UK Budget

12 March 2020

The new Chancellor spends big to counter Coronavirus and to keep the "levelling-up" promise

- The Budget constitutes a large increase in government investment and day-to-day spending but only back to pre-austerity levels. It does seemingly mark a turning-point in terms of spending as a percentage of GDP, however,
- The last-minute emergency measures came too late to be factored into the OBR's growth and borrowing forecasts and are especially unreliable this time. The OBR forecasts only a partial offset to Brexit headwinds
- This fiscal year's higher debt issuance and the extra £100bn implied by deficit forecasts over the next 4 years have so far not perturbed Gilts
- Changes to tapered annual allowance from April 2020
- RPI consultation launched.

An incredibly difficult time for the Chancellor's debut

Even before the virus outbreak, today's Budget was set to be a hugely significant one. Following the election victory in December, the government announced an expansive agenda of "levelling-up" the regions through increased investment in infrastructure, the NHS and several other key departments. The UK has also just left the European Union and the future relationship negotiations are just beginning. A number of storms exposed the flooding vulnerability in many towns and cities. Now, the virus outbreak seriously threatens the near-term strength of the economy, which had already been facing a slowing global economic backdrop. From a policy perspective, there was widespread expectation of an announcement to align the RPI measure of inflation with CPIH. What an inbox for the new Chancellor!

Furthermore, today may well be seen with hindsight as a turning point in austerity and one signal is the number of "fiscal events" this year.
Today's Budget will be followed by a spending review in the summer and another Budget in the Autumn.

A raft of emergency policies

Against this backdrop, the Chancellor announced several emergency measures to help mitigate the very likely economic damage from the current virus outbreak. These include extra funding for the NHS, regardless of cost – a blank cheque essentially, statutory sick pay if told to self-isolate, even without symptoms, a government refund scheme on statutory sick pay up to 2 weeks for businesses with fewer than 250 employees, a Coronavirus business lending scheme, a one year abolishment of business rates for smaller companies and a £3000 cash grant for each small business (eligible for small business rates relief) in the country.

In total, the fiscal impact of these emergency measures is an estimated £7bn and the total fiscal stimulus from today's Budget, including a rise in the National Insurance threshold, a freeze on alcohol and fuel duties and the doubling in the flood defences fund, is estimated to be £30bn.

Government starts to deliver the "levelling-up" agenda

The other major element of today's Budget was the "levelling-up" of the regions away from London and the South East, in order to repay the votes given to the Conservatives from traditional Labour heartlands. So, the Chancellor also

announced a large increase in infrastructure and upgrade investments. Indeed, it is mooted to be the highest real terms increase in public investment in many decades, with a clear signal that the regions would be emphasised. The policies included investment projects in major roads and rail projects, broadband and 4G upgrades and extra money for the devolved governments. Additionally, and equally important in terms of the future emphasis of government spending, the Green Book – guidelines published by the Treasury for appraisal of central government projects – would be reviewed and around 22,000 government employees would be moved away from the South East.

It must be said, however, that this increase in overall and day-to-day government spending should be seen in the context of sharp budgetary cuts over the past decade and the OBR now estimates that per person spending will only be back to pre-austerity levels rather than anything greater.

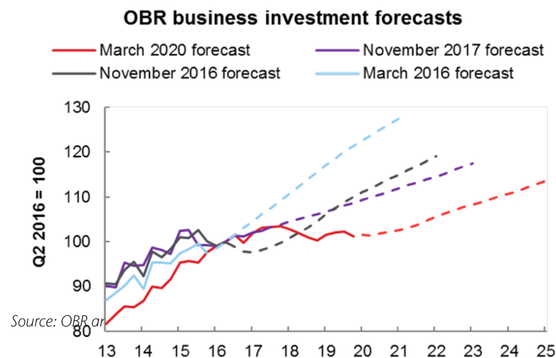
Brexit impact on future growth only partially offset

Inevitably, given the large fiscal response to the Coronavirus that was drawn up literally in the past week, the Office for Budget Responsibility's forecasts cannot be fully relied upon and are not considered to be the central case.

For what they're worth, the OBR would have lowered its real GDP growth forecasts in the next 2 years, based on a weaker outlook for productivity growth. The OBR estimates that the UK's exit from the European Union has knocked 2% off the UK's potential output, with a third having already occurred, due to subdued investment and inward migration.

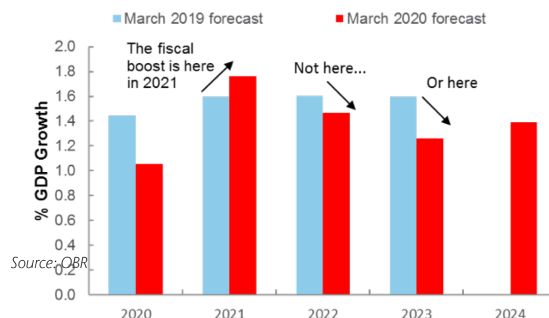
However, if the increases in government spending are sustained indefinitely, the OBR estimates an increase to potential growth of as much as 2.5% over the long term. Clearly, the underlying assumption that spending will remain at this level, is questionable. A more reasonable analysis is to look at the GDP growth forecasts for the next few years and what they show is a large boost to activity of 0.5% over the next two years, but much weaker growth thereafter as the effects of Brexit take hold. The conclusion to be drawn is that today's announced policies only partially offset the impact of Brexit. Indeed, one clear indication of the strength of the Brexit effect is in the continual downgrade to business investment forecasts by the OBR.

Business investment revised down continually



The latest forecasts for growth show downgrades from the March 2019 numbers, implying that the OBR's outlook would have been even more pessimistic without today's fiscal stimulus.

The fiscal boost to GDP growth does not offset Brexit impacts



A big rise in spending but no change to the fiscal rules

The latest forecasts indicate that public sector borrowing will rise to almost £70bn by next year and will remain around £60bn over the forecast period.

At first glance, the OBR's deficit and debt forecasts look optimistic but it is worth noting, as the Chancellor himself did, that they do not incorporate the new Coronavirus response measures. However, he remained committed to the fiscal rules and highlighted the fact that there is still 2 years to the target date for the current Budget. It remains to be seen if this really will be the case, of course, as no-one has an accurate sense of the economic impact of the outbreak, the amount that will finally need to be spent, the associated level of government borrowing and the international context.

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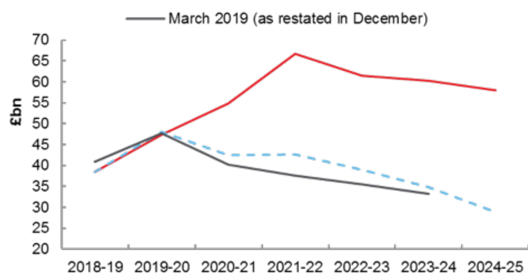
Borrowing forecasts



Source: OBR

The Debt Management Office reports that debt issuance this year will be an extra £30bn, raising the total to £156.1bn. Additionally, the government is set to increase deficits in each year of the forecast period – the cumulative increase in public sector net borrowing to fiscal year 2023-24 is £96.6bn. This brings annual debt issuance back to levels last seen in 2013-14.

Given this, one might have expected a bigger reaction from bond markets, but this has not been the case at all. One possible explanation is that very low interest rates have comforted markets that this extra spending will be affordable. Indeed, the OBR has revised down its forecasts for debt interest payments by £6.7bn in 2020-21, rising to £8.5bn by 2023-24. These forecasts were based on the assumption that the base rate would be 50bps, so the cut to 25bps would increase these savings further. Whilst this benign funding environment could well last for a while, it does also imply that the government's finances will be extra sensitive to both future interest rates and the growth outlook. This is not a near-term risk but one to watch out for in future years.

Market reaction and our view

The immediate response of the Gilt market and sterling has been muted, whilst the FTSE 100 is down around 1.1% at the time of writing (3.30pm).

It seems that market participants remain concerned about the outlook for the UK economy and do not see today's monetary and fiscal announcements as anything more than offsetting the significant negative economic impact to come from Brexit. There is no doubt that bond issuance will rise quite significantly as a result of the measures announced but we cannot see interest rates rising anytime soon. This is because the international context matters a great deal and it is definitely pushing yields lower in the near-term.

As for equities, the international context matters greatly too and the possible seizing-up of global trade flows and the fall-off in demand will likely increase headwinds. Beyond that, there are, of course, key questions surrounding the UK's future trading relationships and the impact on investment and productivity.
Considerations for pension schemes

RPI consultation - As expected, the consultation on future changes to RPI was published to coincide with the Budget. This does not appear to contain any major surprises. The consultation runs until 22 April.

Tapered Annual Allowance - From 2020/21 the "threshold income" below which individuals do not have to consider the Tapered Annual Allowance (TAA) will be increased from the current £110,000 to £200,000. The "adjusted income" (which includes allowance for pensions savings) above which the TAA starts to apply, will increase from £150,000 to £240,000.

The taper reduces the individual's annual allowance, from £40,000, by £1 for every £2 of income above the adjusted income level. A further change is that the minimum tapered annual allowance will now be £4,000, rather than £10,000 - this minimum will apply for individuals with adjusted income over £312,000.

It was widely expected that some adjustment to the TAA would be announced to address the concerns of NHS staff. The budget proposal affects all workers, not just NHS or public sector. The overall impact of the change is that far fewer individuals will be affected by the taper. However, those individuals with threshold income in excess of £300,000 (the point at which the tapered annual allowance will fall below the current minimum of £10,000) will see a reduction in their annual allowance from the current position.

Lifetime Allowance - The budget confirmed that the LTA will increase to £1,073,100 for 2020/21, in line with the CPI increase to September 2019.

Review of Pensions Tax Administration - The government has committed to reviewing options for addressing the effect of different pensions tax relief approaches ('net pay' and 'relief at source') for those earning below the level of the personal allowance. It will shortly publish a call for evidence on this.
Collective defined contribution pensions – the government will legislate to ensure that the 'CDC schemes' to be introduced under the Pension Schemes Bill can operate as registered pension schemes for tax purposes.

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