

End of year fiscal report

November 2008



HM TREASURY



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ISBN 978-1-84532-517-6
PU646

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1

Introduction

The annual publication of the *End of year fiscal report*, first published alongside the 2002 Pre-Budget Report, reflects the Government's commitment to transparency in the conduct of fiscal policy. The report provides 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 2006-07 and 2007-08, putting these into an historical context. The report analyses:

- performance against the fiscal rules and fiscal policy objectives; and
- differences between forecast and outturn for the year-ahead fiscal forecasts published in Budget 2006 and Budget 2007.

The report shows that the Government met its fiscal rules over the cycle that ended during 2006-07.

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

- since the introduction of the new macroeconomic framework in 1997, outturn public sector net borrowing (PSNB) has been lower on average than the year-ahead forecast, compared with before the new framework when outturns tended to be higher than forecast. This is in line with the move to using a cautious approach in projecting the public finances. The profile of the forecast differences since 1997 is such that PSNB has tended to be higher than forecast when the output gap is negative, and lower than forecast when the output gap is positive; and
- the UK's forecasting performance compares well with that of other countries and international organisations: on average since 1997, UK net borrowing forecasts have been equal to the average of the EU 15 Member States in terms of caution (as measured by average forecast difference), and better than average in terms of accuracy (as measured by average absolute forecast difference).

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;

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

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

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

1.4 The EYFR supports the effective implementation of the Government's fiscal framework by increasing:

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

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 provides a retrospective examination of the forecast performance in the fiscal years 2006-07 and 2007-08, together with the Government's historical forecasting performance.³ The detailed forecast analysis considers the Budget 2006 forecast for 2006-07 and the Budget 2007 forecast for 2007-08. The two-year horizon strikes a balance between timely reporting of fiscal developments and the quality and robustness of data. Public finance data are open to revision for a considerable period after the end of the relevant financial year. In addition, the analysis presented in this report depends on macroeconomic data that are subject to revision for several years, as the data are refined on the basis of more comprehensive information. The data presented in this report are consistent with *First Release: Public sector finances, September 2008*.⁴

1.7 The data and analysis presented here are therefore not final. This is particularly the case for the most recent year, 2007-08. Nonetheless, the information is sufficiently robust to provide a sound basis for forecast analysis. Future revisions, particularly for 2006-07, are more likely to affect the detail while leaving the main conclusions unchanged.

1.8 To aid understanding of the analysis set out in the *End of year fiscal report*, the 2003 EYFR described the forecasting process. In particular it described the linkages between the Treasury's economic forecast and the projections for the public finances. It also described how the projections for the public finances are based on cautious, independently-audited assumptions, which help to build in a margin against unexpected events.

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

³ Analysis of fiscal trends in the current fiscal year is undertaken in Chapter 2 and Annex B of the 2008 Pre-Budget Report.

⁴ *First Release: Public sector finances, September 2008*, ONS/HM Treasury, 20 October 2008.

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:

- differences between forecast and outturn for **economic determinants**. For example, forecasts for taxes and spending are heavily influenced by forecasts for economic growth and the composition of economic growth. This category would therefore include any difference in the public finance projections that can be ascribed to variation between forecast and outturn for economic growth and the components of economic growth;
- divergences between the **NAO-audited assumptions** and their outturn.⁵ This would include, for example, the effects of the level of unemployment on social security spending, or the effects of the oil price on receipts from North Sea taxes;
- **fiscal forecasting differences**, i.e. changes in the relationship between the tax rate and tax base, and the receipts actually received. On the spending side, this would include differences between the forecast take-up of benefits and the actual outturn, or differences between outturns and plans for Departmental Expenditure Limits (DEL); and
- **other**, which includes a variety of factors, such as the impact of new measures announced in-year and statistical classification changes.

1.10 Chapter 2 provides a summary of developments from a macroeconomic perspective. It shows that, over the economic cycle that ran between 1997-98 and 2006-07, the Government met its fiscal rules.

1.11 Chapter 2 also examines the UK's forecast performance over a longer timescale and compares it internationally. Performance is assessed in terms of accuracy and caution. Accuracy is measured using the absolute average difference: the smaller the average absolute difference, the more accurate the forecast. Caution is measured by the simple average of the differences of forecast from outturn. A borrowing forecast is cautious if the outturn is lower than forecast – this is indicated by a positive forecast difference, which is calculated as forecast minus outturn.

1.12 The key findings of Chapter 2 are:

- outturn net borrowing has on average been marginally lower than the year-ahead forecast since the introduction of the new macroeconomic framework in 1997. This is shown by the positive average forecast difference of 0.2 per cent of GDP since 1997-98, which compares favourably with an average of -0.1 per cent before 1997-98. The profile of the forecast differences since 1997 is such that PSNB has tended to be higher than forecast when the output gap is negative, and lower than forecast when the output gap is positive;
- the two-year ahead net borrowing forecast differences in the period since 1997-98 have been similar on average to those in the preceding period. However, borrowing has been marginally higher than the two-year ahead forecasts on average in this period, with a -0.1 per cent of GDP forecast difference, compared to a 0.0 per cent average forecast difference prior to 1997-98;
- the overall accuracy of one-year ahead PSNB forecasts under the new framework is similar to that of the period before 1997-98, with an average absolute forecast

⁵ A list of the assumptions audited by the NAO for Budget 2007 and Budget 2008 is shown in Annex A.

error of 0.8 per cent of GDP since 1997, compared to 1.2 per cent of GDP in the earlier period. The accuracy of the two-year ahead PSNB forecasts under the new framework has also been of similar accuracy to that of the period before 1997-98. In each Budget since 2003, both the one-year and two-year ahead forecasts have been more accurate than the respective long-run averages; and

- the UK's forecasting performance compares well with that of other countries and international organisations: on average since 1997 UK net borrowing forecasts have been equal to the average of the EU 15 Member States in terms of caution (as measured by average forecast difference), and better than average in terms of accuracy (as measured by average absolute forecast difference).

1.13 Chapter 3 provides a detailed analysis of projections for tax receipts made at Budget 2006 and Budget 2007 for the fiscal years 2006-07 and 2007-08 respectively. The key conclusions of the chapter are:

- total receipts in 2006-07 were £3.1 billion above the Budget 2006 forecast. Though there was a shortfall in receipts from corporation tax, this was more than offset by higher receipts from a number of other taxes, including income tax and stamp duty; and
- total receipts in 2007-08 were £5.3 billion below the Budget 2007 forecast. This shortfall was the result of lower than expected receipts from a number of taxes, including corporation tax.

1.14 Chapter 4 presents an analysis of the projections for public spending made at Budget 2006 for the fiscal year 2006-07, and at Budget 2007 for 2007-08. The main conclusions of Chapter 4 are:

- in 2006-07, Total Managed Expenditure stood at £549.9 billion and was approximately £2.4 billion lower than the Budget 2006 forecast, due in large part to lower-than forecast capital expenditure; and
- in 2007-08, Total Managed Expenditure rose to £583.4 billion, £3.2 billion below the Budget 2007 projection. This was mainly due to lower than expected current expenditure.

2

Meeting the fiscal rules over the past cycle (1997-98 to 2006-07)

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 economic cycle that ran between 1997-98 and 2006-07, the Government met its fiscal rules:

- the average surplus on the current budget over the period 1997-98 to 2006-07 was positive, thus meeting the golden rule; and
- public sector net debt stood at 36.0 per cent of GDP in 2006-07, and remained below the 40 per cent of GDP limit of the sustainable investment rule over the cycle.

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

- since the introduction of the new macroeconomic framework in 1997, outturn public sector net borrowing (PSNB) has been lower on average than the year-ahead forecast, compared with before the new framework when outturns tended to be higher than forecast. This is in line with the move to using a cautious approach in projecting the public finances. The profile of the forecast differences since 1997 is such that PSNB has tended to be higher than forecast when the output gap is negative, and lower than forecast when the output gap is positive; and
- the UK's forecasting performance compares well with that of other countries and international organisations: on average since 1997, UK net borrowing forecasts have been equal to the average of the EU 15 Member States in terms of caution (as measured by average forecast difference), and better than average in terms of accuracy (as measured by average absolute forecast difference).

2.1 The macroeconomic framework is designed to promote economic stability. To achieve this, 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 ensure low and stable inflation. The fiscal policy framework seeks to maintain sound public finances in the medium term, while allowing fiscal policy to help smooth the path of the economy. The public spending framework facilitates long-term planning, helps protect public investment and provides incentives for departments to increase the quality and cost-effectiveness of public services.

Fiscal objectives and rules

2.2 The Government's objectives for fiscal policy are:

- over the medium term, to ensure sound public finances and that spending and taxation should 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.

2.3 The Treasury's assessment is that the economic cycle judged to have started in the first half of 1997 ended during the second half of 2006.¹ The Government's fiscal objectives were implemented over this past economic cycle through two fiscal rules, against which the performance of fiscal policy during this period can be judged:

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

Performance against objectives and rules

2.4 Table 2.A shows that the government met its fiscal rules over the economic cycle that ran from 1997-98 to 2006-07. The table shows the key fiscal aggregates over the cycle.

The golden rule

2.5 The golden rule required, over the economic cycle, the average surplus on the current budget expressed as a ratio to GDP to be equal to or greater than zero.² Table 2.A shows that the golden rule was met over the economic cycle that ended in 2006-07, with an average surplus of 0.1 per cent of GDP.

Table 2.A: Meeting the fiscal rules over the past cycle

	Per cent of GDP										
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Golden rule											
Surplus on current budget		-0.1	1.2	2.2	2.4	1.2	-1.0	-1.5	-1.6	-1.1	-0.3
Average surplus since 1997-98		-0.1	0.5	1.1	1.4	1.4	1.0	0.6	0.3	0.2	0.1
Cyclically-adjusted surplus on current budget		0.0	1.0	1.9	1.8	0.9	-0.7	-1.3	-1.5	-1.0	-0.3
Sustainable investment rule											
Public sector net debt	42.5	40.6	38.4	35.6	30.7	29.7	30.8	32.2	34.1	35.4	36.0
Core debt	41.2	39.3	37.5	35.1	31.0	30.2	31.0	32.2	34.0	35.2	35.9

Note: As debt is a stock measure, performance against the sustainable investment rule is measured against the end point of the previous cycle.

The sustainable investment rule

2.6 The sustainable investment rule required public sector net debt (PSND)³ as a proportion of GDP to be held at a stable and prudent level over the economic cycle. In 1998 the Government announced that it would maintain net debt below 40 per cent of GDP over the course of the economic cycle beginning in 1997-98. In 2003, the Government strengthened this commitment, stating that to meet the sustainable investment rule with confidence, net debt would be maintained below 40 per cent of GDP in each and every year of the economic cycle. Table 2.A shows that net debt was maintained below 40 per cent of GDP on average over the cycle, meeting the sustainable investment rule. The Government also met its additional commitment to

¹ See Chapter 2 of the 2008 Pre-Budget Report, and *Evidence on the Economic Cycle*, HM Treasury, November 2008, for more detail.

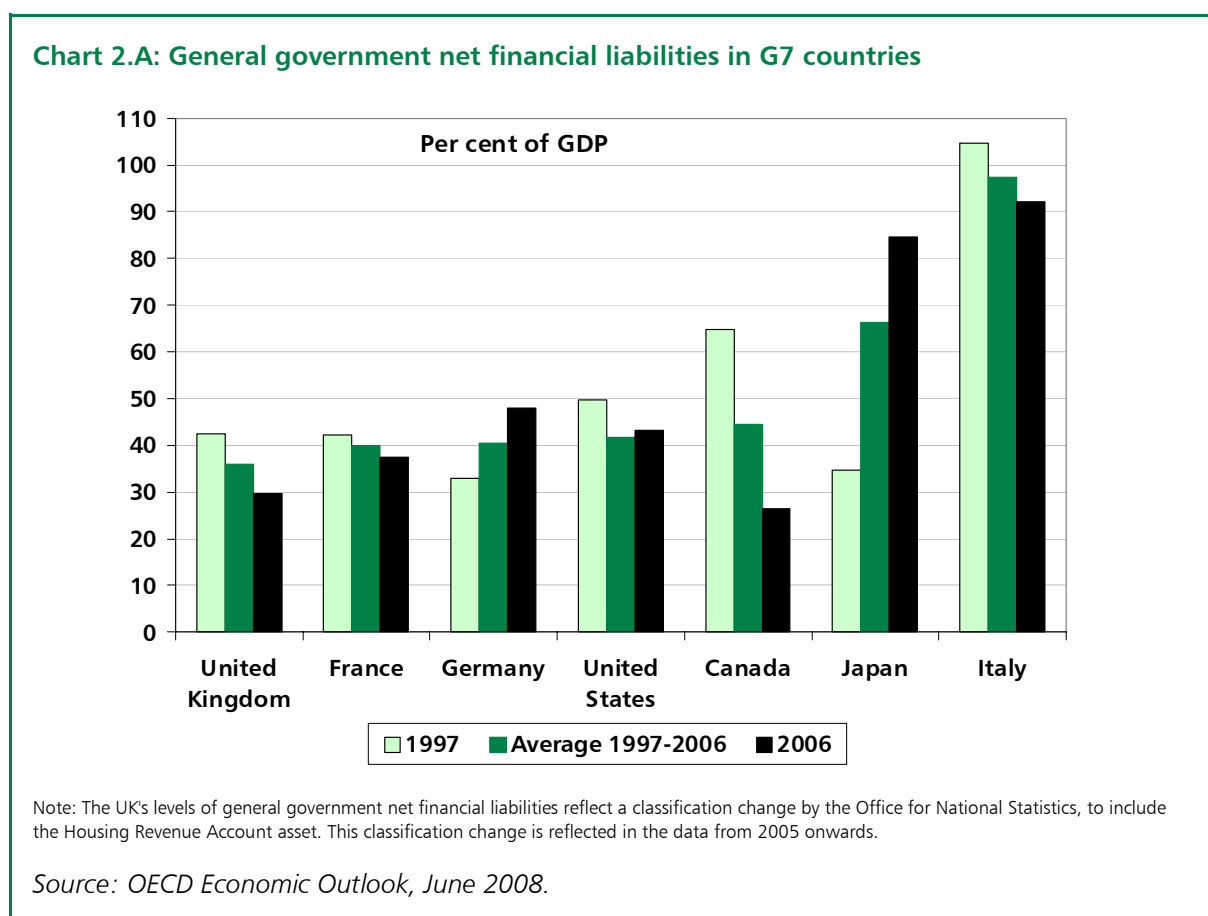
² Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002. Performance over past cycles is described further in Chapter 2 of the 2008 Pre-Budget Report.

³ Budget 2008 explained that for the purpose of measuring performance against the sustainable investment rule, the Government would use a measure of PSND excluding Northern Rock's assets and liabilities.

maintain net debt below 40 per cent of GDP in each and every year from 2003-04 to 2006-07. The table also shows core debt, which excludes the estimated impact of the economic cycle on net debt.⁴

2.7 Chart 2.A shows how the UK's debt-to-GDP ratio over the cycle compared to that of the other G7 nations over the same period, using the OECD's general government net financial liabilities measure of debt. Note that the OECD definition of general government net financial liabilities differs from the UK government's measure of PSND in a number of respects. In particular, the OECD measure excludes public corporations but uses a wider definition of general government assets and liabilities, values gilts according to their market value rather than their nominal value and uses different reference periods (debt is measured at the end of the calendar year as opposed to the end of the financial year, and GDP for the previous year is used rather than GDP centred on the debt period).

2.8 On average over the period from 1997 to 2006, general government net financial liabilities in the UK were lower than in all other G7 economies, and in 2006, the last year of the UK's past economic cycle, remained lower than in all the G7 countries except Canada.



Economic impact

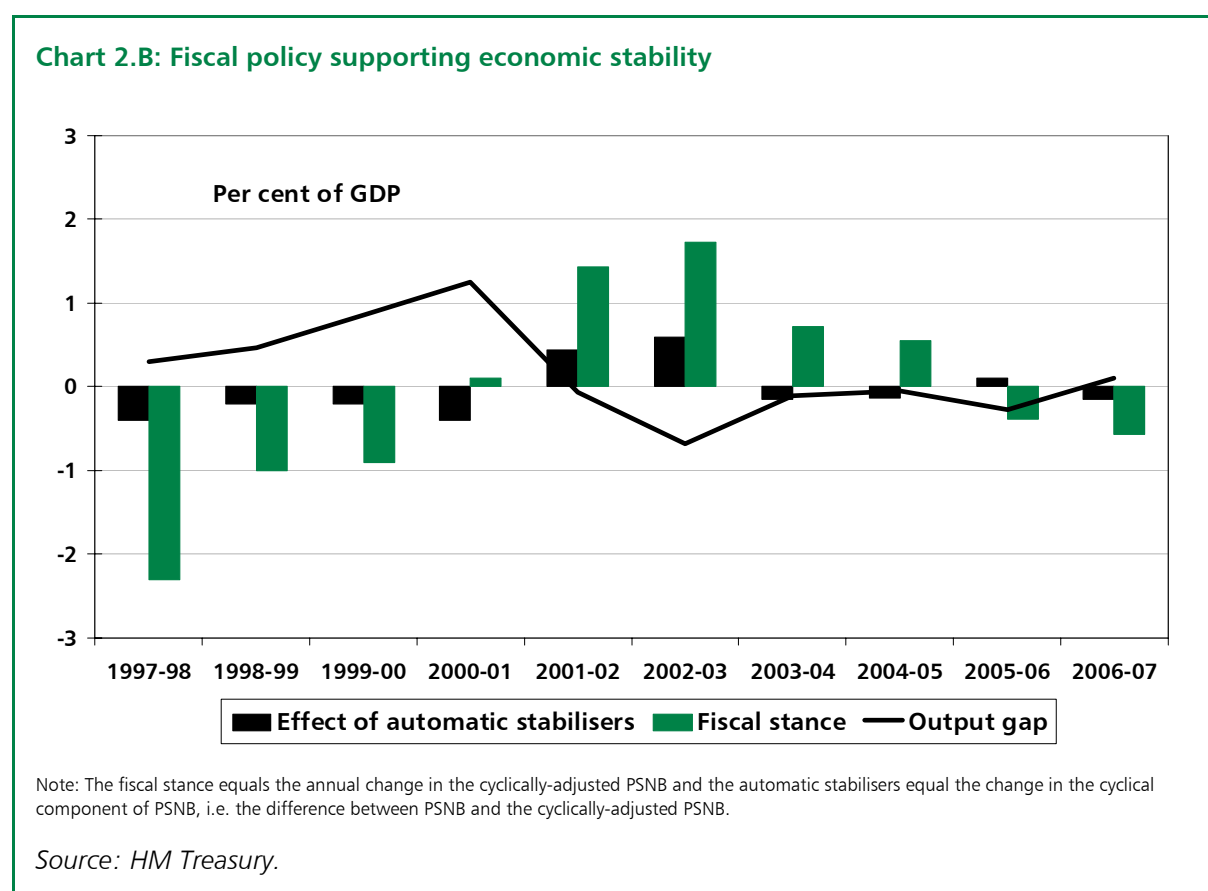
2.9 Whilst the primary objective of fiscal policy is to ensure sound public finances over the medium term, fiscal policy also plays an important role by supporting monetary policy to deliver economic stability.

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

⁴ An explanation of core debt can be found in *Core debt: an approach to monitoring the sustainable investment rule*, HM Treasury, April 2002.

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

2.11 As shown in Chart 2.B, since the introduction of the fiscal framework, fiscal policy has supported economic stability. During the period from 1997-98 to 2002-03, when the economy operated above trend until 2001 and then below trend during the global slowdown from 2001 to 2003, fiscal policy played a significant role in smoothing the path of the economy. Fiscal policy tightened to reduce demand in the economy while it was operating above trend and loosened to support demand, both through the operation of the automatic stabilisers and the fiscal stance, as the economy moved below trend in 2001. Between 2003-04 and 2006-07, when the economy was generally operating close to (albeit below) trend, the degree of fiscal support moderated.

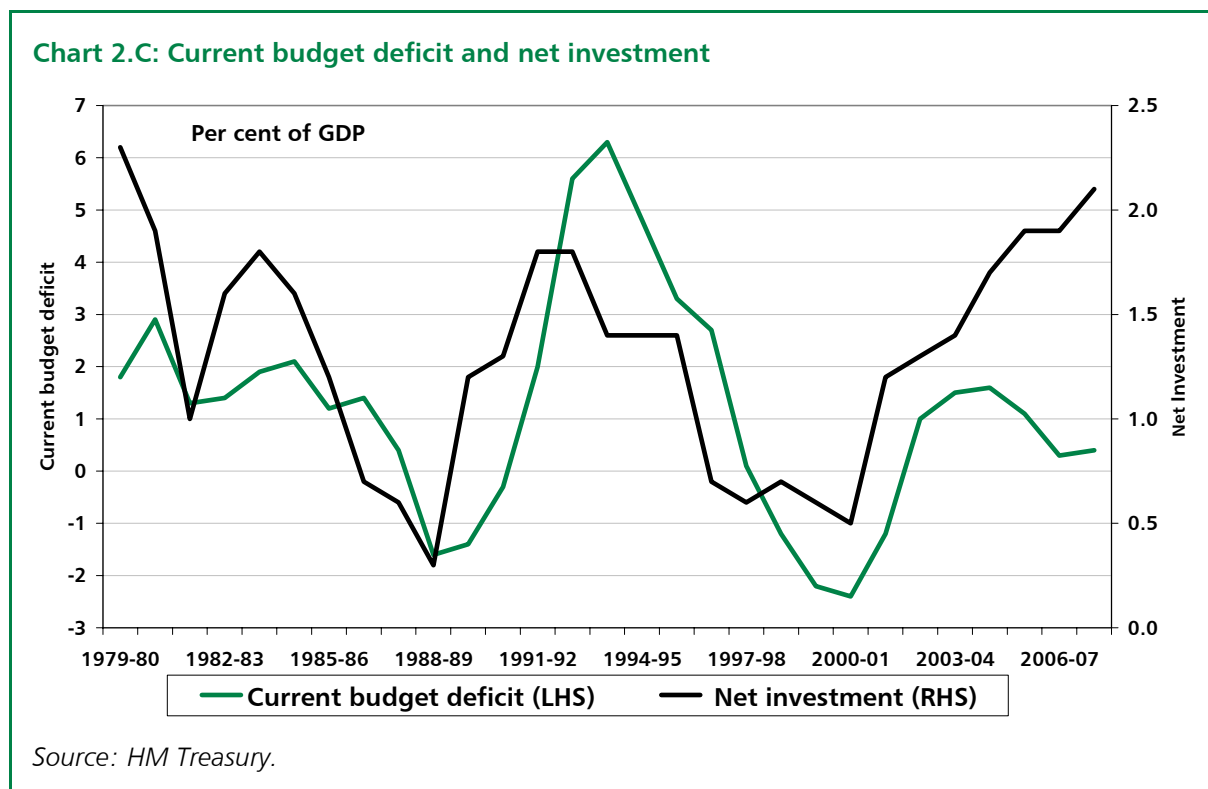


Borrowing for investment

2.12 The golden rule and sustainable investment rule were designed to work together to promote capital investment, while ensuring sustainable public finances.

2.13 Historically, it has been extremely rare for public investment to grow during periods of fiscal consolidation, and prior to the introduction of the macroeconomic framework in 1997 this had not happened for 40 years. The effectiveness of the golden rule in eliminating this historic bias against capital spending is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment in Chart 2.C. The fiscal rules ensured that, over the past economic cycle, borrowing was reduced at the same time as net investment was increased. Public sector net investment, at 2 per cent of GDP in 2007-08, is now over three times higher as a share of the economy than it was in 1997-98, and is at its highest level since 1979-80.

Chart 2.C: Current budget deficit and net investment



Source: HM Treasury.

Historical forecasting performance

2.14 Projections for the public finances are subject to a considerable degree of uncertainty. This section considers the overall forecasting performance for public sector net borrowing from an historical perspective, measured in terms of accuracy and caution:⁵

- the relative *accuracy* of forecasts is compared using the absolute average difference, which measures the difference between forecasts and outturns, but ignores whether those differences are positive or negative. The smaller the absolute average difference the more accurate the forecast; and
- to compare the relative *caution* of forecasts over time the simple average of the forecast differences is used. The forecast difference is calculated as forecast minus outturn. Therefore, if the forecasts of net borrowing are generally cautious, the average forecast differences will be positive.

2.15 Table 2.B summarises the one- and two-year ahead PSNB forecast differences since 1970-71 and 1980-81 respectively. The key points to note are:

- outturn net borrowing has on average been marginally lower than the year-ahead forecast since the introduction of the new macroeconomic framework in 1997. This is shown by the positive average forecast difference of 0.2 per cent of GDP since 1997-98, which compares favourably with an average of -0.1 per cent before 1997-98. The profile of the forecast differences since 1997 is such that PSNB has tended to be higher than forecast when the output gap is negative, and lower than forecast when the output gap is positive;

⁵ The current presentation of the fiscal aggregates was first introduced in the 1998 Economic and Fiscal Strategy Report. Data for 1998 onwards refer to PSNB. Differences prior to 1998 are based on forecasts and outturn for the public sector net cash requirement (PSNCR, 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.

- the overall accuracy of one-year ahead PSNB forecasts is similar to that of the period before 1997-98, with an average absolute forecast error of 0.8 per cent of GDP, compared to 1.2 per cent of GDP in the earlier period. In each Budget since 2003, both the one-year and two-year ahead forecasts have been more accurate than the respective long-run averages; and
- the two-year ahead PSNB forecasts since 1997-98 have been of similar accuracy on average to the forecasts before 1997-98. The average forecast difference is also similar in both periods, though borrowing has been marginally higher than the two-year ahead forecasts on average in this period, with a -0.1 per cent of GDP forecast difference, compared to a 0.0 per cent average forecast difference prior to 1997-98.

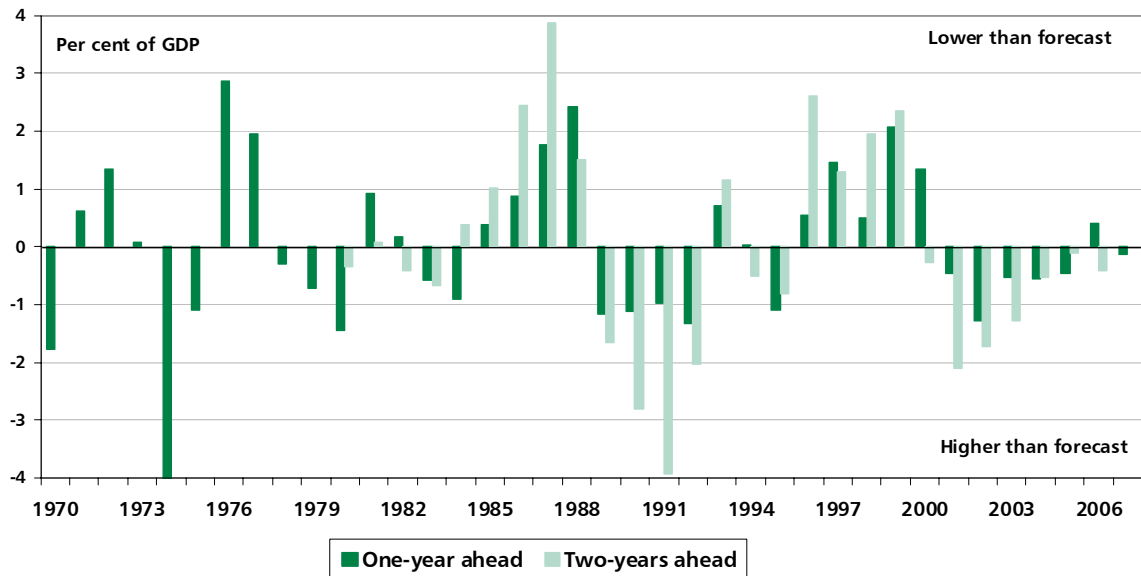
Table 2.B: Summary statistics for net borrowing forecast differences

	Per cent of GDP			Number of observations in whole sample
	Whole sample	Before 1997-1998	Since 1997-1998	
One-year ahead PSNB forecasts				
Average absolute difference	1.1	1.2	0.8	38
Average difference	0.0	-0.1	0.2	
Two-year ahead PSNB forecasts				
Average absolute difference	1.4	1.5	1.2	27
Average difference	0.0	0.0	-0.1	
<i>Note: The one-year ahead forecasts sample is from 1970-71 onwards, and the two-year ahead forecasts sample is from 1980-81 onwards. This reflects the length of the available time series.</i>				

2.16 While PSNB forecast accuracy is broadly unchanged compared with the period before 1997-98, the data in Table 2.B above provide some emerging evidence of an improvement in the overall accuracy of the year-ahead PSNB forecasts in the period since 1997-98 compared with previous decades. However, this improvement in forecast accuracy may in part reflect the greater stability in terms of GDP growth and inflation that the UK economy benefited from in the decade to 2007-08. Economic and fiscal forecasts might be expected to be more accurate during periods of macroeconomic stability. Conversely, the unprecedented shocks that have hit the UK economy in recent months will impact on the accuracy of forecasts made at Budget 2008.

2.17 Chart 2.D plots the one- and two-year ahead forecast differences for PSNB (PSNCR before Budget 1997). It shows that forecast differences have narrowed significantly over the past five years. The difference between the 2007-08 year-ahead forecast from Budget 2007 and outturn was -0.1, whilst the 2007-08 two-year ahead forecast from Budget 2006 showed a difference of -0.3 per cent of GDP.

Chart 2.D: PSNB forecast differences since 1970-71



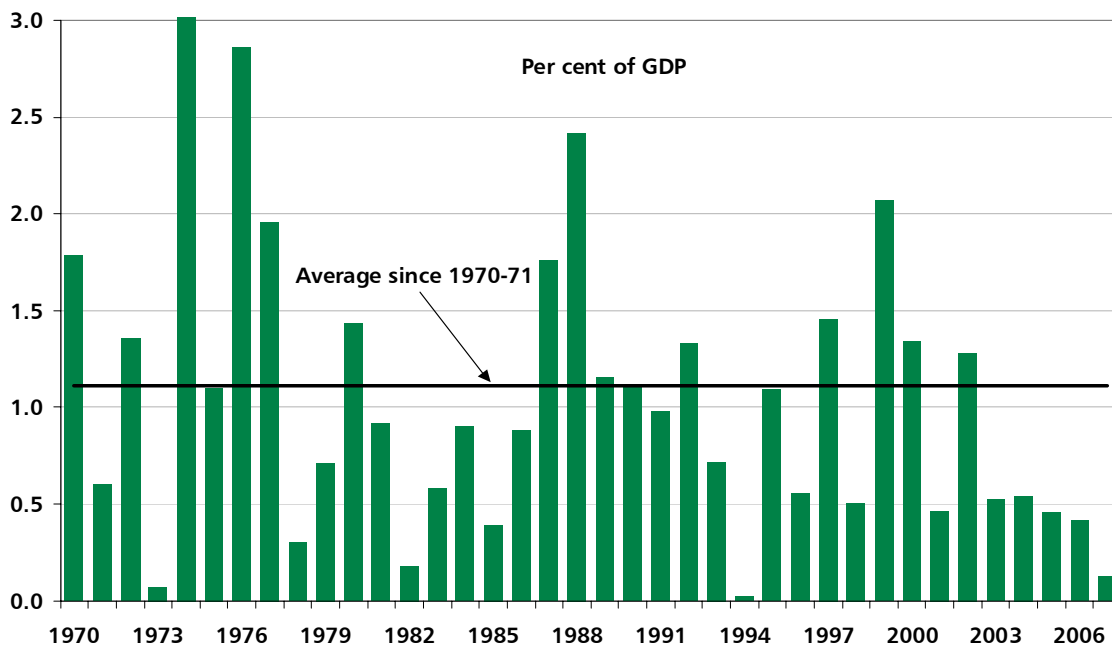
Note: The one-year ahead forecast difference was -5.9 per cent of GDP in 1974-75.

Source: HM Treasury.

2.18 There is a positive correlation between borrowing forecast differences and the economic cycle since 1997 (though this relationship is based on a small sample size). PSNB has tended to be lower than forecast (resulting in a positive forecast difference) when economic growth is above trend, and higher than forecast (a negative forecast difference) when economic growth is below trend. The fact that economic growth had been below trend for the period from the third quarter of 2001 to the second half of 2006 may therefore help to explain the negative forecast differences seen over this period.

2.19 If a stable and predictable relationship existed between forecast differences and the output gap, that information could in theory be used to adjust the fiscal projections and improve the accuracy of the fiscal forecasts. However, the relationship is one between forecast differences and the latest estimates of the output gap, rather than the estimates that were available at the time. The two will usually differ due to revisions to National Accounts data. Therefore it would not have been possible at the time to use evidence of this relationship to improve forecast accuracy.

Chart 2.E: One-year ahead absolute forecast differences for PSNB



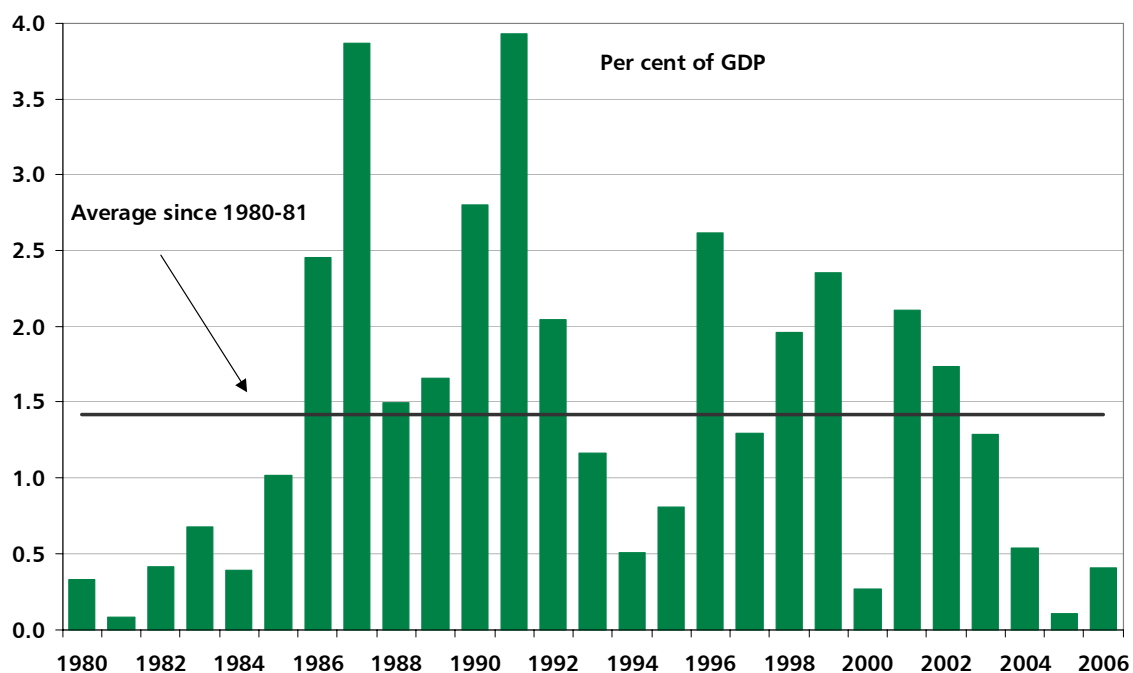
Note: The absolute forecast difference in 1974-75 was 5.9 per cent of GDP. The time period of the chart reflects the length of the available time series.

Source: HM Treasury.

2.20 The improvement in the accuracy of both the one-year ahead and two-year ahead fiscal forecasts over the last few years is shown in Charts 2.E and 2.F. Chart 2.E shows the absolute differences for one-year ahead forecasts since 1970-71. It shows that on the basis of current data, the year-ahead forecasts in every Budget since 2003 have been considerably more accurate than the average since 1970-71. The absolute year-ahead forecast difference was less than half the long-run average in each of the last five years, while the forecast in Budget 2007 for 2007-08 was one of the most accurate of the whole period, with an error of -0.1.

2.21 Chart 2.F shows the absolute differences for two-year ahead forecasts since 1980-81. It shows that on the basis of current data the two-year ahead forecasts in each Budget since 2003 were more accurate than the average since 1980-81. Since 1980-81 only five out of 27 forecasts were more accurate than the Budget 2006 forecast for 2007-08.

Chart 2.F: Two-year ahead absolute forecast differences for PSNB



Note: There is no data for 2007. The time period of the chart reflects the length of the available time series.

Source: HM Treasury.

International comparisons

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

International organisations

2.23 Table 2.C summarises the forecast differences for the UK's net borrowing (or nearest fiscal aggregate) since 1997 for the main international organisations and the Treasury.⁶ Two IMF forecasts have been included. The first is drawn from the annual *United Kingdom Article IV Consultation*, which is published at a similar time to the Budget and forecasts borrowing on a financial year basis in line with practice in the UK. The second is from the *World Economic Outlook*, which forecasts borrowing on a calendar year basis and is more closely comparable to the OECD's *Economic Outlook* and the European Commission's *Autumn Forecasts* in that it simultaneously forecasts for a broad range of countries.

Table 2.C: Forecast differences for UK net borrowing, 1997 to 2007

	Per cent of GDP	
	Absolute average difference	Average difference
Treasury	0.8	0.2
OECD	1.3	0.2
IMF (Article IV)	1.0	0.4
IMF (WEO)	1.1	0.0
European Commission	1.0	-0.4

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

2.24 Table 2.C shows that the Treasury's forecast performance compares well with that of the IMF, OECD and European Commission in terms of accuracy – as shown by the Treasury's relatively low average absolute difference, and has exhibited a level of caution within the range of these forecasts – as shown by the average forecast differences, where a positive forecast difference means that outturn borrowing was lower than had been forecast. It is important, though, to bear in mind the difficulty of making comparisons with and between international organisations.

Comparisons with EU Member States

2.25 It is also possible to compare the UK's forecasting performance with that of other Member States in the European Union. Table 2.D shows the average one-year ahead forecast difference from 1997 to 2007 in forecasts for general government net borrowing – using the year-ahead projections set down in the EU 15 Member States' annual Stability or Convergence Programmes.⁷ Since the Stability and Convergence Programmes are generally published in December, Member States' calendar year forecasts are for the year ending 12 months after the forecast is made, the same timeframe as for the UK's Budget forecasts. By contrast, the UK's Convergence Programme contains a financial year forecast for the year ending 15 months after the forecast is made. Despite this, UK forecasting performance is equal to the EU 15 average in terms of caution (as measured by average forecast difference), and better than average in terms of accuracy (as measured by average absolute forecast difference).

Table 2.D: Convergence Programme net borrowing forecasts – differences between forecast and outturn, 1997 to 2007

	Per cent of GDP	
	Absolute average difference	Average difference
France	0.50	-0.25
Spain	0.57	0.05
Austria	0.69	-0.15
Belgium	0.76	0.15
UK	0.83	0.05
Italy	1.11	-0.64
Germany	1.22	0.32
Finland	1.24	1.07
Portugal	1.29	-0.96
Sweden	1.40	0.02
Denmark	1.61	0.05
Netherlands	1.71	0.60
Ireland	1.93	1.11
Luxembourg	2.44	2.29
Greece	3.02	-3.02
EU 15 Average	1.36	0.05
<i>Memo: UK Budget forecasts</i>	<i>0.84</i>	<i>0.22</i>

Note: Differences refer to general government net borrowing. The forecast data are from the Stability and Convergence Programmes submitted by each country and are available on the European Commission's website (http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/sg_programmes9147_en.htm) From 1998 onwards, the programmes are generally submitted in December of each year. In 1997, the timing of the forecasts was more varied throughout that year. Eurostat data is used for the outturn data. For the UK, ONS outturn data submitted to Eurostat is used. Outturn data for the UK is on a financial year basis to be consistent with the forecasts.

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

Forecast analysis for the last two years

2.26 Table 2.E provides a summary comparison of the year-ahead projections for the main fiscal aggregates in Budget 2006 and Budget 2007 compared with the latest outturn information.

Table 2.E: Differences in Budget forecasts for main aggregates

	Per cent of GDP					
	2006-07			2007-08		
	Budget 2006 Forecast	Outturn	Difference	Budget 2007 Forecast	Outturn	Difference
Surplus on current budget	-0.5	-0.3	0.2	-0.3	-0.4	-0.1
<i>Memo: average absolute difference, current budget, since 1998-99</i>			0.8			0.8
Cyclically-adjusted surplus on current budget	0.4	-0.3	-0.7	-0.3	-0.7	-0.4
Public sector net borrowing	2.7	2.3	-0.4	2.4	2.5	0.1
<i>Memo: average absolute difference, net borrowing, since 1970-71</i>			1.1			1.1
Cyclically-adjusted public sector net borrowing	1.7	2.3	0.5	2.4	2.8	0.5
Public sector net debt	36.7	36.0	-0.7	38.0	36.3	-1.7

Note: Forecasts are given as a percentage of outturn GDP, and thus may differ slightly to the forecasts as published in Budget 2006 and Budget 2007. The 2007-08 public sector net debt outturn figures exclude Northern Rock. In contrast to elsewhere in the report, the difference column in this table is calculated as outturn minus forecast.

2.27 The key messages from Table 2.E on the surplus on the current budget are:

- in 2006-07, there was a deficit on the current budget of 0.3 per cent of GDP, compared with the Budget 2006 forecast of 0.5 per cent;
- the current budget deficit in 2007-08 was 0.4 per cent of GDP, compared with the Budget 2007 forecast of 0.3 per cent; and
- in both 2006-07 and 2007-08, the absolute forecast difference was significantly below the average absolute forecast difference since 1998-99, of 0.8 per cent of GDP, meaning the forecasts were accurate by historical standards.

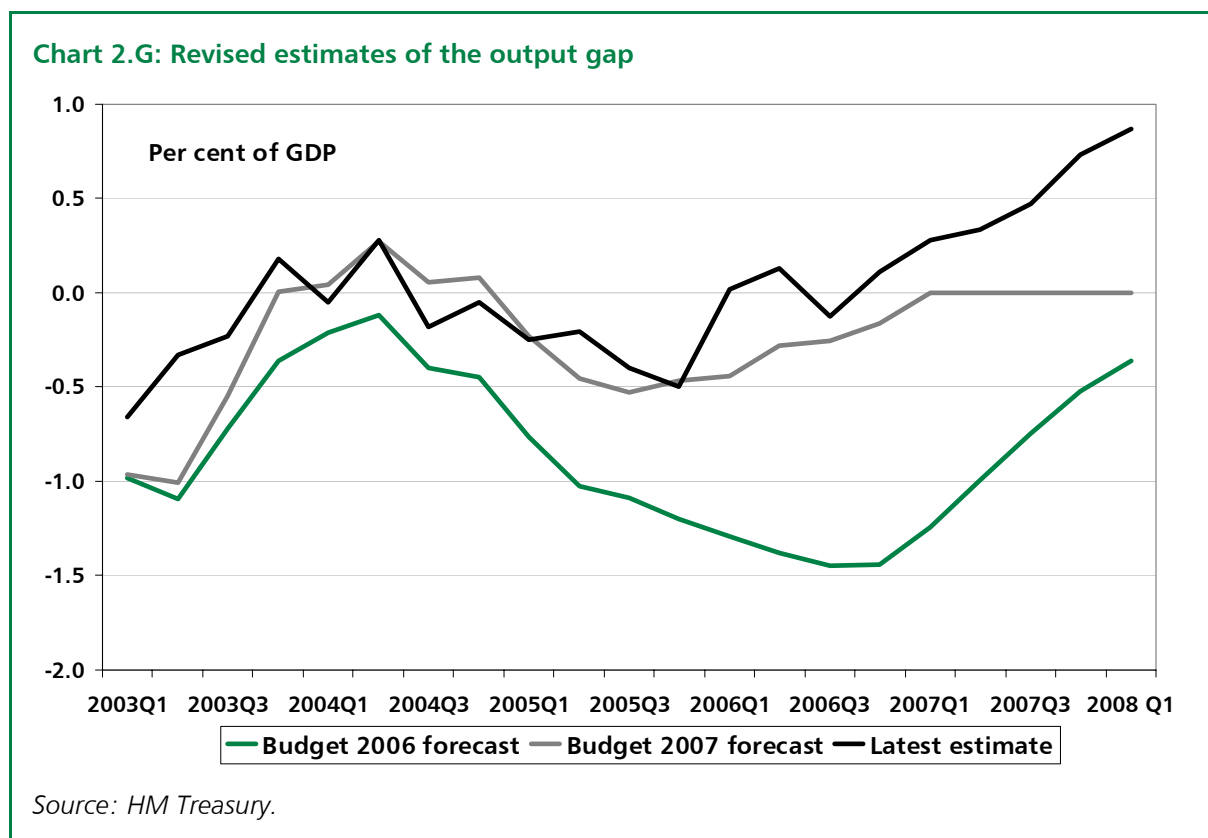
2.28 The key messages from Table 2.E on net borrowing are:

- PSNB in 2006-07 was 2.3 per cent of GDP, lower than the Budget 2006 forecast of 2.7 per cent of GDP;
- PSNB in 2007-08 was 2.5 per cent of GDP, marginally higher than the Budget 2007 forecast of 2.4 per cent of GDP; and
- the absolute one-year ahead forecast differences for these two years of 0.4 per cent of GDP and 0.1 per cent of GDP respectively are well below the average absolute one-year ahead forecast difference since 1970-71 of 1.1 per cent of GDP, meaning the forecasts were accurate by historical standards. They also compare well with the average absolute forecast difference since 1998-99 of 0.9 per cent of GDP.

Impact of the economic cycle

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

difference between forecast and outturn for the output gap therefore affects the public finances.



2.30 The output gap is the difference between actual non-oil output and the estimated trend level of non-oil output. Since the publication of the 2007 EYFR there have been revisions to the profile of output growth, which have fed through directly to the latest estimate of the profile of the output gap, as shown in Chart 2.G. Taken together with the Treasury's trend growth assumptions, the latest data imply an output gap in 2006-07 of 0.1 per cent of GDP, which compares to the year-ahead forecast in Budget 2006 of -1.4 per cent, and an output gap of 0.2 per cent in 2007-08, which compares to the year-ahead forecast in Budget 2007 of 0.0 per cent. The new output gap estimates directly affect the cyclically-adjusted fiscal balances, which are calculated using a formula that relates the fiscal aggregates to the cycle on the basis of past relationships.⁸ As the output gap becomes less negative, a smaller proportion of actual borrowing is attributed to cyclical factors and a larger proportion to non-cyclical factors.

The Treasury's cyclical adjustment methodology

2.31 The economic cycle has important short-term effects on the public finances, which need to be taken into account when assessing the underlying structural position of the public finances. The *Code for fiscal stability* requires the Government to publish cyclically-adjusted estimates of the key fiscal balances. The Treasury's latest forecasts of cyclically-adjusted PSNB and the cyclically-adjusted surplus on the current budget are published in each Budget and Pre-Budget Report.

2.32 The Treasury's methodology for estimating the impact of the economic cycle on the public finances, described in the 2008 HM Treasury Economic Working Paper *Public Finances and the Cycle*, is based on the average impact of changes in the output gap on the public finances over

⁸ See *Public Finances and the Cycle*, HM Treasury Economic Working Paper No.5, HM Treasury, November 2008.

previous cycles. To the extent that a given economic cycle differs from the average, temporary changes in the public finances may not be fully ascribed to the economic cycle.

Breakdown of forecast differences

2.33 Table 2.F provides more detailed information on the sources of forecast difference. In 2006-07, outturn current receipts were £3.1 billion higher than forecast at Budget 2006, while in 2007-08 outturn current receipts were £5.3 billion lower than forecast at Budget 2007. In both cases the absolute forecast difference was below the average absolute difference since 1998-99. Outturn current expenditure was £0.4 billion higher than forecast in 2006-07, and £2.9 billion lower than forecast in 2007-08. In both cases, the absolute forecast difference was below the average absolute difference since 1998-99. The outturn for depreciation was £0.1 billion above forecast for 2006-07 and £0.8 billion below forecast for 2007-08.

2.34 The forecast differences for current expenditure and current receipts in 2006-07 and 2007-08 are affected by a classification change by the Office for National Statistics (ONS) – a change to its treatment of local authorities' Housing Revenue Accounts. Although this change is fiscally neutral to the public sector, it has the effect of increasing both expenditure and receipts totals.

2.35 Net borrowing is equal to net investment less the surplus on the current budget. Outturn net investment was below forecast by £3.0 billion in 2006-07, but was £0.5 billion above forecast in 2007-08. Net investment increased by over 15 per cent between 2006-07 and 2007-08. The current budget surplus forecast differences were £2.6 billion in 2006-07 and -£1.6 billion in 2007-08. Net borrowing was £5.5 billion below forecast in 2006-07 and £2.1 billion above forecast in 2007-08.

Table 2.F: Summary of differences in Budget forecasts

	£ billion					
	2006-07			2007-08		
	Budget 2006 Forecast	Outturn	Difference	Budget 2007 Forecast	Outturn	Difference
Current budget						
Current receipts	516.4	519.5	3.1	553.0	547.6	-5.3
<i>Memo: average absolute difference in current receipts since 1998-99¹</i>			7.6			8.1
Current expenditure	506.7	507.2	0.4	538.6	535.7	-2.9
<i>Memo: average absolute difference in current expenditure since 1998-99¹</i>			4.6			4.8
Depreciation	16.8	16.9	0.1	18.7	17.8	-0.8
Surplus on current budget	-7.1	-4.6	2.6	-4.3	-5.9	-1.6
Capital budget						
Gross investment	52.2	42.7	-9.5	48.0	46.4	-1.6
Less asset sales	-6.6	-6.2	0.4	-6.2	-6.5	-0.3
Less depreciation	-16.8	-16.9	-0.1	-18.7	-17.8	-0.9
Net investment	28.8	25.8	-3.0	29.4	29.9	0.5
Public sector net borrowing	35.9	30.4	-5.5	33.7	35.8	2.1
<i>Memo: average absolute difference between forecast and outturn net borrowing since 1970-71¹</i>			15.2			16.1
Public sector net debt	493.3	497.9	4.6	540.3	526.9	-13.4
Memo						
Treaty deficit ²	37.8	34.4	-3.4	35.1	38.7	3.5
Treaty debt ³	562.6	574.2	11.6	610.5	614.4	3.9

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

² General government net borrowing on a Maastricht basis.

³ General government gross debt on a Maastricht basis.

Note: The difference column in this table is calculated as outturn minus forecasts. The 2007-08 public sector net debt outturn figures exclude Northern Rock. Figures may not sum due to rounding.

2.36 Table 2.G breaks down the differences between the year-ahead Budget forecasts and outturns into the four categories described in Chapter 1. The table shows that:

- in 2006-07 the caution provided by the NAO-audited assumptions, and by the fiscal forecasting differences affecting net investment, more than offset the effect of the economic determinants differences, causing net borrowing (PSNB) outturn to be lower than forecast; and
- the difference between forecast and outturn for the main fiscal aggregates in 2007-08 was mainly due to economic determinants. Fiscal forecasting differences also contributed to net borrowing (PSNB) being higher than forecast. The NAO-audited assumptions again provided the intended caution to offset some of these effects.

2.37 More detailed analysis of the forecast differences for spending and receipts in 2006-07 and 2007-08 is developed in Chapters 3 and 4.

Table 2.G: Breakdown of differences in the main fiscal aggregates¹

	£ billion	
	Budget 2006 forecast for 2006-07	Budget 2007 forecast for 2007-08
Current receipts difference	3.1	-5.3
<i>contribution from:</i>		
Economic determinants	-1.5	-6.9
NAO-audited assumptions	4.2	4.4
Fiscal forecasting differences	-1.0	-4.7
Other	1.3	1.7
Current spending difference	0.4	-2.9
<i>contribution from:</i>		
Economic determinants	1.0	0.7
NAO-audited assumptions	0.4	-0.1
Fiscal forecasting differences	-0.6	-3.9
Other	-0.2	0.4
Depreciation	0.1	-0.8
<i>contribution from:</i>		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	0.1	-0.8
Other	0.0	0.0
Current budget difference	2.6	-1.6
<i>contribution from:</i>		
Economic determinants	-2.5	-7.6
NAO-audited assumptions	3.9	4.5
Fiscal forecasting differences	-0.5	0.0
Other	1.6	1.3
Net investment difference	-3.0	0.5
<i>contribution from:</i>		
Economic determinants	0.0	0.0
NAO-audited assumptions	0.0	0.0
Fiscal forecasting differences	-4.2	0.5
Other	1.3	0.0
Net borrowing difference	-5.5	2.1
<i>contribution from:</i>		
Economic determinants	2.5	7.6
NAO-audited assumptions	-3.9	-4.5
Fiscal forecasting differences	-3.8	0.5
Other	-0.3	-1.3

¹ Contributions may not sum due to rounding.

3

Receipts

This chapter provides more detailed analysis of developments in receipts in 2006-07 and 2007-08. The detailed forecast analysis considers the Budget 2006 forecast for 2006-07 and the Budget 2007 forecast for 2007-08. It shows that:

- current receipts rose from £519.5 billion in 2006-07 to £547.6 billion in 2007-08; and
- in 2006-07 receipts were £3.1 billion above forecast, reflecting higher receipts from a number of taxes, including income tax and stamp duties. In 2007-08 receipts were below forecast as a result of lower than expected receipts from a number of taxes, including corporation tax.

3.1 This chapter provides more detailed analysis of developments in current receipts and, in particular, the year-ahead forecasts made in Budget 2006 and Budget 2007. 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.A shows the differences between the year-ahead forecasts of and outturn for receipts for Budget 2006 and Budget 2007. Current receipts were £519.5 billion in 2006-07, and rose to £547.6 billion in 2007-08.

Table 3.A: Summary of differences in Budget receipts forecasts

	Forecast	Outturn	Difference
Budget 2006 forecast of 2006-07			
Current receipts (£ billion)	516.4	519.5	3.1
Current receipts (per cent of GDP)	40.3	38.6	-1.7
Cyclically-adjusted current receipts (per cent of GDP)	40.6	38.7	-1.9
Budget 2007 forecast of 2007-08			
Current receipts (£ billion)	553.0	547.6	-5.3
Current receipts (per cent of GDP)	40.1	38.5	-1.6
Cyclically-adjusted current receipts (per cent of GDP)	40.1	38.5	-1.7

Note: Figures may not sum due to rounding.

3.3 Current receipts were £3.1 billion above forecast in 2006-07 and £5.3 billion below forecast in 2007-08. Table 3.B shows that there was a shortfall in receipts in 2006-07 from corporation tax and national insurance contributions, but this was more than offset by higher receipts from income tax and stamp duty. Table 3.C shows that in 2007-08 the deficit was driven by lower than expected receipts from a number of taxes, including corporation tax. This is described in more detail in the next section.

3.4 In order to focus on underlying or structural trends in receipts, the Government also produces estimates of cyclically-adjusted fiscal aggregates (see Chapter 2). These remove the estimated effect of the economic cycle on public sector spending and receipts. The estimates of cyclically-adjusted current receipts shown in Table 3.A are based on the methodology described in the 2008 HM Treasury Economic Working Paper *Public Finances and the Cycle*.¹

3.5 The Treasury's approach to cyclical adjustment is based on the relationship between the output gap and fiscal aggregates over previous cycles. 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 differences:** in some cases, forecasts of the relevant economic variables for the tax base are not produced by the Treasury, and more aggregated economic variables have to be used. For example, the Treasury does not forecast consumers' expenditure on beer, which would be used to forecast beer duty receipts. In these cases, fiscal forecasting models are used to estimate the relationship between the most relevant macroeconomic variable (total consumers' expenditure in the case of beer) and the corresponding tax base. These models are also used to estimate actual tax receipts. Any differences in tax receipts resulting from unexpected changes in the relationship between main economic determinants, tax rates and revenues, as contained in the fiscal models, are therefore defined as fiscal forecasting differences. For example, if income tax receipts turned out to be higher than forecast even after taking account of

¹ *Public Finances and the Cycle*, HM Treasury Economic Working Paper No.5, HM Treasury, November 2008.

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

- **other:** differences in the economic determinants and the fiscal forecasting models are not the only potential source of forecasting differences. Other factors include changes in definitions of taxes or the impact of tax measures announced after the publication of the forecast that have an effect on receipts in that year.

Tax by tax forecasting differences

3.7 Tables 3.B and 3.C use this breakdown of forecasting differences for the Budget 2006 and Budget 2007 year-ahead forecasts for each of the main taxes. These tables also group the taxes to show the same breakdown for HM Revenue and Customs (HMRC) receipts, net taxes and national insurance contributions (NICs), and current receipts.

Tax by tax analysis

Income tax and national insurance contributions

3.8 Cash receipts of combined income tax and national insurance contributions (NICs) were £1.4 billion above forecast in 2006-07. However, a greater than usual share of combined Pay as You Earn (PAYE) payments were allocated to income tax leading to an underforecast for PAYE income tax and an overforecast for national insurance contributions (NICs). Higher overall receipts were partly due to higher than expected wages and salaries growth. Self assessment receipts were £1.6 billion above forecast, largely due to fiscal forecasting differences. This was partly offset by lower than expected other income tax receipts.

3.9 Combined income tax and national insurance contributions were £0.3 billion above forecast in 2007-08. Income tax receipts in 2007-08 were £5.0 billion below forecast, but this shortfall was more than offset by higher national insurance contributions of £5.3 billion. A new approach to allocating PAYE receipts between income tax and NICs has been introduced with the aim of minimising the need to re-allocate between the two receipts streams in future. Self assessment receipts were £1.4 billion above forecast, with self employment income declared for tax stronger than the Office for National Statistics (ONS) data. This divergence is scored under fiscal forecasting differences. This was largely offset by the effect of lower than expected increases in wages and salaries, which have been scored as differences in economic determinants.

Value added tax

3.10 VAT receipts in 2006-07 were £0.9 billion above forecast. The VAT forecast assumes the VAT gap, defined as the gap between theoretical VAT liability and receipts, will increase by 0.5 percentage points from the latest outturn value. The latest VAT gap estimates for 2006-07 was 0.7 per cent lower, increasing receipts by £1.6 billion compared to the Budget 2006 forecast. This was due to a reduction in Missing Trader Intra-Community (MTIC) fraud, following the strengthening of HMRC's operational strategy to combat such activity. This difference in forecast and outturn as a result of the lower than expected VAT gap has been scored to NAO-audited assumptions. VAT receipts were further boosted by higher-than-expected growth in the government and housing elements of the VAT tax base. The overall total was partly offset by a negative fiscal forecasting difference.

Table 3.B: Breakdown of Budget 2006 forecasting differences of receipts for 2006-07

	Forecast	Outturn	Difference	£ billion			
				of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
HM Revenue & Customs							
Income tax (gross of tax credits)	144.0	147.8	3.7	0.6	0.5	2.6	0.0
Income tax credits ¹	-4.6	-4.4	0.2	0.0	0.0	0.2	0.0
National insurance contributions	89.6	87.3	-2.4	0.2	0.1	-2.7	0.0
Value added tax	76.5	77.4	0.9	0.6	1.7	-1.5	0.0
Corporation tax ²	48.5	44.3	-4.1	-4.8	1.3	-0.7	0.0
Petroleum revenue tax	1.9	2.2	0.3	-0.3	0.3	0.3	0.0
Fuel duties	24.0	23.6	-0.5	0.2	-0.1	-0.3	-0.2
Capital gains tax	3.8	3.8	0.0	0.0	0.0	0.0	0.0
Inheritance tax	3.6	3.6	0.0	0.1	0.0	0.0	-0.1
Stamp duties	12.2	13.4	1.2	1.9	0.0	-0.7	0.0
Tobacco duties	8.0	8.1	0.1	0.1	0.2	-0.1	0.0
Alcohol duties	8.1	7.9	-0.2	0.0	0.0	-0.2	0.0
Other HMRC	8.9	8.8	-0.1	0.1	0.0	-0.4	0.2
Total HMRC	424.4	423.7	-0.7	-1.2	4.1	-3.4	-0.2
Vehicle excise duties	5.1	5.1	0.0	0.0	0.0	0.0	0.0
Business rates	21.4	21.0	-0.4	0.0	0.0	-0.4	0.0
Council tax	22.0	22.2	0.2	0.0	0.0	0.2	0.0
Other taxes and royalties	13.6	14.2	0.6	0.0	0.0	0.6	0.0
Net taxes and national insurance contributions	486.5	486.2	-0.4	-1.3	4.1	-3.0	-0.2
Accruals adjustment on taxes less VAT and own resources EU contributions	2.3	4.9	2.6	0.1	0.1	2.3	0.0
less PC onshore CT payments	-4.2	-4.6	-0.4	-0.4	0.0	0.0	0.0
Tax credits adjustment ³	-0.1	-0.3	-0.2	0.0	0.0	-0.2	0.0
Interest & dividends	0.6	0.6	-0.1	0.0	0.0	-0.1	0.0
Other receipts	5.7	6.3	0.7	0.0	0.0	0.7	0.0
Other receipts	25.6	26.5	0.9	0.0	0.0	-0.6	1.5
Current receipts	516.4	519.5	3.1	-1.5	4.2	-1.0	1.3

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.

Note: Figures may not sum due to rounding.

3.11 VAT receipts in 2007-08 were £0.6 billion above forecast. The estimated gap between theoretical VAT liability and receipts declined by 1.5 percentage points, increasing receipts relative to the Budget 2007 forecast by £0.9 billion, scored to NAO-audited assumptions. The decrease in the VAT gap was supported by the continued efforts of HMRC to reduce the level of attempted fraud. More detail on measuring overall VAT losses in these years can be found in the HM Revenue and Customs release *Measuring Indirect Tax Gaps 2008*. This increase in VAT receipts was partly offset by lower growth in the government element of the VAT base. A lower share of household expenditure liable to the standard rate of VAT offset stronger growth in consumer expenditure.

Corporation tax

3.12 The outturn of total corporation tax receipts (including North Sea oil and gas receipts) in 2006-07 was £4.1 billion below forecast. The shortfall for onshore companies was partly due to slower than expected profits growth, particularly in the financial sector. Lower than expected profits in the life assurance sector also contributed to the shortfall, which was largely driven by lower than expected bond prices in 2006. The overall negative fiscal forecasting difference of £0.7 billion in 2006-07 was in part due to the effect of revised accounting data on the composition of 2005-06 receipts.

Table 3.C: Breakdown of Budget 2007 forecasting differences of receipts for 2007-08

	Forecast	Outturn	Difference	£ billion			
				of which:			
				Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
HM Revenue & Customs							
Income tax (gross of tax credits)	156.9	151.9	-5.0	-2.8	0.8	-3.0	0.0
Income tax credits ¹	-4.4	-4.4	0.0	0.0	0.0	0.0	0.0
National insurance contributions	95.1	100.4	5.3	-1.2	0.2	6.4	0.0
Value added tax	80.0	80.6	0.6	-0.4	1.0	-0.1	0.0
Corporation tax ²	49.5	46.4	-3.1	-1.9	1.8	-3.1	0.0
Petroleum revenue tax	1.6	1.7	0.1	-0.1	0.4	-0.3	0.0
Fuel duties	25.1	24.9	-0.2	0.3	-0.3	-0.2	0.0
Capital gains tax	4.6	5.3	0.6	0.1	0.0	0.4	0.2
Inheritance tax	4.0	3.8	-0.2	0.0	0.1	-0.1	-0.2
Stamp duties	14.3	14.1	-0.2	-0.5	0.0	0.4	0.0
Tobacco duties ³	8.1	8.1	0.0	0.0	0.3	-0.3	0.0
Alcohol duties	8.2	8.3	0.1	0.0	0.0	0.1	0.0
Other HMRC	10.3	10.1	-0.2	0.1	0.0	-0.3	0.0
Total HMRC	453.4	451.2	-2.2	-6.4	4.2	-0.1	0.0
Vehicle excise duties	5.6	5.4	-0.2	0.0	0.0	-0.2	0.0
Business rates	22.1	21.4	-0.7	0.0	0.0	-0.7	0.0
Council tax	23.5	23.2	-0.2	0.0	0.0	-0.2	0.0
Other taxes and royalties	14.5	14.6	0.1	0.0	0.0	0.1	0.0
Net taxes and national insurance contributions	519.2	515.9	-3.3	-6.4	4.3	-1.1	0.0
Accruals adjustment on taxes less VAT and own resources EU contributions	2.4	1.2	-1.2	0.0	0.2	-1.4	0.0
less PC onshore CT payments	-4.1	-5.0	-0.9	-0.5	0.0	-0.5	0.0
Tax credits adjustment ⁴	-0.2	-0.3	0.0	0.0	0.0	0.0	0.0
Interest & dividends	0.6	0.6	0.0	0.0	0.0	0.0	0.0
Other receipts	7.1	8.3	1.1	0.0	0.0	1.1	0.0
Current receipts	553.0	547.6	-5.3	-6.9	4.4	-4.7	1.7

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 A revised NAO audited assumption was adopted in Budget 2007, which assumes that the underlying level of duty paid consumption of cigarettes will be set at least 3 per cent per year lower than the estimated outturn of the current year.

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

Note: Figures may not sum due to rounding.

3.13 In 2006-07, North Sea corporation tax receipts were £1.5 billion below forecast. This was largely caused by a combination of lower than expected production, higher than expected operating and capital expenditure, and the appreciation of sterling against the US dollar (which reduced the oil price in sterling terms), all scored as economic determinant differences. The shortfall was partly offset by higher than expected oil prices; at Budget 2006 the NAO-audited assumption for the average price of oil was \$57.4 per barrel, but the outturn for 2006 as a whole was \$66.1 per barrel. Gas prices were also higher than expected.

3.14 The outturn of total corporation tax receipts (including North Sea oil and gas receipts) in 2007-08 was £3.1 billion below forecast. Higher than expected repayments explain almost the entire shortfall in onshore corporation tax in 2007-08. While some companies had overpaid tax for recent accounting periods by more than expected, HMRC also made efforts to finalise tax liabilities relating to historic accounting periods.

3.15 In 2007-08, North Sea corporation tax receipts were £0.3 billion below forecast. This was largely caused by a combination of lower than expected production, and higher than expected operating and capital expenditure, scored as economic determinant differences. The shortfall was partly offset by higher than expected oil prices; at Budget 2007 the NAO-audited assumption for the average price of oil was \$58.1 per barrel, but the outturn for 2007 as a whole was \$72.4 per barrel.

Petroleum revenue tax

3.16 Receipts of petroleum revenue tax (PRT) in 2006-07 were £0.3 billion higher than forecast, largely due to higher than forecast oil prices scored to NAO-audited assumptions. Economic determinant differences, due to an overestimation of North Sea production, were broadly offset by fiscal forecasting differences attributed to an underestimate of gas prices. Receipts of PRT in 2007-08 were £0.1 billion higher than forecast, largely due to higher than forecast oil prices, scored as an NAO-audited assumption difference. However, this increase was largely offset by fiscal forecasting differences.

Fuel duties

3.17 Fuel duty receipts in 2006-07 were £0.5 billion below forecast. At Budget 2006 it was announced that fuel duties would be raised in line with inflation at the start of September, but this was delayed until the 2006 Pre-Budget Report, contributing £0.2 billion to the shortfall, which has been scored under other factors. Receipts were further weakened by the fact that oil prices were higher than the NAO-audited assumption. With fuel duties charged on a per litre basis, higher pump prices reduce the demand for fuel and hence fuel duty receipts. These shortfalls were partially offset by a positive impact from economic determinants, principally Retail Prices Index (RPI) inflation and GDP growth.

3.18 Fuel duty receipts in 2007-08 were £0.2 billion below forecast. Receipts were weakened by the fact that oil prices were higher than the NAO-audited assumption. This was partially offset by a positive impact from economic determinants of £0.3 billion due to stronger GDP growth, higher RPI inflation, and movements in exchange rates.

Capital gains tax and inheritance tax

3.19 Capital gains tax receipts and inheritance tax receipts in 2006-07 were very close to the Budget 2006 forecasts. Capital gains tax receipts in 2007-08 were £0.6 billion above the Budget 2007 forecast, most of which can be attributed to fiscal forecasting differences related to modelling taxpayer behaviour. Inheritance tax receipts in 2007-08 were £0.2 billion lower than the Budget 2007 forecast.

Stamp duties

3.20 In 2006-07 total stamp duty receipts were £1.2 billion higher than forecast. Higher than forecast receipts from stamp duty on land and property more than offset lower than forecast receipts on shares. Receipts on land and property were above forecast due to higher than expected house prices, house transaction volumes and commercial transaction volumes. The lower stamp duty receipts from shares, reflected as fiscal forecasting differences, was largely due to the proportion of transactions liable for duty being lower than forecast.

3.21 In 2007-08 total stamp duty receipts were £0.2 billion lower than forecast. Receipts on land and property were below forecast primarily due to lower than expected commercial prices and house transaction volumes. However, these shortfalls were partially offset by higher than expected stamp duty receipts from shares.

Tobacco duties

3.22 In 2006-07, tobacco receipts were £0.1 billion above the Budget 2006 forecast. The mid-point of the smuggled share of cigarettes estimate for 2006-07 was 13 per cent, which was lower than the NAO-audited assumption of 16 per cent, and this increased revenue by £0.2 billion.

3.23 In 2007-08 tobacco receipts were very close to the Budget 2007 forecasts. A revised NAO-audited assumption was adopted in Budget 2007, which assumes that the underlying level of duty paid consumption of cigarettes will be set at least 3 per cent per year lower than the estimated outturn of the current year. In 2007-08 duty paid clearances increased by 0.4 per cent, which resulted in a £0.3 billion underforecast attributed to the NAO-audited assumption. This was offset by a negative fiscal forecasting difference of £0.3 billion, which can be attributed to an overestimate of underlying duty paid clearances in 2006-07 and a timing effect shifting receipts between years.

Alcohol duties

3.24 In 2006-07, alcohol duty receipts were £0.2 billion lower than forecast, largely due to fiscal forecasting differences. Alcohol receipts in 2007-08 were £0.1 billion above forecast, largely due to forestalling bringing forward receipts expected in 2008-09 into 2007-08.

Other HMRC taxes

3.25 Receipts from other HMRC taxes were £0.1 billion below forecast in 2006-07 and £0.2 billion below forecast in 2007-08. Fiscal forecasting differences more than explain the shortfall in both years.

Vehicle excise duty

3.26 Vehicle excise duty receipts were very close to forecast in 2006-07, and £0.2 billion below forecast in 2007-08 due to fiscal forecasting differences.

Council tax

3.27 Council tax increases are determined annually by local authorities rather than the Government, so council tax forecasts are projections based on a set of stylised assumptions. Forecasts for the forthcoming financial year in Budgets 2006 and 2007 were based on the latest available estimates released by the Chartered Institute for Public Finance and Accountancy (CIPFA). Council tax receipts in 2006-07 were £0.2 billion higher than forecast in Budget 2006. This is attributable to fiscal forecasting differences and is largely explained by higher than forecast growth in the council tax base. Council tax receipts were £0.2 billion lower in 2007-08 than forecast in Budget 2007.

Other taxes and royalties

3.28 In 2006-07, receipts of other taxes and royalties were £0.6 billion higher than forecast in Budget 2006. In 2007-08 receipts of other taxes and royalties were £0.1 billion higher than forecast at Budget 2007.

Accruals adjustments

3.29 In 2006-07 accruals adjustments were £2.6 billion above forecast, which is largely due to a positive fiscal forecasting difference of £2.3 billion. This reflects higher accruals adjustments for both NICs and VAT. The latter reflects strong growth in cash receipts of VAT in the early part of 2007-08, which largely accrues back to 2006-07.

3.30 In 2007-08 accruals adjustments were £1.2 billion below forecast, which can be attributed to a negative fiscal forecasting difference of £1.4 billion. This was due to lower accruals adjustments for both NICs and VAT. Cash receipts of VAT were weak at the start of 2008-09, which meant that less than expected VAT accrued back to 2007-08.

Interest and dividends

3.31 Interest and dividend receipts were £0.7 billion above forecast in 2006-07, partly reflecting the decision of the ONS to include the interest accruing on student loans. Interest and dividend receipts were £1.1 billion in 2007-08, reflecting higher than expected interest receipts received by the Debt Management Office (DMO) on short-term deposits, which are scored under fiscal forecasting differences.

Other receipts

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

3.33 Other receipts in 2006-07 were £0.9 billion above forecast. Receipts in 2006-07 were boosted by the Housing Revenue Account (HRA) reclassification, which added £1.5 billion and the inclusion of renewable obligation certificates. In June 2007, the ONS changed their treatment of local authorities' Housing Revenue Accounts. In the National Accounts, these are regarded as 'quasi-corporations' net borrowing. The effect was to impute equal amounts of additional expenditure by local authorities and increases in the gross operating surplus of public corporations. These changes are shown as other factors, both in the other receipts category and in the accounting adjustments on public expenditure.

3.34 Other receipts in 2007-08 were £1.0 billion below forecast. Receipts in 2007-08 were increased by the HRA reclassification, which added £1.8 billion. However, the non-HRA elements of the gross operating surplus were lower than expected.

4

Public expenditure

This chapter provides a detailed analysis of public expenditure in 2006-07 and 2007-08. It shows that:

- spending was lower than forecast by £2.4 billion (0.2 per cent of GDP) in 2006-07 because of lower capital expenditure, and lower than forecast by £3.2 billion (0.2 per cent of GDP) in 2007-08 because of lower current spending in Annually Managed Expenditure;
- Total Managed Expenditure rose from £549.9 billion in 2006-07 to £583.4 billion in 2007-08; and
- there were substantial increases in public sector net investment in both 2006-07 (over 8 per cent on the previous year) and 2007-08 (over 15 per cent on the previous year).

4.1 This chapter provides a detailed examination of trends and developments in public expenditure in 2006-07 and 2007-08 and, in particular, differences between projected expenditure and outturn for the year-ahead projections in Budgets 2006 and 2007.

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 (ESA95).

4.3 For budgeting purposes, TME is divided into:

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

4.4 To improve long-term planning and to protect capital investment, DEL is further divided into Capital and Resource (current) Budgets, which are managed separately. End-year flexibility (EYF) is a process which, with Treasury agreement, allows departments to carry forward unspent resources from one year to the next.

4.5 Data on public spending remain provisional for a considerable period after the end of the relevant financial year. For example, resource accounts for central government departments may not be finalised until around nine months after the end of the year, while consolidated data for local authorities is produced over a longer time scale. That means that the data in this chapter, particularly for 2007-08, are not final. The information is, however, sufficiently robust to allow

analyses of forecasting differences; future revisions are likely to change the detail rather than the main conclusions.

Overall public expenditure forecasting differences

4.6 Table 4.A shows the latest outturn for key public spending aggregates for 2006-07 and 2007-08, including a comparison of the differences in the year-ahead forecasts for spending published in Budgets 2006 and 2007 respectively.

Table 4.A: Summary of public expenditure forecasting differences for 2006-07 and 2007-08

	£ billion					
	2006-07			2007-08		
	Forecast	Outturn	Difference	Forecast	Outturn	Difference
Public sector current expenditure	506.7	507.2	0.4	538.6	535.7	-2.9
Public sector net investment	28.8	25.8	-3.0	29.4	29.9	0.5
Public sector depreciation	16.8	16.9	0.1	18.7	17.8	-0.8
Total Managed Expenditure	552.3	549.9	-2.4	586.6	583.4	-3.2
<i>of which:</i>						
Departmental Expenditure Limits						
Resource Budget	294.5	291.3	-3.3	310.0	310.0	0.1
Capital Budget	42.5	38.8	-3.6	44.3	44.1	-0.2
<i>Less depreciation</i>	-11.8	-10.3	1.5	-10.6	-10.7	-0.1
Total Departmental Expenditure Limits	325.2	319.8	-5.4	343.7	343.5	-0.2
Total Annually Managed Expenditure	227.1	230.1	3.0	242.9	239.9	-3.0

Note: Figures may not sum due to rounding.

4.7 TME rose from £549.9 billion in 2006-07 to £583.4 billion in 2007-08 (approximately 41.1 per cent of GDP). Net investment increased by over 8 per cent in 2006-07 to £25.8 billion, and over 15 per cent in 2007-08, to £29.9 billion.

4.8 In both 2006-07 and 2007-08 TME outturn was lower than the year-ahead forecast in Budget 2006 and Budget 2007 respectively. However, classification changes since those Budgets have increased TME by £1.9 billion in both years.

4.9 The main classification change affecting both years has been the additional local authority imputed subsidy for the injection of equity into Housing Revenue Accounts (HRAs), which the ONS introduced in June 2007. This was fiscally neutral, but it increased public sector current receipts by £1.5 billion and £1.8 billion in 2006-07 and 2007-08 respectively. The other main classification change affecting both years has been the reclassification by the ONS of expenditure on nuclear decommissioning from current to capital expenditure, which the ONS introduced between the 2006 Budget and the 2007 Pre-Budget Report. This switched £0.7 billion from current to capital expenditure in both relevant years, but with no overall effect on TME.

Forecast differences in 2006-07

4.10 In 2006-07, TME was £2.4 billion below forecast. Public sector current expenditure was £0.4 billion higher than forecast, including increases of £1.1 billion from classification changes (see paragraph 4.9, above). Public sector net investment was £3.0 billion lower than projected, due to lower than planned capital DEL spending.

Forecast differences in 2007-08

4.11 In 2007-08, TME was £3.2 billion below forecast. Public sector current expenditure was £2.9 billion lower than forecast, however this outturn also includes increases of £1.2 billion from classification changes (see paragraph 4.9, above). Public sector net investment was £0.5 billion higher than projected, mainly due to higher than forecast capital AME spending. Public sector depreciation was £0.8 billion lower than forecast.

Spending forecasts and reasons for differences

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

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

DEL forecasting differences

4.13 Tables 4.B and 4.C provide a breakdown of TME forecasting differences for 2006-07 and 2007-08 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 forecast differences', with the exception of classification changes and discretionary changes, including expenditure financed by allocations made from the special reserve, which are attributed to 'other factors'.

4.14 Departments can 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 (PEOWP), published in July of each year².

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

² See http://www.hm-treasury.gov.uk/public_expenditure_statistics_publications.htm.

Table 4.B: Breakdown of Budget 2006 forecasting differences of public expenditure for 2006-07

	Forecast	Outturn	Difference	£ billion			
				of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Departmental Expenditure Limits							
Resource Budget	294.5	291.3	-3.3	0.0	0.0	-2.4	-0.9
Capital Budget	42.5	38.8	-3.6	0.0	0.0	-4.6	1.0
<i>Less depreciation</i>	-11.8	-10.3	1.5	0.0	0.0	0.6	0.9
Total Departmental Expenditure Limits	325.2	319.8	-5.4	0.0	0.0	-6.5	1.0
Annually Managed Expenditure	227.1	230.1	3.0	1.0	0.4	1.7	0.0
Total Managed Expenditure	552.3	549.9	-2.4	1.0	0.4	-4.8	1.0
<i>of which:</i>							
Public sector current expenditure	506.7	507.2	0.4	1.0	0.4	-0.6	-0.2
Public sector net investment	28.8	25.8	-3.0	0.0	0.0	-4.2	1.3
Public sector depreciation	16.8	16.9	0.1	0.0	0.0	0.1	0.0

Note: Figures may not sum due to rounding.

DEL in 2006-07

4.15 Outturn for total DEL in 2006-07 was £319.8 billion, £5.4 billion below the Budget 2006 forecast. This difference between planned and outturn spending is largely due to lower than planned capital expenditure, and is equivalent to less than 2 per cent of forecast total DEL, or roughly 0.4 per cent of GDP.

4.16 Spending on Resource DEL was £3.3 billion below the Budget 2006 forecast as a result of lower than planned spending, mainly in the Department of Health and Department for Children, Schools and Families. There was also a reclassification of £0.7 billion of nuclear decommissioning from resource to capital budgets (see paragraph 4.9).

4.17 Capital DEL outturn was £3.6 billion below the Budget 2006 plans. This difference includes the £0.7 billion nuclear decommissioning classification change, which is more than offset by underspends from departments, including the Department of Health and the Department for Children, Schools and Families. Unspent capital provision can be carried forward from one year to the next through the Government's EYF scheme.

4.18 Outturn for DEL depreciation was £1.5 billion below the Budget 2006 forecast. This reflects classification changes that moved £0.9 billion of DEL depreciation from DEL to AME, and £0.3 billion of fiscal forecasting differences due to revised reporting of impairments by the NHS and Foundation Trusts.

Table 4.C: Breakdown of Budget 2007 forecasting differences of public expenditure for 2007-08

	Forecast	Outturn	Difference	£ billion			
				of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Departmental Expenditure Limits							
Resource Budget	310.0	310.0	0.1	0.0	0.0	0.8	-0.7
Capital Budget	44.3	44.1	-0.2	0.0	0.0	-1.1	0.9
<i>Less depreciation</i>	-10.6	-10.7	-0.1	0.0	0.0	-0.1	0.0
Total Departmental Expenditure Limits	343.7	343.5	-0.2	0.0	0.0	-0.4	0.2
Annually Managed Expenditure	242.9	239.9	-3.0	0.7	-0.1	-3.8	0.2
Total Managed Expenditure	586.6	583.4	-3.2	0.7	-0.1	-4.2	0.4
<i>of which:</i>							
Public sector current expenditure	538.6	535.7	-2.9	0.7	-0.1	-3.9	0.4
Public sector net investment	29.4	29.9	0.5	0.0	0.0	0.5	0.0
Public sector depreciation	18.7	17.8	-0.8	0.0	0.0	-0.8	0.0
<small>Note: Figures may not sum due to rounding.</small>							

DEL in 2007-08

4.19 Outturn spending for total DEL in 2007-08 was £343.5 billion, just £0.2 billion below the Budget 2007 forecast of £343.7 billion.

4.20 Resource DEL outturn was £0.1 billion above the Budget 2007 forecast. Lower than planned spending by the Ministry of Defence and the reclassification of nuclear decommissioning (see paragraph 4.9) were more than offset by departmental drawdown of EYF.

4.21 Capital DEL was £0.2 billion less than the Budget 2007 forecast. This was due to the increase from the nuclear decommissioning classification change being more than offset by lower than planned spending in the Department of Health, and the Department for Children, Schools and Families.

4.22 DEL depreciation was £0.1 billion higher than forecast, resulting entirely from fiscal forecasting differences.

AME forecasting differences

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

4.24 Tables 4.D and 4.E present a breakdown of forecasting differences in AME for 2006-07 and 2007-08 respectively. Forecast differences for each AME spending component are apportioned to one or more of the four types of forecast differences discussed previously. For AME as a whole, outturn was higher than forecast by £3.0 billion in 2006-07, and lower than forecast by £3.0 billion in 2007-08. Both of these differences are equivalent to 0.2 per cent of GDP.

Table 4.D: Breakdown of Budget 2006 AME forecasting differences of public expenditure 2006-07

	Forecast	Outturn	Difference	£ billion			
				of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Annually Managed Expenditure							
Social security benefits ¹	131.5	131.3	-0.2	0.0	0.0	0.0	-0.3
Tax credits	15.6	16.3	0.7	0.0	0.0	0.7	0.0
Net public service pensions ²	0.4	1.1	0.7	0.0	0.0	0.7	0.0
National Lottery	1.7	1.6	-0.1	0.0	0.0	0.0	-0.1
BBC domestic services	3.3	3.4	0.1	0.0	0.0	0.1	0.0
Public corporations' own-financed capital expenditure	2.9	5.2	2.3	0.0	0.0	0.0	2.3
Other departmental expenditure	3.6	1.9	-1.7	0.0	0.0	-0.5	-1.2
Net expenditure transfers to EC Institutions ³	5.4	4.7	-0.8	0.0	0.0	-0.8	0.0
Locally financed expenditure	27.7	26.6	-1.0	0.0	0.0	1.3	-2.3
Central government gross debt interest	26.3	27.6	1.3	1.0	0.3	0.0	0.0
Accounting adjustments	7.7	10.3	2.6	0.0	0.0	0.1	2.5
AME margin	1.0	0.0	-1.0	0.0	0.0	0.0	-1.0
Total Annually Managed Expenditure	227.1	230.1	3.0	1.0	0.4	1.7	0.0

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

² Net public service pensions expenditure is reported on a National Accounts basis.

³ Gross National Income-based contributions less UK abatement.

Note: Figures may not sum due to rounding.

Table 4.E: Breakdown of Budget 2007 AME forecasting differences of public expenditure 2007-08

	Forecast	Outturn	Difference	£ billion			
				of which: Economic determinants	Assumptions audited by the NAO	Fiscal forecasting differences	Other factors
Annually Managed Expenditure							
Social security benefits ¹	139.2	138.8	-0.4	0.0	-0.4	0.3	-0.3
Tax credits	16.5	17.1	0.6	0.0	0.0	0.6	0.0
Net public service pensions ²	1.7	2.3	0.6	0.0	0.0	0.6	0.0
National Lottery	1.6	1.4	-0.2	0.0	0.0	0.0	-0.2
BBC domestic services	3.3	3.3	0.1	0.0	0.0	0.1	0.0
Public corporations' own-financed capital expenditure	4.6	5.9	1.3	0.0	0.0	1.3	0.0
Other departmental expenditure	3.1	1.3	-1.9	0.0	0.0	-1.2	-0.7
Net expenditure transfers to EC Institutions ³	5.0	5.4	0.4	0.0	0.0	0.4	0.0
Locally financed expenditure	27.8	28.3	0.5	0.0	0.0	0.5	0.0
Central government gross debt interest	29.1	29.9	0.8	0.7	0.3	-0.2	0.0
Accounting adjustments	10.0	6.2	-3.8	0.0	0.0	-6.2	2.4
AME margin	1.0	0.0	-1.0	0.0	0.0	0.0	-1.0
Total Annually Managed Expenditure	242.9	239.9	-3.0	0.7	-0.1	-3.8	0.2

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

² Net public service pensions expenditure is reported on a National Accounts basis.

³ Gross National Income-based contributions less UK abatement.

Note: Figures may not sum due to rounding.

AME component analysis

Social security benefits

4.25 Social security payments in 2006-07 were £0.2 billion lower than the Budget 2006 forecast. This was more than accounted for by the reclassification of £0.3 billion of spending on the Independent Living Fund (ILF) from AME to DEL (at Budget 2008).

4.26 Outturn in 2007-08 was £0.4 billion lower than the Budget 2007 forecast. This was largely due to a decrease in unemployment caseload, causing a fall in expenditure of £0.4 billion. The £0.3 billion classification change for the previously mentioned ILF movement was offset by fiscal forecasting differences from factors affecting housing benefit (such as increases in the working age caseload).

Tax credits

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

4.28 In 2006-07 tax credits expenditure was £0.7 billion higher than forecast and this is entirely scored as fiscal forecasting differences. These arose because of higher than forecast in-work entitlement, partly offset by lower out of work entitlement and net overpayments.

4.29 Outturn in 2007-08 was £0.6 billion above forecast, again because of fiscal forecasting differences. This reflects new information on the effects of turnover among the tax credits population on income growth, and higher than projected birth rates.

Net public service pensions

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

4.31 In 2006-07 the outturn for net public service pensions was £0.7 billion higher than forecast, and this is scored as a fiscal forecasting difference. This difference was mainly due to higher than expected cash expenditure, and lower than expected receipts by the NHS Pension Scheme (NHSPS), which caused £0.6 billion of the discrepancy.

4.32 Outturn in 2007-08 was £0.6 billion above the Budget 2007 forecast. This was mainly due to lower than expected receipts by the NHSPS, and higher than forecast cash expenditure from other smaller schemes.

National lottery

4.33 The lottery outturn for 2006-07 was £0.1 billion below forecast. This resulted from the movement of Olympic Lottery Distribution Fund (OLDF) expenditure from AME to DEL. This difference is allocated to 'other factors'.

4.34 Outturn for 2007-08 was £0.2 billion below the Budget 2007 forecast, again due to OLDF spending now being scored in DEL.

BBC domestic services

4.35 BBC domestic services were reclassified by the ONS from the public corporations sector to the central government sector in January 2006, and have been a component of AME since Budget 2006. Outturn in both 2006-07 and 2007-08 were very close to forecast.

Public corporations' own-financed capital expenditure

4.36 Public corporations' own-financed capital expenditure (PCOFCE) comprises the capital expenditure of public corporations, net of any capital grants or loans given by a public corporation's parent department and net of any private sector borrowing.

4.37 Outturn for 2006-07 was £2.3 billion above forecast. This was due to the reclassification of Housing Revenue Account (HRA) net capital spending, moving £2.3 billion from the local authority to the public corporations sector.

4.38 PCOFCE in 2007-08 was £1.3 billion higher than forecast, attributable to fiscal forecasting differences. The underlying cause for this difference was higher HRA net capital spending, which in turn partly reflected lower housing sales.

Other departmental expenditure

4.39 Outturn for other departmental expenditure in 2006-07 was £1.7 billion lower than forecast, £1.2 billion of which reflects two changes to the budgeting regime, as shown in the other factors. These changes are in respect of Education Maintenance Allowances (EMA), which were moved from AME into DEL at Budget 2007, and grants to local authorities in respect of some financial transactions, which were previously included within other departmental expenditure in the Budget 2006 forecast, but which were subsequently removed from AME. Since these financing transactions do not score in TME, there is a corresponding offsetting change in accounting adjustments. £0.3 billion of the remaining difference was due to greater than expected receipts from the Coal Pension Fund surplus.

4.40 For 2007-08, other departmental expenditure was £1.9 billion lower than forecast. The other factors difference is a result of the one-off sale of Chelsea Barracks, which accounted for £0.7 billion of the difference. The largest contributing fiscal forecasting difference is a change to the measurement of outturn, compared to forecast, to include certain financial transactions which are included in other departmental expenditure in AME and which are then removed.

Net expenditure transfers to EC Institutions

4.41 Net expenditure transfers to EC institutions consists of the UK's contribution in respect of UK Gross National Income (GNI), offset by the UK abatement, which reduces the UK net transfer.

4.42 Outturn in 2006-07 was £0.8 billion lower than forecast, primarily due to the use of later data on the EC Budgets for 2006 and 2007, particularly in respect of the UK abatement. The abatement was some £0.7 billion higher than forecast, and there was also a reduction of £0.1 billion in UK GNI-based contributions compared to forecast.

4.43 Outturn in 2007-08 was £0.4 billion higher than forecast at Budget 2007. This was largely the result of the use of later data on the EC Budgets for 2007 and 2008, including the profile requested for Member States' payments in the first quarter of 2008.

Locally-financed expenditure

4.44 Locally-financed expenditure consists of local authority self-financed expenditure (LASFE), Scottish spending financed by local taxation, and spending in Northern Ireland financed by regional rates. LASFE is local authority net expenditure, financed by council tax and other sources of local authority income (other than grants from central government).

4.45 Outturn for 2006-07 was £1.0 billion below forecast. The difference allocated to 'other factors' was due to a £2.3 billion reclassification of HRAs, from the local authority sector to the public corporations sector (see paragraph 4.37). The fiscal forecasting differences were mainly a result of lower capital receipts from the sale of assets (£0.5 billion) coupled with a greater drawdown of previous capital receipts (£1.0 billion).

4.46 Locally-financed expenditure for 2007-08 was £0.5 billion higher than the Budget 2007 forecast. This difference arose because of a problem with the forecasting methodology used at Budget 2007 (and previous Budgets), which has now been corrected.

Central government gross debt interest

4.47 Central government gross debt interest in 2006-07 was £1.3 billion higher than the Budget 2006 forecast. This difference resulted from higher than forecast uplift on index-linked debt, which is scored as a £1.0 billion economic determinant difference, and from higher than forecast interest rates, which is scored as a £0.3 billion difference arising from the assumptions audited by the NAO.

4.48 Central government gross debt interest in 2007-08 was £0.8 billion higher than the Budget 2007 forecast. Of this difference, £0.7 billion resulted from higher than forecast uplift on index-linked debt, which is scored as an economic determinant difference, and £0.3 billion from higher than forecast interest rates, which is scored as a difference arising from the assumptions audited by the NAO. Partially offsetting these, the central government net cash requirement was lower than forecast, providing a moderating influence on debt interest expenditure; this difference is scored as a fiscal forecasting difference.

Accounting 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 factors column shows changes in National Accounts adjustments which the ONS have made since the forecasts were compiled, and offsets changes in definitions of DEL and AME, where there are relevant accounting adjustments.

4.50 In both 2006-07 and 2007-08, the other factors include the new accounting adjustment, which the ONS introduced in June 2007 for local authorities' imputed subsidies for the injection of equity into HRAs (see paragraph 4.9).

4.51 In 2006-07, the other factors also include the offset to the removal of grants to local authorities in respect of financial transactions (see paragraph 4.39). The fiscal forecasting differences accounted for just £0.1 billion of the difference.

4.52 In 2007-08, the fiscal forecasting differences reflect several areas where the measurement of accounting adjustments has been improved, and where outturn is now compiled on a different basis compared to the forecasts made at Budget 2006 and Budget 2007. This includes NHS trusts, where the ONS now use outturn data taken directly from DEL and no longer include accounting adjustments in respect of NHS trusts' spending, which has reduced outturn current expenditure by £1.1 billion, compared to forecast. This also includes improvements to fully itemise ONS accounting adjustments which were previously included in LASFE, but which are now separately distinguished in accounting adjustments (see paragraph 4.42 in the 2007 EYFR). These reduced the accounting adjustments by over £2 billion, compared to forecast. The main other fiscal forecasting differences were on the accounting adjustments for VAT refunds and depreciation, which were both £0.8 billion lower in outturn than forecast, where the lower outturn for depreciation reflects significant downward reductions to ONS published outturns.

AME Margin

4.53 The year-ahead forecasts of AME for Budget 2006 and Budget 2007 included an AME margin of £1.0 billion to minimise the risk of outturn AME exceeding its forecast. The change in AME margin is classified as an other factor in the breakdown of forecasting differences.

A

Assumptions used in Budget 2006 and Budget 2007

Table A.1: Budget 2006 – key assumptions audited by the National Audit Office

Assumption used for Budget 2006	
Dating of the cycle	The end date of the previous economic cycle was in the first half of 1997.
Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
Trend GDP growth	2½ per cent a year to 2006 and 2¼ per cent in the subsequent years.
UK claimant unemployment	Rising slowly to 0.97 million in 2007-08 from recent levels of 0.91 million.
Interest rates	3-month market rates change in line with market expectations (as of 10 March 2006).
Equity prices	FTSE-All share index rises from 3004 (close 10 March 2006) in line with money GDP.
VAT	The VAT gap will rise by 0.5 percentage points per year from a level that is at least as high as the estimated outturn for the current year.
GDP deflator and RPI	Projections of price indices used to project the public finances are consistent with CPI.
Composition of GDP	Shares of labour income and profits in national income are broadly constant in the medium term.
Funding	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Oil prices	\$57.4 a barrel in 2006, the average of independent forecasts, and then constant in real terms
Tobacco	The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For Budget 2006, a share of 16 per cent is used for 2006-07 onwards.

Table A.2: Budget 2007 – key assumptions audited by the National Audit Office

Assumption used for Budget 2007	
Trend GDP growth	2½ per cent a year.
Dating of the cycle	The end date of the previous economic cycle was in the first half of 1997.
Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
UK claimant unemployment	Rising slowly to 0.95 million in 2007-08, from recent levels of 0.93 million.
Interest rates	3-month market rates change in line with market expectations (as of 9 March 2007).
Equity prices	FTSE All-share index rises from 3244 (close 9 March 2007) in line with money GDP.
VAT	The underlying VAT gap will rise by 0.5 percentage points per year from the estimated outturn for the current year.
Consistency of price indices	Projections of price indices used to project the public finances are consistent with CPI.
Composition of GDP	Shares of labour income and profits in national income are broadly constant in the medium term.
Funding	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
Oil prices	\$58.1 a barrel in 2007, the average for the three months to March 9, and then constant in real terms. This is lower than the \$58.6 average of independent forecasts for 2007.
Tobacco	The underlying level of duty paid consumption of cigarettes will be set at least three per cent per year lower than the estimated outturn for the current year.

B

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List of abbreviations

AME	Annually Managed Expenditure
BBC	British Broadcasting Corporation
CIPFA	Chartered Institute for Public Finance and Accountancy
CPI	Consumer Prices Index
DEL	Departmental Expenditure Limits
DMO	Debt Management Office
EMA	Education Maintenance Allowances
ESA95	European System of Accounts
EU	European Union
EYF	End-year flexibility
EYFR	<i>End of year fiscal report</i>
FTSE	Financial Times Stock Exchange
G7	A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States)
GDP	Gross Domestic Product
GNI	Gross National Income
HMRC	Her Majesty's Revenue and Customs
HRA	Housing Revenue Account
ILF	Independent Living Fund
IMF	International Monetary Fund
LASFE	Local authority self-financed expenditure
MTIC	Missing Trader Intra-Community
NAO	National Audit Office
NHS	National Health Service
NHSPS	National Health Service Pension Scheme
NICs	National Insurance Contributions
OECD	Organisation for Economic Cooperation and Development
OLDF	Olympic Lottery Distribution Fund
ONS	Office for National Statistics
PAYE	Pay as You Earn
PC	Public corporations
PCOFCE	Public corporations' own-financed capital expenditure
PEOWP	Public Expenditure Outturn White Paper
PRT	Petroleum Revenue Tax
PSCE	Public sector current expenditure
PSNB	Public sector net borrowing
PSNCR	Public sector net cash requirement
PSND	Public Sector Net Debt
PSNI	Public sector net investment
RPI	Retail Prices Index
TME	Total Managed Expenditure
VAT	Value Added Tax

ISBN 978-1-84532-517-6



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