# Sailing close to the wind: UK Spring Budget 2023

## Economic commentary

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Key points

- Jeremy Hunt's Spring Budget delivered a modest fiscal stimulus, with the aim of boosting investment spending by businesses and increasing labour market participation, while also offering further assistance in coming months with household energy bills.
- The forecasts presented by the OBR no longer anticipate a recession, and project the annual rate of inflation to be back at around 3% by the end of this year.
- But the fiscal forecasts have very little headroom, with the key measure of debt as a percentage of GDP expected to fall by a fractional 0.2 percentage points in 2027/28. Without further improvement in the economic and fiscal outlook, the government may struggle to deliver some of its cherished ambitions without making tough choices in other areas.

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Jeremy Hunt's second set-piece fiscal statement brought few surprises. The giveaways had been well trailed, with little held back for the big day. The statement was framed as a strategy for growth, designed to improve the economy's productive capacity, based around the four "E"s of everywhere (that's to say levelling-up), enterprise, employment, and education. With the net effects of the measures that were announced delivering a maximum annual stimulus of £22 billion in the 2023/24 fiscal year, this Budget was on a modest scale compared with some other recent fiscal events.

The only real surprise was that the Chancellor not only increased the Annual Allowance for pension contributions from £40,000 to £60,000, but also opted to do away with the Lifetime Allowance (LTA) altogether. Most pundits had expected the LTA to be increased, not abolished. The LTA was originally introduced in 2006 when it was set at £1.8 million. It was subsequently reduced to just £1 million, and stood at £1,073,000 before this Budget.

*continued overleaf …*

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## Households are spared another energy price hike …

Otherwise, the announcements were much as expected. The Energy Price Guarantee (EPG), which caps gas and electricity charges at £2,500 for a typical domestic customer, will not increase to £3,000 in April, as was announced last November, but will instead be held at its current level until the end of June. This will cost the government an additional £2.9 billion, with some smaller energy price measures adding a further £1.6 billion. But, with European wholesale gas prices now at only about €40 a megawatt hour, it's likely that Ofgem's price cap will fall below the EPG from July. Barring any adverse developments in the gas market, this will end the need for government support, though utility bills will remain high by historic standards.

The government has also decided not to reverse the 5p cut in vehicle fuel duties announced last November, at a cost of £4.6 billion in the 2023/24 fiscal year. This too had been widely expected, and it represents a clear choice about how to deploy scarce resources, at a time when public sector workers are clamouring for pay increases, and demonstrating their willingness to take industrial action. With the benchmark Brent crude price currently at under $80 a barrel, this might have been an opportunity to garner some much-needed tax income.

The aforementioned pension tax changes are aimed at keeping well-heeled 50-somethings in work and off the golf course. But the Chancellor is also seeking to improve workforce participation at the other end of the working-age spectrum, and announced a widely-anticipated extension of childcare support: parents of children aged from nine months to two years will be eligible for up to 30 hours of free nursery provision, in line with what's available for three- and four-year-olds. These arrangements will be phased in gradually, and won't be fully in place until September 2025. The Chancellor cited the time it will take to increase capacity as a reason for this phased approach, which is a valid point, though a gradual deployment will also help with costings, pushing expenditure out to the latter part of the five-year forecasting horizon. Additional childcare support will cost just £400 million in the 2023/24 fiscal year, but will climb to around £5 billion from 2026/27 onwards.

## … but more are caught in the net of 'fiscal drag'

There were no changes to rates of personal taxation, though with inflation running high the government is raking in revenues from so-called "fiscal drag", as taxpayers find that their pay rises lift them into higher-rate tax bands. Businesses may be disappointed that the increase in the headline rate of Corporation Tax from 19% to 25% will still go ahead, but they can hardly say that they weren't warned – the measure was announced in 2021 – and in any case the pill has been considerably sweetened. The Super Deduction investment incentive scheme, which ends in April, will be replaced by "full expensing" of qualifying capital expenditures for three years, which means that anything spent on IT and equipment can be deducted from profits before Corporation Tax is levied. This was the biggest single measure of this Budget, with the OBR forecasting that it will cost the Exchequer a cumulative £28 billion by 2027/28.

The OBR's revised growth forecast: avoiding recession in 2023
(annual GDP growth, %)

| | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|
| November 2022 | 4.2 | -1.4 | 1.3 | 2.6 | 2.7 | 2.2 |
| **Spring 2023** | **4.0** | **-0.2** | **1.8** | **2.5** | **2.1** | **1.9** |
| *Change (percentage points)* | *-0.2* | *+1.2* | *+0.5* | *-0.1* | *-0.6* | *-0.3* |

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*

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## A better outlook for growth and inflation

Taken together, the measures announced in the Budget are forecast to cost around £90 billion over the period out to 2027/28. The fact that no new tax increases were thought necessary is a testament to the improvement in the economic and fiscal situation since November's Autumn Statement. With commodity prices having continued to fall, including gas prices in particular, the Office for Budget Responsibility (OBR) no longer expects that the economy will suffer a recession. Back in November, the OBR had expected that GDP would fall by 1.4% in 2023, but now thinks that the annual decline will be just 0.2%. It then anticipates a return to annual growth of 1.8% in 2024, and of 2.5% in the following year, with continued growth of around 2% in 2026 and 2027.

No economic forecasters will quibble with the improved assessment of the outlook for this year, but they might take issue with the OBR's relatively rosy assessment of growth prospects for following years. The OBR itself has raised the issue of the economy's weak growth potential, but has presumably been persuaded that the government's measures in relation to workforce participation and business investment will provide a significant fillip to the economy's supply capacity. The OBR also believes, in line with the consensus among economic forecasters, that the outlook for inflation has brightened significantly in recent months. With energy prices having fallen sharply, and with the government having extended the EPG at £2,500, the OBR expects that the annual rate of CPI inflation will be down at around 3% by the end of this year. In other words, barring new adverse economic shocks, the government should have little difficulty in meeting its goal of halving the rate of inflation during 2023.

As a result of its more robust growth projections, and improved outlook for inflation and interest rates, the OBR has been able to take an axe to its assessment of how much it will cost the government to service its borrowings. With net interest costs expected to come in at £103 billion for the current fiscal year, the good news is that the eye-watering sums will now start to come down. In 2023/24, the OBR thinks that the government will need to shell out £75 billion to service its borrowings, a reduction of £50 billion from what was pencilled in last autumn.

Thanks to these favourable fiscal winds, the OBR's judgement is that the government will just about meet its primary fiscal rule that debt should be falling, as a proportion of GDP, by the end of the forecast period (in this case 2027/28). The government's preferred measure, which strips out the effects of Bank of England activities, continues to increase gradually over coming years, reaching a peak of 94.8% of GDP in 2026/27, before falling back a touch to 94.6% in 2027/28. But the OBR also notes that the amount of 'headroom', at just over £6 billion, is the narrowest in any of its forecasts going back to its founding in 2010. The more widely-used internationally-comparable measure of debt, which doesn't strip out the Bank of England, has outstanding borrowings in relation to GDP rising to 108.3% in 2026/27, before easing back to 107.7% in the following year.

## The key fiscal forecasts

| | 2022/23 | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|---|
| **Public sector net debt (excl. Bank of England) - % of GDP*** | **88.9** | **92.4** | **93.7** | **94.6** | **94.8** | **94.6** |
| General govt gross debt - % of GDP | 103.7 | 106.9 | 107.8 | 108.0 | 108.3 | 107.7 |
| Public sector net borrowing - % of GDP | 6.1 | 5.1 | 3.2 | 2.8 | 2.2 | 1.7 |
| Taxes - % of GDP | 36.8 | 36.9 | 37.3 | 37.3 | 37.7 | 37.7 |
| Net debt interest - £ billion | 103.1 | 75.2 | 61.4 | 65.2 | 77.3 | 82.4 |

* Primary fiscal target: net debt excl. Bank of England to fall (as % of GDP) in the final year of the forecast
Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*

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## Not much margin for error … and little room for future giveaways

As regards the trajectory for the annual budget deficit, the OBR reckons that the government will be running a surplus on its current budget (its day-to-day activities) by 2026/27. This is generally regarded as a happy state of affairs by Chancellors of the Exchequer, as it allows them to claim that they are only borrowing to invest. Meanwhile, the overall deficit, as measured by public sector net borrowing (PSNB), is forecast to come in at a better-than-expected £152 billion for the fiscal year just ending, compared with an expectation in November that it would amount to £177 billion. It's expected to be £132 billion in the upcoming fiscal year, falling to just £50 billion in 2027/28. In relation to GDP, the deficit is forecast to shrink from 6.1% in 2022/23 to under 2% at the end of the forecasting horizon.

The government will doubtless be hoping that the OBR will deliver further fiscal windfalls from the next couple of forecasting rounds. As noted above, the 'headroom' of £6 billion in relation to the debt-to-GDP ratio is small, and could get eaten up by any adverse economic developments. To put this into perspective, if the forecasts were to remain as they are now, there would be no scope for taking a penny off the rate of Income Tax in the run-up to the next General Election, as that would cost around £7 billion. Further improvements in the forecasts would likewise be needed for the government to be able to deliver on its implicit promises that have not, as yet, been factored into the arithmetic. Every year since 2010, Conservative chancellors have chosen not to increase fuel duties in line with inflation. But the OBR's sums always assume that it will, and also that the recent cut of 5p will only be temporary. It's highly unlikely that Jeremy Hunt will want to raise fuel duties in the run-up to elections. He also made it clear that he would like to extend the 100% expensing of capital spending beyond the initial three years. But that will mean being able to find around £10 billion a year from 2026/27 onwards. Ultimately, these items on the Chancellor's wish-list, which also includes additional allocations for defence, will only be deliverable if the fiscal arithmetic gets even better, or if difficult choices on tax increases or spending cuts are made.

After the convulsions that gripped financial markets following Kwasi Kwarteng's mini-Budget last September, Jeremy Hunt has sought to convey an aura of calm competence in his two fiscal statements. But the bottom line for investors, after all the sums have been done, is how much the government will need to raise from the bond markets in coming years. One of the most important numbers accompanying any fiscal statement is the assessment by the Debt Management Office (DMO) of the quantity of gilts (UK government bonds) that it will need to issue. This is essentially determined by the size of the government's deficit, by the stock of previously-issued bonds that are due to mature (and so will need to be refinanced), and by the flow of funding from other sources such as sales of Premium Bonds and other products by National Savings and Investments.

Investors can therefore take some cheer from the DMO's announcement that it expects gross gilts issuance to be £241 billion in the 2023/24 fiscal year, a reduction of more than £60 billion from what had been expected at the time of last November's Autumn Statement. To state the obvious, it's a lot of money to ask of investors, especially at a time when the Bank of England is also shrinking its balance sheet by selling around £80 billion of gilts into the market each year. Moreover, the amount of money that the DMO will have to raise is expected to rise to around £270 billion in 2024/25, before subsequently falling back to more comfortable levels.

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