

# Budget Focus.

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Tom Vosa | Head of Market Economics - UK | 020 7710 1573 | tom.vosa@eu.nabgroup.com

### Emergency Budget: Hard Times.

- As expected, the Chancellor announced additional fiscal tightening to ensure that the cyclically adjusted deficit on the current account is in surplus by 2014-15.
- Although the scale of tightening is in line with our own and market expectations, much of it has been delayed until 2011.
- Main tax measures include a 2.5pp increase in VAT in January 2011, a bank levy and a 10pp increase in Capital Gains Taxation for higher rate tax payers.
- Thresholds for income tax have been frozen until 2014.
- Of the £32 billion of spending cuts to be enacted by 2014, around £11 billion comes from cuts in welfare payments. A further £3 billion comes from a two year freeze on civil service pay.
- The reliance on tax increases in the early years means that we have more comfort that the borrowing targets will be met, as do the downward revisions to growth by the interim Office of Budget Responsibility (OBR).
- The removal of the structural deficit should give greater comfort to Ratings Agencies and market participants that the UK will keep its AAA sovereign credit rating.
- A reduction in planned gilt issuance gave bond markets a small fillip. Sterling could also benefit should reserve managers also gain comfort. We look for the pound to appreciate.

New Chancellor Osborne revealed an 'emergency' Budget today that sought to eliminate the structural current deficit over the course of the Parliament, implying an extra fiscal tightening of £40 billion by 2014-15 compared to the March Budget. In the main the Chancellor kept to his promise to rely more on spending restraint than tax increases, though there are some hefty tax rises coming down the track, particularly for higher earners.

### Economic and Fiscal Projections.

Alongside the detail of key tax and spend announcements detailed below the Budget today presents revised projections

for economic growth and the key fiscal aggregates from the Office for Budget Responsibility.

The new Office for Budget Responsibility (OBR) published its 'baseline' forecasts for the economy and the public finances last week. These were based on the public spending and taxation decisions taken under the last government and announced in the first Budget of 2010, taking on board any news in the data outturns since then. The OBR projected growth at 1.3% in 2010 and 2.6% in 2011. In 2012 and 2013 growth was expected at 2.8%.

The revised forecasts today from the OBR are all based on decisions announced today by Mr Osborne, including the previously announced £6 billion of cuts in 2010. On top of that, the public sector finances for May showed a small downward revision to the totals for 2009-10 (not available for the OBR forecasts), and so the starting point for the revised OBR forecasts are a little better.

The OBR's economic growth forecasts following the June Budget show a small downward revision in 2010 and 2011 as a result of the impact of extra fiscal tightening on the economy. Growth this year is now expected at 1.2%, in 2011 at 2.3%, in 2012 at 2.8% and in 2013 at 2.9%. In its approach to forecasting the OBR has taken a fairly middle-of-the-road view on the relationship between government spending and growth. Extra fiscal tightening has led to some downward revision to the output projections in the short-term, but in later years some private spending is 'crowded in' as public spending retreats and there is marginally more excess capacity from earlier slower growth.

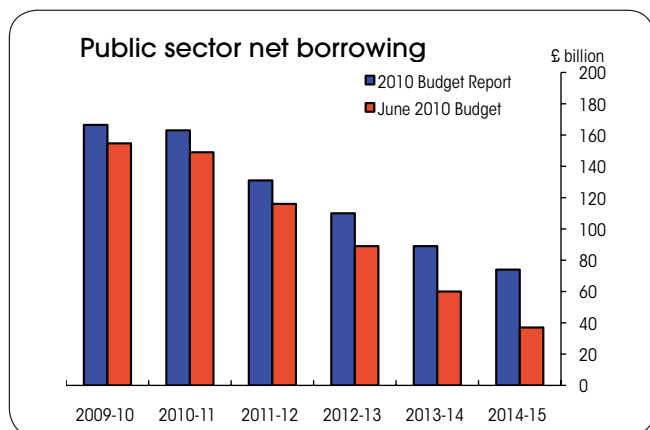
Table 1.2: Summary of OBR's Budget central economic forecast<sup>1</sup>

	Percentage change on a year earlier, unless otherwise stated						
	2009	Forecasts					
		2010	2011	2012	2013	2014	2015
Gross domestic product (GDP)	-4.9	1.2	2.3	2.8	2.9	2.7	2.7
CPI inflation (Q4)	2.1	2.7	2.4	1.9	2.0	2.0	2.0

<sup>1</sup> All growth rates in this table are rounded to the nearest 1 decimal place. This is not intended to convey a degree of unwarranted accuracy.

Source: Budget June 2010.

The baseline OBR forecasts projected public sector net borrowing at £155 billion in 2010-11 (11.1% of GDP), £127 billion in 2011-12 (8.3% of GDP), £106 billion in 2012-13 (6.6% of GDP), £85 billion in 2013-14 (5.0% of GDP) and £71 billion in 2014-15 (3.9% of GDP). Taking on the policy measures announced in today's Budget, borrowing is now forecast at £149 billion in 2010-11 (10.1% of GDP), £116 billion in 2011-12 (7.5% of GDP), £89 billion in 2012-13 (5.5% of GDP), £60 billion in 2013-14 (3.5% of GDP) and £37 billion in 2014-15 (2.1% of GDP).



Source: Budget Report March 2010, Budget Report June 2010. National Australia Bank.

But alongside the headline deficit, the Chancellor's key focus is on eliminating the so-called structural current deficit. This is the deficit on everyday spending, excluding capital projects, that will not be reduced simply by the economy returning to trend output levels. It is this measure of the fiscal stance that the Chancellor has asked the OBR to assess it against in the 'fiscal mandate'. The OBR has to judge whether the Government has a better than even chance of meeting its goal of reaching a zero current structural deficit by the end of a rolling five year window (so by 2015-16).

On that score the OBR says the Government plans pass muster – though of course Osborne wouldn't be presenting them if that were not the case. Indeed the Budget projections show a surplus on the current cyclically adjusted deficit one year earlier. The OBR projections based on the March Budget forecast the surplus on the current budget as percentage of GDP at 5.2%, 4.2%, 3.1%, 2.3% and 1.6% over the years 2010-11 to 2014-15. The new projections in the June Budget are for a structural current surplus of -4.8%, -3.2%, -1.9%, -0.7% and +0.3% over the years 2010-11 to 2014-15. In other words, the latest plans now target a small surplus at the end of the Parliament to ensure the fiscal mandate is achieved with some room to spare.

The move from a current structural deficit of 1.6% in 2014-15 in the March Budget to a surplus of 0.3% in the June Budget implies an extra fiscal tightening over the period of around £40 billion. In terms of discretionary policy decisions, today's announcements involve around £8 billion of that tightening coming from increases in tax receipts, the rest coming from spending restraint that will be fleshed out in the Spending Review in the Autumn.

Going into the Budget the Chancellor had indicated he would prefer spending cuts and tax rises in something close to a 80:20 ratio. It appears he has largely been true to his word. Total Managed Expenditure as a percentage of GDP falls from 47.3% in 2010-11 to 40.9% in 2014-15, while current receipts rise from 37.2% to 38.8% over the same period. It's worth noting though that the ratio starts out more skewed towards tax than spend, only getting towards the 80:20 split by the end of the forecast horizon.

## Key Policy Announcements.

Total policy decisions announced in this Budget totalled £8.1 billion, with a £2.8 billion increase in tax this year accompanied by a £5.2 billion package of spending cuts, that incorporated a £3.5 billion fall in current spending and a £1.8 billion fall in capital expenditure.

By 2014-15, discretionary measures announced in today's Budget will see spending some £32 billion lower than the March baseline, with taxes £8 billion higher.

An increase in taxation largely explains tightening in the early years, with tax increases matched by freezes in thresholds. Despite the freeze in civil service pay, fiscal drag, will still see more enter higher tax rate bands in 2013-14.

The main tax increase was the heavily trailed 2.5pp rise in VAT from 17.5% to 20% on 4th January 2011. The measure will bring in a little under £3 billion this fiscal year before contributing around £12.5 billion thereafter.

A bank levy is also to be introduced from 1st January 2011. The levy will be based on bank liabilities, with deductions for Tier 1 capital; insured retail deposits; repos secured on sovereign debt; and policyholder liabilities of retail insurance businesses within banking groups. The levy is to start at 0.04% of qualifying assets, before rising to 0.07% in 2012, raising over £2 billion. The levy appears to be aimed at encouraging banks to adopt much longer funding strategies to avoid the deposit runs seen from 2007 onwards. Ahead of the Budget, press reports had speculated that the levy could raise anywhere between £3-£8 billion, so the levy could be seen as being smaller than expected. However, the Coalition government is looking at the introduction of a Financial Activities Tax on profits and remuneration in line with other G20 partners, so the banking sector could be seeing further tax increases later out.

The final large area of taxation involved changes to CGT. Again these were heavily trailed and the increase for higher rate taxpayers to a 28% rate was again not as punitive as feared. HMT calculations are that the tax will raise around £1 billion per year as people switch back to receiving income rather than paying CGT at 18%. Whether that assumption will be met remains questionable.

The Coalition government also looks to be edging back towards tax simplification. While it intends to repeal parts of the Finance Act 2010 that looked at restricting pensions tax relief, nonetheless, there is a desire not to lose the £3.5 billion in tax revenue that the measure was set to bring in. It seems that annual allowances could well be capped to limit tax rebates, but overall such a change would be much less harmful for direct benefit schemes.

Although the Chancellor added an additional £32 billion of spending cuts on top of the £44 billion included in the March 2010 Budget, most of the cuts have been delayed until April 2011.

While welfare spending is to be reduced by £11 billion per year by 2014-15, the reduction this year is only £385 million, with the largest contribution coming from the phased abolition of Government contributions to Child Trust Funds. By 2011-12, welfare cuts should be running at £2 billion per year, with the largest element coming from the decision to switch benefits, tax credits and public sector pensions to CPI indexation, rather than using RPI. Over the spending period, this measure broadly contributes around half of total welfare savings.

The other significant contribution comes from a reform of tax credit, which sees a number of reliefs removed. There are 9 separate measures all together, with the common aim being to reduce eligibility for families with income over £40,000 from April 2011, before changing thresholds further in April 2012.

Overall, this should lead to some simplification of the system, which if handled correctly could increase take-up rates, especially from lower income households.

£3.3 billion of savings comes from a 2 year freeze for public sector workers earning above £21,000 per year.

With only £14 billion of the £32 billion of total spending cuts identified, we will have to wait until the Comprehensive Spending Review, to be held on 20th October to see how 25% cuts in spending departments will be divided.

## Implications.

Sterling's trade-weighted performance over the last few weeks - it is up almost 4% since May and within 1% of levels that have not been bettered since last September - suggests that the broader market is siding with the UK government's plans of accelerating the fiscal austerity measures. That in turn suggests GBP should perform reasonably well in the aftermath of today's emergency budget. Sterling was just above \$1.47 before Osborne's speech and rallied to an immediate high of \$1.4820 mid afternoon. Against the euro, sterling dropped below 83 pence.

The new deficit forecast implies less financing from the UK Debt Management Office (DMO), who reduced their issuance plans by £20 billion (to £165 billion) and cancelled three Gilt auctions in 2010-11. That and a set of fiscal plans that tackle the deficit more aggressively helped 10 year yields fall by around 5 basis points. The extra fiscal tightening and a slower growth outlook in the short-run also underline that the Bank of England will be keeping Bank Rate at exceptionally low levels for a considerable time to come. Again, that will further take upward pressure off of yields.

As to the UK's sovereign credit rating, since March 2009 the ratings agencies have said the key to the UK's AAA

sovereign rating is what the new government does with the public finances. We start from a position where all three have maintained the AAA view, but S&P has the UK on a negative outlook. Fitch is on record as saying the current budget plans (as delivered by the previous government in March 2010) are not sufficient and the new government needs to go further. It would be very ironic if having gone the extra mile on fiscal austerity and laying out a programme for bringing the public finances under control - based on independent economic growth forecasts - the government found itself being criticised by the agencies for risking economic growth.

In any case, one would have thought the government would have courted opinion on such matters before today's publication of measures. We do not look for a clean bill of health from the ratings agencies - it is too early for this - but a positive work in progress assessment that will ease the pressure on the AAA rating. It is also not impossible that S&P removes the negative watch. Accordingly and as laid out in the FX Strategist we look for EUR/GBP to feel the brunt of a GBP positive reaction and slide back from the 0.8350-70 area towards 0.8200.

## Summary of public finances.

Table C6: Fiscal aggregates

	Per cent of GDP							
	Outturn 2008-09	Estimate 2009-10	Forecasts					2015-16
			2010-11	2011-12	2012-13	2013-14	2014-15	
<b>Receipts and expenditure</b>								
Public sector current receipts	37.2	36.6	37.2	38.0	38.4	38.7	38.8	38.7
Total managed expenditure	43.9	47.5	47.3	45.5	43.9	42.2	40.9	39.8
<b>Deficit</b>								
Surplus on current budget	-3.5	-7.5	-7.5	-5.7	-4.0	-2.3	-0.9	0.0
Public sector net borrowing	6.7	11.0	10.1	7.5	5.5	3.5	2.1	1.1
Cyclically-adjusted surplus on current budget	-3.1	-5.3	-4.8	-3.2	-1.9	-0.7	0.3	0.8
Cyclically-adjusted net borrowing	6.3	8.7	7.4	5.0	3.4	1.8	0.8	0.3
<b>Financing</b>								
Central government net cash requirement	11.3	14.1	9.9	7.8	5.5	3.8	2.0	1.1
Public sector net cash requirement	4.2	9.6	9.3	7.7	5.6	4.3	2.5	1.5
<b>Sustainability</b>								
Public sector net debt <sup>1</sup>	44.0	53.5	61.9	67.2	69.8	70.3	69.4	67.4
Net worth <sup>2</sup>	22.4	13.8	6.9	2.4	-0.8	-2.5	-2.2	-0.2
Primary balance	-5.0	-9.0	-7.4	-4.8	-2.7	-0.6	0.9	1.9
<b>Stability and Growth Pact</b>								
Treaty deficit <sup>3</sup>	6.8	11.3	10.1	7.6	5.6	3.6	2.2	1.2
Cyclically-adjusted Treaty deficit <sup>3</sup>	6.4	9.0	7.5	5.1	3.5	1.9	0.9	0.4
Treaty debt ratio <sup>4</sup>	55.8	71.2	78.9	83.6	85.5	84.9	83.1	80.4
<b>£ billion</b>								
Surplus on current budget	-49.7	-105.6	-110	-88	-65	-40	-17	0
Net investment	46.4	49.0	39	27	24	20	21	21
Public sector net borrowing	96.1	154.7	149	116	89	60	37	20
Central government net cash requirement	162.4	198.9	146	121	90	65	35	21
Public sector net debt	616.9	771.5	932	1,059	1,162	1,235	1,284	1,316
<i>Memo: Output gap (% of GDP)</i>	<i>-1.0</i>	<i>-4.1</i>	<i>-3.7</i>	<i>-3.5</i>	<i>-2.8</i>	<i>-2.3</i>	<i>-1.6</i>	<i>-0.9</i>

Note: All measures are shown on the basis which excludes the temporary effect of the financial interventions except the aggregates shown in the Financing and Stability and Growth Pact sections.

<sup>1</sup> Debt at end March; GDP centred on end March.

<sup>2</sup> Estimate at end December; GDP centred on end December.

<sup>3</sup> General government net borrowing on a Maastricht basis.

<sup>4</sup> General government gross debt on a Maastricht basis.

Source: Budget Report June 2010.