

Novus Capital Markets Research

Broadly on track – upside risks

25 August 2011

OBR forecast broadly on track but upside risk: July's near-balance on the public finances took the 4-month deficit on the PSNBex definition to £40.1bn, £2.9bn below the year-earlier outturn. The OBR's Budget forecast was for PSNBex to fall from £145.9bn in 2010-11 to £121.8bn in 2011-12, a reduction of £24.1bn. Since then the 2010-11 deficit has been revised down to £142.7bn so that the OBR forecast requires a more modest (£20.9bn) fall in the deficit this year. The forecast was based on a 7.2% rise in central government receipts and a 3.6% increase in expenditure. Since central government spending rose only 3.2% in Apr-Jul, it can rise more rapidly (3.7%) over the coming eight months and still hit the target. The revenue forecast is more challenging – an 8.6% rise in required over the balance of the year, exactly twice what has been achieved in the first four months. There are reasons to expect the balance of the year to be stronger (the move from the bank payroll tax to the bank levy, the supplementary charge on offshore oil production from October and the lagged effects of the 50% income tax rate). Overall, the OBR forecast looks broadly on track, though there are upside risks principally from a shortfall of corporation tax payments from the banks (losses from the euro area sovereign debt crisis and misselling of payment protection insurance) and the oil sector (lower oil output).

Right said Fred: I'm looking forward to reading the new book by Matthew Hancock and Nadhim Zahawi (Masters of Nothing). Apparently it reveals that he who must not be named 'went so far as to refuse to allow his chief economist to attend the Select Committee hearing, until the chair of the committee was forced to call and explain that if he chose not to attend he would be summoned, with the full force of the police in reserve'. I guess they are referring to a TSC hearing on Britain and the euro when John McFall was the TSC chairman. I can't think who the chief economist might have been.

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Public finances – an improving trend

The public finances returned to balance in July (a deficit of £20m on the PSNBex definition which excludes the effects of financial interventions). This was better than City forecasts (a deficit of £2.4bn), a £3.5bn improvement on July 2010 and a £6bn advance on July 2009's record (for the month) shortfall. The trend is in the right direction though in 'normal' times July is a surplus month with strong receipts of corporation tax, self-assessment income tax and VAT.

July's improvement reflected a 5.6% increase in central government receipts against a 1.9% rise in expenditure. On the receipts side VAT was up 22.4%, mainly because of the hike in the rate from 17½% to 20% at the start of the year, but income tax payments were down (this might be a timing issue since the 31 July deadline fell on a Sunday) and corporation tax rose a modest 1%. On the spending side interest payments rose 11.1% and net social benefits were up 3.4%. Other expenditure, which includes the main departmental spending programmes and accounts for 60% of the central government total, was down 0.1% from July 2010.

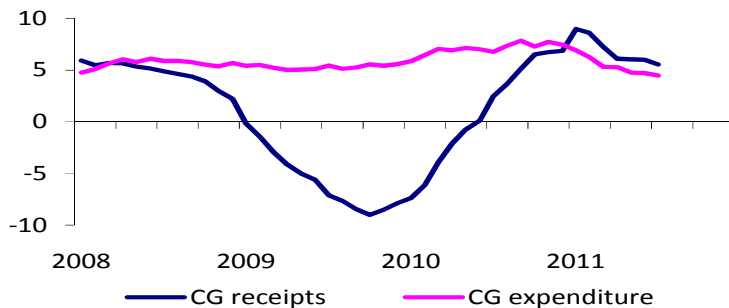
After four months of the financial year PSNBex is £40.1bn, £2.9bn down from Apr-Jul 2010 (receipts up 4.3% versus 3.2% for expenditure). On the receipts side VAT is up 18.8%, while income and corporation tax are up by around 1½%. On the expenditure side interest payments have risen 14%, way ahead of net social benefits (4.3%) and other spending (1.5%). Overall the growth in spending in Apr-Jul was above what we saw in July alone (which could mean either that the trend deceleration is gathering pace or that July was erratically good).

The underlying improvement is somewhat greater than the raw data suggest since the April 2010 receipts included a £3.5bn contribution from the bank payroll tax which has been replaced by the bank levy, the first payment of which (£660m) was made in July. Allowing for these changes a simple extrapolation suggests that PSNBex is on track for a full-year outturn of £126-127bn, a £16bn improvement on 2010-11's £142.7bn. The consensus forecast, according to the HMT survey is £125bn.

On a longer-term basis the improvement in the public finances is clear. Central government revenues which plummeted in the recession are rising at a near-6% rate against 4½% for expenditure (Chart 1). Within the latter, interest payments (over which the Government has almost no control) are growing at

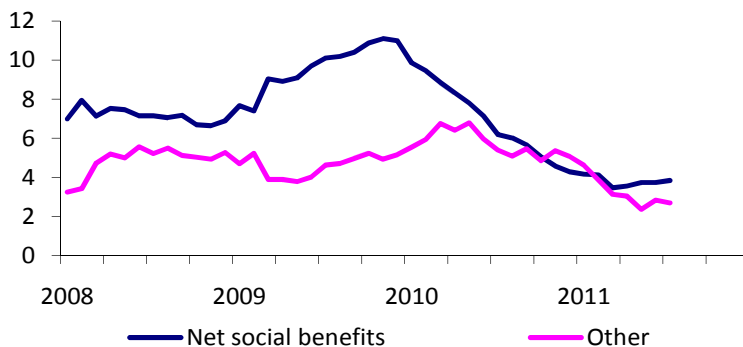
a 25% rate while the quantitatively much more important other component (over which the Government has far greater control) is rising at 2.7% and net social benefits (where the Government can fix the rate but then are largely demand-determined) are rising at just under 4%. The trend in other expenditure is still down though the growth in net social benefits, which fell sharply in 2010-11, appears to be levelling out now that unemployment has stopped falling (Chart 2).

Chart 1: Central government receipts & expenditure (12m rolling total, % y/y)



Source: ONS

Chart 2: Central government expenditure (12m rolling total, % y/y)



Source: ONS

Public finances – the OBR forecast

At the time of the March Budget the OBR forecast a 2011-12 deficit (PSNBex) of £121.8bn, a drop of £24.1bn from its estimate of the 2010-11 outturn of £145.9bn. This comprised a £14.8bn reduction in the current account deficit and a £9.3bn drop in net investment. Public sector current receipts were forecast to rise 7.3% against 3.8% for expenditure (Table 1).

Table 1: OBR forecast March 2011

£bn	2010-11	2011-12	change
Current budget			
Current receipts	548.5	588.6	7.3
Current expenditure	632.8	656.7	3.8
Depreciation	20.5	21.9	6.8
Surplus on current budget	-104.8	-90.0	14.8
Capital budget			
Gross investment	61.6	53.7	-12.8
Depreciation	-20.5	-21.9	6.8
Net investment	41.1	31.8	-22.6
Net borrowing	145.9	121.8	-24.1

Changes are % except for surplus on current budget and net borrowing which are £bn

Source: OBR

The latest ONS data put the 2010-11 deficit at £142.7bn, £3.2bn below the OBR Budget estimate. As a result the OBR forecast is now for an improvement in PSNBex this year of £20.9bn (rather than £24.1bn at the time of the Budget). This is slightly more optimistic than the £16bn improvement that I obtained from simple extrapolation but with the year only one third through the difference is insignificant.

The OBR publishes a helpful table which shows progress through the year and calculates what needs to be achieved in the remaining months for its forecast to be on track (Table 2). For example, central government receipts, which rose 4.3% in the first four months of the financial year, need to rise 8.6% over the next eight months to hit the full-year forecast of 7.2%. The key shortfalls are in taxes on production (excluding VAT, which is ahead of schedule), taxes on income and wealth and corporation tax. The last looks particularly problematic: having risen 1.6% in the year-to-date (ytd), it needs to rise at a 22.2% rate over the balance of the year to average the OBR's 14.5% full-year forecast. The weakness is

in the oil sector, where production was down more than 13% in the first half of the year, and in financial companies, where bank losses from weaker investment banking, the euro area sovereign debt crisis and misselling of payment protection insurance reduced tax payments. Industrial & commercial tax payments are broadly in line with the OBR forecast. By contrast the OBR forecast appears to be ahead of schedule on the spending front. Current expenditure has risen 3.2% in the first four months and can grow more rapidly (3.7%) over the next eight months and still come in on target.

Table 2: OBR forecasts vs ytd outturn

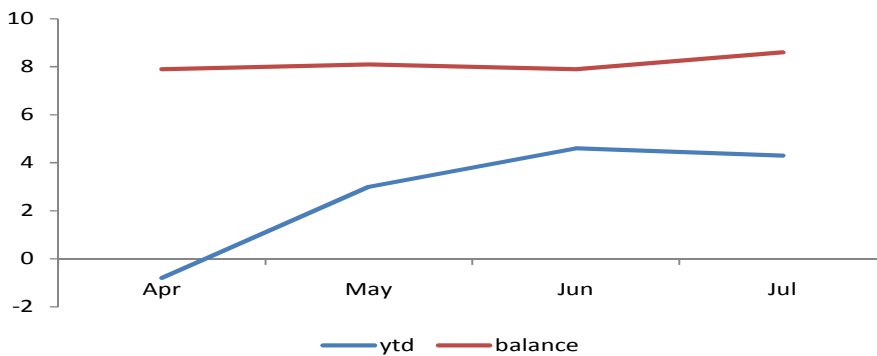
% change	Apr-Jul	Aug-Mar	2011-12
Taxes on production	4.9	12.6	10.0
Taxes on income & wealth	1.7	8.4	6.3
Corporation tax	1.6	22.2	14.5
Other taxes	16.6	-5.6	2.0
Compulsory social contributions	5.2	2.4	3.2
Interest & dividends	18.8	27.4	25.0
Other receipts	6.6	6.2	6.4
Total CG receipts	4.3	8.6	7.2
Interest payments	14.0	9.9	11.3
Net social benefits	4.3	4.5	4.4
Other	1.5	2.8	2.3
CG current expenditure	3.2	3.7	3.6
PSNBex (£bn)	40.1	81.6	121.8

Source: OBR

The OBR points out in its monthly press release that if both the bank payroll tax and the bank levy were excluded then receipts would have risen 6.1% in the Apr-Jul period and there would be correspondingly less of a jump required over the remainder of the year. Similarly they note that receipts will be boosted over the coming months by the supplementary charge on offshore corporation tax (which starts in October) and the delayed impact of the 50% rate of income tax. Against that, on the experience of the first four months, corporation tax could be depressed by weaker profitability than expected in the financial sector and a shortfall in oil & gas production.

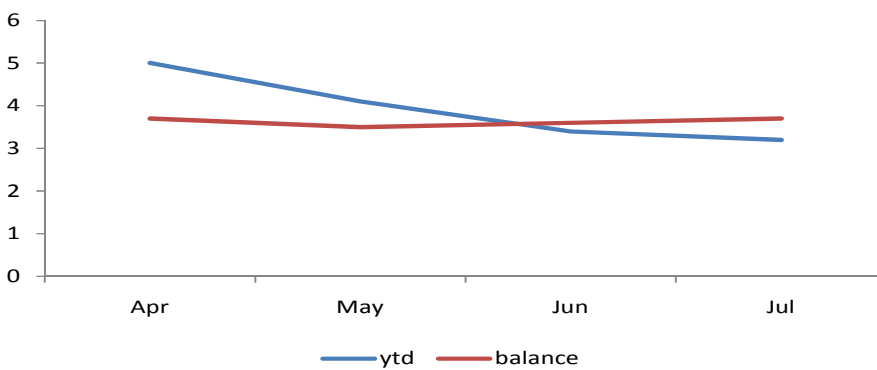
The OBR publishes the equivalent to Table 2 every month from which we can plot progress towards the full-year forecast. Revenues were down 0.8% y/y in April (the bank payroll tax effect) which required growth of 7.9% over the balance of the year. Since then the growth of revenues has picked up but with little effect on what still needs to be done (Chart 3). By contrast, expenditure growth started more rapidly than the full-year target but after four months is growing more slowly (Chart 4).

Chart 3: Central government receipts (% ytd and balance required to achieve 7.2% forecast)



Source: OBR

Chart 4: Central government expenditure ((% ytd and balance required to achieve 3.6% forecast)



Source: OBR

Overall, with some obvious reservations on the revenue front from the oil and financial sectors but some leeway for slippage on expenditure, the OBR forecast for PSNBex appears to be broadly on track. If this is the case, it is worth asking why, especially if the OBR has to revise its 2011-12 GDP forecast down again. At the time of the Budget last year the OBR forecast was for GDP to rise 2.4% this financial year (*mea culpa*) with PSNBex forecast to fall to £115.6bn. Since then, firstly in the November EFO and again in the March Budget, they have lowered the GDP and raised the PSNBex forecasts (Table 3).

Table 3: OBR GDP and PSNB forecasts

	GDP 11-12 %	GDP£ 11-12 £bn	PSNBex 11-12 £bn
June 2010 Budget	2.4	1539	115.6
November EFO	2.0	1550	117.5
March 2011 Budget	1.8	1544	121.8

Source: OBR

The net effect on the deficit forecast has been smaller than might have been expected for the GDP downgrade since the forecast for nominal GDP (GDP£) has been less affected (particularly if we compare the two Budget forecasts). Higher inflation has pushed up nominal GDP and hence the tax base. As a result, revenues have held up better than they otherwise would have done. Inflation may be squeezing household budgets and consumer spending in real terms but VAT, for example, is levied on consumer spending in cash terms which, as last week's retail sales data show, is rising at a 4.3% rate (0.1% real and 4.2% inflation). Inflation may be deflation as far as the real economy is concerned but it is positive for the public finances.

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