IFS analysis of today’s public finance figures

Today the Office for National Statistics and HM Treasury published Public Sector Finances October 2008. 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 2008–09.

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

“Weak revenues from taxes on income, earnings and profits last month pushed government borrowing further above the Treasury’s Budget forecasts. On current trends borrowing is now on course to reach £68 billion this year, compared to the £42.5 billion Alistair Darling forecast in March. This underlines the need for the Government to accompany any short-term giveaway to boost the economy in Monday’s Pre-Budget Report with measures to reassure people that the public finances will be strengthened again once the economy stabilises.

October is one of the most important months of the year for corporation tax receipts. Today’s figures show corporation tax payments a quarter lower than last October across most of the economy. Even with revenues from UK North Sea oil companies doubling, thanks to the higher oil price, this left total corporation tax payments only fractionally higher overall in October than they were last year last year – a far cry from the 11% increase that the Treasury was looking for over the year as a whole at the time of the Budget.

The outlook for the public finances over the next three years also seems very bleak. The central forecast from last week’s Bank of England Inflation Report suggests that, without further interest rate cuts and/or a fiscal stimulus package, the current recession could be as deep as that in the early 1980s. Previous experience suggests that a downturn of this magnitude would add about 4% of national income or £60 billion in today’s money to borrowing in 2010–11, leaving aside the impact of sharp falls in property prices and share prices and other factors. One of the most important issues for the Pre-Budget Report to address is how much of the additional borrowing we see over the next couple of years is likely to be purely temporary and how much will require a combination of new tax raising measures and lower public spending to reverse.”

Headline Comparisons

- Central government current receipts in October were 0.3% higher than in the same month last year. Receipts in the first seven months of 2008–09 were 1.9% 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 4.9% above 2007–08 levels.
- **Central government current spending** in October was 5.1% higher than in the same month last year. Spending in the first seven months of 2008–09 was 6.0% 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 October was £2.4bn, compared to £2.2bn in the same month last year. Together, public sector net investment during the first seven months of 2008–09 has been £13.7bn, which is 30% higher than in the same months of 2007. The Budget predicted that net investment in 2008–09 would be £33.8bn, which is 13% above last year’s level.

- **Public sector net borrowing** during the first seven months on 2008–09 was £37.0bn, which is 84.4% higher than the same period last year. If this trend were to continue for the remaining five months of this financial year, and taking into account the fact that the cost of freezing nominal fuel duties and suspending stamp duty on some residential housing transactions has almost entirely not yet been felt, then Public Sector Net Borrowing for the year as a whole would be around £68bn. This is compared to the £42.5bn forecast in the March 2008 Budget. An error of this magnitude would be large even relative to the average absolute error in forecasting one year ahead of around £15bn.

**Assessing compliance with the fiscal rules**

Since coming to power, the Labour government has operated two fiscal rules – 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 little room to manoeuvre against either fiscal rule. Developments since then suggest that one, if not both, rules are likely to be breached. However, given current economic conditions, a breach is preferable to implementing drastic fiscal action to ensure this does not occur. But the pain cannot be delayed forever: once the current crisis abates, this government (or its successor) is likely to have to introduce a combination of new tax raising measures and further spending cuts as a share of national income to reduce borrowing and debt.

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 sensibly announced at the time of the Budget that it would operate 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. This judgement should also be made about the additional debt arising from the nationalisation of Bradford & Bingley and the purchase of £37 billion worth of shares in RBS, HBOS and Lloyds TSB. Since 1998–99 this ‘underlying’ public sector net debt has been kept below 40% of national income. However, over the next few years there is virtually no room left to manoeuvre against the sustainable investment rule. The economic slowdown, which the Bank of England and other forecasters now predict, is very likely to lead to ‘underlying’ public sector net debt exceeding 40% of national income next year and possibly sooner. Indeed such a slowdown could push debt closer to 50% 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 currently estimates that an economic cycle began during 1997–98 and that this cycle ended (and a new cycle began) in 2006–07. Over the years 1997–98 to 2006–07 there was a small cumulative current budget surplus. Therefore, if this period does constitute an economic cycle, Mr Brown’s golden rule was met over this period. The first two years of this economic cycle have seen a cumulative deficit of 0.8% of national income. Therefore, looking forwards, meeting the golden rule depends on there being a cumulative surplus of at least this size over the remainder of the new economic cycle. Achieving this would require this government, or its successor, to accrue current budget surpluses during periods when the economy is weak.

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 half. Bearing this in mind, the figures for receipts and spending in October 2008 show:

Central government current receipts

Cash receipts of Income Tax, Capital Gains Tax and National Insurance Contributions for October 2008 were 6.7% lower than in the same month last year. This dramatic fall is in large part due to almost half of the impact of the £2.7bn income tax cut (announced in May 2008) being felt by the Exchequer in October. Looking instead at accrued receipts of Income Tax, Capital Gains Tax and National Insurance Contributions for October 2008, these were 1.0% higher than in the same month last year. Accrued receipts of these taxes during the first seven months of 2008–09 were 2.3% higher than those for the first seven months of 2007–08. The Budget forecasts imply that cash receipts of these taxes will grow by 4.6% over the whole of 2008–09.

Corporation tax receipts for October 2008 were 0.2% higher than in the same month last year. Corporation tax receipts over the first seven months of 2008–09 were 2.1% higher than those for the same months last year. The Budget forecast implies that corporation tax receipts will grow by 10.6% over the whole of 2008–09. October is usually an important month for corporation tax receipts, and receipts from North Sea oil companies have doubled from the same month a year ago – bringing in an extra £2 billion to the Treasury. But receipts of corporation tax from other companies fell by a quarter, costing the Treasury a similar £2 billion. In part this is due to the impact of relatively high energy prices and the credit crunch on the fortunes of non-North Sea oil companies in the UK.

Cash receipts of VAT in October 2008 were 2.6% higher than the same month last year. Overall VAT receipts over the first seven months of 2008–09 were 4.3% higher than those for the same months in 2007. The Budget forecast implies that VAT receipts will grow by 4.0% over the whole of 2008–09.

Central government current spending

Expenditure on net social benefits was 5.9% higher in October 2008 than in the same month last year. Expenditure over the first seven months of 2008–09 was 7.1% higher than in the same months of 2007. The Budget forecast implies that central government net social benefit expenditure will grow by 6.2% over 2008–09.
Spending on debt interest (which is relatively small as a share of spending overall) was £3.4bn in October 2008, which is 11.4% higher than in October 2007.

Other current spending by central government, including spending on the delivery of public services, was 4.1% higher in October 2008 than in the same month last year. Comparing the first seven months of 2008–09 with the first seven months of 2007–08, the figure is 4.9%. The Budget forecast implies that this component of spending will grow by 5.5% over the year as a whole.

In October 2008, public sector net investment was £2.4bn compared to £2.2bn in the same month in 2007. So far in 2008–09, a total of £13.7bn has been spent on public sector net investment, compared to the £10.6bn 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 13% above last year’s level.

Further information and contacts
For further information on today’s public finance release please contact: Robert Chote, Carl Emmerson or Gemma Tetlow on 020 7291 4800, or email rchote@ifs.org.uk, 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 December 2008.

The Chancellor will make his Pre-Budget Report statement at 3.30pm on Monday 24th November. IFS will hold a briefing to present our analysis of this report at 1pm on Tuesday 25th November. The briefing is free of charge and will take place at The Building Centre, Store Street, WC1E 7BT. Places for this event are now fully booked, however if you would like to be added to the waiting list, please contact our conference organiser Bonnie Brimstone (bbrimstone@ifs.org.uk). Slides and Robert Chote’s opening remarks will be available after the event from the IFS website.

Relevant links:
This, and previous editions of this press release, can be downloaded from http://www.ifs.org.uk/press/pub_fin.shtml

IFS analysis of some of the issues underlying the forthcoming Pre-Budget Report can be found at: http://www.ifs.org.uk/budgets/pbr2008/index.php


Useful links and background information on Budget 2008 can be found at http://www.ifs.org.uk/budgets/budget2008/index.php


HM Treasury, Budget 2008: http://www.hm-treasury.gov.uk/budget/budget_08/bud_bud08_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.