Economic and Investment Insight

UK Budget 2016: Ties that bind

16 March 2016

The Chancellor could be forgiven for approaching this Budget with a certain weary resignation. It is, after all, his fourth fiscal statement in 12 months. And he will have been well aware that the constraints he always faces on Budget Day have only tightened over the past year.

What are these constraints? First, Mr Osborne had to demonstrate his grip on the economy, despite a more troubling global backdrop and cuts not only to the Office for Budget Responsibility's (OBR's) short-term growth forecasts but also its view on longer-term growth potential. Second, he needed to convey a sense of control over the public finances, despite abandoning his self-imposed welfare cap in the Autumn Statement and missing his target to reduce government debt's share in the economy next year. And finally, he had to avoid doing anything to thwart his political goals - to achieve a vote to remain in the EU in June's referendum and to shore up his support amongst Conservative backbenchers ahead of the future leadership election.

Faced with these challenges, Mr Osborne has adopted a three-pronged approach to Budget 2016. First, he has executed a version of political strategist Sir Lynton Crosby's 'dead cat'. In other words, by throwing a livelier feline on the table – in this case, a tax on sugary drinks – Mr Osborne hopes to distract from some of the more difficult messages underlying Budget 2016. His announcement of a Lifetime ISA for the under 40s is a slightly cuter version of the same strategy. But there were surprisingly few giveaways that hadn't been trailed in advance, such as tax allowance changes and devolution measures. This may be a sign of the constraints under which he is currently operating.

Second, Mr Osborne has used a range of revenue-raising techniques to safeguard his one remaining fiscal goal. By taking this approach, he hopes to avoid another 'omnishambles' fiasco of the kind that afflicted him following the 2012 pasty and caravan Budget. While he spent an hour talking about gathering storm clouds and devolution revolutions, the real question for economists was how the Chancellor plans to achieve a virtually unchanged £10.4 billion fiscal surplus by 2019/20, given sharp gross domestic product (GDP) growth downgrades and much larger projected deficits over the next few years. Though the Sugar Levy will grab the headlines, bringing in an anticipated £0.5 billion a year from 2018-19, far larger sums are expected to be raised from four sources:

- *The politically uncontentious:* tax clampdowns of £2-3 billion a year;
- *The technically complex:* changes to the public sector pensions discount rate bringing £2 billion a year into the government's coffers by 2019/20;
- *The well-trailed:* cuts to disabled benefits amounting to £1.2 billion a year of extra revenues by 2018/19;
- *The handily deferred:* a deferment of the retiming of corporation tax payments for large groups is projected to push back a two-year budgetary gain of £10 billion to when the Chancellor needs it most – in other words, 2019/20 and 2020/21.

Third, while 'Project Fear' may be a term of abuse in the EU referendum debate, Mr Osborne has deployed a version of it in Budget 2016 – accompanied by more positive messages about sunny uplands to come. On the former, there were mentions of "a dangerous cocktail of risks" and reminders of the UK's lack of immunity to "slowdowns and shocks", combined with appeals to recognise the Chancellor's track record since 2010 in repairing the public finances. In addition, Mr Osborne was careful to link the OBR's downgraded view on the UK's productivity outlook – which will have been an unexpected blow, given its negative implications for the UK's medium-term growth potential – to the global financial crisis (which did not, of course, occur on his watch). On the latter, there were education reforms for the much-mentioned "next generation", tax gains for small businesses and increases in the income tax personal allowance and higher rate threshold from April 2017. All of these measures should appeal to his backbenchers and, he hopes, to the wider electorate.

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Dealt a difficult hand, Mr Osborne may feel reasonably pleased with his Budget. But past experience and natural caution suggest that he won't yet rest easy. For all the talk of his track record, he has now abandoned two of his three fiscal targets. For all the care taken to achieve that one remaining fiscal goal in the least politically risky way, it will still involve substantial revenue-raising tax changes for large corporates. The focus on achieving a fiscal surplus by 2019/20 may be Mr Osborne's ideological imperative. But the economic case for such a move is less clear. After all, we do not know how the UK economy will be performing at that time. Nor do we know whether we may have reached the limits of central banks' ability to do all the work to prop up anaemic global growth. Spending cuts of £3.5 billion a year, amounting to 0.5% of GDP, may not sound large, but on top of a huge squeeze already in train there will undoubtedly be difficult decisions ahead.

Against this backdrop, what have the markets made of today's announcements?

Market implications

The Budget is likely to be received calmly by equity, currency and, perhaps most importantly for the Chancellor, debt markets. However its backdrop, as noted by the OBR, is one of a more challenged global economic environment – a backdrop that has led to considerable nervousness in these markets so far this year.

The changes announced to the business tax regime were significant and far-ranging. The further reduction on the rate of corporation tax will be welcomed by business, as will the additional tax incentives for small businesses and the two-year deferment of the retiming of corporation tax payments for large groups.

However, there are various changes to the tax rules, such as those on interest relief and loss relief, which will result in significant tax increases on large corporations. This will be unhelpful to this group in aggregate and will have a significant impact on the biggest users of these reliefs. The Chancellor also continued his focus on ensuring that multi-nationals pay a "fair" tax rate, though he is not the only finance minister in the world with his eye on this source of income.

At the individual sector level, the abolition of the Petroleum Revenue Tax will be welcomed by a North Sea oil industry, which is under some considerable pressure at the moment. However, the sums are small given the scale of the problems caused by the oil price at current levels.

The introduction of a Soft Drinks Industry Levy was one that had been talked about, but perhaps not expected in this Budget. Shares of companies such as AG Barr have weakened slightly on the news. Investors will watch with interest how the levy changes behaviour; whether the cost of it is passed on to customers, and how food company strategies continue to evolve to take account of the more health-aware environment noted by the Chancellor.

Bond investors will note the OBR's more cautious view on UK productivity and its related caution on the longer-term prospects for UK economic growth, but will note also the Chancellor's continued desire to "balance the books" over the forecast period. The Debt Management Office's announcement that accompanied the Budget forecast slightly lower issuance than had been expected, which was helpful to the market. It also announced changes in the way that it will conduct Gilt sales in order to increase flexibility in a more volatile UK and global bond market environment.

There were further changes to the UK savings market, most significantly with an extension to the ISA allowances and with the introduction of a new Lifetime ISA. These moves add to the significant changes to the savings market seen in this and the previous Parliament. They offer considerable opportunity and responsibility to a savings industry that will be continuing to think hard about how best to assist the growing numbers of savers with considerably greater control and responsibility for their own savings and investments.

This was statement that did not move markets significantly, an outcome that the Chancellor is likely to be happy with. It is also a budget statement delivered in the context of a global economy experiencing substantial economic, market and geopolitical uncertainty. The outcomes of events beyond our shores are therefore likely to have more influence on UK markets, in all their forms, than the Chancellor's pronouncements from the dispatch box this afternoon.

Lucy O'Carroll and Richard Dunbar
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