

IFS analysis of today's public finance figures

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

IFS public finance bulletins are generously supported by the Economic and Social Research Council.



The analysis is based on IFS calculations and does not reflect the views of the ESRC.

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

“Tax receipts are weaker than Alistair Darling predicted at Budget time, while spending on social security benefits and tax credits is overshooting his forecasts. If these trends continue, public sector net borrowing will come in around £64 billion this year rather than the £42.5 billion he predicted in March.

The extra borrowing means that public sector net debt is likely to breach Gordon Brown's ceiling of 40% of national income next year, even excluding the impact of the nationalisation of Northern Rock and Bradford & Bingley, and the capital injections into other banks. These decisions are likely to increase the headline measure of public sector net debt by around 12% of national income all told, plus up to 120% of national income if the Office for National Statistics decides to treat RBS as a public corporation. Most of this increase is likely to be temporary and the Government hopes to make a profit on its investments, as Norway did after its banking crisis in the early 1990s. Given the uncertain long-term impact of these measures, the Government is right to regard the level excluding these factors as the best indicator of public sector indebtedness for the time being.

Today's figures also show that public sector net investment is currently running ahead of Budget forecasts, although these figures tend to be erratic through the year. The Government may not be disappointed by an overshoot in investment spending this year, as it has indicated that it may wish to bring forward capital spending from future years to help support economic growth. The Government is currently planning to invest around 2¼% of national income in each of the next five years.

If the Government had acted earlier to address its repeatedly optimistic forecasts for the public finances, we would not now be embarking on a recession with public sector borrowing and debt as high as they are. But starting in this position it clearly makes sense to borrow more as the economy weakens rather than trying to stick to the rules in the short term. 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.”

Headline Comparisons

- **Central government current receipts** in September were 2.4% higher than in the same month last year. Receipts in the first six months of 2008–09 were 2.0% 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 September was 5.1% higher than in the same month last year. Spending in the first six months of 2008–09 was 6.1% 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 September was £2.2bn, compared to £1.5bn in the same month last year. Together, public sector net investment during the first six months of 2008–09 has been £12.1bn, which is 44.4% higher than in the same months of 2007. The Budget predicted that net investment in 2008–09 would be £33.8bn, which is 13.1% above last year's level.
- **Public sector net borrowing** during the first six months on 2008–09 was £37.6bn, which is 75.2% higher than the same period last year. If this trend were to continue for the second half 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 £64bn. This is compared to the £42.5bn forecast in the March 2008 Budget. It should be remembered that the average absolute error in forecasting one year ahead has been around £15bn. So an error of this magnitude would be only slightly larger than average.

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 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 only a small cumulative current budget surplus. Looking forwards, meeting the golden rule will depend either on whether there is a surplus over the years from 2006–07 to when the new economic cycle closes, or on whether the cumulative current budget remains in surplus over the years from 1997–98 to when the current economic cycle ends. Either way the golden rule is likely to be breached unless the government chooses 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 September 2008 show:

Central government current receipts

Cash receipts of Income Tax, Capital Gains Tax and National Insurance Contributions for September 2008 were 4.2% higher than in the same month last year. Together, receipts of these taxes during the first six months of 2008–09 were 3.8% higher than those for the first six months of 2007–08. The Budget forecasts imply that receipts of these taxes will grow by 4.6% over the whole of 2008–09.

Cash receipts of VAT in September 2008 were 5.1% higher than the same month last year. Overall VAT receipts over the first six months of 2008–09 were 4.8% 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.

Corporation tax receipts for September 2008 were 8.1% lower than in the same month last year. Corporation tax receipts over the first six months of 2008–09 were 3.0% 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.

Central government current spending

Expenditure on net social benefits was 8.3% higher in September 2008 than in the same month last year. Expenditure over the first six months of 2008–09 was 7.4% 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 £1.2bn in September 2008, which is 12.2% higher than in September 2007.

Other current spending by central government, including spending on the delivery of public services, was 3.6% higher in September 2008 than in the same month last year. Comparing the first six months of 2008–09 with the first six months of 2007–08, the figure is 5.1%. The Budget forecast implies that this component of spending will grow by 5.5% over the year as a whole.

In September 2008, **public sector net investment** was £2.2bn compared to £1.5bn in the same month in 2007. So far in 2008–09, a total of £12.2bn has been spent on public sector net investment, compared to the £8.3bn 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 13.1% 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 20th November 2008.

Relevant links:

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

IFS Green Budget, January 2008, containing in-depth public finance analysis, can be found at:
<http://www.ifs.org.uk/budgets/gb2008/index.php>

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

Office for National Statistics & HM Treasury, Public Sector Finances, September 2008:
<http://www.statistics.gov.uk/pdfdir/psf1008.pdf>

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