



House of Commons
Treasury Committee

The 2004 Pre-Budget Report

First Report of Session 2004–05

*Report, together with formal minutes, oral and
written evidence*

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PRE-BUDGET REPORT 2004: TESTING THE FISCAL RULES

INTRODUCTION

1. There could not presently be a Pre-Budget Report or Budget Report without the customary barrage of pre-announcements and diversions and of Treasury-sponsored reports on a plethora of topics nominally within the jurisdiction of other departments. Similarly, at this stage in the electoral cycle, the search for black holes and election bribes is in full swing. Cutting through this cacophony indicates relatively little substantive change. The one safe bet was that the Treasury would not announce that the fiscal rules were about to be breached.
2. This memorandum concentrates on three issues:
 - Testing the fiscal rules.
 - The independent audit of macroeconomic assumptions.
 - The End-of-Year Fiscal Report.

TESTING THE FISCAL RULES

3. The Treasury (2004b, p 193, Box B1) explicitly rejects the claim that it has moved the goal-posts, by redefining how the golden rule is measured. The projected future surpluses in Table B1 (Treasury, 2004b, p 192) are just large enough to keep the average surplus since 1999–2000 positive. Observers may feel that this is too convenient, but the Treasury's recent forecasting track record means that it would be unwise to bet against it. The chosen measure is more difficult to explain to a non-technical audience than that of the cumulative surplus over the economic cycle being non-negative, but that is not a decisive consideration. My personal view is that:

- From a *public finance viewpoint*, it would have been preferable not to have such high fiscal deficits when the economy continues to perform strongly; the breach of the Treaty deficit in 2003–04 is indicative of the lack of fiscal room for manoeuvre should there be serious economic difficulties ahead.
- From a *macroeconomic viewpoint*, the fact that there have been 49 successive quarters of GDP growth, notwithstanding the weaker performance of major trading partners, is impressive and the Treasury might argue that macro-fiscal management took precedence over this period.

4. Uncertainty about the world economy, and the margins of error attached to forecasting, means that it is a matter of judgement whether the golden rule will be met over the current or next cycle, when safety margins are so small. A curious paradox comes into play. With one caveat, it is immaterial from a macroeconomic perspective whether the golden rule is precisely met *ex post*; its usefulness is as a guide to fiscal planning. However, the present Chancellor of the Exchequer has placed such great store on the golden rule that its breach would be widely portrayed as a devastating blow to his credibility. This leads on to the caveat; a loss of credibility by the fiscal rules might erode their beneficial effects in terms of promoting economic stability. Such a charged political context emphasises the importance of Parliamentary monitoring of the fiscal numbers and alertness to any rechannelling of policy commitments into forms that evade the scoring mechanisms.

INDEPENDENT AUDIT OF MACROECONOMIC ASSUMPTIONS

5. The Treasury always makes extensive reference to the fact that certain Budget assumptions are audited by the National Audit Office under the provisions of the 1998 Finance Act. The level of assurance provided is much less than what is portrayed in Budget documents. Unlike in its financial audit and VFM work, the National Audit Office cannot choose which assumptions to audit. It can only audit (a) those assumptions that are specifically referred to it by the Treasury, and (b) previously audited assumptions that come up for review on a three-year cycle. Box B2 (page 199 of the *Pre-Budget Report 2004*) lists the "Key assumptions audited by the NAO". However, with reference to Box B2, paragraph B27 states:

All these assumptions are subject to review by the NAO under the three-year rolling review process, but none were due for review in this Pre-Budget Report.

This is consistent with there being no NAO Report on newly audited assumptions either on the Treasury's Pre-Budget 2004 website or on the NAO's website.

6. Although experience-to-date of the 1998 macro-fiscal framework allows reflected credit to be claimed, I have always had reservations about this unusual role—the "client" determines what can be looked at—for the National Audit Office;

The Treasury relied quite heavily on the assumptions having been independently audited by the National Audit Office (NAO), following the practice first established in 1997. The NAO does not audit the forecasts, its role being to ensure that these forecasts of the public finances are based on assumptions that are transparent and widely regarded as reasonable. However, the NAO can only audit the assumptions that the Treasury puts to it, though since the March 2000 Budget there has been a rolling review of previously audited assumptions. Thus far, the assumptions embodied in earlier macro forecasts have not been seriously tested by events. In such an eventuality, the NAO could be seen to be implicated in forecasts that later came under challenge, thus deflecting some blame from the Treasury and potentially creating difficulties in its relationship to Parliament and its committees. Although the NAO only audits certain forecasting assumptions, and not forecasting systems or methodology, this distinction might be lost in practice (Heald and McLeod, 2002, para 505).

Although the three-year cycle means that assumptions, once referred, will in due course be reassessed, the notion that the NAO's sanction can be claimed for three years, without it having the opportunity to decide for itself what assumptions now need to be revisited, is strange at best and manipulative at worst.

7. The Committee's requests for clarification about the NAO's role have generated only the following non-answer in the Government's Reply to the Committee's Report on the 2004 Budget, HC 654, Session 2003-04, page 7:

MACROECONOMIC ASSUMPTIONS AND THE NAO

15. *We ask the Treasury to clarify how they decide which macroeconomic assumptions, apart from those automatically revisited, should be referred to the National Audit Office. This is an issue which we shall be monitoring. (Paragraph 31)*

The audited assumptions are referred to the Comptroller and Auditor General as part of the three-year rolling review process. In addition, the assumptions are submitted for audit when they are changed or modified, as set out in the Code for Fiscal Stability. In addition, the Government asks the Comptroller and Auditor General to audit significant "spend to save" compliance packages where these principally affect operational activity rather than requiring legislative change.

8. The NAO's role in auditing "cautious assumptions" is credited a remarkable number of times in *Pre-Budget Report 2004*, as in previous Budgetary documents. Moreover, the calls by policy critics for greater audit involvement seriously underestimate the limitations of audit in the area of macro-forecasting, where policy expertise and experienced judgement are paramount. The auditor needs to establish that the assumptions led to the forecasts, and were not chosen in order to generate particular forecasts. Alarming, the annual costs incurred by the NAO in this role in 2002-03 were only £65,000 (National Audit Office, 2003, p 4), which pales into insignificance against the resources available to the Treasury. A possible reason for such low spending is that the Treasury delivers its requests for audits close to the dates on which it requires an answer.¹ As there is no immediate prospect of the statutory duties imposed by the 1998 Finance Act being revisited, the Committee may wish to ask the Treasury and the National Audit Office to provide clarification about how the system operates and how it might be modified within the present statutory provisions.

END-OF-YEAR FISCAL REPORT 2004

9. The Treasury should be commended on the *End-of-Year Fiscal Report (EYFR)* (Treasury, 2004c), now in its third edition. This brings together valuable fiscal data for the previous two years, this year these being 2002-03 and 2003-04. The provision of reliable and prompt outturn data was for many years a serious deficiency; the *End-of-Year Fiscal Report* can be seen as a reporting counterpart to the invaluable *Public Expenditure: Statistical Analyses*. Encouragingly, the *EYFR* exhibits the measured tone of *PESA*, not the breathless tone into which Pre-Budget and Budget Reports often lapse.

10. The usefulness of *PESA* is, in part, a consequence of the Committee's systematic pressure over the years for more comprehensive coverage. There is now an opportunity to press for extensions to the coverage of the *EYFR*. Some examples of what might be sought are listed below:

- (a) An unexpected characteristic of the post-1998 expenditure planning system has been the build-up for various reasons of a stock of End-Year Flexibility (EYF) claims. These are reported, annually in July, in the *Public Expenditure Provisional Outturn White Paper*. Table 6 (Treasury, 2004a, p 14) shows Total DEL carried over to 2004-05 as £11,394 million.² One of the present uncertainties regarding compliance with the golden rule in circumstances when the margins are small concerns the speed with which departments holding EYF entitlements will run these down, thus adding to current year expenditure, as planned spending growth decelerates and especially if their freezing is anticipated. Data tracking the evolution of EYF would be a valuable addition to the *EYFR*.
- (b) The Private Finance Initiative has become an important form of public procurement, with many PFI assets falling off the public sector balance sheet and, indeed, often appearing on the balance sheet of no organisation. The *EYFR* is the ideal place for systematic reporting of PFI capital expenditure and of the stock of future commitments. Without this information, it is difficult to place in context reported underspendings of direct public sector capital expenditure.
- (c) The accounting numbers for UK central government are now on a Resource Accounting & Budgeting (RAB) basis, and the fiscal numbers are on an ESA95 (ie national accounts) basis.

¹ The Public Accounts Commission put the following question to the National Audit Office after its evidence session on 24 February 2004:

Question: How much advance notice does the Treasury give the National Audit Office of the assumptions that it wishes to be audited before a particular budget or pre-budget?

Answer: For the 2003 Pre-Budget Report, the National Audit Office staff first met Treasury staff on 5 November 2003 to consider the remit for that audit, and the report was published on 10 December 2003. In the most recent analyses, for Budget 2004, the first discussions of the remit took place on 12 February 2004 and the report was published on 17 March 2004. The agenda for these meetings was circulated in advance, and the Treasury also sometimes forewarn the Office of the likely extent of the audit some time before the first meeting. For example an informal meeting was arranged in the summer to discuss some of the background issues that would be relevant to the 2003 Pre-Budget Report audit. The budget assumptions work also includes a rolling review of assumptions last audited three years ago; as this element of the audit is carried out on a cyclical basis it is known about well in advance (National Audit Office, 2004, p 6).

² The composition of the total amount of £11,394,246,000 is as follows: Administration costs (£1,233,398,000); EC Structural funds Resources (£93,884,000); Other resources (£7,466,368,000); EC Structural funds Capital (£12,231,000); and Other Capital (£2,588,365,000). These amounts are analysed by departmental group in Table 6 (Treasury, 2004a, p 14).

Accordingly, changes to accounting do not necessarily affect the fiscal numbers. The *EYFR* is the ideal place for systematic reporting of important issues such as the outstanding debt of quasi-public organisations, such as Network Rail, and of liabilities arising from public sector (employee) pension schemes.

7 December 2004

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