

UK PRE-BUDGET REPORT PREVIEW

13th Nov.
2008

How bold?

- Alistair Darling may be the man at the despatch box, but the main architect of this Pre-Budget Report will be John Maynard Keynes. **With the Government having firmly signalled its intention to support the ailing economy with a much-needed fiscal boost, the key question is just how bold it is prepared to be.**
- The case for a loosening of fiscal policy has grown steadily stronger over recent months as the outlook for the economy has deteriorated and inflation pressures have started to subside. **With the effectiveness of monetary policy impaired by the credit crunch, it is time to use every weapon in the arsenal.**
- **Of course, tax cuts and spending increases will put further strain on the creaking public finances.** But with the previous fiscal framework already blown to pieces, the Government appears to have concluded that there is little to lose. And if the package prevents the recession from becoming a depression, it may ultimately *improve* the fiscal position.
- So what should we expect? The Government will have to spend at least £15bn – around 1% of GDP – just to prevent an already planned fiscal *tightening* from deepening the downturn in the economy. **To provide a meaningful boost, it may have to spend as much as £30bn.**
- Some of this may be achieved by bringing forward capital spending projects. But if the Government wants to boost activity quickly, it needs to cut taxes too. **Moreover, tax cuts need to be targeted at those people who will spend the extra income, not save it.**
- At the very least, Mr Darling will extend the measures to compensate those affected by the scrapping of the 10p tax band implemented in April. He may also steal some of the Conservatives' proposals on inheritance tax and national insurance. **If he really wants maximum bang for his buck, however, big cuts in income tax or VAT may be needed.**
- Of course, there is no guarantee that these measures would work. At the very least, they are unlikely to prevent the economy from contracting sharply over the next year or two. What's more, the prospect of a major fiscal consolidation at some point casts a shadow



over the longer-term outlook for the economy. **But as Keynes himself said, in the long run we are all dead.**

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How bold?

A nation expects. It has been a very long time since a fiscal announcement was as eagerly awaited as this year's Pre-Budget Report. With the Government signalling that is prepared to demolish its own fiscal framework to implement a Keynesian-style boost to the ailing economy, hopes of major increases in government spending and/or tax cuts are riding high. But just how bold will the measures be? What form will a fiscal boost take and what effects will it have on the economy? And how will the Government reassure the markets that it still intends to get the public finances back into a sustainable position one day?

Keynes lives!

Calls for some form of fiscal response to the downturn in the economy have grown steadily louder over recent months as the likely severity of the recession has become clear. At the same time, though, two other developments have also strengthened the case for such action.

First, as inflation pressures in the economy have started to ease, concerns that the Bank of England's Monetary Policy Committee (MPC) would simply react to any fiscal loosening by keeping interest rates correspondingly higher have evaporated. And second, the continuation of the credit crunch and its effects on market interest rates and the availability of credit have no doubt diminished the effectiveness of changes in monetary policy. **This suggests that both deep**

cuts in interest rates and looser fiscal policy are required.

Of course, some economists have objected to the idea of a fiscal loosening on the basis that it will make the already dreadful state of the public finances even worse. This, in turn, could diminish the effectiveness of the measures if taxpayers conclude that any giveaways now will simply result in higher taxes in the future - the so-called theory of "Ricardian equivalence".

We have a little sympathy with that view. It is certainly regrettable that, after a decade of pretty solid growth in the economy, the public finances are not in a better position - ideally a *surplus* - to accommodate a downturn in the economy.

But such concerns are for another day. The immediate priority is to do everything possible to ensure that the inevitable severe recession in the economy does not turn into something resembling an outright depression.

In any case, as we have been warning for some time, public borrowing is already set to rise very sharply over the next few years as a natural consequence of the downturn in the economy. We have predicted that borrowing will rise as high as £150bn per annum over the next few years, the equivalent of almost 10% of GDP. Against that background, even tax cuts or spending increases worth tens of billions of pounds won't make an enormous difference to

the public finances. Indeed, it is even possible that they end up *improving* the fiscal outlook if they help to avoid an even deeper economic downturn.

What and how big?

So the case for some sort of fiscal boost is, in our view, a solid one. Indeed, I have argued as much since the start of the year. More importantly, though, the Government itself now appears to be fully signed up the idea, to the extent that the Prime Minister has even started to encourage other countries to support their economies by "putting more money into the economy by tax cuts or by public spending rises".

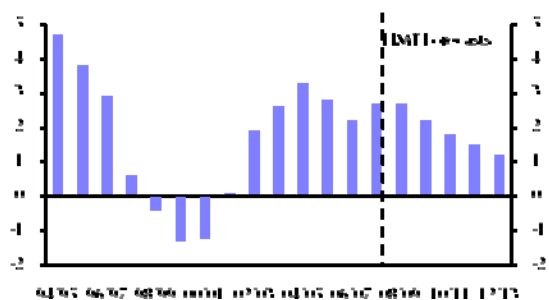
But just what form is such action likely to take and how big will it be? Initial hints from the Government centred on the bringing forward of existing capital spending projects. Limiting the fiscal boost to such action would presumably have the advantage of leaving the level of public borrowing unchanged over the long-term - it would simply alter the *timing* of some borrowing.

But the *disadvantage* is that even capital spending projects which are already in the pipeline are likely to take some time to get off the ground, delaying any positive effect on the economy. Accordingly, it now seems likely that any fiscal rescue package will also include some form of tax cuts and perhaps increases in *current* - i.e. day-to-day - spending as well as capital spending.

In terms of size, it seems clear that the package will have to be

pretty sizeable if it is really going to have any significant bearing on the path of the economy over the next year or two. Indeed, it is worth remembering that the existing fiscal plans published in the last Budget already include a fairly sizeable fiscal *tightening* over the next few years, with the cyclically adjusted budget deficit - a measure of the overall fiscal stance - projected to shrink from around 2.7% of GDP to 1.8% of GDP by 2010-11 and then to 1.2% of GDP by 2012-13. (See Chart 1.)

CHART 1: CYCLICALLY ADJUSTED PSNB (% OF GDP)



Source - HM Treasury

Admittedly, as well as a sharp slowdown in the growth of spending, these projections also included the effects on tax receipts of the scrapping of the 10p starting rate of income tax announced in Gordon Brown's last Budget in 2007 but implemented in April 2008. Since then, the Government has spent some £3bn on measures to compensate some of those households affected. In addition, the rise in fuel excise duty planned for October this year was postponed and stamp duty on houses worth £175,000 or less suspended. But these measures will come to an end next year unless the

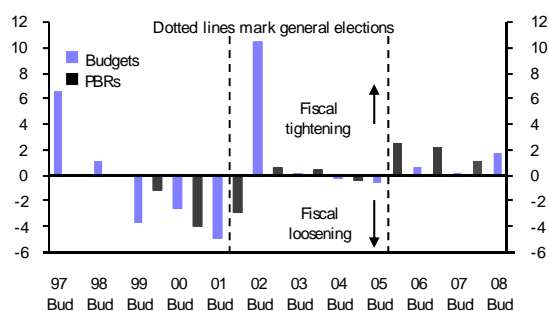
Government spends the same amount of money to extend them for another year.

The upshot is that the Government needs to implement tax cuts or spending increases worth almost 1% of GDP - close to £15bn - just to prevent fiscal policy from tightening over the next two years and hence deepening the downturn in the economy. If it really wants to boost the economy, then it would seem likely that any package would have to be worth at least £20bn, if not £30bn.

The package

Whether or not the Government is prepared to be quite that bold is far from clear. After all, Chart 2 shows that tax and spending measures worth even £20bn would eclipse the value of the measures announced in any of the Budgets or Pre-Budget Reports seen since Labour came to power in 1997.

CHART 2: TAX & SPENDING PACKAGES (£BN)



Source - HM Treasury

But as we have said before over recent weeks, extraordinary circumstances require extraordinary actions, a fact underlined by the Monetary Policy Committee's 1.5% cut in interest rates earlier this

month. So what might a spending and tax cut package worth £30bn actually consist of?

Clearly the possible combinations of measures are endless and the Tax Ready Reckoner in the Annex gives costings for various tax changes. But Table 1 gives an illustrative idea of what the giveaway might look like if it were made up of £10bn of spending increases and £20bn of tax cuts. As a bare minimum, the Chancellor is likely to extend the measures to compensate the losers from the scrapping of the 10p band, as well as perhaps compensating some of the other 1.1m households who are still losing out. He may also extend the freezing of fuel duty (at a cost of £550m) and the one-year stamp duty holiday for properties worth less than £175,000 (at a cost of £0.6bn).

The Chancellor may also feel a political imperative to steal the Conservatives' thunder by matching some of their proposals, as indeed he did in last year's PBR. These might include tax breaks for employers taking on new staff (which the Conservatives are costing at £2.4bn), a freeze on council tax (which they cost at around £1.0bn) and reducing inheritance tax. The full-year cost of a cut in the inheritance tax rate from 40% to 30% would be around £0.6bn.

TABLE 1: POSSIBLE PBR PACKAGE

New Measures	Cost 2009/10
Capital spending brought forward	£5.0bn
Current spending (e.g. public sector jobs & pay)	£5.0bn

Tax breaks for employers taking on new staff	£2.6bn
1-year council tax freeze	£1.0bn
Cut inheritance tax from 40% to 30%	£0.6bn
Continue compensation for end of 10p tax rate	£2.7bn
Increase compensation for end of 10p tax rate	£1.0bn
Extension of fuel duty freeze	£0.55bn
Extension of stamp duty holiday on houses	£0.6bn
1p cut in basic rate of income tax	£4.9bn
Suspend stamp duty on houses altogether	£6.1bn
Total tax cuts	£20.0bn
OR	
4% cut in main rate of VAT	£20.9bn
Total fiscal package	cf30bn

Source - HM Treasury/Bootle Estimates

Beyond those possible measures, the key for the Chancellor will be to target tax cuts at those people who are most likely to spend the extra income rather than save it. Possibilities might include a 1p cut in the basic rate of income tax (at a cost of £4.9bn and perhaps pre-announced for April), a 1p cut in the corporate tax rate (at a cost of just under £1.8bn) and even a total suspension of all stamp duty on residential housing for a year (costing around £6bn). **Alternatively, Mr Darling could eschew all the above measures and attempt to get maximum bang for his buck by spending all £20bn on a headline-grabbing 4% reduction in the VAT rate from 17.5% to 13.5%.** Needless to say, such a measure would have powerful downward effects on inflation. A cut in VAT to 13.5% would in theory contravene the European Union's VAT directive,

which sets a minimum standard rate of 15%. However, the directive also allows for temporary derogations.

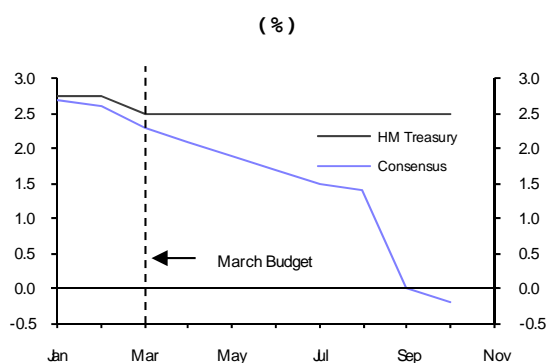
The economic forecasts

While the size and form of any fiscal rescue package will be the main focus of the PBR, the Chancellor's new forecasts for the economy and public finances are also likely to be watched with interest. **The severe deterioration in the economy over the past few months means that the Chancellor will have no choice but to slash his economic forecasts, at least for this year and next.** The blame, no doubt, will be put firmly at the door of global factors.

His forecast in March's Budget for GDP growth of between 1.75% and 2.25% this year will have to be reduced to just 0.75% to 1%. **But he will really have to bite the bullet when it comes to the forecast for next year.** In the Budget, the Chancellor forecast growth in 2009 of 2.25% to 2.75%. Yet the most recent consensus forecast was for a 0.2% *contraction* in the economy (and has almost certainly become even gloomier in the weeks since the last survey). (See Chart 3.)

Even if forecasting an outright fall in GDP proves to be one step too far for the Chancellor, he will have to concede that the economy is at least unlikely to grow at all next year. And while he will presumably predict some recovery in 2010, his forecast is still likely to be weaker than that presented in the March Budget.

CHART 3: FORECASTS FOR ANNUAL GDP GROWTH IN 2009



Source - HM Treasury

Beyond that, he will hope that some of the spare capacity created in the next few years will allow rapid growth in the later years of the forecast. But even growth of 3% or above in 2011 and 2012 would leave the level of output at the end of the forecast period a long way below that predicted in the Budget, with serious adverse consequences for the public finances. (See Table 2.)

TABLE 2: GDP FORECASTS

% y/y	2008	2009	2010	2011*	2012*
Budget 08	1.75 to 2.25	2.25- 2.75	2.5-3.0	2.5	2.5
PBR 08 (exp.)	0.75 to 1.0	-0.5 to 0	1.5 to 2.0	3.0	3.0
Bootle F'cast	0.8	-1.5	-1.0	0.0	1.2

*fiscal year assumptions

Source - HM Treasury

The fiscal forecasts

Needless to say, the dramatic deterioration in the outlook for the economy will blow the Chancellor's previous fiscal projections to pieces. Back in the March Budget, Mr Darling predicted that public sector net borrowing (PSNB) would fall from £43bn in 2008-09 to £30bn in 2009-10 and then to £23bn by 2012-13, the

latter equivalent to just over 1% of GDP.

But this year's borrowing figure already looks set to come in at a much higher £60bn or so, while the weaker forecasts for the economy will push the borrowing numbers in later years sharply higher too. **Our own prediction is that borrowing will ultimately rise as far as £150bn per annum within the next three years, even excluding any fiscal package.**

Mr Darling's forecasts are unlikely to be this high since his economic projections won't be as gloomy as ours. Nonetheless, taking account both of the GDP forecasts we expect him to publish and a fiscal package worth something like £30bn over the next two years, suggests that he may forecast a rise in annual borrowing as far as £100bn over the next few years. (See Table 3.)

TABLE 3: PUBLIC BORROWING FORECASTS

£ bn	08-09	09-10	10-11	11-12	12-13
Budget 2008	43	38	32	27	23
PBR 2008 (exp.)	55	75	90	100	100
Bootle F'cast (ex. tax changes)	60	90	120	150	160

Source - HM Treasury

A new fiscal framework?

Needless to say, the new fiscal forecasts will put the final nail in the coffin of the fiscal framework the Government introduced shortly after it came to power back in 1997. Mr Darling has indicated that the Pre-Budget Report will include a new framework setting out the Government's plans to bring the

public finances back towards a sustainable position over the medium-term, but this will not be an easy task. After all, that the fiscal forecasts are unlikely to indicate any significant improvement in the public finances within the normal forecast period of five years. (See Table 3 again.)

Accordingly, it seems likely that any new framework will be reasonably vague and focused on the medium-to long term outlook. **Whatever the Chancellor comes up with, however, the bottom line is that a major fiscal consolidation will be required at some point in order to get the public finances back into a sustainable position. Needless to say, this casts a shadow over the longer-term outlook for the economy.**

The market implications

The increase in borrowing to record levels and/or any further injections of capital into the banks are likely to spook the gilt market, at least in the near-term. As Table 4 shows, the larger than expected Central Government Net Cash Requirement (CGNCR) - due to the rise in borrowing - may result in total gilt sales of around £138bn this financial year. This would be higher than the latest official projection of £110bn, which included an extra £30bn of gilts to fund the Government's recapitalisation of the banks.

What's more, as we expect that borrowing will be some £15bn higher than the Chancellor is likely to predict for 2009-10, gilt sales are

also likely to be £15bn higher. We have pencilled in issuance of around £120bn for next year. Much more significant, though, will be the surge in issuance in future years. The economic downturn could mean that by 2011-12, the Government will need to issue a whopping £185bn of gilts. And the actual total could be even larger if it was forced to inject yet more cash into the banks.

TABLE 4: GILT FUNDING ARITHMETIC

	Bud 08	Bootle estimates			
		08-09	09-10	10-11	11-12
£bn					
CGNCR	59.3	79.6	101.0	125.3	152.4
Redemptions	17.3	18.6	18.1	44.1	33.4
Financing for banks	0.0	37.0	0.0	0.0	0.0
Other	2.0	2.0	0.0	0.0	0.0
Financing adjustment	4.2	4.2	0.0	0.0	0.0
Financing Requirement't	82.8	141.2	119.1	169.4	185.8
Less National savings	4.0	4.0	0.0	0.0	0.0
Net Fin'g Requirement't	78.8	137.2	119.1	169.4	185.8
Ways and means	-7.0	-7.0	0.0	0.0	0.0
Financed by: T bills	5.8	6.1	0.0	0.0	0.0
	80.0	138.1	119.1	169.4	185.8
: Gilts					

Source - Debt Management Office & Bootle Estimates

Given the continued strong institutional demand for long bonds, it seems likely that issuance will be skewed towards the long-end of the curve. Meanwhile, with long index-linked yields down at 1% and, despite the prospect of deflation in the short-term, considerable anxiety about inflation in the medium-term, there could be significant institutional demand for index-

linked bonds. It therefore makes sense for the government to skew issuance in this direction.

Chart 4 shows that the market did not take too kindly to the rise in issuance seen after the Government's initial injection of £37bn into the banks. We would not be surprised to see a similar reaction to the surge in gilt sales announced alongside this PBR. If long yields were to rise significantly, this could put a further dent in the public finances by raising the cost of servicing the Government's debt.

However, the chart also shows that in response to the recent downturn in activity and the rapid fading of inflation fears, bond yields have since fallen back. And we have noted before that during a similar set of circumstances in Japan in the 1990s, the onset of a prolonged recession and very low inflation more than offset concerns over issuance to drive bond yields lower. As such, although the downturn in the economy and further cuts in official rates will steepen the yield curve, long yields may not rise that much further.

As for other markets, the stockmarket may enjoy at least a temporary bounce from the news that the Government is deploying its fiscal armoury. However, growing concerns over the sustainability of the UK's public finances in the medium-term may weigh on the pound.

CHART 4: UK 2 & 20 YEAR GILT YIELDS (%)



Source - Thomson Datastream & Bloomberg

Annex A – Tax Ready Reckoner

	Cost/yield (accruals) 2009-10 (£m)
Income Tax	
Rates	
Change starting rate for savings income by 1p ^a	15
Change basic rate by 1p ^a	4,910
Change higher rate by 1p ^a	1,550
Allowances	
Change personal allowance by £100	680
Starting-rate limit	
Increase starting-rate limit by £100	5
Basic-rate limit	
Change basic-rate limit by 1%	300
Change basic-rate limit by 10%:	
increase (cost)	2,800
decrease (yield)	3,550
Allowances and limits	
Change all main allowances, starting and basic-rate limits:	
increase/decrease by 1%	760
increase by 10% (cost)	7,350
decrease by 10% (yield)	8,600
Working tax credit	
Change basic element by £100	280
Change 30-hour element by £100	210
Change element for couples/lone parents by £100	260
Child tax credit	
Change family element by £100	600
Change child element by £100	650
Corporation Tax	
Change main rate by 1 percentage point	1,750
Change small companies' rate by 1 percentage point	395
National Insurance Contributions	
Change employee rate by 1%	4,100
Change employee rate above UEL by 1%	1,100
Change employer rate by 1%	5,300
Change employee entry threshold by £2 per week	260
Change employer threshold by £2 per week	310

^a includes savings income taxable at the starting rate.

Annex A - Tax Ready Reckoner (cont.)

Revenue impact of 1% change	Cost/yield (non-accruals) 2009-10 (£m)
Excise duties^a	
Beer up 0.3p a pint	30
Wine up 1.3p a bottle (75cl)	25
Spirits up 5.5p a bottle (70cl)	10
Cigarettes up 3.4p a packet (20 king-size)	10
Petrol up 0.5p a litre	120
Diesel up 0.5p a litre	140
Change insurance premium tax (standard rate) by 1 percentage point	490
VAT	
Change both standard and reduced rates by 1 percentage point	5,220
VAT coverage	
2007-08	
Extend VAT to:	
food	11,300
domestic and international passenger transport (UK portion)	2,650
construction of new homes	8,200
books, newspapers, etc.	1,700
water and sewerage services	1,300
children's clothing	1,350
prescriptions	1,350
Stamp duty	
Change 1% rate by 1 percentage point	1,390
Change 3% rate by 1 percentage point	1,270
Increase £125,000 threshold by £5,000	25
Increase £250,000 threshold by £5,000	80
Inheritance tax	
Change rate by 1 percentage point	60
Increase threshold by £5,000	40

^a Figures are calculated given the price and tax charged on a typical item. All changes are assumed to be implemented in April 2008, except the change to the insurance premium tax (July 2007).
Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, October 2007