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Economic Bulletin

FISCAL PRUDENCE TRIUMPHS OVER POLITICAL GIMMICKS

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- UK's borrowing forecast for this year drops by £16bn. But borrowing from 2017-18 onwards is unchanged and the UK will still have a budget deficit of 0.9% GDP in 2020-21.
- It is welcome that the Chancellor's budget measures are fiscally neutral over the forecast period. Fiscal prudence is needed over the next few years.
- NICs change could affect competitiveness and entrepreneurship. Instead, the Chancellor could have lowered NICs for the employed and reduced spending in other areas to pay for the change.
- However, recommitments on income tax thresholds and lowering corporation tax rates to 17% show that Britain is still open for business.
- New free schools and the introduction of T-levels will offer a much needed long-term boost to productivity and skills across the UK.

1. MACROECONOMIC OUTLOOK

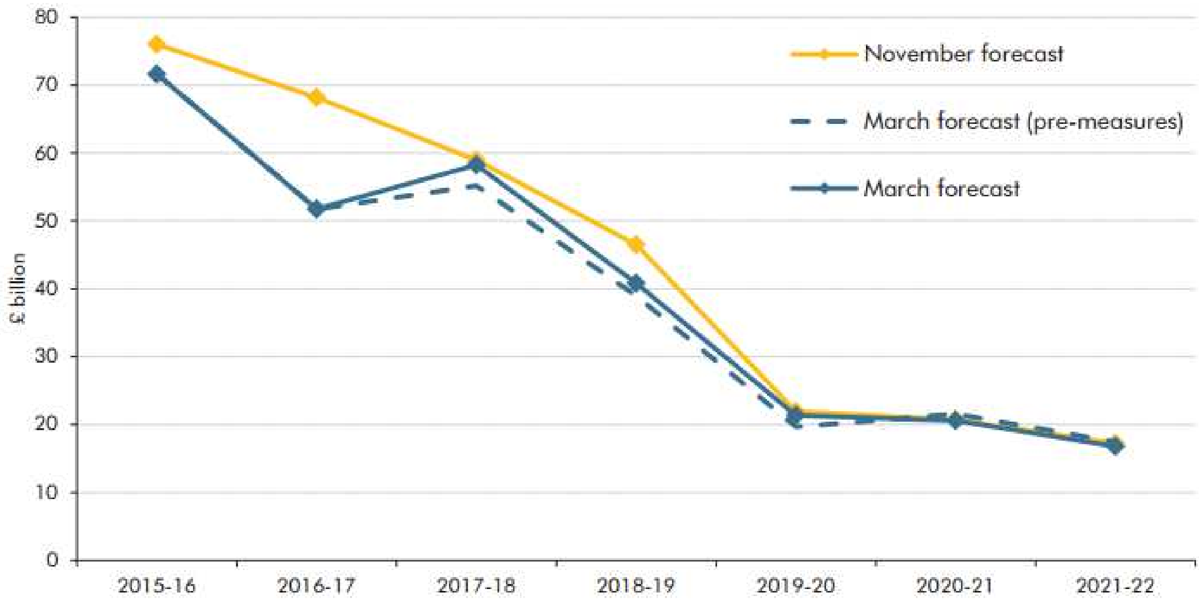
1.1 Borrowing and debt projections

The UK's net borrowing projection for 2016-17 has seen a dramatic change since the Autumn Statement 2016 (see Figure 1). The borrowing forecast for this financial year is down by £16.4 billion compared to November 2016's forecast, according to the Office for Budget Responsibility (OBR). This has primarily been driven by unexpectedly strong tax receipts from corporation tax, income tax, NICs and capital gains tax.

However, the fiscal forecast from 2017-18 onwards remains similar to that projected in November last year. Public sector net borrowing and cyclically adjusted net borrowing (usually referred to as the structural budget deficit) is expected to be 0.9% of GDP by 2020-21. This would undershoot the Chancellor's new fiscal rule that stipulates the structural budget deficit should be below 2% of GDP by 2020-21.

Debt to GDP ratios are expected to peak in 2017-18 at 88.8% of GDP. Debt to GDP ratios that breach this level could have implications for economic growth. A study conducted by Reinhart and Rogoff suggests that median economic growth rates fall by 1% above the threshold of a 90% debt to GDP ratio. Although the findings of this study have been disputed, there is broader evidence of a negative association between high levels of debt and economic growth.

Figure 1: Public sector net borrowing



Source: Office for Budget Responsibility link

1.2 Economic growth and inflation forecasts

Economic growth projections have, once again, been revised upwards for 2017. Prior to the EU referendum, the Treasury projected that a Leave vote would lead to growth of between -0.8%

and +0.2% in 2017. This was then revised up to 1.4% by the OBR in November last year, and the OBR is now projecting that economic growth will reach 2% (see Table 1). For the following four years, the forecast suggests that annual growth will be between 1.6% and 2%, according to the OBR's latest analysis.

Table 1: UK Growth Forecasts for 2017

OBR (March 2017)	2%
OBR (November 2016)	1.4%
UK Treasury (shock scenario)	0.2%
UK Treasury (severe shock scenario)	-0.8%

Source: OBR and Treasury

The CPI inflation rate is expected to peak at around 2.7% in the final quarter of 2017, before gradually declining towards the Bank of England's 2% target. The UK's increasing inflation rate has resulted from the fall in the value of sterling and rising global commodity prices, but the increase has not been as stark as some feared. For example, the National Institute of Economic and Social Research expected CPI inflation to average 3.3% in 2017.

2. THE KEY BUDGET DECISIONS

Table 2: Impact of policy decisions at Budget 2017

	2017-18	2018-19	2019-20	2020-21	2021-22	Total
Total Policy Decisions	-£1,710m	-£665m	+£825m	+£930m	+£445m	-£175m

Source: Budget 2017 link

The overall impact of the Budget's decisions will be fiscally neutral, costing the Treasury a mere £175m over the five-year forecast period. This supports the Chancellor's pronouncement that he would not use the improved borrowing forecast for 2016-17 for Budget giveaways.

2.1 Dealing with political problems

Business rates and social care

The Chancellor needed to tackle two key political problems in this Budget: the discrepancies with business rates and the underfunded social care sector.

On business rate reform, the Chancellor announced three measures that will alleviate the regime's discrepancies. These include a £300m business rate relief fund for councils and a £1,000 discount for pubs with a rateable value of below £100,000. Future reform of the business rate system has, however, been deferred until the next revaluation in 2022. It is widely understood that the growth of the digital economy will mean that the current business rate regime will be unfit for a modern economy.

The Chancellor has also allocated an additional £2.4bn to social care over the next three years, which will help alleviate the immediate strains in the system. This is a temporary measure. The Budget announced that a Green Paper will be published to examine a long-term solution to the funding of social care – although the so-called "death tax" has been ruled out as a funding mechanism.

2.2 The Revenue Raisers

Changes to NICs and the dividend allowance

The Treasury has argued that the fiscal impact arising from the growing number of self-employed people risks eroding the tax base. It is estimated that the foregone NICs from lower rates paid by the self-employed compared with employees will cost the public finances £5.1 billion in 2016-17. The Budget therefore announced that the rate of class 4 NICs will be brought closer to the rate of employee NICs, which will net the Treasury over £2bn over the forecast period.

However, the policy has come in for criticism. Some have argued that the increase in NICs violates the Conservative Party's 2015 Manifesto, which pledged no increases in income tax, VAT or NICs. The policy has also come under attack from the Federation of Small Businesses (FSB), who claimed it *"undermines the government's own mission for the UK to be the best place to start and grow a business".*

In addition to the changes in NICs, the Budget announced a reduction in the dividend allowance to £2,000 from April 2018, which will increase Treasury revenues by over £2.6bn over the forecast period. Concerns about the impact on UK competitiveness have been highlighted by both the FSB and the IPSE, which represents self-employed workers.

2.3 But many recommitments will boost competitiveness

Income tax thresholds and corporation tax rates

As previously planned, the personal allowance will be increased to £11,500 and the higher rate threshold to £45,000. This means that the Government is still on course to meets its manifesto commitment of increasing the personal allowance to £12,500 and the 40p rate to £50,000 by the end of the parliament.

The Chancellor also recommitted the Government to reducing corporation tax rates to 17% by 2020, which will mean the UK has the lowest rate in the G20. The headline rate of corporation tax has fallen from 28% in 2010, and despite this fall, corporation tax receipts have increased by 26% since 2011-12. Strong economic growth and higher profitability for companies are the driving force behind this rise in receipts – which themselves have been brought about by Government measures to boost competitiveness, including cuts to corporation tax.

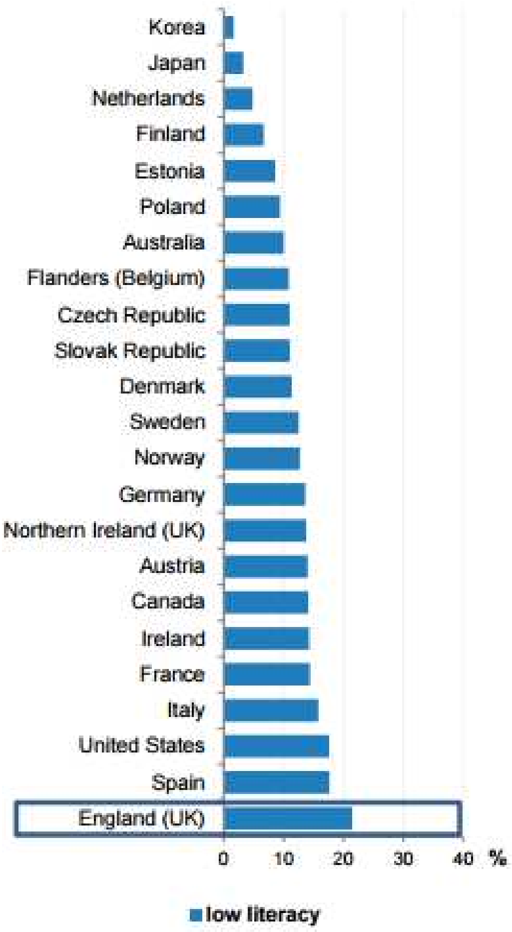
2.4 Boosting skills and productivity

More free schools and new T-Levels

In his Budget speech, the Chancellor asserted that "choice is the key to excellence in education". To support this assertion, the Budget announced funding for a further 110 free schools – some of which are expected to be grammar schools. There was also an announcement that the recommendations of Lord Sainsbury's Independent Review on Technical Education would be implemented. The number of programme hours of training for 16-19 year olds on technical routes will increase by more than 50%, and new "T-Levels" will help introduce a clearer system of qualifications for technical educations.

These reforms are aimed at tackling issues in the UK's education and skills system. There are major skills shortages in some areas with, for example, the manufacturing industry needed to recruit and train 82,000 engineers, scientists and technicians in the UK by 2016. There are also major issues with basic skills among some youngsters. The UK has the highest proportion of teenagers that lack basic literacy skills in the OECD (see Figure 2).

Figure 2: % of 16-19 year olds with low literacy



Source: OECD link

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3. CONCLUSION

It is welcome that, despite the UK's borrowing forecasts improving in the year 2016-17, the Budget was effectively fiscally neutral across the forecast period. Fiscal prudence is required over the coming years. Net borrowing forecasts for 2017-18 onwards remain unchanged, the UK's budget deficit is still substantial and the UK's national debt continues to grow.

Changes around National Insurance and the tax-free dividend allowance will inevitably be a concern from a competitiveness standpoint. The Treasury is, of course, right to be concerned about the potential erosion of the tax base and the different treatment of the self-employed and employees. But these changes could hamper the UK's flexible labour market, which has been key to the UK's strong economic growth. Instead, it might have been sensible to lower the rate of NICs paid by employees, and pay for the loss in revenue with spending cuts in other areas. However, despite the announced change in NICs, the recommitment to cutting corporation tax to 17% by 2020 will help ensure that the UK remains open for business.

The most encouraging aspect of this Budget was on education where the Chancellor asserted that 'choice is the key to excellence in education'. This is absolutely right. The announcement of further funding for new free schools and grammar schools along with the promotion of technical education with the introduction of 'T-levels' will offer welcome choice to parents, while helping boost the long-term skills and productivity of the UK.

This Budget did not address many of the issues faced by the 'just about managing', including in areas such as marginal tax rates and energy bills. However, there is some indication that future Budgets may offer relief to the JAMs. For example, the Government has set out its intention to replace the limits on renewable energy subsidies with a new set of controls later in the year.

Overall, this Budget was sensible and fiscally prudent. The measures on National Insurance and the tax-free dividend allowance are indeed disappointing. However, recommitments to raise income tax thresholds and lower corporation tax rates will boost the UK's competitiveness, and the newly announced education measures will help tackle the UK's lagging productivity.

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