End of year fiscal report

December 2005

HM TREASURY

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ISBN: 1-84532-119-7

Printed by The Stationery Office 12/05 319525

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1 INTRODUCTION

The *End of year fiscal report*, first published alongside the 2002 Pre-Budget Report, is central to the Government's retrospective reporting and analysis of fiscal issues and builds on the information published in the Pre-Budget Report and the Budget. This year's report looks at trends in the public finances and fiscal policy in 2003-04 and 2004-05, setting these into an historical context. The report analyses:

- **performance against the fiscal rules and fiscal policy objectives; and**
- **differences between forecast and fiscal outturn for the year-ahead forecasts published in Budget 2003 and Budget 2004.**

The report shows that the Government was meeting its strict fiscal rules in 2003-04 and 2004-05 while allowing fiscal policy to support monetary policy following a period of global economic uncertainty and weakness.

This report also examines the UK's forecast performance over a longer timescale and compares it internationally. This analysis shows that:

- **since the introduction of the new macroeconomic framework in 1997, outturn public sector net borrowing has been lower on average than the year-ahead forecast, compared with before the new framework when outturns tended to be higher than forecast; and**
- **the UK's forecasting performance compares well with that of other countries and international organisations: on average net borrowing outturns since 1997 have been lower than forecast for the UK while for a number of other European Union Member States outturn borrowing has been above forecast on average.**

1.1 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. Transparency is one of the Government's principles for fiscal management set out in the *Code for Fiscal Stability*.[1] It allows effective scrutiny of the conduct of fiscal policy and the state of the public finances, thereby improving the credibility of macroeconomic policy.

1.2 A transparent approach means the Government:

- clearly states the objectives of fiscal policy;
- is open about the way in which those objectives are implemented through the fiscal rules; and
- provides full and complete information on the performance of the public finances against those rules in a clear and timely manner.

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

Purpose of the EYFR

I.3 The *End of year fiscal report* (EYFR) helps ensure transparency by enhancing the Government's fiscal reporting and analysis. It is retrospective, describing fiscal developments for the previous two financial years, and setting these into an historical context. The EYFR complements the data on and analysis of the public finances that are published at the time of the Pre-Budget Report and Budget, in accordance with the requirements of the *Code for Fiscal Stability*. It ensures that the UK is fully in line with international best practice, including the International Monetary Fund's *Code of good practices on fiscal transparency*.[2]

I.4 The EYFR strengthens the Government's fiscal framework by increasing:

- the understanding of how fiscal developments have affected performance against the Government's fiscal rules and fiscal policy objectives; and
- the depth of analysis of key fiscal developments and knowledge of where outturns are significantly different from forecasts.

Coverage

I.5 The focus of the EYFR is on:

- fiscal trends over previous financial years and, in particular, performance against the Government's fiscal rules; and
- a forecast analysis of the difference between forecast and outturn for the year-ahead forecasts from the last two Budgets.

I.6 This report examines the forecast performance in 2003-04 and 2004-05 together with the Government's historical forecasting performance. The detailed forecast analysis considers the Budget 2003 forecast for 2003-04 and the Budget 2004 forecast for 2004-05. The two year horizon strikes a balance between timely reporting of fiscal developments and the quality and robustness of data. Public finance data is open to revision for a considerable period after the end of the relevant financial year. In addition, the analysis presented in this report depends on macroeconomic data that is subject to revision for several years, as the data is refined on the basis of more comprehensive information.

I.7 The data and analysis presented here are therefore not final. This is particularly the case for the most recent year, 2004-05. Nonetheless, the information is sufficiently robust to provide a sound basis for forecast analysis. Future revisions, particularly for 2003-04, are more likely to affect the detail while leaving the main conclusions unchanged.

I.8 To aid understanding of the analysis set out in the EYFR, the 2003 report described the forecasting process. In particular it described the linkages between the Treasury's economic forecast and the projections for the public finances. It also described the cautious approach to forecasting, and the use of independently audited assumptions to build in a margin against unexpected events.

Forecast differences

I.9 One of the main purposes of the EYFR is to compare forecasts and outturns for the public finances. The analysis in this report identifies a number of possible reasons for differences between forecasts and outturn, reflecting the nature of the forecasting process. Differences between forecast and outturn are attributed to one of four categories:

[2] *Code of good practices on fiscal transparency*, International Monetary Fund (2001).

- **economic determinants:** those attributable to differences between forecast and outturn for economic determinants. For example, forecasts for taxes and spending are heavily influenced by forecasts for economic growth and the composition of economic growth. This category would therefore include any difference in the public finance projections that can be ascribed to variation between forecast and outturn for economic growth and the components of economic growth;

- **NAO assumptions:** those differences that can be attributed to a divergence between the NAO-audited assumptions and their outturn.[3] This would include the effects of the level of unemployment on social security spending or the oil price on receipts from North Sea taxes;

- **fiscal forecasting differences:** those that can be ascribed to changes in the relationship between the tax rate and tax base, and the receipts actually received. On the spending side, this would include differences between the forecast take-up of benefits and the actual outturn, or differences between outturns and plans for DEL; and

- **other:** which includes a variety of factors, such as the impact of new measures announced in-year.

1.10 Chapter 2 provides a summary of developments from a macroeconomic perspective. It shows that the Government remained on track to meet its strict fiscal rules in 2003-04 and 2004-05, despite the weaker than expected fiscal outturns that followed the global economic slowdown of 2001 and 2002, which affected UK growth prospects and the composition of economic growth. The Government remains vigilant in the face of these risks and the public finance forecasts will continue to be based on cautious assumptions. Chapter 2 also examines the Government's forecasting performance historically and by comparison internationally. Chapters 3 and 4 set out in more detail the analysis of projections for tax receipts and public spending.

[3] A list of the assumptions audited by the NAO for Budget 2003 and Budget 2004 is shown in Annex A.

2 MEETING THE FISCAL RULES

This chapter examines performance against the Government's fiscal policy objectives and fiscal rules, and analyses the differences between forecasts for the main fiscal aggregates and outturns. It shows that, over the years 2003-04 and 2004-05:

- **the Government was meeting its strict fiscal rules over the economic cycle;**
- **the average surplus on the current budget since 1997-98, the year in which the current economic cycle is judged to have started, is positive and fully consistent with meeting the golden rule over the economic cycle; and**
- **public sector net debt remained below 35 per cent of GDP, well below the 40 per cent limit of the sustainable investment rule.**

This chapter also examines the UK's forecast performance over a longer timescale and compares it internationally. This analysis shows that:

- **since the introduction of the new macroeconomic framework, the overall accuracy of year-ahead forecasts has been broadly unchanged. However, outturn public sector net borrowing has been lower on average than the year-ahead forecast, compared with before the new framework when outturns tended to be higher than forecast. This is in line with the move to using a cautious approach in projecting the public finances; and**
- **the UK's forecasting performance compares well with that of other countries and international organisations, and on average net borrowing outturns since 1997 have been lower than forecast for the UK while for a number of other European Union Member States outturn borrowing has been above forecast on average.**

2.1 The macroeconomic framework is designed to promote economic stability. Stability helps individuals, businesses and the Government to plan effectively for the long term, improving the quantity and quality of investment in physical and human capital, and helping to increase productivity.

2.2 To achieve the Government's macroeconomic objectives, monetary policy, fiscal policy and the public spending framework are designed to work together in a coherent and integrated way. The monetary policy framework seeks to deliver low and stable inflation, while fiscal policy ensures that the public finances are sustainable over the medium term. The fiscal framework also forms the basis for the public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and to deliver specified outcomes.

Fiscal objectives and rules

2.3 The Government's objectives for fiscal policy are:

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

2.4 These objectives are implemented through two fiscal rules, against which the performance of fiscal policy can be judged. The fiscal rules are:

- **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 being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

PERFORMANCE AGAINST OBJECTIVES AND RULES

2.5 Table 2.1 shows performance against the fiscal rules. It shows the key fiscal aggregates since 1997-98, the year in which the current economic cycle is judged to have started.[1]

The golden rule

2.6 The golden rule is met if, over the economic cycle, the average surplus on the current budget expressed as a ratio to GDP is equal to or greater than zero.[2] While the current budget moved into deficit in 2002-03, Table 2.1 shows that the average surplus since 1997-98 is positive, showing that the Government is meeting the golden rule.

Table 2.1: Meeting the fiscal rules

	Per cent of GDP							
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Golden rule								
Surplus on current budget	–0.2	1.2	2.2	2.2	1.0	–1.2	–1.9	–1.7
Average surplus since 1997–98	–0.2	0.5	1.1	1.4	1.3	0.9	0.5	0.2
Cyclically-adjusted surplus on current budget	0.0	1.1	1.9	1.6	0.8	–0.8	–1.4	–1.3
Sustainable investment rule								
Public sector net debt	41.4	39.1	36.1	31.1	30.2	31.4	32.8	34.7
Core debt	40.6	38.5	35.8	31.5	30.7	31.5	32.5	34.0

Sustainable investment rule

2.7 The sustainable investment rule requires public sector net debt (PSND) as a proportion of GDP to be held at a stable and prudent level over the economic cycle. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle. Table 2.1 shows that while net debt has risen following the global slowdown of 2001 and 2002, it has remained comfortably below 40 per cent of GDP. The table also shows core debt, which excludes the estimated impact of the economic cycle on net debt and has therefore risen more slowly than PSND.[3]

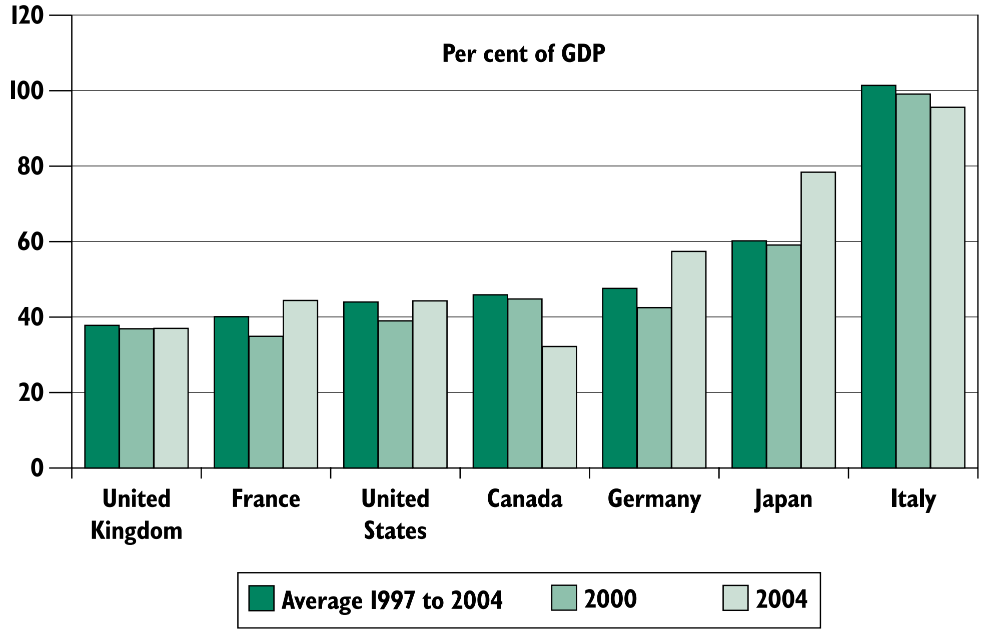
[1] Following significant revisions to national accounts data with the publication of Blue Book 2005, the Government's earlier provisional judgement on the start of the current economic cycle was revised in July 2005. See *Evidence on the UK economic cycle*, HM Treasury (July 2005) for details.

[2] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002 and performance over past cycles was described in Box 2.5 of Budget 2005.

[3] An explanation of core debt can be found in *Core debt: an approach to monitoring the sustainable investment rule*, HM Treasury (April 2002).

2.8 Following the global economic slowdown most G7 economies have experienced rising debt-to-GDP ratios as public finances moved into deficit. Only Canada and Italy saw net debt ratios fall between 2000 and 2004. Chart 2.1 shows that on average since 1997, net debt in the UK has been both lower and more stable than in other G7 economies. In 2004, only the UK and Canada among G7 countries had net debt below 40 per cent of GDP.

Chart 2.1: Estimates of net debt in G7 countries



Source: OECD Economic Outlook

Economic impact

2.9 While the primary objective of fiscal policy is to ensure sound public finances over the medium term, fiscal policy also plays an important role by supporting monetary policy to deliver economic stability over the cycle.

2.10 The overall impact of fiscal policy on the economy is made up of changes in:

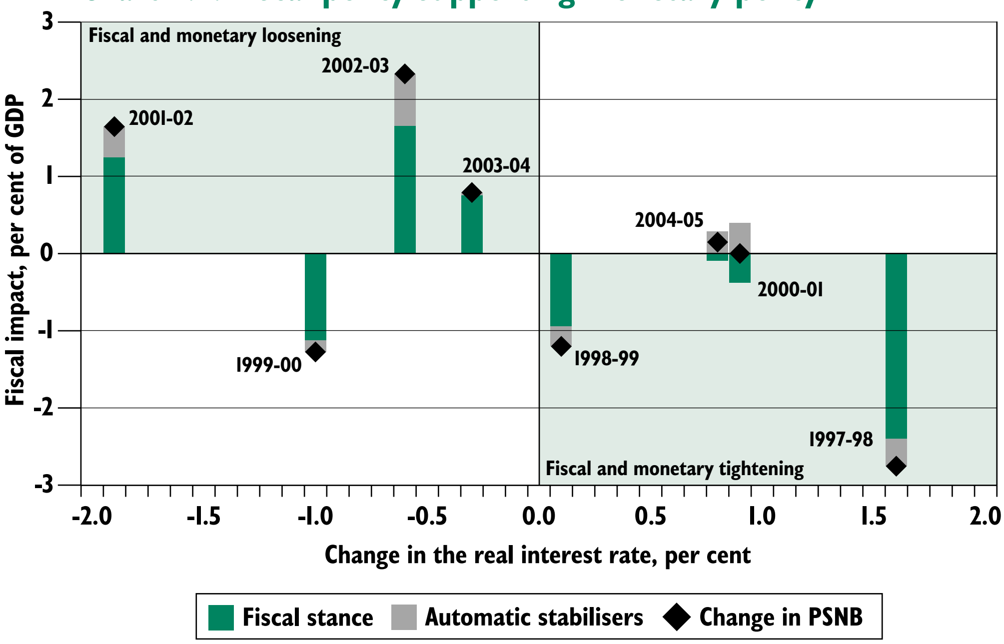
- the fiscal stance: that part of the change in public sector net borrowing (PSNB) resulting from changes in cyclically-adjusted PSNB; and
- the automatic stabilisers: that part of the change in PSNB resulting from cyclical movements in the economy.

2.11 The Treasury's methodology for estimating the impact of the economic cycle on the public finances, described in the 2003 *End of year fiscal report*, is based on the average impact of changes in the output gap on the public finances over previous cycles. To the extent that this economic cycle differs from previous ones, temporary changes in the public finances may not be fully attributed to the effects of the economic cycle.

2.12 Furthermore, the Treasury's methodology for cyclical adjustment may not capture temporary factors such as movements in asset prices. These are likely to affect the fiscal balances, but to the extent that they do not move in line with the economic cycle, they are not accounted for in the cyclical adjustment process. As a result, factors that are temporary in nature might show up as changes in the cyclically-adjusted fiscal balances.

2.13 Chart 2.2 shows changes in PSNB broken down into the effects of the fiscal stance and the automatic stabilisers and compares these with changes in the real interest rate since 1997-98. If fiscal policy is supporting monetary policy the majority of the columns on the chart should lie in the top left or bottom right quadrants, which is what the chart shows. For example, in 2001-02 when the global economy slowed down sharply, monetary policy reacted quickly to support the economy by reducing the real interest rate. Fiscal policy was able to support monetary policy through the automatic stabilisers and the fiscal stance and continued to do so in 2002-03 and 2003-04. By contrast, in 1997-98 and 1998-99 when the economy was generally above trend, fiscal policy supported monetary policy in bringing the economy back towards trend.

Chart 2.2: Fiscal policy supporting monetary policy



Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB and the automatic stabilisers equal the change in the cyclical component of PSNB, ie the difference between PSNB and the cyclically-adjusted PSNB. The real interest rate in this chart refers to the financial year average of the Bank of England base rate deflated by CPI inflation.

HISTORICAL FORECASTING PERFORMANCE

2.14 Projections for the public finances are subject to a considerable degree of uncertainty. This section considers the overall forecasting performance for public sector net borrowing from an historical perspective.[4] The relative accuracy of forecasts is compared using the absolute average difference, which measures the difference between forecasts and outturns but ignores whether those differences are positive or negative. The smaller the absolute average difference the more accurate the forecast. To compare the relative caution of forecasts over time the simple average of the forecast differences is used. If the forecasts are generally cautious, the average forecast difference will be positive.

[4] The current presentation of the fiscal aggregates was first introduced in the 1998 Economic and Fiscal Strategy Report. Data for 1998 onwards refers to public sector net borrowing. Differences prior to 1998 are based on forecasts and outturn for the public sector net cash requirement (PSNCR, previously know as the public sector borrowing requirement). Adjustments have been made for the move to ESA95 where these adjustments are available: these are set out in table 4 of Monthly Statistics on Public Sector Finances, GSS methodology series no. 12, Government Statistical Service, 1999.

2.15 Table 2.2 summarises the one- and two-year ahead PSNB forecast differences since 1970-71 and 1980-81 respectively. The key points to note are:

- the overall accuracy of the one-year ahead forecast under the new framework continues to be similar to that in preceding decades. The year-ahead forecast has on average been cautious, as shown by the positive average forecast difference of 0.3 per cent of GDP, compared with –0.1 per cent before 1997-98; and

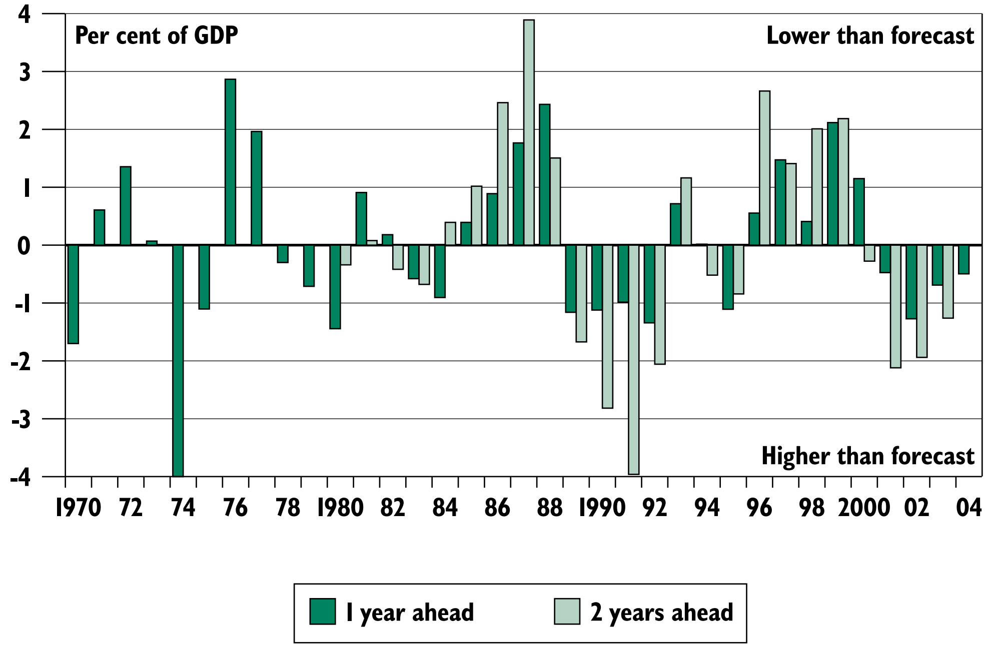
- the two-year ahead forecast under the new framework has been of similar accuracy and caution as the forecasts before 1997-98. For both periods, the average forecast difference was close to zero.

Table 2.2: Summary statistics for net borrowing forecast differences

	Per cent of GDP			
	Whole sample	Before new framework	New framework	Number of observations in whole sample
One year ahead forecasts				
Average absolute difference	1.2	1.2	1.0	35
Average difference	0.0	–0.1	0.3	
Two year ahead forecasts				
Average absolute difference	1.6	1.6	1.6	24
Average difference	0.0	0.0	0.0	

2.16 Chart 2.3 plots the one- and two-year ahead forecast differences for PSNB (PSNCR before Budget 1997). It shows firstly how the effects of the global slowdown pushed borrowing higher than forecast in recent years, but secondly how the forecast difference has narrowed significantly over the past three years to the point where the 2004-05 forecast from Budget 2004 showed a difference of just 0.5 per cent of GDP.

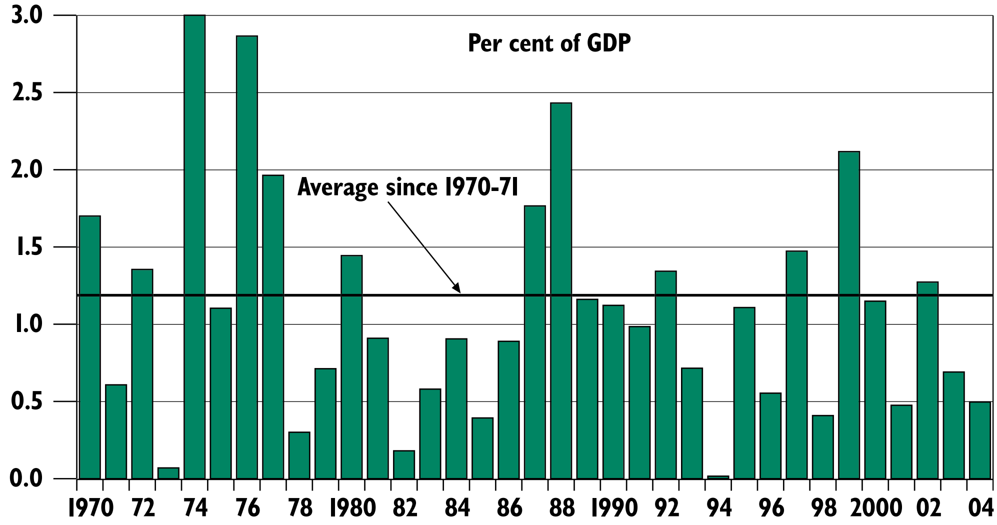
Chart 2.3: PSNB forecast differences since 1970-71



Note: The forecast difference in 1974-75 was –5.9 per cent of GDP.

2.17 Chart 2.4 shows the absolute differences for one-year ahead forecasts since 1970-71. It shows that the Budget 2003 and Budget 2004 year-ahead forecasts were more accurate than the long-run average.

Chart 2.4: 1 year ahead absolute forecast differences for PSNB



Note: The absolute forecast difference in 1974-75 was 5.9 per cent of GDP.

INTERNATIONAL COMPARISONS

2.18 This section compares the UK's forecasting performance with that of international organisations and other countries. International comparisons have to be treated with caution as the forecast horizon and the fiscal aggregate being forecast will often differ.

Comparisons with the USA

2.19 In the USA, the Congressional Budget Office (CBO) produces forecasts for the public finances up to six years ahead and has data on the difference between forecast and outturn going back to 1981. Table 2.3 compares the absolute average differences between forecast and outturn for the UK and the USA. Since the ratio of revenue and expenditure to GDP is different in each country, the differences between forecast and outturn are expressed as a proportion of total revenues.

2.20 Table 2.3 suggests that the UK's forecasting performance is comparable with that of the CBO for the year ahead, with the absolute average difference around 3 per cent of revenues in both the USA and the UK.[5] However, the UK's forecasting performance is better two, three and four years ahead. This is shown by the absolute average difference for the two, three and four-year ahead forecasts being smaller in the UK compared with the USA.

Table 2.3: Absolute average differences between forecast and outturn

	Per cent of outturn revenues					
	Year ahead	2 years ahead	3 years ahead	4 years ahead	5 years ahead	6 years ahead
USA, Congressional Budget Office	3.0	6.0	9.3	11.0	12.1	13.5
UK, HM Treasury	2.9	4.1	4.9	6.8		

Note: Data for USA is from 1981 onwards (1982 excluded) and refers to the primary balance. Data for UK is from 1970-71 onwards for 1 year forecasts, 1980-81 onwards for 2 year forecasts, 1980-81 onwards for 3 year forecasts, using forecasts from the previous autumn as proxies between 1994 and 1997 and 1980-81 onwards excluding1981-82 and 1983-84 and again using autumn proxies between 1994 and 1997 for 4 year forecast, and refers to PSNB or PSNCR.

Source: US data from The Uncertainty of Budget Projections: A Discussion of Data and Methods, CBO February 2005 (http://www.cbo.gov/showdoc.cfm?index=6119&sequence=0)

[5] This probably understates the relative forecasting performance of the UK as the typical year-ahead forecast in the USA is for the financial year ending 9 months after the forecast is made, while the typical year-ahead forecast in the UK is for the financial year ending 12 months after the forecast is made.

International organisations

2.21 Table 2.4 summarises the forecast differences for the UK's net borrowing (or nearest fiscal aggregate) since 1997 for the main international organisations and the Treasury.[6] Two IMF forecasts have been included. The first is drawn from the annual *United Kingdom Article IV Consultation*, which is published at a similar time to the Budget and forecasts borrowing on a financial year basis in line with practice in the UK. The second is from the *World Economic Outlook (WEO)*, which forecasts borrowing on a calendar year basis and is more closely comparable with the OECD's *Economic Outlook* and the European Commission's *Autumn Forecasts* in that it simultaneously forecasts for a broad range of countries.

Table 2.4: Forecast differences for UK net borrowing, 1997 to 2004

	Per cent of GDP	
	Average difference	Absolute average difference
Treasury	0.3	1.0
IMF (Article IV)	0.5	1.1
IMF (WEO)	0.2	1.2
OECD	–0.1	1.4
European Commission	–0.4	1.1

2.22 Table 2.4 shows that the Treasury's forecast compares well with those of the IMF, OECD and European Commission in terms of accuracy – as shown by the average absolute difference – and in terms of caution – as shown by the positive average forecast difference. It is important, though, to bear in mind the difficulty of making comparisons with and between international organisations.

Comparisons with EU Member States

2.23 It is also possible to compare the UK's forecasting performance with that of other Member States in the European Union. Table 2.5 shows the average one-year ahead forecast difference from 1997 to 2004 – using the year-ahead projections set down in Member States' annual Stability or Convergence Programmes.[7] In terms of both forecast accuracy and caution the UK performs slightly better than average. The UK is one of the countries that on average has borrowed less than forecast.

2.24 Since the Stability and Convergence Programmes are generally published in December, Member States' calendar year forecasts are for the year ending 12 months after the forecast is made, the same timeframe as for the UK's Budget forecasts. By contrast, the UK's Convergence Programme contains a financial year forecast for the year ending 15 months after the forecast is made. The benefit of the extra three months worth of information between the Convergence Programme and Budget forecasts can be seen by comparing the average differences of the Budget forecasts (the memo item in Table 2.5) with the UK's Convergence Programme forecasts (highlighted in Table 2.5). The Budget forecasts have been more accurate and more cautious than the Convergence Programme forecasts.

[6] To ensure broad comparability with the Treasury's forecast, the effect of the spectrum licence proceeds has been removed from the OECD, IMF and European Commission outturn data. This reduces outturns for 2000 by around 2.4 per cent of GDP.

[7] This analysis remains confined to the former-EU15 Member States as the 10 accession Member States produced their first Convergence Programmes in 2004, the final year for which outturn data is available. On average, the accession states' forecasts were cautious by 0.9 per cent of GDP in 2004 and showed an absolute average forecast difference of 1.1 per cent. That compared with 0.1 per cent incaution and 1.0 per cent absolute average forecast difference for the former-EU15.

Table 2.5: Differences between forecast and outturn, 1997 to 2004

	Per cent of GDP	
	Average difference	Absolute average difference
Luxembourg	2.17	2.40
Finland	0.75	0.90
Belgium	0.64	0.64
Ireland	0.53	1.68
Sweden	0.39	1.56
Netherlands	0.31	1.83
UK	**0.20**	**1.05**
Austria	0.17	0.39
Germany	–0.06	1.13
Spain	–0.16	0.26
Denmark	–0.36	0.64
France	–0.39	0.62
Italy	–0.73	1.10
Portugal	–0.89	0.89
Greece	–3.13	3.25
Memo: UK Budget forecasts	*0.28*	*1.01*

Note: Differences refer to general government net borrowing. The forecast data are from the Stability and Convergence Programmes submitted by each country and are available on the European Commission's website (http://www.europa.eu.int/comm/economy_finance/about/activities/sgp/scplist_en.htm). From 1998 onwards, the programmes have generally been submitted in December of each year. In 1997, the timing of the forecasts was more varied throughout the year. Eurostat data is used for the outturn data. For the UK, outturn data is used on a financial year basis to be consistent with the forecasts.

FORECAST ANALYSIS FOR THE LAST TWO YEARS

2.25 Table 2.6 provides a summary comparison of the year-ahead projections for the main fiscal aggregates in Budget 2003 and Budget 2004 compared with the latest outturn information.

Table 2.6: Differences in Budget forecasts for main aggregates

	Per cent of GDP					
	2003-04			2004-05		
	Budget 2003 forecast	Outturn	Difference	Budget 2004 forecast	Outturn	Difference
Surplus on current budget	–0.8	–1.9	–1.1	–0.9	–1.7	–0.8
Memo: average absolute difference, current budget since 1998–99			*1.1*			*1.1*
Cyclically-adjusted surplus on current budget	0.2	–1.4	–1.6	–0.2	–1.3	–1.1
Public sector net borrowing	2.5	3.1	0.6	2.8	3.3	0.5
Memo: average absolute difference, net borrowing since 1970–71			*1.2*			*1.2*
Cyclically-adjusted public sector net borrowing	1.5	2.7	1.1	2.1	2.9	0.8
Public sector net debt	32.2	32.8	0.7	34.4	34.7	0.3

2.26 The current budget was in deficit in 2003-04 and 2004-05. In 2003-04, the deficit was 1.9 per cent of GDP compared with the forecast of 0.8 per cent. The forecast difference was comparable with the average under the new framework. The deficit in 2004-05 was 1.7 per cent of GDP compared with the forecast of 0.9 per cent. As such, the forecast difference was reduced in 2004-05 from the previous year and was smaller than the average since 1998-99.

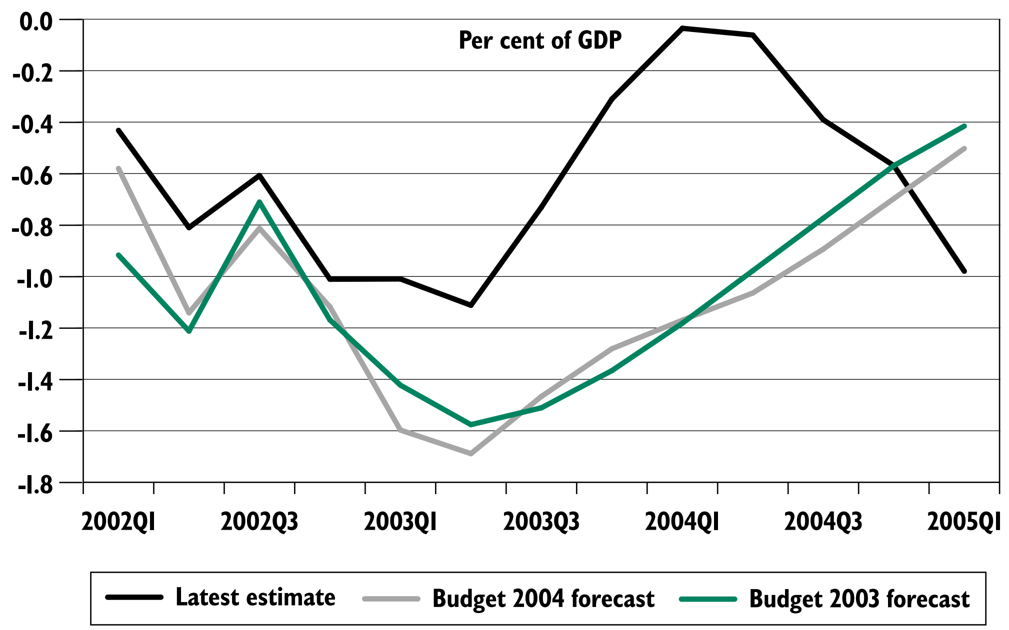
2.27 The outturn for net borrowing was 3.1 per cent of GDP in 2003-04 and 3.3 per cent in 2004-05 compared with forecasts of 2.5 per cent and 2.8 per cent of GDP respectively. The forecast differences of 0.6 per cent of GDP and 0.5 per cent of GDP are well below the average absolute one-year forecast difference since 1970-71 of 1.2 per cent of GDP. They also compare well with the average absolute forecast difference under the new framework of 1.0 per cent of GDP.

Impact of the economic cycle

2.28 Short-term economic prospects have a significant influence on the public finances and differences between forecast and outturn for key economic variables may account for a large proportion of the differences in the fiscal projections. In particular, the public finances are strongly related to the cyclical position of the economy, measured by the output gap. Any difference between forecast and outturn for the output gap therefore affects the public finances.

2.29 Since the last *End of year fiscal report* was published there have been significant revisions to the profile of GDP growth, which have fed through directly to the profile of the output gap as shown in Chart 2.5. The revised data has reduced the negative output gap in 2003-04 from 1.4 per cent of GDP forecast in Budget 2003 to 0.5 per cent and reduced the negative output gap in 2004-05 from 0.8 per cent of GDP forecast in Budget 2004 to 0.5 per cent.

Chart 2.5: Revised estimates of the output gap



2.30 The new output gap estimates directly affect the cyclically-adjusted fiscal balances, which are calculated using a formula that relates the fiscal aggregates to the cycle on the basis of past relationships.[8] As the output gap becomes less negative, a smaller proportion of actual borrowing is attributed to cyclical factors and a larger proportion to non-cyclical factors. This effect can be seen in the estimates for cyclically-adjusted net borrowing in 2003-04. At the time of last year's *End of year fiscal report* actual borrowing was estimated at 3.1 per cent of GDP, the same as the current estimate, but cyclically-adjusted borrowing was estimated to be 2.2 per cent instead of the current estimate of 2.7 per cent.

[8] See Annex A of the 2003 *End of year fiscal report* for the latest estimates of the cyclical adjustment parameters.

Breakdown of forecast differences

2.31 Table 2.7 provides more detailed information on the sources of forecast difference. In 2003-04, receipts were £9.1 billion lower than forecast, comparable with the average absolute difference over the last six years. In 2004-05 they were lower by a smaller margin of £6.2 billion. Outturn current expenditure was £3.8 billion higher than forecast in 2003-04 and £3.7 billion higher in 2004-05. Again, the 2003-04 forecast difference was in line with the average absolute difference since 1998-99 while the 2004-05 forecast was slightly more accurate. The outturn for depreciation was broadly in line with forecast for 2003-04 and £0.6 billion below forecast for 2004-05.

2.32 Net borrowing is equal to net investment less the surplus on the current budget. Outturn net investment was below forecast by £5.3 billion in 2003-04 and by £3.4 billion in 2004-05. Despite being below forecast, net investment increased by 28 per cent between 2003-04 and 2004-05. In both years, the forecast difference on net investment partially offset the forecast difference for the current surplus. As a result, the net borrowing forecast difference was £7.4 billion in 2003-04 and £5.9 billion in 2004-05, in each case smaller than the current budget forecast differences of £12.7 billion and £9.3 billion respectively.

Table 2.7: Summary of differences in Budget forecasts

	£ billion					
	2003-04			2004-05		
	Budget 2003 forecast	Outturn	Difference	Budget 2004 forecast	Outturn	Difference
Current budget						
Current receipts	428.3	419.2	–9.1	454.7	448.4	–6.2
Memo: average absolute difference in current receipts since 1998–99[1]			*8.6*			*9.1*
Current expenditure	422.3	426.1	3.8	449.7	453.4	3.7
Memo: average absolute difference in current expenditure since 1998–99[1]			*4.0*			*4.2*
Depreciation	14.4	14.3	–0.1	15.5	14.9	–0.6
Surplus on current budget	–8.4	–21.1	–12.7	–10.5	–19.9	–9.3
Capital budget						
Gross investment	37.1	31.7	–5.5	41.7	39.1	–2.5
Less asset sales	–3.8	–3.8	0.0	–3.8	–5.2	–1.5
Less depreciation	–14.4	–14.3	0.1	–15.5	–14.9	0.6
Net investment	18.9	13.6	–5.3	22.4	19.0	–3.4
Public sector net borrowing	27.3	34.7	7.4	32.9	38.8	5.9
Memo: average absolute difference between forecast and outturn net borrowing since 1970–71[1]			*13.2*			*13.8*
Public sector net debt	366.9	377.3	10.4	416.2	416.7	0.5
Memo						
Treaty deficit[2]	27.1	34.5	7.4	30.4	38.3	7.9
Treaty debt[3]	432.6	442.5	9.9	480.9	480.3	–0.6

[1] *Derived from average difference as a ratio to GDP and stated in money GDP in that year.*

[2] *General government net borrowing on a Maastrict basis.*

[3] *General government gross debt on a Maastrict basis.*

2.33 Table 2.8 breaks down the differences between the year-ahead Budget forecasts and outturns into the four categories described in Chapter 1. In both 2003-04 and 2004-05, the difference between forecast and outturn for the main fiscal aggregates was mainly due to economic determinants and fiscal forecasting differences. The NAO-audited assumptions provided a source of caution in both years as intended. This analysis is developed in the next two chapters.

Table 2.8: Breakdown of differences in the main fiscal aggregates[1]

	£ billion	
	Budget 2003 forecast for 2003–04	Budget 2004 forecast for 2004–05
Current receipts difference	**–9.1**	**–6.2**
contribution from:		
Economic determinants	–6.2	–5.2
NAO-audited assumptions	3.3	3.1
Fiscal forecasting differences	–3.5	–3.1
Other	–2.7	–1.0
Current spending difference	**3.8**	**3.7**
contribution from:		
Economic determinants	0.2	0.0
NAO-audited assumptions	0.1	–0.2
Fiscal forecasting differences	7.6	6.7
Other	–4.1	–2.8
Depreciation	**–0.1**	**–0.6**
contribution from:		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	–0.1	–0.6
Other	0.0	0.0
Current budget difference	**–12.7**	**–9.3**
contribution from:		
Economic determinants	–6.4	–5.2
NAO-audited assumptions	3.2	3.3
Fiscal forecasting differences	–10.9	–9.2
Other	1.3	1.8
Net investment difference	**–5.3**	**–3.4**
contribution from:		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	–5.4	–3.6
Other	0.1	0.2
Net borrowing difference	**7.4**	**5.9**
contribution from:		
Economic determinants	6.4	5.2
NAO-audited assumptions	–3.2	–3.3
Fiscal forecasting differences	5.5	5.7
Other	–1.2	–1.6

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

3 RECEIPTS

This chapter provides more detailed analysis of developments in receipts in 2003-04 and 2004-05. It shows that:

- **current receipts rose from around £419 billion in 2003-04 to around £448 billion in 2004-05, providing resources for the Government's priorities; and**
- **in both years receipts were lower than originally forecast, largely reflecting lower growth in tax determinants.**

Sound public finances and the use of cautious assumptions has meant, even though receipts have been lower than expected, the Government is meeting its fiscal rules, while allowing fiscal policy to support monetary policy in maintaining economic stability.

INTRODUCTION

3.1 This chapter provides more detailed analysis of developments in current receipts and, in particular, the forecasts made in Budget 2003 and Budget 2004. 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 shows the differences between the year-ahead forecasts of and outturn for receipts for Budget 2003 and Budget 2004. Current receipts were £419 billion in 2003-04, and rose to £448 billion in 2004-05. As a share of national income, receipts rose from 37.4 per cent of GDP to 38.1 per cent.

Table 3.1: Summary of differences in Budget receipts forecasts

	Forecast	Outturn	Difference
Budget 2003 forecast of 2003–04			
Current receipts (£ billion)	428.3	419.2	–9.1
Current receipts (per cent of GDP)	38.6	37.4	–1.2
Cyclically–adjusted current receipts (per cent of GDP)	38.9	37.5	–1.4
Budget 2004 forecast of 2004–05			
Current receipts (£ billion)	454.7	448.4	–6.2
Current receipts (per cent of GDP)	38.7	38.1	–0.5
Cyclically–adjusted current receipts (per cent of GDP)	38.9	38.2	–0.6

3.3 Current receipts were around £9.1 billion and £6.2 billion lower than forecast in 2003-04 and 2004-05. Around £2.7 billion of the difference in 2003-04 and £2.5 billion in 2004-05 are due to reclassifications and policy changes introduced after the forecasts were prepared. The reclassifications are largely fiscally neutral. Table 3.2 shows that the differences in 2003-04 were largely the result of lower than expected income tax due to lower than expected growth in wages and salaries as well as lower than projected corporation tax because of lower than expected economic determinants, in particular financial company profits. Table 3.3 shows that in 2004-05 the underforecast was more widely spread across different taxes and other receipts. The forecasting difference for net taxes and national insurance contributions is £2.7 billion overall. This is described in more detail below.

3.4 In order to focus on underlying or structural trends in receipts, the Government also produces estimates of cyclically-adjusted fiscal aggregates (see Chapter 2). These remove the estimated effect of the economic cycle on public sector spending and receipts. The estimates of cyclically-adjusted current receipts shown in Table 3.1 are based on the methodology described in Annex A of the 2003 *End of year fiscal report*.

3.5 The Government's approach to cyclical adjustment is based on the relationship between the output gap and fiscal aggregates over the last 30 years. Consequently, this approach may understate the effects of the economic cycle on the public finances to the extent that one cycle differs from another. In addition, if the output gap does not fully capture the main drivers of receipts, the cyclically-adjusted aggregates will need to be interpreted with care, as temporary changes in receipts may not be fully attributed to the effects of the economic cycle.

TAX FORECASTING AND REASONS FOR DIFFERENCES

Tax forecasts and economic determinants

3.6 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 used in the original tax forecasts and their eventual outturn values will partly explain differences between forecast and outturn tax receipts;

- **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 direct 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 central case. These estimates will not include the second round effects of these audited assumptions, for example, the impact the interest rate assumption has on receipts through its impact on the RPI, which would be captured in the economic determinants line;

- **fiscal forecasting difference:** in some cases, forecasts of the relevant economic variables for the tax base are not produced by the Treasury, and more aggregated economic variables have to be used. 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; and

- **other:** differences in the economic determinants and the fiscal forecasting models are not the only potential source of forecasting differences. 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.

TAX BY TAX FORECASTING DIFFERENCES

3.7 Tables 3.2 and 3.3 use this breakdown of forecasting differences for the Budget 2003 and Budget 2004 year-ahead forecasts for each of the main taxes. These tables also group the taxes to show the same breakdown for HM Revenue and Customs (HMRC) receipts, net taxes and national insurance contributions, and current receipts.

Tax by tax analysis

Income tax

3.8 Gross income tax receipts for 2003-04 were £3.7 billion below the Budget 2003 forecast of £122.1 billion, reflecting shortfalls in both Pay As You Earn (PAYE) and self-assessment receipts. Economic determinant differences account for £2.3 billion, mainly because of lower than expected growth in wages and salaries. This is partially offset by £0.2 billion scored to NAO-audited assumption differences, mostly due to the trend growth assumption.

3.9 The remaining difference of £1.6 billion is attributable to fiscal forecasting differences mainly relating to self-assessment receipts. The 2003-04 receipts relate mainly to self-assessment liabilities from the previous financial year. These proved lower than expected, partly due to timing issues.

3.10 Gross income tax receipts for 2004-05 were £0.4 billion below the Budget 2004 forecast of £127.8 billion. The economic determinant difference was £0.6 billion, with £0.2 billion due to fiscal forecasting differences arising from self-assessment receipts.

Income tax credits

3.11 In 2003-04 the negative tax element was £0.4 billion below forecast. This difference between forecast and outturn is entirely attributed to fiscal forecasting differences. These fiscal forecasting differences arose due to a greater number of working families being entitled to higher levels of support.

3.12 In 2004-05 the negative tax element was £0.9 billion below forecast. The forecasting difference for 2004-05 arose from higher payments to low income working families. A significant component of this forecast difference arose because entitlement in 2004-05 was higher than projected.

Table 3.2: Breakdown of Budget 2003 forecasting differences of receipts for 2003–04

				£ billion			
	Forecast	Outturn	Difference	of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
HM Revenue & Customs							
Income tax (gross of tax credits)	122.1	118.4	–3.7	–2.3	0.2	–1.6	0.0
Income tax credits[1]	–4.0	–4.4	–0.4	0.0	0.0	–0.4	0.0
National insurance contributions	74.5	72.5	–1.9	–1.6	0.1	–0.4	0.0
Value added tax	66.6	69.1	2.5	–0.1	1.7	0.8	0.0
Corporation tax[2]	30.3	28.1	–2.2	–1.4	0.2	–1.0	0.0
Petroleum revenue tax	1.5	1.2	–0.3	–0.1	0.1	–0.2	0.0
Fuel duties	23.0	22.8	–0.3	0.1	–0.1	–0.3	0.0
Capital gains tax	1.2	2.2	1.0	0.0	0.0	1.2	–0.1
Inheritance tax	2.4	2.5	0.1	0.0	0.0	0.0	0.0
Stamp duties	7.9	7.5	–0.3	–0.3	0.2	–0.3	0.0
Tobacco duties	8.0	8.1	0.1	0.0	0.5	–0.4	0.0
Alcohol duties	7.5	7.6	0.1	0.0	0.0	0.1	0.0
Other HMRC	8.0	8.2	0.1	0.0	0.0	0.1	0.0
Total HMRC	349.0	343.8	–5.2	–5.7	3.1	–2.5	–0.1
Vehicle excise duties	4.8	4.7	–0.1	0.1	0.0	–0.3	0.0
Oil royalties	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Business rates	18.6	18.4	–0.3	0.0	0.0	–0.3	0.0
Council tax	18.6	18.8	0.2	0.0	0.0	0.2	0.0
Other taxes and royalties	11.9	11.1	–0.8	0.0	0.0	0.0	–0.7
Net taxes and national insurance contributions	402.9	396.7	–6.2	–5.6	3.1	–2.9	–0.8
Accruals adjustment on taxes	3.6	2.6	–1.0	–0.3	0.0	–0.7	0.0
less VAT and own resources EU contributions	–4.5	–4.5	–0.1	–0.1	0.0	0.0	0.0
less PC onshore CT payments	–0.1	–0.1	0.0	0.0	0.0	0.0	0.0
Tax credits adjustment[3]	0.6	0.5	0.0	0.0	0.0	0.0	0.0
Interest & dividends	4.0	4.9	0.8	0.0	0.0	0.8	0.0
Other receipts	21.8	19.2	–2.6	0.0	0.0	–0.7	–1.9
Current receipts	428.3	419.2	–9.1	–6.0	3.2	–3.5	–2.7

[1] *The Budget only includes tax credits that offset income tax liability, in line with internationally agreed definitions.*

[2] *Net of negative tax tax credits.*

[3] *Tax credits that are classified as expenditure in the national accounts but negative taxation in the calculation of net taxes and national insurance contributions.*

Table 3.3: Breakdown of Budget 2004 forecasting differences of receipts for 2004–05

	Forecast	Outturn	Difference	£ billion of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
HM Revenue & Customs							
Income tax (gross of tax credits)	127.8	127.4	–0.4	–0.6	0.4	–0.2	0.0
Income tax credits[1]	–3.6	–4.5	–0.9	0.0	0.0	–0.9	0.0
National insurance contributions	77.7	78.1	0.4	–0.6	0.1	0.9	0.0
Value added tax	73.1	73.0	–0.1	–0.2	0.9	–0.8	0.0
Corporation tax[2]	34.3	33.6	–0.6	–2.9	1.1	1.2	0.0
Petroleum revenue tax	1.0	1.3	0.3	–0.3	0.5	0.0	0.0
Fuel duties	24.4	23.3	–1.1	0.1	–0.2	–0.5	–0.5
Capital gains tax	1.5	2.2	0.7	0.1	0.0	0.6	0.0
Inheritance tax	2.8	2.9	0.1	0.1	0.0	0.1	–0.1
Stamp duties	9.4	9.0	–0.4	1.9	0.1	–2.3	0.0
Tobacco duties[3]	8.1	8.1	0.0	0.0	–	–	0.0
Alcohol duties	7.7	7.9	0.2	–0.1	0.0	0.3	0.0
Other HMRC	8.3	8.6	0.4	0.0	0.0	0.4	0.0
Total HMRC	**372.6**	**371.1**	**–1.5**	**–2.4**	**2.8**	**–1.3**	**–0.5**
Vehicle excise duties	4.9	4.7	–0.2	0.0	0.0	–0.1	0.0
Oil royalities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Business rates	19.0	18.6	–0.3	0.0	0.0	–0.3	0.0
Council tax	19.7	20.1	0.4	0.0	0.0	0.4	0.0
Other taxes and royalities	13.3	12.2	–1.2	0.0	0.0	–0.4	–0.7
Net taxes and national insurance contributions	**429.4**	**426.7**	**–2.7**	**–2.4**	**2.8**	**–1.7**	**–1.3**
Accruals adjustment on taxes	1.8	1.8	0.1	–0.3	0.0	0.3	0.0
less VAT and own resources EU contributions	–3.7	–4.1	–0.4	–0.2	0.0	–0.3	0.0
less PC onshore CT payments	–0.1	–0.1	0.0	0.0	0.0	0.0	0.0
Tax credits adjustment[4]	0.6	0.6	0.0	0.0	0.0	0.0	0.0
Interest & dividends	4.9	5.7	0.7	0.0	0.0	0.7	0.0
Other receipts	21.7	17.8	–3.9	0.1	0.0	–2.8	–1.3
Current receipts	**454.7**	**448.4**	**–6.2**	**–2.8**	**2.9**	**–3.7**	**–2.5**

[1] *The Budget only includes tax credits that offset income tax liability, in line with internationally agreed definitions.*

[2] *Net of negative tax tax credits.*

[3] *No tobacco smuggled share is available for 2004-05 (see Section 3 of "Measuring Indirect Tax Losses – 2005") so it is not possible to identify the effect of the NAO-audited assumption on the fiscal forecasting difference for tobacco.*

[4] *Tax credits that are classified as expenditure in the national accounts but negative taxation in the calculation of net taxes and national insurance contributions.*

National insurance contributions

3.13 In 2003-04 receipts from national insurance contributions were £1.9 billion below the Budget 2003 forecast. The difference due to economic determinants was £1.6 billion primarily due to lower than forecast wage and salary growth. There was also a small fiscal forecasting difference of £0.4 billion.

3.14 In 2004-05 receipts from national insurance contributions were £0.4 billion higher than forecast. The economic determinant difference reduced contributions by -£0.6 billion. This was more than offset by a fiscal difference of £0.9 billion. Half of this difference was due to rebates relating to personal pensions being lower than forecast. The remainder was mainly due to higher than expected NIC arrears receipts relating to the 2003-04 liability year.

Value added tax

3.15 VAT receipts in 2003-04 were £2.5 billion above the Budget 2003 forecast. This was largely driven by the £1.7 billion difference caused by the NAO-audited assumption on the decline over time of the ratio of VAT receipts to underlying consumer expenditure. Under this assumption, the ratio was forecast to decline, but its outturn was a large increase. At the time of Budget 2004 the forecasting model was replaced with a new model which projects the theoretical VAT liability coupled with an NAO-audited rule for projecting the VAT gap. The new model takes into account all elements of the VAT tax base, developments in fraudulent activities as well as HMRC's compliance strategy. This new model is described in Annex A of the 2004 *End of year fiscal report*.

3.16 VAT receipts in 2004-05 were very close to the Budget 2004 forecast. VAT gap estimates for 2004-05 suggest that the gap between the theoretical VAT liability and receipts turned out lower than anticipated at Budget 2004, which is scored to NAO-audited assumptions. This was offset by a fiscal difference of around £0.8 billion.

Corporation Tax

3.17 The forecast of total corporation tax receipts (including those from North Sea oil and gas companies) in 2003-04 was £2.2 billion lower than the eventual outturn. One of the reasons was the lower than expected outturn of economic determinants, in particular financial companies' profits. There were also fiscal forecasting differences, including some arising from higher than expected capital allowance claims of a temporary nature.

3.18 In 2003-04, North Sea corporation tax receipts were £0.1 billion below forecast. World oil prices were higher than expected for 2003 (at $27.9 per barrel compared with the NAO-audited assumption of $26.6 per barrel, the average price of the independent forecasters). However, this was offset largely by economic determinants, in particular the appreciation of sterling in 2003 which reduced yield.

3.19 Total corporation tax (including North Sea oil and gas companies) receipts in 2004-05 were £0.6 billion below forecast. The shortfall for onshore companies was due mainly to weaker than expected profit growth for both financial and non-financial companies, scored to economic determinant differences. This was largely offset by fiscal forecasting differences due to life assurance companies' receipts, which rose significantly more than expected.

3.20 In 2004-05, North Sea corporation tax receipts were £1.3 billion above forecast. This was mostly due to higher oil prices than forecast, scored as NAO-audited assumptions. While the NAO-audited assumption for the price of oil at the time of the budget was $27.4 per barrel, the outturn price was $38.8 per barrel. This was partly offset by production being lower than forecast, in part due to higher maintenance, scored as economic determinants.

Petroleum revenue tax

3.21 Receipts of petroleum revenue tax (PRT) in 2003-04 were below forecast by £0.3 billion. The fiscal forecasting difference was due primarily to gas price changes. The difference due to determinants is mainly due to the appreciation of sterling in 2003, which has the effect of decreasing sterling oil prices and reducing yield. This was partly offset by an increase in yield attributable to slightly higher oil prices, scored to NAO assumptions.

3.22 Receipts of PRT in 2004-05 were £0.3 billion higher than forecast. The increase in oil prices was largely responsible for this. This was partly offset by lower than expected production levels for fields liable to PRT. Production was revised down by 6 per cent for oil and 2 per cent for gas.

Fuel duties

3.23 Fuel duties in 2003-04 were £0.3 billion below their forecast at Budget 2003. Around £0.1 billion of this was due to the increase in oil prices above the level forecast by the NAO-audited assumption. Higher pump prices meant that outturn demand for road fuels, and therefore revenues from fuel duties, were lower.

3.24 Fuel duty receipts in 2004-05 were £1.1 billion below forecast. At Budget 2004 it was announced that fuel duties would be raised in line with inflation at the start of 1 September. In July 2004, the Government announced it would review this increase in the 2004 Pre-Budget Report. The 2004 Pre-Budget Report announced that the level of fuel duty would continue to be frozen in response to continued volatility in the oil market and this contributed £0.5 billion to the forecasting difference, scored to other factors. There was also a £0.2 billion overforecast due to the fact that oil prices turned out higher than the NAO-audited assumption. The fiscal forecasting difference is £0.5 billion, part of which is due to the effect on demand of higher than expected pump prices.

Capital gains tax and inheritance tax

3.25 Receipts from capital gains tax in 2003-04 were £1.0 billion above the Budget 2003 forecast. This difference is almost entirely due to fiscal forecasting differences arising from larger than expected disposals of business assets. Differences due to economic determinants were small.

3.26 Capital gains tax receipts in 2004-05 were £0.7 billion above the Budget 2004 forecast, due to a greater than expected reaction to the business asset taper relief, scored to fiscal forecasting differences. Economic determinants explained £0.1 billion of the difference due to higher volumes of housing and equity transactions in 2003-04 than expected.

3.27 Inheritance tax receipts were marginally above forecast both in 2003-04 and 2004-05.

Stamp duties

3.28 In 2003-04 stamp duty receipts were £0.3 billion lower than forecast. This was largely due to lower than expected receipts from stamp duty on land and property due to lower than expected commercial prices. The outturn for stamp duty on shares was higher than expected, mainly due to higher than expected equity prices scored under NAO-audited assumptions.

3.29 In 2004-05 total stamp duty receipts were £0.4 billion below forecast. This was due to lower than forecast receipts from shares mainly caused by lower than expected volumes of shares traded. Stamp duty land tax receipts (stamp duty on land and property became stamp duty land tax in December 2003) were close to forecast with a step change in transaction volumes, not reflected in higher receipts. This was reflected in a forecasting difference of £1.9 billion, scored to economic determinants partly offset by a difference of £2.3 billion, scored as fiscal forecasting differences. As this step change in transaction volumes was also not reflected in other property transaction series (e.g. Land Registry) it is likely that it was due to the change in recording and processing associated with the replacement of stamp duty on land and property by stamp duty land tax.

Tobacco duties

3.30 In 2003-04 tobacco duties were £0.1 billion higher than forecast in Budget 2003. In accordance with the NAO-audited assumption, the market share of smuggled cigarettes was 21 per cent in all forecast years. The outturn for 2003-04 was 16 per cent. The lower than forecast smuggled share increased revenues by £0.5 billion and is scored under assumptions audited by the NAO. This was largely offset by fiscal forecasting differences, in part due to a steeper fall in tobacco consumption than expected.

3.31 Tobacco receipts in 2004-05 were close to the Budget 2004 forecast. No estimate of the 2004-05 smuggled share of cigarettes is available yet. It is therefore not possible to identify the breakdown of error between the NAO-audited rule and fiscal forecasting difference at this stage

Alcohol duties

3.32 Alcohol duty receipts in 2003-04 were close to the Budget 2003 forecast. In 2004-05, receipts were £0.2 billion higher than forecast, primarily due to greater than forecast growth in wine receipts, scored under fiscal forecasting differences.

Other HMRC **3.33** Other HMRC receipts were close to their one-year ahead forecast in 2003-04, and £0.4 billion above forecast in 2004-05, mostly because of fiscal forecasting differences.

Vehicle excise duty **3.34** VED receipts were marginally below forecast in 2003-04. In 2004-05 VED receipts were £0.2 billion below forecast.

Council tax **3.35** Council tax receipts in 2003-04 were £0.2 billion higher than forecast in Budget 2003, and £0.4 billion higher in 2004-05 than forecast in Budget 2004. This is attributable to fiscal forecasting differences and is mainly due to higher than forecast growth in the council tax base assumed by local authorities. Council tax increases are determined annually by local authorities, not by the Government and so the council tax forecasts are projections based on stylised assumptions. The forecasts for 2003-04 and 2004-05 in Budgets 2003 and 2004 respectively were based on the latest available local authority estimates released by the Chartered Institute for Public Finance and Accountancy (CIPFA).

Other taxes and royalties **3.36** In both 2003-04 and 2004-05, the difference between the forecast and the outturn receipts of other taxes and royalties was negative, mainly driven by a fall in VAT refunds. This was largely due to the reclassification of NHS Trusts, from the public corporation sector to the central government sector, which has the effect of symmetrically reducing both receipts and expenditure by about £0.7 billion in 2003-04 and £0.7 billion in 2004-05 scored to other factors. Additionally, there was a fiscal forecasting difference of £0.4 billion in 2004-05, mainly due to lower than expected local authority VAT refunds.

Accruals adjustments **3.37** In 2003-04 the biggest component of the difference in accruals adjustments was due to lower accrued levels of income tax, but this was largely offset by positive differences in other components, because of re-allocations between PAYE and class 1 national insurance contributions. In 2004-05 accruals adjustments were close to forecast.

Other receipts **3.38** Other receipts consist of gross operating surplus and rent, including accruals adjustments of the proceeds from the auction of spectrum licences, current transfers from households and general government rent receipts.

3.39 Other receipts in 2003-04 were £2.6 billion below forecast. This was partly due to changes introduced by the Office for National Statistics in the 2003 Blue Book in the definition of taxes. The definition of current receipts was changed so that they no longer included business rates paid by local authorities. This reduced receipts by about £0.8 billion and was matched by a corresponding reduction in local authority expenditure, such that there is no overall impact on fiscal aggregates. In the 2004 Blue Book ONS reclassified NHS Trusts to the central government sector instead of public corporations. This had no effect on the public sector overall, but it did reduce gross operating surplus by £0.7 billion. These changes are scored as other factors, matched by a corresponding difference in spending. Additionally, in 2005 the ONS reclassified roads maintenance expenditure to correct the double counting that had occurred in the past, reducing both current spending and depreciation. The decrease in depreciation has an effect on current receipts through a decrease in gross operating surplus of £0.4 billion. The remaining difference was mainly due to public sector gross operating surplus, which was £1.5 billion lower than expected, scored to fiscal forecasting differences. This was partly offset by a number of small components and statistical adjustments.

3.40 Other receipts in 2004-05 were £3.9 billion below forecast. As in 2003-04, changes in the definition of taxes explain some of this difference. The reclassification of NHS trusts contributes £0.8 billion, while the reclassification of roads expenditure contributes £0.4 billion. The fiscal forecasting difference was due to underforecasts of public sector operating surplus and taxes on products sold to the EU, as well as underforecasts of a number of small components and statistical adjustments.

4 PUBLIC EXPENDITURE

This chapter provides a detailed analysis of public expenditure in 2003-04 and 2004-05. It shows that:

- **forecasts of spending have been close to outturn in each financial year: the difference between forecast and outturn was 0.1 per cent of GDP in 2003-04 and negligible in 2004-05;**
- **the Government continues to reduce the costs of social and economic failure: debt interest and social security benefit payments have continued to fall to around 30 per cent of total spending in 2003-04 and 2004-05, releasing additional resources for priority public services; and**
- **there was a substantial increase in public sector net investment over the past two years, addressing the historical under-investment in public services.**

4.1 This chapter provides a more detailed examination of trends and developments in public expenditure in 2003-04 and 2004-05 and, in particular, differences between projected expenditure and outturn for the year-ahead projections in Budgets 2003 and 2004.

4.2 Public expenditure is measured across the whole of the 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.

4.3 For budgeting purposes, TME is divided into:

- Departmental Expenditure Limits (DEL): firm three–year spending limits for departments; and
- Annually Managed Expenditure (AME): spending that, due to its nature, cannot reasonably be subject to firm multi-year limits. It includes social security and debt interest payments, some central government non-departmental spending, some local authority and public corporation spending as well as adjustments that are made to reconcile with national accounts.

4.4 To improve long-term planning and to 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 unspent resources from one year to the next.

4.5 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 around nine months after the end of the year, while consolidated data for local authorities is produced over a longer time scale. That means that the data in this chapter, particularly for 2004-05, is not final. The information is, however, sufficiently robust to allow analyses of forecasting differences, with future revisions likely to change the detail rather than the main conclusions.

OVERALL PUBLIC EXPENDITURE FORECASTING DIFFERENCES

4.6 Table 4.1 shows the latest outturn for key public spending aggregates for 2003-04 and 2004-05, including a comparison of the differences in the year-ahead forecasts for spending in Budgets 2003 and 2004. TME rose to £487.3 billion or 41 per cent of GDP in 2004-05.

4.7 Net investment has increased by 28 per cent between 2003-04 and 2004-05. The rise in investment reflects the Government's determination to address the historical under-investment in public services.

Forecast differences in 2003-04

4.8 In 2003-04, TME was £1.7 billion below forecast. Public sector current expenditure was £3.8 billion higher than forecast. Public sector net investment was £5.3 billion less than projected due to lower capital expenditure in DEL and AME. The latter reflected, in part, lower locally-financed capital expenditure and lower expenditure by the National Lottery.

Forecast differences in 2004-05

4.9 In 2004-05, TME was £0.3 billion below forecast. Public sector current expenditure was £3.7 billion higher than forecast. Public sector net investment was £3.4 billion lower than projected due to lower capital expenditure in DEL and AME.

Table 4.1: Summary of public expenditure forecasting differences

	£ billion					
	2003-04			2004-05		
	Forecast	Outturn	Difference	Forecast	Outturn	Difference
Total Managed Expenditure						
of which:						
Public sector current expenditure	422.3	426.1	3.8	449.7	453.4	3.7
Public sector net investment	18.9	13.6	–5.3	22.4	19.0	–3.4
Public sector depreciation	14.4	14.3	–0.1	15.5	14.9	–0.6
Total Managed Expenditure	**455.7**	**454.0**	**–1.7**	**487.6**	**487.3**	**–0.3**
of which:						
Departmental Expenditure Limits						
Resource Budget	249.1	251.6	2.5	263.9	266.2	2.3
Capital Budget	25.1	23.6	–1.5	26.3	25.4	–0.9
Less depreciation	–10.4	–9.0	1.4	–11.0	–8.4	2.6
Total Departmental Expenditure Limits	**263.8**	**266.2**	**2.4**	**279.3**	**283.3**	**4.0**
Total Annually Managed Expenditure	**191.9**	**187.8**	**–4.0**	**208.3**	**204.0**	**–4.3**

Note: Figures may not sum due to rounding.

SPENDING FORECASTS AND REASONS FOR DIFFERENCES

4.10 The following section analyses the differences between forecasts and outturns. Differences are decomposed into 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, and classification changes.

DEL FORECASTING DIFFERENCES

4.11 Tables 4.2 and 4.3 below provide a breakdown of TME forecasting differences for 2003-04 and 2004-05 respectively. Differences between outturn and plans reflect the difference between the planned limits for departmental expenditure and the actual expenditure – such differences are treated as fiscal forecasting differences with the exception of classification changes and discretionary changes, including allocations made from the special reserve, which are treated as other differences.

4.12 Departments are able to carry forward unspent budgetary allocations into future years under the end-year flexibility arrangements. This is designed to avoid wasteful year-end surges in spending by allowing departments to commit funding to planned projects in subsequent years and deliver the Government's plans for improvements to public services. The take-up of EYF by departments in subsequent years can increase total DEL spending above the planned or forecast levels set out in successive Budgets. Further information on the stock of EYF, including a breakdown by department, is included in the Public Expenditure Outturn White Paper, published in July of each year.[1]

[1] http://www.hm-treasury.gov.uk/economic_data_and_tools/finance_spending_statistics/pes_publications/pespub_index.cfm

Table 4.2: Breakdown of Budget 2003 forecasting differences for public expenditure for 2003-04

	Forecast	Outturn	Difference	£ billion of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Departmental Expenditure Limits							
Resource Budget	249.1	251.6	2.5	0.0	0.0	0.0	2.5
Capital Budget	25.1	23.6	–1.5	0.0	0.0	–1.6	0.1
Less depreciation	–10.4	–9.0	1.4	0.0	0.0	1.8	–0.5
Total Departmental Expenditure Limits	**263.8**	**266.2**	**2.4**	**0.0**	**0.0**	**0.2**	**2.1**
Annually Managed Expenditure	**191.9**	**187.8**	**–4.0**	**0.2**	**0.1**	**1.8**	**–6.1**
Total Managed Expenditure	**455.7**	**454.0**	**–1.7**	**0.2**	**0.1**	**2.1**	**–4.0**
of which:							
Public sector current expenditure	422.3	426.1	3.8	0.2	0.1	7.6	–4.1
Public sector net investment	18.9	13.6	–5.3	0.0	0.0	–5.4	0.1
Public sector depreciation	14.4	14.3	–0.1	0.0	0.0	–0.1	0.0

Note: Figures may not sum due to rounding.

Table 4.3: Breakdown of Budget 2004 forecasting differences for public expenditure for 2004-05

	Forecast	Outturn	Difference	£ billion of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Departmental Expenditure Limits							
Resource Budget	263.9	266.2	2.3	0.0	0.0	–0.1	2.4
Capital Budget	26.3	25.4	–0.9	0.0	0.0	–1.1	0.2
Less depreciation	–11.0	–8.4	2.6	0.0	0.0	2.6	0.0
Total Departmental Expenditure Limits	**279.3**	**283.3**	**4.0**	**0.0**	**0.0**	**1.4**	**2.6**
Annually Managed Expenditure	**208.3**	**204.0**	**–4.3**	**0.0**	**–0.2**	**1.1**	**–5.2**
Total Managed Expenditure	**487.6**	**487.3**	**–0.3**	**0.0**	**–0.2**	**2.5**	**–2.6**
of which:							
Public sector current expenditure	449.7	453.4	3.7	0.0	–0.2	6.7	–2.8
Public sector net investment	22.4	19.0	–3.4	0.0	0.0	–3.6	0.2
Public sector depreciation	15.5	14.9	–0.6	0.0	0.0	–0.6	0.0

Note: Figures may not sum due to rounding.

DEL in 2003-04

4.13 Outturn spending on total DEL in 2003-04 was £266.2 billion, £2.4 billion above the forecast set out in Budget 2003 of £263.8 billion. Of this increase, £2.5 billion was due to higher resource DEL, with lower capital spending of £1.5 billion almost entirely offset by lower depreciation of £1.4 billion. This difference between planned and outturn spending is equivalent to 0.9 per cent of forecast total DEL, or 0.2 per cent of GDP.

4.14 Spending on resource DEL was £2.5 billion above the Budget 2003 forecast. This difference was almost entirely due to classification and policy changes. Classification changes amounted to £1.9 billion of the difference, driven in particular by the reclassification of expenditure under the Supporting People programme from AME into DEL. This reclassification is TME neutral. Around £0.6 billion of the difference is expenditure related to a decision in the 2003 Pre-Budget Report to increase the resources available for the military conflict in Iraq and the UK's continuing international commitments, which is scored under other.

4.15 Outturn on capital DEL was £1.5 billion below Budget 2003 plans due to fiscal forecasting differences. This was driven by lower than forecast capital spending in several departments, including the Department for Transport, Scottish Executive and the Department of Health which was £0.4 billion lower than forecast. Unspent capital provision is carried forward through the Government's EYF scheme to maintain the Government's overall investment plans. Outturn figures for DEL depreciation were £1.4 billion below Budget 2003 forecasts. 2003-04 was the first year in which depreciation costs were fully included in resource DEL. Classification changes increased depreciation by £0.5 billion, and were more than offset by fiscal forecasting differences of £1.8 billion, mainly within the Ministry of Defence.

DEL in 2004-05

4.16 Provisional outturn for total DEL spending in 2004-05 was £283.3 billion, £4.0 billion above the Budget 2004 forecast of £279.3 billion. Much of this increase (£2.6 billion) was due to classification and policy changes following the Budget 2004 forecast. The remainder was a result of fiscal forecasting differences, in particular lower than expected depreciation. This difference between planned and outturn spending is equivalent to 1.4 per cent of forecast total DEL, or 0.3 per cent of GDP.

4.17 Provisional outturn for resource DEL was £2.3 billion above the Budget 2004 forecast. The majority of this difference was the result of classification and other changes including – as for 2003-04 – the move of Supporting People expenditure from AME into DEL and expenditure related to the decisions taken after the Budget 2004 forecast to allocate further resources to the military conflict in Iraq and the UK's international commitments, scored as other changes.

4.18 Provisional outturn for capital DEL was £0.9 billion below the Budget 2004 forecast. The shortfall was the result of lower than forecast capital spending in the Department of Health, Department for Transport and elsewhere. As departments retain entitlement to underspent provision through EYF to allow reprofiling of capital spending plans, spending below forecast in-year does not reduce the Government's capital investment plans. As with 2003-04, DEL depreciation was below forecast, with outturn £2.6 billion lower than the £11.0 billion forecast, mainly within the Ministry of Defence.

AME FORECASTING DIFFERENCES

4.19 Expenditure in AME, unlike spending in DEL, is not subject to firm spending limits. AME projections are based on forecasts for individual AME components, with forecasts being reviewed at each Pre-Budget Report and Budget.

4.20 Tables 4.4 and 4.5 present a breakdown of forecasting differences in AME for 2003-04 and 2004-05 respectively. Forecast differences for a particular AME spending component are apportioned to one or more of the four types of forecast differences discussed above. For AME as a whole, forecasting differences correspond to only 0.3 and 0.4 per cent (£4.0 and £4.3 billion respectively) of GDP in 2003-04 and 2004-05 respectively. After subtracting the differences due to reclassifications and policy changes scored as other factors, total AME spending was £2.1 billion higher than forecast in 2003-04 and £0.9 billion higher in 2004-05.

Table 4.4: Breakdown of Budget 2003 AME forecasting differences for 2003-04

				£ billion of which:			
	Forecast	Outturn	Difference	Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Annually Managed Expenditure							
Social security benefits[1,2]	111.0	109.5	–1.5	0.0	0.0	0.7	–2.2
Tax credits[1]	11.7	13.7	2.0	0.0	0.0	2.0	0.0
Housing Revenue Account Subsidies	4.3	4.3	0.0	0.0	0.0	0.0	0.0
Common Agricultural Policy	2.3	2.9	0.6	0.0	0.0	0.6	0.0
Public corporations' own-financed capital expenditure	2.6	3.0	0.4	0.0	0.0	0.4	0.0
Net public service pensions[3]	1.9	1.8	–0.1	0.0	0.0	–0.1	0.0
National Lottery	2.2	1.9	–0.3	0.0	0.0	–0.3	0.0
Other departmental expenditure	2.2	1.6	–0.6	0.0	0.0	–0.6	0.0
Net payments to EU institutions	2.3	2.5	0.2	0.0	0.0	0.2	0.0
Locally financed expenditure	23.0	21.5	–1.5	0.0	0.0	–1.5	0.0
Central Government gross debt interest	21.8	22.3	0.5	0.2	0.1	0.2	0.0
Accounting Adjustments[4]	5.5	2.8	–2.7	0.0	0.0	–0.2	–2.9
AME margin	1.0	0.0	–1.0	0.0	0.0	0.0	–1.0
Total Annually Managed Expenditure	**191.9**	**187.8**	**–4.0**	**0.2**	**0.1**	**1.8**	**–6.1**

[1]For 2003-04 to 2004-05, child allowances in Income Support and Jobseeker's Allowance, which, from 2003-04, are paid as part of the Child Tax Credit, have been included in the tax credits line and excluded from the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.

[2]For 2003-04 to 2004-05, the rent rebate element of Housing Revenue Account subsidies, which, from 2004-05, have been administered by DWP, have been included in the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.

[3]Net public service pensions expenditure is reported on a national accounts basis. The forecast has been revised accordingly to reflect this reclassification.

[4]In Budget 2003, the other departmental 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 Budget 2003, 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 in Budget 2003.

Note: Figures may not sum due to rounding.

Table 4.5: Breakdown of Budget 2004 AME forecasting differences for public expenditure for 2004-05

				£ billion			
	Forecast	Outturn	Difference	of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Annually Managed Expenditure							
Social security benefits[1,2]	123.3	121.3	–2.0	0.0	–0.2	0.4	–2.2
Tax credits[1]	13.8	15.3	1.5	0.0	0.0	1.5	0.0
Common Agricultural Policy	2.5	3.1	0.6	0.0	0.0	0.6	0.0
Public corporations' own-financed capital expenditure	2.6	2.5	–0.1	0.0	0.0	–0.1	0.0
Net public service pensions[3]	1.8	1.1	–0.7	0.0	0.0	–0.7	0.0
National Lottery	2.0	1.8	–0.2	0.0	0.0	–0.2	0.0
Other departmental expenditure	2.7	2.8	0.1	0.0	0.0	0.1	0.0
Net payments to EU institutions	2.7	3.3	0.6	0.0	0.0	0.6	0.0
Locally financed expenditure	24.2	25.8	1.6	0.0	0.0	1.6	0.0
Central Government gross debt interest	23.9	24.0	0.0	0.0	0.0	0.0	0.0
Accounting Adjustments[4]	7.7	3.0	–4.7	0.0	0.0	–2.7	–2.0
AME margin	1.0	0.0	–1.0	0.0	0.0	0.0	–1.0
Total Annually Managed Expenditure	**208.3**	**204.0**	**–4.3**	**0.0**	**–0.2**	**1.1**	**–5.2**

[1]For 2003-04 to 2004-05, child allowances in Income Support and Jobseeker's Allowance, which, from 2003-04, are paid as part of the Child Tax Credit, have been included in the tax credits line and excluded from the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.

[2]For 2003-04 to 2004-05, the rent rebate element of Housing Revenue Account subsidies, which, from 2004-05, have been administered by DWP, have been included in the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.

[3]Net public service pensions expenditure is reported on a national accounts basis. The forecast has been revised accordingly to reflect this reclassification.

[4]In Budget 2004, the other departmental 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 Budget 2004, 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 in Budget 2004.

Note: Figures may not sum due to rounding.

AME COMPONENT ANALYSIS

Social security benefits

4.21 The outturn for social security payments in 2003-04 was £1.5 billion below the Budget 2003 forecast. This difference was mainly attributed to fiscal forecasting differences offset by the reclassification in the other category.

4.22 Fiscal forecasting differences arose principally due to a combination of higher than forecast spending on Rent Allowance, Attendance Allowance and Statutory Maternity Pay. Rent Allowance was greater than forecast as the previous year's higher spending had not been passed through fully to the 2003-04 baseline. Attendance Allowance and Statutory Maternity Pay expenditure were above forecast due to a higher than anticipated take up of benefits at Budget 2003. This was offset by the £2.2 billion Supporting People item which was switched out of Annually Managed Expenditure (AME) into Departmental Expenditure Limits (DEL).

4.23 With effect from 2004-05 social security benefits have been reclassified to include the rent rebate element of Housing Revenue Account Subsidies, which are administered by the Department for Work and Pensions.

4.24 Outturn figures for 2004-05 are preliminary in nature. The estimated outturn for social security payments was £2.0 billion below the Budget 2004 forecast. This is explained by the Supporting People switch out of AME into DEL, partially offset by fiscal forecasting differences.

Tax credits

4.25 To take account of the introduction of the Child Tax Credit and Working Tax Credit in April 2003, separate figures for the spending element of tax credits were published for the first time in Budget 2003 in order to give a consistent time series. These figures included spending on child allowances in Income Support and Jobseeker's Allowance, which will in due course be paid as Child Tax Credit.

4.26 Expenditure related to tax credits was £2.0 billion in 2003-04 and £1.5 billion in 2004-05 above the Budget 2003 and Budget 2004 forecasts respectively. This difference between forecast and outturn is entirely attributed to fiscal forecasting differences.

4.27 These fiscal forecasting differences arose due to a higher than forecast number of working families entitled to higher levels of support and due to differences in reporting rises in in-year income.

4.28 The forecasting differences for 2004-05 arose from higher payments to more low income working families. While the process of finalisation has only just been completed, it appears that income growth among lower income households was less strong than expected.

4.29 Tax credits are a new programme, and it therefore is unsurprising that the forecast differences for this programme are larger than for more established programmes. In the light of the first two years' experience, the Government is refining the approach used to forecast tax credits.

Housing Revenue Account Subsidies

4.30 Outturn in 2003-04 was consistent with the Budget 2003 forecast. In 2004-05 Housing Revenue Account Subsidies was reclassified as Other departmental expenditure. The rent rebate element was however included in Social Security benefits.

Common Agricultural Policy

4.31 The outturn for expenditure in 2003-04 and 2004-05 was £0.6 billion above the Budget 2003 and Budget 2004 forecasts respectively, owing to fiscal forecasting differences. This reflects a number of factors including movements in exchange rates and the phased introduction of the dairy premium from 2003-04 to compensate for institutional price cuts in the dairy sector.

Public corporations' own-financed capital expenditure

4.32 In 2003-04, the outturn for public corporations' own-financed capital expenditure was £0.4 billion above the Budget 2003 forecast. These fiscal forecasting differences are mainly due to lower than expected capital spending by British Nuclear Fuels and other public corporations. In 2004-05 outturn was close to the Budget 2004 forecast.

Net public service pensions

4.33 Net public service pensions figures are presented on a national accounts basis which reflects the difference between the cash paid out during the year and any contributions received for the main unfunded public service pension schemes.

4.34 Outturn for 2003-04 was very close to the Budget 2003 forecast.

4.35 In 2004-05 the outturn for net public service pensions was £0.7 billion lower than forecast. This was due to lower than expected cash expenditure (£0.5 billion) and higher than expected receipts (£0.2 billion). The lower than expected cash expenditure relates to armed forces pensions, due to overestimated expenditure on a one-off payment of pensioner arrears.

4.36 Cash expenditure by the NHS (England and Wales) Pension Scheme was also lower than forecast, partly because of lower payments in respect of staff transfers to other pension schemes. The higher than anticipated receipts can mostly be explained by increased contributions into the NHS Pensions scheme, reflecting in year experience of recent changes to the NHS workforce and levels of pensionable pay associated with improving front line services.

National Lottery

4.37 Lottery expenditure outturn figures for 2003-04 and 2004-05 were £0.3 and £0.2 billion respectively lower than forecast. These figures are scored as fiscal forecasting differences and reflect slower-than-forecast draw down by Lottery distributing bodies. Distributing bodies depend to a significant extent on draw down forecasts provided by grant recipients. Draw down can be slower as a result of delays in securing partnership funding or planning consents, or in getting construction work under way.

Other departmental expenditure

4.38 The outturn for other departmental expenditure in 2003-04 was £0.6 billion lower than forecast. There are a number of reasons that explain these fiscal forecasting differences.

4.39 ECGD net lending to the private sector on the capital side was £0.3 billion lower than forecast. This was a result of repayment of loans made to refinance bank lending. The timing and size of repayments are determined by banks and exporters, outside ECGD's control, so are difficult to forecast. On the current expenditure items, ECGD other current expenditure of goods and services (OCEGS) and ECGD subsidies differed by £0.2 billion. This related to Fixed Rate Export Finance (FREF, an interest subsidy scheme) and are driven by changes in market interest rates, both in sterling and foreign currency, and so are difficult to forecast.

4.40 Outturn for lending to public corporations in Budgets was £0.6 billion lower than forecast, largely as a result of higher than expected Post Office repayments on their loan facilities with the Department of Trade and Industry at year end.

4.41 Outturn for 2004-05 close to the Budget 2004 forecast.

Net payments to EU institutions

4.42 The outturn for net payments to EU Institutions for 2003-04 was slightly higher than the Budget 2003 forecast. This can be explained by fiscal forecasting differences.

4.43 Outturn in 2004-05 was £0.6 billion higher than forecast. This was largely a timing effect. Under EU legislation, the EU can request draw-forward of payments within the calendar year and asked for extra payments to be made in the first quarter of 2005. This was not anticipated at the time of the forecast, but was balanced by lower payments in the remainder of 2005, which will impact upon 2005-06 net payments.

Locally-financed expenditure

4.44 This covers local authority expenditure financed from council tax 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 2003-04 and 2004-05 were £1.5 billion lower and £1.6 billion higher than forecast, respectively. Much of the shortfall in 2003-04 reflects lower capital expenditure.

4.45 Differences in both financial years are scored as arising from fiscal forecasting differences. Forecasts of expenditure are produced by making assumptions about the growth rates of the individual income components available to local authorities. Therefore, possible sources of fiscal forecasting differences are due to errors in these income projections but also partly due to timing and other differences between income and expenditure.

Central government gross debt interest

4.46 Central government gross debt interest in 2003-04 was £0.5 billion higher than the Budget 2003 forecast. Some £0.2 billion of this difference resulted from a higher than forecast uplift on index-linked debt, which is scored as an economic determinant difference. A further £0.1 billion was attributed to higher than expected interest rates on short-term borrowing. This is scored as a difference arising from the NAO-audited assumption on market interest rates. The remaining difference of £0.2 billion is scored as a fiscal forecasting difference, which includes the effect of higher than forecast central government borrowing in that year.

4.47 In 2004-05, central government gross debt interest outturn was very close to the Budget 2004 forecast.

Accounting and other adjustment

4.48 The accounting adjustments reconcile the budgeting aggregates DEL and AME with the national accounts definition of TME, removing items that score in DEL or AME but not in TME, and adding in items included in TME but not in DEL or AME. The 'other' column shows classification changes made by the Office for National Statistics since the forecast was compiled, principally the reclassification of NHS trusts from the public corporations to central government sector, and the decision to consolidate local government payments of business rates out of TME. Remaining changes in outturn for specific accounting adjustment items (for example, non-cash items in budgets and VAT refunds) appear in the column for fiscal forecasting differences.

AME Margin

4.49 The year ahead forecasts for AME for Budget 2004 and 2005 included an AME margin of £1.0 billion to minimise the risk of outturn AME exceeding its forecast. The change in AME margin is classified as other in the breakdown of forecasting differences.

A ASSUMPTIONS USED IN BUDGET 2003 AND BUDGET 2004

Table A.1: Budget 2003 – key assumptions audited by the National Audit Office

	Assumption used for Budget 2003
Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth	2½ per cent a year to 2006-07 and 2¼ per cent in 2007-08.
UK claimant unemployment	Rising slowly to 1.03 million in 2005-06, from recent levels of 0.93 million, consistent with the average of independent forecasters.
Interest rates	3-month market rates change in line with market expectations (as of 28 March).
Equity prices	FTSE All-Share index rises from 1778 (close 28 March) in line with money GDP.
VAT	Ratio of underlying 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	$26.6 a barrel in 2003, the average of independent forecasters, and then constant in real terms.
Tobacco	The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For Budget 2003, a share of 21 per cent has been used for all forecast years. This is in line with the most recently published outturn figure for 2001-02 and takes account of the indications from duty receipts for 2002-03 that the smuggled share in this year is likely to be lower than 21 per cent.
Inland Revenue compliance and enforcement package	Only direct and some preventive effects are allowed for.

Table A.2: Budget 2004 – key assumptions audited by the National Audit Office

	Assumption used for Budget 2004
Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth	2½ per cent a year to 2006-07 and 2¼ per cent in 2007-08 and 2008-09.
UK claimant unemployment	Remaining at recent levels of 0.92 million.
Interest rates	3-month market rates change in line with market expectations (as of 5 March).
Equity prices	FTSE-All share index rises from 2271 (close 5 March) in line with money GDP.
VAT	The VAT gap will rise by 0.5 percentage points per year from a level that is at least as high as the estimated outturn for the current year.
GDP deflator and RPI	Projections of price indices used to project the public finances are consistent with CPI.
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	$27.4 a barrel in 2004, the average of independent forecasters, and then constant in real terms.
Tobacco	The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For Budget 2004, a share of 18 per cent has been used in all forecast years.

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List of Abbreviations

AME	Annually Managed Expenditure
ARBs	Actuarially Reduced Benefits
CA	Cyclically adjusted
CAP	Common Agricultural Policy
CBO	Congressional Budget Office
CPI	Consumer Prices Index
DEL	Departmental Expenditure Limits
ECGD	Export Credits Guarantee Department
ESA-95	European System of Accounts
EU	European Union
EYF	End-year flexibility
EYFR	End of year fiscal report
FTSE	Financial Times Stock Exchange
G7	Group of seven (leading industrial nations): Canada, France, Germany, Italy, Japan, the United Kingdom and the United States
GDP	Gross Domestic Product
GEFCO	Guaranteed Export Finance Corporation
GGDIP	General government debt interest payments
GSS	Government Statistical Service
HMRC	Her Majesty's Revenue and Customs
IMF	International Monetary Fund
IS/JSA	Income Support / Jobseeker's Allowance
NAO	National Audit Office
NHS	National Health Service
NICs	National insurance contributions
OECD	Organisation for Economic Cooperation and Development
ONS	Office for National Statistics
PAYE	Pay As You Earn
PC	Public corporations
PCSPS	Principle Civil Service Pension Scheme
PRT	Petroleum Revenue Tax
PSNB	Public sector net borrowing
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
TME	Total Managed Expenditure
VAT	Value added tax
VED	Vehicle excise duty
WFTC	Working Families' Tax Credit

ISBN 1-84532-119-7