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APPENDIX 5

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THE PUBLIC FINANCES IN THE 2003 FINANCIAL STATEMENT AND BUDGET REPORT

1. This memorandum concentrates on four issues arising from the information provided in Chapter C (The Public Finances) of the "Red Book" (Treasury, 2003). The issues discussed are: the fiscal framework established in June 1998 (Treasury, 1998); the role of the National Audit Office (NAO) in providing assurance about Treasury economic assumptions; issues arising from the changing method of financing a certain proportion of capital assets used in public services; and the problems confronting Parliament and other users of government financial information arising from the public expenditure timetable. These issues have intrinsic importance, but will also grow in significance in the context of a less certain fiscal environment.

2. The fiscal framework (ie Golden Rule and Sustainable Investment Rule) established in June 1998 has attracted considerable praise as part of the foundation for a more stable macroeconomic environment. There have always been two possible ways in which to interpret this framework. The first is that these are rigid rules to be followed mechanistically whatever the circumstances, because of the financial discipline they will exert on governments and because of benefits in terms of credibility.[3] On this interpretation, a point in an economic cycle might be reached where the requirements for meeting the rules over the economic cycle diverge from optimal fiscal policy in the light of current economic conditions. The alternative interpretation is that they are not really rules, but statements of intent, designed to provide a framework for budgetary decisions. This softer interpretation allows for more policy judgement, thereby avoiding the adoption of inappropriate fiscal policy solely to comply with the rules. There is the additional advantage that there is less incentive to manipulate data scoring or forecasts. However, softness means that it would be harder to establish credibility

[3] "The vulnerability of general government figures to manipulation (eg transactions between general government and public organisations outside general government) is [a problem for fiscal rules]. The rationale for the rigidity in [the EU Stability and Growth Pact] probably stemmed from concern that flexibility in interpretation would lead to laxity" (Heald and McLeod, 2002, paragraph 524).

for the rules, as many observers may expect governments to be more enthusiastic about running deficits in difficult times than running surpluses in good times. In the years ahead, the rules seem likely to be subject to more testing than in their first five years. Moreover, the very large surpluses in the early years of the present Government, originating partly in expenditure restraint imposed by political undertakings and partly in one-off auction proceeds, made the accumulation of surpluses much easier than would have been the case in a normal cycle. It would be most helpful if the Treasury were to publish, in accompanying technical papers, much more comprehensive sensitivity analyses of the effect of particular assumptions on the fiscal projections and on their implications for the fiscal rules. Determining exactly what constitutes the economic cycle is clearly one of the practical issues arising from the fiscal framework, particularly in regard to forward projections.

3. The fact that many independent commentators now consider that the Treasury's economic assumptions (eg about growth in 2004–05) are too optimistic draws attention to the degree of assurance which the Red Book implies should be drawn from the audit of key assumptions by the NAO. Under the Finance Act 1998, section 156(5):

> It shall be the duty of the Comptroller and Auditor General to examine and report to the House of Commons on such of the conventions and assumptions underlying the preparation by the Treasury of the documents prepared by them under this section as, in accordance with the code for fiscal stability, are submitted to him by the Treasury for his examination.

The crucial aspect is that the Comptroller and Auditor General only audits those assumptions submitted to him by the Treasury. The headline presentation of his role in Chapter C of the Red Book can easily lead to this point being lost sight of:

> The fiscal projections continue to be based on deliberately cautious key assumptions audited by the National Audit Office (Treasury, 2003, para C2).

Box C1 (Treasury, 2003, p 252) provides a listing of key assumptions audited by the NAO under the three-year rolling review process (para C25). At the bottom of Box C1, there is helpful cross-referencing to the individual audits that the Comptroller and Auditor General has done on individual assumptions. As explained in para C25, the rolling review on this occasion (National Audit Office, 2003) covers the assumptions relating to privatisation proceeds, interest rates and tobacco anti-smuggling measures. For Budget 2003, there were specific referrals on a change to the assumption dealing with tobacco revenues and the revenue impact of a new direct taxation and national insurance contributions compliance and enforcement package (Treasury, 2003, para C25). However, the fact that individual assumptions have been audited during a three-year period does not mean that the Comptroller and Auditor General would necessarily conclude that the whole package of assumptions underlying Budget 2003 projections is cautious and reasonable. These concerns have been summarised by Heald and McLeod (2002, para 505):

> Whether [the fiscal rules] are shown by particular Budget documents to be met depends crucially on the macroeconomic assumptions within which future expenditure plans are assessed. For example, the Treasury's upward revision of its trend growth assumption at the time of the 17 April 2002 Budget was portrayed by some as opportunistic. On the new assumption, of 2.5% trend growth rather than the previous 2.25%, it was much easier to show that the two fiscal rules would be met. Commentators have expressed surprise that this upgrading should have been done at a time of great uncertainty about macroeconomic performance. The Treasury relied quite heavily on the assumptions having been independently audited by the 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.

If the Treasury intends to place so much emphasis upon its assumptions having been audited as cautious and reasonable by the NAO, it is vital that the Comptroller and Auditor General can himself decide which assumptions should be audited at which dates.[4] Moreover, it is essential that Parliament receives full information about the methodology adopted by the NAO, and about the level of resources devoted to this activity. This activity is an unusual one for the NAO in that the way in which the Comptroller and Auditor General undertakes his statutory duty is so narrowly defined.

4. The emphasis upon fiscal aggregates inevitably creates the danger that governments will seek to camouflage the extent of public financial commitments, for example by borrowing through off-balance sheet vehicles or private bodies. Even if governments do not do this, such accusations are likely to be levied by political opponents. These issues are particularly important at present, given the rapid development of the

[4] It should be noted that the Comptroller and Auditor General's latest audit of the trend growth assumption (National Audit Office, 2002) covers only the trend, not forecasts for specific years.

Private Finance Initiative (PFI) as a procurement mechanism. Whatever the merits of particular PFI schemes for hospital, prison or school construction on efficiency grounds, comprehensive and consistent information on the scale of related capital expenditure should be placed in the public domain on a regular basis. Although the inclusion of what are now Tables C18 to C20 on the PFI were welcome additions to the Red Book when they first appeared, they are no longer sufficient. Comprehensive data should be systematically provided in annual editions of Public Expenditure: Statistical Analyses, so that it is possible to establish the extent to which their existence affects the interpretation of the fiscal tables in the Red Book. If there had been conventional procurement, borrowing would have contributed to the measures of debt used for the Sustainable Investment Rule. When so much emphasis is placed on the United Kingdom's comparative borrowing and debt levels, such information must be in the public domain so that differences in capital financing mechanisms can be adjusted for.

5. There are two important concerns about the timetable of the public expenditure cycle. First, a pattern has now been established for the main public expenditure announcements to be made in July on a biennial cycle, with the next major announcement expected in July 2004. After the exceptionally high settlements in 2000 and 2002, it must be expected that additional resources will be scarcer in Spending Review 2004. It is difficult to imagine a worse timetable for Parliament than having major announcements at such a date. There is not time for serious consideration before the summer adjournment, and the newsworthiness has gone by the time Parliament resumes thereafter. Moreover, departments by then are beginning to take action on the new plans and the scope for Parliamentary influence inevitably diminishes. Second, owing to exceptional circumstances, the last two Budgets have been delayed to 17 April 2002 and 9 April 2003. A consequence of these late Budgets is that the whole timetable for public expenditure documentation slips back, with delayed publication of Public Expenditure: Statistical Analyses and Departmental Reports. Delays, and also uncertainties about the timetable of publication, diminish the usefulness of these documents to Parliamentary Committees and other users. This is damaging to the effectiveness of scrutiny, as these are the documents that contain the disaggregation and comprehensive explanations on which scrutiny must be built. Pre-Budget and Budget documents do not always provide a full reconciliation to the corresponding document in the previous financial cycle, sometimes just referring back to the latest document. It is always difficult for users to chain-link data from successive Treasury publications because of the ongoing process of definitional and measurement change.[5]

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References to Appendix 5

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[5] An illustration of the problem can be found in Table C14 (Treasury, 2003, p 268). Changes to TME relate to the plans in the 2002 Pre-Budget Report (Treasury, 2002b) rather than to the 2002 Budget Report (Treasury, 2002a); and the figures are affected by a change in the treatment of public service pensions. Although there is some explanation in para C68, interpretation is difficult when the change in Annually Managed Expenditure is not the same as the sum of the identified components.