



National Audit Office

Audit of Assumptions for Budget 2007

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 393 Session 2006-2007 | 21 March 2007

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Audit of Assumptions for Budget 2007

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Comptroller and Auditor General
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REPORT

Audit of Assumptions for Budget 2007

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 The Chancellor has requested that I conduct a three year Rolling Review of the assumptions I have audited previously. These arrangements were introduced at the time of the March 2000 Budget, to provide a check both that the audited assumptions remain reasonable and cautious, and to see whether they were reasonable and cautious projections in the period since they were last audited. The 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.

3 On this occasion, the Rolling Review covers the following assumptions:

- the Budget 2004 direct tax and National Insurance contributions compliance and enforcement package;
- the VAT gap;
- tobacco revenues;
- factor shares in national income; and
- debt interest.

4 I last examined these assumptions in 2004¹ other than those for VAT and tobacco revenues. On VAT, I have previously examined assumptions for the VAT Compliance Strategy introduced in Pre-Budget 2002², the VAT ratio³ and the VAT gap⁴. My audit for the 2005 Pre-Budget Report set out that the Treasury planned to ask me to carry out a review of the forecasting assumptions underlying VAT receipts as a whole, for Budget 2007 or before⁵. As well as looking back to assess the performance of the assumptions for the VAT Compliance Strategy and the VAT gap, I have now been asked to examine a new forward assumption for VAT receipts, as follows:

- *For the purpose of projecting VAT receipts, the underlying VAT gap will be assumed to rise by at least 0.5 percentage points per year from the estimated outturn for the current year. It will be adjusted for the effects of changes in rates and coverage of VAT.*

¹ *Audit of Assumptions for Budget 2004*, HC 434, Session 2003-04.

² *Audit of Assumptions for the 2002 Pre-Budget Report*, HC 109, Session 2002-03 and *Audit of Assumptions for the 2005 Pre-Budget Report*, HC 707, Session 2005-06.

³ *Audit of Budget Assumptions for the Pre-Budget Report November 1997*, HC 361, Session 1997-98; *Audit of Assumptions for the Pre-Budget 2000 Report*, HC 959, Session 1999-00; *Audit of Assumptions for the 2003 Pre-Budget Report*, HC 35, Session 2003-04.

⁴ *Audit of Assumptions for Budget 2004*, HC 434, Session 2003-04.

⁵ *Audit of Assumptions for the 2005 Pre-Budget Report*, HC 707, Session 2005-06, paragraph 114.

5 With regard to tobacco duties, I concluded in my Budget 2006 Report that data anomalies and the absence of recent data on the market share of smuggled tobacco meant it was not possible to conclude for the Rolling Review then whether the assumption had proved reasonable and cautious over the full three year period or would be so for future forecasts⁶. HM Revenue & Customs undertook to carry out work to resolve the problems. In the light of this HMRC work I have now been asked to examine a revised assumption for tobacco revenues as follows:

- *For the purpose of projecting the revenue duties on 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. The underlying level is defined as HMRC clearances, adjusted for timing impacts.*

6 The Treasury has advised me that there are no other new assumptions and that there is no change in the way that the existing assumptions are applied, other than for VAT and tobacco revenues as above. 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

7 I have considered the available evidence gathered for this audit from relevant papers and discussions with officials as appropriate in the Treasury and HM Revenue & Customs.

Report

The Budget 2004 direct tax and National Insurance contributions compliance and enforcement package

8 In Budget 2004, the Inland Revenue, now a part of HM Revenue & Customs⁷, introduced a new compliance package for direct tax and National Insurance contributions. I was asked by the Chancellor to determine whether the revenue impact of the package estimated for the purposes of the fiscal projections was reasonable and cautious⁸. The Chancellor has now requested that I conduct a three year Rolling Review of these assumptions.

Projected revenue impact of the 2004 compliance package

9 The new package focused on improving compliance through:

- better use of management information to improve both the targeting and effectiveness of Corporation Tax and other enquiry work in the Large Business Office⁹ and the HMRC 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 HMRC, 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.

10 HMRC expected that the package would produce additional revenue in three ways:

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

11 On the grounds of caution, given the uncertainties about the size of the deterrent effects, the Treasury included only the direct and preventive effects of the package in the fiscal projections. HMRC estimated at the time of Budget 2004 that these revenue impacts would be £1,660 million over the three years 2004-05 to 2006-07, mainly comprising the direct impact of these measures, **Figure 1 overleaf**.

12 I concluded in my review of the assumptions for the 2004 Budget that the projections for additional revenue in Figure 1 were reasonable and incorporated caution, although there were uncertainties. Given the importance of the contribution of the performance and management information system to the package of measures as a whole, I noted that it was important that HMRC succeeded in its plans to convert time freed-up by the system into increased effectiveness in handling tax cases and higher tax yield¹⁰.

6 *Audit of Assumptions for Budget 2006*, HC 937, Session 2005-06, paragraph 72.

7 In April 2005, a new Department was created, HM Revenue & Customs, HMRC, which brought together most of the functions of the Inland Revenue and HM Customs and Excise.

8 *Audit of Assumptions for Budget 2004*, HC 434, Session 2003-04.

9 Following the creation of HMRC, the Large Business Office became the Large Business Service.

10 *Audit of Assumptions for Budget 2004*, HC 434, Session 2003-04, paragraph 59.

Actual revenue impact of the 2004 compliance package

13 HMRC estimates that the package will generate outturn yield of £2,540 million in the three years to 2006-07, exceeding the original forecast by £880 million, **Figure 2**. It also shows the revised forecast adopted in the 2006 Budget and how this compares to the actual outturn. HMRC estimates that the package will exceed the revised forecast by £1,200 million.

14 In line with my recommendations, HMRC put in place monitoring processes for the package. Following a review of outturn in 2005-06, the Treasury revised its forecast in the 2006 Budget when it thought that yield was likely to fall below expectations. This followed a change in HMRC's strategy for tackling avoidance and non-compliance, and its decision to make more use of litigation in pursuing non-compliance. While HMRC considers this approach should lead to higher receipts in the longer term, the short term effect is a delay in

1 Original estimates of the additional revenue from the 2004 compliance package

	2004-05 £m	2005-06 £m	2006-07 £m	Total £m
Direct effects	200	480	900	1,580
Preventive effects	0	20	60	80
Indirect/Deterrent effects	Nil	Nil	Nil	Nil
Total	200	500	960	1,660

Source: HMRC

2 Budget 2004 and 2006 forecasts compared with actual outturn and estimates for 2006-07

	2004-05 £m	2005-06 £m	2006-07 £m	Total £m
Budget 2004 Forecast (A)	200	500	960	1,660
Revised Budget 2006 Forecast (B)	200	500	640	1,340
Outturn = (C)	400	360	1,780	2,540
Budget 2004 Forecast less outturn (C - A)	200	-140	820	880
Budget 2006 Forecast less outturn (C - B)	200	-140	1,140	1,200

Source: HMRC

settlements and a fall in receipts as a consequence of potential litigation. This was a prudent approach to revising the forecast in the light of future expectations.

Improving compliance in large businesses

15 The actual yield achieved over the three years of the package has been dominated by the initiative to improve compliance in large businesses. The main thrust of this package was to improve the quality and hence yield of compliance work by existing staff resources through a new performance and management information system for the Large Business Service, LBS. Other initiatives involved additional resources to create a new Financial Office and enable increased use of specialists. HMRC originally estimated that this would generate around two thirds of the revenue impact of the package. In practice, it generated 85 per cent of the total yield.

16 HMRC introduced caution into its original estimates by reducing estimates that were based on management judgement. In particular, managerial estimates that the information system would allow a 35 per cent increase in the time spent on pursuing enquiries within the LBS were reduced to 30 per cent. In estimating the additional yield to be generated, HMRC calculated productivity gains using a baseline of the average yield generated by the LBS over the four year period from 2000-01 to 2003-04.

17 The outturn yield has been calculated by taking the original baseline, based on the average compliance yield achieved in the four years up to 2004, uprating this for inflation (using the GDP deflator in each year) and comparing this with the actual outturn. HMRC has attributed any increase in yield above this adjusted baseline to the measures designed to improve compliance in large businesses. This is not unreasonable, but assumes that there would have been no productivity growth in the absence of the package. Yield can also be affected by wider changes in the economy, although this effect is complicated, as settlements can relate to issues arising from a number of years earlier.

18 I have examined HMRC's methodology to calculate the outturn yield achieved by the LBS over the three year period. I have confirmed that HMRC's original baseline has been used as the basis for measuring additional yield over the three years. My staff have examined HMRC's procedures to record compliance yield generated by the LBS and reviewed a sample of cases to confirm that the quality assurance procedures were properly applied in the validation and recording of compliance yields. HMRC's Quality Standards team has independently validated the compliance yield recorded by the LBS. In the light of this work, I am satisfied that the yield has been calculated in accordance with HMRC's procedures.

19 Over the period of the Rolling Review the package of measures designed to improve compliance in large businesses has evolved in the light of experience. My audit therefore covers the total revenue yield of the package as it was implemented over the period of the Rolling Review as a whole.

20 The outturn yield of the direct tax and National Insurance compliance package has been dominated by measures to improve compliance in large businesses, which have evolved over time. It is not therefore possible to assess the extent to which the yield expected from the original package of measures was achieved. Other factors, most notably the integration of the Inland Revenue and HM Customs and Excise and the creation of the LBS, have led to changes in the way compliance work is organised and undertaken.

21 These changes mean that HMRC cannot determine whether the performance and management information system actually led to the estimated 30 per cent increase in productivity included in its original forecast. Such an assessment would require a detailed examination of business processes and changes in staff utilisation.

22 A further uncertainty stems from sensitivities of the actual yield to complex one-off settlements, the timing of which can be difficult to predict. The amounts in Figure 2 have been significantly affected by a number of such settlements. The timing and complexity of these settlements meant that it was not possible for HMRC to complete its quality assurance procedures on the most recent of these settlements ahead of the 2007 Budget. HMRC is satisfied that it is appropriate to include this additional yield in the estimated revenue impact of the package, but it was not possible for me to review the papers or the results of the quality assurance procedures in advance of the 2007 Budget.

Other initiatives within the Compliance Package

23 Some of the other initiatives in the package have not met their yield forecasts over the expected period. These shortfalls have arisen because HMRC:

- encountered delays and technical problems in delivering the computer systems intended to provide better data needed for some of the initiatives;
- experienced delays in deploying suitably qualified staff; and
- took longer than originally planned to fully commence some work.

24 On the other hand, the initiative for taxpayers with complex personal tax affairs has successfully delivered more than the expected yield. When examining individual cases these teams have generated higher rates of yield than was originally forecast. The new Labour Providers Unit has also exceeded the original yield forecasts. The teams have developed a greater understanding of the risks involved in this area and have tailored their approach to focus on emerging risks of non-compliance.

Forward look

25 The Treasury has told me that no additional revenue impact for the direct tax and National Insurance compliance package is assumed beyond 2006-07. The activities undertaken as part of this package will now be subsumed within the wider work that HMRC is undertaking to improve taxpayer compliance as part of its Public Service Agreement targets. I have therefore not been asked to consider whether reasonable and cautious assumptions for the Package have been used in the fiscal projections beyond 2007.

The VAT gap

26 At the time of Budget 2004 the Treasury changed the forecasting of the underlying trend in VAT receipts. It now estimates the 'VAT Theoretical Tax Liability', VTTL, and deducts the estimated 'VAT gap' to forecast what receipts are likely to be. The VAT gap is the measure of VAT losses from error, fraud, evasion and avoidance.

27 In 2004 I reviewed the following assumption for the VAT gap¹¹:

For the purpose of projecting VAT receipts, the VAT gap 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.

Assessment of past performance

28 I can confirm that the 0.5 percentage points growth has been applied to a level at least as high as the estimated VAT gap outturn for the current year. The Treasury, where applicable, increased the estimated VAT gap outturn for the current year when it appeared low, either because recent declines were not thought to be sustainable, or because recent indicators suggested that an increase in the gap was likely. This happened at Budgets 2004 and 2006.

29 The Treasury also made adjustments to the forecast VAT gap to take account of both new legislative measures and the forecast direct and preventive revenue impacts of the VAT compliance strategy introduced in the 2002

11 *Audit of Assumptions for Budget 2004, HC 434, Session 2003-04.*

Pre-Budget Report and extended in the 2003 Pre-Budget Report. The allowance for legislative measures is not part of the VAT gap growth assumption that I audit.

30 I examined the revenue impact of the 2002 VAT Compliance Strategy in 2005¹² and found that “it was not possible to evaluate the degree to which the assumption had proved to be cautious and reasonable, as the operational data to evaluate the actual revenue impacts achieved by the Strategy was limited and HM Revenue & Customs, HMRC, had not established a clear link between these results and the additional VAT received”. In view of this, the Treasury and HMRC agreed to carry out the necessary evaluative work¹³.

31 My discussions with HMRC indicate that it is still not possible, however, to evaluate the degree to which the VAT Compliance Strategy has been successful. HMRC’s view is that it is not feasible to identify accurately the separate contributions of the underlying trend in the VAT gap, the Compliance Strategy, and the impact of legislative measures on VAT receipts.

32 Given the absence of information about the separate impact of the VAT Compliance Strategy and impacts of legislative measures on the size of the outturn VAT gap, sources of the differences between the outturn and forecast VAT gap cannot be identified.

33 The comparison of the actual VAT gap against the forecast VAT gap since 2003-04¹⁴ shows that the estimated actual VAT gap was below the forecast in three of the last

four years, **Figure 3**. In 2005-06, however, the outturn VAT gap is estimated to have been above the forecast path, when the VAT gap rose sharply. A major factor contributing to this increase is likely to have been an increase in the scale of missing trader fraud.

34 **Figure 4** shows how the projected annual VAT gap growth has been built up from the assumption of 0.5 percentage points growth a year and other adjustments which the Treasury applies. It also shows that the actual VAT gap growth has been less than the assumed VAT gap growth in three out of the four years in the period since 2003-04.

35 The impact of the differences between the forecast and outturn VAT gap can be measured in terms of VAT receipts. The calculations need to take account of in-year adjustments arising from estimating full year receipts from part year information and changes to the tax base arising from errors in assumptions made for the composition of spending, subject to different rates of VAT.

36 **Figure 5** shows, for the three years 2003-04¹⁵, 2004-05 and 2006-07 (estimated full year) taken together, that VAT receipts were about £4.8 billion more than forecast, as a result of over-forecasting the VAT gap (the sum of £2.4, £1.0 and £1.4 billions). In 2005-06, however, when the actual VAT gap exceeded forecast, there was a shortfall in receipts from this source alone of £2.7 billion. On this basis, while the VAT gap assumption did not prove to be cautious in each individual year of the Rolling Review, it was cautious over the period as a whole, under-forecasting receipts by more than £2 billion.

3

Comparison of forecast VAT gap estimated at the time of the Budget with outturn VAT gap

	Budget 2003 ¹ forecasts for 2003-04	Budget 2004 forecasts for 2004-05	Budget 2005 forecasts for 2005-06	Budget 2006 forecasts for 2006-07 (estimates) ³
	%	%	%	%
Forecast VAT Gap using outturn base	15.9	13.4	11.9	15.2
Outturn VAT gap ²	12.9	12.2	15.0	13.8
Forecast minus outturn ⁴	3.0	1.2	-3.0	1.5

Source: HM Revenue & Customs

NOTES

- Figures for 2003-04 are calculated on the basis of the 2004 VAT gap assumption.
- For forecasting purposes, the measure of the VAT gap includes VAT losses on smuggling. Published VAT gap estimates and the basis for HMRC’s target to reduce the VAT gap exclude smuggling losses. The VAT gap including smuggling losses is about half a percentage point higher.
- These are provisional estimates at the time of the Budget 2007. Final outturn figures will be published later in 2007.
- Figures may not sum due to rounding.

¹² *Audit of Assumptions for the 2005 Pre-Budget Report*, HC 707, Session 2005-06, paragraphs 90-114.

¹³ *Audit of Assumptions for the 2005 Pre-Budget Report*, HC 707, Session 2005-06, paragraphs 113, 114.

¹⁴ The figures for 2003-04 have been estimated by HMRC on the basis that the Budget 2004 VAT gap assumption had been in force, rather than the previous assumption for VAT used at the time.

¹⁵ The figures for 2003-04 are included as they have not previously been covered by my audit work. As the current VAT assumption was introduced in Budget 2004, it is necessary to estimate what the VAT gap would have been on the basis of the Budget 2004 VAT gap assumption.

4 Projected VAT gap growth (percentage points) estimated at the time of the Budget

	Budget 2003 ¹ forecasts for 2003-04	Budget 2004 forecasts for 2004-05	Budget 2005 forecasts for 2005-06	Budget 2006 forecasts for 2006-07 (estimates) ³
	%	%	%	%
VAT gap growth comprised as follows:				
Assumed underlying growth	0.5	0.5	0.5	0.5
Outlier adjustment ²	–	1.3	–	0.3
Allowance for VAT Compliance Strategy	– 0.5	– 0.9	– 0.6	– 0.3
Allowance for legislative measures	– 0.5	– 0.4	– 0.2	– 0.2
VAT gap growth used for forecasting VAT receipts at the time of the Budget	– 0.5	0.5	– 0.3	0.2
Actual VAT gap growth	– 3.5	– 0.6	2.7	– 1.2

Source: HM Revenue & Customs

NOTES

- Figures for 2003-04 are calculated on the basis of the 2004 VAT gap assumption.
- The outlier adjustment to the underlying VAT gap is made in some cases, to reflect the 'at least' formulation of the audited assumption. A VAT gap higher than the estimated outturn for the current year can be used as the starting point for the VAT gap forecasts, if the reason(s) for a decline in the VAT gap are not fully understood or are thought to be not sustainable.
- These are provisional estimates at the time of the Budget 2007. Final outturn figures will be published later in 2007.
- Figures may not sum due to rounding.

5 Comparisons of forecast and outturn VAT receipts, £ billion

	2003-04 ¹	2004-05	2005-06	2006-07 (estimates) ²
Forecast VAT receipts	66.6	73.1	76.3	76.5
Outturn VAT receipts	69.1	73.0	72.9	77.3
Overall difference (£ bn), outturn less forecast	2.5	– 0.1	– 3.5	0.9
Overall difference (% as share of forecast VAT receipts)	3.7%	– 0.1%	– 4.6%	1.2%
Of which ³ (£bn):				
In-year receipts	0.1	– 0.4	0.4	– 0.6
Tax base forecast	– 0.5	– 0.7	– 1.1	0.1
VAT gap growth assumption	2.4	1.0	– 2.7	1.4

Source: HM Revenue & Customs

NOTES

- The 2003-04 forecast VAT receipts is based on the VAT assumption in force before Budget 2004. The figures for the 2003-04 components of the 'Overall difference (£ bn)', are calculated on the basis of the 2004 VAT gap assumption. As a result, the sum of the components is not equal to the 'Overall difference (£ bn)'. Also, figures may not sum due to rounding.
- These are provisional estimates at the time of the Budget 2007. Final outturn figures will be published later in 2007.
- In-year receipts adjustment allows for errors in estimating current year receipts from part year data. The tax base forecast adjustment allows for errors in forecasting VTTL.

Revised Budget 2007 VAT gap assumption

37 The Treasury has adopted a new assumption in Budget 2007 for forecasting VAT receipts:

For the purpose of projecting VAT receipts, the underlying VAT gap will be assumed to rise by at least 0.5 percentage points per year from the estimated outturn for the current year. It will be adjusted for the effects of changes in rates and coverage of VAT.

38 HMRC considers that the measures in the original VAT Compliance Strategy have now reached a broadly steady state. Although it is continuing to strengthen its VAT compliance activities, it no longer proposes to make a specific downward adjustment to the VAT gap for compliance related activities in the Budget 2007 assumption.

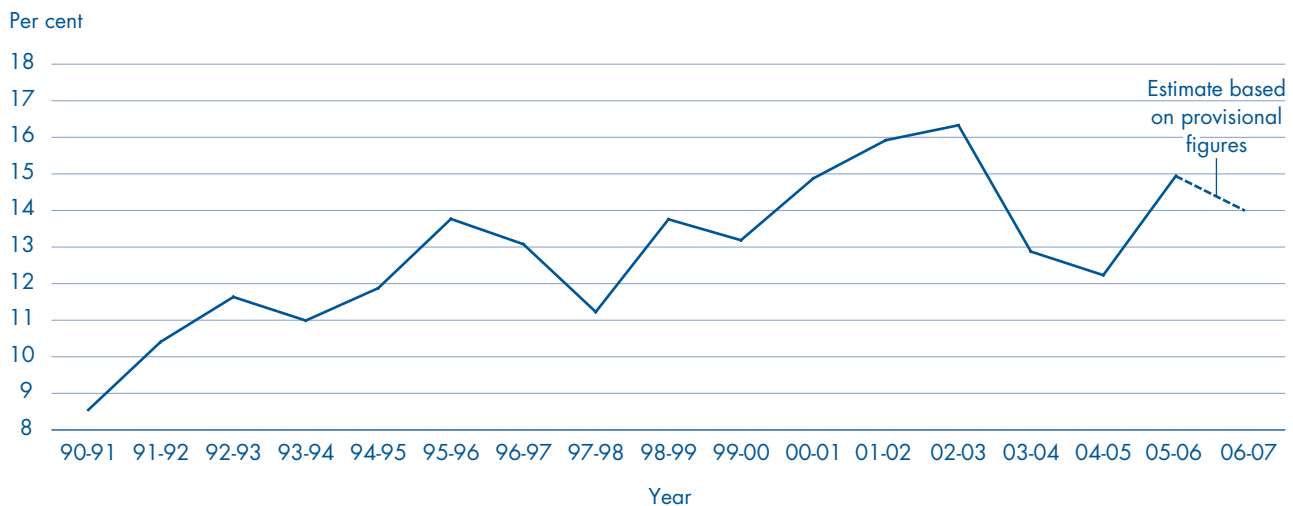
39 The assumption is based on the 'underlying' VAT gap. This builds in adjustments, where applicable, to take into account the impact of large one-off VAT payments and repayments that relate to past liabilities. This will allow for some timing differences, that in the past have contributed to volatility in the VAT gap and to errors in the forecast.

40 Other factors also introduce volatility. **Figure 6** shows movements in the actual VAT gap. This volatility stems from a range of factors, including:

- changes in compliance behaviour by taxpayers and/or in the impact of operational and other compliance measures by HMRC;
- the impact of legislative measures;
- other timing differences between VAT liabilities being incurred and the payments of VAT receipts to HMRC; and
- the estimate of VTTL not measuring accurately movements in the tax base.

41 The complex nature of VAT means that it is not currently possible to make a precise assessment of the relative contributions of the different factors, though in the past, changes in the scale of missing trader fraud have been a major factor. The fall in the VAT gap in 2003-04 coincided with a time when the level of missing trader fraud was falling, while the rise in the VAT gap in 2005-06 coincided with a sharp increase¹⁶. Because of the scale and rapidity of the changes, errors in measurement of the VTTL tax base are unlikely to be a major cause of the volatility.

6 Estimated actual VAT gap as a percentage of VTTL, 1990-91 to 2006-07



Source: HM Revenue & Customs

NOTE

For forecasting purposes, the measure of the VAT gap includes VAT losses on smuggling. Published VAT gap estimates and the basis for HMRC's target to reduce the VAT gap exclude smuggling losses. The VAT gap including smuggling losses is about half a percentage point higher.

¹⁶ HM Revenue & Customs, *Measuring Indirect Tax Losses*, 2006.

42 The new assumption retains an allowance in the previous assumption for growth in the VAT gap of 0.5 of a percentage point per year. This figure was based on fitting a time trend to outturn estimates for the VAT gap, which showed an annual average growth rate of 0.4 percentage points per year over the period from 1990-91 to 2002-03. The figure adopted on the grounds of caution was 0.5 of a percentage point, which implies lower VAT receipts than would be expected on the continuation of the historical trend.

43 Figure 7 shows the VAT gap from 1990-91 to 2005-06. Over this period, the VAT gap increased on average by 0.3 of a percentage point per year. If this trend applied to the future, the assumed rate of growth in the VAT gap of 0.5 percentage points a year would be cautious.

44 As noted above, however, the VAT gap is volatile from year to year, for reasons which are not fully understood. As a result, a forecast for any one year may be subject to errors larger than those averaging over a longer period. Figure 8 overleaf shows year to year changes in the VAT gap in comparison with the assumed 0.5 percentage points and that the changes in recent years have been particularly large.

45 Increased effectiveness of compliance measures would reduce the growth of the VAT gap all else equal. HMRC believes that missing trader fraud losses have been falling recently as a result of its strengthened measures to tackle the fraud¹⁷. It is possible that the nature of fraud may shift, as appears to have occurred in 2005-06, when there was a large unpredicted rise in the VAT gap, see Figure 8.

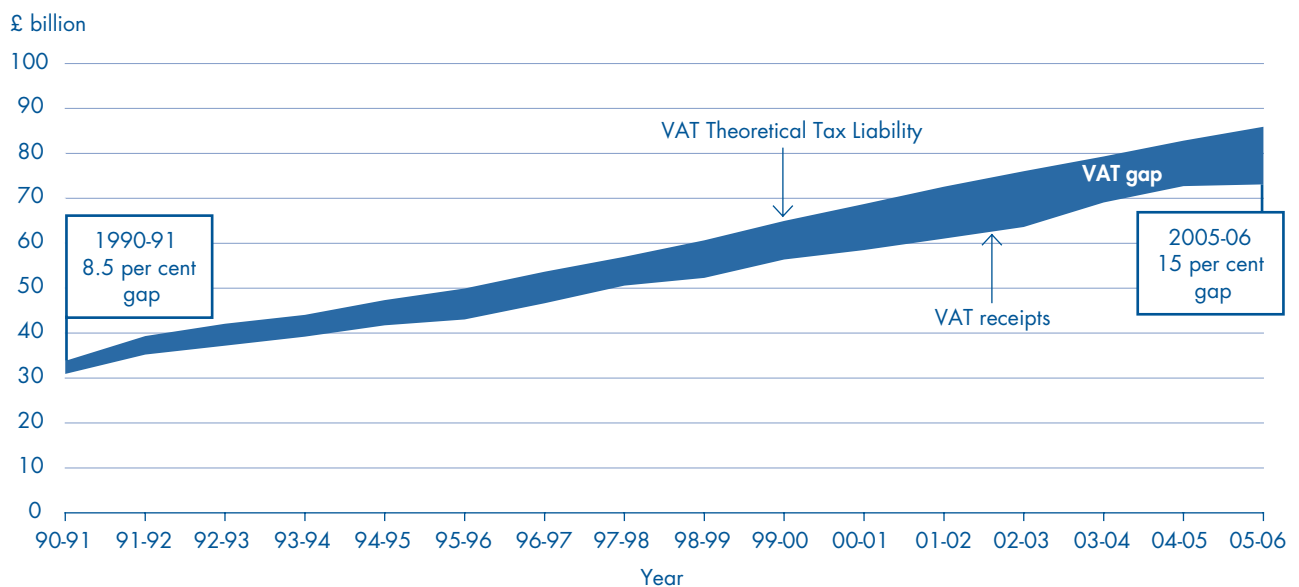
46 To address the problem of volatility, the revised assumption includes the “at least” formulation so that, if circumstances warrant it, the increase in the forecast VAT gap for any given year can be taken to be higher than 0.5 of a percentage point. This provides a prudent approach so long as forecasters are able to recognise events which are off trend and incorporate this information into the VAT forecasts.

Tobacco revenues

47 The assumption I audited for Budget 2003¹⁸ was that:

For the purposes of projecting the revenue from duties on tobacco, the underlying market share of smuggled cigarettes will be set at least at the latest published outturn.

7 Relationship between the VAT theoretical liability, actual VAT receipts and the VAT gap, 1990-91 to 2005-06



Source: HM Revenue & Customs

NOTES

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 the relevant expenditure statistics produced by the Office for National Statistics.

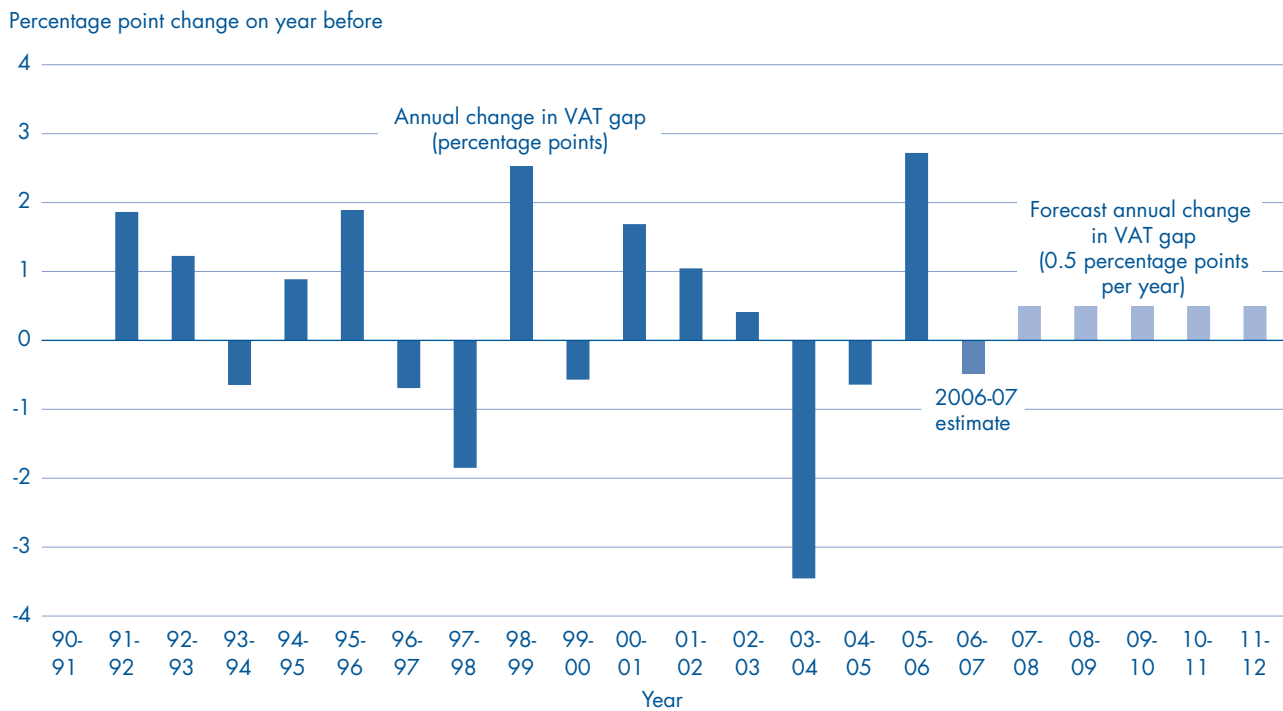
For forecasting purposes the measure of the VAT gap includes VAT losses on smuggling. Published gap estimates, and the basis for HMRC’s target to reduce the gap, exclude smuggling losses. The VAT gap including smuggling losses is about half a percentage point higher.

17 “...A significant number of cases of attempted fraud are now being stopped and the strengthened operational strategy has greatly reduced the level of attack as reflected in the rapid fall in imports reported in ONS trade statistics...” Source: HM Revenue & Customs Annual Report 2005-06, page 29.

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

8

Percentage point change in the VAT gap on the previous year, 1991-92 to 2006-07 (estimated), and the assumed 0.5 percentage points a year increase used for forecasts



Source: HM Treasury

NOTE

Figure 8 shows, for example, that the VAT gap increased between 2004-05 and 2005-06 by 2.8 per cent.

48 I was due to audit this assumption for Budget 2006, but as firm data were available only for 2003-04, the first year of the then three year Rolling Review period, I was unable to carry out a full audit. The Treasury therefore asked me to carry out a full Rolling Review for Budget 2007, by when HMRC expected to have estimates of the illicit market share for the three years 2003-04 to 2005-06¹⁹.

49 HMRC has now estimated the illicit share of total cigarette consumption for 2004-05, but does not expect to have an estimate of the illicit market share for 2005-06 until later in 2007. I therefore remain unable to undertake a full Rolling Review of the 2003 assumption.

50 The Treasury has instead asked to me review:

- the results of action by HM Revenue & Customs to resolve the anomalies preventing the preparation of robust estimates of the 2004-05 and 2005-06 illicit market shares;
- the available evidence for 2003-04 and 2004-05 and whether the forecasts of the illicit market proved reasonable and cautious; and
- a new forecasting assumption to be used from Budget 2007 to project revenue from duties on tobacco.

¹⁹ *Audit of Assumptions for Budget 2006*, HC 937, Session 2006-07, paragraph 72.

Results of action by HMRC to resolve the problems in preparing estimates of the illicit tobacco market share

51 In late 2005, HMRC calculated the 2004-05 illicit market share based on Office for National Statistics Omnibus Survey data. Its analysis indicated an increase in the illicit market share which it regarded as infeasibly high. A number of issues cast doubt on the reliability of the estimate:

- the apparent increase between 2003-04 and 2004-05 was at odds with data collected by the Tobacco Manufacturers' Association on non-duty paid consumption (both illicit activity and cross-border shopping). These data indicated a flat trend in the illicit share, albeit at a higher level than indicated by HMRC's estimates, although the difference was not statistically significant;
- the increased estimate of illicit market share implied a rising prevalence of smoking, given the methodology used by HMRC. Rising prevalence is at odds with a long standing declining trend in smoking shown in survey data; and
- ONS survey evidence indicates a falling trend in the number of cigarettes smoked per person year on year, which suggests a flat rather than a rising trend in the illicit market share.

52 HMRC's further work to understand these issues has concluded as follows:

- the underlying data that HMRC uses are not robust enough to support point estimates of the illicit market share. HMRC now presents estimates of the illicit tobacco market share as a range²⁰, within which the illicit market share is likely to lie.
- in particular, General Household Survey, GHS, based estimates of the illicit market share are likely to be biased and underestimate the long term decline in cigarette consumption. Given the timing of the GHS, HMRC does not expect to publish the 2005-06 estimate of illicit market share until towards the end of 2007;
- nevertheless, the GHS alone provides better estimates of the illicit market share than using a combination of data from the GHS and ONS Omnibus surveys.

Assessment of the 2003-04 and 2004-05 illicit share forecasts

53 The Treasury's forecasts of tobacco revenues for both Budgets and Pre-Budget Reports over the Rolling Review period incorporated the latest published estimates of the illicit market share available at the time. For Budget 2003, the latest published estimate of the illicit market share available at the time was 21 per cent, **Figure 9 overleaf**. The most recent information shows an outturn of 18 per cent for 2003-04. For the 2003 Pre-Budget Report, the latest available estimate at the time was 18 per cent. The forecast for 2004-05 at this level compares with latest estimated outturn for that year of 14 per cent. For Budget 2004, the forecasts were based on an illicit market share of 18 per cent for 2004-05, while the most recent estimated outturn is 14 per cent. As a result, forecasts of tobacco receipts made in 2003 and for Budget 2004 were less than outturn. The evidence therefore indicates that for 2003-04 and 2004-05 the forecasting assumption was cautious. In the absence of outturn figures for the illicit market share for 2005-06 and 2006-07, it is not possible to make a comparison for the forecasts for the 2004, 2005 and 2006 Pre-Budget Reports.

Revised methodology for forecasting receipts of duty on cigarettes

54 The analysis above indicates that forecasts of tobacco revenues based on the latest published outturn for illicit market share have proved cautious for the two years of the Rolling Review period since 2003, for which data are available to make an assessment. The Treasury has decided, however, taking account of the problems involved in making estimates of the illicit market share, that it will now adopt an alternative approach to forecasting tobacco revenues.

55 Tobacco manufacturers are required to notify HMRC of all cigarettes that have been removed from their warehouses for consumption each month, as the excise duty has to be paid at this point. These volumes represent 'clearance' data, which HMRC then adjusts to remove the effects of 'forestalling'. Forestalling occurs when manufacturers stockpile cleared, duty paid, cigarettes, in advance of an anticipated increase in excise duty or a manufacturer's price increase. The adjusted volume data are underlying duty paid clearances.

²⁰ The mid-points of the ranges in each year give an indication of the long term trend in the illicit market share 2000-01 to 2004-05. HM Revenue & Customs stresses that the true value of the illicit market share will not necessarily lie towards the centre of the range. The mid-point estimate of illicit market share was first used in Pre-Budget 2006.

9

Estimated outturns of illicit market share (per cent) of cigarette consumption and the forecasts used for making projections of Tobacco Duty Revenues

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
	Estimated outturn				Forecast			
Budget March 2003	21%	21%	n/a	21%	→	→	→	→
PBR December 2003	21%	21%	18%	n/a	18%	→	→	→
Budget March 2004	21%	20%	18%	n/a	18%	→	→	→
Budget March 2005	21%	20%	15%	14.5%	n/a	14.5%	→	→
Budget March 2006	21%	20%	15%	16%	n/a	n/a	16%	→
PBR December 2006	21%	20%	15%	18%	14%	n/a	n/a	14%

Source: HM Revenue & Customs

NOTES

n/a = the outturn figure for the year in question was not published at the time of the respective Budget/Pre-Budget.

The Figure shows, for example, that at the time of Budget 2003 the latest outturn figure available was that for 2001-02, 21 per cent, and that forecasts of tobacco revenues for 2003-04 onwards were based on an assumed illicit market share at this level. For Budget 2006, the most recent estimate available at the time was for 2003-04.

56 From Budget 2007, the revised methodology for forecasting cigarette receipts within tobacco duties overall²¹ comprises three elements:

- an estimate of the volume of duty paid clearances derived from the following assumption, which I have been asked to audit:

For the purpose of projecting the revenue duties on tobacco, the underlying level of duty paid consumption of cigarettes will be set at least 3 per cent per year lower than the estimated outturn for the current year. The underlying level is defined as HMRC clearances, adjusted for timing impacts.

- multiplying the assumed volume of duty paid cleared cigarettes by an assumed future duty rate of cigarettes; and
- adjusting the resulting revenue forecast for the impact of any projected legislative and regulatory measures.

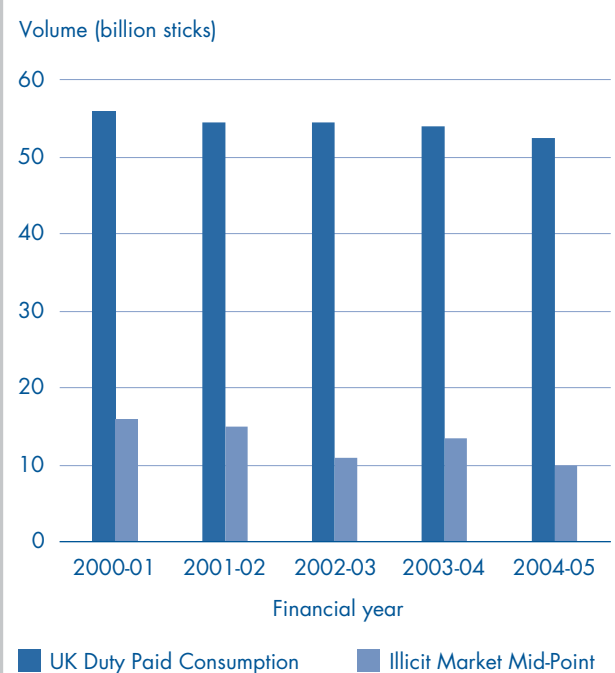
57 The second and third elements above are similar to the approach used prior to Budget 2007. I have not been asked to audit them.

58 The main advantages of the new approach are that:

- duty paid consumption has been relatively stable over the last five years, while estimates of total cigarette consumption and the illicit share have been volatile, as shown by **Figure 10**; and

10

UK Duty Paid Consumption and Illicit Market Mid-point



Source: HM Revenue & Customs, Measuring Indirect Tax Losses 2006, Table D3

21 The Treasury also makes a simple forecast of non-cigarette receipts, which is added to the cigarette forecast receipts to give total tobacco duties. Cigarettes make up the bulk of receipts, comprising approximately 96 per cent of total receipts.

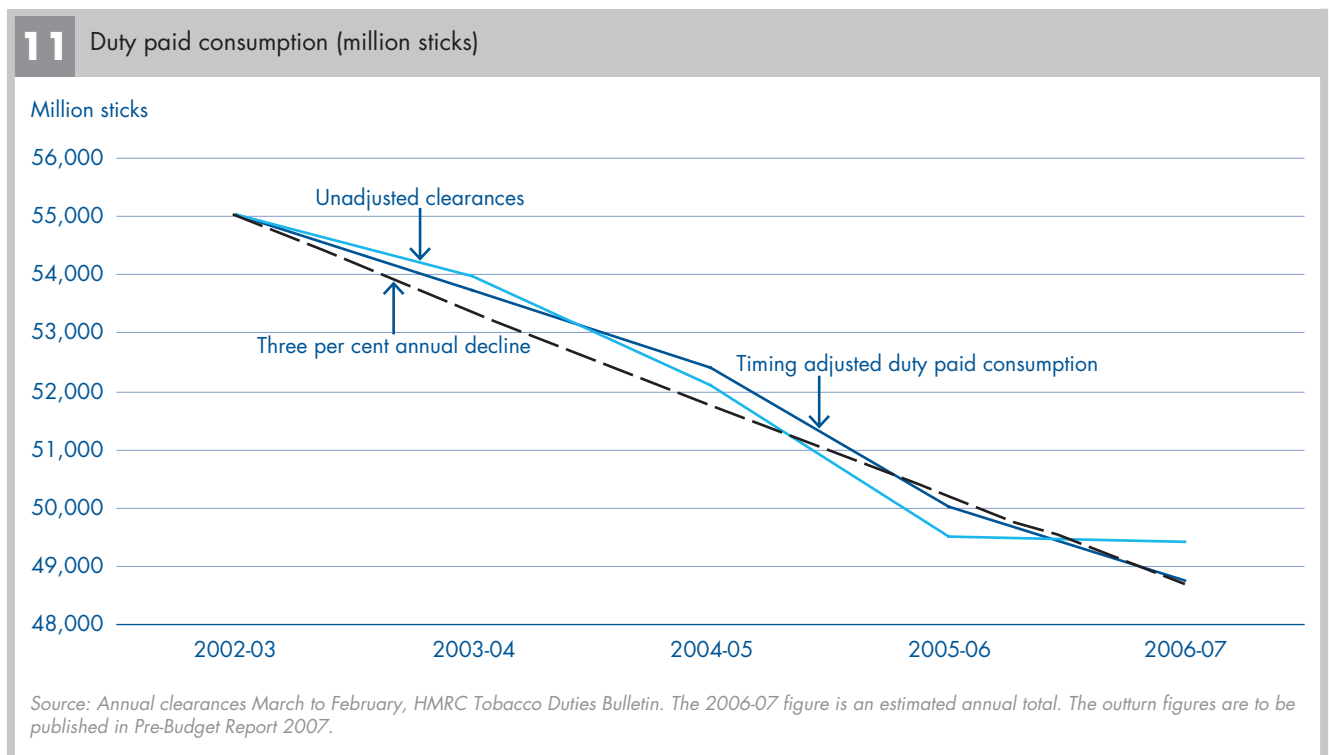
■ clearance data are directly observable by HMRC and are more reliable than estimates of the illicit share, which in any case are subject to the limitations of sample survey information. The clearance data are also more timely as they are collected on a monthly basis, and for the future, should be less affected by the effects of forestalling as the possibilities for this are now more limited²².

59 Figure 11 shows the trends in clearance data since 2002-03. The data indicate a decline in the underlying level of duty paid consumption, at a rate of 3 per cent per year, though this is a short period on which to base a time trend.

60 Earlier data are available on which to base a time trend, but there are reasons to regard the period prior to 2002-03 as unrepresentative of the underlying clearances. Before 2002-03, there were far larger forestalling impacts than in recent years, which are difficult to remove from the data. HMRC's assessment is that smuggling fell rapidly until 2002-03 and that the illicit share has been broadly constant since then, reducing the influence of this effect on the time series data. The period since 2002-03 also represents one in which consumption fell in a stable manner, as indicated by the stable decline in duty paid consumption. As the Treasury considers these conditions to be appropriate assumptions to apply for the forecast period, it has estimated the trend in underlying duty paid consumption from 2002-03 onwards, rather than using a longer time period.

61 The Treasury expects the projected 3 per cent per year trend decline in the underlying level of duty paid consumption to be an overestimate of outturns over the forecast period. It points out that, over the period 2002-03 to 2005-06, in only one year did the underlying level of duty paid consumption fall by more than 2.5 per cent. In 2005-06, however, it fell by 4.5 per cent. The trend decline in the underlying level of duty paid clearances has therefore shown variability over the period since 2002-03, which affects the certainty that can be attached to the forecasts of tobacco revenues.

62 HMRC attributes the substantial 2005-06 fall in duty paid consumption mainly to slow growth in real consumer spending and increases in real duty paid cigarette prices since 2002-03, measured against the increase in the RPI index. For the forecast period, the Treasury assumes that cigarette prices will increase in line with RPI. In the event that real prices rise substantially, there could be an increase in the illicit market and cross-border shopping shares of tobacco, which could in turn reduce duty paid consumption. More modest real price increases are less likely to impact on either duty paid consumption or the illicit market share²³.



22 Since Budget 2000, tobacco companies are restricted to a maximum amount of cigarettes they can clear in advance of the next Budget.

23 The impact on duty receipts of lower duty paid consumption would be partly offset by more revenue from the increased ad valorem element of tobacco duty, resulting from increasing real prices.

63 Other things equal, the Treasury's forecast of tobacco revenue for 2007-08 will be over-estimated by about £0.1 billion for every one percentage point in excess of the 3 per cent per year assumed decline for underlying duty paid consumption.

64 The new assumption contains the safeguard, similar in nature to that in the previous assumption for tobacco revenues, that the assumed rate of decline of underlying duty paid volumes will be set at *least* 3 per cent per year lower than the estimated outturn for the current year. If circumstances warrant it, the Treasury can assume lower clearances than this implies. Given that data on underlying duty paid cleared volumes can be estimated monthly, the lag between new data consistent with a faster rate of decline and altering the assumption would not be long. This gives some added assurance in respect of caution.

Factor income shares

65 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.

66 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.

67 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 £1½ billion after one year.

68 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 assumption I audited in my report on the 2006 Pre-Budget Report²⁴.

69 As in my 2004 Report²⁵ where I looked at the factor shares assumption, I have examined the empirical evidence for the constancy of shares of labour incomes and profits. **Figure 12** shows the latest data for the period from 1959 to 2005²⁶. The shares have tended to be broadly constant, with fluctuations around an average level of 78.1 per cent for labour incomes share over the whole period, and in most (43 out of 47) years the labour incomes share has ranged between 75 per cent and 81 per cent.

70 Over the three year Rolling Review period the share of labour income averaged 78.9 per cent, just above the 1959 to 2005 average, but still well within that period's overall range of fluctuation. In 2003 the labour share fell to 79.1 per cent (from 79.7 per cent in 2002), then fell further to 78.4 per cent in 2004, before increasing to 79.4 per cent in 2005. 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 constant²⁷.

71 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.

Debt Interest

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

73 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.

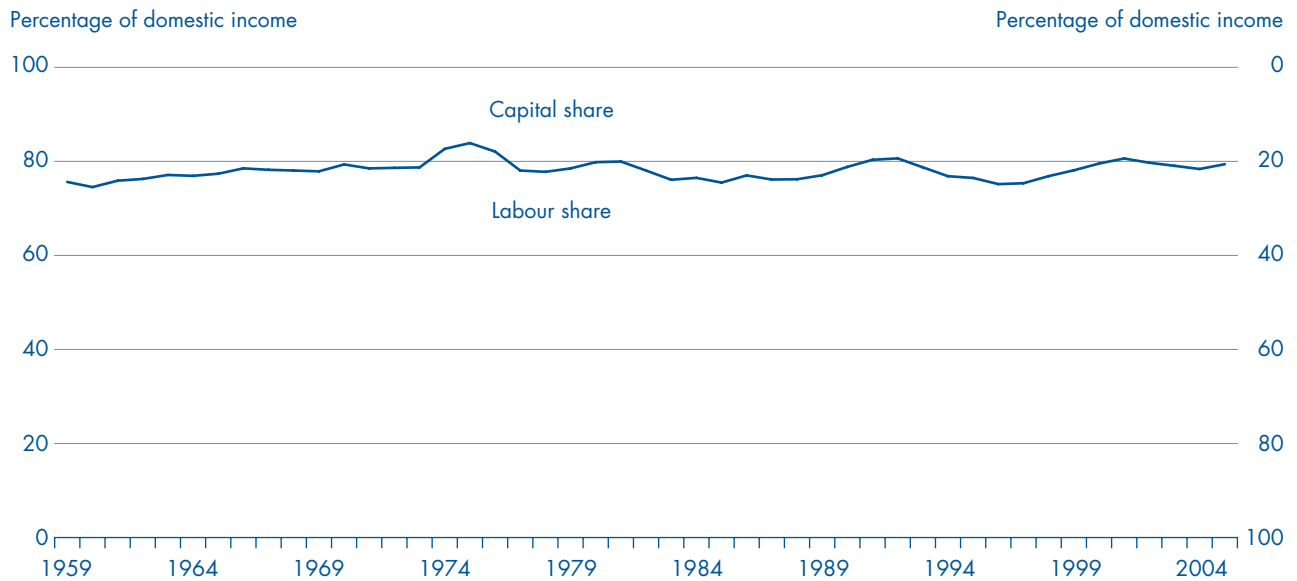
²⁴ *Audit of Assumptions for the 2006 Pre-Budget Report*, HC 125, Session 2006-07.

²⁵ *Audit of Assumptions for Budget 2004*, HC 434, Session 2003-04.

²⁶ At the time of Budget 2004, data on factor shares were only available up to the end of 2002. As a result this audit covers the period from 2003 to the end of 2005, the latest full year for which factor shares data are available.

²⁷ *Audit of Assumptions for the March 2001 Budget*, HC 304, Session 2000-01.

12 Factor shares in domestic income net of stock appreciation and rental income, 1959-2005



Source: HM Treasury analysis of Office for National Statistics data

NOTE

Domestic income equals the compensation of employees, mixed income, and gross trading profits (less inventory holding gains) of all corporations (both private and public); and labour income comprises the compensation of employees and mixed income.

74 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 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 and Investments' net contribution to meeting the net financing requirement. This affects debt interest payments to the extent that interest rates paid on National Savings and Investments' products differ from those on other debt instruments; and

- policy decisions regarding the mix and maturity of financing through the 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.

75 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.

76 For the three year period of the Rolling Review since March 2004, I examined the relevant working papers relating to the 2005 and 2006 Budgets and the 2004, 2005 and 2006 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 rates²⁸, and has applied the outcome in its calculations of debt interest payments, including for Budget 2007.

²⁸ *Audit of Assumptions for Budget 2006, HC 937, Session 2005-06.*

77 For Budget 2007, 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.

78 The Government's current statement of financing policy is set out in the DRMR published on 21 March 2007 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.

79 For 2007-08, 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 2007-08 pattern remains unchanged. I have confirmed that this assumption has been applied in making forecasts of debt interest for future years.

Conclusions and recommendations

The Budget 2004 direct tax and National Insurance contributions compliance and enforcement package

80 Taking the impact of the measures in place over the Rolling Review period, the estimated overall revenue impact of the Compliance Package was £880 million higher than originally forecast in the 2004 Budget. The Treasury reviewed this forecast in 2006 when it thought yield was likely to fall below expectation, and the estimated revenue impact exceeds this revised lower forecast by £1,200 million. This estimate was significantly affected by a number of complex one-off settlements, in relation to some of which HMRC had not completed its own quality assurance procedures ahead of Budget 2007. HMRC is satisfied that it is appropriate to include this additional yield in the estimated revenue impact of the Package but I was not able to review these cases in advance of the Budget. Excluding such cases would still have resulted in an estimated yield greater than the revised forecast, and it was therefore cautious on this basis.

81 The activities within the Compliance Package will be subsumed within the wider work that HMRC is undertaking to improve taxpayer compliance. The Treasury has not separately forecast the revenue from the Package beyond March 2007.

The VAT gap assumption

82 The use of the VAT gap assumption over the Rolling Review period from 2003 resulted in forecasts which were cautious in three of the four years and over the Rolling Review period as a whole, underforecasting overall VAT receipts. The estimated outturn VAT gap has, however, exhibited significant year to year volatility, especially in recent years, in part due to changing levels of VAT fraud and HMRC measures to address this. This means that any forecast is subject to uncertainty.

83 The VAT gap has been adjusted for the impact of the 2002 VAT Compliance Strategy. I was unable in 2005 to draw a conclusion on the reasonableness of the allowance made for the Strategy and this remains the case. The Treasury and HMRC undertook to carry out further evaluation work but this has still not yielded sufficient evidence on which to base a judgement.

84 For the future, the revised assumption for the VAT gap will be based on an 'underlying' VAT gap that makes adjustments for the timing of large one-off payments and repayments. This is reasonable as it seeks to reflect the way in which VAT receipts arise in practice. It is important that the impact on the VAT gap of all timing differences between tax liabilities and VAT receipts is fully understood. I therefore recommend that HMRC carries out further work to assess such timing differences.

85 The revised assumption is for an increase in the VAT gap of 0.5 of a percentage point per year - the same rate as in the previous assumption. This figure is based on a long run average growth rate of the VAT gap of 0.3 of a percentage point per year, which on this comparison provides a cautious estimate. This approach gives equal weight to both past and current developments. The revised assumption of the VAT gap will therefore be cautious to the extent that these historical trends are a good indicator of future trends in the VAT gap. The shorter term trends in the VAT gap have been much more volatile, resulting in significant positive and negative forecasting errors in the VAT gap. In view of this uncertainty, the degree of caution in the assumption overall is hard to assess. However, the assumption includes a safeguard that an increase in the forecast VAT gap of more than 0.5 percentage points can be assumed if necessary, which introduces an element of caution. While the new assumption is reasonable, to ensure caution in practice, I recommend that forecasts and outturns of the VAT gap are regularly subjected to analytical review and that HMRC should continue to work to understand better the reasons for volatility in the VAT gap.

Tobacco revenues

86 The revised assumption for forecasting tobacco revenues introduced at Budget 2003 has proved cautious in 2003-04 and 2004-05, the two years of the Rolling Review period for which data are available to make an assessment. In the absence of estimates of the illicit tobacco market share for 2005-06 and 2006-07, I am unable to conclude whether the assumption has proved reasonable and cautious over the whole period covered by the Rolling Review, since Budget 2003.

87 The Treasury's revised approach is a response to further work carried out by HMRC, which indicates that there are significant problems in producing a consistently reliable estimate for the illicit share. The previous approach proved to be cautious in so far as it was possible to assess this, but there is a sound case for the revised methodology based on an assumed average rate of decline of duty paid volumes of cigarettes. This approach is a reasonable one as it has the advantage over the previous assumption of using directly observable, more robust and up to date information.

88 It is more difficult to judge how cautious the approach will prove to be in practice as there are a number of uncertainties, including the fact that the approach is based on a short run of data and the possible impact of significant increases in real tobacco prices.

89 The assumed rate of 3 per cent per year decline in underlying duty paid consumption is consistent with the recent available data and the assumption includes a safeguard that a faster rate of decline in duty paid cigarettes can be assumed if necessary. This in principle introduces an element of caution.

90 Given the uncertainties, I recommend that the Treasury and HMRC closely monitor trends in the monthly data on duty paid cigarettes, and as soon as practical after the end of 2007-08, publish an assessment of how reliable the new assumption has been to date.

Factor income shares

91 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

92 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 Budget 2004, and are for Budget 2007.

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