Research Institute - Insight

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#UK / #Politics / #Fiscal policy

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The UK's Spring Budget will only marginally improve the long-term growth outlook

The government focuses on labour market reforms and on encouraging business investment to boost growth, but household finances and housing prices are projected to fall.

Key Takeaways

- The Office for Budget Responsibility (OBR) has concluded that the UK's economic outlook has improved since November. It is no longer forecasting a 2023 recession.
- Major measures aiming to lower childcare costs for parents of young children and encouraging business investment have been judged positively by the OBR.
- A more positive short-term outlook has not alleviated financial strain for households. Housing prices are now expected to drop by 10% from Q4 2022 and real disposable incomes are not forecast to return to pre-pandemic levels until 2027-2028.

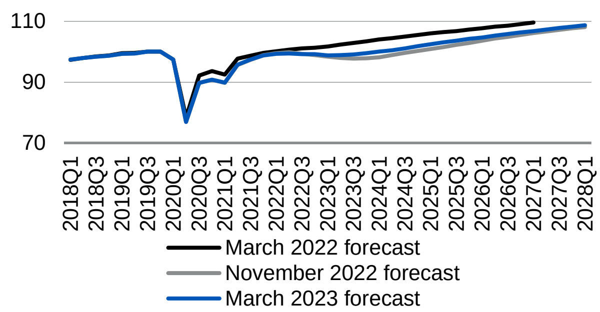
UK fiscal background

Since the last official full budget, the UK has had four chancellors, three prime ministers and experienced double-digit inflation, and a cost of living crisis. Jeremy Hunt will be hoping to put that turbulence behind him after a run of more positive economic and fiscal news in recent months.

The OBR now forecasts the UK will not enter a technical recession this year, with inflation falling to 2.9% by the end of 2023. The underlying debt-to-GDP ratio is estimated to be 92.4% of GDP in 2024, before reaching 94.6% in 2027-2028.

The OBR believes the economic downturn in 2023 is going to be shorter and shallower than previously thought, due to stronger real wage growth and lower-than-expected interest rates. However, the medium-term potential growth rate of 1.75% remains unchanged from its November forecast.

Figure 1: The OBR forecasts a moderate improvement in short term GDP growth



Source: OBR, abrdn, March 2023

While the short-term outlook may have improved, the OBR highlighted low business investment, falling post-pandemic labour market participation, and productivity as structural drags on future growth prospects that have been exacerbated by recent economic shocks.

Hunt's budget acknowledges these issues, but his measures do not significantly alter the medium-term outlook.

Cost of living measures have been extended

In what is now becoming a traditional part of UK budgets, fuel duty was frozen for another year. The 5p cut in fuel duty was also retained for another year.

Hunt also extended the energy price guarantee cap of £2500 for another quarter, postponing its planned increase to £3000 from April.

The government expects that, by the time a decision needs to be taken on the guarantee for Q3, falling energy prices will mean an increase to the cap is avoided without additional government subsidy. This is supported by the OBR, which predicts energy bills will fall to £2,200 by the end of 2023.

Household finances will continue to be under strain, however. Real household disposable income is forecast to fall by 2.6% in 2023. By 2027-2028, real living standards are expected to remain around 0.5% below pre-pandemic levels.

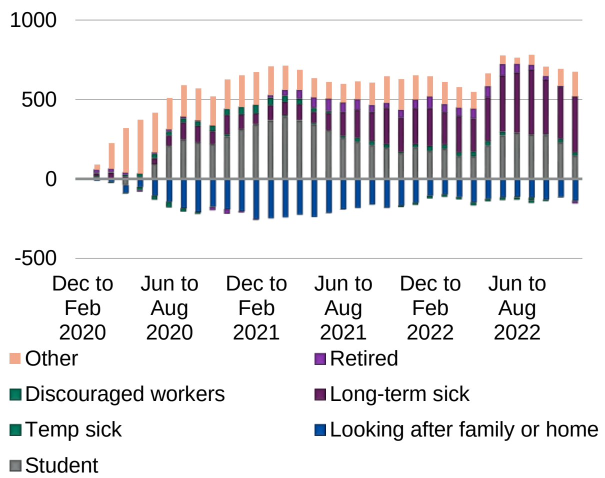
Additionally, The OBR forecasts a 10% drop in house prices from a Q4 2022 peak, citing "low consumer confidence, the squeeze on real incomes, and the expectation of mortgage rate rises to come."

Labour market reforms focus on phased expansion of childcare

Labour market supply has been a key government focus. Economic inactivity among all adults has risen by 830,000 since the start of the pandemic, with more than three-quarters being people aged 50 and above.

To target these early retirees, Hunt announced the lifetime allowance for pension savings will be abolished to encourage people, particularly higher earners, to keep working. The annual allowance will also be raised to £60,000 a year.

Figure 2: Post-pandemic increases in economic inactivity have been driven by growth in those with long-term illness



Source: Office for National Statistics, abrdn, March 2023

While the government is keen to reduce the economically inactive population, making meaningful progress is likely to be challenging.

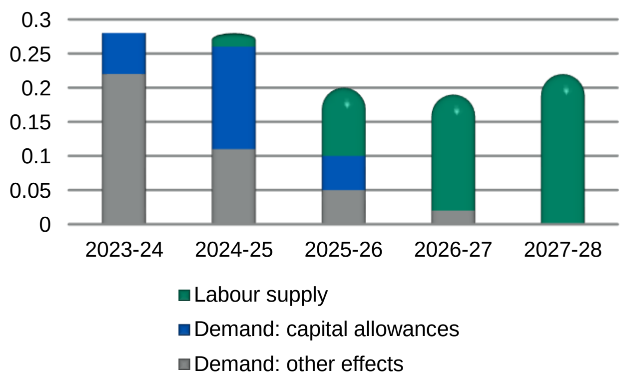
Much of the rise in inactivity has been driven by an increase in the overall number of people over 65, as well as a rise in the number of people with long-term health conditions. With these groups facing issues often challenging to address, the government has focused on other economically inactive groups, which are easier to incentivise, notably parents of young children. Taken together, the labour market reforms are forecast to increase employment by 110,000 by 2027-2028.

The cost of childcare has been rising across the UK. This is having a knock-on effect on the number of parents able to afford to return to work after having children.

Hunt announced the government is extending the free childcare policy to all children older than 9 months where all adults are working more than 16 hours a week. The reforms will be introduced on a phased basis from April 2024, with the full rollout not due to complete before the next general election.

Hunt also announced the government will tweak Universal Credit rules to provide eligible parents with upfront support for childcare costs, rather than having fees reimbursed, and increase the maximum amount that can be claimed.

Figure 3: OBR estimates of the impact of policy announcement on UK GDP



Source: OBR, abrdn, March 2023

Business investment incentives will be introduced to offset the rise in corporation tax

Despite opposition from Conservative backbenchers and business lobby groups, Hunt retained the planned increase in corporation tax to 25%.

To soften the blow, he announced an investment allowance regime for companies to replace the "super-deduction", a £25bn two-year investment incentive scheme that is about to expire in April.

The new scheme will allow businesses to deduct all investments in IT equipment, machinery or plant goods from profits. A new SME tax credit will be introduced for companies that spend 40% of expenditure on R&D.

These incentives to accelerate investment plans have increased the OBR's business investment forecast by amounts peaking at almost 3% in 2024-2025 and 2025-2026.

A long-term issue facing the UK is how to respond to the growing trend across Europe and the US for protectionism, triggered by the introduction of the Inflation Reduction Act (IRA).

Hunt pledged to announce a full response to the IRA at the Autumn Statement, where he will also set out plans to increase investment in high-growth UK firms. In advance of this, Hunt announced support for energy generation and carbon reduction. Carbon capture and storage will receive £20bn in funding over 20 years while nuclear will be recategorized as a 'green' source of energy to enable it to qualify for investment incentives.

Left outside the government's area of focus are high profile industries like electric vehicles and batteries, which may become political flashpoints during the next general election.

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