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II. Macroeconomic policy

Against the background of a small positive output gap and buoyant aggregate demand, the macroeconomic policy stance was fairly tight in 2000, but it has eased since. Short-term interest rates were raised early in 2000 and then remained unchanged, while fiscal consolidation continued, with the cyclically-adjusted primary surplus rising by another 0.3 per cent of GDP on a year-average basis. In the context of a significant drop-off in external demand, however, interest rates were brought down starting in early 2001, and concerns over the economic consequences of the terrorist attacks in the United States prompted further cuts. Stepped-up public spending combined with a small projected decline in the revenue ratio should amount to a significant easing in the fiscal stance in 2001 and beyond. Viewed in this light, monetary and fiscal policies have both turned from restrictive to supportive in 2001. However, since this shift in stance will take some time to work its way through the economy, its impact will mostly be felt in 2002.[10]

Against this backdrop this chapter analyses the evolution of the monetary and fiscal stance in more detail. It also reviews a selection of monetary framework issues that have been discussed publicly since the last *Survey*. Fiscal framework issues are dealt with in the special chapter of this *Survey* on public expenditure.

Monetary management

In the course of 2000, near-term growth prospects as seen by the Monetary Policy Committee (MPC) of the Bank of England did not change much, with projected output close to potential, while projected inflation remained subdued. Accordingly, the official repo rate was left unchanged after the February 2000 hike to 6 per cent (Figure 7). But towards the end of 2000 and more unambiguously in early 2001, the international environment started to deteriorate; as a result, activity looked set to weaken (Figure 8). With inflation projected to continue to run below the 2½ per cent target in the near future, the MPC decided to cut the official rates in three steps of 25 basis points each, in February, April and May. The weaker global environment, easier outturn data for activity in the second quarter, coupled with disquieting signals from some of the advance indicators and a strong exchange rate, led the MPC to proceed with an additional 25 basis point cut in

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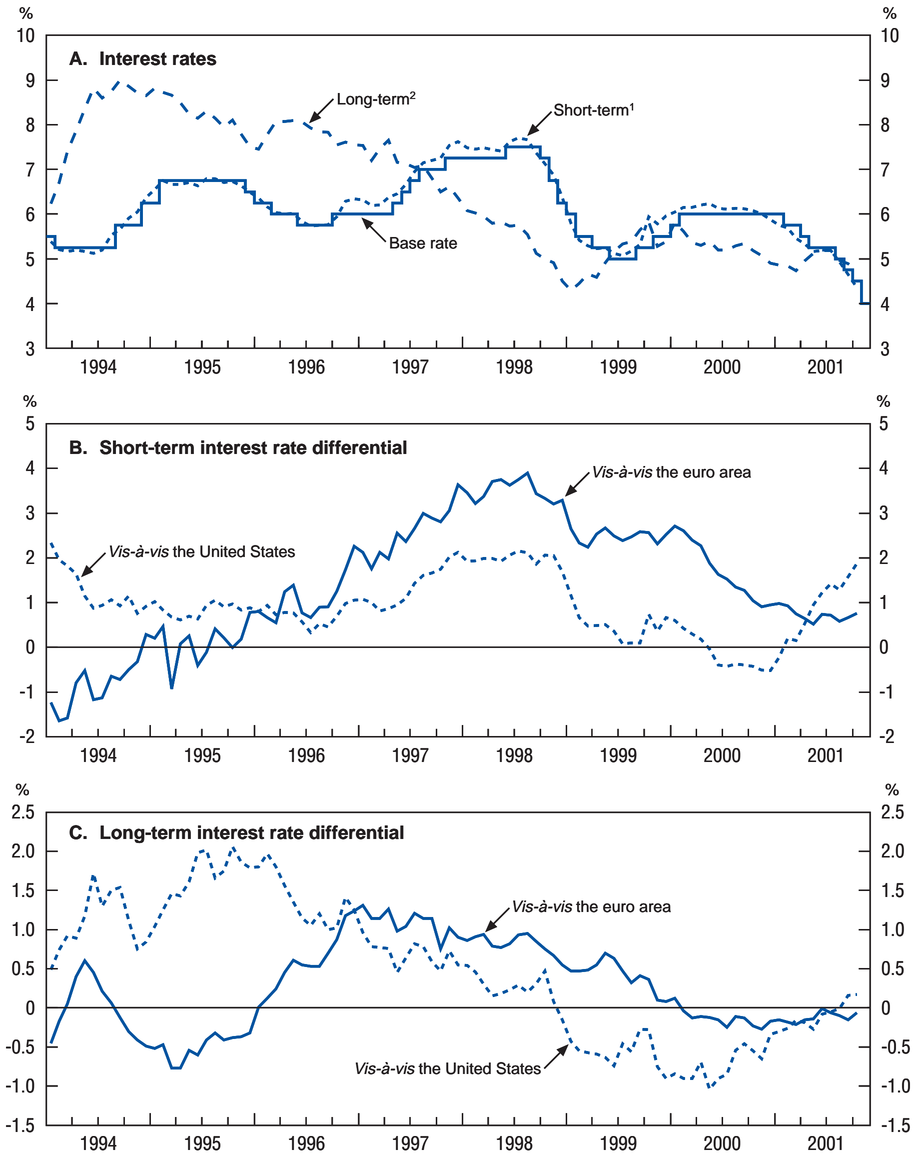
Figure 7. **Interest rates**
Per cent



1. Three-month interbank rate.
2. Central government ten-year Treasury bonds.

Source: ECB, *Monthly Bulletin* and OECD, *Main Economic Indicators*.

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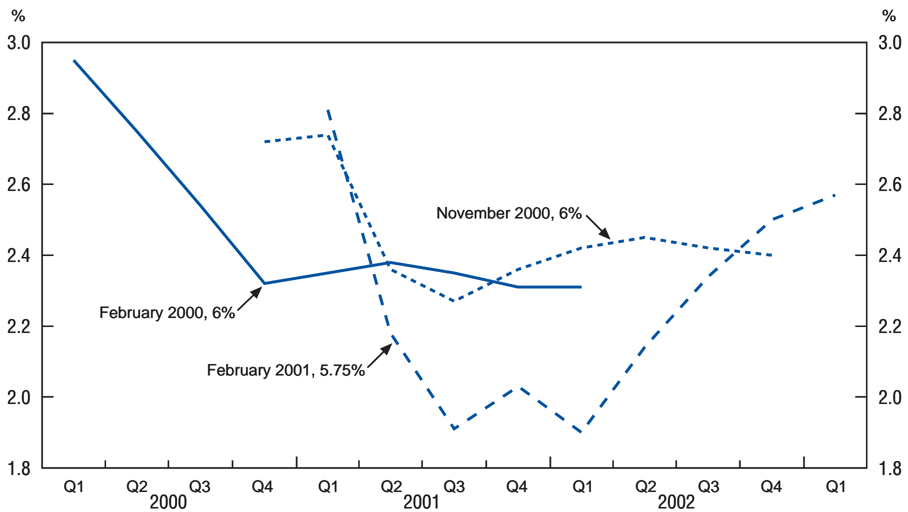
Figure 8. **MPC GDP projections**
Median constant-interest rate projection in the Inflation Report



Source: Bank of England.

early August, notwithstanding buoyant retail spending and household borrowing as well as close to double-digit house price inflation. Unlike the situation for most of the earlier rate changes, markets were taken by surprise by the August move. Despite those downward moves the repo rate of 5 per cent was 75 basis points higher than the corresponding euro area policy rate and 150 basis points above the US one. By domestic standards, however, it was as low as in mid-1999, which itself marked a trough since the early 1970s.

In its early-September meeting the MPC considered further moves to be unnecessary, but this decision was soon overtaken by the terrorist attacks in the United States, which prompted three further cuts in the repo rate, to a historical low of 4 per cent. The cuts were smaller than those by the Federal Reserve and of the same size as the European Central Bank's. As a result, the three-month interest rate spread against the euro has remained around 80 basis points since September, but the narrowing from the 2¾ percentage point spread in January 1999 is marked. On the other hand, long-term interest rates have increased a bit since the start of 2001, while consistently remaining a notch below euro area ones. It should be stressed that since mid-1997, when the Bank was given operational independence, both short-term and long-term interest rates have fluctuated within what

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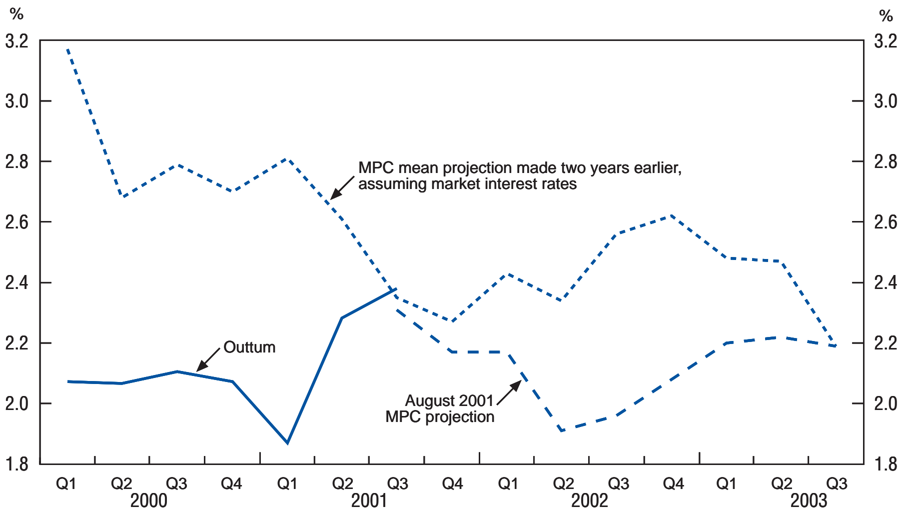
by UK historical standards is a remarkably compressed range. As regards the official repo rate, the range was indeed narrower than what market participants tended to expect, and also narrower than in the euro area.

Inflation has been close to target

As noted in Chapter I, inflation has remained low and stable in recent years. On the RPIX measure, which is the retail price index excluding mortgage interest payments targeted by the Bank of England, the 12-month rate of inflation has fluctuated between 1.8 and 3.2 per cent since mid-1997, when the current monetary policy framework was put in place. Between the spring of 1999 and summer 2001, it has consistently undershot the symmetric 2½ per cent target, and since the last OECD *Survey*, published in mid-2000, it has averaged 2.1 per cent. Actual inflation has thus systematically surprised the MPC (Figure 9) as well as private sector forecasters on the downside, even though in August 2001 it rose to just above the inflation target.[11] It has to be stressed however, that the strength of sterling, which is a key driver underlying these developments, was largely unanticipated by the MPC and outside observers alike and could not have been reasonably factored into interest rate policy decisions *ex ante*.[12] In the light of

Figure 9. **Projected *versus* observed RPIX inflation**

Annual percentage change



Source: Bank of England and National Statistics.

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historical inflation volatility and taking into account the fact that since the inception of the present regime in 1997 it has averaged 2.4 per cent, inflation can fairly be judged to have stayed remarkably close to target. Indeed, the Governor of the Bank of England has confessed his "amazement" at not having had to write the Chancellor any explanatory letters thus far.[13]

A number of alternative measures confirm that inflation has been very subdued. HICP inflation has averaged only 1.3 per cent since mid-1997. In fact, on this indicator, a distinctly greater measure of price stability has been achieved in the United Kingdom since the start of 1999 than in the euro area, with HICP inflation averaging just over one per cent in the former against close to 2 per cent in the latter. Turning to core inflation measures, which attempt to strip out temporary departures from trend, a similar picture emerges. RPIY inflation, which excludes indirect taxes from the RPIX, has almost uninterruptedly remained below RPIX inflation since the mid-1990s. Trimmed mean inflation, which excludes the 15 per cent largest and smallest price changes, averaged 2 per cent since mid-1997, and 1.8 per cent in the two years to mid-2001. Against this background, and with the latest MPC central projection involving persistent undershooting of RPIX inflation through early 2003, some on and outside the MPC have argued that monetary policy has been overly tight,[14] while others have proposed to lower the inflation target.

Were monetary conditions too harsh?

The evolution of monetary conditions can be gauged using a variety of measures. Looking at interest rates alone may not be enough when the exchange rate, which also directly and significantly affects aggregate demand, moves around. Some central banks therefore calculate and publish Monetary Conditions Indices (MCIs), which jointly reflect interest rate and exchange rate movements.[15] Traditional MCIs are weighted averages of the percentage point change in the domestic interest rate and in the exchange rate *vis-à-vis* some base period. The weights typically represent the estimated relative impact on aggregate demand of interest and exchange rate changes. Recent research at the Bank of England by Batini and Turnbull (2000) has attempted to overcome some of the shortcomings plaguing traditional MCIs with the development of a dynamic MCI (DMCI). It explicitly takes into account the lags with which interest rates and exchange rates affect GDP, with interest rate changes starting to bite two quarters down the road, but exchange rate movements impacting on activity with a much longer lag.

The DMCI points to a significant tightening of monetary conditions during the two years ending in the spring of 1999 (Figure 10)[16] and signals that conditions eased marginally during the following year, but have become somewhat more restrictive since mid-2000. Given the aforementioned lags, conditions are bound to continue to have tightened until mid-2001, before easing again thereafter.[17] In common with static MCIs, the DMCI is not a gauge about whether monetary policy

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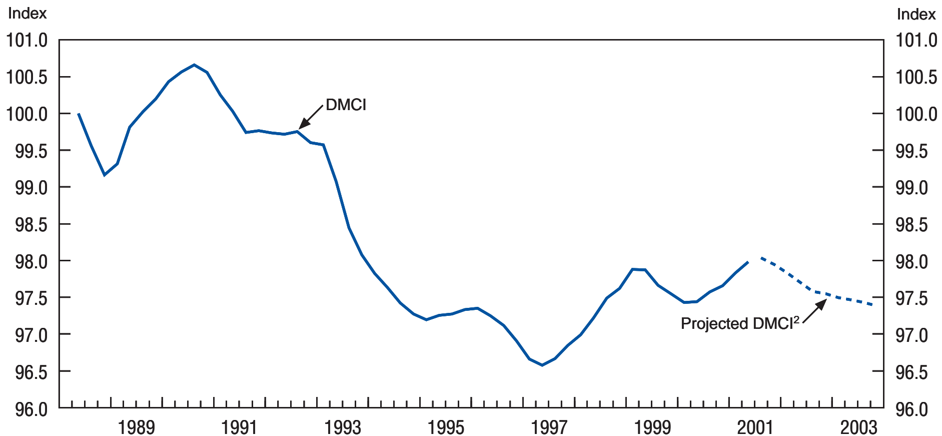
Figure 10. **Dynamic monetary condition index**[1]
June 1988 = 100



1. A downward movement in the index indicates an easing of monetary conditions while an upward movement represents a tightening.
2. On the basis of the central assumptions in the August 2001 Inflation Report.
Source: Batini and Turnbull (2000) and OECD.

is too tight or too loose. It is only an indicator of whether monetary policy has tightened or has become looser. Moreover, the DMCI's exchange rate weight is much lower than the weight usually found in static MCIs.

The pain endured by many producers in the tradeable sector, as described in the previous chapter, reinforces the impression that the exchange rate has been strong. However, even if the effective exchange rate is widely reckoned to be too strong, there is no obvious lever for the authorities to pull to correct this misalignment.[18] Moreover, monetary policy in any currency area has to be set in accordance with area-wide rather than regional or sectoral conditions. Overall, inflation outcomes would tend to suggest that the monetary stance has, if anything, erred on the restrictive side.

On the other hand, the evolution of key money and credit aggregates can hardly be taken to suggest that monetary policy throttled growth (Figure 11). In fact, on that score, concerns have been voiced that corporations have built up excessive debt, with debt-to-profit ratios reaching historical highs, contributing to a sharp increase in the number of rating downgrades in 2001. But income gearing (*i.e.* the ratio of interest payments to pre-tax profits) remains well below earlier peaks, despite its increase in recent years. Lending to households has also been

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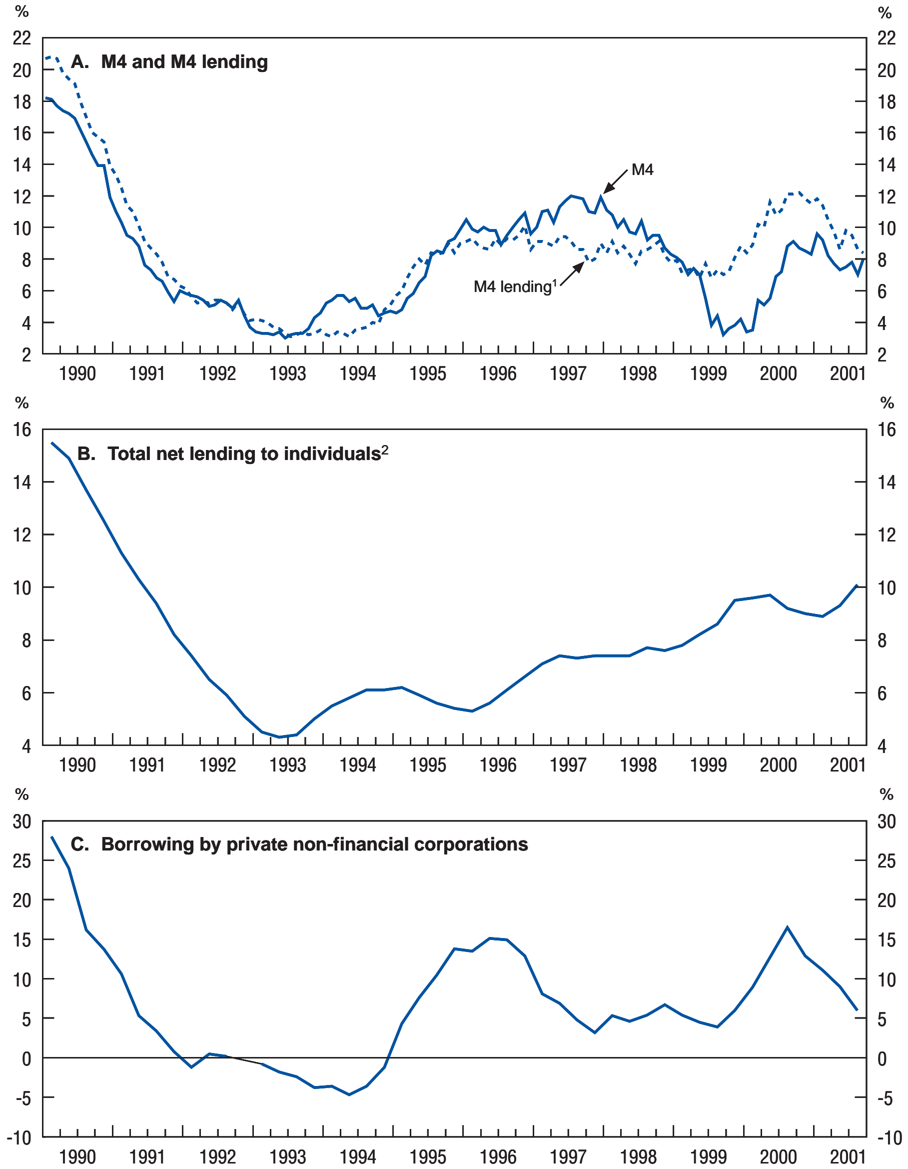
Figure 11. **Money and credit**
Annual percentage change



1. M4 lending measures bank and building society lending to the rest of the private sector.
2. Households excluding non profit making institutions and unincorporated businesses.
Source: Bank of England.

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rising fast, with default rates on credit cards for example on the rise since 1999. Spurred by heightened competition between banks, mortgage-loan-to-income ratios have been rising substantially, although mortgage payments as a share of household income remain around their long-run levels, and far below the ominous levels around the end of the 1980s. In addition, the share of mortgage loans in arrears is at its lowest since the early 1980s. In this context, the authorities consider that overall households' balance sheet positions remain sounder than in the late 1980s.[19]

Can the monetary policy framework be improved further?

With the benefit of hindsight, few observers, if any, would dispute that the changes to the monetary policy framework introduced in spring 1997 have significantly improved it. Nonetheless, suggestions have been tabled to amend some of the features of the current regime, in particular as concerns the definition of the target, the forecast and forecasting process, the degree of transparency and accountability and the appointment and terms of MPC members.[20, 21]

Since 1997, the numerical inflation target is spelled out annually by the Chancellor of the Exchequer in the budget. At the time, the Treasury indicated that the "presumption is that there will be no changes during the present Parliament. However, the target could be lowered if the Government judges that an improvement in the underlying performance of the economy or international trends justifies such a move" (HMT, 1997). In light of the aforementioned sustained undershooting of the target, and with a view to more closely align it with the ECB's objective, some have suggested to lower it to 2 per cent (Pain and Kneller, 2001). The undershooting, they argued, means that shifting the target down by half a percentage point could be done seamlessly. The proposal to settle on 2 per cent takes into account the formula bias between RPIX and HICP, which currently explains half a percentage point of the gap between annual HICP and RPIX inflation (Figure 12),[22] on the assumption that the difference in coverage between the two indices does not impart any lasting bias:[23] targeting RPIX inflation at 2 per cent would then be broadly equivalent to an HICP objective of around 1½ per cent, which can be interpreted as the implicit ECB medium-term notion of price stability (OECD, 2001*a*). While in the long run such a redefinition of the target would translate into a downward shift of nominal interest rates, it would call for tighter monetary policy in the short run.

The proposal to lower the target raises a number of questions, however. *First*, it remains to be established that a target significantly below the current one would not be too low. The ECB's recent experience can be interpreted as illustrating the difficulties associated with an overly "ambitious" quantitative definition of price stability (OECD, 2001*a*). On the other hand, durable undershooting in the United Kingdom does not appear to have harmed growth and employment, although the counterfactual is hard to pin down. *Second*, it would have been problematic, and might

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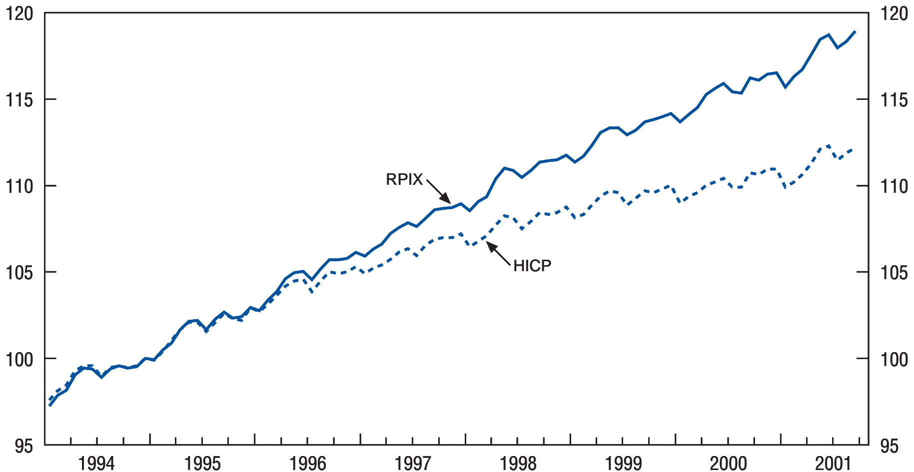
Figure 12. **Drifting apart**

December 1994 = 100



Source: National Statistics.

still be in the near future, to change the target so soon after the inception of the new regime, and before the latter was tested more fully.

A closely related issue pertains to the choice of the targeted index. One option would be to target the HICP directly, thus going one step further than the above suggestion. Another would be to target some smoother measure of inflation. In both cases, the corresponding numerical target might be below 2½ per cent, although that need not correspond to an effectively lower rate of inflation. Over time, the index switch might help bring down perceived and anticipated inflation.[24] In turn, lower inflation expectations would translate into more moderate wage settlements. But the merits of targeting the HICP would of course become more palatable in the context of prospective euro area membership, or at least once the HICP includes a measure of owner-occupied housing costs. As long as the latter are excluded, the HICP is unlikely to be used as the benchmark in wage-setting and more broadly, to anchor the public's perception of inflation.

A feature of the MPC forecast that has given rise to debate is the fact that, as put by one commentator, it resembles a Victorian novel, in that it always has a happy ending, with inflation after two years at or very close to 2½ per cent, the only suspense residing in how the plot will unfold along the way. This analogy is

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somewhat misleading, however, insofar as a key dimension of the story depicted in the fan chart pertains to the degree of symmetry of the envisaged outcomes around the central forecast ("the news is in the skews"). Moreover, at least some of the MPC members have indicated that that they see the 2½ per cent forecast as just an intermediate target to help the MPC achieve the objective set by the Government, and that they would not necessarily wish to adjust policy to always keep two-year-ahead projected inflation exactly at 2½ per cent (Kohn, 2000).[25]

Although the Bank of England is far more transparent than most other central banks, some former MPC members advocate even greater openness. In particular, it has been argued that the minutes of the MPC meetings should spell out more explicitly the reasons underlying each member's vote so as to enhance individual accountability (Budd, 2000).[26] Alternatively, it has been proposed that the Governor, instead of the MPC, take personal responsibility for the *Inflation Report* and for the forecast therein, which would be approved by the MPC but without committing each member individually, and allowing members to come out with dissenting forecasts (Goodhart, 2001).[27] It is not obvious, however, that more transparency of this sort would provide for more clarity. It might also stifle the debate within the MPC, which at present is genuinely open and allows participants to change their minds if swayed by others' arguments. Furthermore, individual MPC members already publicly explain their views and votes when periodically questioned by the Treasury Select Committee as well as in the speeches they give.

Another issue concerning the framework that has been raised by a number of observers and also by Bank staff is the frequency of MPC meetings.[28] The 1998 Bank of England Act stipulates that the MPC should meet every month, which is more frequent than in the United States. An argument against meeting less often is that much of the relevant news comes in a monthly cycle. Moreover, the Bank has recently streamlined the process, so that the associated demands on staff and policymakers' time have been eased.

Alongside the Governor, two deputy governors, and two executive Bank directors, the MPC includes four "outside" experts, who are nominated by the Chancellor of the Exchequer. The House of Commons Treasury Committee examines new members. Some parliamentarians in this Committee have, however, long demanded a bigger say in the choice of these MPC members, believing that they should be allowed to conduct US-style confirmation hearings with the ultimate right of veto over government appointees. There are also suggestions that the outside MPC members be given fixed, non-renewable five- or six-year terms, instead of the current three-year renewable terms. By precluding reappointment, such an arrangement would insulate members more clearly from perceived or actual political pressure. The Government considers that it is already difficult to get outstanding experts to accept a three-year career break and that there is no evidence to

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suggest that any appointment or re-appointment would have been influenced by expected or past voting behaviour (Balls, 2001).

Important as they are, the above are not the only aspects of the framework that are at times questioned. One more fundamental dimension pertains to the Bank of England's independence. The 1997 reform granted it "instrument independence", *i.e.* full independence to set interest rates, but the target – both the index and the number – continues to be set annually by the Treasury. This is done in an open, transparent and explicit way. In addition, the Chancellor decides on currency intervention and more generally on exchange-rate policy. Only in very exceptional circumstances, the Treasury is entitled to override MPC interest rate decisions. While the Bank of England is very transparent and has full operational independence, the Bank of England remains less independent than the European Central Bank in certain respects,[29] and a legislative change would be required if the United Kingdom were to join the euro area.[30]

The fiscal stance

Recent evolution

Fiscal consolidation has been impressive in recent years in the United Kingdom, not least when compared with the EU average (Figure 13). While the EU saw its fiscal position improving from a 2.5 per cent deficit of GDP in 1997 to virtual balance in 2000, the United Kingdom turned its 2 per cent deficit into a 2 per cent surplus – excluding third-generation mobile phone (UMTS) auction proceeds in both cases. Concomitantly, the UK gross debt ratio had declined to under 43 per cent of GDP, against 64 per cent for the EU as a whole, helped in 2000 by large UMTS auction proceeds, equivalent to 2.4 per cent of GDP. As stressed in the previous *Survey*, the extent of fiscal adjustment has been equally remarkable by the standards of the United Kingdom's own past. It has also consistently exceeded what had been projected *ex ante* in budgets, reflecting a combination of revenue overshooting and spending undershooting underpinned by sustained strong growth (Table 2).

Going forward, however, from an admittedly strong fiscal position, the fiscal stance is easing over time, in line with the projections already set out in Budget 2000 and confirmed in Budget 2001.[31] Over the medium term, the Government is now projecting a deficit of around one per cent of GDP, both in unadjusted and on a cyclically-adjusted basis (since the output gap is projected to remain very small). Correspondingly, the net debt and net worth ratios would not change much from FY2001/02 onwards. The projected move into a small deficit is consistent with the government's fiscal rules and is mainly the result of increased investment spending to redress past under-investment. The move to a moderate deficit contrasts with the European Union as a whole, where a zero balance was

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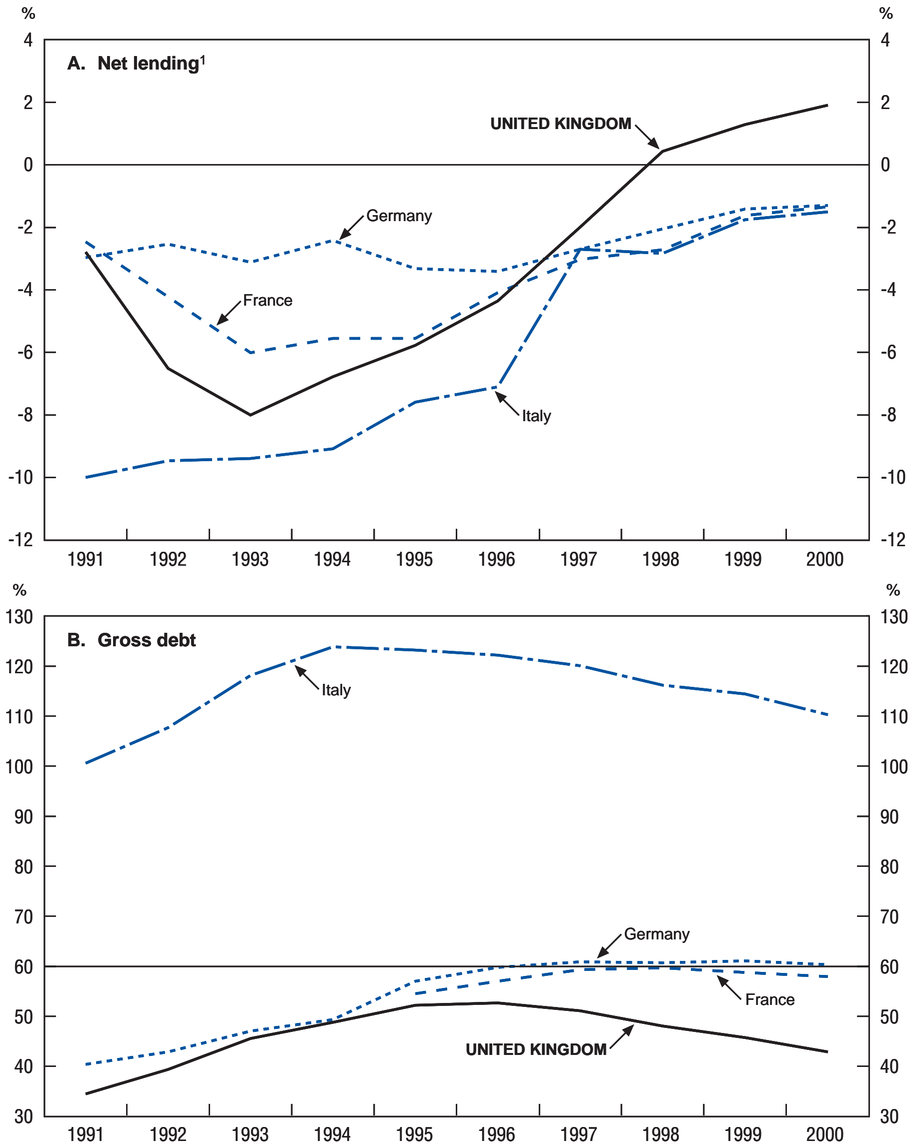
Figure 13. **Fiscal position with respect to the Maastricht criteria**
As a per cent of GDP



1. For 2000, excludes receipts from sale of UMTS licences where applicable (in line with national UK practice). This affects in particular Germany and Italy where net lending would be 1.2 and –0.3 per cent respectively.

Source: National Statistics and Eurostat.

Table 2. **Public sector finances: selected summary indicators**

As a per cent of GDP[1]

	1999/2000	2000/01	Budget 2001 projections				
			2001/02	2002/03	2003/04	2004/05	2005/06
Flow							
Current receipts							
Budget 1999	39.2	39.4	39.5	39.6	39.7	. .	. .
Budget 2000	39.6	39.7	39.9	39.8	39.4	39.3	. .
Budget 2001	39.6	40.5	40.2	40.1	39.8	39.9	39.8
Latest estimate	39.4	40.0					
Current expenditure							
Budget 1999	37.4	37.4	37.1	37.1	37.1	. .	. .
Budget 2000	36.2	36.8	36.9	37.1	37.2	37.2	. .
Budget 2001	35.9	36.6	37.1	37.3	37.5	37.5	37.5
Latest estimate	35.7	36.1					
Depreciation	1.4	1.3	1.6	1.5	1.5	1.5	1.5
Gross investment[2]	2.5	2.5	3.1	3.4	3.6	3.6	3.6
Net investment[2, 3]	0.5	0.7	1.1	1.5	1.7	1.8	1.8
Cyclically-adjusted balances							
Surplus on current budget							
Budget 1999	0.6	1.0	1.1	0.9	1.0	. .	. .
Budget 2000	1.8	1.3	1.3	1.0	0.7	0.7	. .
Budget 2001	1.9	2.1	1.4	1.1	0.6	0.7	0.7
Latest estimate	2.3	2.7					
Net lending[4]							
Budget 1999	0.0	0.2	0.1	–0.3	–0.4	. .	. .
Budget 2000	1.2	0.5	0.3	–0.5	–1.1	–1.1	. .
Budget 2001	1.6	1.4	0.3	–0.3	–1.1	–1.1	–1.1
Latest estimate	1.8	2.0					
End-period stocks							
Public sector net debt	36.7	31.7	30.3	29.6	29.7	29.9	30.0
Net worth	17.4	18.8	21.3	21.6	21.4	21.0	20.4
Stability and Growth Pact indicators							
Balance[4]	1.7	1.7	0.5	–0.1	–0.9	–0.9	–1.0
Debt ratio	43.7	40.6	37.6	36.1	35.7	35.6	35.6
Memorandum item							
Output gap	0.2	0.6	0.5	0.3	0.2	0.1	0.0

1. Budget 2001 unless noted otherwise
2. Latest estimate for FY2000/01.
3. Equals gross investment minus asset sales and depreciation.
4. The receipts from the UMTS licence auction (amounting to 2.4 per cent of GDP) are treated as rental payments and spread over the duration (21 years) of the licences.

Source: HM Treasury.

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Table 3. **Key fiscal aggregates on a national accounts basis**
General government, calendar year, as a per cent of GDP

	1993	1994	1995	1996	1997	1998	1999	2000	2001[1]	2002[1]	2003[1]
Flows											
Total expenditure	43.2	42.6	42.2	40.7	38.9	37.7	37.1	37.0	38.4	39.4	39.8
Current receipts	35.3	35.9	36.5	36.3	36.7	38.1	38.2	39.0	39.5	39.4	39.1
Financial balances											
Net lending	–7.9	–6.7	–5.8	–4.4	–2.2	0.4	1.1	1.9	1.1	0.0	–0.7
Primary balance[2]	–5.7	–4.1	–2.8	–1.6	0.8	3.2	3.5	4.1	2.9	1.8	1.0
Structural balance[2]	–5.6	–5.6	–5.0	–3.7	–2.0	0.4	1.4	1.9	1.2	0.4	–0.5
Primary structural balance[2]	–3.5	–3.1	–2.1	–0.9	1.0	3.2	3.8	4.1	3.0	2.1	1.2
Gross saving	–6.7	–5.7	–4.7	–4.1	–2.4	0.2	0.9	1.6	1.6	0.7	0.1
Government debt											
Gross[3]	45.4	48.5	51.8	52.3	50.8	47.6	45.2	42.4	41.3	40.5	40.2
Net	30.9	31.1	36.9	38.7	40.1	41.9	36.7	33.1	30.5	29.2	28.5

1. Projections.
2. As a per cent of potential GDP.
3. Maastricht definition.
Source: OECD.

projected for 2003 in the latest vintage of stability and convergence programmes. On the other hand, a deficit of the Union as a whole of a similar size to the United Kingdom is projected in the autumn 2001 *Economic Outlook*. These OECD projections also suggest that the move into a small deficit may be a bit more pronounced than implied by the Budget (Table 3).

This raises two questions. *First*, how "safe" is a 1 per cent deficit compared with the margins needed to avoid being pushed over the 3 per cent Stability and Growth Pact threshold in the event of a slowdown? Treasury estimates suggest that the UK economy can allow the automatic stabilisers to operate fully without breaching the Maastricht Treaty 3 per cent reference value. *Second*, might fiscal outcomes continue to outshine budget projections, in which case the available margins would in fact be more comfortable? In the current situation, however, some of the pleasant fiscal surprises witnessed lately and partly built into the projected revenue ratios, are less likely to reoccur. However, the assumptions underpinning recent budget projections are deliberately cautious, which helps ensure fiscal sustainability.

Budget projections and outcomes to date

Budget 2000, covering the financial year April 2000-March 2001, was made public in March 2000 and its main features were described in the last *Survey*. Taking into account the latest data, current revenue has exceeded and current spending has undershot Budget 2000 projections, respectively by 0.3 and 0.7 percentage

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points of GDP. Coupled with a 0.2 percentage point of GDP shortfall in planned net investment, this led to net lending turning out 1.3 per cent of GDP above the Budget 2000 projection – a surplus of 2.0 per cent of GDP compared with the 0.7 per cent in the Budget.

As in previous years, "over-performance" resulted to some extent from the deliberately cautious assumptions underpinning the budget, but there were also other reasons. The revenue surprise in FY2000/01 stemmed mainly from extra income tax receipts (0.7 percentage point of GDP) and social security contributions (0.1 percentage point), as a result of higher and perhaps also more unequal than anticipated regular earnings and bonuses. Much of this was, however, offset by slight weakness in Corporation Tax, value added tax (VAT) and various other taxes. The bedding in of the still relatively recent self-assessment system may also have played a role, with incomes that heretofore had remained undeclared now recorded and taxed.[32] On the spending side, social security and debt interest outlays came in lower than budgeted, reflecting the fall in unemployment, lower-than-projected interest rates and the larger-than-projected fall in public debt associated with the UMTS auction proceeds. As a matter of fact, virtually all departments spent less than originally planned. This might be partly because they can now carry forward entitlements that were not spent during the fiscal year. Difficulties in setting up various kinds of public-private partnership contracts may also have caused delays.

Budget 2001 was unveiled on 7 March 2001. It contained a number of new measures and confirmed the implementation of others that had been announced in the November 2000 *Pre-Budget Report* or in earlier budget documents. The measures coming into effect in FY2001/02 included:

– An increase of the threshold for the 10 per cent starting rate of the personal income tax by £300 on top of indexation for inflation, which over the medium run will reduce tax receipts by £1 billion per annum (or about 0.1 per cent of GDP).

– A freeze of fuel duties (plus a £1 billion-worth cut for ultra-low sulphur diesel and petrol), and a mere indexation of duties on tobacco products on projected inflation. This contrasted with the automatic annual increases ("escalators") that had prevailed between 1993 and early 2000, justified *inter alia* by environmental and health considerations. The end of the escalator regime has to be seen against the background of the fuel protests and oil refinery blockades that disrupted activity in September 2000 and of the increasing concerns about cross-Channel tobacco smuggling.

– A freeze of alcohol and automobile vehicle excise duties and the abolition of the betting tax (replaced with a tax on bookmakers' gross profits).[33]

– The implementation of the climate change levy applicable to energy use in the business, public and agriculture sectors, which together account for one third of carbon dioxide (CO_2) emissions. It is to raise

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around £1 billion per annum but the associated revenue is recycled through a 0.3 percentage point cut in employer national insurance contributions (implying a net gain for some labour-intensive sectors).

- Various tax relief measures targeted at deprived areas (complete stamp duty exemption for all property transactions, lower VAT rate on conversion of dwellings).
- Additional resources for hospitals and schools, over and above what was committed in Spending Review 2000, which itself exceeded the amounts enshrined in Budget 2000. The Departmental Expenditure Limit for education was raised by £290 million and that for health by £360 million for FY2001/02 (and by similar amounts for the next two years).
- Increases in various family-oriented tax credits compared with the amounts envisaged earlier (for the children's tax credit [CTC], which from April 2001 replaced the married couples allowance that was repealed in April 2000) or compared with mere indexation on inflation (*e.g.* for the working families tax credit [WFTC], which was introduced in October 1999, and for the childcare tax credit limits within the WFTC).
- A 7.4 per cent increase in the basic state pension from April 2001 (to be followed by a 4.1 per cent increase one year later) and a sizeable increase in the minimum income guarantee for pensioners. In total, the pensioners' package is projected to cost £1.6 billion in FY2001/02 and £2.4 billion in FY2002/03.

Budget 2001 also contained measures to come into effect after FY2001/02, of which: the introduction of a year-long CTC top-up for new-born babies of up to £10 per week, as well as an increase in various maternity benefits, starting in FY2002/03; the introduction of two-week paid paternity leave for working fathers from FY2003/04; and a sizeable increase in age-related personal allowances (above indexation) from FY2003/04.

Outturn data for the first five months of FY2001/02 up to August 2001 suggest an acceleration of both current and capital spending, combined with more subdued revenue increases. As a result, public sector net borrowing rose to 0.9 per cent of GDP, from –0.2 per cent a year earlier.[34] Among the unforeseen developments, the foot-and-mouth crisis is estimated to add at least 0.1 per cent of annual GDP to net budgeted spending (for details, see Annex I).

A number of other measures, spelled out in recent budget documents or in the Government's June 2001 strategy on enterprise and productivity (HMT and DTI, 2001), are still up for consultation. Several of them are discussed in Chapter III. They notably relate to:

- The extension of research and development tax credits to larger companies.

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- The tax regime applicable to gains arising on the disposal of substantial shareholdings.
- The taxation of intellectual property, goodwill and other intangibles.
- The introduction of an optional flat VAT rate for smaller firms simply calculated as a percentage of their taxable turnover.
- The consolidation of child-related income support payments, the WFTC and the CTC into a means-tested integrated child credit, which would be introduced in April 2003.
- The extension of the principle of the WFTC to childless low-income families in the form of a means-tested employment tax credit.
- The creation of a pension credit, from 2003, allowing pensioners to benefit from modest private incomes.
- The creation of a new tax credit for community investment that would support projects in deprived areas which cannot attract financing on market terms even if they stand a fair chance to become commercially viable over time.
- The encouragement of saving through "asset-based welfare" schemes (see Annex IV).

Several of these measures have significant and intended redistributional effects in favour of lower income groups, as have the tax and benefit changes that have already been introduced in recent years. Some of the measures may be quite costly and would come on top of existing medium-term spending plans, although the final shape of the measures may significantly depart from the original blueprints, as illustrated by the case of the climate change levy. Moreover, the contingency reserves built into the 2001 Budget have already largely been spent *inter alia* on fighting foot-and-mouth disease and on improving rail safety after the Hatfield crash, prompting a call from the Treasury to spending departments to refrain from demands for further top-ups of expenditure limits.

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Notes

1. It has been argued that the gap between US productivity and growth performance on the one hand, and UK and euro area performance on the other, may be overstated because efforts to better measure the "new economy" have started later in Europe than across the Atlantic (not least because it took off later in Europe). Views differ on the importance of the possible statistical distortion, see *inter alia* Kodres (2001), Vaze (2001), Oulton (2001), King (2001), Wadhwani (2001), Lequiller (2001) and Schreyer (2000).
2. International comparisons of rates of return on capital are compromised by the often poor quality of capital stock data and different methodologies used in each country to calculate them.
3. On an inflation-adjusted basis – *i.e.* controlling for the real capital losses on nominal wealth caused by inflation – the saving ratio was significantly higher in 2000 than in the late 1980s, but its decline in the course of the 1990s is similar on both measures (Davey, 2001).
4. For the impact of different types of wealth increases on consumption, see Boone *et al.* (2001).
5. Annex II discusses the degree of overvaluation of sterling. Effective appreciation is driven by the weakness of the euro and masks a significant depreciation *vis-à-vis* the US dollar.
6. Youll (2001) documents the short-run noise imparted by bonus payments, noting that over the longer run their share in the total paybill tends to increase.
7. Demutualisations reached a peak in 1997, when the windfall amounted to £37 billion. E*x post*, it appeared that less than one quarter thereof was actually spent within a year.
8. In 1999, the United States accounted for 17 per cent of UK exports, while France and Germany accounted for, respectively, 9 and 12 per cent, and the European Union represented 53 per cent. For Germany the respective shares are 10 and 58 per cent and for France 10 per cent and 61 per cent. The data for France are for 1998.
9. With a remit defined in terms of inflation and not price level (see Chapter II), monetary policy would not necessarily have to tighten if the exchange rate shock were expected to have only a one-off price-level effect, without any tangible second-round effects.
10. Fiscal policy lags have been investigated recently by Blanchard and Perotti (2000) and Fatás and Mihov (2001), but using US data only. Given that the lags are shown to depend on the composition of the change in the stance – in particular on whether it stems from the tax or the spending side – and on the institutional set-up (*e.g.* tax collection lags) the specific numerical results obtained by these authors may not carry over to the United Kingdom.

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11. In fact, since the onset of inflation targeting in late 1992, the four-quarter ahead forecast as recorded by Consensus Economics has on average turned out to be about half a percentage point too high.
12. The exchange rate is by no means the only source of surprises. Policymakers have also been surprised by revisions of the past, notably because of a consistent downward bias plaguing preliminary GDP estimates, documented by Barklem (2000), Symons (2001) and, in a rather unflattering comparison across G7 countries, Faust *et al.* (2000).
13. If RPIX inflation deviates more than one percentage point on either side of the symmetric 2½ per cent target, the Governor has to write a public letter to the Chancellor of the Exchequer explaining why and setting out the measures being taken to bring inflation back to the target.
14. For example, the Treasury Select Committee recently concluded: "We commend the MPC on establishing a high level of credibility; however we are concerned that in an effort to establish such credibility the MPC may have biased policy towards undershooting the target" (Treasury Select Committee, 2001).
15. Among OECD countries, cases in point include Canada and New Zealand, although in both countries less emphasis is now put on such measures than hitherto.
16. A permanent one percentage point increase in the DMCI would correspond to a permanent increase of a bit more than one percentage point in the real interest rate, or to a permanent 21.7 per cent real effective exchange rate appreciation.
17. In Figure 10, the projected DMCI is based on the assumption that RPIX inflation evolves as does the central projection in the August 2001 *Inflation Report* constant interest rate-based fan chart and that the effective exchange rate depreciates by close to 2 per cent at a two-year horizon, as assumed in this report.
18. Announcing entry into the euro area at a weaker rate *vis-à-vis* the euro, if credible, could be thought to help. But irrespective of the political considerations associated with what amounts to a constitutional rather than a monetary policy decision, such a move might not lead to a weaker effective exchange rate over the medium run, if at that horizon the euro, which is widely regarded as being undervalued, were to appreciate a lot.
19. The impact on financial fragility of these aggregate credit trends importantly depends on heterogeneity across sectors, firms and households, but this aspect relates to supervision – discussed in Chapter III – more than to the monetary stance. It may also be noted that the 1974 Consumer Credit Act is being reconsidered, with a view to target loan sharks, to reduce burdens on legitimate businesses, to ensure that market changes are better reflected in consumer credit conditions and to provide more timely and effective advice to consumers when they take out loans.
20. Some of the suggestions appeared in a report prepared by D. Kohn, Director of Monetary Affairs at the US Federal Reserve Board. This external audit and the Bank's response were published in late 2000, even though they deal with a number of sensitive matters which by the standards of traditional central banking culture would be considered as strictly internal.
21. The previous *Survey* discussed the constant interest rate assumption and this debate is not reopened here. Another debate that is not entered into here revolves around the role asset prices should play in setting monetary policy, given their role via wealth and balance sheet effects (Cecchetti *et al.*, 2000). For a concrete example of how house and share prices can be taken into account in broad financial conditions indices, see Goodhart and Hofmann (2001).

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22. The bulk of the spread between RPIX and HICP inflation in recent years stems from the weighting methodology and from the treatment of housing:
    - At the lowest level of aggregation, prices are averaged using an arithmetic mean in the case of the RPIX, versus a geometric mean in the case of the HICP. In the presence of relative price variability, geometric averaging results in a lower measure of aggregate inflation. This is one of the features of the RPIX currently being reviewed by National Statistics (alongside quality adjustment, outlet selection, treatment of discounts and appropriate index population).
    - The RPIX encompasses an estimate of the notional amount that home owners would need to regularly set aside to preserve the quality of their estate, based on an index of house prices. In contrast, the HICP has no owner-occupied housing component.
23. In recent years, and largely reflecting rapid increases in house prices, the difference in coverage has on average accounted for around half a percentage point of the wedge between the HICP and the RPIX. It is hard to foresee how persistent this wedge will be in the future.
24. The long-standing Basix survey of inflation expectations shows that the general public, unlike other groups, continues to anticipate an inflation rate of close to 4 per cent. Several reasons may account for what might look like exceedingly sluggish adaptive expectations. *First*, the survey fails to specify the measure of inflation, possibly inviting respondents to take into account asset prices for example. *Second*, the survey asks to choose from a misleadingly wide range of figures (from "below zero" to "greater than 10 per cent"); a recent survey carried out by the same polling organisation for the Bank of England and offering a more restricted set of options (from "gone down" to "up by 5 per cent or more") suggests that the public's expectations are much lower and close to 2½ per cent. *Third*, the distribution of answers in the Basix survey is highly skewed, so that the mean is inflated by a few awkwardly high outliers. Moreover, if the public really expected 4 per cent inflation, nominal wage demands would presumably well exceed what is actually observed.
25. A more technical discussion of the optimal horizon for monetary policy is offered by Batini and Nelson (2000).
26. In theory, this could result in as many as 10 different views being aired: one for each MPC member plus the "collective view", which may not coincide with any of the individual views.
27. For the time being, dissenting views are reflected without attribution in Table 6B of the *Inflation Report*, which since August 1999 spells out the effects on RPIX inflation and GDP growth of assumptions deviating from those underlying the central projection.
28. This was, for instance, discussed by the House of Lords Select Committee on the Monetary Policy Committee of the Bank of England in February 2001.
29. In the United Kingdom, exchange rate policy is set by the Chancellor, while for the euro area the general orientation of exchange rate policy is set by the euro group.
30. The Chancellor indicated in June 2001 that the government's position on the conditions for entry into the euro area had not changed since October 1997 when the five economic tests were originally set out (see Box 3 in the previous Survey), and that an assessment of the economic case for joining would be carried out by the Treasury by mid-2003.
31. The stance is assessed here as the absolute change in the cyclically-adjusted public sector net borrowing (HMT, 1999).

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32. Under self-assessment, which was introduced in April 1996 and concerns in particular the 8 million self-employed, the tax bill is based on the figures provided by the taxpayer without Inland Revenue first checking and agreeing them. Hence, taxpayers are now responsible for ensuring that they pay the right amount of tax. In FY1999/2000, Inland Revenue collected tax receipts of about 2 per cent of GDP through the system.
33. Thus, UK bookmakers are to end the deductions they charged punters, and to repatriate their off-shore operations. The industry welcomed it saying: "For customers, bookmakers, the racing industry and the Government, this is a win-win-win-win situation."
34. It should be recalled in this regard that the monthly fiscal accounts display a fair measure of seasonality, with the balance typically much weaker in the first quarter of the fiscal year.
35. Most initiatives concern the United Kingdom as a whole or England and Wales. However, some initiatives, for instance, in education are not implemented in Scotland, reflecting its autonomy in this area.
36. Over time, the relative position of the United Kingdom has deteriorated (Stewart *et al.*, 2001).
37. See Bosworth (1999), DTI (2001*a*), Council for Excellence in Management and Leadership (2001) and, as regards the lack of specific implementation skills in the civil service, Montague (2001).
38. Some 80 per cent of teachers receive performance-related top-ups. The latter are criticised by the unions, on the grounds that the assessment of performance is entirely left to the head teacher, even though teachers have a right to appeal to an external commission.
39. These reflect mainly housing costs, which are substantially higher in these areas.
40. The recently published White Paper on "Excellence in Schools" (DfEE, 2001*b*) proposes to extend the areas of specialisation as well as the number of specialised schools. Specialised schools achieve higher exam scores and will be required to share practice and funding with less well-performing schools.
41. Some measures need further assessment. For example, the Office of Her Majesty's Chief Inspector of Schools in England reports that among the six pilot Education Action Zones (described in the previous *Survey*) there was too much variability to draw any conclusion as to their impact on schools (House of Commons Select Committee on Education and Employment, 2001).
42. While overall unemployment is relatively low, pockets of distress remain locally, as highlighted in the previous *Survey*.
43. The likelihood of women being economically active still varies considerably according to the presence, or not, of a partner, and the number of dependent children: 75 per cent of lone mothers with one child or more were economically inactive in spring 2000, against 23 per cent with a partner and one child, not least reflecting the high cost of childcare.
44. In practice, a number of young people falling in this category fail to enrol in the NDYP (*e.g.* some of the homeless residents of the charity Centrepoint).
45. This is confirmed by a comparison of the evolution of unemployment for different age groups. Over 1997-2000 or 1998-2000, total claimant unemployment of the 18-24 years old group fell less (in per cent) than total claimant unemployment for all ages, and marginally less than for 25-29-years-olds.

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46. This also implies that the dead-weight loss reported above is probably higher.
47. The way sanctions have been applied across options suggests that the ETF has been seen as the option of last resort. Most sanctions apply there to people declining to enter the option, whereas 58 per cent of the sanctions imposed on participants in the FTET option resulted from voluntarily leaving the option or misbehaviour.
48. See Riley and Young (2001) and Van Reenen (2001). Higher estimates, as provided by the Centre for Policy Studies for example (£14 300), reflect differences in netting out associated costs and benefits. Van Reenen (2001) undertook some sensitivity analysis to the assumptions underlying cost and benefits computations and found that in all cases social benefits exceeded social costs.
49. An early study suggested, however, that the actual destinations of those leavers were not significantly different from the known destinations (Hales and Collins, 1999).
50. Against the advice of the LPC, the Government did not lower the 21-year age limit, despite the fact that the wage distribution for the 21-year-olds is very similar to that of the 22-year-olds. Workers aged 18 to 21, especially the low-skilled, have relatively poorer labour market outcomes than those aged 22 and above. It was on this basis that the Government decided to retain 21-year-olds on the youth rate.
51. This is a measure of relative poverty, as opposed to the headline absolute poverty measure used in the United States (referring to the cost of a minimal basket of goods and services). For more detailed comparisons between the two measures, see for example Brewer (2001*a*).
52. The Gini coefficient for equivalised original income stood at 0.53 at the end of the 1990s, up from 0.46 in 1981 (it was broadly stable over the second half of the 1990s). The Gini coefficient measures income inequality and ranges from 0 to 1: the higher the coefficient, the more unequal the income distribution. Equivalisation adjusts household incomes to take into account their size and composition: for instance, a single person's income of £6 100 would be treated as equivalent to an income of £10 000 for a couple without children.
53. The reforms included in these simulations are the Working Families Tax Credit (October 1999), the child benefit (since 1997), the Council Tax Credit (April 2001), and the increase in income support since 1999.
54. The poverty gap – defined as the total shortfall of household equivalised income for each child below the poverty line – was expected to shrink a bit less in proportional terms than the headcount of poor children. Yet overall, and taking into account the upward shift of the poverty line entailed by the tax and benefit measures, child poverty would have been reduced by between one quarter and one third, by 2001.
55. Overall, most household types gained on average through the personal tax and benefit changes made during the last Parliament, but families with children and pensioners have benefited most (Brewer, 2001*b*). As 31 per cent of single pensioners and 59 per cent of lone parents are poor, compared with 23 per cent for all family types, the targeting was effective.
56. The Government has not yet published WFTC take-up rates, but the latest published statistics show that in May 2001 over 1.25 million families were benefiting from the WFTC. The Government estimates the long run caseload to be 1.4 million. The take up of Family Credit was between 66 and 70 per cent by caseload, excluding self-employed, and between 73 and 79 per cent by expenditure, for FY1998/99. However it is the lowest of all take-ups. For example, income support take-up was between 79 and 89 per cent by caseload, and between 88 and 95 per cent by expenditure in FY1998/99.

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57. So far, the Government estimates that fraud in social security benefits costs the tax-payer at least £2 billion per year. The draft Social Security Fraud Act 2001, which has recently been presented to Parliament, aims at reducing fraud by at least 10 per cent by March 2002. The Bill includes measures to increase information sharing, the possibility of reducing or withdrawing benefits, and financial penalties for employer fraud.
58. The take-up rates of many of the benefits for the disabled is only about 50 per cent (Walker *et al.*, 2000).
59. Only 25 000 disabled workers are benefiting from this credit, a small number given the 1.4 million people who wish to work.
60. A focus on total fixed investment, excluding housing, but including government, is justified because government investment also contributes to growth. Also, with the expansion of various PPPs, the boundary between public and private investment shifts over time.
61. However, this masks some disparities across sectors: except pharmaceuticals, aerospace and health, R&D as a proportion of sales is lower in the United Kingdom than the OECD average. Moreover, government R&D is low compared to other OECD countries and its share is declining.
62. Informal investment refers to individuals who invest in start-ups which are not their own.
63. See the consultation document on "Increasing Innovation", HM Treasury, Inland Revenue, March 2001.
64. Recent regulatory changes include the Working Time Regulation (1998), the Unfair Dismissal and Statement of Reasons for Dismissal Order (1999), the Employment Relations Act (1999), the Part Time Workers Regulation (2000) and the National Minimum Wage Act (1998).
65. So far, the measures adopted are a reform of the law on gaming machines and proposals to relax licensing restrictions on New Year's eve.
66. The incentive has proven popular as more than 480 companies had awarded EMI options to over 2 600 employees until the end of February 2001.
67. There is a special treatment of R&D for SMEs (introduced in the Finance Bill 2000) and of R&D capital expenditure in all firms. However, since R&D is made up of around 40 per cent wages and salaries, 50 per cent current expenditures and 10 per cent capital expenditures, it does not provide a very significant subsidy to overall R&D (Bloom *et al.*, 2001).
68. Since the 1980s, the Secretaries of State and Industry have publicly promised to base their own decisions only on competition criteria.
69. The first case of abuse of a dominant position to be fined is that of the pharmaceutical company NAPP, which supplied sustained release morphine to patients at excessively high prices, while granting hospitals discounts that blocked competitors. The OFT has fined NAPP £3.21 million and made proposals to end the infringement, in particular by reducing the price of the drug to the community and limiting the degree to which community prices can exceed hospital prices. NAPP has appealed to the CC Appeals Tribunal. The second case is Aberdeen Journals Ltd., found to be dominant in the market for the supply of advertising space in local newspapers, and to have engaged in predatory pricing. A £1.33 million fine was imposed.
70. The regulators have all the powers of the Director General of Fair Trading (DGFT) to apply and enforce the Act to deal with anti-competitive agreements or abuse of mar-

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ket dominance relating to relevant activities in their designated sector. The DGFT alone, however, has powers to issue guidance on penalties and to make and amend the DGFT's procedural rules.

71. The two sectors are increasingly linked: 40 per cent of electricity is now generated by gas, and companies are now active in both markets, often offering "dual fuel deals".
72. Since the previous survey, the telecommunications and broadcasting regulators have merged in a single regulator, OFCOM.
73. The earlier comprehensive reviews of company legislation are the Cohen Committee Report (1945) and the Jenkins Committee Report (1962).
74. Blake (2001) estimates that the BSP, which is around 16 per cent of today's national average earnings, will only represent 10 per cent by 2025.
75. Disney *et al.* (2001*a*) find a positive but small net effect on the saving rate of around 0.2 per cent of GDP in 1990, when the possibility of contracting out of state pensions was offered. Similar systems, as in Canada for example, did not trigger any rise in savings either.
76. Nevertheless, the Government has decided not to legislate on this issue, but rather has given the City two years to come up with its own proposals.
77. Namely: *i*) to confine decision making with professionals endowed with appropriate skills and expertise, *ii*) to establish clear objectives and time scales for managers, *iii*) to implement performances measurement, and *iv*) to produce regular reports on the investment strategy to members and the public.
78. This would require fund managers to intervene in companies, for example by voting, whenever they believe this can enhance corporate performance, and hence the value of the investment.
79. The MFR, created by the Pensions Act 1995, aims both at protecting pensioners in the case of a company's insolvency and safeguarding from fraud. It imposes a minimum level of assets that must be matched by liabilities. In practice, it defines benchmark discount rates that should be used for valuing a pension scheme's liabilities, most notably the market yield on government securities. In response, pension funds sought to minimise their exposure to interest rate fluctuations by allocating a greater share of their portfolios to government securities, at the expense of equities. This results in standardised portfolios, that is not necessarily efficient as a consumer umbrella, and can even distort financial markets (Blake, 2001).
80. At the same time, the need for reform was underscored by some lapses in supervision, revealed notably by the Mirror Group pension scandal, the collapse of Bank of Credit and Commerce International and of Barings Bank, and in the insurance sector the heavy losses incurred by Lloyds, which drove it to the brink of bankruptcy.
81. The merger process is expected to be completed in November 2001.
82. However, reports in the 1990s suggested growing dissatisfaction with the previous regime of self-regulation and the self-regulatory organisations (*e.g.* Mayer, 2000).
83. The procedure for a troubled insurance company is relatively straightforward. The Policyholders Protection Board (PPB) was established by the Policyholders Protection Act (1975 Act), and will be superseded by the Financial Services Compensation Schemes (FSCS) as a result of the Financial Services and Markets Act (FSMA) 2000 from December 2001. The rules governing the FSCS are a matter for the FSA, which is currently conducting a consultation process. Currently, the PPB is funded by the insurance industry. Claims under UK policies can be met by the PPB in two ways:

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i) Valid claims made under compulsory insurance, which includes third party motor insurance and compulsory employers' liability insurance are met 100 per cent.

ii) Valid claims made by private individuals under non compulsory insurance are payable to 90 per cent of the agreed value of the claim.

Claims by businesses, except for claims under compulsory insurance policies, will generally rank with other creditors of the company to be paid in due course by the provisional liquidator to the extent that funds are available.

84. Direct costs are linked to bailout operations, and more indirect and longer-term costs are due to the impact of financial markets on growth (Leahy *et al.*, 2001).

85. In 1984, it rescued Johnson Matthey Bankers Ltd. because of its stated concern that failure could trigger problems elsewhere, especially in the interbank gold market.

86. In UK policy documents reference is made usually to finances of the public sector, which is broader than general government. Capital grants from the Government to state-owned companies are included in general government outlays, and so is expenditure by public bodies outside government departments, unless they are part of state-owned companies (this is the case if for example, a regulatory activity is carried out by a state-owned company). Local authorities and social security institutions are also in general government. However, if public service providers are organised in trusts or partnerships selling their services to a government department, such providers are outside general government. This is the case in the United Kingdom, where National Health Service Trusts are part of the public sector but not comprised in general government. Hence out-of-pocket payments by users are not in general government revenue either and only the grants or fees paid by the relevant department on behalf of the users are included in general government expenditure – similar to subsidies to state-owned companies. Due to privatisation of public companies, the differences between general government and public sector spending levels have come to be insignificant.

87. For a number of reasons, international and inter-temporal comparisons of public expenditure may be misleading due to differences in institutions and accounting conventions with regard to social transfers, see Adema (2000). Specifically, the extent to which social benefits are taxed varies across countries and over time and mandatory or voluntary private arrangements providing close substitutes to public social expenditure are usually not taken into account.

88. Based on National Accounts numbers for general government.

89. This table reports expenditure as a percentage of trend rather than actual GDP in order to remove the impact of GDP volatility on the denominator.

90. Meanwhile, with the National Health Service being funded largely by general tax revenues and providing universal health care free of charge, the United Kingdom has the most redistributive health care system of a sample of countries including Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, Switzerland and the United States. This reflects the large share of expenditure funded by general taxes, and its relative progressivity. See Wagstaff *et al.* (1999) and Van Dorslaer *et al.* (2000).

91. The privatisation of the National Bus Company has been less problematic as the coach operators recovered part of the clientele of the railways.

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92. Each budget cycle a ritual dance between spending departments and the Treasury would typically continue until time ran out and core Ministers (the Star Chamber) or the Prime Minister had to step in.
93. Accrual accounting and budgeting recognises the financial implications of transactions when they occur, irrespective when cash is paid or received.
94. The Government thus *de facto* pre-empted key elements of the IMF's *Code on Good Practices* and the OECD *Best Practices* on fiscal transparency, akin to the reforms introduced by New Zealand and Australia (the Fiscal Responsibility Act and the Charter of Budget Honesty, respectively).
95. The United Kingdom is not unique in this regard: in Germany the golden rule is enshrined in the constitution, and is used by most individual states in the United States, while Australia adopted it recently.
96. The basic assumptions underlying this projection are the following. Trend GDP growth is assumed to be 2¼ per cent per year rather than the central estimate of 2½ per cent. As a result, the output gap, which is estimated to be 0.6 per cent in 2000/01, would steadily fall to zero by the end of the projection period. Net investment is projected to gradually approach the target of 1.8 per cent of GDP.
97. The *Code* stipulates that discretionary fiscal policy could be used in support of monetary policy through changes in the fiscal stance, "where prudent and sensible". Its thrust is clearly to avoid a pro-cyclical fiscal stance, *i.e.* to stimulate in an upswing or to tighten in a downturn, but does not exclude anti-cyclical fiscal policy. The prominence given to automatic stabilisers has prompted the Government to provide estimates of the structural fiscal balances since 1997. The methodology adopted for these calculations is broadly similar to that used by the IMF, OECD and the European Commission.
98. Generational accounts for the United Kingdom suggest that intergenerational equity is practically achieved on the basis of current fiscal policy, given that a simultaneous increase in health and education spending, as intended by the Government, is directed to different age groups. See Agulnik *et al.* (2000), Banks *et al.* (2000) and Carderelli *et al.* (2000). On the other hand, it could be argued that the "unchanged policy" assumptions, on which such accounts are based, are not realistic.
99. In a system of pure accrual accounting public-private partnerships and publicly funded investment are broadly equivalent from a budgeting point of view, because capital charges would be the same in both cases. However, in national accounts terms, off-budget investment gives rise to a decline in the surplus on current account equivalent to the total capital charges whereas on-budget investment would have this effect only for the amount of the depreciation charge.
100. Van den Noord (2000).
101. Earlier work by the OECD suggests that the budget would need to be in structural surplus of around ½ per cent of GDP to reduce the probability of breaching the ceiling within five years to 10 per cent (Dalsgaard and de Serres, 2000). However, this is based on the previous policy framework which may have been conducive to larger economic volatility than the present framework.
102. The Government has started to produce detailed medium-term projections for public expenditure every two years for a planning horizon of three years, in the so-called Spending Reviews. The first Review was published in July 1998 and spanned the period from fiscal year 1999/2000 to 2001/02. The second Review was published in July 2000, and covered 2001/02 to 2003/04. The third Review for the period 2003/04 to 2005/06 has been scheduled for July 2002.

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103. While spending departments will be held accountable for success or failure of investment projects, the Treasury retains a role in monitoring and advising project teams at all stages of the investment process, including planning, procurement and implementation.

104. The five policy areas with a cross-departmental PSA are Sure Start (a programme for disadvantaged children aged 0-3), Welfare to Work (a programme providing employment opportunities for the young and the long-term unemployed), the Criminal Justice System, Action against Illegal Drugs and Local Government issues.

105. A striking example of this was the former PSA concerning the National Health Service, which set a target for the reduction of the number of patients waiting more than a year. This gave an incentive to treat new patients with priority and keep patients who had been on a waiting list for over a year waiting even longer. This was corrected in the new PSA, which targets a reduction in the maximum wait for treatment.

106. Unlike competitive tendering and outsourcing, the concept of "public-private partnerships" may have different meanings across countries. For instance, in the United States it often refers to programmes for technological innovation linking publicly funded research with industry application.

107. In the United States the use of private prisons has grown rapidly from a capacity of 1 200 prisoners in 1985 to almost 50 000 ten years later. Still, only 3 per cent of all prisoners are held in privately operated prisons. Savings from outsourcing this activity to private companies through competitive tendering generally amount to 10 per cent of the cost, largely due to publicly employed prison guards on average earning 15 per cent higher wages than private guards.

108. For example, the French toll road system allows rationing based on variation in toll levels during the day and managing traffic flows by expanding or reducing the number of tollgates.

109. The implications for long-term fiscal sustainability are similar in both cases. Consequently, the increased use of private finance of public services might call for reconsidering the present practice of not including public obligations under such schemes in the measures of public debt when evaluating the government's debt position.

110. For example the Lewisham concession of the Dockland Light Railway extension in east London was put into operation almost a year before planned.

111. Although, in a sufficiently large market this may not be a problem, since there would be a continuous flow of contracts despite their long duration.

112. DETR (2000). The Local Government Association (2000) largely shares these recommendations.

113. The recent devolution of legislative and executive power to Scotland, Wales and Northern Ireland have raised this share somewhat (the numbers in Figure 30 refer to 1997, the latest year for which internationally comparable data are available). However, the overall picture has not changed much to date (see Table 10).

114. The share of local government in the total tax take in the United Kingdom has been found to be the second-lowest of a sample of 19 OECD countries after the Netherlands, see OECD (1999). However, this stylised fact conveys little information on the UK's relative position against other OECD countries concerning sub-central tax autonomy, which depends also on the power of local governments to set tax rates and/or bases.

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115. The SSA formula attempts to capture variations in the cost of providing services due to factors that are beyond the control of any individual authority. Local authorities do not necessarily have to spend exactly the amounts indicated by the formula, as this depends on the level of efficiency achieved (higher efficiency means they could spend less) or the actual rate of council tax (a higher rate means they could spend more than the formula indicates).
116. This is due mostly to changes in the population data that enter the formula and *ad hoc* changes to the formula. Moreover, the grant system relies too much on the mechanical use of statistics and seldom draws on wider evidence.
117. The arrangements for investment in council housing would also remain separate.

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Glossary of acronyms

AGM	Annual General Meeting
AME	Annually Managed Expenditure
BRTF	Better Regulation Task Force
BSP	Basic State Pension
BT	British Telecom
CC	Competition Commission
CGT	Capital Gains Tax
CTC	Children's Tax Credit
CVA	Company Voluntary Arrangements
DEL	Departmental Expenditure Limit
DGFT	Director General of Fair Trading
DMCI	Dynamic Monetary Conditions Index
DTI	Department of Trade and Industry
EC	European Commission
ECB	European Central Bank
EMI	Enterprise Management Incentive
ETF	Environmental Task Force
EU	European Union
EUR	Euro
FMD	Foot-and-Mouth Disease
FSA	Financial Services Authority
FSCS	Financial Services Compensation Schemes
FTET	Full-Time Education and Training
FY	Financial Year
G10	Group of ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, United States) plus Switzerland
GAR	Guaranteed Annuity Rate
GDP	Gross Domestic Product
GP	General Practitioner
HB	Housing Benefit
HICP	Harmonised Index of Consumer Prices
HMT	Her Majesty's Treasury
ICT	Information and Communication Technology
IMF	International Monetary Fund
ISA	Individual Savings Accounts
IT	Information Technology
JSA	Job Seeker Allowance
LEA	Local Education Authority

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LFS	Labour Force Survey
LOLR	Lender Of Last Resort
M&A	Mergers and Acquisitions
MAFF	Ministry of Agriculture, Food and Fisheries
MCI	Monetary Conditions Index
METR	Marginal Effective Tax Rate
MFR	Minimum Funding Requirement
MIG	Minimum Income Guarantee
MPC	Monetary Policy Committee
NAO	National Audit Office
NDDP	New Deal for Disabled People
NDLP	New Deal for Lone Parents
NDLTU	New Deal for Long-Term Unemployed
NDYP	New Deal for Young People
NHS	National Health Service
NIC	National Insurance Contributions
NMW	National Minimum Wage
OFGEM	Office of Gas and Electricity Markets
OFT	Office of Fair Trading
OPRA	Occupational Pensions Regulatory Authority
PBR	Pre-Budget Report
PFI	Private Finance Initiative
PPB	Policyholders Protection Board
PPP	Public-Private Partnership
PSA	Public Service Agreements
PSBR	Public-Sector Borrowing Requirement
R&D	Research and Development
RIU	Regulatory Impact Unit
RPIX	Retail Price Index excluding mortgage interest payments
RPIY	Retail Price Index excluding mortgage interest payments and indirect taxes
SBS	Small Business Service
SERPS	State Earnings-Related Pension Scheme
SME	Small and Medium-sized Enterprises
SR	Spending Review
SRA	Strategic Rail Authority
SSA	Standard Spending Assessment
UMTS	Universal Mobile Telephone Systems (third generation mobile telephone systems)
VAT	Value Added Tax
WBTYP	Work-Based Training for Young People
WFTC	Working Families Tax Credit
WRPA	Welfare Reform and Pensions Act

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BASIC STATISTICS OF THE UNITED KINGDOM (2000)

THE LAND

Area (1 000 km²):		Major cities (thousand inhabitants, 1997):	
Total	241	Greater London	7 122
Agricultural (1997)	187	Birmingham	1 014
		Leeds	727
		Glasgow	612

THE PEOPLE

Population (thousands, mid-2000)	59 756	Total labour force (thousands)	29 572
Number of inhabitants per km²	248	Civilian employment (% of total):	
Net increase in population, 1997-2001,		Agriculture, forestry and fishing	1.5
estimated annual average (thousands)	154	Industry and construction	25.1
		Services	73.1

PRODUCTION

Gross domestic product:		Gross fixed capital investment:	
In £ billion	943.4	As a % of GDP	17.5
Per head (US$)	23 930	Per head (US$)	4 192

THE GOVERNMENT

Public consumption (% of GDP)	18.5	Composition of House of Commons	
General government (% of GDP):		(number of seats):	
Current and capital expenditure	37.0	Labour	410
Current revenue	39.0	Conservatives	164
Net debt	33.1	Liberal	52
		Ulster Unionists	6
Last general elections: 7 June 2001		Other	27
		Total	659

FOREIGN TRADE

Exports of goods and services (% of GDP)	28.1	Imports of goods and services (% of GDP)	29.8
Main commodity exports (% of total):		Main commodity imports (% of total):	
Chemicals	13.3	Manufactured goods and articles	28.6
Manufactured goods and articles	23.4	Electrical machinery	23.4
Electrical machinery	22.6	Road vehicles	10.8
Mechanical machinery	11.8	Mechanical machinery and other transport equipment	11.7

THE CURRENCY

Monetary unit: Pound sterling		September 2001, average of daily rates:	
		£ per US$	0.683
		£ per euro	0.623

Note: An international comparison of certain basic statistics is given in an annex table.

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•

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•

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•

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