17 October 2018

Investec Bank plc (UK)

Economics

Investec Economics

UK Budget preview: Pushing the envelope (back to 2019)?

- On Monday 29 October UK Chancellor of the Exchequer Philip Hammond will deliver his third Budget. This will take place in the context of a marked reduction in borrowing in the fiscal year to date, but against a growing shopping list of spending demands over the medium-term. Front and centre is a commitment from Prime Minister Theresa May to deliver a large boost to health spending, which the Office for Budget Responsibility (OBR) estimates would amount to an increase in (real terms) spending of £20.5bn by 2023/24.

- At the Spring Statement in March the Chancellor had said he would announce the aggregate planned spending totals for the 2019 Spending Review (SR 2019) – the so-called public expenditure 'envelope' – at the forthcoming Budget. Given the PM's NHS pledge and broader comments on the end of austerity, this would involve material increases in expected government expenditure. If Mr Hammond is serious about eliminating the deficit over the medium-term, new spending commitments would need to be offset by major tax increases. Amidst Brexit uncertainty and a political backdrop that does not lend itself to big tax rises, Mr Hammond may argue that it is more sensible to wait until next year to publish the envelope.

- This would imply that the upcoming Budget will deal with imminent spending demands, but not longer-term pressures. That way Mrs May is not faced with Mr Hammond seeking to put through a series of eye watering tax increases, to avoid him having to admit defeat on his fiscal objectives. Here we suspect Mr Hammond, whilst taking on board Prime Minister May's "end of austerity" commitment during her Conservative party conference speech, will continue to broadly set his sights on eliminating the deficit around the mid-2020s, or thereabouts.

- Note that on the economic forecasts, the OBR has continued to indicate that it will work off "broad brush" non-specific Brexit assumptions, which we would expect to be refined in the Spring Statement next year, once the outcome of Brexit talks is clearer. This uncertainty highlights the headache the Chancellor could face, if he commits himself to a SR 2019 envelope at a time when the economic outlook is particularly uncertain. Of course, at this stage it is not possible for the OBR to build in any "Brexit dividend" to the fiscal numbers. As such, if Brexit talks reach a positive outcome from an economic perspective, a 2019 decision on the spending envelope might also allow Mr Hammond to include something from this, as well as helping him to avoid a tricky situation now.

- For the upcoming Budget we expect to see Mr Hammond put forward the cash for an uplift to NHS spending for the coming year, alongside other short term giveaways such as a freeze in fuel duty. On the revenue raising front, it is likely that the Chancellor will look to the likes of another clampdown on tax avoidance and a few other smaller ticket tax rises, to fund one year ahead pressures. We suspect he will strive for more sensitive tax changes in 2019, a year when he can look at spending pressures in the round too.

Philip Shaw
+44 (0) 20 7597 4302
philip.shaw@Investec.co.uk

Victoria Clarke
+44 (0) 20 7597 5154
victoria.clarke@investec.co.uk

An improved recent borrowing backdrop, but growing spending demands…

The UK is set to enjoy a rare period of respite from Brexit related issues on 29 October when Philip Hammond delivers his third Budget. The Chancellor may be in two minds about the fiscal position. In the near-term, borrowing has shrunk by more than expected this year. Data for the first five months of 2018/19 suggest that the UK will record a deficit of £25-£30bn over this year, some 1½% of GDP. Over the longer-term though, pressures on public expenditure are mounting. In common with other mature economies, adverse demographic trends imply that various categories of age related spending will rise over time. Even more significantly, strains on the health budget are intensifying. In its recent assessment of fiscal sustainability, the Office for Budget Responsibility (OBR) identified health spending as the single most significant drag on the public finances over the medium-term.

This dichotomy is reflected in his fiscal rules. Overall Mr Hammond has said that he intends to balance the Budget during the next parliament. This pledge was made before last year's 'snap' General Election and has not been updated since. Hence the precise timescale to bring the public finances back in the black is unclear. At the time Mr Hammond made this commitment, the intention was for an election to be held in 2020 rather than 2017. Hence it is reasonable to suggest that he is aiming for 2025. In addition to the Chancellor's broad (and ambitious) objective, there are three detailed rules:

- to reduce the structural deficit (cyclically adjusted PSNBx) below 2% of GDP by 2020-21. This is the 'fiscal mandate'.
- that net debt (PSNDx) is falling as a percentage of GDP in 2020-21. This is the 'supplementary target'.
- welfare spending in 2022-23 is subject to a predetermined cap.

Ahead of the OBR feeding in any policy measures at the upcoming Budget, these appear to be on track. At the time of the March Spring Statement, the OBR forecast that the structural deficit would be 1.3% of GDP in two years' time. In other words the primary mandate would be met with a margin of 0.7% of GDP (or £15.4bn). The OBR's (non-adjusted) PSNBx forecast for this year in March was £37.1bn, which looks as if it could be undershot by £10bn or so. Strictly speaking we cannot say that this will represent an additional margin on the fiscal mandate – the target is cyclically adjusted and therefore also depends on the OBR's judgements on factors such as spare capacity. But in broad terms, this year's trends so far point in that direction.

Table 1: OBR March 2018 fiscal forecasts (£bn)

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
PSNBx	45.2	37.1	33.9	28.7	26.0	21.4
% of GDP	(2.2)	(1.8)	(1.6)	(1.3)	(1.1)	(0.9)
Cyclically adjusted PSNBx	46.7	40.2	35.8	29.5	26.1	21.4
% of GDP	(2.3)	(1.9)	(1.6)	(1.3)	(1.1)	(0.9)
PSNDx	1783	1835	1880	1868	1841	1893
% of GDP	(85.6)	(85.5)	(85.1)	(82.1)	(78.3)	(77.9)

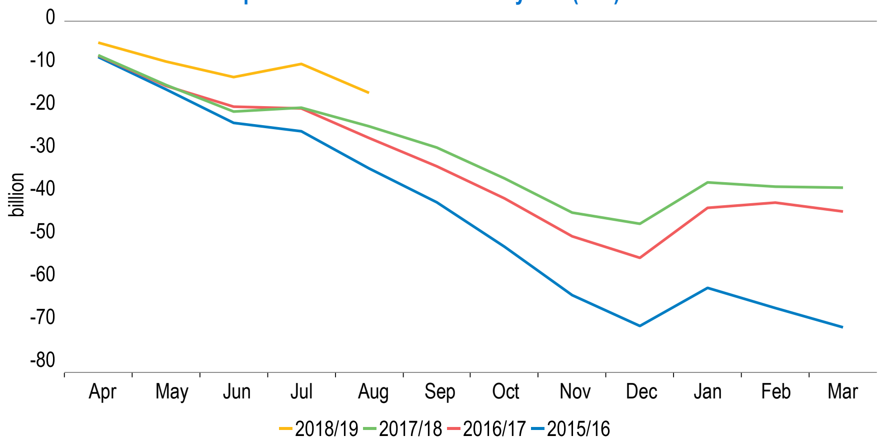
Source: Office for Budget Responsibility

On the second rule, the OBR's March judgement envisaged that debt to GDP would fall marginally this year (i.e. two years early), following a modest increase in 2017/18. Latest official data at the time of writing (new figures for September were due on 19 October) show that debt was stable last year at 85.3% of GDP. With the trends in the public finances better than expected this year (we have long argued that the goal on supplementary debt is a quasi deficit target), the OBR seems likely this time to conclude that debt to GDP will be falling more materially in 2020/21 than it believed seven months ago.

The welfare cap was only reset a year or so ago. In March the OBR reported that, at this early stage, spending in 2022/23 (the point at which the rule is assessed), was on track to undershoot the £130.2bn cap by £1.5bn. It seems unlikely that much has changed at this stage.

Decent data on the public finances so far this year partly reflects special factors, such as the timing of payments to the EU. But even abstracting from this we expect the deficit (PSNBx) to come down to £25bn-£30bn this year, a steady improvement over the past 3-4 years (see Chart 1). This marks an impressive turnaround since the end of the financial crisis. In 2009/10 borrowing totalled £153bn, 9.9% of GDP. This year the total should come in below 1.5% of GDP. Outstanding debt remains high at close to 85% of GDP, which implies that the government should at least aim to contain borrowing over the medium-term. But Mr Hammond appears to face few problems in meeting his explicit fiscal rules.

Chart 1: Cumulative fiscal position across recent fiscal years (£bn)



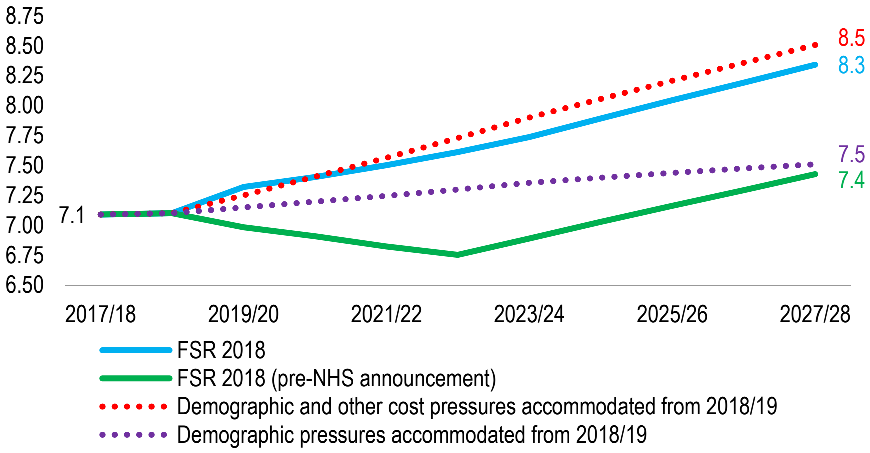
Source: Macrobond

Will Mr Hammond still aim for a balanced Budget?

A much tougher constraint would be achieving a balanced budget. In its 'Green Budget' earlier this week, the Institute for Fiscal Studies (IFS) pointed out that the government's existing plans implied continued real terms spending cuts in non-protected departments. But at the same time the PM has pledged that the UK is leaving austerity behind it. According to IFS calculations the government would require some £19bn to keep spending in these 'unprotected' areas steady. The government also faces immense pressure to provide additional funding to the NHS, relative to its current plans. Indeed at the 70th anniversary of its creation, Mrs May announced that there would be a boost to health spending. The OBR's estimates suggest that this is equivalent to an increase (in real terms) of £20.5bn by 2023/24.

Although the public finances appear to have improved more rapidly than expected at the time of the Spring Statement, there is a clear conflict between balancing the books and ending the squeeze on expenditure, at least without major tax increases. Ending the squeeze on spending and delivering Mrs May's health pledge (for example) would of course add significantly to the projected deficit which the OBR in March put at £21.4bn in 2022/23. There has been some talk about higher taxes being announced at the forthcoming Budget, but this would be politically toxic at this juncture. Indeed in the near-term, we strongly suspect that the battle between the Chancellor's economic policies and the PM's political agenda is likely to be won by Mrs May. This is especially so given the uncertainties surrounding the Brexit process and that the Prime Minister may be susceptible to a challenge at some stage.

Chart 2: Impact of unfunded June 2018 NHS spending announcement (% of GDP)



Source: OBR Fiscal sustainability report (July 2018)

Notes: The OBR has published its baseline projection for health spending over the next decade both with and without the additional funding pledged to the NHS. Based on the measures outlined at the Spring Statement, the OBR projected that health spending as a proportion of GDP would decline steadily through to 2022/23 before subsequently rising amid the demographic pressures outlined earlier. After factoring in the subsequent NHS announcement in June, however, the OBR now assumes it will rise throughout the full 10-year horizon without any offsetting tax or spending measures. This consequently sees it reach 8.3% of GDP in 2027/28, or almost a full percentage point higher than it otherwise would have been.

Not the time for a big forecast rehash…

In terms of the economy itself, the OBR will publish an updated set of growth forecasts, underpinning its new fiscal projections and the upcoming Budget. At this stage in the negotiations over the UK's exit from the EU, with Brexit talks still very much up in the air, the OBR is not planning to base its economic assessments on any specific Brexit deal. Indeed, it has said for Budget 2018 there will be no significant changes to its "broad brush" Brexit assumptions.

In the midst of this Brexit uncertainty, we also suspect that forecast changes made at this round will be of the nature of adjustments to existing numbers, rather than a wholesale re-work. Broadly, we would expect the other contours of the economic forecasts to hold up, albeit probably on a view that global growth this year and next will be slightly, but not materially, less robust, than envisaged back in March 2018 (forecasts were for 3.9% world GDP growth this year and next). We suspect we will be faced with a modest downgrade to the 2018 UK GDP growth forecast (currently 1.5%) and perhaps a modest upgrade to the 2019 forecast (currently 1.3%). However we see little shift in the medium term UK growth positon, which currently envisages growth in a range of 1.3%-1.5% over the period to 2022.

Table 2: OBR March 2018 macroeconomic forecasts (annual % change unless stated)

	2017	2018	2019	2020	2021	2022
GDP	1.7	1.5	1.3	1.3	1.4	1.5
Output gap (% of potential GDP)	0.1	0.3	0.1	0.0	0.0	0.0
Productivity (GVA per hour)	0.6	0.8	0.9	1.0	1.1	1.2
Average earnings	2.6	2.7	2.4	2.5	2.8	3.0
Household consumption	1.7	0.9	0.9	1.1	1.4	1.5
Unemployment (% rate)	4.4	4.4	4.5	4.6	4.6	4.6
CPI	2.7	2.4	1.8	1.9	2.0	2.0
RPI	3.6	3.7	3.0	2.9	2.9	3.0

Source: Office for Budget Responsibility

One area which the OBR might have had a bigger look at is its unemployment projections which, in March 2018, envisaged the unemployment rate closing the current year at 4.4% and then rising a little to 4.6% by the end of 2022. Given that the jobless rate has continued to decline (to 4.0% currently), the OBR will almost certainly push down its end of 2018 forecast. Note though that again, much like with its GDP projections, it may be reluctant at this stage to make much bigger wholesale revisions, given the scope for the shape of the final Brexit deal to shift the balance of both the supply and demand for labour.

Broadly, we do not envisage the independent forecasting office making big enough changes to its economic forecasts, to shift the dial much on the fiscal backdrop. While the latter will be updated of course, this will principally be on account of any policy changes announced, plus ‘autonomous’ shifts (in this case the improvements discussed above) in the public finances.

PM May has given the Chancellor an expensive shopping list…

Since the Spring Statement in March 2018, Prime Minister May has pointed to numerous medium term fiscal giveaways and none of which look particularly cheap. They include:

- The Prime Minister’s June 2018 promise that the NHS budget will be expanded materially, with the OBR estimating her pledge would amount to a real terms increase in spending of £20.5bn by 2023/24.
- The announcement that Fuel Duty will be frozen for the ninth year in a row. The freeze on fuel duty will cost £800m a year.
- Prime Minister May’s renewal of her personal mission to fix the UK’s broken housing market in her speech at the Conservative Party conference this year, implying there may be further support on its way. Specifically here, we have already heard May’s pledge to raise councils’ borrowing cap (on how much councils could borrow against the value of their housing stock) so they are able to fund for housebuilding; an increase in council borrowing will lift the overall public sector net borrowing total, with the impact expected to be around £1bn a year.
- The government’s Universal Credit scheme has come under increasing pressure of late, with a group of 27 Conservative MPs arguing that the welfare scheme needs an extra £2-3bn of cash to avoid leaving groups “significantly out of pocket”.

How does the Spending Review fit in?

The next Spending Review (SR 2019) is set to take place in 2019 and this will provide the Chancellor with the opportunity to review how it responds to the long term fiscal challenges facing the Exchequer. It was envisaged at the time of the Spring Statement that the envelope for SR 2019 – i.e. the total envelope for spending over the period - would be published at the 2018 Budget (i.e. 29 October). This would outline the government's spending commitments in aggregate and would therefore provide a template for the extent of tax increases that would be necessary to balance the books.

Would the government really want to do this at this stage? We guess probably not. Accordingly it is possible that the Chancellor will delay publishing the envelope. He could argue that it is sensible to do so until there is a clearer view of the final Brexit package and therefore the path the economy will take over the next few years.

Mr Hammond could instead commit to some increases in NHS cash over the short-term and announce that long-term decisions will be published at SR 2019. This would of course minimise disruption to the fiscal arithmetic without unveiling a major programme of tax increases and allow the Chancellor to look for some offsetting savings in other areas too.

Revenue raising measures to be measured…

Assuming the Chancellor does shy away from publishing the envelope for SR 2019 and making long term spending promises at the upcoming Budget, we suspect that any revenue raising tax announcements in this Budget will not be of the biggest ticket type.

In this context, we note that the Institute for Fiscal Studies (IFS) has looked at approaches which could increase tax revenues by around 1% of national income, enough to pay for the increase in NHS cash. They estimate that adding 1ppt to all income tax rates, or all self-employed NICs rates or the main rate of VAT would raise similar amounts of the order of £5.4bn to £6.2bn. These would be material changes; lifting tax revenue by 1% of national income would "put the tax burden in the UK at around the highest level seen in the post-war era", the IFS estimates. We do not see tax changes of this scale as politically feasible, at this stage. As such, we suspect that the Chancellor will be looking at other smaller options to pick-up some cash, without worsening the political firestorm ahead of Brexit. Here we note there has been talk of the following fiscal measures coming forward:

- A cut to pension tax relief for high earners. Here it is being reported that Mr Hammond is either considering a reduction to the tax-free annual allowance or by reducing the rate of relief. Currently, annual allowances of £40k (tax free) are tapered downwards after earnings reach £150k. The talk is that this that could be lowered.
- Recognising that it is easier to withhold than to withdraw a current benefit, there has also been some talk that the Chancellor might delay plans to raise income tax thresholds. Here the Conservative party's manifesto pledge to raise the personal allowance (threshold for the 20p tax rate) to £12.5k by 2020 and the 40p rate threshold to £50k, could be vulnerable. However, no matter how desperate Mr Hammond is to raise some cash, we wonder if Prime Minister May will put the brakes on any such ideas, fearing a rebellion from within an already hostile Tory party.

- Other revenue raisers that the Chancellor might look to include a further shot at overhauling tax rules which allow self-employed people to avoid paying National Insurance Contributions, whilst it is quite possible that Mr Hammond will have another broad shot at closing tax loopholes. Indeed, loophole closing will probably be one of the revenue raisers the Chancellor can actually get away with without too much pushback from the PM.

Whilst we expect to see some revenue raising initiatives announced on the 29 October, our assumption is that this will not be a Budget littered with tax rises and indeed some of the above changes could well be left in Mr Hammond's back pocket. If the Chancellor does opt to delay the publication of the Spending Review envelope that will allow him to look more comprehensively at how he funds new fiscal commitments such as the NHS and what tax adjustments (at next year's Budget) are needed. On top of this, if Brexit talks reach a positive outcome, a 2019 decision on the spending envelope might also allow Mr Hammond to build in something of a boost from this, if this leads the OBR to push up its economic projections. This might further limit the scale of any revenue raising measures required and/or the need for Chancellor to admit defeat on his ambition to eliminate the deficit in the middle of the next decade.