IFS analysis of today’s public finance figures

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

Headline Comparisons

- **Central government current receipts** in June were 7.0% higher than in the same month last year. Receipts in the first three months of 2005–06 were 7.0% 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 June was 7.3% higher than in the same month last year. Spending in the first three months of 2005–06 was 7.2% 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 June was £1.3bn, or 36.8% higher, than in the same month last year. Together, public sector net investment during the first three months of 2005–06 has been £3.9bn, which is 70.4% 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.

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.

In the 2005 Budget the Treasury estimated that the present economic cycle began in 1999–2000 and would close in 2005–06. As a result of recent revisions to national accounts data showing that economic activity in 1999 was stronger than previously thought, the Chancellor yesterday announced that the current cycle probably began two years earlier in 1997–98. This makes it considerably easier for the golden rule to be met over the current cycle, since it increases the cumulative surplus on the current budget to date by £12½bn thanks to the big surplus in 1998–99. It makes no difference as to whether the golden rule will be met over subsequent economic cycles.

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. Had the cycle begun in 1999–2000, as
estimated in the 2005 Budget, the Treasury could only record a current budget deficit as high as £9.6bn in 2005–06 without breaking the rule. 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 quarter of the present financial year the current budget deficit was 18.9% higher than in the equivalent period last year – if the same were to be true over the next three quarters, which it might not be, the deficit for 2005–06 would come in at £21.3bn. The average absolute forecasting error made one year ahead by the Treasury in the past is equivalent to £15bn in today’s terms.

The Treasury’s new analysis of the national accounts data suggests that in the first quarter of 2005 economic activity was around ¾% below the level thought consistent with stable inflation. The present economic cycle will only end when this “output gap” is closed. For this to happen in 2005–06, the economy will 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 in addition to assuming an earlier start to the cycle, 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.

Christine Frayne, a senior research economist at the IFS said:

“With a quarter of the financial year now passed, the current budget deficit is running almost 20% higher than last year rather than shrinking by around 70% as Gordon Brown predicted in Budget 2005. If this trend were to continue, which is highly uncertain at this early stage of the financial year, the Chancellor would clearly breach the golden rule over an economic cycle running from 1999–2000 to 2005–06. But by having reassessed the start date of the cycle to be two years earlier, increasing the surplus recorded over the cycle to date, the rule would now be met narrowly even if the current budget deficit continues to overshoot the Budget forecast at the rate it has done over the past three months. Assessing the chances of meeting the rule is, however, complicated by the fact that the cycle may end later than currently assumed.

Whether the rule is met or missed by a few billion pounds either way would have negligible direct economic consequences, although it would be embarrassing for the Chancellor to miss it on the first attempt – especially given his repeated insistence that he would meet it. Moving the start of the economic cycle clearly makes it much more likely that the rule will be met over the current cycle, but at the possible cost of undermining the credibility of the policy framework if people assume that the Chancellor has simply acted to avoid embarrassment. Shifting the start date of the cycle does seem reasonable in the light of the new national accounts data, but the decision underlines the case for reforming the fiscal rules, as we discussed in this year’s IFS Green Budget.

Making the golden rule easier to achieve in the short term by shifting the start of the cycle neither strengthens nor weakens the case for fresh tax increases. The case for considering fresh tax increases rests on our view – shared by other independent forecasters – that tax revenues are unlikely to rise as quickly as the Treasury hopes over the next few years. If the Treasury wants to pay for its existing spending plans, and enter the next economic cycle with the public finances in as strong a shape as it has sought in the past, then new tax raising measures will probably be needed.”
Further Analysis

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

Central government current receipts

Income Tax and Capital Gains Tax receipts for June 2005 were 12.4% higher than in the same month last year. Together, the receipts for these taxes during the first three months of 2005–06 were 14.7% higher than those for the same months in 2004–05. The Budget forecasts imply that these taxes’ receipts will grow by 9.6% over the whole of 2005–06.

In June 2005, receipts of National Insurance Contributions were marginally below last June’s level. Receipts of National Insurance Contributions for the first three months of 2005 were 1.6% higher than those for the same months last year. The Budget forecast implies that National Insurance Contributions will grow by 5.8% over the whole of 2005–06.

Cash receipts of VAT in June 2005 were 0.1% higher than the same month last year. VAT receipts for the first three months of 2005 were 3.6% 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.

Corporation tax receipts for June 2005 were 8.9% higher than in the same month last year. Corporation tax receipts for the first three months of 2005 were 10.3% 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.

Central government current spending

Expenditure on net social benefits was 4.4% higher in June 2005 than in June 2004. Expenditure during the first three months of 2005 was 6.0% 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 £1.9bn in June 2005 compared to £1.6bn in June 2004.

Other current spending by central government, including spending on the delivery of public services, was 7.8% higher in June 2005 than in June 2004. Comparing the first three months of 2005–06 with the same months in 2004–05, the figure is 7.3%. The Budget forecast implies that this component of spending will grow by 4.9% over the year as a whole.

In June 2005, public sector net investment was £1.3bn compared to £0.9bn in the same month in 2004. So far in 2005–06, a total amount of £3.9bn has been spent on public sector net investment, compared to the £2.3bn 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, June 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.