



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



The Budget: the beginning of the election campaign

Introduction

Next week's Budget will almost certainly be the last major political exercise before the calling of the general election, which is expected to be on 6 April, a month before the expected election date of 6 May. Economically it will surely be a holding exercise, with no major announcements by way of further higher taxes or spending constraints. There may be some pre-election lollipops for, say, pensioners or the lower paid – but little of fiscal significance. There will however, probably be much political rhetoric from the Chancellor about the alleged “clear blue water” between the current Government that will not cut spending until it is “safe to do so” in terms of the economic recovery (“protecting the recovery”) and suggestions that the opposition would, if they formed the next government, cut irrespective of economic circumstances. In effect the Budget will mark the beginning of the election campaign.

The economic background

Even though the Budget will be primarily political, it will of course contain an economic commentary. The economic background to the Budget is one of modest recovery. GDP growth in 2009Q4 was 0.3% (revised) in the quarter and recent business surveys suggest continuing recovery. But it should be noted that the 2010Q1 GDP figure (due 23 April 2010) could be very weak as January's economic activity was depressed by the “big freeze”. In addition, VAT reverted to 17.5% from 15% in January and the stamp duty threshold for property reverted to £125,000 from £175,000. The car scrappage scheme is, however, now expected to expire at the end of March (instead of the end of February), even though no new funds will be made available.

In the 2009 PBR the Chancellor forecast a decline in GDP of 4¼% for 2009 (the ONS recently estimated a fall of 5.0%) followed by modest growth in 2010 and above-trend growth of 3½% in 2011.¹ We do not expect him to materially change the GDP forecast in the upcoming Budget. As can be seen from the table below, the Consensus forecast broadly agrees with the Chancellor for 2010, but is noticeably less optimistic for 2011 and expects growth of less than 2½%. We would broadly concur with the Consensus and note that actual growth in 2011 and subsequent years will in part depend on the tightness of the fiscal policy followed by the next government.

Turning to CPI inflation some concern has been expressed about the recent spike in the figures. CPI inflation touched 3.5% in January though this partly reflected “base effects” including the VAT rate reverting to 17.5% in the month (it had been cut to 15% in December 2008) and increases in fuel prices (whereas there had been falls a year earlier). A weak currency has contributed to prices inflation. Earnings inflation remains very subdued and, under these circumstances, it is reasonable to assume that prices inflation will stay under control.² The Bank of England's latest inflation report shows CPI inflation falling below 1% by early 2011 and being around its 2% target by the second half of 2012.³

At the time of the PBR the Chancellor forecast inflation rates of 1¾% for 2010Q4 and 1½% for 2011Q4. Both these numbers look on the low side and we expect modest upgrades for both 2010 and 2011.

Table 1 GDP and CPI forecasts (year-on-year, %)

	2008	2009	2010	2011	2012
PBR 2009:					
GDP growth	½	-4%	1 to 1½	3¼ to 3¾	3¼ to 3¾
CPI inflation (Q4)	4	2	1¾	1½	2
Current Consensus forecast: GDP growth	0.6	-5.0	1.4	2.3	Na
Current ABG forecast: CPI inflation (Q4)	4	2	2	2	2

Sources: (i) HM Treasury, *Pre-Budget Report, Securing the recovery: growth and opportunity*, December 2009, Cm 7747, (ii) *Consensus Forecasts*, Survey date 8 March 2010, Consensus Economics for 2010 and 2011. Out-turns for 2008 and 2009 are from the ONS.

Two observations on GDP

It is widely accepted that the recent financial crisis will have taken a major toll on the level of potential GDP. As the IFS's 2010 "Green Budget" argues:⁴

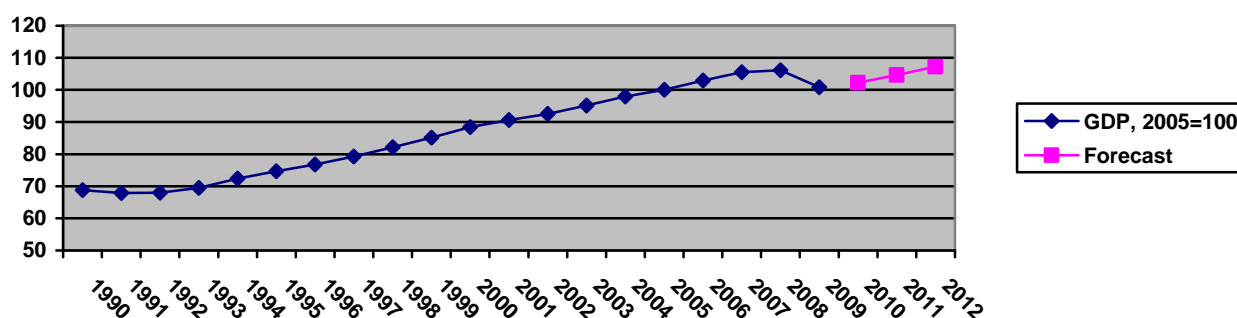
"The overall impact [of the crisis] varies from one crisis to another depending, among other things, upon: how the economy was performing pre-crisis; how severely the economy first contracted when the crisis struck; the level of "pre-crisis" imbalances (such as the current account balance); whether or not the currency also came under severe pressure; and how other countries were faring when the crisis struck."

The IFS concluded that judged against these yardsticks "the UK currently looks very poorly placed" and would, therefore, probably suffer a further marked deterioration in its productive capacity from the effects of the crisis. Significantly they suggested that the deterioration would leave the total decline in potential GDP greater than the 5% that the Treasury has assumed when making its projections. The IFS's central estimate was for a 7½% decline – possibly as severe as 10%.

This has implications for the growth rate of potential GDP. The IFS suggested that, rather than the 2¾% annual potential growth assumed in the PBR as a central estimate, potential growth could be closer to 1¾%. The output gap (the difference between "actual" and "full capacity" output) could also be expected to be lower than previously estimated – possibly as low as 4% of potential output. Clearly these downgradings have severe implications for the GDP growth over the next 2-4 years and cast even more doubt over the Chancellor's optimistic growth projections over this period. If the IFS's analysis turns out to be valid, the outlook for the public sector finances is even worse than projected in the PBR.

The second observation is that because the recession has been so severe, it will be 2012 before the GDP level of 2008 will be exceeded – providing there is fairly steady growth. The total fall in GDP between 2008Q1 (the last peak) and 2009Q3 (the trough) was 6.25%.

GDP, volume, 2005=100 indices



Notes: back data are from the ONS. The forecast assumes growth rates of 1.4%, 2.3% and 2.5% for 2010 to 2012.

The public finances: projections

In the 2009 PBR the Chancellor forecast public borrowing of £178bn for FY2009. The data on the public finances so far released (to January) suggest that this forecast may be tad too pessimistic, despite the appalling January figures.^{5,6} The IFS is currently projecting borrowing of £169bn, after adjusting for the estimated impact of temporary measures and mechanically extrapolating the data for the first 10 months of the financial year for both receipts and spending.⁷ We expect the Chancellor to similarly downgrade his projection. For FY2010 up to FY2014, we do not expect the Treasury to significantly amend the projections though there may be some acknowledgment that, if growth disappoints, the public finances would be poorer.

Table 2 Public sector finances: projections for the PBR and the 2010 Budget

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
2009 PBR:						
Current Budget (£bn)	-128.1	-137	-111	-91	-74	-59
PSNB (£bn)	177.6	176	140	117	96	82
PSNB (% of GDP)	12.6%	12.0%	9.1%	7.1%	5.5%	4.4%
Debt (£bn)*	798.9	986	1139	1270	1379	1473
Debt (% of GDP)	55.6%	65.4%	71.7%	75.4%	77.1%	77.7%
2010 Budget, expectations:						
PSNB (£bn)	170	175	140	120	100	90

Sources: (i) HM Treasury, *Pre-Budget Report, Securing the recovery: growth and opportunity*, December 2009, Cm 7747.

* Public sector net debt, at end financial year.

The Budget: fiscal consolidation

As already stated, the Budget is likely to be policy-light. But there will be scope for the Government to repeat its overall fiscal strategy as already laid out prior to the PBR, in the PBR and since. Specifically there will be an emphasis on “fiscal responsibility” and the new Fiscal Responsibility Act (the bill received the Royal Assent in February 2010) will probably be quoted to support the Government’s claims to a viable Fiscal Consolidation Plan (FCP). The Act aims to cut borrowing as a share of GDP by half over 4 years and ensure debt as a share of GDP is falling in FY2015, after peaking in FY2014. The PBR forecast debt will be nearly 78% of GDP in FY2014. There will almost certainly be no further fiscal tightening announced in this Budget.

As we have argued on several previous occasions, the Government’s fiscal consolidation plans are not sufficiently rapid. Further tightening, preferably in the form of spending cuts, will be needed – and quicker.⁸ The recent comment by Bill Gross of investment management firm PIMCO that gilts rested on “a bed of nitroglycerine” may have been melodramatic but graphically illustrated investor doubts about British sovereign debt.⁹

Spending projections

The Chancellor has recently said that the “time is not ripe” to publish a set of detailed spending plans beyond FY2010 (either for the 2 years FY2011 and FY2012 or for the three years FY2011 to FY2013) as the economic circumstances are too “uncertain”. This is not convincing. Given the expected squeezes on total spending, in general, and departmental expenditure limits (DELs), in particular, this may be regarded as an exercise in procrastination – if not obfuscation. The squeeze on departments will be especially tight because the Treasury estimates significant increases in annually managed expenditures (AMEs), including debt interest and social security payments.¹⁰

Specifically AMEs are expected to grow as follows:¹¹

- Debt interest: reflecting the increase in public sector debt, debt interest payments will increase rapidly over the next few years. The PBR forecast that gross debt interest payments will grow by 9.4% annually (average, real terms) from FY2011 to FY2014 – from £45bn to £71bn in cash terms.
- Social security: figures published by the Treasury in September 2009 showed that social security spending was projected to grow by 1.4% annually (average, real terms) from FY2011 to FY2013. Given subsequent Treasury increases to its inflation forecasts, this growth rate is probably too low; the IFS raised the rate to 1.5%.

- Other AMEs (including public sector pensions and EU contributions): these are projected to increase at 3.1% annually (average, real terms) from FY2011 to FY2014.

The table below shows the potential squeeze on the departments, as calculated by the IFS using Treasury data. Departmental spending is estimated to fall by nearly 3% annually (average, real terms) between FY2011 and FY2014. This estimate is consistent with a “flat cash” position.

But not all departments are to be treated equally. The Government has, for example, “protected” overseas aid spending, front-line schools (and also 16-19 education and Sure Start) and the front-line NHS for the two years FY2011 and FY2012. Other departments, including the beleaguered MOD, are “unprotected”. The table shows the “unprotected” departments will face a 13% cumulative cut for these first two years.

Table 3 Public spending: the squeeze on departmental spending, FY2011-FY2014

	Average annual real growth (%)		
	FY2011-FY2012	FY2013-FY2014	FY2011-FY2014
Provisional spending plan:			
Total managed expenditure (TME)	-0.1	+0.1	0
Memo: cumulative change	-0.2	+0.1	0
Memo: £/year by end year	-£1.1bn	+£1.0bn	-£0.1bn
Projections for AME:			
Debt interest	+12.6	+6.3	+9.4
Social security	+1.5	+1.5	+1.5
Other AME	+2.4	+3.7	+3.1
Total AME	+3.5	+3.0	+3.2
Memo: £/year by end year	+£21.8bn	+20.1bn	+£41.9bn
Residual: DEL, average growth	-3.0	-2.7	-2.9
Memo: cumulative change	-6.0	-5.3	-5.7
Memo: £/year by end year	-£22.9bn	-£19.1bn	-£42.0bn
“Protected” DEL, average growth:	+0.8	Na	Na
“Unprotected” DEL, average growth:	-6.7	Na	Na
Memo: cumulative change	-12.9	Na	Na
Memo: £/year by end year	-£25.8bn	Na	Na

Source: IFS, *The IFS Green Budget*, February 2010, tables 8.2 and 8.3, and figure 8.15. There are rounding errors in the table. “Unprotected” DEL excludes overseas aid, front-line schools (and 16-19 education and Sure Start also) and the front-line NHS.

There are three points to be added which make the situation even more difficult for departmental spending - “protected” or otherwise:

- According to the IFS, the government intends to implement a fiscal tightening worth 5.5% of GDP (£77bn) over the next 8 years (FY2010 to FY2017). It intends to implement just over 60% of the tightening between FY2010 and FY2014 (two-thirds through spending cuts and one-third through tax increases). But the remaining 40% of the tightening is to come from further tax increases and/or spending cuts after FY2014. So the tightening measures announced to date amount to just 3/5^{ths} of the total tightening factored in. There is, in other words, more pain to come after FY2014.¹²
- As already pointed out, the rate of fiscal consolidation in the PBR is arguably too leisurely. If cuts are quicker then the pressure on budgets will be more severe over the period of cuts.
- The above analysis assumes the Treasury’s projections are accurate. But there is a strong possibility they are too optimistic – not least of all on growth. Treasury public finance forecasts in recent years have had a strong bias towards the optimistic.

Budget: what else can be expected?

Apart for a lack of fiscal significance, there is already speculation about other possibilities, including:

- There could be an announcement of more anti-tax avoidance measures, even though it is unlikely there will be any explicit tax increases - in addition to the 50% on incomes above £150,000 and removal of allowances for incomes above £100,000 from April 2010; the windfall tax on bonuses; and the 1% increase in NICs (employers and employees) from April 2011. The proximity of the Budget to the election means that complex tax changes would be difficult to implement.
- The revenue from the bonus tax (which was originally expected to be £550m, but is now estimated to be around £1.5bn, possibly as high as £2bn) will probably be used to provide further support for jobs, especially for young people.
- There are also some savings in the budget from the lower-than-expected unemployment level, but these are also likely to be spent on targeted schemes such as support for jobs or infrastructure.
- There is the possibility that the Government may announce a Government-sponsored fund to invest in infrastructure such as roads or rail.
- Even though detailed public spending plans will not be forthcoming, there may be more details on efficiency savings and there may be more on the already announced 3-year public sector pay freeze for senior public servants.¹³
- There could be announcements on the sale and/or management of Government assets including property.

References

1. HM Treasury, *Pre-Budget Report, Securing the recovery: growth and opportunity*, December 2009, Cm 7747.
2. ONS data show that average earnings (including bonuses) rose by 0.8% in 2009Q4 (YOY) whilst average earnings (excluding bonuses) rose by 1.2%.
3. Bank of England, *Inflation Report*, February 2010.
4. IFS, *The IFS Green Budget*, February 2010.
5. The February public finances data are due on 18 March 2010.
6. ONS, "Public sector finances, January 2010", 18 February 2010. January's PSNB was +£4.3bn even though January is a "good" month for revenues (self-assessment receipts are high) and the VAT rate had risen to 17.5%.
7. IFS, "The IFS analysis of today's public finance figures", 18 February 2010, www.ifs.org.uk. The IFS's February Green Budget had forecast the PSNB at £167.2bn.
8. For example Ruth Lea, "The Pre-Budget Report: yet more irresponsible procrastination", Arbuthnot Banking Group, 13 December 2009.
9. Dominic Elliott, "Pimco's Gross: 'UK gilts rest on a bed of nitroglycerine'", *Financial News*, 28 January 2010.
10. Total Managed Expenditure (TME) = Departmental Expenditure Limits (DEL) + Annually Managed Expenditure (AME).
11. IFS, *The IFS Green Budget*, February 2010.
12. IFS, *The IFS Green Budget*, February 2010.
13. Nicholas Timmins, "Pay is frozen for 120,000 senior staff in public sector", *FT*, 11 March 2010.

**Ruth Lea, Economic Adviser, Director,
Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
Tel: 07800 608 674**