

## A holding operation

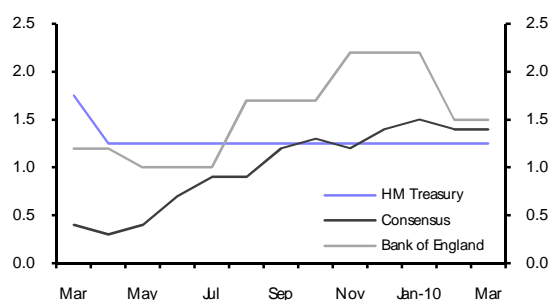
In his third and possibly last Budget (on 24<sup>th</sup> March) Alistair Darling faces the unenviable task of trying to improve the Government's election prospects whilst at the same time not endangering the UK's credit rating. **The result is likely to be a holding operation, with the momentous task of tackling the UK's fiscal crisis left to whichever party, or combination of parties, is at the helm after the general election.**

### Economic projections unlikely to change

**One thing in Mr Darling's favour is that he will not be forced to make major alterations to his forecasts for the economy.** The pace of economic recovery has been disappointingly sluggish, prompting the Bank of England in its February Inflation Report to reduce its forecast for GDP growth in 2010 from around 2.25% to about 1.5%. The consensus forecast amongst outside commentators has also edged down a touch in the last month or two. (My own forecast is 1%.)

However, as Chart 1 shows, the Chancellor has maintained a relatively cautious forecast range of 1% to 1.5% throughout the last year and is likely to stick with it in the Budget. Likewise, the forecasts for GDP growth of 3.25% per annum from 2011 onwards, while far too optimistic in my view, are also unlikely to be altered at this stage.

CHART 1: FORECASTS FOR GDP GROWTH IN 2010 (%)



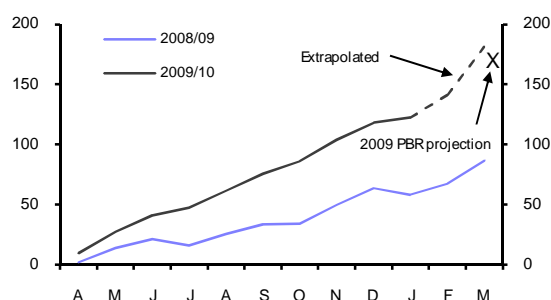
Source – HM Treasury, Bank of England

### Fiscal plans to stay largely unchanged

In the absence of major new measures in the Budget itself, the fiscal projections also seem unlikely to change very much from those presented in December's Pre-Budget Report (PBR). Admittedly, Chart 2 shows that extrapolating the increase in public sector net borrowing (PSNB) seen in the first ten months of the year points to a full-year total of about £180bn. That would be some £10bn higher than Mr Darling's PBR forecast (for that measure of borrowing).

However, the Treasury has argued that timing effects have had a detrimental effect on the recent numbers. Meanwhile, the bank bonus tax is now expected to yield around £2bn more than was expected in the PBR, most of which should fall into the current year. **As such, I suspect that Mr Darling will keep his borrowing forecast for 2009/10 pretty much unchanged and he may even reduce it a touch.**

CHART 2: PUBLIC SECTOR NET BORROWING (£BN)



Source – Thomson Datastream & Bootle Estimates

**As for next year and beyond, there are several factors which might actually point to lower borrowing than predicted in the Pre-Budget Report.** First, having pulled down his estimate of the likely costs of the various banking support measures in the PBR, there is a possibility that Mr Darling may be able to do so again. (Despite its name, the new headline measure of borrowing, PSNB ex, includes some elements of the banking intervention costs.)

And second, Mr Darling may also be able to pull down his projections for unemployment. The PBR assumed that the claimant count would rise to 1.9m by the end of 2010, but the figures have recently flattened off at around 1.6m. On the face of it, that could cut social security spending and public borrowing by several billion pounds.

**I have my doubts over whether such savings will actually materialise.** For a start, I have argued before that unemployment could yet rise considerably further if the economic recovery continues to disappoint and employers are forced to cut unit wage costs. And even if it does not, the impact of lower social security spending is likely to be largely offset by lower tax receipts resulting from the squeeze on working hours and wages.

More fundamentally, I expect any savings from lower unemployment to be much more than offset by the wider effects of weaker economic growth. I still expect real GDP to expand by just 1.5% or so in 2011, less than half the expansion expected by Mr Darling. According to the Treasury's own rules of thumb, such an undershoot could boost borrowing by over 1% of GDP - £15bn or more.

Nonetheless, along with rather higher equity and oil prices than assumed in the PBR, these factors suggest that Mr Darling will have a little wiggle room in this Budget. **As a rough estimate, I think he might have something of the order of £3bn to £5bn at his disposal.**

### Save or spend?

How will Mr Darling use that money? Needless to say, fiscal prudence would dictate that he save it – in other words, use it to reduce borrowing more quickly than current plans allow. Admittedly, that sort of saving would make little inroads into a budget deficit of some £170bn odd. But it might at least serve as a signal to the markets and credit rating agencies that the Government recognises the need to bring borrowing down more quickly.

**But let's not forget that this is a pre-election Budget and that the Government is still**

**lagging behind in the opinion polls.** While an obvious pre-election splurge would almost certainly not play well with the electorate, the Chancellor – and, more importantly, the Prime Minister – will surely want to devote at least some portion of any spare cash to trying to improve the Government's popularity. Doing so would harden the perceived election battle-lines between the Government and the Conservative Party.

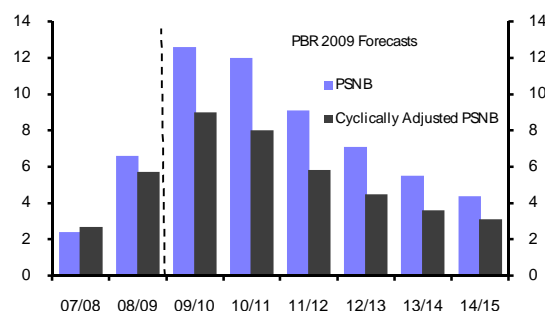
**At the same time, though, Mr Darling will no doubt feel that he can offer a solid economic justification for spending any available funds.**

While the recent data have suggested that the recovery might have picked up a bit in the first quarter of the year, the outlook remains extremely uncertain. Meanwhile, following the "battle of the letters" in which one group of economists (including myself) pressing for an earlier and more decisive fiscal tightening was countered by two larger groups urging greater caution, the Chancellor may feel that he has the consensus of economic opinion on his side.

### A more credible medium-term plan?

So I don't expect Mr Darling to cut the short-term path of public borrowing in this Budget. At least not materially. But what about the longer-term outlook? **Even amongst those economists who have argued *against* an early tightening, there is some sense that the current plans to halve the budget deficit as a share of GDP over the next four years do not go far enough.**

CHART 3: PUBLIC SECTOR NET BORROWING (% OF GDP)

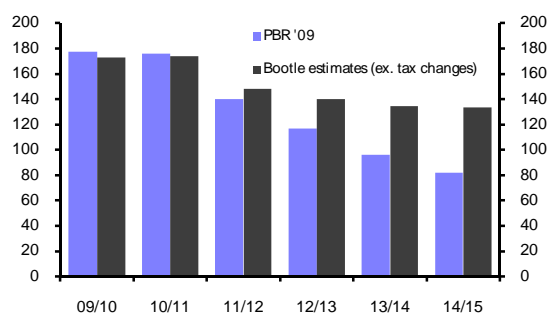


Source – Thomson Datastream & Bootle Estimates

After all, Chart 3 shows that they leave a cyclically adjusted or *structural* budget deficit of some 3% of GDP – over £50bn – still in place after five years. Bank of England Governor Mervyn King has suggested that the structural deficit should be eliminated altogether over the next parliament – implying an additional tightening eventually worth some £50bn per annum – and I have argued for a similar scale of action.

**Meanwhile, there are major doubts over whether even the currently planned deficit reduction can actually be achieved.** I have already mentioned that the plans rely on a very optimistic outlook for the economy. As Chart 4 shows, using my own weaker forecasts for GDP growth suggests that, without further tax and spending changes, public borrowing will remain much higher than the Treasury plans suggest. But on top of that, the lack of any detailed spending plans beyond 2010-11 casts considerable uncertainty over just how the planned cuts will be implemented.

**CHART 4: PUBLIC SECTOR NET BORROWING (£BN)**



Source – Thomson Datastream & Boote Estimates

Against this background, several credit rating agencies have already warned that the UK might lose its AAA rating if it does not produce a more credible plan to restore the public finances to health. This, of course, could lead to a rise in bond yields and hence worsen the fiscal position even further. With over £200bn of gilts to be issued this year, a rise in yields of 1% would add

over £2bn to the budget deficit this year alone and eventually much more.

**However, I doubt that Mr Darling will do much to satisfy such calls in the Budget.** Admittedly, he may pre-announce some minor measures to cut borrowing in the later years of the forecast period. Remember that last year's Budget package turned from a net giveaway of around £5bn in year 1 into a *tightening* of the same scale in year 3. Meanwhile, December's PBR also tightened policy by about £5bn three years ahead.

**But political constraints will surely limit how far Mr Darling will be prepared to go this time.** Few Chancellors would dare to pre-announce major additional tax increases or spending cuts just ahead of an election, even if they don't actually kick in for several years. As such, I expect any reduction in the medium-term path of borrowing in the Budget to be very modest.

**It is possible that the Chancellor will seek to compensate for this by strengthening the fiscal framework.** After the effective abandonment of the two previous fiscal rules, Mr Darling introduced the Fiscal Responsibility Act which put into law the planned reduction in the deficit. But the apparent lack of enforceability and general belief that the plans are not adequate has meant that the Act has lacked bite. So the Chancellor may seek to go further to set out more meaningful long-term constraints on borrowing. Perhaps he will even seek to steal the Conservatives' thunder by announcing the intention to establish an independent body to monitor the public finances.

**But any such announcements will have little impact in the absence of concrete measures to bring borrowing lower.** As such, much more decisive action will still be needed once the general election is out of the way to put the public finances back on a path towards sustainability and keep the markets and rating agencies at bay.

## The Budget measures

Against these wider considerations, just which measures might actually appear in the Budget might seem of secondary importance. But given the political pressures, Mr Darling will no doubt aim to get as much bang from his few bucks as possible. **As such, some extra spending on politically sensitive areas such as health, education and perhaps defence seems likely.**

But minor populist tax changes may also be possible. Again, Mr Darling may seek to steal some ideas from the Conservatives, just as he did with the rise in inheritance tax thresholds in the 2007 Pre-Budget Report. Another change to inheritance tax is possible, as is some form of reduction in corporation tax. The Conservatives have pledged to reduce the main rate by 3 percentage points at an annual cost of some £2.5bn. Mr Darling could pre-empt some of that promise for little cost.

**Other measures may include efforts to tackle youth unemployment and initiatives for the “industries of the future” - expected to be two key planks of Labour’s election manifesto.** These may be partly paid for by the freeze on senior civil servants’ pay already announced, as well further projected efficiency savings and some minor, politically palatable, tax increases, such as further rises in the duty on spirits and cigarettes.

**Table 1 shows how a combination of such measures might add up to a net giveaway of £3bn or so in 2010/11, financed by the bonus tax and lower unemployment.** I would stress that this is just an illustration, not a prediction. The revenue effects of various other possible tax changes are set out in the Tax Ready Reckoner in the Annex. But whatever the precise contents of the Budget, they are unlikely to add up to very much.

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

New Measures

2010-11

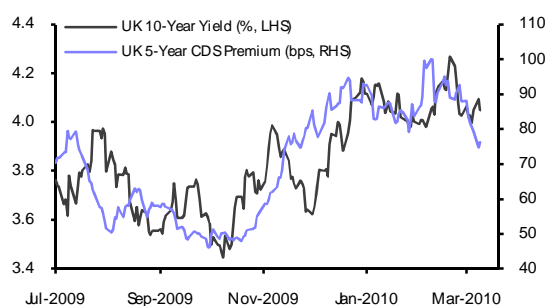
Extra spending on key areas	-2.0
2p cut in corporation tax	-0.8
Inheritance tax cuts	-0.5
Measures to tackle youth unemployment	-1.0
Other industry measures	-1.0
Civil service pay freeze	+0.3
Other efficiency savings	+1.0
Rise in alcohol & tobacco duties	+1.0
<b>Total impact on revenue</b>	<b>-3.0</b>

Source – HM Treasury & Bootle Estimates

## Financing & market implications

How will the Budget go down in the markets? Equities may like any minor steps to support the economy, but gilts and the pound will be troubled by the lack of any material reduction in the path of public borrowing. After all, fiscal concerns have had a clearly detrimental impact on the markets over recent months. As Chart 5 shows, gilt yields have risen in line with CDS spreads – the cost of insuring against default by the UK Government – while the pound has also been hit hard by worries about the UK’s credit rating.

**CHART 5: GILT YIELDS & UK CDS SPREADS**



Source – Thomson Datastream

**One aspect which almost certainly won’t go down too well is the gilt funding arithmetic.** Table 2 maps out the illustrative financing numbers for 2010-11 onwards published at the time of the PBR. Provided that the borrowing forecasts are largely unchanged in the Budget, projected gilt sales will drop only marginally from around £225bn in 2009-10 to about £213bn in 2010-11. And with the Bank of England probably

absorbing significantly less of that issuance – even if it resumes quantitative easing – *net* supply to the market will probably rise sharply.

Of course, the markets are already aware of this general trend. But seeing the numbers in black and white won't help. Meanwhile, any perception that the Budget has boosted the chances of a hung parliament by improving Labour's election prospects presumably will not be well received either.

**TABLE 2: GILT FUNDING ARITHMETIC**

£bn	PBR 09	Illustrative			
	09-10	10-11	11-12	12-13	13-14
<b>CGNCR</b>	<b>223.3</b>	<b>174</b>	<b>146</b>	<b>118</b>	<b>101</b>
Redemptions	16.6	39	49	44	47
Financing for banks	-1.0				
Other	0.0				
Carried over	0.0				
<b>Financing Requirem't</b>	<b>242.4</b>	<b>213</b>	<b>195</b>	<b>162</b>	<b>148</b>
Less National savings	-0.5				
<b>Net Fin'g Requirem't</b>	<b>242.9</b>	<b>213</b>	<b>195</b>	<b>162</b>	<b>148</b>
Ways and means	-3.8				
Financed by: T bills	21.6				
<b>: Gilts</b>	<b>225.1</b>	<b>213</b>	<b>195</b>	<b>162</b>	<b>148</b>

Source – Debt Management Office & Bootle Estimates

**But I suspect that these concerns will ultimately prove to be relatively short-lived.** After all, the cross-party consensus on the need to improve the fiscal position suggests that some additional tightening – or at least *plan* to tighten - would be likely even under a minority or coalition government. Alongside fading inflation worries and still exceptionally loose monetary policy, that should allow both gilts and the sterling exchange rate to fare rather better later on in the year.

## Annex A – Tax Ready Reckoner

	Cost/yield (accruals) 2010-11 (£m)
<b>Income Tax</b>	
<b>Rates</b>	
Change starting rate for savings income by 1p	neg.
Change basic rate by 1p <sup>a</sup>	3,400
Change higher rate by 1p <sup>a</sup>	670
Change basic rate in Scotland by 1p <sup>b</sup>	340
Change additional (50%) higher rate by 1p	290
<b>Allowances</b>	
Change personal allowance by £100	510
<b>Starting-rate limit</b>	
Increase starting-rate limit for savings income by £100	neg.
<b>Basic-rate limit</b>	
Change basic-rate limit by 1%	180
Change basic-rate limit by 10%:	
increase (cost)	1,650
decrease (yield)	2,100
<b>Allowances and limits</b>	
Change all main allowances, starting and basic-rate limits:	
increase/decrease by 1%	590
increase by 10% (cost)	5,550
decrease by 10% (yield)	6,350
<b>Working tax credit</b>	
Change basic element by £100	340
Change 30-hour element by £100	250
Change element for couples/lone parents by £100	300
<b>Child tax credit</b>	
Change family element by £100	530
Change child element by £100	800
<b>Corporation Tax</b>	
Change main rate by 1 percentage point	400
Change small companies' rate by 1 percentage point	20
<b>National Insurance Contributions</b>	
Change employee rate by 1%	3,850
Change employee rate above UEL by 1%	950
Change employer rate by 1%	4,900
Change employee entry threshold by £2 per week	230
Change employer threshold by £2 per week	275

<sup>a</sup> Excluding savings income taxed at the lower or starting rates and dividends

<sup>b</sup> includes non-savings income only

## Annex A - Tax Ready Reckoner (cont.)

Cost of indexation for 2010-11 and 2011-12 (£m)		
	2010-11	2011-12
Indexation of income tax allowances, starting and basic rate limits <sup>1</sup>	0	0
of which:		
Increases in allowances <sup>1</sup>	0	0
Increases in the basic rate limit <sup>1</sup>	0	0
Increases in the Child Tax Credit & Working Tax Credit <sup>1</sup>	0	0
Indexation of inheritance tax threshold <sup>1</sup>	0	0
Indexation of capital gains tax annual exempt amount <sup>1</sup>	0	0

1. The estimates are zero as the standard indexation rates for these taxes are based on the annual increase in the RPI in September 2009, which was negative.  
Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, December 2009

Revenue impact of 1% change	Cost/yield (non-accruals) 2010-11 (£m)
<b>Excise duties<sup>a</sup></b>	
Beer up 0.4p a pint	30
Wine up 1.6p a bottle (75cl)	20
Spirits up 6.1p a bottle (70cl)	5
Cigarettes up 3.7p a packet (20 king-size)	35
Petrol up 0.6p a litre	130
Diesel up 0.6p a litre	160
Change insurance premium tax (both standard and higher rates) by 1 percentage point	340
<b>VAT</b>	
Change both standard and reduced rates by 1 percentage point	4,390
<b>VAT coverage</b>	<b>2010-11</b>
Extend VAT to:	
food	11,450
domestic and international passenger transport (UK portion)	2,600
construction of new homes	5,700
books, newspapers, etc.	1,500
water and sewerage services	1,350
children's clothing	1,200
prescriptions	1,450

<sup>a</sup> Figures are calculated given the price and tax charged on a typical item. All changes are assumed to be implemented in April 2010, except the change to the insurance premium tax (July 2010 and no allowing for any concessionary period).  
Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, December 2009