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UK BUDGET 2017 PREVIEW – POLICY CHANGES UNLIKELY TO ALTER ECONOMIC OUTLOOK

Berenberg Macro Flash

Since 2010 UK fiscal policy has been neither here nor there. The economy is in its 8th year of expansion, yet the cyclical adjusted deficit is still close to 3% - Chart 1. The Conservatives' balancing act of reducing the deficit while limiting the impact on growth has failed. Meanwhile, the rate of productivity growth has slowed to close to zero as strong employment gains have far outpaced the weak expansion in capital spending amid extra-caution by the private sector following the Lehman crisis. In real terms, annual public sector investment growth has stagnated over the past six years (Chart 2) and remains well below the 2009 peak, thereby exacerbating the dramatic fall in the UK's trend rate of growth since the financial crisis. Will Chancellor Hammond tackle these key issues and others in his first budget on Wednesday? Don't get your hopes up.

Fiscal policy could help mitigate the damage from Brexit: With Brexit uncertainty hanging over the economy for the foreseeable future, and with a general election coming in 2020, the Chancellor cannot afford to run the risk of destabilising growth by speeding up the on-going gradual fiscal consolidation. While the UK does not need a fiscal stimulus designed to boost short-term demand, especially at this mid-stage in the cycle, it could benefit from modest rise in public sector capital spending. Brexit could reduce the UK's long-term potential growth rate to 1.8% from 2.2%. An increase in spending on projects designed to boost productivity and raise trend growth would be well timed. Let's be clear, a wealthy and developed country such as the UK, with its own central bank, does not have to worry too much about a rise in borrowing costs from a high level of debt. If done properly, a near-term rise in borrowing to finance capital spending could raise the long-term GDP growth rate and raise future tax revenues. Disappointingly, capital spending plans are likely to fall way short of the mark.

No spending splurge even as stronger growth lowers outlook for borrowing: We do not expect Chancellor Hammond to announce anything that will alter the economic outlook by much. The better-than-expected GDP growth since the Brexit vote will lead the OBR (Office of Budget Responsibility) to revise up its near-term outlook by around 0.4-0.6ppt in 2017. The upward revision to the GDP growth outlook will reduce near-term borrowing and the forecast for the cyclically adjusted deficit a little over the forecast horizon. The modest rise in gilt yields since the Autumn Statement 2016 may add a little to borrowing costs late in the forecast. Nominal departmental spending is fixed until 2019-20 – faster growth eases the burden of these commitments. Net-net, the positive impact of the better near-term growth outlook on borrowing will outweigh any negative effects of higher borrowing costs. Chancellor Hammond has already made clear that the government will not step up its spending following the improvement to the outlook for borrowing. Any changes announced will likely be fiscally neutral with any rises in spending offset by tax hikes and savings elsewhere. Having scrapped Osborne's target of achieving a headline surplus by 2019-20, the OBR's upgrades should leave the Chancellor on track to easily meet his new targets set out in the Fiscal Charter to reduce the cyclically adjusted budget deficit to less than 2% by 2020-21.

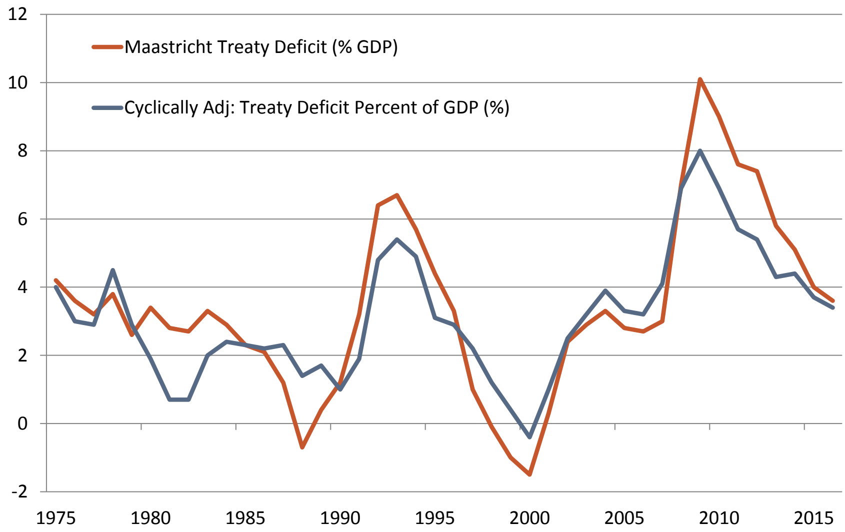
Potential announcements: Any policy changes will remain in line with the broad framework for fiscal policy in place since the Conservatives' came into power in 2010. That is, a gradual fiscal tightening from three main areas: (1) discretionary tax changes to raise revenues, (2) measures to reduce working age benefits, and (3) reduced spending on public services. We will take any big announcements linked to housing or infrastructure with a lot of caution. The government has a habit of rehashing headline sums in these politically sensitive areas. All too often, they are simply old policies re-announced and thus rarely reflect additional spending. Possible announcements could include:

- A modest rise (c£500m) in funding for R&D and for non-academic training for people aged 16 and above
- A £1bn+ rise in spending on social care
- A review/small adjustment to business rates following the revaluation of properties this year that sharply increased rates in the south-east and London while reducing them in the north
- A £500 rise in the personal allowance for income tax to £11,500 for the 2017-18 tax year and a rise in threshold for 40% income tax to £45,000 from £43,000
- A small rise in National Insurance for the self-employed
- A 2.5% rise in the state pension from April
- A freeze in housing, child and jobseekers benefits and tax credits in 2017/18 – representing a real terms cut as inflation rises to close to 3% this year
- A review of, or a rise in, the threshold for stamp duty – homes under £125,000 are currently exempt
- A review of taxes on pensions and/or a delay on the reduction in the monetary purchase annual allowance – the amount that can be taken from a pension and saved tax free. It is set to fall to £4k from £10k in April

All in all, Budget 2017 looks set to underwhelm from an economic point of view with capital spending still falling far short of what the economy needs while any positive consumption effects of income tax reductions will be offset by the real terms cut stemming from freezes in welfare spending. With the economy facing significant long-term risks from Brexit, the budget will most likely further illustrate the government's lack of initiative and willingness to use fiscal policy to support the long term growth outlook.

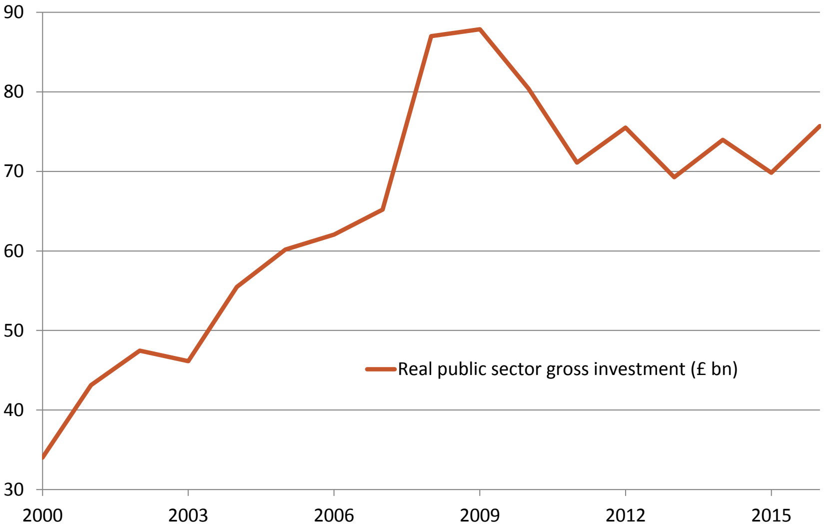
Please refer to 'UK approaches a critical juncture – choices ahead' for more insight on these themes.

Chart 1: UK public deficit (%)



Source: OBR

Chart 2: Real public sector gross investment (£ bn)



Source: OBR, ONS, Berenberg calculations

Real GDP (% change yoy)	2016	2017	2018	2019	2020	2021
OBR (November 2016)	1.8	1.4	1.7	2.1	2.1	2.0
Bank of England (Feb 2017)	1.8	2.0	1.6	1.6		
Berenberg	1.8	2.0	1.7			

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