Group Economics

Budget 2008: stability, but will the horses bolt in any case?

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With horses and race-goers battling against the storms at Cheltenham, the strengthening headwinds in the world economy provided the backdrop to Alistair Darling's inaugural Budget. In his first sentence he told us that its purpose was stability. For those who had been talking at the back of the classroom when he said it, "stability" received a further 22 mentions in the speech. But when he opened the fiscal cupboard there was little on the shelves with which to ward off the effects of a deteriorating global outlook. The public finances simply do not permit any fiscal boost. Compared with Gordon Brown's dramatic curtain call in 2007 and the vintage performances of Lords Healey, Howe and Lawson in the good old days of economic turbulence, this was a tame affair, with no clear unifying theme: boring but worthy, and none the worse for that in the circumstances.

Slower growth, but still unduly optimistic?

The Chancellor cut his growth forecast for 2008 to 1¾%-2¼% but left subsequent years unchanged, with growth rising to 2¼ -2¾% in 2009 and a return to trend growth of 2¾% from 2010. Underpinning the rebound is an up-tick in consumption and investment spending, both of which are far from certain, not least because of the slowing housing market and the credit crisis. The projections are higher than the consensus outside government, but remember that the Treasury has a better forecasting track record than most.

Public finances: a tightening straitjacket

More challenging economic conditions are bad news for the public finances. Weaker growth means higher spending – on social security, for example – while tax receipts grow more slowly. That is why the Treasury expects the **current budget** to remain in the red until 2010, two years longer than anticipated in 2007. The deficit is also expected to be higher, reaching -£10bn in 2008, before improving to -£4bn in 2009 and returning to surplus (£4bn) in 2010. **Total public borrowing** – the current deficit plus investment – will edge up to £43bn (2.9% of GDP) this year, before starting its projected descent towards £23bn in 2012.

The forecasts meet the government's fiscal policy rules, but only just. The Golden Rule (GR) requires the current budget to be in balance over the economic cycle. Even though in deficit for the last six years and projected to remain there for two more, the **average** budget balance since 1997 remains in surplus. The debt to GDP ratio is projected to stay below 40%, meeting the Sustainable Investment Rule (SIR). But there is virtually no margin for error, with the ratio climbing to 39.8% in 2010. As the Treasury's research shows, one sneeze and the limits might be breached. A ¼% shortfall in expected GDP growth would raise the current deficit to GDP ratio and the public debt to GDP ratio each by 0.18%. Without offsetting measures, the SIR would then be violated in 2009. A sharper than anticipated slowdown in growth is also likely to interfere with the GR, but the government enjoys discretion over the dating of the cycle, allowing it to average the current deficit over many years, thus dampening the negative effects of any single year.

Sin taxed and virtue encouraged

Sharpen your elbows, drinkers, as you head to the supermarket. From midnight on Sunday, **alcohol duty** rates will increase by 6% above the rate of inflation, adding 4p to a pint of beer, 14p to a bottle of wine and 55p to a bottle of spirits. What's more, alcohol duties will rise by 2% above inflation in each of the next four years. These changes are anything but small beer, yielding the Exchequer an extra £400m in 2008-09, the largest revenue boost of any Budget measure. Smokers will pay more for their habit, assuming they can find somewhere to practise it, the price of a packet of 20 **cigarettes** rising by 11p.

Among a range of **environmental** measures, the most eye-catching were proposals to reform **vehicle excise duty (VED)**. From 2009, drivers of the most polluting cars will pay £950 of VED in the first year of ownership, while the least polluting will be exempt. In addition, existing capital allowances for business cars will be changed to favour low-emissions vehicles. Bad news for Chelsea tractors, good news for smarter cars. Elsewhere, environmental measures were a mixture of exhortation – do away with plastic bags, supermarkets – and longer-term goals such as requiring electricity generators to buy permits to emit carbon in the EU Emissions Trading Scheme after 2012.

$100 oil: it's an ill wind that blows no one any good

There will be changes to the **fiscal regime for oil and gas** companies operating in the North Sea aimed at maximising production of reserves. We await the details before making judgement on their likely effectiveness, but at a cost of £25m in each of the next couple of **years** they look modest when set against estimated **daily** oil production of more than twice that figure. More striking is the benefit to the government's coffers of high oil prices. October's Pre-Budget Report assumed **oil prices** would average $68 per barrel in 2008. With prices already north of $100, the Treasury has revised its assumption to $83.80. That would see North Sea revenues up 28% on 2007-08, with more revenue for the Treasury each day they remain above that level.

Get digging: boosting housing supply

One of Gordon Brown's early concerns on entering Number 10 was to boost the supply of houses, with a target of 3m new homes in England by 2020. Funding the Housing Corporation to deliver 70,000 new homes each year to 2010/11 is a step towards that.

'Gold Standard' mortgages

The government's enthusiasm for Gold Standard mortgages seems to have been tempered. Proposed as a way of reactivating the market in residential mortgage backed securities (RMBS), the government had signalled its wish to find a way of designating some mortgages as Gold Standard, to make them attractive to investors. It seems that they have heeded warnings on two fronts. The RMBS market is in limbo because of the overhang of these securities held in complex investment vehicles, not because investors are unable to distinguish between good and bad assets. Secondly, the law of unintended consequences would likely result in mortgages not ranked as Gold Standard being shunned by markets, possibly reducing permanently the supply of credit to higher risk borrowers. The government will consult on the next steps.

'Non' to Non-Doms

The Government held firm and from April 'Non-Doms' of more than seven years residency will have to pay £30,000 to maintain Non-Dom tax status. The Chancellor also said that this was the last word on the matter – for this Parliament and the next (he hopes).

Enterprise Strategy

As part of the Budget, the government published a new Enterprise Strategy designed to ensure that entrepreneurs continue to have access to start-up and growth finance. The government recognises that the UK has one of the most sophisticated finance markets in the world and that despite the credit crisis SME lending remains strong. The measures build on that and include:

- strengthening the Small Firms Loan Guarantee (SFLG):
  - a 20% uplift in lenders' SFLG allocations for one year, providing an additional £60million of lending;
  - extending the eligibility of SFLG to businesses with growth ambitions that are more than five years old;
- an additional £12.5m for capital focussed primarily on investing in women-led businesses;
- an additional £30m available through Enterprise Capital Funds, to stimulate delivery of mezzanine finance;
- developing investment readiness support, including targeted support for under-represented groups such as women.

Longer-term issues – signs of progress

Economic policy can take years to bear fruit and as John Maynard Keynes remarked, in the long-run we are all dead. But there is evidence that some of the government's long-term aspirations are being realised. When Gordon Brown first held the reins at the Treasury he wanted an end to boom and bust – greater stability – and boost productivity. In a weighty tome replete with hard sums, the Treasury compares 14 OECD economies and concludes that: the UK economy has become much more **resilient** in the last few years; is now the most resilient of these countries; and the main reasons are improved macro-economic policy, flexible labour markets and, above all, more competitive product markets. On **productivity**, the UK has made progress in closing the gap with the USA, France and Germany, but there remains some way to go.

Gordon Brown's old chum **Prudence** is set for a return. During Labour's first 10 years, real public spending growth averaged 3.6% per year. In the period to 2011 the rate falls to 2.2% and thereafter to 1.9%, well below the economy's trend growth rate of 2.75%. Expect meeting that target to be challenging and for demand from the public sector to grow much more slowly.

Looking forward to the wisdom of hindsight

Instant judgements on Budgets are often revised in the cold light of the welter of announcements from Whitehall's armies that accompany the speech. It is hard to resist the conclusion, however, that the Chancellor found his hands tied by the fiscal rules a good deal more tightly that he would have wished at this stage in the cycle. What's more, all of the risks to the fiscal position look to be on the downside. This may have been an uneventful Budget, but might we get fireworks, or very damp squibs, in 2009?