IFS analysis of today’s public finance figures

Today the Office for National Statistics and HM Treasury published *Public Sector Finances July 2005*. We now have details of central government receipts, central government spending, public sector net investment, borrowing and debt for the first third of financial year 2005–06.

Headline Comparisons

- **Central government current receipts** in July were 9.1% higher than in the same month last year. Receipts in the first four months of 2005–06 were 6.9% higher than in the same months of 2004–05. The 2005 Budget implied that central government current receipts for the whole of 2005–06 would be 8.3% above 2004–05 levels.

- **Central government current spending** in July was 4.5% higher than in the same month last year. Spending in the first four months of 2005–06 was 6.4% higher than in the same months of 2004–05. The 2005 Budget implied that central government current spending for the whole of 2005–06 would be 6.0% above 2004–05 levels.

- **Public sector net investment** in July was £1.2bn, or 91.8% higher, than in the same month last year. Together, public sector net investment during the first four months of 2005–06 has been £7.2bn, which is 102.6% higher than in the same months of 2004–05. The Budget predicted that net investment in 2005–06 would be £26.2bn, which is 38.0% above last year’s level.

Carl Emmerson, a deputy director at the IFS said:

“Today’s figures reveal strong growth in tax receipts. The Government always receives a large slice of corporation tax receipts in July, and these grew by 21.4% compared to same month last year. However this looks less impressive when compared to the 28.8% growth that Gordon Brown is expecting over the whole year. For Corporation Tax receipts to come in at the £43.2bn forecast in the Budget there would need to be growth in receipts of 37.4% over the next 8 months compared to the same months last year. In the first four months of this year VAT receipts have also grown less quickly than the Treasury forecast for the year as a whole. Potentially better news for the Chancellor is the strong growth in spending on public sector net investment which should aid efforts to improve the delivery of public services.

On current trends it remains more likely than not that the golden rule would be met over an economic cycle running from 1997–98 to 2005–06. Despite this, as the Treasury admits, strong growth in tax revenues is required over the next few years to pay for the Government’s spending plans and strengthen the public finances. Higher-than-anticipated oil prices could help, but recent experience suggests that most of revenue coming directly from this is
likely to be foregone through cuts in fuel duty. Therefore it seems likely that new tax raising measures will be needed to deliver the strong growth in tax revenues.”

Assessing compliance with the golden rule

The Chancellor is committed to running fiscal policy in line with two fiscal rules. The golden rule requires public sector current spending to be met entirely out of public sector receipts over the course of an economic cycle – in other words, that the public sector current budget should be in balance or surplus on average over the cycle.

If the present economic cycle runs from 1997–98 to 2005–06, the golden rule will be met over this period as long as the current budget is not in deficit by more than £22.5bn in 2005–06. The Treasury forecast a current budget deficit of £5.7bn in Budget 2005, while the January 2005 IFS Green Budget predicted a deficit of £13.4bn. Over the first third of the present financial year the current budget deficit was 5.4% higher than in the equivalent period last year – if the same were to be true over the next two thirds, which it might not be, the deficit for 2005–06 would come in at £18.8bn. The average absolute forecasting error made one year ahead by the Treasury in the past is equivalent to £15bn in today’s terms.

For the cycle to close in 2005–06, based on the Treasury’s latest estimates, the economy would need to grow by 3½% between the first quarter of 2005 and the first quarter of 2006, more than most independent forecasters expect. This suggests that the Treasury may predict in this year’s Pre-Budget Report that it will not close until 2006–07. Whether this would make the golden rule harder to achieve would depend on whether the current budget is likely to be in deficit next year; in Budget 2005 the Treasury predicted there will be a small surplus.

The effects of raised oil and equity prices on the public finances

Oil prices

Higher oil prices affect tax revenues directly by raising the tax receipts from North Sea Oil taxes, but may also reduce them indirectly if it leads to lower economic activity. The assumption made about oil prices in Budgets and Pre-Budget Reports depends on how the price at the time of the forecast compares to the average of the latest independent forecasts for the current year. If the former exceeds the latter, the independent forecast is used and projected to remain constant in real terms. If the actual price is below the forecast, the actual price is used instead. In March 2005, at the time of the Budget, the average of the independent forecasts was an oil price of $40.6/barrel in 2005 and $37.8/barrel in 2006. The assumption used by the Treasury was that oil prices would be $40.6/barrel this year and would remain the same in real terms thereafter. Yesterday, the most recent independent forecasts have an average of $51.1/barrel in 2005 and $47.4/barrel in 2006. According to the most recent NAO audit of the oil price assumption, the Treasury estimates that a 5% increase in the oil price would, other things being equal, increase revenues directly by about £220m in the first year and £270m in the next. The latest 2005 forecast is 26% higher than the Budget one for 2005 and 14% higher for 2006. This suggests that, given the Treasury’s estimates of the revenue effects of oil prices, there may be about £1.1bn of extra revenue this year and £0.9bn next. Whether these gains persist will depend on whether the oil price remains above the level assumed by the Treasury in the Budget. Moreover recent experience suggests that the higher than expected current oil price may prompt the Chancellor to
delay or abandon the usual inflation increase in road fuel duties. If the Chancellor chooses not to implement both the fuel duty increase that has been delayed since April 2005 and the one that is planned for April 2006, then this would cost around £1bn a year from April 2006 onwards. This would be roughly equivalent to the additional revenue arising from a higher-than-expected oil price as long as the oil price (in real terms) remained at $47.4/barrel beyond 2006.

**Equity prices**

The stock market’s performance has an effect on stamp duty, corporation tax, Capital Gains Tax and inheritance tax revenues. The current assumption used to forecast equity prices is that the FTSE All-Share index rises from its value at the time of the forecast in line with money GDP. The FTSE All-Share index is currently around 2650 which is about 2½% above what had been expected at the time of the Budget. Extrapolating from Treasury estimates of the impact of previous changes in equity prices on the public finances suggests that this could boost revenues by around £½bn a year.

**Further Analysis**

Little can be inferred or extrapolated with confidence about the public finances in 2005–06 from information on only the first third of the financial year. Bearing this in mind, the figures for receipts and spending in July 2005 show:

**Central government current receipts**

Corporation tax receipts for July 2005 were 21.4% higher than in the same month last year. Corporation tax receipts for the first four months of 2005 were 15.4% higher than those for the same months last year. The Budget forecast implies that Corporation tax receipts will grow by 28.8% over the whole of 2005–06.

Receipts of Income Tax, Capital Gains Tax and National Insurance Contributions for July were 7.2% higher than in the same month last year. Together, the receipts for these taxes during the first four months of 2005–06 were 8.3% higher than those for the same months in 2004–05. The Budget forecasts imply that these taxes’ receipts will grow by 8.2% over the whole of 2005–06.

Cash receipts of VAT in July 2005 were 0.7% higher than the same month last year. VAT receipts for the first four months of 2005 were 2.4% lower than those for the same months in 2004. The Budget forecast implies that VAT receipts will grow by 4.5% over the whole of 2005–06.

**Central government current spending**

Expenditure on net social benefits was 0.9% higher in July 2005 than in July 2004. Expenditure during the first four months of 2005 was 5.4% higher than in the same months of 2004. The Budget forecast implies that central government net social benefit expenditure will grow by 8.3% over 2005–06.

Spending on debt interest (which is relatively small as a share of spending overall) was £2.5bn in July 2005 compared to £2.1bn in July 2004.
Other current spending by central government, including spending on the delivery of public services, was 4.9% higher in July 2005 than in July 2004. Comparing the first four months of 2005–06 with the same months in 2004–05, the figure is 6.3%. The Budget forecast implies that this component of spending will grow by 4.9% over the year as a whole.

In July 2005, public sector net investment was £2.5bn compared to £1.3bn in the same month in 2004. So far in 2005–06, a total amount of £7.2bn has been spent on public sector net investment, compared to the £3.6bn that had been spent by the same point in 2004–05. The Budget predicted that net investment in 2005–06 would be £26.2bn, which is 38.0% above last year’s level.

Further information and contacts
For further information on today’s public finance release please contact: Carl Emmerson or Christine Frayne on 020 7291 4800, or email cemmerson@ifs.org.uk or cfrayne@ifs.org.uk.

Relevant links:
This, and previous editions of this press release, can be downloaded from http://www.ifs.org.uk/press/pub_fin.shtml
Useful links and background information on the Budget can be found at http://www.ifs.org.uk/budgets/budget2005/index.php
Office for National Statistics & HM Treasury, Public Sector Finances, July 2005:
HM Treasury, Evidence on the UK economic cycle, 19th July 2005
http://www.hm-treasury.gov.uk/media/2E6/A5/economic_cycles190705.pdf
The IFS Green Budget, January 2005:
HM Treasury, Budget 2005:
http://www.hm-treasury.gov.uk/budget/budget_05/bud_bud05_index.cfm
HM Treasury, Public Finance Statistics Index:
http://www.hm-treasury.gov.uk/economic_data_and_tools/pubfinance/data_pubfinance_index.cfm
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Notes to editors:
1. Central government current spending includes depreciation.
2. Where possible we compare figures on an accruals basis with the HM Treasury forecast.