End of year fiscal report

November 2002

HM TREASURY

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INTRODUCTION

This is the first year that the Government has published an *end of year fiscal report*. It provides a further enhancement in the Government's reporting and analysis of retrospective fiscal developments. In particular, the report looks at trends in the public finances and fiscal policy in 2000–01 and 2001–02, analysing:

- **performance against the fiscal rules and fiscal policy objectives; and**
- **differences between forecast and fiscal outturn for the year-ahead forecasts published in Budget 2000 and Budget 2001.**

The report shows that the Government was firmly on track to meet its fiscal rules in 2000–01 and 2001–02 with strong surpluses on the current budget in both years and low and stable levels of public sector net debt leaving the public finances well placed to play their part in maintaining economic stability.

Further improving transparency will bring the UK fully in line with international best practice and will provide a better understanding of the background to the forward-looking public finance projections published in the Pre-Budget Report. End of year fiscal reports will be published alongside future Pre-Budget Reports.

INTRODUCTION

I.1 The Government's reforms to the fiscal framework since 1997 have been designed to ensure that the highest standards of transparency and openness apply to fiscal policy decisions. Transparency is one of the Government's principles of fiscal management set out in statute and which underpins the *Code for Fiscal Stability*.[1] It is important because it enables the public to scrutinise the conduct of fiscal policy and the state of the public finances. It provides the essential background for all decisions on taxation and public spending taken by the Government and, as such, is a fundamental building block of a credible fiscal policy.

I.2 A transparent approach means the Government is clear about the objectives of fiscal policy, the implementation of those objectives through the fiscal rules and reports on the performance of the public finances against those rules in a way that is clear, comprehensive and timely.

I.3 This end of year fiscal report (EYFR) is intended to further increase transparency by enhancing the Government's reporting and analysis of fiscal developments. Its focus is retrospective, looking at performance against the fiscal rules and other fiscal news for the previous two financial years. The EYFR will be published annually, alongside future Pre-Budget Reports with the next 2003 report looking at developments in 2001–02 and 2002–03.

I.4 In doing so, the EYFR will build on the significant amount of historical data and analysis of the public finances already published at the time of the Pre-Budget Report and Budget, in accordance with the requirements of the *Code for Fiscal Stability*.

Benefits of the EYFR

I.5 By providing more comprehensive information and analysis, it is intended that the EYFR will permanently strengthen the Government's fiscal framework by increasing:

- understanding of fiscal developments, including performance against the Government's fiscal rules and fiscal policy objectives;
- analysis of key fiscal developments or where outturns are significantly different from forecasts; and

[1] *Code for Fiscal Stability*, HM Treasury (1998).

- awareness about the starting point for forward-looking projections which will continue to be published, as usual, in accordance with the Code in Pre-Budget Reports and Budgets.

1.6 Improving reporting on outturns will bring the UK fully in line with international best practice, including the International Monetary Fund (IMF) *Code of Good Practices on Fiscal Transparency*.[2]

Horizon

1.7 The EYFR is both a source of data on the public finances, and analysis and explanation of significant trends and fiscal news. More specifically, the focus of the EYFR is on:

- fiscal trends over the two previous financial years and, in particular, performance against the Government's fiscal rules; and
- a comparative analysis of forecast and fiscal outturn for the two one year ahead Budget forecasts.

1.8 This report therefore covers the two years 2000–01 and 2001–02 and, in particular, the Budget 2000 forecast for 2000–01 and the Budget 2001 forecast for 2001–02.

1.9 The two year horizon strikes a balance between timely reporting of fiscal developments and the quality and robustness of data. Data on receipts and public spending is subject to revision for a considerable period after the end of the relevant financial year. For example, departmental accounts which feed into public spending totals are finalised about nine months after year-end, while those from local authorities can take longer still.

1.10 Moreover, the analysis of fiscal developments also depends on macroeconomic data published in national accounts which is subject to revisions for several years, as the data is refined on the basis of more comprehensive information. This means that the data and analysis presented here are not final, particularly for 2001–02, which will be subject to revisions. Nonetheless, the information is sufficiently robust to provide a sound basis for forecast analysis and future revisions, particularly for 2000–01, are more likely to change the detail rather than the main conclusions.

Forecast developments

1.11 A key part of the analysis will be to compare fiscal outturns with forecasts. Forecasts of the public finances are inevitably subject to wide margins of uncertainty and outturns can be expected to be different from forecasts. This is particularly true for the fiscal balances which represent the difference between two very large aggregates of spending and receipts. Chapter 2 explains that the average size of error for year-ahead forecasts of the overall budget balance (public sector net borrowing) since 1989–90 has been about 1.1 per cent of Gross Domestic Product (GDP).

Box 1.1 : Cautious assumptions

The Government's fiscal framework explicitly recognises that projections of the current budget and net debt inevitably involve an element of uncertainty. Projections are therefore deliberately based on prudent assumptions for key economic variables. These assumptions, which include the trend rate of growth, the level of unemployment and oil and equity prices are audited by the National Audit Office (NAO) under a three-year rolling review to ensure they remain both reasonable and cautious. The audited assumptions used in the Budget 2000 and 2001 forecasts are set out in Annex A to this report.

Using cautious assumptions means that forecasts are not the Government's central view of prospects for the public finances. The impact of the trend growth assumption (whereby trend growth is assumed to be ¼ percentage point below the neutral view) alone means that, other things equal, the forecast will underestimate receipts by £1 billion one year ahead. However, the assumptions are audited to be both reasonable and cautious. Excessive caution could distort the management of public finances, particularly public spending.

[2] *Code of Good Practices on Fiscal Transparency*, International Monetary Fund (2001).

1.12 The analysis in this report distinguishes between a number of possible sources of differences between forecast and outturn:

- **economic determinants:** forecasts of tax and some spending programmes depend heavily on the forecast of economic growth (GDP) and its component elements. For example, income tax is dependent on the forecast of wages and salaries. Changes attributable to differences between forecasts of these determinants and their outturn fall into this category;
- **NAO assumptions:** Box 1.1 explains that the audited assumptions are deliberately cautious meaning that outturns dependent on the assumptions can be expected to be different to forecast. Differences attributable to these assumptions, including the trend growth assumption, fall into this category;
- **fiscal differences:** this captures changes in the relationship between the tax base and tax rates on the one hand and revenue received on the other. An example of a fiscal difference on spending is the differences between the forecast take-up of some benefits and the outturn; and
- **other differences:** this includes a variety of factors, for example, the impact of new measures announced in-year on the outturn.

Box 1.2 : The forecast process

Consistent with the *Code for Fiscal Stability*, the Treasury updates its projections of the public finances twice a year in the Pre-Budget and Budget Reports. These projections reflect the work of the Treasury and other departments, particularly Inland Revenue and Customs and Excise on the tax projections and the Department of Work and Pensions on social security spending.

The Treasury's forecast for the economy underpins the fiscal projections. Its forecast of GDP and its key components is expressed in terms of ranges for growth, reflecting the supply side potential of the UK economy. The public finances projections are based on the low end of the forecast range, anchored on the cautious trend growth assumption, currently $2\frac{1}{2}$ per cent. This 'low end' forecast provides the economic determinants underpinning the fiscal projections, including for example forecasts of wages and salaries, a determinant of income tax, and consumers' expenditure, a determinant of value added tax. The Treasury also supplies departments with information on the other NAO-audited assumptions, including for example oil prices and equity prices and levels of unemployment.

The Inland Revenue and Customs and Excise use the Treasury's economic determinants and the NAO assumptions to forecast individual taxes, often using individual tax models. By themselves, the economic determinants provided by the Treasury are insufficient to produce the forecasts and departments are required to forecast the relationship between the tax base as forecast by the Treasury and tax rates on the one hand, and total receipts on the other. It also requires departments to forecast other detailed determinants (many of which are economic) that are not forecast by the Treasury, for example air travel for air passenger duty.

The forecast process is iterative. Forecasts for receipts and spending are incorporated into the Treasury economic projections and the forecast process repeats, converging on the final projections. Latest data and the impact of Pre-Budget Report and Budget decisions are also incorporated into the economic and fiscal projections. The decomposition of forecast errors into its components presented in this report partly reflects the forecast process. Those differences attributable to the Treasury's forecast, but not audited by the NAO, are scored as economic determinants. Where differences relate to forecasts made by other departments (for example on the effective tax rate), the differences are classified as fiscal differences.

I.13 Decomposing differences in this way will give a clear picture of why fiscal developments vary from forecast. Chapters 3 and 4 set out in more detail how these categories are applied to the tax and spending analysis.

Performance against the fiscal rules

I.14 Chapter 2 presents a summary of developments from a macroeconomic perspective. It sets out in particular the Government's performance against the fiscal rules, demonstrating how the Government remained on track to meet the rules in this period. It also analyses fiscal developments from an aggregate perspective, explaining why outturns for the fiscal balances deviate from forecasts. It shows:

- the Government was fully on track to meet its fiscal rules over the economic cycle and met these rules in cyclically-adjusted terms in 2000–01 and 2001–02;
- the actual and cyclically-adjusted current budget remained in surplus while public sector net debt fell to 30 per cent of GDP, well below the 40 per cent limit of the sustainable investment rule; and
- differences between forecast and outturn were mainly due to receipts; spending remained closer to forecast.

Receipts and public spending

I.15 Chapters 3 and 4 provide more detailed analysis on the components of government receipts and public spending respectively. The chapters show:

- receipts rose from £383 billion in 2000–01 to £391 billion in 2001–02, providing resources for the Government's priorities and ensuring that the Government remained on track to meet its fiscal rules; and
- total public spending rose from £367 billion in 2000–01 to £392 billion in 2001–02, as the Government has released resources for its public service priorities while also reducing the proportion of spending on debt interest and social security payments, including on benefits for the unemployed.

2 MEETING THE FISCAL RULES

This chapter analyses trends in fiscal policy and performance against the Government's fiscal policy objectives. It shows that the Government was firmly on track to meet its fiscal rules over the economic cycle and met the rules in cyclically-adjusted terms in 2000-01 and 2001-02:

- **the actual and cyclically-adjusted current budget remained comfortably in surplus, consistent with meeting the golden rule over the cycle;**
- **public sector net debt fell to 30 per cent of GDP, well below the 40 per cent limit of the sustainable investment rule;**
- **fiscal policy supported monetary policy in maintaining economic stability in response to the global economic slowdown in 2001; and**
- **low and stable debt levels and strong surpluses on the current budget have left the public finances well placed to withstand shocks and wider global instability and to continue to play their part in supporting monetary policy over the economic cycle.**

For the current budget, the latest outturn is a surplus of £21.3 billion in 2000-01 and £7.7 billion in 2001-02, consistent with meeting the golden rule while increasing current spending on the Government's priorities. This was a higher surplus than the Budget 2000 forecast for 2000-01, but lower than the Budget 2001 forecast for 2001-02. Public sector net debt fell to 30 per cent of GDP as a result of surpluses on net borrowing and the proceeds of the spectrum licence auction.

FISCAL FRAMEWORK

2.1 The Government's macroeconomic framework is designed to maintain economic stability, an essential platform for individuals, businesses and Government to plan effectively for the long term. The monetary policy framework aims to deliver low and stable inflation, while the fiscal framework aims to achieve the Government's objectives for fiscal policy:

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

Fiscal rules

2.2 These objectives are implemented through the Government's two fiscal rules, against which the performance of fiscal policy can be judged:

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

2.3 An objective of the end of year fiscal report (EYFR) is to further enhance reporting on our performance against these fiscal rules and fiscal policy objectives. It provides information on fiscal trends and whether the Government remained on track to meet both its fiscal rules in the previous two financial years. Since both rules are set over the whole economic cycle, a definitive statement as to whether the rules have been met is only possible when a full cycle has been completed. The report therefore also assesses developments in the economic cycle which feed into estimates of the structural or cyclically-adjusted current budget and core debt.[1]

[1] *Core debt: An Approach to Monitoring the Sustainable Investment Rule*, HM Treasury (April 2002).

Fiscal trends

2.4 Table 2.1 summarises latest outturns for the main fiscal balances for 2000–01 and 2001–02, including a comparison with the year-ahead forecasts in Budget 2000 and Budget 2001 respectively.

Table 2.1: Fiscal balances[1]

	2000–01			2001–02		
	Budget 2000 forecast	Outturn	Difference	Budget 2001 forecast	Outturn	Difference
Fiscal balances (£ billion)						
Surplus on current budget	12.9	21.3	8.4	15.9	7.7	–8.2
Public sector net borrowing	–4.7	–15.9	–11.2	–4.7	1.2	5.8
Fiscal balances (per cent of GDP)						
Surplus on current budget	1.4	2.2	0.9	1.6	0.8	–0.8
Public sector net borrowing	–0.5	–1.7	–1.2	–0.5	0.1	0.6
Cyclically adjusted balances (per cent of GDP)						
Surplus on current budget	1.2	1.7	0.6	1.2	0.7	–0.5
Public sector net borrowing	–0.3	–1.2	–0.9	–0.1	0.2	0.3

[1] *Including Windfall Tax and associated spending.*

2.5 The outturn surplus on current budget is £21.3 billion in 2000–01 and £7.7 billion in 2001–02 compared with year-ahead Budget forecasts of £12.9 billion and £15.9 billion respectively. The outturn on net borrowing is a net repayment of £15.9 billion in 2000–01 and net borrowing of £1.2 billion in 2001–02. The reduction in the current surplus between 2000–01 and 2001–02 reflects faster growth in current spending than in current receipts over this period, partly as a result of higher departmental spending on the Government's public service priorities announced in the 2000 Spending Review. For the overall budget balance, the move from net surplus to net borrowing reflects both the declining current surplus and rising net investment over this period.

2.6 The table also sets out the fiscal balances as a per cent of GDP, both in actual and cyclically-adjusted terms. The latter adjust the actual fiscal balances for the estimated impact of the economic cycle on the public finances and are necessary because the Government takes care not to treat cyclical changes to the public finances as structural charges. Differences between forecast and outturn for these ratios are also affected by upward revisions to levels of GDP for this period. Comparing these ratios, the differences between forecast and outturn are smaller when expressed in cyclically-adjusted terms.

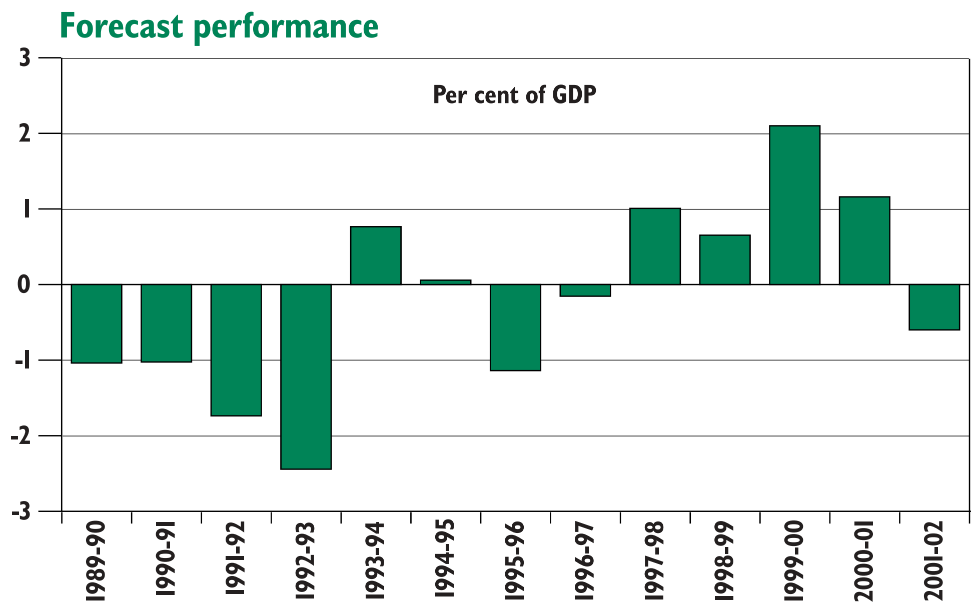
2.7 In 2001, even before the events of 11 September, economic growth slowed significantly and simultaneously in the US, Europe and Japan. For the US and the Euro-area, last year's slowdown brought to an end a period of continuous growth stretching back to the beginning of 1993. Although decisive action by policymakers, particularly in the aftermath of the terrorist attacks on the US, has limited the extent of the slowdown, weaker growth has impacted on activity and output in the UK and therefore the public finances. While the outturn surplus on current budget was 0.8 per cent of GDP lower than forecast in Budget 2001 in actual terms, it was 0.5 per cent lower in cyclically-adjusted terms. Paragraph 2.16 analyses this further, demonstrating that the public finances were supporting monetary policy in maintaining economic stability.

Box 2.1 : Understanding differences between forecasts and outturns

Chapter 1 explained that forecasts of the public finances, even one year ahead, are subject to a considerable degree of uncertainty. In particular, short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure – notably elements of social security spending – vary directly with the economic cycle.

The chart below shows the difference between forecast and outturn on the year-ahead forecast of public sector net borrowing. The average absolute difference between forecast and outturn since 1989-90 has been 1.1 per cent of GDP. It peaked at over 2 per cent of GDP in 1992-93 when receipts in particular were significantly lower than forecast.

The forecast performance compares well with international comparisons. Over the past two years, the average absolute error in forecasts of the overall budget balance in the US by the Congressional Budget office has been 1.2 per cent of GDP. In the EU (excluding the UK), the average absolute error on year-ahead projections presented in stability and convergence programmes over the past two years has also been equal to 1.2 per cent of GDP. In the UK, the average absolute error on the year-ahead Budget forecasts for 2000–01 and 2001–02 has been 0.9 per cent of GDP.



Year-ahead differences on public sector net borrowing: a positive number indicates outturn of higher surplus or lower borrowing than forecast

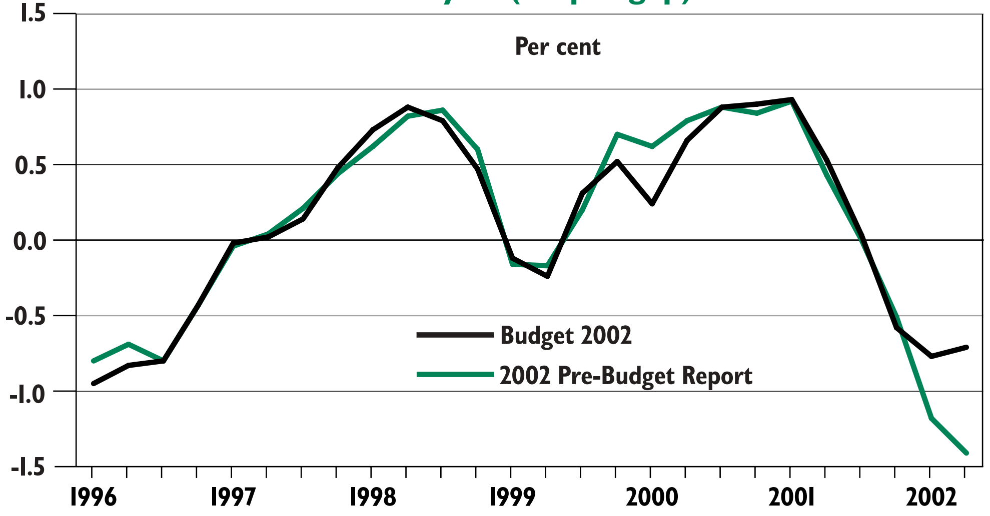
From both a policy and forecasting perspective, it is important to distinguish between fiscal developments related to the economic cycle, including levels of GDP and its composition, and those developments which are not, but are permanent or structural changes.

Where fiscal developments are related to the economic cycle, the appropriate response is to allow the automatic stabilisers to operate freely and symmetrically to support monetary policy in smoothing economic fluctuations. Where not, the Government must decide as part of the Budget process whether to offset structural developments through discretionary changes to taxation or spending. It is not a straightforward decision and forecasts do not represent targets. Key to this decision will be whether the Government remains on track to meet the fiscal rules and the Government's assessment of the appropriate stance for fiscal policy, taking into account developments in the economy.

Economic cycle

2.8 Since both the fiscal rules are set over the economic cycle, an assessment of the performance of the public finances against the rules requires an analysis of the cycle. This is set out below in Chart 2.1 which illustrates the Government's estimate of the output gap since 1996. The output gap is an estimate of the difference between actual and potential output and acts as an indicator of inflationary pressure. The chart compares latest outturn data which underpins the Pre-Budget Report forecast with that available in Budget 2002.

Chart 2.1: The economic cycle (output gap)



Note: Actual output less trend output as a per cent of trend output (non-oil basis).

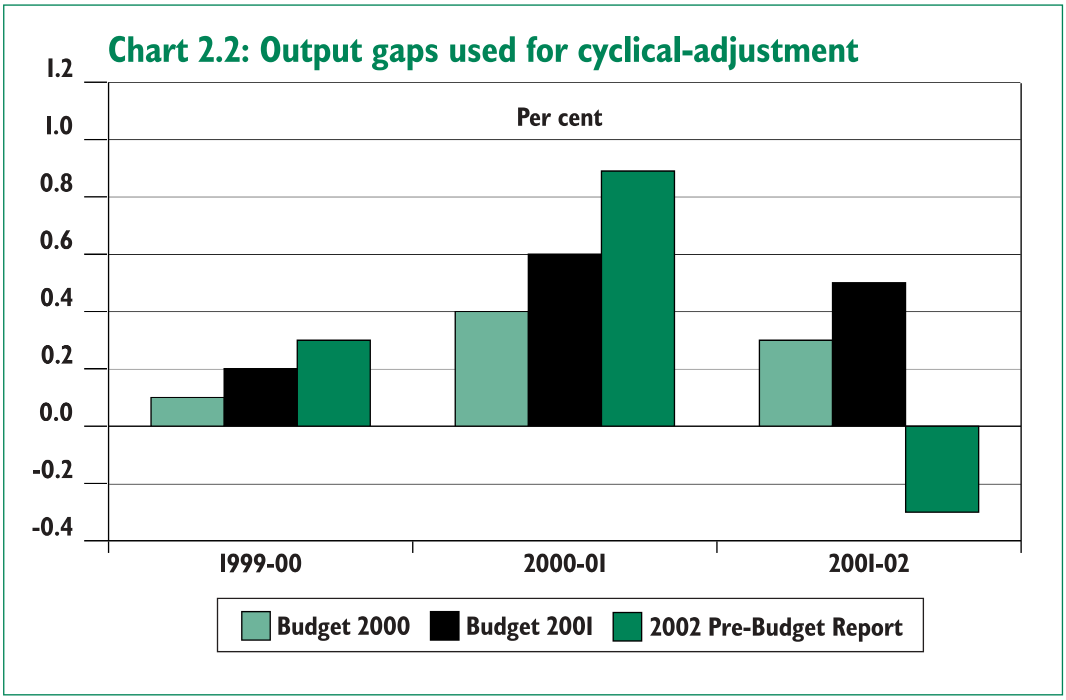
2.9 Based on business survey indicators of capacity and labour utilisation and other labour market indicators, the economy was judged in Budget 2002 to have completed a small cycle between the first half of 1997 and mid-1999 when the current economic cycle was assumed to have begun. In the 2002 Pre-Budget Report, the Government's provisional judgement remains that for the purposes of assessing performance against the fiscal rules the current cycle began in mid-1999, with output moving slightly above trend in 2000 and the first half of 2001.[2] Latest available data suggests the economy remained above trend until the third quarter of 2001, when last year's sharp world economic downturn brought output back below potential. The current cycle will be completed when the economy next returns to trend.

Cyclical-adjustment

2.10 An estimate of the output gap is also important for calculating cyclically-adjusted balances. These are a function of the actual fiscal balances and the average output gap for the current year and the previous year.[3] Chart 2.2 below sets out the average output gap for the three years from 1999–2000 to 2001–02, comparing the latest estimate underpinning the Pre-Budget Report with forecasts in Budget 2000 and Budget 2001. It shows that in 1999–2000 and 2000–01, the Budget forecasts understated the extent to which the economy would move above trend. In 2001–02, the impact of the global economic slowdown meant that the economy moved below trend. The precise magnitude of the output gap over the recent past, however, remains sensitive to potential data revisions in the future.

[2] This is analysed in more detail in Annex A of the 2002 Pre-Budget Report.

[3] See *Fiscal Policy: Public Finances and the Cycle*, HM Treasury (November 1999) for more detail. In 2000–01, cyclically-adjusted public sector current budget (PSCB) = PSCB – 0.46 output gap – 0.24 lagged output gap. In 2001–02, cyclically-adjusted PSCB = PSCB – 0.47 output gap – 0.23 lagged output gap.



Meeting the fiscal rules

Golden rule

2.11 Using latest outturn information, Table 2.2 sets out performance against the fiscal rules since 1999–2000, the start of the current cycle. The golden rule is met when on average over the economic cycle the current budget is in balance or surplus. The actual current budget remained in surplus, while the average since 1999–2000 remained well above one per cent demonstrating that the Government was fully on track to meet the golden rule over the economic cycle. This is confirmed by the strong surpluses on the current budget in cyclically-adjusted terms.

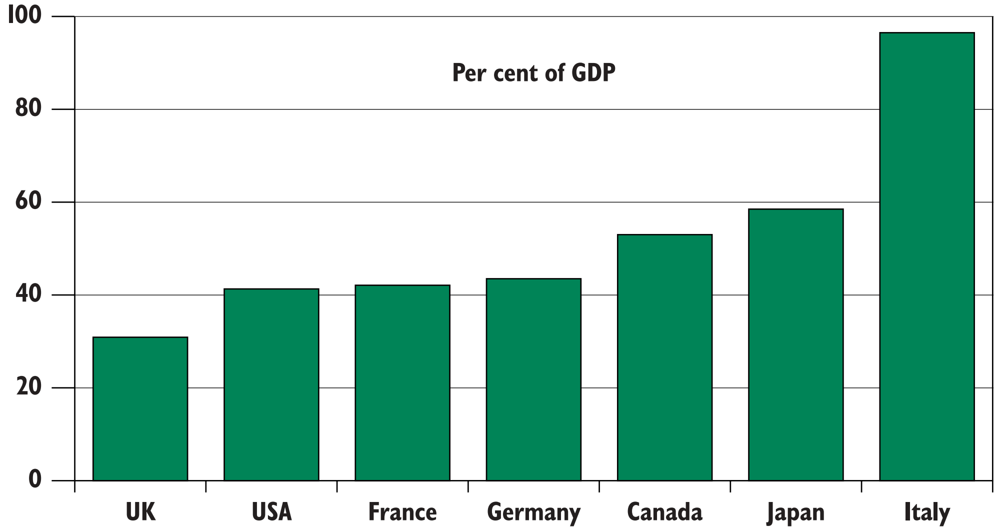
Table 2.2: Meeting the fiscal rules

	Per cent of GDP		
	1999–00	2000–01	2001–02
Golden rule			
Surplus on current budget	2.2	2.2	0.8
Average surplus since 1999–00	2.2	2.2	1.7
Cyclically-adjusted surplus on current budget	1.9	1.7	0.7
Sustainable investment rule			
Public sector net debt	36.2	31.2	30.4
Core debt	35.5	31.1	30.3

Sustainable investment rule

2.12 The sustainable investment rule requires public sector net debt as a proportion of GDP to be held at a stable and prudent level over the cycle, defined as 40 per cent. Net debt as a per cent of GDP continued to fall in 2000–01 and 2001–02 and it remained well below the 40 per cent limit set by the sustainable investment rule. This reflects surpluses on the overall budget balance, the proceeds from the auction of spectrum licences and continued economic growth. Sound public finances mean debt and debt interest payments are low. Core debt excludes the estimated impact of the economic cycle on public sector net debt and remained close to net debt, given that the economy remained relatively close to trend in this period.

Chart 2.3: OECD estimate of general government net financial liabilities for G7 countries, 2001



Source: OECD Economic Outlook June 2002

2.13 In total, the Government has repaid over £50 billion of debt since 1997. Public sector net debt has been reduced from 44 per cent of GDP to 30 per cent. Chart 2.3 illustrates that the UK has the lowest debt levels of any G7 country.

2.14 Low levels of debt and strong surpluses on the current budget have left the public finances well placed to withstand shocks and wider global instability and to support monetary policy over the economic cycle.

Economic impact of fiscal policy

2.15 While the primary objective of fiscal policy is to ensure sound public finances, fiscal policy impacts on the economy and plays a role in supporting monetary policy over the economic cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB), which moved from surplus into moderate deficit in this period. This reflects changes in both the fiscal stance (that part of PSNB resulting from changes in cyclically-adjusted PSNB) and the automatic stabilisers (that part which results from the impact of the economic cycle such as changes in elements of social security spending).

2.16 Outturn information in Table 2.1 shows that, relative to the year-ahead forecasts in Budget 2000 and Budget 2001, the fiscal stance supported monetary policy in maintaining economic stability. In 2000–01 there was a significant tightening of the fiscal stance relative to that anticipated in Budget 2000. The surplus on cyclically-adjusted net borrowing was 1.2 per cent of GDP, compared to the Budget 2000 forecast of 0.3 per cent, a tightening of 0.9 per cent. This greater than forecast surplus of receipts over spending supported monetary policy as the economy was above trend, as illustrated in Chart 2.1. Higher than forecast growth meant the automatic stabilisers also operated to an extent greater than forecast. In total the overall fiscal impact was tighter by 1.2 per cent of GDP.

2.17 For 2001–02, the outturn information suggests a slight easing of the fiscal stance in 2001–02 compared to the Budget 2001 forecast, which supported monetary policy as the economy moved below trend. The outturn for cyclically-adjusted net borrowing is 0.2 per cent of GDP compared to the forecast cyclically-adjusted net repayment of 0.1 per cent. As in 2000–01, the automatic stabilisers operated to a greater extent than forecast which meant that the overall fiscal impact was greater than forecast by 0.6 per cent of GDP.

FORECAST ANALYSIS

2.18 Table 2.1 summarised fiscal developments over 2000–01 and 2001–02. Table 2.3 below sets out a more detailed comparison of the year-ahead forecasts in Budget 2000 and Budget 2001 with latest outturn information.

Table 2.3: Summary of differences in Budget forecasts of fiscal aggregates

	£ billion					
	2000–01			2001–02		
	Budget 2000 forecast	Outturn	Difference	Budget 2001 forecast	Outturn	Difference
Current budget						
Current receipts	375.6	382.9	7.3	398.4	390.7	–7.7
Current expenditure	348.2	348.6	0.4	367.0	369.6	2.5
Depreciation	14.5	13.0	–1.4	15.5	13.4	–2.1
Surplus on current budget	12.9	21.3	8.4	15.9	7.7	–8.2
Capital budget						
Gross investment	26.4	23.0	–3.4	30.4	26.5	–3.9
less asset sales	–3.8	–4.6	–0.8	–3.8	–4.3	–0.5
less depreciation	–14.5	–13.0	1.4	–15.5	–13.4	2.1
Net investment	8.2	5.4	–2.8	11.2	8.8	–2.4
Public sector net borrowing	–4.7	–15.9	–11.2	–4.7	1.2	5.8
Public sector net debt	339.8	305.9	–33.9	307.0	310.9	3.9
Memos:						
Treaty deficit[1]	–5.5	–16.1	–10.6	–5.1	1.7	6.8
Treaty debt[2]	397.1	383.6	–13.6	372.3	380.7	8.4

[1] *General government net borrowing.*

[2] *General government gross debt.*

2.19 The table shows that most of the difference between the respective Budget forecasts and outturns for the current budget and net borrowing are explained by differences between the forecast and outturn for receipts. In 2000–01, the outturn for receipts was £7.3 billion higher than forecast; in 2001–02, receipts were £7.7 billion lower than forecast. Current spending remained closer to forecast, particularly in 2000–01, while revaluations of the public sector capital stock meant that depreciation was lower than projected.

2.20 Net borrowing is equal to net investment less the surplus on the current budget. In both years, net investment was lower than forecast in the respective Budgets. Public sector net debt was lower than forecast in 2000–01, but close to the forecast in 2001–02. In 2000–01, the greater than expected proceeds from the spectrum licence auction contributed significantly to the lower outturn for net debt, accounting for £19.5 billion of the difference. Box 3.2 explains in more detail how the proceeds affect the public finances.

2.21 Table 2.4 decomposes the differences between Budget forecast and outturn for the surplus on current budget and net borrowing. It analyses the differences due to the economic assumptions and those due to other fiscal errors, the NAO assumptions and other factors. Chapter 1 provided a more detailed explanation of these categories.

Table 2.4: Breakdown of forecast differences in the main fiscal aggregates[1]

	£ billion	
	Budget 2000 forecast for 2000–01	Budget 2001 forecast for 2001–02
Current receipts difference	**7.3**	**–7.7**
contribution from:		
Economic determinants	1.2	–5.7
NAO-audited assumptions	–0.3	0.5
Fiscal forecasting differences	6.4	–2.3
Other	0.0	–0.1
Current spending difference	**0.4**	**2.5**
contribution from		
Economic determinants	–0.2	–0.2
NAO-audited assumptions	–1.2	–0.7
Fiscal forecasting differences	1.8	3.8
Other	0.0	–0.3
Depreciation	**–1.4**	**–2.1**
contribution from:		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	–1.4	–2.1
Other	0.0	0.0
Current budget difference	**8.4**	**–8.2**
contribution from:		
Economic determinants	1.4	–5.5
NAO-audited assumptions	0.9	1.2
Fiscal forecasting differences	6.1	–4.1
Other	0.0	0.2
Net investment difference	**–2.8**	**–2.4**
contribution from:		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	–2.5	–2.1
Other	–0.3	–0.3
Net borrowing difference	**–11.2**	**5.8**
contribution from:		
Economic determinants	–1.4	5.5
NAO-audited assumptions	–0.9	–1.2
Fiscal forecasting differences	–8.6	2.0
Other	–0.4	–0.5

[1] *Contributions may not sum to totals due to rounding.*

2.22 It is not possible to make a direct read-across from differences between forecast and outturn attributed to the economic determinants in this decomposition to those attributed to the economic cycle in an analysis of cyclically-adjusted figures. The two approaches to looking at the public finances have different purposes. Cyclically-adjusted numbers are useful for estimating the impact of the cycle on the public finances at an aggregate level as set out in Table 2.1. But, as Chapter 1 explained, the classification of forecasting differences presented in Table 2.4 and the following chapters allows a more detailed analysis of differences between forecast and outturn for individual taxes and spending programmes, and reflects the forecast process rather than the division between cyclical and structural errors. Differences attributed to economic determinants could reflect either structural or cyclical differences. Similarly, changes attributed to wider fiscal forecasting differences could be cyclical if they were associated with changes in the output gap, but were not forecast by the Treasury.

2.23 The table shows that in both years the overall impact of the NAO-audited assumptions on the year-ahead forecasts of the current budget and net borrowing was cautious. Their impact contributed about £1 billion in each year to explaining the difference between forecast and outturn.

2.24 In 2000–01, the overall difference between forecast and outturn on the current budget was, however, primarily due to the impact of fiscal forecasting differences, particularly affecting receipts. Chapter 3 analyses these in more detail, showing in particular the important contribution of income tax relating to higher than forecast bonus payments. Since the Treasury does not directly forecast bonuses, this is regarded as being a fiscal forecasting difference.

2.25 In 2001–02, by contrast, the lower than forecast current surplus was due to the impact of differences relating to the economic determinants as well as fiscal forecasting differences. Chapter 3 shows that weaker world growth affected output in the UK, particularly profits, and that therefore corporation tax was significantly weaker than forecast.

3 RECEIPTS

This chapter provides more detailed analysis of developments in receipts in 2000-01 and 2001-02. It shows that:

- **current receipts rose from £383 billion in 2000-01 to £391 billion in 2001-02, providing resources for the Government's priorities and ensuring that the Government remained fully on track to meet its firm fiscal rules;**
- **differences between forecast and outturn of current receipts were ¾ per cent of GDP in each year:**
  - **in 2000-01, receipts were £7 billion higher than forecast, mainly as a result of higher than expected income tax; and**
  - **in 2001-02, receipts were £8 billion lower than forecast, mainly as a result of the impact of the global economic slowdown on corporation tax receipts.**

The differences were within historical averages. Sound public finances mean that the Government can let fiscal policy play its part in maintaining economic stability. Developments in receipts have supported monetary policy as the economy was above trend in 2000-01, but moved below trend in 2001-02.

INTRODUCTION

3.1 This chapter provides more detailed analysis of developments in public sector current receipts and, in particular, the forecasts in Budget 2000 and Budget 2001. It analyses the overall forecasting differences, both in actual and cyclically-adjusted terms, before looking in detail at each of the main taxes.

Overall receipts forecasting differences

3.2 Table 3.1 sets out the differences in the year-ahead forecasts of receipts for Budget 2000 and Budget 2001. Current receipts were nearly £383 billion in 2000-01 and rose to almost £391 billion in 2001-02. As a share of national income, receipts fell from 39.8 per cent of GDP to 39.2 per cent.

3.3 Current receipts in 2000-01 were around £7 billion (¾ per cent of GDP) higher than originally forecast. Table 3.2 shows that this was largely the result of higher than expected income tax receipts and social security contributions. Upward revisions to the level of money GDP meant that despite the higher than expected receipts, the ratio of receipts to GDP remained close to its forecast level.

Table 3.1: Summary of differences in Budget receipts forecasts

	Forecast	Outturn	Difference
Budget 2000 forecast of 2000–01			
Current receipts (£ billion)	375.6	382.9	7.3
Current receipts (per cent of GDP)	39.7	39.8	0.1
Cyclically-adjusted current receipts (per cent of GDP)	39.7	39.7	0.1
Budget 2001 forecast of 2001–02			
Current receipts (£ billion)	398.4	390.7	–7.7
Current receipts (per cent of GDP)	40.2	39.2	–1.1
Cyclically-adjusted current receipts (per cent of GDP)	40.1	39.1	–1.1

3.4 In contrast to 2000-01, receipts in 2001-02 were around £8 billion (3/4 per cent of GDP) lower than forecast. This reflected the impact of the world economic slowdown, which particularly affected corporation tax receipts, especially those from financial companies. Chapter 2 explained that this reduction in receipts was consistent with the Government's fiscal policy objectives, as the automatic stabilisers operated to support monetary policy in maintaining economic stability.

3.5 The differences between forecast and outturn on receipts explain most of the overall differences between forecast and outturn on public sector net borrowing. Box 2.1 explained that public finance forecasts are subject to a considerable degree of uncertainty, and the year-ahead differences between forecast and outturn on net borrowing in 2000–01 and 2001–02 were close to historical averages. The average absolute difference was 0.9 per cent of GDP, compared with the average absolute difference of 1.1 per cent since 1989–90.

3.6 In order to focus on underlying or structural trends in receipts, the Government also produces estimates of cyclically-adjusted fiscal aggregates (see Table 2.1). These remove the estimated effect of the economic cycle on public sector spending and receipts. The difference in the cyclically-adjusted estimates of current receipts was closer to the unadjusted estimates than might be expected. This was because much of the downturn in receipts was caused by factors not fully reflected in measures of GDP and the output gap, but which are expected to be temporary, such as elements of financial company profits.

TAX FORECASTING AND REASONS FOR DIFFERENCES

Tax forecasts and economic determinants

3.7 Chapter 1 explained that differences between forecast and outturn can be split into several categories:

- **economic determinants:** tax revenues, or more specifically tax bases (the transactions or assets on which the taxes are charged) are largely related to particular macroeconomic variables forecast by the Treasury. For example, income tax receipts are heavily dependent on levels of wages and salaries, and VAT receipts on consumers' expenditure. Any difference between the forecasts of these economic determinants and their eventual outturn values will partly explain differences in tax forecasts;

- **audited assumptions:** many of the economic determinants described above are calculated using assumptions that are audited by the National Audit Office (NAO), ensuring that they remain both reasonable and cautious. The impacts of differences in the forecasts of these determinants with their outturn on the tax forecasts can be separately identified. This includes the impact of using a trend growth assumption that is one quarter of a percentage point below the Treasury's neutral view. Other things equal, the overall impact of the cautious audited assumptions will on average be positive in Tables 3.2 and 3.3 (i.e. the outturn will be for higher receipts);

- **fiscal forecasting differences:** in some cases, forecasts of the relevant economic variables for the tax base are not produced by the Treasury. For example, the Treasury does not forecast consumers' expenditure on beer, which would be used to forecast beer duty receipts. In these cases, 'fiscal forecasting models' are used to estimate the relationship between the most relevant macroeconomic variable (total consumers' expenditure in the case of beer) and the corresponding tax base. These models are also used to estimate actual tax receipts. Any differences in tax receipts resulting from unexpected changes in the relationship between main economic determinants, tax rates and revenues, as contained in the fiscal models, are therefore defined as fiscal forecasting differences. For example, if income tax receipts turned out to be higher than forecast even after taking account of differences in the eventual level of wages and salaries, then there is a fiscal forecasting difference. Fiscal forecasting differences can be either cyclical, if they are related to the economic cycle and the output gap, or structural, if they are not; and

- **other:** other factors include changes in definitions of taxes or the impact of tax measures announced after the publication of the forecast that have an effect on receipts in that year. For example, in the November 2000 Pre-Budget Report the Government implemented transitional arrangements as a first stage of the vehicle excise duty (VED) reforms, which had an impact on VED receipts in 2000-01 explaining some of the difference between forecast and outturn.

TAX BY TAX FORECASTING DIFFERENCES

3.8 Tables 3.2 and 3.3 use this breakdown of forecasting differences for the Budget 2000 and Budget 2001 year-ahead forecasts for each of the main taxes. These tables also group the taxes to show the same breakdown for Inland Revenue receipts, HM Customs and Excise receipts, net taxes and social security contributions and current receipts.

Tax by tax analysis

Income tax

3.9 Gross income tax receipts in 2000-01 were £4.9 billion (5 per cent) higher than forecast in Budget 2000. Around £1.8 billion of this is explained by differences in the levels of economic determinants. The determinants used to forecast the tax base for self assessment income contributed £1.4 billion, and higher than expected overall levels of wages and salaries contributed a further £0.5 billion through their impact on Pay as You Earn (PAYE). The interest rate assumption, based on market expectations, led to an overestimate of £0.3 billion for receipts from tax deducted from savings income. This is scored under assumptions audited by the NAO, although it is partly offset by the impact of the audited assumption on trend GDP growth on wages and salaries. The remaining difference of £3.2 billion falls under the category of fiscal differences. Almost all of this is attributable to PAYE, and is analysed in Box 3.1.

3.10 In contrast to 2000-01, income tax receipts in 2001-02 were £1.2 billion lower than forecast. However, latest provisional data suggests determinant differences, and the impact of the NAO assumptions should have led to an outturn £0.8 billion higher than forecast. This implies a difference of around £1.9 billion from fiscal forecasting. About £0.9 billion of this relates to the PAYE forecast (discussed in Box 3.1), while the remaining £1 billion largely relates to self assessment receipts and tax on savings and investment income.

3.11 Recent tax data helps explain this self assessment fiscal forecasting difference. The growth rates of taxable self employment and investment income relative to the respective determinants were weaker than forecast in Budget 2001, and this explains about £1.5 billion of the fiscal difference. In contrast to self assessment, receipts from tax deducted at source on savings and investment income were £0.5 billion higher than forecast because of fiscal differences. About half of this was because average interest rates on savings accounts were higher than would have been expected and results from a change in the relationship between these rates and the 3 month market rate set by the NAO-audited assumption.

Box 3.1: Pay as You Earn (PAYE)

Income tax received through PAYE is projected by applying appropriate tax rates to changes in the tax base and then allowing for the effects of changes to tax rates and allowances and other Budget measures affecting PAYE coverage. Wages and salaries are by far the most important component of the tax base. Changes in wages and salaries arising from changes in employment and increases in average earnings have to be treated separately: the progressive nature of the income tax system means that the latter are subject to a higher average rate.

The tax rates used in PAYE projections take the latest available information on the earnings distribution, and combine this with information on income tax rates, allowances and thresholds, to calculate the PAYE yield of each additional pound of wages and salaries. In projecting these rates forward, some allowance is made for fiscal drag: the positive effect on receipts resulting from real wage growth leading to an increasing proportion of taxpayers in higher tax brackets. Until recently it was assumed that earnings increases would impact evenly across the income distribution. This assumption worked well until the end of the 1990s. However, recent shifts in the distribution of earnings increases – in particular between basic rate taxpayers, taxed at 22 per cent, and higher rate taxpayers, taxed at 40 per cent - have affected the amount of PAYE collected. Detailed investigation of tax records for 1999-2000 suggests that people at the very top end of the income distribution received much bigger than average percentage increases, and a similar effect was also observed in 2000-01. As these top earners pay income tax at 40 per cent on all of their extra earnings this had an impact on the average tax rate that should have been applied to the extra income. This change in the pattern of earnings explains much of the forecasting difference in 2000-01.

The main reason for the higher than average increases in earnings for higher rate taxpayers is likely to be the high level of bonus payments received by financial sector employees, which rose significantly at the end of the 1990s. The amount of tax paid on bonus payments cannot be separately identified but tax data on the pattern of payments over the year suggests that bonus payments make up a large proportion of total earnings in the financial sector, and that this proportion increased rapidly up until 2000-01.

The effects of these increases in bonuses on tax rates were not fully allowed for in the Budget 2000 forecast of PAYE receipts in 2000-01 and almost certainly explain most of the PAYE fiscal difference of £3.3 billion. However, some of the extra receipts were due to an underestimate of the effect of a Budget measure that extended PAYE to cover tax due when certain unapproved share options are exercised. This measure was announced in November 1996 but only started to have a significant effect on receipts in 1999, when the high level of equity prices and increased use of such options led to a larger effect on tax receipts than previously projected.

When the Budget 2001 projections were made it was expected that bonuses in 2001-02 would grow in line with other wages and salaries. As this forecast pre-dated the analysis above, it was again assumed that bonuses would have no effect on the tax rates used in the PAYE projections. However financial company profits fell in 2001-02 and this was to some extent reflected in bonus payments. Full data is not yet available, but it seems likely that the tax rate effect observed in 2000-01 was partially reversed in 2001-02, explaining most of the £0.9 billion shortfall attributed to fiscal differences in 2001-02.

Table 3.2: Breakdown of Budget 2000 forecasting differences of receipts for 2000–01

£ billion

	Forecast	Outturn	Difference	of which: Economic determinants[1]	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Inland Revenue							
Income tax (gross of tax credits)	101.0	105.9	4.9	1.8	–0.1	3.2	0.0
Income tax credits[2]	–5.1	–1.0	4.1	0.0	0.0	0.1	4.0
Corporation tax	33.8	32.4	–1.4	–1.3	0.4	–0.5	0.0
Petroleum revenue tax	1.2	1.5	0.3	–0.1	0.5	–0.1	0.0
Capital gains tax	3.4	3.2	–0.1	0.2	0.0	–0.3	0.0
Inheritance tax	2.3	2.2	0.0	0.0	–0.1	0.1	0.0
Stamp duties	7.2	8.2	0.9	0.5	0.1	0.3	0.1
Social security contributions	58.8	60.6	1.8	0.3	0.1	1.4	0.0
Total Inland Revenue	**202.6**	**213.2**	**10.6**	**1.4**	**0.9**	**4.1**	**4.1**
Customs and Excise							
Value added tax	59.6	58.5	–1.1	0.1	–0.9	–0.3	0.0
Fuel duties	23.3	22.6	–0.7	–0.1	–0.4	–0.2	0.0
Tobacco duties	7.4	7.6	0.3	0.0	0.1	0.2	0.0
Alcohol duties	6.7	6.7	0.0	0.0	0.0	0.0	0.0
Other Customs and Excise	6.4	6.7	0.3	–0.1	0.0	0.4	0.0
Total Customs and Excise	**103.3**	**102.2**	**–1.2**	**0.0**	**–1.2**	**0.0**	**0.0**
Vehicle excise duties	4.9	4.3	–0.7	0.0	0.0	–0.4	–0.3
Oil royalties	0.5	0.6	0.1	0.1	0.1	–0.1	0.0
Business rates	16.2	16.7	0.5	0.0	0.0	0.5	0.0
Council tax	13.6	14.1	0.5	0.0	0.0	0.5	0.0
Other taxes and royalties[3,4]	8.2	9.0	0.7	0.0	0.0	0.9	–0.2
Net taxes and social security contributions	**349.4**	**360.0**	**10.6**	**1.5**	**–0.1**	**5.6**	**3.6**
Accruals adjustment on taxes	3.0	3.4	0.4	–0.2	0.1	0.6	0.0
less VAT and own resources EC contributions	–5.4	–6.3	–0.9	0.0	0.0	–0.9	0.0
less PC onshore CT payments	–0.4	–0.1	0.3	0.0	0.0	0.3	0.0
National Accounts income tax credits[2]	5.1	0.9	–4.1	0.0	0.0	–0.1	–4.0
Interest and dividends	4.4	6.1	1.7	0.0	–0.2	1.9	0.0
Other receipts[3]	19.6	19.0	–0.6	0.0	0.0	–1.0	0.4
Current receipts	**375.6**	**382.9**	**7.3**	**1.2**	**–0.3**	**6.4**	**0.0**

[1] *Excluding those audited by the NAO.*

[2] *The Budget 2000 forecast of income tax credits classified all of the Working Families' Tax Credit as negative tax, whereas the outturn figure only includes that amount that offsets income tax liability, in line with OECD guidelines. There is an equal and opposite adjustment in the National Accounts income tax credits line.*

[3] *In September 2001, there was a change in the classification of ITC franchise payments. They used to score in taxes on production, in 'other taxes and royalties', but now score as gross operating surplus and rent, in 'other receipts'.*

[4] *This line includes levy funded bodies receipts in outturn but not forecast values. This is because of a reclassification in the National Accounts. Levy funded bodies' receipts and expenditure are now published as gross figures in the National Accounts, whereas expenditure used to be published net of receipts.*

Table 3.3: Breakdown of Budget 2001 forecasting differences of receipts for 2001–02

				£ billion			
	Forecast	Outturn	Difference	of which:			
				Economic determinants[1]	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Inland Revenue							
Income tax (gross of tax credits)	111.5	110.4	–1.2	0.6	0.2	–1.9	0.0
Income tax credits[2]	–7.2	–2.2	5.0	0.0	0.0	0.1	4.9
Corporation tax	37.8	32.4	–5.4	–6.5	–0.3	1.5	0.0
Corporation tax credits	–0.2	–0.1	0.1	0.0	0.0	0.1	0.0
Petroleum revenue tax	1.6	1.3	–0.3	0.0	0.0	–0.4	0.0
Capital gains tax	2.5	3.0	0.4	0.1	–0.1	0.4	0.0
Inheritance tax	2.3	2.4	0.1	0.0	–0.1	0.1	0.0
Stamp duties	8.0	7.1	–0.9	0.7	–0.4	–1.3	0.0
Social security contributions	62.6	63.2	0.5	–0.1	0.1	0.6	0.0
Total Inland Revenue	**219.0**	**217.4**	**–1.7**	**–5.2**	**–0.6**	**–0.8**	**5.0**
Customs and Excise							
Value added tax	61.3	61.0	–0.3	–0.3	0.6	–0.5	0.0
Fuel duties	22.5	21.9	–0.6	–0.1	0.1	–0.2	–0.3
Tobacco duties	7.6	7.8	0.2	0.0	0.3	–0.2	0.0
Alcohol duties	6.8	7.0	0.2	0.0	0.0	0.1	0.0
Other Customs and Excise	7.7	7.2	–0.5	–0.1	0.0	–0.4	0.0
Total Customs and Excise	**105.9**	**104.9**	**–1.0**	**–0.4**	**1.0**	**–1.2**	**–0.3**
Vehicle excise duties	4.5	4.2	–0.3	0.0	0.0	–0.2	0.0
Oil royalties	0.6	0.5	0.0	0.0	0.0	0.0	0.0
Business rates	17.5	17.5	0.0	0.0	0.0	0.0	0.0
Council tax	14.7	15.3	0.6	0.0	0.0	0.6	0.0
Other taxes and royalties[3,4]	9.5	10.1	0.5	0.0	0.0	0.9	–0.3
Net taxes and social security contributions	**371.6**	**369.8**	**–1.8**	**–5.7**	**0.4**	**–0.8**	**4.3**
Accruals adjustment on taxes	1.7	1.3	–0.5	0.0	0.1	–0.5	0.0
less VAT and own resources EC contributions	–5.9	–5.6	0.3	0.0	0.0	0.3	0.0
less PC onshore CT payments	–0.2	–0.1	0.1	0.0	0.0	0.1	0.0
National Accounts income tax credits[2]	5.8	0.8	–5.0	0.0	0.0	–0.1	–4.9
Interest and dividends	4.8	4.7	–0.1	0.0	0.0	–0.1	0.0
Other receipts[3]	20.5	19.7	–0.8	0.0	0.0	–1.2	0.4
Current receipts	**398.4**	**390.7**	**–7.7**	**–5.7**	**0.5**	**–2.3**	**–0.1**

[1] *Excluding those audited by the NAO.*

[2] *The Budget 2001 forecast of income tax credits classified all of the Working Families' Tax Credit as negative tax, whereas the outturn figure only includes that amount that offsets income tax liability, in line with OECD guidelines. There is an equal and opposite adjustment in the National Accounts income tax credits line.*

[3] *In September 2001, there was a change in the classification of ITC franchise payments. They used to score in taxes on production, in 'other taxes and royalties', but now score as gross operating surplus and rent, in 'other receipts'.*

[4] *This line includes levy funded bodies receipts in outturn but not forecast values. This is because of a reclassification in the National Accounts. Levy funded bodies' receipts and expenditure are now published as gross figures in the National Accounts, whereas expenditure used to be published net of receipts.*

Income tax credits **3.12** The £4.1 billion and £5.0 billion differences between the Budget 2000 and Budget 2001 forecasts of income tax credits and the eventual outturn are almost entirely due to the changes in the classification of tax credits used in the calculation of net taxes and social security contributions that were introduced in Budget 2002. Tax credits are now scored as negative taxation to the extent that they are less than or equal to the tax liability of the household, and as public expenditure where they exceed the liability. This treatment is consistent with OECD guidance, which was reviewed in 2001 following extensive consultation including with the UK. Previously, the tax credits were scored as negative tax. The Office for National Statistics (ONS) have announced that they will also be adopting the OECD guidance for the classification of the Working Tax Credit and the Child Tax Credit that are to be introduced in 2003. However, they will continue to classify the Working Families' Tax Credit and the Disabled Person's Tax Credit as public expenditure. As a result, there is as equal and opposite adjustment within Tables 3.2 and 3.3 to the National Accounts income tax credits line, which ensures that there is no overall impact on the level of total public sector receipts.

Corporation tax **3.13** Corporation tax receipts in 2000-01 were £1.4 billion below the Budget 2000 forecast. This difference is almost entirely due to lower than forecast company profits and is scored as a determinant difference. This was partly offset by higher than expected corporation tax from oil companies as a result of higher oil prices than projected under the NAO-audited assumption.

3.14 Lower than forecast company profits also explain most of the difference in 2001–02 relative to the Budget 2001 forecast. The decline in profitability reflected the impact of the global economic slowdown in 2001. The effects were particularly significant in the financial sector, where taxable profits fell sharply as a result of weaker activity in financial markets. Equity prices fell by about 6 per cent over the fiscal year, and merger and acquisition activity, a major driver of financial companies' fee-earning activity, was almost 75 per cent lower in 2001 than in 2000. The impact of the fall in profits is generally scored under economic determinant differences. However, the effects of the fall in equity prices on life insurers profitability are scored under the NAO assumptions since the taxable income and capital gains of this sector are highly dependent on equity price changes.

Petroleum revenue tax **3.15** Receipts from petroleum revenue tax in 2000-01 were around £0.3 billion higher than forecast. This is more than accounted for by higher than expected oil prices (scored under assumptions audited by the NAO), partly offset by lower than expected production levels.

Stamp duties **3.16** Receipts from stamp duty in 2000-01 were around £0.9 billion higher than forecast. A small proportion of this amount (£0.1 billion) was because equity prices were higher than forecast using the assumption audited by the NAO, which resulted in higher receipts on share transactions. However, the majority of the difference results from the higher than forecast levels of mergers and acquisitions and equity transactions. These are scored under economic determinant differences. They are partly offset by lower than expected house transaction volumes.

3.17 In 2001-02 stamp duty receipts were around £0.9 billion lower than forecast. This was due to lower receipts from stamp duty on equity transactions, which were partly a result of lower than projected equity prices (scored under assumptions audited by the NAO), offset by higher house prices and volumes. Mergers and acquisition activity was weaker than expected, but this was offset by higher than projected volumes of equity trading.

Capital gains tax **3.18** Capital gains tax receipts in 2000-01 were marginally below their forecast values, despite outturn equity volumes being slightly higher than those used to produce the forecast. Receipts in 2001-02 were around £0.4 billion higher than forecast. The main differences in both years were fiscal forecasting differences and reflect differences between the forecast levels of gains realised in each year and the outturn.

Social security contributions

3.19 Receipts of social security (or national insurance) contributions were £1.8 billion above the Budget 2000 forecast in 2000-01. Around £0.4 billion of this is determinant related and is explained by higher than forecast wages and salaries. Since the 2001 Pre-Budget Report, a more detailed methodology has been used in the preparation of these forecasts.

3.20 Receipts of social security contributions were £0.5 billion above the Budget 2001 forecast in 2001-02. Again, most of this is attributable to fiscal forecasting differences of £0.6 billion.

Value added tax

3.21 VAT receipts in 2000-01 were £1.1 billion below their Budget 2000 forecast. This is partly a result of the £0.3 billion difference in the estimate of receipts in 1999-2000, which was used as the base when calculating the VAT forecasts. This amount is scored under fiscal forecasting differences (the audited assumption only applies to years after the current 'base' year).

3.22 The remaining difference results from the fact that the ratio of underlying VAT receipts (VAT receipts adjusted for changes in rates and coverage) to consumers' expenditure fell by more than was forecast under the NAO-audited assumption. This reflected changes in the share of total VAT-liable expenditure accounted for by consumers' expenditure on the one hand, and other sectors on the other.

3.23 VAT receipts in 2001-02 were £0.3 billion below the Budget 2001 forecast. As with the previous forecast, this is largely a result of the £0.5 billion difference in the estimate of receipts in 2000-01, which scores as a fiscal difference. Lower then expected consumers' expenditure also contributed to the lower than forecast outturn. This is reflected in the £0.3 billion of economic determinant differences.

3.24 These factors were partly offset by a higher than forecast ratio of underlying VAT receipts to consumers' expenditure between 2000-01 and 2001-02. Data is not yet available to fully explain all of this change, although recent strategies put in place by HM Customs and Excise are reducing levels of fraud and avoidance.

Fuel duties

3.25 Fuel duties in 2000-01 were £0.7 billion below their Budget 2000 forecast. This is mainly due to much higher than projected oil prices, which increased petrol and DERV fuel prices and lowered demand. This difference has been scored under assumptions audited by the NAO as these are used to forecast oil prices. The fuel blockades that occurred in October and November contributed towards the remaining fiscal errors.

3.26 Fuel duties in 2001-02 were £0.6 billion below their Budget 2001 forecast. Around £0.3 billion of this is explained by the later than usual date of the 2002 Budget. This meant that the normal surge in receipts that occurs in March as oil retailers forestall duty increases was instead received in April, depressing 2001-02 receipts but with a corresponding positive impact on 2002-03 receipts. This is scored under other forecasting differences.

Tobacco duties **3.27** Tobacco receipts in 2000-01 were around £0.3 billion above forecast. This was partly a result of lower than expected levels of cross border shopping. There was also a small contribution from the NAO-audited tobacco assumption that allows only the direct effects of the anti-fraud strategy to be included in the forecast. This meant that the forecast assumed that smuggled cigarettes would account for 22 per cent of the UK market, whereas HM Customs and Excise now estimate the actual share was 21 per cent.

3.28 Tobacco receipts in 2001-02 were also higher than forecast. This is despite total tobacco consumption being lower than forecast. The higher than expected revenue is again largely explained by the exclusion of the indirect effects of the anti-fraud strategy in the NAO-audited assumption. The forecast assumed that the smuggled share would be 24 per cent of the total UK market, whereas the provisional outturn share is 21 per cent. The NAO has reviewed the tobacco assumption in this Pre-Budget Report in order to take account of these effects.

Alcohol duties **3.29** Alcohol duty receipts were close to forecast in 2000-01 but £0.2 billion higher than forecast in 2001-02. This was largely a result of higher than expected spirits and wine duty receipts. Most of the wine duty increase resulted from a significant increase in sales of coolers, or alcopops, which was not adequately accounted for in the forecasting model. These differences score under fiscal forecasting differences.

Other HM Customs and Excise **3.30** Higher than expected insurance premium tax, betting and gaming duties and customs duties in 2000–01 meant that receipts from other HM Customs and Excise duties were around £0.3 billion higher than forecast. However, this difference was reversed in 2001-02, with outturn around £0.5 billion lower than forecast. This reflected a number of factors, including an underestimate of the revenue costs of restructuring the air passenger duty (APD) regime and the reduction in air travel in response to the September 11 attacks. These factors were only partly offset by higher than expected insurance premium tax receipts, and all score as fiscal forecasting differences.

Vehicle excise duty **3.31** VED receipts were £0.7 billion lower than forecast in 2000-01. This was partly because of the transitional arrangements as a first stage of the VED reforms announced in the November 2000 Pre-Budget Report, which reduced VED receipts by around £0.3 billion in 2000-01, and therefore scores as 'other' differences. The remaining difference reflects lower than expected growth of the vehicle stock, which is scored as a fiscal forecasting difference. In 2001-02, VED receipts were £0.3 billion lower than forecast, largely reflecting changes in the composition of the vehicle fleet towards lower taxed vehicles, which is also a fiscal forecasting difference.

Business rates **3.32** Business rates were £0.5 billion higher in 2000-01 than projected in Budget 2000. This was principally the result of fiscal forecasting differences, mainly resulting from an underestimation of the rateable values of the total stock of business properties at the time of Budget 2000. Business rates in 2001-02 were close to the Budget 2001 forecast.

Council tax **3.33** Council tax in 2000-01 was £0.5 billion higher than forecast in Budget 2000, and £0.6 billion higher in 2001-02 than forecast in Budget 2001. These were both the result of fiscal forecasting differences. Net council tax receipts are defined as local authority gross council tax receipts less Council Tax Benefits paid to local authorities by central government. In 2000-01, the former were underestimated by £0.3 billion because of the higher than forecast growth in the number of properties that pay council tax. The latter was overestimated by £0.2 billion and reflects the overestimation of the number of claimants receiving Income Support and Council Tax Benefits and Housing Tax Benefits. This is explained further in Chapter 4. For 2001-02, the £0.6 billion underestimation of council tax was again, for the same reasons, due to an under-forecasting of gross council tax receipts by £0.4 billion and the over-forecasting of Council Tax Benefit by £0.2 billion.

Other taxes and royalties **3.34** The difference in other taxes and royalties in both 2000-01 and 2001-02 largely reflects higher than expected VAT refunds to central government and public corporations, which scores entirely as a fiscal forecasting difference. Since VAT refunds are also included in expenditure, this has no effect on net borrowing.

3.35 ONS changes to the classification of taxes also explains part of the difference. In particular, Independent Television Commission (ITC) franchise payments which amount to around £0.4 billion per annum, were moved out of taxes on production and into gross operating surplus and rent, with no net impact on total receipts. Similarly, levy funded bodies' receipts and expenditure are now separated in the National Accounts, whereas expenditure used to be published net of receipts. This revision increases other taxes and royalties and also total receipts and current expenditure by around £0.2 billion in both years, therefore it has no effect on the current budget or net borrowing.

EC contributions **3.36** The £0.9 billion difference in EC contributions in 2000-01 was mainly due to a higher than forecast VAT-based contribution. The £0.3 billion difference in EC contributions in 2001-02 was due to a negative VAT base adjustment in August 2001 when the European Commission returned some contributions back to member states.

Interest and dividends **3.37** Interest and dividend receipts received by the public sector in 2000-01 were £1.7 billion higher than forecast in Budget 2000. This is partly a result of the auction of spectrum licences (see Box 3.2). There was also an unexpected one-off receipt of a £0.2 billion. These factors are scored under fiscal forecasting differences. These upward factors were partly offset by lower than expected interest rates, scored under assumptions audited by the NAO. Receipts from interest and dividends in 2001–02 were close to forecast.

Other receipts **3.38** 'Other receipts' consists of gross operating surplus and rent, accrued proceeds from the auction of spectrum licences, central government current transfers from households, general government rent receipts (excluding oil royalties) and central government current transfers to public corporations.

3.39 In 2000-01 these were £0.6 billion lower than originally forecast. This was mainly due to outturn gross operating surpluses for public corporations being lower than forecast by £2.3 billion. These were only partly offset by gross operating surpluses for general government being £0.7 billion higher than forecast, which reflected the fact that forecasts were based on data for capital stock and non-trading capital consumption that were subsequently revised upwards. Rent receipts were also higher than expected, resulting from the auction of spectrum licences, the full impact of which is explained in Box 3.2. These factors are all scored as fiscal differences. The remaining difference is explained by the positive impact of the reclassification of ITC franchise payments discussed in paragraph 3.35, scored in 'other' and amounting to £0.4 billion.

3.40 In 2001-02 'other receipts' were £0.8 billion lower than originally forecast. This was the result of public corporations and general government gross operating surpluses coming in £0.8 billion and £0.2 billion lower than expected respectively. Again the latter was due to the forecasts being based on data that was subsequently revised downwards. Central government current transfers from households were also overestimated by £0.2 billion. These factors all score as fiscal differences. The remaining difference is explained by the positive impact of the reclassification of ITC franchise payments, scored in 'other' and amounting to £0.4 billion.

Box 3.2: Spectrum licence proceeds

The auction of licences that enabled mobile phone companies to access the electromagnetic spectrum for third generation mobile phones held in 2000 raised £22.5 billion, £19.5 billion more than the £3 billion forecast at the time of Budget 2000.

In line with the view of the Office for National Statistics in the National Accounts, the Government treats these receipts as rent and accrues them evenly across the whole of the licence period of about 21 years. The difference between forecast and outturn added £0.9 billion to rent receipts in 2000-01.

The Government decided that the extra cash payments would be used to reduce public sector net debt. Consequently, a revised Debt Management Office's remit was published on 12 June 2000. As well as a reduction in gross gilt sales, it announced pre-financing of foreign currency debt and gilt buy-backs and also allowed for increases in short-term assets holdings, which would be used to reduce net short-term debt. The extra auction receipts hence led to extra interest and dividend receipts of £0.4 billion in 2000-01 as well as reducing debt interest payments by £0.3 billion that year.

These savings from debt interest payments were factored into the 2000 Spending Review and made room for additional spending on key public services over several years.

The total effect of the extra proceeds in 2000-01 was to add an extra £1.3 billion to receipts (£0.4 billion to interest and dividend receipts and £0.9 billion to rent) and reduce spending by £0.3 billion. All these changes are scored as fiscal forecasting differences and explain £1.6 billion of the difference in the current surplus. However, the whole £19.5 billion extra proceeds score as a reduction to public sector net debt.

Conclusion

3.41 Current receipts rose from £383 billion in 2000-01 to £391 billion in 2001-02. Differences between forecasts and outturns of current receipts in this period were less than 2 per cent in each year. The uncertainty in forecasting receipts is recognised in the fiscal framework and projections of receipts (and spending) are deliberately based on prudent assumptions for key economic variables, minimising the need for unexpected changes in direction in fiscal policy. The sound position of the public finances, including surpluses in the current budget and low and stable levels of debt, means that the Government can let fiscal policy play its part in maintaining economic stability. Developments in receipts have supported monetary policy as the economy was above trend in 2000-01, but moved below trend in 2001-02.

4 PUBLIC EXPENDITURE

This chapter provides a detailed analysis of public expenditure in 2000-01 and 2001-02. It shows that:

- **forecasts on spending have been close to outturn in each financial year: the difference between forecast and outturn was 0.4 per cent of GDP in 2000-01 and 0.2 per cent of GDP in 2001-02;**
- **the Government has reduced the costs of social and economic failure: debt interest and social security benefit payments have continued to fall from 35 per cent of total spending in 2000-01 to 34 per cent in 2001-02, releasing additional resources for priority public services;**
- **the Government has released substantial resources for its priorities: total public sector spending has increased by nearly £25 billion or 7 per cent from 2000-01 to 2001-02; and**
- **there has been a substantial increase in public sector net investment over the past two years, equivalent to 63 per cent in nominal terms, addressing the historic under-investment in public services.**

INTRODUCTION

4.1 This chapter provides more detailed analysis of trends and developments in public expenditure in 2000-01 and 2001-02 and, in particular, the differences between projected expenditure and outturn for the year-ahead projections in Budgets 2000 and 2001.

Total Managed Expenditure

4.2 Public expenditure is measured across the whole public sector using the aggregate Total Managed Expenditure (TME). TME is the sum of public sector current expenditure, public sector net investment and public sector depreciation. These aggregates are based on National Accounts definitions defined under the European System of Accounts 1995. For budgeting purposes, TME is split into:

- Departmental Expenditure Limits (DEL): firm three-year spending limits for departments; and
- Annually Managed Expenditure (AME): spending that cannot reasonably be subject to firm multi-year limits. It includes social security and debt interest payments, spending by departments in AME, some central government non-departmental spending, some local authority and public corporation spending, and adjustments to reconcile with National Accounts.

To improve long-term planning and protect capital investment, DEL is further divided into capital and resource (current) budgets which are managed separately. Full end-year flexibility (EYF) allows departments to carry forward resources from one year to the next.

Resource accounting and budgeting

4.3 In order to enable a more meaningful comparison of trends and the differences between forecasts and outturns, the projections in this chapter have been adjusted where relevant for changes associated with the introduction of resource accounting and budgeting (RAB). RAB replaces the previous approach of planning and controlling public expenditure on a cash basis and applies the best financial and disclosure practices of commercial accounting to central government finance. Resource budgeting was introduced in two stages: in part during the 2000 Spending Review, when a hybrid of resource budgeting and the cash management system was in operation, and in full in the 2002 Spending Review. RAB captures the full economic costs of providing public services, since costs are scored when resources are consumed or accrued rather than when cash is spent, which generally occurred in the previous system that was in place up to and including Budget 2000. Resource accounts and budgets also include the non-cash costs of economic consumption such as depreciation. The RAB changes have no effect on National Accounts aggregates, and therefore Total Managed Expenditure, but in order to put all DEL and AME figures on the same basis, the forecasts made at the time of Budget 2000 have been restated using the budgeting system used for the 2000 Spending Review.

Data revisions

4.4 The two-year horizon in the end of year fiscal report (EYFR) provides a balance between the timely reporting of spending developments and the robustness of data. However, data on public spending remains provisional for a considerable period after the end of the relevant financial year. For example, resource accounts for central government departments are finalised about nine months after year-end, while consolidated data for local authorities is produced over a longer time scale. This means that the data in this chapter, particularly for 2001-02, is not final. That said, the information is sufficiently robust to provide a sound platform for analysing forecast differences, and future revisions are likely to change the detail rather than the main conclusions.

OVERALL PUBLIC EXPENDITURE FORECASTING DIFFERENCES

4.5 Table 4.1 below shows the latest outturn for key public spending aggregates for 2000-01 and 2001-02, including a comparison of the differences in the year-ahead forecasts for spending in Budgets 2000 and 2001. TME rose to £392 billion in this period, close to 40 per cent of GDP.

4.6 Overall, the provisional outturns for TME remained close to forecast in both years. Differences between outturn and forecast for 2000-01 were 0.4 per cent of GDP in 2000-01 and 0.2 per cent of GDP in 2001-02.

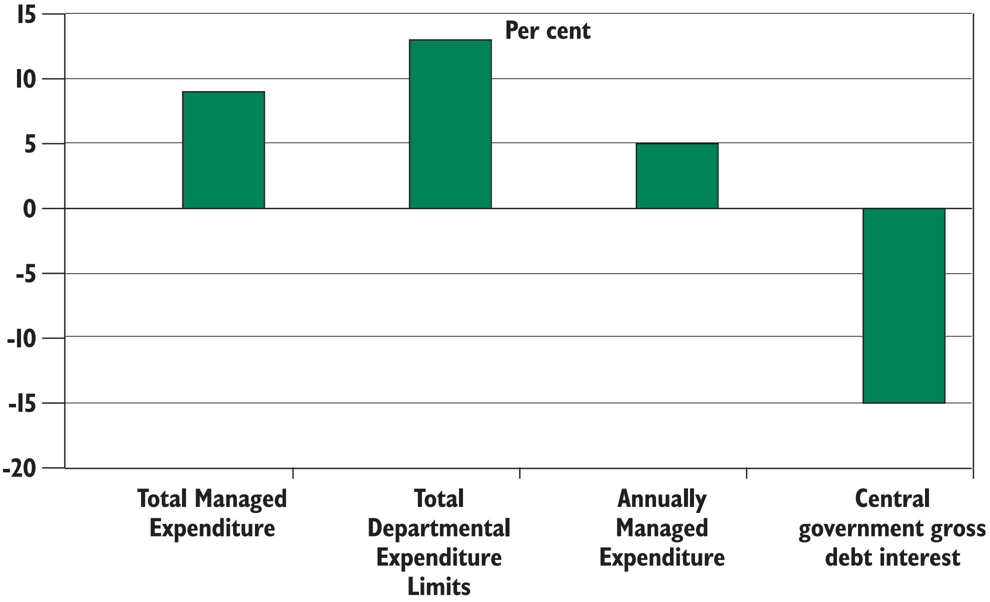
Table 4.1: Summary of public expenditure forecasting differences

£ billion

	2000–01			2001–02		
	Budget 2000	Outturn	Difference	Budget 2001	Outturn	Difference
Total Managed Expenditure *of which:*						
Public sector current expenditure	348.2	348.6	0.4	367.0	369.6	2.5
Public sector net investment	8.2	5.4	–2.8	11.2	8.8	–2.4
Public sector depreciation	14.5	13.0	–1.4	15.5	13.4	–2.1
Total Managed Expenditure *of which:*	**370.9**	**367.0**	**–3.9**	**393.7**	**391.8**	**–1.9**
Departmental Expenditure Limits						
Resource Budget	172.4	172.4	0.0	187.0	188.7	1.7
Capital Budget	22.1	20.4	–1.6	25.3	23.7	–1.6
Total Departmental Expenditure Limits	**194.5**	**192.9**	**–1.6**	**212.3**	**212.3**	**0.0**
Total Annually Managed Expenditure	**176.4**	**174.1**	**–2.3**	**181.4**	**179.5**	**–1.9**
Total Managed Expenditure (per cent of GDP)	**39.2**	**38.2**		**39.8**	**39.3**	

4.7 Table 4.1 shows that investment has increased in nominal terms by 63 per cent between 2000-01 and 2001-02. This is in addition to an increase of more than 20 per cent in nominal terms between 1999-2000 and 2000-01. As a per cent of GDP, net investment rose from 0.5 per cent in 1999-2000 to 0.9 per cent by 2001-02. The rise in investment reflects the Government's determination to address the historic under-investment in public services.

Chart 4.1: Real growth in public expenditure, 1999-2000 to 2001-02



4.8 Chart 4.1 illustrates the real growth rate of public expenditure from 1999-2000 to 2001-02. It shows that total government spending grew by just under 10 per cent in real terms over the two year period; within this DEL grew by 13 per cent and AME by 5 per cent. Within AME, debt interest payments contracted by 15 per cent in real terms. Lower growth in debt interest payments has therefore freed up resources for priority public services.

Forecast differences in 2000–01

4.9 TME in 2000-01 was £3.9 billion lower than projected at the time of Budget 2000. Within this, public sector current expenditure was £0.4 billion higher than forecast. This reflected higher than projected AME spending and was mainly due to higher than forecast net payments to the EC, locally-financed current expenditure by local authorities and AME accounting adjustments. These were partly offset by lower than forecast expenditure on social security payments, public sector pensions and central government debt interest payments.

4.10 Public sector net investment was £2.8 billion lower than forecast. This was due to lower than projected capital expenditure in both DEL and AME. The latter was due to lower locally financed capital expenditure by local authorities, lower capital expenditure financed by the National Lottery and lower capital expenditure included in the AME accounting adjustments. The lower outturn for depreciation reflected revisions to Office for National Statistics (ONS) data for depreciation and capital stock.

Forecast differences in 2001–02

4.11 In 2001-02, TME was £1.9 billion below forecast. Public sector current expenditure was £2.5 billion higher than forecast due to higher than projected resource expenditure in AME and DEL. The former was primarily a function of spending to control the outbreak of Foot and Mouth Disease and higher than forecast locally-financed expenditure. This was partly offset by lower net payments to the EC institutions, lower public sector pensions expenditure and lower central government debt interest payments.

4.12 Public sector net investment was £2.4 billion lower than projected due to lower capital expenditure in DEL and AME. The latter reflected lower locally-financed capital expenditure, and lower expenditure by the National Lottery and within the AME accounting adjustments. This was partly offset by capital spending related to the Foot and Mouth epidemic. The lower outturn for depreciation again reflected data revisions made subsequent to the forecasts.

SPENDING FORECASTING AND REASONS FOR DIFFERENCES

4.13 The following section analyses the differences between forecasts and outturns. Differences are decomposed into the four categories used in Chapters 2 and 3:

- **economic determinants**: for example, debt interest payments on index-linked government bonds are affected by the accrued inflation uplift on these bonds, which is in turn dependent upon inflation forecasts;
- **audited assumptions**: for example, the assumption on the unemployment claimant count used in the social security forecast and the assumption for interest rates used in the forecast of debt interest payments;
- **fiscal forecasting differences**: which could arise from differences in the projected number of benefit recipients, or differences between outturns and plans for DEL; and
- **other**: includes measures announced after the publication of the Budget forecast, for example, the measure related to Winter Fuel Payments announced in the 2001 Pre-Budget Report, as well as any classification changes.

DEL FORECASTING DIFFERENCES

4.14 Tables 4.2 and 4.3 below present a breakdown of DEL forecasting differences for 2000-01 and 2001-02 respectively. For Budgets 2000 and 2001, DEL expenditure for the following year was based on the level planned in the relevant Spending Review: the 1998 Comprehensive Spending Review in the case of 2000-01 and the 2000 Spending Review for 2001-02. Differences between outturn and plans therefore reflect differences between the planned limits for departments' expenditure and their actual expenditure. All DEL forecast differences are allocated as fiscal forecasting differences with the exception of classification changes, which are scored in 'other'. Overall forecasting differences were 0.2 per cent of GDP for 2000-01, and the outturn equalled the Budget 2001 plan in 2001-02.

Table 4.2: Breakdown of Budget 2000 forecasting differences for public expenditure for 2000–01

£ billion

	Forecast published in Budget 2000	Forecast restated on Spending Review 2000 budgeting basis	Outturn	Difference	of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other
Departmental Expenditure Limits								
Resource Budget	177.3	172.4	172.4	0.0	0.0	0.0	–0.5	0.5
Capital Budget	16.5	22.1	20.4	–1.6	0.0	0.0	–1.3	–0.3
Total Departmental Expenditure Limits	**193.7**	**194.5**	**192.9**	**–1.6**	**0.0**	**0.0**	**–1.9**	**0.2**
Annually Managed Expenditure	**177.2**	**176.4**	**174.1**	**–2.3**	**–0.2**	**–1.2**	**–0.3**	**–0.6**
Total Managed Expenditure	**370.9**		**367.0**	**–3.9**	**–0.2**	**–1.2**	**–2.2**	**–0.3**
of which:								
Public sector current expenditure	348.2		348.6	0.4	–0.2	–1.2	1.8	0.0
Public sector net investment	8.2		5.4	–2.8	0.0	0.0	–2.5	–0.3
Public sector depreciation	14.5		13.0	–1.4	0.0	0.0	–1.4	0.0

Table 4.3: Breakdown of Budget 2001 forecasting differences for public expenditure for 2001–02

£ billion

	Forecast	Outturn	Difference	of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other
Departmental Expenditure Limits							
Resource Budget	187.0	188.7	1.7	0.0	0.0	0.9	0.7
Capital Budget	25.3	23.7	–1.6	0.0	0.0	–1.3	–0.3
Total Departmental Expenditure Limits	**212.3**	**212.3**	**0.0**	**0.0**	**0.0**	**–0.4**	**0.4**
Annually Managed Expenditure	**181.4**	**179.5**	**–1.9**	**–0.2**	**–0.7**	**0.1**	**–1.1**
Total Managed Expenditure	**393.7**	**391.8**	**–1.9**	**–0.2**	**–0.7**	**–0.3**	**–0.6**
of which:							
Public sector current expenditure	367.0	369.6	2.5	–0.2	–0.7	3.8	–0.3
Public sector net investment	11.2	8.8	–2.4	0.0	0.0	–2.1	–0.3
Public sector depreciation	15.5	13.4	–2.1	0.0	0.0	–2.1	0.0

DEL in 2000–01

4.15 The DEL plan in Budget 2000 for 2000–01 was £193.7 billion. This plan was in cash terms, but this was updated at the 2000 Spending Review to reflect the move to partial resource budgeting. On this revised basis, DEL plans were £194.5 billion, and DEL outturn is £192.9 billion. The difference between forecast and outturn is 1 per cent of the DEL outturn, equivalent to 0.2 per cent of GDP.

4.16 Spending on resource DEL was in line with plans. Within this, £0.5 billion of outturn was accounted for by classification changes, which had no impact on total public spending.

4.17 Spending on capital DEL was £1.6 billion below plans. £0.3 billion of the reduction was accounted for by reclassifications. The remainder represents the difference between actual spending by departments and plans. Departments are entitled to carry forward unspent funds from one year to the next under end-year flexibility. This allows departments to plan spending to maximise value for money, avoiding wasteful end-year surges. Spending below forecast in 2000-01 therefore does not mean a reduction in the Government's plans for investment in public services. Departments will be able to commit this expenditure to projects as planned in future years.

DEL in 2001–02

4.18 The provisional DEL outturn for 2001-02 is £212.3 billion, equal to the forecast of £212.3 billion made at Budget 2001. However, the total DEL limit of 2001–02 was £212.7 billion, after allowing for classification charges. Taking these into account, the DEL outturn was £0.4 billion below forecast.

4.19 The outturn on the resource budget was above planned spending. This reflects the fact that departments generally spent their full resource allocation in 2001-02, and also drew down funds from previous years under the end-year flexibility arrangements.

4.20 The outturn on capital was below plans. Nonetheless, the year on year increase in capital spending was substantial: net investment increased by over 63 per cent in 2001-02 compared with 2000-01. As with the resource budget, departments will be able to carry forward any unspent capital funds for investment over future years.

4.21 The stock of end-year flexibility at the end of 2001-02 is set out and broken down by department in the Public Expenditure Outturn White Paper, published in July 2002.

AME FORECASTING DIFFERENCES

4.22 Expenditure in AME, unlike spending in DEL, is not subject to firm limits, and projections for AME are based on forecasts for individual components of AME. These are reviewed at each Budget.

4.23 Tables 4.4 and 4.5 below present a breakdown of forecasting differences in AME for the 2000-01 and 2001-02 financial years respectively. Forecast differences for a particular AME spending component are apportioned to one or more of the four types of forecast differences discussed in paragraph 4.13. Forecasting differences correspond to 0.2 per cent of GDP in both 2000-01 and 2001-02.

Table 4.4: Breakdown of Budget 2000 AME forecasting differences for public expenditure for 2000–01

					£ billion			
	Forecast published in Budget 2000	Forecast restated on 2000 Spending Review budgeting basis	Outturn	Difference	of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other
Annually Managed Expenditure								
Social security benefits	99.6	99.6	99.1	–0.5	0.0	–0.6	–0.5	0.7
Housing Revenue Account subsidies	3.3	3.3	3.1	–0.3	0.0	–0.1	–0.1	0.0
Common Agricultural Policy[1]	2.5	2.7	2.8[2]	0.1	0.0	0.0	0.3	–0.2
Export Credits Guarantee Department	0.3	0.3	1.3	1.0	0.0	0.0	1.0	0.0
Self-financing public corporations' capital expenditure[3]	0.2	1.6	1.4	–0.2	0.0	0.0	–0.2	0.0
Net public service pensions	5.7	5.7	5.0	–0.7	0.0	0.0	–0.7	0.0
National Lottery	2.3	2.3	1.9	–0.5	0.0	0.0	–0.5	0.0
Net payments to EC institutions	2.7	2.7	3.7	1.0	0.0	0.0	1.0	0.0
Locally financed expenditure	18.1	18.1	18.6	0.5	0.0	0.0	0.5	0.0
Central government gross debt interest	27.8	27.8	25.9	–1.8	–0.2	–0.4	–0.8	–0.4
Accounting and other adjustments	13.7	11.2	11.4	0.2	0.0	0.0	–0.2	0.4
AME Margin	1.0	1.0	0.0	–1.0	0.0	0.0	0.0	–1.0
Total Annually Managed Expenditure	**177.2**	**176.4**	**174.1**	**–2.3**	**–0.2**	**–1.2**	**–0.3**	**–0.6**

[1] *At Spending Review 2000, payments related to the Over Thirty Month Scheme (OTMS) were switched from DEL to AME. OTMS was introduced during the BSE outbreak to compensate farmers for the slaughtering of older cattle to reduce the risk of new cases of BSE emerging.*

[2] *Includes the costs arising from Foot and Mouth Disease in AME.*

[3] *For Budget 2000, this line recorded self-financing public corporations' (SFPC) external financing limits. For Spending Review 2000 onwards this line shows SFPC's capital expenditure.*

Table 4.5: Breakdown of Budget 2001 AME forecasting differences for public expenditure for 2001–02

				£ billion			
	Forecast	Outturn	Difference	of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other
Annually Managed Expenditure							
Social security benefits	104.9	104.9	–0.1	0.0	–0.3	–0.2	0.4
Housing Revenue Account subsidies	4.6	4.5	0.0	0.0	0.0	0.0	0.0
Common Agricultural Policy	2.6	3.8	1.2[2]	0.0	0.0	1.4	–0.2
Export Credits Guarantee Department	0.8	0.2	–0.6	0.0	0.0	–0.6	0.0
Self-financing public corporations' capital expenditure	1.0	1.0	0.0	0.0	0.0	0.0	0.0
Net public service pensions	5.6	4.9	–0.7	0.0	0.0	–0.7	0.0
National Lottery	2.3	1.7	–0.6	0.0	0.0	–0.6	0.0
Other programme expenditure[1]	0.4	0.4	0.0	0.0	0.0	0.1	–0.1
Net payments to EC institutions	2.7	0.8	–1.9	0.0	0.0	–1.9	0.0
Locally financed expenditure	19.1	20.3	1.2	0.0	0.0	1.2	0.0
Central government gross debt interest	23.1	22.2	–1.0	–0.2	–0.4	0.0	–0.4
Accounting and other adjustments[1]	13.1	14.8	1.6	0.0	0.0	1.4	0.2
AME Margin	1.0	0.0	–1.0	0.0	0.0	0.0	–1.0
Total Annually Managed Expenditure	**181.4**	**179.5**	**–1.9**	**–0.2**	**–0.7**	**0.1**	**–1.1**

[1] In Budget 2001, the other programme expenditure line included a number of items that did not score as expenditure under national accounts definitions, and these items were adjusted out in accounting adjustments. In order to provide a clearer breakdown of the reasons for differences between forecast and outturn expenditure, these items have been removed from the figures in this table. For the same reason, non-cash items, which were shown separately in table C11 of 2001 Budget, have also been removed from this table, and the accounting adjustments. Forecast figures for the other programme expenditure and accounting adjustments line therefore do not match those published at the 2001 Budget.

[2] Includes the costs arising from Foot and Mouth Disease in AME.

AME component analysis

Social security benefits 2000–01

4.24 The outturn on social security benefits for 2000-01 was £0.5 billion below the Budget 2000 forecast. This was partly attributable to the NAO-audited assumption on the unemployment claimant count. The forecast assumed that the claimant count would be 1.16 million: its outturn was 1.05 million and therefore expenditure on Jobseekers' Allowance, as well as related payments of Housing and Council Tax benefits were lower than forecast.

4.25 Fiscal differences for 2000-01 were partly due to spending on Incapacity Benefit being lower than projected. Payments had been forecast to rise at the time of Budget 2000, but there was a fall in new awards of Incapacity Benefit in 2000-01.

4.26 Housing and Council Tax Benefit expenditure in 2000-01 was also lower than forecast because the proportion of Income Support recipients also drawing Housing and Council Tax Benefit was lower than expected. For a number of years this proportion had been increasing, reflecting the increasing likelihood of Income Support recipients to be living in rented housing. However, this trend did not continue in 2000-01 as had been forecast. The impact of this factor is classified as a fiscal forecasting difference.

4.27 However, these fiscal forecast differences were partially offset by the impact of the Government's policy to improve the speed and consistency of decision-making and appeals relating to Disability Living Allowance. The impact of this policy change meant that new awards of Disability Living Allowance were higher than forecast.

4.28 Lower than projected outturn payments on benefits were further offset by discretionary policy changes affecting 2000-01 payments that were announced after Budget 2000. These included higher Winter Fuel Payments (announced in the 2000 Pre-Budget Report), Vaccine Damage Payments, and ex-gratia payments to Far Eastern Prisoners of War. In total, these added £0.7 billion to the difference between forecast and outturn in 2000-01 and are included in the 'other' category.

Social security benefits 2001–02

4.29 The outturn for social security benefits payments in 2001-02 was very close to forecast. The difference was partly due to the audited assumption for claimant unemployment. The outturn was 0.96 million, 70,000 lower than the assumption of 1.03 million, and this resulted in lower than forecast expenditure on Jobseekers' Allowance and Housing and Council Tax Benefit paid during 2001-02.

4.30 Fiscal forecasting differences in 2001-02 were due to spending on Housing Benefit and Council Tax Benefit being lower than expected for the same reasons as in 2000-01. These were partly offset by the under-estimation of spending on Disability Living Allowance, again for the same reason as in 2000-01, and on Incapacity Benefits.

4.31 The impact of differences arising from the audited assumptions and other fiscal differences was offset by the higher than forecast spending on Winter Fuel Payments, due to the decision in the 2001 Pre-Budget Report to maintain the level of the payment at £200 a year rather than £150. The difference here is scored in the 'other' category.

Housing Revenue Account subsidies

4.32 Spending on Housing Revenue Account Subsidies was £0.3 billion lower than the forecast made at the time of Budget 2000, and mostly originates from forecast differences on Rent Rebate Subsidies (Housing Benefit payments for tenants in local authority-owned social housing). The main causes of the forecast differences for tenants living in local authority housing and in receipt of Housing Benefit are the same as those for general Housing Benefit, and have been described in paragraphs 4.24 to 4.26. Forecast expenditure on housing revenue subsidies paid in 2001-02 was equal to its preliminary outturn level.

Common Agricultural Policy (CAP)

4.33 The outturn for expenditure related to the Common Agriculture Policy (CAP) for 2000-01 was £0.1 billion above the Budget 2000 forecast, and £1.2 billion above the projection made at the time of Budget 2001. Forecast differences for both financial years arise from a combination of fiscal and 'other' forecasting differences. The former has been driven by the primary and secondary effects of Foot and Mouth Disease (FMD), whilst the latter refers to a change in classification of spending related to the Over Thirty Month Scheme from AME to DEL. Primary effects cover the direct costs arising as a result of measures to control the Foot and Mouth epidemic, for example disposal and haulage costs. Secondary effects cover differences between forecast and outturn arising indirectly from the Foot and Mouth outbreak, for example the suspension or delay of payments for existing schemes.

4.34 Over the two financial years, spending in AME related to controlling the primary effects of FMD was £2 billion. Box 4.1 provides a breakdown of this spending.

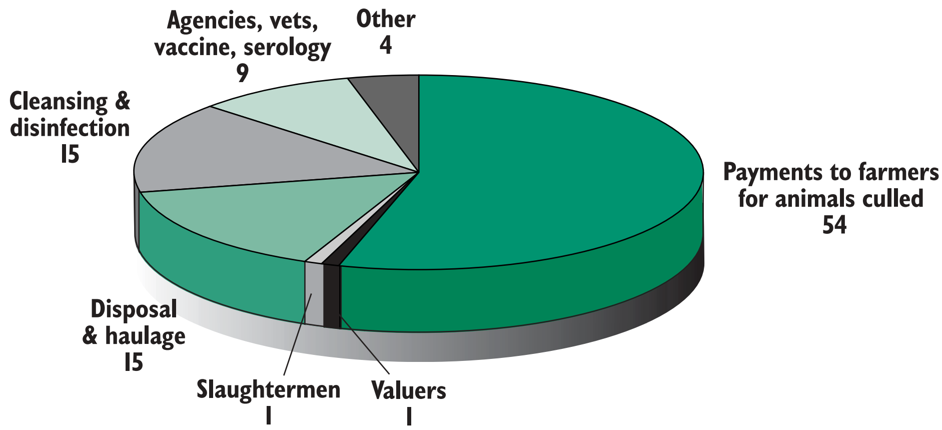
4.35 For 2000-01, fiscal forecasting differences not due to spending on the primary impact of FMD were due to spending on the secondary impact. For example, FMD movement restrictions led to the suspension of the Over Thirty Month Scheme (OTMS) which led to a reduction in expenditure on that scheme.

Box 4.1: The Impact of Foot and Mouth

In February 2001, after an absence of 34 years, an outbreak of Foot and Mouth Disease (FMD) arose in the UK. Unlike the last outbreak in 1967, which was mainly a regional epidemic, the 2001 outbreak quickly spread from an isolated outbreak in the North-East of England into a national epidemic. FMD had a serious impact on the rural community and the UK tourist industry.

The Government's eradication policy succeeded in stamping out the latest epidemic. Over the 2000-01 and 2001-02 financial years, DEL expenditure related to the control of the epidemic was £0.8 billion whilst AME expenditure was £2 billion. The chart below presents a breakdown of AME spending. It shows that just over half of all expenditure was related to payments made to farmers for animals culled, which was then followed by costs related to disposal and cleansing as well as veterinary related expenses.

Breakdown of FMD spending in AME over 2000-01 and 2001-02



The Government recognised that non-farming businesses would also be affected by FMD and the measures imposed to control it. A range of schemes and policies were introduced to help these businesses including:

- deferral of tax and VAT payments, which have benefited over 25,000 businesses;
- hardship rate relief – the Government increased funding to 151 rural local authorities in order for them to offer grant relief to businesses suffering hardship as a result of FMD;
- the Business Recovery Fund which has helped over 9,000 businesses and provides assistance to help bring visitors back to rural areas;
- fast-tracking and prioritising rural regeneration measures;
- the Charities Matched Funding Scheme; and
- the Rights of Way Recovery Fund.

4.36 For 2001-02, excluding the impact of spending on the primary effects of FMD, the rest of the fiscal forecasting differences for this year are mainly attributable to the impact of FMD on the OTMS and delays in payment of CAP direct aid to farmers.

Export Credits Guarantee Department

4.37 Expenditure related to the Export Credits Guarantee Department (ECGD) was £1 billion higher than forecast in 2000-01 but £0.6 billion below forecast in 2001-02. ECGD expenditure includes lending to assist UK exporters. Under national accounts, lending by government departments is classified as a financial transaction and is therefore netted out within accounting adjustments (see paragraph 4.52 below). Differences are scored as fiscal differences as they predominately relate to differences between assumptions and outturn levels on the volume of lending by ECGD.

Net public service pensions

4.38 Net public service pension payments reflect the difference between contributions made by and the payments made to public service pensions by scheme members. The outturn for net public sector pensions was £0.7 billion below forecast in both 2000-01 and 2001-02. For the first of the two years, forecasts by the Ministry of Defence on its Armed Services Pension Scheme and by the Principal Civil Service Pension Scheme (PCSPS) over-estimated spending, accounting for most of the forecast differences. For the second year, the NHS (England and Wales) Pension Scheme was responsible for the majority of forecast differences. For both years, differences are scored as fiscal forecasting differences.

4.39 The Armed Services Pension Scheme's net pension payments for 2000-01 were £0.1 billion lower than forecast. Net payments made to the PCSPS were also below their Budget 2000 estimates, this time by £0.3 billion, reflecting higher than forecast receipts.

4.40 Of the £0.7 billion of forecast differences for 2001-02, net payments made by the NHS (England and Wales) Pension Scheme accounted for £0.4 billion of this difference, and arose due to the impact of the NHS Plan and Improving Working Lives Initiative, which is part of the overall NHS Plan that seeks to improve the working conditions for all staff. During this financial year, there was a 70,000 increase in the NHS (England and Wales) Pension Scheme's membership.

National Lottery

4.41 Lottery forecasts for 2000-01 and 2001-02 were £0.5 billion and £0.6 billion respectively higher than outturn. The differences arise from funding being drawn down more slowly than forecast. These delays could be for a variety of reasons including organisations waiting partnership funding or the project itself being scheduled to run from a future date.

Net payments to EC institutions

4.42 The outturn for net payments to EC institutions for 2000-01 was £1 billion higher than forecast, whilst for 2001-02 it was £1.9 billion below the Budget 2001 forecast. Differences between forecast and outturns are partly a reflection of the methodology used to forecast these payments.

4.43 As a result of the uncertainties in forecasting payments, including the timing risk associated with payments being made to and from EC institutions which arises from the UK operating an April to March financial year compared to the calendar year for the EC, forecasts for forward years are given on a trend basis. This is based on an average of the one-year or 'spot' forecasts of expenditure using both past, current and future years. The methodology for publishing forecasts on a trend basis has been accepted by the Treasury Select Committee. Consequently, under this forecasting methodology, even if spot forecasts are correct there will still be a difference between the outturn and trended forecast. This difference is classified as a fiscal forecasting difference. It is estimated that this accounted for £0.5 billion of the £1 billion of total forecast differences in 2000-01, and £1.4 billion of the £1.9 billion of forecast differences in 2001-02.

4.44 Of the remaining forecasting differences in 2000-01, other fiscal forecasting differences produced an outturn that was £0.3 billion below forecast. These reflected data revisions.

4.45 For the 2001-02 financial year, the remaining £0.5 billion of forecast differences reflected a combination of data revisions and differences between forecast and outturn for assumptions about the growth of net payments.

Locally-financed expenditure

4.46 Local authority expenditure relates to spending financed from council tax, business rates and other sources of finance other than central government grants, and central government expenditure in Northern Ireland financed by regional rates. The outturns for locally financed expenditure for 2000-01 and 2001-02 were £0.5 billion and £1.2 billion higher than the respective Budget 2000 and 2001 forecasts. However, the outturns are still subject to change, particularly for 2001-02 where local authority expenditure is at this stage provisional.

4.47 Forecast differences in both financial years are scored as fiscal forecasting differences. Forecasts on expenditure depend on assumptions about the growth rates of the individual components of finance for local authorities. One source of the differences results from differences between forecasts and outturn for these projections of income.

4.48 Another source of fiscal forecast differences is due to the fact that while outturn data is on a National Accounts basis, forecasts are based on local government accounting principles. Differences associated with reconciling the two approaches account for changes between forecast and outturn of £0.9 billion in 2000-01 and £0.3 billion for 2001-02.

Central government gross debt

4.49 Central government gross debt interest payments in 2000-01 were £1.8 billion lower than the Budget 2000 forecast. £0.4 billion of this difference results from a redefinition by the ONS of government debt interest payments to exclude payments made within the public sector. This is attributed to 'other' factors.

4.50 Of the remaining £1.4 billion of forecast differences for 2000-01, £0.2 billion was due to a lower than forecast uplift on index-linked debt, which is scored as an economic determinants difference. A further £0.4 billion was attributed to lower than expected interest rates on short-term borrowing on Treasury bills. This is scored as a difference arising from the NAO-audited assumption on market interest rates. The remaining £0.8 billion of forecast differences for 2000-01 are classified as arising from fiscal differences. Factors here include the impact of spectrum auction receipts, which raised £19.5 billion more than had been anticipated (see Box 3.2). Most of the auction proceeds were used to pay down debt which, with Debt Management Office remit changes in that year, reduced debt interest payments by over £1 billion in 2001-02. A proportion of proceeds were held back in a short-term cash position that is being gradually wound down.

4.51 Outturn debt interest payments for 2001-02 were £1 billion below the forecast made at the time of Budget 2001. Again, £0.4 billion of this was due to the redefinition of debt interest payments by the ONS. A further £0.2 billion was due to the inflation uplift on index-linked debt being overestimated. The remaining difference of £0.4 billion was brought about by lower interest rates for short-term borrowing on Treasury bills for example, and has been scored as a differences arising from the NAO audited assumptions.

Accounting and other adjustments

4.52 The accounting adjustments reconcile the budgeting aggregates DEL and AME with the National Accounts aggregate TME. They remove items which are included within DEL and AME but which do not score in TME, for example financial transactions such as lending by the ECGD, and includes items that score within TME but not elsewhere in DEL and AME, for example VAT refunded to central and local government and to public corporations.

4.53 In 2000-01, accounting adjustments were £0.2 billion higher than forecast. This reflected a combination of an extra £0.4 billion of local authority and public corporation debt interest payments and an extra £0.9 billion for higher than forecast VAT refunds to the public sector offset by the adjustment to remove ECGD lending, mentioned in paragraph 4.37, which was £1 billion higher than forecast. The first of these is the result of the reclassification of debt interest payments mentioned in paragraph 4.49 and scores as 'other'. The remainder score as fiscal forecasting differences.

4.54 The accounting adjustments were £1.6 billion higher than forecast in 2001-02. This was mainly due to outturn VAT refunds to the public sector being £1 billion higher than forecast and £0.4 billion of re-classified debt interest payments as mentioned previously. Changes to VAT refunds to the public sector have offsetting changes in spending and are therefore fiscally neutral.

AME Margin **4.55** The year-ahead forecasts for AME at Budget 2000 and 2001 included an AME margin of £1 billion to minimise the risk of outturn AME exceeding its forecast. The change in the AME margin is classified as 'other' in the breakdown of forecast differences.

Conclusion

4.56 Total government spending rose by 7 per cent in nominal terms from £367 billion in 2000-01 to £392 billion during 2001-02. Net public sector investment has increased by 63 per cent over the two financial years, reflecting the Government's commitment to address the historic under-investment in public services. The increases in spending are however fully consistent with the Government remaining on track to meet its fiscal rules since, as explained in more detail in Chapter 2, the current budget remained in surplus (in actual and cyclically-adjusted terms) in 2000–01 and 2001–02 and public sector net debt fell to 30 per cent of GDP, well below the 40 per cent limit of the sustainable investment rule.

A ANNEX

Budget 2000: Key assumptions audited by the NAO

• Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
• Trend GDP growth	$2^1/_4$ per cent a year.
• UK claimant unemployment	Constant at recent levels, 1.16 million.
• Interest rates	3 month market rates change in line with market expectations (as of 14 March 2000).
• Equity prices	FT-All share index rises from 3,126 in line with money GDP.
• VAT	Ratio of VAT to consumption falls by 0.05 percentage points a year.
• GDP deflator and RPI	Projections of price indices used to plan public expenditure are consistent with RPIX.
• Composition of GDP	Shares of labour income and profits in national income are broadly constant in the medium term.
• Funding	Funding assumptions used to project debt interest are consistent with the public finances forecast and with financing policy.
• Oil prices	$22.40 a barrel in 2000, the average of independent forecasts, and then constant in real terms.
• Anti-tobacco smuggling measures	Only direct effects, including deterrent effects of fiscal marks, are allowed for.

Budget 2001: Key assumptions audited by the NAO

• Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
• Trend GDP growth	$2^1/_4$ per cent a year.
• UK claimant unemployment	Rising slowly to 1.06 million in 2003-04, from recent levels of 1.03 million, consistent with the average of independent forecasts.
• Interest rates	3 month market rates change in line with market expectations (as of 28 February 2001).
• Equity prices	FT-All share index rises from 2902 in line with money GDP.
• VAT	Ratio of VAT to consumption falls by 0.05 percentage points a year.
• GDP deflator and RPI	Projections of price indices used to plan public expenditure are consistent with RPIX.
• Composition of GDP	Shares of labour income and profits in national income are broadly constant in the medium term.
• Funding	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
• Oil prices	\$24.40 a barrel in 2001, the average of independent forecasts, and then constant in real terms.
• Anti-tobacco smuggling measures	Only direct effects, including deterrent effects of fiscal marks, are allowed for.

LIST OF TABLES

LIST OF CHARTS

LIST OF ABBREVIATIONS

AME	Annually Managed Expenditure
APD	Air passenger duty
CAP	Common Agriculture Policy
DEL	Departmental Expenditure Limits
ECGD	Export Credits Guarantee Department
EC	European Communities
EYFR	End of year fiscal report
FMD	Foot and Mouth Disease
FT	The Financial Times
G7	Group of seven (leading industrial nations): Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
GDP	Gross Domestic Product
IMF	International Monetary Fund
ITC	Independent Television Commission
NAO	National Audit Office
NHS	National Health Service
OECD	Organisation for Economic Cooperation and Development
ONS	Office for National Statistics
OTMS	Over Thirty Month Scheme
PAYE	Pay as You Earn
PCSPS	Principal Civil Service Pension Scheme
PSCB	Public sector current budget
PSNB	Public sector net borrowing
RAB	Resource accounting and budgeting
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
SFPC	Self-financing public corporations
TME	Total Managed Expenditure
VAT	Value added tax
VED	Vehicle excise duty