IFS analysis of today’s public finance figures

- Spending growth pushes Government deeper into the red
- GDP revisions make ‘golden rule’ harder to meet
- PFI/PPP change will push Government closer to debt ceiling

Today the Office for National Statistics and HM Treasury published Public Sector Finances June 2006. 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 2006–07.

Headline Comparisons

- **Central government current receipts** in June were 6.8% higher than in the same month last year. Receipts in the first three months of 2006–07 were 5.1% higher than in the same months of 2005–06. The 2006 Budget implied that central government current receipts for the whole of 2006–07 would be 6.4% above 2005–06 levels. *Strong growth in tax revenues in June will be welcome to the Chancellor, but over the financial year to date it is still weaker than he hoped at Budget time.*

- **Central government current spending** in June was 10.2% higher than in the same month last year. Spending in the first three months of 2006–07 was 8.3% higher than in the same months of 2005–06. The 2006 Budget implied that central government current spending for the whole of 2006–07 would be 4.8% above 2005–06 levels. *Central government current spending is accelerating further away from the Chancellor’s Budget forecast, but the Treasury believes that this reflects timing effects that will unwind.*

- **Public sector net investment** in June was £0.9bn, or 37.8% lower, than in the same month last year. Public sector net investment has totalled £3.8bn during the first three months of 2006–07, up 16.0% on the same months of 2005–06. The Budget predicted that net investment in 2006–07 would be £28.8bn, which is 11.9% above last year’s level. *The Chancellor will be pleased to see that public sector investment is growing strongly relative to last year.*

PFI accounting

Today’s press release announced changes to the treatment of the Private Finance Initiative (PFI) and Public Private Partnerships (PPP) that will increase the official estimate of public sector net debt. This will appear in the public sector finances figures released on 20 September 2006.
Currently, debt taken on by the private sector under PFI and PPP appears on the balance sheets of public sector bodies where accountants judge (and the National Audit Office agrees) that the public sector has taken on the risks and rewards of owning the asset concerned (e.g. a hospital), and where the new asset – or a phase of improvement work on an existing asset – is operational. The Public Sector Finances data will adopt these estimates.

The Treasury estimates that the capital value of assets on (or to be on) the public sector balance sheet at £23bn. Two-thirds is accounted for by the London Underground PPP. From September public sector net debt will increase by an amount equivalent to the present value of future finance lease payments to be made to private sector partners for these projects. This will be less than the £23bn capital value because a) this includes projects that are not yet operational and for which the public sector has not yet started to make payments and b) the public sector has already paid private sector partners money to cover some of the finance lease liability.

The Chancellor’s self-imposed ‘sustainable investment rule’ commits him to keeping public sector net debt at or below 40% of national income. Over the current economic cycle this needs to be true every year. Today’s figures show that net debt stands at 37.6% of national income. According to Treasury forecasts in Budget 2006, net debt is expected to rise to 38.4% of national income by 2009–10. A significant addition to net debt would increase the risk that the 40% ceiling will be breached over the medium term. But it is important to remember that there is nothing special about the choice of 40% as a ceiling and it could be argued that a significant change in the definition of net debt should be accompanied by an equivalent change in the ceiling under the sustainable investment rule.

**Assessing compliance with the golden rule**

The Chancellor’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 can only borrow to finance capital spending.

In the 2006 Budget the Treasury estimated that the present economic cycle began in 1997–98 and would close in 2008–09, in line with its Pre-Budget Report 2005 judgement.

Revisions to national accounts data published on 30 June 2006 raise the possibility that the Treasury will once again have to revise its dating of the cycle. In particular, economic growth has been stronger than previously thought in recent years. The Treasury argued at Budget time that activity in the economy was consistent with stable inflation (‘on trend’) in 2001Q3 and that since then it could grow by 2¼ percent a year until 2006Q4 and 2½ percent a year thereafter without putting upward or downward pressure on inflation. Before the revisions, this implied that the economy had been running below trend since 2001 Q3 and that economic activity was around 1.3 percent below the level consistent with stable inflation (the ‘output gap’) at the end of 2005. If the Treasury sticks to its estimates of trend growth and the ‘on trend’ point, the revisions would now imply that the economy was running slightly above trend from 2003Q4 to 2004Q4 and that it was only 0.6% below trend at the end of 2005 (see chart).

The Treasury might conclude from this revised picture that, rather than continuing to 2008–09, the cycle which began in 1997–98 ended in either 2003–04 or 2004–05, and that a fresh cycle started in the same year. Over a cycle
running from 1997–98 to 2003–04 there would have been a cumulative surplus on the current budget of 3.8% of one year’s national income, corresponding to £49bn in today’s prices. So the golden rule would have been met. But over the first 3 years of the next cycle (2003–04 to 2005–06) there would already have been a cumulative deficit of 4.6% of one year’s national income, or £59bn in today’s prices. With the national accounts revisions implying that the economy would probably be back ‘on trend’ in 2008–09 or earlier, it seems highly unlikely that the golden rule would be met over this period.

The fact that the economy may also have been running about 0.6% below trend in 2005Q4 rather than 1.3% below trend also means that public finances are weaker in an underlying sense than they previously appeared, because there is less scope for the economy (and tax revenues) to grow strongly in the future without upward pressure on inflation. This could cost the Government around £6 billion a year in revenue looking forwards.

Having said all this, it is far from a foregone conclusion that the Treasury will change the date of the cycle in this way. Even if it concedes that the economy moved above trend from late 2003 to late 2004, it may argue that that it did so by an insignificant amount and that this ‘mini-cycle’ should be considered as part of a longer cycle. This would be consistent with its decision last year to add 1997–98 and 1998–99 into its definition of the current cycle.

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

“Today’s figures show that the current budget deficit has to date increased by almost a third since last year rather than shrinking by half as the Treasury hoped at Budget time. This reflects both weak revenues and rapid spending growth, although it is far too early to tell if these trends will persist over the rest of the year.

The latest figures also include substantial revisions to past data. Taking these into account, the Treasury can now afford to borrow £12–13bn more over the next three years than it predicted it would borrow at Budget time without breaking the ‘golden rule’. This is useful room for manoeuvre, but it would be more than used up if the public finances continue to under-perform the Treasury’s Budget forecasts to the degree that we have seen so far this year.

Recent revisions to the national accounts further complicate the Chancellor’s life. They imply that the Treasury may have overestimated the extent to which the public finances will improve automatically as a result of stronger economic growth. It might even be necessary to re-date the economic cycle again, with the result that the Government would have met the golden rule at its first attempt, but now be on course to break it over its second.”
Further Analysis

Little can be inferred or extrapolated with confidence about the public finances in 2006–07 from information on only the first quarter of the financial year. Bearing this in mind, the figures for receipts and spending in June 2006 show:

Central government current receipts

Receipts from Income Tax, Capital Gains Tax and National Insurance Contributions for June 2006 were 6.2% higher than in the same month last year. Together, the receipts for these taxes during the first three months of 2006–07 were 5.9% higher than those for the same months in 2005–06. The Budget forecasts imply that these taxes’ receipts will grow by 6.1% over the whole of 2006–07.

Cash receipts of VAT in June 2006 were 8.1% higher than the same month last year. VAT receipts for the first three months of 2006 were 3.9% higher than those for the same months in 2005. The Budget forecast implies that VAT receipts will grow by 5.0% over the whole of 2006–07.

Corporation tax receipts for June 2006 were 0.3% lower than in the same month last year. Corporation tax receipts for the first three months of 2006 were 1.5% higher than those for the same months last year. The Budget forecast implies that Corporation tax receipts will grow by 15.3% over the whole of 2006–07.
Central government current spending

Expenditure on net social benefits was 6.0% higher in June 2006 than in June 2005. Expenditure during the first three months of 2006 was 5.3% higher than in the same months of 2005. The Budget forecast implies that central government net social benefit expenditure will grow by 2.8% over 2006–07.

Spending on debt interest (which is relatively small as a share of spending overall) was £2.2bn in June 2006 compared to £2.3bn in June 2005.

Other current spending by central government, including spending on the delivery of public services, was 12.9% higher in June 2006 than in June 2005. Comparing the first three months of 2006–07 with the same months in 2005–06, the figure is 10.3%. The Budget forecast implies that this component of spending will grow by 5.9% over the year as a whole.

In June 2006, public sector net investment was £0.9bn compared to £1.5bn in the same month in 2005. So far in 2006–07, a total amount of £3.8bn has been spent on public sector net investment, compared to the £3.2bn that had been spent by the same point in 2005–06. The Budget predicted that net investment in 2006–07 would be £28.8bn, which is 11.9% above last year’s level.

Further information and contacts
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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/budget2006/index.php
Office for National Statistics & HM Treasury, Public Sector Finances, June 2006:
The IFS Green Budget, January 2006:
HM Treasury, Budget 2006:
http://www.hm-treasury.gov.uk/budget/budget_06/bud_bud06_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.