An ambitious bid to repair the public finances

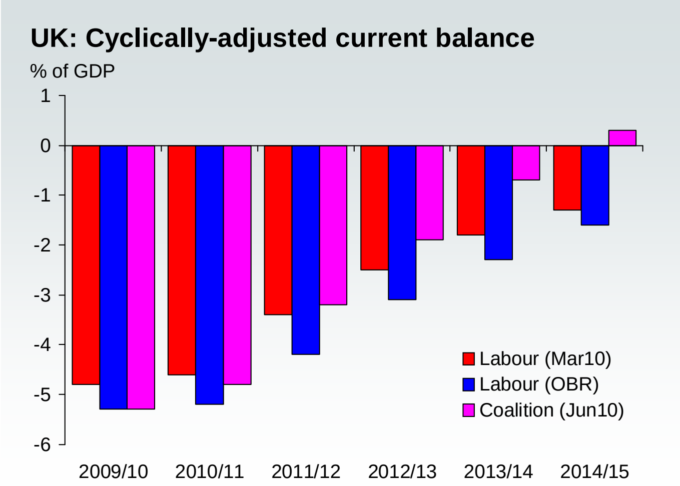
Key points:

- This was an ambitious bid to repair the public finances, with the Chancellor setting a target of returning the cyclically adjusted current budget to balance by 2015/16 and then setting out plans to reach this target a year early. The additional tightening is split 77:23 in favour of spending cuts and history tells us that austerity packages which are focused on spending have the best chance of succeeding
- In the context of the hand that the Chancellor had been dealt, this looks like a well crafted Budget. But we are concerned that the OBR has under-estimated the damage that the tightening will do to near-term growth prospects. While the effects are unlikely to be sufficient to push the economy back towards recession, it does suggest that there is some upside risk to the borrowing forecasts.

This was the most eagerly awaited Budget in many years and in the event it did not disappoint with the Chancellor setting in train the most aggressive fiscal consolidation package since the early 1980s. Mr Osborne said that the Budget was 'unavoidable', given the state of the public finances, and emphasised that all parts of society would have to share the cost of reducing the deficit. In an attempt to bolster credibility the Chancellor published significantly more information than his predecessor and laid out a far more detailed plan to regain control over the public finances.

Significant acceleration in the fiscal consolidation plans…

The Chancellor made good on his pre-election pledge to significantly accelerate the pace of fiscal consolidation. Arguing that running persistently wide deficits would push up long-term interest rates and crowd out the private sector, he announced that the government's target was to return the cyclically-adjusted current budget to balance by 2015/16, but then gave himself a buffer by announcing a package that he expected to deliver this aim a year ahead of schedule. In order to achieve this aim he presented a further tightening of policy equivalent to £40bn, which is carefully phased in across the course of the parliament, in an attempt to avoid applying too much pressure on consumers and businesses in the early stages of the recovery.



Source : HM Treasury, Office for Budget Responsibility

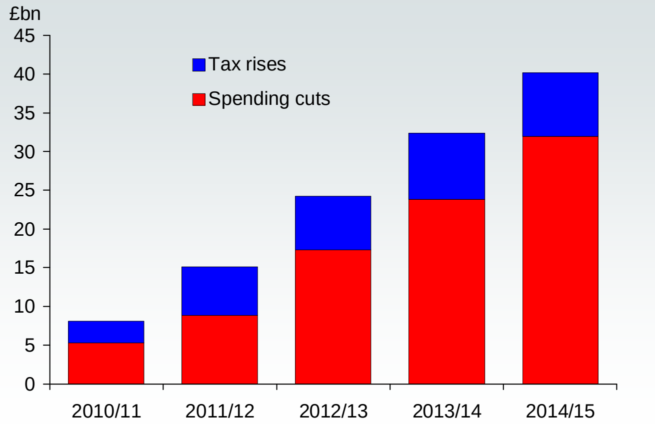
….with the focus on spending cuts

As expected the package was focused on spending cuts, which accounted for 77% of the £40bn of tightening. Having criticised his predecessor for a lack of clarity on where the axe would fall, the Chancellor broke his spending projections down into Departmental Expenditure Limits (DEL) and Annually Managed Expenditure for the next five years, with the pain spread across both areas.

£11bn of spending costs are planned to come through reform of the welfare system, including a move to using the CPI, rather than the RPI, for the indexation of benefits. Plans for DEL are around £16bn lower by 2014/15, compared with the Office of Budget Responsibility (OBR) analysis of the Labour plans, and with the Chancellor restating his desire to protect health spending and fulfil foreign aid obligations, this implies real terms cuts of 25% over four years for the other departments. The exact split will be announced in the Comprehensive Spending Review (CSR) on 20th October, but the Chancellor made clear that the cuts will not be uniform and that the claims of departments such as education and defence are likely to be viewed more favourably than others. As part of the spending cuts, public sector pay will be frozen for two years for anyone earning more than £21,000.

It will be difficult to judge the credibility of the planned spending cuts until the CSR has taken place, but the Chancellor has provided as much detail as could realistically have been expected at this juncture, given that he has been in office for just over a month. In terms of the composition of the package, however, the signs are promising as a substantial literature suggests that budgetary adjustments focused on expenditure reductions have a better chance of success than tax-driven adjustments. In addition, the literature suggests that corrections which concentrate on cutting current spending, rather than capital spending, have the best chance of success. The Chancellor declined to make any further cuts to capital spending – the Labour cuts were already draconian – so Mr Osborne also appears to be on the right track here too.

UK: Composition of fiscal tightening

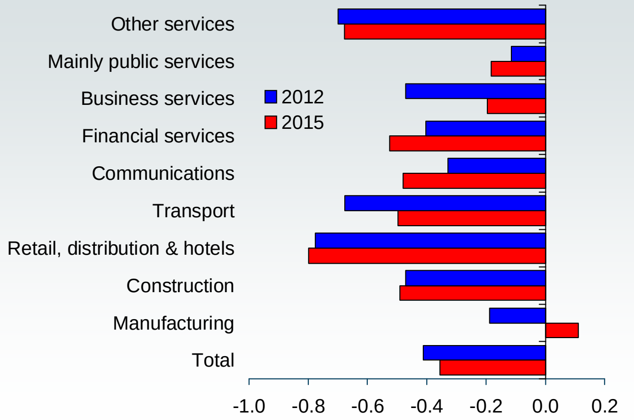


Source : HM Treasury

Tax changes aimed at promoting business and fairness

Though tax changes accounted for only 23% or £8bn of the total package, there were a number of significant announcements. The headline measure was the increase in the standard rate of VAT from 17.5% to 20% on 4th January 2011, which the Chancellor expects to raise an extra £13.5bn in 2014/15. This move was so well trailed that it would have been a surprise had it not happened, but it does represent a risk for the Chancellor; our modelling prior to the Budget suggested that raising VAT to 20% would have a significant impact on the fortunes of all parts of private services, with the retailers and the hospitality sector being particularly badly affected.

Impact on output of increase in VAT to 20%



Source : Oxford Economics

However, one benefit of raising so much from VAT was that the Chancellor could offset it with tax cuts in other areas, with the accent on helping business and promoting fairness. This included raising the income tax personal allowance by £1,000 from April 2011 – with offsets to ensure that higher rate taxpayers do not gain – in an attempt to help lower paid workers. This could be expected to partially offset the impact of the VAT rise, given that the lower paid tend to consume a greater proportion of their incomes than higher earners.

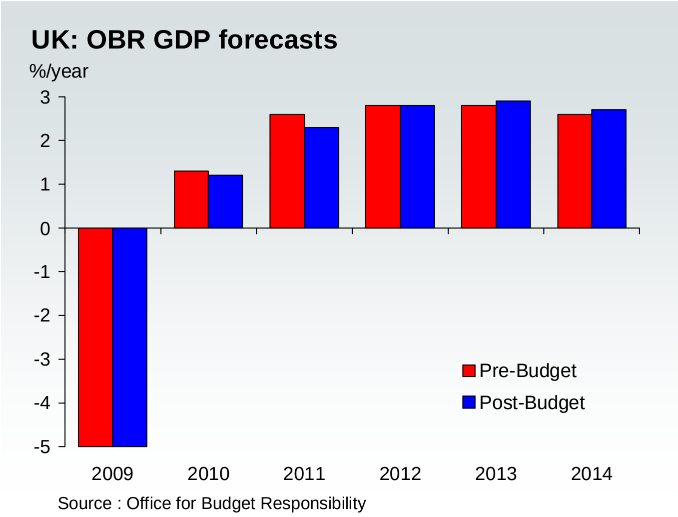
There was also significant assistance for business. The main rate of corporation tax is due to be reduced by 1% a year so that it reaches 24% by 2015, although the benefits will be mitigated to some extent by changes to capital allowances. And the Chancellor followed through his pledge to offset the impact of Labour’s planned increase in employers’ National Insurance Contributions, even going further for new, small, firms outside of London and the South East.

The other significant revenue raiser for the Chancellor was the introduction of a bank levy on banks’ balance sheets. This carries risks in terms of international competitiveness, though the Chancellor attempted to head off concerns by announcing that France and Germany were keen to implement a similar policy imminently.

The economic forecasts remain a concern

In previous Budgets we routinely expressed concern about the economic forecasts and the rapid recovery that they assumed. The first experience of the OBR, with last week’s release of the Pre-Budget forecast, suggested that the new regime was destined to publish more credible forecasts and the advent of the ‘before and after’ forecasts, which would effectively show the impact on the wider economy of Budget policy decisions, should have been another step in the right direction.

However, the first set of post-Budget forecasts raise concerns that the OBR has under-estimated the impact of the planned tightening package. While the scale of the boost to growth in later years – generated by the benefits of lower borrowing – does not look unreasonable, the damage done to short-term prospects looks too low. This is most obvious in 2011 where, despite VAT rising to 20% and current spending being around £10bn lower than the pre-Budget forecast, GDP growth is forecast to be just 0.3 percentage points lower than before. While the effects of the tightening package are unlikely to be sufficient to push the economy back towards recession, given that they are phased in over the course of the parliament, it does suggest that there is some upside risk to the borrowing forecasts, which might mean that the Chancellor needs to use the extra year to return the cyclically-adjusted current budget to balance after all.



Conclusion

Overall this was a landmark Budget, with the Chancellor choosing to pursue the most ambitious of his possible options and we would expect markets to be broadly happy with this approach. In terms of the policy mix, the focus on spending would appear to be the right one and, though we have some concerns about the potential damage that the rise in VAT could do, these concerns are partly assuaged by the fact that some of the proceeds have been used to promote effective tax cuts elsewhere, in particular in raising income tax personal allowances for the lower paid and reducing corporation tax.

There is some concern that the OBR has under-estimated the damage that the tightening will do to near-term growth prospects. While the effects are unlikely to be sufficient to push the economy back towards recession, it does suggest that there is some upside risk to the borrowing forecasts.

If you would like to discuss the implications of the Budget with one of our economists then please contact Andrew Goodwin (T: 020 7803 1417, E: agoodwin@oxfordeconomics.com) or Hetal Mehta (T: 020 7803 1420, E: hmehta@oxfordeconomics.com)