HENRY COOK
Europe Economist

Economic Research Office

T: +44 (0)20 7577 1591
E: henry.cook@uk.mufg.jp

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A budget of transition

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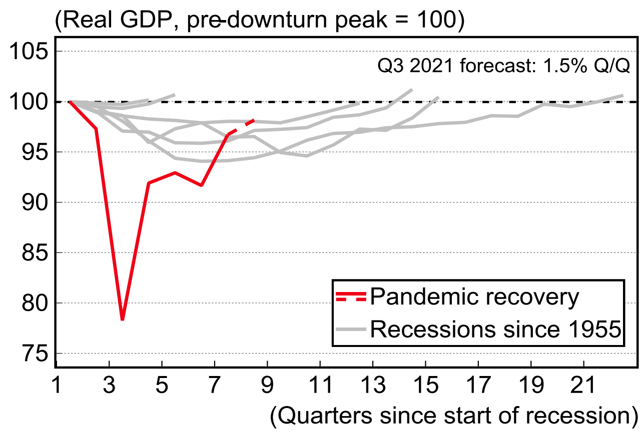
A substantial and broad-based increase in government spending will help to support the UK's post-pandemic recovery. Beyond that, the focus of yesterday's Budget was on the transition to more sustainable public finances and (hopefully) a more productive economy. However, government finances would be exposed to any stagflationary mix of muted growth and persistent price pressures. This means that the government might find it harder to reduce the increasingly high tax burden in the future than it would like.

Spending will be substantially increased

Rishi Sunak, the UK chancellor, has made the most of the room afforded to him by the faster-than-expected economic recovery to significantly increase government spending. It was announced at yesterday's Spending Review and Autumn Budget that departmental spending is to grow by 3.8% on average a year in real terms.

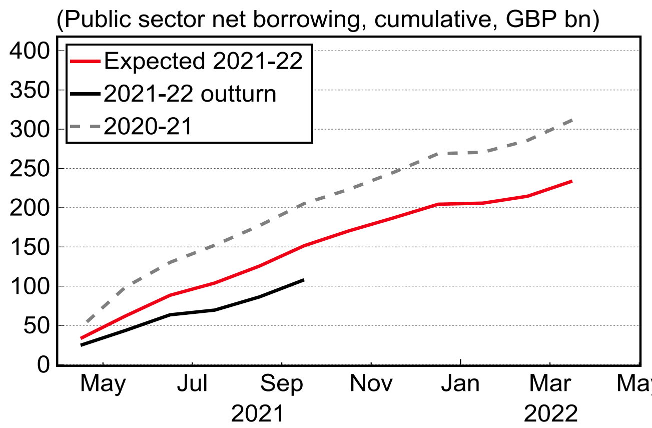
A lot of this will be gobbled up by healthcare: 44% of cash increases will go to the Department of Health and Social Care as the need for pandemic-related catch-up spending adds to the pressures from an ageing population. But all government departments will see a real terms rise in overall spending with particular focus placed on the increased budgets for areas which suffered most from the post-GFC austerity years such as education and justice.

A FASTER THAN EXPECTED RECOVERY SO FAR



Source: ONS, MUFG Bank Economic Research Office

BORROWING THIS YEAR IS LOWER THAN FORECASTED



Source: ONS, MUFG Bank Economic Research Office

In terms of specific measures, there was recognition that the post-pandemic recovery still requires support. There will be a 50% discount on business rates for firms in customer-facing industries in 2022-23. Despite an increasingly gloomy outlook for real disposable income, there was surprisingly little in the way of immediate support for households (there were no crowd-pleasing measures such as a temporary VAT cut on energy bills). However, there is to be an immediate change in the taper rate of

Universal Credit which means recipients will retain more as earnings increases. This will ease the burden on many lower income households from rising energy costs. That said, it will only benefit those in work, and the estimated cost £2bn shows that it falls short of the temporary pandemic-related £20-a-week uplift (estimated to cost around £6bn annually if made permanent). However, further ahead, lower earners will benefit from a 6.6% increase in the minimum wage from April 2022.

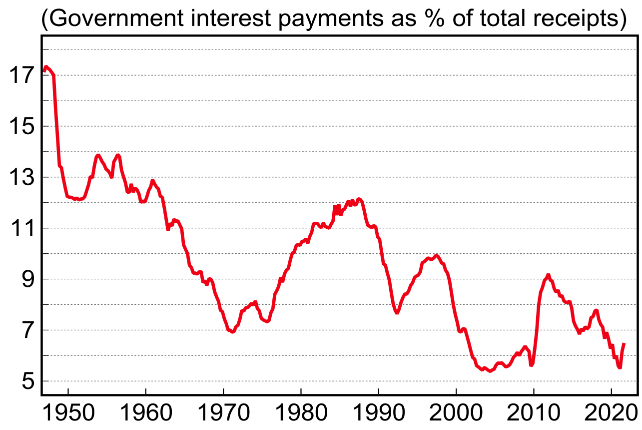
We'd also note that this was not a green budget. Fuel duty, essentially the UK's largest carbon tax, was frozen for a twelfth consecutive year and so will continue to fall in real terms. There was also a 50% cut in air passenger duty for domestic flights which seems inconsistent with the government's net zero aims.

The chancellor has given himself less room for manoeuvre in the future

We had expected a tighter outlook for fiscal policy, with the chancellor prioritising room for manoeuvre in the case of future shocks over the need for measures to shore up the post-pandemic recovery. Instead, Sunak used up almost all of the extra leeway afforded to him by the Office for Budget Responsibility (OBR)'s improved GDP outlook. The government has left itself headroom of just 0.6% of GDP to meet its fiscal target for debt-to-GDP to be falling by 2024-25. There is also a target to balance day-to-day spending.

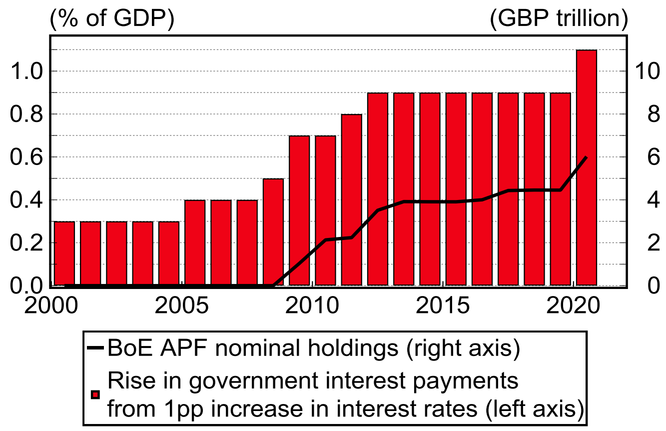
These targets are almost always missed, but developments since the OBR closed its forecast on 24 September may make it even harder. In particular, the repricing of the future path for BoE rate hikes and signs of more persistent inflation point to a larger debt interest burden.

INTEREST PAYMENTS ARE HISTORICALLY LOW



Source: ONS, MUFG Bank Economic Research Office

QE HAS INCREASED DEBT INTEREST SENSITIVITIES



Source: OBR, BoE, MUFG Bank Economic Research Office

The average maturity of UK public debt is around 15 years which is relatively long (it's around seven years in Germany and five in the US). This means that changes in long-term rates affect debt interest payments only gradually. However, the BoE's QE programme increases the short-run sensitivity of debt interest payments to rate rises.

Around a third of the UK's public sector gross debt is now held in the BoE's Asset Purchase Facility and the BoE pays interest at Bank Rate, currently 0.1%, on the reserves created to finance them (unlike the ECB or BoJ, the BoE does not have a tiering system of rates). This effectively shortens the average maturity of UK public debt by around four years and leaves public finances more exposed to changes in interest rates. Interest payments are also more sensitive to inflation as the share of index-linked gilts has gradually risen to around a quarter (from 15% in 1990).

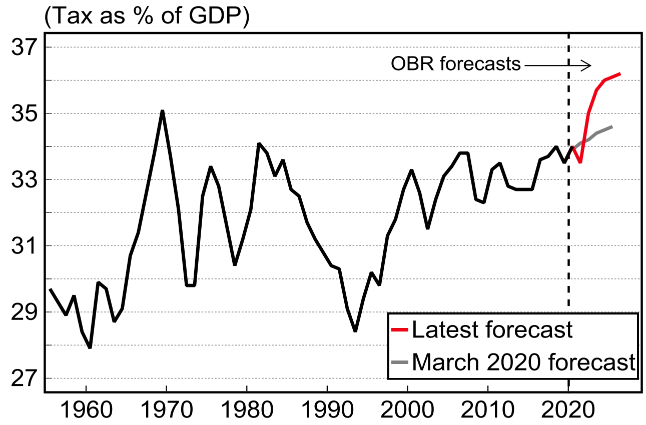
None of this is necessarily a problem if interest rates reflect a better growth outlook. But an increasingly plausible stagflationary scenario in which the BoE is forced to respond to higher inflation in spite of a muted growth outlook would make it considerably harder for the government to restore public finances to a more sustainable path.

We had expected that the government would give itself more leeway to loosen fiscal policy ahead of the next general election which is to be held by 2024. Unless growth exceeds expectations over the next two years, there seems to be less headroom for meaningful pre-election giveaways (e.g. tax cuts on income) now.

Transitioning to sustainable public finances and higher productivity growth

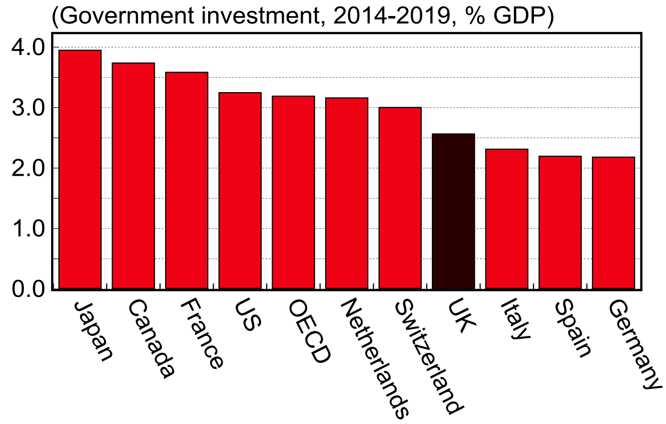
The spending pledges outlined above will be accompanied by an increasing tax burden (from 33.5% of GDP before the pandemic to 36.2% by 2026-27, the highest since the early 1950s) according to the OBR's projections. This is largely driven by the already-announced increases in corporation tax (to 25% from April 2023) and national insurance contributions (a 1.25pp rise, paid by both employers and workers). The latter will reduce the take-home pay of a median-income worker by around 1%. Meanwhile, funding for local government still looks tight which could point to significant council tax increases down the line.

A SIGNIFICANT INCREASE TO THE TAX BURDEN



Source: OBR, MUFG Bank Economic Research Office

PUBLIC INVESTMENT HAS BEEN RELATIVELY LOW



Source: OECD, MUFG Bank Economic Research Office

This higher-tax, higher-spend economy is an uncomfortable position for the Conservative government to be in, but we think it can be rationalised if seen as a transitionary Budget towards a post-Brexit economy with sustainable public finances.

The Government wants to return public finances to a more steady footing after pandemic-related expenditures but seems aware that a lurch towards austerity could jeopardise the economic recovery. While the post-pandemic rebound has been quicker than expected, GDP remains below its Q4 2019 level – and has a long way to go to catch up to the pre-pandemic trend as pressures remain. Rising living costs look likely to slow any rotation back towards services consumption and there's also set to be an increase in unemployment now that the furlough scheme has ended (the ONS expects it to peak at 5.2%, an increase from 4.5% in August). And the UK is not out of the woods when it comes to COVID risks either with the daily caseload looking high going into the winter months. Against that background, the government's plan for a relatively normalisation process for public finances seems sensible.

The Budget also looks to support the government's ambition to transition towards a different economic model. Johnson, the UK's prime minister, has said that he wants the UK to move to a "high-wage, high-skill, high-productivity" economy (see here).

While productivity gains are much easier said than done, this Budget is consistent with those aims. The UK minimum wage is to rise by 6.6% next April, government R&D spending is to increase from 0.7% to 1.1% of GDP, and various measures have been announced to incentivise business investment.

Over the longer-term, the scarring effect from Brexit (e.g. from trade friction) is likely to be higher than that of the pandemic, so supply-side improvements are important. This budget may not be bold enough to have a meaningful impact on the UK's economic model, constrained as it is by the effect on public finances from the pandemic, but it does seem to be part of a coherent plan to improve productivity growth.

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