

Novus Capital Markets Research

Blue Book to Square the Circle

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PSNB £40bn below forecast: my observation last week that PSNB in 2010-11 came in some way below successive forecasts from HMT and the OBR and £40bn below what HMT expected less than two years ago had not, it seems, been picked up elsewhere. This week I show that there was no one obvious factor or group of factors that explain the improvement. Rather there were successive upward revisions to most of the main categories of receipts and similar downward revisions to the main items of expenditure. Policy can explain only a small part of the improvement, the bulk of which is due to forecast error. One possibility is that back in 2009 HMT (by then under Alistair Darling) was deliberately cautious (seeking to compensate for the over-optimism of the Brown era) and that it and the OBR have spent the last two years in catch-up mode.

Blue Book to revise up GDP: if HMT made the strategic decision to be cautiously pessimistic, it is not obvious in the GDP forecasts (real and nominal) which have been very much on track over the last two years. An alternative explanation is that the ONS estimates of GDP have been consistently too low. The long-awaited and much-delayed 2011 Blue Book due out next Wednesday will include some important methodological changes, the chief of which will be a move from the RPI to the CPI for most of the deflators. If, as seems likely, that gives less inflation then, for a given nominal GDP, it will give more real GDP. This would help explain not just the trends in the public finances but also why employment has held up relatively well over the last two years (productivity has not been nearly as poor as the earlier estimates suggested). If that is the case, my original cynicism will after all be justified: the HMT/OBR line-by-line methodology really does give accurate forecasts for the public finances contingent on a GDP forecast that is inevitably going to be wrong – eventually.

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PSNB £40bn below forecast

My observation last week that PSNB in 2010-11 came in £40bn below the Treasury's most pessimistic forecast had not apparently been picked up elsewhere and, for that reason, came as a surprise to most commentators. It merits a more detailed look.

At the time of the 2009 PBR the Treasury forecast was for PSNB to peak at £177.6bn (12.6% of GDP) in 2009-10 and to fall very slightly in 2010-11 to £176.3bn (12%). In the March 2010 Budget, which announced tax cuts in 2010-11 worth £1.4bn, the forecasts for both 2009-10 and 2010-11 were revised down by over £10bn (nearly 1% of GDP). In the emergency Budget which followed the May 2010 election George Osborne introduced measures to cut borrowing by just over £8bn in 2010-11. A hike in Vat to 20% in January 2011 was expected to raise nearly £3bn with cuts in public spending worth another £5bn.

The newly-formed OBR had already lowered the 2010-11 forecast to £155bn (10.5% of GDP) in its pre-Budget forecast. It lowered it again when it took on board the Budget measures but still had to make further modest downward adjustments in November and again in March 2011 (Table 1). Even then after five successive downward revisions it was too pessimistic – on the latest ONS estimates the 2010-11 PSNB was £136.7bn (9.3% of GDP), nearly £40bn (2.7% of GDP) below where the Treasury started less than two years ago.

Table 1 PSNB forecasts

	2009-10		2010-11	
	£bn	% GDP	£bn	% GDP
2009 PBR	177.6	12.6	176.3	12.0
2010 March Budget	166.6	11.8	163.2	11.1
2010 June pre-Budget	156.1	11.1	155.0	10.5
2010 June Budget	154.7	11.0	149.1	10.1
2010 November EFO	156.0	11.1	148.5	10.1
2011 March Budget	156.4	11.1	145.9	9.9
Latest ONS data	154.5	11.1	136.7	9.3

Source: HMT, OBR, ONS

As I observed last week, the PSNB undershoot owes nothing to the GDP forecast which, with the exception of the November 2010 EFO forecast has changed little over the last two years (Table 2). Nor does it owe very much to policy changes which were worth less than £7bn in aggregate (Alistair Darling's £1.4bn fiscal loosening and George Osborne's £8.1bn tightening). So where does it come from?

Table 2: GDP

	2009-10		2010-11	
	real %	nominal £bn	real %	nominal £bn
2009 PBR	-3.5	1409	2.0	1472
2010 March Budget	-3.8	1406	2.0	1464
2010 June pre-Budget	-3.7	1408	2.1	1476
2010 June Budget	-3.7	1408	1.8	1474
2010 November EFO	-3.7	1403	2.5	1483
2011 March Budget	-3.6	1405	1.9	1473
Latest ONS data	-3.6	1404	1.8	1472

Source: HMT, OBR, ONS

Nearly all of the total reduction in PSNB (£39.6bn) comes from the current budget (£38.7bn), very little from net investment (£0.9bn). Note that the reduction in the structural budget is considerably less than the cash budget as a result of the OBR taking a gloomier view of the output gap than the Treasury. This can be seen in the June 2010 pre-Budget forecast which lowered the cash numbers but raised the structural numbers (Table 3).

Table 3: Breakdown of 2010-11 PSNB forecasts

	Current budget			PSNB		
	£bn	% GDP	structural	£bn	% GDP	structural
2009 PBR	-136.8	-9.1	-5.4	176.3	12.0	8.0
2010 March Budget	-123.6	-8.3	-4.6	163.2	11.1	7.3
2010 June pre-Budget	-114.0	-7.7	-5.2	155.0	10.5	8.0
2010 June Budget	-110.2	-7.5	-4.8	149.1	10.1	7.4
2010 November EFO	-106.2	-7.6	-4.7	148.5	10.1	7.6
2011 March Budget	-104.8	-7.6	-4.6	145.9	9.9	7.4
Latest ONS data	-98.1	-6.7		136.7	9.3	

Source: HMT, OBR, ONS

The reduction in the current budget deficit owes slightly more to receipts (£21.5bn) than to expenditure (£17.6bn). Some of the improvement stems from the June 2010 Budget hike in Vat (£2.9bn) and the post-election cuts in spending (£5.2bn), though again what is notable is that receipts were revised up and expenditure down in every forecast (bar one) over the last two years (Table 4).

Table 4 Current budget forecasts

2010-11, £bn	Receipts	Expenditure	Depreciation	Current	Net investment	PSNB
2009 PBR	530.3	647.1	20.1	-136.8	39.5	176.3
2010 March Budget	540.8	644.0	20.5	-123.6	39.6	163.2
2010 June pre-Budget	546.4	639.8	20.6	-114.0	41.0	155.0
2010 June Budget	547.7	637.3	20.6	-110.2	38.9	149.1
2010 November EFO	549.7	635.4	20.5	-106.2	42.3	148.5
2011 March Budget	548.5	632.8	20.5	-104.8	41.1	145.9
Latest ONS data	551.8	629.5	20.4	-98.1	38.6	136.7

Source: HMT, OBR, ONS

A breakdown in the receipts forecast shows a similar pattern across most of the main categories (Table 5). Taxes on income & wealth and on production & imports (which includes Vat) have been revised up on almost every occasion (and in the case of the latter by far more than the Vat hike).

Table 5: Receipts forecasts

2010-11, £bn	Taxes on income & wealth	Taxes on production & imports	Other taxes	Compulsory social contributions	Gross operating surplus	Total
2009 PBR	184.5	180.0	37.7	97.2	24.1	530.3
2010 March Budget	189.1	185.5	37.7	97.5	24.8	540.8
2010 June Budget	192.4	188.8	36.9	98.7	24.7	547.7
2010 November EFO	193.2	191.3	37.3	98.5	23.8	549.7
2011 March Budget	193.8	191.6	37.2	96.5	24.5	549.7
Latest ONS data	196.6	190.9	37.3	97.7	25.1	551.8

Source: HMT, OBR, ONS

The successive downgrades to the expenditure forecast are principally to expenditure on current goods & services (£15.5bn) and, as a result of the dramatic fall in gilt yields, to interest payments (£2.2bn, Table 6).

Table 6: Expenditure forecasts

2010-11, £bn	Current g&s	Subsidies	Social benefits	Current grants	Interest & dividends	Expenditure
2009 PBR	351.3	9.4	194.0	45.1	45.4	647.1
2010 March Budget	350.5	10.2	196.4	43.4	42.5	644.0
2010 June Budget	346.8	9.5	194.5	42.4	44.2	637.3
2010 November EFO	342.9	9.5	195.3	44.2	43.5	635.4
2011 March Budget	339.4	9.4	194.3	46.0	43.9	635.4
Latest ONS data	335.8	9.5	196.3	44.6	43.2	629.5

Source: HMT, OBR, ONS

If the data are expressed as a share of nominal GDP (which has changed little over the last two years), then receipts and expenditure have contributed more or less equally to the reduction in the deficit – receipts have risen 1.4pp and expenditure has fallen by 1.3pp (Table 7).

Table 7: Public finances forecasts

% GDP	Dec09	Mar10	Jun10	Jun10	Nov10	Mar11	ONS
Current budget							
Current receipts	36.0	36.9	37.1	37.2	37.3	37.2	37.4
Current expenditure	44.0	44.0	43.4	43.2	43.1	42.9	42.7
Depreciation	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Surplus on current budget	-9.3	-8.4	-7.7	-7.5	-7.2	-7.1	-6.7
Capital budget							
Gross investment	4.0	4.1	4.2	4.0	4.3	4.2	4.0
Depreciation	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4
Net investment	2.7	2.7	2.8	2.6	2.9	2.8	2.6
Net borrowing	12.0	11.1	10.5	10.1	10.1	9.9	9.3

Source: HMT, OBR, ONS

Last week I concluded that, for all the rigour of its line-by-line analysis of the public finances, and despite very good forecasts of GDP (both real and nominal), the forecasts for the public finances were seriously awry. This week I show that there is no one explanation for this, rather that most of the major categories of tax receipts have been consistently understated and expenditure overstated. The explanation might be that the Treasury and the OBR have just been playing catch-up (having started off way too pessimistic, they have been gradually adjusting the forecast to what has really been happening). Or, I would suggest, there might be something else going on.

The 2011 Blue Book

Next week (Wednesday) sees the long-awaited and much-delayed 2011 Blue Book and the Q2 national accounts with the expenditure breakdown that was missing from the August release. In addition to the usual rebasing of the national accounts (to 2008) and the incorporation of the 2007 Standard Industrial Classification, the 2011 Blue Book will take on board rather more methodological changes than usual. Chief of these is a new consistent approach to deflation in the national accounts which sees the CPI replace the RPI as the key deflator in many areas.

Ahead of the publication of the Blue Book the ONS is cagey on what the effects of the RPI-CPI switch will be though in a paper released today it acknowledges that, since CPI inflation is typically lower than RPI inflation, we might expect to get more real GDP for a given level of nominal GDP¹. If that is what happens – and the ONS points out that a whole host of other changes will be made at the same time – it will square a number of circles, most obviously the relatively modest effect on employment compared with the much larger fall in GDP that we saw in the recession that followed the financial crisis and the scarcely credible path for productivity that resulted. (If that is what happens it will be the mirror image of the US where the first estimates showed employment falling much faster than GDP so that

¹ ‘The basic theory and expected impact of changing the basis of the prices previously used (RPI) to using price changes from the CPI is that it will raise volume GDP ... However, a number of additional changes are being made alongside the change to deflator that will impact on the estimates.’ Methods Changes in the 2011 Blue Book, 29 September

productivity rose rapidly, and the most recent estimates which show a far weaker recovery in GDP and productivity.)

If we do get an upward revision to GDP, it might help to explain why tax receipts in particular and public spending to a lesser extent have been better than forecast (any revisions to nominal GDP are also potentially significant). In which case my original cynicism might have to be re-instated – the Treasury/OBR forecasting methodology really does give good predictions for the public finances contingent on a GDP forecast which is always going to be wrong – even if it does take the ONS two or three years to come up with the ‘right’ numbers for GDP.

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