

End of year fiscal report

December 2006



HM TREASURY

End of year fiscal report

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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 2004–05 and 2005–06, 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 2004 and Budget 2005.

The report shows that the Government was meeting its strict fiscal rules in 2004–05 and 2005–06 while allowing fiscal policy to support monetary policy following a period of global economic uncertainty.

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

- since the introduction of the new macroeconomic framework in 1997, the overall accuracy of year-ahead forecasts has been broadly unchanged. 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: 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.

Purpose of the EYFR

1.3 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 in 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

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

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 2004–05 and 2005–06 together with the Government's historical forecasting performance. The detailed forecast analysis considers the Budget 2004 forecast for 2004–05 and the Budget 2005 forecast for 2005–06. The two year horizon strikes a balance between timely reporting of fiscal developments and the quality and robustness of data. Public finance data are 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 are subject to revision for several years, as the data are 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, 2005–06. Nonetheless, the information is sufficiently robust to provide a sound basis for forecast analysis. Future revisions, particularly for 2004–05, 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 End of year fiscal report, the 2003 EYFR 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:

- **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;

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

- **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.

I.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 2004–05 and 2005–06, despite growth slowing during 2005 in the face of a number of challenges including sustained high oil prices, weak demand growth in the euro area and a slowing housing market. 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 2004 and 2005 is shown in Annex A.

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 2004–05 and 2005–06 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 37 per cent of GDP, 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. 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	2005–06
Golden Rule									
Surplus on current budget	–0.1	1.2	2.3	2.5	1.0	–1.1	–1.7	–1.6	–1.2
Average surplus since 1997–98	–0.1	0.5	1.1	1.5	1.4	1.0	0.6	0.3	0.1
Cyclically-adjusted surplus on current budget	0.0	1.1	2.0	1.9	0.9	–0.7	–1.3	–1.6	–1.0
Sustainable investment rule									
Public sector net debt	41.6	39.3	36.6	31.7	30.6	32.0	33.2	35.0	36.5
Core debt	40.6	38.6	36.2	31.8	31.0	31.8	32.7	34.6	35.8

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 since 1998–99 net debt has remained below 40 per cent of GDP. The Government has continued to meet the sustainable investment rule at the same time as borrowing to fund sustained high levels of public sector investment, addressing the historic under-investment in the UK’s public services. 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

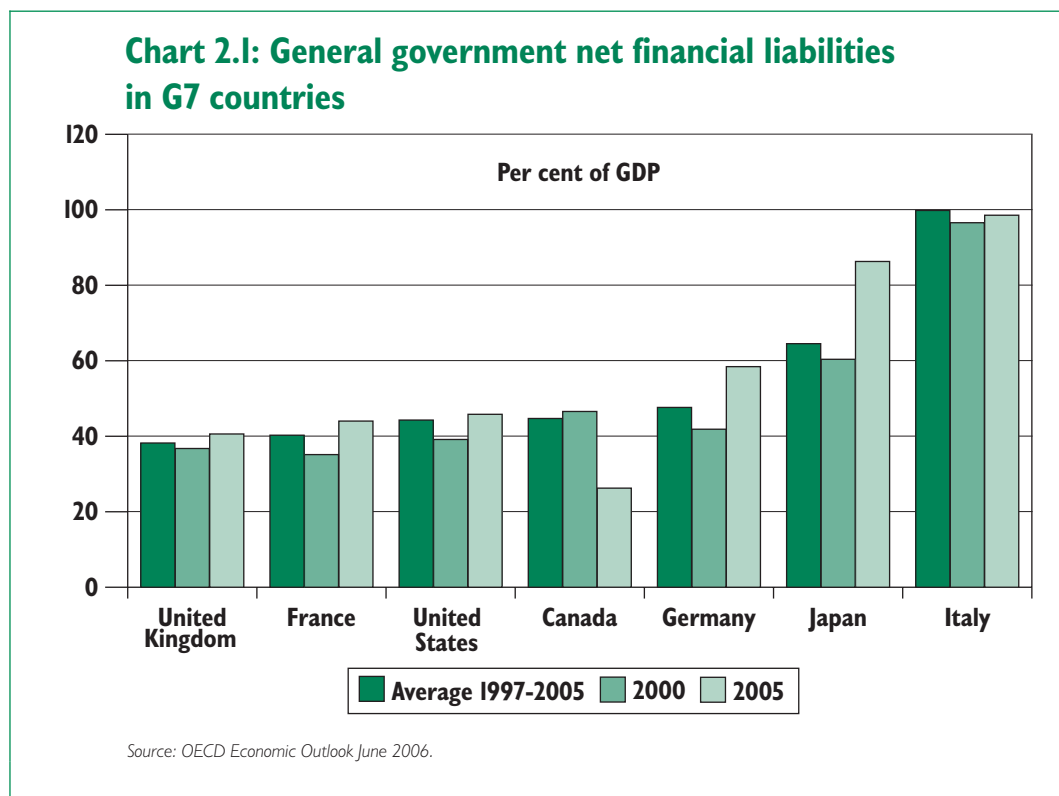
¹ See *Evidence on the UK economic cycle*, HM Treasury (July 2005) for details.

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 Since 2002 most G7 economies have experienced rising debt-to-GDP ratios as public finances moved into deficit. Chart 2.1 presents Organisation for Economic Cooperation and Development (OECD) data on general government net financial liabilities for the G7 countries. Note that the OECD definition of general government net financial liabilities differs from the UK government's measure of public sector net debt (PSND) in a number of respects. In particular, the OECD measure excludes public corporations but uses a wider definition of general government assets and liabilities, values gilts according to their market value rather than their nominal value and uses different reference periods (debt is measured at the end of the calendar year as opposed to the end of the financial year, and GDP for the previous year is used rather than GDP centred on the debt period).

2.9 Chart 2.1 shows that only Canada saw its general government net financial liabilities ratio fall between 2000 and 2005. On average since 1997, general government net financial liabilities in the UK have been lower than in other G7 economies, and in 2005 remained lower than all the G7 countries except Canada.



Economic impact 2.10 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.

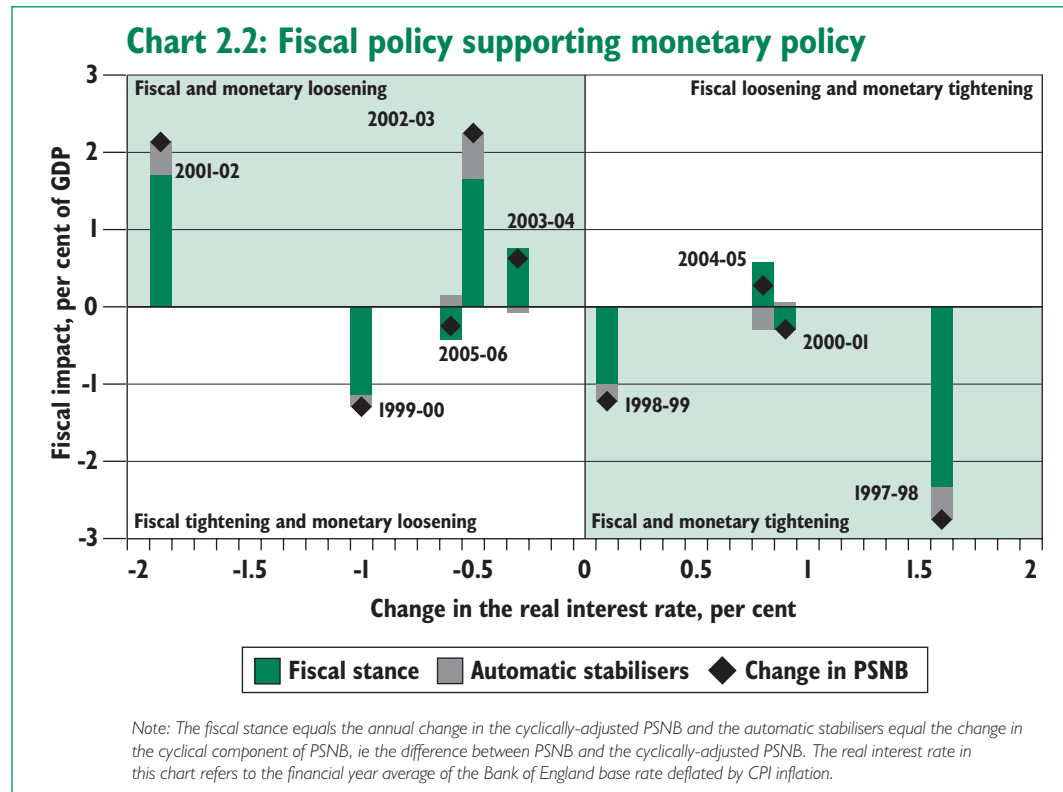
2.11 The overall impact of fiscal policy on the economy is made up of changes in:

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

2.12 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.

2.13 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.

2.14 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 in each year 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. This is what the chart shows, suggesting that fiscal policy has tended to be counter-cyclical. During the late 1990s, the fiscal stance and the automatic stabilisers tightened at a time when the economy was above trend. As the economy moved below trend in 2001, the automatic stabilisers and the fiscal stance supported the economy. With the economy operating close to trend in 2004 and 2005, the impact of fiscal policy became more muted.



HISTORICAL FORECASTING PERFORMANCE

2.15 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, measured in terms of accuracy and caution: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.

2.16 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:

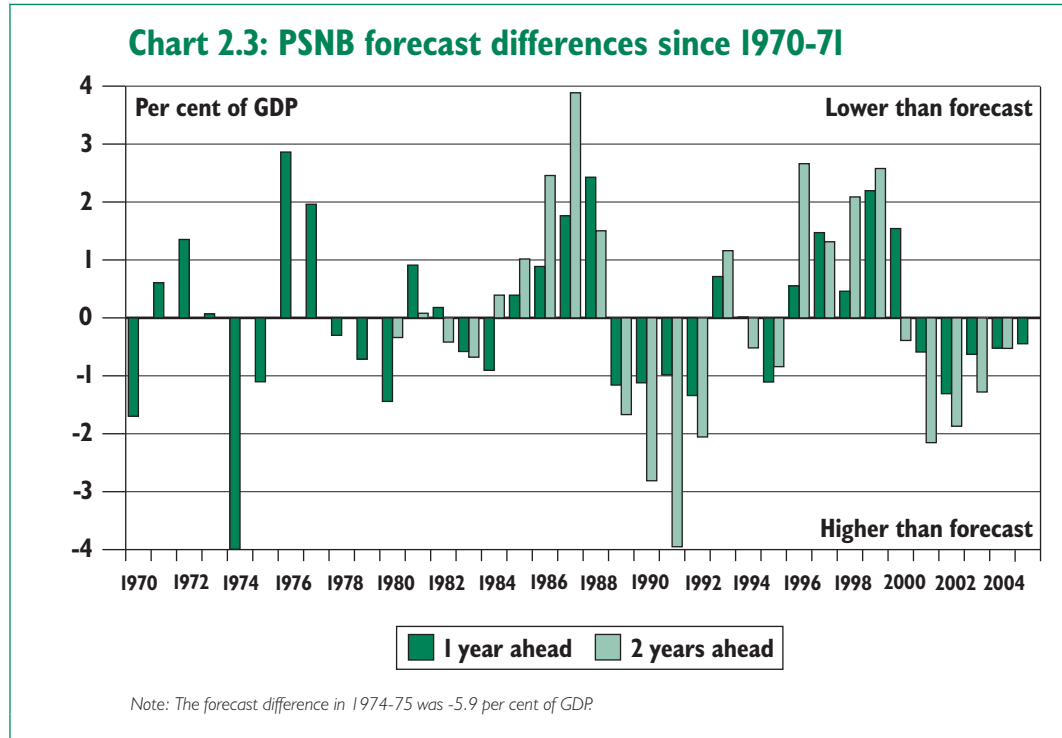
- the overall accuracy of the one-year ahead forecast under the new framework (i.e. since 1997–98) continues to be similar to that in preceding decades. The year-ahead forecast has on average been cautious, as shown by the positive average forecast difference of 0.2 per cent of GDP, compared with –0.1 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			Number of observations in whole sample
	Whole sample	Before new framework	New framework	
One year ahead forecasts				
Average absolute difference	1.2	1.2	1.0	36
Average difference	0.0	–0.1	0.2	
Two year ahead forecasts				
Average absolute difference	1.5	1.6	1.5	25
Average difference	0.0	0.0	0.0	

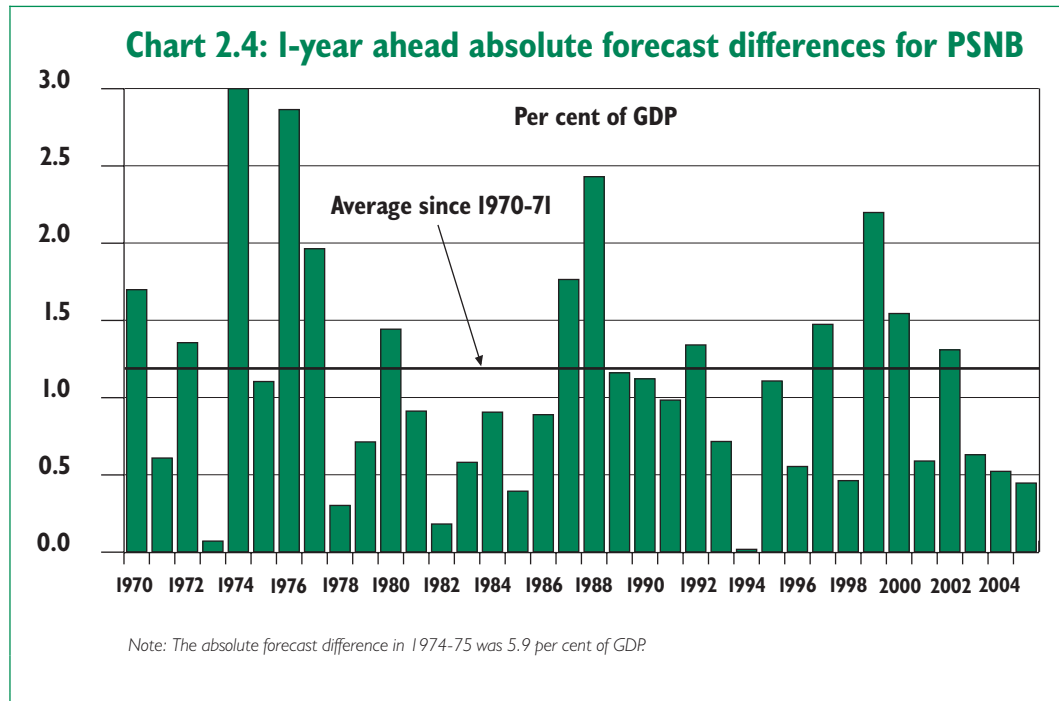
2.17 Chart 2.3 plots the one- and two-year ahead forecast differences for PSNB (PSNCR before Budget 1997). It shows how forecast differences have narrowed significantly over the past four years, to the point where the 2005–06 year-ahead forecast from Budget 2005 showed a difference of just 0.4 per cent of GDP compared with outturn PSNB.

⁴ The current presentation of the fiscal aggregates was first introduced in the 1998 Economic and Fiscal Strategy Report. Data for 1998 onwards refer 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.



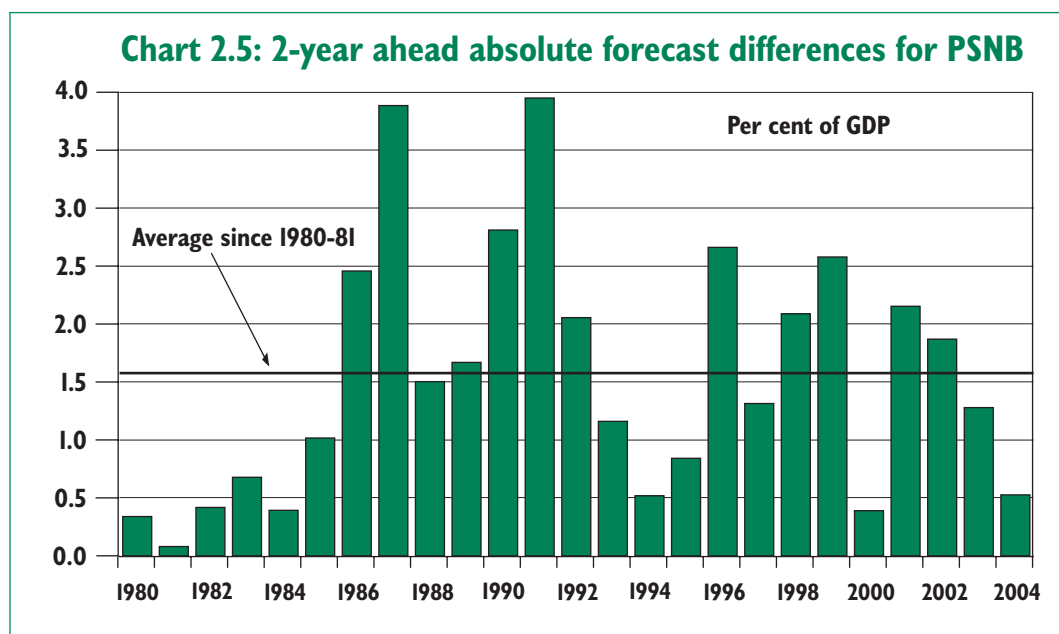
2.18 There is a positive correlation between forecast differences and the economic cycle since 1997 (though this relationship is based on a small sample size). Forecast PSNB has tended to be higher than outturn PSNB when the output gap is positive, and forecast PSNB has tended to be lower than outturn PSNB when the output gap is negative. The fact that the economy has been below trend for much of the period since 2000 may therefore help to explain the negative forecast differences over this period.

2.19 If a stable and predictable relationship existed between forecast differences and the output gap, it would be desirable to use that information to adjust the fiscal projections for the expected impact of the output gap, thereby improving the accuracy of the fiscal forecasts. However, the relationship is between forecast differences and the *latest* estimate of the output gap. The estimates of the output gap that are available after a number of years will often differ from *real-time* (i.e. contemporaneous) forecasts, for example because of subsequent revisions to National Accounts data. It would not have been possible, based on the relationship between fiscal forecast differences and *real-time* forecasts of the output gap, to adjust the fiscal forecasts in a way that on average improved forecasting accuracy.



2.20 The improvement in the accuracy of the fiscal forecasts over the last few years is shown in Charts 2.4 and 2.5. Chart 2.4 shows the absolute differences for one-year ahead forecasts since 1970–71. It shows that on the basis of current data the Budget 2003, Budget 2004 and Budget 2005 year-ahead forecasts were considerably more accurate than the average over the last 36 years, and that the accuracy has improved in every year since 2002. Since 1970–71 only five out of 36 forecasts were more accurate than the Budget 2005 forecast for 2005–06.

2.21 Chart 2.5 shows the absolute differences for two-year ahead forecasts since 1980–81. It shows that on the basis of current data the Budget 2003 and Budget 2004 two-year ahead forecasts were more accurate than the average over the last 25 years, and that the absolute forecast difference for 2004 was less than half the long-run average. Since 1980–81 only six out of 25 forecasts were more accurate than the Budget 2004 forecast for 2005–06.



INTERNATIONAL COMPARISONS

2.22 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

2.23 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.

2.24 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	8.9	10.7	12.0	12.9
UK, HM Treasury	2.9	4.1	4.9	6.7		

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 3 years forecasts, using forecasts from the previous autumn as proxies between 1994 and 1997 and 1980–81 onwards excluding 1981–81 to 1983–84 and again using autumn proxies between 1994 and 1997 for 4 year forecasts and refers to PSNB or PSNCR.

Source: US data from *The Uncertainty of Budget Projections: A Discussion of Data and Methods*, CBO March 2006 (<http://www.cbo.gov/spreadsheets.shtml>).

International Organisations

2.25 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 International Monetary Fund (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*, which forecasts borrowing on a calendar year basis and is more closely comparable to the OECD's *Economic Outlook* and the European Commission's *Autumn Forecasts* in that it simultaneously forecasts for a broad range of countries.

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.

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.

Table 2.4: Average forecast differences for UK net borrowing, 1997 to 2005

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

2.26 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 absolute average difference, and in terms of caution – as shown by the average forecast differences. It is important, though, to bear in mind the difficulty of making comparisons with and between international organisations.

Comparisons with EU Member States

2.27 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 EU 15 Member States' annual Stability or Convergence Programmes.⁷ 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. In terms of both forecast accuracy and caution the UK performs better than average. Of the major EU economies the UK is the only one that has on average borrowed less than forecast.

⁷ This analysis remains confined to the former-EU15 Member States as the 10 accession Member States produced their first Convergence Programmes in 2004.

Table 2.5: Convergence Programme forecasts – Differences between forecast and outturn, 1997 to 2005

	Per cent of GDP	
	Absolute average difference	Average difference
Spain	0.37	–0.08
Austria	0.45	–0.02
Belgium	0.50	0.48
France	0.57	–0.35
Finland	0.91	0.64
UK	0.96	0.16
Germany	1.02	–0.04
Denmark	1.21	–0.66
Italy	1.24	–1.00
Portugal	1.30	–1.30
Sweden	1.66	0.50
Ireland	1.81	0.79
Netherlands	1.83	0.47
Luxembourg	1.96	1.76
Greece	3.69	–3.69
<i>Memo: UK Budget forecasts</i>	<i>1.02</i>	<i>0.24</i>

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>). From 1998 onwards, the programmes are generally submitted in December of each year. In 1997, the timing of the forecasts was more varied throughout that year. Eurostar 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

2.28 Table 2.6 provides a summary comparison of the year-ahead projections for the main fiscal aggregates in Budget 2004 and Budget 2005 compared with the latest outturn information.

Table 2.6: Differences in Budget forecasts for main aggregates

	Per cent of GDP					
	2004–05			2005–06		
	Budget 2004 Forecast	Outturn	Difference	Budget 2005 Forecast	Outturn	Difference
Surplus on current budget	–0.9	–1.6	–0.7	–0.5	–1.2	–0.7
<i>Memo: average absolute difference, current budget, since 1998–99</i>			<i>1.0</i>			<i>1.0</i>
Cyclically-adjusted surplus on current budget	–0.2	–1.6	–1.4	–0.3	–1.0	–0.7
Public sector net borrowing	2.8	3.3	0.5	2.6	3.0	0.4
<i>Memo: average absolute difference, net borrowing, since 1970–71</i>			<i>1.2</i>			<i>1.2</i>
Cyclically-adjusted public sector net borrowing	2.1	3.3	1.2	2.4	2.8	0.5
Public sector net debt	34.4	35.0	0.6	35.5	36.5	1.0

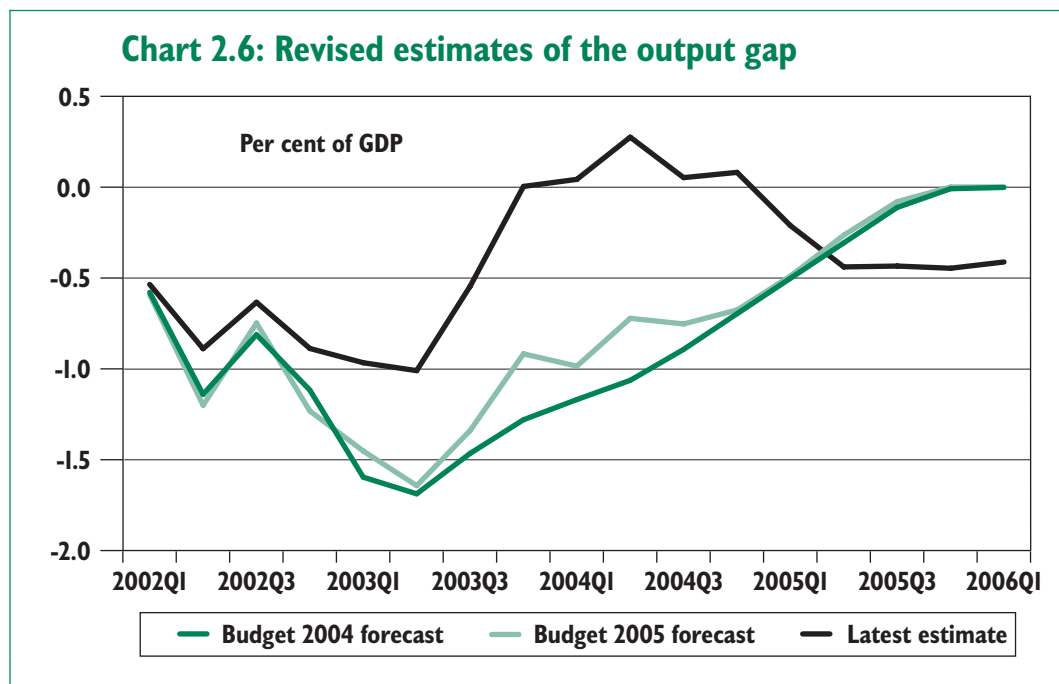
Note: figures may not sum due to rounding.

2.29 The current budget was in deficit in 2004–05 and 2005–06. In 2004–05, the deficit was 1.6 per cent of GDP compared with the forecast of 0.9 per cent. The forecast difference was lower than the average under the new framework. The deficit in 2005–06 was 1.2 per cent of GDP compared with the forecast of 0.5 per cent. The forecast difference was again smaller than the average since 1998–99.

2.30 The outturn for net borrowing was 3.3 per cent of GDP in 2004–05 and 3.0 per cent in 2005–06 compared with forecasts of 2.8 per cent and 2.6 per cent of GDP respectively. The forecast differences of 0.5 per cent of GDP and 0.4 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 1.2 per cent of GDP.

Impact of the economic cycle

2.31 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.



2.32 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 2.6. The revised data have changed the output gap in 2004–05 from -0.8 per cent of GDP forecast in Budget 2004 to 0.0 per cent and increased the negative output gap in 2005–06 from -0.2 per cent forecast in Budget 2005 to -0.4 per cent. 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.

Breakdown of forecast differences **2.33** Table 2.7 provides more detailed information on the sources of forecast difference. In 2004–05, receipts were £2.8 billion lower than forecast, below the average absolute difference over the last seven years. In 2005–06 the size of the forecast difference fell to –£1.3 billion. Outturn current expenditure was £6.0 billion higher than forecast in 2004–05 and £7.0 billion higher in 2005–06. The outturn for depreciation was £0.1 billion below forecast for 2004–05 and £1.0 billion above for 2005–06.

2.34 The forecast differences for current expenditure and current receipts in 2004–05 and 2005–06 are affected by the decision by the Office of National Statistics (ONS) in January 2006 to reclassify the BBC and S4C to the central government sector from the public corporations sector. Although this change is fiscally neutral to the public sector, it adds approximately £2.8 billion to both expenditure and receipts totals. As the reclassification was made after the Budget 2004 and Budget 2005 forecasts, it has the effect of increasing forecast differences for expenditures and reducing them for receipts. After adjustment for this classification change, outturn current expenditure was £3.2 billion higher than forecast in 2004–05 and £4.2 billion higher than forecast in 2005–06, while outturn current receipts were £5.6 billion lower than forecast in 2004–05 and £4.1 billion lower than forecast in 2005–06.

2.35 Net borrowing is equal to net investment less the surplus on the current budget. Outturn net investment was below forecast by £2.5 billion in 2004–05 and by £3.8 billion in 2005–06. Despite being below forecast, net investment increased by 13 per cent between 2004–05 and 2005–06. 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 £6.3 billion in 2004–05 and £5.5 billion in 2005–06, in each case smaller than the current budget forecast differences of £8.8 billion and £9.3 billion respectively.

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

Table 2.7: Summary of differences in Budget forecasts

	£ billion					
	2004–05			2005–06		
	Budget 2004 Forecast	Outturn	Difference	Budget 2005 Forecast	Outturn	Difference
Current budget						
Current receipts	454.7	451.9	–2.8	486.6	485.3	–1.3
<i>Memo: average absolute difference in current receipts since 1998–99¹</i>			7.9			8.3
Current expenditure	449.7	455.7	6.0	476.9	483.9	7.0
<i>Memo: average absolute difference in current expenditure since 1998–99¹</i>			4.5			4.7
Depreciation	15.5	15.4	–0.1	15.5	16.5	1.0
Surplus on current budget	–10.5	–19.3	–8.8	–5.8	–15.1	–9.3
Capital budget						
Gross investment	41.7	41.6	–0.1	46.9	44.8	–2.1
Less asset sales	–3.8	–6.3	–2.6	–5.2	–5.9	–0.6
Less depreciation	–15.5	–15.4	0.1	–15.5	–16.5	–1.0
Net investment	22.4	19.9	–2.5	26.2	22.4	–3.8
Public sector net borrowing	32.9	39.2	6.3	32.0	37.5	5.5
<i>Memo: average absolute difference between forecast and outturn net borrowing since 1970–71¹</i>			13.9			14.5
Public sector net debt	416.2	424.5	8.3	452.1	462.7	10.6
Memo						
Treaty deficit ²	30.4	37.6	7.1	32.0	35.0	3.0
Treaty debt ³	480.9	481.5	0.6	520.9	529.1	8.2

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 Maastricht basis

³ General government gross debt on a Maastricht basis

2.36 Table 2.8 breaks down the differences between the year-ahead Budget forecasts and outturns into the four categories described in Chapter 1. In 2005–06, the difference between forecast and outturn for the main fiscal aggregates was mainly due to economic determinants and fiscal forecasting differences, while in 2004–05 other factors, particularly classification changes, also made a significant contribution. Overall, the NAO-audited assumptions provided a source of caution in both years as intended. For example, in 2005–06 there is a positive sign on the PSNB forecast difference because borrowing was higher than forecast. Economic determinants and, to a lesser extent, fiscal forecasting differences more than explain the PSNB forecast difference. The contribution of the NAO-audited assumptions has a negative sign because these assumptions added caution to the forecast, partly offsetting the effects of the economic determinants and fiscal forecasting differences. More detailed analysis of the forecast differences for spending and receipts in 2004–05 and 2005–06 is developed in Chapters 3 and 4.

Table 2.8: Breakdown differences in the main fiscal aggregates¹

	£ billion	
	Budget 2004 forecast for 2004–05	Budget 2005 forecast for 2004–05
Current receipts difference	– 2.8	– 1.3
<i>Contribution from:</i>		
Economic determinants	– 2.7	– 5.3
NAO-audited assumptions	3.3	0.9
Fiscal forecasting differences	– 3.8	0.2
Other	0.5	2.9
Current spending difference	6.0	7.0
<i>contribution from:</i>		
Economic determinants	0.0	0.2
NAO-audited assumptions	– 0.3	0.1
Fiscal forecasting differences	2.1	3.7
Other	4.3	3.0
Depreciation	– 0.1	1.0
<i>contribution from:</i>		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	– 0.1	1.0
Other	0.0	0.0
Current budget difference	– 8.8	– 9.3
<i>contribution from:</i>		
Economic determinants	– 2.7	– 5.5
NAO-audited assumptions	3.6	0.8
Fiscal forecasting differences	– 5.8	– 4.5
Other	– 3.8	– 0.1
Net investment difference	– 2.5	– 3.8
<i>contribution from:</i>		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	– 2.2	– 3.7
Other	– 0.3	– 0.1
Net borrowing difference	6.3	5.5
<i>contribution from:</i>		
Economic determinants	2.7	5.5
NAO-audited assumptions	– 3.6	– 0.8
Fiscal forecasting differences	3.6	0.9
Other	3.5	– 0.1

¹ Contributions may not sum due to rounding.

3

RECEIPTS

This chapter provides more detailed analysis of developments in receipts in 2004–05 and 2005–06. It shows that:

- current receipts rose from around £452 billion in 2004–05 to around £485 billion in 2005–06, providing resources for the Government’s priorities; and
- in both years receipts were lower than originally forecast, largely reflecting lower growth in tax determinants. In 2004–05, this shortfall was spread across a variety of taxes; in 2005–06 income tax and VAT receipts were the main contributors to the shortfall.

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.

INTRODUCTION

3.1 This chapter provides more detailed analysis of developments in current receipts and, in particular, the forecasts made in Budget 2004 and Budget 2005. 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 2004 and Budget 2005. Current receipts were £452 billion in 2004–05, and rose to £485 billion in 2005–06.

Table 3.1: Summary of differences in Budget receipts forecasts

	Forecast	Outturn	Difference
Budget 2004 forecast of 2004–05			
Current receipts (£ billion)	454.7	451.9	– 2.8
Current receipts (per cent of GDP)	38.7	38.0	– 0.6
Cyclically-adjusted current receipts (per cent of GDP)	38.9	38.1	– 0.8
Budget 2005 forecast of 2005–06			
Current receipts (£ billion)	486.6	485.3	– 1.3
Current receipts (per cent of GDP)	39.3	39.2	– 0.1
Cyclically-adjusted current receipts (per cent of GDP)	39.4	39.2	– 0.1

3.3 Current receipts were £2.8 billion lower than forecast in 2004–05 and £1.3 billion lower than forecast in 2005–06. Table 3.2 shows that the difference in 2004–05 was spread widely across a number of different taxes and other receipts. Table 3.3 shows that in 2005–06 the shortfall was again spread across a number of taxes and other receipts, with significant contributions to the overall shortfall from income tax and VAT receipts. This is described in more detail in the next section.

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 Retail Prices Index, which would be captured in the economic determinants line;
- **fiscal forecasting differences:** 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 2004 and Budget 2005 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 2004–05 were £0.5 billion below the Budget forecast of £127.8 billion. The economic determinant difference was £1.0 billion, which was partly offset by £0.2 billion due to fiscal forecasting differences. There was a further offset of £0.3 billion scored to NAO assumptions, due to the effect of the trend-growth assumption and the effect of the NAO-audited interest rate assumption on tax on savings income.

3.9 Gross income tax receipts for 2005–06 were £3.2 billion lower than the Budget forecast of £138.2 billion. This was largely due to lower than expected wages and salaries growth, particularly from weaker earnings growth. A fiscal forecasting difference of £1.0 billion was made up of an overforecast of £2.7 billion for PAYE which was mainly due to receipts originally assumed to be income tax receipts, but subsequently reallocated to national insurance contributions. This was partially offset by stronger than expected self-assessment and other income tax receipts.

Income tax credits 3.10 In 2004–05 the negative tax element was £0.9 billion below forecast, primarily arising from higher than expected payments to low income working families. A significant component of this forecast difference arose because entitlement in 2004–05 was higher than projected and because of lower recovery of end-year adjustments. In 2005–06 the negative tax element was £0.5 billion below forecast, primarily arising from higher than expected payments to low income working families.

Table 3.2: Breakdown of Budget 2004 forecasting differences of receipts for 2004–05

	Forecast	Outturn	Difference	£ billion			
				of which:	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
				Economic determinants			
HM Revenue & Customs							
Income tax (gross of tax credits)	127.8	127.3	−0.5	−1.0	0.3	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	−0.9	0.1	1.1	0.0
Value added tax	73.1	73.0	−0.1	0.2	1.1	−1.3	0.0
Corporation tax ²	34.3	33.6	−0.6	−2.7	1.0	1.0	0.0
Petroleum revenue tax	1.0	1.3	0.3	−0.3	0.5	0.1	0.0
Fuel duties	24.4	23.3	−1.1	0.1	−0.2	−0.6	−0.4
Capital gains tax	1.5	2.3	0.7	0.1	0.0	0.3	0.4
Inheritance tax	2.8	2.9	0.1	0.1	0.0	0.1	−0.1
Stamp duties	9.4	9.0	−0.4	2.1	0.0	−2.5	0.0
Tobacco duties	8.1	8.1	0.0	0.0	0.3	−0.4	0.0
Alcohol duties	7.7	7.9	0.2	−0.1	0.0	0.3	0.0
Other HMRC	8.3	8.6	0.3	0.0	0.0	0.3	0.0
Total HMRC	372.6	371.0	−1.6	−2.3	3.1	−2.3	−0.1
Vehicle excise duties	4.9	4.7	−0.2	0.0	0.0	−0.1	0.0
Business rates	19.0	18.7	−0.2	0.0	0.0	−0.2	0.0
Council tax	19.7	20.1	0.4	0.0	0.0	0.4	0.0
Other taxes and royalties	13.3	12.2	−1.1	0.0	0.0	−0.4	−0.7
Net taxes and national insurance contributions							
Net taxes and national insurance contributions	429.4	426.8	−2.7	−2.3	3.1	−2.6	−0.8
Accruals adjustment on taxes	1.8	1.2	−0.6	−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 ³	0.6	0.5	0.0	0.0	0.0	0.0	0.0
Interest & dividends	4.9	5.6	0.7	0.0	0.0	0.7	0.0
Other receipts	21.7	21.9	0.2	0.1	0.1	−1.2	1.3
Current receipts	454.7	451.9	−2.8	−2.7	3.3	−3.8	0.5

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

² Net of negative 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.

Note: Figures may not sum due to rounding.

Table 3.3: Breakdown of Budget 2005 forecasting differences of receipts for 2005–06

	Forecast	Outturn	Difference	£ billion			
				of which:	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
				Economic determinants			
HM Revenue & Customs							
Income tax (gross of tax credits)	138.2	135.0	−3.2	−2.4	0.2	−1.0	0.0
Income tax credits ¹	−3.9	−4.5	−0.5	0.0	0.0	−0.5	0.0
National insurance contributions	82.6	85.5	2.9	−1.0	0.1	3.8	0.0
Value added tax	76.3	72.9	−3.5	−0.5	−2.6	−0.4	0.0
Corporation tax ²	43.1	41.9	−1.3	−0.8	2.6	−3.1	0.0
Petroleum revenue tax	1.5	2.0	0.5	0.0	0.6	−0.1	0.0
Fuel duties	24.6	23.4	−1.1	−0.1	−0.3	−0.4	−0.4
Capital gains tax	3.0	3.0	0.0	0.0	0.0	0.0	0.1
Inheritance tax	3.4	3.3	−0.1	0.1	0.1	−0.2	0.0
Stamp duties	9.7	10.9	1.2	0.4	0.1	0.7	0.0
Tobacco duties ³	8.4	8.0	−0.5	−0.5	–	–	0.0
Alcohol duties	8.2	7.9	−0.3	0.0	0.0	−0.3	0.0
Other HMRC	9.0	8.7	−0.3	0.0	0.0	−0.3	0.0
Total HMRC	404.1	398.0	−6.0	−4.8	0.9	−1.7	−0.4
Vehicle excise duties	5.1	5.0	−0.1	−0.1	0.0	0.0	0.0
Business rates	19.4	19.9	0.5	0.0	0.0	0.5	0.0
Council tax	20.9	21.4	0.5	0.0	0.0	0.5	0.0
Other taxes and royalties	12.4	12.7	0.3	0.0	0.0	0.3	0.0
Net taxes and national insurance contributions	461.9	457.0	−4.9	−4.9	0.9	−0.5	−0.4
Accruals adjustments on taxes less VAT and own resources EU contributions less PC onshore CT payments	1.8	1.6	−0.1	−0.3	0.0	0.1	0.0
Tax credits adjustment ⁴	−3.9	−4.3	−0.4	−0.1	0.0	−0.3	0.0
Interest & dividends	−0.1	−0.2	−0.2	0.0	0.0	−0.2	0.0
Other receipts	0.5	0.6	0.1	0.0	0.0	0.1	0.0
	4.9	6.2	1.3	0.0	0.0	1.3	0.0
	21.5	24.5	3.0	0.0	0.0	−0.3	3.3
Current receipts	486.6	485.3	−1.3	−5.3	0.9	0.2	2.9

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

² Net of negative tax credits.

³ No tobacco smuggled share estimate is available for 2005–06 (see Section 3 of "Measuring Indirect Tax Losses—2005") so it is not possible to identify the effect of the NAO-audited assumption of 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.

Note: Figures may not sum due to rounding.

National insurance contributions 3.11 In 2004–05 receipts from national insurance contributions were £0.4 billion higher than forecast. The impact of determinant differences was to reduce the outturn by £0.9 billion, and the impact of fiscal forecasting differences was to increase it by £1.1 billion. A major component of the fiscal forecasting difference was due to rebates relating to personal pensions being lower than forecast. The remainder was mainly due to higher than expected arrears receipts for the 2003–04 liability year.

3.12 In 2005–06 receipts were £2.9 billion above forecast, broadly offsetting the income tax shortfall. This was driven by a £3.8 billion fiscal forecasting difference due to a reallocation of receipts originally assumed to be income tax, and payments of personal pension rebates being lower than forecast. These increases were partially offset by determinant differences reflecting lower than forecast wages and salaries.

Value added tax 3.13 VAT receipts in 2004–05 were close to the Budget 2004 forecast. VAT gap estimates for 2004–05 suggest that the gap between theoretical VAT liability and receipts turned out lower than anticipated at Budget 2004, scored to NAO-audited assumptions. This was broadly offset by a negative fiscal forecasting difference of £1.3 billion.

3.14 VAT receipts in 2005–06 were £3.5 billion below forecast. VAT gap estimates for 2005–06 suggest that the gap between theoretical VAT liability and receipts was £2.6 billion higher than anticipated at Budget 2005, scored to NAO-audited assumptions. The overall difference was further driven by slower than expected growth in consumer spending, which represents around two-thirds of the total VAT tax base, scored to economic determinants.

Corporation Tax 3.15 The outturn of total corporation tax (including North Sea oil and gas companies) receipts in 2004–05 was £0.6 billion below forecast. The shortfall from onshore companies was mainly due to lower than expected profit growth for both financial and non-financial companies, scored as economic determinant differences. This was largely offset by fiscal forecasting differences due to life assurance companies' receipts, which were stronger than expected after accounting for equity price trends.

3.16 In 2004–05, North Sea corporation tax receipts were £1.3 billion above forecast. This was mostly due to the higher than forecast average of oil prices scored as NAO assumptions: while the NAO assumption for the price of oil at the time of the Budget was \$27.4 per barrel, the outturn price was \$38.2 per barrel. The resulting increase in yield was partly offset by lower than expected production, scored as economic determinants.

3.17 The outturn of total corporation tax (including North Sea oil and gas companies) receipts in 2005–06 was £1.3 billion below forecast. The shortfall for onshore companies was partly due to slower than expected profits growth, particularly in the industrial and commercial sectors. These losses were somewhat offset by increases in equity prices above the NAO-audited assumption which provided a £0.9 billion gain in receipts from the life assurance sector. However, overall life assurance receipts were weaker than expected due to receipts growth being lower than that implied by the growth in equity prices. This contributed to a negative fiscal forecasting difference.

3.18 In 2005–06, North Sea corporation tax receipts were £2.1 billion above forecast. This was mostly due to higher oil prices which resulted in a sizeable increase in yield, scored as NAO assumptions: at Budget 2005 the NAO assumption for the average price of oil was \$40.6 per barrel, but the outturn was \$54.5 per barrel. The resulting increase in yield was partly offset by lower than expected production, scored as economic determinants. Fiscal forecasting differences due to higher than forecast gas prices accounted for a further £0.9 billion of the overall total.

Petroleum revenue tax 3.19 Receipts of petroleum revenue tax (PRT) in 2004–05 were £0.3 billion higher than forecast, largely due to the increase in oil prices above that assumed by the NAO. This impact was partly offset by lower than expected production levels for fields liable to PRT.

3.20 Receipts of PRT in 2005–06 were £0.5 billion higher than forecast, largely due to an increase in oil prices scored as NAO assumptions. Fiscal forecasting differences reduced yield compared to forecast by £0.1 billion, reducing the size of the overall difference.

Fuel duties 3.21 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. The 2004 Pre-Budget Report announced that the level of fuel duty would continue to be frozen and this contributed £0.4 billion to the forecasting difference, scored to other factors. There was also a £0.2 billion overforecast due to the fact that oil prices rose higher than the NAO-audited assumption. The fiscal forecasting difference was £0.6 billion, part of which was due to the effect on demand of higher than expected pump prices.

3.22 Fuel duty receipts in 2005–06 were £1.1 billion below forecast. At Budget 2005 it was announced that fuel duties would be raised in line with inflation at the start of 1 September. The 2005 Pre-Budget Report announced that the level of fuel duty would continue to be frozen and this contributed £0.4 billion to the forecasting difference, scored to other factors. There was also a £0.3 billion overforecast due to the fact that oil prices turned out higher than the NAO-audited assumption. The fiscal forecasting difference was £0.4 billion.

Capital gains tax and inheritance tax 3.23 Capital gains tax receipts in 2004–05 were £0.7 billion above the Budget 2004 forecast. At Budget 2004 too little of self-assessment receipts in 2003–04 were assigned to the capital gains tax element, leading to an under-forecast in 2004–05. The higher receipts were largely due to the behavioural effects of the maturing of business asset taper relief, scored to fiscal forecasting differences. Capital gains tax receipts in 2005–06 were very close to the Budget 2005 forecast.

3.24 Inheritance tax receipts were close to forecast in both 2004–05 and 2005–06.

Stamp duties 3.25 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 were close to forecast despite a step change in transaction volumes. This change in volumes was not reflected in higher receipts, but was instead reflected in a forecasting difference of £2.1 billion scored to economic determinants, offset by £2.0 billion scored as fiscal forecasting differences. As this step change in transaction volumes was not reflected by other property transaction series (e.g. Land Registry), it is likely that it was due to a change in recording and processing associated with the modernisation of the stamp duty regime at December 2003.

3.26 In 2005–06 total stamp duty receipts were £1.2 billion above forecast. Much of this difference was due to higher than expected stamp duty land tax receipts, as a result of economic determinants reflecting higher commercial property prices and higher commercial transaction volumes. Receipts from shares were also higher than forecast as a result of higher than expected volumes of shares traded, and to a lesser extent higher prices.

Tobacco duties 3.27 Tobacco receipts in 2004–05 were close to the Budget 2004 forecast. In 2005–06 tobacco duties were £0.5 billion lower than forecast in Budget 2005, of which £0.3 billion was due to a change in clearance patterns at the end of the year. No estimate of the 2005–06 smuggled share of cigarettes is currently available and it is not possible to identify the breakdown between the NAO-audited rule and fiscal forecasting difference at this stage.

Alcohol duties 3.28 In 2004–05, alcohol duty receipts were £0.2 billion higher than forecast, primarily due to greater than forecast growth in wine receipts scored under fiscal forecasting differences. Alcohol receipts in 2005–06 were £0.3 billion lower than forecast, in part due to lower than expected receipts from spirits, scored under fiscal forecasting differences.

Other HMRC taxes 3.29 Receipts from other HMRC taxes were £0.3 billion above their one-year ahead forecast in 2004–05 and £0.3 billion below forecast in 2005–06, mostly due to fiscal forecasting differences.

Vehicle excise duty 3.30 Vehicle excise duty receipts were £0.2 billion below forecast in 2004–05. In 2005–06 vehicle excise duty receipts were £0.1 billion below forecast.

Council tax 3.31 Council tax receipts in 2004–05 were £0.4 billion higher than forecast in Budget 2004, and £0.5 billion higher in 2005–06 than forecast in Budget 2005. This is attributable to fiscal forecasting differences and is largely explained by higher than forecast growth in the council tax base. Council tax increases are determined annually by local authorities rather than the Government, so council tax forecasts are projections based on a set of stylised assumptions. The forecast for the forthcoming financial year in the Budget is based on the latest available estimates released by the Chartered Institute for Public Finance and Accountancy (CIPFA).

Other taxes and royalties 3.32 In 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 had the effect of reducing both receipts and expenditure by £0.7 billion. Additionally, there was a fiscal forecasting difference of £0.4 billion, mainly due to lower than expected local authority VAT refunds. In 2005–06 receipts of other taxes and royalties were £0.3 billion above forecast.

Accruals adjustments 3.33 In 2004–05 accruals adjustments were £0.6 billion below forecast. This was mainly the result of a lower indirect tax accruals adjustments following weaker than expected VAT receipts in early 2005–06, which accrue back to the 2004–05 financial year. In 2005–06 accruals adjustments were close to forecast.

Other receipts 3.34 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.

3.35 Other receipts in 2004–05 were close to forecast. In the 2004 Blue Book, ONS reclassified NHS Trusts from the public corporations sector to the central government sector. This had no effect on the public sector overall, but reduced gross operating surplus by £0.8 billion. These changes are scored under other factors and matched by a corresponding expenditure adjustment. Additionally, in 2005 the ONS reclassified roads maintenance expenditure to correct for double counting that had occurred in the past, which reduced both current spending and depreciation. This decrease in depreciation had an effect on current receipts by decreasing gross operating surplus by a further £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.

3.36 The reclassification of BBC license fees and passport fees further increased receipts by £2.7 billion, scored under other factors. On 20 January 2006 ONS announced that TV licenses should no longer be regarded as a service charge and consequently license fee receipts were reclassified from the public corporations sector to the central government sector. This change is fiscally neutral and adds to both receipts and expenditure totals. HM Treasury has decided to continue to follow the Organisation for Economic Cooperation and Development (OECD) Revenue Statistics guidelines, which treat such license fees as a service charge. Following OECD guidelines allows the tax-GDP ratio to be more easily compared internationally. License fee receipts are therefore not included in net taxes and national insurance contributions, but are included in other receipts.

3.37 Other receipts in 2005–06 were £3.0 billion above forecast as a result of the reclassification of BBC license fee and passport fee receipts. These reclassifications are neutral overall and are matched by corresponding expenditure adjustments.

4

PUBLIC EXPENDITURE

This chapter provides a detailed analysis of public expenditure in 2004–05 and 2005–06. It shows that:

- **total managed expenditure rose from £491 billion in 2004–05 to £523 billion in 2005–06;**
- **spending has been higher than forecast, in each financial year by 0.4 per cent of GDP in 2004–05 and 0.5 per cent in 2005–06, largely because of classification changes;**
- **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 29 per cent of total spending in 2004–05 and 2005–06, releasing additional resources for priority public services; and**
- **there was a substantial increase in public sector net investment (around 13 per cent) 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 2004–05 and 2005–06 and, in particular, differences between projected expenditure and outturn for the year-ahead projections in Budgets 2004 and 2005.

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 The DEL and AME figures reflect the changes to the budgeting regime implemented in Budget 2006 and described in detail in paragraph C74 of Budget 2006. These changes affect the split between Resource and Capital DEL, and between DEL and AME, but have no impact on TME or on the national accounts spending aggregates. The DEL and AME forecasts have been adjusted to bring them into line with the main changes to the budgeting regime.

4.6 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 may not be finalised until 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 2005–06, 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

4.7 Table 4.1 shows the latest outturn for key public spending aggregates for 2004–05 and 2005–06, including a comparison of the differences in the year-ahead forecasts for spending in Budgets 2004 and 2005. TME rose to £522.8 billion or 42 per cent of GDP in 2005–06.

4.8 Classification changes since the 2005 *End of year fiscal report* have increased TME by £3.8 billion in 2004–05 and by £3.9 billion in 2005–06. These changes include the reclassification of the BBC to central government, and changes to the treatment of Renewable Obligation Certificates. These are fiscally neutral changes which increase both current expenditure and current receipts. Other changes include the reclassification of London and Continental Railways as a public rather than a private corporation.

4.9 Net investment has increased by 13 per cent, from £19.9 billion to £22.4 billion, between 2004–05 and 2005–06. The rise in investment reflects the Government's determination to address the historical under-investment in public services.

Forecast differences in 2004–05 **4.10** In 2004–05, TME was £3.4 billion above forecast, which includes and is largely accounted for by the £3.8 billion classification changes described in paragraph 4.8. Public sector current expenditure was £6.0 billion higher than forecast, largely because of reclassifications and policy changes made subsequent to the forecast. Public sector net investment was £2.5 billion less than projected due to lower capital expenditure in DEL and AME.

Forecast differences in 2005–06 **4.11** In 2005–06, TME was £4.2 billion above forecast, which includes and is largely accounted for by the £3.9 billion classification changes described in paragraph 4.8. Public sector current expenditure was £7.0 billion higher than forecast, again largely due to reclassifications and policy changes. Public sector net investment was £3.8 billion lower than projected.

Table 4.1: Summary of public expenditure forecasting differences

	£ billion					
	2004–05			2005–06		
	Forecast	Outturn	Difference	Forecast	Outturn	Difference
Total Managed Expenditure						
<i>of which:</i>						
Public sector current expenditure	449.7	455.7	6.0	476.9	483.9	7.0
Public sector net investment	22.4	19.9	–2.5	26.2	22.4	–3.8
Public sector depreciation	15.5	15.4	–0.1	15.5	16.5	1.0
Total Managed Expenditure	487.6	491.0	3.4	518.6	522.8	4.2
<i>of which:</i>						
Departmental Expenditure Limits						
Resource Budget	254.3	258.1	3.8	277.7	277.1	–0.7
Capital Budget	35.1	32.7	–2.4	38.4	35.8	–2.6
Less depreciation	–11.0	–8.3	2.6	–11.8	–10.3	1.5
Total Departmental Expenditure Limits	278.4	282.4	4.0	304.4	302.6	–1.8
Total Annually Managed Expenditure	209.2	208.6	–0.6	214.2	220.3	6.1

Note: Figures may not sum due to rounding.

SPENDING FORECASTS AND REASONS FOR DIFFERENCES

4.12 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

4.13 Tables 4.2 and 4.3 provide a breakdown of TME forecasting differences for 2004–05 and 2005–06 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 expenditure financed by allocations made from the special reserve, which are treated as ‘other’ differences. Forecast figures have been adjusted to take account of certain classification changes which took effect in Budget 2006.

4.14 Departments are able to carry forward unspent budgetary allocations into future years under the end-year flexibility (EYF) 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 the 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

Table 4.2: 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
Departmental Expenditure Limits							
Resource Budget	254.3	258.1	3.8	0.0	0.0	0.0	3.8
Capital Budget	35.1	32.7	-2.4	0.0	0.0	-2.1	-0.3
Less depreciation	-11.0	-8.3	2.6	0.0	0.0	2.7	0.0
Total Departmental Expenditure Limits	278.4	282.4	4.0	0.0	0.0	-0.6	3.4
Annually Managed Expenditure	209.2	208.6	-0.6	0.0	-0.3	-1.0	0.7
Total Managed Expenditure	487.6	491.0	3.4	0.0	-0.3	-0.4	4.1
<i>of which:</i>							
Public sector current expenditure	449.7	455.7	6.0	0.0	-0.3	2.1	4.3
Public sector net investment	22.4	19.9	-2.5	0.0	0.0	-2.2	-0.3
Public sector depreciation	15.5	15.4	-0.1	0.0	0.0	-0.1	0.0

Note: Figures may not sum due to rounding.

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

Table 4.3: Breakdown of Budget 2005 forecasting differences for public expenditure for 2005–06

	Forecast	Outturn	Difference	£ billion			
				of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Departmental Expenditure Limits							
Resource Budget	277.7	277.1	−0.7	0.0	0.0	−0.5	−0.2
Capital Budget	38.4	35.8	−2.6	0.0	0.0	−2.5	−0.1
Less depreciation	−11.8	−10.3	1.5	0.0	0.0	1.2	0.3
Total Departmental Expenditure Limits	304.4	302.6	−1.8	0.0	0.0	−1.7	−0.1
Annually Managed Expenditure	214.2	220.3	6.1	0.2	0.1	2.7	3.1
Total Managed Expenditure	518.6	522.8	4.2	0.2	0.1	1.0	3.0
<i>of which:</i>							
Public sector current expenditure	476.9	483.9	7.0	0.2	0.1	3.7	3.0
Public sector net investment	26.2	22.4	−3.8	0.0	0.0	−3.7	−0.1
Public sector depreciation	15.5	16.5	1.0	0.0	0.0	1.0	0.0

Note: Figures may not sum due to rounding.

DEL in 2004–05 4.15 Outturn spending on Total DEL in 2004–05 was £282.4 billion, £4.0 billion above the adjusted Budget 2004 forecast of £278.4 billion. (As explained in paragraph 4.5 above, the Budget figures were adjusted in line with the main changes in the budgeting regime to maintain consistency over time.) Of this increase, £3.8 billion was due to higher Resource DEL, with lower capital spending of £2.4 billion offset by lower depreciation of £2.6 billion. 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.

4.16 Spending on Resource DEL was £3.8 billion above the adjusted Budget 2004 forecast. This difference was almost entirely due to classification and other changes, in particular the move of Supporting People expenditure from AME into DEL, which took place after Budget 2004 and is TME neutral. The Supporting People programme provides housing related support to vulnerable people. In addition, expenditure related to the decisions taken after the Budget 2004 forecast to allocate further resources to the UK's international commitments, scored as other changes, increased outturn.

4.17 Outturn on Capital DEL was £2.4 billion below adjusted Budget 04 plans, including £0.3 billion attributed to classification changes. Fiscal forecasting differences on Capital DEL amounted to £2.1 billion. This was driven by lower capital spending in the Department of Health and also in the Home Office and the Department for Communities and Local Government. Unspent capital provision is carried forward through the Government's End-Year Flexibility (EYF) scheme to maintain the Government's overall investment plans. In addition, outturn figures for DEL depreciation were £2.6 billion below Budget 2004 forecasts, mainly because of lower depreciation figures for the Ministry of Defence.

DEL in 2005–06 4.18 Provisional outturn spending (as explained in paragraph 4.6) for total DEL in 2005–06 was £302.6 billion, £1.8 billion below the adjusted Budget 2005 forecast of £304.4 billion. Much of this reduction (£1.7 billion) was due to fiscal forecasting differences, in particular lower than forecast capital spending. This difference between planned and outturn spending is equivalent to 0.6 per cent of forecast Total DEL, or 0.15 per cent of GDP.

4.19 Provisional outturn for Resource DEL was £0.3 billion below the adjusted Budget 2005 forecast. Of this difference £0.2 billion was the result of classification and other changes. Fiscal forecasting differences were around £0.5 billion, reflecting underspending in the Department for Transport and elsewhere.

4.20 Capital DEL was £2.6 billion below the adjusted Budget 2005 plan in provisional outturn, including £0.1 billion of decreases attributable to classification changes. As for 2004–05, this fiscal forecasting difference was the result of lower than forecast capital spending in the Department of Health, Department for Education and Skills 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. DEL depreciation was £1.5 billion lower than forecast, again as a result of lower depreciation figures for the Ministry of Defence.

AME FORECASTING DIFFERENCES

4.21 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.

4.22 Tables 4.3 and 4.4 present a breakdown of forecasting differences in AME for 2004–05 and 2005–06, 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 0.04 and 0.48 per cent (£0.6 and £6.1 billion) of GDP in 2004–05 and 2005–06 respectively.

Table 4.4: Breakdown of Budget 2004 AME 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
Annually Managed Expenditure							
Social security benefits ^{1,2}	123.3	121.9	– 1.4	0.0	– 0.3	0.6	– 1.8
Tax credits ¹	13.8	15.0	1.2	0.0	0.0	1.2	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
BBC domestic services ⁴	-	3.1	3.1	0.0	0.0	0.0	3.1
Public corporations' own-financed capital expenditure	2.6	3.8	1.2	0.0	0.0	0.3	0.9
Other departmental expenditure	2.7	2.1	– 0.7	0.0	0.0	0.0	– 0.7
Net expenditure transfers to EC Institutions ⁵	4.9	4.9	0.0	0.0	0.0	0.0	0.0
Locally financed expenditure	24.2	23.0	– 1.2	0.0	0.0	– 1.0	– 0.2
Central Government gross debt interest	23.9	24.0	0.0	0.0	0.0	0.0	0.0
Accounting adjustments	8.9	7.9	– 0.9	0.0	0.0	– 1.3	0.4
AME margin	1.0	0.0	– 1.0	0.0	0.0	0.0	– 1.0
Total Annually Managed Expenditure	209.2	208.6	– 0.6	0.0	– 0.3	– 1.0	0.7

¹ 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 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.

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

⁴ BBC was reclassified as Central Government and therefore went into AME as an additional item of expenditure.

⁵ Gross National Income-based contributions less UK abatement.

Note: Figures may not sum due to rounding.

Table 4.5: Breakdown of Budget 2005 AME forecasting differences for public expenditure for 2005–06

	Forecast	Outturn	Difference	£ billion			
				of which:	Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences
Annually Managed Expenditure							
Social security benefits ^{1,2}	127.3	127.4	0.1	0.0	0.1	-0.2	0.3
Tax credits ¹	14.6	15.4	0.8	0.0	0.0	0.8	0.0
Net public service pensions ³	0.7	0.3	-0.4	0.0	0.0	-0.4	0.0
National Lottery	1.7	1.8	0.1	0.0	0.0	0.1	0.0
BBC domestic services ⁴	-	3.2	3.2	0.0	0.0	0.0	3.2
Public corporations' own-financed capital expenditure	2.3	6.1	3.8	0.0	0.0	1.2	2.6
Other departmental expenditure	5.2	3.6	-1.6	0.0	0.0	-0.9	-0.7
Net expenditure transfers to EC Institutions ⁵	4.7	4.4	-0.3	0.0	0.0	-0.3	0.0
Locally financed expenditure	25.4	25.4	0.0	0.0	0.0	2.0	-2.0
Central Government gross debt interest	25.6	25.8	0.2	0.2	0.0	0.0	0.0
Accounting adjustments ⁶	5.8	6.8	1.0	0.0	0.0	0.3	0.7
AME margin	1.0	0.0	-1.0	0.0	0.0	0.0	-1.0
Total Annually Managed Expenditure	214.2	220.3	6.1	0.2	0.1	2.7	3.1

¹ 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 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.

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

⁴ BBC was reclassified as Central Government and therefore went into AME from non-Budget.

⁵ Gross National Income-based contributions less UK abatement.

Note: Figures may not sum due to rounding.

AME COMPONENT ANALYSIS

Social security benefits **4.23** The outturn for social security payments in 2004–05 was £1.4 billion lower than was forecast at Budget 2004. This difference was mainly attributed to ‘other’ forecasting partially offset by fiscal forecasting differences. The ‘other’ forecasting differences arose principally due to the switch of Supporting People spending out of AME into DEL, and an increase of spending recorded under Social Security expenditure of £0.4 billion, to include other Social Security spending which was previously recorded within other AME components (e.g. Other departmental expenditure) in the forecast. Claimant count unemployment was lower than assumed leading to an overforecast of £0.35 billion, scored to NAO-audited assumptions. The largest contribution to the fiscal forecasting difference of £0.6 billion arose from higher than expected Housing Benefit expenditure on temporarily homeless tenants placed in temporary accommodation by local authorities.

4.24 Outturn figures for 2005–06 were very close to the Budget forecast. This overall small net difference covers an increase of £0.3 billion in outturn because of a definitional change shown in the ‘other’ column in Table 4.5, because the outturn data now includes additional elements of Social Security spending which were previously included in other AME components. This is largely offset by fiscal forecasting differences spread across a number of different benefits.

Tax credits **4.25** The tax credit figures used here include spending by The Department for Work and Pensions on child allowances in Income Support and Job Seekers Allowance, which will in due course be paid as Child Tax Credit. These child allowances are grouped, by HMRC, together under tax credits, so that historical and future spending is on a consistent basis.

4.26 In 2004–05 expenditure related to tax credits was £1.2 billion higher than forecast and this is entirely attributed to fiscal forecasting differences. These largely reflect more end-year adjustments and higher than expected take up.

4.27 Outturn in 2005–06 was £0.8 billion above the forecast, again because of fiscal forecasting differences. This arose because of an under-forecast of both the level of entitlement in 2004–05, and the rate of growth into 2005–06. In the light of previous years’ experience, the Government continues to refine the approach used to forecast tax credits.

Net public service pensions **4.28** Net public service pensions figures are presented on a National Accounts basis, which reflects the difference between the payments to pensioners paid out during the year and contributions received for the main unfunded public service pension schemes.

4.29 In 2004–05 the outturn for net public service pensions was £0.7 billion lower than forecast. This was due to lower than expected pension payments (£0.5 billion) and higher than expected receipts (£0.2 billion). The lower than expected payments relates to armed forces pensions, due to overestimated expenditure on a one-off payment of pensioner arrears, and to NHS pensions. The higher than anticipated receipts can mostly be explained by increased contributions into the NHS Pensions scheme.

4.30 In 2005–06, outturn was £0.4 billion lower than forecast. This was mainly due to a lower than expected cash expenditure by the Principal Civil Service Pension Scheme (PCSPS), offset by a higher expenditure by the NHS Pensions scheme. This was partly offset by higher than anticipated receipts by PCSPS.

National Lottery 4.31 The lottery outturn expenditure figure in 2004–05 was £0.2 billion lower than forecast and outturn in 2005–06 £0.1 billion higher. The rate of lottery expenditure cannot be predicted exactly, as it depends on the rate of drawdown from distributing bodies by successful applicants for Lottery grant, which can be slower or faster than expected. In 2005–06, efforts by distributors during the previous few years to increase their forward commitment and, in line with Government policy, to reduce the balances held on their behalf in the Fund, may have worked through into higher expenditure.

BBC domestic services 4.32 British Broadcasting Corporation (BBC) domestic services remains in the public sector, but was reclassified from the public non-financial corporations sector to central government in January 2006. Numbers have been updated retrospectively so that historical and future spending is on a consistent basis. This difference scores in the ‘other’ category.

Public corporations’ own-financed capital expenditure 4.33 In 2004–05, the outturn for public corporations’ own-financed capital expenditure was £1.3 billion higher than the Budget 2004 forecast. Of this, £0.9 billion is attributed to the ‘other’ category, which is the result of moving the Housing Revenue Account (£0.2 billion) from local authority to the Public Corporations sector and the reclassification of London Continental Railways (LCR) (£0.7 billion) from the private to the public sector.

4.34 In 2005–06, outturn was £3.8 billion higher than the Budget 2005 forecast. Much of this can be explained by the move of the Housing Revenue Account (£2.0 billion) from local authority and again, the reclassification of LCR (£0.6 billion) from the private to the public sector. In both 2004–05 and 2005–06, there was a general underestimate of capital expenditure in this sector.

Other departmental expenditure 4.35 The outturn for other departmental expenditure in 2004–05 was £0.7 billion lower than forecast. For 2005–06, outturn was £1.6 billion lower than forecast. About £0.7 billion of the under forecast in each year reflects a change to the budgeting regime which scores as ‘other’. The change removes grants to local authorities in respect of some financial transactions from other departmental expenditure. As financial transactions, these grants did not feed into TME and were previously removed in accounting adjustments. In 2005–06 there was an overestimate of spending of £0.3 billion on coal health liabilities, which scores as a fiscal forecasting difference.

Net expenditure transfers to EU institutions 4.36 The outturn for net expenditure transfers to EU Institutions for 2004–05 was the same as in the Budget 2005 forecast.

4.37 Outturn in 2005–06 was £0.3 billion lower than forecast attributable to fiscal forecasting differences. This was largely the result of using later data on the EC Budgets for 2005 and 2006, particularly in respect of the UK abatement in these two years. The abatement was some £0.4 billion lower than anticipated at the time of the Budget 2005 forecast. This was partially offset by slightly higher GNI-based contributions in 2005–06 than had been previously forecast.

Locally-financed expenditure 4.38 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 outturn for locally financed expenditure for 2004–05 was £1.2 billion below the Budget forecast. In 2005–06 forecast and outturn were very close. However, the outturn for 2005–06 is still subject to change as data on local authority expenditure is provisional. Much of the under forecast in 2005–06 reflects a shortfall in receipts from sales of capital assets which increases net investment.

4.39 The 'other' forecasting differences in both years relate to the completion of the move of the Housing Revenue account from the Local Authority sector to the Public Corporations sector. The forecast makes assumptions about the growth rates of the individual components of finance available to local authorities as well as assumptions about the use of financial reserves and earnings from investments. Therefore, the remaining fiscal forecasting differences are due to changes in these projections but also partly due to timing and other differences between income and expenditure. The fiscal forecasting differences also reflect subsequent revisions made to outturn information used as the basis for the forecast. Much of the underforecast in 2005-06 reflects a shortfall in receipts from sales of capital assets which increases net investment.

Central Government gross debt interest **4.40** Central government gross debt interest in 2004–05 was very close to forecast.

4.41 Central government gross debt interest in 2005–06 was £0.2 billion higher than the Budget 2005 forecast. This difference resulted from a higher than forecast uplift on index-linked debt, which is scored as an economic determinant difference.

Accounting and other adjustments **4.42** 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 and changes to the budgeting regime.

4.43 In both 2004–05 and 2005–06, the classification differences are mainly attributed to the budgeting regime change on grants to Local Authorities in respect of financial transactions, which were removed from budgets, the reclassification of contributions to international development organisations and adjustments in respect of Renewable Obligations Certificates and Passport Fees.

AME Margin **4.44** 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 2004 AND BUDGET 2005

Table A.1: 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	FT-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 forecasts, 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.

Table A.2: Budget 2005 — key assumptions audited by the National Audit Office

	Assumption used for Budget 2005
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 subsequent years.
UK claimant unemployment	Rising slowly to 0.89 million in 2007–08, from recent levels of 0.82 million.
Interest rates	3-month market rates change in line with market expectations (as of 7 March).
Equity prices	FT-All share index rises from 2523 (close 7 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.
Consistency of price indices	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	\$40.6 a barrel in 2005, the average of independent forecasts, 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 2005, a share of 14.5 per cent has been used for 2005–06 onwards.

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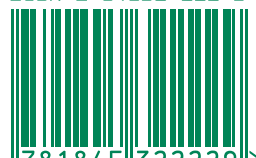
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List of Abbreviations

AME	Annually Managed Expenditure
ARBs	Actuarially Reduced Benefits
CA	Cyclically adjusted
CAP	Common Agricultural Policy
CBO	Congressional Budget Office
CIPFA	Chartered Institute for Public Finance and Accountancy
CSS	Cyclical social security
DEL	Departmental Expenditure Limits
DWP	Department for Work and Pensions
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
GNI	Gross National Income
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	Principal Civil Service Pension Scheme
PRT	Petroleum Revenue Tax
PSNB	Public sector net borrowing
PSNCR	Public sector net cash requirement
PSND	Public sector net debt
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

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