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Economics

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Budget reaction 2018 – Budget bonanza before Brexit

- Philip Hammond delivered his third Budget this afternoon. In a difficult political climate he has avoided a few potentially debilitating pitfalls recently. One was that by holding the Budget Statement today instead of Wednesday, he sidestepped a volley of vampire-type Halloween based headlines. And while there was talk of a Chancellor quitting earlier today, the subject was Angela Merkel rather than himself.
- In our Budget preview *(Pushing the envelope (back to 2019))*, we argued that Mr Hammond faced an unusual combination of circumstances in preparing his Budget. On one side, the deficit is closing more rapidly than expected at the time of his Spring Statement in March. On the other, the public finances are under greater pressure over the longer-term, not least due to the PM's commitments to the health service and 'ending austerity'. His approach was straightforward – spend the budgetary windfall and concentrate on the NHS. The numbers are considerable. Last year we talked about a meaningful fiscal stimulus in the third year of the forecast of £9.9bn. The equivalent numbers this year are £2.3bn this year, £15.1bn next, rising to £30.6bn by 2023/24. Almost needless to say, this is a considerable fiscal expansion.
- The Chancellor made quite a lot of the OBR's forecast of meeting his relevant fiscal rules early. Indeed, the (cyclically adjusted) deficit is estimated to have been below 2% of GDP last year (three years early). Meanwhile outstanding debt is expected to be falling rapidly as a percentage of GDP in the targeted year of 2020/21. But Mr Hammond said nothing about balancing the Budget by 2025, his broad aim. Perhaps unsurprisingly, political imperatives have overtaken strict fiscal orthodoxy.
- We should stress that a budget deficit of below 1% of GDP in five years or so's time is relatively respectable. The point of concern is that debt as a percentage of GDP is still envisaged to be relatively high at 74.1%. An economic shock, were it to occur could raise this to dangerous territory. We would also make the point that a squeeze will remain on other areas of public services. We will not know for sure quite how much until next year's Spending Review (SR), which will finalise the 'envelope' and clarify the allocation of cash across the various departments. But we suspect that while austerity might be perceived to have ended in the NHS, this may not be the case in other areas of government. Hence today's Budget is probably not a '*get out of jail free card'* in terms of overall political pressure on expenditure.
- The OBR's economic forecasts have a similar look and feel to them from seven months ago. However in terms of interest rate policy, the extent of fiscal stimulus will make the Monetary Policy Committee more rather than less inclined to tighten policy. We may get a qualitative assessment from Mark Carney at Thursday's Inflation Report press conference. However the Budget measures were unlikely to be known in time for the MPC to assess them within its formal forecasting process. This is convenient as it gives the committee the chance to see how Brexit developments pan out. Of course a disruptive no deal could alter the economic landscape abruptly, and with it the policy outlook.

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Few changes to borrowing, huge policy shift

As we mentioned above, the policy give away has been considerable, rising above £30bn in 2023/24. The specific measures are discussed below, but from an overall cost perspective they are largely offset by a handful of revenue raising measures and the improvement in the public finances which has unfolded over the course of this financial year.

The OBR's borrowing forecast for 2018/19 has been lowered to £25.5bn from (a restated) £36.2bn in March. But thereafter there is little or no improvement in the profile (Table 1). As the OBR explains, the 'in-year judgements' provide a budgetary windfall for the Exchequer. Table 2 also shows that a change in the OBR's judgement on 'equilibrium unemployment' (a wider than expected output gap) also helps here. But the favourable effects are all spent (and more).

Table 1: OBR October 2018 fiscal forecasts, £bn (figures in brackets % of GDP)

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
PSNBx	39.8 (1.9)	25.5 (1.2)	31.8 (1.4)	26.7 (1.2)	23.8 (1.0)	20.8 (0.9)	19.8 (0.8)
OBR March 2018 forecast	45.2 (2.2)	37.1 (1.8)	33.9 (1.6)	28.7 (1.3)	26.0 (1.1)	21.4 (0.9)	
OBR November 2017 forecast	49.9 (2.4)	39.5 (1.9)	34.7 (1.6)	32.8 (1.5)	30.1 (1.3)	25.6 (1.1)	
Cyclically adjusted PSNBx	39.4 (1.9)	28.4 (1.3)	36.0 (1.6)	30.1 (1.3)	25.9 (1.1)	22.2 (0.9)	21.0 (0.8)
OBR March 2018 forecast	46.7 (2.3)	40.2 (1.9)	35.8 (1.6)	29.5 (1.3)	26.1 (1.1)	21.4 (0.9)	
OBR November 2017 forecast	48.0 (2.3)	37.9 (1.8)	32.3 (1.5)	29.7 (1.3)	28.1 (1.2)	25.0 (1.1)	
PSNDx	1779 (85.0)	1810 (83.7)	1851 (82.8)	1841 (79.7)	1809 (75.7)	1856 (75.0)	1896 (74.1)
OBR March 2018 forecast	1783 (85.6)	1835 (85.5)	1880 (85.1)	1868 (82.1)	1841 (78.3)	1893 (77.9)	
OBR November 2017 forecast	1791 (86.5)	1840 (86.4)	1885 (86.1)	1879 (83.1)	1853 (79.3)	1909 (79.1)	
Welfare cap and pathway (plus margin)#		122.1	123.8	127.2	131.0	135.0	
Welfare spending October 2018 forecast*		119.8	121.8	123.4	126.0	129.1	
Difference		-2.3	-2.0	-3.8	-5.0	-6.0	

#Welfare cap is set at £131.1bn by the 2022/23 fiscal year. Margin for error reaches 3% in the target year. *Includes an adjustment for inflation. Source: Office for Budget Responsibility

The latest profile for borrowing (beyond the current year) is in the same ballpark as that published in March. By 2023/24 the deficit is reckoned to be £19.8bn, or 0.8% of GDP. Again as referenced above, there seems little attempt here to square the books, for obvious political reasons. We would reinforce the point that simply looking at the borrowing profile masks what is going on. A significant dividend is being spent. The OBR makes the point that were it not for the Chancellor's policy decisions, the public finances would enjoy a small surplus in five years' time.

The budgetary watchdog acknowledges that Mr Hammond is on course to meet his fiscal targets. His fiscal mandate (cyclically adjusted borrowing to be below 2% of

GDP in 2020/21) was hit last year i.e. three years early. On debt, his rule is that PSND to GDP should be falling in 2020/21. This is forecast to be dropping sharply in the target year and is in fact expected to decline this year. Separately (and following various reclassifications) the OBR also expects the government to undershoot its welfare cap (including margin) by £6.0bn in 2022/23.

However the OBR makes it clear that eliminating the deficit by 2025/26 is even more challenging than seemed the case in March. Indeed our guess is that despite today's Budget, political pressures on the government to spend more will remain over the next couple of years. Hence any further 'windfalls' are likely to be spent rather than banked. Furthermore while we remain of the view that a disorderly Brexit is unlikely, should this occur, then negative economic consequences are likely to follow. In such an instance the public finances would look very different indeed.

Table 2: Changes to public sector net borrowing since 2018 Spring Statement

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
PSNBx							
March 2018 forecast (restated#)	45.6	36.2	32.9	27.6	24.8	20.2	
October 2018 forecast	39.8	25.5	31.8	26.7	23.8	20.8	19.8
Like-for-like difference	-5.8	-10.8	-1.1	-1.0	-1.0	0.6	
Revisions to receipts							
Of which							
In-year judgements	-0.4	-6.4	-6.5	-6.6	-6.8	-7.1	
Other	0.0	-1.0	-1.5	-1.4	-4.4	-7.0	
Revisions to spending							
Of which							
Equilibrium unemployment	0.0	-0.3	-0.6	-0.6	-0.6	-0.5	
Other	-5.3	-4.2	-3.5	-3.1	-3.0	-3.5	
Total effect of gov. decisions		1.1	10.9	10.7	13.7	18.8	23.2
Of which							
Impact of NHS settlement on TME		0.0	7.4	11.1	16.1	21.4	27.6
Other		1.1	3.6	-0.4	-2.4	-2.6	-4.4

Source: HMT Autumn 2018 Budget, Investec calculations

Economic forecasts similar amidst Brexit uncertainty…

The OBR published an updated set of growth forecasts, underpinning its new fiscal projections today. The broad shape of these was relatively similar to the projections published at the time of the Spring Statement with the independent forecasting office continuing with its "broad brush" Brexit assumptions, rather than working off any specific Brexit deal. At home, GDP growth for the current year was pushed down to 1.3% (was 1.5%) whilst there was an upgrade to the 2019 forecast to 1.6% (was 1.3%). However, despite the chunky fiscal giveaway, overall there was relatively little change in the medium term UK growth positon, which now envisages growth in a range of 1.4%-1.6% over the period to 2023 (was 1.3%-1.5% out to 2022). Overall, the economic backdrop was not a key driver of the shift in the fiscal projections laid out today. As explained above this came from the planned (very material) loosening of the purse strings. The key macroeconomic forecasts are summarised below.

Table 3: OBR October 2018 macroeconomic forecasts (annual % change unless stated)

	2018	2019	2020	2021	2022	2023
GDP	1.3	1.6	1.4	1.4	1.5	1.6
OBR March 2018 forecast	1.5	1.3	1.3	1.4	1.5	
OBR November 2017 forecast	1.4	1.3	1.3	1.5	1.6	
Output gap (% of potential GDP)	0.2	0.3	0.2	0.1	0.1	0.1
OBR March 2018 forecast	0.3	0.1	0.0	0.0	0.0	
OBR November 2017 forecast	-0.1	-0.2	-0.2	-0.1	0.0	
Productivity (GVA per hour)	0.8	0.8	0.9	1.0	1.1	1.2
OBR March 2018 forecast	0.8	0.9	1.0	1.1	1.2	
OBR November 2017 forecast	0.9	1.0	1.2	1.3	1.3	
Average earnings	2.6	2.5	2.8	3.0	3.1	3.2
OBR March 2018 forecast	2.7	2.4	2.5	2.8	3.0	
OBR November 2017 forecast	2.3	2.3	2.6	3.0	3.1	
Household consumption	1.3	1.2	1.2	1.3	1.4	1.5
OBR March 2018 forecast	0.9	0.9	1.1	1.4	1.5	
OBR November 2017 forecast	0.8	1.2	1.2	1.5	1.6	
Unemployment (% rate)	4.0	3.7	3.8	3.9	3.9	4.0
OBR March 2018 forecast	4.4	4.5	4.6	4.6	4.6	
OBR November 2017 forecast	4.3	4.4	4.6	4.6	4.6	
CPI inflation	2.6	2.0	2.0	2.1	2.1	2.0
OBR March 2018 forecast	2.4	1.8	1.9	2.0	2.0	
OBR November 2017 forecast	2.4	1.9	2.0	2.0	2.0	
RPI inflation	3.5	3.1	3.1	3.2	3.1	3.1
OBR March 2018 forecast	3.7	3.0	2.9	2.9	3.0	
OBR November 2017 forecast	3.3	2.8	2.9	2.9	3.0	

Source: Office for Budget Responsibility

Fiscal Phil feeling less thrifty….

Amidst the tense political backdrop which has existed in the run up to this Budget, including continuing debate over whether Prime Minister Theresa May will face a leadership challenge soon, she has been busy making various spending promises to try and shore up the support of her colleagues and the electorate. Indeed, at the recent Conservative party conference the Prime Minister pledged to end austerity. She also insisted that we would not see the end of responsibility although she left her Chancellor with quite a shopping list which was laid bare in today's Budget.

More than just some money for the NHS

The flagship pledge made by the Prime Minister, back in June, was her promise that the NHS budget would be expanded materially. The Chancellor confirmed this again today stating that the NHS "is the public's number one priority and the government will increase its budget by £20.5 billion after inflation by 2023-24". Today's Budget included £7.4bn for the next fiscal year and £11.1bn for this in 2020/21, rising to £27.6bn by 2023/24. Other big spending commitments are listed below - note this is not an exhaustive list:

- Mr Hammond made a costly pledge to deliver on the manifesto promise to raise the personal allowance by £650 to £12,500 and the Higher Rate Threshold from £46,350 to £50,000 in April 2019, a year earlier than planned. This comes at an estimated cost of £2.8bn in 2019/20 and £1.9bn in 2020/21.
- More cash to smooth the introduction of Universal Credit was set out, with the scheme coming under increasing pressure of late. Here £1.7bn was made available; the Chancellor said this would mean working parents and people with disabilities claiming Universal Credit will be £630 better off each year.
- Alongside the extra cash earmarked for the NHS we also saw the Chancellor dish out further cash for social care, with local authorities in England set to receive a further £650m next year.
- At the recent Conservative party conference the Prime Minister again promised to personally fix the broken housing market. Today we heard the Chancellor commit the government to raising councils' borrowing cap (on how much councils could borrow against the value of their housing stock) so they are able to fund more housebuilding. There was also extra cash for Scotland, Wales and Northern Ireland to spend in devolved areas, including education, health and housing.
- Also on the housing front, note that the Chancellor announced the government is extending first-time buyers relief in England and Northern Ireland so that "all qualifying shared ownership property purchasers can benefit, whether or not the purchaser elects to pay SDLT on the market value of the property". This looks to be a relatively cheap 'gift' from government, at a cost of £5m in 2019/20.
- A £28.8bn National Roads Fund, paid for by vehicle excise duty, including £25.3bn for the Strategic Road Network was set out.
- On duties, it was confirmed today that fuel duty will be frozen again, costing £840m next year. Most alcohol duties were also frozen (spirits, beer and cider) costing the exchequer another £170m next fiscal year and more over the subsequent years.
- Finally note that Mr Hammond pledged £1.5bn to support the high street. Specifically here we had the news that small retail businesses will see their business rate bills cut by a third for two years from April 2019, saving them £900m.

Revenue raisers in the shadows…

Today's Budget was very much about giveaways, but any Chancellor, no matter how much political pressure is faced, will feel compelled to look to raise some revenue where possible. Clearly the scale of the revenue raising measures announced today do not match up to the promises, but there were some of note as listed below - again this is not an exhaustive list.

- A new digital services tax was unveiled where from April 2020 "large social media platforms, search engines and online marketplaces" will pay a 2%

tax on the revenues they earn which are linked to UK users. This is expected to bank £440m a year for the exchequer by 2023/24.

- On the small company front, the threshold at which companies start paying VAT has been frozen at £85,000 for a further two years.
- The Chancellor earmarked the extension of reforms to "off-payroll working" to the private sector as another source of revenue, where he looks for this to bring in £1.2bn at its peak in 2020/21.
- As part of its wider strategy on tackling single-use plastic waste, Mr Hammond announced he will introduce a tax on the production and import of plastic packaging from April 2022. The details of this will be subject to consultation.

Table 4 below summarises the key policy measures announced and the overall fiscal cost of these announcements.

Table 4: Policy decisions taken at Autumn Budget 2018 (£mn)

	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Spending measures						
NHS: 5 year settlement agreed in June 2018	0	-7,350	-11,130	-16,090	-21,400	-27,610
Universal Credit: various changes	-35	-730	-715	-540	-895	-1,650
Local Authority Housebuilding: borrowing cap	-95	-385	-850	-855	-1,235	-1,235
Social Care: 2018/19 & 2019/20 funding	-285	-775	-	-	-	-
Defence: 2018/19 & 2019/20 funding	-200	-800	0	0	0	0
Future High Streets Fund: resource	0	-20	-15	-15	-10	-5
Transport: road maintenance	-500	0	0	0	0	0
Schools: 2018-19 capital	-475	0	0	0	0	0
Other spending measures	-445	-845	-660	-380	-110	-20
Total spending decisions	**-2,035**	**-10,905**	**-13,370**	**-17,880**	**-23,650**	**-30,520**
Tax measures						
Personal Allowance & Higher Rate Threshold: increase to £12.5k & £50.0k	0	-2,790	-1,935	-1,445	-1,605	-1,780
Fuel Duty: freeze for 2019/20	0	-840	-855	-880	-910	-935
Off-payroll Working: extend reforms	-5	-150	1,165	595	635	725
Structures & Buildings Allowance changes	-55	-165	-260	-365	-475	-585
NICs adjustments	-5	180	395	370	335	310
Digital Services Tax	0	5	275	370	400	440
Remote Gaming Duty: raise to 21% Oct-2019	0	130	255	265	280	295
Fixed Odds Betting Terminals	0	-120	-245	-255	-260	-270
Alcohol Duties: freeze spirits, beer & cider in 2019 & set rate for high strength cider	-35	-165	-175	-175	-180	-185
Business Rates: retail premises	10	-490	-450	45	-15	0
Other tax measures	-180	225	805	1,755	1,920	1,945
Total tax decisions	**-270**	**-4,180**	**-1,025**	**280**	**125**	**-40**
Net effect of policy decisions[1]	**-2,305**	**-15,085**	**-14,395**	**-17,600**	**-23,520**	**-30,560**

[1] Totals may not sum due to rounding.

Source: HMT Autumn 2018 Budget

Back to Brexit and then to the next fiscal event…

Today's big giveaway Budget is quite clearly a concerted play by the Chancellor and his Prime Minister to build up the support of the electorate and in achieving this it has sought to ensure the end of austerity message reaches the "man on the street". It is, of course, but particularly so this time, designed make the opposition's life more difficult, with the Budget loosening the purse strings by so much. The Prime Minister and her Chancellor will clearly be hoping this helps to see off the threat of a leadership challenge.

Note that as material as today's Budget's announcements are, these do still mark the start of a new fiscal process as we move towards Spending Review 2019 (SR2019); today Mr Hammond announced his indicative 5-year path for departmental spending, which will grow by an average 1.2% a year in real terms, with further funding expected from the Brexit deal "dividend". Here Mr Hammond expects that if Brexit goes to plan, he gets extra fiscal wiggle room from a better economic backdrop and from being able to re-divert his Brexit contingency fund. As Mr Hammond has indicated, if Brexit is smoother than this, the Chancellor will be looking to bank his "double dividend" which will no doubt make the spending round process less uncomfortable, though we note that spending reviews are never comfortable experiences. Note that we do not yet know the precise timing of SR2019. That will depend on how smooth the UK's path through Brexit is as will the timing of the next Budget. Mr Hammond again indicated that, depending on the path of Brexit, another extra Budget could be forthcoming too.

Note finally, Prime Minister Theresa May is probably breathing a sigh of relief after the government's confidence and supply partner - the Democratic Unionist Party - said it will support the Budget, having previously threatened to vote against it. With Budget votes (at least prior to the Fixed-term Parliaments Act, which put certain confidence motions on a statutory basis for the first time) seen as effective confidence votes this looked to be problematic. For now, that looks to be one imminent challenge to Prime Minister May averted.