IFS analysis of today’s public finance figures

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

Headline Comparisons

- **Central government current receipts** in September were 7.0% higher than in the same month last year. Receipts in the first half of 2005–06 were 7.2% 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 8.5% above 2004–05 levels.

- **Central government current spending** in September was 4.3% higher than in the same month last year. Spending in the first half of 2005–06 was 5.4% 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 5.9% above 2004–05 levels.

- **Public sector net investment** in September was £0.9bn higher (102.6%) than in the same month last year. Together, public sector net investment during the first half of 2005–06 has been £2.4bn higher (40.2%) than in the same months of 2004–05. The Budget predicted that net investment in 2005–06 would be 38.3% above last year’s level.

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

“Today’s figures show that receipts have been growing strongly, but not as strongly as the Chancellor hoped. In contrast, growth in central government spending is slightly below what the Chancellor forecast for the year as a whole. Overall, substantial revisions to previously published figures do not change the comfort with which the Chancellor expects to meet his Golden Rule over the current economic cycle: the £0.9bn upward revision to the current budget in the first five months of this financial year is offset by equivalent downgrades to previous years’ data.”

**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.
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 £21.7bn in 2005–06. 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 half of the present financial year the current budget deficit was 17.4% lower than in the equivalent period last year – if the same were to be true over the next six months, which it might not be, the deficit for 2005–06 would come in at £15.6bn. The average absolute forecasting error made one year ahead by the Treasury in the past is equivalent to £12bn in today’s terms.

For the cycle to close in 2005–06, based on the Treasury’s latest estimates, the (non-oil) economy would need to grow by nearly 4% between the first quarter of 2005 and the first quarter of 2006, considerably more than most independent forecasters expect. This suggests that the Treasury may predict in this year’s Pre-Budget Report – expected next month – 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 would be a small surplus, while in the January 2005 Green Budget we predicted a deficit.

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 September 2005 show:

**Central government current receipts**

Receipts of Income Tax, Capital Gains Tax and National Insurance Contributions for September were 4.4% higher than in the same month last year. Together, the receipts for these taxes during the first half of 2005–06 were 8.5% higher than those for the same months in 2004–05. The Budget forecasts imply that these taxes’ receipts will grow by 8.1% over the whole of 2005–06, so the last six months have been encouraging for the Chancellor.

Cash receipts of VAT in September 2005 were 10.7% higher than the same month last year. VAT receipts for the first half of 2005 were 0.3% 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 September 2005 were 16.7% higher than in the same month last year. Corporation tax receipts for the first half of 2005 were 16.1% higher than those for the same months last year. The Budget forecast implies that Corporation tax receipts will grow by 28.4% over the whole of 2005–06, well above the trend to date.

**Central government current spending**

Expenditure on net social benefits was 9.9% higher in September 2005 than in September 2004. Expenditure during the first half of 2005 was 5.4% higher than in the same months of 2004. The Budget forecast implies that central government net social benefit expenditure will grow by 7.2% over 2005–06, faster than the first six months of this year.
Spending on debt interest (which is relatively small as a share of spending overall) was £1.2bn in September 2005 compared to £1.4bn in September 2004.

Other current spending by central government, including spending on the delivery of public services, was 3.3% higher in September 2005 than in September 2004. Comparing the first half of 2005–06 with the same months in 2004–05, the figure is 5.0%. The Budget forecast implies that this component of spending will grow by 5.2% over the year as a whole, broadly in line with the first six months of this year.

In September 2005, public sector net investment was £1.8bn compared to £0.9bn in the same month in 2004. So far in 2005–06, a total amount of £8.3bn has been spent on public sector net investment, compared to the £5.9bn 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 38.3% above last year’s level.

**The effect of raised oil price on the public finances**

Higher oil prices affect tax revenues directly by raising the tax receipts from North Sea Oil taxes, but may also reduce them indirectly if it leads to lower economic activity.

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 for the current year. 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 2005, at the time of the Budget, the average of the independent forecasts was an oil price of $40.6/barrel in 2005 and $37.8/barrel in 2006. The assumption used by the Treasury was that oil prices would be $40.6/barrel this year and would remain the same in real terms thereafter. Yesterday, the most recent independent forecasts have an average of $55.5/barrel in 2005 and $54.3/barrel in 2006.

According to the most recent NAO audit of the oil price assumption, the Treasury estimates that a 5% increase in the oil price would, other things being equal, increase revenues directly by about £220m in the first year and £270m in the next. The latest 2005 forecast is 37% higher than the Budget one for 2005 and 30% higher for 2006. This suggests that, given the Treasury’s estimates of the revenue effects of oil prices, there may be as much as £1¾bn of extra revenue directly resulting from higher-than-expected oil prices this year and next.

Whether these gains persist will depend on whether the oil price remains above the level assumed by the Treasury in the Budget. Moreover recent experience suggests that the higher than expected current oil price may prompt the Chancellor to delay or abandon the usual inflation increase in road fuel duties. If the Chancellor chooses not to implement both the fuel duty increase that has been delayed since April 2005 and the one that is planned for April 2006, then this would cost around £1bn a year from April 2006 onwards. This would be roughly equivalent to the additional revenue arising directly from a higher-than-expected oil price as long as the oil price (in real terms) remained around $50/barrel beyond 2006. Any indirect impact of higher-than-expected oil prices (for example through reduced profitability of non North Sea oil companies) would reduce the Exchequer gain, and could even lead to an overall net loss of revenue.

**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/budget2005/index.php

Office for National Statistics & HM Treasury, Public Sector Finances, September 2005:

HM Treasury, Evidence on the UK economic cycle, 19th September 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.