
The UK **BUDGET** *March 1998*

INTRODUCTION

The Budget is an annual statement of the government's plans for the public finances over a planning horizon of usually 4 to 5 years. However, over the last 40 years governments have used their Budgets to address perceived problems in the economy and society generally. The so-called Keynesian "revolution" led governments to use the Budget for short-term demand management. Later intellectual developments including the growth of "monetarism" cast doubt on the efficacy of using tax and spend, or fiscal, policies to manage the economy. Margaret Thatcher's early governments set a medium term financial strategy and where the Budget was used to influence the behaviour of the economy the focus was on stimulating enterprise and individual responsibility and improving the flexibility of the labour market. Recent Conservative governments moved back somewhat to using the Budget to manage demand. However, it is clear that the new Labour Government sees the role of the Budget primarily in terms of its potential influence on the long-run performance of the economy against a background of prudent management of the public finances i.e. promoting microeconomic efficiency and equity rather than macro management. The aim here is to improve the supply-side performance of the economy by removing inherent structural weaknesses, thereby raising potential output and the trend rate of growth.

This Review will first focus on the economic background to the Budget. Secondly, the Budget Strategy and the key measures to be adopted will be outlined. Thirdly, the Review discusses the implications of the Chancellor's proposals for the public finances. This will be followed by a brief consideration of the economic assumptions that underpin the Budget. Finally, the Review concludes by

posing a few questions on the economic impact and consequences of the Budget.

1. ECONOMIC BACKGROUND

After six years of expansion UK GDP is currently growing above trend. The economy grew by 3% in 1997. While there might be some debate about the matter it would appear that the economy is either at, or very near, full capacity. Capacity utilisation is at high levels and above the long-run average. For example, 73% of those of working age are in employment, although this still leaves 4.25m people of working age without a job either through choice, or because of lack of suitable skills and opportunities. In addition, several business surveys have reported increasing recruitment difficulties in specific occupational areas and this is also the case in Scotland as revealed by the most recent Deloitte & Touche Scottish Chambers' Business Survey.

GDP is therefore set to slow down with below trend growth likely for an uncertain period. The key question here is whether there will be – to use the jargon favoured by city economists and Kenneth Clarke's "teenage scribblers" – a "soft landing", of below trend growth followed by a return to trend, or a full-blown recession. Domestic demand and consumption continue to show strong growth. But the UK is effectively experiencing a two-speed economy, with weak manufacturing performance co-existing with strong service sector growth. The slow-down in manufacturing reflects the effects of the strong £, which has appreciated by 25% since August 1996, and, to some extent, the recent crisis in Asia. The strong growth of the service sector, on the other hand, reflects the sustained buoyancy of consumer demand, which in turn was bolstered by the 'windfall' gains consequent upon the demutualisation of several building societies and insurance companies.

Against this background of the economy having reached a cyclical peak in its growth rate, the rate of inflation while rising still remains, along with associated wage-bargaining pressure, relatively quiescent for the current phase of cycle. There is still uncertainty about future course of consumer demand, the further effect of the windfall gains, and the effect on consumption of house price inflation and low unemployment. However, there is less uncertainty about the state of the public finances. The effects of above trend economic growth coupled with the

tax raising and expenditure reducing Budgets of previous Chancellor's have produced an unexpectedly rapid increase in revenues and reduction of expenditures (transfers). The last Conservative Budget forecast a PSBR of £19 billion in 1997-98. This forecast was revised downward to £13.5 billion in last July's Budget and then again to £12 billion in November's Pre-Budget Statement.

2. THE MARCH 1998 BUDGET

(i) Strategy

The July 1997 Budget laid the foundations for the March 1998 Budget. It

- set out a five year deficit reduction plan,
- began to reform corporation tax to promote investment,
- announced a New Deal to get the young and long-term unemployed into jobs, and
- made more funding available for the NHS and schools.

The recent Budget has the following broad strategy:

- to secure economic stability
- to encourage work
- to promote enterprise, and
- to create a fairer society.

Note these are longer-run objectives. They reflect the view that while the short-term economic position may be fairly healthy, the problems of manufacturing apart, there are deep-seated structural weaknesses in the British economy. The new Labour Government identifies these as: macroeconomic instability, low productivity and investment, low R&D and innovation, a low skills base and significant disadvantaged groups.

(ii) Specific Measures

a) Economic Stability

- **Bank of England Reforms**

An independent monetary policy was introduced shortly after the new government came into office. This implies that the Bank of England and not the Treasury is effectively responsible for short-term demand management where it is deemed appropriate, through interest rate adjustments.

- **Code of Fiscal Stability**

This sets out requirements for an open, transparent and accountable approach to managing public finances. Objective: to ensure that fiscal policy is set in UK's long-term interests and avoids short-run political considerations, thereby countering the history of macroeconomic mismanagement by governments of both political colours.

- **Tougher rules for spending and borrowing**

The Chancellor will continue to apply the rules set out in his July 1997 Budget. First, the 'golden rule', where government borrowing over the economic cycle is set to fund investment and not current spending; and second, a rule where *public debt* as a proportion of national income is to be set at a stable and prudent level.

b) Encouraging Work

This is central to government's long-run objective, which is to deal with low incomes and poverty not by taxing and redistributing from the better-off but by helping individuals to get off welfare benefits and back in to paid work. The government believes that increased equity can enhance economic performance and growth and not be detrimental to it. This is also politically necessary to protect the consensus which brought New Labour to power through the support of 'middle Britain'. Specific measures adopted here include:

- **Extending the New Deal**

Additional measures to provide help to: young people, lone parents, long-term unemployed, partners of the unemployed, disabled people and disadvantaged communities. e.g. £100 million of pilot initiatives to help 700,000 long-term unemployed people aged over 25.

- **Making work pay**

The Budget introduced a £1.4 billion reform of NI contributions, which should make it more attractive to employ people moving from welfare to work. A new Working Families Tax Credit (WFTC) to replace Family Credit. A childcare tax credit within the WFTC and a Disabled Person's Tax Credit replace Disability Working Allowance.

- **Improving skills**

Additional expenditure to tackle the problem of structural skill shortages.

c) **Promoting Enterprise**

- **Corporation Tax reforms**

A 1% cut in the main and small firm rates of Corporation Tax. Quarterly payments for large companies to replacing ACT. An extension of the enhanced temporary 1st year allowance at a new rate of 40%.

- **Capital Gains Tax reforms**

A taper introduced to reduce CGT on assets held for longer periods. A unified Enterprise Investment Scheme and CGT reinvestment relief.

- **Innovation and R&D**

A £50 million University Challenge Fund was unveiled to create seed venture capital to help commercialise university research. Furthermore the government is to produce a Report and consultation on R&D. There will also be consultation on management recruitment incentives. The government is also to seek to improve the advice and service to business of the Inland Revenue and the Customs.

d) **Creating a Fairer Society**

- **Families and children**

Child Benefit increased by £2.50 per week for eldest child; carried through to poorer families; help to families with young children. The government to consider taxing Child Benefit.

- **Tax rates and allowances**

Some movement to towards equality of treatment in certain areas e.g. additional personal allowance now to be paid to women with incapacitated husbands as well as men with incapacitated wives.

- **Additional health and education expenditure.**

Extra £500 million for NHS in 1998-99; extra £250m for education in 1998-99.

- **Environmental package**

Extra £500 million for public transport in next two years, this includes £50 million a year for rural transport; car tax frozen with lower tax for smallest cars.

- **Fairness in savings**

e.g. New tax-free Individual Savings Account.

3. **THE PUBLIC FINANCE IMPLICATIONS**

The Chancellor's five-year deficit reduction plan was unveiled last July against the background of a PSBR outturn of £22.7 billion in 1996-97. For the reasons discussed above, the PSBR in 1997-98 is now estimated to be £5 billion, which is £8.25 billion lower than forecast in the July 1997 Budget. The Treasury forecast for the PSBR in 1998-99 is now £3.9 billion - £1.6 billion lower than forecast in the July 1997 Budget. The PSBR is now expected to move into balance in 1999-2000.

The Budget measures increase tax receipts by £1.75, £2.5 and £2.75 billion from 1998-99 to 2000-01, respectively. Estimated Control Total spending for 1997-98 is projected to be £1.5 billion lower than assumed in the last Budget, while the Control Total for 1998-99 is projected to rise 1 per cent in real terms as the 1997-98 shortfall is reallocated. So the government is seeking to keep to its pledge of following the last Conservative government's aggregate spending plans for two years. However, spending plans over the medium term (1999-2000 onwards) will be set only after the Comprehensive Spending Review has been completed, probably in June or July of this year. It is therefore difficult to judge economic and, particularly microeconomic, implications of the government's spending plans. Overall, the prospect for the public finances is such that there is clearly scope for increased real spending if the government wishes but the desire to secure economic stability and to retain the confidence of the financial markets will remain paramount.

4. **UNDERLYING MACROECONOMIC ASSUMPTIONS**

The Budget is largely neutral in 1997-98 in terms of its effect on demand in the economy and will be slightly deflationary in future years. However, the success of the measures

will in part depend on whether the behaviour of the economy lives up to government expectations. GDP is forecast to grow by between 2 and 2.5% this year, reflecting a revision downward in treasury forecasts, due in part to the anticipated effects of the Asian crisis. The higher rate of 2.5% will, the Chancellor expects, be achievable if the welfare to work programme is a success and there is restraint in wage bargaining. Independent forecasters are on average predicting GDP growth of 2.3% this year. Many would disagree with the Chancellor's expectation that the successful implementation of the New Deal will add one half of a percentage point to GDP growth in the current year. Even if the programme is successful at creating jobs with little displacement, the work provided will be for low skilled, low productivity employees and so the contribution to net output growth is not likely to be large. For, 1999 and 2000 growth is projected to be in the range of 1.75% to 2.25%, and 2.25% to 2.75%, respectively. The higher figures in the range again reflecting the successful outcome of the welfare to work programme.

- Consumer spending is forecast to grow by 3.75% to 4% this year and growth of 1.75% to 2.25% is forecast for 1999. This broadly reflects the consensus view but some argue that the slow down will not be as great, others worry that the weakness of manufacturing will precipitate a recession and a marked fall in consumption.
- Investment overall is expected to rise from 4.75% in 1997 to around 5% in 1998, 3% in 1999 and under 2.75% in 2000. Given the weak performance of investment over the present cycle there must be considerable uncertainty as to the actual outcome.
- Export volumes are forecast to grow by around 3% this year, which represents a reduction on the November forecast of 5%. The downward revision reflects fears about the impact of the Asian crisis. Imports, on the other hand, are forecast to grow by 8% in 1998, with the result that the current account deficit is forecast to rise to £7 billion.
- Retail price inflation is projected to peak at 3% this year, averaging 2.75%, with the government's target of 2.5% being attained next year. These projections indicate that the government is more pessimistic than the Bank of England about the short-run

prospects for inflation in 1998 but less pessimistic than the Bank and the consensus of economic forecasters about inflation in 1999. The GDP price deflator expected to average 2.75% this year and 3% next. Given that this index is the basis for the estimation of real government spending, any significant deviation from the forecast will undermine the credibility of the government's spending and benefit plans.

5. SOME QUESTIONS

- **What will be the impact on interest rates?**

Because the Chancellor will not use the Budget for short-term macro management, he did not bring in a Budget that tightened the fiscal position. The fiscal stance of the Budget was largely neutral. This would have helped the Bank not to raise interest rates and would have perhaps let them lower rates sooner. Now rates are likely to rise. There will probably be one more quarter percentage point increase in rates before they reach their peak. This will clearly have implications for manufacturing. The Budget was well received by the financial markets and particularly the foreign exchange markets where sterling rose to over 3 deutschmarks. Clearly, this will further increase the recessionary prospects for manufacturing. The main hope is that there is further evidence of a slowing down of consumer demand and a weakening of inflation, both of which would reduce the need for the Bank to raise rates. Moreover, as the growth of the economy slows this should reduce the upward pressure on sterling and offer some compensation to the hard-pressed manufacturing sector.

- **Where are the extra jobs to come from?**

The success of the New Deal requires the demand for labour to be strong. A weak economy, with slow growth and the possibility of recession, will increase the probability of New Deal jobs displacing existing jobs. However, the Chancellor wants the Budget to be judged against the long-term and not its short-term effects. If successful the current and future measures will improve the labour supply potential of the UK economy. However, at this stage it is too early to judge the likely

outcome, although for the reasons noted above it is unlikely that the project will have much impact on output growth even if it is successful in raising the number of jobs. The reforms of National Insurance are likely to improve the employment prospects for those with low skills seeking low-paid jobs. However, the reforms will be paid for from the increased receipts from firms who have a significant proportion of high-skilled workers earning above the average wage (i.e. more than £440 per week). Sectors such as higher education, business and financial services, and IT intensive activities will see their cost base rise.

- **How favourable is the Budget to capital investment?**

A key objective of the Budget is to raise UK investment levels, promote enterprise, R&D and innovation. But one source of higher investment is higher returns to exports. The current situation facing sterling limits the return to exports. But again the pound's strength is relatively temporary and driven by external as well as internal political factors. Also it is fair to point out that academic evidence suggests that while policy can affect labour market behaviour it is much less certain that it can affect business behaviour in the desired direction.

- **Can the economy stay on trend?**

A return to 'boom and bust' would undermine what the Chancellor is trying to do by eroding job creation and reducing the net returns to investment. The success of the economic stability objective is crucial to the wider long-term economic objectives of the Budget.

- **Will the Budget preserve the political consensus?**

From the Labour government's point of view this is key to the realisation of their programme, which requires a second term at least. "Middle Britain" was not harmed by the Budget. However, the job ahead for the Chancellor is to convince that constituency that while they will not be expected to bear an increased tax burden they cannot expect a reduced burden. It is clear that the realisation of the government's economic objectives requires a *relative* shift in resources to the poorer sections of society to raise their

chance of work. The economic, as opposed to social or moral, justification for this is that *sustained* growth in a modern mixed market economy must be associated with social inclusion: the stakeholder concept if you like. Without this, the belief is that social conflict, low education levels, and an unhealthy society etc. will eventually act to retard the rate of growth so damaging every one, rich and poor, in society. Only time will tell whether the Chancellor can convince the British people to give the Government enough time to put these views to the test.