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Economic Bulletin

A NORMA DESMOND BUDGET

"I am big. It's just the pictures that got small."

- OBR forecasts house prices to rise by 32% to 2017; double previous estimate.
- Productivity up just 0.2% in second half of 2013 and structural deficit is larger.
- ISA reforms, abolishment of compulsory annuities are welcome, Thatcherite policies.
- Need for clear programme of supply side reforms to boost productivity.

OVERVIEW

Norma Desmond's retort in Sunset Boulevard ("You used to be in silent pictures. You used to be big". Norma Desmond: "I am big. It's the pictures that got small") might also apply to recent budgets, perhaps particularly that delivered yesterday by George Osborne. For while some of the measures (particularly on pensions and the increase in the individual allowance) are commendable, what was missing was a clear sense of direction, an overall strategy for economic reform. Where for example was the bold clarity of the great Howe and Lawson reforming budgets of the 1980s? Where was the big picture?

This lack of a coherent and cogent strategy may explain why the 2014 Budget contained a number of internal contradictions. Yes, the Chancellor announced several pro-growth supply side reforms, eased the burden on lower and middle income households and (largely) kept to the programme of deficit reduction. Yes, radical savings and pension reform, more income tax cuts and a boost to exports are all welcome. But this Budget also increased tax complexity, increased pork barrel spending and gave higher estimates for cyclically adjusted net borrowing.

What is needed now is a dynamic programme of supply side reform, clearly focused on increasing productivity (the only sustainable route to greater prosperity for all). Proposals on how to achieve this will be set out in a paper to be published shortly by the Centre for Policy Studies.

Growth Forecasts

- Growth in 2013 was 1.8%. Three times faster than OBR predicted at the last Budget.
- Growth for 2014 and 2015 upgraded to 2.7% and 2.4%. This is good news.
- **However, these forecasts rely too heavily on the very optimistic assumption that business investment will increase as a share of GDP from 8.2% to 10.8% at the end of 2018**.

Borrowing Forecasts

- Public sector net borrowing from this year until 2018/19 is expected to be £23.5 billion less than was expected at the Autumn Statement and £60 billion less than at the last Budget. This is a welcome downward revision to borrowing.
- However, public sector net borrowing next year is forecast at 5.5% of GDP excluding the Royal Mail and APF. In June 2010, **this was forecast to be just 2.1%.**
- The forecast for net borrowing this year is down by £12 billion but we will still have borrowed £108 billion. Can this really be claimed as a success?
- Public Sector net debt has increased by 46% since the election and is now forecast to reach a peak of 78.7% in 2015/16. This compares with the June 2010 forecast peak of 70.3% in 2013/14.

Output Gap

- OBR has substantially reduced its estimate of the size of the output gap from 3.7% of GDP in 2013/14 at the last Budget to 2% yesterday. The estimate of the output gap has also been reduced for every year after.
- This means that cyclically adjusted net borrowing **will be higher** in the next two years than expected at the Autumn Statement.

- Further public spending cuts are required. Growth alone is insufficient.

Productivity

- Long-term real wage rises and economic growth depend on productivity.
- The Chancellor's speech was 7,726 words **but "productivity" was not mentioned once.**
- Productivity would be 20% higher if it had continued growing at the pre-crisis trend.
- OBR says that productivity in 2013 was "exceptionally weak" and estimated that it was just 0.2% higher in the second half of 2013 than the first half.
- **Confident OBR assumptions in 2010 and 2011 of 2% annual productivity growth over the course of this Parliament have proven completely wrong.**
- We would like to have seen further action on deregulation, more reform of the tax system, improved competition policy and greater freedom for innovation through patent reform.

Savings and Pensions

- The savings and pensions reforms announced in the Budget are radical and potentially transformative. These are very welcome.
- The 10% savings tax rate has been abolished, cash and stock ISAs have been merged with a new threshold of £15,000.
- Abolishing compulsory annuities will give pensioners greater freedom and promote product innovation.
- Cutting the withdrawal tax rate on pensions from 55% is Thatcherite economics in action. **This is predicted to raise £3 billion by 2019**.
- However the 4% pensioner bond could make it difficult for businesses to compete for capital.

Taxation

- The increase in the personal allowance to £10,500 is extremely welcome.
- Bold cuts in income tax rates or at least more substantial increases in thresholds would have been welcome.
- Extra complexity has been added to the tax system for example through differing treatment of bingo and fixed odds betting terminals.
- Measures such as the 1p off the pint of beer duty (at estimated annual cost of £110m) are unlikely to have a noticeable impact on prices.

- We would prefer the earlier introduction of permanent tax changes such as the 20% corporation tax.

Welfare

- The introduction of the welfare cap at £120 billion in 2015/16 is a useful measure to help constrain the size of the state.
- However, state pensions, pensioner benefits and JSA which make up half of the welfare budget have been excluded.
- The Chancellor should increase the scope of the cap on welfare spending and also consider if it really needs to rise with inflation.

Housing

- The announcement of a new Garden City is welcome although greater simplification of planning laws and regulations would have been more powerful.
- The equity loan part of the Help to Buy Scheme is being extended to 2020. Potentially dangerously inflationary.
- **The Chancellor neglected to highlight massive rises in house price forecasts.** From price rises of 1.6% and 3.3% predicted in last year's Budget for 2014 and 2015 to now forecasts of 8.5% and 1.6%.
- Last year, the OBR forecast house prices would rise by **15**% between 2013 and 2017. Yesterday, the OBR forecast a **32**% increase in house prices over the same period.
- Last year, the OBR forecast stamp duty revenue of £47.6 billion between 2013/14 and 2017/18. Now they forecast stamp duty revenue of £69.1 billion. This means they forecast **an extra £21.5 billion** to be raised from stamp duty land tax compared to last year.

Exports

- The cut in aviation duty by abolishing bands C and D will make long haul flights cheaper and boost exports.
- The cancellation of the fuel duty rise is welcome and will ease the cost of the transportation of goods.
- More action could be taken to simplify transit visas to support tourism.

Carbon Price Floor

- CPF trajectory 'top up' has been frozen from 2016 at £18.08t/CO2 - admission that this policy is ludicrous and the frozen rate remains far too high.

- In the EU, the carbon price is around €6 today and is not expected to rise above €10 before 2016/17.
- The Government must now review the policy in full and look to reduce the gap between EU carbon prices and those being levied by the Government. This will reduce electricity bills, boost economic competitiveness and improve security of energy supply.

Pork

- £20m tax credit for theatre productions.
- £20m Cathedrals grant repair scheme.
- £50m extension of the cultural gifts scheme.
- £200m made available to fix potholes.

Also interesting

- Spectacular changes to OBR forecasts on the labour market. Employment in 2017 is now expected to be 0.7 million higher than was forecast last year.
- **OBR actually believes it is LESS likely the Government will reach its fiscal targets by 2018/19 compared to the Autumn Statement**. 75% probability now compared to 80% then.
- Debt interest payments in 2015/16 are expected to be £59 billion. OBR estimates that for every 10% of GDP that debt is lower, interest payments would be reduced by £8 billion a year.
- The Government will spend £3 million annually from next year to attract more international students. (This of course would increase migration).
- **The Government hopes it will raise £4.3 billion over the next 5 years from new tax avoidance schemes. This seems optimistic** and places too large a proportion of deficit reduction on uncertain revenue streams.

Nevertheless, in total, some of the policies announced in this Budget are potentially transformative. **The CPS had at least 12 policy wins** including:

- The increase in the personal allowance (remember that the proposal to increase the personal allowance to £10,000 was originally made in 'Poor People! Stop Paying Tax!' by Maurice Saatchi back in 2001)
- ISA reform (Costly and Ineffective: Why Pension Tax Reliefs Should be Reformed).
- Garden cities (Simplified Planning: the need for sunset clauses)

- The fuel duty freeze
- Confirmation of new flat 20% corporation tax (How To Cut Corporation Tax)
- Simplification of employee share ownership (Owners All: a proposal for Personal Investment Pools)
- Vehicle excise duty simplification
- Carbon price floor freeze (The Atomic Clock)
- Measures tackling the inflated costs of childcare
- Aviation duty cut
- Retail banking sector competition reform (Greater transparency for UK retail banking)
- Steps to improve the effectiveness of UKTI

The conclusion? More such policies are desirable, all painted within the bigger picture of dynamic supply-side reform.

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