



# Perspectives by Ruth Lea

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### **The public finances: prepare for even worse figures**

The current crisis in the financial markets, and the banking rescue, has understandably taken centre stage in the recent media coverage of finance and the economy. But as the Chancellor prepares for the Pre-Budget Report, expected next month, the real economy and the public finances will come to the fore. Central to the Pre-Budget Report are the revised forecasts for GDP, other key economic variables and the public finances. This note concentrates on the rapidly deteriorating public finances, which are, of course, partly dependent on our economic fortunes.

#### *The outlook for the public finances: public sector borrowing*

The recent data on public sector borrowing have shown a significant deterioration as the economic slowdown has both dampened tax receipts and pushed up spending. Receipts have been particularly hit by the falling housing market (leading to weaker stamp duty receipts) and the downturn in the City (a major contributor to the Chancellor's coffers for both corporate and personal taxes).

Taking the first 5 months of the current financial year, the deterioration is clear.<sup>1</sup> The cumulative current budget deficit is nearly twice as high as last year and public sector borrowing is 70% higher. Central government current receipts in the first 5 months were only 2.3% higher than in the equivalent period in the previous year, whilst the March budget projected an annual increase in receipts for the year FY2008 as a whole of 5.0%. But not merely are receipts badly undershooting, spending is overshooting. In the first 5 months of the financial year central government current spending was 6.4% higher than the equivalent period in FY2007, compared with the budget forecast for the year as a whole of just 5.3%.<sup>2</sup> If these trends are sustained for the rest of the financial year, and indeed they could get worse, public borrowing would be around £65bn for FY2008.

#### **Public sector finances to August 2008, £bn**

	Aug 2008	Aug 2007	Apr-Aug 2008	Apr-Aug 2007	5 month comparison
Current budget	-7.8	-6.2	-19.3	-10.0	-9.3
Public sector net borrowing	10.4	8.0	28.2	16.5	11.7

Source: ONS, "Public sector finances", August 2008, 18 September 2008.

The Pre-Budget Report's revised projections for borrowing will surely show a significant deterioration compared with the budget. Not merely are the Treasury's projections prone to an optimistic bias,<sup>3</sup> but the slowdown in the economy and certain policy decisions will intensify the need to downgrade the forecasts.

At the time of writing the following specific factors seem especially relevant.

- Economic growth: For every percentage point that GDP is lower than expected, public borrowing will be roughly £7.5bn higher than forecast in the 1<sup>st</sup> year, rising to £10bn in the 2<sup>nd</sup> year, according to the Treasury's ready reckoner.<sup>4</sup> The Treasury assumed GDP growth of 1¾% for FY2008, 2½% for FY2009 and 2½% for FY2010 for the public finance projections in the March 2008 budget. Clearly these projections will not be achieved. The latest consensus forecasts are for 1.1% in 2008 and - 0.2% for 2009.<sup>5</sup> The Bank of England's August forecast saw growth stalling in the second half of 2008 and the first half of 2009, before showing some recovery in the second half of 2009.<sup>6</sup>
- £3.6bn of "giveaways" that have already been announced this year, comprising £2.7bn (for basic rate taxpayers in the wake of the 10p tax debacle), £0.6bn (for the postponement of the increase in fuel duty) and £0.3bn (for the suspension of stamp duty payments on homes).
- The higher than expected 5% RPI inflation rate for September, which is used to up-rate pensions, and the higher than expected 6.3% annual increase in the Rossi index (the RPI index excluding rent, mortgage interest payments, council tax and depreciation costs), which is used to up-rate income-related benefits (including the JSA), will add an extra £3bn to spending next year.
- The impact of the "reprioritisation" of spending as announced by the Chancellor recently. The Treasury's existing plans include some tightening in order to reduce the budget deficit by 0.4% of GDP in FY2009 compared with FY2008 - partly reflecting higher taxes but partly reflecting tighter spending. (Table 3 in the annex provides data on public spending.) The Chancellor is, apparently, proposing to bring spending ear-marked for FY2010 forward to FY2009 - to give a "Keynesian" boost to the economy - but leaving the plans for FY2010 eye-wateringly tight. Details are expected in the Pre-Budget Report.<sup>7</sup>
- The higher costs of servicing increased public sector debt, reflecting the rescue plan for the RBS, HBOS and Lloyds TSB. The Treasury will however recoup some of the costs from the 12% interest on its preference shares in the banks. The IFS has estimated that the £37bn bank rescue will cost £1.7bn a year to service.<sup>8</sup>

Given all these imponderables it is especially difficult to forecast borrowing at present. But the aforementioned £65bn looks highly plausible for FY2008. The Ernst and Young Item club, which uses the Treasury forecasting model, projects borrowing of £92bn for FY2009.<sup>9</sup> This figure, which is in line with several other authoritative forecasts, could well be an underestimate - especially if Darling "reprioritises" large chunks of spending from FY2010 to FY2009. Projections further out become even more speculative, not least of all because of the problems with forecasting the economy. And they will not be made here.

#### **Forecasts of public sector net borrowing, % of GDP**

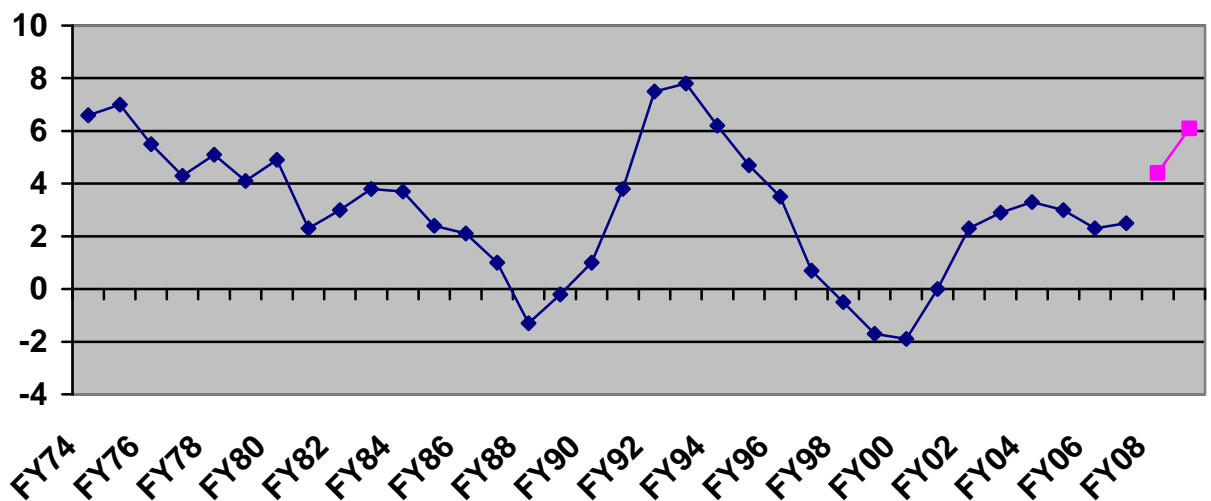
	Budget forecast (£bn)	%, GDP	Current expectations (£bn)	%, GDP
FY2007	36.4	2.6%	35.8 (outturn)	2.6%
FY2008	43	2.9%	65	4.4%
FY2009	38	2.5%	92	6.1%

Source: HM Treasury, *Budget 2008, Stability and opportunity: building a strong, sustainable future*, HC 388, March 2008.

The FY2007 out-turn figure is from: ONS, "Public sector finances", August 2008, 18 September 2008.

The chart below underlines the degree of the deterioration expected in public borrowing over the next two years.

### Public sector net borrowing, % of GDP, including FY2008 & FY2009



Source for back data: HM Treasury, *Budget 2008, Stability and opportunity: building a strong, sustainable future*, HC 388, March 2008.

#### Public sector debt

There is little doubt that public sector debt is set to soar. There are several key reasons for this:

- The slowdown in the economy and the worsening borrowing figures clearly will add to public sector debt. This is the most significant factor. What really will hit the public finances is the economy.
- The nationalisation of Northern Rock is currently adding £87bn (2008Q2) to debt. But note, however, this does not increase public sector borrowing. The nationalisations of Northern Rock and Bradford and Bingley and the part-nationalisations of RBS, HBOS and Lloyds TSB (taxpayer stake in banks in the latter cases) should be treated in an equal but opposite way to privatisations. They do not add to public-sector net borrowing just as privatisations did not reduce that deficit. They are below-the-line financial transactions.
- The IFS expects the nationalisation of Bradford and Bingley to add about 3% of GDP (about £43.5bn) to the national debt.<sup>10</sup>
- The £37bn rescue plan so far announced for RBS, HBOS and Lloyds TSB will be added to public debt, unless the ONS allows the Treasury to treat the shares as liquid assets.<sup>11</sup> There is some speculation that all the banks' liabilities may be added to public sector debt (amounting to multiples of billions), but the critical classification criterion for the ONS is control of a bank's "general corporate policy", rather than ownership. If the ONS rules that the Government does not have control of said "general corporate policy", the liabilities will not be added to the national debt.
- It should be noted that the Treasury, when it first announced its bank bail-out, stated it was prepared to put at least £50bn (3.5% of GDP) into the banks. And this it may still well do.
- Allowances for the losses relating to the collapse of the Icelandic banks, relatively minor.
- There is a possibility that the £250bn of bank guarantees may be added to debt. They would, however, normally be treated as contingent liabilities and would not generally appear on balance sheets. There is, however, a potential risk to the taxpayer.

- There is also a possibility that the Bank of England's £200bn Special Liquidity Scheme (SLS) may be added, though they are more likely to be treated as contingent liabilities. The ONS is currently considering the classification implications of the SLS.

Currently the public debt, including Northern Rock, amounts to 44.3% of GDP. This is already above the Treasury's 40% ceiling for the sustainable investment rule (see below). The addition of Bradford and Bingley and the £50bn bank rescue scheme pushes the debt to GDP ratio up to nearly 51%. Northern Rock, Bradford and Bingley and the £50bn bank rescue scheme between them add £180bn to the national debt – 12.5% of GDP.

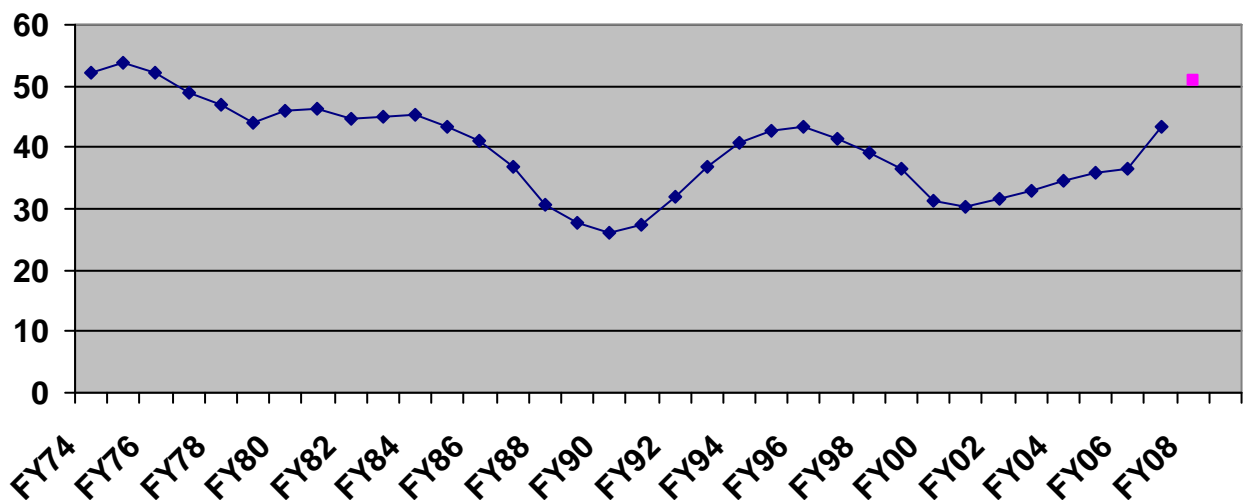
#### **Possible increase in public debt: illustrative calculation**

	Debt (£bn)	Net debt as % GDP
Excluding Northern Rock (2008Q2)	554.7	38.3
Northern Rock (2008Q2)	87.0	6.0
Including Northern Rock (2008Q2)	641.7	44.3
Likely additions:		
Bradford & Bingley	43.5 (about)	3.0
Rescue plan	50 (about)	3.5
Grand total	735.2	50.8

Source for 2008Q2 data: ONS, "Public sector finances", August 2008, 18 September 2008.

In the chart below, the illustrative total is added as a projection for FY2008.

#### **Public sector net debt, % of GDP, including illustrative projection for FY2008**



Source of back data: HM Treasury, *Budget 2008, Stability and opportunity: building a strong, sustainable future*, HC 388, March 2008.

#### *Mr Brown's fiscal rules: farewell*

In his early years as Chancellor, Gordon Brown boasted about his "prudent" fiscal rules. They were:

- The golden rule, which stated that, on average over the cycle, the government will borrow only to invest and not to fund current spending
- The sustainable investment rule, which stated that public sector debt as a proportion of GDP would be held over the cycle at a stable and prudent level. The government believed that, other things being equal, it was desirable that public spending net debt should be below 40% of GDP over the cycle.

The golden rule has had more makeovers than it cares to remember, it has quite lost credibility, and the sustainable investment rule has been consigned to the history books.

### References

1. The September 2008 data for the public finances are released on 20 October 2008.
2. IFS analysis of August's public sector figures, 18 September 2008.
3. Detailed tables are shown in annex 1. These tables are taken from Ruth Lea, "Public sector productivity: a shocking record", *Arbuthnot Banking Group Perspective*, 17 March 2008.
4. "Counting the cost", *Economist*, 18 October 2008.
5. Consensus Forecasts, survey date: 13 October 2008.
6. Bank of England, "Inflation report", August 2008. Conditions have deteriorated since this forecast was undertaken.
7. George Parker et al, "Darling to fast-track public spending", *Financial Times*, 18 October 2008.
8. Patrick Hennessy, "We'll put cash in the economy...", *Sunday Telegraph*, 19 October 2008.
9. David Smith, "Banking crisis infects the real economy", *Sunday Times*, 19 October 2008.
10. Robert Chote, "Someone will have to dig us out of all this debt", *Daily Telegraph*, 9 October 2008.
11. It is worth noting that the tax payer will not necessarily lose money from investing in banks.

### Annex: Treasury forecasts of public sector finances

**Table 1 Public sector current balance, £bn, FY2006 onwards**

	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
Date of forecast							
Nov 01	9						
Apr 02	9						
Nov 02	8	10					
Apr 03	6	9					
Dec 03	0	4	8				
Mar 04	0	4	9				
Dec 04	1	4	9	12			
Mar 05	1	4	9	12			
Dec 05	-4	0	7	11	13		
Mar 06	-7	1	7	10	12		
Dec 06	-8	-1	4	7	10	14	
Mar 07	-9.5	-4	3	6	9	13	
Oct 07	-4.7	-8	-4	3	9	14	20
Mar 08	-4.3	-7.9	-10	-4	4	11	18

**Table 2 Public sector net borrowing, £bn, FY2006 onwards**

	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
Date of forecast							
Nov 01	13						
Apr 02	18						
Nov 02	19	20					
Apr 03	22	22					
Dec 03	27	27	24				
Mar 04	27	27	23				
Dec 04	29	28	24	22			
Mar 05	29	27	24	22			
Dec 05	34	31	26	23	22		
Mar 06	36	30	25	24	23		
Dec 06	37	31	27	26	24	22	
Mar 07	35	34	30	28	26	24	
Oct 07	31	38	36	31	28	25	23
Mar 08	30.1	36.4	43	38	32	27	23

Notes to the tables:

- The data are taken from successive Budget Reports and Pre-Budget Reports.
- It can be seen that, on balance, the forecasts worsen significantly from their first “entry”. For example, in November 2001 it was expected that there would be a current surplus of £9bn and net borrowing of £13bn for FY2006. The estimated outturns are for a current deficit of around £4½bn and net borrowing of £30bn.
- In November 2002 it was expected that there would be current surplus of £10bn for FY2007 and net borrowing of £20bn. The respective current estimates are a current deficit of £8bn and borrowing of over £36bn.

**Table 3 Public spending plans (£bn)**

Year	Item	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
2002	DEL	239.7	<b>263.5</b>	<b>279.8</b>	<b>301.0</b>					
	AME	178.7	<b>191.2</b>	<b>201.7</b>	<b>210.4</b>					
	TME	418.4	<b>454.6</b>	<b>481.5</b>	<b>511.4</b>					
2004	DEL			279.3	<b>301.9</b>	<b>321.4</b>	<b>340.5</b>			
	AME			208.3	<b>218.9</b>	<b>227.8</b>	<b>239.5</b>			
	TME			487.6	<b>520.8</b>	<b>549.2</b>	<b>580.0</b>			
2007	DEL					320.4	344.6	<b>361.1</b>	<b>377.5</b>	<b>396.9</b>
	AME					229.7	244.6	<b>256.4</b>	<b>269.2</b>	<b>281.4</b>
	TME					550.1	589.2	<b>617.4</b>	<b>646.6</b>	<b>678.3</b>
TME YOY, growth	Na	8.7%	7.3%	6.8%	5.6%	7.1%	4.8%	4.7%	4.9%	

DEL = Departmental Expenditure Limit (net of depreciation).

AME = Annually Managed Expenditure.

TME = Total Managed Expenditure. TME=DEL+AME

Sources: Successive Spending Reviews, including HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review, Meeting the aspirations of the British people*, Cm7227, October 2007. The bold data show the new spending plans for each Spending Review.

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