End of year fiscal report

October 2007

HM TREASURY

HM TREASURY

End of year fiscal report

October 2007

HMSO
Licensing Division
St Clements House
2-16 Colegate
Norwich
NR3 1BQ

Fax: 01603 723000

E-mail: hmsolicensing@cabinet-office.x.gsi.gov.uk

HM Treasury contacts

This document can be found on the Treasury website at:

hm-treasury.gov.uk

For general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861
E-mail: public.enquiries@hm-treasury.gov.uk

ISBN-13: 978-1-84532-332-5

Printed by The Stationery Office 10/07 379366

Printed on at least 75% recycled paper.
When you have finished with it please recycle it again.

PU340

CONTENTS

		Page
Chapter 1	Introduction	1
Chapter 2	Meeting the fiscal rules	5
Chapter 3	Receipts	19
Chapter 4	Public expenditure	27
Annex A	Assumptions used in Budget 2005 and Budget 2006	37
	List of Charts, Tables and Abbreviations	39

1 INTRODUCTION

The End of year fiscal report, first published alongside the 2002 Pre-Budget Report, is central to the Government's retrospective reporting and analysis of fiscal issues and builds on the information published in the Pre-Budget Report and the Budget. This year's report looks at trends in the public finances and fiscal policy in 2005-06 and 2006-07, putting these into an historical context. The report analyses:

- **performance against the fiscal rules and fiscal policy objectives; and**
- **differences between forecast and outturn for the year-ahead fiscal forecasts published in Budget 2005 and Budget 2006.**

The report shows that the Government was meeting its strict fiscal rules in 2005-06 and 2006-07.

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, outturn public sector net borrowing (PSNB) 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 since 1997 UK net borrowing forecasts have been more accurate and more cautious than the average of the EU15 Member States.**

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 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]

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

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

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 2005-06 and 2006-07 together with the Government's historical forecasting performance. The detailed forecast analysis considers the Budget 2005 forecast for 2005-06 and the Budget 2006 forecast for 2006-07. 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, 2006-07. Nonetheless, the information is sufficiently robust to provide a sound basis for forecast analysis. Future revisions, particularly for 2005-06, 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:

- 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;
- divergences 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;

[3] A list of the assumptions audited by the NAO for Budgets 2005 and 2006 is shown in Annex A.

- **fiscal differences**, i.e. 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.

Overview **1.10** Chapter 2 provides a summary of developments from a macroeconomic perspective. It shows that the Government remained on track to meet its strict fiscal rules in 2005-06 and 2006-07.

1.11 Chapter 2 also examines the UK's forecast performance over a longer timescale and compares it internationally. The key findings of this assessment are:

- the year-ahead net borrowing forecast has on average been cautious since the introduction of the new macroeconomic framework in 1997, as shown by the positive average forecast difference of 0.3 per cent of GDP since 1997-98, compared with an average of –0.1 percent before 1997-98. This is in line with the move to using a cautious approach in projecting the public finances;
- since the introduction of the new macroeconomic framework two-year ahead net borrowing forecasts have performed similarly well in terms of caution as they did in the period before 1997-98 (in both cases the average difference is 0.0 per cent of GDP); and
- The overall accuracy of one-year ahead and two-year ahead PSNB forecasts (measured by the average absolute forecast difference since 1997-98) has remained broadly unchanged compared with the period before 1997-98. However, in each Budget since 2003 both the one-year and two-year ahead forecasts have been more accurate than the respective long-run averages.

1.12 Chapters 3 and 4 set out in more detail the analysis of projections for tax receipts and public spending. The key conclusions of Chapter 3 are:

- Total receipts in 2005-06 were in line with the Budget 2005 forecast. Though there was a shortfall from VAT receipts, this was offset by higher interest and dividend receipts and the effect of several classification changes.
- Total receipts in 2006-07 were £2.6 billion above the 2006 Budget forecast. This surplus was due to higher receipts from a number of taxes and other receipts, including VAT and self-assessment receipts, and by further classification changes.

1.13 The main conclusions of Chapter 4 are:

- In 2005-06, Total Managed Expenditure stood at £524.2 billion and was approximately £5.6 billion higher than forecast, due in large part to classification changes. Higher than forecast current expenditure was partially offset by lower than forecast capital expenditure.
- In 2006-07, Total Managed Expenditure rose to £550.1 billion, £2.2 billion below the Budget 2006 projection. This was mainly due to lower-than-expected capital expenditure.

2 MEETING THE FISCAL RULES

This chapter examines performance against the Government's fiscal policy objectives and fiscal rules, and analyses the differences between forecasts for the main fiscal aggregates and outturns. It shows that, over the years 2005-06 and 2006-07 the Government was meeting its strict fiscal rules over the economic cycle:

- **the average surplus on the current budget since 1997-98 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 in 2005-06 and 2006-07, 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 in 1997, outturn public sector net borrowing has been lower on average than the year-ahead forecast, compared with before the new framework when outturns tended to be higher than forecast. 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 since 1997 UK net borrowing forecasts have been more accurate and more cautious than the average of the EU 15 Member States.**

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 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.[1] 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	2006-07
Golden rule										
Surplus on current budget	–0.1	1.2	2.3	2.4	1.2	–1.0	–1.5	–1.6	–1.1	–0.4
Average surplus since 1997–98	–0.1	0.5	1.1	1.4	1.4	1.0	0.6	0.4	0.2	0.1
Cyclically-adjusted surplus on current budget	0.0	1.0	2.0	1.8	1.1	–0.6	–1.2	–1.5	–0.9	–0.2
Sustainable investment rule										
Public sector net debt	41.3	39.2	36.4	31.4	30.3	31.5	32.8	34.7	36.1	36.7
Core debt	40.2	38.2	35.8	31.5	30.5	31.3	32.2	34.1	35.3	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.[2]

2.8 Since 2002 most G7 economies have experienced rising debt-to-GDP ratios as public finances moved into deficit. Chart 2.1 presents 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 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).

[1] 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 2.2 of Budget 2007.

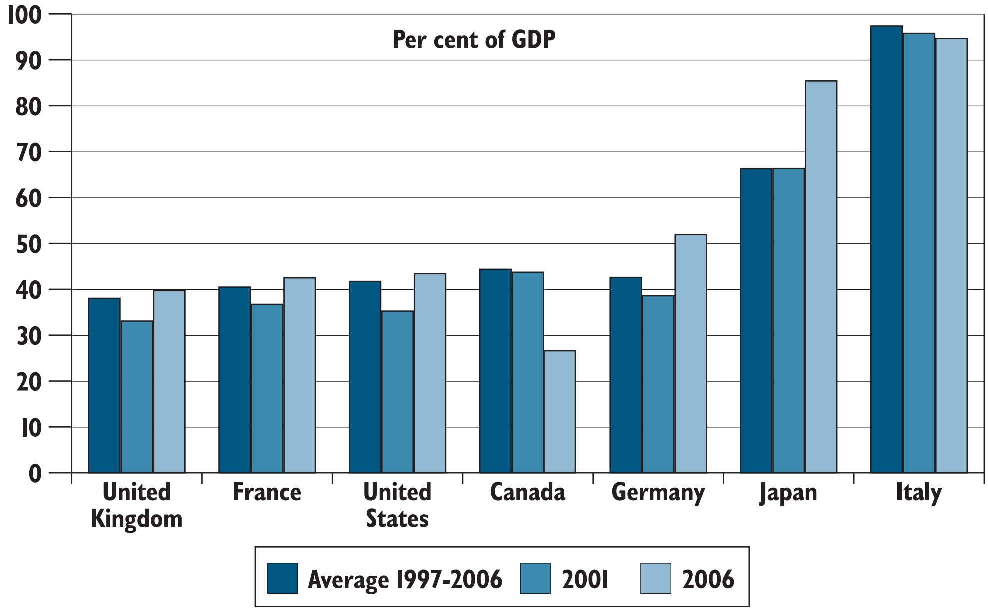
[2] An explanation of core debt can be found in *Core debt: an approach to monitoring the sustainable investment rule*, HM Treasury (April 2002).

2.9 On average since 1997, general government net financial liabilities in the UK have been lower than in other G7 economies, and in 2006 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.

Chart 2.1: General government net financial liabilities in G7 countries



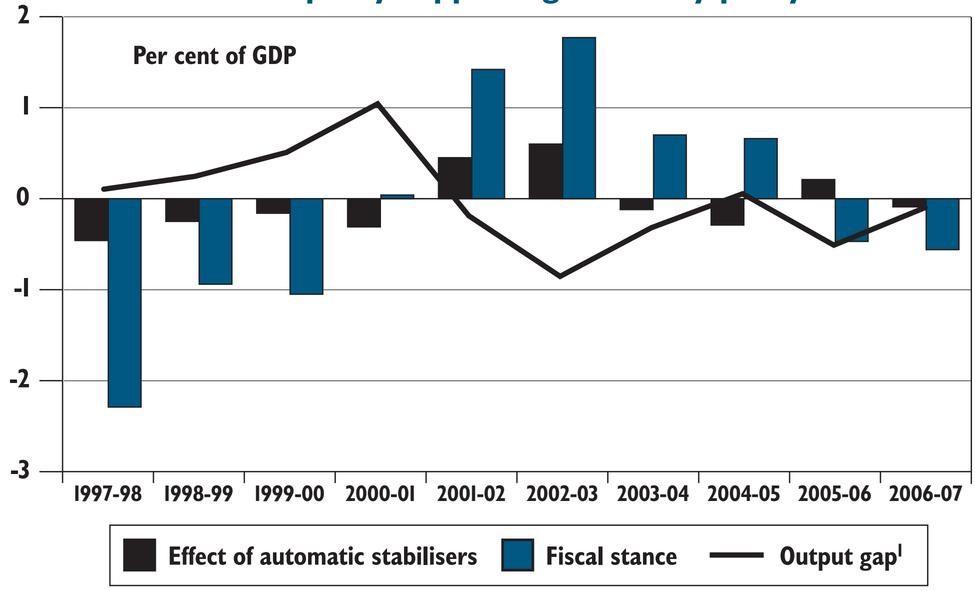
Source: OECD Economic Outlook, June 2007.

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 As shown in Chart 2.2, 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 output gap closing and the economy appearing to have passed through trend towards the end of 2006, the fiscal stance was tighter in 2005-06 and 2006-07.

Chart 2.2: Fiscal policy supporting monetary policy



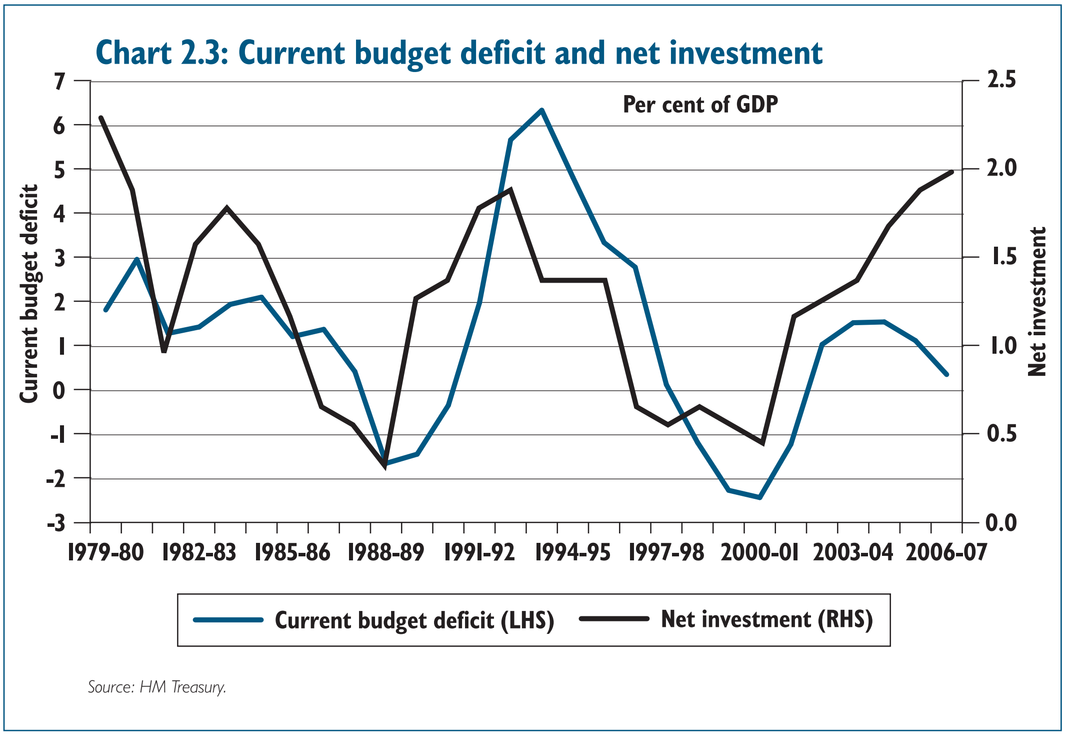
[1]Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB and the automatic stabilisers equal the change in the cyclical component of PSNB, ie the difference between PSNB and the cyclically-adjusted PSNB. The real interest rate in this chart refers to the financial year average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

Source: HM Treasury.

Borrowing for investment

2.13 The fiscal rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level.

2.14 Historically, it has been extremely rare for public investment to grow during periods of fiscal consolidation, and prior to the introduction of the macroeconomic framework it had not happened for 40 years. The effectiveness of the golden rule in eliminating this historic bias against capital spending is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment shown in Chart 2.3. Public sector net investment is now over three times higher as a share of the economy than it was in 1997-98, having risen from less than $^3/_4$ per cent to 2 per cent of GDP in 2006-07.



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:[3]

- 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 forecasts since 1997-98 has been broadly similar to that in previous decades. The year-ahead forecast has on average been cautious under the new framework, as shown by the positive average forecast difference of 0.3 per cent of GDP, compared with -0.1 per cent before 1997-98: and
- the two-year ahead forecasts since 1997-98 have been of similar accuracy and caution on average to the forecasts before 1997-98. For both periods, the average forecast difference was 0.0 per cent of GDP.

[3] 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.

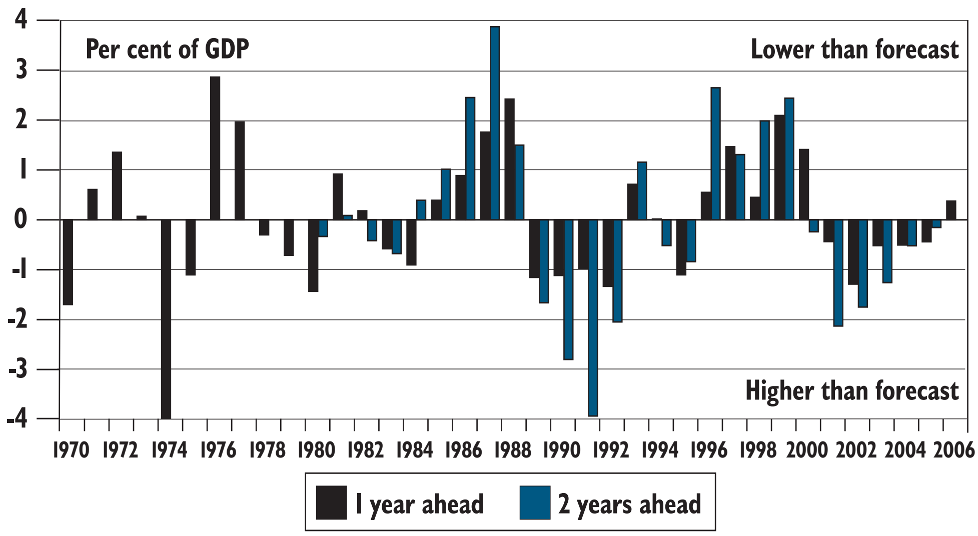
Table 2.2: Summary statistics for net borrowing forecast differences

	Per cent of GDP			
	Whole sample	Before new framework	New framework	Number of observations in whole sample
One year ahead forecasts				
Average absolute difference	1.1	1.2	0.9	37
Average difference	0.0	–0.1	0.3	
Two year ahead forecasts				
Average absolute difference	1.5	1.5	1.3	26
Average difference	0.0	0.0	0.0	

2.17 While PSNB forecast accuracy is broadly unchanged compared with the period before 1997-98, the data in Table 2.2 above provide some emerging evidence of an improvement in the overall accuracy of the year-ahead PSNB forecasts in the period since 1997-98 compared with previous decades. However, this is based on a relatively small sample size, and the data may be subject to revisions. This improvement in forecast accuracy may in part reflect the fact that over the past decade the UK economy has experienced greater stability in terms of GDP growth and inflation than in any decade since the war. Economic and fiscal forecasts might be expected to be more accurate during periods of macroeconomic stability.

2.18 Chart 2.4 plots the one- and two-year ahead forecast differences for PSNB (PSNCR before Budget 1997). It shows that forecast differences have narrowed significantly over the past five years. The 2006-07 year-ahead forecast from Budget 2006 was cautious, with a difference of 0.4 per cent of GDP compared with outturn PSNB, and the 2006-07 two-year ahead forecast from Budget 2005 showed a difference of –0.2 per cent of GDP.

Chart 2.4: PSNB forecast differences since 1970-71

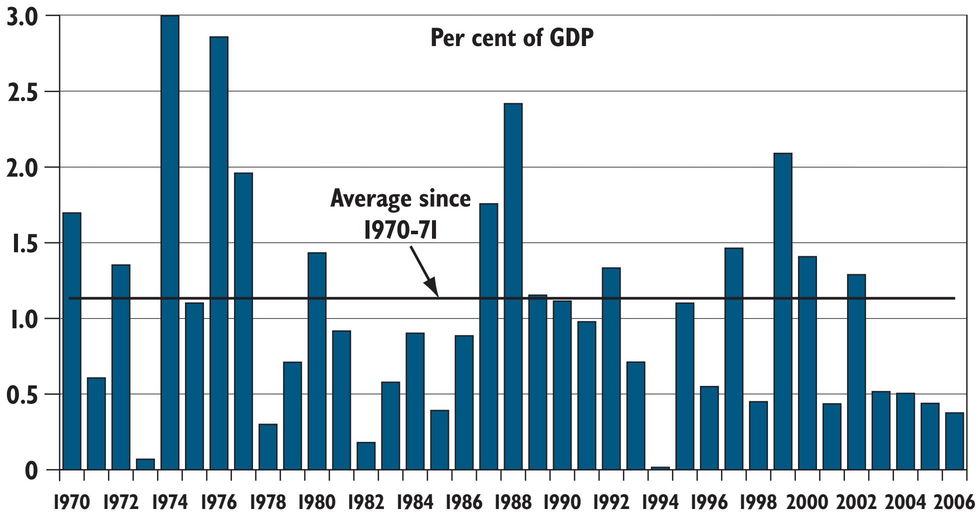


Note: The one-year ahead forecast difference in 1974-75 was -5.9 per cent of GDP.
Source: HM Treasury.

2.19 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 (a positive forecast difference) when the output gap is positive, and forecast PSNB has tended to be lower than outturn PSNB (a negative forecast difference) 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.

2.20 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.

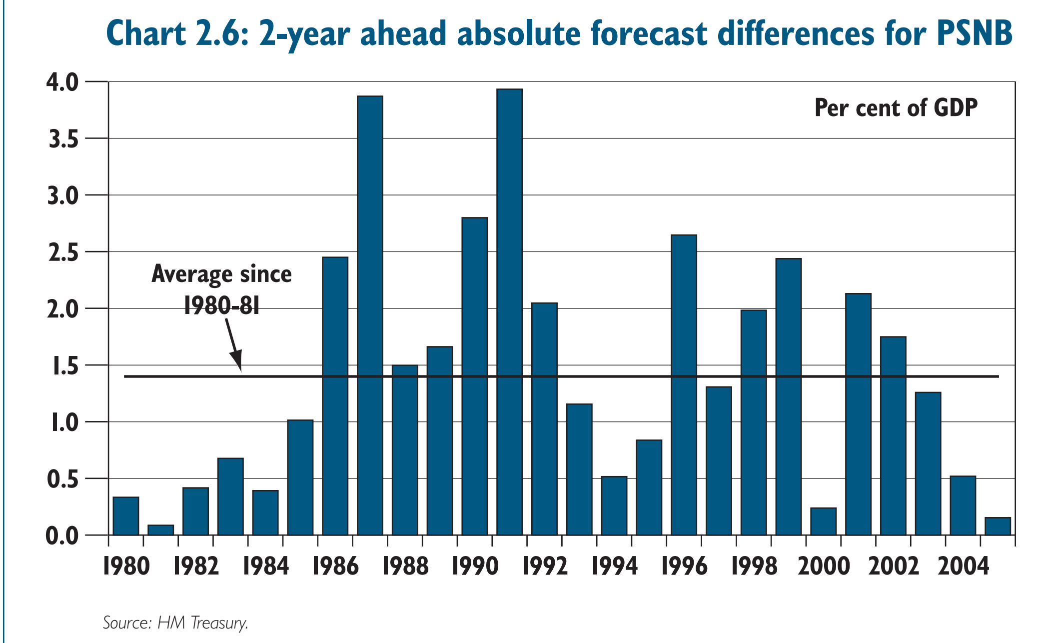
Chart 2.5: 1-year ahead absolute forecast differences for PSNB



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

2.21 The improvement in the accuracy of both the one-year ahead and two-year ahead fiscal forecasts over the last few years is shown in Charts 2.5 and 2.6. Chart 2.5 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, Budget 2005 and Budget 2006 year-ahead forecasts were considerably more accurate than the average over the last 37 years. The absolute year-ahead forecast difference was less than half the long-run average in each of the last four years. Since 1970-71 only four out of 37 forecasts were more accurate than the Budget 2006 forecast for 2006-07.

2.22 Chart 2.6 shows the absolute differences for two-year ahead forecasts since 1980-81. It shows that on the basis of current data the Budget 2003, Budget 2004 and Budget 2005 two-year ahead forecasts were more accurate than the average over the last 26 years, and that forecast accuracy has improved in every Budget since 2001. Since 1980-81 only one out of 26 forecasts was more accurate than the Budget 2005 forecast for 2006-07.



INTERNATIONAL COMPARISONS

2.23 This section compares the UK's fiscal 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

2.24 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.

2.25 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.[4] 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.

[4] 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.

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	3.1	6.0	8.8	10.4	11.3	12.4
UK, HM Treasury	2.8	3.9	4.8	6.3		

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

Source: US data from The Uncertainity of Budget Projections: A Discussion of Data and Methods, CBO March 2007 (http://www.cbo.gov/spreadsheets.shtml)

International Organisations

2.26 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.[5] Two IMF forecasts have been included. The first is drawn from the annual *United Kingdom Article IV Consultation,* which is published at a similar time to the Budget and forecasts borrowing on a financial year basis in line with practice in the UK. The second is from the *World Economic Outlook,* 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.

Table 2.4: Forecast differences for UK net borrowing, 1997 to 2006

	Per cent of GDP	
	Absolute average difference	Average difference
Treasury	0.9	0.3
IMF (Article IV)	1.0	0.5
IMF (WEO)	1.3	0.1
OECD	1.1	0.0
European Commission	1.3	–0.5

2.27 Table 2.4 shows that the Treasury's forecast compares well with those of the IMF, OECD and European Commission in terms of accuracy – as shown by the average absolute difference, and in terms of caution – as shown by the 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

2.28 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 2006 – using the year-ahead projections set down in EU 15 Member States' annual Stability or Convergence Programmes.[6] 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 the EU 15 average.

[5] 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 increases outturn net borrowing for 2000 by around 2.3 per cent of GDP.

[6] 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 forecasts and outturn, 1997 to 2006

	Per cent of GDP	
	Absolute average difference	Average difference
Spain	0.42	0.02
Austria	0.46	0.16
France	0.54	–0.26
Belgium	0.72	0.26
UK	**0.83**	**0.00**
Finland	1.07	0.87
Germany	1.08	0.13
Italy	1.17	–0.91
Portugal	1.24	–1.10
Denmark	1.29	–0.15
Sweden	1.56	0.42
Netherlands	1.85	0.65
Ireland	1.95	1.03
Luxembourg	2.04	1.86
Greece	3.37	–3.37
EU15 Average	1.30	–0.03
Memo: UK Budget forecasts	*0.90*	*0.26*

Note: Differences refer to general government net borrowing. The forecast data are from the Stability and Convergence Programmes submitted by each country and are available on the European Commission's website (http://www.europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm). 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. Eurostat data is used for the outturn data. For the UK, ONS outturn data submitted to Eurostat is used. Outturn data for the UK is used on a financial year basis to be consistent with the forecasts.

FORECAST ANALYSIS FOR THE LAST TWO YEARS

2.29 Table 2.6 provides a summary comparison of the year-ahead projections for the main fiscal aggregates in Budget 2005 and Budget 2006 compared with the latest outturn information.

Table 2.6: Differences in Budget forecasts for main aggregates

	Per cent of GDP					
	2005-06			2006-07		
	Budget 2005 Forecast	Outturn	Difference	Budget 2006 Forecast	Outturn	Difference
Surplus on current budget	–0.5	–1.1	–0.7	–0.5	–0.4	0.2
Memo: average absolute difference, current budget, since 1998–99			*0.8*			*0.8*
Cyclically-adjusted surplus on current budget	–0.3	–0.9	–0.6	0.4	–0.2	–0.6
Public sector net borrowing	2.6	3.0	0.4	2.7	2.3	–0.4
Memo: average absolute difference, net borrowing, since 1970–71			*1.1*			*1.1*
Cyclically–adjusted public sector net borrowing	2.4	2.8	0.4	1.8	2.2	0.4
Public sector net debt	35.6	36.1	0.5	36.7	36.7	–0.1

Note: figures may not sum due to rounding.

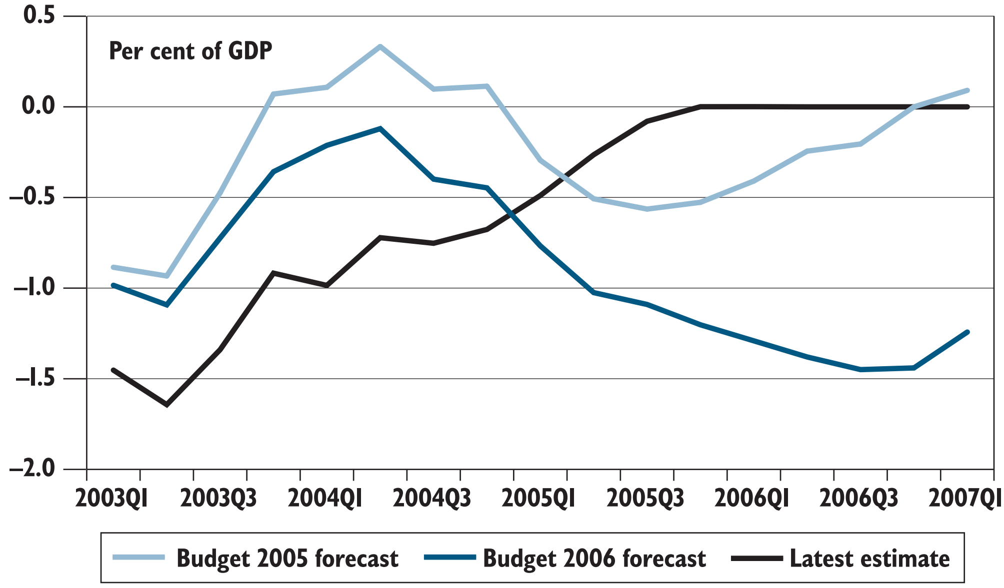
2.30 The current budget was in deficit in 2005-06 and 2006-07. In 2005-06, the deficit was 1.1 per cent of GDP compared with the Budget 2005 forecast of 0.5 per cent. The current budget deficit in 2006-07 was 0.4 per cent of GDP compared with the Budget 2006 forecast of 0.5 per cent. The forecast was therefore cautious. The forecast difference was reduced in 2006-07 from the previous year. In both 2005-06 and 2006-07 the absolute forecast difference was smaller than the average absolute forecast difference since 1998-99 of 0.8 per cent of GDP.

2.31 The outturn for net borrowing was 3.0 per cent of GDP in 2005-06 and 2.3 per cent in 2006-07 compared with forecasts of 2.6 per cent and 2.7 per cent of GDP respectively. The 2006-07 forecast was therefore cautious, and the absolute forecast differences of 0.4 per cent of GDP in both years are well below the average absolute one-year ahead forecast difference since 1970-71 of 1.1 per cent of GDP. They also compare well with the average absolute forecast difference under the new framework of 0.9 per cent of GDP.

Impact of the economic cycle

2.32 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.

Chart 2.7: Revised estimates of the output gap



Source: HM Treasury.

2.33 Since the last *End of year fiscal report* was published there have been 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 2005-06 from –0.1 per cent of GDP forecast in Budget 2005 to –0.5 per cent and changed the output gap in 2006-07 from –1.4 per cent forecast in Budget 2006 to –0.1 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.[7] 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.

The Treasury's cyclical adjustment methodology

2.34 Because the economic cycle has important short-term effects on the public finances, it is important to distinguish between cyclical and underlying or 'structural' effects. The UK's experience suggests that errors can occur if purely cyclical improvements are interpreted as if they were structural, and conversely if a structural deterioration is interpreted as cyclical. The *Code for Fiscal Stability* requires the Government to publish cyclically-adjusted estimates of the key fiscal balances. The Treasury's latest forecasts of cyclically-adjusted PSNB and the cyclically-adjusted surplus on the current budget are published in each Budget and Pre-Budget Report.

2.35 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. The cyclically-adjusted balances also may not accurately reflect the impact of temporary non-cyclical factors such as movements in asset prices or oil production. 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.

Breakdown of forecast differences

2.36 Table 2.7 provides more detailed information on the sources of forecast differences. In 2005-06, receipts were as forecast at Budget 2005. In 2006-07 outturn current receipts were £2.6 billion higher than forecast. In both cases the absolute forecast difference was below the average absolute difference since 1998-99. Outturn current expenditure was £7.7 billion higher than forecast in 2005-06. In 2006-07 outturn current expenditure was £0.1 billion lower than forecast, below the average absolute difference since 1998-99. The outturn for depreciation was £0.8 billion above forecast for 2005-06 and £0.3 billion above for 2006-07.

2.37 The forecast differences for current expenditure and current receipts in 2005-06 and 2006-07 are affected by several classification changes by the Office for National Statistics (ONS). In particular, the decision by the ONS in January 2006 to reclassify the BBC and S4C to the central government sector from the public corporations sector affects both current expenditure and receipts in 2005-06, while the ONS's change to its treatment of local authorities' Housing Revenue Accounts affects current expenditure and receipts in both 2005-06 and 2006-07. Although both these changes are fiscally neutral to the public sector, they have the effect of increasing both expenditure and receipts totals in 2005-06 and 2006-07. More detail on these classification changes can be found in paragraphs 3.32 and 3.33.

2.38 Net borrowing is equal to net investment less the surplus on the current budget. Outturn net investment was below forecast by £2.8 billion in 2005-06 and by £2.5 billion in 2006-07. Despite being below forecast, net investment increased by 12 per cent between 2005-06 and 2006-07. The current budget forecast differences were -£8.4 billion in 2005-06 and £2.4 billion in 2006-07. Net borrowing was £5.6 billion above forecast in 2005-06 and £4.9 billion below forecast in 2006-07.

[7] 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					
	2005-06			2006-07		
	Budget 2005 forecast	Outturn	Difference	Budget 2006 forecast	Outturn	Difference
Current budget						
Current receipts	486.7	486.7	0.0	516.4	519.1	2.6
Memo: average absolute difference in current receipts since 1998-99[1]			*7.3*			*7.7*
Current expenditure	476.9	484.6	7.7	506.7	506.6	–0.1
Memo: average absolute difference in current expenditure since 1998-99[1]			*4.5*			*4.8*
Depreciation	15.5	16.2	0.8	16.8	17.2	0.3
Surplus on current budget	–5.7	–14.1	–8.4	–7.1	–4.7	2.4
Capital budget						
Gross investment	46.9	45.8	–1.1	52.2	49.2	–2.9
Less asset sales	–5.2	–6.2	–0.9	–6.6	–5.8	0.8
Less depreciation	–15.5	–16.2	–0.8	–16.8	–17.2	–0.3
Net investment	26.2	23.4	–2.8	28.8	26.3	–2.5
Public sector net borrowing	31.9	37.5	5.6	35.9	31.0	–4.9
Memo: average absolute difference between forecast and outturn net borrowing since 1970-71[1]			*14.2*			*15.0*
Public sector net debt	452.1	463.2	11.1	493.3	500.2	6.9
Memo						
Treaty deficit[2]	32.0	38.0	6.0	37.8	34.0	–3.8
Treaty debt[3]	520.9	531.4	10.5	562.6	574.4	11.8

[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
Note: figures may not sum due to rounding.

2.39 Table 2.8 breaks down the differences between the year-ahead Budget forecasts and outturns into the four categories described in Chapter 1. In both years, the difference between forecast and outturn for the main fiscal aggregates was mainly due to economic determinants and fiscal forecasting differences. In both years other factors, in particular classification changes, also made a significant contribution. For example, in 2006-07 there is a negative sign on the PSNB forecast difference because borrowing was lower than forecast. Fiscal forecasting differences explain most of the caution in the PSNB forecast. The contribution of the NAO-audited assumptions has a negative sign because these assumptions also added caution to the forecast, offsetting the effects of the economic determinants. More detailed analysis of the forecast differences for spending and receipts in 2005-06 and 2006-07 is developed in Chapters 3 and 4.

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

	£ billion	
	Budget 2005 forecast for 2005-06	Budget 2006 forecast for 2006-07
Current receipts difference	**0.0**	**2.6**
contribution from:		
Economic determinants	–5.7	–1.7
NAO-audited assumptions	0.1	3.1
Fiscal forecasting differences	1.2	–1.0
Other	4.5	2.3
Current spending difference	**7.7**	**–0.1**
contribution from:		
Economic determinants	0.2	1.0
NAO-audited assumptions	0.1	0.5
Fiscal forecasting differences	3.1	–2.0
Other	4.2	0.4
Depreciation	**0.8**	**0.3**
contribution from:		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	0.8	0.3
Other	0.0	0.0
Current budget difference	**–8.4**	**2.4**
contribution from:		
Economic determinants	–6.0	–2.7
NAO-audited assumptions	0.0	2.6
Fiscal forecasting differences	–2.7	0.6
Other	0.3	1.8
Net investment difference	**–2.8**	**–2.5**
contribution from:		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	–3.2	–3.3
Other	0.4	0.9
Net borrowing difference	**5.6**	**–4.9**
contribution from:		
Economic determinants	6.0	2.7
NAO-audited assumptions	0.0	–2.6
Fiscal forecasting differences	–0.5	–4.0
Other	0.1	–0.9

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

3 RECEIPTS

This chapter provides more detailed analysis of developments in receipts in 2005-06 and 2006-07. It shows that:

- **current receipts rose from around £487 billion in 2005-06 to around £519 billion in 2006-07, providing resources for the Government's priorities; and**
- **in 2005-06 receipts were close to forecast. In 2006-07 receipts were above forecast due to higher receipts from a number of taxes including VAT and self-assessment receipts.**

INTRODUCTION

3.1 This chapter provides more detailed analysis of developments in current receipts and, in particular, the forecasts made in Budget 2005 and Budget 2006. 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 and outturns for receipts in Budget 2005 and Budget 2006. Current receipts were around £487 billion in 2005-06, and rose to around £519 billion in 2006-07.

Table 3.1: Summary of differences in Budget receipts forecasts

	Forecast	Outturn	Difference
Budget 2005 forecast of 2005-06			
Current receipts (£ billion)	486.7	486.7	0.0
Current receipts (per cent of GDP)	39.3	39.0	–0.3
Cyclically-adjusted current receipts (per cent of GDP)	39.4	39.0	–0.4
Budget 2006 forecast of 2006-07			
Current receipts (£ billion)	516.4	519.1	2.6
Current receipts (per cent of GDP)	40.3	39.2	–1.1
Cyclically-adjusted current receipts (per cent of GDP)	41.3	39.3	–2.0

3.3 Current receipts were in line with their forecast in 2005-06 and £2.6 billion above forecast in 2006-07. Table 3.2 shows that there was a shortfall from VAT receipts, but this was offset by higher interest and dividend receipts and the effect of several classification changes. Table 3.3 shows that in 2006-07 the surplus was driven by stronger than expected receipts from a number of taxes and other receipts, including VAT and self-assessment receipts, and by further classification changes. 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;

- **NAO-audited assumptions:** many of the economic determinants described above are calculated using assumptions that are audited by the National Audit Office (NAO), ensuring that they remain both reasonable and cautious. The direct impacts of differences in the forecasts of these determinants with their outturn on the tax forecasts can be separately identified. This includes the impact of using a trend growth assumption that is one quarter of a percentage point below the Treasury's central case. These estimates will not include the second round effects of these audited assumptions, for example, the impact the interest rate assumption has on receipts through its impact on the RPI, which would be captured in the economic determinants line;

- **Fiscal forecasting 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 factors:** 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 2005 and Budget 2006 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 and national insurance contributions

3.8 Although income tax receipts in 2005-06 were £3.2 billion lower than forecast, this was almost entirely offset by higher national insurance contributions (NICs), reflecting reallocation of PAYE receipts to NICs. Overall receipts of income tax and NICs, gross of income tax credits, for 2005-06 were just £0.2 billion lower than forecast. This was due to lower-than-expected wages and salaries growth, particularly from lower earnings growth, offset by fiscal forecasting effects, from lower-than-forecast payments of personal pension rebates and stronger-than-expected self assessment and other income tax receipts. In 2005-06 the negative tax element of tax credits was £0.5 billion below forecast, primarily arising from higher-than-expected payments to low income working families.

3.9 In 2006-07, a greater than usual share of combined PAYE payments being allocated to income tax led to an underforecast for PAYE income tax and overforecast for national insurance contributions. Combined income tax and national insurance contributions were £1.4 billion above forecast in 2006-07, partly due to higher than expected wages and salaries growth. Self assessment receipts were £1.6 billion above forecast, largely due to fiscal forecasting differences. This was partially offset by weaker than expected other income tax receipts.

Table 3.2: Breakdown of Budget 2005 forecasting differences of receipts for 2005-06

				£ billion			
	Forecast	Outturn	Difference	of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
HM Revenue & Customs							
Income tax (gross of tax credits)	138.1	135.0	–3.2	–1.7	0.2	–1.7	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	–0.7	0.1	3.5	0.0
Value added tax	76.3	72.9	–3.5	–0.6	–2.8	–0.1	0.0
Corporation tax[2]	43.1	41.8	–1.4	–3.0	1.9	–0.2	0.0
Petroleum revenue tax	1.5	2.0	0.5	–0.4	0.6	0.3	0.0
Fuel duties	24.6	23.4	–1.1	0.1	–0.3	–0.6	–0.4
Capital gains tax	3.0	3.0	0.0	0.0	0.0	0.0	0.0
Inheritance tax	3.4	3.3	–0.1	0.1	0.1	–0.2	0.0
Stamp duties	9.7	10.9	1.2	0.6	0.1	0.5	0.0
Tobacco duties	8.4	8.0	–0.5	0.0	0.2	–0.6	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	0.1	0.0	–0.4	0.0
Total HMRC	**404.0**	**397.9**	**–6.2**	**–5.5**	**0.1**	**–0.4**	**–0.4**
Vehicle excise duties	5.1	5.0	–0.2	–0.1	0.0	–0.1	0.0
Business rates	19.4	19.8	0.4	0.0	0.0	0.4	0.0
Council tax	20.9	21.2	0.3	0.0	0.0	0.3	0.0
Other taxes and royalties	12.4	12.9	0.5	0.0	0.0	0.2	0.2
Net taxes and national insurance contributions	**461.9**	**456.7**	**–5.2**	**–5.6**	**0.1**	**0.5**	**–0.2**
Accruals adjustment on taxes	1.8	1.7	0.0	–0.1	0.0	0.1	0.0
less VAT and own resources EU contributions	–3.9	–4.3	–0.4	–0.1	0.0	–0.3	0.0
less PC onshore CT payments	–0.1	–0.2	–0.2	0.0	0.0	–0.2	0.0
Tax credits adjustment[3]	0.6	0.5	–0.1	0.0	0.0	–0.1	0.0
Interest & dividends	4.9	6.8	1.9	0.0	0.0	1.9	0.0
Other receipts	21.5	25.5	4.0	0.0	0.0	–0.7	4.7
Current receipts	**486.7**	**486.7**	**0.0**	**–5.7**	**0.1**	**1.2**	**4.5**

[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 calulation of net taxes and national insurance contributions.*

Note: Figures may not sum due to rounding.

Table 3.3: Breakdown of Budget 2006 forecasting differences of receipts for 2006-07

	Forecast	Outturn	Difference	of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
					£ billion		
HM Revenue & Customs							
Income tax (gross of tax credits)	144.0	147.8	3.7	0.6	0.3	2.9	0.0
Income tax credits[1]	–4.6	–4.4	0.2	0.0	0.0	0.2	0.0
National insurance contributions	89.6	87.3	–2.4	0.0	0.1	–2.5	0.0
Value added tax	76.5	77.4	0.9	0.6	1.0	–0.8	0.0
Corporation tax[2]	48.5	44.3	–4.2	–3.8	1.3	–1.7	0.0
Petroleum revenue tax	1.9	2.2	0.3	–0.4	0.3	0.4	0.0
Fuel duties	24.0	23.6	–0.5	0.2	–0.1	–0.3	–0.2
Capital gains tax	3.8	3.8	0.0	0.0	0.0	0.0	–0.1
Inheritance tax	3.6	3.6	0.0	0.1	0.0	0.0	0.0
Stamp duties	12.2	13.4	1.2	1.0	0.0	0.2	0.0
Tobacco duties[3]	8.0	8.1	0.1	0.1	–	–	0.0
Alcohol duties	8.1	7.9	–0.2	0.0	0.0	–0.2	0.0
Other HMRC	8.9	8.8	–0.1	0.1	0.0	–0.2	0.0
Total HMRC	**424.4**	**423.7**	**–0.7**	**–1.4**	**3.0**	**–2.0**	**–0.3**
Vehicle excise duties	5.1	5.1	0.0	0.1	0.0	–0.1	0.0
Business rates	21.4	21.0	–0.4	0.0	0.0	–0.4	0.0
Council tax	22.0	22.2	0.2	0.0	0.0	0.2	0.0
Other taxes and royalties	13.6	13.8	0.3	0.0	0.0	0.0	0.3
Net taxes and national insurance contributions	**486.5**	**485.9**	**–0.7**	**–1.3**	**3.0**	**–2.3**	**0.0**
Accruals adjustment on taxes	2.3	4.7	2.4	0.0	0.1	2.3	0.0
less VAT and own resources EU contributions	–4.2	–4.6	–0.4	–0.4	0.0	0.0	0.0
less PC onshore CT payments	–0.1	–0.3	–0.2	0.0	0.0	–0.2	0.0
Tax credits adjustment[4]	0.6	0.5	–0.1	0.0	0.0	–0.1	0.0
Interest & dividends	5.7	6.3	0.6	0.0	0.0	0.6	0.0
Other receipts	25.6	26.6	1.0	0.0	0.0	–1.3	2.3
Current receipts	**516.4**	**519.1**	**2.6**	**–1.7**	**3.1**	**–1.0**	**2.3**

[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 estimate for the underlying market share of smuggled cigarettes is available for 2006-07 (see Section 3 of "Measuring Indirect Tax Losses – 2007") so it is not possible to identify the effect of the NAO audited assumption on the fiscal forecasting difference for tobacco.

[4] Tax credits that are classified as expenditure in the National Accounts but negative taxation in the calulation of net taxes and national insurance contributions.

Note: Figures may not sum due to rounding.

Value added tax

3.10 VAT receipts in 2005-06 were £3.5 billion below forecast. The latest VAT gap estimates for 2005-06 suggest that the gap between theoretical VAT liability and receipts was £2.9 billion higher than anticipated at Budget 2005. Increases in Missing Trader Intra-Community (MTIC) fraud were a significant factor in this overforecast. This is scored to NAO-audited assumptions. The overall difference was further boosted by slower than expected growth in consumer spending, which represents about two-thirds of the total VAT tax base, scored to economic determinants.

3.11 VAT receipts in 2006-07 were £0.9 billion above forecast. The estimated gap between theoretical VAT liability and receipts was £1.0 billion lower than anticipated at Budget 2006, increasing receipts relative to the Budget 2006 forecast. The difference in forecast and outturn as a result of the lower than expected VAT gap has been scored to NAO-audited assumptions. This was aided by a reduction in the level of attempted MTIC fraud, following the strengthening of HMRC's operational strategy to combat such activity. VAT receipts were further boosted by higher-than-expected growth in the government and housing elements of the VAT tax base. The overall total was partly offset by a negative fiscal forecasting difference.

Corporation Tax

3.12 The outturn for total corporation tax receipts (including North Sea oil and gas receipts) in 2005-06 was £1.4 billion below forecast. The shortfall for onshore companies was partly due to slower-than-expected profit growth in the industrial and commercial sectors. The negative fiscal forecasting difference is largely due to changes in the composition of 2004-05 receipts which meant that the Budget 2005 forecast's estimate of 2004-05 liabilities (derived from in-year receipts data) was too high. New estimation methods have since been introduced that should help ensure these differences are avoided in future.

3.13 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 and higher operating and capital expenditure, 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.

3.14 The outturn for total corporation tax receipts (including North Sea oil and gas receipts) in 2006-07 was £4.2 billion below forecast. The shortfall for onshore companies was in part due to slower than expected profits growth in the industrial and commercial sectors. Weaker-than-expected profits in the life assurance sector also contributed to the shortfall, caused by falls in bond prices in 2006. There was a further £1.7 billion fiscal forecasting error, in part due to higher-than-expected repayments in relation to previous years' accounting periods.

3.15 In 2006-07, North Sea corporation tax receipts were £1.5 billion below forecast. This was largely caused by a combination of lower-than-expected production, higher-than-expected operating and capital expenditure and the appreciation of sterling against the dollar which lowered the dollar oil price in sterling terms. These are scored as economic determinants. The shortfall was partly offset by higher-than-expected oil prices; at Budget 2006 the NAO assumption for the average price of oil was $57.4 per barrel, but the outturn was $66.3 per barrel.

Petroleum revenue tax

3.16 Receipts of petroleum revenue tax (PRT) in 2005-06 were £0.5 billion higher than forecast, largely due to higher-than-forecast oil prices scored as NAO assumptions. Receipts of PRT in 2006-07 were £0.3 billion higher than forecast, largely due to higher-than-forecast oil prices, scored as NAO-audited assumptions.

Fuel duties

3.17 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 September. The 2005 Pre-Budget Report announced that the level of fuel duty would continue to be frozen until Budget 2006 and this contributed £0.4 billion to the forecasting difference, scored to other factors. Much of the remaining overforecast was a result of higher oil prices relative to the NAO-audited assumption, which reduces the demand for fuel. This includes a direct effect of higher oil prices of £0.3 billion which is allocated to NAO assumptions, and other effects included in fiscal forecasting differences.

3.18 Fuel duty receipts in 2006-07 were £0.5 billion below forecast. At Budget 2006 it was announced that fuel duties would be raised in line with inflation at the start of September, but this was delayed until the 2006 Pre-Budget Report, contributing £0.2 billion to the shortfall. Receipts were further weakened by the fact that oil prices were higher than the NAO-audited assumption, and by fiscal forecasting differences. These shortfalls were partially offset by a positive impact from economic determinants, principally GDP growth.

Capital gains tax and inheritance tax

3.19 Capital gains tax and inheritance tax receipts in 2005-06 and 2006-07 were close to the Budget 2005 and Budget 2006 forecasts respectively.

Stamp duties

3.20 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 above forecast as a result of higher-than-expected volumes of shares traded and, to a lesser extent, higher equity prices.

3.21 In 2006-07 total stamp duty receipts were also £1.2 billion higher than forecast. Receipts on land and property were above forecast due to higher-than-expected house prices and house transaction volumes. Stamp duty receipts from shares were below forecast, reflecting fiscal forecasting errors, largely due to a fall in the proportion of equity trades subject to stamp duty.

Tobacco duties

3.22 Tobacco receipts in 2005-06 were £0.5 billion lower than forecast at Budget 2005, of which £0.3 billion was due to a change in clearance patterns at the end of the year, which led to more receipts scoring at the beginning of 2006-07. In accordance with the NAO-audited assumption at the time, the market share of smuggled cigarettes was assumed to be 15 per cent in all forecast years. The mid-point outturn for 2005-06 was 13 per cent. The lower-than-forecast smuggled share increased revenue by £0.2 billion, which is scored under assumptions audited by the NAO. The outstanding forecast difference can be explained by lower-than-forecast consumption.

3.23 In 2006-07 tobacco duties were £0.1 billion above forecast. No estimate of the 2006-07 smuggled share of cigarettes is currently available and so it is not possible to identify the breakdown between the NAO-audited assumption and fiscal forecasting difference at this stage. A revised NAO-audited assumption was adopted in Budget 2007. This assumes that the underlying level of duty paid consumption of cigarettes will be set at least 3 per cent per year lower than the estimated outturn of the current year.

Alcohol duties

3.24 In 2005-06, alcohol duty receipts were £0.3 billion lower than forecast, largely due to lower-than-expected receipts from spirits, scored under fiscal forecasting differences. Alcohol receipts in 2006-07 were £0.2 billion below forecast, largely due to fiscal forecasting differences.

Other HMRC taxes

3.25 Receipts from other HMRC taxes were £0.3 billion below their one-year ahead forecast in 2005-06, mostly due to fiscal forecasting differences. Other HMRC taxes were £0.1 billion below forecast in 2006-07 due to fiscal forecasting differences, partially offset by economic determinants.

Vehicle excise duty **3.26** Vehicle excise duty receipts were £0.2 billion below forecast in 2005-06 and close to forecast in 2006-07.

Council tax **3.27** Council tax receipts in 2005-06 were £0.3 billion higher than forecast in Budget 2005, and £0.2 billion higher in 2006-07 than forecast in Budget 2006. 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 Budget 2007 is based on the latest available estimates released by the Chartered Institute for Public Finance and Accountancy (CIPFA).

Other taxes and royalties **3.28** In 2005-06, receipts of other taxes and royalties were £0.5 billion above forecast, while in 2006-07, receipts of other taxes and royalties were £0.3 billion above forecast.

Accruals adjustments **3.29** In 2005-06 accruals adjustments were close to forecast. In 2006-07 accruals adjustments were £2.4 billion above forecast. This reflects higher accruals adjustments for both NICs and VAT. The latter reflects strong growth in VAT receipts in the first three months of 2007-08, part of which accrues back to 2006-07.

Interest and dividends **3.30** Interest and dividend receipts were £1.9 billion and £0.6 billion above forecast in 2005-06 and 2006-07 respectively. Part of the overforecast in both years reflects the decision of the ONS to include the interest accruing on student loans. Interest and dividend receipts were also boosted in 2005-06 by an unexpectedly high level of payments associated with early repayments of loans guaranteed by the Export Credit Guarantee Department (ECGD).

Other receipts **3.31** Other receipts consist of gross operating surplus, rent, accruals adjustments of the proceeds from the auction of spectrum licences, current transfers from households and receipts from TV licences.

3.32 Other receipts in 2005-06 were £4.0 billion above forecast, which can be entirely explained by reclassifications. All these classification changes were fiscally neutral, adding to both receipts and expenditure totals. The two main classification changes by the ONS have been on TV licences and the Housing Revenue Accounts, although receipts were also boosted by the ONS inclusion of passport fees and renewable obligation certificates. On 20 January 2006 the 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 added around £2.6 billion to other receipts in 2006-07. In June 2007, the ONS changed their treatment of local authorities' Housing Revenue Accounts. In the National Accounts, these are regarded as 'quasi-corporations' and are included in the public corporations sub-sector. The revised treatment led to fiscally neutral offsetting revisions to both local authority and public corporations' net borrowing. The effect was to impute equal amounts of additional expenditure by local authorities and increases in the gross operating surplus of public corporations. These changes are shown as other factors, both in the other receipts category and in the accounting adjustments on public expenditure. This added around £1.4 billion to receipts in 2005-06.

3.33 Other receipts in 2006-07 were £1.0 billion above forecast. Receipts in 2006-07 were boosted by the Housing Revenue Account reclassification, which added £1.9 billion and the inclusion of renewable obligation certificates.

4 PUBLIC EXPENDITURE

This chapter provides a detailed analysis of public expenditure in 2005-06 and 2006-07. It shows that:

- **Spending was higher than forecast by £5.6 billion (0.5 per cent of GDP) in 2005-06, due in large part to a classification change, and lower than forecast by £2.2 billion (0.2 per cent of GDP) in 2006-07;**
- **Total Managed Expenditure rose from £524.2 billion in 2005-06 to £550.1 billion in 2006-07; and**
- **There was a substantial increase in public sector net investment (over 12 per cent) over the past two years, addressing the historical under-investment in public services.**

4.1 This chapter provides a detailed examination of trends and developments in public expenditure in 2005-06 and 2006-07, in particular, differences between projected expenditure and outturn for the year-ahead projections in Budgets 2005 and 2006.

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, 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 outturn figures reflect changes to the budgeting regime implemented in Budgets 2006 and 2007, as described in the public finances annexes of those Budgets. 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. For Budget 2005 forecasts of 2005-06, the DEL and AME forecasts in this chapter have been restated to take account of the Budget 2006 budgeting regime changes, in line with the forecasts shown for 2005-06 in the 2006 *End of year fiscal report* (EYFR). For 2006-07, the forecasts in this chapter are those published in Budget 2006. Changes to the budgeting regime since Budget 2006 are included within the DEL and AME differences attributed to other factors.

4.6 Data on public spending remains provisional for some time after the end of the relevant financial year. For example, local government accounts may not be finalised until around six months after the end of the year, and final consolidated data are not available until some time after that. That means that the data in this chapter, particularly for 2006-07, are not final. The information is, however, sufficiently robust to allow analyses of forecasting differences; future revisions are 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 2005-06 and 2006-07, including a comparison of the differences from the year-ahead forecasts for spending published in Budgets 2005 and 2006 respectively. TME rose from £524.2 billion in 2005-06 to £550.1 billion in 2006-07 (approximately 42 per cent of GDP). Since the 2006 EYFR, classification changes have increased TME by £1.4 billion in 2005-06 and £1.9 billion in 2006-07. (These are described further in paragraph 4.47 below.) Together with the classification changes reported in paragraph 4.8 of the 2006 EYFR, these classification changes account for £5.3 billion of the forecast differences in 2005-06, and £2 billion of the forecast differences in 2006-07.

4.8 Net investment increased by over 12 per cent, from £23.4 billion to £26.3 billion between 2005-06 and 2006-07. The rise in investment reflects the Government's success in addressing the historical under-investment in public services.

Forecast differences in 2005-06

4.9 In 2005-06, TME was £5.6 billion above forecast. Public sector current expenditure was £7.7 billion higher than forecast, mainly due to classification changes on current expenditure of £4 billion. Public sector net investment was £2.8 billion less than projected due to lower-than-planned capital expenditure in DEL and AME.

Forecast differences in 2006-07

4.10 In 2006-07, TME was £2.2 billion below forecast. Public sector curent expenditure was £0.1 billion lower than forecast, which included additional spending of £1 billion from classification changes on current expenditure, offset by lower spending than forecast. Public sector net investment was £2.5 billion lower than projected, again due to lower-than-planned capital expenditure in DEL and AME.

Table 4.1: Summary of public expenditure forecasting differences for 2005–06 and 2006–07

	£ billion					
	2005–06			2006–07		
	Forecast	Outturn	Difference	Forecast	Outturn	Difference
Public sector current expenditure	476.9	484.6	7.7	506.7	506.6	–0.1
Public sector net investment	26.2	23.4	–2.8	28.8	26.3	–2.5
Public sector depreciation	15.5	16.2	0.8	16.8	17.2	0.3
Total Managed Expenditure	**518.6**	**524.2**	**5.6**	**552.3**	**550.1**	**–2.2**
of which:						
Departmental Expenditure Limits						
Resource Budget	277.7	277.4	–0.4	294.5	291.2	–3.3
Capital Budget	38.4	35.2	–3.3	42.5	39.1	–3.4
Less depreciation	–11.8	–9.5	2.3	–11.8	–9.9	1.9
Total Departmental Expenditure Limits	**304.4**	**303.0**	**–1.4**	**325.2**	**320.4**	**–4.8**
Total Annually Managed Expenditure	**214.2**	**221.2**	**7.0**	**227.1**	**229.7**	**2.6**

Note: Figures may not sum due to rounding.

SPENDING FORECASTS AND REASONS FOR DIFFERENCES

4.11 The following section analyses the differences between forecast and outturn data. As with Chapters 2 and 3, differences are decomposed into the following four categories:

- **economic determinants,** for example, debt interest payments on index-linked gilts are affected by the accrued uplift, which is in turn dependent upon inflation forecasts;
- **NAO-audited assumptions**[1], 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 forecast differences,** which could arise from the differences in the projected number of benefit recipients, or differences between outturns and plans for DEL; and
- **other factors,** which include measures announced after the publication of the Budget forecast and classification changes.

DEL FORECASTING DIFFERENCES

4.12 Tables 4.2 and 4.3 provide a breakdown of TME forecasting differences for 2005-06 and 2006-07 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 attributed to other factors.

[1] See Annex A for a full list of NAO-audited assumptions.

4.13 Departments can carry forward unspent budgetary allocations into future years under the end-year flexibility (EYF) arrangements. These are 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 (PEOWP), published in July of each year.[2]

DEL in 2005-06

4.14 Outturn for total DEL in 2005-06 was £303.0 billion, £1.4 billion below the adjusted Budget 2005 forecast of £304.4 billion. (As explained in paragraph 4.5, the Budget figures were adjusted in line with the main changes in the budgeting regime in Budget 2006 to maintain consistency over time.) This difference between planned and outturn spending is largely due to lower than planned capital expenditure, partly offset by lower depreciation, and is equivalent to less than 0.5 per cent of forecast total DEL, or roughly 0.1 per cent of GDP.

4.15 Spending on Resource DEL was £0.4 billion below the adjusted Budget 2005 forecast as a result of classification changes.

4.16 Capital DEL outturn was £3.3 billion below the adjusted Budget 2005 plans. Fiscal forecasting differences amounted to £3.0 billion due to lower-than-planned capital spending in the Department of Health, the Department for Education and Skills (now the Department of Children, Schools and Families) and elsewhere. Unspent capital provision was carried forward through the Government's end-year flexibility (EYF) scheme to maintain the Government's overall investment plans.

4.17 Outturn for DEL depreciation was £2.3 billion above Budget 2005 forecasts, of which £0.9 billion was due to classification changes. The fiscal forecasting differences largely arose from higher depreciation figures for the Ministry of Defence.

Table 4.2: Breakdown of Budget 2005 forecasting differences of public expenditure for 2005-06

				£ billion			
	Forecast	Outturn	Difference	of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Departmental Expenditure Limits							
Resource Budget	277.7	277.4	−0.4	0.0	0.0	0.0	−0.4
Capital Budget	38.4	35.2	−3.3	0.0	0.0	−3.0	−0.3
Less depreciation	−11.8	−9.5	2.3	0.0	0.0	1.4	0.9
Total Departmental Expenditure Limits	**304.4**	**303.0**	**−1.4**	**0.0**	**0.0**	**−1.6**	**0.2**
Annually Managed Expenditure	**214.2**	**221.2**	**7.0**	**0.2**	**0.1**	**2.3**	**4.4**
Total Managed Expenditure	**518.6**	**524.2**	**5.6**	**0.2**	**0.1**	**0.7**	**4.6**
of which:							
Public sector current expenditure	476.9	484.6	7.7	0.2	0.1	3.1	4.2
Public sector net investment	26.2	23.4	−2.8	0.0	0.0	−3.2	0.4
Public sector depreciation	15.5	16.2	0.8	0.0	0.0	0.8	0.0

Note: Figures may not sum due to rounding.

[2] http://www.hm-treasury.gov.uk/econmic_data_and_tools/finance_spanding_statistics/pes_publications/pespub_index.cfm

Table 4.3: Breakdown of Budget 2006 forecasting differences of public expenditure for 2006–07

				£ billion			
	Forecast	Outturn	Difference	of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Departmental Expenditure Limits							
Resource Budget	294.5	291.2	–3.3	0.0	0.0	–2.5	–0.9
Capital Budget	42.5	39.1	–3.4	0.0	0.0	–4.4	1.0
Less depreciation	–11.8	–9.9	1.9	0.0	0.0	1.0	0.9
Total Departmental Expenditure Limits	**325.2**	**320.4**	**–4.8**	**0.0**	**0.0**	**–5.8**	**1.0**
Annually Managed Expenditure	**227.1**	**229.7**	**2.6**	**1.0**	**0.5**	**0.8**	**0.3**
Total Managed Expenditure	**552.3**	**550.1**	**–2.2**	**1.0**	**0.5**	**–5.0**	**1.3**
of which:							
Public sector current expenditure	506.7	506.6	–0.1	1.0	0.5	–2.0	0.4
Public sector net investment	28.8	26.3	–2.5	0.0	0.0	–3.3	0.9
Public sector depreciation	16.8	17.2	0.3	0.0	0.0	0.3	0.0

Note: Figures may not sum due to rounding.

DEL in 2006-07

4.18 Provisional outturn spending (as explained in paragraph 4.6) for total DEL in 2006-07 was £320.4 billion, £4.8 billion below the Budget 2006 forecast of £325.2 billion. This difference between planned and outturn spending is equivalent to 1.5 per cent of forecast total DEL, or 0.4 per cent of GDP.

4.19 Resource DEL was £3.3 billion below the Budget 2006 plan, due to classification changes and lower than planned spending, mainly in the Department of Health and Department for Education and Skills (now the Department for Children, Schools and Families). Under the Government's EYF regime, both departments can carry forward underspending into future years.

4.20 Capital DEL was £3.4 billion less than the Budget 2006 forecast, largely due to fiscal forecasting differences. This was the result of lower than planned capital spending in the Department of Health, Department for Education and Skills and elsewhere. Unspent capital provision was carried forward through the Government's EYF scheme to maintain the Government's overall investment plans.

4.21 DEL depreciation was £1.9 billion higher than forecast, resulting from £0.9 billion of classification changes and £1.0 billion of fiscal forecasting differences, again as a result of higher depreciation figures from the Ministry of Defence.

AME FORECASTING DIFFERENCES

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

4.23 Tables 4.4 and 4.5 present a breakdown of forecasting differences in AME for 2005-06 and 2006-07 respectively. Forecast differences for a particular AME spending component are apportioned to one or more of the four types of forecast differences discussed previously. For AME as a whole, forecasting differences correspond to 0.6 and 0.2 per cent (£7.0 and £2.6 billion) of GDP in 2005-06 and 2006-07 respectively.

Table 4.4: Breakdown of Budget 2005 AME forecasting differences of public expenditure for 2005–06

	Forecast	Outturn	Difference	of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
				£ billion			
Annually Managed Expenditure							
Social security benefits[1]	127.3	127.4	0.1	0.0	0.1	–0.2	0.3
Tax credits	14.6	15.5	0.9	0.0	0.0	0.9	0.0
Net public service pensions[2]	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[3]	–	3.2	3.2	0.0	0.0	0.0	3.2
Other departmental expenditure	5.2	2.9	–2.3	0.0	0.0	–1.3	–1.0
Net expenditure transfers to EC Institutions[4]	4.7	4.4	–0.3	0.0	0.0	–0.3	0.0
Locally-financed expenditure	25.4	29.5	4.1	0.0	0.0	3.0	1.1
Central government gross debt interest	25.6	25.8	0.2	0.2	0.0	0.0	0.0
Public corporations' own-financed capital expenditure	2.3	5.1	2.9	0.0	0.0	0.3	2.6
Accounting adjustments	5.8	5.3	–0.5	0.0	0.0	0.2	–0.8
AME margin	1.0	0.0	–1.0	0.0	0.0	0.0	–1.0
Total Annually Managed Expenditure	**214.2**	**221.2**	**7.0**	**0.2**	**0.1**	**2.3**	**4.4**

[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] Net public service pensions expenditure is reported on a National Accounts basis.

[3] BBC domestic services was reclassified to the central government sector in Budget 2006.

[4] Gross National Income–based contributions less UK abatement.

Note: Figures may not sum due to rounding.

Table 4.5: Breakdown of Budget 2006 AME forecasting differences of public expenditure for 2006–07

	Forecast	Outturn	Difference	of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
				£ billion			
Annually Managed Expenditure							
Social security benefits[1]	131.5	131.8	0.3	0.0	0.1	0.2	0.0
Tax credits	15.6	16.3	0.7	0.0	0.0	0.7	0.0
Net public service pensions[2]	0.4	1.2	0.7	0.0	0.0	0.8	–0.1
National Lottery	1.7	1.7	0.0	0.0	0.0	0.0	0.0
BBC domestic services	3.3	3.3	0.0	0.0	0.0	0.0	0.0
Other departmental expenditure	3.6	2.7	–0.9	0.0	0.0	0.3	–1.2
Net expenditure transfers to EC Institutions[4]	5.4	4.7	–0.8	0.0	0.0	–0.8	0.0
Locally-financed expenditure	27.7	30.5	2.9	0.0	0.0	0.2	2.7
Central government gross debt interest	26.3	27.6	1.3	1.0	0.4	–0.1	0.0
Public corporations' own-financed capital expenditure	2.9	5.7	2.8	0.0	0.0	0.8	2.0
Accounting adjustments	7.7	4.3	–3.4	0.0	0.0	–1.3	–2.1
AME margin	1.0	0.0	–1.0	0.0	0.0	0.0	–1.0
Total Annually Managed Expenditure	**227.1**	**229.7**	**2.6**	**1.0**	**0.5**	**0.8**	**0.3**

[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] Net public service pensions expenditure is reported on a National Accounts basis.

[3] Gross National Income-based contributions less UK abatement.

Note: Figures may not sum due to rounding.

AME COMPONENT ANALYSIS

Social security benefits

4.24 Social security payments in 2005-06 were very close to forecast. The outturn includes an increase of £0.3 billion due to a definitional change: additional elements of social security spending, which were previously in other AME components are now included. This is offset by fiscal forecasting differences spread across a number of different benefits.

4.25 Outturn in 2006-07 was £0.3 billion higher than the Budget 2006 forecast. This is fully scored as a fiscal forecasting difference and is accounted for, in large part, by three particular benefits. Higher-than-anticipated Income Support caseload and amounts, and above-forecast claims for housing benefit, were partly offset by lower-than-expected payments on the State Pension.

Tax credits

4.26 The tax credits line includes spending by the Department for Work and Pensions on child allowances in Income Support and Jobseeker's Allowance, which will in due course be paid as Child Tax Credit. These child allowances are grouped together under tax credits, so that historical and future spending is on a consistent basis.

4.27 In 2005-06 tax credits expenditure was £0.9 billion higher than forecast and this is entirely apportioned to 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.

4.28 Outturn in 2006-07 was £0.7 billion above forecast, again because of fiscal forecasting differences. This primarily reflects new information on the effects of turnover among the tax credits population on income growth among tax credit recipients as a whole.

Net public service pensions

4.29 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 schemes.

4.30 In 2005-06 the outturn for net public service pensions was £0.4 billion lower than forecast, and this is scored as a fiscal forecasting difference. This difference was mainly due to lower-than-expected cash expenditure, and higher-than-expected receipts by the Principal Civil Service Pension Scheme (PCSPS). These effects were partially offset by higher expenditure from the NHS Pensions Scheme (NHSPS).

4.31 Outturn in 2006-07 was £0.7 billion higher than Budget 2006 forecast. This was due to higher-than-expected cash expenditure of £0.7 billion, £0.4 billion of which resulted from the NHSPS, and lower-than-anticipated NHSPS receipts of £0.3 billion.

National Lottery

4.32 The lottery outturn forecasts for 2005-06 and 2006-07 were both very close to outturn.

BBC domestic services

4.33 BBC domestic services was reclassified from the public corporations to the central government sector in January 2006 and has been a component of AME since Budget 2006. Given this change in treatment, a forecast is included in table 4.5 for 2006-07, but not in table 4.4 for 2005-06. Outturn in 2006-07 matched the Budget 2006 forecast.

Public corporations' own-financed capital expenditure

4.34 Public corporations' own-financed capital expenditure (PCOFCE) comprises the capital expenditure of public corporations, net of any capital expenditure already scored in DEL and net of any capital grants or loans given by a public corporation's parent department.

4.35 In 2005-06, PCOFCE outturn was £2.9 billion higher than the Budget 2005 forecast. Much of this can be explained by the reclassification of the Housing Revenue Account (£2.0 billion) from the local authority to the public corporations sector and of London and Continental Railways (£0.6 billion) from the private to the public sector, both scored as other factors.

4.36 In 2006-07, PCOFCE was £2.8 billion higher than Budget 2006 forecast, in large part, as with 2005-06, due to the reclassification of HRAs. This is offset by £0.8 billion of fiscal forecasting differences.

Other departmental expenditure

4.37 Outturn for other departmental expenditure in 2005-06 was £2.3 billion lower than forecast, £1.0 billion of which reflects two changes to the budgeting regime. Education Maintenance Allowances (EMA) were moved from AME into DEL at Budget 2007, and grants to local authorities in respect of some financial transactions were removed from AME (see paragraph 4.35 of 2006 EYFR). The remaining differences are accounted for by a number of relatively small changes, all due to fiscal forecasting.

4.38 For 2006-07, other departmental expenditure was £0.9 billion lower than forecast. As in 2005-06, £1.2 billion occurred as a result of changes to the budgeting regime.

Net expenditure transfers to EC Institutions

4.39 The outturn for net payments to EU institutions in 2005-06 was £0.3 billion lower than forecast, fully 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, which was some £0.4 billion lower than Budget 2005 forecast. This was partially offset by slightly higher-than-forecast contributions based on Gross National Income (GNI).

4.40 Outturn in 2006-07 was £0.8 billion lower than forecast, again scoring wholly as a fiscal forecasting difference. As with 2005-06, this was primarily due to the use of later data on the EC Budgets for 2006 and 2007, particularly in respect of the UK abatement. The abatement was some £0.7 billion higher than forecast, and there was also a reduction of £0.1 billion in UK GNI-based contributions compared to forecast.

Locally-financed expenditure

4.41 Local authority self-financed expenditure (LASFE) consists of local authority expenditure financed from council tax and other sources of finance, aside from central government grants.

4.42 The other factors differences in both 2005-06 and 2006-07 reflect two changes to the definition of LASFE. The first is the reduction in LASFE due to the reclassification of HRAs from the local authority sector to the public corporations sector (note the offsetting change in PCOFCE above), which occurred after Budget 2006. The second revision, which takes effect from the 2007 Pre-Budget Report, is a change to the definition of LASFE to remove adjustments that are applied to the local authorities' own data within the National Accounts. These adjustments are now included within the accounting adjustments component of AME. The result is that the LASFE figures now only reflect the data returned by local authorities to the Department for Communities and Local Government and the Devolved Administrations. This change better distinguishes local authorities' own data from the adjustments applied to those data within the National Accounts adjustments, and improves the transparency of the public finances

4.43 Fiscal forecasting differences in 2005-06 occurred mainly because of higher-than-expected levels of prudential borrowing, combined with higher-than-expected use of capital receipts, and an overall decline in the level of capital receipts from the sale of assets. In 2006-07, they resulted from a capital receipts shortfall.

Central government gross debt interest

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

4.45 In 2006-07, central government gross debt interest was £1.3 billion higher than Budget 2006 forecast. £1.0 billion of this difference resulted from higher-than-forecast uplift on index-linked debt, which is scored as an economic determinant difference, and

£0.4 billion from higher-than-forecast interest rates, which is scored as a difference arising from assumptions audited by the NAO. A minor offset arises from a lower than forecast financing requirement.

Accounting adjustments

4.46 The accounting adjustments reconcile the budgeting aggregates DEL and AME with the National Accounts definition of TME, removing items that score in DEL and AME but not in TME, and adding in items included in TME but not in DEL or AME. The other factors column shows changes in National Accounts adjustments which the Office for National Statistics (ONS) has made since the forecasts were compiled, and also includes offsets to changes in the definitions of DEL and AME, where there are relevant accounting adjustments.

4.47 In both 2005-06 and 2006-07, the classification changes scored as other factors are mainly the offsets to the changes in the AME LASFE definition described above, and in addition, a new National Accounts adjustment which the ONS introduced in June 2007 for local authorities' imputed subsidies for the injection of equity into HRAs. This increases TME by £1.4 billion in 2005-06 and £1.9 billion in 2006-07, but is offset by the additional HRA gross operating surplus within current receipts, and so is neutral across the public finances as a whole. More detail on this classification change can be found in paragraphs 3.32 and 3.33.

AME Margin

4.48 The year-ahead forecasts of AME for Budget 2005 and 2006 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 an other factor in the breakdown of forecasting differences.

A Assumptions used in Budget 2005 and Budget 2006

Table A.1: 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 recent 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	FTSE-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 outturnfor 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.

Table A.2: Budget 2006 – key assumptions audited by the National Audit Office

	Assumption used for Budget 2006
Dating of the cycle	The end date of the previous economic cycle was in the first half of 1997.
Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth	2½ per cent a year to 2006 and 2¼ per cent in the subsequent years.
UK claimant unemployment	Rising slowly to 0.97 million in 2007-08 from recent levels of 0.91 million.
Interest rates	3-month market rates change in line with market expectations (as of 10 March).
Equity prices	FTSE-All share index rises from 3004 (close 10 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	$57.4 a barrel in 2006, 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 2006, a share of 16 per cent is used for 2006-07 onwards

List of charts, tables and Abbreviations

List of Charts

2.1	General government net financial liabilities in G7 countries
2.2	Fiscal policy supporting monetary policy
2.3	Current budget deficit and net investment
2.4	PSNB forecast differences since 1970-71
2.5	1-year ahead absolute forecast differences for PSNB
2.6	2-year ahead absolute forecast differences for PSNB
2.7	Revised estimates of the output gap

List of Tables

2.1	Meeting the fiscal rules
2.2	Summary statistics for net borrowing forecast differences
2.3	Absolute average differences between forecast and outturn
2.4	Average forecast differences for UK net borrowing, 1997 to 2006
2.5	Convergence Programme forecasts – Differences between forecast and outturn, 1997 to 2006
2.6	Differences in Budget forecasts for main aggregates
2.7	Summary of differences in Budget forecasts
2.8	Breakdown of differences in the main fiscal aggregates
3.1	Summary of differences in Budget receipts forecasts
3.2	Breakdown of Budget 2005 forecasting differences of receipts for 2005-06
3.3	Breakdown of Budget 2006 forecasting differences of receipts for 2006-07
4.1	Summary of public expenditure forecasting differences for 2005-06 and 2006-07
4.2	Breakdown of Budget 2005 forecasting differences of public expenditure for 2005-06
4.3	Breakdown of Budget 2006 forecasting differences of public expenditure for 2006-07
4.4	Breakdown of Budget 2005 AME forecasting differences of public expenditure for 2005-06
4.5	Breakdown of Budget 2006 AME forecasting differences of public expenditure for 2006-07
A.1	Budget 2005 – key assumptions audited by the National Audit Office
A.2	Budget 2006 – key assumptions audited by the National Audit Office

List of Abbreviations

AME	Annually Managed Expenditure
BBC	British Broadcasting Corporation
CBO	Congressional Budget Office
CIPFA	Chartered Institute for Public Finance and Accountancy
CPI	Consumer Prices Index
CT	Corporation tax
DEL	Departmental Expenditure Limits
ECGD	Export Credit Guarantee Department
EMA	Education Maintenance Allowances
ESA95	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
GNI	Gross National Income
GSS	Government Statistical Service
HMRC	Her Majesty's Revenue and Customs
HRA	Housing Revenue Account
IMF	International Monetary Fund
LASFE	Local authority self-financed expenditure
LCR	London Continental Railways
MTIC	Missing Trader Intra-Community
NAO	National Audit Office
NHS	National Health Service
NHSPS	National Health Service Pensions Scheme
NICs	National insurance contributions
OECD	Organisation for Economic Cooperation and Development
ONS	Office for National Statistics
PAYE	Pay As You Earn
PC	Public corporations
PCOFCE	Public corporations' own-financed capital expenditure
PCSPS	Principal Civil Service Pension Scheme
PEOWP	Public Expenditure Outturn White Paper
PRT	Petroleum Revenue Tax
PSCE	Public sector current expenditure
PSNCR	Public sector net cash requirement

PSND	Public sector net debt
PSNB	Public sector net borrowing
PSNI	Public sector net investment
RPI	Retail Prices Index
TME	Total Managed Expenditure
VAT	Value added tax

ISBN 978-1-84532-332-5