InvestmentUpdate

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A “mini budget” in name only

A giant fiscal package reduces the risk of a very deep recession, but high inflation could stick around for longer

Today’s so-called “mini-budget” was anything but, confirming the transformation that UK fiscal policy has undergone since the start of the pandemic. The austerity of the 2010s now feels like a distant memory, with the Chancellor loosening the purse strings via the largest packages of tax cuts in about five decades, and even controversially delaying the publication of the forecasts compiled by the fiscal watchdog established in the Cameron-Osborne era.

The good news is that the measures announced today, combined with the previous decision to freeze energy bills, should reduce the likelihood of a very deep and long recession in the coming year, something that had previously seemed very possible. Together, they amount to a loosening of fiscal policy worth perhaps 6% of GDP. But the accompanying bad news has clearly been the focus on the initial market reaction. Opting for broad-brush fiscal loosening over targeted support for those most vulnerable to rising energy costs has increased the chances of high inflation sticking around for longer – particularly as there are plenty of reasons to be sceptical about the boost to the supply side of the economy (from deregulation, lower taxes and new investment zones) that the Chancellor is counting on.

While the energy bill freeze has lowered and brought forward the likely peak in headline inflation, the substantial extra support to demand may well keep underlying inflation pressure uncomfortably strong for an extended period, as the Bank of England (BoE) flagged yesterday. That in turn shifts more of the onus to bring inflation down onto monetary policy. The likely outcome is a longer cycle of interest rate increases from the Bank, something that is already being reflected in the sharp bond market sell-off since the Chancellor spoke.

What has been announced?
Chancellor Kwasi Kwarteng announced a large package of tax cuts and regulatory reforms under the auspices of his “growth plan”, which aims to “turn the vicious cycle of stagnation into a virtuous cycle of growth”.

The biggest news was the sweeping, larger-than-expected package of tax cuts. Most eye-catching was the surprise scrapping of the top 45% “additional” rate of income tax. Alongside that, the basic rate of income tax will fall from 20% to 19% a year earlier than planned, the widely trailed reversal of April’s 1.25 percentage point increase in national insurance will go ahead, and the previously planned rise in corporation tax from 19% to 25% will be cancelled. The Chancellor also doubled the threshold at which stamp duty on residential property purchases must be paid (from £125,000 to £250,000) and did away with planned increases to alcohol duties. All told, these measures probably amount to a permanent tax cut worth close to 2% of GDP, reportedly the largest since Anthony Barber was Chancellor in the early 1970s.

The context also matters here. These measures come hot on the heels of the decision to freeze household energy bills for two years. The total cost of that intervention is unknown since it depends on international gas prices. But it is likely to be very large, probably bigger than the furlough scheme during the pandemic, and possibly above 4% of GDP in its first year alone.

At the same time, the Chancellor announced a raft of regulatory changes. The government plans to scrap the cap on banker’s bonuses while tightening restrictions on claiming universal credit. It also announced the creation of nearly 40 new “investment zones”, specific areas of the country with tax breaks and looser planning regulations designed to attract investment. Legislation to make industrial action more difficult is on the way too. And a review of the planning system aimed at speeding up large infrastructure projects is coming, though we don’t know much detail yet.

Will tax cuts prevent a recession this year?
The fiscal cavalry is probably arriving too late to stop a recession. We already know that the economy contracted in the second quarter of this year, and the latest survey data suggest that it may well have done so again in Q3. Meanwhile, energy bills are still set to climb again in October – the freeze just means that they just won’t hit the stratospheric levels they might have done otherwise. (Ofgem’s cap will be frozen at £2,500 from October, compared to £1,971 now and just £1,277 at the end of last year. Without a freeze, the cap could have risen above £5,000 in early 2023.) At the same time, interest rates continue to climb. The BoE announced a second consecutive 0.5 percentage point increase at its meeting this week, with a minority of policymakers voting for an even larger rise. Given its commitment to get

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Look forward

inflation back under control “no ifs no buts”, substantial further increases are likely.

Having said all that, the combined effect of such a large loosening of fiscal policy will make a significant difference and reduce the risk of a deeper and more prolonged recession. Freezing energy bills has hopefully prevented the cost-of-living squeeze from getting far worse, while tax cuts more generally should support demand.

What about the longer-term growth outlook?
The key principle motivating the government’s growth plan is a belief that lower taxes and reduced regulation can boost the supply side of the UK economy, lifting its longer-term trend rate of growth. Chancellor Kwarteng talked about a target of a 2.5% trend for annual growth, well above the average rate of 1.5% that the economy has achieved since 2000.

But setting a target for faster trend growth is one thing. Achieving it is different matter entirely. For a start, it’s not clear that high taxes and regulation have been the main things holding the UK back in recent years. Corporate taxes are already low by both international and historical standards. And the evidence that reducing corporate taxes spur investment is weak in any case. The UK already has the lowest corporate tax rate in the G7, but the lowest business investment as a share of GDP. The UK economy is already lightly regulated in most areas compared to its peers too. The Organisation of Economic Cooperation and Development (OECD) compiles composite measures of labour and product market regulation for its member countries. The UK is already significantly less regulated than its average peer on both counts.

Otherwise, the idea of designated zones offering lower taxes and regulation to attract investment is old wine in new bottles. The idea, first introduced by the Thatcher government in the early 1980s, was revived under George Osborne’s chancellorship. The government of the day created 24 so-called enterprise zones in 2012, with a further 24 added in 2016-17. Those zones offered either large discounts to business rates or substantial tax relief to firms investing in plant and machinery, along with a simplified planning regime – as Chancellor Kwarteng is now promising for his new zones. These zones have a patchy track record, with evidence suggesting that they displace activity from elsewhere rather than significantly boosting the national economy.

Meanwhile, some of the other factors hindering growth in supply remain unaddressed. One such factor is growth in the labour force. Inward migration has fallen sharply recently, largely because of significantly lower flows from the EU. And there has been a worrying rise in the number of people leaving the labour force due to long-term sickness, reflecting a combination of long COVID and the broader impact of the pandemic on the health service. Nearly 380,000 people in the UK have now waited more than a year for NHS treatment, compared to scarcely more than 1,000 before the pandemic. Addressing that should surely be a priority.

Another is stability in the UK’s relationship with the EU. There’s evidence that the immense uncertainty of the past six years has hampered business investment. Private investment in the UK has stagnated since 2016, trailing other major economies by a wide margin. We believe a lasting resolution to the ongoing uncertainty over the Northern Ireland Protocol and the threats to suspend it would surely help on this front.

What will it mean for inflation and interest rates?
The previously announced energy bill freeze has lowered and brought forward the likely peak in headline inflation. Without the freeze, headline CPI inflation probably would have surged to the high teens early next year. Now, it’s likely to peak in the 10-11% range later this year and fall thereafter (you can read more about our views on the UK and global economy in our latest *Quarterly* Investment*Update*).

However, that’s where the good news on inflation ends. Much looser fiscal policy will support demand, without a corresponding boost to supply. The net result is likely to be that underlying inflationary pressure stays stronger for longer than it would have otherwise. At its meeting this week, the BoE argued that the bill freeze, for example, will “add to inflationary pressures in the medium term”. That’s also true of the package of tax cuts announced today.

The UK is already in a difficult position on this front. Core inflation (i.e. excluding energy and food) rose to 6.3% last month. Wage growth is 5.5%, and the labour market is still extremely tight with the unemployment rate at its lowest in nearly five decades. Firms surveyed by the BoE plan to raise their prices by more than 6% again in the next 12 months. No wonder, then, that unflattering comparisons are being made between the current loosening of fiscal policy and the one that preceded the ill-fated “Barber boom” of the early 1970s.

The net result is that the BoE’s job of bringing inflation sustainably back to target is getting harder. Gilt yields have risen sharply across the range of maturities since the Chancellor spoke, and could continue to climb for a while.

Is all the extra debt sustainable?
The government is now likely to run a budget deficit of more than 9% of GDP this fiscal year. As a result, the ratio of public debt to GDP is likely to rise considerably. There’s little hope of the old fiscal mandate – debt to GDP on course to fall in three years’ time – being met.

Despite the scale of the spending, some of the alarmist commentary about the immediate sustainability of the UK’s public debt is misplaced. The UK is starting with the third-lowest ratio of debt to GDP in the G7, and even after today’s announcement isn’t likely to climb that leader board any time soon. More generally, governments that borrow in their own currency can sustain very high debt to GDP ratios – true sovereign debt crises (ending in default) nearly always involve countries

borrowing heavily in other currencies. Japan's ratio is currently more than double that of the UK, at nearly 170%, and has been very high for years.

The UK itself maintained far higher ratios than today in the two decades after the Second World War. However, focusing narrowly on debt sustainability risks missing the point. The fact that that government *can* borrow much more to fund its tax cuts doesn't mean that it *should*. With inflation already far too high, and supply not likely in our view to benefit as much as the Chancellor hopes, it's not obvious that what the economy needs most is another big injection of demand.

We believe an approach much more carefully targeted at those most vulnerable to the energy crisis would have made more sense. The likely price will be higher-for-longer inflation and an extended cycle of rising interest rates, plus the possibility of more weakness in the gilt market.

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