Spring Statement March 2022

Background to the Spring Statement

With the key spending and taxation decisions now largely taken in the Autumn, the traditional March Budget showpiece has been relegated to a 'Spring Statement', essentially a statutory update on the government's finances. Even so, ahead of his address to the Commons there was still considerable speculation that Chancellor Sunak would use the opportunity to introduce additional measures aimed at alleviating the burgeoning cost of living crisis facing hard-working families.

Certainly, much in the economic and geopolitical landscape has changed since October when the Chancellor countenanced a substantial relaxation of fiscal policy amounting to some £75 billion over the next five years. Russia's invasion of Ukraine has resulted in soaring oil and gas prices, further exacerbating the surge in energy costs already being experienced by businesses and households.

Meanwhile, economic recovery has continued apace, with GDP 0.8% above pre-pandemic levels in January, whilst inflation, much to the apparent surprise of the Bank of England, has climbed to a 30-year high of 6.2% in February. What's more, it will rise further over the coming months, with the Bank warning that it could even top 10% in a worst-case scenario.

This combination of upside growth and inflation surprises has thus far been helpful to the public finances, with total public net borrowing for the 11 months to February 2022 coming in at £138.4 billion, down more than 50% for the same period to February 2021 (£290.9 billion). Expectations were high that Mr Sunak would mitigate some of the intended National Insurance (NI) increase by raising the income threshold below which NI contributions do not have to be paid. And with the surge in petrol prices boosting VAT receipts, there were hopes that the Chancellor would announce a reduction of as much as 5p per litre in vehicle fuel duty.

In the event market expectations were not disappointed, although the Chancellor did spring a surprise with a 1p cut in the basic rate of income tax from 2024. Excluding the higher education reform package already announced, today's measures represent a fiscal stimulus of £20 billion in 2022-23, £4 billion in 2023-24, £8 billion in 2024-25, £9 billion in 2025-26 and £8 billion in 2026-27.

Main Announcements

Helping with the cost of living and supporting businesses

- National Insurance: increase annual Primary Threshold and Lower Profits Limit to £12,570 from July 2022—Cost to the Exchequer of £6.25 billion in 2022-23 (£26 billion over the next five years).
- Income Tax: reduce basic rate from 20% to 19% from April 2024—cost of £5.3 billion in 2024-25 and £6 billion in both 2025-26 and 2026-27.
- Fuel Duty: reduce main rates of petrol and diesel by 5p per litre for 12 months—cost of £2.4 billion in 2022-23.
- Energy bills support package (pre-announced)—cost of £9.1 billion in 2022-23 but raises £1.2 billion over the following five years as loans are repaid.
- Household Support Fund—doubled to £1 billion in 2022-23—cost of £0.5 billion.
- VAT: expanding the VAT relief for energy saving materials from April 2022—cost of £0.5-0.6 billion for next five financial years.
- Employment Allowance: increased from £4,000 to £5,000—cost of £0.42-0.44 billion a year over the next five financial years.

Tackling fraud and supporting compliance

- HMRC: investment in compliance—raises £0.455 billion in 2022-23 rising to £0.855 billion in 2023-24.
- DWP: investment in compliance—raises £2.3 billion over the next five financial years.

Economic Analysis

The economic forecasts from the independent Office for Budget Responsibility (OBR) made for sobering reading. With the ultimate effects on the global economy of 'Vladimir Putin's unprovoked, pre-meditated attack on the Ukraine' unknown, the OBR was at pains to point out that its forecasts were subject to even greater uncertainty than normal. Growth in 2021 was a full percentage point higher than predicted at the time of the Autumn Budget at 7.5%, but the forecast for this year was slashed from 6.0% to 3.8%, with 2023 cut from 2.1% to 1.8%.

The good news is that the outlook for unemployment is scarcely changed, but the real issue is with inflation, where the annual rate of change in consumer prices is now expected to average 7.4% for 2022. This compares with an Autumn Budget forecast of just 4.0% and worse still, implies a peak of more than 9% at some point during the year. Further hikes in bank rate are nailed on for this year.

On a positive note, the combination of stronger growth in 2021 and higher than anticipated inflation helps generate a significantly lower profile for government borrowing and debt over the coming few years. Indeed, public sector net borrowing for 2021-22 is now likely to come in at £183 billion, which is more than £50 billion lower than projected in the Autumn. This in turn allows net debt to peak at 95.6% of GDP this year before falling to 83.1% of GDP by 2026-27.

That said, there is barely any discernible decline in 2022-23, courtesy of a spike in debt interest payments from an estimated £23.6 billion in 2020-21 to £83.0 billion next financial year. To put this into perspective, this is more than the entire budgets for schools, the home office and the justice department combined. It is also two-and-a-half times government spending on defence. Herein lies a key risk to the fiscal arithmetic.

Should inflationary pressures turn out to be more entrenched than is implied by the OBR forecasts—and we suspect they will—debt interest payments will continue to rise as interest rates, both short and long, move progressively higher.

The Chancellor's decision to stick with the previously announced 1.25-percentage point increase in national insurance contribution rates but to raise the threshold from which it is paid (albeit from July) was convoluted to say the least. Whilst tax cuts are always to be welcomed in our model of how the economy works, in terms of differential supply performance effects there is little to commend the move as opposed to simply reversing the original decision.

However, importantly it leaves the Exchequer up a net £6 billion on the deal whilst the Chancellor can argue that a substantial number of low earners will no longer be permanently affected. The announcement of a 1p cut in the basic rate of income tax in 2024—in time for the next General Election—is unambiguously positive for the economy's supply potential. That said, at a cost to the Exchequer of only £5 billion, it needs to be set in the context of the £68 billion of tax hikes he announced back in the Autumn.

As a result of these, the tax burden is still destined to exceed 50% of GDP, the highest since the second world war. Since the empirical evidence across the globe suggests that countries with the highest levels of taxation relative to GDP have the slowest trend rates of GDP growth, the implication is that in the UK the rate of economic expansion consistent with price stability is likely to decline over the coming years.

The 5p per litre reduction in fuel duty will help to lower measured consumer price inflation over the coming months. However, as the measure will only last until March 2023, its reinstatement will result in a corresponding spike upwards in measured inflation in 12 months' time. Clearly the hope is that underlying inflationary pressures will be on the way down by then, but if our analysis of monetary trends is correct this is unlikely to be the case.

Implications for Financial Markets

Despite all the spectacle surrounding occasions like the Budget, changes in fiscal policy and their macroeconomic implications pale into insignificance when compared with monetary policy. Thus, whilst the Autumn Budget saw a cumulative fiscal relaxation of around £75 billion, the Asset Purchase Programme pursued by the Bank of England in recent years had added some £895 billion to the total stock of money. Without this, private sector deposits would be around one-third smaller than they are currently, with resultant implications for nominal national income.

Consequently, the Chancellor's statement was never going to make that much of an impression on financial markets; equities edged lower as he was speaking, whilst government bonds responded positively to confirmation of a reduction in future supply of new issues.

The key concern for investors over the next couple of years is what might happen to inflation. If, as we suspect, inflation proves to be higher and more entrenched than is generally anticipated, the best solution for investors remains a well-diversified portfolio of assets, with a significant exposure to equities.

John Clarke
Chief Investment Officer

23 March 2022