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A "game-changing" Budget: the most important for a generation

Introduction: a "game-changing" Budget

Even though the March 1981 Budget was delivered in the depths of the early-1980s recession, it was tough and contained plans to cut public sector borrowing by some £3.3bn, mainly by increasing taxes. 364 university economists famously wrote to complain about the tightness of macroeconomic policy. In fact, though it was not clear at the time, the 1981 budget marked the beginning of Britain's long economic upturn of the 1980s, which lasted until early-1990s. Far from deepening the depression, the Budget signalled the start of the recovery - though it should be noted that a 2% cut in interest rates and a weakening of the currency helped the recovery along. The 1981 Budget has gone down in history as a "game-changing" Budget.

There have been other important Budgets since. Notably Norman Lamont's tax-raising 1993 Budget, which repaired the damaged public sector balance sheet in the wake of the early-1990s recession, and Gordon Brown's 2000 Budget, in which he turned on the spending taps and thus undermined his claim to fiscal prudence.

As in 1981 this week's Budget will surely also prove to be a "game-changing" Budget. It will be the most important for a generation. George Osborne will have to show that he is determined to tackle the debt mountain bequeathed to him by the previous Government. As former Chief Secretary to the Treasury Liam Byrne wrote to his immediate successor (David Laws) "Dear Chief Secretary, I'm afraid to tell you there's no money left." It was certainly honest if a tad unhelpful. In fact the situation is worse than this. Not only is there "no money left" but the Chancellor has inherited a hefty structural deficit. Liam Byrne's letter recalls a similar note left by Conservative Chancellor Reginald Maudling to his Labour successor James Callaghan in 1964: "Good luck, old cock ... Sorry to leave it in such a mess."

The Chancellor will have to tackle the debt mountain because, quite simply, the British Government is on probation with the financial markets. The markets, which lend the Government one pound for every four it spends, expect no less than this. If the Government does not deliver, then interest rates will rise, borrowing will become more expensive and growth will be undermined. And this assumes there will not be a major crisis of confidence in Britain's sovereign debt. The issue facing the country is not so much a matter of whether big deficit cuts will wreck the recovery, as some claim. The issue is whether our huge, unsustainable public sector deficits will wreck confidence in British sovereign debt. The grim situation in countries like Greece, Spain and Portugal surely focuses minds on this score.

The OBR's Pre-Budget economic forecast

The economic forecast underpins all Budget statements. This time there is the recently released forecast from the newly established Office for Budget Responsibility (OBR) as the starting point.[1,2] The OBR's approach to the forecast contained several innovations, including the introduction of "Bank of England style" probability fan charts around a central estimate for GDP growth and borrowing. The publication of ranges for GDP growth was dropped.

The OBR's forecast was based on refreshingly transparent assumptions and estimates, notably:

- It incorporated the fiscal decisions of the Labour government but did not allow for the £6bn of spending cuts for FY2010. It also made no allowance for any spending cuts and/or tax rises that will be announced in the Budget.
- There were downward revisions to the estimate "output gap" (a measure of spare capacity in the economy) for end-2009, from 6¼% of GDP to 4% of GDP, and to the trend rate of growth from 2.75% to 2.35% (2010-2013) and 2.1% (2014). These downgrades reflect the OBR's assessment of the damaging impact of the financial crisis on the economy's capacity and ability to grow. They are major factors behind the downgrade to the growth forecasts.
- Short-term and long-term interest rates were assumed to move in line with market expectations – though it should be noted that current market expectations may have already priced in a tough budget and therefore be lower than otherwise would have been the case. The forecast was, therefore, "biased towards optimism".
- Equity prices are assumed to rise in line with nominal growth and ignore the possibility of a Black Monday style crash. Exchange rates are based on comparative interest rates. Oil prices are based on information from the futures markets. And credit conditions are assumed to continue improving throughout 2010.
- World GDP growth is expected to be 4% in 2010 and pick-up slightly to the long-run average rate of 4.5% by the end of the forecast. UK export markets are forecast to grow by 4% in 2010, 4¾% in 2011 and close to the long-run average of 6½% thereafter.
- Employment is projected to stabilise in 2010 and start rising in 2011. The ILO unemployment count is expected to peak at 8% in 2010 and fall over the forecast period to just over 6% in 2014. These projections were more optimistic than the assumptions used for the March Budget.

Table 1 shows the OBR's GDP forecast, including the downgrade to growth compared with the March Budget.

Table 1 March Budget GDP forecast, OBR's central forecast for GDP and components

	2009	2010	2011	2012	2013	2014
March Budget forecast:						
GDP (YOY, %)	-5	1 to 1½	3 to 3½	3¼ to 3¾	3¼ to 3¾	3¼ to 3¾
OBR June forecast:						
GDP (YOY, %)	-4.9	1.3	2.6	2.8	2.8	2.6
Components (YOY, %):						
Household consumption	-3.2	0.4	1.6	1.8	2.0	2.0
Business investment	-19.3	1.3	8.0	9.7	10.6	9.1
General Government consumption	2.2	1.9	-0.5	-1.5	-2.0	-2.3
General Government investment	15.7	-3.1	-19.0	-8.5	-6.6	0.6
Net trade (see note below)	0.7	-0.5	0.7	0.8	0.6	0.5
Inflation (Q4, YOY, %)	2.1	2.3	1.6	2.0	2.0	2.0
ILO unemployment rate (%)	7.6	8.1	7.9	7.4	6.8	6.3

Sources: (i) HM Treasury, *Budget 2010: securing the recovery*, March 2010, (ii) Office for Budget Responsibility, *Pre-Budget Forecast June 2010*, table 3.1. Note that the data for net trade refer to its contribution to GDP (% points).

Even though the OBR forecast contains a downgrade to GDP growth, we believe there are risks on the downside in addition to the OBR's caveat about interest rates (see above):

- In particular business investment is expected to grow strongly from 2011, though "only" returning to its "pre-recession peak" in 2013. However, with surplus spare capacity forecast to remain in the economy (the output gap is still expected to be 1% of GDP by the end of the forecasting period), it is not clear why businesses would want to step up their investment spending to match, even by 2013, this "pre-recession peak". The forecast looks optimistic.
- Similarly the net exports forecast, incorporating an "export led boom", could be over-optimistic if the OBR's growth forecast for British export markets, uncomfortably reliant on the fortunes of the eurozone, are undershot.

The OBR's borrowing forecasts and fiscal retrenchment
Despite the downgrade to the GDP growth forecasts, the actual borrowing projections were marginally better than in the March Budget. (The structural projections were however slightly worse.) There were savings on spending, partly reflecting more optimistic unemployment forecasts, but these were partly offset by lower receipts.

Some taxes were expected to perform better than at the time of the Budget (notably VAT and corporation tax) but others were projected to perform worse (including CGT, council tax and income taxes). The poor performance of CGT specifically casts doubt on the notion that the likely hike in the CGT rate will raise enough extra revenue to significantly contribute to the funding of higher income tax thresholds – a key LibDem policy.

Table 2 March Budget and OBR projections for Public Sector Net Borrowing (PSNB)

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
March Budget:						
PSNB (£bn)	167	163	131	110	89	74
PSNB (% of GDP)	11.8	11.1	8.5	6.8	5.2	4.0
Cyclically adjsted PSNB (% of GDP)	8.4	7.3	5.3	4.1	3.1	2.5
OBR June forecast:						
PSNB (£bn)	156	155	127	106	85	71
PSNB (% of GDP)	11.1	10.5	8.3	6.6	5.0	3.9
Cyclically adjusted PSNB (% of GDP)	8.8	8.0	6.1	4.7	3.5	2.8
Nominal GDP (£bn)	1408	1476	1538	1620	1710	1802
Cyclically adjusted, structural PSNB (£bn)	124	118	94	76	60	50
Cyclical element of PSNB	32	37	33	30	25	21

Sources: (i) Office for Budget Responsibility, *Pre-Budget Forecast June 2010*, table 4.5, (ii) author's calculations for the cyclically adjusted PSNB (£bn) and the cyclical element of the PSNB.

As we have discussed in a previous Perspective the Chancellor will probably aim to eliminate the bulk, if not all, of the structural deficit by FY2014 – in other words, by the end of the current Parliament if it survives 5 years.[3] The urgency and necessity of implementing tough policies was reinforced by a recent comment from the Credit Ratings Agency Fitch. Fitch stated that for Britain to retain its "triple A" sovereign credit rating, the deficit reduction profile (borrowing as a % of GDP) should be at least 1% lower than in March Budget.[4] The Treasury endorsed Fitch's comments.

In the following scenario, shown in table 3 and chart 1, the following assumptions have been made:
- The Chancellor will stick to the OBR's forecasts as the basis for his projections.
- The structural deficit is completely eliminated by FY2014, but not the cyclical element. This amounts to a deficit of £21bn in FY2014, some £50bn lower than in the OBR June forecast. This scenario may be regarded as the upper limit of what the Chancellor will do.

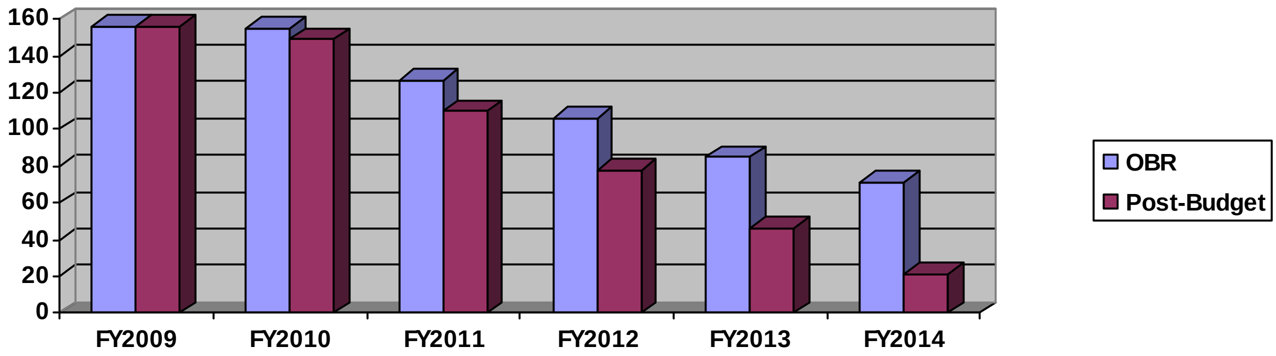
- Given the £6bn of cuts announced for FY2010 the Chancellor will do little more for this financial year. The focus of the Budget will be on FY2011 to FY2014.
- The £6bn of cuts is extrapolated forward over the forecasting period.
- About three quarters of the fiscal retrenchment will come from spending cuts and about a quarter from higher (net) taxes. [5] Overall this suggests that spending needs to be about £37bn lower in FY2014 than currently planned and (net) taxes need to be about £13bn higher.
- The scenario below is mechanistic and does not allow for any feedback processes. For example reductions in GDP, following fiscal retrenchment, which will in turn have implications for the public finances.

Table 3 Possible deficit reduction scenario, cumulative data, £bn

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
PSNB (% of GDP in brackets):						
March Budget	167 (11.8)	163 (11.1)	131 (8.5)	110 (6.8)	89 (5.2)	74 (4.0)
OBR June forecast	156 (11.1)	155 (10.5)	127 (8.3)	106 (6.6)	85 (5.0)	71 (3.9)
Targeted PSNB, interpolated	156 (11.1)	149 (10.1)	110 (7.2)	78 (4.8)	46 (2.7)	21 (1.1)
Deficit “cuts”:						
PSNB “cuts”, cumulative	0	6	17	28	39	50
PSNB “cuts”, annual increase (% of GDP in brackets)	0	6 (0.4)	11 (0.7)	11 (0.7)	11 (0.65)	11 (0.6)
Of which (annual increase in brackets):						
Spending cuts (¾)	0	6	13 (+7)	21 (+8)	29 (+8)	37 (+8)
Net tax rises (¼)	0	0	4 (+4)	7 (+3)	10 (+3)	13 (+3)
Total Managed Expenditure (TME):						
TME, June OBR	671	701	709	726	744	767
TME after “spending cuts”	671	695 (-6)	696 (-13)	705 (-21)	715 (-29)	730 (-37)
Memorandum (annual increase in brackets):						
Spending cuts, announced May 2010	0	6	6 (0)	6 (0)	6 (0)	6 (0)
Additional spending “cuts”	0	0	7 (+7)	15 (+8)	23 (+8)	31 (+8)

Source: Office for Budget Responsibility, *Pre-Budget Forecast June 2010*, table 4.8 (TME).

Chart 1 Public sector net borrowing, £bn, OBR forecast and possible post-Budget trajectory



Possible spending announcements

Even though the detailed departmental expenditure plans will not be available until autumn,[6] the Chancellor will make some announcements concerning spending in the Budget. They are likely to include:

- Possible cuts and freezes to public sector pay and pensions. Before the election the Conservatives pledged to freeze the pay for a year for those earning more than £18,000.
- Probable cuts to child tax credit for middle income earners. This is currently paid to families with incomes of up to £58,000, or £66,000 if the child is under the age of one.
- Possible cuts to pensioners' "freebies" such as winter fuel payments.
- In addition, there may be an announcement concerning changes to the retirement age. The state pension age is already scheduled to rise to 66 between 2024 and 2026, eventually rising to 68 by 2046 for both men and women.
- There is, however, a Coalition pledge to restore the earnings link for the basic state pension from April 2011, with a "triple guarantee" that pensions are raised by the higher of earnings, prices or 2.5%.

Possible tax announcements

Though most of the deficit reduction programme is expected to rely on spending cuts, nevertheless there will surely be (net) tax hikes. In the list below some are pledges, whilst some are speculative:

- VAT: a possible rise in the standard rate of VAT. An increase of 1 percentage point would raise £4.5bn in FY2011.[7] An increase in the rate from 17.5% to 20% would raise £11.25bn.
- The probable introduction of a levy on banks to raise at least £1bn and possibly as high as £3bn. The levy may possibly be on banks' wholesale funded assets rather than on profits. The revenues will probably go into the central budget rather than be set aside in a resolution fund for future bank failures.
- There is Coalition pledge to increase the personal allowance for income tax from the current £6,475, to help lower and middle income earners, with a target of £10,000. A substantial increase in the personal allowance from April 2011 will probably be announced. The cost is planned to be partly funded by the revenues from the increased CGT rates for non-business assets (though this could fall below expectations, as already discussed).[8]
- The CGT rate for non-business assets will almost certainly rise to "rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities" – probably to 40%. There may be the reintroduction of indexation and tapering and generous concessions for those nearing retirement.
- The planned 1% increase in employees' NIC rates will go ahead in April 2011, and there will be no change in thresholds. The planned 1% increase in employers' NI rates will also go ahead in April 2011, but it will be partly offset by an increase the threshold.[9]
- A possible "regional" cut in employers' NICs outside London, the SE and East of England. New businesses would not have to pay employers' NICs for a year on the first 10 people hired. This is expected to be 3-year scheme.
- A possible reduction in the standard rate of corporation tax to boost the competitiveness of the private sector, possibly paid for by cuts in capital allowances, with a plan to cut the rate from the current 28% to 20% (or below) by 2015.

- Simplification of corporate taxes may be part of a more generalised tax simplification programme (long overdue).
- Possible further increases in the "sin" taxes on tobacco and alcohol.
- The possible announcement of the details of a new "per-plane" levy, which may replace the Airport Passenger Duty (which is due to rise in November).
- Possible increases in Insurance Premium Tax.
- Probable freezing of council tax in England for one year.

Fiscal retrenchment: the impact on the economy
If this week's Budget implements the sort of deficit cuts we have outlined above these cuts, at face value, would amount to 0.4% of GDP in FY2010, and 0.6-0.7% from FY2011 to FY2014. (See table 3.) And if there were a straightforward 1:1 impact on growth, then the OBR's GDP forecasts could be expected to be reduced by these magnitudes.[10] But this is most unlikely to happen.

Even though there will be an intitial "hit" on growth of deficit-cutting, the longer-term impact should be advantageous as interest rates can be expected to stay lower for longer (helping to support a competitive currency) which in turn will stimulate the private sector. Moreover, as the size of the public sector shrinks as a proportion of GDP, potential growth should pickup as the more productive and dynamic private sector, no longer "crowded out" by an expanding state, will expand to fill the gap left by the shrinking state.[11] Additionally, policies that may be introduced in this Budget, such as the lower rate of corporation tax, should help business eneterprise and growth.

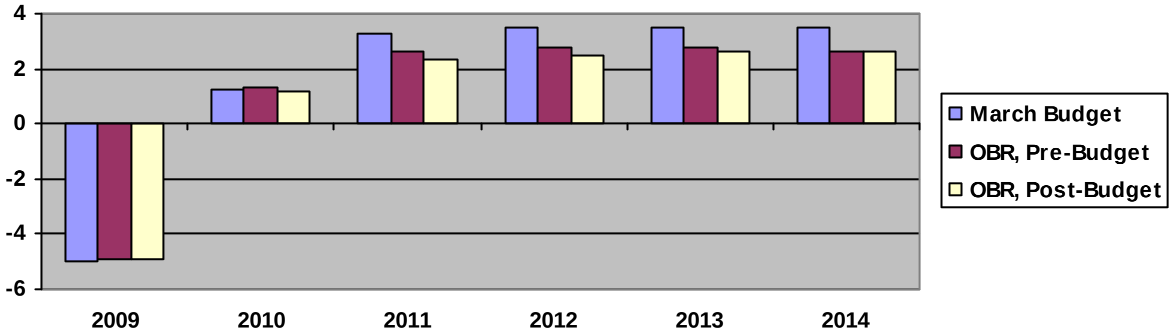
We expect therefore that the OBR Post-Budget forecasts for GDP growth (to be published on Tuesday alongside the Budget), will show a significant "hit" on growth for 2010-2012 but thereafter the "hit" will diminish. Indeed the press have already reported that the OBR will downgrade GDP growth in 2011 ("nearer to 2%") and 2012, but growth in the longer-term will not be undermined by the Budget measures.[12] There is little suggestion that the recovery will be derailed and that the economy will experience a "double dip". But given the initial negative impact on economies of fiscal tightening, a note of caution should be sounded. There is a "speed limit" to the pace of fiscal retrenchment. However, much the Chancellor would like to get most of the "pain" over in the early years of this Parliament for political reasons, he is restrained by the economic consequences of acting "too deeply, too quickly".

The OBR has already warned that forecasting the economic impact of deficit cuts is an uncertain procedure: [13, 14]

- "Another major area of uncertainty is whether, and to what extent, private sector spending and employment are able to fill the gap that the cuts in public spending in our forecast leave."

Uncertainties apart, the OBR's post-Budget GDP forecast could show the following growth rates: 1.2% (2010), 2.3% (2011), 2.5% (2012), 2.6% (2013) and 2.6% (2014). And the following chart shows the comparison of the GDP forecasts for the March Budget, the OBR's Pre-Budget forecast and the OBR's Post-Budget forecast.

Chart 2 GDP forecasts, annual growth (%): comparisons



References

1. Office for Budget Responsibility, *Pre-Budget Forecast June 2010*, available from www.budgetresponsiblity.independent.gov.uk
2. IFS, "OBR sets the scene for a painful Budget", 14 June 2010.
3. Ruth Lea, "Tackling the deficit: an excellent start but there's much to be done", Arbuthnot Banking Group, 7 June 2010.
4. "Fitch says UK fiscal challenge is formidable", *Financial news*, Dow Jones Newswires, 8 June 2010,
5. Before the election, the Conservatives proposed a spending cuts/tax rises ratio of 4/1. The LibDem manifesto suggested a 2½/1 ratio.
6. HM Treasury, "Spending Review 2010 – the Government's approach", press release, 8 June 2010, announced that the autumn Spending Review will set spending limits for every Government department for the period FY2011 to FY2014.
7. HM Treasury and HM Revenue & Customs, *Tax ready reckoner and tax reliefs*, December 2009.
8. HM Government, *The Coalition: our programme for government: freedom, fairness and responsibility*, May 2010.
9. The proposed *National Insurance Contributions Bill*, as mentioned in the Queen's speech.
10. Technically, this refers to the fiscal multiplier, which is the ratio of the change in GDP to an exogenous change in the fiscal deficit (either a change in spending or taxation or both). Different types of multiplier can be used depending on the time period under consideration – eg initial impact, peak or cumulative multipliers. If, for example, public spending increases by £1bn and GDP by the same amount, the multiplier is 1.
11. Ruth Lea, "Tax 'n' spend: No way to run an economy, a paper for the 2004 Spending Review", *Centre for Policy Studies*, 2004 discusses the relationship between large public sectors and growth.
12. David Smith and Iain Dey, "Osborne bashes banks with £3bn assets levy", *Sunday Times*, 20 June 2010. They also report that the OBR is expected to say "that the Chancellor has a better than 50% chance of meeting his target of eliminating the structural budget deficit."
13. Office for Budget Responsibility, *Pre-Budget Forecast June 2010*.
14. Brian Groom, "Deficit plans will add to job losses, warns economist", *FT*, 10 June 2010 reported that the CIPD now expect the public sector to lose 750,000 jobs over the next 5 years, out of 6 million (about 12.5% or 1 in 8). The CIPD forecasts that total unemployment will rise to 2.95m in the second half of 2012 and remain close to that until 2015.

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