



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



The Pre-Budget Report: primarily a political exercise?

This week's Pre-Budget Report (PBR) could have more political than fiscal or economic significance. Whilst there is room in the electoral timetable for a March (or even April) 2010 Budget, such an event would be before a rapidly approaching a general election (assuming this occurs in May or June 2010 and not before) which implies that the Government is likely to use the PBR for setting the economic battle-lines for the next election rather than wait until the Budget.

The present parliament, which first met on 11 May 2005, will expire at midnight on 10 May 2010. If a proclamation summoning a new Parliament is made on 10 May 2010 (the last possible date) the date of the general election would almost certainly be Thursday 3 June 2010. A proclamation could, of course, be made before 10 May and an election could be held in, for example, March or, much more likely, Thursday 6 May – the date of the local elections.¹

The economic background

Even though the PBR could be very political, it will of course contain valuable economic commentary. The economic background to the PBR is one of slow improvement. The rate of decline of GDP has decelerated rapidly and there is the strong possibility of modest growth being recorded for the 4th quarter of 2009.

The 4th quarter figure will also be helped by spending brought forward ahead of the VAT rise from 15% to 17.5% on 1 January 2010 – assuming the Chancellor does not change the timing of the VAT rate increase in the PBR. The stamp duty threshold for property, currently at £175,000, will also revert to £125,000 at the end of this year. And the car scrappage scheme has helped the recovery in car sales. But this is due to expire, on current policy, in February 2010 – budget permitting. The changes in these three policy areas could undermine growth in the 1st and 2nd quarters of 2010.

There is also potentially better news about 3rd quarter 2009 GDP, which was revised recently to show a quarterly fall of 0.3% compared with the original decline of 0.4%.² Very recent data on construction output, where a 3rd quarter fall of 1.1% was revised to show a 2% rise, is positive and when the next estimate for GDP is released on 22 December, it could show a fall of only 0.1% or 0.2% though there may be revisions downward so caution is advisable.³

Growth should pick up modestly as 2010 proceeds, aided by recovery in some of Britain's main markets and the expansionary impact of the Bank of England's very slack monetary policy. Indeed the Bank released a sanguine set of forecasts at the time of its latest *Inflation Report*⁴, which, on current policies, showed GDP growth around 4% by the second half of 2010 and for much of 2011. If, however, any incoming Government tightened fiscal policy sharply in the second half of 2010 this would have a negative impact on growth for this period. But at the present juncture it is impossible to second-guess fiscal decisions made by a new Government – especially as they will be partly determined by the state of the economy at the time.

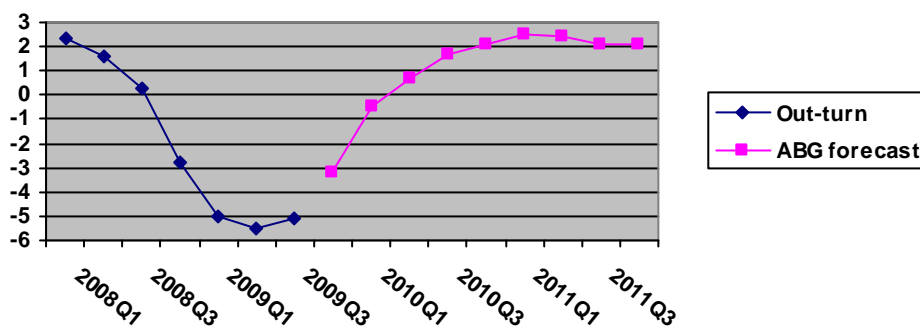
In his Budget speech the Chancellor forecast a decline in GDP of 3½% for 2009 followed by modest growth in 2010 and above-trend growth in 2011.⁵ We are currently forecasting a fall of about 4¾% in 2009 followed by 1% growth for 2010 and 2¼% for 2011, making a working assumption that fiscal tightening, principally in the form of additional spending restraints, starts biting in 2011Q2. But clearly much will depend on the degree and timing of fiscal tightening. We expect the Chancellor to concede that GDP fell by around 4¾% in 2009 in the PBR and then stick to his forecast of growth of 1 to 1½% for 2010 and 3¼% to 3¾% for 2011.

GDP and CPI forecasts (year-on-year, %)

	2008	2009	2010	2011
Budget 2009:				
GDP growth	%	-3 ¾ to -3 ¼	1 to 1 ½	3 ¼ to 3 ¾
CPI inflation (Q4)	4	1	1	2 ¼
Current consensus forecasts:				
GDP growth	0.6	-4.5	1.2	Na
CPI inflation (annual data)	3.6	2.1	2.0	Na
Current ABG forecast:				
GDP growth	0.6	-4.8	1.0	2.3
CPI inflation (Q4)	3.9	1.8	1.8	1.9

Sources: (i) HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009; (ii) *Consensus Forecasts*, Survey date 9 November 2009, Consensus Economics.

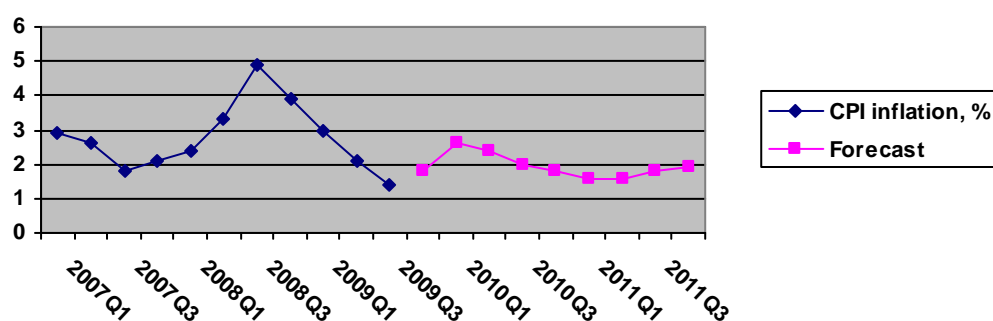
Chart 1 ABG GDP forecast, year-on-year growth rates (%)



Source of data up to 2009Q3: ONS, "UK output, income and expenditure, 3rd quarter 2009", 25 November 2009.

Inflation remains relatively subdued, even though running higher than the Budget forecast partly reflecting the impact of sterling's past depreciation. It should moreover remain subdued over the forecast period given the degree of spare capacity in the economy. There will however be a sharp blip upwards early in 2010 primarily reflecting the reversal of the VAT reduction. The 12-month inflation rate of CPI was reduced by about 0.5% in December 2008 as a result of the VAT reduction being passed on to consumers.⁶

Chart 2 ABG CPI annual inflation forecast, %



Sources: ONS for back data and ABG forecast assuming no change in tax policies, except those already announced.

The public finances: latest data

In the 2009 Budget the Chancellor forecast public borrowing of £175bn for FY2009. The data on the public finances so far released (to October) suggest that this forecast, if anything, was an underestimate.⁷ It is widely expected that total borrowing for FY2009 could be nearer to £180bn.

Public Sector Net Borrowing (PSNB) in October was £11.4bn. In most years, the Government is a net lender, rather than a borrower, in October because October is one of the four months when a significant proportion of Corporation Tax (CT) receipts are received. But in October 2009 cash receipts of CT were a precipitous 25% lower than a year earlier. The shortfall in CT receipts is one of the main factors, along with lower VAT receipts, contributing to the continuing weakness of tax revenues whilst government spending continues to grow strongly.

Government finances: comparisons with a year earlier

	October 2009	Cumulative April to October 2009	Budget projections for FY2009
Public sector:			
Current budget (£bn)	-£7.7bn	-£68.2bn	-£132bn
PSNB (£bn)	£11.4bn	£86.9bn	£175bn
Central government:			
Current receipts (% change)	-9.1%	-10.0%	-7.8%
Current spending (% change)	+10.2%	+6.0%	+7.5%

Sources: ONS press release on the Public Finances and "The IFS analysis of today's public finance figures", 19 November 2009, www.ifs.org.uk

Borrowing and the squeeze on spending

One of the key parts of the PBR concerns the public borrowing data. In the Budget the Chancellor announced a PSNB of £175bn for FY2009, over 12% of GDP, which then declined to £97bn, some 5.5% of GDP, by FY2013. Borrowing as a % of GDP would therefore more than halve after 4 years. The current deficit was forecast to be £132bn in FY2009, nearly halving in absolute terms to £74bn by FY2013.

As we have discussed before, the deficit reduction trajectory shown in the Budget involves a considerable squeeze on spending.⁸ In September the Treasury released (leaked?) the figures for the main components of public spending for the years FY2011 to FY2013. According to IFS director Robert Chote the Treasury expected debt interest payments would increase by 11.1% a year, social security costs by 1.4% a year and "other AME" (including public sector pension payments and contributions to the EU) by 3.1% a year. Taking these AME (Annually Managed Expenditure) components into account left total spending for the departments falling by 2.9% a year (real terms) or 8.6% in total for the three years cumulatively (real terms).⁹ In cash terms budgets would be effectively unchanged year-on-year. In other words, departments would be facing a "flat cash" situation.

This “flat cash” situation will place considerable spending pressures on departments – even without any further fiscal tightening. It is expected that the Chancellor will make detailed statements in the PBR about protecting “frontline” services such as patient care, classroom teaching and policing – partly in an attempt to put “clear blue water” between the Labour Government and the Conservative Opposition - while pushing forward with tough cuts to other departmental budgets. By setting out “frontline” areas of spending to be protected in the coming squeeze the Chancellor will, in effect, be saying that other areas are fair game.

In addition, there is speculation that:

- The pay bill of senior civil servants will be cut by 20% over 3 years.
- Efficiency savings will be increased from previous Budget plans of £9bn to £12bn.

No further tightening

There is the possibility that the Chancellor could announce further spending restraints, as many have called for in order to keep the markets on side. The Governor of the Bank of England for example recently called for a more rapid path of fiscal consolidation than that envisaged at the time of the Budget or risk endangering the UK’s credit rating.^{10, 11}

But any further major spending curbs seem unlikely in the PBR and it is widely expected that the Budget will be broadly neutral with extra revenue from a few tax measures (see below) allocated to, say, spending on “green” technology and possibly an extra £1bn on the “jobs guarantee” programme for young people. Any further major fiscal consolidation will in other words almost certainly be deferred.¹²

Under these circumstances we do not expect the Chancellor to radically alter his projections for the public sector finances, which we show in the table below. As already indicated it is widely expected the FY2009 PSNB forecast will be revised up – to say £180bn.

Public sector finances: projections for the Budget and the PBR

	FY2009	FY2010	FY2011	FY2012	FY2013
2009 Budget:					
Current Budget (£bn)	-132	-137	-111	-91	-74
PSNB (£bn)	175	173	140	118	97
PSNB (% of GDP)	12.4%	11.9%	9.1%	7.2%	5.5%
2009 PBR, ABG expectation of official forecast:					
Current Budget (£bn)	-140	-140	-120	-95	-74
PSNB (£bn)	180	175	145	120	95

Sources: HM Treasury, *Budget 2009, Building Britain’s future*, HC407, April 2009 and author’s forecasts.

PBR: possible tax measures

There is much speculation that the Chancellor will use the PBR in order to put “clear blue water” between the Labour Government and the Conservative Opposition by raising taxes on the rich thus setting battle-lines for the general election. There are fears of a “soak the rich budget”, as part of the Government’s “class war” declaration, with the emphasis on IHT and taxing bankers’ bonuses.

The key speculations include:

- There could be a windfall tax on bankers’ bonuses or, if a windfall tax is not introduced, measures to clamp down on tax avoidance schemes that shield bonuses. Alternatively there may be an employers’ National Insurance charge for banks that pay big bonuses or even a direct windfall tax on the profits of investment banks.
- The planned increase in the threshold for IHT from £325,000 to £350,000 (double for couples) could be frozen. Alternatively IHT rates could be increased for large estates.
- The Chancellor is expected to confirm the increase in the top income tax rate to 50% for incomes over £150,000 from April 2010 and the restrictions in income tax personal allowances for those on more than £100,000.

- Even though there is some speculation that the reversal in the VAT rate to 17.5% will be postponed, this is unlikely.
- Despite the gap between the 18% Capital Gains Tax rate and the 50% higher income tax rate, it is thought unlikely that the Chancellor will increase the CGT rate in the PBR. But this issue may be returned to in the Budget.

Fiscal policy: other considerations

There are at least three other policy initiatives that are likely to be included in the PBR.

The first concerns the Fiscal Responsibility Bill, which was originally announced in the Queen's Speech of 18 November, and is intended to boost credibility in the markets. The purpose of the Bill is to put the Government's deficit reduction plan on a statutory footing, in order to halve the deficit over four years and put debt on a sustainable path in the medium term. The Chancellor will set out full details in the PBR, alongside his fiscal forecast. The Bill has been widely criticised on at least three grounds.¹³ Firstly, it assumes a government can precisely forecast and target the budget deficit, which is clearly nonsense. Secondly, if there is a shock to the economy it may not be economically sensible to reduce the deficit quickly, even though this may be a legal requirement under a Fiscal Responsibility Act. And, thirdly, if it is necessary to temporarily run wider budget deficits, then fiscal rules will inevitably be eased, so the supposed legal sanction lacks credibility to start with. The rewriting and eventual suspension of Gordon Brown's "golden rule" and "sustainable investment rule" are only too fresh in the memory.

The second relates to the provision for banking sector losses. It is speculated that the Treasury will revise down its provision from the Budget estimate of £20-50bn to "below £10bn", which is currently estimated to be broadly the difference between the market value of the Government's shareholdings in the banks and the higher price they initially paid.¹⁴

Finally, a paper on long-term fiscal challenges will accompany the shorter-term forecasts in the PBR. The paper is intended to focus on the risks faced by Britain unless radical actions are contemplated such as increasing the retirement age or cutting back on free healthcare provision.^{15,16}

References

1. House of Commons Library, "Election Timetables", research paper 07/31, March 2007.
2. ONS, "UK output, income and expenditure, 3rd quarter 2009", 25 November 2009.
3. ONS, "Output in the construction industry, 3rd quarter 2009", 4 December 2009.
4. Bank of England, *Inflation Report*, November 2009.
5. HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009.
6. ONS, "VAT cut took 0.5 points off CPI rate in December", 11 August 2009.
7. ONS, "Public sector finances, October 2009", 19 November 2009.
8. Ruth Lea, "Spending cuts: a necessary and painful debate begins", Arbuthnot Banking Group Perspective, 21 September 2009
9. Robert Chote, "The black hole is even deeper than I thought", *The Times*, 17 September 2009. Chote had originally estimated annual falls of 2.3% rather than 2.9%.
10. George Parker and Chris Giles, "King warns of risk to credit rating", *FT*, 25 November 2009.
11. See also Ruth Lea, "Of course there will have to be public spending cuts: and big ones at that", Arbuthnot Banking Group Perspective, 6 July 2009.
12. George Parker & Chris Giles, "Darling to defer moves to cut deficit", *FT*, 4 December 2009.
13. Times leader, "Fiscal fantasies", 3 December 2009.
14. Chris Giles, "Treasury to slash banking loss provision", *FT*, 5 December 2009.
15. Ruth Lea, "There's worse to come as we all get older", *Spectator*, 24 October 2009.
16. Ruth Lea, "The public finances are shocking – but an ageing population means there is worse to come", Arbuthnot Banking Group perspective, 19 October 2009.