

## Novus Capital Markets Research

### Budget Blog

23 March 2011

**Fiscally neutral:** the Budget was designed to be fiscally neutral. Tax cuts worth nearly £2bn on fuel duty, over £1bn on income tax and rising to £1bn on corporation tax were offset by higher North Sea taxes, an increase in the bank levy and measures to reduce avoidance.

**Weaker outlook:** the OBR has revised down its forecast for economic growth to 1.7% this year (from 2.1% in November) and to 2.5% in 2012 (from 2.6%). With growth last year of 1.3% against 1.8% forecast, the level of GDP by the end of 2012 is 1% below what was expected in November. Some of this is recovered after 2012 but, even so, by 2015-16 the level of GDP is 0.7% below what the OBR was forecasting in November. Most of this shortfall comes about in 10q4 and 11q1 when GDP rises only 0.2% (a 0.6% decline followed by a 0.8% increase) against 0.8% forecast in November. The OBR estimates that there was a (non-weather related) slowdown in the economy and that the output gap increases from 3% in 10q3 to 4% in mid-2011. My judgment is that this 'extra' spare capacity is not really there and that the OBR was right not to use it to boost GDP growth over the medium term. At some future point, when it has the cyclical indicators to hand, my guess is that the OBR will need to write it off.

**Public finances:** despite a neutral Budget, the Government's borrowing numbers were raised by around £10bn over the medium term as weaker economic growth raises the contribution of the economic cycle to the overall deficit and higher inflation feeds through to social security and debt interest. The structural deficit is raised but only very slightly. The Chancellor continues to meet his fiscal rule (surplus on the cyclically adjusted current budget by 2015-16) with a year to spare. If the OBR eventually 'writes off' the extra spare capacity, the underlying fiscal position will be worse than portrayed here.

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## The real economy

The OBR has revised down its forecasts for GDP growth to 1.7% in 2011 and 2.5% in 2012. With 2010 also coming in well below the November forecast, the level of GDP in 2012 has been cut by a cumulative 1%. Only a very small part of this is recovered in 2014 and 2015 so that the level of GDP at the end of the forecast is 0.7% below what was forecast in November, about one quarter of which is due to the higher oil price (Table 1, where the final column is the level of GDP on a 2009 = 100 basis).

**Table 1: GDP forecast**

%	2010	2011	2012	2013	2014	2015	2015
March Budget	1.3	1.7	2.5	2.9	2.9	2.8	115.0
November EFO	1.8	2.1	2.6	2.9	2.8	2.7	115.9

source: OBR

The main source of the weaker forecast is what happened around the turn of the year. The ONS estimates that GDP fell 0.6% in 10q4; the OBR forecast is for this to be reversed in 11q1 but its forecast of 0.8% equates to growth in the two quarters combined of only 0.2%, well below the 0.8% it was expecting in November. As a result, there is more spare capacity in the economy (a larger output gap). This is expected to persist over the medium term; by 2015 the current forecast is for an output gap of 1.4% of GDP, ½pp higher than in November (Table 2). The OBR has made the judgment that the ‘extra’ spare capacity that resulted from the weakness in GDP around the turn of the year will not result in faster GDP growth in 2013 and beyond. This begs the question: if there really is more spare capacity, why are we not able to use it over the next five years? My judgment is that spare capacity has not risen very much over the last few quarters and that at some future point, when it has the cyclical indicators to hand, the OBR will need to write off this spare capacity.

**Table 2: Output gap forecast**

%	2010	2011	2012	2013	2014	2015
March Budget	-3.4	-3.9	-3.6	-3.0	-2.2	-1.4
November EFO	-3.3	-3.4	-3.0	-2.3	-1.6	-0.9

source: OBR

## The public finances

PSNB (on the measure that excludes financial interventions) is forecast to be £145.9bn this year (with only March to go) and to fall steadily to £29.3bn in 2015-16. The estimate for 2010-11 is fractionally below what was expected in November but higher from 2011-12 onwards and by £11bn by the end of the forecast (Table 3). The main difference is on public spending where higher inflation and unemployment boost spending on social security and debt interest. By 2015-16 expenditure on debt interest is nearly £4bn higher than in November, social security benefits and tax credits are over £3bn higher and public pensions are up £1bn.

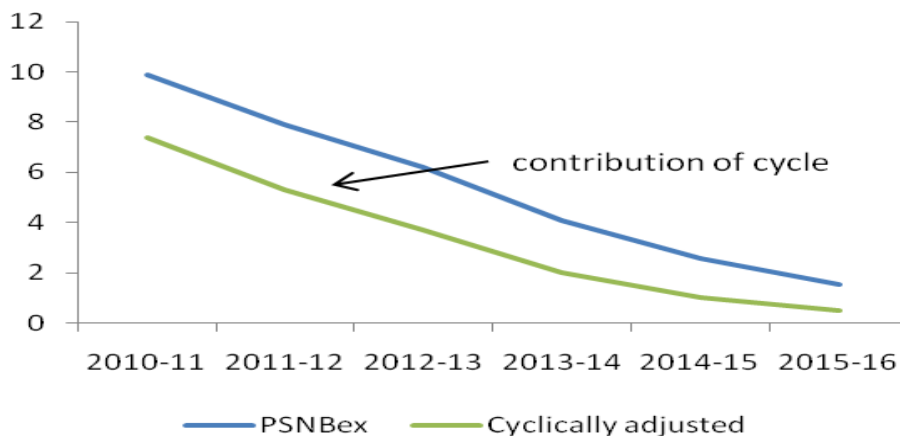
**Table 3: OBR March 2011 - November 2010**

£bn	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
<b>Current budget</b>						
<b>Current receipts</b>	-1.2	2.4	-0.6	1.2	-0.5	-0.1
<b>Current expenditure</b>	-2.6	5.7	8.3	10.2	10.1	10.4
<b>Depreciation</b>	0.0	0.1	0.1	0.1	0.2	0.2
<b>Surplus on current budget</b>	1.4	-3.4	-9.0	-9.1	-10.8	-10.7
<b>Capital budget</b>						
<b>Gross investment</b>	-1.2	1.0	0.8	0.6	0.6	0.6
<b>Depreciation</b>	0.0	-0.1	-0.1	-0.1	-0.2	-0.2
<b>Net investment</b>	-1.2	0.9	0.7	0.5	0.4	0.4
<b>Net borrowing (PSNBex)</b>	<b>-2.6</b>	<b>4.3</b>	<b>9.7</b>	<b>9.6</b>	<b>11.2</b>	<b>11.1</b>

source: EFO

The Budget itself was neutral with cuts in fuel duty effectively funded by higher taxes elsewhere in the North Sea and cuts in corporation tax and income tax by an increase in the bank levy and measures to reduce tax evasion and avoidance. As a result, the forecast for the structural (cyclically adjusted) budget deficit was little different from November and most of the increase in the overall deficit was attributable to the weaker economic growth outlook (Chart 1). Overall the forecast for the structural deficit has changed very little since last year's emergency Budget and is about 1-1½% by the end of the forecast below what was planned by the previous Government (Table 4). If the OBR's estimate of the output gap is too high, the underlying fiscal position is weaker than they portray.

**Chart 1: PSNB (% GDP)**



Source: OBR

**Table 4: The structural deficit**

% GDP		2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
<b>Current budget (cyc adj)</b>	Mar11	-4.6	-3.2	-2.0	-0.6	0.4	0.8
	Nov10	-4.7	-3.3	-1.8	-0.5	0.5	0.9
	Jun10	-4.8	-3.2	-1.9	-0.7	0.3	0.8
	Mar10	-4.6	-3.4	-2.5	-1.8	-1.3	
<b>PSNB (cyc adj)</b>	Mar11	7.4	5.3	3.7	2.0	1.0	0.5
	Nov10	7.6	5.3	3.5	1.9	0.8	0.3
	Jun10	7.4	5.0	3.4	1.8	0.8	0.3
	Mar10	7.3	5.3	4.1	3.1	2.5	

source: OBR, HMT

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