

Going for broke?

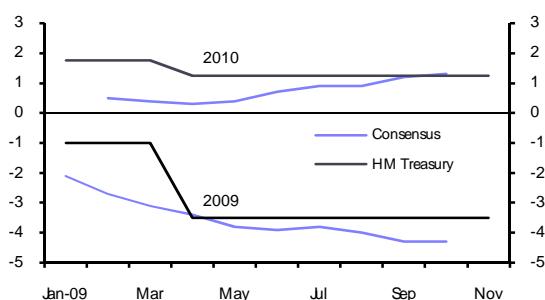
Alistair Darling faces some difficult choices in presenting the Pre-Budget Report on December 9th. While the pressure to sort out the public finances is building, the economy remains in need of support. And the general election is looming. In this *Preview*, I discuss which route the Chancellor will take and what measures might be included. Will he tighten the screws, or go for broke?

The economy

The good(ish) news for Mr Darling is that, for the first time in a while, he will not have to tear up his previous projections for the economy completely. Admittedly, Q3's unexpected 0.3% drop in GDP left his Budget forecast of average growth this year of between -3.75% and -3.25% unattainable without substantial revisions to the data. He is likely to pull it down to around -4.5%.

But Chart 1 shows that, while at the time of the Budget, his midpoint forecast of growth of 1.25% in 2010 was well above the consensus prediction amongst outside forecasters, the latter has risen to meet it over recent months. He is therefore likely to keep it unchanged in the PBR, or possibly even nudge it a touch higher. The forecast of 3.5% growth in 2011 - though far too optimistic in our view - is also likely to remain intact.

CHART 1: HMT & CONSENSUS FORECASTS FOR GDP GROWTH

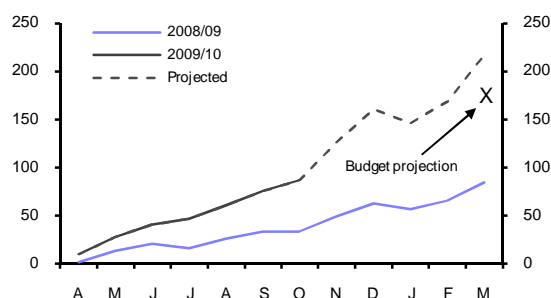


Source – HM Treasury

The public finances

Likewise, for once the outlook for the public finances has not deteriorated *too* dramatically since the Budget. Admittedly, October's £11.4bn public sector net borrowing (PSNB) total left borrowing on track, on current trends, to reach around £215bn in the full year, some £40bn above the April Budget forecast. (See Chart 2.) But Mr Darling will hope for a more favourable trend in the remaining five months, not least because of the renewed rise in VAT in January. He may therefore push his PSNB forecast up just a touch, perhaps to around £185bn.

CHART 2: PUBLIC SECTOR NET BORROWING (£BN, FY CUM.)



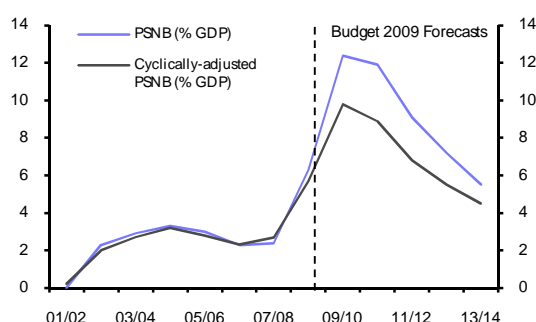
Source – HM Treasury

What's more, with the economic forecasts for next year and beyond unlikely to alter much, the Chancellor should not feel the need to lift his medium-term projections for borrowing sharply. Indeed, there may even be some reasons for bringing them *down* a bit. It now looks unlikely, for example, that claimant count unemployment will rise as far as the Budget assumed, with the result that social security spending may be lower.

The problem for the Chancellor is that, even without any major changes in the PBR, the current projected path for the public finances is clearly not a sustainable one. After all, public borrowing is still expected to total close to £100bn per annum at the end of the forecast period in 2013-14, over 5% of GDP. What's more, Chart 3

shows that the vast bulk of this is accounted for by cyclically-adjusted or *structural* borrowing, suggesting that even a stronger economic recovery than Mr Darling has assumed might not plug the gap in the public finances.

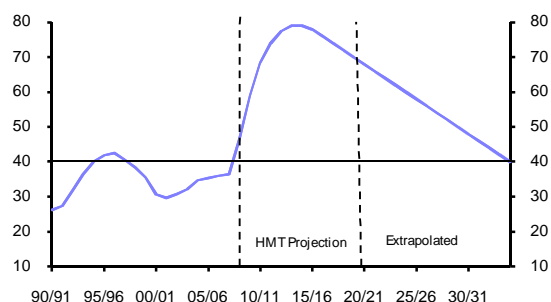
CHART 3: PSNB & CYCLICALLY-ADJUSTED PSNB



Source – HM Treasury

The persistence of a sizeable budget deficit means that the outstanding amount of public sector net debt is set to rise sharply over the coming years. As Chart 4 shows, on current plans, the ratio of public debt to GDP will not start to fall until around 2015 and will not return to the 40% ceiling previously specified as “prudent” by the now-abandoned fiscal rules until about 2035.

CHART 4: PUBLIC SECTOR NET DEBT (% OF GDP)



Source – HM Treasury & Bootle Estimates

Cut or boost?

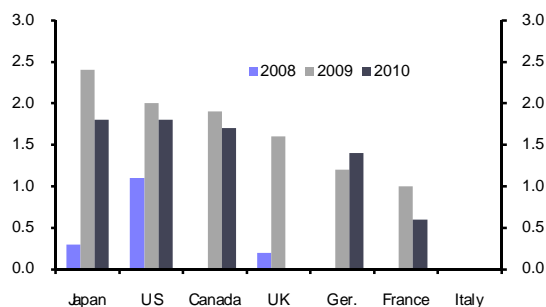
So it seems clear that further policy action will be needed to get the public finances back into a sustainable position. **But how much of that action, if any, will Mr Darling implement in this PBR?**

From a purely fiscal perspective, the sooner corrective action comes, the better. Markets have so far been sanguine about the state of the public finances but, as the Governor of the Bank of England has repeatedly warned, that situation could change quickly. Several credit rating agencies have already warned that they will downgrade the UK if it does not soon set out firmer plans to restore fiscal sustainability.

But the broader state of the economy argues strongly against an early fiscal tightening. If anything, another fiscal *boost* seems more appropriate. Even though the outlook has not deteriorated dramatically since the Budget, the UK has remained stuck in recession for longer than most of its major competitors and there are still huge uncertainties over the likely strength and durability of the economic recovery.

Some forecasters have suggested that the adverse impact of a fiscal tightening on aggregate demand would be offset by the drop in the sterling exchange rate, as was at least partly the case during the last major fiscal tightening in the early 1990s. But this looks optimistic, given that the required tightening is probably twice the size of that seen in the 1990s. Note too that, despite its recently weaker performance, the UK is just about the only major economy whose current fiscal stimulus disappears completely in 2010 under existing plans. (See Chart 5.)

CHART 5: G7 FISCAL STIMULUS PACKAGES (£BN)



Source – IMF

Finally, both Mr Darling and the Prime Minister will clearly have at least one eye on the forthcoming general election. With opinion polls suggesting that voters recognise the need to sort out the public finances, the main opposition parties have jostled to present themselves as most willing to do so. In their October conference, the Conservatives set out plans for a pay freeze for the majority of public sector workers. Mr Darling responded by announcing the so-called Fiscal Responsibility Bill, which will enshrine in law the halving of the budget deficit by 2013-14.

At the same time, though, the Chancellor has sought to draw up pre-election battle-lines by emphasising the need to support the economy in the near-term. The Tories have responded by suggesting that, should they win the election, they would hold an emergency budget within 50 days which would likewise initially “go for growth”.

The package

Pulling the economic and political considerations together, then, it is clear that the choices facing Mr Darling are complex. As such, the contents and stance of the PBR itself are highly uncertain. **Our guess, though, is that the Chancellor will attempt to balance the various considerations by unveiling a PBR package which both provides additional near-term support for the economy, and then prompts a more decisive improvement in the public finances once the election is out of the way.** This would, after all, be similar in basic shape both to last year’s Pre-Budget Report - in which a giveaway of £16bn turned into a tightening of £7bn - and April’s Budget.

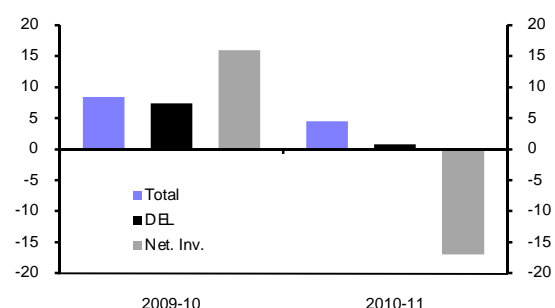
What might such a “dual-purpose” package look like? In terms of near-term support for the economy, one option would be an extension of the reduction in the standard rate of VAT introduced in last year’s PBR and due to be reversed on January 1st 2010. A 12 month extension would inject an additional £12bn into the economy.

But I suspect that such a move is unlikely. Not only are there doubts over just how effective the cut in VAT has been, but extending it would prevent the widely expected surge in consumer spending at the end of this year, as households bring some of their spending forward. It may also be impractical to alter the planned change in VAT at such short notice.

A more plausible way of providing temporary support would be to bring forward further capital spending from future years. As Chart 6 shows, although total spending is already planned to rise by some 4.5% in cash terms next fiscal year (2010-11), that is largely accounted for by steep rises in unavoidable elements of spending such as social security and debt interest. Core departmental spending is set to rise by just 0.8% after a rise of more than 7% in 2009-10. And within that, net public sector investment will actually *fall* by some 17%, partly reflecting the bringing forward in last year’s PBR of around £3bn of investment from 2010-11 to 2009-10.

So the Chancellor might consider repeating last year’s trick by bringing forward another chunk of public investment. A £5bn increase would still leave investment lower next year than this year, but it would mean that overall departmental spending rises by some 2%.

CHART 6: SPENDING INCREASES (2009-10 & 2010-11)



Source – HM Treasury

Other possible sources of near-term support might include help for those suffering from the current low rates of inflation and interest rates,

such as savers and pensioners, and measures to improve conditions in the labour and housing markets. On the business front, the Chancellor may seek to steal some of the Conservatives' thunder by announcing some reduction in corporation tax and perhaps a VAT holiday for small companies. **Altogether, the spending and tax measures could add up to a fiscal-loosening of £10bn to £15bn in 2010-11.**

Beyond that, though, the package is likely to turn into a sizeable fiscal tightening. One element of this might be a second increase in VAT, perhaps to 20%. This would bring borrowing *down* by around £12bn per annum. Widening the VAT net, which currently captures only around half of goods and services, is another possibility.

Other possible deficit-cutting measures might include further increases in national insurance or some form of increase in capital gains tax (CGT). At 18%, the standard rate of CGT looks very low compared to the forthcoming highest rate of income tax of 50%. An increase to, say, 25% would raise around £1bn p.a. in extra revenue. It has also been suggested that the threshold for the new higher rate of income tax may be reduced from the planned £150,000.

At the same time, any further fiscal squeeze is almost certain to incorporate additional downward pressure on public spending. Spending is already set to be frozen in real terms from 2011-12 onwards, but I estimate that it probably needs to fall by around 2% per annum for five years in order to eliminate the expected structural budget deficit within about five years. This would almost inevitably involve large-scale reductions in public sector employment.

The sale of various public sector assets may also be a useful way of raising some extra revenue – the channel tunnel rail link, Dartford crossing and student loan book are all on the list of potential disposals.

TABLE 1: POSSIBLE PBR PACKAGE £BN– COST(-)/YIELD (+)

New Measures	10-11	11-12	12-13
Capital spending brought forward	-5.0	+5.0	-
Extra support for labour market	-3.0	-2.0	-
Help for savers	-1.0	-1.0	-
Corp.tax/VAT holiday	-1.0	-	+2.0
Increase in CGT	-	+1.0	+1.0
Increase in VAT to 20% from 2011	-	+12.0	+12.0
Cuts in current spending	-	+5.0	+10.0
Sale of public sector assets	-	-	+5.0
Total impact on revenue	-10.0	+20.0	+30.0

Source – HM Treasury & Boote Estimates

Table 1 incorporates some of these possible measures into a Pre-Budget Report tax and spending package which injects an additional £10bn into the economy in 2010-11, before then turning into a fiscal *tightening* of some £30bn per annum by 2012-13. This is meant as an illustration only, not a firm forecast of what will actually appear in the PBR. The revenue effects of various other possible tax measures are shown in the Tax Ready Reckoner in the annex.

Market implications

How might the PBR go down in the markets? A package which both supports near-term growth prospects and provides some re-assurance on the fiscal outlook should be well-received. But much will depend on the relative sizes and credibility of the different elements.

While the pound and equity market will welcome decisive support for the economy, the bond market will be more interested in the extent of the medium-term fiscal consolidation and the implications for supply. As Table 2 shows, the combination of high borrowing and a demanding redemption schedule looks set to keep gilt sales at very high levels over the next few years. **But bond markets should take comfort from the prospect of a further fiscal squeeze after the election which will help to keep inflation pressures subdued and interest rates low for a prolonged period.**

TABLE 2: GILT FUNDING ARITHMETIC

£bn	Bud	CE estimates			
	09	09-10	10-11	11-12	12-13
CGNCR	220.8	240	190	150	110
Redemptions	16.6	16.6	39.0	49.2	44.4
Financing for banks	-1.0	-1.0	-	-	-
Other	2.0	2.0	-	-	-
Financing adjustment	-0.6	-0.6	-	-	-
Financing	237.8	257	230	200	155
Requirem't					
Less National savings	0.0	0.0	5.0	5.0	5.0
Net Fin'g	237.8	257	225	195	150
Requirem't					
Ways and means	-3.8	-3.8	0.0	0.0	0.0
Financed by: T bills	21.6	22	20.0	20.0	20.0
: Gilts	220.0	240	205	175	130

Source – Debt Management Office & Bootle Estimates

Annex A – Tax Ready Reckoner

	Cost/yield (accruals) 2010-11 (£m)
Income Tax	
Rates	
Change starting rate for savings income by 1p ^a	15
Change basic rate by 1p ^a	4,900
Change higher rate by 1p ^a	1,450
Allowances	
Change personal allowance by £100	650
Starting-rate limit	
Increase starting-rate limit by £100	5
Basic-rate limit	
Change basic-rate limit by 1%	280
Change basic-rate limit by 10%:	
increase (cost)	2,500
decrease (yield)	3,150
Allowances and limits	
Change all main allowances, starting and basic-rate limits:	
increase/decrease by 1%	720
increase by 10% (cost)	6,850
decrease by 10% (yield)	7,900
Working tax credit	
Change basic element by £100	330
Change 30-hour element by £100	240
Change element for couples/lone parents by £100	290
Child tax credit	
Change family element by £100	560
Change child element by £100	750
Corporation Tax	
Change main rate by 1 percentage point	1,000
Change small companies' rate by 1 percentage point	450
National Insurance Contributions	
Change employee rate by 1%	4,100
Change employee rate above UEL by 1%	1,000
Change employer rate by 1%	5,200
Change employee entry threshold by £2 per week	245
Change employer threshold by £2 per week	295

^a excludes savings income taxable at the starting rate.

Annex A - Tax Ready Reckoner (cont.)

Revenue impact of 1% change	Cost/yield (non-accruals) 2010-11 (£m)
Excise duties^a	
Beer up 0.4p a pint	40
Wine up 1.5p a bottle (75cl)	25
Spirits up 6.0p a bottle (70cl)	5
Cigarettes up 3.5p a packet (20 king-size)	10
Petrol up 0.5p a litre	110
Diesel up 0.5p a litre	150
Change insurance premium tax (standard rate) by 1 percentage point	485
VAT	
Change both standard and reduced rates by 1 percentage point	5,060
VAT coverage	
	2008-09
Extend VAT to:	
food	11,950
domestic and international passenger transport (UK portion)	2,850
construction of new homes	7,650
books, newspapers, etc.	1,750
water and sewerage services	1,350
children's clothing	1,300
prescriptions	1,500
Stamp duty	
Change 1% rate by 1 percentage point	920
Change 3% rate by 1 percentage point	540
Increase £125,000 threshold by £5,000	35
Increase £250,000 threshold by £5,000	70
Inheritance tax	
Change rate by 1 percentage point	45
Increase threshold by £5,000	30

^a Figures are calculated given the price and tax charged on a typical item. All changes are assumed to be implemented in April 2010.
Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, November 2008