In the long-term, the Government expects the path of the public finances to be determined by its fiscal objectives and fiscal policy settings. However, it is important to understand the potential pressures that long-term challenges and trends could exert on public finances and the 2009 *Long-term public finance report* illustrates how spending and revenue would evolve under a set of given assumptions. However, these projections should be caveated as involving a high degree of uncertainty.

**6.15** A long-term projection for public sector net debt is shown in Chart 6.C. This chart takes into account consolidation plans and projections as set out in the 2009 Pre-Budget Report and

thereafter assumes that expenditure and receipts (excluding interest payments and receipts) grow in line with the economy. This is based on assumptions covering three future periods:

- the 2009 Pre-Budget Report medium-term forecast covers the period 2009-10 to 2014-15;
- beyond 2014-15, projected further reductions in borrowing mean that debt begins to fall and the current budget reaches balance as set out in the 2009 Pre-Budget Report; and
- thereafter, the projections are based on a long-term economic growth of between 2 ¼ and 2 ½ per cent and the assumption that expenditure and receipts (excluding interest payments and receipts) grow in line with the economy. Interest payments are determined by assumptions about the rate of interest and projected debt levels. A range of outcomes is illustrated for the long term, depending on the relationship between growth and interest rates. These include a projection that assumes the real interest rate is equal to the real growth rate of the economy and projections that assume interest exceeds growth by between 0.5 and 1.5 per cent. The historic average in the UK is for the real interest rate to exceed the real growth rate of the economy by around 1 per cent.

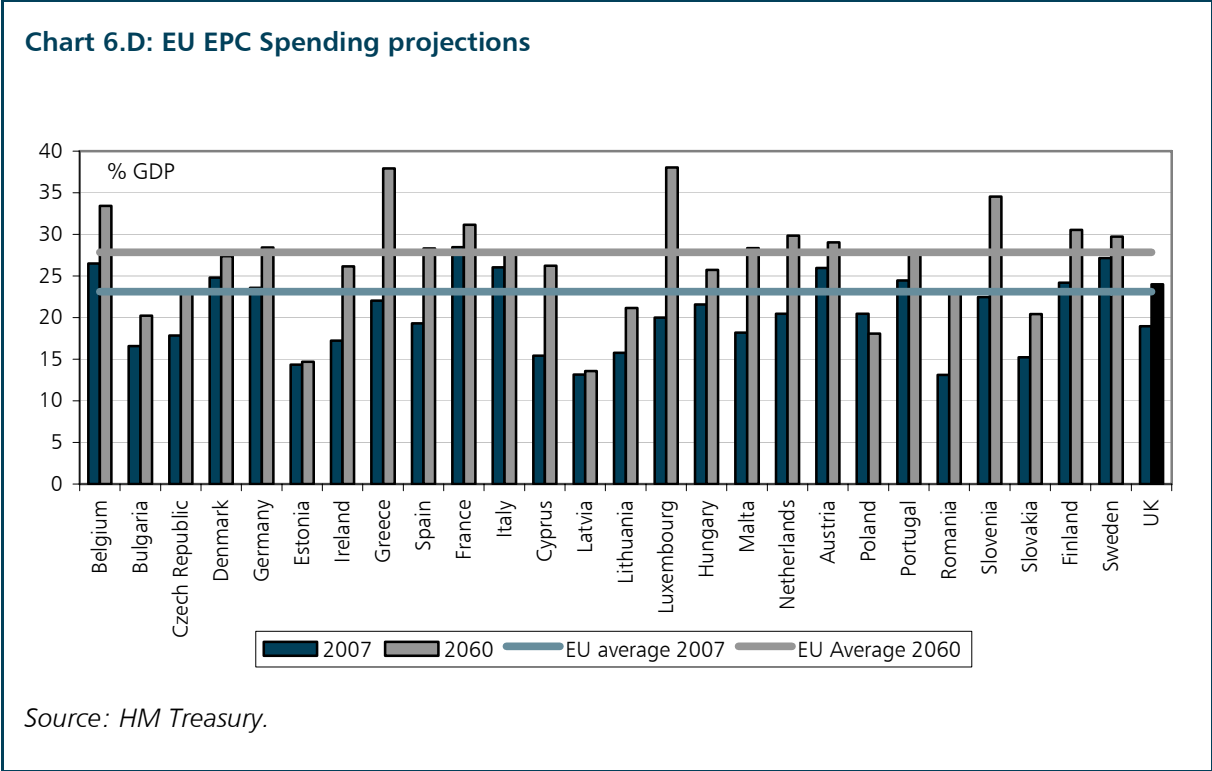


**6.16** Under the range of assumptions set out, debt is projected to fall to between 0 and 30 per cent of GDP by 2050.

**Economic Policy Committee (EPC) Projections**

**6.17** There are alternative ways to make fiscal projections, one of which is carried out by the Economic Policy Committee (EPC) who makes projections for the EU Member States. Like the LTPFR, they provide an indication of the timing and scale of economic changes that would result from an ageing population in a ‘no-policy’ change scenario on the main age-related spending items such as health, long-term care and education. However, the underlying commonly-agreed assumptions differ from those used by HM Treasury and the most recent projections are shown in the 2009 Ageing Report. Nonetheless, the report provides a set of projections that are comparable between the different member states.

6.18 Chart 6.D shows the projection results from the 2009 Ageing Report. Age-related expenditure in the UK is projected to be significantly lower than most EU countries and also to remain well below EU average by 2060.



6.19 However, as explained in the Ageing Report, the long-term projections are not forecasts as the uncertainty surrounding the projections is high and the longer the projection period, the higher the degree of uncertainty. Results are strongly influenced by the underlying assumptions and will be affected by medium-term economic developments.

# 7

## Quality of public finances

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### Sustaining efficient and effective public services

#### Improvements in public services

7.1 Since 1997, a combination of investment and reform has radically improved the quality of Britain's public services, delivering real and lasting improvements. Total public spending has increased by 57 per cent in real terms, compared to 15 per cent in the preceding 12 years, enabling the Government to achieve sustainable front-line services that deliver high quality outcomes<sup>1</sup>. For example:

- NHS spending in England has more than doubled in real terms since 1997. This has allowed the NHS to deliver improved services, achieving the national level targets for hospital treatment within 18 weeks, referral to a cancer specialist within 2 weeks and A&E treatment within 4 hours;
- spending on education in the UK has increased in real terms by £31.2 billion since 1997. As a result, the number of schools with less than 30 per cent of pupils gaining five or more good GCSEs or equivalent, including English and maths, has fallen from 1,600 in 1997 to a projected 270 in 2009, according to self-reported results; and
- central government spending on the police has increased by 19 per cent in real terms since 1997. As a result, there are now 16,000 more police officers than in 1997 and this has helped the police to continue to play a vital role in keeping Britain's communities safe and secure.

#### A decade of investment

7.2 At the same time, record levels of capital investment have reversed a legacy of underfunding. Public sector net investment is now at its highest level in 30 years, up from 0.6 per cent of GDP in 1997-98 to 3.3 per cent in 2009-10<sup>2</sup>. For example:

- total capital investment in education in the UK has increased from £1.7 billion in 1998-99 to £8.3 billion in 2008-09, resulting in the rebuilding or significant refurbishment of 3,800 schools and over 3,000 Sure Start Children's Centres;
- capital investment in housing and community amenities has risen from £2.7 billion in 1998-99 to £11.3 billion in 2008-09, annual average real growth of 12.8 per cent. A £33 billion investment has reduced the number of social homes not meeting the Decent Homes standard by one million. This and other housing programmes are expected to have lifted over a million children out of poor housing; and
- UK transport spending has more than doubled since 1997, which has led to major improvements in the transport network including over 70 major motorway and trunk road schemes completed since 2001, a high-speed rail link from St Pancras to

the South East, the West Coast Mainline upgrade, and the enhancement of over 100 stations across the London Underground network.

## Value for money

**7.3** This increased investment has been accompanied by a strong focus on value for money, improving efficiency and cutting down on waste. Over the 2004 Spending Review period, departments over-delivered on the Government's value for money target by 20 per cent, achieving savings of £26.5 billion. Over the 2007 Comprehensive Spending Review (CSR) period the Government has committed to a cash-releasing value for money target worth £35 billion by the end of 2010-11. Departments are making good progress towards their 2007 CSR targets and the 2009 Pre-Budget Report announced that £8.5 billion of efficiencies have been delivered so far. This includes savings reported in 2008-09 departmental annual reports and, where available, departmental savings reported in the first half of 2009-10.

**7.4** In addition, the 2004 Lyons Review<sup>3</sup> laid down a target of relocating 20,000 civil service posts out of London and the South East by 2010-11. Budget 2009 extended this target by an additional 4,000 posts and the 2009 Pre-Budget Report announced that by June 2009 nearly 21,000 posts had been relocated.<sup>4</sup> *Putting the Frontline First: smarter government*<sup>5</sup> published on 7 December 2009 announced that Ian Smith, former Chief Executive Officer of Reed Elsevier and Taylor Woodrow, would lead a review on the scope for further civil service relocations, to report by Budget 2010. The review will set out what specific efficiencies this might bring and outline how at least 10 per cent of civil service posts currently based in London and the South East can be relocated in the medium term.

**7.5** Budget 2008 announced the next stage of the Government's programme of value for money reforms, setting up the Operational Efficiency Programme (OEP) and the Public Value Programme (PVP) to capitalise on best practice and leading thinking in the private and public sectors. Budget 2009 accepted the recommendations of the OEP reviewers that the Government could achieve £15 billion of additional efficiency savings a year by 2013-14 compared to 2007-08, in back office and IT, collaborative procurement, asset management, property and local incentives and empowerment. Budget 2009 also set out details of the early savings from the PVP and announced that the programme would be expanded to ensure demanding value for money reviews are conducted across a minimum of 50 per cent of each department's budget. Initial savings options identified by the PVP are set out later in this chapter.

## Public service reform

**7.6** Alongside this drive to improve efficiency, the Government has also implemented significant reforms to improve public services: with institutions such as Foundation Trusts and Academies to increase choice and raise standards; new performance management tools such as Public Service Agreements; more joined up inspections through Local Area Assessments; more front-line staff – 16,000 more police officers, 42,400 more teachers, and over 70,000 more nurses; and new services such as Sure Start Children's Centres, Jobcentre Plus and neighbourhood police teams.

**7.7** In 1997, as the Government began to correct the legacy of under-investment in public services, clear national standards and targets were needed to drive up performance. But as services were repaired and rebuilt, the challenge became to increase standards while ensuring the necessary flexibility and incentives at the front line. The 2004 Spending Review focussed on fewer, sharper targets; new freedoms for front-line staff; and greater choice and diversity of services for citizens, including from private and third sector providers. The 2007 CSR announced just 30 cross-cutting Public Service Agreements setting out the Government's top priorities for improving outcomes and services for citizens, down from 600 targets in 1998.



**7.8** In March 2009, the Government published *Working Together – Public Services on your Side*<sup>6</sup>, which set out more detail on the three principles underpinning further public service reform:

- empowering citizens – through the creation of clear public service entitlements that make citizens more aware of what they can expect from public services, through giving them more choice and control, and providing more access to public data. For example, entitlements to be treated within 18 weeks under the NHS Constitution, or for the NHS to take all reasonable steps to offer alternative treatment; and the release of valuable public datasets which will be made free for reuse, including NHS Choices data;
- new professionalism – through giving front-line professionals the space, skills and power to respond to citizens’ needs. For example, by giving service leaders the freedom to join up and tailor services across local areas; and
- strategic leadership – with central government setting standards and entitlements only. For example, by setting out clear entitlements in education but preserving local flexibility regarding the form of delivery.

**7.9** *Building Britain’s Future*<sup>7</sup> and *Putting the Frontline First: smarter government* show how going forward, these principles will be embedded into public service delivery.

## The BBC

**7.10** As recently stated in the Government’s response to the Public Accounts Committee’s April 2009 report<sup>8</sup> into the efficiency of radio production at the BBC, the National Audit Office (NAO) should have unrestricted access to the BBC in scrutinising the effectiveness and efficiency of its service delivery. The Government is encouraging the BBC to discuss with the NAO how this can be best achieved whilst maintaining the BBC’s editorial independence.

## Supporting the economy through the downturn

**7.11** Over the last year, all the world’s major advanced economies have been affected by a steep and synchronised global downturn and, as the economic challenge has deepened, a key issue for governments has been how to continue to drive improvements in public services whilst ensuring sustainable public finances over the medium term. In line with the international consensus and the work of the G20, the Government’s approach has been:

- to allow public spending to rise to support the economy through the global downturn in the short term; and
- to deliver fiscal consolidation once recovery is secured, to ensure sound public finances over the medium term, but doing so in a way that is in line with the Government’s values, focussing on the priorities set out in *Building Britain’s Future*.

## Capital fiscal stimulus

**7.12** The 2008 Pre-Budget Report announced that £3 billion of capital spending would be brought forward from 2010-11 into 2008-09 and 2009-10 to support aggregate demand and maintain jobs during the economic downturn. A projected £1.7 billion of accelerated investment has been delivered to date<sup>9</sup>, which is supporting a number of jobs and industries across the country. For example:

- more than 800 GP practices have had additional funding to improve and extend training facilities. This will provide 1,400 extra training places, primarily in areas that

historically have had a lower provision of doctors. To date, over 200 schemes are in construction or have been completed;

- housing and regeneration capital funds brought forward will bring 10,000 council homes up to the Decent Homes standard in 2009-10;
- the Highways Agency is continuing to progress £400 million of high value schemes on the strategic road network. These include the A46 road-widening scheme and the acceleration of specific asset renewal and managed motorway works across the network. 21 of these schemes have been completed to date; and
- all of the £100 million funding allocated for the Warm Front Programme in 2009-10 has been spent, benefiting almost 38,000 households and saving them each up to £300 in energy bills every year. The 2009 Pre-Budget Report announced an additional £200 million to fund the Warm Front Scheme and the greener boiler incentive scheme in 2010-11.

**7.13** In addition, Budget 2009 announced £600 million of new investment to move forward stalled housing projects and kick-start house building. *Building Britain's Future* included an additional £1.5 billion to deliver 20,000 more affordable homes. Together, these contribute to the Government's aim of delivering over 55,000 affordable homes this year and over 56,000 in 2010-11.

### Support for PFI projects

**7.14** To ensure that Private Finance Initiative (PFI) projects continued as planned despite the current financial market conditions, the Infrastructure Financing Unit (TIFU) was established at Budget 2009 to lend to PFI projects that cannot raise sufficient debt finance, on acceptable terms, to reach financial close on a timely basis. Since then, 23 PFI projects involving some £3.7 billion of finance have reached financial close, compared to less than £1 billion for PFI projects in 2007-08.<sup>10</sup>

### Support for families and businesses during the downturn

**7.15** As well as action to maintain financial stability and support economic demand, the Government is also providing targeted support to families and businesses most affected by the recession. As the economy starts to recover, it is right that these temporary measures are slowly withdrawn, but the Government is determined to continue to provide short-term support to particularly vulnerable groups.

### Support for families and individuals

**7.16** In the 2008 Pre-Budget Report and Budget 2009 the Government set aside £3 billion of additional funding over two years for Jobcentre Plus and the Flexible New Deal programme to ensure the employment interventions regime has the capacity to enable people to get back to work quickly. Over 70 per cent of Jobseekers Allowance (JSA) recipients leave unemployment benefit within six months<sup>11</sup>.

**7.17** Budget 2009 also introduced a £1.2 billion guarantee of 6 months meaningful activity for all young people who have been claiming JSA for 12 months to prevent individuals from becoming detached from the labour market. Up to 95,000 Future Job Fund jobs have already been announced across the country as a result of this intervention. Building on this success, the 2009 Pre-Budget Report announced £300 million to strengthen and bring forward the Youth Guarantee, offering 18 to 24 year olds who have been claiming Jobseeker's Allowance for six months a job, training or a work placement lasting at least six months.

## Support for homeowners

**7.18** For homeowners, temporary schemes are helping the most vulnerable to stay in their homes and offering support to first-time buyers. The 2009 Pre-Budget Report announced that the Standard Interest Rate used to calculate Support for Mortgage Interest will be frozen at 6.08 per cent for a further six months. Around 220,000 homeowners will continue to benefit from this extra support. In addition, the Government will make available over £150 million of funding through 2010-11 for the HomeBuy Direct shared equity loan scheme, helping an additional 3,000 households purchase their new homes.

## Support for business

**7.19** Over the past year the Government has provided significant temporary support for businesses, for example action to help small and medium-sized enterprises (SMEs) access the finance they need through the Enterprise Finance Guarantee scheme. In addition, to support innovative advanced industrial projects of strategic importance, the Government announced a £750 million Strategic Investment Fund (SIF) at Budget 2009.

**7.20** The 2009 Pre-Budget Report did more to support business and create a platform for future economic growth, including by:

- supporting investment in low-carbon projects by providing £200 million additional funding to the SIF and investing £90 million in the 2020 European Fund for Energy, Climate Change and Infrastructure, to be overseen by Infrastructure UK;
- continuing the Enterprise Finance Guarantee scheme for a further twelve months, recognising the continued challenges that smaller businesses face in accessing finance;
- creating a Growth Capital Fund that will target SMEs for which traditional bank finance is either inappropriate or unavailable; and
- setting out details of a new body, Infrastructure UK, to advise the Government on the UK's infrastructure needs over the next 5 to 50 years. Infrastructure UK will act as a focal point for the UK's infrastructure strategy and its long-term development and delivery.

**7.21** These new measures on growth will continue to be supported by the Government's action to deliver key infrastructure projects now. For example, a significant milestone has been reached with the commencement of the Blackfriars station redevelopment as part of the £5.5 billion Thameslink upgrade, and construction has started on the £640 million Birmingham New Street station redevelopment. Construction of Crossrail has begun, with engineering underway to create the Isle of Dogs station, whilst work is progressing at Tottenham Court Road and Farringdon. In 2009-10, the Highways Agency is investing over £1.5 billion on capital infrastructure including major road improvements on the M1, M25, M40, A1 and A46.

## Sustainable medium-term path for public spending

**7.22** The 2009 Pre-Budget Report confirmed that overall departmental spending in 2010-11 will be maintained as planned to help support the economy through recovery. But, as set out in Budget 2009, spending growth will reduce from 2011-12 onwards in order to ensure sustainable public finances over the medium term. The 2009 Pre-Budget Report announced that employer, employee and self-employed rates of national insurance contributions will rise by an additional 0.5 per cent from 2011-2012. As a result, the 2009 Pre-Budget Report announced that public sector current expenditure will grow by an average of 0.8 per cent in real terms

between 2011-12 and 2014-15.<sup>12</sup> In line with Budget 2009, public sector net investment will move to 1¼ per cent of GDP by 2013-14 and remain at that level in 2014-15.

**7.23** The Government is not doing a spending review at this stage, but the 2009 Pre-Budget Report set out more detail on the Government's commitment to continuing to protect the key public service priorities which are vital for ensuring opportunity, social mobility and fairness for all; and to making the tough choices necessary to fund this by increasing efficiency and cutting lower value programmes and lower priority budgets.

## Protecting public service priorities

### Health

**7.24** Spending on the NHS has more than doubled in real terms since 1997<sup>13</sup>. In assessing the resources needed to maintain high quality healthcare, the 2009 Pre-Budget Report announced a package to ensure that NHS near-cash front-line spending – the 95 per cent of spending that supports patient care – will rise in line with inflation in 2011-12 and 2012-13.

**7.25** Alongside this additional investment, the Government has a comprehensive programme in place to identify value for money savings in all parts of the NHS, including in front-line services. As an interim step towards the £15 to £20 billion savings that the NHS Chief Executive has challenged the NHS to achieve, the 2009 Pre-Budget Report announced that value for money savings of around £10 billion per year will be delivered by 2012-13 through the work underway within the NHS and through the PVP, OEP and other value for money initiatives, including by:

- improving how the NHS buys services for patients and adjusting the price it pays, enabling all hospitals to reach the productivity levels achieved by the best, ensuring that people get the most appropriate treatment in the right place at the right time;
- delivering more efficient, integrated and people-centred community and mental health services, including by developing common prices to reduce variation and transforming the care and lives of those with long-term conditions; and
- driving down back office and procurement costs.

**7.26** Budget 2010 will set out in detail the £15 to £20 billion savings.

**7.27** Front-line NHS spending rising in line with inflation, combined with the progress that has already been made in identifying value for money savings will ensure that the NHS can continue to deliver key service outcomes. This includes the proposed new patient entitlements to hospital treatment within 18 weeks, referral to a cancer specialist within 2 weeks, and free NHS Health Checks every five years for all those aged 40-74, which will be set out in a revised version of the NHS Constitution. It will also allow the Government to introduce an entitlement to cancer diagnostics within 1 week, to be phased in from 2011-12.

### Education

**7.28** Since 1997, spending on education in the UK has increased in real terms by £31.2 billion.<sup>14</sup> The 2009 Pre-Budget Report made an assessment of the resources necessary to protect front-line education and announced a package for 2011-12 and 2012-13 that will ensure near-cash funding for front-line schools rises in real terms by 0.7 per cent a year, and near-cash funding for 16 to 19 participation rises in real terms by 0.9 per cent a year. Near-cash spending on Sure Start Children's Centres will be maintained in line with inflation. The 2009 Pre-Budget Report also announced an additional £202 million in 2010-11 to ensure that the September Guarantee of a place in education or training to every 16 and 17 year old who wants one is met in full.

**7.29** Alongside this additional investment the Government has a comprehensive programme in place to identify value for money savings in schools, 16 to 19 participation and Sure Start Children's Centres. The 2009 Pre-Budget Report announced over £800 million of efficiency savings in front-line areas by 2012-13, including from increased collaborative procurement of goods and services and rationalising back-office costs.

**7.30** The commitment to protect all near-cash funding for front-line schools, 16 and 19 participation and Sure Start Children's Centres, and the progress that has already been made in identifying value for money savings, will ensure that every school in the country can guarantee an education that is individually tailored to each child, including through catch-up support in English and maths for every child aged seven to eleven who is behind expected levels of progress; and that the September Guarantee of a place in education or training to every 16 and 17 year old who wants one will be met in full. In addition, free childcare will continue to be available for all three and four year olds, and there will be more free childcare places for disadvantaged two year olds; and every community will have easy access to high quality, integrated early education and childcare, health, employment and family support services through Sure Start Children's Centres.

## **Police**

**7.31** Spending on the police by central government has increased by 19 per cent in real terms since 1997 and as a result, there are now 16,000 more police officers.<sup>15</sup> The 2009 Pre-Budget Report announced that sufficient funding will be available in the years to 2012-13 to enable Police Authorities to maintain the current number of warranted Police Officers, Police Community Support Officers and other staff exercising police powers.

**7.32** This funding will be accompanied by reforms to increase value for money in policing, as set out in *Protecting the Public: Supporting the Police to Succeed* on 2 December 2009. These will include, by 2013-14, increasing delivery to the public by an equivalent of at least £500 million by improving processes, and at least £70 million of savings from police overtime. At least £428 million of these savings will be delivered by 2012-13. The Government has also launched a PVP for the police that will, working closely with the service, identify opportunities to go even further to maximise value for money, reporting at Budget 2010.

**7.33** These commitments will ensure that the police continue to play a vital role in keeping communities safe and secure. The Government will ensure that policing meets the needs of the public, including through the Policing Pledge which sets out minimum service standards in serving local communities.

## **Overseas development assistance**

**7.34** Spending on international development has increased from £2 billion in 1997 to £6.3 billion in 2008<sup>16</sup>. The Government has provided international leadership to a collective aid effort that has contributed towards lifting 250 million people out of poverty in the last ten years and provided primary school education to 40 million more children<sup>17</sup>. The Government remains committed to tackling global development challenges, playing a leading role in achieving the Millennium Development Goals, tackling climate change and promoting peace and stability around the world. In addition, the Department for International Development (DFID) is committed to ensuring efficiency and value for money in all of their operations, and the 2009 Pre-Budget Report announced that DFID will make value for money savings of £593 million a year by 2013-14. This will be achieved primarily through improving the allocation of funding to achieve greater impact, and through reducing consultancy spend, improving procurement practices and streamlining back office processes. The 2007 CSR set out spending plans that put the UK on track to spend 0.7 per cent of Gross National Income (GNI) on Overseas Development Assistance by 2013, two years ahead of the EU target. In September 2009, the Prime Minister

announced plans to set in legislation the commitment to reach 0.7 per cent by 2013. Spending on international development will continue to rise in the next Spending Review period to meet that target.

## Defence

**7.35** By the end of 2009-10, more than £14 billion of Reserve funding will have been spent on resourcing the cost of operations in Iraq and Afghanistan<sup>18</sup>. This is additional to the core defence budget. Over £5.2 billion of this has been committed to spending on equipment to meet the specific threats and requirements of those theatres. For 2010-11, the 2009 Pre-Budget Report announced that an additional £2.5 billion will be added to the Reserve to ensure that sufficient funding is available for military operations in Afghanistan. At the same time, the Government is working to improve the efficiency and effectiveness of core defence spending. Since 1997, the Ministry of Defence's (MOD) civilian workforce has reduced in size by 45,000, so that it is now 86,000<sup>19</sup>, including a 23,000 reduction in the last four years. MOD expects this to fall to around 81,000 by 2011 as a consequence of initiatives already in hand. The Secretary of State will be commissioning an independent review to look at the scope for further reductions as an input to the forthcoming Defence Review.

## Infrastructure spending

**7.36** Capital spending can boost public sector productivity and provide the physical infrastructure needed to enable economic growth. Record levels of investment over the past decade have allowed the Government to renew substantial parts of the public estate and transform public service delivery, and in real terms public sector net investment will remain over three times as high in 2014-15 as it was in 1997-98. The 2009 Pre-Budget Report announced that the Government will focus capital spending in the next Spending Review in the areas where it generates high economic returns in order to achieve maximum long-term benefit for the taxpayer. The new Infrastructure UK body will assist in this task by advising Government on the priorities for infrastructure investment, more details of which are provided in the 2009 Pre-Budget Report.

## Greater freedom and flexibilities for the front line

**7.37** Protecting front-line priorities means not just protecting budgets but also accelerating the next phase of public service reform in order to improve outcomes for people. So the Government will provide greater freedoms for front-line services to give them more flexibility to respond to the priorities of communities and play a stronger role in promoting growth and tackling economic barriers. Commitments set out in *Putting the Frontline First: smarter government* included:

- letting local areas set priorities by: streamlining the national performance framework; removing a number of national indicators from April 2010 and further substantial reductions from 2011; and, by Budget 2010, setting out plans to further align sector-specific performance frameworks across key local agencies;
- letting local areas guide resources by: reducing the level of ring-fencing for local authorities and streamlining different funding streams, with specific plans set out by Budget 2010; publishing guidance on pooling and aligning of local-level budgets; and coordinating the timing of grant payments from departments to local authorities for 2011-12;
- supporting local investment by: allowing local authorities that wish to use their trading powers to create further commercial opportunities; setting out guidance on effective use of joint ventures by local authorities and their partners by February

2010; and considering single-area based capital pots with recommendations by Budget 2010;

- reducing burdens on the front line by: ensuring reporting, inspection and assessment frameworks only include what is necessary to guarantee accountability, access and quality; co-ordinating the timings of assessments and inspections by 2010-11; reviewing the work of inspectorates with firm proposals by Budget 2010; and removing as many burdens identified by Total Place pilots and government departments as possible in time for the 2011-12 financial year; and
- strengthening the role of civic society in public life by: announcing a pilot of the Social Impact Bonds model; promoting wider use of community shares; enabling community groups already owning community assets acquired with Government funding to maximise their finance-raising potential by considering the scope for removing clawback conditions; and producing a regularly updated Civic Health Index.

**7.38** The 2009 Pre-Budget Report announced further steps to increase professional freedoms within front-line organisations by:

- expanding freedoms and flexibilities for front-line staff: including in 2010-11 consulting on proposals to extend non-medical prescribing for certain allied health professionals, such as physiotherapists and podiatrists; and working with the NHS to explore options to support GPs in referring patients to high quality and cost-effective alternative settings; and
- strengthening professionalism: for example tackling the variation in teachers' access to effective continuing professional development by encouraging peer learning; awarding Trust status to local probation areas that meet tough performance criteria, with greater flexibility to innovate and to pool local budgets; and more proportionate crime reporting in policing.

## **Total Place**

**7.39** The measures set out in *Putting the Frontline First: smarter government* take up the challenges presented by emerging evidence from Total Place, launched at Budget 2009. It has been led by local government and builds on the partnership work of recent years. By Budget 2010, the Government will respond to detailed evidence from Total Place about the added value of freeing up front-line services and encouraging collaboration in terms of better services at less cost. Early findings from the pilots are set out in Box 6.A.

### **Box 7.A: Total Place - A whole area approach to public services**

Total Place counts the total public funding in one place and considers how local organisations can use their combined resources to generate efficiencies and transform local public services. Bottom-up learning from 13 pilot areas and more than 20 'parallel places' is generating new ideas about how local partnerships can deliver more efficient and effective services.

To find new solutions to complex public service challenges, each pilot is undertaking detailed analysis of public service challenges which have high and diverse cost impacts and wide-ranging effects on the lives of local people, and where there is significant scope for collaboration. The pilots are seeking to devise solutions that redesign services around users, while reducing duplication and overlaps between organisations. For example:

- Leicestershire and Leicester City partners are exploring innovative joint commissioning arrangements to tackle drug and alcohol dependency, including interagency venues where people can be treated effectively as alternatives to A&E and police stations;
- Bradford partners are working towards a single point of access to services for young people leaving care, elderly people with dementia leaving hospital and offenders leaving prison, underpinned by eight key service design principles that support links between agencies and reduce overlaps;
- Kent partners are working together, transforming access to public services via the 'Gateway' multi-channel model. Associated with this is a single asset-management strategy to further increase the efficiencies gained from transformed public access; and
- Lewisham partners are exploring the case for integration of health and social care, extending a joint commissioning approach across all of adult health and social care and testing whether and how joint working can be extended across adult and children's client groups.

Results of these pilots will be set out in the final report of Total Place at Budget 2010.

## **City Regions**

**7.40** Budget 2009 announced two new pilot city-regions with which Government would put in place more devolved arrangements, in order to better drive growth. [The 2009 Pre-Budget Report announced agreements with both pilots](#). For Manchester, this includes designation as the UK's fourth low-carbon economic area specialising in the built environment, new powers over adult skills and a stronger role on 16-19 learning, apprenticeships and transport. For Leeds, this includes greater control over housing and regeneration funding, a timetable for new powers on adult skills and work with Government to deliver low-carbon housing developments and to integrate transport funding.

**7.41** In addition, the measures set out in Box 6.B will strengthen the accountability of the Scottish Parliament.



### Box 7.B: Flexibilities for the Scottish Parliament

As announced in *Scotland's future in the United Kingdom*<sup>20</sup> in November 2009, in response to the recommendations made by the Calman Commission, the Government agreed that the financial accountability of the Scottish Parliament should be strengthened by moving to a system where a greater proportion of the Scottish Executive's budget comes from its own decisions on taxation and where the Scottish Executive can increase borrowing subject to HM Treasury limits through increasing taxation. Taken together the plans set out in the White Paper represent the most radical changes to the way in which Scotland is funded for a generation.

These plans will require legislation in the United Kingdom Parliament. The Government envisages introducing the necessary legislation as soon as possible during the next parliament and will undertake further detailed work to establish viable timings for implementation.

## A smarter, more streamlined government

**7.42** In order to continue to protect the key public service priorities set out earlier in the chapter, the 2009 Pre-Budget Report announced savings across the public sector by making government smarter, rationalising projects and programmes on the basis of the early findings of the Public Value Programme, and taking tough choices on public sector pay and pensions.

### Making government smarter

**7.43** The Government is determined to deliver services in a more effective way. The 2009 Pre-Budget Report announced further details of the £12 billion a year of savings set out in *Putting the Frontline First: smarter government* and announced that £11 billion a year of these savings will be delivered by 2012-13.

**7.44** £8 billion of the £11 billion to be delivered by 2012-13 are savings identified across the public sector by five external advisers to the Operational Efficiency Programme (OEP), through improving back office functions, IT, collaborative procurement and property running costs. *Putting the frontline first: smarter government* outlined the next stage in realising savings from back office and IT by setting out comparator benchmarks for central government and departmental plans. For example:

- the Ministry of Justice will save around £65 million per annum in estates through rationalisation, co-location and moving posts out of London; and
- the Department for Communities and Local Government (CLG) have set an interim benchmark of 65:1 on Human Resources to be achieved by 2010-11, after which they will work towards benchmark levels of 77:1 in line with the new government comparators.

**7.45** The additional £3 billion of savings a year by 2012-13 includes:

- at least £500 million by reducing duplication between organisations and streamlining Arms Length Bodies (ALBs). As a first step, *Putting the Frontline First: smarter government* announced a rationalisation of over 120 ALBs across government, including reducing the number of bodies performing advisory or related functions by over 25 per cent, subject to the necessary legislation and consultation. By Budget 2010, a review will identify further options for rationalisation. This will include considering options for rationalising up to a third of DCMS non-museum ALBs, including streamlining ten DCMS advisory bodies and

bringing forward plans for merging the UK Film Council and the British Film Institute;

- £650 million from cuts of 50 per cent in consultancy spend and 25 per cent in marketing and communications spend across government;
- £300 million by improving energy efficiency across the public sector to reduce energy demand and costs, cutting bills by around 10 per cent and contributing to climate change goals;
- £170 million by taking further steps to maximise value for money in Home Office operational bodies focussing on immigration, crime and back-office support for the police, including through faster asylum claim processing saving;
- £550 million from local government, including more efficient waste collection and disposal, reducing the burdens of inspection, assessment and reporting requirements from across government and measures to reduce duplication and inefficiency between different tiers of local government;
- £120 million from improvements to the administration of concessionary travel including shifting responsibility to county councils, speeding up the rollout of smartcards across the bus network and, subject to consultation, streamlining arrangements for reimbursing bus operators;
- £600 million from greater use of online systems and streamlining contact with the public, including: £35 million from providing business services and advice online and charging for schemes with the greatest benefit to business, £15 million from national rollout of 'Tell Us Once' (through which people only have to inform the Government once about a change in circumstance), and £500 million from more efficient use of automation, e-channels and telephony and greater risk profiling within HM Revenue and Customs (HMRC) and the Department for Work and Pensions (DWP);
- £140 million from reducing the costs of the senior civil service by up to 20 per cent and cutting sickness absence amongst civil servants;
- £92 million from protecting the environment more cost-effectively and making more efficient use of funding available under the Rural Development Programme for England; and
- further action to better manage and sell Government assets as detailed in Box 6.C.

## Prioritising projects and programmes

**7.46** Going further, the Government has also looked at what other efficiencies can be achieved across the public sector through better procurement, or through cutting lower-value or lower-priority programmes or projects on the basis of the early findings of the PVP. The Government will continue to identify further opportunities for savings through the PVP, [but the 2009 Pre-Budget Report already announced £5 billion of additional savings by 2012-13:](#)

- £340 million from improved targeting of regeneration and housing growth funding, concluding the New Deal for Communities programme, prioritising regeneration and growth programmes to maximise value for money as the economy recovers, and saving public money by directly tackling the barriers to housing growth with a reduction in the impact of regulation on house building. The Government, will assess the efficiency and effectiveness across government of

interventions to tackle worklessness and promote growth and inclusion in deprived areas, and the institutions that deliver them;

- £500 million from reducing spend on IT, including by reducing the cost and scope of the NHS IT programme;
- £360 million of savings in the Criminal Justice System by improving case management, putting underperforming or expensive public sector prisons out to competition during 2010-11, and reforming legal aid;
- £250 million from reducing variations in spend on residential care, including greater use of preventative approaches to care for older people allowing people to stay longer in their homes;
- £170 million from smarter procurement of new rail franchises and additional trains, and by generating higher passenger revenues by increasing station car park capacity and clamping down on fare evasion. Reflecting long planning horizons for transport spending, the Department for Transport will be launching a study aimed at reducing future rail industry costs while increasing capacity, to get best value beyond 2014;
- £1.4 billion from ending additional employment schemes introduced during the downturn when the economy recovers;
- £300 million by reducing funding not directly supporting learner participation and lower priority adult skills budgets, increasing co-funding of training, and further efficiencies in the delivery of learning to focus spending on those people that need it most and on the skills most vital to Britain's future;
- £60 million from the costs of concessionary travel by aligning eligibility with forthcoming changes in the state pension age. No one currently receiving these benefits will be affected;
- £600 million from higher education and science and research budgets from a combination of changes to student support within existing arrangements; efficiency savings and prioritisation across universities, science and research; some switching of modes of study in higher education; and reductions in budgets that do not support student participation;
- £160 million from clamping down on fraudulent access to social housing tenancies, and rationalising smaller Communities and Local Government (CLG) funded community programmes as well as ending time-limited schemes in CLG;
- £350 million of savings from the Department for Children, Schools and Families to be found from central budgets, NDPB efficiency savings and from reviewing pilots and programmes to focus on the most effective interventions; and
- £13 million from ensuring payments made to public servants posted overseas reflect modern lifestyles and family circumstances.

**7.47** At the next Spending Review, the Devolved Administrations' budgets will be determined in the normal way in line with the Barnett formula to reflect the budgetary changes made as a result of these savings and associated decisions on protecting key front-line priorities as outlined earlier in the chapter.

## Box 7.C: Operational Efficiency Programme – Asset strand

### Asset Portfolio:

On 7 December 2009 the Government published the *Operational Efficiency Programme: Asset Portfolio*<sup>21</sup> alongside *Putting the Frontline First: smarter government*, setting out the next steps to deliver £16 billion from asset and property sales by 2013-14.

The asset portfolio presents reviews of public sector businesses and seeks to open a dialogue with the private sector to explore alternative options for their management, including partial or full sale where appropriate.

In a number of cases the Government has now concluded that a partial or full sale is the right approach, and the following transactions are now being progressed:

- **the tote** – a sale process is expected to be launched during summer 2010 following the year end financial results of 31 March 2010;
- **Student Loans Portfolio** – as a securitisation option may not currently be a viable option, other ways to monetise the portfolio are now being explored and the Government will report on a feasibility study at Budget 2010;
- **Dartford Crossing** – following a review of capacity needs and concession structures currently underway, the necessary processes will commence during summer 2010;
- **High Speed 1** – preparations for sale are now at an advanced stage, and it is the Government's intention to launch a sale process as soon as practicable following the introduction of domestic services on the line in December 2009; and
- **URENCO** – the Government will explore options to realise value from the UK's stake, subject to security issues being addressed.

The portfolio also sets out the progress the Government has made in improving the management of its assets and the next steps to manage its assets more effectively – one of the five strategic priorities of *Putting the Frontline First: smarter government* – by laying out an asset management framework, and identifying new assets that will be considered in the next phase of work. Budget 2010 will report progress on the commercialisation of the assets presented in the portfolio, and the initial conclusions of the asset reviews under the new framework.

### Property:

As *Putting the Frontline First: smarter government* also announced, the Government has created a strategic property team within the Shareholder Executive to undertake a strategic review of different public sector estates management and ownership options. This will include assessing the feasibility of creating one or more property companies that would own and manage portfolios of public sector properties with a view to maximising efficiency.

To improve the incentive for more effective asset management planning and lock-in the benefits of the significant growth in capital investment since 1997-98, CLG will progress the technical aspects of introducing a formal depreciation-based funding scheme in the local government sector, and progress will be reported at Budget 2010.

## Tough choices on public sector pay

**7.48** Public sector workers are at the heart of delivering world-class public services and supporting long-term economic growth, prosperity and fairness. Following substantial investment in public sector pay since 1997, continued pay restraint will be important to support front-line service delivery while ensuring sustainable public finances over the medium term. The 2009 Pre-Budget Report set out an ambitious package of measures on public sector pay.

**7.49** The Government has already proposed awards in the range of up to one per 6.49 cent in 2010-11 for key public service workforces not in multi-year deals. Going forward, the 2009 Pre-Budget Report announced that the Government will seek a one per cent cap on basic pay uplifts across the public sector for 2011-12 and 2012-13, generating savings of £3.4 billion a year by 2012-13.

**7.50** The Government expects senior staff to show leadership in exercising pay restraint. For 2010-11 the Government has proposed a freeze for senior groups including chief executives of non-departmental public bodies (NDPBs), senior civil servants, judges, senior NHS managers, consultant doctors and GPs. The 2009 Pre-Budget Report announced a set of fundamental reforms to pay-setting for senior staff, aimed at increasing the robustness, transparency and accountability of decision making across the public sector, including:

- new scrutiny of pay levels above £150,000: the Chief Secretary to the Treasury will approve pay levels in excess of £150,000 for all civil service appointments and appointments to public sector bodies which are subject to Ministerial approval. This will also apply to all bonus payments of over £50,000 where Ministerial sign-off is needed. For public sector bodies where Ministerial approval is not required, the Government expects all organisations making senior managerial appointments in excess of £150,000 to publicly justify this level, and any bonus in excess of £50,000, to the relevant Secretary of State;
- transparency and accountability: all public sector bodies subject to direct Ministerial control will be required to publish the salary, including benefits in kind and the level of any bonus, of named individuals paid more than £150,000 to the nearest £5,000 and the number of staff paid more than £50,000 in £5,000 increments. The Government will expect all other public bodies to comply with this level of disclosure. Government departments will publish collective information on pay for senior staff in public sector bodies within their area of responsibility, and the Government has commissioned relevant audit or regulatory bodies to incorporate into their regimes certification that the relevant body operates remuneration policies which maximises value for money for the taxpayer; and
- reviewing senior pay across the public sector: the Prime Minister will ask Bill Cockburn as Chair of the Senior Salaries Pay Review Body (SSRB) to report by Budget 2010 on senior pay across the public sector. The Government will work with the review to determine what legislative and non-statutory means are most appropriate to enforce compliance with pay and bonus principles and caps across the wider public sector.

## Public service pensions

**7.51** Since 1997, the Government has introduced reforms to tackle increasing pension costs arising from longevity; these include higher pension ages and reform of ill health benefits. In addition to these cost saving measures, the Government is implementing further significant reforms to public service pensions. Cap and share reforms to the Teachers, Local Government, NHS and Civil Service pension schemes will cap the contribution to pensions made by employers,

thereby limiting the liability of the taxpayer as pensions become more valuable. Cost increases below the cap will be shared equally between employers and employees, and those above the cap met solely by employees. In addition, as part of cap and share, the Government will expect those earning the highest salaries to pay a greater contribution towards their pension. These reforms will save an estimated £1 billion a year from 2012-13, and at least twice this amount over the long-term.

# A The fiscal impact of budget policy decisions

Table A.1: Budget April 2009 policy decisions

	(+ve is an Exchequer yield)			£ million
	2009-10 indexed	2010-11 indexed	2011-12 indexed	2009-10 non-indexed
<b>Supporting Business</b>				
1 Business rates: deferral of payments	-700	+335	+320	+600
2 First-year capital allowances: one year increase to 40%	-1,640	-190	+380	-1,640
3 Loss carry back: further temporary extension	-55	-195	-45	-55
4 Car scrappage	-300	0	0	-300
5 Strategic Investment Fund	-400	-350	0	-400
6 Lloyd's UK dividend exemption	-10	-10	-10	-10
7 Loan relationships: late paid interest to connected companies	-5	-15	-5	-5
8 North Sea fiscal regime: incentives for investment	0	-5	-10	0
9 Residence and domicile: consequential changes	-5	-5	-5	-5
10 VAT Package: refund scheme	*	-5	-5	*
11 Agricultural property and woodlands relief: extension	-5	-5	-5	-5
12 Building Colleges for the Future	-200	0	0	-200
<b>Helping People Fairly</b>				
13 DWP additional employment funding	-590	-1,080	0	-590
14 Employment: guarantee for young people <sup>1</sup>	-300	-900	-	-300
15 Increase in Statutory Redundancy Pay	-15	-25	-	-15
16 Age related payments to pensioner households	-600	0	0	-600
17 Increase ISA limits	-5	-20	-60	-5
18 Increase Pension Credit capital disregards	-60	-130	-	-60
19 Working Tax Credit run-ons: extension	-5	-10	-	-5
20 Child Trust Fund: extra payments for disabled children	0	-15	-	0
21 Increase Child Element of Child Tax Credit	0	-140	-	0
22 Housing Benefit/Council Tax Benefit overpayments: remove double subsidy provision	0	+10	-	0
23 Housing Benefit/Council Tax Benefit: earnings disregard	0	-5	-	0
24 Housing Benefit: managing gains from Local Housing Allowance	0	+145	-	0
25 Increase Social Fund	-125	-145	0	-125
26 Support for Mortgage Interest	-135	0	0	-135
27 SDLT holiday for residential homes: extension to 31 December 2009	-90	0	0	-90
28 Support for housing supply	-420	-180	0	-420
29 Local Authority guideline rent increases in 2009-10	-10	-10	0	-10
30 Repeal furnished holiday lettings rules	0	-15	+20	0
31 Reduced VAT rate for children's car seat bases	*	-5	-5	*
32 Financial assistance for charities affected by the Icelandic banking crisis	-20	0	0	-20
33 Armed forces accommodation	-50	+25	-	-50
<b>Preparing for a green recovery</b>				
34 Support for low carbon technologies	-160	-65	0	-160
35 Support for energy and resource efficiency	-220	-55	0	-220
36 Landfill tax reform	+30	+70	+70	+30
37 Landfill tax rates	-5	-25	+80	-5
38 Enhanced capital allowances	+10	+15	+15	+10
39 Company car tax rates	0	0	+85	0
40 Vehicle excise duty	0	-5	-5	0
41 VAT: Revalorisation of fuel scale charges	0	0	0	-10
<b>Ensuring sustainability of the public finances</b>				
42 Fuel duty: increases	+600	+1,250	+1,750	+1,575
43 Income Tax: full withdrawal of personal allowance from £100,000 <sup>2</sup>	0	+100	+180	0
44 Income Tax: increase additional rate to 50% from £150,000 and increase trust rate to 50% from 2010-11 <sup>3</sup>	0	+1,130	+1,810	0
45 Pensions Tax: restrict tax relief to 20% above £150,000 <sup>4</sup>	0	0	+200	0
46 Tobacco: 2% increase in specific duty	+60	+60	+60	+60
47 Gambling participation fees: removal of VAT	-50	-55	-60	-50
48 Gaming duty on casino card rooms	+5	+5	+5	+5
49 Bingo duty: increase rate to 22%	+35	+35	+35	+35
50 Amusement machine licence duty: increase rates	+20	+15	+15	+20
<b>Protecting Revenue</b>				
51 Foreign exchange: targeted anti-avoidance rule	+20	+20	+20	+20
52 Corporate intangible assets regime: countering abuse	+70	+130	+110	+70
53 Review of Alcohol Fraud Strategy	+20	+10	+10	+70
54 Manufactured overseas dividends: avoidance	0	0	+50	0
55 Double tax relief: avoidance	+100	+100	+200	+100
56 Living accommodation benefit charge: avoidance	+45	+45	+55	+45
57 Publishing names of serious tax defaulters	0	+20	+60	0
58 Accountability of senior accounting officers	0	+40	+50	0
59 Review of powers: debt management	+5	+5	-135	+5
<b>TOTAL POLICY DECISIONS:</b>	<b>-5,160</b>	<b>-100</b>	<b>+5,230</b>	<b>-2,845</b>
<b>ADDITIONAL ITEMS:</b>				
60 Reserve: support for military operations	-1,900	0	0	-1,900
61 Reprofile addition to 2008-09 DEL reserve	-500	-500	0	-500
Memo: Reset AME Margin	-1,000	-2,000		

- Included within the current spending growth assumption for 2011-12 onwards.

\* Negligible

<sup>1</sup> Gross costs are £1.4 billion over 2009-10 and 2010-11. The figures in the table are net of associated savings.

<sup>2</sup> This modifies the yield published at PBR 2008 for the staged restriction of the personal allowance. The total yield in 2012-13 from the removal of the personal allowance will be £1.5 billion.

<sup>3</sup> This measure is in addition to the yield published at PBR 2008 for the 45% additional rate commencing from 2011-12. The total yield in 2012-13 from the 50% additional rate will be £2.4 billion

<sup>4</sup> Yield increases due to lagged effect of self-assessment. For 2012-13, the yield is £3.1 billion.

**Table A.2: Estimated costs for 2009 Pre-Budget Report policy decisions and others announced since Budget 2009<sup>1</sup>**

	Head	£ million			
		2009-10	2010-11	2011-12	2012-13
<b>Measures announced since Budget 2009<sup>2</sup></b>					
Stamp Duty - Exemption for company buybacks of shares of overseas branches	Tax	0	-5	-5	-5
Financial products avoidance	Tax	+50	+100	+100	+50
Pensions tax: anti-forestalling rules	Tax	-30	-40	0	0
Digital Britain: Landline Duty	Tax	0	+90	+175	+175
Childcare: employer supported childcare tax relief <sup>3</sup>	Tax/Spend	0	0	-	-
Gurkhas: removal of 1997 cut-off	Spend	-70	-240	-	-
Cold Weather Payments	Spend	-20	0	0	0
Funding for <i>Building Britain's Future</i>	Spend	-35	+35	0	0
<b>Measures announced at Pre-Budget Report 2009</b>					
<b>Ensuring Sustainability of the Public finances</b>					
Freeze NICs Higher Rate Threshold in 2012-13	Tax	0	0	0	+400
Increase NICs Primary Threshold by £570 in 2011-12	Tax	0	0	-1,480	-1,500
Increase employer NICs rate by 0.5% from 2011-12	Tax	0	0	+2,350	+2,470
Increase main employee and self-employed NICs rate by 0.5 per cent from 2011-12	Tax	0	0	+1,970	+2,080
Increase additional employee and self-employed NICs rate by 0.5 per cent from 2011-12	Tax	0	0	+320	+340
Pensions tax: updated income definition	Tax	-10	-40	0	+500
Freeze Inheritance Tax Threshold in 2010-11	Tax	0	+80	+170	+190
Bank payroll tax	Tax	+550	0	0	0
Salary sacrifice: workplace canteens	Tax	0	0	+110	+110
Pensions auto-enrolment: slower introduction <sup>4</sup>	Tax	0	0	0	+100
<b>Protecting Revenues</b>					
Insurance Premium Tax: avoidance	Tax	+5	+10	+10	+10
Index linked gilts	Tax	0	+40	+65	+40
Substantial donors to charity: replacement of anti-avoidance legislation	Tax	0	-10	-10	-10
<b>Supporting Business</b>					
Rates on empty property: temporary exemption	Tax	0	-135	+10	0
Small Companies Rate of corporation tax: defer increase to April 2011	Tax	0	-10	-380	-110
Patent Box from April 2013 <sup>5</sup>	Tax	0	0	0	0
Bingo Duty: reduce to 20%	Tax	0	-5	-10	-10
Seafarer's earning deduction	Tax	0	0	-5	-5
Venture Capital Schemes: State Aid changes	Tax	0	0	-20	-30
Strategic Investment Fund addition <sup>6</sup>	Spend	0	-110	-	-
<b>Protecting the Environment</b>					
Climate change levy: reduction of relief from 2011-12	Tax	0	0	+50	+50
Fuel Benefit Charge: increase multiplier	Tax	0	+50	+45	+45
Company Car Tax: extend bands from 2012-13	Tax	0	0	0	+120
Biofuels Duty Differential: limited extension	Tax	0	-10	-10	0
Electric vehicles: tax relief	Tax	0	-5	-5	neg
Warm Front and Greener Boiler Incentive <sup>7</sup>	Spend	0	-85	0	0
<b>Helping People Fairly<sup>8</sup></b>					
Tax relief for travel expenses	Tax	0	+35	+85	+85
Extension of free school meals	Spend	0	-140	-	-
Benefits uprating	Spend	0	-700	-	-
Local authority guideline rents <sup>9</sup>	Spend	0	-115	-	0
Money Guidance rollout in 2010/11	Spend	0	-10	0	0
Working Tax Credits: extension to over 65s from April 2010	Spend	0	-5	-	-
Tackling benefit error	Spend	0	95	-	-
Housing benefit: managing gains from Local Housing Allowance from 2011	Spend	0	-40	-	-
Support for Mortgage Interest <sup>10</sup>	Spend	-25	-70	0	0
<b>TOTAL POLICY DECISIONS</b>		<b>+415</b>	<b>-1,240</b>	<b>+3,535</b>	<b>+5,095</b>
Reserve: support for military operations	Spend	0	-2,500	0	0
Memo: Increase to public sector current expenditure	Spend	0	0	-7,700	-6,900

<sup>1</sup>Included within the current spending growth assumption for 2011-12 onwards.

<sup>2</sup>Costings shown relative to an indexed base.

<sup>3</sup>Costings reflect Pre-Budget Report economic forecast and assumptions.

<sup>4</sup>Employer supported childcare tax relief measure used to fund expansion of free childcare for 2 year olds.

<sup>5</sup>In 2013-14 the yield is £0.7 billion, in 2014-15 the yield is £1.6 billion.

<sup>6</sup>The costs of this measure will rise to £1.3 bn in steady state.

<sup>7</sup>The total addition to the Strategic Investment Fund at the PBR is £210m in 2010-11, including Barnett consequentials for non-reprioritising funding. £100m of this is funded through reprioritisation.

<sup>8</sup>Total funding for Warm Front and the Greener Boiler Incentive is £215m in 2010-11, including Barnett consequentials for non-reprioritising funding. £130m of this is funded through reprioritisation.

<sup>9</sup>Employment support package costing £45 million in 2009-10 and £355 million in 2010-11 funded by DWP underspend.

<sup>10</sup>Total support for Local Authority Guideline rents is £170m in 2010-11. £55m of this is funded through reprioritisation.

<sup>11</sup>Total support for Mortgage Interest in 2009-10 is £70m, including Barnett consequentials for non-reprioritised funding. £45m, of this is funded through reprioritisation.



# B

## Supplementary information

**Table B.1: Macroeconomic prospects<sup>1</sup>**

	£bn	Percentage change on a year earlier unless otherwise stated					
		2008	2008	Forecast <sup>2,3,4</sup>			
				2009	2010	2011	2012
<b>Real GDP</b>			½	-4¾	1 to 1½	3¼ to 3¾	3¼ to 3¾
<b>Nominal GDP</b>	1448		3½	-3¼	3¾ to 4¼	5 to 5½	5½ to 6
<b>Expenditure components of GDP at market prices<sup>5</sup></b>							
Private consumption expenditure <sup>6</sup>			1	-3	0 to ½	2¾ to 3¼	2¾ to 3¼
Government consumption expenditure			2½	2	1¼	-1½	-2
Gross fixed capital formation <sup>7</sup>			-3¼	-14¼	-2 to -1½	4¼ to 4¾	8½ to 9
Changes in inventories and net acquisition of valuables <sup>8</sup>			-½	-1¼	¾	½	0
Exports of goods and services <sup>9</sup>			1	-10¾	2 to 2½	4½ to 5	5 to 5½
Imports of goods and services <sup>9</sup>			-¾	-12½	½ to 1	1¾ to 2¼	2¾ to 3¼
<i>Exports of goods and services (excluding MTIC)</i>			1	-10¾	2 to 2½	4½ to 5	5 to 5½
<i>Imports of goods and services (excluding MTIC)</i>			-¾	-12½	½ to 1	1¾ to 2¼	2¾ to 3¼
<b>Contributions<sup>10</sup> to real GDP growth<sup>11</sup></b>							
Final domestic demand <sup>12</sup>			½	-4	¼	2½	3
Changes in inventories and net acquisitions of valuables			-½	-1¼	¾	½	0
Net trade			½	¾	½	½	½

<sup>1</sup> The forecast is consistent with output, income and expenditure data for the third quarter of 2009, released by the Office for National Statistics on 25 November 2009.

<sup>2</sup> All growth rates in this table are rounded to the nearest ¼ percentage point.

<sup>3</sup> 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 trend output. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances, which is a ¼ percentage point below the neutral assumption.

<sup>4</sup> The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

<sup>5</sup> Further detail on the expenditure components of GDP is given in Table A10 of the 2009 Pre-Budget Report.

<sup>6</sup> Household consumption under UK definition. Includes households and non-profit institutions serving households.

<sup>7</sup> Fixed investment under UK definition.

<sup>8</sup> Change in inventories under UK definition. Contribution to GDP growth, percentage points.

<sup>9</sup> Figures up to and including 2010 are distorted by MTIC.

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

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

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

**Table B.2: Real GDP Growth**

	Per cent						
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Real GDP growth	-1 ¼	-3 ½	2	3 ¼	3 ¼	3 ¼	3 ¼

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 23/4 per cent with a phasing reduction to the level of trend output of around 5 per cent between mid-2007 and mid-2010. 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**

	Per cent						
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Change in gross debt ratio <sup>1</sup>	12.2	17.3	9.3	5.8	2.9	0.7	-0.4

<sup>1</sup> General government gross debt measure on a Maastricht basis.

**Table B.4: General government interest and dividends paid**

	Per cent of GDP		
	2008-09	2009-10	2010-11
General government interest and dividends paid <sup>1</sup>	2.2	2.2	3.0

Note: GDP growth as used for public finance projections.

<sup>1</sup> FISM recorded as consumption not included.

**Table B.5: General government primary balance**

	Per cent of GDP						
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Primary balance <sup>1</sup>	4.7	10.4	9.0	5.6	3.6	1.8	0.7

<sup>1</sup> General government net borrowing less interest expenditure.

**Table B.6: Stock-flow adjustments**

	Per cent of GDP						
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Stock-flow adjustment <sup>1</sup>	5.9	3.7	0.4	0.6	0.5	0.3	0.3

<sup>1</sup> Change in gross debt ratio less general government net borrowing

**Table B.7: Cyclical budget components**

	Per cent of GDP						
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Cyclical budgetary component <sup>1</sup>	1.0	3.6	3.9	3.2	2.6	1.9	1.3

Note: GDP growth as used for public finance projections.

<sup>1</sup> Treaty deficit less cyclically-adjusted Treaty deficit.

**Table B.8: Cyclically-adjusted primary balance**

	Per cent of GDP						
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Cyclically-adjusted primary balance <sup>1</sup>	3.7	6.8	5.0	2.4	1.0	-0.1	-0.6

Note: GDP growth as used for public finance projections.

<sup>1</sup> General government net borrowing less interest paid less cyclical budgetary component.

**Table B.9: GDP growth forecasts at the 2009 Pre-Budget Report and Budget 2009**

		Per cent of GDP				
		Forecast				
		2008	2009	2010	2011	2012
GDP growth	2009 Pre-Budget Report	½	-4¾	1 to 1½	3¼ to 3¾	3¼ to 3¾
	Budget 2009	¾ 3¾' to -3¼'	1 to 1½	3¼ to 3¾	-	-

**Table B.10: Private consumption deflator**

	Level	Percentage change on a year earlier				
		2008	2009	2010	2011	2012
Private consumption deflator <sup>1</sup>	109½	2¾	1¾	2	2	2½

<sup>1</sup> Q4.

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

	Percentage change on a year earlier				
	2008	2009	2010	2011	2012
Export price deflator <sup>1</sup> (goods and services)	12¾	2	¼	¾	1¾

<sup>1</sup> Average value indices.

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

	Percentage change on a year earlier				
	2008	2009	2010	2011	2012
Import price deflator <sup>1</sup> (goods and services)	11¼	3½	1¾	2¼	2¼

<sup>1</sup> Average value indices.

**Table B.13: Balance of goods and services**

	Per cent of GDP				
	2008	2009	2010	2011	2012
Balance on goods and services	-2½	-2¼	-2¼	-2	-1½

**Table B.14: Balance of primary incomes and transfers**

	Per cent of GDP				
	2008	2009	2010	2011	2012
Balance of primary income and transfers	1	0	¼	0	-¼

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

	Per cent of GDP				
	2008	2009	2010	2011	2012
Net lending of the private sector <sup>1</sup>	3½	8¾	11¼	8	6

<sup>1</sup> Mid-points of forecast ranges.

**Table B.16: Implicit interest rates on debt**

	Per cent of GDP		
	2008-09	2009-10	2010-11
Implicit interest rate on debt <sup>1</sup>	5.1	3.9	4.4

<sup>1</sup> Interest expenditure as a per cent of gross debt in previous year.

**Table B.17: Net borrowing by sub-sector**

	Outturn	Estimates
	2008-09	2009-10
Net borrowing (£ billion)		
Central Government	93.4	170.7
Local authority	4.4	6.9
Net borrowing (% GDP)		
Central Government	6.5	12.1
Local authority	0.3	0.5

**Table B.18: Comparing GDP growth and inflation between 2007 and 2008 PBR**

	2007	Percentage change on a year earlier			
		2008	2009	2010	2011
Gross domestic product					
PBR 2008	¾	-1¼ to -¾	1½ to 2	2¾ to 3¼	-
PBR 2009	½	-4¾	1 to 1½	3¼ to 3¾	3¼ to 3¾
CPI inflation (per cent, Q4)					
PBR 2008	3¾	½	2¼	2.0	-
PBR 2009	4	2.0	1¾	1½	2

**Table B.19: Comparing public sector finances between 2008 and 2009 PBR**

	Per cent of GDP					
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Current receipts						
PBR 2008	37.3	36.2	37.2	37.9	38.3	38.6
PBR 2009	37.1	35.3	36.0	37.3	37.7	37.8
Current expenditure						
PBR 2008	38.8	40.1	40.6	39.9	39.1	38.4
PBR 2009	39.3	43.1	44.0	43.1	41.9	40.7
Surplus on current budget						
PBR 2008	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
PBR 2009	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3
Net Investment						
PBR 2008	2.5	2.7	2.1	2.0	1.9	1.8
PBR 2009	3.2	3.5	2.7	1.9	1.6	1.3
Public sector net borrowing (PSNB)						
PBR 2008	5.3	8.0	6.8	5.3	4.1	2.9
PBR 2009	6.6	12.6	12.0	9.1	7.1	5.5
Cyclically-adjusted surplus on current budget						
PBR 2008	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
PBR 2009	-2.6	-5.5	-5.4	-3.9	-3.0	-2.3
Cyclically-adjusted PSNB						
PBR 2008	5.3	7.2	5.6	4.3	3.5	2.8
PBR 2009	5.7	9.0	8.0	5.8	4.5	3.6
Treaty deficit <sup>1</sup>						
PBR 2008	5.4	8.1	7.0	5.6	4.4	3.3
PBR 2009	6.9	12.6	12.0	9.1	7.3	5.7
Treaty debt ratio <sup>2</sup>						
PBR 2008	52.9	60.5	65.1	67.5	68.6	68.5
PBR 2009	55.5	72.9	82.1	88.0	90.9	91.6

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

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

**Table B.20: Comparing public sector finances between 2008 and 2009 Budgets**

	Per cent of GDP				
	2008-09	2009-10	2010-11	2011-12	2012-13
Current receipts					
Budget 2008	39.0	39.2	39.7	39.7	39.8
Budget 2009	36.9	35.1	36.2	37.2	37.7
Current expenditure					
Budget 2008	38.4	38.2	38.1	37.8	37.5
Budget 2009	39.2	43.1	44.2	43.0	41.9
Surplus on current budget					
Budget 2008	-0.7	-0.2	0.3	0.6	1.0
Budget 2009	-3.6	-9.3	-9.4	-7.2	-5.6
Net Investment					
Budget 2008	2.2	2.2	2.3	2.2	2.3
Budget 2009	2.6	3.1	2.5	1.9	1.6
Public sector net borrowing (PSNB)					
Budget 2008	2.9	2.5	2.0	1.6	1.3
Budget 2009	6.3	12.4	11.9	9.1	7.2
Cyclically-adjusted surplus on current budget					
Budget 2008	-0.5	0.1	0.5	0.8	1.0
Budget 2009	-3.1	-6.7	-6.4	-4.9	-3.9
Cyclically-adjusted PSNB					
Budget 2008	2.7	2.2	1.8	1.5	1.2
Budget 2009	5.7	9.8	8.9	6.8	5.5
Treaty deficit <sup>1</sup>					
Budget 2008	3.2	2.8	2.3	1.9	1.6
Budget 2009	7.1	12.6	12.0	9.2	7.3
Treaty debt ratio <sup>2</sup>					
Budget 2008	46.1	46.9	47.2	47.0	46.6
Budget 2009	55.2	71.9	82.1	87.2	89.9

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

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



# C

## Structural reform measures

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**C.1** The Government set out in the UK National Reform Programme 2009<sup>1</sup> 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 and points to watch under the Lisbon Strategy for Jobs and Growth, as agreed by the European Council in March 2009. This is in the context of the current downturn and medium-term reform measures, in line with the European Economic Recovery Plan (EERP), agreed by the European Council in December 2008.

**C.2** The main reform actions are summarised in the box below, taken from the National Reform Programme 2009 and updated to take into account the announcements made in the Pre-Budget Report 2009.

<p><b>Council Recommendation:</b> Ensure a sustainable fiscal position in the medium-term, including through fiscal consolidation measures geared towards enhancing the quality of the public finances.</p>	<ul style="list-style-type: none"> <li>• £11 billion of savings by 2012-13 through smarter government for example through rationalising Arms Length Bodies, greater use of online systems for providing advice and information to the public, cutting consultancy spend by 50 per cent, and better management of government assets.</li> <li>• £5 billion of savings from 2012-13 from targeting and prioritising spending including by reforming the Criminal Justice System and legal aid, reducing lower priority provision within the adult skills budget, phasing out temporary employment programmes, and reducing the cost and scope of the NHS IT programme.</li> <li>• A one per cent cap on public sector pay settlements in 2011-12 and 2012-13, delivering £3.4 billion of savings a year by 2012-13.</li> </ul>
<p><b>Council Recommendation:</b> Continue to implement plans to substantially improve skill levels and establish an integrated approach to employment and skills in order to raise productivity and increase</p>	<ul style="list-style-type: none"> <li>• £5 billion of public investment in adult skills during 2009/10.</li> <li>• Targeted support to maintain skill and employment levels throughout the downturn.</li> <li>• Increased funding for Skills Accounts, increasing from £500 million 2010/11 to £1.5 billion by 2015.</li> <li>• <i>Skills for Growth</i> white paper published in November 2009, which builds on progress made since the Leitch Review of Skills was published in 2006.</li> <li>• <i>Higher Ambitions</i>, published in November 2009, set the forward looking framework for</li> </ul>



	<p>the higher education sector, and identified the challenges and opportunities facing the sector if it is to remain world class.</p> <ul style="list-style-type: none"> <li>• Future Jobs Fund provides £1 billion worth of funding to support creation of jobs for long-term unemployed, young people, and others who face disadvantage in the labour market over the next two years.</li> <li>• Improved flexibility of the Train to Gain programme has led to significant expansion of demand from employers to participate.</li> <li>• The Welfare Reform Bill was introduced into Parliament in January 2009, and the Government in December 2009 set out the next stage of welfare reform in its employment white paper <i>Building Britain's Recovery</i>.</li> </ul>
<p><b>Council Point to Watch:</b> Improve R&amp;D intensity in order to meet medium- to long-term demand pressures.</p>	<ul style="list-style-type: none"> <li>• The Government continues to significantly expand investment in R&amp;D – this has increased by 5 per cent in real terms since 2006.</li> <li>• The first Annual Innovation Report was published in December 2008 setting out progress against policy commitments from the <i>Innovation Nation</i> white paper.</li> <li>• The UK Innovation Investment Fund (UKIIF), launched in June 2009, will invest venture capital in technology companies with high growth potential across important sectors such as life sciences, clean technologies, digital, and advanced manufacturing. The UKIIF will provide for total</li> </ul>

	<p>funding of £325 million at first sing, which it is hoped will take place in January 2010.</p> <ul style="list-style-type: none"> <li>• Building on the £750 million Strategic Investment Fund introduced at Budget 2009 to support innovative industrial projects of strategic importance, the PBR 2009 announced additional funding for the Strategic Investment Fund of £200 million.</li> </ul>
<p><b>Council Point to Watch:</b> Increase housing supply in order to meet medium- to long-term demand pressures.</p>	<ul style="list-style-type: none"> <li>• The Government continues to work towards target of 240,000 net additional homes per year in England by 2016 to more effectively match supply with demand.</li> <li>• £7.5 billion investment over the next two years to deliver up to 112,000 new, social and affordable homes and 15,000 market properties.</li> <li>• PBR 2009 outlined the Government's strategy to support a timely and effective housing response through the recovery and to address the long-term challenge of increasing housing supply, including through: bringing forward more land for development; ensuring cumulative regulation does not unduely constrain housebuilding; promoting a strong and diverse house building industry; enhancing the role of Local Authorities in enabling housing growth locally; and delivering effective and coordinated infrastructure nationally and locally.</li> </ul>



## HM Treasury contacts

This document can be found in full on our website at:

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