IFS analysis of today’s public finance figures

Today the Office for National Statistics and HM Treasury published Public Sector Finances May 2008. We now have details of central government receipts, central government spending, public sector net investment, borrowing and debt for the first two months of financial year 2008–09.

Gemma Tetlow, a senior research economist at the IFS, said:

“The Government has had to borrow 50% more during the first two months of the financial year than in the same period last year to meet the gap between what it spends and raises in tax revenue. But Alistair Darling’s Budget prediction was that borrowing in 2008–09 as a whole would be higher than last year. VAT and corporation tax revenues are growing less strongly than Mr Darling predicted for the year as a whole at Budget time, although we are much too early in the financial year to be confident that this pattern will persist.

Recent sharp increases in the oil price will also have several effects on the public finances. The latest independent forecasts for the oil price suggest that North Sea oil revenues could be boosted by around £5½ billion in 2008–09, compared to the Treasury’s predictions at Budget time, falling to about £3½ billion in 2009–10. But other revenues will be depressed by the higher than expected oil price, for example because higher fuel costs encourage people to buy less road fuel and may also reduce profits outside the oil sector. In addition to this indirect effect, the Chancellor has hinted that he may abandon the 2p rise in fuel duties scheduled for 1st October if the oil price remains high. This would cost £550 million this year and £1.1 billion a year thereafter. Taking all these factors together, it is far from clear that there will be a net gain to the public finances from the higher oil price.”

Headline Comparisons

- **Central government current receipts** in May were 2.7% higher than in the same month last year. Receipts in April and May 2008 were 3.6% higher than in the same months of 2007. The 2008 Budget implied that central government current receipts for the whole of 2008–09 would be 4.8% above 2007–08 levels.

- **Central government current spending** in May was 3.5% higher than in the same month last year. Spending in April and May 2008 was 5.4% higher than in the same months of 2007. The 2008 Budget implied that central government current spending for the whole of 2008–09 would be 5.4% above 2007–08 levels.

- **Public sector net investment** in May was £1.9bn, compared to £1.0bn in the same month last year. Together, public sector net investment during April and May 2008 has been £3.4bn, which is 167% higher
than in the same two months of 2007. The Budget predicted that net investment in 2008–09 would be £33.8bn, which is 22.2% above last year’s level.

**The effects of raised oil prices on the public finances**

The last four months have seen sharp – and greater than expected – increases in oil prices, which will have several impacts on the public finances. Higher oil prices affect tax revenues by raising tax receipts from petroleum revenue tax and North Sea corporation tax, and by depressing receipts of other taxes such as fuel duties and non-North Sea corporation tax. This latter effect is likely to be significant, not least because, as a net importer of oil, the UK’s national income is reduced by increases in the oil price.

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. 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 2008, at the time of the Budget, the average of the independent forecasts was an oil price of $83.80/barrel in 2008, which was lower than the oil price at the time (which was close to $100/barrel). Therefore the Treasury assumed that oil prices would be $83.80/barrel this year and would remain the same in real terms thereafter.

The most recent independent forecasts, which were published by the Treasury yesterday (Wednesday June 18th), have an average of $112.0/barrel in 2008 and $104.6/barrel in 2009. According to the most recent NAO audit of the oil price assumption (December 2005), the Treasury estimates that a $1 increase in the oil price would, other things being equal, increase North Sea revenues by about £0.2bn a year.

The latest forecast is about $28/barrel higher than the Budget for 2008, and $18/barrel higher for 2009. This suggests that, given the Treasury’s estimates of the revenue effects of oil prices, there may be about £5½bn of extra North Sea revenues this year, falling to £3½bn next year. However the oil price is not the only determinant of North Sea oil revenues: production levels, the operating costs of North Sea oil companies, and the dollar/pound exchange rate are also important. Lower forecasts of production levels and higher forecast production costs meant that in Budget 2008 the Treasury only revised up its forecast of North Sea oil revenues by £0.9bn despite a $16 increase in the oil price, which would otherwise have been thought to boost North Sea oil revenues by around £3.2bn.

Furthermore other tax receipts are likely to fall as a result of the increase in the oil price. Higher fuel prices will reduce road fuel consumption, reducing revenues from fuel duties. Reduced economic activity will reduce tax receipts from other sources – for example, in the first instance there may be less corporation tax revenue from non-North Sea oil companies. (And, to the extent to which consumers spend more on fuel and less on other goods, the increase in revenue from VAT on fuel is likely to be offset by lower VAT receipts elsewhere.) Moreover rises in the oil price since the Budget mean that the Chancellor is likely to choose to either delay or abandon the 2p increase in road fuel duties planned for 1st October 2008. Deferring this for a further six months until 1st April 2009 would cost the exchequer £550m in 2008–09, while abandoning this increase completely would cost £1.1bn a year forever more.

**Assessing compliance with the fiscal rules**
Gordon Brown operated two fiscal rules during his period as Chancellor and Alistair Darling has continued to operate these since he took over. These are the sustainable investment rule and the golden rule. The Treasury forecasts for the public finances published in March’s Budget implied that looking forwards there was virtually no room to manoeuvre against either fiscal rule.

Gordon Brown said in 1998 that in order to stick to his “Sustainable Investment Rule” public sector net debt should be kept below 40% of national income in each year of the economic cycle that the Treasury believes began in 1997–98. Given that the impact of Northern Rock on measures of the public finances is expected to be temporary, the Treasury has, sensibly, announced that it will be operating a modified sustainable investment rule over this period – aiming to keep public sector net debt excluding Northern Rock’s liabilities below 40% of national income.

Since 1998–99 public sector net debt has been kept below 40% of national income. The forecasts from Budget 2008, combined with Mr Darling’s May 13th mini-Budget announcement of a £2.7bn giveaway to basic-rate income tax payers this year¹, suggest that he has virtually no room left to manoeuvre against the sustainable investment rule over the next few years (even assuming that Mr Darling succeeds in making this a purely one-off giveaway). Some assistance for Mr Darling may come from a change to how the ONS treats financial intermediation services in the national accounts. This change will increase the level of national income and so reduce the apparent level of public sector net debt when expressed as a share of national income.

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 Treasury estimates that an economic cycle began during 1997–98 but is currently unsure whether this cycle ended (and a new cycle began) in 2006–07, or whether we are now in the twelfth year of the same economic cycle. Over the years 1997–98 to 2006–07 there was a small cumulative current budget surplus. Looking forwards, meeting the golden rule will depend on either whether there is a surplus over the years from 2006–07 to when the new economic cycle closes, or whether the cumulative current budget remains in surplus over the years from 1997–98 to when the current economic cycle ends.

Further Analysis

Little can be inferred or extrapolated about the public finances in 2008–09 from information about only the first two months of the financial year. Bearing this in mind, the figures for receipts and spending in May 2008 show:

Central government current receipts

Receipts of Income Tax, Capital Gains Tax and (cash) National Insurance Contributions for May 2008 were 0.5% higher than in the same month last year. Together, the receipts for these taxes during the first two months of 2008–09 were 5.2% higher than those for the first two months of 2007–08. The Budget forecasts imply that these taxes’ receipts will grow by 4.7% over the whole of 2008–09.

Cash receipts of VAT in May 2008 were 6.0% lower than the same month last year. Monthly receipts in May 2008 may have been depressed relative to May 2007 due to the fact that consumer spending over the Easter period will
have occurred earlier in 2008 than in 2007. This may also have boosted receipts in April 2008 relative to April 2007: overall VAT receipts for April and May 2008 were 1.3% higher than those for the same two months in 2007. The Budget forecast implies that VAT receipts will grow by 4.0% over the whole of 2008–09.

Corporation tax receipts for May 2008 were 9.5% lower than in the same month last year. Corporation tax receipts for April and May 2008 were 5.0% higher than those for the same two months last year. The Budget forecast implies that Corporation tax receipts will grow by 9.9% over the whole of 2008–09.

Central government current spending

Expenditure on net social benefits was 5.9% higher in May 2008 than in May 2007. Expenditure during April and May 2008 was 6.8% higher than in the same months of 2007. The Budget forecast implies that central government net social benefit expenditure will grow by 6.5% over 2008–09.

Spending on debt interest (which is relatively small as a share of spending overall) was £2.9bn in May 2008, which is the same as in May 2007.

Other current spending by central government, including spending on the delivery of public services, was 2.7% higher in May 2008 than in May 2007. Comparing the first two months of 2008–09 with the first two months of 2007–08, the figure is 4.2%. The Budget forecast implies that this component of spending will grow by 5.3% over the year as a whole.

In May 2008, public sector net investment was £1.9bn compared to £1.0bn in the same month in 2007. So far in 2008–09, a total of £3.4bn has been spent on public sector net investment, compared to the £1.3bn that had been spent by the same point in 2007–08. The Budget predicted that net investment in 2008–09 would be £33.8bn, which is 22.2% above last year’s level.

Further information and contacts

For further information on today’s public finance release please contact: Carl Emmerson or Gemma Tetlow on 020 7291 4800, or email cemmerson@ifs.org.uk or gtetlow@ifs.org.uk.

The next Public Sector Finances is due to be published by the Office for National Statistics on 18th July 2008.

Relevant links:

This, and previous editions of this press release, can be downloaded from http://www.if...
Notes to editors:


2. Central government current spending includes depreciation.

3. Where possible we compare figures on an accruals basis with the HM Treasury forecast.