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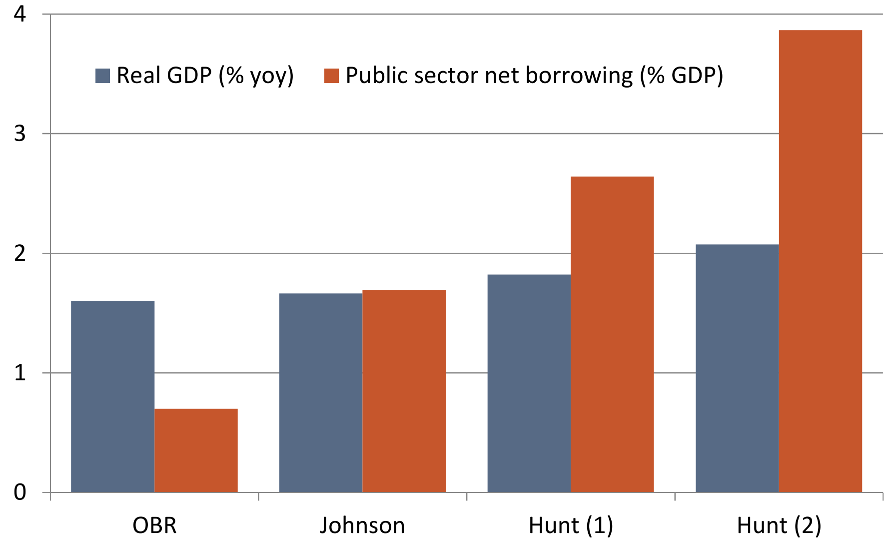
UK fiscal stimulus ahead? Consequences and risks

- **Going for broke:** Amid pressure to stimulate the economy and reverse the Conservative Party's ongoing slide in the polls, Boris Johnson and Jeremy Hunt, the candidates to be the next Conservative Party leader and UK prime minister (PM), promise significant fiscal easing if they end up in 10 Downing Street.
- **A major u-turn:** A fiscal stimulus would mark a major change of course. Since coming to power in 2010, the Conservative Party has pursued mostly sensible economic policies. Due to a combination of gradual fiscal consolidation and pro-growth reforms, public-sector net borrowing has fallen from a peacetime high of 9.9% of GDP in 2009 to sustainable 1.1% in 2018.
- **What the candidates promise:** Johnson proposes significant income tax cuts to stimulate demand. Hunt promises a combination of tax-and-spending policies that will mostly lift demand but could boost supply too. Both candidates plan to finance their policies through additional borrowing.
- **Stronger growth for a while, at a high price:** In our view, a large demand-side stimulus at this stage of the economic cycle would be misguided and carries risks. To differing degrees, all the plans being proposed would lift real growth for a few years. However, a stimulus would add to inflationary pressures and amplify existing long-run fiscal challenges linked to rising health costs and an ageing population.
- **Bottom line:** While markets may respond well to the initial sugar high of fiscal easing, the risks are not worth it, in our view. A better approach would focus on improving the UK's low trend rate of productivity growth. That would raise confidence among foreign and domestic firms – confidence that has been badly knocked by the Brexit vote.
- **Tighter monetary policy:** A pro-cyclical fiscal expansion that raised demand and inflation over the medium term would likely elicit more rate hikes by the BoE than our current expectation of two 25bp rate hikes in 2020.

Chart 1: Impact of fiscal proposals (2020-23 average)



Annual data. Source: IFS, OBR, Berenberg. See page 2 of this note for details of the three proposals

Note: The calculations in this report are intended as a guide to the potential impacts of the candidates' fiscal plans and are not our base case for the UK economy. Uncertainty about whether such plans will be enacted and under what circumstances remains high – eg what if there is a hard Brexit? Furthermore, a lot will depend on who the future PM chooses as his chancellor

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On the campaign trail, both Johnson and Hunt have so far discussed a wide-ranging set of policies. In this note, we focus on the key tax and spending plans highlighted and costed in two detailed reports by the Institute for Fiscal Studies (IFS): Boris Johnson's tax policies: what they cost and who would benefit? and Jeremy Hunt's tax and spending policies: what they cost and who would benefit?. All estimates in this note are based on the assumption that the UK will avoid a hard Brexit.

Boris Johnson's tax plan

1) **Raise the threshold level of income at which the higher rate of income tax (40%) is applied to £80,000 from £50,000.**
2) **Raise the threshold level of income at which workers begin to pay National Insurance (NI) contributions.**

Total cost £20bn pa: Increasing the higher rate threshold on income tax would imply that earnings between £50,000 and £80,000 would be taxed at 20% instead of 40%. The IFS calculates that this would cost £9bn pa. Johnson has not specified whether the change would occur in one go or whether it would be phased in gradually.

Johnson has not provided much detail on his plans to change NI. Currently, NI is paid on annual earnings above £8,632 (at 12% on earnings up to £50k pa and 2% on earnings thereafter). The IFS calculates that it would cost roughly £3bn pa for every £1,000 that the threshold is increased. Raising the threshold to the current personal allowance level for income tax (£12,500), as proposed by Conservative MP Dominic Raab, would thus reduce revenues by £11bn pa.

Jeremy Hunt's tax-and-spending plan

1) **Cut the main rate of corporation tax to 12.5% from 19% (current legislated cuts will reduce the rate to 17% by April 2020).**
2) **Raise the level of income at which workers begin to pay NI.**
3) **Increase defence spending in a "decisive" way from 2% of national income to between 2.5% and 4%.**
4) **Reduce the interest rate paid on student loans to the annual rate of RPI (retail price index) – whereas it is currently RPI plus X – with X depending on the individual's annual income.**

Total costs: £40bn-65bn pa: The IFS estimates that cutting the rate of corporation tax to 12.5% would cost £13bn pa; raising the NI threshold to £12,500 would cost £11bn; raising defence spending to between 2.5% and 4% of GDP would cost £15bn-40bn; and the changes to student loan interest rates would cost £1bn pa.

Economic consequences

Estimating the economic consequences of fiscal policy changes is tricky. As for the impact on aggregate demand, past experience may not provide a sensible guide as to how much of the windfall from tax cuts will be spent, and what consumers and businesses will spend it on. Some of the additional income for households and firms, which we assume to be equivalent to the IFS cost estimates, will be saved or used to pay down debt, while firms may pay out dividends. There is significant uncertainty about how much of the rise in demand will translate into higher output and/or higher inflation, and how much the stimulus will lift growth after the first year.

To simplify the discussion and illustrate potential effects, we therefore assume that:

- 90% of cost of the change to NI is spent; 50% of the cost of the income tax change is spent, and 25% of the cost of the change to corporate tax is spent;
- the increase in spending in year one boosts incomes, which raises spending thereafter, but the effects gradually fade; for the Johnson proposals, we assume that businesses and consumers will follow up on the boost to income generated by the fiscal stimulus in the first year by spending 40% of that increase in the second year and so on; for Hunt, owing to the positive impact on supply potential from the tax cut for businesses, we assume this rate is 50%. Note that by 2023, real GDP growth rates for all proposals are at, or close to, the Office for Budget Responsibility's (OBR) baseline as the initial impulse fades.

- the marginal propensity to import is 25% and 35% of the lift to nominal GDP from the fiscal boost finds it way back into the public sector coffers via taxes;
- there are no crowding-out effects and no reduction in expenditure from lower payments to unemployed workers;
- all policies are enacted in year one and continue thereafter based on the IFS estimates of the costs.

We estimate impacts on headline real GDP growth and public sector net borrowing based on three proposals: Johnson, Hunt (1) and Hunt (2). Hunt (1) assumes defence spending rises to 2.5% of national income while Hunt (2) assumes it rises to 4.0%. As our base case, we take the economic and fiscal projections from the OBR's Economic and fiscal outlook of March 2019.

Table 1 sets out our estimates for real GDP growth to 2023. We calculate that all three plans would lift growth relative to the OBR's March 2019 forecast with the boost occurring in the near term and fading thereafter. However, the positive impact of the proposals on real GDP is likely to decrease as the stimulus increases, owing to the resulting rise in inflation. Due to rounding, the numbers in the tables may differ slightly from the description of the data below. We calculate that:

- Johnson's plans would raise real GDP growth by 0.3ppt in 2020, and by an average of 0.1ppt pa from 2020 to 2023, and lift the GDP deflator from an average of 1.9% yoy (OBR current estimate) from 2020-2023 to 2.1%;
- Hunt (1) would raise growth by 0.7ppt in 2020, and by an average of 0.2ppt pa from 2020-2023, with the yoy rate in the GDP deflator averaging 2.1% between 2020 and 2023;
- Hunt (2) would lift real growth by 1.4ppt in 2020, and by an average of 0.5ppt pa (2020-2023), with the rate in the GDP deflator averaging 2.2% between 2020 and 2023 (Chart 2).

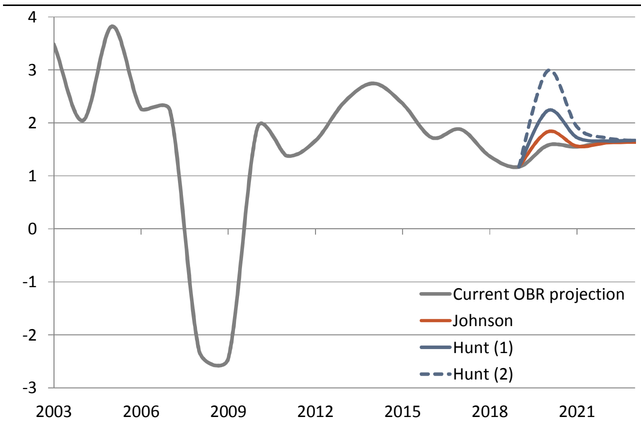
Table 1: Real GDP (GDP deflator), (% yoy)

	2019	2020	2021	2022	2023
OBR March 2019	1.2 *(1.9)*	1.6 *(1.8)*	1.5 *(2.0)*	1.6 *(1.9)*	1.6 *(2.0)*
Johnson		1.8 *(2.1)*	1.6 *(2.1)*	1.6 *(2.0)*	1.6 *(2.0)*
Hunt (1)		2.2 *(2.2)*	1.7 *(2.2)*	1.7 *(2.1)*	1.7 *(2.0)*
Hunt (2)		3.0 *(2.3)*	1.9 *(2.3)*	1.7 *(2.1)*	1.7 *(2.1)*

Source: OBR, Berenberg

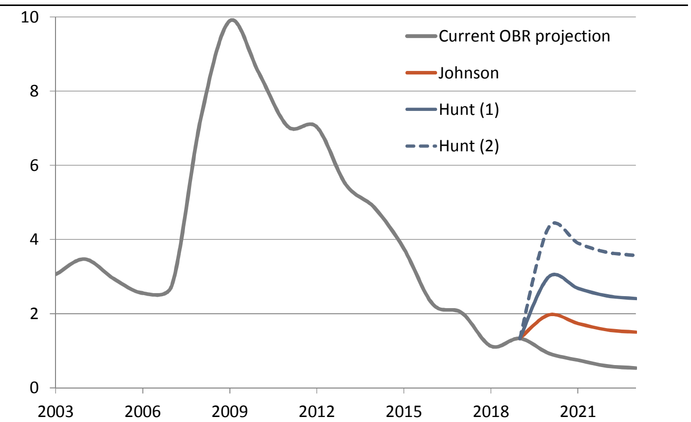
Table 2 shows our estimates for public sector net borrowing. In March 2019 the OBR forecast that net borrowing as a percentage of GDP would fall from 1.3% in 2019 to 0.5% by 2023. We calculate that, following an initial jump in 2020 for all three plans, borrowing as a percentage of GDP would be 1.5% by 2023 for the Johnson plan, 2.4% for Hunt (1), and 3.6% for Hunt (2) – see Chart 2. To put Hunt's plans into perspective, borrowing during the most profligate Gordon Brown years – 2002 to 2007 – averaged 2.9%. Table 3 sets out our estimates for the impact of the three plans on public sector net debt as a percentage of GDP.

Chart 2: Stimulus would lift growth... (real GDP % yoy)



Annual data. Source: OBR, IFS, Berenberg calculations

Chart 3: ...But at the cost of higher borrowing (borrowing % GDP)



Annual data. Source: OBR, IFS, Berenberg calculations
The chart shows public sector net borrowing % GDP

Figure 2: Public sector net borrowing (% GDP)

	2019	2020	2021	2022	2023
OBR March 2019	1.3	0.9	0.7	0.6	0.5
Johnson		2.0	1.7	1.6	1.5
Hunt (1)		3.0	2.7	2.5	2.4
Hunt (2)		4.3	3.9	3.7	3.6

Source: OBR, Berenberg

Figure 3: Public sector net debt (% GDP)

	2019	2020	2021	2022	2023
OBR March 2019	83.6	80.4	76.3	75.3	74.3
Johnson		82.4	81.2	79.9	78.6
Hunt (1)		83.0	82.6	82.1	81.6
Hunt (2)		83.7	84.3	84.8	85.3

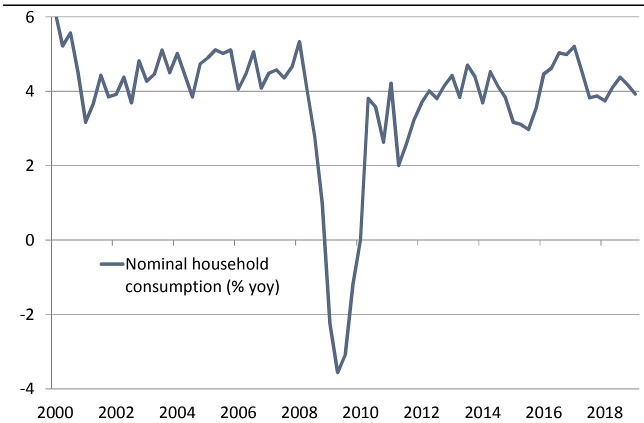
Source: OBR, Berenberg

Further observations

- **The boost to domestic demand from tax cuts may disappoint:** Nominal household spending growth averaged 4.4% yoy in the three years to Q1 2019, in line with the boom years of 2001-2007 – see Chart 4. Households continue to report solid finances and resilient confidence. It is not obvious, therefore, that income is a major constraint on household demand. Consumer credit growth remains tame. Households may choose to save more than we had assumed in our calculations. Johnson's proposal to increase the higher-rate income tax threshold will mostly benefit the top 10% of earners whose propensity to consume is, according to empirical studies, the lowest of all income groups. However, the increase in the threshold for NI payments might be a different story. As raising the NI threshold would predominately benefit lower-income individuals – whose propensity to consume should be relatively high – it is likely to give, on a pound-for-pound basis, a relatively large boost to household spending growth.

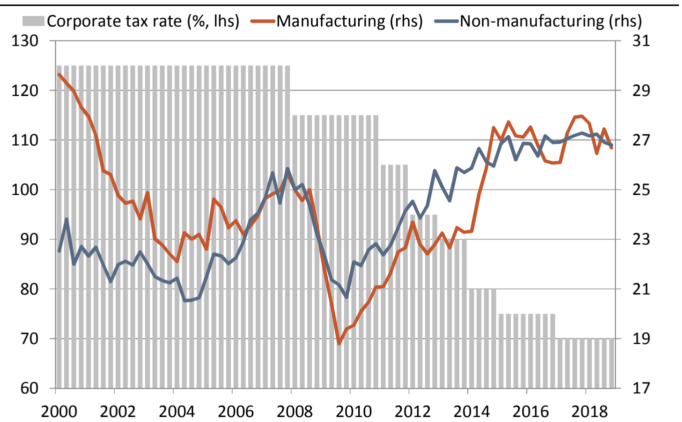
- **Imports could rise sharply:** The UK economy is very close to, or at, full employment. Most estimates suggest only a negligible gap between aggregate supply and aggregate demand. Since households have access to both domestic and foreign goods, part of any rise in household demand from tax cuts will flow out of the UK. This would widen the trade deficit and drag on headline GDP growth. It would also raise the UK's foreign liabilities and widen the current account deficit – a recurring risk for the UK. In 2018, the UK already ran a high current account deficit of 3.9% of GDP.

Chart 4: Household demand growth remains firm (% yoy)



Quarterly data. Source: ONS, Berenberg

Chart 5: Corporate tax cuts have lifted investment



Quarterly data. Source: ONS, Berenberg. Investment data - 2008 Q1 = 100

- **Corporate tax cuts are likely to lift private business investment:** But that may not translate into stronger gains in productivity. The UK standard corporate tax rate has fallen from 30% in 2007 to 19% in 2019. By boosting profits, the tax cut has promoted healthy gains in private sector business investment – see Chart 5. Hunt's plan to reduce the corporate tax rate to 12.5% goes further than the existing planned cuts to 17% by 2020. At 12.5%, the UK rate would be the joint lowest in the OECD, along with that of the

Republic of Ireland. Unlike the proposed changes to income tax and NI, which would lift aggregate demand, lower corporate taxes can also raise supply potential by promoting spending on capacity and productivity-enhancing capital investment. However, despite the recovery in business investment over the last 10 years, productivity growth has broadly flatlined. This is partly the result of the unusually rapid rate at which firms have hired workers relative to increases in production. This has constrained output-per-worker growth. As firms hit greater supply constraints in the workface they are likely to invest more to boost their productive capacity. This ought to raise productivity growth, if and when it happens.

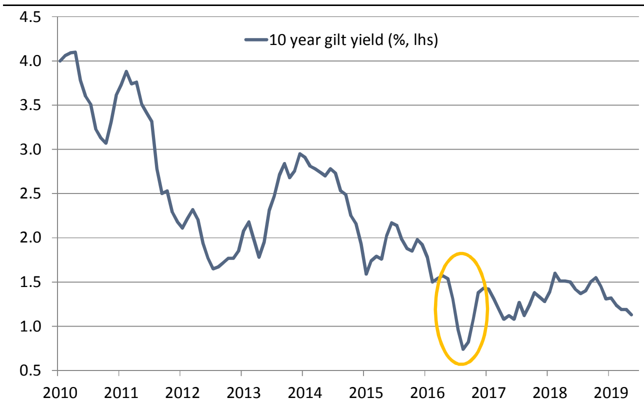
- **Uncertain demand impact of defence spending:** Hunt's planned increase in defence spending would lift aggregate demand to the extent that the rise was spent in the UK– which would show up in public investment and consumption – rather than abroad (say on technology and arms). Hunt has provided little detail beyond the headline numbers. Once again, the boost to UK domestic demand could end up being lower than the total cost of the spending plans may suggest.

Is it worth the risks?

Despite a growing case for a modest easing of fiscal policy in the UK, the policy proposals of Johnson and Hunt appear to be aimed at grabbing headlines rather than tackling the economic problems facing the UK. As a case in point, Johnson's plans to increase the higher-rate threshold for income tax would reduce the number of payers from just under 4m to 1.3m (IFS estimate). That number is the same as in 1990-1991 – the final year of Margaret Thatcher's prime ministership. That may or may not be a coincidence. In our view, rather than funding an expensive – if politically attractive – tax cut, the money borrowed could be better spent on improving key sectors that can boost long-term growth, such as infrastructure, education and energy.

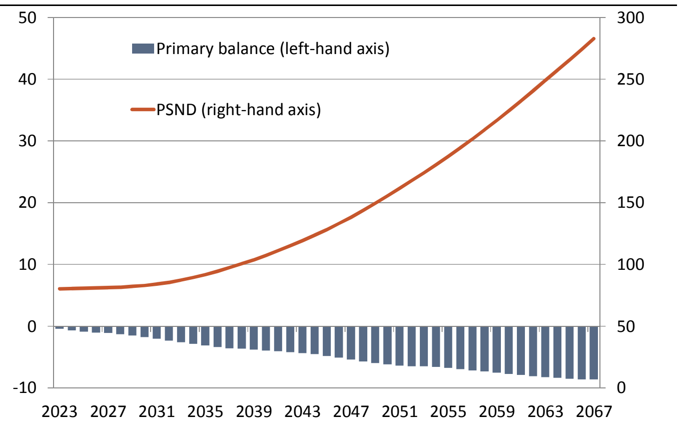
Perhaps the candidates have been encouraged by the recent US example, where a sizeable fiscal stimulus combined with some supply-side reform has lifted US GDP growth since 2017. However, the sugar rush of the fiscal easing in the US seems to be fading fast. After peaking at 4.2% annualised in Q2 2018, US real GDP growth looks set to level off at slightly above 2% yoy later this year, and by 2020 it should be roughly in line with the five-year average before Donald Trump became president and Congress passed his expensive tax-and-spending plan. The US public sector deficit, meanwhile, looks set to hit 4.5% this year, up from 3.2% in 2016.

Chart 6: 10-year gilt yield (%)



Monthly data. Source: BoE

Chart 7: Long-run fiscal projections (% GDP)



Annual data. Source: OBR. PSND = public sector net debt.

The impact on UK fiscal sustainability in the long run is a related issue. Currently, financial markets do not worry much about UK fiscal sustainability. Long-term gilt yields even declined in June 2016 following the EU referendum, despite the Brexit-related risks to the UK's long-run growth potential – and thus the fiscal outlook – see Chart 6. The fall in yields reflected the market's lower-expected GDP growth and chance of a monetary stimulus from the BoE. If markets had genuinely believed that the risks to the UK's fiscal position had increased materially, long-term bond yields would have risen instead.

However, the UK's fiscal position is not completely in the safe zone. The OBR's most recent forecasts suggest that the UK's long-run fiscal outlook is currently unsustainable. Based on current tax-and-spending projections, the public sector primary balance is forecast to worsen from -0.5% of GDP in 2023, to -8% of GDP by the 2060s as debt as a percentage of GDP rises above 250% – see Chart 7. The expected explosion in borrowing is mainly the result of a likely sharp rise in healthcare costs and other spending linked to the UK's ageing population. As the OBR does not project that the costs will really begin to accumulate in a major way until the 2030s, when the deficit could begin to rise above 2% of GDP, there is still time to set fiscal policy on a sustainable course.

However, the Johnson and Hunt proposals would bring these risks and challenges to the fore. A hard Brexit, in which both Johnson and Hunt promise to spend way beyond the policy measures we cover in this paper, could turn the UK's long-run debt sustainability into an urgent issue. We calculate that a hard Brexit could lower UK potential growth to sub-1.5% from +2% inside the EU. On its own, this would have a significant detrimental impact on the UK's fiscal outlook. Add to it Johnson's or Hunt's plans and the UK could rapidly find itself in deep fiscal waters.

Implications for monetary policy

When an economy is approaching full employment, a demand-side stimulus typically raises both real output and inflation. Facing strong demand and supply constraints, firms will likely raise prices. With the unemployment rate at 3.8% – well below the pre-crisis level and the lowest since 1973 – a fiscal stimulus at this stage in the cycle is unusual, to put it mildly, and would be likely to exacerbate existing inflation risks in the UK economy that have developed since the Brexit vote.

A pro-cyclical fiscal expansion that raised inflation over the medium-term would be likely to elicit more rate hikes by the BoE than we currently expect in our base case (two 25bp rate hikes in 2020). The impacts on inflation and real output will likely differ across the three plans. On the one hand, Johnson's plan proposes the smallest stimulus – but it is entirely focused on raising demand. On the other hand, both Hunt's proposals entail more borrowing, to the order of two or three times that of Johnson's plan, but include corporate tax cuts which would contribute to the UK's supply potential by stimulating private-sector investment spending. While Hunt's plans may lift medium-term inflation by more than Johnson's plan, the BoE could take the view that the long-term upside risks to the inflation outlook would not be materially higher since the extra demand would be compensated by additional supply.

A higher deficit to finance a fiscal stimulus would likely limit the headroom to stimulate demand via fiscal policy during the next downturn. However, by enabling the BoE to hike rates by more beforehand, it may lead to a situation where monetary policy would have more headroom to stimulate demand during the downturn. Is this a sensible policy? Probably not. While the BoE may react more quickly than the government to a future economic slump, monetary policy has a much longer lag to boost demand than fiscal policy.

By how much the BoE would step up the pace of rate hikes if a fiscal stimulus goes ahead is not obvious. As monetary policy works with a lag of more than a year, the BoE would likely react to an anticipated stimulus only once the details of the policies became clear. The BoE would probably take its cue from market-implied indicators of inflation expectations and changes in long-term bond rates as markets judge the implications of any policies. A big jump in market expectations for growth and inflation would likely prompt a swift reaction by the BoE whereas more muted reaction by markets would give the BoE some room to wait and see how the data develop.

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