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Written evidence

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PRE-BUDGET REPORT 2009: A HOLDING STATEMENT

Introduction

1. Unlike the 2008 Pre-Budget Report (Treasury 2008), which was more important than most Budgets, the 2009 Pre-Budget Report (Treasury 2009d) is best regarded as a holding statement. Some now expect two exciting Budget-like events each year, and that expectation can distort what actually happens. I concur with the view (Keegan 2009) that the Chancellor of the Exchequer's "budget judgement" in PBR 2009, namely to do little until the picture clarifies, is the appropriate response in such exceptional macroeconomic circumstances. The huge UK deficit is in large part a planned or accepted response to the global financial crisis (ie through the automatic stabilisers which have been allowed to take effect). While the economic situation remains so fragile, reducing borrowing is not the highest priority (Brittan 2009).

2. However, there are several aspects of the policy process that are unsatisfactory, which have the effect of damaging the credibility of UK policy. This memorandum will concentrate on:

- the public finances at PBR 2009 in relation to those at Budget 2009 (Treasury 2009a);
- prospects for public expenditure;
- the dangers of an excessive focus on net debt as the primary fiscal indicator; and
- issues relating to transparency of information on the public finances.

The Fiscal Position at PBR 2009

3. Table 2.4 of PBR 2009 (Treasury 2009d, p. 29) shows what, in the macroeconomic circumstances, are modest changes to net borrowing, surplus on the current budget and net investment. The text of the PBR indicates that, though the reduction of output in the first quarter of 2009 was sharper than was expected at Budget 2009, the element of caution built into the public finance forecasts has meant that there was not an equivalent worsening of net borrowing.

4. The PBR states that there are currently large uncertainties inherent in macroeconomic forecasting: "… the size and timing of the adjustment to trend output remains subject to significant uncertainty" (Treasury 2009d, para A.37). After a 5% reduction in the level of trend output, it is assumed that trend output growth resumes at 2.75% a year (Table A2 on p. 143). The assumptions made here are of critical importance as they project the size of the economy in relation to which planning decisions on aggregate public expenditure will be taken. The global financial crisis has exposed structural weakness in the UK economy, particularly in relation to financial services and housing, which might negatively affect the future trend rate of growth. Judgements that have to be made affect the calculation of the output gap and of cyclically-adjusted fiscal indicators.

5. The End of Year Fiscal Report (Treasury 2009e) is one of the supplementary documents accompanying the PBR. This contains interesting analyses of outturns in 2007–08 and 2008–09, particularly regarding the components of variances against forecast. These components are: economic determinants; National Audit Office (NAO) audited assumptions; fiscal forecasting differences; policy measures; and other factors. The difference between Budget 2007 forecast net borrowing for 2007–08 and outturn was £(0.1) billion, with the components netting off to almost zero. In contrast, Budget 2008 forecast net borrowing for 2008–09 was £42.4 billion below the outturn, with large contributions from economic determinants (£24.4 billion), fiscal forecasting differences (£10.5 billion); and policy measures (£8.4 billion) (Treasury 2009e, p. 12). On the basis of PBR 2009 data, 2008–09 may prove to have been the exceptional year, with 2009–10 possibly coming in reasonably in line with Budget 2009.

6. In common with previous publications, the PBR documents make extensive reference to the role of the National Audit Office in auditing the assumptions behind the Treasury's macroeconomic forecasts. Heald and McLeod (2002, para 505) warned against this role for the NAO:

> 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 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.

There have always been two central problems in this role, the latest instalment being reported on in National Audit Office (2009). First, the NAO does not have, nor could it have, the technical macroeconomic expertise to match that of the Treasury. Second, this arrangement ("look only at what we ask you to look at") breaches the fundamental postulate of auditing that there must be independence to investigate as well as independence to report. In my view, the NAO has allowed itself to be misused. Parliament should ask the NAO how it proposes to gain release from this inappropriate task and then devise genuinely independent and competent monitoring arrangements.

Prospects for Public Expenditure

7. Table B24 (Treasury 2009d, p. 206) reports Total Managed Expenditure (TME) as 43.8% of GDP, an increase of 7.5 percentage points on 1999–2000, itself the lowest level in a data series that begins at 1970–71. In the years immediately before the global financial crisis, namely 2004–05 to 2006–07, the ratio was circa 41%. This strong growth of public expenditure was not the accidental consequence of a loss of expenditure control, but the result of ministerial decisions announced in successive Spending Reviews since 1998. Over the period 1997–98 to 2008–09, TME at 2008–09 prices grew by 49.9%, confirming that it was taking a larger share of a growing economy.

8. Unfortunately the global financial crisis has coincided with what, in any case, would have been the end of this period of rapid public expenditure growth. This creates additional pressure on Annually Managed Expenditure (AME) from higher benefit payments and debt interest, quite apart from the permanent output loss of 5% of GDP making the economy smaller. How severe will be the reductions in real-terms public expenditure is likely to depend on the strength and speed of the recovery of the economy as a whole. Much publicity has been given to proposals for large public expenditure reductions, yet the actual content of those reductions is often poorly specified. Table A10 (Treasury 2009d, p. 162) shows general government consumption returning to just below its 2008 level (£282.3 billion) in 2012 (£281.3 billion).[1] This involves reductions of 1.5 per cent in 2011 and 2% in 2012.

9. Table B13 (Treasury 2009d, p. 189) shows public sector gross investment reducing from £68.7 billion (2009–10 estimate) to £47 billion (2014–15 projection). The fall in public sector net investment is more pronounced, the corresponding figures being £49.5 billion and £23 billion. In paragraph B.7 (p. 164), this is euphemistically expressed: "public sector net investment is projected to move to 1.25 per cent of GDP in 2013–14". Given previous legacies of infrastructure neglect, the way in which investment is affected by public expenditure constraints needs to be carefully monitored.[2]

10. The Spending Review (SR) system was established in 1998, with SRs subsequently held in 2000, 2002, 2004 and 2007. The cycle of SRs every two years, each looking ahead three years, seemed to have become established but has now been broken. SR 2007 covered the years to 2010–11, so there are now no detailed spending plans for 2011–12. Decisions about timing are entirely for the Government, and the ending of the two-year frequency seems to have resulted from considerations of internal party management and the general election cycle. Given the Treasury's (2009b) proposal to have more integration between Budgets, Estimates and Accounts, Parliament requires an explicit role in the timing of major expenditure decisions. The customary July date for SR announcements, just before the summer recess, and uncertainties of when SRs will be held, have together damaged Parliamentary scrutiny of spending.

Net Debt as a Fiscal Indicator

11. There are legitimate reasons for a policy focus on public sector net debt, arising from the United Kingdom's international obligations (eg Maastricht Treaty and the EU Stability and Growth Pact) and the UK tradition of concentrating on the public sector rather than on general government. Nevertheless, net debt is not the only fiscal indicator, indeed it is one whose significance in terms of levels can be disputed. Although UK net debt is rising fast, it started from a comparatively low level. An exclusive focus on net debt would impoverish debate on UK public finances. There are many steps that governments might take to reduce net debt, but some of these may worsen the fiscal position on other criteria (Heald and Georgiou 2009). For example:

- — sell public sector assets
- — cut capital expenditure
- — substitute Private Finance Initiative assets for conventional public procurement
- — neglect public sector assets
- — structure transactions so that their economic substance is missed by the accounting systems that govern financial reporting and national accounts
- — arbitrage the boundary between the public and private sectors or the boundary between general government and the public sector

[1] "£ billion chained volume measures at market prices, seasonally adjusted" (Treasury 2009d, Table A10 on p. 162).

[2] See paragraph 14 of this memorandum on the possibility that restrictions on public sector net investment might lead to more recourse to Private Finance Initiative schemes that are off-balance sheet in the national accounts, even when on-balance sheet in the Estimates and Resource Accounts. Also see supplementary written evidence at pp Ev 78-80 of this volume.

The first three of these steps are legitimate instruments of public policy, but their adoption should be motivated by Value-for-Money considerations.

12. Paragraphs B.20 and B.21 of PBR 2009 (Treasury 2009d, p. 169) might be interpreted as a weakening of commitment to the Whole of Government Accounts project (originally scheduled for 2005–06 and now for 2009–10) and to the usefulness of net worth as a fiscal indicator. It is valid to argue that valuation issues mean that interpretation would always require care, but looking only at some of the liabilities on the government balance sheet (ie net debt) is insufficient. An excessive focus on net debt would be likely to lead to a renewed period of deterioration of the United Kingdom's public infrastructure, necessitating at a future date another enormous catch-up programme. Given the short-term macro-economic uncertainty, the more limited scope of the 2009 Long-term Public Finance Report (Treasury 2009f) is understandable, but the description of previous simulations as "mechanistic projections" (Treasury 2009d, para 2.93 on p. 38) is an unfortunate choice of words.

Transparency Issues

13. Transparency is one of the lauded virtues of the age, yet the design of effective instruments of transparency is an elusive task. In the specific case of fiscal transparency, the two most important issues are timeliness (putting information into the public domain as quickly as is practicable) and comprehensibility. The obstacles to the comprehensibility of public finance data are partly technical; for example, in relation to the interface between financial reporting (as in annual accounts for accountability purposes) and national accounts (as used for public expenditure planning). The Treasury has a creditable record with regard to the quality and clarity of the annual publication *Public Expenditure: Statistical Analyses* (PESA). However, PESA is a retrospective statistical publication and there are much greater transparency problems with regard to budgetary publications such as the Pre-Budget and Budget Reports. Over recent years the Reports themselves, and the accompanying publications, have become more difficult to digest, particularly at the speed required by the pace of political and media discussion.

14. In previous memoranda to the Committee, I have commented extensively on Executive domination of debate on the public finances and on the weaknesses in Parliamentary scrutiny (eg Heald 2009). Without these being addressed, I would expect transparency initiatives to have limited impact. In this memorandum, I will provide three examples of contemporary concerns, but not repeat the general discussion:

— **Scattering of data:** It is difficult for the Treasury to decide what to include in the main PBR/Budget Report. However, my view is that extraneous materials have displaced public finance data. It is not in the interests of users of public finance data that PBR/Budget Reports have become less stand-alone: for example, some of the material in the Supplementary Data publication (Treasury 2009g) belongs in the main Report

— **Fiscal costs of financial sector interventions:** I can understand why the Treasury wishes to exclude such costs on the basis that they are temporary and exceptional. However, there is a climate of public distrust in official numbers. Any special treatments should be comprehensively explained and the differences that these make kept within clear view. This exclusion has led to some internal inconsistency within tables (ie like is not being compared with like) and it introduces new differences between UK and EU statistical treatments

— **Treatment of PFI contracts:** From 2001–02 to 2008–09, when central government accounting was on an accruals basis linked to UK Generally Accepted Accounting Practice (UK GAAP), many PFI projects were kept off the balance sheet of the public sector client. This occurred because there was the opportunity for regulatory arbitrage (ie choose the accounting rule which gave the desired result) between the Accounting Standards Board's FRS 5A (ASB 1998) and the Treasury's Technical Note 1 (Revised) (Treasury Taskforce 1999). With the anchor for central government accounting moving to International Financial Reporting Standards (IFRS) in 2009–10, the expectation is that almost all PFI assets will go on balance sheet. However, in June 2009, the Treasury reissued its 2009–10 Consolidated Budgeting Guidance (Treasury 2009c), announcing that the budgeting treatment of PFI would be on a national accounts basis, not on an IFRS basis. This opens up a new opportunity for arbitrage, this time between financial reporting and national accounts, because the Eurostat (2004) guidance is so lax.[3] Given the dramatic planned reduction in public sector net investment, it is possible that there will be a new wave of PFI projects driven by accounting treatment rather than by VFM. The new condition for project approval might be that the project is off-balance sheet on the Eurostat rules, whatever its treatment in Estimates and Resource Accounts

[3] For the asset to be off-balance sheet to the public sector client, Eurostat (2004) requires that construction risk, together with either availability risk or demand risk, are transferred to the private partner. Normally, availability risk will be lower than demand risk, so the condition reduces to the transfer of construction risk and availability risk. Such conditions are not difficult to meet. Historically, owing to lack of information and the sheer number of PFI projects, the Office for National Accounts has treated more PFI projects as being on the public sector balance sheet than a literal application of the Eurostat rules would require.

15. Alongside PBR 2009, the Government has published the *Fiscal Responsibility Bill 2009*. This proposes the adoption of legislatively-mandated targets for the reduction of net borrowing and net debt. This proposal sits oddly with PBR 2009's emphasis on the pervasive uncertainty currently affecting macroeconomic forecasts. It also reinforces concerns that steps might be taken to reduce net debt in ways that have longer-term fiscal costs. Instead, what is required is legislation that provides for greater transparency of public finance information, addressing defective processes and documentation.

14 December 2009

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Written evidence submitted by the Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)

1. Introduction

1.1. This paper sets out comments from the CIOT and LITRG on some aspects of the tax proposals contained in the Chancellor's PBR statement and associated papers. It is not a full analysis; we would be happy to supply fuller comments on specific aspects if that would be of assistance to the Committee.

2. National Insurance

2.1. Tax & NIC rates are a matter for political decision. Our interest is in the implications such changes have on the running of the tax system. We would simply note that higher NIC rates make it even more important that remaining differences between the PAYE & NIC systems need to be smoothed out.