

# UK ECONOMICS FOCUS

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## The Chancellor's hands are tied

- **The ailing economy desperately needs more support and yet the Chancellor is more hemmed in than ever by the fiscal position. With no money to spend, Mr Osborne will instead use the Autumn Statement to flesh out his Plan for Growth. But these primarily long-term, supply-side measures will not help to dig the UK out of its hole in the near-term.**
- The Chancellor may regret his decision to create an independent Office for Budget Responsibility! **The OBR is likely to revise *down* its growth forecasts and revise *up* its borrowing forecasts.**
- Admittedly, the extra borrowing caused by weaker growth arguably has little implication for the Government's fiscal mandate to eliminate the *cyclically-adjusted* current deficit over a rolling, five year period. But the OBR is also expected to revise up its estimate of the *structural* deficit.
- Accordingly, while the Government was previously expected to meet the mandate by a reasonably comfortable margin, **that margin will now be reduced and it is not out of the question that the Chancellor will have to announce a bit more fiscal tightening to meet his mandate at all.**
- Given that the coffers are empty, the Chancellor will struggle to put much substance into his Plan for Growth. **As far as proper giveaways go, we imagine that the best he can do is scrape together enough cash to scrap or delay the rise in fuel duty.** This will probably be partly paid for by uprating benefits by less than September's 5.2% inflation rate.
- **Most of the measures will instead be aimed at getting the private sector to spend** - probably the best thing the Government can do in the circumstances. The well-trailed centrepieces are likely to be "credit easing" measures and facilitating private sector bonds for investment in infrastructure. **We will also probably see measures aiming at cutting red tape and encouraging private sector employment.**
- **However, none of this will salvage the economic recovery.** Most measures won't take effect straight away. And the Plan for Growth is more generally designed to boost the supply-side of the economy, rather than to stimulate demand immediately. **We doubt that anything announced next week will stop the economy heading for a double-dip.**

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## The Chancellor's hands are tied

**A double-dip in the economy looms, yet with the coffers bare, the Chancellor has little choice but to sit back and hope for the best.** Of course, he still has the option of switching to a "Plan B" and ditching his fiscal mandate in order to support the economy. But, for now at least, he still seems wedded to using the euro-zone crisis to illustrate why he needs to stick to his austerity programme. With no money to spend, he has therefore been left scrabbling around for measures to flesh out his Plan for Growth, which are unlikely to do much to support demand in the near-term.

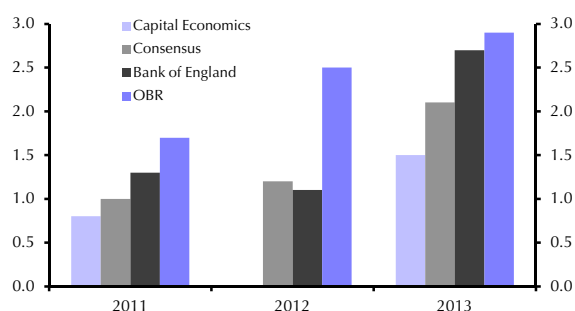
### OBR to slash growth forecasts

The Autumn Statement was introduced for the first time last year by the new Government and it is still not entirely clear what the coalition aims to achieve with it. Originally, it looked as though it would be a simple comment on the updated economic and fiscal forecasts published by the Office for Budget Responsibility (OBR). However, the Chancellor used last year's statement to announce a growth review and corporate tax reform. Already, then, it is looking closer in format to Labour's Pre-Budget Report – which had essentially become a mini-Budget.

Either way, the Chancellor will start with a commentary on the OBR's new forecasts. And they won't look pretty. Indeed, Mr Osborne may be starting to regret his decision to devolve forecasting responsibility to an independent body!

**Obviously the growth forecasts will have to come down significantly.** In its last forecasts in March, the OBR forecast growth of 1.7% this year, 2.5% next year and 2.9% in 2013. (See Chart 1.) The Bank of England bit the bullet last week and revised down its own forecasts from similar rates to more like 1% both this year and next. We expect the OBR to do the same. Table 1 shows some plausible estimates of what the OBR might now forecast.

CHART 1: REAL GDP FORECASTS (% Y/Y)



Source – Thomson Datastream

TABLE 1: REAL GDP (% Y/Y)

% y/y	2011	2012	2013	2014	2015
OBR March	1.7	2.5	2.9	2.9	2.8
<b>OBR Nov (f)</b>	<b>1.0</b>	<b>1.0</b>	<b>2.5</b>	<b>2.9</b>	<b>2.9</b>
Cap. Econ.	0.8	0.0	1.5	3.0*	3.0*

\* Working assumptions

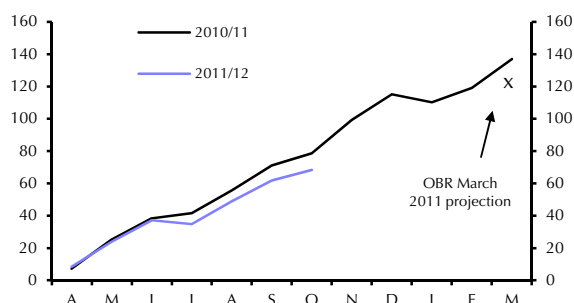
Source – OBR, Capital Economics

### Borrowing forecasts to rise

Normally, if the economy were weakening this much, we would expect to see some sort of action from the Government. When the economy was last falling into recession at the end of 2008, then Chancellor Alistair Darling used November's Pre-Budget Report to announce a temporary VAT cut from 17.5% to 15% as part of a net giveaway package worth £25bn over two years.

But the current Chancellor is clearly still severely hemmed in by the fiscal position. **Admittedly, the recent fiscal figures have not been that bad.** Since the OBR last made its forecasts, borrowing for 2010/11 has been revised down by about £6bn. And even though economic growth has been weaker than the OBR was expecting, public sector borrowing for 2011/12 is broadly on track to meet, or even slightly undershoot, its full-year forecast of £122bn. (See Chart 2.)

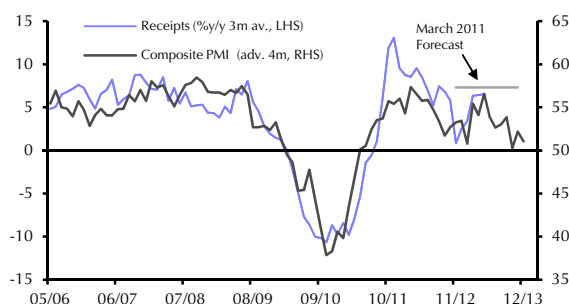
**CHART 2: PSNB Ex. (CUMULATIVE, £BN)**



Source – Thomson Datastream

However, we do not think that this reflects a fundamental improvement in how the economy affects the public finances. As Chart 3 shows, tax revenues *have* suffered more than the OBR expected and, once the usual time lags kick in, are likely to weaken further in response to the recent economic slowdown. And as the economy has slowed, spending on social benefits has risen more than forecast. Borrowing has therefore only fallen because of a tighter squeeze on other public spending than planned. While this should alleviate concerns that the spending plans are unachievable, it suggests that borrowing won't maintain its good performance of late.

**CHART 3: CENTRAL GOV. TAX RECEIPTS & CIPS/MARKIT PMI**



Sources – Thomson Datastream, CIPS/Markit

**In fact, given the weaker growth outlook, the OBR's new fiscal forecasts are set to look even worse than its ones in March.** As a rule of thumb, each 1% off GDP growth adds about £10bn to borrowing. So the downgrades to the growth forecasts that we expect should add about £15bn

to borrowing in 2012/13 and £20bn or so in 2013/14. (See Table 2.)

**TABLE 2: PSNB Ex. (£BN)**

	11/12	12/13	13/14	14/15	15/16
OBR March	122	101	70	46	29
<b>OBR Nov (f)</b>	<b>122</b>	<b>115</b>	<b>90</b>	<b>65</b>	<b>50</b>
Cap. Econ.	130	120	100	90	80

Source – OBR, Capital Economics

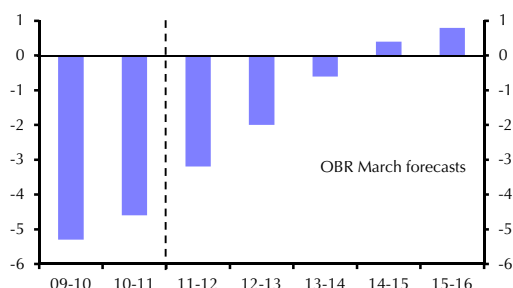
### Meeting the mandate

Of course, the Government's main fiscal mandate is to balance the *cyclically adjusted* current budget. Accordingly, these changes on their own might not seem to have any major implications for the Government.

But we would not be so sanguine, for several reasons. **For a start, there has also been speculation that the OBR will revise up its estimate of the structural budget deficit too.** In particular, the OBR might judge that the "output gap" - the amount of spare capacity in the economy - is not as big as it previously thought. In that case, the OBR will judge that less of the deficit will be naturally eroded as economic growth picks up. Indeed, the IMF estimated in September that the structural deficit was £12bn larger than the OBR estimated in March. It is also possible that the continued sluggishness of productivity growth prompts the OBR to revise down its estimate of the economy's potential growth rate further ahead.

**Admittedly, the Chancellor was on course to meet his fiscal mandate by a fairly comfortable margin, so the OBR's forecasts would have to deteriorate significantly to mean that he now will not honour his mandate.** The OBR forecast in March that the cyclically adjusted budget would return to surplus in 2014/15 - a year earlier than the five year horizon specified under the mandate - and would be £15bn in surplus by 2015/16, equivalent to 0.8% of GDP. (See Chart 4.) **Moreover, the time that has passed since March means that, under the five year rolling target, Mr Osborne presumably now has until 2016/17 to meet the mandate.**

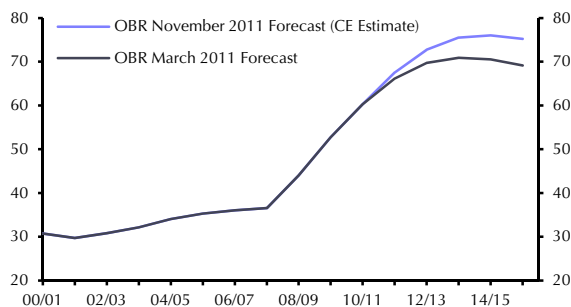
**CHART 4: CYCLICALLY ADJUSTED BUDGET (% OF GDP)**



Sources – Thomson Datastream, OBR

**But even if he meets his target for the cyclically adjusted budget, meeting the supplementary objective for the overall debt to GDP ratio to be falling by 2015/16 might be a closer-run thing.** The OBR forecast in March that debt as a share of GDP would be falling by 2014/15. On its new growth forecasts, it probably won't show debt falling until 2015/16 and quite possibly later. (See Chart 5.)

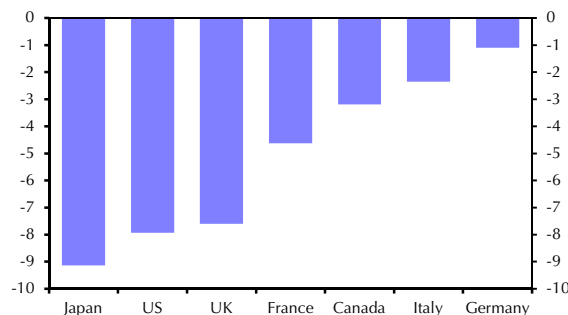
**CHART 5: PUBLIC DEBT (AS A % OF GDP)**



Sources – Thomson Datastream, OBR, Capital Economics

And more generally, we have pointed out before that markets are unlikely to be so concerned with the minutiae of the mandate. The knee-jerk reaction is likely to be to the simple deterioration in the overall borrowing figures. We think that the OBR's new forecasts could show borrowing set to be almost 8% of GDP in 2012, putting the UK towards the top end of G7 countries and above borrowing in many euro-zone countries. (See Chart 6, based on the IMF's September forecasts.)

**CHART 6: G7 BUDGET BALANCES (AS A % OF GDP)**



Sources – IMF, Capital Economics

**Chancellor still wedded to austerity plans**

So the Chancellor will have enough trouble as it is persuading the markets that the austerity plans are still on track. Will he really want to worsen the borrowing forecasts even further by spending extra money to help out the economy?

Of course, those advocating a switch to "Plan B" would argue that slowing the pace of fiscal consolidation might lead to higher public borrowing in the near-term but, by averting a possible recession, would ultimately have a positive effect on the public finances. Indeed, the opposition is already arguing that the austerity plans are backfiring and that the fiscal tightening is pushing the economy back towards recession.

However, the Government has been quick to put the blame for the UK's economic slowdown on events abroad, rather than its own actions. (See *UK Economics Weekly*, "Is the euro-zone really to blame?" 21<sup>st</sup> November.) **And the Chancellor has continued to use the crisis in the euro-zone as justification for adhering to his own austerity plans.** In an Evening Standard article recently, he said: "What is happening in Europe is a stark reminder of what a disaster it would have been for us to have taken any other path."

The upshot is that the Chancellor's resolve to adhere to his plans does not seem to have weakened. **In fact, if in the worst case scenario the fiscal mandate was on course to be broken, the Chancellor would probably opt to increase his**

**austerity measures even further in order to make sure he met it** – perhaps by announcing extra spending cuts for the latter half of the Parliament when he could argue that the economy would have strengthened enough to withstand them.

### **The policy options**

Hopefully it won't come to that. **Nonetheless, the big picture is clear - the Government has no money to spend.** Yet it's fair to say the Chancellor has not exactly dampened expectations about this Autumn Statement. So what can he do?

He certainly needs some sort of fanfare measure. **The most obvious candidate is postponing or doing away with altogether the 3p rise in fuel duty planned for January.** The rise itself is a delayed increase from earlier this year. In March's Budget, the Chancellor scrapped the fuel escalator (under which fuel duty rose by 1p above inflation each year); postponed the inflation-linked part from April 2011 to January 2012 and from April 2012 to August 2012; and cut duty immediately by 1p.

Scrapping January's rise would cost about £1.5bn. Mr Osborne paid for the changes in March's Budget by raising taxes on oil producers, the argument being that they had benefited from the rise in oil prices which had pushed up petrol prices. **Unable to repeat this trick, he will probably pay this time by saving money on the welfare bill.** The Chancellor is widely expected to announce that benefits in April 2012 will be uprated by the average inflation rate over the six months to September 2011 (4.5%), rather than September's rate (5.2%). This should save about £1bn. Other mooted revenue-raising measures include scrapping higher rate tax relief on pensions and a further crack-down on tax avoidance.

**Otherwise, the Chancellor is likely to resort to measures that won't actually cost him much or anything, in large part because they involve encouraging the private sector to spend.** Many of these possibilities have been well-trailed and some have actually already been announced. (See Table 3.) The Government announced new incentives for

employers to take on apprentices. It also announced a scheme to underwrite high loan to value mortgages for new-build homes. And it unveiled a £400m "Get Britain Building Fund," whereby housebuilders will get funding to restart construction on stalled building sites. Only the latter will cost anything; the cost of the apprentices comes out of the apprenticeships' budget and the underwritten mortgages will appear in the public finances as contingent liabilities.

**Other policies set to be announced include the acceleration of public sector projects already in the pipeline; measures to enable private sector investment in public sector infrastructure projects; and plans to increase lending to small and medium sized businesses, so-called "credit easing."** As a first step in the latter, the Government may start to purchase corporate bonds immediately. However, the Chancellor's ultimate aim will be to facilitate an SME bond market, where banks bundle small business loans and issue them as bonds, which the Government (and other investors) could then buy.

**We also expect to see further measures in order to try to encourage private sector hiring, by increasing the flexibility of the labour market and making it easier for firms to hire new workers.** For example, the British Chambers of Commerce has urged the Government to reform the employment tribunal system, impose a new no fault dismissal route, cancel the proposed extension of flexible working to all employees and introduce additional exemptions from pensions auto-enrolment. Further moves to reduce remove regulatory red tape are also likely.

Again, none of these will increase public sector borrowing by much, if at all. And in the case of bringing forward public sector investment, it will just involve the "re-profiling" of spending, perhaps raising borrowing a bit in the near-term, offset by lower borrowing later on.

### **Saving the recovery?**

In all, then, the package of measures looks set to be broadly revenue neutral. With a bit of creative accountancy, though, Mr Osborne will no doubt add it all together to show that the Government is providing a huge boost to the economy – a “£50bn plan for growth” has been talked about.

**In reality, though, the impact on the economy is likely to be a mere fraction of that.** Most of the measures will focus on boosting the longer-term, supply-side of the economy, rather than helping to boost demand over the next few months. And few infrastructure projects are “shovel ready”.

**There are question marks over how effective the measures will be in any case.** The take-up of previous schemes such as the National Insurance holiday for small firms taking on new workers has been notoriously low. And remember that in response to the initial Plan for Growth announced in March, the OBR declared: “we do not believe there is sufficiently strong evidence to justify changing our trend growth assumption.” Meanwhile, the extra funds provided through credit easing are likely to be small compared to the shortage of bank lending; outstanding bank lending to companies has been falling by an average of £2bn *per month* recently. Even scrapping the rise in fuel duty would boost consumers’ annual incomes by only 0.2% - and will be largely offset by benefits rising by less than inflation.

**To sum up, the Autumn Statement is unlikely to contain anything that will help the economy to get out of its current malaise.** What’s more, the Chancellor could face much trickier decisions before long. Even the OBR’s downgraded forecasts will probably still be too optimistic. We think that borrowing will fall even more slowly than the OBR will predict next week. As long as this extra borrowing is purely cyclical, Mr Osborne can just let total borrowing rise while still claiming to meet his mandate. **But he will still have an increasingly tough task persuading both markets and voters that his austerity plans remain on track.**

**TABLE 3: POSSIBLE MEASURES**

Measure	Comments	£bn 2011/12 Cost(-)/Yield(+)
<b>Fiscal Loosening</b>		
<b>Already announced:</b>		
Support for first time buyers	The Government has announced plans to underwrite a portion of first time buyers' mortgages. The aim is to reduce deposit ratios from 20% to 5%. The measures will not raise borrowing immediately, but will increase taxpayers' contingent liabilities.	-
Support for house-building	A £400m subsidy to house builders, to support the construction of 16,000 new homes, has been announced.	-£0.4bn
Youth unemployment	Vince Cable has already announced incentive payments of up to £1,500 for employers with up to 50 employees to take on apprentices which is planned to support up to 20,000 new apprenticeships in 2012/13, to the cost of £30m. However, the money will come out of the £1.4bn apprenticeships budget.	-
<b>Possible further measures:</b>		
Credit easing	Measures to boost lending to small business look likely to take centre stage. As a first step, the Government may start to purchase corporate bonds immediately. However, this will not get credit to SMEs who need it most. The Chancellor's ultimate aim will be to facilitate an SME bond market, where banks bundle small business loans and issue them as bonds, which the Government (and other investors) could then buy. These purchases would be contingent liabilities on the public sector's balance sheet, and would therefore only increase borrowing if the loans turned bad.	-
Infrastructure projects	The Treasury hopes that pension funds, frustrated by low returns from gilts, will invest up to £50bn into infrastructure schemes (such as toll roads, power stations and social housing) which the Government will facilitate. In return, pension funds will receive the proceeds from tolls, rents and energy bills.	-
Fuel duty	The Chancellor scrapped the annual fuel tax escalator - a mechanism under which duty rose by 1p above inflation every year - and cut fuel duty by 1p in March's Budget. However, he only postponed the planned inflation-linked part of the duty rise from April 2011 to January 2012, and from April 2012 to August 2012. Cancelling January 2012's rise would cost £1.5bn.	-£1.5bn
Support for industry	The Treasury is reportedly looking at giving tax breaks to energy-intensive firms which have been hit by higher electricity price rises. These include aluminium, steel and chemical producers. A 10% cut in the Climate Change Levy that applies to business electricity would cost £100m.	-£0.1bn
Air passenger duty	The airline industry has lobbied for the abolition of Air Passenger Duty. A 10% cut in the rate of duty would cost £200m. However, the Government has shown little sign of caving into this pressure.	-£0.2bn
50p tax rate	Some economists have recently urged the Government to scrap the 50p top rate of income tax. The Government is still reviewing whether the tax makes any money overall. However, the Government previously said that the tax would remain in force at least until the public sector pay freeze was over (in April 2013).	-£1.8bn
<b>Fiscal Tightening</b>		
Indexation of benefits	Benefits look likely to be uprated in line with the average rate of CPI inflation over the six months to September (4.5%), rather than September's 5.2% figure. This would save around £1bn. If state pensions were also uprated by the average inflation rate, the saving would rise to £1.4bn, but such a move seems unlikely for political reasons.	£1.0bn
Higher rate tax relief	The Chancellor could save a considerable sum if he capped the tax relief on pension contributions at 20%, the basic rate of tax. But the Treasury has denied that it is considering such a bold move.	£7.0bn