IFS analysis of today’s public finance figures

Today the Office for National Statistics and HM Treasury published *Public Sector Finances October 2006*. We now have details of central government receipts, central government spending, public sector net investment, borrowing and debt for the first seven months of financial year 2006–07.

**Headline Comparisons**

- **Central government current receipts** in October were 7.5% higher than in the same month last year. Receipts in the first seven months of 2006–07 were 6.5% 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.

- **Central government current spending** in October was 5.8% higher than in the same month last year. Spending in the first seven months of 2006–07 was 7.1% 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 4.6% above 2005–06 levels.

- **Public sector net investment** in October was £0.5bn higher (28.9%) than in the same month last year. Together, public sector net investment during the first seven months of 2006–07 has been £5.1bn higher (55.5%) than in the same months of 2005–06. The Budget predicted that net investment in 2006–07 would be 28.4% above last year’s level.

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

“Today’s figures show strong growth in receipts – in particular Income Tax and Capital Gains Tax – bringing growth over the year to date in line with the Budget projection. This suggests that the Chancellor will not revise downwards his forecast for receipts in the Pre-Budget Report in two weeks’ time, which would be the first time that this has not happened since the December 2000 Pre-Budget Report. Current spending by central government continues to grow faster than forecast at the time of the Budget despite very low growth in spending on benefits and tax credits in October 2006. The Pre-Budget Report has never revised the in-year projection for spending. Taken together, these suggest that the Chancellor’s forecasts for both the current budget and Public Sector Net Borrowing will be similar to, or slightly lower than, the £7.0bn deficit and £35.8bn borrowing that the Budget forecast.”
What is likely to be of more interest in the Pre-Budget Report than these headline measures of borrowing is the Treasury’s assessment of the relationship between the performance of the economy and the public finances. It appears that the economy is growing more quickly this year than the Treasury expected at Budget time. This may be contributing to the buoyancy of tax revenues and flattering the strength of the public finances because the economy might already be closer to trend than previously thought. If this is the case, it could prompt the Treasury to predict that the economic cycle will end more quickly than it had previously estimated, which would make the golden rule harder to meet over the current cycle. But, at the same time, some economists believe that extra spare capacity has been generated in the economy by higher than expected inward migration. In addition to boosting the underlying strength of the public finances, this might prompt the Treasury to push the end date of the cycle back, both of which would make the golden rule easier to achieve over the current cycle.”

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 2005 Pre-Budget Report judgement. As was discussed in more detail in July’s press release, revisions to national accounts data published on 30 June 2006 raised the possibility that the Treasury would once again have to revise its dating of the cycle. In particular, economic growth had been stronger in recent years than previously thought.

One possibility is that the Treasury could conclude 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 4.0% of one year’s national income, corresponding to £51bn 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 4.5% of one year’s national income, or £58bn 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, if policies remain unchanged, that the golden rule would be met over a cycle starting in 2003–04 or 2004–05 and ending in or before 2008–09.

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 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 July 2005 decision last year to add 1997–98 and 1998–99 into its definition of the current cycle. If the forecasts from the 2006 Budget prove to be correct, the golden rule would be met over a 1997–98 to 2008–09 cycle with £15.2bn to spare. The Budget forecast implies that the current budget deficit this year would be 53.6% lower than the £15.1bn recorded last year. Over the first half of this year, the current budget is only 24.2% lower than
the same period last year. Were this to continue for the next five months, which it might not, the outturn for 2006–07 would be a current budget deficit of £11.4bn (compared to the £7.0bn deficit forecast in the 2006 Budget). This would reduce the margin with which the golden rule would be met to just £10.7bn. This is broadly in line with the forecast of the margin of error at the time of the Budget, as the worse outcomes for this year so far are being offset by upward revisions to previous years’ outturns. For example, today’s revisions boosted the pre-existing margin on the golden rule by some £2.8bn in current terms.

**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 seven months of the year. Bearing this in mind, the figures for receipts and spending in October 2006 show:
Central government current receipts

Receipts of Income Tax and Capital Gains Tax for October were 10.3% higher than in the same month last year. Together, the receipts for these taxes during the first seven months of 2006–07 were 9.0% higher than those for the same months in 2005–06. The Budget forecasts imply that these taxes’ receipts will grow by 7.3% over the whole of 2006–07.

Corporation tax receipts for October 2006 were 15.0% higher than in the same month last year. Corporation tax receipts for the first seven months of 2006 were 17.8% higher than those for the same months last year. The Budget forecast implies that Corporation tax receipts will grow by 15.5% over the whole of 2006–07.

Cash receipts of VAT in October 2006 were 10.7% higher than the same month last year. VAT receipts for the first seven months of 2006–07 were 4.7% higher than those for the same months in 2005–06. The Budget forecast implies that VAT receipts will grow by 5.0% over the whole of 2006–07.

Net cash receipts of National Insurance Contributions were 6.0% higher in October 2006 than in the same month last year and for the first seven months of 2006–07 were 1.0% higher than in the same months in 2005–06. The Budget forecast implies that these receipts will grow by 4.8% over the whole of 2006–07.

Central government current spending

Expenditure on net social benefits was 0.7% higher in October 2006 than in October 2005. Expenditure during the first seven months of 2006–07 was 4.4% higher than in the same months of 2005–06. The Budget forecast implies that central government net social benefit expenditure will grow by 2.6% over 2006–07.

Spending on debt interest (which is relatively small as a share of spending overall) was £2.2bn in October 2006 compared to £2.1bn in October 2005.

Other current spending by central government, including spending on the delivery of public services, was 8.0% higher in October 2006 than in October 2005. Comparing the first seven months of 2006–07 with the same months in 2005–06, the figure is 8.7%. The Budget forecast implies that this component of spending will grow by 5.7% over the year as a whole.

In October 2006, public sector net investment was £2.4bn compared to £1.8bn in the same month in 2005. So far in 2006–07, a total amount of £14.2bn has been spent on public sector net investment, compared to the £9.1bn 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 28.4% above last year’s level.

Further information and contacts

For further information on today’s public finance release please contact: Carl Emmerson, Christine Frayne or Gemma Tetlow on 020 7291 4800, or email cemmerson@ifs.org.uk, cfrayne@ifs.org.uk or gtetlow@ifs.org.uk
The Pre-Budget Report will be at 12.30pm on Wednesday the 6th of December. An IFS briefing will be held at 1pm on Thursday 7th December. The briefing is free of charge and will take place at our offices in Ridgmount Street. If you wish to attend please contact our conference organiser Bonnie Brimstone (bbrimstone@ifs.org.uk).

The IFS Green Budget, which will again be in collaboration with Morgan Stanley, will be on Wednesday 31st January 2007. 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

Useful links and background information on the Budget can be found at http://www.ifs.org.uk/budgets/budget2006/index.php


HM Treasury, Pre-Budget Report 2006: http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm

The IFS Analysis of Pre-Budget Report 2006 will be available at: http://www.ifs.org.uk/budgets/pbr2006/index.php


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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.