Bournemouth University

Regional Economic Development
Local Economy Briefing

The Budget : July 2015

In macro terms, the UK Budget of July 2015 pushes back the forecasts on fiscal surpluses by a year in an economy still likely to achieve only moderate growth. The Budget aims to change the incentive structure in a way that encourages more growth based on private sector investment and personal saving. The risk is that it hurts demand growth by cutting household incomes before the hoped-for structural changes to supply come through. The worry is that the long-awaited rebalancing towards higher productivity growth remains more hope than expectation.

Meanwhile, it was a net tax-raising budget – less tight than in March, but still tight. It may dampen demand slightly over the next few years in the hope that changing incentives will boost private sector performance in the longer run. The stated principle of an economy with ‘higher wages, lower taxes, and less welfare’ and, thereby, more productivity is admirable. But, as the small changes in the OBR forecasts released today suggest (see table below), the macro story has not really altered that much. UK growth remains vulnerable to external shocks, weaker domestic demand and poor international competitiveness over the next few years.

The table (below) shows the main OBR forecasts based on today’s policy announcements. It indicates flat growth and unemployment, as well as subdued inflation for five years (Do we believe that the real world will behave so quietly for so long?) We have lower employment growth and implicitly improved, but still too low, productivity growth, despite better (but not outstanding) business investment and net trade. The debt/GDP ratio drops a little but barely enough to notice. We do get a fiscal surplus by about 2020 but that is delayed compared with what we were told before the General Election. Overall, this is a “no change” forecast with a big dollop of wishful thinking. If the official forecasters are saying “no change”, the focus has to be on where the shocks will come: how the forecast may turn out to be wrong.

There are plenty of candidates for shocks – Greece, China, and the Middle East stand out at this point but there will be others we cannot yet see. The Treasury must be hoping the world’s economic environment improves. The much-repeated statement that “we are better than the rest” is not much comfort at these low investment levels and low growth rates.

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The Chancellor and his party believe reducing the Government's role in the economy and switching incentives to 'crowd in' the private sector is better for economic prospects in the long run. There is much to recommend this view in economic theory, at least at the margin, but there is also a lot of concern about the economy's resilience at this time. The future is almost bound to be more volatile and precarious than the Budget and the OBR forecasts suggest.

OBR	2015	2016	2017	2018	2019
real GDP	2.4	2.3	2.4	2.4	2.4
inflation	0.1	1.1	1.6	1.8	1.9
unemployment	5.4	5.1	5.2	5.3	5.4
business investment	6.0	7.2	6.9	6.6	6.5
net trade	-0.5	-0.4	-0.2	-0.2	-0.2
employment growth	1.6	1.0	0.3	0.3	0.6
productivity growth	0.8	1.3	2.1	2.1	1.8
	2015/16	2016/17	2017/18	2018/19	2019/20
public net borrowing/GDP	3.7	2.2	1.2	0.3	0.4
public net debt/GDP	80.3	79.1	77.2	74.7	71.5

Turning to the prospects for economic growth and structural development in Dorset and its hinterland, several Budget announcements stand out:

1) *Proposals to cut welfare benefits and increase pay.*
a) In the near term, the welfare reforms take spending power out of final demand and soften growth potential. Further out, they may 'crowd in' higher wages and more sustainable growth as incentives to work increase.
b) The proposed National Living Wage is really a new, higher Minimum Wage band for the over 25s. The OBR acknowledges that this could cost 60,000 jobs over the five-year term as some jobs are priced out of the market, but this is supposedly outweighed by the overall impact of the 'better economy' on employment prospects (adding a million jobs over the term).
c) The further pay restraint/real wage cuts for public sector workers will also dampen demand prospects.
Generally, the problem will be the period and process of adjustment as households learn to adopt and adapt to the new rules and requirements.

2) *Plans to increase tax thresholds and reduce evasion*.
The measures on tax allowances may offset some of the negatives of 1) above for final demand. Simpler, flatter and fairer tax structures and processes are generally welcome.
The rest of the fiscal measures, however, are a mixed bag of positives and negatives for growth. They range from the moves to increase Inheritance Tax allowances and cut corporation tax, through the new Bank profits tax, to the rise in dividend taxes and vehicle excise duties. In their own right, many of these proposals make economic sense. It is difficult, however, to entangle the net impact without further analysis when we have all the detail.
Meanwhile, the commitment to hold the main income tax rates for the Parliamentary term provides some welcome stability in an otherwise shifting fiscal world.

3) *Policies to support business.*
At this point, anything that stimulates UK investment and productivity is good. The medium term commitment to an annual £200,000 investment allowance is a positive for business planning and development.
The items termed as productivity boosting measures (for roads/transport, apprenticeships/skills/universities, regions/northern powerhouse and housing/inheritance) will need some digesting before we can fully judge their potential impact.

4) *Policy commitments*.
Whilst still demanding efficiency savings from all public sector activities, the Chancellor promised to enforce and/or legislate:
a) defence and security spending at 2% of GDP;
b) a lock on headline tax rates for this parliament;
c) a promised boost to NHS spending of £10bn per annum;
d) holding the line on the Aid budget; and
e) a fiscal charter to set a requirement for government current surpluses in ‘normal’ times into law. It will be interesting to see how this and future Chancellors interpret what is ‘normal’ and what might constitute an ‘abnormal’ slowdown triggering a move into deficit.

Meanwhile, although not Budget specific, we also need to consider

5) *Plans to reform the EU and maintain UK membership*.
The economics of the EU is clear:

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1) Borders, boundaries or barriers increase costs and decrease growth potential - single markets make macro sense, but
2) Reform to increase efficiency and decrease unwarranted micro interference in the single market is good for all.
It remains to be seen whether Prime Minister Cameron can negotiate 2) in order to cement 1). This will be an important area of uncertainty for business and productivity-led growth in the next two and a half years.

Conclusion

When/if fully implemented, Budget 2015 will alter the incentive environment for Dorset business and households in many important ways. Some will gain and some will lose. The net impact is dampening for near term growth but offers some prospect of a more balanced economy in the longer run.

There are lots of specific measures that will affect local firms, especially small and medium enterprises. There will be some that thrive in these new incentive structures but there will be others that will find it too burdensome and will sell up or close. The tax accountants and lawyers will do well from the myriad of changes now in train.

This is not to say the reforms are unwelcome. For the economist, the question is whether, in the long run, the new incentive structures encourage more efficient and effective economic practices and promote more sustained and sustainable economic growth. It will be some time before we know.

By 2020, we will have had a decade of gradual, painful adjustment in which many households will not feel much better off but some may feel more empowered. The hope is that, through private-led investment, productivity is rising, net exports are stronger, competitiveness is increased, innovation is widespread, skills are building and entrepreneurship is flourishing.

Against this background, Dorset's economy is robust enough to benefit from the changes and challenges underway. In the end, it may be despite rather than because of the Chancellor's measures that we prosper and grow.

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