

End of year fiscal report

December 2004



HM TREASURY



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ISBN: 1-84532-048-4

Printed by The Stationery Office 12/04 991160

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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 2002-03 and 2003-04, setting these in an historical context. The report analyses:

- €# performance against the fiscal rules and fiscal policy objectives; and
- €# differences between forecast and fiscal outturn for the year-ahead forecasts published in Budget 2002 and Budget 2003.

The report shows that the Government was meeting its fiscal rules in 2002-03 and 2003-04 while allowing fiscal policy to support monetary policy following a period of global economic uncertainty and weakness.

This report also examines the UK's forecasting performance in an historical context 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 on average lower than the year-ahead forecast, compared to before the new framework when outturns tended to be higher than forecast; and
- €# the UK's forecasting performance is comparable with that of other countries and international organisations: on average net borrowing outturns since 1998 have been lower than forecast for the UK while for many other European Union Member States outturn borrowing has been above forecast.

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 to ensure transparency by enhancing the Government's fiscal reporting and analysis. It is retrospective, describing fiscal developments for the previous two financial years, and setting these in 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

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

international best practice, including the International Monetary Fund's *Code of good practices on fiscal transparency*.²

1.4 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 when outturns are significantly different from forecasts.

Coverage 1.5 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.

1.6 This report examines the forecast performance in 2002-03 and 2003-04 together with the Government's historical forecasting performance. The detailed forecast analysis considers the Budget 2002 forecast for 2002-03 and the Budget 2003 forecast for 2003-04. The two year horizon strikes a balance between timely reporting of fiscal developments and the quality and robustness of data. Public finance data is open to revision for a considerable period after the end of the relevant financial year. In addition, the analysis presented in this report depends on macroeconomic data that is subject to revision for several years, as the data is refined on the basis of more comprehensive information.

1.7 The data and analysis presented here are therefore not final. This is particularly the case for the most recent year, 2003-04. Nonetheless, the information is sufficiently robust to provide a sound basis for forecast analysis. Future revisions, particularly for 2002-03, are more likely to change the detail rather than the main conclusions.

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

Forecast differences

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

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

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

- €# **NAO assumptions:** those differences that can be attributed to a divergence between the NAO-audited assumptions and their outturn.³ This would include the effects of the level of unemployment on social security spending or the oil price on receipts from North Sea taxes;
- €# **fiscal differences:** those that can be ascribed to changes in the relationship between the tax rate and tax base, and the receipts actually received. On the spending side, this would include differences between the forecast take up of benefits and the actual outturn, or differences between outturns and plans for DEL; and
- €# **other differences:** which includes a variety of factors, such as the impact of new measures announced in-year.

1.10 Chapter 2 provides a summary of developments from a macroeconomic perspective. It shows that the Government was meeting its strict fiscal rules in 2002-03 and 2003-04, despite the weaker than expected fiscal outturns resulting from the recent period of global uncertainty, which affected UK growth prospects and the composition of economic growth. The Government remains vigilant in the face of these risks and the public finances will continue to be based on cautious assumptions. Chapter 2 also examines the government's historical forecasting performance showing forecasting performance over time and compares the UK's forecasting performance with that of other countries and international organisations. Chapters 3 and 4 set out in more detail the analysis of projections for tax receipts and public spending.

³ A list of the NAO-audited assumptions for Budget 2002 and 2003 is shown in Annex B.

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 2002-03 and 2003-04:

- €# the Government was meeting its firm fiscal rules;
- €# the average surplus on the current budget since 1999-2000, which is the Government's provisional judgement on the start date of the current economic cycle, is positive and fully consistent with meeting the golden rule over the economic cycle; and
- €# public sector net debt remained under 33 per cent of GDP over this period, well below the 40 per cent limit of the sustainable investment rule.

This chapter also compares the UK's forecast performance historically and internationally. This analysis shows that:

- €# since the introduction of the new macroeconomic framework, the overall accuracy of year-ahead forecasts has been broadly unchanged. However, outturn public sector net borrowing has been on average lower than the year-ahead forecast, compared to before the new framework when outturns tended to be higher than forecast. This is in line with the move to using a cautious approach to projecting the public finances.
- €# the UK's forecasting performance is comparable with that of other countries and international organisations, and on average net borrowing outturns since 1998 have been lower than forecast for the UK while for many other European Union Member States outturn borrowing has been above forecast.

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 1999-2000, which is the Government's provisional judgement on the start of the current economic cycle, on the basis of the latest outturn information.

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 1999-2000 is positive, showing that the Government is meeting the golden rule.

Table 2.1: Meeting the fiscal rules

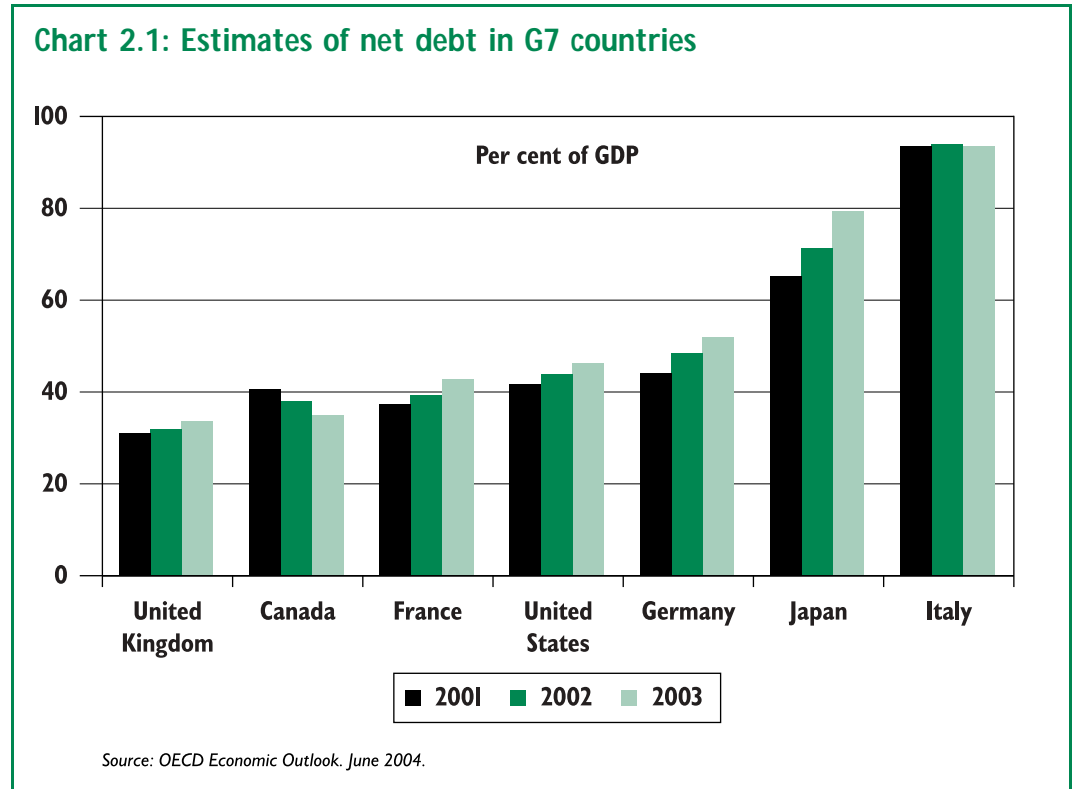
	Per cent of GDP				
	1999-00	2000-01	2001-02	2002-03	2003-04
Golden rule					
Surplus on current budget	2.1	2.1	0.9	-1.3	-1.9
Average surplus since 1999-00	2.1	2.1	1.7	1.0	0.4
Cyclically-adjusted surplus on current budget	1.9	1.6	0.7	-0.7	-1.0
Sustainable investment rule					
Public sector net debt	36.3	31.3	30.2	31.5	32.8
Core debt	35.7	31.3	30.5	31.1	31.6

Sustainable investment rule 2.7 The sustainable investment rule requires public sector net debt as a proportion of GDP to be held at a stable and prudent level over the 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 net debt has been comfortably below 40 per cent and, despite the weaker than expected fiscal outturns resulting from the recent period of global economic uncertainty, has

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 is described in Budget 2002.

risen only modestly between 2001-02 and 2003-04. It also shows core debt, which excludes the estimated impact of the economic cycle on net debt.²

2.8 Chart 2.1 shows that the recent global economic slowdown has had a significant impact on public finances throughout the world and many of the G7 economies have experienced rising debt-to-GDP ratios since 2000. The UK has had the lowest debt-to-GDP ratio in the G7 over this period.



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

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

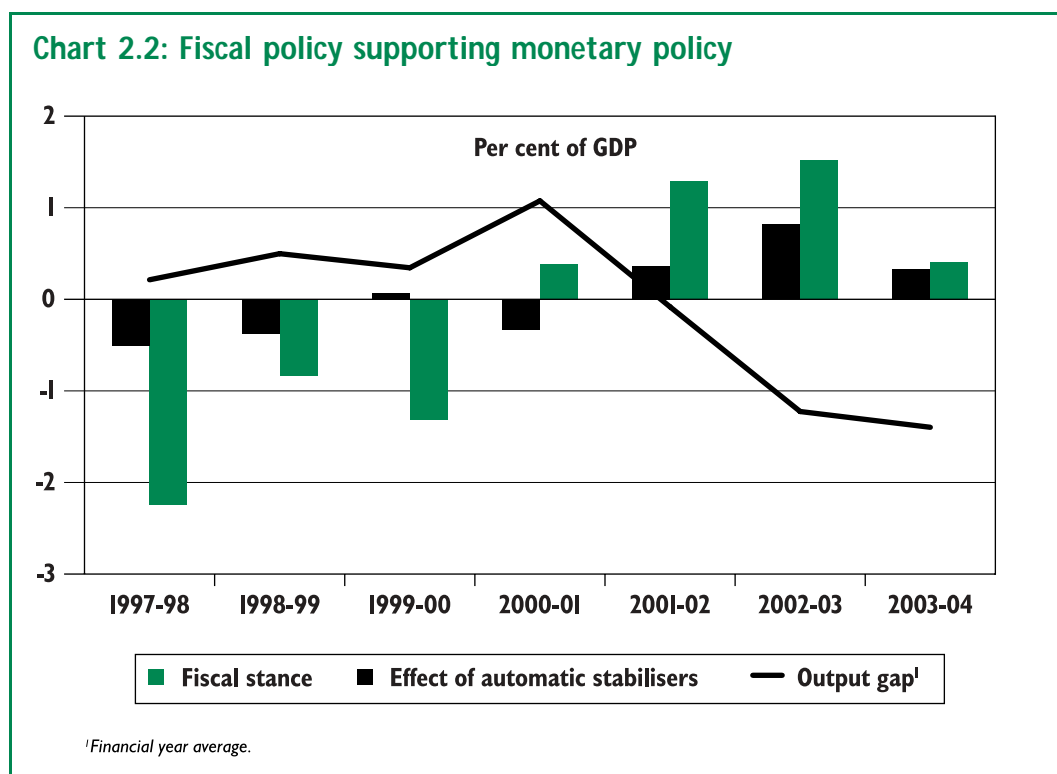
- £# the fiscal stance: that part of the change in public sector net borrowing (PSNB) resulting from changes in cyclically-adjusted PSNB; and
- £# the automatic stabilisers: that part of the change in PSNB resulting from cyclical movements in the economy.

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

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

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

2.13 Chart 2.2 shows the fiscal stance and the effect of the automatic stabilisers³ alongside the output gap since 1997. It shows how fiscal policy supported monetary policy during the late 1990s, when the economy was above trend, and the fiscal stance tightened supporting the effect of the automatic stabilisers. By contrast, since 2001-02, fiscal policy has – through both the fiscal stance and the automatic stabilisers – supported the economy as it operated below trend.



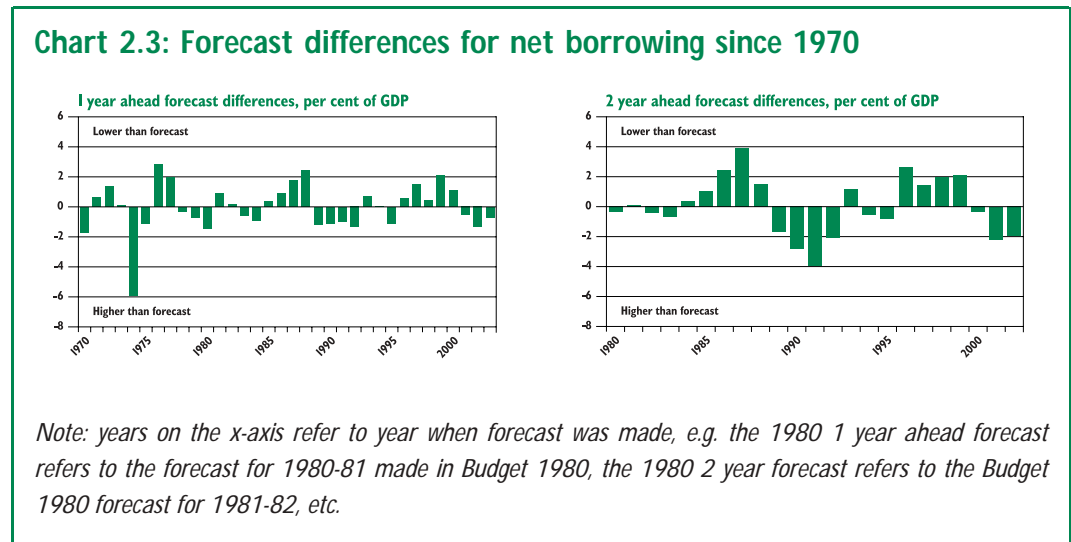
HISTORICAL FORECASTING PERFORMANCE

2.14 Projections for the public finances are subject to a considerable degree of uncertainty. This section considers the overall forecasting performance for public sector net borrowing. Since last year, the data available has increased as a result of additional research and a further year of outturn data.⁴

³ The fiscal stance is calculated by the year on year change in the cyclically-adjusted public sector net borrowing and the effect of the automatic stabilisers by the year on year change in public sector net borrowing less the year on year change in cyclically-adjusted net borrowing.

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

2.15 Chart 2.3 shows the available data. A positive forecast difference means that the outturn level of net borrowing is lower than forecast; it represents the case where the outturn is better than expected.



2.16 The data is summarised in Table 2.2 below. The main points to note are:

- ⌘ the overall accuracy of the forecasts has been broadly unchanged since the introduction of the new framework. The two year ahead average absolute forecast difference is larger than the year-ahead difference throughout the sample period, reflecting greater forecast uncertainty as the forecast horizon lengthens; and
- ⌘ the forecasts made since the introduction of the new framework have been on average cautious, as shown by the positive average differences of 0.4 and 0.2 per cent of GDP respectively. This was not the case before the new framework was introduced.

Table 2.2: Summary statistics for net borrowing forecast differences

	Whole sample	Per cent of GDP		Number of observations in whole sample
		Before new framework	New framework	
One year ahead forecasts				
Average absolute difference	1.2	1.2	1.1	34
Average difference	0.0	-0.1	0.4	
Two year ahead forecasts				
Average absolute difference	1.6	1.6	1.7	23
Average difference	0.0	0.0	0.2	

INTERNATIONAL COMPARISONS

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

Comparisons with the USA

2.18 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. To help ensure comparability with countries that have different revenues and expenditure as a share of GDP, the differences between forecast and outturn are expressed as a proportion of total revenues.

2.19 Table 2.3 suggests that the UK's forecasting performance is comparable to that of the CBO for the year ahead. The absolute average year ahead difference is 3 per cent of revenues in both the USA and the UK.⁵ The absolute average difference for the two, three and four-year ahead forecasts are smaller in the UK compared to the USA.

Table 2.3: Absolute average differences between forecast and outturn

	Per cent of outturn revenues					
	Year ahead	2 years ahead	3 years ahead	4 years ahead	5 years ahead	6 years ahead
USA, Congressional Budget Office	3.0	6.2	9.3	10.7	12.3	14.2
UK, HM Treasury	3.0	4.1	4.9	6.9		

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.

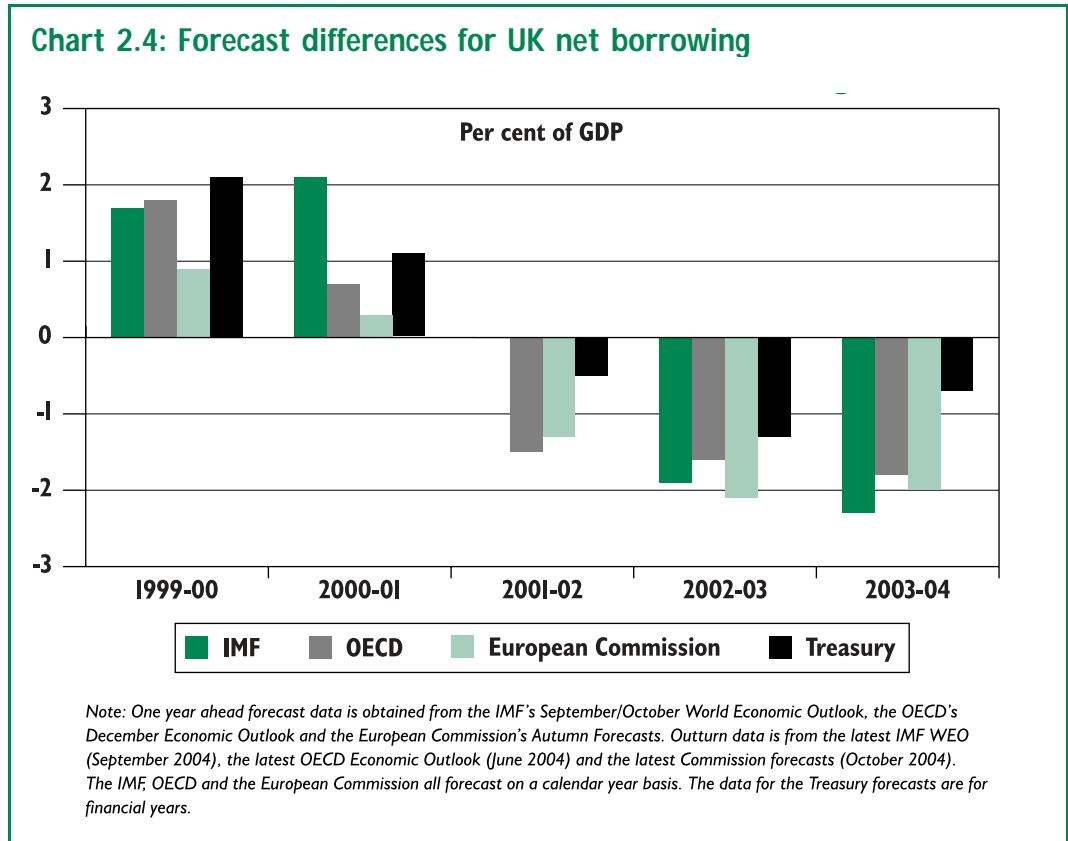
Source: US data from The Uncertainty of Budget Projections: A Discussion of Data and Methods, CBO April 2004 (<http://www.cbo.gov/showdoc.cfm?index=5396&sequence=0>)

International Organisations

2.20 Chart 2.4 below shows the forecast differences for the last 5 years for the UK's net borrowing (or the closest fiscal aggregate) as forecast by the OECD, IMF and European Commission.⁶ It also shows the Treasury's financial year forecast differences for public sector net borrowing. It shows that, in recent years, the Treasury's forecast differences have tended to be smaller than those of the OECD, IMF and European Commission.

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

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



2.21 Table 2.4 below reports the average forecast difference and the absolute average forecast difference over this five year period. The table shows that the Treasury has a good record both in terms of forecast accuracy – as indicated by the lowest absolute average forecast difference – and also in terms of caution, as indicated by the positive average forecast difference. It is important, however, to bear in mind the difficulty of making comparisons with and between international organisations.

Table 2.4: Forecast differences for UK net borrowing, 1999 to 2003

	Per cent of GDP	
	Absolute average difference	Average difference
Treasury	1.2	0.1
IMF	1.6	-0.1
OECD	1.5	-0.5
European Commission	1.3	-0.8

Comparisons with EU Member States

2.22 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 one year ahead forecast difference from 1997 to 2003 – using the year-ahead projections set down in Member States' annual Stability and Convergence Programmes. The average absolute difference for the UK is close to the mean and median for all fifteen countries. However, the average difference is positive for the UK which suggests that outturn net borrowing has tended to be lower than the UK's forecasts, while a number of countries have a negative average difference, suggesting outturns have tended to be higher than forecast.

Table 2.5: Differences between forecast and outturn, 1997 to 2003

	Per Cent of GDP	
	Absolute average difference	Average difference
Luxembourg	2.22	2.18
Finland	1.13	0.90
Belgium	0.78	0.78
UK	1.50	0.56
Ireland	1.87	0.43
Sweden	1.73	0.37
Netherlands	1.93	0.16
Denmark	0.82	-0.82
Spain	0.33	-0.03
Austria	0.26	-0.03
Germany	1.29	-0.26
France	0.72	-0.38
Italy	0.93	-0.50
Portugal	1.18	-1.18
Greece	2.58	-2.48

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. 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 (The information can be found at http://europa.eu.int/comm/economy_finance/publications/european_economy/1998/ee65_98en.pdf). European Commission AMECO data is used for the outturn data. For the UK, Eurostat outturn data is used on a financial year basis to be consistent with the forecasts.

FORECAST ANALYSIS FOR THE LAST TWO YEARS

2.23 Table 2.6 provides a summary comparison of the year-ahead projections for main fiscal aggregates in Budget 2002 and Budget 2003 compared with the latest outturn information.

Table 2.6: Differences in Budget forecasts for main aggregates

	Per cent of GDP					
	2002-03			2003-04		
	Budget 2002 Forecast	Outturn	Difference	Budget 2003 Forecast	Outturn	Difference
Surplus on current budget	0.3	-1.3	-1.6	-0.8	-1.9	-1.1
<i>Memo: average absolute difference, current budget, since 1998-99</i>			1.1			1.1
Cyclically-adjusted surplus on current budget	0.5	-0.7	-1.2	0.2	-1.0	-1.1
Public sector net borrowing	1.1	2.4	1.3	2.5	3.1	0.7
<i>Memo: average absolute difference, net borrowing, since 1970-71</i>			1.2			1.2
Cyclically-adjusted public sector net borrowing	0.9	1.8	0.9	1.5	2.2	0.6
Public sector net debt	30.2	31.5	1.4	32.2	32.9	0.7

2.24 The outturn for the current budget was a deficit of 1.3 per cent of GDP in 2002-03 and 1.9 per cent of GDP in 2003-04 compared to forecasts of a surplus of 0.3 and a deficit of 0.8 per cent of GDP respectively. The forecast differences of 1.6 per cent of GDP and 1.3 per cent of GDP compare with the average absolute one-year forecast difference of 1.1 per cent of GDP since 1998-99.

2.25 The outturn for net borrowing was 2.4 per cent of GDP in 2002-03 and 3.1 per cent of GDP in 2003-04 compared to forecasts of 1.1 per cent of GDP in 2002-03 and 2.5 per cent of GDP in 2003-04. The forecast differences of 1.3 per cent of GDP and 0.7 per cent of GDP are in line with the average absolute one-year forecast difference since 1970-71 of 1.2 per cent of GDP.

2.26 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 economy's position in the economic cycle, measured by the output gap. Any difference between forecast and outturn for the output gap therefore affects the public finances.

2.27 The outturn output gap for 2002-03 was more negative than the Budget 2002 forecast. The extent to which the economy would move below trend was underestimated, reflecting the impact of significant global uncertainties during this time. In 2003-04, the output gap developed broadly as in Budget 2003. Despite this, the composition of growth altered from that projected at the time of Budget 2003. In particular, growth in wages and salaries was lower than projected, which reduced receipts from income tax and national insurance contributions as described in Chapter 3.

2.28 Table 2.6 also shows that for 2002-03 and 2003-04, there was an easing of the fiscal stance compared to the forecasts in Budget 2002 and Budget 2003. The outturn for cyclically-adjusted net borrowing was 1.8 per cent of GDP for 2002-03 and 2.2 per cent for 2003-04 compared to forecasts of 0.9 per cent of GDP in Budget 2002 and 1.5 per cent in Budget 2003. The larger difference between outturn and forecast for non-cyclically adjusted net borrowing in 2002-03, suggests that the automatic stabilisers operated to a greater extent than forecast in Budget 2002, which is consistent with the unexpected change in the output gap discussed above.

2.29 In 2003-04, with the output gap broadly as forecast, all the forecast difference is attributed to the fiscal stance. However, as noted above, the Treasury's methodology for cyclical adjustment is based on the average impact of changes in the output gap on the public finances over previous cycles. To the extent that this cycle has been different from previous ones, temporary changes in the public finances might not be fully attributed to the effects of the economic cycle.

2.30 Table 2.7 provides more detailed information on the sources of difference. In 2002-03, receipts were £14 billion lower than forecast. In 2003-04 they were £9.6 billion lower, comparable with the average absolute difference in forecasting current receipts over the last 6 years. These differences are largely the result of lower than expected income tax as well as lower than projected corporation tax, as described in Chapter 3. In addition, around £3.3 billion of the difference in 2002-03 and around £2.6 billion in 2003-04 are due to reclassifications and policy changes introduced after the forecasts were prepared. These are largely fiscally neutral.

2.31 Outturn current expenditure in 2002-03 was £3.1 billion and £3.2 billion above forecast in 2002-03 and 2003-04 respectively. This includes additional resources to meet the UK's international commitments, as described in Chapter 4, and is consistent with the average absolute difference in forecasting current expenditure over the last 6 years. The outturn for depreciation was broadly in line with forecast for both years.

2.32 Net borrowing is equal to net investment less the surplus on the current budget. Outturn net investment was below forecast by £3.2 billion in 2002-03 and below forecast by £5.2 billion in 2003-04. There has, nevertheless, been a substantial increase in public sector net investment over the last two years. As explained in Chapter 4, unspent capital allocations were carried forward under the end-year flexibility (EYF) arrangements to maintain the Government's investment plans.

2.33 In both 2002-03 and 2003-04, the forecast difference for net borrowing was smaller than the forecast difference for the current budget, and comparable with the absolute average forecast difference over the past 30 years.

Table 2.7: Summary of differences in Budget forecasts

	£ billion					
	2002-03			2003-04		
	Budget 2002 forecast	Outturn	Difference	Budget 2003 forecast	Outturn	Difference
Current Budget						
Current receipts	407.2	393.2	-14.0	428.3	418.7	-9.6
<i>Memo: average absolute difference in current receipts since 1998-99¹</i>			8.5			8.9
Current expenditure	389.9	393.0	3.1	422.3	425.5	3.2
<i>Memo: average absolute difference in current expenditure since 1998-99¹</i>			3.2			3.3
Depreciation	14.0	14.1	0.1	14.4	14.3	-0.1
Surplus on Current Budget	3.2	-13.9	-17.2	-8.4	-21.1	-12.7
Capital budget						
Gross investment	32.2	29.7	-2.5	37.1	32.7	-4.4
Less asset sales	-3.8	-4.3	-0.6	-3.8	-4.7	-0.9
Less depreciation	-14.0	-14.1	-0.1	-14.4	-14.3	0.1
Net investment	14.4	11.3	-3.2	18.9	13.7	-5.2
Public sector net borrowing						
	11.1	25.2	14.0	27.3	34.8	7.5
<i>Memo: average absolute difference between forecast and outturn net borrowing since 1970-71¹</i>			12.7			13.4
Public sector net debt	325.8	342.0	16.2	366.9	376.0	9.1
Memo						
Treaty deficit ²	10.0	23.1	13.1	27.1	37.2	10.1
Treaty debt ³	388.1	399.8	11.7	432.6	441.4	8.8

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

2.34 Table 2.8 breaks down the differences between Budget forecast and outturn for the surplus on the current budget and net borrowing into the four categories described in Chapter 1. In both 2002-03 and 2003-04, the difference between forecast and outturn for receipts, and for the current budget and net borrowing was primarily due to

economic determinants and fiscal forecasting differences. More detail on receipts, and in particular on income tax and corporation tax can be found in Chapter 3.

Table 2.8: Breakdown of differences in the main fiscal aggregates¹

	£ billion	
	Budget 2002 forecast for 2002-03	Budget 2003 forecast for 2003-04
Current receipts difference	-14.0	-9.6
<i>contribution from:</i>		
Economic determinants	-2.7	-4.7
NAO-audited assumptions	0.0	3.5
Fiscal forecasting differences	-8.1	-5.8
Other	-3.3	-2.6
Current spending difference	3.1	3.2
<i>contribution from:</i>		
Economic determinants	-0.3	0.3
NAO-audited assumptions	-0.6	0.1
Fiscal forecasting differences	6.5	5.6
Other	-2.5	-2.8
Depreciation	0.1	-0.1
<i>contribution from:</i>		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	0.1	-0.1
Other	0.0	0.0
Current budget difference	-17.2	-12.7
<i>contribution from:</i>		
Economic determinants	-2.4	-5.0
NAO-audited assumptions	0.6	3.4
Fiscal forecasting differences	-14.7	-11.3
Other	-0.8	0.2
Net investment difference	-3.2	-5.2
<i>contribution from:</i>		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	-3.3	-5.0
Other	0.1	-0.2
Net borrowing difference	14.0	7.5
<i>contribution from:</i>		
Economic determinants	2.4	5.0
NAO-audited assumptions	-0.6	-3.4
Fiscal forecasting differences	11.4	6.3
Other	0.9	-0.4

¹ Contributions may not sum due to rounding

3

RECEIPTS

This chapter provides more detailed analysis of developments in receipts in 2002-03 and 2003-04. It shows that:

- current receipts rose from around £393 billion in 2002-03 to around £419 billion in 2003-04, providing resources for the Government's priorities; and
- in both years receipts were lower than originally forecast, largely reflecting lower growth in tax determinants, particularly company profits and income tax.

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

INTRODUCTION

3.1 This chapter provides more detailed analysis of developments in current receipts and, in particular, the forecasts made in Budget 2002 and Budget 2003. It analyses the overall forecasting differences, both in actual and cyclically-adjusted terms, before looking in detail at each of the main taxes.

Overall receipts forecasting differences

3.2 Table 3.1 shows the differences between the year-ahead forecasts of and outturns for receipts for Budget 2002 and Budget 2003. Current receipts were £393.2 billion in 2002-3, and rose to £418.7 billion in 2003-4. As a share of national income, receipts rose from 37.2 per cent of GDP to 37.5 per cent.

3.3 Current receipts were around £14 billion and £9.6 billion lower than forecast in 2002-03 and 2003-04. Tables 3.2 and 3.3 show that these differences are largely the result of lower than expected income tax, principally the result of lower than expected bonuses, as well as lower than projected corporation tax, including the result of lower than forecast growth in companies' profitability. This is described in more detail below. In addition, around £3.3 billion of the difference in 2002-03 and around £2.6 billion in 2003-04 are due to reclassifications and policy changes introduced after the forecasts were prepared. These are largely fiscally neutral.

Table 3.1: Summary of differences in Budget receipts forecasts

	Forecast	Outturn	Difference
Budget 2002 forecast of 2002-03			
Current receipts (£ billion)	407.2	393.2	-14.0
Current receipts (per cent of GDP)	38.7	37.2	-1.6
Cyclically-adjusted current receipts (per cent of GDP)	38.8	37.3	-1.5
Budget 2003 forecast of 2003-04			
Current receipts (£ billion)	428.3	418.7	-9.6
Current receipts (per cent of GDP)	38.6	37.5	-1.1
Cyclically-adjusted current receipts (per cent of GDP)	38.9	37.8	-1.1

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

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

TAX FORECASTING AND REASONS FOR DIFFERENCES

Tax forecasts and economic determinants

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

- ⚡ **economic determinants:** tax revenues, or more specifically tax bases (the transactions or assets on which the taxes are charged) are largely related to particular macroeconomic variables forecast by the Treasury. For example, income tax receipts are heavily dependent on levels of wages and salaries, and VAT receipts on consumers' expenditure. Any difference between the forecasts of these economic determinants used in the original tax forecasts and their eventual outturn values will partly explain differences between forecast and outturn tax receipts;
- ⚡ **audited assumptions:** many of the economic determinants described above are calculated using assumptions that are audited by the National Audit Office (NAO), ensuring that they remain both reasonable and cautious. The direct impacts of differences in the forecasts of these determinants with their outturn on the tax forecasts can be separately identified. This includes the impact of using a trend growth assumption that is one quarter of a percentage point below the Treasury's central case. These estimates will not include the second round effects of these audited assumptions, for example, the impact the interest rate assumption has on receipts through its impact on the RPI, which would be captured in the economic determinants line;
- ⚡ **fiscal forecasting difference:** in some cases, forecasts of the relevant economic variables for the tax base are not produced by the Treasury, and more aggregated economic variables have to be used. For example, the Treasury does not forecast consumers' expenditure on beer, which would be used to forecast beer duty receipts. In these cases, fiscal forecasting models are used to estimate the relationship between the most relevant macroeconomic variable (total consumers' expenditure in the case of beer) and the corresponding tax base. These models are also used to estimate actual tax receipts. Any differences in tax receipts resulting from unexpected changes in the relationship between main economic determinants, tax rates and revenues, as contained in the fiscal models, are therefore defined as fiscal forecasting differences. For example, if income tax receipts turned out to be higher than forecast even after taking account of differences in the

eventual level of wages and salaries, then there is a fiscal forecasting difference; and

€# **other:** differences in the economic determinants and the fiscal forecasting models are not the only potential source of forecasting errors. 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 2002 and Budget 2003 year-ahead forecasts for each of the main taxes. These tables also group the taxes to show the same breakdown for Inland Revenue receipts, HM Customs and Excise receipts, net taxes and national insurance contributions, and current receipts.

Tax by tax analysis

Income Tax 3.8 Gross income tax receipts for 2002-03 were £4.9 billion below the Budget 2002 forecast of £117.5 billion. Differences in forecasts of economic determinants caused £0.5 billion of the shortfall and this was mainly due to lower than expected growth in wages and salaries. The lower wages and salaries growth was partly offset by higher self-employment income. The remaining difference is attributable to fiscal forecasting differences of £4.4 billion. This was due to lower than expected bonuses going to higher rate taxpayers, resulting from the impact of the global economic slowdown and depressed equity markets on the financial sector, and lower than expected self-assessment tax receipts.

3.9 Gross income tax receipts for 2003-04 were £3.7 billion below the Budget forecast of £122.1 billion. Economic determinant differences account for £1.7 billion, mainly because of lower than expected growth in wages and salaries. This is partially offset by £0.3 billion scored to NAO-audited assumption differences.

3.10 The remaining difference of £2.2 billion is attributable to fiscal forecasting differences.¹ These differences again mainly reflected lower than expected bonuses. Although bonuses were higher than in the previous two years, the recovery was weaker than assumed in the Budget forecast. Another significant contributor to the fiscal forecasting difference was self assessment receipts.

Income tax credits 3.11 The £0.5 billion differences between the Budget 2002 forecast of income tax credits and the eventual outturn is largely due to a £0.5 billion difference in disaggregating the Working Families' Tax Credit and Disabled Person's Tax Credit between their negative tax and expenditure elements. This has no impact on the total level of public sector receipts, as there is an equal and opposite adjustment to the tax credits adjustments' line within table 3.2. In 2003-04 the negative tax element was £0.4 billion lower than forecast. This was mainly due to fiscal forecasting differences.

¹ Information from employers' end of year returns suggests that the fiscal forecasting difference is understated because of the re-allocation between national insurance contributions and PAYE.

Table 3.2: Breakdown of Budget 2002 forecasting differences of receipts for 2002-03

	Forecast	Outturn	Difference	£ billion			
				of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Inland Revenue							
Income tax (gross of tax credits)	117.5	112.6	-4.9	-0.5	0.1	-4.4	-0.1
Income tax credits ¹	-3.6	-3.1	0.5	0.0	0.0	0.5	0.0
Corporation tax ²	32.9	29.3	-3.5	-2.5	0.4	-1.4	0.1
Petroleum revenue tax	1.4	1.0	-0.4	-0.3	0.3	-0.4	0.0
Capital gains tax	1.8	1.6	-0.2	0.0	0.0	-0.1	-0.1
Inheritance tax	2.5	2.4	-0.1	0.1	-0.1	-0.1	0.0
Stamp duties	8.2	7.5	-0.7	0.9	-0.6	-0.9	0.0
National insurance contributions	65.0	64.6	-0.4	-0.7	0.1	0.1	0.0
Total Inland Revenue	225.6	215.8	-9.7	-2.9	0.0	-6.7	-0.1
Customs and Excise							
Value added tax	63.9	63.5	-0.4	-0.2	-0.2	0.0	0.0
Fuel duties	23.1	22.1	-0.9	0.4	-0.2	-0.9	-0.2
Tobacco duties	7.7	8.1	0.3	0.0	0.5	-0.1	0.0
Alcohol duties	7.3	7.3	0.0	-0.1	0.0	0.1	0.0
Other Customs and Excise	7.7	7.8	0.0	0.0	0.0	0.0	0.0
Total Customs and Excise	109.7	108.7	-1.0	0.0	0.1	-0.8	-0.2
Vehicle excise duties	4.5	4.3	-0.1	0.0	0.0	-0.1	0.0
Oil royalties	0.5	0.4	-0.1	-0.1	0.1	-0.1	0.0
Business rates	18.5	18.5	-0.1	0.0	0.0	-0.1	0.0
Council tax	16.1	16.9	0.8	0.0	0.0	0.8	0.0
Other taxes and royalties	10.7	10.2	-0.5	0.0	0.0	0.1	-0.6
Net taxes and national insurance contributions	385.6	374.9	-10.7	-3.0	0.2	-6.9	-0.9
Accruals adjustment on taxes	0.8	-0.6	-1.4	-0.2	-0.2	-1.0	0.0
less VAT and own resources EC contributions	-5.4	-4.4	1.0	0.5	0.0	0.5	0.0
less PC onshore CT payments	-0.2	-0.1	0.1	0.0	0.0	0.1	0.0
Tax credits adjustment ³	1.6	1.1	-0.5	0.0	0.0	-0.4	-0.1
Interest & dividends	4.2	4.5	0.3	0.0	0.0	0.3	0.0
Other receipts	20.6	17.7	-2.9	0.0	0.0	-0.6	-2.3
Current receipts	407.2	393.2	-14.0	-2.7	0.0	-8.1	-3.3

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

Table 3.3: Breakdown of Budget 2003 forecasting differences of receipts for 2003-04

	Forecast	Outturn	Difference	£ billion			
				of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Inland Revenue							
Income tax (gross of tax credits)	122.1	118.4	-3.7	-1.7	0.3	-2.2	0.0
Income tax credits ¹	-4.0	-4.4	-0.4	0.0	0.0	-0.4	0.0
Corporation tax ²	30.3	28.1	-2.2	-0.7	0.3	-1.8	0.0
Petroleum revenue tax	1.5	1.2	-0.3	-0.1	0.1	-0.3	0.0
Capital gains tax	1.2	2.2	1.0	0.0	0.0	1.1	-0.1
Inheritance tax	2.4	2.5	0.1	0.0	0.0	0.0	0.0
Stamp duties	7.9	7.6	-0.3	-0.5	0.2	-0.1	0.0
National insurance contributions	74.5	72.5	-2.0	-1.4	0.1	-0.7	0.0
Total Inland Revenue	235.8	228.0	-7.8	-4.4	1.1	-4.4	-0.1
Customs and Excise							
Value added tax	66.6	69.1	2.5	-0.1	1.7	0.8	0.0
Fuel duties	23.0	22.8	-0.2	0.1	-0.1	-0.3	0.0
Tobacco duties	8.0	8.1	0.1	0.0	0.7	-0.6	0.0
Alcohol duties	7.5	7.6	0.1	0.0	0.0	0.1	0.0
Other Customs and Excise	8.0	8.2	0.1	0.0	0.0	0.1	0.0
Total Customs and Excise	113.1	115.7	2.5	0.0	2.3	0.1	0.0
Vehicle excise duties	4.8	4.8	-0.1	0.1	0.0	-0.2	0.0
Oil royalties	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Business rates	18.6	18.3	-0.3	0.0	0.0	-0.3	0.0
Council tax	18.6	18.8	0.1	0.0	0.0	0.1	0.0
Other taxes and royalties	11.9	12.2	0.3	0.0	0.0	1.0	-0.7
Net taxes and national insurance contributions	402.9	397.7	-5.2	-4.3	3.4	-3.5	-0.9
Accruals adjustment on taxes less VAT and own resources EC contributions	3.6	2.8	-0.8	-0.2	0.0	-0.6	0.0
less PC onshore CT payments	-4.5	-4.6	-0.1	-0.1	0.0	0.0	0.0
less PC onshore CT payments	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Tax credits adjustment ³	0.6	0.6	0.0	0.0	0.0	0.0	0.0
Interest & dividends	4.0	4.4	0.3	0.0	0.0	0.3	0.0
Other receipts	21.8	17.9	-3.9	0.0	0.0	-2.1	-1.8
Current receipts	428.3	418.7	-9.6	-4.7	3.5	-5.8	-2.6

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

² Net of negative tax tax credits.

³ Tax credits that are classified as expenditure in the National Accounts but negative taxation in the calculation of net taxes and national insurance contributions.

Corporation Tax 3.12 Corporation tax receipts in 2002-03 were £3.5 billion below the Budget 2002 forecast. This difference was partly due to economic determinants such as financial company profit growth. The fiscal forecasting difference for on-shore companies was negative for both financial and non-financial companies, due to the variable used to forecast Double Taxation Relief. A different measure has since been adopted in order to improve the performance of the model. This was partially offset by a positive fiscal forecasting difference for life assurance companies, caused by the assumption that their corporation tax liabilities were solely driven by capital gains.

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

3.14 North Sea corporation tax receipts in 2002-03 were £0.1 billion higher than forecast. World oil prices in 2002 were higher than expected averaging \$25 per barrel, compared to the assumed level of \$21.5, derived using the methodology audited by the NAO. Fiscal forecasting differences arising from gas price changes and modelling refinements also contributed to receipts coming in above forecast. However these effects were largely offset by North Sea production being below profile. In 2003-4, North Sea corporation tax receipts were £0.1 billion below forecast. As in 2002-03, world oil prices were higher than expected (at \$28.9 per barrel compared with an assumed level of \$26.6 per barrel) However, this was offset by production being below profile and gas price changes, scored as fiscal forecasting differences.

Petroleum revenue tax

3.15 Receipts of petroleum revenue tax (PRT) in 2002-03 from the North Sea were £0.4 billion lower than forecast. Higher than expected oil prices brought in some additional yield but this was offset by both lower than expected North Sea production and fiscal forecasting differences due to modelling, which together contributed to receipts coming in below forecast.

3.16 Receipts of PRT in 2003-04 were also below forecast, by £0.3 billion. Oil production, which scores as a determinant effect was again lower than expected, but there was an offsetting effect from higher oil prices, scoring as NAO-audited assumptions differences. The fiscal forecasting differences were principally due to differences in modelling and changes in gas prices. Although the oil production and price effects were smaller, the pattern was very similar to 2002-03.

Capital gains tax and inheritance tax

3.17 Receipts from capital gains tax in 2002-03 were close to the forecast. The largest difference is due to fiscal forecasting differences, arising from differences in the levels of gains realised.

3.18 Receipts in 2003-04 were £1.1 billion above the Budget 2003 forecast. This difference is almost entirely due to fiscal forecasting differences arising from larger than expected disposals of business assets, itself a result of larger than expected behavioural effects arising from the maturing of the business asset taper in 2002-03.

3.19 Inheritance tax receipts were slightly below forecast in 2002-03 and marginally above forecast in 2003-04.

Stamp duties

3.20 In 2002-03 stamp duty receipts were £0.7 billion below the Budget 2002 forecast. This was largely due to the lower receipts from stamp duty on equity transactions, almost entirely resulting from lower than projected equity prices (scored under NAO-audited assumptions). As for stamp duty on land and property, property prices were higher than expected, the effect of which is scored under economic determinants. The fiscal forecasting difference was mainly caused by the Budget 2002-03 forecast assumption that commercial prices would grow in line with residential property prices, as well as the assumption that growth in both sectors was uniform across the UK.

3.21 In 2003-04 stamp duty receipts were £0.3 billion lower than forecast. This was largely due to lower than expected receipts from stamp duty on land and property. For Budget 2003 the model was improved so that the commercial market was forecast separately, as a result, commercial prices are scored as economic determinant

differences. Commercial prices still turned out to be lower than expected in Budget 2003 and this accounts for almost all of the shortfall in receipts from stamp duty on land and property. Although there was no separate regional forecasting the effect of different regional growth of commercial and house property prices was better understood and accounted for in the modelling process. The outturn for stamp duty on shares was higher than expected, mainly due to higher than expected equity prices (scored under NAO-audited assumptions).

National insurance contributions **3.22** Receipts of national insurance contributions in 2002-03 were £0.4 billion lower than the Budget 2002 forecast. Most of this difference was due to lower than forecast wages and salaries, which is scored under economic determinants. The fiscal forecasting difference was only £0.1 billion.

3.23 In 2003-04 receipts from national insurance contributions were £2.0 billion below the Budget 2003 forecast. The economic determinants difference was of £1.4 billion while the difference due to fiscal forecasting was £0.7 billion.²

Value added tax **3.24** VAT receipts in 2002-03 were £0.4 billion below their Budget 2002 forecast. This was due in part to lower than expected growth in consumers' expenditure, which is attributed to economic determinants. In addition the ratio of underlying VAT receipts (VAT receipts adjusted for the changes in rates and coverage) to consumers' expenditure fell by slightly more than was forecast under the NAO-audited assumption.

3.25 VAT receipts in 2003-04 were £2.5 billion above the Budget 2003 forecast. This was largely driven by the £1.7 billion difference caused by the NAO-audited assumption for projecting the ratio of VAT receipts to underlying consumer expenditure. Under this assumption, the ratio was forecast to decline, but its outturn was a large increase. This was partially offset by the difference scored under economic determinants and the small difference scored under fiscal forecasting difference. The VAT forecasting assumption was replaced in Budget 2004 with a new NAO-audited assumption for projecting the VAT gap, coupled with a projection of the theoretical VAT liability,³ which is described in Annex A.

Fuel Duties **3.26** Fuel duties in 2002-03 were £0.9 billion below their Budget 2002 forecast. Oil prices turned out higher than they were forecast by the NAO-audited assumption, and higher pump prices meant that outturn demand for road fuels, and therefore revenues from fuel duties were lower. The main cause of the difference was, however, due to fiscal forecasting differences, a result of the poor performance of the forecasting model and in this case, the petrol model. The remaining £0.2 billion difference was caused by the late Budget.

3.27 In 2003-04 receipts from fuel duties were £0.2 billion below their forecast at Budget 2003. Higher oil prices than forecast by the NAO-audited assumption explain around £0.1 billion of the forecast difference. A new forecasting model was introduced in Budget 2003 leading to a substantial reduction in the fiscal forecasting difference.

Tobacco duties **3.28** In 2002-03 tobacco duties were £0.3 billion higher than forecast in Budget 2002. This was largely because of the NAO-audited assumption for projecting the smuggled share of cigarettes, which meant that the forecast assumed a smuggled share of 25 per cent, whereas the outturn fell to 15 per cent. The lower than forecast smuggled share generated a difference of £0.5 billion, and is scored under assumptions audited by the

² This could be overstated because of subsequent re-allocation between income tax and national insurance contributions.

³ Audit of Assumptions for Budget 2004, 17 March (HC434).

NAO. As a consequence of the effectiveness of the anti-smuggling strategy, the tobacco smuggled share assumption was changed and was audited by the NAO at the time of Budget 2003.

3.29 Tobacco receipts in 2003-04 were £0.1 billion higher than the Budget 2003 forecast, which used the new smuggled share assumption. As in 2002-03, the NAO-audited smuggled market share assumption contributed a significant element of the difference, around £0.7 billion. The assumption projected the smuggled share at 21 per cent,⁴ but the outturn was 15 per cent. The resulting difference is largely attributable to differences in fiscal forecasting.

Alcohol duties 3.30 Alcohol duty receipts in both 2002-03 and 2003-04 were close to their respective Budget 2002 and Budget 2003 forecasts. In 2002-03, lower than expected receipts from economic determinants were largely offset by greater than expected receipts from fiscal forecasting differences. In 2003-04 both economic determinants and fiscal forecasting differences caused receipts to be slightly higher than forecast.

Other HM Customs and Excise 3.31 Receipts from other HM Customs and Excise taxes were close to their respective one-year ahead forecasts in 2003-04, and very close in 2002-03.

Vehicle excise duty 3.32 VED receipts were marginally below forecast in both 2002-03 and 2003-04.

Council tax 3.33 Council tax receipts in 2002-03 were £0.8 billion higher than projected in Budget 2002. This is attributable to fiscal forecasting differences and is mainly due to higher than projected growth in the council tax base assumed by local authorities. Council tax receipts in 2003-04 were slightly higher than projected.

Other taxes and royalties 3.34 In 2002-03, the difference between the forecast and the outturn receipts of other taxes and royalties was negative, mainly driven by a fall in VAT refunds. This was largely due to the reclassification of NHS Trusts, from the public corporation sector to the central government sector, which had the effect of reducing both receipts and expenditure by about £0.6 billion. This reclassification was introduced by ONS in the Blue Book 2004 and scores as 'other'.

3.35 In 2003-04, there was a positive forecast difference. The reclassification of the NHS Trusts had a negative effect of £0.7 billion. This was, however, more than offset by fiscal forecasting differences in VAT refunds, miscellaneous taxes and statistical adjustments.

Accruals adjustments 3.36 In 2002-03 the forecast difference in the accruals adjustment was due to lower accrued levels of business rates, as well as income tax and national insurance contributions. In 2003-04 the biggest component of the difference was due to lower accrued levels of income tax, but this was largely offset by positive differences in other components, because of re-allocations between PAYE and class 1 national insurance contributions.

Other receipts 3.37 Other receipts consists of gross operating surplus and rent, including accruals adjustments of the proceeds from the auction of spectrum licences, current transfers from households, general government rent receipts (excluding oil royalties) and statistical adjustments.

⁴ Annex B lists the NAO-audited assumptions for Budget 2002 and Budget 2003.

3.38 In 2002-03 'other receipts' were £2.9 billion lower than originally forecast. This was largely due to changes introduced by the Office of National Statistics in the 2003 and 2004 Blue Books in the definition of taxes. The definition of current receipts was changed so that they no longer included business rates paid by local authorities. This reduced receipts by about £0.9 billion and was matched by a corresponding reduction in local authority expenditure, such that there is no overall fiscal impact. The 2004 Blue Book reclassification of NHS Trusts has no effect on the public sector overall, but does reduce the public sector gross operating surplus by £0.8 billion and miscellaneous transfers by £0.6 billion. These changes are scored as 'other', matched by a corresponding difference in spending. The fiscal forecasting difference was mainly due to lower than forecast receipts from the gross operating surplus, certain other components and statistical adjustments.

3.39 Other receipts' in 2003-04 were £3.9 billion below forecast. As in 2002-03, changes in the definition of taxes make up a large proportion of this difference. The redefinition of local authorities business rates contributed £0.8 billion. The reclassification of NHS Trusts contributed £0.9 billion to the difference. The fiscal forecasting difference was due to lower than forecast receipts from the public sector gross operating surplus, some other small components and statistical adjustments.

4

PUBLIC EXPENDITURE

This chapter provides a detailed analysis of public expenditure in 2002-03 and 2003-04. It shows that:

- €# forecasts of spending have been close to outturn in each financial year: the difference between forecast and outturn was negligible in 2002-03 and 0.2 per cent of GDP in 2003-04;
- €# the Government continues to reduce the costs of social and economic failure: debt interest and social security benefit payments have continued to fall from 31 per cent of total spending in 2002-03 to 30 per cent of total spending in 2003-04, releasing additional resources for priority public services; and
- €# there was a substantial increase in public sector net investment over the past two years, addressing the historic under-investment in public services.

4.1 This chapter provides a more detailed examination of trends and developments in public expenditure in 2002-03 and 2003-04 and, in particular, differences between projected expenditure and outturn for the year ahead projections in Budgets 2002 and 2003.

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

4.3 For budgeting purposes, TME is divided into:

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

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

4.5 For Budget 2002, DEL expenditure for 2002-03 was based on the levels planned under the budgeting basis used for the 2000 Spending Review. This was a hybrid of the cash budgeting used prior to Spending Review 2000 and resource budgeting. Full resource budgeting was introduced in Spending Review 2002 and is used as a basis for Budget 2003 DEL numbers.

4.6 Data on public spending remains provisional for a considerable period after the end of the relevant financial year. For example, resource accounts for central government departments are finalised nine months after the end of the year, while consolidated data for local authorities is produced over a longer time scale. That means that the data in this chapter, particularly for 2003-04, is not final. The information is however, sufficiently robust to allow analyses of forecasting differences, with future revisions likely to change the detail rather than the main conclusions.

OVERALL PUBLIC EXPENDITURE FORECASTING DIFFERENCES

4.7 Table 4.1 shows the latest outturn for key public spending aggregates for 2002-03 and 2003-04, including a comparison of the differences in the year-ahead forecasts for spending in Budgets 2002 and 2003. TME rose to £453.6 billion or 41 per cent of GDP in 2003-04.

4.8 The table shows that investment has increased in nominal terms by 21 per cent between 2002-03 and 2003-04. The rise in investment reflects the Government's determination to address the historic under-investment in public services.

Forecast differences in 2002-03

4.9 In 2002-03, TME was close to forecast. Public sector current expenditure was £3.1 billion higher than forecast, largely due to higher than projected resource expenditure in DEL, discussed in more detail below. Public sector net investment was £3.2 billion less than projected due to lower capital expenditure in DEL and AME. The latter reflected, in part, lower locally-financed capital expenditure and lower expenditure by the National Lottery.

Forecast differences in 2003-04

4.10 In 2003-04, TME was £2.1 billion below forecast. Public sector current expenditure was £3.2 billion higher than forecast. Public sector net investment was £5.2 billion lower than projected due to lower capital expenditure in DEL and AME.

Table 4.1: Summary of public expenditure forecasting differences

	£ billion					
	2002-03			2003-04		
	Forecast	Outturn	Difference	Forecast	Outturn	Difference
Total Managed Expenditure						
<i>of which:</i>						
Public sector current expenditure	389.9	393.0	3.1	422.3	425.5	3.2
Public sector net investment	14.4	11.3	-3.2	18.9	13.7	-5.2
Public sector depreciation	14.0	14.1	0.1	14.4	14.3	-0.1
Total Managed Expenditure	418.4	418.4	0.0	455.7	453.6	-2.1
<i>of which:</i>						
Departmental Expenditure Limits						
Resource Budget	201.2	204.9	3.7	249.1	250.5	1.4
Capital Budget	28.3	28.1	-0.2	25.1	23.2	-1.9
Depreciation ¹				-10.4	-9.2	1.2
Total Departmental Expenditure Limits	229.5	233.0	3.6	263.8	264.6	0.8
Total Annually Managed Expenditure	188.9	185.3	-3.6	191.9	189.0	-2.9

¹ Depreciation was in AME in 2002-03.

Note: Figures may not sum due to rounding.

SPENDING FORECASTS AND REASONS FOR DIFFERENCES

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

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

DEL FORECASTING DIFFERENCES

4.12 Tables 4.2 and 4.3 provide a breakdown of TME forecasting differences for 2002-03 and 2003-04 respectively. Differences between outturn and plans reflect the difference between the planned limits for departmental expenditure and the actual expenditure – such differences are treated as ‘fiscal forecasting differences’ with the exception of classification changes and discretionary changes, including allocations made from the special reserve, which are treated as ‘other’ differences.

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

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

Table 4.2: Breakdown of Budget 2002 forecasting differences for public expenditure for 2002-03

	Forecast	Outturn	Difference	£ billion			
				of which:			
				Economic Determinants	Assumptions Audited by the NAO	Fiscal Forecasting Differences	Other
Departmental Expenditure Limits							
Resource Budget	201.2	204.9	3.7	0.0	0.0	3.0	0.7
Capital Budget	28.3	28.1	-0.2	0.0	0.0	-0.3	0.1
Total Departmental Expenditure Limits	229.5	233.0	3.6	0.0	0.0	2.7	0.8
Annually Managed Expenditure	188.9	185.3	-3.6	-0.3	-0.6	0.5	-3.2
Total Managed Expenditure	418.4	418.4	0.0	-0.3	-0.6	3.2	-2.4
<i>of which:</i>							
Public sector current expenditure	389.9	393.0	3.1	-0.3	-0.6	6.5	-2.5
Public sector net investment	14.4	11.3	-3.2	0.0	0.0	-3.3	0.1
Public sector depreciation	14.0	14.1	0.1	0.0	0.0	0.1	0.0

Note: Figures may not sum due to rounding.

Table 4.3: Breakdown of Budget 2003 forecasting differences for public expenditure for 2003-04

	Forecast	Outturn	Difference	£ billion			
				of which:			
				Economic Determinants	Assumptions Audited by the NAO	Fiscal Forecasting Differences	Other
Departmental Expenditure Limits							
Resource Budget	249.1	250.5	1.4	0.0	0.0	0.5	0.9
Capital Budget	25.1	23.2	-1.9	0.0	0.0	-1.7	-0.2
Depreciation	-10.4	-9.2	1.2	0.0	0.0	1.2	0.0
Total Departmental Expenditure Limits	263.8	264.6	0.8	0.0	0.0	0.0	0.7
Annually Managed Expenditure	191.9	189.0	-2.9	0.3	0.1	0.5	-3.7
Total Managed Expenditure	455.7	453.6	-2.1	0.3	0.1	0.5	-2.9
<i>of which:</i>							
Public sector current expenditure	422.3	425.5	3.2	0.3	0.1	5.6	-2.8
Public sector net investment	18.9	13.7	-5.2	0.0	0.0	-5.0	-0.2
Public sector depreciation	14.4	14.3	-0.1	0.0	0.0	-0.1	0.0

Note: Figures may not sum due to rounding.

DEL in 4.14 Actual spending on total DEL was £233.0 billion, or some £3.6 billion above the **2002-03** forecast set out in Budget 2002 of £229.5 billion. The difference between plans and outturn is equivalent to 1.5 per cent of forecast total DEL or 0.3 per cent of GDP.

4.15 Spending on resource DEL was £3.7 billion above the Budget 2002 forecast. Of this, £3.0 billion was ascribed to fiscal forecasting differences, and £0.7 billion to other, including an offset of £0.4 billion from classification changes. In part, the difference arose from the additional provision made available to meet the costs of the UK's international commitments over this period in Iraq and elsewhere. In Budget 2003, the Government made a special contingency provision to meet the costs of the military conflict in Iraq and £1 billion was allocated to the Ministry of Defence DEL in 2002-03.

4.16 The outturn for capital DEL was only £0.2 billion below the Budget 2002 forecast, or 0.7 per cent of total capital DEL.

DEL in 2003-04

4.17 The provisional outturn for total DEL spending in 2003-04 is £264.6 billion, or some £0.8 billion above the forecast of £263.8 billion set out in Budget 2003. The difference between forecast and provisional outturn amounts to 0.3 per cent of forecast total DEL or 0.1 per cent of GDP.

4.18 The provisional outturn for resource DEL is £1.4 billion above the Budget 2003 forecast. This comprises £0.5 billion due to fiscal forecasting differences and £0.9 billion, including £0.2bn of classification changes, scored as other. Around £0.7 billion of the difference relates to a decision in the 2003 Pre-Budget Report to increase the resources available for the UK's continuing international commitments, and is scored under other. In addition, spending on transport was around £0.5 billion higher than originally planned and financed by additional resources.

4.19 The outturn for capital DEL was £1.9 billion below the Budget 2003 forecast due mainly to fiscal forecasting changes. Capital spending by the Department of Health was some £0.4 billion lower than forecast. In addition, capital spending on transport, Scotland and defence also fell below forecast. Unspent capital allocations were carried forward under the EYF arrangements to maintain the Government's investment plans.

4.20 In addition, DEL depreciation was £1.2 billion above the Budget 2003 forecast. This was almost entirely due to fiscal forecasting differences. The year 2003-04 was the first year in which departments' resource DELs had included all depreciation costs. These had previously scored mainly in Annually Managed Expenditure.

AME FORECASTING DIFFERENCES

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

4.22 Tables 4.4 and 4.5 present a breakdown of forecasting differences in AME for 2002-03 and 2003-04 respectively. Forecast differences for a particular AME spending component are apportioned to one or more of the four types of forecast differences discussed above. Forecasting differences correspond to 0.3 and 0.2 per cent (£3.6 and £2.9 billion respectively) of GDP in 2002-03 and 2003-04 respectively. After subtracting the differences due to reclassifications and policy changes scored as other factors, total AME spending was just £0.4 billion lower than forecast in 2002-03 and £0.8 billion higher in 2003-04.

Table 4.4: Breakdown of Budget 2002 AME forecasting differences for 2002-03

	Forecast	Outturn	Difference	£ billion			
				of which:			
				Economic Determinants	Assumptions Audited by the NAO	Fiscal Forecasting Differences	Other
Annually Managed Expenditure							
Social security benefits	109.0	108.9	-0.1	0.0	-0.1	0.1	0.0
Housing Revenue Account Subsidies	4.5	5.2	0.7	0.0	0.0	0.7	0.0
Common Agricultural Policy	2.6	2.6	0.0	0.0	0.0	0.0	0.0
Export Credits Guarantee Department	0.4	0.1	-0.3	0.0	0.0	-0.3	0.0
Self-financing public corporations' capital expenditure	1.2	0.8	-0.4	0.0	0.0	-0.4	0.0
Net public service pensions	5.1	4.3	-0.8	0.0	0.0	-0.8	0.0
National Lottery	2.3	1.8	-0.5	0.0	0.0	-0.5	0.0
Other departmental expenditure	0.1	2.7	2.6	0.0	0.0	2.6	0.0
Net payments to EC institutions	2.2	2.3	0.1	0.0	0.0	0.1	0.0
Locally financed expenditure	20.7	20.4	-0.3	0.0	0.0	-0.3	0.0
Central Government gross debt interest	21.1	20.8	-0.3	-0.3	-0.5	0.5	0.0
Accounting Adjustments	18.7	15.3	-3.4	0.0	0.0	-1.2	-2.2
AME margin	1.0	0.0	-1.0	0.0	0.0	0.0	-1.0
Total Annually Managed Expenditure	188.9	185.3	-3.6	-0.3	-0.6	0.5	-3.2

¹ In Budget 2002, the other departmental expenditure line included a number of items that did not score a expenditure under national accounts definitions, and these items were adjusted out in accounting adjustments. In order to provide a clearer breakdown of the reasons for differences between forecast and outturn expenditure, these items have been removed from the figures in this table. For the same reason, non-cash items, which were shown separately in table C11 of Budget 2002, have also been removed from this table and the accounting adjustments. Forecast figures for the other departmental expenditure and accounting adjustments line therefore do not match those published in the 2002 Budget.

Note: Figures may not sum due to rounding.

Table 4.5: Breakdown of Budget 2003 AME forecasting differences for 2003-04

	Forecast	Outturn	Difference	£ billion			
				of which:			
				Economic Determinants	Assumptions Audited by the NAO	Fiscal Forecasting Differences	Other
Annually Managed Expenditure							
Social security benefits	111.0	112.4	1.4	0.0	0.0	1.6	-0.2
Tax credits	11.7	13.3	1.6	0.1	0.0	1.5	0.0
Housing Revenue Account Subsidies	4.3	4.3	0.0	0.0	0.0	0.0	0.0
Common Agricultural Policy	2.3	2.9	0.6	0.0	0.0	0.6	0.0
Public corporations' own-financed capital expenditure	2.6	2.5	-0.1	0.0	0.0	-0.1	0.0
Net public service pensions	0.2	1.8	1.6	0.0	0.0	1.6	0.0
National Lottery	2.2	1.9	-0.3	0.0	0.0	-0.3	0.0
Other departmental expenditure	2.2	2.3	0.1	0.0	0.0	0.1	0.0
Net payments to EC institutions	2.3	2.4	0.1	0.0	0.0	0.1	0.0
Locally financed expenditure	23.0	20.6	-2.3	0.0	0.0	-2.3	0.0
Central Government gross debt interest	21.8	22.2	0.4	0.2	0.1	0.1	0.0
Accounting adjustments	7.2	2.4	-4.9	0.0	0.0	-2.4	-2.5
AME margin	1.0	0.0	-1.0	0.0	0.0	0.0	-1.0
Total Annually Managed Expenditure	191.9	189.0	-2.9	0.3	0.1	0.5	-3.7

¹ In Budget 2003, the other departmental expenditure line included a number of items that did not score as expenditure under national accounts definitions, and these items were adjusted out in accounting adjustments. In order to provide a clearer breakdown of the reasons for differences between forecast and outturn expenditure, these items have been removed from the figures in this table. For the same reason, non-cash items, which were shown separately in table C11 of Budget 2003, have also been removed from this table and the accounting adjustments. Forecast figures for the other departmental expenditure and accounting adjustments line therefore do not match those published in the 2003 Budget.

Note: Figures may not sum due to roundings.

AME COMPONENT ANALYSIS

Social security benefits 2002-03 **4.23** The outturn for social security payments in 2002-03 was £0.1 billion lower than the Budget 2002 forecast. Lower than expected spending, scored under NAO-audited assumptions was offset by higher than expected spending, scored under fiscal forecasting differences.

4.24 Forecasting differences due to NAO-audited assumptions resulted from the outturn claimant unemployment count being lower than assumed at the time of Budget 2002. This led to lower expenditure than forecast, mainly on the Jobseeker's Allowance.

4.25 Fiscal forecasting differences occurred mainly due to a combination of higher than forecast spending on Rent Allowance, Minimum Income Guarantee and Disability Living Allowance. The difference for Rent Allowance was due to an underestimate of the rise in Housing Association rents, with expenditure related to housing support costs growing sharply in the run up to the transfer of the responsibility for such costs to the Supporting People scheme. This was, however, partly offset by lower than forecast expenditure on Council Tax Benefit and Income Support, due to the respective caseloads being lower than expected.

Social security benefits 2003-04 **4.26** Outturn figures for 2003-04 are preliminary. The estimated outturn for social security payments was £1.4 billion above the Budget 2003 forecast. This difference was mainly attributed to fiscal forecasting differences.

4.27 Fiscal forecasting differences arose principally due to a combination of higher than forecast spending on Rent Allowance, Attendance Allowance and Statutory Maternity Pay. Rent Allowance was greater than forecast as the previous year's higher spending had not been passed through fully to the 2003-04 baseline. Attendance Allowance and Statutory Maternity Pay expenditure were above forecast due to a higher than anticipated take up of benefits at Budget 2003.

Tax credits 4.28 To take account of the introduction of the Child Tax Credit and Working Tax Credit in April 2003, separate figures for the spending element of tax credits were published for the first time in Budget 2003 in order to give a consistent time series. These figures included spending on child allowances in Income Support and Jobseeker's Allowance, which will in due course be paid as Child Tax Credit.

4.29 Expenditure related to tax credits was £1.6 billion higher than forecast in 2003-04. Economic determinants accounted for £0.1 billion of the forecast difference, namely, assumptions on earnings growth, which is a key determinant for tax credit forecasts. The remaining difference was attributed to fiscal forecasting differences (£1.5 billion). Fiscal forecasting differences arose due to an under-estimate in the number of working families entitled to relatively high levels of support than was forecast in the Budget 2003.

4.30 In addition, tax credit awards are initially based on previous year's income and circumstances. A reconciliation process is then undertaken after the end of the year. To avoid large fluctuations in family income at the end of the year following reclamation, claimants are encouraged, but in general not required, to notify in-year of changes in income and circumstances that could affect their entitlement and hence tax credit award. The Budget 2003 forecast assumed higher levels of reporting of rises in income in-year than was seen in the administrative data. This led to higher than forecast spending for 2003-04.

Housing Revenue Account Subsidies 4.31 Forecast expenditure on housing revenue subsidies paid in 2002-03 was £0.7 billion lower than its outturn level, largely due to housing revenue account subsidies from local authorities being lower than anticipated. Provisional figures for 2003-04 suggest the forecast was very close to outturn.

Common Agricultural Policy 4.32 The outturn for expenditure related to Common Agricultural Policy for 2002-03 was very close to forecast. The outturn on expenditure for 2003-04 was £0.6 billion above the Budget 2003 forecast, owing to fiscal forecasting differences. This reflects a number of factors including movements in exchange rates and the phased introduction of the dairy premium from 2003-04 to compensate for institutional price cuts in the dairy sector.

Public corporations' capital expenditure 4.33 In 2002-03, the outturn for self-financing public corporations' capital expenditure was £0.4 billion less than forecast. This was scored as a fiscal forecasting difference and was mainly the result of Royal Mail's rephasing of significant change programmes as part of the company's renewal plan. In 2003-04 outturn was close to forecast.

Export Credits Guarantee Department 4.34 Expenditure related to the Export Credits Guarantee Department (ECGD) was lower than forecast by £0.3 billion in 2002-03.

4.35 ECGD expenditure includes lending to the Guaranteed Export Finance Corporation (GEFCO) to refinance loans to UK exporters. Forecasting differences arising in 2002-03 reflect the difficulties in estimating the volume of lending by ECGD to GEFCO and assumptions made with regard to interest rates. Under national accounts,

lending by government departments is classified as a financial transaction and is therefore netted out within accounting adjustments when calculating TME. Figures are not shown separately for 2003-04 onwards and are included in 'other departmental expenditure' on a national accounts basis.

Net public service pensions 2002-03 **4.36** Net public service pension payments in 2002-03 are on a national accounts basis and reflect the difference between contributions made by and the payments made to scheme members. The outturn for net public sector pensions was £0.8 billion lower than forecast for 2002-03, scored as fiscal forecasting differences.

4.37 The £0.8 billion of forecast differences for 2002-03 were in part attributed to net payments made by the NHS (England and Wales) Pension Scheme and by the Teachers (England and Wales) Pension Scheme being lower than forecast.

Net public service pensions 2003-04 **4.38** From 2003-04 the adoption of the accounting standard FRS17 by the public services meant that all pension schemes in the public services were required to reflect the accruing pension costs of scheme members in their accounts. Changes were therefore reflected in departmental budgets (DEL and departmental AME). However, the national accounts treatment remains unchanged and as TME is consistent with national accounts, an adjustment is made within the accounting adjustments.

4.39 In 2003-04 the outturn for net public sector pensions was £1.6 billion higher than forecast on a FRS17 basis, scored as fiscal forecasting differences. On a national accounts basis, reflecting a different accounting treatment, the outturn was only £0.1 billion higher than forecast. On a FRS17 basis, the difference was mainly due to an increase in accruals (liabilities incurred for future pensions payments) of £2 billion. Partially offsetting this was an increase in receipts (payments received by schemes from employers and employees or transfers to cover payments to pensioners) of £0.4 billion.

4.40 The main contributors to the differences in changes in liabilities were Teachers Pensions (England and Wales) and civil service pensions. The offsetting difference in receipts were mainly attributed to NHS pensions (England and Wales), due to the continued growth in the NHS Scheme Membership.

National Lottery **4.41** Lottery expenditure outturn figures for 2002-03 and 2003-04 were £0.5 and £0.3 billion respectively lower than forecast. These figures are scored as fiscal forecasting differences and reflect the fact that draw down of grants by project operators is often slower than expected by lottery distributing bodies. There can be many reasons for this, for example delays in securing partnership funding or planning consents, or in getting construction work under way.

4.42 The recent National Audit Office report *Managing National Lottery Distribution Fund Balances* (July 2004) recognised that distributing bodies depend, to a significant extent, on draw down forecasts provided by grant recipients and looked at, among other questions, how distributors might work with projects to achieve forecasts of expenditure that they could have greater confidence in.

Net payments to EC institutions **4.43** The outturn for net payments to EC Institutions for 2002-03 and 2003-04 were slightly higher than forecast. Differences between forecast and outturn reflects the methodology used to forecast net payments to EC Institutions.

4.44 Due to the known uncertainties in forecasting payments to the EC Institutions, in particular for the timing risk associated with payments being made to and from EC Institutions, forecasts for forward years were made on a trend basis. This was based on the average of the one-year or 'spot' forecasts of expenditure using past, current and

forward years. Under this trend based forecasting methodology, there is likely to be a difference between the outturn and trended forecast. This difference is classified as a fiscal forecasting difference.

Locally-financed expenditure

4.45 This covers local authority expenditure financed from council tax and other sources of finance, other than central government grants and central government expenditure in Northern Ireland financed by regional rates. The outturns for locally-financed expenditure for 2002-03 and 2003-04 were £0.3 billion and £2.3 billion lower than forecast, respectively. The data for 2003-04 are highly provisional. Much of the shortfall in 2003-04 reflects lower capital expenditure.

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

Central Government gross debt interest

4.47 Central government gross debt interest payments in 2002-03 were £0.3 billion lower than forecast in Budget 2002. Uplift on index-linked gilts was £0.3 billion lower, which scored as economic determinants. Lower interest rates on short term borrowing, which score as NAO audited assumptions, accounted for a further £0.5 billion. These shortfalls were partially offset by an increase of £0.5 billion in fiscal forecasting differences. This includes the effect of higher than forecast central government borrowing in the year.

4.48 In 2003-04, central government gross debt interest was £0.4 billion higher than the Budget 2003 forecast. Some £0.2 billion of this difference resulted from a higher than forecast uplift on index-linked debt, which is scored as an economic determinant difference. A further £0.1 billion was attributed to higher than expected interest rates on short-term borrowing. This is scored as a difference arising from the NAO-audited assumption on market interest rates. The remaining difference of £0.1 billion is scored as a fiscal forecasting difference, which includes the effect of higher than forecast central government borrowing in that year.

Accounting and other adjustments

4.49 The accounting adjustments reconcile the budgeting aggregates DEL and AME with the national accounts definition of TME, removing items that score in DEL or AME but not in TME, and adding in items included in TME but not in DEL or AME. The 'other' column shows classification changes made by ONS since the forecast was compiled, principally the reclassification of NHS trusts from the public corporations to central government sector, and the decision to consolidate local government payments of business rates out of TME. Remaining changes in outturn for specific accounting adjustment items (mainly changes in liabilities of pension schemes) appear in the column for fiscal forecasting differences. In 2003-04 these largely reflect the adjustment required for public sector pensions (as described above).

AME Margin

4.50 The year ahead forecasts for AME for Budget 2003 and 2004 included an AME margin of £1 billion to minimise the risk of outturn AME exceeding its forecast. The change in AME margin is classified as 'other' in the breakdown of forecasting differences.

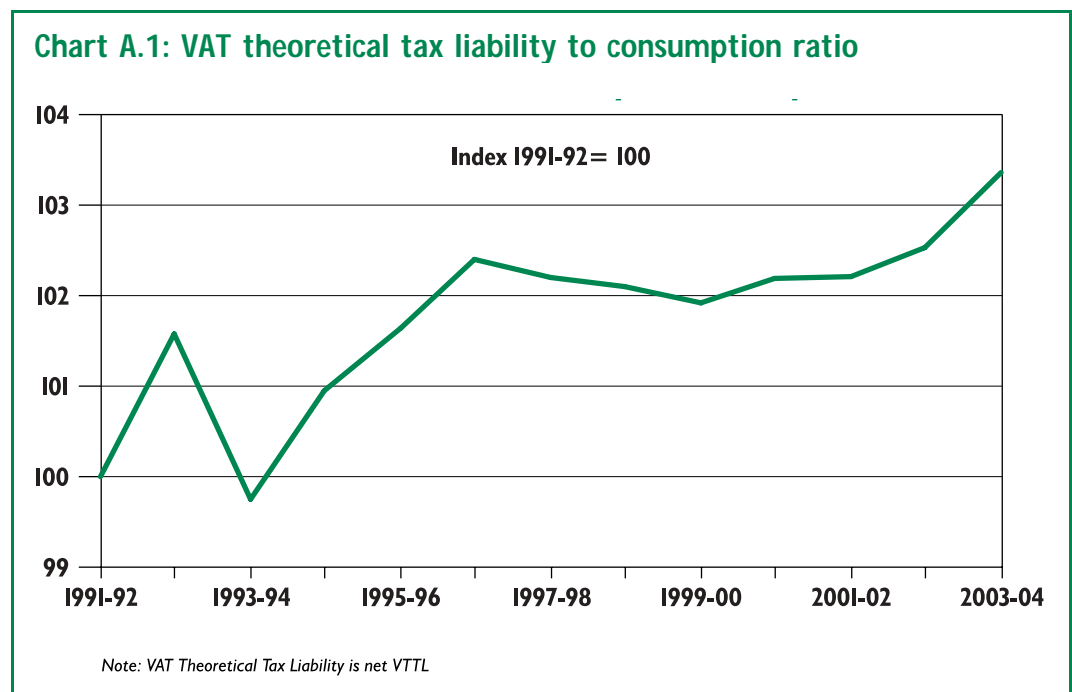
A

IMPROVEMENTS IN VAT FORECASTING

A.1 This annex sets down the new approach to projecting VAT receipts, including the NAO-audited assumption for the VAT gap, that was adopted in Budget 2004. It explains the advantages of the new approach compared to the previous method, used in Budget 2002 and Budget 2003.

A.2 The Budget 2002 and Budget 2003 forecasts of VAT receipts analysed in this *End of year fiscal report* were based on the NAO-audited assumption that *'the underlying ratio of VAT receipts to consumers' expenditure will be assumed to fall by 0.05 percentage points a year'*. The sizeable forecast difference in 2003-04 reflected that this ratio rose by 0.3 percentage points, rather than the 0.05 percentage point decline assumed. The volatility in this ratio has meant that this approach has resulted in some significant forecasting differences since its adoption in 1997.

A.3 This approach had two clear drawbacks. Firstly, it centred on consumers' expenditure and failed to take into account movements in other VAT liable expenditure across the economy. The forecast difference recorded in 2003-04 reflected, in part, changes in the composition of the tax base and in particular a shift towards non-consumer forms of expenditure on which VAT is payable. This is illustrated in Chart A.1 which shows an upward trend in the ratio of VAT theoretical tax liability (VTTL, the amount of VAT the government would receive if there were no fraud or avoidance) to consumption. This indicates that the tax base was growing more strongly than would be implied by nominal consumption growth alone. Secondly, this approach did not explicitly take account of movements in the VAT gap.

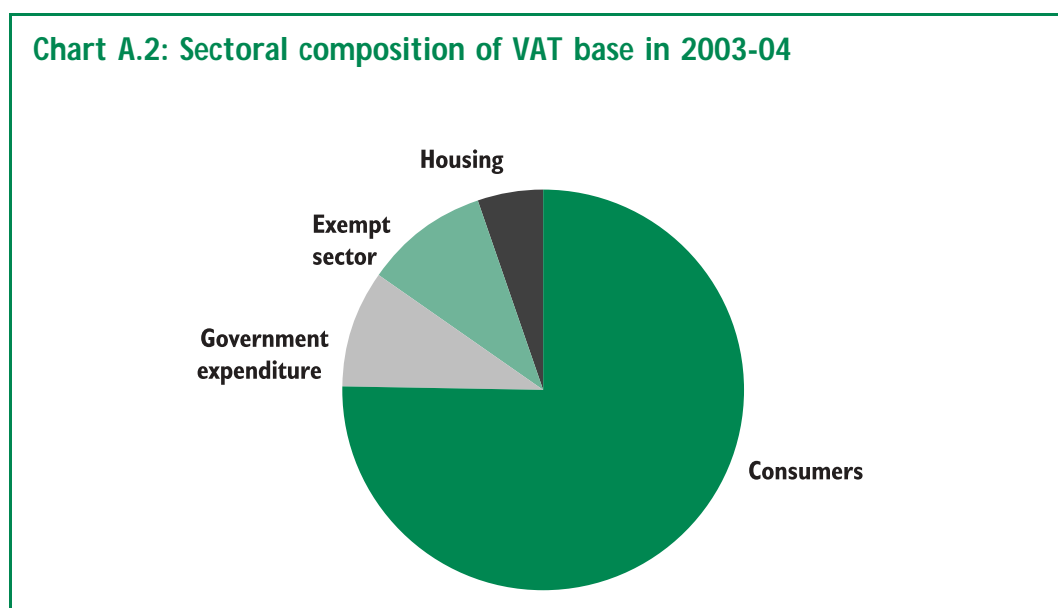


A.4 A new methodology for forecasting VAT receipts that incorporates the whole VAT tax base and explicitly projects the VAT gap was introduced in Budget 2004. The new methodology developed by HM Customs and Excise involves:

- €# estimating and projecting the VTTL;
- €# comparing the current year VTTL with estimated VAT receipts to derive the VAT gap, expressed as a percentage of the VTTL and assuming that it grows from at least this level by 0.5 percentage points per year; and
- €# adjusting the resulting VAT gap projections for the future impact of anti-fraud and avoidance measures, and then deduct the resulting VAT gap projection from the VTTL forecast to derive the VAT receipts forecast.

A.5 Chart A.2 shows the sectoral breakdown of the VAT base and highlights that around a quarter of the VAT base is related to non-consumer expenditure.

Chart A.2: Sectoral composition of VAT base in 2003-04



A.6 An estimate of VTTL is obtained by multiplying various categories of taxable expenditure in the economy by the appropriate VAT rates.¹ For each category of expenditure, detailed data are used to allocate the total between zero, reduced or standard rates of VAT, or exempt from the tax. These categories are:

- €# consumers' expenditure and non-profit bodies;
- €# general government current and capital expenditure;
- €# the exempt sector – when a business makes a supply which is exempt from VAT, they cannot pass on the VAT incurred when making purchases related to that supply and the VAT 'sticks' with them as though they were the final consumer. This includes financial services among others; and
- €# certain housing expenditures – chiefly capital expenditure by households and businesses upon which VAT 'sticks'.

¹ A more detailed explanation of VTTL is available in *Measuring indirect tax losses*, HM Customs and Excise, November 2002, paragraphs 2.9-2.26 (<http://www.hm-treasury.gov.uk/media/389/E5/admeas02-297kb.pdf>).

A.7 A net VTTL figure is then calculated by adjusting for the theoretical VAT that is intentionally foregone or that is refunded to government bodies and local government. This method of calculating the VTTL allows for changes in the mix of commodities taxable at different rates within a category and the relative contributions of each of the categories within the overall economy.

A.8 Projecting VTTL requires each sector's total expenditure to be projected forward using appropriate economic determinants from the Treasury's economic forecast. Within each sector, the shares subjected to different VAT rates are projected forward in line with the recent trend. VAT rates are assumed to remain constant in the absence of policy decisions.

A.9 The second stage is the projection of the VAT gap,² the difference between net VTTL and actual tax receipts. The new assumption is that the VAT gap '*will be assumed to 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*'. This assumption is based on the finding that growth in the VAT gap between 1990-91 and 2002-03 was 0.4 percentage points a year on average. This was estimated across a period in which there was significant growth in VAT losses from Missing Trader Intra-Community fraud and smuggling. Both of these are now being successfully tackled, reflected in the fall in the VAT gap for 2003-04.

A.10 The final stage is to adjust the VAT gap downwards to take account of the future additional revenue expected in future years from the direct and preventive, but not the deterrent effects, of the VAT Strategy measures announced in the 2002 and 2003 Pre-Budget Reports.

A.11 The Comptroller and Auditor General audited the assumption on the VAT gap when it was first used to project VAT receipts in Budget 2004. In his report, the Comptroller and Auditor General concluded that the assumption had features that introduced caution in the projections for VAT and was reasonable.

² A more detailed explanation of the VAT gap is available in *NAO Audit of Assumptions for Budget 2004*, March 2004 (http://www.nao.org.uk/publications/nao_reports/03-04/0304434.pdf).

B

ASSUMPTIONS USED IN BUDGET 2002 AND BUDGET 2003

Table B.1: Budget 2002 - key assumptions audited by the National Audit Office

	Assumption used for Budget 2002
Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth	2½ per cent a year.
UK claimant unemployment	Rising slowly to 1.00 million in 2003-04, from recent levels of 0.95 million, consistent with average of independent forecasts.
Interest rates	3-month market rates change in line with market expectations (as of 10 April).
Equity prices	FT-All share index rises from 2542 (close 5 April) from Q2 2002 in line with money GDP.
VAT	Ratio of underlying VAT receipts to consumption falls by 0.05 percentage points a year.
GDP deflator and RPI	Projections of price indices used to plan public expenditure are consistent with RPIX.
Composition of GDP	Shares of labour income and profits in national income are broadly constant in the medium term.
Funding	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Oil prices	\$21.5 a barrel in 2002, the average for Q1 2002, and then constant in real terms.
Anti-tobacco smuggling measures	Only direct effects, including deterrent effects of fiscal marks, are allowed for.

Table B.2: Budget 2003 - key assumptions audited by the National Audit Office

	Assumption used for Budget 2002
Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth	2½ per cent a year to 2006-07 and 2¼ per cent in 2007-08.
UK claimant unemployment	Rising slowly to 1.03 million in 2005-06, from recent levels of 0.93 million, consistent with average of independent forecasts.
Interest rates	3-month market rates change in line with market expectations (as of 28 March).
Equity prices	FTSE All-Share index rises from 1778 (close 28 March) in line with money GDP.
VAT	Ratio of underlying VAT to consumption falls by 0.05 percentage points a year.
GDP deflator and RPI	Projections of price indices used to plan public expenditure are consistent with RPIX.
Composition of GDP	Shares of labour income and profits in national income are broadly constant in the medium term.
Funding	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Oil prices	\$26.6 a barrel in 2003, the average of independent 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 2003, a share of 21 per cent has been used for all forecast years. This is in line with the most recently published outturn figure for 2001-02 and takes account of the indications from duty receipts for 2002-03 that the smuggled share in this year is likely to be lower than 21 per cent.
Inland Revenue compliance and enforcement package	Only direct and some preventive effects are allowed for.

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List of Abbreviations

AME	Annually Managed Expenditure
ARBs	Actuarially Reduced Benefits
CA	Cyclically adjusted
CAP	Common Agricultural Policy
CBO	Congressional Budget Office
CSS	Cyclical social security
CT	Corporation tax
DEL	Departmental Expenditure Limits
EC	European Communities
ECGD	Export Credits Guarantee Department
ESA-95	European System of Accounts
EU	European Union
EYF	End-year flexibility
EYFR	End of year fiscal report
FTSE	Financial Times Stock Exchange
G7	Group of seven (leading industrial nations): Canada, France, Germany, Italy, Japan, the United Kingdom and the United States
GDP	Gross Domestic Product
GEFCO	Guaranteed Export Finance Corporation
GGDIP	General government debt interest payments
GSS	Government Statistical Service
IMF	International Monetary Fund
IS/JSA	Income Support / Jobseeker's Allowances
NAO	National Audit Office
NHS	National Health Service
NICs	National insurance contributions
OECD	Organisation for Economic Cooperation and Development
ONS	Office for National Statistics
PAYE	Pay As You Earn
PC	Public corporations
PCSPS	Principle Civil Service Pension Scheme

LIST OF CHARTS, TABLES AND ABBREVIATIONS

PRT	Petroleum Revenue Tax
PSNB	Public sector net borrowing
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
TME	Total Managed Expenditure
VAT	Value added tax
VED	Vehicle excise duty
VTTL	VAT theoretical tax liability
WFTC	Working Families' Tax Credit

ISBN 1-84532-048-4



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