

IFS analysis of today's public finance figures and Treasury announcement on taxpayer support for Northern Rock

Today the Office for National Statistics and HM Treasury published *Public Sector Finances December 2007*. We now have details of central government receipts, central government spending, public sector net investment, borrowing and debt for the first nine months of financial year 2007–08.

IFS public finance bulletins are generously supported by the Economic and Social Research Council.



The analysis is based on IFS calculations and does not reflect the views of the ESRC.

Gemma Tetlow, a Senior Research Economist at the IFS, said:

“Spending on public services by central government is on course to undershoot the Chancellor’s Pre-Budget Report forecast, but the impact on borrowing is being more than offset by weak growth in VAT and corporation tax receipts. If these patterns over the first nine months of the year were to continue over the next three, this would leave the current budget £12bn in deficit in 2007–08 rather than the £8.3bn forecast by Alistair Darling. The actual outturn will depend crucially on next month’s figures, as January is a particularly important month for receipts of both corporation tax and of income tax paid on bonuses and through self-assessment.

Taxpayer support for Northern Rock could, depending on the decision of the ONS, add £55 billion to public sector net debt, which today’s figures show is already at an eight-year high. This would bring it significantly above the 40% ceiling which Gordon Brown imposed when he was Chancellor. The addition to public sector net debt would be even greater if Northern Rock is nationalised or if the ONS judges that it is in effect under public control already. Whether or not taxpayer guarantees for Northern Rock’s borrowing are included in net debt does not affect the true exposure of taxpayers. It would be sensible and desirable for the Treasury to publish measures of borrowing and debt that include and exclude the impact of commitments made to Northern Rock in order to aid analysis of both the underlying position of the public finances and the total commitments of taxpayers.”

Headline Comparisons

- **Central government current receipts** in December were 3.9% higher than in the same month last year. The Pre-Budget Report forecast for 2007–08 published in October implies an increase over last year’s levels of 5.9% for the year as a whole and of 6.6% for the period from September 2007 to March 2008. The latest figures show an increase over last year’s levels of 4.9% for the year to date, and a 4.8% increase between September and December 2007 over the same four months last year.
- **Central government current spending** in December was 3.1% higher than in the same month last year. The Pre-Budget Report forecast for 2007–08 published in October implies an increase over last year’s levels of 6.5% for the year as a whole and of 6.3% for the period from September 2007 to March 2008. The latest

figures show an increase over last year's levels of 6.1% for the year to date, and a 5.3% increase between September and December 2007 over the same four months last year.

- **Public sector net investment** in December was £2.7bn compared to £2.4bn in the same month in 2006. So far in 2007–08, a total amount of £15.6bn has been spent on public sector net investment, which is 12.3% higher than had been spent by the same point in 2006–07. The Pre-Budget Report forecast for 2007–08 published in October predicted that net investment in 2007–08 as a whole would be £29.7bn, which is 15.5% above last year's level and implies an increase of 27.2% for the period from September 2007 to March 2008.

What would happen if these trends continued?

- Under the assumption that borrowing in the first nine months of 2007–08 as a proportion of the year's total is the same as it was in 2006–07 then **Public Sector Net Borrowing would be around £41bn**. This is compared to the £35.1bn forecast in the March 2007 Budget and the £38.0bn forecast in October's Pre-Budget Report.
- Under the assumption that both receipts and current spending by central government in the first nine months of 2007–08 as a proportion of the year's total is the same as it was in 2006–07, and that local authorities' and public corporations run a current budget balance (which is what the Treasury forecasts and the latest data suggest) then the **current budget would be in deficit by around £12bn**. This is compared to the £5.7bn deficit forecast in the March 2007 Budget and the £8.3bn forecast in October's Pre-Budget Report.

It should be remembered that the average absolute error in forecasting one year ahead has been around £15bn. So an error of the magnitude implied by extrapolating from these trends would be small by historical standards.

Northern Rock

The Treasury announced this morning that the loan from the Bank of England to Northern Rock PLC would be extended to March 17th 2008. The repayment of this loan, for around £25 billion, is to remain guaranteed by the taxpayer. In addition the taxpayer continues to guarantee other creditors – estimated at around £30 billion – to Northern Rock PLC, which ensures that savings deposited at Northern Rock remain risk-free from the point of view of savers. Today's announcement by the Treasury also states that in the event of an acceptable private sector takeover of Northern Rock occurring it would allow the Northern Rock to issue bonds, the repayment of which (including interest) would be underwritten by the taxpayer, in order to repay in full the loan (and interest) to the Bank of England and also to provide some working capital for the operation of the business.

These taxpayer guarantees will only affect official estimates of borrowing and debt if the ONS's National Accounts Classification Committee decides that the Government is the true economic owner of Northern Rock's liabilities. The ONS ruled that this was not the case with the Government-backed liabilities of Network Rail but, in August 2005, it did rule that the imputed debt associated with securitised bonds issued by London & Continental Railways should be included in official estimates of borrowing and debt.

Therefore the ONS could decide that the current taxpayer support for Northern Rock – or the support proposed were an acceptable private sale to take place – should be included in official estimates of borrowing and debt. This could add up to around £55 billion (4% of GDP) to public sector net debt which would increase it from £536.5 billion (37.7% of GDP) today to around £590 billion (42% of GDP). This would clearly breach the 40% of national income ceiling that the Treasury set for debt under the sustainable investment rule for the economic cycle that it believes covered the financial years 1997–98 to 2006–07.

Alternatively the ONS could decide that the Government has sufficient power to control Northern Rock that it should be included as part of the public sector. This would be the case were Northern Rock brought into temporary public ownership, which is what the Treasury has said will happen if an acceptable private sector sale is not made. This would bring both Northern Rock's liabilities and its assets (each valued at around £113 billion) onto the public sector balance sheet. The impact on public sector net debt would be to add Northern Rock's liabilities (£113 billion) to net debt less any short-term financial assets (£13 billion) that it held. The net addition of around £100 billion would increase the debt ratio from its current 37.7% of GDP to around 45%.³ The impact on net debt would also be mitigated by the sale of any of Northern Rock's long-term financial assets. We would therefore expect the long-term impact on net debt – which is what should matter for fiscal policy decisions – to be much less than £100 billion and could potentially reduce, rather than increase, net debt.

However whether or not the ONS decides that the taxpayer guarantees for Northern Rock's borrowing should be included in net debt does not affect in any way the true exposure of taxpayers. Therefore the fact that net debt might well be pushed significantly above 40% of national income – should not affect the approach the Government takes. The Government should take the right decision for taxpayers and wider economic considerations such as the long term strength and stability of the banking system.

Regardless of the decision by the ONS it would be sensible and desirable for the Treasury to publish measures of borrowing and debt that include and exclude the impact of commitments made to Northern Rock. This would aid analysis of both the underlying position of the public finances (excluding the impact of Northern Rock which the Government believes will be temporary) and also the total commitments of taxpayers (including those made to Northern Rock).

Assessing compliance with the fiscal rules

The sustainable investment rule states that “net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level”. Since July 2005 the Treasury has estimated that an economic cycle began in the first half of 1997 and currently believes ended in late 2006. If correct then the financial years 1997–98 to 2006–07 inclusive would cover the HM Treasury's definition of an economic cycle. The government said that, over this economic cycle, “stable and prudent” would be defined as keeping public sector net debt below 40% of GDP in each and every year. Apart from in 1997–98, when debt was at 41.3% of GDP, public sector net debt was indeed kept below this level in each year. However, Alistair Darling is yet to announce whether he will continue to aim to keep net debt below 40% of national income in each year of the new economic cycle. When considering how this rule is to be applied, the Treasury should assess whether a broader measure of the public sector's indebtedness (for example,

to include more PFI or public sector pension liabilities) and a suitably higher debt ceiling would be more appropriate. However some difficulties exist with, in particular, measuring public sector pension liabilities accurately since their magnitude is heavily dependent on the assumptions underpinning them, which is not the case with conventional government debt.

The Treasury's '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. The government should only borrow to finance capital spending. The cumulative surplus over the years 1997–98 to 2006–07 is estimated to have been £18.9bn in 2007–08 terms. This means that over this period the government met its golden rule. However, looking forward over the new economic cycle, some improvements to the golden rule may be desirable and the start of the new cycle would be a good time to consider these. In particular, as discussed in Chapter 3 of the January 2007 IFS Green Budget, the golden rule should be made more forward-looking, less reliant on our ability to date the economic cycle, and should take explicit account of the significant uncertainty around any fiscal forecast.

Further Analysis

We should be cautious in inferring or extrapolating likely outcomes over the financial year as a whole from information on only the first nine months. Bearing this in mind, the figures for receipts and spending in December 2007 show:

Central government current receipts

Receipts of Income Tax, Capital Gains Tax and (net cash) National Insurance Contributions in December 2007 were 9.2% higher than in the same month last year. The Pre-Budget Report forecast published in October implies that the receipts from these taxes will be 7.0% up on last year's levels over the whole year, and 7.2% up over the period from September 2007 to March 2008. Together, the receipts for these taxes during the first nine months of 2007–08 were 7.5% higher than those for the same months of 2006–07, while receipts for September, October, November and December 2007 were 8.8% higher than the same four months last year.

Cash receipts of VAT in December 2007 were 5.4% lower than the same month last year. The Pre-Budget Report forecast published in October implies that these receipts will be 5.2% up on last year's levels over the whole year, and 2.9% up over the period from September 2007 to March 2008. VAT receipts for the first nine months of 2007 were 5.1% higher than those for the same months in 2006, while receipts for September, October, November and December 2007 were just 0.8% higher than the same four months last year.

Corporation Tax receipts in December 2007 were 4.7% lower than in the same month last year. The Pre-Budget Report forecast published in October implies that these receipts will be 4.5% up on last year's levels over the whole year, and 9.6% up over the period from September 2007 to March 2008. Corporation Tax receipts for the first nine months of 2007 were slightly (0.3%) lower than those for the same months last year, while receipts for September, October, November and December 2007 were 2.3% higher than the same four months last year.

Central government current spending

Expenditure on net social benefits was 4.1% higher in December 2007 than in December 2006. The Pre-Budget Report forecast published in October implies that this spending will be 5.9% up on last year's levels over the whole year, and 4.9% up over the period from September 2007 to March 2008. Expenditure during the first nine months of 2007 was 6.5% higher than in the same months of 2006, while spending in September, October, November and December 2007 was 5.4% higher than the same four months last year.

Spending on debt interest (which is relatively small as a share of spending overall) was £2.4bn in December 2007 compared to £2.3bn in December 2006.

Other current spending by central government, including spending on the delivery of public services, was 2.6% higher in December 2007 than in December 2006. The Pre-Budget Report forecast published in October implies that this spending will be 6.5% up on last year's levels over the whole year, and 7.2% up over the period from September 2007 to March 2008. Comparing the first nine months of 2007–08 with the same months in 2006–07, the figure is 5.3% while spending in September, October, November and December 2007 was 5.1% higher than the same four months last year.

In December 2007 **public sector net investment** was £2.7bn compared to £2.4bn in the same month in 2006. So far in 2007–08, a total amount of £15.6bn has been spent on public sector net investment, which is 12.3% higher than had been spent by the same point in 2006–07. The Pre-Budget Report forecast published in October predicted that net investment in 2007–08 as a whole would be £29.7bn, which is 15.5% above last year's level and implies an increase of 27.2% for the period from September 2007 to March 2008.

Further information and contacts

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The IFS Green Budget, which will again be in collaboration with Morgan Stanley, will be on Wednesday 30th January 2008. For more details please email bbrimstone@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

Statements by HM Treasury, the Bank of England and the Financial Services Authority relating to Northern Rock can be found at <http://www.bankofengland.co.uk/publications/northernrock/index.htm>

Useful links and background information on Pre-Budget Report / Comprehensive Spending Review 2007 can be found at <http://www.ifs.org.uk/budgets/pbr2007/index.php>

Office for National Statistics & HM Treasury, Public Sector Finances, December 2007:

<http://www.statistics.gov.uk/pdfdir/psf0108.pdf>

HM Treasury, Pre-Budget Report / Comprehensive Spending Review 2007:

http://www.hm-treasury.gov.uk/pbr_csr/pbr_csr07_index.cfm

IFS Green Budget, January 2007, containing in-depth public finance analysis, can be found at:
<http://www.ifs.org.uk/budgets/gb2007/index.php>

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.
3. Approximate figures for Northern Rock's assets and liabilities from their latest annual report and interim report (<http://companyinfo.northernrock.co.uk/investorRelations/results/>).