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POLLYANNA, NOT PRUDENCE

THE CHANCELLOR'S FINANCES

Ruth Lea

THE AUTHOR

Ruth Lea is Director of the Centre for Policy Studies. She is on the University of London Council and is a Governor of the London School of Economics. She has served on the Council of the Royal Economic Society, the National Consumer Council, the Nurses' Pay Review Body, the ONS Statistics Advisory Committee, the ESRC Research Priorities Board and the Retail Prices Advisory Committee. She is the author of many papers including *The Price of the Profligate Chancellor: higher taxes to come, The Essential Guide to the EU* and *Tax 'n' Spend: no way to run an economy.* She was Head of the Policy Unit at the Institute of Directors (IoD) from 1995 to 2003 before which she was the Economics Editor at ITN, was Chief Economist at Mitsubishi Bank and Chief UK Economist at Lehman Brothers. She also spent 16 years in the Civil Service in the Treasury, the Department of Trade and Industry and the Central Statistical Office.

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Centre for Policy Studies
57 Tufton Street, London SW1P 3QL
Tel: 020 7222 4488 Fax: 020 7222 4388
e-mail: mail@cps.org.uk
website: www.cps.org.uk

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POLLYANNA

Pollyanna was the heroine of stories for children written by Eleanor Hodgman Porter (1868-1920), US author. The term is used generally for "a person able to find apparent cause for happiness in the most disastrous situations; or for a person who is unduly optimistic or achieves spurious happiness through self-delusion."*[1]

According to Humphrey Carpenter and Mari Prichard,[2] Pollyanna has a perpetually sunny disposition and her favourite word is "glad". Eventually she is knocked down by a motorcar and paralysed ("If I can't walk, how am I ever going to be glad or – anything?") But she recovers.

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1 *Shorter Oxford English Dictionary*, 5th edition, OUP, 2002.

2 *The Oxford Companion to Children's Literature*, OUP, 1995

CHAPTER ONE
INTRODUCTION AND SUMMARY

1.1 INTRODUCTION

On 2 December 2004, the Chancellor of the Exchequer is due to present his next Pre-Budget Report – his eighth. Political commentators will, doubtless, be listening for any hints concerning any election giveaways that may be announced in next year's Budget – probably the last before the next election.

In his eight years as Chancellor, Gordon Brown has changed from being the friend of Prudence, sticking to the Conservatives' tight spending plans for his first two years, to a profligate "tax 'n' spend" advocate, who knows how to spend people's hard-earned cash better than they do.[1] But he is more than this as his persistently over-optimistic forecasts for the public finances confirm. He is Pollyanna.

More specifically, commentators will be watching for:

- The general *economic forecasts*: in particular, whether the Chancellor will downgrade his GDP growth forecast for 2005. On a more arcane note, there is the possibility (albeit slight) that the Chancellor will respecify the current economic cycle, which is currently defined as running from FY1999 (financial year 1999/2000) to FY2005 (financial year 2005/06). These issues are discussed in chapter 2.
- The forecasts for the *public finances*: in particular, whether the Chancellor still believes he can meet his Golden Rule for the current economic cycle. The Golden Rule states that the Treasury only borrows for investment "over the cycle". Revenues have been

disappointing so far this financial year, despite strong economic growth, and this makes it even harder for the Chancellor to meet his Golden Rule. Commentators will also be looking for the Chancellor's views on the prospects of the public finances in the next economic cycle, which starts in FY2006 and could run to FY2011 or even later. In particular, is the Chancellor even hinting that there may be a case for raising taxes and/or decelerating public spending growth after the next election? These issues are discussed in chapter 3.

1.2 THE ECONOMIC BACKGROUND

Chapter 2 looks at the UK's economic prospects and comes to the following conclusions:

- Even though the Chancellor should meet his GDP forecast for 2004, there is near unanimity amongst forecasters that he will miss it in 2005. After growth of 3% to 3¼% this year, GDP is expected to grow by around 2½% in 2005. This growth shortfall has implications for the public finances in 2005, making it harder for the Chancellor to meet his revenue projections. (Section 2.2.)
- The Treasury's over-optimistic estimates of the "output gap" (the difference between actual and non-inflationary potential output) are partly behind the expected growth shortfall in 2005. At the time of the March 2004 Budget, the Treasury expected the output gap to disappear in early 2006 (in other words, at the end of FY2005), allowing the economy to grow faster than trend throughout 2005. Independent commentators, including the Bank of England, have suggested that the output gap is already disappearing. (Section 2.3.)
- If the output gap has disappeared, then the Treasury's specification of the current economic cycle from FY1999 (when the economy was judged to be last "at trend") to FY2005 (when the economy is expected to be next "at trend") needs to be revised. The cycle should probably be specified from FY1999 to FY2004. For political reasons, however, it is unlikely the Chancellor will make an announcement along these lines in the Pre-Budget Report. It would look, rather obviously, as though he were fudging the Golden Rule. (Section 2.3.)
- The British economy has performed well, but not spectacularly since 1997. GDP growth has not been exceptional by either international standards or compared with the last Conservative term of office. Even though inflation has been better controlled since 1997 than before, it is much in line with international experience. (Section 2.4.)
- In some ways, however, the British economy has deteriorated since 1997. The Balance of Payments are currently chalking up record deficits and, at some point, there will be a correction that will depress domestic spending. Much more worryingly, Britain is slipping down the competitiveness league. (Section 2.4.)

1.3 GOLDEN RULE OR IN THE RED: THE PUBLIC FINANCES

Chapter 3 analyses the recent trends in the public finances and concludes:

- Recent data on public finances have been disappointing; revenues are running below target and current spending above. (Section 3.2.)
- Key analysts (including the IFS, the ITEM Club, NIESR and PwC) are all forecasting worse outcomes for the public finances than the Treasury's Budget forecasts. Yet again the Treasury's forecasts are turning out to be too optimistic, too Pollyanna-ish. The Chancellor may revise his forecasts. (Section 3.3.)
- There is little doubt that the Chancellor will miss his Golden Rule if the current economic cycle remains defined as running from FY1999 to FY2005. But the margin is likely to be small and without economic significance – even if politically embarrassing. (Section 3.4.)

If the Chancellor's current spending plans are adhered to, then substantial tax rises are inevitable after the next election if the then Chancellor wishes to meet the Golden Rule.

- Much more serious than the near missing of the Golden Rule for the present cycle, is the fact that the public sector current budget is expected to show a structural deficit of around 1% of GDP (£11 to £12 billion the start of the next economic cycle (FY2006)). If the Chancellor (whoever he/she may be) wishes to meet the Golden Rule during the next cycle (which may end in FY2011 or even later), there will have to be fiscal tightening of the order of this 1% of GDP structural deficit early in the cycle – preferably in FY2006. (Section 3.5.)
- Fiscal tightening can take the form of higher taxes or slower spending growth or a mixture of the two. If the Chancellor's current spending plans are adhered to, then substantial tax rises are inevitable after the next election if the then Chancellor wishes to meet the Golden Rule. But higher taxes can only damage the prospects for the British people and the economy. The British people need lower taxes not higher taxes. The infinitely preferable alternative is slower spending growth. The Shadow Chancellor has already announced some plans, which are probably more than enough to provide the necessary fiscal tightening. (Section 3.6.)
- Without this fiscal tightening then the next economic cycle will mean the effective dumping of the Golden Rule. The public finances will be "in the red".

REFERENCE

1. Ruth Lea, *The price of the profligate Chancellor: higher taxes to come*, CPS, March 2004.

CHAPTER TWO
THE ECONOMIC BACKGROUND

2.1 INTRODUCTION

One of the most keenly awaited parts of the Pre-Budget Report will be the section on the economy. The City, in particular, will be listening for the GDP growth forecasts – not least of all because they have implications for the public finances.

The Chancellor's economic forecasts (as opposed to his forecasts on the public finances) have been reasonably accurate. But there is almost unanimity that, even though the Chancellor may meet his growth forecast for this year, he will miss it next year. This is partly because of the deterioration in the world economy (there is global growth slowdown, reflecting higher oil prices) and partly because the British economy's "output gap" (see section 2.3) is disappearing faster than the Treasury expected. The former cannot be laid at the Chancellor's door, but the latter, arguably, can.

2.2 THE ECONOMIC FORECASTS

The main components of the Chancellor's Budget forecasts are set out in table 1, below.

TABLE 1: THE CHANCELLOR'S BUDGET FORECASTS

	2003	2004	2005	2006
GDP at constant market prices*	2¼	3 to 3½	3 to 3½	2½ to 3
Manufacturing output*	¼	1½ to 2	1¾ to 2¼	1¾ to 2¼
Balance of payments (current account) (£bn)	-24	-32¾	-32	-31¼
CPI (Q4)*	1½	1¾	2	2
Money GDP, £bn	1100	1160 to 1164	1226 to 1236	1291 to 1308
Money GDP, % change*	5½	5½ to 5¾	5¾ to 6¼	5¼ to 5¾

* % change year-on-year. The Consumer Price Index (CPI) forecast refers to the year-on-year change for the 4th quarter average.

Source: HM Treasury, *Budget 2004: Prudence for a Purpose: a Britain of stability and strength*, TSO, HC 301, March 2004, table B9.

Much of the Chancellor's forecast is uncontroversial. And even though the third quarter GDP figure, showing quarterly growth of just 0.4%, was weaker-than-expected by the City, GDP growth in 2004 should easily reach 3% (unless there is little to no growth in the final quarter of the year or there are some significant downward revisions by the ONS). As table 2 shows the "consensus" of forecasters is more optimistic concerning the Current Account of the Balance of Payments than the Chancellor was at the time of the Budget. But the one area where there is disagreement, and a disagreement that should be of concern, is the GDP growth figures for next year. The consensus GDP growth figure is just 2½% compared with the Chancellor's 3% to 3 ½%.[1]

TABLE 2: CONSENSUS FORECASTS

	2003 (outturn)	2004	2005
GDP*	2.2	3.2	2.6
Manufacturing output*	0.4	1.2	1.8
CPI*	1.3	1.4	1.7
Balance of payments (current account) (£bn)	-20.4	-25.6	-28.1

* % change year-on-year. The CPI forecast refers to the year-on-year change for the annual average.

Source: Consensus Economics, *Consensus Forecasts*, November 2004.

If growth falters next year, then this has implications for the public finances. Even with strong GDP growth for 2004, revenues have been disappointing so far this year (see chapter 3). If GDP growth weakens in 2005, as expected, then it is more than likely that the shortfall on the public revenues will be exacerbated. Table 3 shows clearly that the Treasury assumed 3% GDP growth for next year for the public finance projections.

TABLE 3: THE TREASURY'S ECONOMIC ASSUMPTIONS FOR THE PUBLIC FINANCE PROJECTIONS

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008
Output (GDP)	1¾	2¾	3	3	2½	2¼	2¼
Prices:							
- CPI	1¼	1¼	1¾	2	2	2	2
- GDP deflator	3¼	2¾	2¼	2½	2¾	2¾	2¾
Money GDP (£bn)	1054	1115	1176	1243	1308	1372	1440

Note on the status of the data: FY2002 was an outturn, FY2003 was an estimate and FY2004 to FY2008 were projections.

Source: HM Treasury, Budget 2004: *Prudence for a Purpose: a Britain of stability and strength*, TSO, HC 301, March 2004, table C3.

2.3 THE OUTPUT GAP

The "output gap" is defined as the difference between "potential GDP" (when the economy is working at full capacity) and "actual GDP". It is calculated as "actual GDP" minus "potential GDP" so:

- When the output gap is negative, there is unused capacity (eg unemployment) and the economy can grow faster than "trend" without risking stoking up inflationary pressures. ("The porridge is too cold.")
- When the output gap is positive, the economy is running ahead of its non-inflationary capacity and is risking stoking up inflation. The policy response should be to tighten fiscal and/or monetary policy. ("The porridge is too hot.")
- When the output gap is zero, the economy can run at trend (but no faster) without risking stoking up inflationary pressures. The economy is "at trend". ("The porridge is just right.")

At the time of the Budget, the Treasury claimed that the (negative) output gap was:

> …estimated to have stood at around 1¼% [of potential GDP] in the final quarter of 2003. [It] is forecast to close by early 2006 [following above trend growth in 2005] and GDP growth is forecast to moderate thereafter, with the economy projected to remain at trend.[2, 3]

The Treasury's estimates for the output gap are economically significant for the following reasons:

- The Treasury uses its estimates of the output gap to specify the current economic cycle. The years FY1999 and FY2005 are identified as the start (FY1999) and end (FY2005) points of the current cycle, when the Treasury estimates that the economy was (or will be) "at trend" (with zero output gaps). A full economic cycle encompasses the pattern of an upswing to a peak, followed by a downswing to a trough, which is then, in turn, followed by an upswing.[4]

- There is now increasing evidence that the Treasury has been too optimistic about the size and resilience of the output gap and, therefore, too optimistic about the scope for an extended period of above trend growth. Increasingly, it looks as though the output gap has already all but disappeared and the effective end of the current cycle should be FY2004 rather than FY2005. For political reasons, however, it seems unlikely that the Chancellor would make an announcement along these lines in the Pre-Budget Report because it would seem as if he were fudging the Golden Rule (see chapter 3).

The charitable view for the Treasury's optimism is that it simply over-estimated the time it would take to "use up the output gap". But it was right about the size of the gap. In other words, the gap has simply been used up quicker than it expected. But there is also evidence to suggest that its estimates were too generous in the first place. The National Institute of Economic and Social Research (NIESR) suggested in January this year that the gap was nowhere near as large as the Treasury's estimate.[5] Whereas the Treasury estimated the gap in the final quarter of 2003 at around 1¾% (of potential GDP), NIESR estimated it at around 0.4% for the year 2003. It now looks as though NIESR's more modest figure was nearer reality.

As table 4 shows, it is not just NIESR that does not share the Treasury's optimism about the size and resilience of the output gap. The OECD also differs.

TABLE 4: NIESR AND OECD ESTIMATES OF OUTPUT GAPS (AS A PERCENTAGE OF POTENTIAL GDP)

	NIESR	OECD	Treasury
1999	-0.2	0	Na
2000	0.7	1.3	Na
2001	0.3	0.6	0.0 (FY2001)
2002	-0.3	-0.4	-1.2 (FY2002)
2003	-0.5	-0.7	-1.4 (FY2003)
2004	0	-0.1	-0.8 (FY2004)
2005	0	0.2	-0.1 (FY2005)
2006	0.2	Na	0.0 (FY2006)
2007	Na	Na	0.0 (FY2007)
2008	Na	Na	0.0 (FY2008)

Sources: Ray Barrell et al, "Prospects for the UK economy", *National Institute Economic Review* (NIER) no. 190, NIESR, October 2004; OECD, *Economic Outlook no. 75*, June 2004; HM Treasury, *Budget 2004: Prudence for a Purpose: a Britain of stability and strength*, TSO, HC 301, March 2004, table C1.

NIESR's estimates indicate that the output gap disappeared in 2004, remained at zero in 2005, and will "go positive" in 2006 (in other words, the economy is forecast to grow above its non-inflationary potential). The cycle, starting in 1999, is effectively over. (NIESR also takes issue with the Treasury's view that the economy was at trend in 1999.) The OECD similarly takes the view that the (negative) output gap has been exhausted. The cycle, starting in 1999, is over. As a final comment, the Bank of England wrote in November "the economy appeared [in recent months] to be operating at, or above, normal capacity, and there seemed to be little slack in the jobs market".[6]

But it is not just that over-optimistic estimates of the output gap have implications for growth and the exact specification of the cycle. They have major implications for meeting of the Golden Rule because it is couched in terms of the economic cycle. This will be discussed in chapter 3.

2.4 JUST HOW WELL HAS THE UK PERFORMED?

The Chancellor will probably use the Pre-Budget Report, and employ a few well-chosen data, to praise his custody of the British economy.[7] But even quite superficial inspection of the data shows that, whilst the economy has performed well since 1997, its performance has not been spectacularly good and, in some fundamental ways, has deteriorated. Table 5 shows that GDP has been good but not remarkable by international standards. (Annex 1, table 1 gives a complete OECD data set.)

TABLE 5: UK GDP GROWTH IN AN INTERNATIONAL CONTEXT

Country	1997	2004 (1997=100)	2004 rank	2005 (1997=100)	2005 rank
Australia	100.0	**129.2**	**6**	**133.7**	**7**
Canada	100.0	**127.3**	**8**	**131.5**	**9**
France	100.0	117.9	18	121.0	19
Germany	100.0	109.2	29	111.5	29
Ireland	100.0	**158.4**	**1**	**165.7**	**1**
Italy	100.0	110.4	28	112.5	28
Japan	100.0	107.8	30	110.8	30
Korea	100.0	**133.8**	**3**	**141.7**	**2**
Netherlands	100.0	114.1	25	116.5	25
New Zealand	100.0	**122.9**	**14**	**126.0**	**15**
UK	100.0	**120.2**	**17**	**123.5**	**17**
US	100.0	**125.1**	**=11**	**129.7**	**11**
Euro area	100.0	114.8		117.6	
Total OECD	100.0	119.3		123.2	

Note: Countries in bold achieved better rates of growth than the OECD average.

Source: OECD, *Economic Outlook*, *number 75*, June 2004.

Of the 30 OECD countries, the UK is in the bottom half of the rankings for expected growth between 1997 and 2004 and between 1997 and 2005. Admittedly, growth is better than the Eurozone's average and, by a whisker, the OECD's average. But this is hardly saying much as the forecast growth rates for Germany, Italy and Japan over these periods are dire. It is notable that the UK's economic performance is poorer than in the other major Anglo-Saxon economies. It is also instructive to compare the economic performance from 1992 to 1997 (the last Conservative term) with the performance since 1997. Table 6 shows the relevant data.

Of the 30 OECD countries, the UK is in the bottom half of the rankings for expected GDP growth between 1997 and 2005.

TABLE 6: UK GDP GROWTH RATES FOR TWO SELECTED PERIODS

	1992 to 1997 (5 years)			1997 to 2005 (8 years)		
	1992	1997	Average annual growth rate	1997	2005	Average annual growth rate
GDP	100.0	116.3	3.1%	100.0	123.5	2.7%

Source: OECD, *Economic Outlook*, *number* 75, June 2004.

In the five years following "Black Wednesday" (16 September 1992), when the pound was expelled from the straightjacket of the Exchange Rate Mechanism (ERM), the economy grew well. The average growth rate was just over 3%. In the eight years since 1997, growth, albeit steadier than in the previous seven years, has been solid – but nothing more. The current Chancellor inherited a golden economy, even though he seems reluctant to admit it.

The Chancellor is also keen to talk about low unemployment and low inflation rates. Undeniably, the unemployment data do look "better". But their economic significance is undermined and compromised by increased incapacity benefit take-up and unproductive make-jobs in the public sector. The inflation figures also appear to have improved, and the Bank of England has done a creditable job since 1997. But as table 7 shows, the UK's improving performance is not exceptional by international standards and the currently higher oil prices could yet reverse the benign trends. (Annex 1, table 2 contains the complete OECD data set.)

TABLE 7: CONSUMER PRICE INDICES, ANNUAL INCREASES (%), INTERNATIONAL COMPARISONS

Country	Average 1979-89	1997	2003	2004F	2005F
Australia	8.4	0.3	2.8	2.0	2.5
Canada	6.5	1.6	2.8	1.1	1.7
France	7.3	1.3	2.2	1.9	1.3
Germany	2.9	1.5	1.0	1.1	0.6
Italy	11.1	1.9	2.8	2.2	2.1
Japan	2.5	1.7	-0.3	-0.2	0.1
Korea	6.0	4.4	3.5	3.2	3.2
UK	7.4	1.8	1.4	1.4	1.9
US	5.5	2.3	2.3	2.3	2.0
Euro area	7.0	1.7	2.1	1.7	1.4

Source: OECD, *Economic Outlook*, *number* 75, June 2004.

It is interesting to note that the Chancellor does not boast about the balance of payments data. Given the data in table 8, this is not altogether surprising. Even though some of the decline in the share of exports reflects the rise of China and is, therefore, to be expected, the worsening trade balances are less defensible. At some point, these deteriorating balances will need to be corrected with implications for domestic consumption.

TABLE 8: UK EXTERNAL TRADE: SOME INDICATORS OF PERFORMANCE

	1997	2004F	2005F
UK share of world exports (%, goods and services)	5.5	4.9	4.8
UK share of world imports (%, goods and services)	5.6	5.6	5.5
Trade balances for goods and services ($bn)	+1.7	-69.6	-75.9
Current account balances ($bn)	-1.6	-67.0	-73.2

Source: OECD, *Economic Outlook*, *number* 75, June 2004.

There are other signs that the economy is not doing as well as the Chancellor likes to indicate. He does not, for example, discuss the UK's declining competitiveness. But it is this that should concern him the most. His "tax 'n' spend" and "tax 'n' red tape" policies are undoubtedly undermining the UK's ability to compete.[8] And the UK is slipping down the international league tables. The World Economic Forum (WEF) calculated that the UK was the fourth most competitive economy in 1998; in 2004 it was the 11th.[9] The International Institute of Management Development (IMD) put the British economy at ninth in 1997 and 22nd in 2004.[10]

With China and India taking their places as major players in the global economy, this is no time to be smug about the British economy's performance.

REFERENCES

1. The Bank of England in its November 2004 Inflation Report wrote that "under the central projection, output growth eases slightly below trend next year and then gradually picks back up". It is clearly not expecting growth at 3% to 3½% in 2005.

2. HM Treasury, *Budget 2004: Prudence for a Purpose: a Britain of stability and strength*, TSO, HC 301, March 2004. See chart B3 and discussion of the output gap on pages 222-223.

3. The Treasury estimates that the trend GDP annual growth rate is 2¾%. See table B2 of the Budget Report.

4. Such economic (or business or trade) cycles occur about the secular or long-run "trend" path of output.

5. Ray Barrell et al, "Prospects for the UK economy", *National Institute Economic Review (NIER) no. 187*, NIESR, January 2004.
6. Bank of England, *Inflation Report*, November 2004.
7. Keith Marsden, *Gordon Brown's boasts*, CPS, July 2004, discusses this issue further.
8. Ruth Lea, *For the economy's sake, we cannot afford not to cut taxes*, CPS, November 2004.
9. Global Competitiveness Report 2004-2005 (for 2003 and 2004 for all countries; website: www.weforum.org), "World competitiveness reports" (for 1996-2002 for major countries only; from website: www.maaw.info).
10. *IMD competitiveness Yearbook 2004* (for 2000-2004) and rankings as of April 2001 from website: www.imd.ch (for 1997-1999).

CHAPTER THREE
GOLDEN RULE OR IN THE RED

3.1 INTRODUCTION

The forecasts for the public finances will undoubtedly be a focus for economic and political commentators in the forthcoming Pre-Budget Report. In particular there will be a focus on:

- Any revisions to the forecasts for the current budget and Public Sector Net Borrowing in the light of the recent poor data. (Sections 3.2 and 3.3.)
- Discussion on the fiscal rules and, in particular, whether the Chancellor believes his Golden Rule can still be met for the current economic cycle. (Section 3.4.)
- What the prospects are for the public finances at the start of the next economic cycle (starting FY2006). And whether there will need to be increases in taxes in order to fund the spending plans announced in the July 2004 Spending Review and/or there will need to be a slowdown in public spending. (Sections 3.5 and 3.6.)

3.2 RECENT DATA

The recent data on the public finances, up to October 2004,[1] have been disappointing. Revenues have undershot, whilst current spending is ahead of target. Public sector investment is, however, way below target. Table 1 compares the growth rates for the first seven months of FY2004 (April to October) with the Treasury's growth figures for the whole financial year.

TABLE 1: THE PUBLIC FINANCES FOR FY2004

	April to October FY2004 compared with April to October FY2003	FY2004 compared with FY2003 (2004 Budget)
CG receipts	6.3%	7.8% (YOY)
CG current spending	6.6%	5.2% (YOY)
Public sector net investment	13.1%	63.3% (YOY)

Source: Institute of Fiscal Studies (IFS).

An inspection of October's data shows that the current deficit (the difference between current revenues and current spending) is, in the words of the IFS, "moving further away from the Budget forecast for the third month in a row. If trends seen so far this year continue, and it is early days, the current deficit for FY2004 would overshoot the Treasury forecast by more than £12 billion."[2]

If current trends continue, PSNB would reach £39 billion in FY 2004 (compared with a Budget forecast of £32.9 billion) and the current deficit would reach £23 billion (compared with a Budget forecast of £10.5 billion).

The IFS also commented that October's revenue data were especially disappointing, as they showed particularly weak corporation tax receipts (and October is the most important month for corporation tax receipts). The IFS estimated that, if the current trends continued, Public Sector Net Borrowing (PSNB) would reach £39 billion in FY2004 (compared with the Budget forecast of £32.9 billion) and the current deficit would reach £23bn (compared with a Budget forecast of £10.5 billion), although the IFS qualified this latter extrapolation by saying that they did not expect the current deficit for FY2004 would be as high as this. (For definitions used in the public finances please see annex 2.)

3.3 RECENT FORECASTS OF THE PUBLIC FINANCES

Recent forecasts of the public sector balances have reflected the weakness in revenues. Tables 2 and 3 show some recent private sector forecasts alongside the official Treasury forecasts for the past 2 ½ years.

TABLE 2: PUBLIC SECTOR CURRENT BUDGET SURPLUS (£ BN)

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008
Budget 2002	3	7	9	7	9	Na	Na
PBR 2002	-5.7	-5	3	5	8	10	Na
Budget 2003	-11.7	-8.4	-1	2	6	9	Na
PBR 2003	-11.8	-19.3	-8.3	-4.7	0	4	8
Budget 2004	-12.3	-21.3	-10.5	-5.5	0	4	9
IFS extrapolation	Na	Na	-23	Na	Na	Na	Na
ITEM	-13.9	-21.2	-16.7	-14.6	-9.3	-5.6	Na
PwC*			1.5% of GDP [-18]	1.3% of GDP [-16]			
NIESR	-13.1	-24.9	-15.3	-12.4	-14.7	-8.9	+0.7
NIESR minus Budget 2004	-0.8	-3.6	-4.8	-6.9	-14.7	-12.9	-8.3

* PwC forecasts the current deficit in terms of percentage of GDP. The data in brackets are the author's calculations in £bn.

Sources: HM Treasury: *Pre-Budget Reports* for 2002 and 2003 and *Budget Reports* for 2002, 2003 and 2004.IFS: see above for explanation; ITEM: *The ITEM Club's Economic Update*, October 2004, Ernest and Young; PwC: *UK Economic Outlook*, November 2004, PricewaterhouseCoopers (main economic scenario). NIESR: *National Institute Economic Review (NIER) no. 190*, NIESR, October 2004.

TABLE 3: PUBLIC SECTOR NET BORROWING (£BN)

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008
Budget 2002	11	13	13	17	18	Na	Na
PBR 2002	20	24	19	19	19	20	Na
Budget 2003	24	27	24	23	22	22	Na
PBR 2003	22.5	37.4	31	30	27	27	24
Budget 2004	22.9	37.5	33	31	27	27	23
IFS extrapolation	Na	Na	39	Na	Na	Na	Na
ITEM	25.9	34.8	39.7	39.6	36.3	36.6	Na
PwC	Na	Na	36	41	Na	38	Na
NIESR	23.5	38.6	34.4	36.2	41.4	37.7	30.4
NIESR minus Budget 2004	0.6	1.1	1.4	5.2	14.4	10.7	7.4

Source: As for table 3 above.

The main conclusions that can be drawn from these tables are:

- All the private sector forecasters are forecasting worse figures for both the current deficit and net borrowing than the Chancellor at the time of the Budget.
- If these commentators are right, then the Budget forecasts will be yet another set of forecasts from the Treasury that have been too optimistic, too "Pollyanna-ish". The above table shows the continuous slippage from the 2002 Pre-Budget forecasts to the present.[3]
- The forecasts on the current deficit have serious implications for the Golden Rule. The CPS does not do its own detailed forecasting, but will take as its "forecasts" in the discussion on the Golden Rule (below) a current deficit of £16 billion for FY2004 (compared with the Treasury's £10.5 billion) and £13 billion for FY2005 (compared with the Treasury's £5.5 billion). These figures are, if anything, on the conservative side.

3.4 WILL THE GOLDEN RULE BE BROKEN?

The Chancellor has two fiscal rules:

The Golden Rule: which states that, on average over the cycle, the government will borrow only to invest and not to fund current spending.

The Sustainable Investment Rule: which states that public sector debt as a proportion of GDP will be held over the cycle at a stable and prudent level. The Government believes that, other things being equal, it is desirable that public sector net debt should be below 40% of GDP over the cycle. The Chancellor should comfortably meet this rule in the short term and there will be no further discussion of it in this paper.

When the Chancellor first announced his Golden Rule, it was assumed that the actual balances would be cumulated over the cycle FY1999 to FY2006, and that the net figure should be zero or positive for the Golden Rule to be met. However, in recent announcements the emphasis has been on the balances as percentage shares of GDP. This has been criticised on the grounds that it gives greater weight to the earlier years of the cycle, when the surpluses were large, and smaller weight to the later years when the deficits were large.[4] In table 4 the Golden Rule is calculated on both bases and covers both the Treasury's Budget data and the "CPS alternative scenario", where the current deficit is taken as £16 billion for FY2004 and £13 billion for FY2005. (See above.)

TABLE 4: CURRENT BUDGET FORECASTS AND THE GOLDEN RULE

1. TREASURY FORECASTS (2004 BUDGET)

	Current budget balance (£bn)	Cumulative FY1999 to FY2004 & FY2005 (£bn)	Current budget as % of GDP	Average, as % of GDP
FY1999	+19.6	+19.6	2.1	
FY2000	+20.5	+40.1	2.1	
FY2001	+9.4	+49.5	0.9	
FY2002	-12.3	+37.2	-1.2	
FY2003	-21.3	+15.9	-1.9	
FY2004	[-10.5]	[+5.4]	[-0.9]	[+0.2]
FY2005	[-5.5]	[-0.1]	[-0.4]	[+0.1]

2. CPS FORECASTS (2004 BUDGET)

	Current budget balance (£bn)*	Cumulative FY1999 to FY2004 & FY2005 (£bn)	Current budget as % of GDP	Average, as % of GDP
FY1999	+19.6	+19.6	2.1	
FY2000	+20.5	+40.1	2.1	
FY2001	+9.4	+49.5	0.9	
FY2002	-13.9	+35.6	-1.3	
FY2003	-21.1	+14.5	-1.8	
FY2004	[-16]	[-1.5]	[-1.4]	[+0.1]
FY2005	[-13]	[-14.5]	[-1.2]	[-0.1]

* Source of back revisions: National Statistics, *Public sector finances*, September 2004, ONS and HM Treasury, 18 November 2004.

The data show clearly that, taking the cycle from FY1999 to FY2005, the Budget forecasts miss the Golden Rule (using actual balances) by a trivial and ignorable amount (£0.1 billion). Using balances as percentage shares of GDP suggests that the Golden Rule will be met with a modest 0.1% of GDP margin. If the Chancellor chooses to use the years FY1999 to FY2004 as the cycle (which for economic reasons would be quite reasonable but is doubtful for political reasons, see chapter 2), the margins would clearly be more favourable.[5]

The CPS alternative scenario suggests that, taking the cycle from FY1999 to FY2005, the Chancellor will miss his Golden Rule in terms of both actual balances and the balances as percentage shares of GDP. But it can be argued that the margins are very small and economically insignificant – even if politically embarrassing. Specifying the cycle as from FY1999 to FY2004 again produces more favourable margins.

There are, of course, other commentators who have suggested that the Golden Rule will be missed. Indeed, the author is unaware of any commentators, apart from the Treasury, who are currently suggesting that the Golden Rule will be met if the cycle is allowed to run on until FY2005.

Here are some key quotations:

- **NIESR**: "The Golden Rule is unlikely to be met if the current cycle continues to March 2006; there is a 50/50 chance of it being met if the cycle ends in March 2005."[6]
- **IFS** commenting on September's public finances data: "If this trend continues, he [the Chancellor] is on course to break his self-imposed Golden Rule over the current cycle – even if none of this year's overshoot in borrowing persists into FY2005. …In the Budget in March the Treasury predicted a cumulative surplus over the cycle of 0.7% of one year's national income. On current trends, and assuming that none of this year's overshoot in borrowing persists, there would be a cumulative deficit of around 0.3%."[7]
- **IFS** commenting on October's public finances data: "On current trends the Chancellor is on course to break his golden rule over the present economic cycle. The BoE and other independent commentators have suggested that spare capacity in the economy may have been used up more quickly than the Budget period, so we may already be in the last year of the cycle. But although this would make it easier to hit the golden rule over this cycle on current trends, there would still only be a 50-50 chance of success."[8]
- **PwC**: "If projections turnout to be correct…[and] if the cycle continues to FY2005, then the Golden Rule will be broken this cycle."[9]
- **ITEM Club**: "The Golden Rule is still likely to be broken next year."[10]

3.5 POST FY2006 PROSPECTS: THE STRUCTURAL DEFICIT

Whether or not the Golden Rule is missed by a whisker during the current cycle is, as already stated, of limited economic significance, even though politically embarrassing. And, if there were just this problem and no other problem with the public finances, there would probably be no need for a policy response (whether by way higher taxes and/or slower spending growth).

But there is another problem with the finances and a serious problem. And that is that the Chancellor(whoever he/she may be) will be entering the next economic cycle in, say, FY2006 with a significant structural deficit (though the Treasury still chooses to deny this). If that Chancellor wishes to continue with the Golden Rule (or with a different but nevertheless "responsible" approach), then fiscal policy will need tightening – either by putting up taxes and/or slowing spending growth. This paper assumes that the Chancellor would wish to continue with the Golden Rule.

The next issue to consider is the possible size of the structural current deficit, which is defined as the actual deficit when the economy is running at full non-inflationary capacity; in other words, when the output gap is zero. Some of the implications of this definition are as follows:

- It is quite possible to run a current deficit when there is a sizeable (negative) output gap, which is not a structural deficit. Any such deficit would be cyclical. The Treasury claims that the current deficit is largely cyclical because it claims there is still unused capacity.[11]
- The smaller the (negative) output gap, the more likely any actual deficits will be mainly structural and not mainly cyclical.
- It is also quite possible to run a current surplus when there is a sizeable (positive) output gap, which is not a structural surplus. Any such surplus would be cyclical.
- The existence of a (positive) output gap may disguise the true size of the structural deficit.
- Actual balances are adjusted for the effects of the cycle to give structural balances (which are also known as "cyclically-adjusted balances").

It is clear that it is unlikely that the forecast actual deficits will give an accurate picture of what the structural deficits are. It is, nevertheless, interesting to note just how far the Treasury's actual forecasts are away from other respected forecasters, as shown in table 5.

TABLE 5: CURRENT BUDGET BALANCES, FORECASTS

	Treasury (2004 Budget)		ITEM	NIESR
	£bn	As % share of GDP*	£bn	£bn
FY2004	-10.5	-0.9 (-0.2)	-16.7	-15.3
FY2005	-5.5	-0.4 (-0.2)	-14.6	-12.4
FY2006	0	0 (0)	-9.3	-14.7
FY2007	4	0.3 (0.3)	-5.6	-8.9
FY2008	9	0.7 (0.7)	Na	+0.7

* Cyclically-adjusted figure in brackets.

Sources: HM Treasury: *Pre-Budget Reports* for 2002 and 2003 and *Budget Reports* for 2002, 2003 and 2004; ITEM: *The ITEM Club's Economic Update*, October 2004, Ernest and Young; NIESR: *National Institute Economic Review (NIER) no. 190*, NIESR, October 2004.

Estimates by respected forecasters of the structural deficit, and the necessary policy responses, vary. But they are all agreed that doing nothing is not an option if the Golden Rule is to be met in the cycle starting FY2006 (and ending, say, in FY2011 or even later). Some estimates are included in the following comments:

- **NIESR**: "With the economy now operating at capacity, it is clear that this [the current deficit] is a structural deficit, which must be addressed by fiscal tightening of around 1% of GDP".[12] (1% of GDP is about £11 to 12 billion.)
- **IFS**: "The Chancellor could argue, like many independent commentators, that the spare capacity in the economy has been used up more quickly than he expected and that we are already in the last year of the current cycle. This would put him back on course to meet the Golden Rule in the short term, but would increase the need for tax increases or spending cuts to ensure that the rule is met over the next economic cycle".[13]
- **PwC**: The structural deficit is expected to be 0.6% of GDP (about £8 billion) in FY2007 – to be met by either higher taxes and/or slower spending.[14]
- **ITEM**: "The Treasury will begin the next cycle with a large structural deficit and the method it uses for assessing the golden rule will add urgency to the need to raise taxes after the election. ITEM forecasts the structural deficit at £13 billion or 1.1% of GDP in FY2005 (it is not cyclical as the Chancellor has been arguing). Taxes will need to be raised or expenditure plans scaled back to avoid breaking the golden rule again in the next economic cycle." [15]
- Finally, the **OECD** is on the record as saying: "The government deficit exceeded 3% of GDP in 2003, and a slowdown in spending or a rise in taxation may be required to ensure that the "golden rule" can be comfortably met over the next cycle. [16]

Estimates of the structural deficit, and the response required, vary. NIESR says a fiscal tightening worth £11 to £12 billion is required; PwC estimates the structural deficit at about £8 billion; while ITEM forecasts it at £13 billion. All agree that doing nothing is not an option.

The estimates produced by ITEM and NIESR are remarkably similar and both conclude that a fiscal correction of about 1% of GDP needs to be implemented for FY2006 onwards if the Golden Rule for the cycle starting in FY2006 is to be met. PwC's estimate of the structural deficit is more modest, but the implication of even their estimates is that taxes will need to rise substantially or spending growth will have to be pared back.

3.6 TAX RISES OR SLOWER SPENDING GROWTH?

When faced with this structural current deficit there are three policy options:

- Stay with the current spending plans, as announced in the July 2004 Spending Review,[17] and raise taxes.
- Slow the growth of spending.
- A combination of the two. This third option will not be discussed further.

If the current Chancellor's current plans are adhered to and, further out, if spending continues to take a 42% share of GDP beyond FY2007, then taxes are inevitably going to rise if the Golden Rule over the next cycle (which may run to FY2011 or even later) is to be met.[18, 19]

But higher taxes damage both individuals and the economy and there is increasing evidence that the Chancellor's large injections of taxpayers' money have resulted in considerable waste and failed to significantly improve public services. (These issues are discussed in other CPS publications.[20]) Moreover, even without extra tax rises, the tax take is forecast by the Treasury to rise quite significantly as shown in table 6.

TABLE 6: TAX-TO-GDP RATIOS (HM TREASURY, BUDGET FORECASTS)

	Net taxes & social security contributions†	Current receipts†
FY2002*	35.6	37.6
FY2003**	35.7	37.8
FY2004	36.5	38.7
FY2005	37.3	39.4
FY2006	37.8	39.9
FY2007	38.1	40.3
FY2008	38.3	40.5

* Actual.
** Estimate (others projections).
† Tax credits scored as negative tax in net taxes & social security contributions.
Source: See HM Treasury, *Budget 2004: Prudence for a Purpose: a Britain of stability and strength*, TSO, HC 301, March 2004, page 261.

A far more preferable alternative to higher taxes is slower growth of public spending. Given the huge increases in public spending pencilled in up to FY2007, this should not be difficult. (Annex 1, table 3 details the current Chancellor's spending plans.) The Shadow Chancellor has already announced some plans for getting public spending down to 40% of GDP in FY2011 and these are undoubtedly a step in the right direction. Table 7 shows how the data pan out.

TABLE 7: THE SHADOW CHANCELLOR'S SPENDING PLANS: TOTAL MANAGED EXPENDITURE (TME)

	FY'05	FY'06	FY'07	FY'08	FY'09	FY'10	FY'11	FY'11 minus FY'05
(I) TME, if 42% of GDP (£bn)*	519 (521)	548 (549)	575 (580)	603	633	665	698	179
TME as % of GDP**	42.0	41.6	41.4	41.1	40.8	40.3	39.9	Na
(II) TME†	519	543	567	590	615	638	663	144
(I)-(II) The Shadow Chancellor's "savings"	0	5	8	13	18	27	35	35

* Calculated by the author, data from 2004 Spending Review in brackets.

** Shadow Chancellor's projections (source: Shadow Chancellor, Medium Term Expenditure Strategy, February 2004, www.conservatives.com.)

† TME calculated by the author, given the Shadow Chancellor's projections on TME as a percentage of GDP.

The author calculates that the Shadow Chancellor's "savings" over the period FY2006 to FY2011 (six years) would be over £100 billion (in cash terms). This amounts to an average annual saving of about £17 billion (in cash terms). This would probably be more than enough to provide the necessary fiscal tightening for a Chancellor to meet his/her Golden Rule for the cycle beginning in FY2006 and likely to run on until FY2011 or even later. If further savings (and they are not "cuts") could be identified, then this would permit the much needed, indeed the necessary, tax cuts.[21, 22]

REFERENCES

1. National Statistics, *Public Sector Finances*, *October 2004*, ONS and HM Treasury, 18 November 2004.

2. Institute for Fiscal Studies, *IFS analysis of today's public finance figures*, 18 November 2004.

3. Ruth Lea, *The price of the profligate Chancellor: higher taxes to come*, CPS, March 2004, discusses the Treasury's over-optimism in the public finances forecasts, for FY 2002 onwards, in detail.

4. Chris Giles, "Brown's 'golden rule' reading attacked", *Financial Times*, 29 October 2004, wrote: "in March Gordon Brown calculated the Golden Rule on the basis of the average current surplus over the cycle as a share of GDP. …Previously he had often presented the expected cumulative surplus for the current budget over the cycle. David Hillier [of Barclays Capital] said it was wrong to deflate the series by GDP, giving further weight to the early years in the cycle. David Hillier said the Chancellor's Golden Rule had been broken and Mr Brown was 'lying and cheating' if he claimed otherwise".

5. Patience Wheatcroft, "Brown could lose balance", *The Times*, 19 November 2004, wrote "This time Mr Brown may be forced to declare the cycle closed now, so the impending horrors of next year will not count".

6. NIESR, *Forecast for the UK Economy*, *Press Release*, 29 October 2004.
7. Institute for Fiscal Studies, *IFS analysis of today's public finance figures*, IFS, 24 October 2004.
8. Institute for Fiscal Studies, *IFS analysis of today's public finance figures*, 18 November 2004.
9. PricewaterhouseCoopers (PwC), *UK Economic Outlook*, November 2004.
10. Ernst and Young, "Why is the Chancellor still failing to meet his fiscal targets?", *The ITEM Club's Economic Update*, October 2004.
11. See HM Treasury, *Budget 2004: Prudence for a Purpose: a Britain of stability and strength*, TSO, HC 301, March 2004, table C2, for the detailed figures.
12. NIESR: *National Institute Economic Review no. 190*, October 2004.
13. Institute for Fiscal Studies, *IFS analysis of today's public finance figures*, 24 October 2004.
14. PricewaterhouseCoopers (PwC), *UK Economic Outlook*, November 2004.
15. ITEM, *The ITEM Club's Economic Update*, October 2004, Ernest and Young.
16. OECD, *Economic Outlook No. 75* – United Kingdom, June 2004.
17. HM Treasury, *2004 Spending Review*, TSO, Cm 6237, July 2004.
18. David Smith, "We face post-election problems too", *Sunday Times*, 7 November 2004, wrote "third term tax rises are becoming an inevitability".
19. See ITEM Club, *Economic Outlook for Business*, Autumn 2004, 18 October 2004. ITEM wrote "ITEM's analysis of the public sector accounts for the first 5 months of the financial year suggests that tax revenues will fall short of the Chancellor's FSBR forecast by £6bn this year, making tax increases inevitable after the next election".
20. See, for example, Ruth Lea, *Tax 'n' spend: no way to run an economy*, CPS, July 2004.
21. Norman Blackwell, *Why Britain can't afford* not *to cut taxes*, CPS, October 2004.
22. Ruth Lea, *For the economy's sake, we cannot afford not to cut taxes*, CPS, November 2004.

ANNEX 1
ADDITIONAL TABLES

TABLE 1: GDP 1997=100, INTERNATIONAL COMPARISONS

Country	1997	2004	2004 rank	2005	2005 rank
Australia	100.0	**129.2**	**6**	**133.7**	**7**
Austria	100.0	115.3	21	118.0	22
Belgium	100.0	114.3	=23	117.2	23
Canada	100.0	**127.3**	**8**	**131.5**	**9**
Czech Republic	100.0	114.7	22	118.6	21
Denmark	100.0	113.5	26	116.4	26
Finland	100.0	**123.2**	**13**	**127.8**	**13**
France	100.0	117.9	18	121.0	19
Germany	100.0	109.2	29	111.5	29
Greece	100.0	**130.7**	**5**	**135.3**	**5**
Hungary	100.0	**131.3**	**4**	**136.3**	**4**
Iceland	100.0	**128.1**	**7**	**134.2**	**6**
Ireland	100.0	**158.4**	**1**	**165.7**	**1**
Italy	100.0	110.4	28	112.5	28
Japan	100.0	107.8	30	110.8	30
Korea	100.0	**133.8**	**3**	**141.7**	**2**
Luxembourg	100.0	**134.5**	**2**	**139.3**	**3**
Mexico	100.0	**122.3**	**15**	**127.5**	**14**
Netherlands	100.0	114.1	25	116.5	25
New Zealand	100.0	**122.9**	**14**	**126.0**	**15**
Norway	100.0	116.0	20	119.1	20
Poland	100.0	**126.2**	**10**	**131.8**	**10**
Portugal	100.0	114.3	=23	117.0	24
Slovak Republic	100.0	**127.1**	**9**	**133.2**	**8**
Spain	100.0	**125.1**	**=11**	**129.2**	**12**
Sweden	100.0	**121.2**	**16**	**124.6**	**16**
Switzerland	100.0	110.7	27	113.2	27
Turkey	100.0	**117.2**	**19**	**123.3**	**18**
UK	100.0	**120.2**	**17**	**123.5**	**17**
US	100.0	**125.1**	**=11**	**129.7**	**11**
Euro area	100.0	114.8		117.6	
Total OECD	100.0	119.3		123.2	

Source: OECD, *Economic Outlook*, *number 75*, June 2004.

Countries in bold achieved better rates of growth than the OECD average.

TABLE 2: CONSUMER PRICE INDICES, INTERNATIONAL COMPARISONS

Country	Average 1979-89	1997	2001	2002	2003	2004F	2005F
Australia	8.4	0.3	4.4	3.0	2.8	2.0	2.5
Austria	3.8	1.2	2.3	1.7	1.3	1.2	1.1
Belgium	4.9	1.5	2.4	1.6	1.5	1.6	1.4
Canada	6.5	1.6	2.5	2.2	2.8	1.1	1.7
Czech Republic	Na	8.5	4.8	1.8	0.1	3.0	2.5
Denmark	6.9	2.2	2.3	2.4	2.1	1.6	1.9
Finland	7.1	1.2	2.7	2.0	1.3	0.5	1.6
France	7.3	1.3	1.8	1.9	2.2	1.9	1.3
Germany	2.9	1.5	1.9	1.3	1.0	1.1	0.6
Greece	19.4	5.4	3.7	3.9	3.4	3.3	3.2
Hungary	Na	18.3	9.2	5.3	4.7	6.9	4.8
Iceland	38.1	1.8	6.4	5.2	2.1	2.5	3.5
Ireland	9.2	1.2	4.0	4.7	4.0	1.8	2.3
Italy	11.1	1.9	2.3	2.6	2.8	2.2	2.1
Japan	2.5	1.7	-0.7	-0.9	-0.3	-0.2	0.1
Korea	6.0	4.4	4.1	2.8	3.5	3.2	3.2
Luxembourg	4.7	1.4	2.	2.1	2.5	1.5	1.6
Mexico	65.1	20.6	6.4	5.0	4.5	4.4	3.2
Netherlands	2.8	1.9	5.1	3.9	2.2	1.2	0.8
New Zealand	11.8	1.2	2.6	2.7	1.8	2.1	2.4
Norway	8.3	2.6	3.0	1.3	2.5	0.5	2.0
Poland	Na	14.9	5.5	1.9	0.8	1.8	2.4
Portugal	17.5	1.9	4.4	3.7	3.3	2.0	1.7
Slovak Republic	Na	6.1	7.3	3.1	8.6	7.6	3.0
Spain	10.2	1.9	2.8	3.6	3.1	2.3	2.6
Sweden	7.9	0.7	2.4	2.2	1.9	0.5	1.6
Switzerland	3.3	0.5	1.0	0.6	0.6	0.2	0.6
Turkey	48.0	85.7	54.4	45.0	25.3	13.7	9.8
UK	7.4	1.8	1.2	1.3	1.4	1.4	1.9
US	5.5	2.3	2.8	1.6	2.3	2.3	2.0
Euro area	7.0	1.7	2.4	2.3	2.1	1.7	1.4

Source: OECD, *Economic Outlook*, *number 75*, June 2004.

TABLE 3: SPENDING REVIEWS: TME PLANS (£BN)

Date	Component	FY'98	FY'99	FY'00	FY'01	FY'02	FY'03	FY'04	FY'05	FY'06	FY'07
July 1998	DEL	168.8	179.2	190.1	200.2						
	AME	164.8	172.4	179.9	189.5						
	TME	333.6	351.6	370.0	389.7						
July 2000	DEL		176.8	195.2	212.1	229.3	245.7				
	AME		163.9	176.4	180.8	186.2	193.9				
	TME		340.7	371.6	392.9	415.4	439.6				
July 2002	DEL					239.7	263.5	279.8	301.0		
	AME					178.7	191.2	201.7	210.4		
	TME					418.4	454.6	481.5	511.4		
July 2004	DEL							279.3	301.9	321.4	340.5
	AME							208.3	218.9	227.8	239.5
	TME							487.6	520.8	549.2	580.0

DEL = Departmental Expenditure Limit (net of depreciation).

AME = Annually Managed Expenditure.

TME = Total Managed Expenditure.

The underlined data show the new spending plans for each Spending Review.

Latest data from: HM Treasury, *2004 Spending Review*, TSO, Cm 6237, July 2004.

ANNEX 2
DEFINITIONS USED IN THE PUBLIC FINANCES

FISCAL RULES

The golden rule: which states that, on average over the cycle, the government will borrow only to invest and not to fund current spending.

The sustainable investment rule: which states that public sector debt as a proportion of GDP will be held over the cycle at a stable and prudent level. The government believes that, other things being equal, it is desirable that public spending net debt should be below 40% of GDP over the cycle.

PUBLIC FINANCES – ACCOUNTS

The key terms and relationships are shown in the table below on public sector transactions by sub-sector and economic category:

1 Total current receipts	Taxes on income & wealth + taxes on production (including VAT) + other current taxes + taxes on capital + compulsory social security contributions + gross operating surplus + interest & dividends from private sector & RoW (rest of world) + interest & dividends (net) from public sector + rent & other current transfers
2 Total current expenditure	Current expenditure on goods & services + subsidies + net social benefits + net current grants abroad + current grants (net) within general government + other current grants + interest & dividends paid to the private sector & RoW
3 = 1-2	
Saving, gross plus capital taxes	
4 Less depreciation (conventionally shown as negative in the accounts)	
5 = 3+4	
Surplus on the current budget (current balance)*	
6 Total net investment	Gross fixed capital formation (GFCF) less depreciation + increase in inventories & valuables + capital grants (net) within public sector + capital grants to private sector + capital grants from private sector
7 = 6-5	
Net borrowing (NB)**	
8 Financial transactions determining the net cash requirement (NCR)	Net lending to private sector & RoW + net acquisition of company securities + accounts receivable/payable + adjustment for interest on gilts + other financial transactions
9 = 7+8	
Net cash requirement (NCR)†	

* The surplus on the current budget can also be defined as: current resources minus current uses (= net saving) plus receipts of capital taxes.

** Public Sector Net Borrowing (PSNB) is the net borrowing for the total public sector. It is the balance between income and expenditure in the consolidated current and capital accounts and is measured on an accruals basis.

† The Public Sector Net Cash Requirement (PSNCR) is the net cash requirement for the total public sector. It is measured on a receipts basis. The PSNCR can also be defined as public sector cash receipts minus public sector cash outlays. It was previously known as the Public Sector Borrowing Requirement (PSBR).