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Schroders Talking Point

UK Emergency Budget 2010
Reality unveiled

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Summary

- **Tougher than expected budget likely to keep growth subdued.** Chancellor Osborne's target to cut the vast bulk of the structural deficit is more ambitious than we expected, though we believe that the OBR's growth forecast is over optimistic further out, particularly on the drag on growth from cuts in public spending. The short-term outlook is in line with consensus views.
- **Pain is yet to come.** Though newspapers have focused on the rise in VAT and other tax increases, the striking message from the fiscal forecast is that government departments are set to face extraordinary cuts to their budgets. The exact distribution of pain will not be known until the October Comprehensive Spending Review, though the Chancellor's bold move is likely to keep the UK's AAA credit rating in place for now.

Bottom Line

Ouch. A much tougher budget than we expected, though it reflects the risks the UK faces from a sovereign debt crisis. The unavoidable budget is likely to (and hopefully will) contain most of the tax rises needed to fill the black hole left by the previous administration. The increases in taxation were broadly what we expected, but the bold deficit-cutting targets indicate harsh spending cuts to follow.

The new Chancellor almost took pride as he went through Gordon Brown's previous trophy policies, tearing them down one at a time – resembling the way statues of communist leaders were taken down after the collapse of the Soviet Union in Eastern Europe. And like the introduction of capitalism, austere times will follow as the country learns that it can no longer rely on the state propping up economic growth in the unsustainable way it has done. The measures set out will hit growth, but are broadly supportive of business, especially new small and medium sized firms. Also a carrot and stick approach is being used to entice long-term benefit claimants to employment. Not only helpful in reducing the nation's welfare bill, but also potentially raising growth prospects in the medium to long-term.

Given the new fiscal forecast, we have revised down our growth forecast from 2011 onwards, but also raised our 2011 inflation forecast on the back of the higher than expected VAT hike. We have also changed our view on the policy interest rate and have pushed out the first rate increase to May 2011, with rates ending 2011 at 1.75%.

Changes in process – independent forecasting

Making good on a pre-election Conservative Party promise, the coalition government created a new independent Office for Budgetary Responsibility (OBR) and in the process abrogated power and responsibility for the macroeconomic forecast. In theory, this means that politicians will no longer be able to shape the economic forecast to allow for more favourable (or not) tax and spending plans.

Cynics have pointed out the convenience of the situation for the new Chancellor, who may harbour a deep desire to shrink the public sector. However, our reaction to the OBR's first outing is positive. We are pleased with the open presentation of the new forecast and the more open debate about the true real trend rate of growth – a heavily politicised number.

Earlier this month, the OBR presented its 'pre-budget' forecast, which gave the Treasury a starting point to work with in deciding on forthcoming tax and spending changes. The OBR slashed the previous government's GDP growth forecasts, and lowered the assumed trend rate of growth from the previously assumed 2.75%, to the new assumed rate of 2.35% until 2014, and 2.1% onwards, with the fall attributed to deteriorating demographics. The latest OBR forecast released within the emergency Budget is an update of the forecast and incorporates the changes to tax and spending outlined by the Chancellor. The OBR is also obliged to indicate whether the Budget presented has a better than 50% chance of meeting the government's fiscal objectives. More details on this later.

On the fiscal front, the underlying message from the OBR was that the structural part of the fiscal deficit is larger than previously expected. This means that more tax increases and spending cuts are required to meet the previous government's fiscal cutting targets – a green light for Osborne to cut public spending faster than his predecessors had planned.

Public Finances

George Osborne's debut budget was inevitably going to be brutal. Taking over the worst balance sheet since the Second World War, the Chancellor has a tough job reversing the UK's course to ruin. Nevertheless, Osborne's first budget is ambitious and sets tougher fiscal austerity targets than we had expected. We had expected the new coalition to aim to cut the deficit to 3% of GDP by 2014/15, leaving a significantly smaller structural deficit. However, Osborne wants to go further by eradicating the vast bulk of the structural deficit by the end of this parliament. This means Osborne aims to cut the deficit by £117.7 billion by 2014/15, over £25bn more than the Alistair Darling had planned in his March 2010 budget (see table 1).

Table 1: Borrowing and debt	Outturn	Estimate	Forecast					
Public Borrowing (£bn)	**08/09**	**09/10**	**10/11**	**11/12**	**12/13**	**13/14**	**14/15**	**15/16**
OBR/Budget June 2010		154.7	149	116	89	60	37	20
OBR/Pre-budget June 2010		156.1	155	127	106	85	71	-
Budget March 2010	91.1	166.5	163	131	110	89	74	-
Pre-Budget 2009		177.6	176	140	117	96	81	-
Schroders		154.7	149	119	96	68	49	32
Public Borrowing (%of GDP)								
OBR/Budget June 2010		11.0	10.1	7.5	5.5	3.5	2.1	1.1
OBR/Pre-budget June 2010		11.1	10.5	8.3	6.6	5.0	3.9	-
Budget March 2010	6.7	11.8	11.1	8.5	6.8	5.2	4.0	-
Pre-Budget 2009		12.6	12.0	9.1	7.1	5.5	4.4	-
Schroders		10.9	10.1	7.6	5.9	4.0	2.8	1.8
Net debt (%of GDP)*								
OBR/Budget June 2010		53.5	61.9	67.2	69.8	70.3	69.4	67.4
OBR/Pre-budget June 2010		53.5	62.2	68.2	71.8	73.7	74.4	-
Budget March 2010	44.0	54.1	63.6	69.5	73.0	74.5	74.9	-
Pre-Budget 2009		55.6	65.4	71.7	75.4	77.1	77.7	-
Schroders		55.6	63.2	67.8	70.7	71.9	71.9	70.9

* Excludes financial sector interventions, currently worth an additional 8.2% of GDP (June 2010 Public Sector Finances release)

Source: HMT, OBR, Consensus Economics (June 2010), Schroders

Arguably, such a tough budget is exactly what the UK needs to avoid a downgrade from the sovereign debt rating agencies, especially with the current crisis in southern Europe. If successfully implemented, the UK's net debt as a percentage of GDP would stabilise at just over 70% by 2013/14. However, our eagle eyed readers will have spotted that we do not think the Chancellor will meet his target. Though this is partly due to our view on growth prospects (more below), the most significant cause for the divergence is our view that the Chancellor will struggle to push through the spending cuts outlined in his budget. Indeed, even Margaret Thatcher's government struggled to contain public spending, and was instead rescued by stronger growth, and better tax revenues as a result. We feel that as the coalition's popularity wanes and the next general election approaches (2015), the Chancellor may struggle to find support for additional spending cuts.

Fiscal Policy

Though newspaper headlines are dominated by the tax increases outlined in the budget, what stood out for us was actually the lack of tax increases given the tough deficit cutting targets outlined at the start of the Chancellor's speech – meaning that this is only the start of the pain to come. Osborne quietly confirmed this by presenting general spending headline numbers, and a illustrative figure of what cuts might look like: the average non-ring fenced departmental budget is set to fall by 25% in real terms by 2014/15 (compared to 20% the previous government had secretly planned). Osborne stated that he plans to reduce the deficit by having a tax raising to spending cutting ratio of 23:77. Chart 1 shows the latest OBR forecast of spending and tax revenue developments.

Details on spending cuts remain thin and realistically, the new government was never going to be in a position to deliver a spending review within a couple of months of winning the election. The Chancellor did make an attempt to reassure public sector workers by guaranteeing fixed pay rises for those earning under £21,000 per annum for the next two years. To pay for this, civil servants earning more than the benchmark will see their wages frozen in nominal terms (or cut in real terms) over the next two years. No doubt part of a strategy to prod public sector workers towards the private sector. The Comprehensive Spending Review (20 October 2010) will be key as it will not only allow us to examine how spending cuts will affect the public sector and wider economy (i.e., job cuts versus efficiency gains), but also to assess whether fiscal targets are likely to be met.

Chart 1: Receipts and expenditure

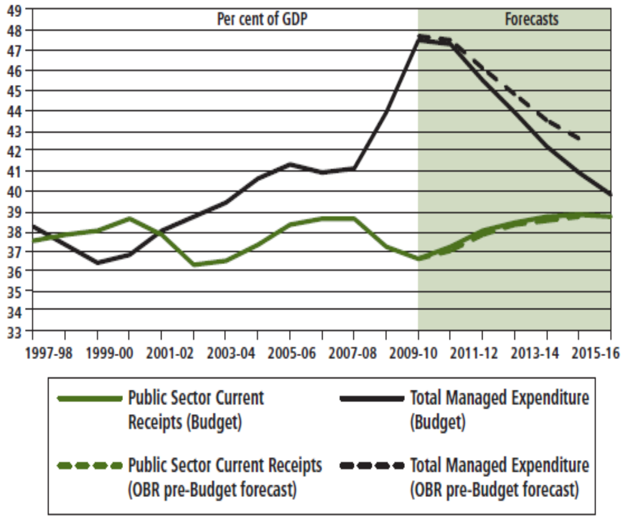
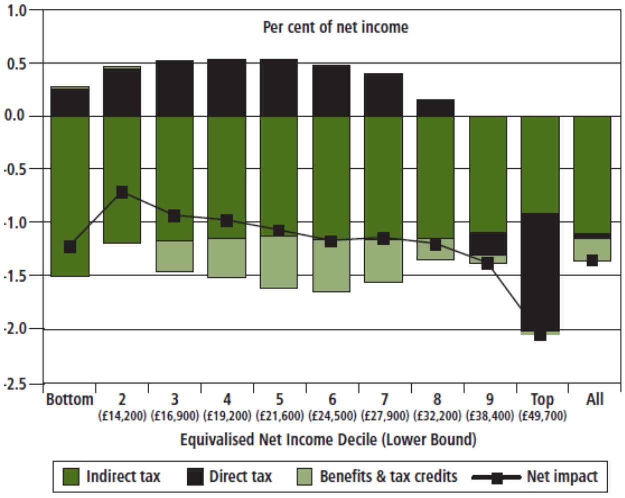


Chart 2: Impact of all measures by income distribution (2012-13)



Source: HM Treasury, OBR, Budget June 2010

In terms of tax changes, VAT is set to be raised in January from its current rate of 17.5% to 20%. We had expected a smaller move to 19%, but had also warned that a rise to 20% was becoming more likely. The pre-announcement of the increase will encourage some households to bring forward spending before the VAT rises. However as we saw at the start of this year, this will be at the cost of purchases in following months.

All duties were left untouched with the exception of the plan to raise duty aggressively on cider, which has now been reversed. It would have been very difficult to raise duties further especially as VAT is being increased, though the lack of movement on duty is not a trend that is likely to last.

The range of goods and services that VAT covers has also remained the same, which will come as a relief to many who had feared VAT would be extended to cover food and children's clothing. Though raising VAT disproportionately hits those on fixed incomes like the unemployed, the disabled and pensioners, the Treasury's analysis shows that the total budget package hits the top decile in the income distribution the hardest (chart 2 above). This is because other tax changes including the raising of capital gains tax for non-corporate higher rate tax-payers, disproportionately affects more wealthy individuals, who tend to receive a higher proportion of their income from non-wage related earnings.

The Chancellor resisted extending the bankers' bonus tax, but did impose a new levy on domestic and foreign banks (with a presence in the UK) linked to the size of their balance sheets. This is expected to eventually raise £2.5 billion per year, though this is a small yield from what is usually a very profitable sector, and does what it had initially intended to do, which is tax banks in a way that reflects the systemic risk their activity posed to the real economy. Still, probably enough to temporarily keep Business Secretary Vince Cable at bay, who along with Bank of England Governor Mervyn King, would like to see retail banking separated from investment activity.

In another move to satisfy the left of the coalition, the tax-free allowance for income tax has been raised by £1,000, to £7,475, with the eventual aim of raising this threshold to £10,000. Combined with freezes and cuts to some out-of-work benefits, increasing the marginal gains from work may indeed help encourage more economically inactive individuals to join the labour force. Though this is generally positive for growth in the medium term, it will be deflationary, as it introduces more spare capacity in the labour market, putting downward pressure on wages.

There were a total of 50 fiscal measures in the emergency budget, most of which looked to support smaller businesses (See Box 1).

Box 1: Key fiscal measures

Personal taxes:

- *VAT will rise from 17.5% to 20% from 4 January 2011.*
- *Personal income tax allowance: To be increased by £1,000 in April to £7,475.*
- *Councils helped to keep local rates frozen for 2011.*
- *Capital Gains Tax to rise from 18% to 28% for higher rate taxpayers. The entrepreneurs' relief rate of 10% on the first £2m of gains will be extended to the first £5m.*

Business:

- *From April 2011, the threshold at which employers start to pay National Insurance will rise by the rate of inflation plus £21 per week.*
- *Corporation Tax will be cut next year to 27%, and by 1% annually for the next three years, until it reaches 24%.*
- *The small companies' tax rate will be cut to 20%.*
- *Companies setting up outside of London, the South East and the east of England will be exempt from £5,000 of National Insurance payments for the first 10 workers.*

Pensioners & Benefits:

- *Child benefit frozen for the next three years.*
- *Tax credits reduced for families earning over £40,000 in 2011, but low income families will get more Child Tax Credits.*
- *Housing benefits will be capped at a new limit of £400 a week for bigger than three-bedroom properties, and £250 a week for one-bedroom flats.*

- *Unemployed people will have Housing Benefit cut by 10% after 12 months of claiming Jobseeker Allowance from April 2013.*
- *Excluding the state pension and pension credit, from 2011 benefits, tax credits and public service pensions will rise in line with the Consumer Price Index, rather than the Retail Price Index.*
- *The basic state pension will be linked to earnings from April 2011, with the pension guaranteed to rise in line with earnings, prices or 2.5%, whichever is the greater.*

Growth

With significantly greater fiscal tightening than the previous Labour budget, the OBR reduced its updated post-budget forecast to 1.2% real GDP growth for 2010, and 2.3% growth for 2012. Interestingly however, the forecast for 2013 is now slightly higher, and there the forecast for beyond is little changed (see table 2). Though forecasting beyond 2-3 years is fraught with danger, we would have expected a weaker growth forecast, especially as most of the harsher measures are coming through spending cuts, which will be felt from 2012 onwards (directly through a smaller contribution from government expenditure, and the negative multipliers).

Table 2: Growth forecast comparison		Forecast					
GDP Growth (%)	2009	2010	2011	2012	2013	2014	2015
OBR/Budget June 2010		1.2	2.3	2.8	2.9	2.7	2.7
OBR/Pre-budget June 2010		1.3	2.6	2.8	2.8	2.6	-
Budget March 2010	-4.9	1 to 1½	3 to 3½	3¼ to 3¾	3.25*	3.25*	3.25*
Pre-Budget 2009		1 to 1½	3¼ to 3¾	3¼ to 3¾	3.25*	3.25*	3.25*
Schroders		1.3	2.3	2.1	2.2	2.0	2.0
Consensus		1.3	2.3	2.1	2.4	2.1	2.2

Source: HMT, OBR, Consensus Economics (June 2010), Schroders. *Implied from fiscal forecast.

The new growth profile is more realistic than the previous forecast, though we believe that it is optimistic, particularly given the scale of fiscal tightening that is now being targeted. We ourselves have nudged down our own forecast for growth, though had partly expected much of the fiscal tightening announced for 2010 and 2011.

Interestingly, the OBR is forecasting that GDP growth remains above its new trend rate of growth assumptions for the whole forecast horizon (chart 3). Despite this, the OBR does not expect the output-gap to have closed by 2015. We disagree. We believe that the permanent structural damage done to the British economy is much greater than is currently being assumed, and so we expect the output-gap to close by the end of 2012.

Taking a closer look at the forecast, the household sector recovery is now expected to make a much smaller contribution to GDP growth in 2010 and 2011. Business investment is still expected to contribute a significant proportion of growth. Improved tax incentives and the expectations that interest rates will remain lower for longer have offset the negative impact of fiscal tightening. Interestingly, the expected drag from government expenditure has been reduced slightly compared to the last budget, despite a much tougher fiscal consolidation path. The lower interest rate profile is not enough to explain this discrepancy and is one of the reasons why we believe the forecast is optimistic in latter years.

The other key judgement is the contribution from net trade. We have consistently doubted the UK's ability to export its way out of its recession, and cited this as the key difference between our forecast and the Treasury's forecast at the last budget. The OBR has changed the previously positive contribution from net trade from the past budget to a small negative contribution for 2010, probably caused by the poor trade data released for the first quarter. However, the OBR has boosted the net trade contribution for 2011 and 2012, holding on to a view that the depreciation in Sterling from 2007 will lead to a rise in export volume growth. This may be a hang-over caused by the OBR using now former HM Treasury staff to conduct its forecast. We continue to argue that the UK's major exporters are large multi-national companies, which face little competition in their respective markets. They are also large enough to price in foreign currencies, and so as Sterling depreciates, they take the gains in profits, rather than cut their foreign prices and increase export volumes. The OBR assumes that consumers will be substituting imported goods for domestic ones. Though the depreciation in sterling supports this story to a certain extent, we do not believe UK producers will have the ability to undercut foreign competition.

Chart 3: GDP growth

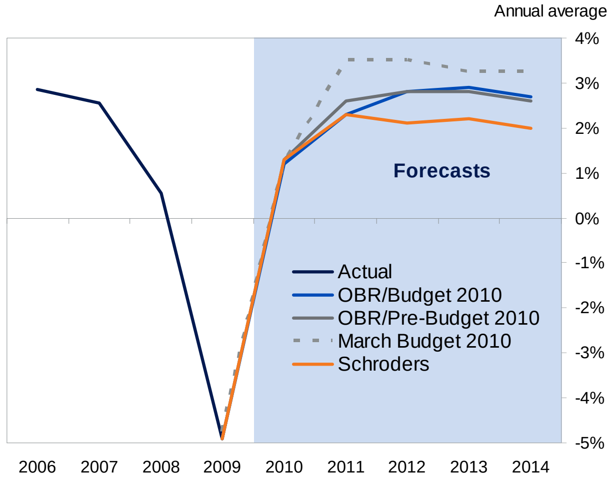
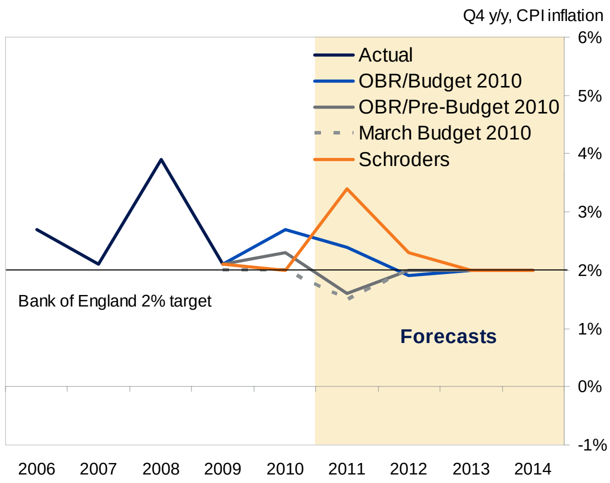


Chart 4: CPI inflation



Source: HM Treasury, OBR, Schroders

Inflation & interest rates

Given the announced rise in VAT, inflation based on both the Consumer Price Index (CPI) and the Retail Price Index (RPI) is now expected to be higher in 2011. As we had anticipated most of the VAT rise even before the general election result, the move only represents a minor upward revision to our own forecast (see table 3). When comparing our forecast with the OBR's pre and post budget forecasts, we reach the conclusion that the OBR thinks some of the VAT related price rises will occur in advance of the actual rise, which can be seen in the upward revision to the 2010 fourth quarter forecast (see chart 4 above). The assumption helps smooth the pick up in inflation, which we expect will play on the minds of the more hawkish members of the Monetary Policy Committee (MPC). Indeed, this morning's MPC minutes showed that Andrew Sentance voted for a rate increase at the June committee meeting.

Table 3: Inflation		**Forecast**					
CPI Q4, y/y (%)	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
OBR/Budget June 2010		2.7	2.4	1.9	2.0	2.0	2.0
OBR/Pre-budget June 2010		2.3	1.6	2.0	2.0	2.0	-
Budget March 2010	2.1	2	1½	2	2.0*	2.0*	2.0*
Pre-Budget 2009		1¾	1½	2	2.0*	2.0*	2.0*
Schroders		2.0	3.4	2.3	2.0	2.0	2.0
Consensus		3.1	1.9	2.1	2.5	2.6	2.4
RPI Q4, y/y (%)							
OBR/Budget June 2010		3.7	3.2	3.2	3.3	3.4	3.5
OBR 2010	0.6	3.3	2.6	3.3	3.3	3.5	-
Schroders		3.3	3.7	3.6	-	-	-

Source: HMT, OBR, Consensus Economics (June 2010), Schroders. *Implied from fiscal forecast.

Despite this, we have changed our view on policy interest rates. In our May Economic & Strategy Viewpoint, we argued that there is a case to raise interest rates this year, especially as there is growing evidence of less spare capacity (and hence deflationary pressure) within the economy than previously expected, but also that there is a danger that high inflation for a second consecutive year may raise inflation expectations, and possibly feed through to higher wage growth. We had warned that the risk to this view was skewed towards rates rising later and in light of the tougher than expected budget, we now expect rates to remain on hold until May 2011, with rates ending the year at 1.75%. We now think that though the committee will probably remain split on its view on rates, the more dovish members will want to wait and see on three important events before making a move:

1. The results of the Comprehensive Spending Review in October, and what it will mean for public sector jobs, and unemployment as a whole.
2. The impact of the VAT rise on retail sales after its introduction. This is likely to rule out an autumn rate rise.
3. The Budget 2011. Though we think the Chancellor has announced most of the tax increases required, there is always the chance of more tax rises, especially if the target spending cuts do prove unrealistic.

Overall, while we have raised our headline inflation forecast, underlying inflation is likely to remain very subdued and reflect the sub-par UK recovery. Interest rates will therefore remain lower for a considerably longer period of time relative to past recoveries.

Wider implications

Two key questions that remain: Will this budget save the UK's AAA credit rating, and will the tougher than expected fiscal tightening cause a double-dip recession?

We assume that sovereign debt agencies will react to the budget in the same way we have – encouraged by the signals seen so far, but as the bulk of the cuts are expected to come through spending cuts, will reserve judgement until everyone can see where the axe will fall. As a result, the AAA rating should remain intact, but the UK negative outlook rating is likely to remain in place.

As for risks of a double-dip recession, we think this remains unlikely especially as most of the fiscal tightening is coming though spending cuts, which realistically are not going to hit the real economy until late 2011 at the earliest. By then, the economy will be in much better shape, and momentum built up by the private sector recovery should help absorb much of the new slack created by public sector job losses.

Could the Chancellor have announced smaller cuts? Probably yes, though there was a real need to reassure international markets that the UK was ready to tackle its deficit. With the world watching, we feel that tax rises were inevitable, and should keep investors on side until more details on spending cuts are released. Moreover, given the deepening crisis in southern Europe, the Chancellor would have been taking a big gamble trying to persuade markets that the UK is not Greece. The UK is not Greece, though nor is Portugal or Spain and yet they are already seeing contagion spreading through their financial markets and imposing much more severe austerity packages. At the cost of lower growth over the next five years, it's better to be safe than sorry.