Mini-Budget - The Growth Plan 2022

Biggest tax cuts since 1972

Billed as a mini-Budget, Chancellor Kwasi Kwarteng's first fiscal statement was anything but mini. With tax cuts amounting to a whopping £146 billion over the next five years, this was the largest reduction in taxation since 1972 when Anthony Barber was Chancellor.

On top of this, Mr Kwarteng confirmed additional spending of more than £25 billion for the Cost of Living Support Package announced in May, as well as an additional £31 billion to fund the Energy Price Guarantee (a cap on the unit price of electricity and gas for households) and £29 billion for the Energy Bill Relief Scheme for businesses. Taken together, the measures amount to a fiscal relaxation of more than £220 billion between now and 2026-27.

What was missing from the statement were any updated independent economic forecasts from the Office for Budget Responsibility or any fiscal arithmetic to help set the measures in context, although we have been assured these will be forthcoming before the end of the year.

Immediate help with energy bills for households and businesses

To describe some of the decisions made by the Chancellor as controversial would be an understatement. However, much of this is simply confusion—amongst news commentators and economists alike—about how some of the measures are meant to impact on the economy.

The rationale behind the essentially short-term measures aimed at tackling soaring energy prices are clear enough; to bring relief and reduced anxiety to already hard-pressed households and businesses. That said, helping to reduce the peak in inflation should also limit the rise in debt servicing costs (a large proportion of public sector debt is inflation linked) which were forecast back in March to quadruple this year to £83 billion.

Tax cuts not aimed at stimulating demand…

It should be noted that the tax cuts are not intended to boost demand, or to even avoid recession in the short term. Indeed, such an objective would be counterproductive to say the least.

With consumer price inflation currently hovering around a 40-year high of 10%, by definition there is an imbalance between aggregate demand and supply; more specifically, demand is too high and/or supply too low. Introducing measures that exacerbated this imbalance would serve only to further increase inflationary pressure.

I recognise that politicians and even Bank of England governors have attempted to attribute most of the surge in inflation to soaring food and energy prices resulting from the conflict in Ukraine, but that doesn't explain why underlying inflation, which excludes both food and energy, as well as alcohol and tobacco, was as high as 6.2% in July or more than three times higher than the Government's target.

Indeed, in our view, the main reason inflation is currently so high is because at the start of the Pandemic the monetary authorities (in the US, the Eurozone as well as here in the UK) engaged in wholly inappropriate asset purchase programmes that resulted in monetary growth far in excess of that required for economic expansion.

The good news is that monetary growth had slowed sharply in recent months. With the Bank of England having previously stopped purchasing assets or reinvesting the proceeds of its maturing holdings, the quantity of money rose by less than 5% in the 12 months to July. This compares with peak rates of more than 15% in 2020-21.

The Bank intended to commence gilt sales, albeit very modestly (£10 billion per quarter) from early October onwards, which should have slowed the rate further over the coming months. Even with the breaking announcement that they will buy government bonds on a temporary basis, we would expect gilt sales to commence again in the near future.

However, there remains a considerable overhang of excess money within the system that will need to be worked off before underlying inflationary pressures can return to what we became accustomed to prior to Covid. Inflation is therefore likely to remain elevated until 2024.

…but at enhancing the economy's productive potential over the longer term

It therefore follows that the Chancellor's 'Growth Plan' would be better described as an attempt to improve the supply performance of the economy over time; in other words, raising the long run rate of economic growth that is consistent with stable inflation.

Unfortunately, this is not something that can be done overnight. Thus, whilst it is a laudable ambition to seek to raise the economy's trend growth rate to 2½% a year (as it was from 1955 through to the Financial Crisis) this will take time. Given that, in my model of how the economy works, there is an inverse relationship between the tax burden (total tax revenues relative to GDP) and long run economic growth, almost anything that brings it down from the 70-year high that we would have seen under Rishi Sunak is to be applauded.

There is a wide divergence of views on the efficacy of the announced tax changes and their ability to transform the supply performance of the economy. One school of thought has it that, because they have a much higher propensity to consume, it would have been better to have targeted the cuts in taxation on people at the lower end of the income distribution. But whilst it is true that this group does indeed spend most of its disposable income, focusing on them would serve only to stimulate demand and not increase supply, which brings us back to the issue of adding to, rather than reducing, inflationary pressure.

Instead, to increase the economy's sustainable rate of growth it is necessary to improve incentives to work and encourage aspiration, create the conditions for innovation and business investment and reward entrepreneurial risk taking. These are the engines of long term sustainable economic growth. To this end, most of the measures announced appear to fit the picture, with the bringing forward of the cut in the basic rate of income tax and the abolition of the additional 45% rate being particularly supply-enhancing.

Against this, the case for increasing the nil-rate thresholds for Stamp Duty on residential property, which will clearly give a further boost to an already overheated housing market, is more difficult to rationalise.

Main Announcements

Tackling energy prices

- Energy Price Guarantee: support for households through a cap on the unit rate of electricity and gas bringing average annual household energy bills to £2,500
- Energy Bill Relief Scheme: support for business for a six-month period

Cutting taxes for people

- National Insurance: reverse temporary 1.25% increase in NICs rates from November 2022 and cancel the Health and Social Care Levy
- Dividend Tax: reverse 1.25% increase to rates from April 2023
- Income Tax: reduce basic rate from 20% to 19% from April 2023
- Income Tax: remove the additional rates of income tax from April 2023
- Stamp Duty Land Tax: increases to nil-rate thresholds

Cutting taxes for businesses

- Corporation Tax: cancel planned rate increase maintaining rate at 19% from April 2023
- Annual Investment Allowance (AIA): permanently set at £1 million from April 2023

Previously announced

- Cost of living support package announced in May 2022
- Energy Bills Support Scheme: cancellation of clawback
- Energy Profits Levy

Implications for Financial Markets

Financial markets were already under pressure ahead of the Chancellor's statement in anticipation of a substantial relaxation of fiscal policy. With the measures exceeding even these expectations and not being set within the context of any fiscal framework, the selling intensified, with government bonds and sterling coming under particular pressure.

Thus, the yield on 10-year gilts, which was less than 1% as recently as September last year, is now a shade above 4%, whilst the pound slipped as low as $1.03 on Monday morning before rebounding, encouraging speculation that the Monetary Policy Committee might have to raise interest rates further specifically to support sterling.

This is all short-term noise, however. Further out, the supply side reforms in the Chancellor's statement should translate, over time, into faster rates of non-inflationary growth, which is unambiguously good news for equities as well as the public finances. Meanwhile, with monetary growth having returned to pre-Pandemic levels, so too (with the usual lags) should inflation.

Beyond matters fiscal, financial markets remain fixated on the ongoing conflict between Russia and Ukraine, but the comparatively small size of Russia (barely 1.5% of world GDP) and its exports of gas (no more than 5% of global gas supply and only a quarter of one percent of combined UK and European GDP) suggest the disequilibrium in world energy prices should not persist beyond the short term.

Over the medium to longer term, it is not unreasonable to expect the reduction in supply from Russia to be more than compensated for by increased production and supply of liquified natural gas (LNG) which now comprises the bulk of gas traded on world markets. To help put this into context, the increase in world LNG between 2015 and 2020 was equal to the total supply of Russian gas during this period.

Given this, it is a reasonable expectation that global macroeconomic conditions, including growth and inflation, will be back within normal parameters within the next couple of years.

As ever, the precise timing of such anticipated developments is rather difficult to pin down, suffice it to say that what we are currently experiencing are normal, albeit rather pronounced, cyclical economic variations. The current uncomfortable combination of slow growth and high inflation will, in due course, give way to a more benign macroeconomic environment.

For these reasons, we continue to advocate maintaining a well-diversified portfolio of assets, with a significant exposure to equities.

John Clarke
Chief Investment Officer
26 September 2022