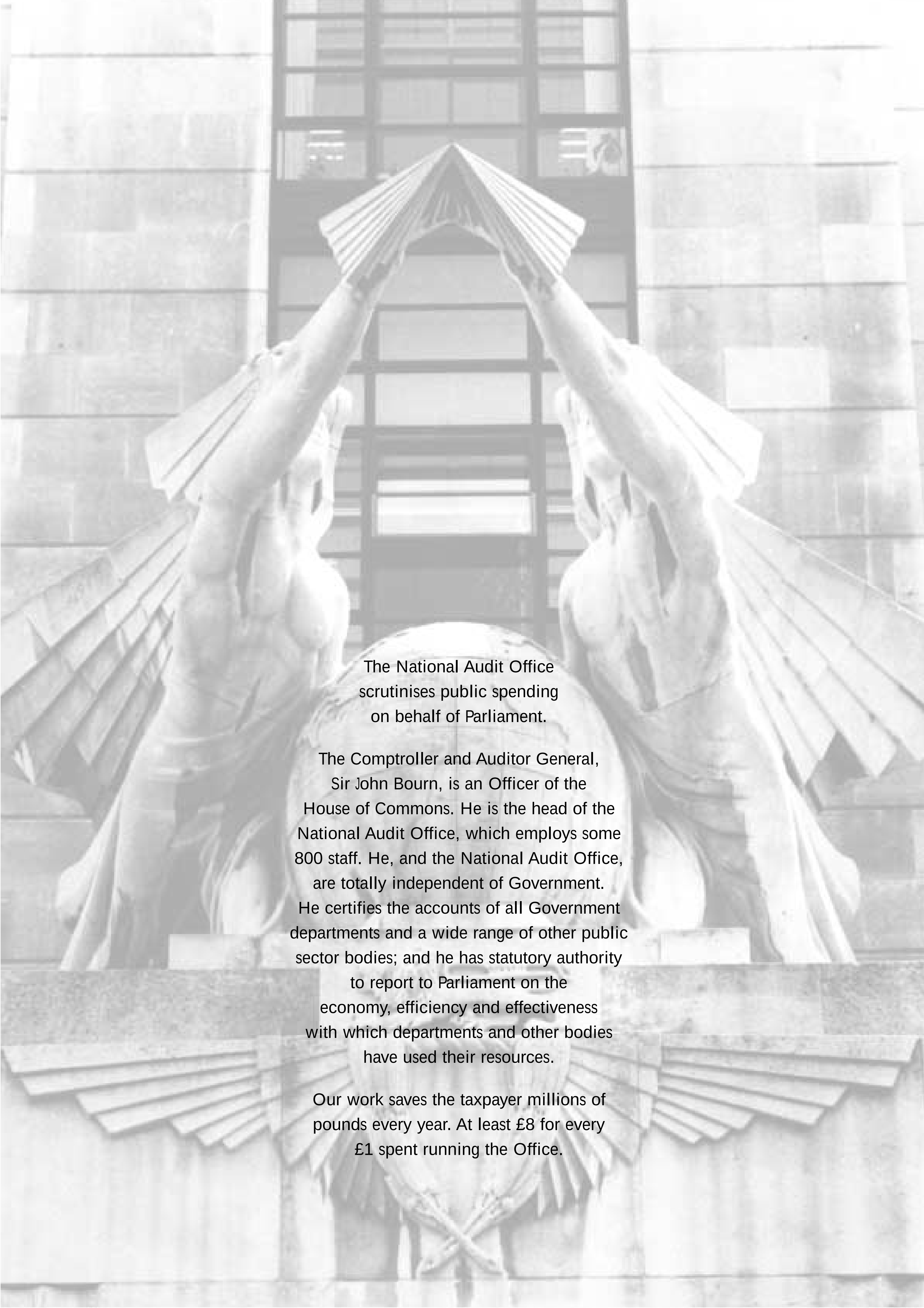
# Audit of Assumptions for Budget 2004

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 434 Session 2003-2004: 17 March 2004



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|---|---|
| ***John Bourn*** | **National Audit Office** |
| **Comptroller and Auditor General** | **15 March 2004** |

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# Report

Report by the Comptroller and Auditor General to the House of Commons

**In this report**



## Statement of Responsibilities

**1** Sections 156 and 157 of the Finance Act 1998 provide for me to examine and report on conventions and assumptions underlying the Treasury's fiscal projections that are submitted to me by the Treasury for examination.

**2** For this Report, the Chancellor of the Exchequer has first asked me to examine an assumption for the increased tax yield from a new compliance package for direct tax and National Insurance contributions announced in Budget 2004.

**3** I commented in my Audit of Assumptions for the 2003 Pre-Budget Report on the difficulties in interpreting current trends in the ratio of VAT receipts to consumers' expenditure[1]. HM Customs and Excise had work in hand to analyse trends in the VAT ratio, and drawing on the conclusions of this, the Treasury has adopted a new approach for projecting VAT receipts. This uses estimates of the level of VAT receipts theoretically due and the extent of the "VAT gap", which reflects the extent of losses from error, fraud and avoidance of VAT.

**4** In line with the approach taken in the audit of the previous VAT forecasting assumption, I have not been asked to audit the methodology as a whole but to look at an assumption for the VAT gap, as follows:

- for the purpose of projecting VAT receipts, the VAT gap (the difference between the estimated theoretical yield and actual VAT receipts, as a percentage of the theoretical yield) will be assumed to rise by 0.5 percentage points per year, from a level that is at least as high as the estimated outturn for the current year.

**5** I have also been asked by the Chancellor to carry out a rolling review. The general remit is:

- to ensure that the key audited assumptions underpinning projections of the public finances remain valid, the Comptroller and Auditor General shall examine each audited assumption three years after its most recent audit:

  (a) to review whether the assumption has resulted in reasonable and cautious projections of the elements of the public finances projections it relates to since it was first audited; and

  (b) to check that it remains a reasonable and cautious assumption to use in future projections of the public finances.

1 *HC 35, Session 2003-04.*

**6** In line with this remit I have for this report re-examined the assumptions I looked at three years ago[2], about:

- the broad constancy of shares of labour incomes and profits in domestic income in the medium term, when the economy is assumed to be on its trend path; and
- the consistency of funding assumptions used to project central government debt interest with the forecast level of government borrowing and with the current financing policy as set out in the Debt and Reserves Management Report.

**7** The Treasury has advised me that none of the other assumptions examined in previous Reports has been changed. As before, the Treasury remains responsible for making projections of future public expenditure and revenue on the basis of the audited and other assumptions.

## Basis of Report

**8** I have considered the available evidence gathered for this audit from relevant papers and discussions with officials in the Treasury, the Inland Revenue and HM Customs and Excise.

## Report

### Increased tax yield from a new compliance package for direct tax and National Insurance contributions announced in Budget 2004

**9** As announced in Budget 2004, the Inland Revenue is introducing a new compliance package for direct tax and National Insurance contributions. I have been asked by the Chancellor to determine for the purposes of the fiscal projections whether the estimated impact of the package on revenue is reasonable and cautious.

**10** The package provides additional resources for the Inland Revenue to invest in a new performance and management information system to enhance and better manage the information needed for compliance work. Much of the revenue impact of the package - around two thirds - will depend on this system. There will also be an increase in staff capacity in areas that pose particular compliance risks.

**11** The package focuses on improving compliance through:

- better use and management of information to improve both the targeting and effectiveness of Corporation Tax and other enquiry work in the Large Business Office and the Inland Revenue network offices;
- measures to raise awareness of tax obligations, including a publicity campaign and new forms of contact with taxpayers;
- measures to identify those liable to tax who hide some or all of their sources of income from the Inland Revenue, and to work closely with them to help them become and remain compliant; and
- expanding specialised teams in specific high risk areas such as taxpayers with complex personal tax affairs.

2 *Audit of Assumptions for the March 2001 Budget, HC 304, Session 2000-01.*

**12** The package as a whole is expected to deliver additional revenue in three ways:

- **direct effects** through increased or better allocation of Inland Revenue resources aimed at ensuring individuals and businesses meet their tax obligations;
- **preventive effects** as these individuals and businesses are more compliant in future years; and
- **indirect/deterrent effects** as other individuals and businesses are encouraged to meet their tax obligations when they learn of the new measures being operated.

**13** For the purposes of fiscal projections, and in line with previous practice, HM Treasury has included only the direct and preventive effects of the package and made no allowance for indirect/deterrent effects.

### *Direct effects*

**14** The direct effects of the package include additional revenue raised through: more individuals and businesses entering the tax system; better data on taxpayers allowing more effective collection of taxes; and expanded specialist teams to tackle complex personal tax returns.

**15** The new performance and management information system will support management action that will generate extra yield by: freeing up specialist staff time to spend on enquiry activity instead of collating data; enabling staff to better profile the tax risk of cases and issues to be pursued; focusing more clearly on the non-compliant; bringing more tax enquiries to a conclusion and taking earlier action to counter non-compliance.

**16** The additional direct revenue yield has been estimated in ways that reflect the nature of the effect. For example, current experience of existing measures provides the basis for estimating the yield from bringing more individuals and businesses into the tax system. Detailed records on the use of staff time have been analysed and used to estimate time that can be freed-up by more readily available data. Results from pilot exercises with specialist teams have been used to estimate the yield from expanding beyond the pilot stage.

**17** The Inland Revenue has introduced elements of caution into the estimates of the direct effects by:

- assuming, in respect of some of the work on Corporation Tax for small and medium enterprises, and for some individual taxpayers, that the cases to be tackled by additional compliance activity will produce less yield on average than those currently being pursued;
- reducing estimates that are based on management judgement. In particular, managerial estimates that the information system will allow a 35 per cent increase in the time spent on pursuing enquiries on specific cases within the Large Business Office have been reduced to 30 per cent; and
- excluding yield where benefits likely to arise from improved data cannot be estimated with any confidence at this stage.

*Preventive effects*

**18** The Inland Revenue believes that the measures will also have preventive effects, since the taxpayers directly addressed will be more likely to comply in future. The proportion of total yield from the new package that is attributed to preventive effects is small in relation to direct effects. To introduce caution where effects are uncertain, the Inland Revenue has assumed that:

- preventive effects from identifying those not complying with their tax obligations and working to keep them compliant are more short lived than existing experience suggests; and
- the ongoing yield from preventive effects will be significantly smaller than the average tax from the relevant population of tax cases.

*Indirect/deterrent effects*

**19** Indirect/deterrent effects may add significantly to the yield arising from several of the measures. But because it is difficult to demonstrate clearly such effects and to predict their scale, no yield has been included for them.

*Revenue effects included in the fiscal projections*

**20** The Inland Revenue estimates that the package as a whole will produce £1.7 billion additional revenue over the three years to 2006-07, with a further £1.1 billion in both 2007-08 and 2008-09. The estimates of additional revenue included in the fiscal projections are shown in **Figure 1**, disaggregated by type of effect. All estimates of yield assume that funding for the package is continued beyond 2005-06, the last year covered by current spending allocations.

**1** **Inland Revenue estimates for the purposes of the fiscal projections of the additional revenue from the new direct taxation and National Insurance compliance package, £ millions**

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 |
|---|---|---|---|---|---|
| Direct effects | 200 | 480 | 900 | 940 | 970 |
| Preventive effects | 0 | 20 | 60 | 110 | 160 |
| Indirect/Deterrent effects | Nil | Nil | Nil | Nil | Nil |
| **Total** | **200** | **500** | **960** | **1,050** | **1,130** |

*Source: Inland Revenue*

**21** As with the direct tax and National Insurance contributions compliance and enforcement package introduced in Budget 2003, the Inland Revenue is putting in place arrangements to monitor and evaluate the new package, and will also monitor the action by operational management that will realise the estimated benefits.

## Conclusion on Inland Revenue package

**22** Overall, the approach for estimating the revenue benefits of the package is reasonable. The estimates incorporate caution, for example, by taking into account for the most part only the direct effects of the measures and excluding the consequences of wider indirect/deterrent effects that are difficult to predict.

## The VAT Gap assumption

**23** Since 1997, the assumption used by the Treasury for forecasting VAT receipts has been that there will be a slight fall in the ratio of VAT receipts to consumers' expenditure[3]. The assumption was adjusted in the 2002 Pre-Budget Report to take account of additional receipts expected from the introduction of a VAT Strategy to improve VAT compliance, and again last year with the launch of further VAT Strategy measures[4]. In the 2003 Pre-Budget Report, the assumption was:

*The underlying ratio of VAT receipts to consumers' expenditure will be assumed to fall by 0.05 percentage points a year. The underlying ratio is adjusted for the effects of changes in rates and coverage of VAT and for the revenue impact of the direct and preventive, but not the deterrent, effects of the VAT strategy as extended in the 2003 Pre-Budget Report[5].*

**24** The assumption of an annual fall of 0.05 percentage points in the underlying ratio of VAT receipts to consumers' expenditure was cautious to the extent that some downward trend was built into the projections at a time when it was thought that the ratio might have been stabilising. In practice, the assumption proved not to be as cautious as expected. Over the three years to 2002-03 the ratio reduced each year by an average of 0.11 percentage points, rather than by the assumed 0.05 percentage points. This was equivalent to an over-estimation of £1.3 billion (0.7 per cent) in that part of the VAT revenue projections tied to the ratio[6]. Contrary to this trend, however, the interim data for 2003-04 showed a sharp rise in the ratio[7].

**25** I reported at the time[8] that, in the light of these uncertainties, HM Customs and Excise continued to apply the assumption of a downward trend as a cautious interim arrangement, but had put work in hand to:

- examine the reasons for the changes in the underlying VAT ratio over recent years;
- investigate, in particular, the extent to which changes in the ratio reflected changes in spending liable to VAT that is not included in consumers' expenditure, or changes in the timing of cash receipts relative to accrued VAT liabilities; and
- consider the scope for a new assumption, perhaps linked to new measures of the VAT expenditure base, developed to measure the scale of VAT losses, which might provide a better basis for forecasting.

**26** As a result of this work HM Customs and Excise has concluded that rather than projecting the VAT to consumers' expenditure ratio, an improved method is to use estimates of VAT receipts due theoretically, the "VAT Theoretical Tax Liability" or VTTL, along with estimates of the "VAT gap". The VAT gap is a measure of VAT losses from error, fraud and avoidance[9]. For any given VTTL, subtracting an estimate of the size of the VAT gap determines what actual VAT receipts will be.

3 *Audit of Assumptions for the Pre-Budget Report November 1997, HC 361, Session 1997-98; and Audit of Assumptions for the Pre-Budget 2000 Report, HC 959, Session 1999-2000.*
4 *Audit of Assumptions for the 2002 Pre-Budget Report, HC 109, Session 2002-03; and Audit of Assumptions for the 2003 Pre-Budget Report, HC35, Session 2003-04.*
5 *HC35, Session 2003-04, paragraph 26.*
6 *HC35, Session 2003-04, paragraph 30.*
7 *HC35, Session 2003-04, paragraph 31.*
8 *HC35, Session 2003-04, paragraph 33.*
9 *HM Customs and Excise has published the methodology for forecasting the VTTL and calculating the VAT gap in Measuring Indirect Tax Losses, November 2002.*

**27** The main reasons why the new approach is preferable to the VAT to consumers' expenditure ratio approach are that:

- the VTTL takes account of VAT liable expenditure across the whole economy[10], rather than only consumers' expenditure;
- over the last three years there has been a shift in the balance of the component parts of the VAT expenditure base. Consumers' expenditure now accounts for 72 per cent of the VAT expenditure base, compared with 74 per cent in 2000, as expenditure in other sectors, not subsumed by the VAT ratio, has become relatively more significant; and
- it is consistent with HM and Customs and Excise's new approach to tackling VAT losses, which includes a target for reducing the VAT gap to 12 per cent by 2005-06.

**28** From Budget 2004, HM Customs and Excise will therefore forecast VAT receipts using the following steps:

i forecasting the VTTL - built up from forward projections of historical patterns of expenditures in the economy and the mix of VAT rates (exempt, zero, reduced or standard rate) that apply to particular categories of expenditure;

ii applying an assumption about the future size of the VAT gap; and

iii adjusting that forecast of the VAT gap downwards to reflect the estimated additional revenue expected in future years from the direct and preventive, but not the deterrent, effects of the VAT Strategy measures announced in the 2002 and 2003 Pre-Budget Reports; as well as from other legislative and regulatory measures.

**29** In line with my previous audits of the VAT forecasting assumptions, my remit for this Report does not extend to a review of the method overall. In previous audits the forecast for consumers' expenditure fell outside my remit, and similarly I have not audited the approach for estimating the VTTL which is largely based on the Treasury's economic forecast. I have not audited the actual adjustment of the VAT gap for the effects of the VAT Strategy and other measures as in part iii of the method above, though I have audited the expected yield of the 2002 VAT Strategy as extended in 2003[11]. These estimates have been and will continue to be used as part of the adjustment.

**30** I have been asked to examine the new assumption which underpins part ii of the new forecasting approach above, as follows:

*For the purpose of projecting VAT receipts, the VAT gap (the difference between the estimated theoretical yield and actual VAT receipts, as a percentage of the theoretical yield) will be assumed to rise by 0.5 percentage points per year, from a level that is at least as high as the estimated outturn for the current year.*

**31** In December 2003, HM Customs and Excise published data on the estimated annual VAT gap since 1990-91[12]. For the purposes of making fiscal projections, HM Customs and Excise has adjusted that data to also include estimated VAT losses from smuggling, increasing the size of the VAT gap.

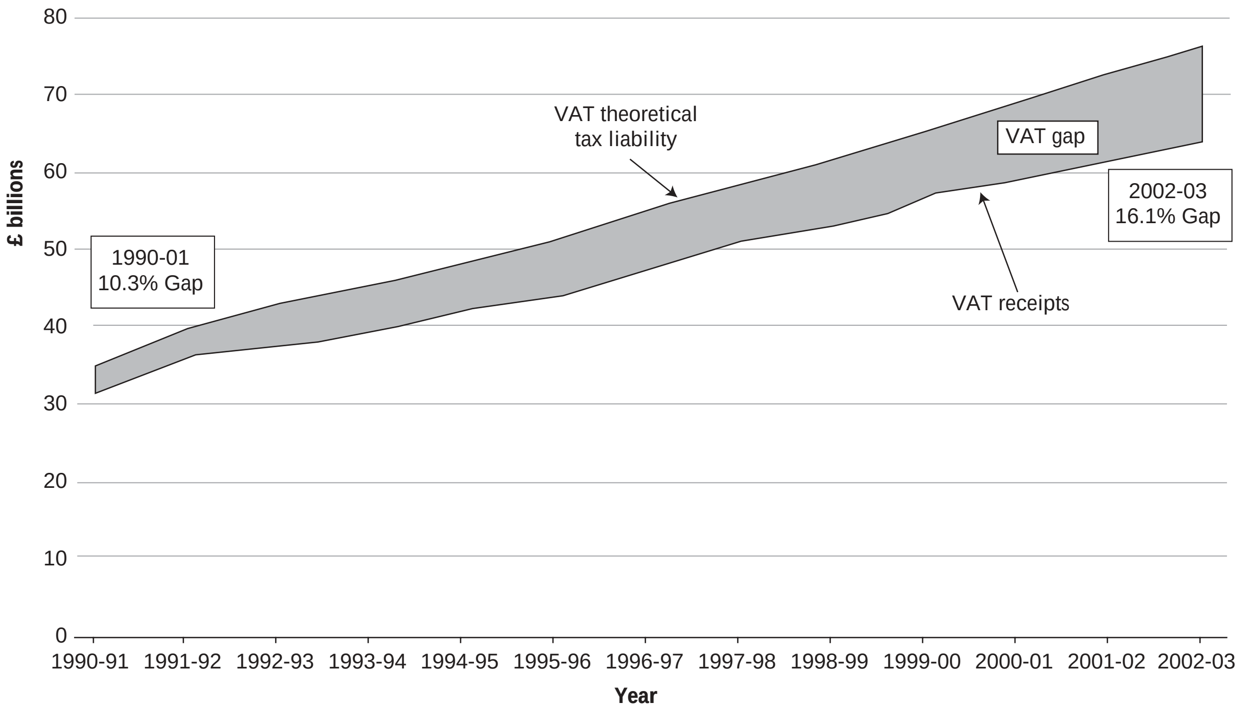
10 *Expenditure across the economy can be divided into five categories for the purpose of forecasting VAT receipts: consumers' expenditure (by households and non-profit bodies); government current expenditure; government capital expenditure; exempt expenditure (where the VAT is not passed on to the consumer); and housing expenditure.*

11 *Audit of Assumptions for the 2002 Pre-Budget Report, HC109, Session 2002-03, paragraphs 9-29; and Audit of Assumptions for the 2003 Pre-Budget Report, HC 35, Session 2003-04, paragraphs 9-23.*

12 *Measuring and Tackling Indirect Tax Losses, HM Customs and Excise, December 2003, Table 3.1.*

32 **Figure 2** shows the VAT gap on this basis from 1990-91 to 2002-03. Fitting a linear trend to the data over this period indicates that the VAT gap increased by 0.40 percentage points a year on average. The new assumption for the growth of the VAT gap is higher than this, at 0.5 percentage points a year, which implies lower VAT receipts than would be expected on the basis of the continuation of the historical trend.

**2 The relationship between the VAT theoretical tax liability, actual VAT receipts and the VAT gap, 1990-91 to 2002-03**




**NOTES**

1. The VAT theoretical tax liability, VTTL, is derived from estimates of the amount of VAT that could theoretically be collected given applicable VAT rates and relevant expenditure statistics produced by the Office for National Statistics.

2. For forecasting purposes the measure of the VAT gap includes VAT losses on smuggling. Previously published gap estimates, and the basis for HM Customs and Excise's target to reduce the gap to 12 per cent by 2005-06, exclude smuggling losses. The VAT gap including smuggling losses would be about half a percentage point higher.

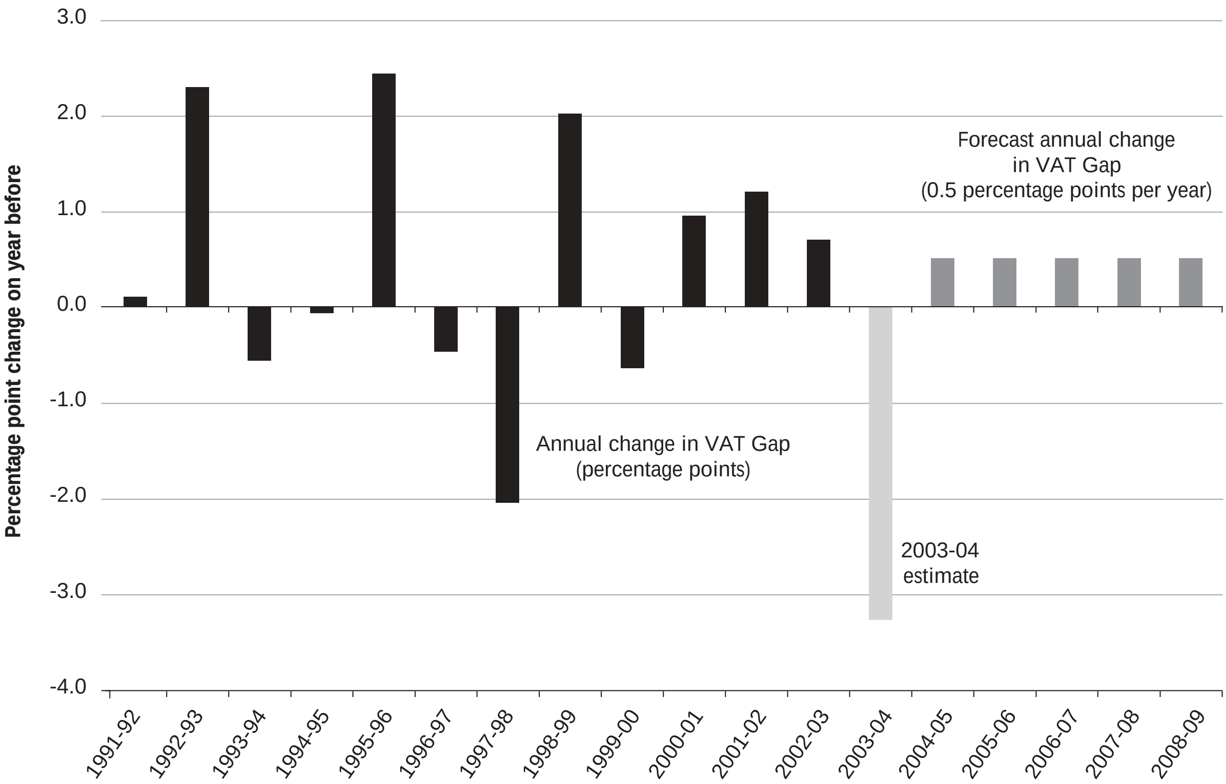
*Source: HM Customs and Excise*

33 In addition, the trend on which the 0.5 percentage points growth per year assumption is based includes a period in which there was significant growth in Missing Trader Intra-Community Fraud (approximately a fifth of the VAT gap in 2002-03), as well as smuggling. HM Customs and Excise believes that VAT losses are falling as a result of measures it has introduced to tackle these forms of fraud[13]. A significant continued fall in such losses would reduce the future trend growth rate of the VAT gap, below the assumed level of 0.5 percentage points growth each year. HM Customs and Excise does not as yet have sufficient data on the trends in losses from error, fraud and avoidance to estimate confidently what allowance might be applicable, and has therefore not made any allowance for this factor.

13 *HM Customs and Excise estimates that Missing Trader Intra-Community fraud is thought to have fallen from between £1.77 billion to £2.75 billion in 2001-02, to between £1.65 billion and £2.64 billion in 2002-03. The illicit share of the tobacco market also fell from 21 per cent to 18 per cent over the last three years - Measuring and Tackling Indirect Tax Losses, HM Customs and Excise, December 2003, Tables 3.2 and 4.2.*

**34** Another uncertainty arises because of the volatility of the year on year change in the VAT gap, **Figure 3**. As an indication of recent trends, the VAT gap grew on average by 0.64 percentage points per year over the five years from 1998-99 to 2002-03. However, if interim data for 2003-04 are included, the average annual growth rate in the VAT gap over the five years from 1999-00 to 2003-04 reduces to about 0.1 percentage points per year, reflecting the unexpected buoyancy in VAT receipts in 2003-04.

**3** **Percentage point change in the VAT gap on the previous year, 1991-92 to 2003-04 (estimated), and the assumed 0.5 percentage points a year increase used for forecasts.**




**NOTE**

Figure 3 shows, for example, that the VAT gap increased between 1991-92 and 1992-93 by 2.3 percentage points, from 10.3 to 12.6 per cent of VTTL

**35** The new assumption is designed to deal with such volatility by the "at least" formulation. This allows a VAT gap higher than the estimated outturn for the current year to be used as the starting point for the VAT gap forecasts, if the reasons for a decline are not fully understood or thought not to be sustainable.

**36** Applying the assumption requires an estimate of the outturn VAT gap (VTTL less VAT receipts) for the current year. Data for VAT receipts are available on a monthly basis, but the data necessary to calculate the VTTL are compiled by the Office for National Statistics and are mostly available on a quarterly basis. HM Customs and Excise therefore has to extrapolate the available data, especially that for VTTL. This introduces some uncertainties in the estimate for the VAT gap, though using the most recent data ensures that any previous errors in the VAT gap are not carried forward. For Budget 2004, the expenditure data for most of the VTTL (household spending) is available in detail for three quarters of 2003. Household spending is available for the final quarter in total, but the breakdown of the figures making up that total is not. The breakdown of household spending for 2003 Q4 between VAT rates is therefore assumed equal to that in the first three quarters. Historically, the breakdown of household spending has changed only slowly, so this is unlikely to introduce much error.

**37** The estimated VAT gap for 2003-04 is 12.8 per cent of VTTL. This is a reduction of 3.3 percentage points compared to the VAT gap for 2002-03. The reduction reflects greater than expected VAT receipts, which look likely to be £3.1 billion higher than forecast in Budget 2003. The explanation for this is not yet clear, so HM Customs and Excise has judged that £1.0 billion of the increase should be treated as temporary for the purposes of forecasting. Removing this amount from the estimate of current year VAT receipts is equivalent to a 1.2 percentage point increase in the estimated VAT gap for 2003-04, from 12.8 to 14.1 per cent of VTTL. The latter figure has been used as the basis for VAT receipt projections for Budget 2004.

### Conclusions on the VAT gap assumption

**38** In line with my remit for previous audits I have not been asked to give an opinion on the new method of forecasting VAT receipts as a whole.

**39** The new assumption for the VAT gap, which I have audited, will be cautious to the extent that the historical long term trend is a good indicator of future trends in the VAT gap. The assumed value of 0.5 percentage points increase in the VAT gap each year is higher than the historical trend. The shorter term trends in the VAT gap are more volatile and not yet well understood but will be influenced by the measures to reduce VAT error, fraud and avoidance.

**40** In the light of this volatility, it is reasonable to rebase the projection of the VAT gap each year and to adjust the latest outturn upwards, as for Budget 2004, where there is uncertainty about sustainability of an increase in VAT receipts. This introduces some degree of caution not achieved by a simple extrapolation from the latest outturn of the VAT gap, though clearly the uncertainties inherent in understanding short term movements in VAT receipts mean it is difficult at the moment to quantify precisely the degree of caution incorporated.

## Factor income shares

**41** In the medium term, when the Treasury assumes that the economy grows at the underlying trend rate, the shares of labour incomes and profits in domestic income are assumed to be broadly constant. This assumption is consistent with economic theory though dependent on a number of assumptions about the nature of technology in the economy and the existence of competitive markets.

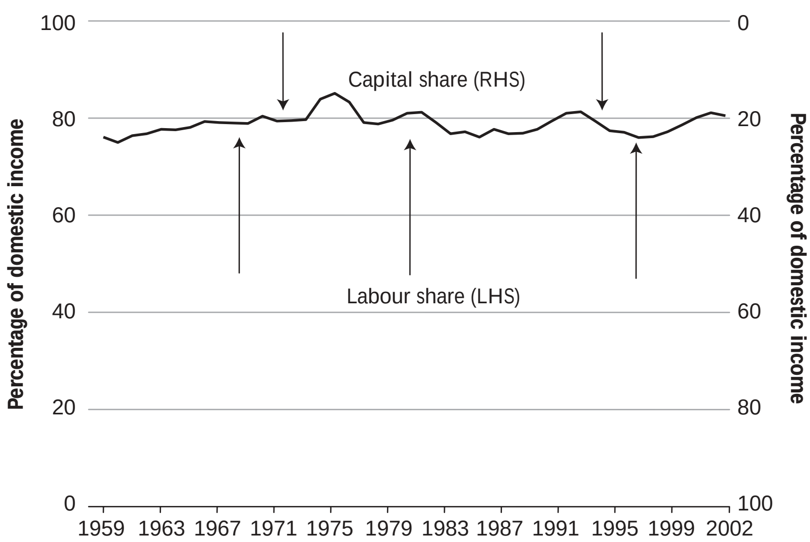
**42** The factor income shares assumption has a direct bearing on the public finances, since labour income and profits are taxed at different rates. Labour incomes at the margin are more highly taxed than company profits. The basic rate of income tax is 22 per cent and, taking account of both employee and employer National Insurance contributions, the marginal tax rate of average earnings for contracted out employees is about 41 per cent. The standard rate of Corporation Tax is 30 per cent.

**43** A shift between labour income and profit shares in domestic income will therefore affect the level of tax revenues. The precise effects will depend on a range of assumptions (especially for average earnings and employment). The Treasury estimates suggest that, if no second round effects on the real economy or on prices are taken into account, then for the tax rates above, a permanent shift of one percentage point in GDP from profits to labour income could raise the total level of tax receipts by about £1¼ billion after one year.

**44** The assumption is also important for the projections of equity prices, which are expected to grow in line with the profitability of businesses. If the share of profits in domestic incomes is constant, then money GDP growth can be seen as a reasonable proxy for growth of profits in the economy in the medium term. It can therefore be expected that equity prices will grow in line with money GDP as in the audited assumption[14].

**45** As in my 2001 Report where I looked at the factor shares assumption[15], I have examined the empirical evidence for the constancy of shares of labour incomes and profits. **Figure 4** shows data for the period from 1959 to 2002, (data for 2003 are not yet published). The shares have tended to be constant with fluctuations around an average level of 78.8 per cent for labour incomes over the whole period, ranging from about 75.0 per cent in 1960 to 85.1 per cent in 1975.

**4** **Factor shares in domestic income net of stock appreciation and rental income, 1959-2002**




*Source: HM Treasury*

**46** Over the three year rolling review period, the share of labour income has been above the 1959 to 2002 average, though still well within that period's overall range of fluctuation. It rose slightly from 80.1 per cent in 2000 to 81.1 per cent in 2001, before falling back slightly in 2002, (again, data for 2003 are not yet published). I commented in my 2001 Report on the cyclical and structural factors that constitute the main possible explanations for why factor shares are not precisely constant[16].

14 *see Audit of Assumptions for the 2003 Pre-Budget Report, HC35, Session 2003-04.*
15 *Audit of Assumptions for the March 2001 Budget, HC 304, Session 2000-01.*
16 *Paragraphs 15-17 of Audit of Assumptions for the March 2001 Budget, HC 304, Session 2000-01.*

**47** For the future, economic theory and long run empirical evidence continue to suggest that it is reasonable to assume that factor shares are broadly constant when the economy is assumed to be on its trend path.

### Conclusion on factor income shares

**48** The assumption of broadly constant factor shares was a reasonable one over the three year rolling review period and it currently remains so for the future.

## Debt Interest

**49** I have examined the consistency of the financing assumptions used in projecting central government debt interest with the forecast of government borrowing and with the financing policy as set out in the Debt and Reserves Management Report, DRMR.

**50** These checks are necessary to ensure that the data input to the Treasury's economic forecasting system are consistent with the detailed forecast of debt interest over the year ahead, which is separately prepared and is based on a known and planned debt issuance and redemption profile.

**51** A further element of ensuring consistency is that both financing requirement forecasts and debt interest calculations need to reflect policy intentions relating to debt management. These policy intentions include:

- maintaining a constant level of Official Reserves of gold and foreign exchange, in line with the policy that, currently, there are no plans to increase borrowing to raise the level of the gross reserves. In practice this means that there should be no net borrowing over the year to finance the reserves and the only impact on debt interest payments should be movements in market variables such as interest rates;
- financing through the issuance of gilts and Treasury bills the central government net cash requirement plus refinancing any maturing debt and any financing required for the Official Reserves. This impacts on the stock of outstanding government debt and hence debt interest payments;
- a forecast of National Savings & Investments' net contribution to meeting the net financing requirement. This affects debt interest payments to the extent that interest rates paid on National Savings & Investments' products differ from those on other debt instruments; and
- policy decisions regarding the mix and maturity of financing through issuance of conventional and index linked gilts. This again affects the level of debt interest payable as the coupons will be different depending on the type and maturity of gilts being issued.

**52** These policies underlie a particular pattern of debt issuance, as set out in the DRMR. For consistency this pattern must be used in the calculations of debt interest payments.

**53** For the three year period of the rolling review since March 2001, I examined the relevant working papers relating to the 2002 and 2003 Budgets and the 2001, 2002 and 2003 Pre-Budget Reports. I confirm that the figures for government borrowing used to calculate debt interest payments were consistent with the forecast of government borrowing, and that they reflected the policy assumptions in the relevant DRMR. I confirmed also that the Treasury has used the audited methodology for projecting interest rates[17], and has applied the outcome in its calculations of debt interest payments, including for Budget 2004.

*17 Audit of Assumptions for Budget 2003, HC 627, Session 2002-03.*

**54** For Budget 2004, my examination of the relevant papers confirms that the data input to the Treasury's economic forecasting system is consistent with the detailed forecast of debt interest over the year ahead.

**55** The government's current statement of financing policy is set out in the DRMR published on 17 March 2004 with the Budget papers. The policy remains that the Government aims to meet the net cash requirement plus any maturing debt and any financing required for additional net foreign currency reserves through the issuance of debt.

**56** For 2004-05, I have confirmed that the pattern of gilt issuance adopted in the DRMR has been used in the calculation of the debt interest forecast. For subsequent years, the DRMR makes no assumptions about the pattern of gilt issuance. However, the Treasury forecasting system assumes that the 2004-05 pattern remains unchanged. I have confirmed that this assumption has been applied in making forecasts of debt interest for future years.

### Conclusion on Debt Interest

**57** I am satisfied that the calculations of debt interest payments were consistent with forecasts for central government's net financing requirement and with current financing policy at the time of each forecast made since the March 2001 Budget, and are for Budget 2004.

## Overall Conclusions & Recommendations

*Increased tax yield from a new compliance package for direct tax and National Insurance contributions announced in Budget 2004*

**58** The approach to projecting the revenue benefits of the package is reasonable, and while there are uncertainties, the estimates incorporate elements of caution.

**59** Given the importance of the contribution of the performance and management information system to the package of measures as a whole, it is important that the Inland Revenue succeeds in its plans to convert time freed-up by the system into increased effectiveness in handling tax cases and higher tax yield.

*The VAT gap*

**60** In line with my remit for previous audits I have not been asked to give an opinion on the new method of forecasting VAT receipts as a whole but I have examined the basis for projecting the VAT gap - which reflects the extent of losses from error, fraud and avoidance.

**61** The new assumption for the growth in the VAT gap will be cautious to the extent that the historical long term trend is a good indicator of future trends in the VAT gap but uncertainties remain. Shorter term trends in the VAT gap are volatile. The intention to adjust the latest estimated outturn VAT gap upwards where there is uncertainty about sustainability of an increase in VAT receipts, as done in Budget 2004, is therefore reasonable and introduces caution.

**62** HM Customs and Excise has told me that as more data become available, it will keep its assessment of the underlying trend in the VAT gap and its forecasting assumption under review. Estimating the trends in the different types of VAT losses that make up the VAT gap would help inform that evaluation. Given that this is the first time that HM Customs and Excise has used this method of forecasting, it will also be important that it tests the robustness of the methods used to estimate the VTTL and the VAT gap.

### *Factor income shares*

**63** The assumption of broadly constant factor shares was a reasonable one over the three year rolling review period and it currently remains so for the future.

### *Debt Interest*

**64** The calculations of debt interest payments were consistent with forecasts for central government's net financing requirement and with current financing policy at the time of each forecast made since the March 2001 Budget, and are for Budget 2004.