Stability and Investment for the Long Term

Economic and Fiscal Strategy Report 1998

Presented to Parliament by
the Chancellor of the Exchequer
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Contents

The Economic and Fiscal Strategy Report and the Financial Statement and Budget Report contain the Government's assessment of the medium-term economic and budgetary position. They set out the Government's tax and spending plans, including those for public investment, in the context of its overall approach to social, economic and environmental objectives. They will form the basis of submissions to the European Commission under Articles 103 and 104c of the Treaty establishing the European Union.

Stability and Investment for the Long Term

This first Economic and Fiscal Strategy Report lays the foundations for the Comprehensive Spending Review, the conclusions of which will be announced in July. The Governments new approach is based on four key themes:

Fiscal prudence:

- The Code for Fiscal Stability sets out the broad fiscal framework. Within that framework, the Governments approach is defined by two strict fiscal rules applied over the economic cycle: the golden rule and the sustainable investment rule (the latter requiring the net public debt to GDP ratio be held at a stable and prudent level). These rules reinforce economic stability, which is vital for growth and employment.
- The fiscal stance was tightened very considerably in 1997-98. The new projections in this Report lock in the fiscal tightening projected in the March Budget. Between 1996-97 and 1999-2000, public sector net borrowing will have fallen by 3½ per cent of GDP.
- The Government has set firm plans for overall spending over the remainder of this Parliament based on a careful assessment of what can be afforded while still meeting the fiscal rules and the Governments spending priorities. This sets the framework for the conclusions of the Comprehensive Spending Review. The Government has concluded that real growth of current spending can average 2¼ per cent per annum over the remainder of this Parliament.

Investment and best use of assets:

- The Government will establish an Investing in Britain Fund to renew and improve Britains infrastructure and public sector. This Fund will allow public sector net investment almost to double, stabilising at 1½ per cent of GDP by the end of this Parliament. Investment will remain well within sustainable bounds: the ratio of net public debt to GDP is projected to decline to below 40 per cent. This decline is prudent over this economic cycle.
- The Government will also continue to improve public sector asset management to produce a more efficient and effective use of resources. This includes a programme of disposals to release funds for new investment and the development of new public-private partnerships.

Stable and long-term plans:

- The Government is establishing a firm public expenditure envelope for the next three years. This gets away from the short-termism, incrementalism and excessive departmentalism of annual spending rounds. It will end the existing piecemeal, department-by-department, approach to spending.
- The Government is reforming the regime for planning and controlling spending to improve spending control and promote longer term planning.

Wider economic reform to support the objectives of the Comprehensive Spending Review:

- The Governments central economic objective is to achieve high and stable levels of economic growth and employment, which will promote greater fairness and social cohesion, while also respecting the environment.
- The Government has put in place major fiscal and monetary policy reforms to deliver greater economic stability and has introduced a wide-ranging programme of structural policy reforms to encourage work and increase productivity. These reforms will also enable Britain in due course to take part successfully in the single European currency, should it choose to do so.

1 Introduction

The first Economic and Fiscal Strategy Report*Stability and Investment for the Long Term*reflects the Governments commitment to a more open and transparent approach to economic policy. It explains how the Governments new fiscal approach will help to achieve the central economic objective of high and stable levels of growth and employment. This strategy is based on prudent management of the public finances to build a platform of stability, a phased programme of higher public investment and more efficient use of public assets, and reform and modernisation of our public serviceseach element underpinned by stable and long-term plans. It combines prudence and stability in public finances with investment and reform in public services.

It is important that the Governments strict fiscal rules are met. Therefore, in a decisive break from the past, the Government is introducing a tough new regime for the long-term control of public expenditure. The public spending round has been a feature of British economic life since the early sixties. It has established an annual cycle of year-on-year incremental bids by departments; settlements reached by bargaining over inputs rather than analysis of outputs and efficiency; excessive departmentalism; a split between public and private provision; and a bias towards consumption today rather than investment in our future.

The new approach to public spending tackles these deficiencies. It is based on multi-year plans rather than an annual cycle; a clearer distinction between current and capital spending; services justified by proper analysis of their effectiveness rather than bargaining over inputs; and the coordination and integration of services rather than departmentalism and a piecemeal approach to spending. The new system will also be based on a proper understanding of the role and limits of government: a shift from the state only as owner, manager and employer to the state also as facilitator and partner.

A key part of this approach is the two strict fiscal rules, first proposed in the Governments election Manifesto, that will govern policy over the course of this Parliament:

- the *golden rule*: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the *sustainable investment rule*: *net public debt* as a proportion of GDP will be held over the economic cycle at a *stable and prudent level*.

These rules are consistent with the common sense principles set out in the *Code for Fiscal Stability* and place Britain at the forefront of international best practice. They also recognise the important distinction between current and capital spending.

This Report sets the stage for the conclusions of the Comprehensive Spending Review (CSR) by setting a firm envelope for growth in total public expenditure over the next three years. These plans are fiscally prudent and sustainable. They not only lock in the fiscal tightening achieved over the past yearthe largest since 1981but carry it into 1999-2000 in line with the tightening projected in the March Budget. On prudent assumptions, to allow for inevitable uncertainties, the plans generate a surplus on current budget over the cycle and also reduce the ratio of net public debt to GDP to below 40 per cent over the economic cycle as the economy returns to trend.

Proper investment by the public sector, and better management of the states assets, are also vital. In the past, cuts in capital expenditure were made too often as a means of accommodating short-term pressures elsewhere. The consequence has been a significant deterioration in the public sector capital stock and a legacy of inefficient use of productive assets.[1]

The Governments approach addresses these shortcomings by making a clear distinction between current and capital spending. Building on a framework of stability, room has been found for an Investing in Britain Fund to provide for the renewal and reform of Britains infrastructure and public sector. This will boost growth and innovation and underpin public services. This strategy recognises the roles that public and private investmentseparately and togethercan play in developing Britains infrastructure. It is also supported by the Private Finance Initiative and public-private partnerships which act to promote the efficient use of resources, encourage value for money in public investment and provide a new source of financing for important investment opportunities.

The Governments plans allow for a near-doubling of public sector net investment by the end of this Parliament (stabilising just below 1½ per cent of GDP). This commitment is prudent, being well within the margins implied by the Governments strict fiscal rules, and contingent not only on efficient appraisal by departments but also their willingness to dispose of surplus assets. That accords with the purpose of the National Asset Register and the announcements of assets sales made today.

Under the new planning regime, real current spending will rise by an average of 2¼ per cent per annum over the rest of this Parliament, in line with our cautious estimate of the trend rate of growth. This will allow the Government to build a surplus on its current budget, and ensure that the golden rule is met even on a pessimistic assumption of the position of the economy relative to its long-term trend. As well as embodying the Governments cautious approach, this also increases the scope for investment in Britains future.

The important distinction between current and capital spending is reinforced in this Report by a new format for the public finances. This format accords with national accounts conventions and is in line with international practice. Transparency is an indispensable hallmark of good policy. The new format will help the assessment of progress within the fiscal framework.

The Report also sketches out the other factors necessary to achieve a sustained improvement in Britains prosperity. A better educated and trained workforce, facing the right incentives to work, and a climate of enterprise involving greater willingness to innovate and compete are all important ingredients of success. The Governments economic and fiscal strategy, which will be supported by the outcomes of the Comprehensive Spending Review, tackles these issues head-on.

Chapter 2 sets out the Governments broad economic strategy for achieving the goals of high and stable levels of growth and employment. The particular role played by the framework for fiscal policy is the focus of Chapter 3. Chapter 4 sets out the Governments expenditure plans, at the aggregate level, for the remainder of this Parliament. Full details of the allocation of spending, and accompanying reforms, will be announced in a White Paper in July.

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1 See *Fiscal Policy: current and capital spending*, HM Treasury June 1998. [Back]

Sustainable growth and employment

This Chapter spells out the Governments central economic objective of achieving high and stable levels of growth and employment. It also discusses what the Government is doing to address long-standing weaknesses of the UK economy.

The key points made in this chapter are that:

- raising the sustainable level of economic growth and employment will provide greater opportunity, higher incomes, improved public services and higher standards of living for all;
- three areas are vital: economic stability, encouraging work and raising productivity;
- the Government has put in place major fiscal and monetary policy reforms to deliver greater stability, and it has also introduced a wide-ranging programme of structural policy reforms designed to encourage work and raise productivity; and
- these reforms are all in the national interest and they will also help to deliver the stability and flexibility needed to allow Britain in due course to take part successfully in the single European currency, should it choose to do so.

2.1 THE OBJECTIVES

2.1.1 A PROSPEROUS BRITAIN

The Governments central economic objective is to achieve high and stable economic growth and employment. This objective recognises that:

- the level of output per head is a key determinant of our overall standard of living. It also provides the scope for assisting those in need and for meeting the Governments spending priorities. The Government is committed to raising the UK economys sustainable growth rate; and
- creating employment opportunities will not only promote economic growth but will ensure that the benefits of growth are shared throughout society.

Economic growth is the key to raising incomes and living standards over time. The post-war Golden Age was an exceptional period of rapid growth (3 per cent per year on average), in which GDP doubled in the 25 years between 1948 and 1973. In contrast, growth over the following 25 years has averaged less than 2 per cent per year.

The Government believes that, with persistence and well-judged policies, it is possible to improve on the recent record. A sustained increase in growth would have enormous consequences for income levels and the ability to sustain and improve public services. For example, if the sustainable growth rate were raised by ½ per cent a year that would add over 120 billion to the level of national income in 20 years time.

Our quality of life, however, also reflects a wide range of factors besides measured incomesfor example, health, personal safety and the quality of the physical and social environment. Invaluable contributions made through unpaid household work, carers, and by those working in the voluntary sector are not captured in GDP. The amount of leisure time is another important factor in the quality of life. Our environmentin the countryside and in citiesis also crucial to our well-being.

GROWTH AND THE ENVIRONMENT

Economic growth cannot be considered in isolation from other aspects of development. In particular, consideration needs to be given to environmental factors to ensure that economic growth is sustainable.

The Government is doing this by:

- ensuring policy decisions take account of environmental costs and benefits;
- making greater use of economic instruments for the environment alongside regulation and voluntary agreements;
- encouraging more environmentally friendly transport and reducing greenhouse gas emissions through tax and duty changes; and
- promoting energy efficiency and renewable sources of energy.

The Government is also taking forward work on environmental accounts and indicators which will help to promote growth which is environmentally sustainable. Later this year the Government will publish its Sustainable Development Strategy, setting out its views on the framework within which environmental, social and economic factors should be weighed and balanced.

2.1.2 SHARING THE BENEFITS

Sustained growth will not just benefit those currently in work. A key element of the Governments strategy is to increase employment opportunities, develop a fair tax system and improve the provision of public services, to raise living standards for all.

Higher employment will ensure that more people can contribute to Britains future. Additional jobs also means that more people are earning incomes, which raises their own standard of living and reduces the call on the public finances. Higher employment raises the level of national income directly.

A modern economy is characterised by continuous innovation and change. The key to higher employment is not to stand in the way of change, but to equip people to meet the challenge of that change. The Governments tax, benefit and employment policies reflect this reality and seek to provide employment opportunity for allthe modern definition of full employment.

Simply examining levels of GDP or average income per head may hide large disparities between rich and poor. The distribution of income in the UK has become more uneven since 1979, and by a greater margin than in the rest of Europe. But there is no reason why economic growth need go hand-in-hand with greater inequality. Quite the reverse:

- faster economic growth should reduce poverty and inequality directly through increased opportunities for work; and
- higher tax receipts increase the Governments capacity to assist those in need.

The tax and benefit system must not blunt incentives. In particular, careful consideration needs to be given to the interaction with economic and employment growth. But a fair tax system produces substantial benefits through increased social cohesion, trust and honesty, and a climate more conducive to economic growth.

2.2 ACHIEVING SUSTAINABLE GROWTH AND EMPLOYMENT

The UKs post-war growth performance has been poor compared with other industrialised countries. Some countries have not only caught up with, but overtaken the UK. As a result, GDP per head is now around 10 to 15 per cent higher in France and Germany, and around 50 per cent higher in the US.

There is considerable scope to improve our growth performance and catch up with the higher incomes of other major economies. The Government has a key role to play in meeting this challenge by working in partnership with business, and ensuring that growth benefits everyone.

In order to improve our growth performance, three areas need particular attention:

- assuring greater economic stability;
- encouraging work; and
- raising productivity.

2.3 ASSURING GREATER ECONOMIC STABILITY

2.3.1 ECONOMIC STABILITY

At least part of the UKs poor growth performance can be attributed to macroeconomic instability. That is why economic stabilitybased on low inflation and sound public financesis a key platform of the Governments economic policy.

Improved macroeconomic stability will have several major benefits for the UK economy. In particular, it will give businesses and individuals the necessary confidence in future economic prospects for them to plan effectively for the long term. This will improve the quantity and quality of long-term investment and help raise productivity. Furthermore, confidence that inflation will remain low is important to encourage the savings which go to fund investment. Low inflation also reduces the distortion of economic decisions and minimises the arbitrary redistribution of income and wealth.

Macroeconomic instability also has substantial personal costs. The loss of security and self-confidence that arise from unemployment during recessions is considerable. In addition, it makes it difficult for individuals to retain or continue to develop the skills necessary for long-term employment.

The Government has a clear role in delivering macroeconomic stability. Fiscal and monetary policies need to focus on the long term and underpin stability rather than contributing to instability, as has sometimes been the case in the past. In addition, tax and spending regimes need to be as stable as possible to generate greater certainty and give businesses and individuals confidence to plan for the long term.

The international dimension must not be overlooked either. The world economy is now so closely interrelated that adverse shocks are just as likely to originate from overseas as they are domestically. The UK takes its international responsibilities to promote a healthy and stable world economy seriously, for example by helping to ensure an appropriate international response to the South East Asian crisis.

Greater transparency and openness are key weapons in avoiding poor policies and bad decision-making. That is why they play a central part in the Governments approach. They also help to enhance the credibility and effectiveness of policies. Accordingly, transparency and openness are at the heart of the new frameworks for monetary policy and fiscal policy. Furthermore, the Government argued successfully for the IMF to develop a Code of Good Practice on Fiscal Transparency, and is now working, with support from other G7 countries, to help the IMF to develop a parallel code for financial and monetary policy.

2.3.2 THE MONETARY AND FISCAL POLICY FRAMEWORKS

One of the first actions of the new Government was to establish a credible monetary policy framework that delivers low inflation. Low inflation is the most appropriate contribution that monetary policy can make to lasting growth. These reforms have been given a statutory basis under the Bank of England Act which came into effect on 1 June 1998.

The Act gives the Bank of Englands Monetary Policy Committee (MPC) the operational responsibility to set interest rates to meet the Governments inflation target. This clear division of responsibilities means that the Bank can focus on the question of what level of interest rates are needed to achieve the target.

The new arrangements make the UK framework among the most transparent and accountable in the world, characterised by the publication of the minutes and the Inflation Report, and the immediate announcement of decisions. The new framework also enhances Parliamentary scrutiny and makes the MPC democratically accountable.

The monetary policy objective of the Bank of England is to maintain price stability and subject to that, to support the Governments economic policy, including its objectives for growth and employment. The remit that the Government has set for the MPCconfirmed in the Chancellors letter of 3 June 1998 to the Governor of the Bank of Englandis an inflation target of 2½ per cent (for retail prices excluding mortgage interest payments). Inflation needs to be consistently low. So the target applies at all times.

These arrangements have already established a much higher degree of credibility than those in place previously, and long-term interest rates and inflation expectations have fallen sharply since May last year. However, there is still more to do. In particular, those involved in wage bargaining in the private sector need to recognise that the new environment means low inflation permanently. Failure to do so will lead to unnecessary job losses and lower growth.

A more credible monetary policy framework, and the achievement of permanently low inflation and inflation expectations, are also key factors behind the achievement of sustainable economic convergence in preparation for the single currency. The Government is committed to creating the period of stability necessary to ensure the UK has a genuine choice of joining EMU early in the next Parliament.

The Government has made major changes to the fiscal policy framework as well, including strict fiscal rules and the introduction of a new Code for Fiscal Stability. This is discussed in more detail in Chapter 3. Chapter 4 announces the fiscal strategy for the next three years, further strengthening the framework. Together, the new fiscal and monetary policy frameworks will generate the necessary confidence to encourage businesses and individuals to plan for the long term.

2.4 ENCOURAGING WORK

In the three months to March 1998 there were 1.9 million people unemployed and a further 2.4 million people of working age who wanted a job but were either not seeking or not available for work. At the same time there is widespread evidence of skill shortages. Correcting this structural weakness requires a framework that rewards and encourages work. That means:

- helping people from welfare into work; and
- making work pay, by removing disincentives to work and ensuring decency and fairness in the workplace.

It also means making individuals more productive by improving skills and helping people move up the employment ladder. This is covered in Section 2.5.1.

2.4.1 FROM WELFARE TO WORK

The Governments New Deal initiative to help young people back to work is now a national programme, guaranteeing new employment and training opportunities to all those aged under 25 who have been out of work for 6 months or more. In its first full year, around 290,000 young people are expected to enter the programme, with over 100,000 to be placed into regular employment.

For those who do not find regular employment from the gateway programme of intensive job search, the New Deal offers the option of a subsidised job, full-time training, work with the voluntary sector or a place on the Environmental Task Force. All options include a training element, and those who complete their options will be given extra assistance to help them stay in work. This month also sees the national start of a new self-employment option; helping those for whom starting their own business offers the best route into the labour market.

The response from employers has been very encouraging, with over 10,000 having signed the agreement to participate. Building on this success the Government is now extending the New Deal to long-term unemployed people aged over 25. The New Deal for lone parents is the first serious national effort to help lone parents who want work to find it, and New Deal opportunities are also being made available to people with disabilities, and partners of the unemployed who find themselves out of work.

Alongside the New Deal, the Government is also developing approaches targeted on areas where long-term unemployment is particularly high. Five areas of the country have been selected as Employment Zones, where partnerships are developing innovative and flexible new approaches to make the best use of government funding. The New Deal for Communities will focus help on particularly disadvantaged housing estates, where poor employment prospects interact with wider problems of social exclusion, crime and poor housing.

2.4.2 MAKING WORK PAY

For the majority of people in work, there are clear financial rewards. But for those out of work who are able to command only low wages, potential in-work income may not be large enough to provide an incentive to work. In addition, for those in low-paid jobs, the tax and benefit systems may mean that they have very little incentive to increase their hours worked, or their hourly wage. The tax and benefit system therefore needs to help those in need whilst not discouraging people from workingthe unemployment trapor from moving up the earnings ladderthe poverty trap.

The 1998 Budget took important steps in tackling these problems through:

- a Working Families Tax Credit (WFTC) to replace the Family Credit system from October 1999;
- a new Disabled Persons Tax Credit to help make work pay for people with disabilities; and
- significant reform of National Insurance contributions to remove distortions at the lower end of the earnings distribution.

These reforms will be underpinned by the national minimum wage.

Together these reforms start to tackle the features in the tax, benefit and national insurance systems that distort the labour market; particularly through the effect they have on low paid workers, and those moving from unemployment into work. For instance, the reforms will cut the numbers of families facing high marginal deduction rates: the numbers facing rates of more than 90 pence of any extra 1 will fall by about four-fifths. In addition, these reforms will boost the effective hourly wage rates for low paid workers. Every working family will be guaranteed an income for full-time work of at least 180 per week. And no family with earnings of less than 220 a week (half average male earnings) will pay net income tax.

2.5 RAISING PRODUCTIVITY

Besides increasing the number of people in work, the other side of the growth strategy is to help each worker to become more productive. A productive labour force is essential to achieving high and stable levels of growth and employment. What is needed is a skilled and flexible labour force that is able to respond effectively to new challenges offered by a dynamic business sector.

Measured by either output per worker or output per hour, the UK has a poor productivity record. US productivity leads the UK by about 40 per cent, and France and Germany are at least 20 per cent ahead of the UK. These large productivity gaps go to the heart of the UKs legacy of under-performance.

Productivity can be raised by increasing and improving the stock of physical capital per worker and by raising skill levels. However, productivity growth cannot be considered in isolation from the fundamental role of innovation, nor from the competitive framework which drives it.

Of clear importance is the need for:

- high levels of educational attainment and training;
- the workforce to be supported by sustained capital investment;
- markets to be open and competitive to create the right incentives for continuous improvement; and
- dynamic and innovative businesses continually developing new products and processes.

In taking this forward, the Chancellor and the President of the Board of Trade have launched a joint programme of seminars with leading business people and others to work together to find ways of bridging the productivity gap.

2.5.1 IMPROVING EDUCATION AND TRAINING

High productivity is associated with an educated and skilled workforce. Improving the skills of those in work and ensuring new workers are highly trained will therefore help employers to raise productivity.

An effective basic education is important for both individuals and the economy alike. Early investment in a childs education will help to raise growth by improving the employability of all, especially the least skilled, and relieving skill shortages. The self-confidence and skills that a good basic education instills can also help to prevent many social problems, and the costs they entail, arising in later years.

There is evidence that the UK has a lower level of basic skills in literacy and numeracy than other major economies. The first step to address this problem is to enable a much higher proportion of 11 year olds to leave primary school with adequate skills in literacy and numeracy through:

- focused and intensive literacy and numeracy strategies;
- reduced class sizes for 5 to 7 year olds; and
- freeing up teachers time to teach.

In the July 1997 Budget, the Government recognised the importance that well-maintained school buildings can play in helping to raise standards, both for pupils and teachers. The Chancellor allocated 1.3 billion from the windfall tax to tackle the backlog of school repairs. This New Deal for Schools has proved an effective measure, with a quarter of all UK schools having been allocated funding already.

Learning basic skills at a young age is fundamental to success in later life. By the time they leave school, children should be able to read and write fluently and handle numbers confidently. The Department for Education and Employment has announced ambitious targets for both literacy and numeracy for 11 year olds. By the year 2002, 80 per cent of 11 year olds will have reached the standards expected of their age in English, and 75 per cent will have achieved the standards expected of their age in Maths (as against 58 per cent and 54 per cent respectively in 1996).

The further education (FE) sector provides a key link between school and the workplace. In 1996-97 there were 1 million students studying full-time in the FE sector and over 2.8 million studying part-time. Of those students, over half were studying to improve basic skills. The Government is developing a range of measures, known collectively as Investing in Young People. These will encourage increased participation and enhance the quality of learning opportunities.

High participation in good quality higher and further education will also help to promote innovation, for example by making it easier to assimilate new ideas or develop and use new technologies.

The Government is taking steps to enable those already in the workforce to improve their level of attainment and to establish a culture of life-long learning. This will help individuals move up the employment ladder and allow them to respond to change throughout their working lives. The Green Paper *The Learning Age* announced proposals to achieve this end. They include setting up the University for Industry and introducing Individual Learning Accounts.

More immediate action has been needed to address particular skills shortages faced by parts of the economy at present. Inadequate education in the past means that information technology and other high technology parts of the economy are struggling to obtain adequate supplies of skilled workers. In the 1998 Budget, the Chancellor allocated an additional 100 million to tackle skills problems, including establishing forty Centres of Technical Excellence and training 20,000 people to tackle the Millennium Bug problem.

Further proposals and targets for education will be announced as part of the Comprehensive Spending Review.

2.5.2 CAPITAL INVESTMENT

A relatively low level of business investment per worker is another key factor in explaining why the UK has a lower level of labour productivity than other major economies. In particular, the UK invests less per worker and has a lower non-residential capital stock per worker than the US, France or Germany. Public sector investment has also been low (see the paper by HM Treasury on *Fiscal policy: current and capital spending*). Improving the amount and quality of capital should help to raise trend growth.

There are a number of possible reasons for the UKs low level of investment. High hurdle rates for investment are probably partly a result of the UKs history of macroeconomic instability as uncertainty about inflation raises risk premia on long-term investment. The UKs relatively low supply of savings may be another factor, which is why the Government is committed to fiscal prudence as a necessary pre-condition for achieving prosperity. In the past, the tax system has also distorted investment decisions. For example, tax credits encouraged firms to pay out dividends rather than reinvest retained profits. For some firms, the availability of external finance has been a constraint on investment and in some cases management attitudes and shortfalls probably also play a part.

The Government is seeking to create a pro-investment business climate. In the last two Budgets, important changes were made to corporation tax and capital gains tax to promote high quality long-term investment. The Chancellor also extended enhanced capital allowances for small and medium-sized enterprises (SMEs). This will assist cashflow and encourage SMEs to invest and modernise.

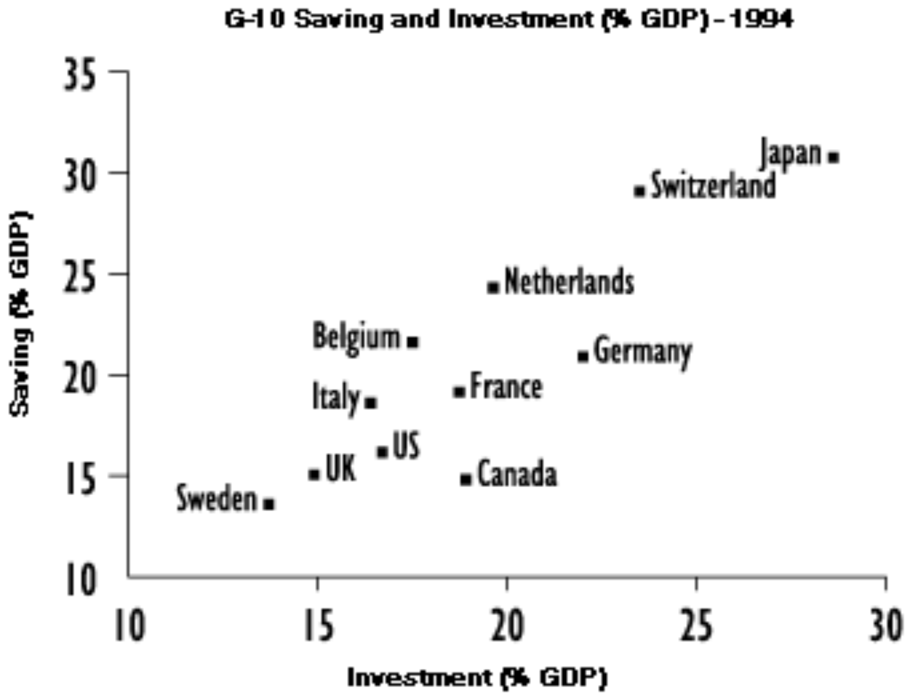
The Government also wants to improve the climate for external finance. To this end, it has reformed the Enterprise Investment Scheme to stimulate the provision of equity capital for smaller, higher risk trading companies. A University Challenge Fund will also help universities bridge the funding gap which has in the past prevented them successfully transforming good research into good business. External finance will be a continuing theme in the preparation of the next Budget.

INVESTMENT AND NATIONAL SAVING

In an open economy, the level of national investment need not be matched by the same amount of national saving. Foreign capital inflows can be used to finance domestic investment, so long as the returns on domestic investment generate the necessary income to pay the foreign investors.

Nevertheless, in the past both the levels and changes in domestic saving and investment have been found to be related strongly in the long term.

For the economy as a whole, it is overall national savingsthe sum of private and government savingthat matters for economic growth. One direct contribution that the Government can make to increasing national saving is to improve its own saving performance. The main factor in the decline in national saving since the 1970s has been higher public borrowing.



2.5.3 OPEN AND COMPETITIVE MARKETS

Dynamic and efficient product markets are good for both consumers and for the economy as a whole. They give customers lower prices, more choice and higher quality; and they provide strong incentives for companies to innovate and improve productivity, driving forward economic success.

Exposure to competition and trade sharpens incentives, encourages the diffusion of technology and opens up opportunities to catch up with the worlds leading firms. Moreover, increased market size allows greater specialisation and exploitation of comparative advantage. Episodes of trade liberalisation are, almost without exception, associated with rapid growth in trade and an increase in economic growth.

The UK benefits, in a similar way, from inward foreign investments; while outward investment has enabled UK firms to expand and develop markets overseas. Maintaining a high level of overseas investment will produce better returns and help spread risks for UK savers.

Over the past year, the Government has begun an ambitious programme to improve the dynamism of product markets. The approach has focused on encouraging competition, improving regulation and promoting open markets, through:

- introducing a new Competition Bill to create a modern framework for competition policy based on a tough and rigorous approach to abuses, whilst increasing transparency and accountability. The Government will also ensure that the Office of Fair Trading has the resources to implement these new arrangements and uses them effectively in those areas that will generate the greatest economic return;
- publishing a Green Paper on regulation of the utility industries. This sets out the Governments strategic proposals for these key industries for the next decade, with the objectives of fairness and efficiency. The aim is to set a long-term, stable and effective framework that safeguards the interests of consumers and shareholders and anticipates changes in market structure; and
- establishing an independent advisory task force to look at regulations protecting the interests of consumers and employeesanother element of an efficient market economy. A report will be published in September 1998.

There is also a crucial international element to this agenda. In international groups the Government plays a leading role in pressing for further liberalisation of trade and investment and for competition policies which ensure free and open markets. In Europe, the Government recognises the need for a more effective Single Market. It is looking for action in a range of areas to improve the functioning of product markets, such as liberalisation of telecommunications and energy markets, public procurement and reform of agricultural support.

2.5.4 STIMULATING INNOVATION AND RESEARCH AND DEVELOPMENT

Research and development (R&D) and innovation by businesses is generally positively associated with economic growth in industrialised countries. The diffusion of ideas and technology has clear potential benefits for the wider community. Basic research also contributes to economic growth, by training skilled individuals for the business sector and by contributing to the stock of knowledge more generally.

In aggregate, the amount of R&D undertaken by UK firms has declined relative to our competitors. Total R&D spending in the UK is ¼ to ½ per cent of GDP less than in most other major economies. UK businesses spend relatively more in high-technology sectors such as chemicals and less in medium and low-technology sectors. But the overall figures are heavily influenced by a few star performers, as nine companies undertake one third of all UK business sector R&D.

The reforms to capital gains tax, corporation tax, and the initiatives to help small and medium-sized enterprises raise finance are important steps towards creating a more favourable environment for investment, including investment in R&D. In a wide-ranging review on how to improve the UKs record of investment in R&D, the Treasury and Department of Trade and Industrys consultative document, *Innovating for the Future*, identified several key issues to explore further, including:

- funding R&D, and the need to attract more finance into high-technology enterprises, especially in the early-stages of their development;
- the appropriate tax treatment of R&D expenditure and intellectual property;
- the right balance between the legal protection of intellectual property and encouraging the diffusion of innovation; and
- how the UK can exploit its science and engineering base better and develop management best practice, especially amongst technology-based companies.

2.6 EMU AND ECONOMIC REFORM

All of these policies directed at reforming markets will help to deliver the vital flexibility should the UK choose to join the single currency. But high and stable levels of growth and employment are also an objective for the European Union on which much of our prosperity depends. The Government believes that economic stability, encouraging work and raising productivity are also key areas for the European Union. Economic and Monetary Union and the introduction of the single currency in 11 Member States on 1 January 1999 will help to lock in monetary and fiscal stability throughout Europe. The single currency will provide a competitive base to European business. Firms and consumers stand to benefit from the greater price transparency, the reduction of transaction costs and the elimination of exchange rate uncertainty.

For these benefits to be realised in full the single currency must be based on solid foundations. More progress is required in two areas, fiscal discipline and economic reform. In particular:

- for labour markets, the key is to increase employability. With a single currency, it will be even more important for Europe to have a well-trained, adaptable and motivated labour force, able to adjust to changes in economic circumstances;
- for better functioning markets for products and services, Europe needs to build on the single market, promote entrepreneurship and improve access to finance. Within the single market this means liberalising markets and promoting better public procurement; and
- for deeper, more competitive and more integrated capital markets, the single market in financial services must be implemented effectively.

The Fiscal Framework: Prudence and Prosperity

This Chapter discusses the framework for fiscal policy and explains how this strategy will help build the platform of stability needed to achieve high and stable levels of growth and employment.

The key points made in this Chapter are that:

- the Code for Fiscal Stability sets out the broad fiscal framework, within which the Government's approach is defined by two strict fiscal rules;
- a coherent strategy for managing the public finances is one which makes a clear distinction between current and capital budgets, as in the fiscal rules;
- the fiscal rules are consistent with the primary role of fiscal policy-to ensure economic stability through prudent management of the public finances; they are also consistent with the requirements of the Stability and Growth Pact; and
- the regime for planning and controlling public spending is being reformed to improve spending control and promote longer-term planning. Departments will be given firm multi-year limits within which they must manage and plan ahead to deliver modern public services. This represents a significant step towards Resource Accounting and Budgeting, which will further reinforce delivery of the fiscal framework.

The previous Chapter set out the broad framework underpinning the Government's approach to economic policy. This chapter focuses on the role that fiscal policy plays within that approach.

The fiscal strategy will ensure that the Government's strict fiscal rules are met through a tough new regime of public expenditure planning, which breaks decisively from the past. The annual public spending round dominated by a cycle of year-on-year incremental bids by departments has been a feature of British economic life since the early sixties. This approach, however, has produced inefficient outcomes as settlements were made on the basis of bargaining over inputs rather than an analysis of outputs and efficiency. Furthermore, it has resulted in excessive departmentalism, a split between public and private provision, and a bias towards consumption today rather than investment in our future.

As a result of this piecemeal approach, fiscal policy did not contribute fully to the UK's long-term interests:

- over the previous economic cycle, current spending exceeded current receipts by an average of over 1½ per cent of GDP, equivalent to 12 billion at today's prices, imposing a burden on future generations; and
- public investment fell to low levels, even allowing for factors such as the effects of privatisation, and maintenance backlogs developed.

In addition, the previous fiscal framework:

- attached insufficient importance to the distinction between current and capital spending so that decisions did not show accurately how future generations would have to pay for today's public spending; and
- was widely seen as creating a bias against capital spending which led to cuts in investment to accommodate short term pressures on current spending.

The new regime tackles these deficiencies. It will embody:

- multi-year plans rather than an annual cycle;

- a clear distinction between capital and current spending;
- a greater focus on effectiveness and outputs rather than bargaining over inputs; and
- the coordination and integration of services rather than departmentalism and a piecemeal approach to spending.

The new system will also be based on a proper understanding of the role and limits of government. In particular, it will recognise the state as not just owner, manager and employer but also as facilitator and partner. The desired outcome is the public and private sectors working together in the place of the discrete public-private split.

3.1 THE CODE FOR FISCAL STABILITY

The framework within which the Government will formulate and implement fiscal (including debt management) policy is set out in *The Code for Fiscal Stability*, published in March 1998.

The Code, which will shortly be given the force of law in the 1998 Finance Bill, ensures that the framework for fiscal policy is characterised by openness, transparency and accountability, mirroring the reform of the monetary policy framework introduced last May.

The Code requires fiscal and debt management policy to be formulated and implemented in accordance with a set of five key principles that are fundamental to a commonsense approach to fiscal management:

- **transparency** in the setting of fiscal policy objectives, the implementation of fiscal policy and the publication of the public accounts;
- **stability** in the fiscal policy-making process and in the way fiscal policy impacts on the economy;
- **responsibility** in the management of the public finances;
- **fairness**, including between generations; and
- **efficiency** in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.

A number of other commitments follow from this. For example, governments must state explicitly their short and long-term fiscal policy objectives, and must ensure these objectives are consistent with the fiscal principles embodied in the Code.

A further important requirement of the Code is that governments report regularly on progress in meeting their fiscal objectives. From now on, the familiar Financial Statement and Budget Report will be supplemented each year by an Economic and Fiscal Strategy Report, setting out the Government's long-term strategy and objectives. The present document is the first of this series. The Code also requires a Pre-Budget Report to be published, reflecting the Government's desire to draw upon the skills and experience of others when forming policy. Together, these reports will ensure that Parliament (in particular, the Treasury Select Committee) and the public, can scrutinise fully the Government's fiscal plans.

3.2 THE FISCAL RULES

3.2.1 Distinguishing between current and capital spending

The Government's first two Budgets have made clear that a key component of the new approach to fiscal policy is to distinguish between *current* and *capital* spending. Current spending provides benefits mainly to the current generation and reflects continuing programmes that are financed each year. Fairness and prudence dictate that this spending should be covered by current revenue. In contrast, spending on capital (ie investment) creates assets which support services and benefit taxpayers in future years as well as now. This does not imply that one type of spending is necessarily better than the other: both must be worthwhile and offer good value for taxpayers' money.

Reflecting the important distinction between current and capital spending, the Government has set two strict fiscal rules to govern policy over the course of this Parliament:

- the *golden rule:* over the economic cycle, the Government will borrow only to invest and not to fund current spending; and

- the *sustainable investment rule: net public debt* as a proportion of GDP will be held over the economic cycle at a *stable and prudent level*.

The golden rule recognises explicitly the different economic nature of current and capital spending. In the past, governments set limits for total spending without distinguishing between current and capital spending. This led to bias against investment, which often constituted an easier (though short-term) target for spending cuts. Net capital spending by the public sector has fallen from 3 per cent of GDP in 1978-79 to ¾ per cent of GDP in the spending plans for 1998-99. This is explained only partly by privatisations and the growth of public-private partnerships. Many services have suffered-and growth too-as a result of inadequate levels of investment. At the same time, the sustainable investment rule recognises that borrowing for public investment must be constrained by the need to ensure a prudent debt ratio.

In accordance with this distinction, the public finances are being presented in a new way, one which is more consistent with the underlying economic realities, as reflected by the move to Resource Accounting and Budgeting, national accounts concepts and international practice (see Chapter 4). In addition, the new spending control regime is based on the distinction between current and capital spending.

3.2.2 Assessing the fiscal rules

The Government's fiscal framework reflects a careful application of the principles of fiscal management which are embedded in the Code for Fiscal Stability. **Transparency** lies at the heart of this framework. It leads to greater certainty for decision makers and makes it possible for Parliament and the public to scrutinise policy decisions. Publishing this Report and setting out unambiguously the role and objectives of fiscal policy-in particular, the fiscal rules and their application-provides a clear demonstration of the Government's commitment to transparency in fiscal policy.

By design, the fiscal rules will lead to greater economic and fiscal **stability**. As suggested above, this strategy allows decision makers to plan and invest for the long term, confident in the knowledge that the public finances will not be managed in a profligate fashion that might necessitate a sudden adjustment at some point in the future.

The fiscal rules also represent a **responsible** approach to fiscal policy. The Government's commitment to keep debt at prudent levels recognises that excessive borrowing has detrimental economic effects. Borrowing will be used only to fund value for money investment, and the overall level of borrowing will be prudent and not excessive.

Furthermore, these rules are consistent with the principle of **fairness**. By funding current spending from current revenue over the economic cycle, today's taxpayers bear the full cost of the public sector current spending from which they benefit.

The Government also places considerable emphasis on ensuring that it raises revenue and uses taxpayers' resources in an **efficient** manner. The top-down approach, and firm plans for overall spending, derived from the fiscal rules, require the Government to prioritise its spending plans following a bottom-up review of spending priorities. The Comprehensive Spending Review (CSR) is the means of doing so. Moreover, by making a proper distinction between capital and current spending, the fiscal rules ensure that the planning and control processes no longer discriminate against capital spending. This will help ensure value for money in the provision of public services.

3.2.3 The golden rule: fairness between generations

As noted above, fairness is one of the five principles of fiscal management embedded within the Code for Fiscal Stability. This principle implies that those generations that benefit from public spending should also meet the cost.

The golden rule helps to match the costs and benefits of public spending across generations. It draws a clear distinction between current and capital spending, recognising that worthwhile capital spending by the Government provides benefits in the year of investment and over the life of the assets. It also recognises that current consumption must be controlled tightly and should not be financed by borrowing. However, the Government acknowledges that any such approach will be, to some extent, an approximation. Some aspects of current expenditure may also transfer the fiscal burden in ways that can not easily be quantified.

It is clearly important to be aware of potential pressures on spending which arise over the longer term from demographic change. Development of long-term public finance projections is one way of approaching this issue. The Code for Fiscal Stability requires governments to publish illustrative long-term projections for the public finances, covering a period of at least 10 years. These projections are currently under development. Once completed, they will give an indication of how fiscal aggregates might evolve over time if policies remain unchanged.

A further approach that has been used in several countries is to calculate what are known as 'generational accounts'. These accounts attempt to estimate each generation's net tax and benefit position over their respective remaining lifetimes, conditional on a given policy approach. The Treasury is currently collaborating with the National Institute for Economic and Social Research and the Bank of England to produce a set of generational accounts for the UK.

3.2.4 Defining a prudent level of public debt

Over the economic cycle, the Government is committed to holding public debt as a proportion of GDP at a stable and prudent level.

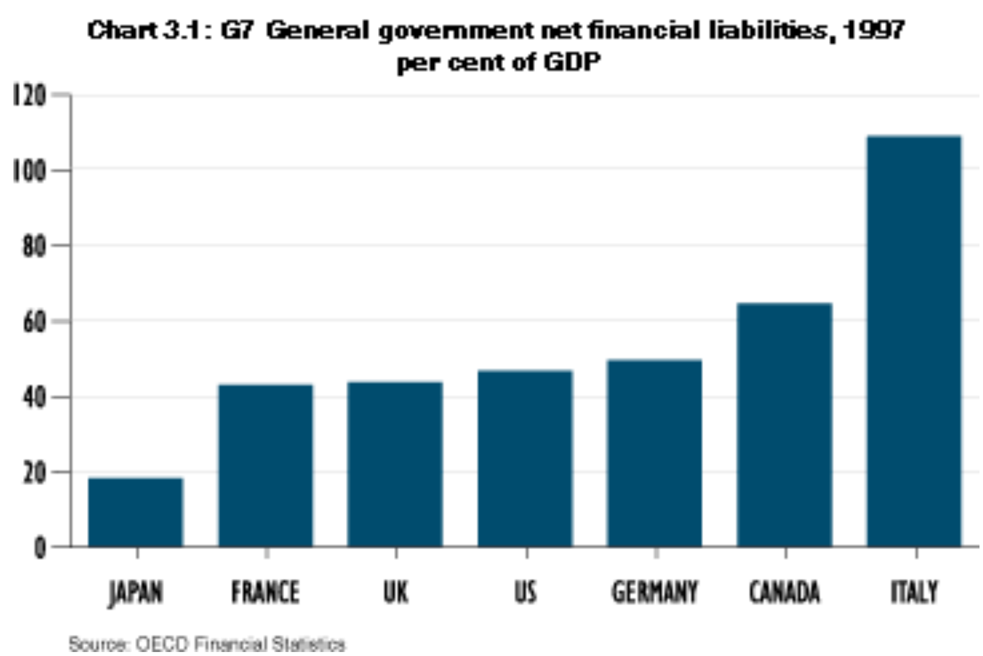
At a basic level, fiscal policy settings can be said to be *sustainable* if, on the basis of reasonable assumptions, the government can maintain its current spending and taxation policies indefinitely while continuing to meet its debt interest obligations. The costs to the British economy if fiscal policy were to become unsustainable would be substantial. Therefore, a more disciplined or *prudent approach* is justified-one that ensures fiscal policy is sustainable even in the face of adverse shocks.

The prudence of the level of Britain's public debt needs to be judged in relation to the size and frequency of the economic shocks to which Britain is exposed. The prudent level of debt also depends on the size of the economy since it becomes possible to sustain a higher money level of public debt as national income grows. This is why the Government's fiscal rule is specified in terms of the ratio of public debt to GDP.

Because countries are not all alike, a level of public debt that is prudent for one country at a particular point in time may not be prudent for another. Indeed, over time, as economies develop, the level of public debt that is prudent for an individual country will change. Simple comparisons of international and historical data may be used as a broad guide, but it is important to look beyond these figures.

Over the past decade or so, Britain has been subject to greater volatility in growth and inflation than any other major industrial economy. The Government's reforms to monetary and fiscal policy will act to reduce the volatility stemming from errors in macroeconomic policy settings. However, unexpected shocks due to other influences, such as developments in the world economy, will continue to impact on the British economy. The Government believes that, other things equal, it is desirable that net public debt be reduced to below 40 per cent of GDP over the economic cycle. As discussed in Chapter 4, the fiscal projections suggest that this will be achieved over the remainder of this Parliament, while still allowing the Government to meet its key spending priorities. The only previous time during the past 30 years that net public debt fell to this level was during the unsustainable boom in the late 1980s.

By way of international comparison, as Chart 3.1 shows, Britain's public debt (measured here using general government net financial liabilities as a proportion of GDP) is low by international standards. As a result of the deficit reduction plan, the level of public debt, and hence debt interest payments, are projected to remain well under control.



Debt performs a valuable function-it helps to spread the cost of public investment fairly across generations. Thus, the optimal level of debt is one that balances the need to undertake worthwhile public investment and fund this in a fair way, against the requirement that debt remains prudent and at levels that do not impose a burden on the economy, or future generations.

Looking at the scope for worthwhile (value for money) spending on public investment is one of the tasks of the CSR. At present, the marginal benefits of public investment are likely to be relatively high reflecting under-investment in public infrastructure over recent years. The national interest will therefore be enhanced by spending on public investment rather than substantially reducing the public debt ratio beyond that projected in this Report. It is important to note, however, that the optimal debt level is likely to change over time as the stock of prospective worthwhile projects changes.

3.2.5 The public sector balance sheet

Over time, the Government intends to pay more attention to movements in the public sector balance sheet, which includes tangible assets as well as net financial liabilities. Public sector net wealth is the balance between total assets and liabilities. The balance sheet approach complements the golden rule because the surplus on the current budget should correspond reasonably closely to the change in public sector net wealth. The Government will also explore whether the balance sheet approach can lead to more effective management of the stock of debt.

There are, however, data and conceptual difficulties that need to be addressed before the balance sheet can be given a more formal role in the fiscal framework. The introduction of Resource Accounting and Budgeting (RAB) offers a good opportunity to improve the balance sheet data, as well as further underpinning the golden rule. Subject to the outcome of a feasibility study currently under way, RAB could be further enhanced by the development of a whole of government account for the UK.

The EU Stability and Growth Pact

The Government is committed in principle to joining a successful single currency, provided the economic benefits are clear and unambiguous. Regardless of whether we join the single currency, fiscal policy in the UK will remain the responsibility of the British Government. At the same time Britain respects the Stability and Growth Pact and the excessive deficits provisions of the Maastricht Treaty.

The Pact clarifies how the excessive deficit procedure will be implemented and strengthens the multilateral surveillance procedure set out in the Treaty. Only members of the single currency can be fined-by up to 0.5 per cent of GDP-if their general government financial deficit exceeds the Treaty reference value of 3 per cent of GDP.

Under the Pact, Member States are required to publish Stability Programmes if they participate in EMU, and Convergence Programmes if they do not. The Stability and Growth Pact specifies a variety of information that must be produced in these Programmes, including the expected path of the general government financial deficit and the key economic assumptions that underpin the fiscal projections, such as the extent to which public borrowing is financing capital rather than current spending.

The fiscal prospects outlined in this Report (see Chapter 4) are consistent with the terms of the Stability and Growth Pact.

3.3 SETTING THE STANCE OF FISCAL POLICY

Sound management of the public finances is an essential building block for long-term prosperity. In particular, when setting the overall stance of fiscal policy, the Government must promote the long-term economic stability that is vital if Britain is to achieve high and stable levels of growth and employment.

The Government's fiscal rules have been formulated to deliver economic stability. A key priority for the Government is to operate fiscal policy in a way that meets these rules with a high degree of certainty. It would be a serious mistake to divert fiscal policy away from this end in an attempt to manage short-term demand and inflationary pressures in the economy. Monetary policy is better suited to this task.

Nonetheless, fiscal policy can provide a useful support for monetary policy in the short-term regulation of the economy so long as the fiscal stance remains demonstrably consistent with meeting the Government's fiscal rules over the economic cycle. For example, the significant tightening of the fiscal stance that has occurred over the past year, where public sector net borrowing (PSNB) has been reduced by around 19 billion or 2¾ per cent of GDP (the largest fiscal tightening in any one year since 1981) undoubtedly helped restrain demand, supporting monetary policy at a time when the Bank of England has also been raising interest rates. At the same time, the fiscal tightening has put Britain on course to meet the fiscal rules over the present cycle.

Apart from any discretionary adjustments to the fiscal stance, the *automatic stabilisers*, which operate through avenues such as unemployment benefits and the progressive tax scale, will also continue to have a stabilising impact on demand. For example, payment of unemployment benefits reduces the extent to which incomes fall in a recession, thereby limiting reductions in demand. The 'over the cycle' formulation of the fiscal rules reflects, and allows for, the impact of the economic cycle on the public finances.

Stability in fiscal policy does not imply that the Government will no longer exercise discretion where it is sensible to do so, for example in response to clear and explicitly identified shocks. If a major economic or natural disaster were to occur, it is self-evident that the Government might need to deviate from its fiscal rules for a short period of time. Under the Code for Fiscal Stability, the Government would be legally obliged to be open about the reasons for the deviation, the alternative rules that would operate, and when and how it planned to return to its original rules and objectives.

3.4 PLANNING AND CONTROLLING SPENDING

The public sector is spending over 330 billion this year, around 40 per cent of national income.

Government uses this huge sum-equivalent to over 5,000 for every man, woman and child in Britain-to purchase a wide range of public services on behalf of the nation as a whole, including education (37 billion in 1997-98), health (43 billion), law and order (17 billion) and defence (21 billion). In addition, government transfers amount to very large sums; for example the Government spent 96 billion on social security in 1997-98.

Given the sums involved, it is crucial that the Government obtains value for money. The quality of spending in the public sector has a large impact on the overall performance of the economy. Improving the effectiveness and efficiency of public spending is therefore a key objective of the CSR (discussed further in Chapter 4). Alongside this Review, the Government is making a major reform to the regime for planning and control of expenditure, to improve control of this spending and to promote longer-term planning.

In order to make more efficient and effective use of public resources, departments will be given firm multi-year spending limits, within which they can prioritise resources and plan ahead, providing a more stable foundation for managing public services. Consistent with the fiscal rules, there will also be a clear distinction between capital and current expenditure to ensure that worthwhile capital investment is not squeezed out by short-term pressures in the way it has been in the past.

This will pave the way for, and as far as possible anticipate, the planned introduction of RAB in 2000. RAB will also reinforce the planning and controlling of spending through providing a clearer distinction between capital and current spending and enhanced incentives for managing existing and new capital assets.

There are four main features to the reformed planning and control regime.

- *Overall spending plans will be based on sound economic principles, with a new distinction between current and capital spending.*

  Decisions on spending will be based on the prudent and sound fiscal rules, rather than on an arbitrary target for expenditure as a proportion of GDP. The plans will cover all spending by the public sector, to be known as Total Managed Expenditure (TME). Within that, capital and current expenditure will be planned and managed separately to ensure that the fiscal rules are met, and to prevent capital investment being cut back to meet short-term pressures on current expenditure. Departments will be able to channel funds earmarked for capital expenditure into current spending only within an agreed margin which allows for some managerial flexibility or to finance private-public partnerships. This is consistent with the objectives of the Investing in Britain Fund discussed further in Section 4.2.2.

- *Firm three-year plans will provide certainty and flexibility for long-term planning and management.*

  Within these overall plans, the Government will set firm and realistic multi-year limits for departments' expenditure, wherever possible, with similar agreements for their running costs. Multi-year limits will cover a three-year period, but will be rolled forward for a further three years in 2000 when the Government plans to move to RAB. The limits will be set in cash to provide a clear incentive for departments to control their own costs and will be reviewed only if inflation varies substantially from forecast. This change will make it possible to have a more stable funding regime for local authorities. In addition, departments and local authorities will have greater end-year flexibility, to carry forward unspent provision.

These multi-year plans will be drawn together in a new aggregate, Departmental Expenditure Limits (DEL). There will be a small Reserve to deal with emergencies and genuine contingencies, but there will not be an annual Public Expenditure Survey, as in the past, in which departments can bid for extra funds. Equally, the Treasury will not be able to use the annual survey to impose incremental cuts. This will give departments a solid base for planning. DEL will include spending funded by the Capital Receipts Initiative and spending on Welfare to Work, which will continue to be administered through an inter-departmental budget, subject to special control arrangements.

- *Annual review of spending outside the DEL.*

  Other expenditure, which cannot reasonably be subject to firm multi-year limits, will be known as Annually Managed Expenditure (AME). This will include social security benefits, local authority self-financed expenditure (LASFE); Scottish expenditure financed by the Scottish variable rate of income tax and non-domestic rates; payments under the Common Agricultural Policy; debt interest; and net payments to EU institutions. This will bring the UK closer to the control regimes of other countries. Tables 3A.1 and 3A.2 in Annex 3A provide details of the composition of the DEL and AME.

- *Annually Managed Expenditure will be subject to constraints.*

  AME will be based on cautious estimates and tough annual scrutiny both as part of the annual Budget process and when setting DEL for a further three years in 2000. The Government will not take policy measures which are likely to have the effect of increasing social security or other elements of AME, without taking steps to ensure that the effects of these decisions can be accommodated prudently within the Government's fiscal rules and can be financed by a fair and efficient tax system that promotes incentives to work, save and invest.

  Treating LASFE in this way is consistent with the relaxation of capping and the greater emphasis on local accountability. However, the Government will also retain strong reserve powers over local authorities. If other safeguards fail and spending financed by local taxes becomes excessive, it may also be necessary to cut back grants to local authorities when plans are reviewed in 2000.

There are three further significant changes:

- *Additional flexibility for large public corporations, which are not dependent on government grants, to put them on a more commercial footing.*

  As the Government made clear in its 1997 Pre-Budget Report, it will continue to apply its fiscal rules to the public sector, including public corporations. Within the new regime, it has decided to give certain, largely self-funding, public corporations more flexibility to manage their spending between years, within agreed limits on external finance. This should lead to better management. These limits will be outside departmental expenditure limits and will be separately managed. This regime will apply to the main nationalised industries and a number of other smaller bodies. Additional flexibilities may be available for some of these bodies in the light of the conclusions of reviews currently under way. Following consultation on the details of implementation, financially sound and profitable local authority airport companies will also be allowed greater commercial flexibility.

Resource Accounting and Budgeting

Resource Accounting and Budgeting (RAB) applies to central government the financial reporting practices of both the private sector and much of the rest of the public sector. It is being developed to fit within and support the new fiscal framework and to increase the efficiency and value for money of public spending.

Based on accruals accounting, RAB will underpin the golden rule by making a clear structural distinction between current and capital spending. It will also align more closely the control framework to that of fiscal policy by capturing the full costs of resources consumed, including the current cost of capital use (depreciation and interest), in delivering government priorities. This will improve the incentive to ensure assets are used as productively as possible, and to the best effect, when delivering public services.

Departments are on course to produce the first full set of published resource accounts for the financial year 1999-2000.

These will be accruals based accounts similar to those prepared for private sector companies but with two additional features: a statement showing use of resources approved by Parliament, and a statement analysing spending by objective.

Resource accounts will provide the basis for a new system of public expenditure planning ('resource budgeting'). Timing of full implementation will be consistent with the Government's reformed planning regime, including the detailed arrangements for the overall control framework. However, in broad terms it is at present envisaged that there will be two key policy aggregates, reflecting the distinction between current and capital expenditure central to both RAB and the fiscal framework.

- *New arrangements for student loans and loan sales to improve decision-making and the management of longer-term liabilities.*

  The accounting treatment which will apply under RAB will be brought forward to make it easier to compare the real costs of loans and grants and to provide better incentives for managing the costs of loans. The cost of bad debt and loan subsidy will be recorded in the DEL. The treatment will be extended over time to other loans to the UK private sector.

- *Departments to keep more of their receipts in order to improve efficiency and effectiveness.*

  Departments will in future be allowed to keep and spend a number of receipts that are at present surrendered as revenue, not treated as negative public expenditure. Departments will be able to keep some levies and similar taxes, netting them off the DEL where this would further the government's economic objectives, improve efficiency, and not prejudice spending plans and priorities. Subject to safeguards, some income from fines may also be netted off the DEL where that would help fight crime. In order to improve incentives to manage assets well, departments will be able to keep rent off land, most dividends (including from joint ventures under the wider markets initiative), and receipts from NHS Trust debt remuneration to match provision.

3.5 DEBT MANAGEMENT POLICY

The primary objective of debt management policy is to minimise the long-term cost of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the objectives of monetary policy.

The Government will meet this objective by:

- determining the maturity and nature of the government debt portfolio, through managing the maturity and composition of debt issuance;
- pursuing debt management policies that are open, predictable and transparent;
- developing a liquid and efficient gilts market; and
- offering retail savings instruments through National Savings which provide cost effective funding.

The Government's debt management policy is now implemented by the UK Debt Management Office (DMO) and National Savings. The aims and objectives of these Agencies are set so as to deliver the objectives set out above.

Debt management is also covered by the Code for Fiscal Stability. In this context, the principle of transparency requires the Government to publish sufficient information to allow market participants to plan their investment strategies and for the public and Parliament to scrutinise the conduct of debt management policy.

The principle of predictability requires the Government and its agents to give as much notice as possible of its debt management plans, particularly gilts issuance, and to refrain from surprising the market, even if this may lead to improved cash flows in the short term. The emphasis on minimising costs over the long term means that the Government will refrain from operations which store up refinancing problems for the future or which unduly transfer costs of debt management to future generations.

In line with these principles, the Code for Fiscal Stability requires governments to publish an annual Debt Management Report which reports on the structure of its borrowing and the cost of government debt, sets remits for the DMO and National Savings, and sets out detailed plans for gilts issuance over the following year. The DMO and National Savings will also publish more detailed information on the implementation of Debt Management Policy in their own annual reports and accounts.

Annex 3A: The new spending aggregates

The new control regime described in Section 3.4 sets out how the Government intends to plan, control and monitor public expenditure in order to deliver its objectives. The tables below illustrate the new spending aggregates on which the new control regime will be based. The tables contain an illustrative presentation of the spending plans for 1998-99, restated in terms of the main elements of the new system. The new arrangements will take effect for the CSR and for in-year control from 1999-2000.

Table 3A.1 shows Total Managed Expenditure (TME). This concept is equivalent to the sum of public sector current expenditure--the key aggregate for meeting the golden rule--and public sector net investment.

Table 3A.1: Total Managed Expenditure 1998-99(1)(2)

	billion 1998-99
Departmental Expenditure Limits	**1688**
Annually Managed Expenditure	
Social Security Benefits[1]	958
Common Agricultural Policy	26
Export Credits Guarantee Department	01
Net Payments to EC Institutions	24
Self Financing Public Corporations	-02
Locally Financed Expenditure[3]	154
National Lottery	16
Central Government Gross Debt Interest	281
Accounting and other adjustments	135
AME Margin[4]	17
Annually Managed Expenditure	**1647**
Total Managed Expenditure[2]	**3335**
of which:	
Public Sector Current Expenditure	3269
Public Sector Net Investment	66
Memo: General Government Expenditure	3323

[1] Figures are consistent with the March 1998 Financial Statement and Budget Report (HC620) except for (a) the effects on the Reserve of a transfer of 750 million unspent in 1997-98 and a rephasing of the sale of student loans (now 1 billion in 1998-99), (b) updated forecasts for Cyclical Social Security and some accounting and other adjustments.

[2] Total Managed Expenditure is equal to the sum of the Departmental Expenditure Limits and Annually Managed Expenditure, and equal to the sum of public sector current expenditure and net investment.

[3] Includes local authority self-financed expenditures and Scottish non-domestic rate payments.

[4] The Reserve for the old Control Total has been split between a Reserve in DEL, shown in Table 3A.2, and a Margin on AME, shown here.

About one half of TME is made up of Annually Managed Expenditure (AME). This aggregate covers programmes for which multi-year limits are not appropriate or possible, but which are taken into account in public expenditure planning. AME also includes a margin. The remaining half of TME is within Departmental Expenditure Limits (DEL).

Table 3A.2 shows the DEL set out by departmental groupings. In addition, the DEL contains separate pan-departmental provision for Welfare to Work, and a Reserve. A memo item shows the DEL split into capital, current and financial transactions. Further memo items show total UK expenditure on education, including expenditure outside DEL, and on the Capital Receipts Initiative.

Table 3A.2: Departmental Expenditure Limits 1998-99[1]

	billion 1998-99
Defence	222
Foreign Office	10
Department for International Development	23
Ministry of Agriculture, Fisheries and Food	14
Forestry Commission	00
Department of Trade and Industry	31
DETR-Transport	50
DETR-Other	44
DETR-Local Government	328
Home Office	69
Lord Chancellor's Departments	27
Department for Education and Employment	142
Department for Culture, Media and Sport	09
Department of Health	372
of which: NHS	365
Social Security (administration)	30
Scottish Office	130
Welsh Office	67
Northern Ireland Departments	57
Chancellor's Departments	29
Cabinet Office	13
Welfare to Work	11
Reserve[2]	10
Departmental Expenditure Limits	1688
of which:	
Current Spending	1565
Capital Spending	112
Financial Transactions	11
Memo: Total Education	395
Memo: Total Capital Receipts Initiative	07

[1] Figures are consistent with the March 1998 Financial Statement and Budget Report (HC620) except for the effects on the Reserve of the transfer of 750 million unspent in 1997-98 and a rephasing of sales of student loans (now 1 billion in 1998-99).
[2] Reserve on DEL. See footnote 4 to Table 3A.1.

Fiscal Strategy: The Next Three Years

This Chapter explains the Governments fiscal strategy and sets the framework for the conclusions of the Comprehensive Spending Review (CSR).

The key points made in this Chapter are that:

- the fiscal stance was tightened very considerably in 1997-98. The new projections in this Report lock in the fiscal tightening projected in the March 1998 Budget;
- over the three years 1996-97 to 1999-2000, public sector net borrowing will have fallen by 3½ per cent of GDP-the same fall as in the March Budget; the public sector net cash requirement will have fallen by 2¾ per cent of GDP, again the same as set out in the March Budget;
- the Government has set firm plans for overall spending over the remainder of this Parliament based on a careful assessment of: what can be afforded whilst meeting the fiscal rules and the Governments key spending priorities. As such it sets the framework for the conclusions of the CSR. To ensure that the golden rule is met, the CSR will be based on an average real growth of current spending of 2¼ per cent per annum;
- an Investing in Britain Fund will be established. Public sector net investment will increase and stabilise at just under 11/2 per cent of GDP by the end of this Parliament, but remain within prudent bounds; and the ratio of net public debt to GDP is projected to decline below 40 per cent of GDP, which is prudent over this economic cycle;
- as part of an improvement in managing public sector assets, and as a precursor to Resource Accounting and Budgeting, new Departmental Investment Strategies will be agreed by the Treasury and published, and a programme of disposals will occur; and
- the Governments approach to fiscal policy is consistent with the UKs European commitments, in particular the Stability and Growth Pact.

This Chapter explains the broad fiscal parameters that underpin the decisions that will be announced in the Comprehensive Spending Review in July. The importance of maintaining fiscal prudence and economic stability has meant that the bottom-up review of spending priorities will be finalised within the context of a disciplined top-down assessment of what the Government can afford to spend, while still ensuring that the strict fiscal rules and the Governments key spending priorities are met. The Government has concluded that, given the path of receipts set in the Budget, the fiscal rules imply that:

- public spending on current goods and services can grow by 2¼ per cent a year in real terms, on average over the next three years, broadly in line with the economys underlying growth rate;
- because investment is lower than required by the national economic interest there should be an Investing in Britain Fund, allowing net public sector investment to increase towards 1½ per cent of GDP by 2001-02, some 13 billion a year. Departments will be required to produce Investment Strategies to make sure that the best possible value for money is delivered from this boost to capital spending;
- within these net totals, new (gross) public sector investment will be expanded further as departments sell off idle or unnecessary assets to make room for higher priority investment needs; and
- at the same time, the ratio of net public debt to GDP will decline below 40 per cent over this economic cycle, as is prudent and sensible.

This Chapter explains these decisions and shows how they fit into the Governments overall fiscal strategy.

4.1 THE COMPREHENSIVE SPENDING REVIEW

All the Governments spending programmes-current and capital-are being reviewed in the Comprehensive Spending Review (CSR), which was launched in June 1997, and will be completed in July 1998. Government departments are scrutinising their programmes and producing recommendations for change, to refocus their policies and spending on the Governments key priorities, as set out in its Manifesto.

The CSR will produce a new set of detailed departmental spending plans for the medium term, initially to cover the remaining three years of this Parliament. In line with the requirements of the fiscal framework, the plans will distinguish clearly between current spending, to be paid for by current receipts, and capital spending, which can be paid for by taxation or borrowing.

The new plans will reflect a cross-departmental and thematic approach, as well as a programme-by-programme scrutiny. They will contribute, in particular, to advancing the key objectives of the Government as a whole:

- growth and investment;
- opportunity and fairness; and
- efficiency and modernisation.

Departments will continue to be clearly accountable for their spending. Individual departments will be required to use their spending resources to deliver specific outputs and targets on which they will be judged at the end of this Parliament.

The approach to planning and controlling expenditure set out in this document, and in the CSR, is a logical preparation for the next stage of fiscal reform, the move to Resource Accounting and Budgeting (RAB). RAB will build on the clear distinctions made in the Governments fiscal strategy between current and capital expenditure, and will plan and control expenditure on the basis of both resource consumption and capital, rather than on a cash measure alone.

The CSR has looked closely at the scope for greater efficiency in government. Modern and effective service delivery is essential if the public are to enjoy high quality services. Three principles have guided this scrutiny:

- tough and stretching objectives and targets;
- robust arrangements for monitoring results; and
- a pragmatic and innovative approach to service delivery.

Challenging efficiency targets will be put in place for key public services which will ensure that these are delivered in a way which maximises the benefits to the public and provides value for money.

Each department will have for the first time clear objectives and measurable targets under RAB, incorporating an aggregate measure of efficiency. These targets will put pressure on departments to improve the efficiency of their operations over time.

4.2 PUBLIC SPENDING OVER THIS PARLIAMENT

4.2.1 CURRENT SPENDING AND THE GOLDEN RULE

The Government has set firm guidelines for overall spending over the remainder of this Parliament based on a careful assessment of:

- what can be afforded while still meeting the fiscal rules; and
- the Governments key spending priorities.

By combining both a top-down and bottom-up approach, the Comprehensive Spending Review will thus be grounded firmly on a platform of macroeconomic stability. The important distinction between current and capital spending, which forms the basis of the fiscal rules, is also reflected in a new format of the public finances, discussed further below.

Current spending has been set at prudent levels so that the Government can be confident of meeting the golden rule over the economic cycle. Current spending is planned to grow, in real terms, by 2¼ per cent per annum on average over the next three years. While the Government does not have a target for public spending as a share of national income, this implies that the growth of real current spending matches the trend growth rate of the economy (abstracting from year-to-year fluctuations in output).

This prudent and cautious approach leads to projections of surpluses on the current budget in each of the next three years - something not achieved in the last 25 years except during the unsustainable boom of the late 1980s. It makes allowance for uncertainties, to ensure that the Government will meet the golden rule over the economic cycle on both the Governments central and cautious estimates of the economys position relative to trend. Nonetheless, additional funds have been allocated to capital spending while also ensuring that net public debt falls to below 40 per cent of GDP.

4.2.2 THE INVESTING IN BRITAIN FUND

Public investment has fallen to such low levels that significantly increased provision is necessary, if the nations interests are to be served effectively. The Investing in Britain Fund will provide for the renewal, reform and modernisation of the UKs infrastructure by providing a catch-up increase in public investment over the next three years. At the same time, the fiscal position remains prudent and the recent improvement in the fiscal aggregates is locked in.

The Investing in Britain Fund will incorporate new measures to ensure that capital investment is targeted and managed in the best way:

- the Treasury will publish by Spring 1999 a compilation of Departmental Investment Strategies. Departments will set out in detail how the resources allocated to finance capital projects in the CSR will be managed so as to deliver the Governments objectives, provide the best value for money and ensure positive social returns. These plans will be scrutinised closely. Departments and the Treasury will work together to examine departmental appraisal, management and evaluation systems to ensure these give sufficient assurance about the quality of investments being proposed. Where the Treasury has doubts about aspects of departmental systems and the quality of their Investment Strategies, it could, for example, tighten the existing thresholds for its approval of capital projects or even suspend firm multi-year plans; and
- the Treasury will retain a Capital Modernisation Fund for additional, innovative, capital or PFI projects from 2000-01 which improve key services or public infrastructure and offer good value for money. Resources will be allocated competitively, ranked on merit and on the quality of the Departmental Investment Strategies.

This approach will pave the way for the introduction of capital plans under RAB, from 2000-01 onwards, and will enhance the incentives and systems in place for managing new and existing capital assets, through, for example, the introduction of capital charging and capital planning.

The Investing in Britain Fund will allow progress towards national renewal while ensuring that the fiscal rules are met. Net public investment is projected to increase from its current level of 7 billion (¾ per cent of GDP) to 13 billion (just under 1½ per cent of GDP) by 2001-02, and to continue at this share of GDP thereafter. As a result, Total Managed Expenditure (TME) grows faster than current spending-by 2¾ per cent on average in real terms over the next three years-reflecting the need to catch up on past under-investment. However, taken over the life of this Parliament, growth is a more modest 2 per cent. Moreover, net public debt is projected to fall from 43½ per cent of GDP in 1997-98 to below 40 per cent of GDP from 2000-01 onwards. The Comprehensive Spending Review will set out the implications of the Investing in Britain Fund for individual spending programmes and departments.

PUBLIC-PRIVATE PARTNERSHIPS

Public-private partnerships (PPPs), and more specifically the Private Finance Initiative (PFI), are now firmly established as means of providing value for money services. This approach promotes the efficient use of resources, encourages value for money in public investment and provides a new source of financing for important investment opportunities. PPPs operate through utilising the very best of what the public and private sectors have to offer. They reduce the costs to the public sector of delivering services and, in many cases, remove the need to make large up-front public sector capital payments. In this way, PPPs free up additional resources that can be focused on high priority areas.

Since May 1997, contracts with a combined capital value of just under 2 billion have been signed, in areas as diverse as health, education, environment, defence and information technology. This represents good new long-term business opportunities for the private sector, as well as good value for money for the taxpayer. A number of changes to the process (including focusing on a smaller number of priority projects) and legislative changes have also been implemented, to help smooth the procedure, and to facilitate a steadier flow of signed contracts across Government.

Consequently, PPPs are starting to play a central role in the development of policy in key areas. For example, in health, the Government has recently announced a second tranche of ten PFI hospital schemes, bringing to 28 the overall total of new hospitals now in the programme, altogether worth some 3 billion. And PFI potential has been identified in all areas of the education sector, one of the Governments main priorities. As a result, five pilot projects have been announced under the New Deal for Schools, involving around 200 million of investment, and addressing major infrastructure needs across a large group of schools in each case. In local government too, the Government has pledged support for 40 projects with more to come.

PFI is also becoming an agent for change at a smaller level across a range of other public services; it is being used in the

Belfast Hospital Renal Unit; the Highlands and Islands Airports; for IT facilities in Dudleys schools and libraries in Kent; and there is even discussion about using PFI for the new British Embassy in Berlin. PFI is delivering a wide range of public services-large and small-right across the UK, in all areas of public service.

And the Government is looking to develop partnerships further. The Deputy Prime Minister has announced recently plans to bring the private sector in to develop 7 billion worth of infrastructure (as well as an additional 1 billion a year for the next two years) to tackle the investment backlog in London Underground.

An indication of progress made is the increasing number of enquiries and visitors from all over the world, eager to find out about the opportunities PFI has to offer. The Treasury has received delegations from areas as diverse as Australia, Brazil, China, Japan, South Africa, Eastern Europe and the Middle East, as well as our European neighbours such as France, Holland and Spain.

4.2.3 ASSET DISPOSALS

As an important part of its overall investment strategy, the Government will continue to look for the best ways of financing public sector capital projects. It recognises that public-private sector partnerships and privately financed projects can offer benefits for the taxpayer and provide the best use of public sector assets, applying the test of what is in the publics best interest.

Making the best use of public sector assets is a vital part of the Governments economic and fiscal strategy. To that end:

- following the publication of the National Asset Register last November, and the introduction of new incentives which allow departments to recycle receipts from disposals into new assets, departments have been scrutinising their holdings. The Government is now projecting central government disposals of around 1 billion per year;
- local authorities are projected to dispose of 2¾ billion per year of their existing assets;
- the Government has assessed which assets are no longer needed to meet the Governments objectives and can be sold to finance investment in key public services, such as education; which can be exploited better (especially through public-private partnerships and the transfer of risk to the private sector); and which can be retained. In 1999-2000, the Government is planning other public-private partnerships and disposals:
  - **National Air Traffic Services**-legislation will be introduced to establish a public-private partnership based on a sale of a majority stake in NATS, to facilitate further investment and improve passenger safety;
  - **Student loans**-following the successful sale in March 1998, a further tranche of student loans will be sold in 1999-2000, thus transferring part of the default risk to the private sector and financing the Governments objectives. This will result in paying a subsidy to the purchaser of the debt. The purchaser will be selected through a competitive tender, the outcome of which will reflect the maturity of the debt and market conditions;
  - **Residual debt**-the Government will dispose of debt held in British Energy plc;
  - **Radio Spectrum**-the Government announced at the end of May that the auction for licences for the 3rd generation of mobile communications services will be held in summer 1999; and
  - **Belfast Port**-as part of the Northern Ireland economic strategy announced on 12 May 1998.

In addition:

- legislation will be introduced to establish a public-private partnership, including sale of a majority stake in **Commonwealth Development Corporation**; and
- the **Royal Mint** is to be examined to establish the scope for, and benefits of, greater private sector participation.

Further examinations will be conducted where appropriate.

4.3 MEETING THE FISCAL RULES

4.3.1 THE ECONOMIC OUTLOOK

Developments in the economy since the March Budget have been broadly in line with expectations. As a result, there is no change to the key economic assumptions underpinning the fiscal projections (see Table 4.1).

Table 4.1: Economic assumptions for public finance projections

	Percentage change on previous year						
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
Output (GDP)	3	1¾	2	2¼	2¼	2¼	2¼
Prices: RPI excluding MIPs	2¾	2¾	2½	2½	2½	2½	2½
GDP deflator	2¾	3	2½	2½	2½	2½	2½
Money GDP (billion)	797	834	872	914	958	1004	1052

As in the Budget, the assumptions used represent the lower end of the range of GDP projections. The reasons for this cautious approach are discussed further below.

The main economic indicators released since completion of the March Budget forecast have turned out much as expected:

- The latest estimate of GDP growth in the first quarter of 1998, at 0.5 per cent, was exactly in line with the Budget forecast. Within that, the main expenditure components, in particular consumer spending, fixed investment and net trade, were also close to forecast, as was manufacturing production on the output side.
- Underlying inflation, as measured by the Retail Prices Index excluding mortgage interest payments, averaged 2.6 per cent in the first quarter, as projected at Budget time; and the rise to 3.0 per cent in April is consistent with the Budget forecast of 3.0 per cent for the second quarter.

Domestic demand growth still looks set to fall back in the second quarter, with latest monthly indicators pointing to a slowdown in consumer spending, and the boost from stock building in the first quarter likely to be temporary.

Moreover, exchange rate and world developments give no clear grounds for revising the forecast for net trade. In the first quarter, sterling was on average a little stronger than projected, reflecting appreciation through March. But its subsequent depreciation has brought it back close to the path assumed for the Budget forecast. The world outlook on balance remains broadly unchanged, underpinned by robust growth in the US and Europe. The central estimate for the impact on the UK economy of financial turbulence in Asia is unchanged. However, recent financial market volatility in Asia and Russia has again highlighted the risks surrounding the world outlook.

Thus, overall, the economic forecast made at Budget time has kept on track and the short-term outlook remains intact. This is consistent with the view of independent forecasters, who have not on average materially revised their short-term forecasts for GDP growth and inflation in recent months. In particular, after a period of above trend growth last year, most forecasters currently predict a period of below trend growth for a while.

There is, of course, always the risk that the current cyclical position of the economy has been assessed incorrectly because of problems either with measuring key economic indicators, or with estimating underlying trends. The main risk is that output is now further above trend than estimated, implying a less healthy underlying fiscal position (ie a larger cyclically-adjusted deficit) and greater than expected inflationary pressure in the pipeline. This explains, at least partly, what went wrong in the late 1980s: initial underestimation of actual GDP growth and over-optimism about the trend level (and growth rate) of GDP meant that output was much further above trend than assumed at the time. These were critical factors for the subsequent deterioration in the public finances.

Early estimates of GDP growth should now be less prone to revision than in the late 1980s. Wide ranging improvements to statistical surveys and better national accounting methods have been progressively introduced since the early 1990s. This appears to have reduced, though possibly has not eliminated, the problem of downward bias in initial estimates of GDP growth during upswings. In the past such bias has tended to be positively associated with the strength of GDP growth.

But, over the recent past, there is little evidence from other economic indicators to suggest that growth has been nearly as strong as in the boom of the late 1980s. At that time, the economy was adjusting to systemic changes in the financial system and, for example, house prices, private sector business surveys, and balance of payments statistics were all indicative of overheating. Recently there have been few similar parallels, with most indicators and anecdotal evidence signalling relatively benign economic conditions. In these circumstances, reasons for expecting upward revisions to initial estimates of GDP growth are further reduced. Nevertheless, it would not be prudent to rule out such revisions.

It is vital not to repeat the mistakes of the last economic cycle. For this reason the lessons have been fully reflected in the design of the new fiscal framework. In particular, a cautious assumption for trend growth has been used in projecting the public finances; and alternative fiscal projections are presented based on an assumption that output is 1½ per cent further above trend than assumed for the central projection. This would be pessimistic but within the range of possibilities. Even on this basis, the Government is on track to meet its fiscal rules, though the margin would then be limited (see section 4.3.5 for further discussion).

4.3.2 A BETTER FORMAT FOR THE PUBLIC FINANCES

This Report implements a better format for the public accounts that corresponds more closely to the two fiscal rules and the national accounts and is in line with international practice. The main changes are to separate the current and capital accounts, and to focus on a measure of budget balance that excludes financial transactions. The three principal measures are:

- **surplus on current budget** which shows whether all current spending is being financed by current receipts, and is used to judge whether the golden rule will be met over the economic cycle. It also relates closely to the balance sheet measure of public sector net wealth;
- **public sector net borrowing** which excludes privatisations and other financial transactions. This is a sensible definition for assessing the fiscal stance. It is consistent with the national accounts, and is the concept used for international comparisons of budget deficits. It is equivalent to what has been called the financial surplus or deficit. Unless otherwise stated, the figures for net borrowing used here cover the whole public sector, whereas the Maastricht deficit criterion relates only to general government and excludes net borrowing by public corporations; and
- **public sector net debt ratio** which shows the total debt of the public sector (net of certain liquid assets) as a proportion of GDP. This measure is used to judge whether the Government is meeting its sustainable investment rule.

Financial transactions are shown, along with the public sector net cash requirement (known formerly as the PSBR). However, these are accorded less prominence because they have less effect on the underlying budgetary position than the items which make up public sector net borrowing. Financial transactions (such as privatisations) entail offsetting changes in both the governments assets and liabilities, with no effect on public sector net financial wealth, although they reduce the public sector net cash requirement and public debt.

4.3.3 RECENT FISCAL TRENDS AND SHORT-TERM OUTLOOK

The fiscal stance tightened very considerably in 1997-98 (see Table 4.2). The new projections in this Report lock in the fiscal tightening projected in the March Budget. Over the three years 1996-97 to 1999-2000, public sector net borrowing will have fallen by 3½ per cent of GDP-the same fall as in the March Budget; the net cash requirement will have fallen by 2¾ per cent of GDP, again the same as set out in the March Budget.

Table 4.2: The fiscal tightening[1]: cumulative change

		per cent of GDP	
	1997-98	**1998-99**	**1999-00**
Public sector net borrowing March Budget	-2½	-2¼	-3½
EFSR 98 update	-2¾	-3½	-3½
Public sector net cash requirement March Budget	-2½	-2½	-2¾
EFSR 98 update	-2½	-2½	-2¾

1 Excluding windfall tax receipts and associated spending

Table 4.3 compares the latest outturns and short-term forecasts with the March Budget figures.

Table 4.3: Comparison of updated forecasts of budget balances with March Budget forecasts

	1997-98	1998-99
		billion
	1997-98	**1998-99**
Current budget surplus[1]		
March Budget	-1.3	3.6
EFSR 98 update	-0.0	5.0
Public sector net borrowing[1]		
March Budget	7.5	3.1
EFSR 98 update	5.9	1.3
Memos:		
Public sector net cash requirement[1]		
March Budget	5.0	3.9
EFSR 98 update	3.5	3.7
Maastricht deficit[2]		
March Budget	5.7	1.3
EFSR 98 update	3.5	-0.4

1 Excluding windfall tax receipts and associated spending.

2 General government net borrowing. The Maastricht definition does not exclude the windfall tax and associated spending.

The estimate for public sector net borrowing in 1997-98 is 6 billion, 1½ billion lower than forecast in the March Budget. The estimated current budget in 1997-98 is about 11/4 billion better than forecast in March, and is close to balance.

These differences reflect the lower than expected outturn for cash borrowing in 1997-98. The public sector net cash requirement of 3.5 billion was 1.5 billion lower than forecast in March. General government cash receipts in 1997-98 were over 1 billion higher than the Budget forecast. This in part reflected higher than expected income tax receipts and social security contributions (¾ billion). A further ½ billion may have reflected timing factors, such as early payments of corporation tax and oil duties, which have no effect on the forecasts for future years. VAT was nearly ½ billion lower than expected.

Changes to the forecasts of receipts and spending for 1998-99 are almost offsetting. Forecast receipts (particularly of social security contributions and income tax) have been increased slightly in the light of improved outturns in recent months. However, in view of the timing factors that seem to have affected corporation tax and oil duties, it would be imprudent to assume that all of the higher than expected receipts in 1997-98 carried forward to later years. The projections of receipts have therefore been raised by about ½ billion in 1998-99 (and in each subsequent year) compared with the Budget figures.

As discussed in Chapter 3, the control regime is being reformed. However, there is still some uncertainty about the final 1997-98 outturn, especially as regards local authority spending, where full information will not be available until around the end of this year the existing regime will remain in operation for 1998-99. The Control Total outturn for 1997-98 is now put at around 1½ billion lower than estimated at the time of the last Budget.

In the last Budget, it was announced that the 1½ billion underspend then projected was being reallocated to 1998-99. In view of the larger underspend now estimated, it has been decided to reallocate to 1998-99 a further ¾ billion. This is consistent with the Governments commitment to work within the Control Totals it inherited for the first two years in office. In addition, the projections of spending on cyclical social security have been revised, reflecting an updated unemployment assumption (it is now assumed flat at its April rather than at its January level) and the lower than expected outturn for 1997-98.

These changes to revenue and expenditure result in a somewhat higher forecast of the surplus on current budget in 1998-99, compared with the March projections, and lower public sector net borrowing.

4.3.4 THE FISCAL OUTLOOK IN THE MEDIUM TERM

Tables 4.4 and 4.5 show the updated medium-term projections of the public finances. (Table 4.4 shows the projections in billion, Table 4.5 shows them as a per cent of GDP.) The path of public expenditure for the years 1999-00 to 2001-02 is set in terms of current spending growing at 2¼ per cent per year, and public sector net investment rising to just under 1½ per cent of GDP. These define the envelope within which spending will be allocated to programmes in the Comprehensive Spending Review. For later years, it is assumed that current spending continues to grow at 2¼ per cent per year and public investment levels off as a percentage of GDP. Therefore, Total Managed Expenditure grows at an annual rate of 2¼ per cent in line with growth in GDP. It is assumed that there are no tax changes beyond the annual real increases in fuel and tobacco duties and the indexation of rates and allowances.

The surplus on the current budget is projected to rise steadily, to about 1½ per cent of GDP in 2003-04. The golden rule is achieved comfortably. Public sector net borrowing remains low, and net public sector debt falls steadily as a per cent of GDP. However, the net wealth of the public sector recovers only slightly, after its sharp deterioration in the early 1990s.

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Table 4.4: Current and capital budgets

				billion			
	Estimate			**Projections**			
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
Current budget							
Current receipts	316.0	334	349	368	389	407	427
Current expenditure	313.4	327	343	359	377	395	414
Surplus on current budget (including windfall tax)	2.5	7	6	9	12	12	13
Surplus on current budget[1]	**0.0**	**5**	**7**	**10**	**13**	**13**	**14**
Capital budget							
Gross investment	20.6	21	24	26	29	30	31
less asset sales	-4.0	-4	-4	-4	-4	-4	-4
less depreciation	-10.6	-11	-11	-12	-12	-12	-13
Net investment	**6.0**	**7**	**9**	**11**	**13**	**14**	**14**
Public sector net borrowing (including windfall tax)	3.5	0	3	1	1	2	1
Public sector net borrowing[1]	**5.9**	**1**	**2**	**0**	**0**	**1**	**0**
Financial transactions:							
Loans and sales of financial assets	-2.0	1	-1	2	2	2	2
Accruals adjustments[2]	-0.4	1	1	2	3	2	2
Public sector net cash requirement (including windfall tax)	1.1	2	4	6	6	6	5
Public sector net cash requirement[1]	**3.5**	**4**	**2**	**4**	**5**	**5**	**4**

1 Excluding windfall tax receipts and associated spending.

2 Includes accruals adjustment for the capital upllift on the redemption of the 2½ per cent 2001 index-linked gilt.

Table 4.5: Current and capital budgets

				per cent of GDP			
	Estimate			**Projections**			
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
Current budget							
Current receipts	39.7	40.0	40.0	40.3	40.6	40.5	40.6
Current expenditure	39.3	39.2	39.3	39.3	39.3	39.3	39.3
Surplus on current budget (including windfall tax)	0.3	0.8	0.7	1.0	1.3	1.2	1.3
Surplus on current budget[1]	**0.0**	**0.6**	**0.8**	**1.1**	**1.4**	**1.3**	**1.4**
Capital budget							

Gross investment	2.6	2.5	2.7	2.8	3.0	3.0	3.0
less asset sales	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
less depreciation	-1.3	-1.3	-1.3	-1.3	-1.2	-1.2	-1.2
Net investment	**0.8**	**0.8**	**1.0**	**1.2**	**1.4**	**1.4**	**1.4**
Public sector net borrowing (including windfall tax)	0.4	0.0	0.3	0.2	0.1	0.2	0.1
Public sector net borrowing[1]	**0.7**	**0.2**	**0.2**	**0.0**	**0.0**	**0.1**	**-0.1**
Financial transactions:							
Loans and sales of financial assets	-0.2	0.1	-0.1	0.2	0.2	0.2	0.2
Accruals adjustments[2]	-0.1	0.2	0.2	0.2	0.4	0.2	0.2
Public sector net cash requirement (including windfall tax)	0.1	0.3	0.4	0.6	0.7	0.6	0.4
Public sector net cash requirement[1]	**0.4**	**0.4**	**0.3**	**0.5**	**0.5**	**0.5**	**0.3**
Net public sector debt[1]	**43.3**	**41.9**	**40.6**	**39.5**	**38.3**	**37.3**	**36.3**
Memos:							
Net taxes[3]	37.3	37.7	37.5	37.7	38.0	38.0	38.1
Maastricht deficit[4]	0.4	0.0	0.3	0.1	0.2	0.1	0.1
General government gross debt	52.0	50.2	48.7	47.4	46.0	44.8	43.5

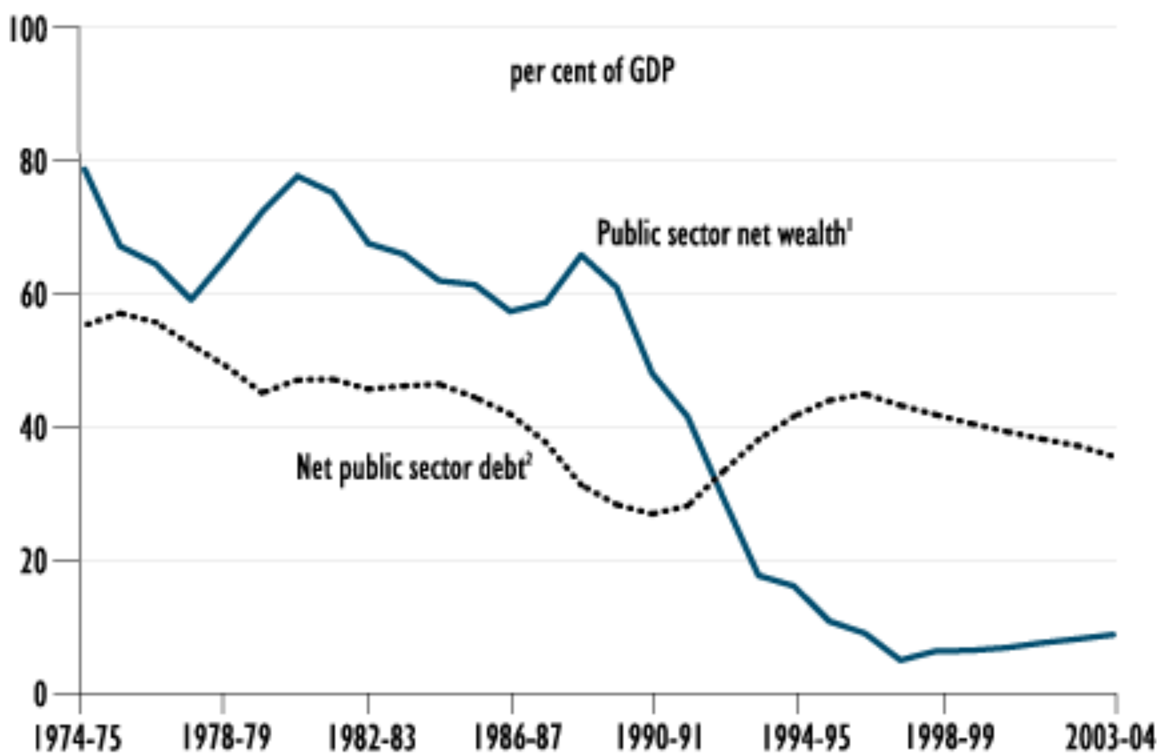
1 Excluding windfall tax receipts and associated spending.

2 Includes accruals adjustment for the capital upllift on the redemption of the 2½ per cent 2001 index-linked gilt.

3 Total tax receipts and social security contributions net of tax credits.

4 General government net borrowing. The Maastricht definition does not exclude the windfall tax and associated spending.

Chart 4.1: Public debt and net wealth



[1] End-December net wealth as per cent of GDP in four quar ters centred on end-December.
[2] End-March debt as per cent of GDP in four quar ters centred on end-March.

4.3.5 CYCLICALLY-ADJUSTED BUDGET DEFICITS

Experience has shown that serious mistakes can occur if purely cyclical improvements in the public finances are treated as if they represented structural improvements, or if a structural deterioration is thought to be merely a cyclical effect. The Government therefore pays particular attention to cyclically-adjusted indicators of the public sector accounts.

Table 4.6 shows cyclically-adjusted measures of government borrowing. As in the March 1998 Budget figures, these are based on a judgement that the economy was on trend, on average, in the first half of 1997. With the economy assumed to remain close to trend, there is relatively little difference between the actual and cyclically-adjusted measures of borrowing.

Following the policy tightening implemented in the Budget last July, the fiscal position has improved considerably. Indeed, the fiscal stance, measured by the change in cyclically-adjusted public sector net borrowing, tightened by more than 2 per cent of GDP in 1997-98, the largest fiscal tightening since 1981. This provided valuable support to monetary policy at a critical point in the cycle. The March Budget locked in that tightening: cyclically-adjusted public sector net borrowing is expected to fall further, bringing the fiscal position into structural balance in 1999-2000. Thereafter, small structural surpluses are recorded, with actual public sector net borrowing remaining close to balance and maintaining a stable path for the public finances into the medium term.

Should output growth over the next few years differ appreciably from what has been assumed, then the outlook for the public finances could be significantly different. However, whatever the path of output growth, the cyclically-adjusted measures provide a broad guide to the underlying state of the public finances and whether policy remains consistent with the fiscal rules.

Table 4.6: Budget balances[1]

				per cent of GDP			
	Estimate			**Projections**			
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
Budget balances							
Surplus on current budget	0.0	0.6	0.8	1.1	1.4	1.3	1.4
Public sector net borrowing	0.7	0.2	0.2	0.0	0.0	0.1	0.0
Cyclically-adjusted budget balances							
Surplus on current budget	0.2	0.4	1.0	1.5	1.7	1.6	1.7
Public sector net borrowing	0.6	0.3	-0.1	-0.4	-0.4	-0.3	-0.4
Memo: Public sector net cash requirement	0.4	0.4	0.3	0.5	0.5	0.5	0.4
Cyclically-adjusted net cash requirement	0.3	0.6	0.0	0.0	0.2	0.1	0.0

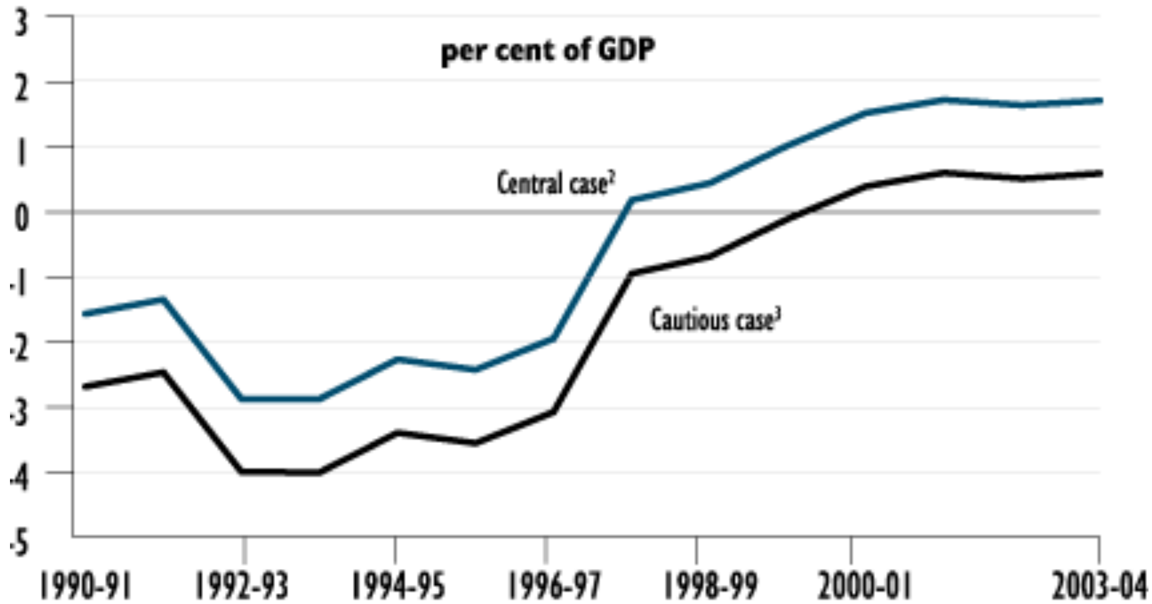
1 Excluding windfall tax receipts and associated spending.

The need to adopt a prudent approach is highlighted by considering what might happen if the assessment of the cyclical position proved to be optimistic. As in the July 1997 and March 1998 Budgets, cyclically-adjusted measures have been calculated on two different assumptions for trend output:

- the first central case is based on the assessment that output was on trend on average in the first half of 1997; and
- the second cautious case assumes that output is 1½ per cent further above trend than this.

The second case represents a cautious view of the economy, but is within the range of possible outcomes. Chart 4.2 shows that on this deliberately cautious assessment of the cyclical position, the underlying state of the public finances is consistent with meeting the golden rule over the economic cycle but that the margin for error would be limited. In particular, the cyclically-adjusted surplus on current budget would average less than ¼ per cent of GDP a year over the period 1997-98 to 2003-04. This underlines the case for caution.

Chart 4.2: Cyclically-adjusted current budget[1]



1 Excluding windfall tax receipts and associated spending.
2 Assuming an output gap of zero in the first half of 1997.
3 Assuming output is 1½ per cent above trend in the first half of 1997.

4.3.6 ASSESSMENT AGAINST THE FISCAL RULES

The Government is well placed to meet its two fiscal rules and the terms of the EU Stability and Growth Pact.

The surplus on current budget and public sector net borrowing are forecast to improve further in 1999-2000; and more so on the cyclically-adjusted measures shown in Table 4.7, which take account of the effects of relatively slow growth in 1998-99. The surplus on current budget is projected to increase steadily over the medium-term. Public sector net borrowing remains low, with the current surplus offset by the increased provision for capital spending during the transitional phase of the Investing in Britain Fund.

Table 4.7: Progress against the golden rule

				per cent of GDP			
	Estimate			**Projections**			
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
Current budget[1]							
Surplus on current budget	0.0	0.6	0.8	1.1	1.4	1.3	1.4
Average surplus since 1997-98	0.0	0.3	0.5	0.6	0.8	0.9	1.1
Cyclically-adjusted current budget[1]							
Surplus on current budget	0.2	0.4	1.0	1.5	1.7	1.6	1.7
Average surplus since 1997-98	0.2	0.3	0.5	0.8	1.0	1.1	1.4

1 Excluding windfall tax receipts and associated spending.

More specifically:

- the **golden rule** will be met if the public sector current budget avoids a deficit on average over the economic cycle. The current budget, which is estimated to have been marginally in surplus last year, is projected to remain in surplus. At just over 1 per cent of GDP, on average, between 1997-98 and 2003-04, the surplus allows some margin for uncertainty. It also increases the scope for meeting priority public investment while avoiding an increase in the public debt ratio. The cyclically-adjusted surplus is, on average, slightly larger;
- **net public sector debt** is projected to fall steadily, to below 40 per cent of GDP from 2000-01 onwards (see Chart 4.1). This level of debt is prudent. Debt interest savings will provide more money for the Governments priorities,

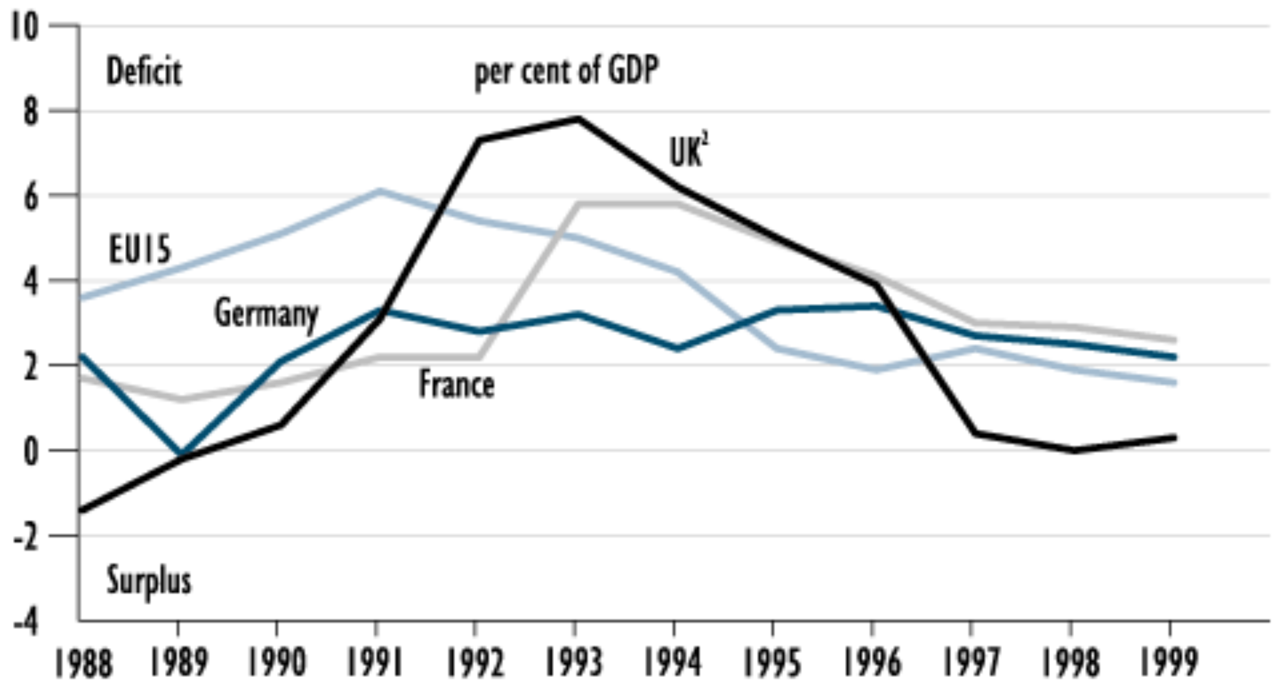
and especially for investment; and

- the projections are consistent with the terms of the **EU Stability and Growth Pact**.

The strict application of the fiscal rules and the total spending limits announced in this Report places the Government in a good position to meet the golden rule over the current cycle. This is in sharp contrast to the past where the public finances have been allowed to deteriorate as a result of persistent current deficits. For example, over the last economic cycle, 1985-86 to 1996-97, the public sector current budget was on average in deficit by over 1½ per cent of GDP.

The Governments fiscal strategy also places the public finances in a sound position relative to other major European countries. In particular, Chart 4.3 shows that by 1999-2000 the UKs general government net borrowing is expected to be well below that of both France and Germany and nearly 2 per cent of GDP lower than the European average. This represents a substantial turn around since 1993 when the UKs net borrowing, as a share of GDP, was more than double that of Germany.

Chart 4.3: Maastricht deficits[1]



1 Forecasts are those of the European Commission, except for the UK.
2 General government net borrowing on a financial year basis. Forecasts are those published in Table 4.5

4.3.7 DEALING WITH UNCERTAINTY

Projections of the public finances are highly uncertain. This is largely because public spending and revenue projections depend heavily on economic growth and trends in other economic variables, which are themselves uncertain. In addition, the demand for public spending can vary unpredictably due to evolving needs and opportunities. Trends in effective tax rates are also difficult to predict accurately. These uncertainties are reflected in past forecasting errors. Over the past ten years, the average absolute error for year-ahead forecasts of the PSBR was 0.9 per cent of GDP. Forecasts further ahead were considerably less accurate. The Governments reforms to monetary and fiscal policy will act to reduce the volatility stemming from errors in macroeconomic policy settings. However, unexpected shocks due to other influences, such as developments in the world economy, will continue to impact on the British economy.

The projections and policy stance need to take these uncertainties into account to ensure that the key public finance aggregates remain consistent with prudent financial management and our European commitments (under the Stability and Growth Pact). Past experience has demonstrated how difficult and painful it can be to restore the public finances to a respectable position once control has been lost.

This is why the Government has based its fiscal projections on cautious assumptions, audited by the National Audit Office. This is also why the Government is committed to taking steps to best ensure that the golden rule is met and that public debt as a proportion of national income is kept at a stable and prudent level, over the economic cycle. By adopting a prudent approach, errors in the short-term projections should not be allowed to accumulate into a significant structural deterioration in the fiscal position. The public can have confidence that the public finances will be managed responsibly and in a way that will position Britain well to meet the challenges of the future.

ANNEX 4A: TIME-SERIES FOR KEY FISCAL AGGREGATES

Table A1 sets out historical series for the main public finances aggregates.

Table 4A.1: Series of government expenditure and receipts and budget balances

	per cent of GDP								
	Public sector current budget	Public sector net borrowing	Public sector net cash requirement	General government net borrowing	Net taxes and social security contributions	Public sector current receipts	Public sector current expenditure	Public sector net capital expenditure	General government expenditure
1970-71	7.1	-0.5	1.5	-2.4		42.8	35.7	6.6	41.4
1971-72	4.5	1.2	1.7	-0.6		41.1	36.6	5.7	41.8
1972-73	2.2	3.1	3.7	1.9		38.7	36.5	5.3	41.6
1973-74	1.1	4.7	5.9	3.5		40.1	38.9	5.8	43.4
1974-75	-0.4	6.8	9.1	4.4		42.9	43.3	6.4	48.8
1975-76	-1.2	7.5	9.4	5.0		43.3	44.6	6.2	49.3
1976-77	-0.7	5.8	6.5	4.4		43.8	44.5	5.2	46.7
1977-78	-0.9	4.4	3.6	3.6		42.0	42.9	3.5	43.0
1978-79	-1.9	5.0	5.4	4.2	33.0	41.0	42.9	3.1	44.0
1979-80	-1.2	4.0	4.8	2.9	33.8	41.8	43.0	2.8	43.9
1980-81	-2.8	5.0	5.4	4.0	35.5	43.0	45.9	2.2	46.5
1981-82	-0.8	2.1	3.4	1.8	38.5	46.6	47.4	1.3	47.0
1982-83	-1.2	3.1	3.2	2.8	38.7	46.1	47.3	1.8	47.3
1983-84	-1.8	3.8	3.2	3.9	37.9	45.1	46.9	2.1	46.1
1984-85	-2.4	4.2	3.1	3.8	38.7	44.6	47.0	1.8	46.3
1985-86	-0.8	2.3	1.6	2.5	37.8	44.1	44.9	1.4	44.3
1986-87	-1.1	2.1	0.9	2.4	37.3	42.8	43.9	1.0	42.7
1987-88	0.1	0.8	-0.8	1.1	37.1	42.1	42.0	0.9	40.7
1988-89	2.1	-1.5	-3.1	-1.0	36.4	41.3	39.2	0.6	37.8

1989-90	2.0	-0.5	-1.5	0.1	36.0	40.7	38.6	1.6	38.9
1990-91	1.0	0.6	-0.1	0.9	36.6	39.7	38.7	1.7	39.2
1991-92	-1.3	3.2	2.4	3.1	35.7	38.9	40.2	2.0	40.6
1992-93	-5.3	7.6	6.0	7.3	34.1	36.8	42.1	2.3	42.9
1993-94	-6.0	7.8	7.1	7.9	33.5	36.2	42.2	1.8	43.2
1994-95	-4.6	6.3	5.3	6.2	34.6	37.2	41.8	1.7	42.5
1995-96	-3.5	4.9	4.4	5.0	35.6	38.3	41.8	1.4	42.7
1996-97	-2.7	3.6	3.0	3.9	36.0	38.3	41.0	0.9	41.1
1997-98	0.0	0.7	0.4	0.4	37.3	39.7	39.3	0.8	39.6
1998-99	0.6	0.2	0.4	0.0	37.7	40.0	39.2	0.8	39.9

1 Excluding windfall tax receipts and associated spending.

2 On UK national accounts definition prior to 1991-92 and a Maastricht basis thereafter.

3 Figures are only available on a consistent basis for the years shown.

Table 4A.2: Series of public debt and net wealth

	Net public sector debt(1)	**General government gross debt**(2)	**Public sector net wealth (3)**
1970-71	70.2	80.0	42.0
1971-72	65.6	76.9	48.4
1972-73	59.0	69.6	60.5
1973-74	59.0	68.0	77.5
1974-75	55.4	65.5	78.8
1975-76	57.2	63.3	67.2
1976-77	55.8	62.9	64.6
1977-78	52.4	61.5	59.2
1978-79	49.2	58.7	65.5
1979-80	45.2	54.4	72.4
1980-81	47.1	55.9	77.8
1981-82	47.3	55.1	75.2
1982-83	45.7	53.8	67.6
1983-84	46.2	54.9	66.0
1984-85	46.5	56.3	62.0

1985-86	44.5	54.0	61.5
1986-87	42.0	52.2	57.4
1987-88	37.8	49.9	58.7
1988-89	31.4	42.3	65.9
1989-90	28.4	37.3	61.0
1990-91	27.0	34.8	48.1
1991-92	28.2	35.9	41.6
1992-93	33.4	42.2	29.5
1993-94	38.2	48.2	17.7
1994-95	41.7	50.3	16.2
1995-96	44.1	53.3	10.9
1996-97	45.0	54.3	9.1
1997-98	43.3	52.0	5.0
1998-99	41.9	50.2	6.4

1 End-March debt as per cent of GDP in four quarters centred on end-March.

2 Definition on a Maastricht basis: per cent of GDP, year ending in March.

3 End-December net wealth as per cent of GDP in four quarters centred on end-December.

ANNEX 4B: FINANCING POLICY

The 1998-99 Debt Management Report, published in March, set out how the Government intended to finance its borrowing requirement for the current financial year. Table 4B.1 updates the financing arithmetic for 1998-99 to allow for the latest forecast of the central government net cash requirement (formerly the CGBR) for 1998-99, and for the 1997-98 outturn.

The financing requirement in 1998-99 is now expected to be 12.1 billion. This is 3.1 billion lower than the requirement published in the Debt Management Report. The revised financing requirement is expected to be net from gilt sales of 11.6 billion and a net contribution from National Savings of 0.5 billion.

Financing policy will be carried out on the basis set out in the Debt Management Report, subject to changes to the remit announced on 11 June 1998, to accommodate the revised gilt sales requirement.

Table 4B.1: Financing requirement (billion)

	1997-98		**1998-99**	
	March 1998 Budget	**Outturn**	**March 1998 Budget**	**EFSR 98 Update**
Central government net cash requirement	6.1	3.4	3.7	3.5
Net change in official reserves	0.0	0.0	0.0	0.0
Expected gilt redemptions	19.9	19.5	16.7	16.8
plus gilt sales residual from previous financial year	-3.9	-3.9	-5.1	-8.2
Financing requirement	22.1	19.0	15.2	12.1
Less net National Savings inflow	1.6	1.5	1.0	0.5
Less other funding	-0.1	-0.1	0.0	0.0
Gross gilt sales requirement	20.6	17.6	14.2	11.6
Actual gilt sales	25.8	25.8		
Estimated residual	5.1	8.2		