

An Independent Assessment of the Mini-Budget

23 September 2022

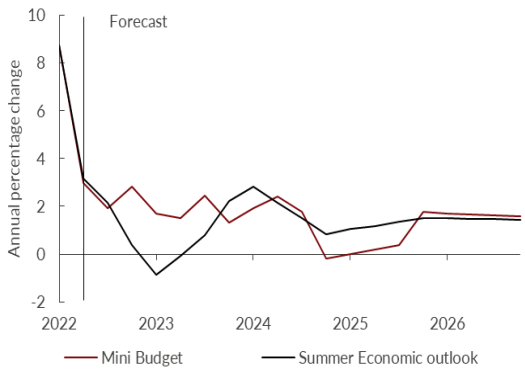
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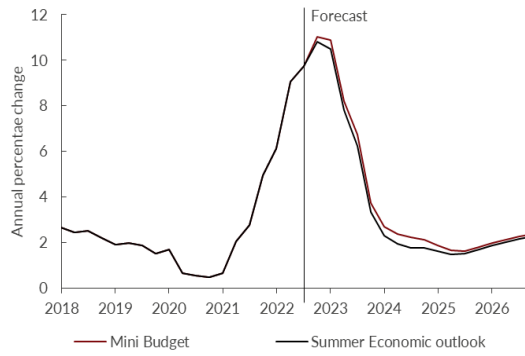
Main Points

- We now forecast that the energy support guarantee, together with the tax cuts announced today, will lead to positive GDP growth in the fourth quarter of this year, shortening the recession and raising annual GDP growth to around 2 per cent over 2023-24.
- The potential inflationary effects of this are likely to lead the Bank of England to raise rates more aggressively than we previously expected. We now expect the Bank rate to peak at around 5 per cent in the third quarter of 2023.
- We expect the extra government spending and tax cuts to increase the government deficit by around £150 billion (roughly 5 per cent of GDP); we now forecast public sector debt to rise to 91.6 per cent of GDP in 2024-25, rather than fall to 87.5 per cent of GDP.
- We welcome the focus on growth and investment but we question whether the measures announced today will reduce regional disparities: while London and the South East have grown by 2.4 per cent per year on average since the financial crisis of 2008-09, the rest of the country has grown by about 1 per cent – well below the target trend growth rate of 2.5 per cent.
- We also welcome government support for household energy bills but we regret that the chosen policy represents a general subsidy for all households rather than targeted assistance for those who need it most, as we have argued in our proposal for a variable price cap.
- We expect that low-income households, which do not qualify for tax credits, pension credits, legacy benefits or Universal Credit, will receive financial help that falls short of the increase in energy bills (nearly £2,000) and in food bills.

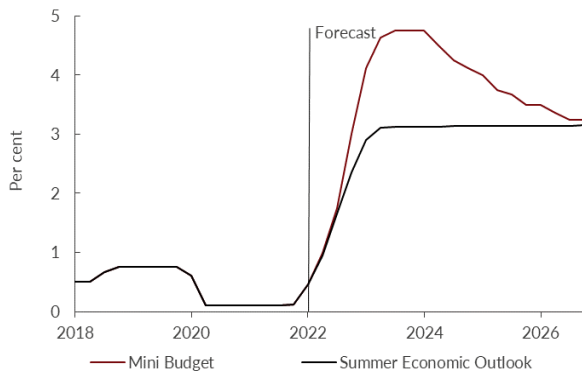
Annual GDP Growth



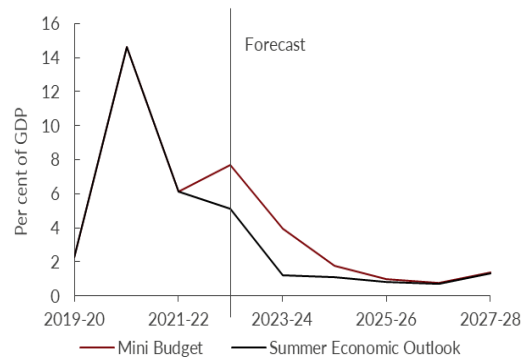
Annual CPI Inflation



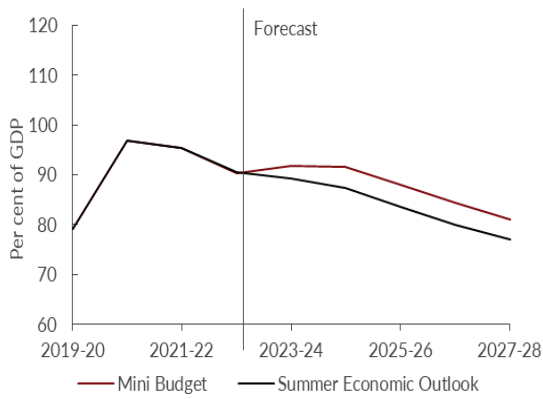
Bank Rate



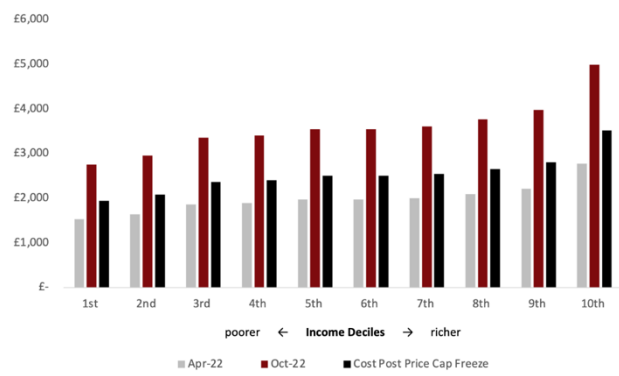
Public-Sector Net Borrowing



Public-Sector Net Debt



Distribution of Energy Bills Following Freeze in the Energy Cap



Background

Today the new Chancellor, Kwasi Kwarteng, presented a 'mini budget' in which he unveiled 'The Growth Plan' that is to be the centrepiece of economic policy for the new government. This mini budget was published against a background of high inflation and recession in the United Kingdom. The tax changes announced today, together with recent announcements around support for households and firms in covering their energy costs, mark a significant 'fiscal event'.

In that light, it is disappointing that the Office for Budget Responsibility (OBR) were asked not to provide their independent analysis of the effects of these announcements on the government's ability to meet its fiscal targets and on the state of the economy more generally. At NIESR, we have argued – in particular, within our Occasional Paper entitled '[Designing a New Fiscal Framework](#)' – that an important underpinning of the credibility of the fiscal framework is precisely the independent oversight that a body such as the OBR can offer. In the absence of an OBR evaluation of the 'mini budget', we aim to fill this gap with our own analysis of the effects of the changes announced today.

Turning to the economic background, the government is facing a recession with high and increasing inflation and rising interest rates. The most recent GDP data showed growth of 0.2 per cent in economic output between June and July. However, as we argued in our recent [GDP Tracker](#), we think that this was affected by the additional Bank Holidays in June. Our view is that the UK economy entered recession in the second quarter of this year (with ONS data showing a fall in GDP of 0.1 per cent) and will remain there until the first quarter of next year, with a further fall of 0.1 per cent in the third quarter of this year and falls of 0.5 per cent in each of the fourth quarter of this year and first quarter of next year.

At the same time, we forecast inflation to rise from its current rate of 9.9 per cent in August of this year to a peak of between 11 and 12 per cent in January of next year. As discussed in [this blog](#), the announced energy price guarantee has taken 2 percentage points off the peak in inflation but, potentially, lengthened the time it will take inflation to fall back to its 2 per cent target. And with inflation high and rising, we expect the Monetary Policy Committee of the Bank of England (MPC) to continue raising interest rates from the 2.25 per cent rate announced yesterday to 5 per cent by the end of September of next year.

In terms of the government's finances, ONS data released on Wednesday of this week suggested that borrowing in the first five months of the 2022-23 fiscal year was £58.2 billion. This was only £0.2 billion above the OBR's March Forecast. But the energy bill support measures announced by the then Chancellor Rishi Sunak in May have yet to make a material difference to the public finances, while the energy price guarantee first announced on 8 September will only kick in as of October. Central government spending in the fiscal year to date was £10.5 billion above the OBR's forecast, reflecting the much higher cost of servicing the government's debt resulting from higher-than-expected inflation. (About a quarter of the government's debt is in the form of Index-linked gilts [IGs], whose interest payments are linked to RPI inflation.) Public sector net debt (PSND) stood at 96.6 per cent of GDP in August, 1.1 percentage points higher than the OBR's March forecast.

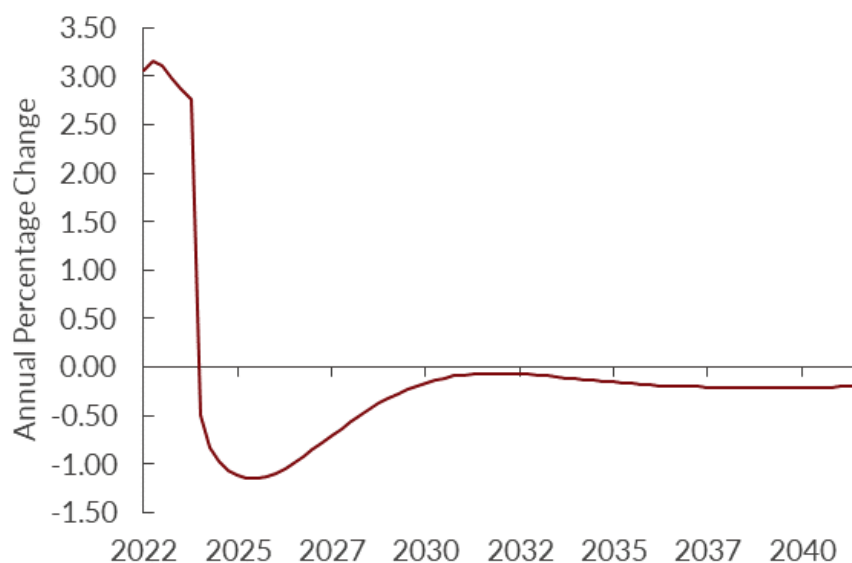
Support for Energy Bills

The 'Energy Price Guarantee', announced on Thursday 8 September, will fix the price per unit that households will have to pay for their energy for two years at a rate that implies an annual bill of around £2,500 for a typical household. [NIESR have already responded to this announcement](#), arguing that, though we welcome the support for households, we do not think that the support is sufficiently targeted while being unnecessarily expensive compared with our suggestion of a [variable price cap](#). In addition, the guarantee removes the incentive for households to cut down on their energy use that would have resulted from a rise in prices. Add this lack of incentive to the close-to-zero gas storage capacity within the United Kingdom and the scene is all but set for shortages this winter. Further, this policy of subsidising the energy retailers – as well as the likely temporary scrapping of the green levies on energy bills – goes against the need to encourage households to move to carbon-free technologies (such as heat pumps) and energy suppliers to move to using renewables to generate electricity.

In addition, the government announced on Wednesday 21 September details of a similar scheme to support businesses with their energy bills, capping wholesale energy prices for six months. Cornwall Insight estimate that the cap represents a discount of 45 per cent on wholesale energy prices at the end of last week. Although we welcome this support for businesses, the fact that the scheme only lasts for six months – albeit that it will be reviewed after three months with an option to extend the support for 'vulnerable businesses' – means that uncertainty over energy prices will persist for businesses, which typically need to plan at horizons of more than six months.

The exact cost of these support schemes to the Exchequer will depend on the evolution of wholesale gas prices over the lifetime of these schemes. The Chancellor announced this morning that he expected the scheme to cost £60 billion over the next six months. Estimates of the total cost of the household package range from £100 to £200 billion over two years. Below we use our macroeconomic model NiGEM to examine the effects of this government support on GDP growth, inflation and interest rates as well as the public sector deficit and debt.

Figure 1: Effect of the support for energy bills on GDP



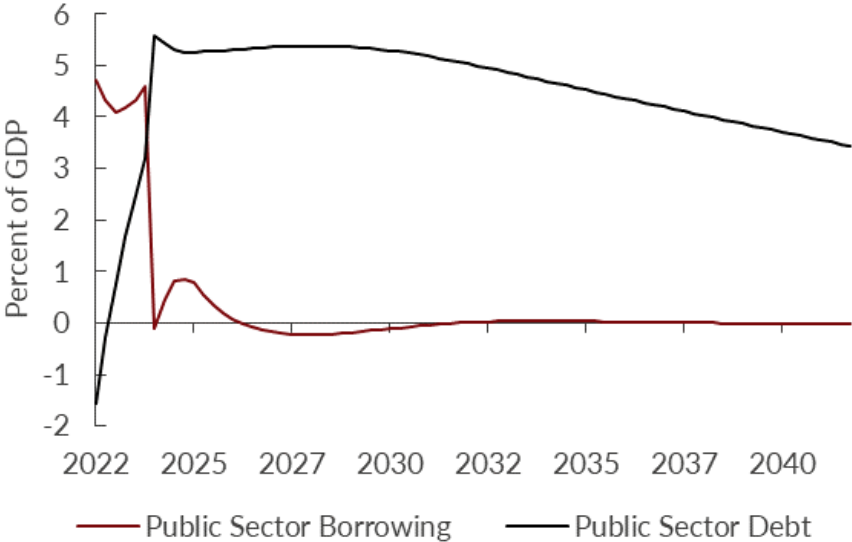
Source: NiGEM Simulations

Our NiGEM model suggests that the “Energy Price Guarantee” will lead to higher GDP growth in 2023 and 2024 but lower growth in the future (once the support is removed).

As energy bills are one of the biggest drivers of CPI inflation, the government’s intervention in the form of an energy price guarantee will cushion the inflation impact. More precisely, as we previously stated [here](#), we expect the energy price guarantee to reduce the peak in annual inflation by 2 percentage points but to lengthen the time it takes for inflation to come back down to the Bank of England’s 2 per cent target.

The support provided to households and businesses to cover their energy bills will be costly. The Chancellor announced this morning that it will cost £60 billion over the next six months. Furthermore, this will be paid for by increased public borrowing. Our NiGEM simulation suggests that the debt to GDP ratio will rise by almost 6 percentage points and stay around 5 percentage points higher than it is now for at least a decade.

Figure 2: Effect of the support for energy bills on public sector finances



Source: NiGEM Simulations

Tax Changes

Today the Chancellor announced a number of tax changes:

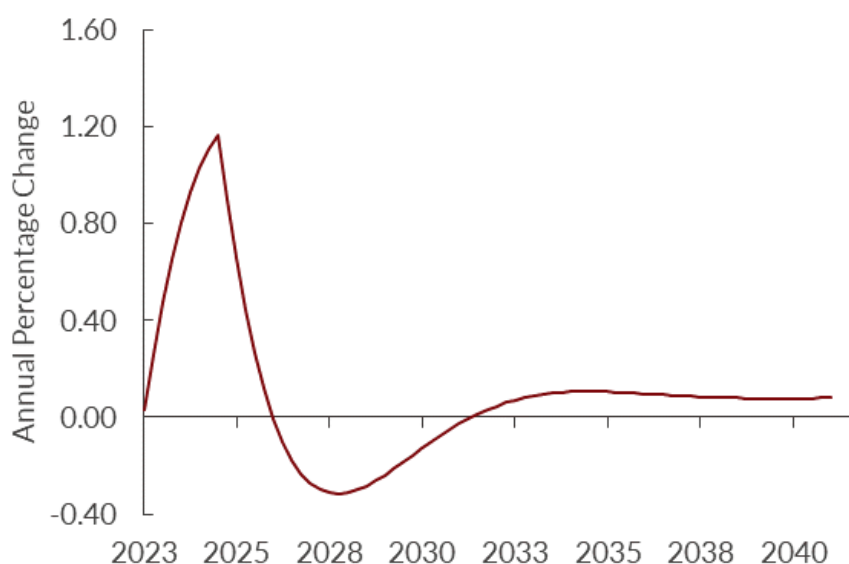
- A reversal of the April increase in National Insurance Contributions of 1.25 per cent and the abolition of the 'Health and Social Care Levy'
- A reversal of the planned increase in the Corporation Tax Rate from 19 per cent to 25 per cent that was due to happen in April of next year
- Cuts in Stamp Duty thresholds and an increase in stamp duty thresholds
- Bringing forward the previously announced 1 percentage point cut in the basic rate of income tax from April 2024 to April of next year and cutting the top rate by 5 percentage points from 45 per cent to 40 per cent

Below we use our macroeconomic model, NiGEM, to examine the effects of each of these tax changes on GDP growth, inflation and interest rates as well as the public-sector deficit and debt.

Effect of Reversing Corporation Tax Increase

Using NiGEM, we simulated the effect on our forecast of reversing the rise in corporation tax that was due to happen in April 2023. We found that the reversal added about 1.2 per cent to GDP growth in 2024. The key to this happening in practice is that the extra profits are fed into investment by companies, which in turn will drive growth. However, given Britain's poor investment performance among the G7 and OECD countries for years, despite repeated tax cuts, there is a possibility that growth is not spurred on by this change. In that light, we welcome the additional investment incentives announced by the Chancellor this morning.

Figure 3: Effect of a corporation tax cut on GDP growth



Source: NiGEM Simulations

Effect of Cuts to Income Tax and National Insurance Contribution

Cuts to income tax and national insurance contributions raise real personal disposable income and, hence, consumption. Our NiGEM simulation suggests that the cut in income tax announced today will result in an immediate rise in GDP growth. However, as demand increases, so will inflation and interest rates.

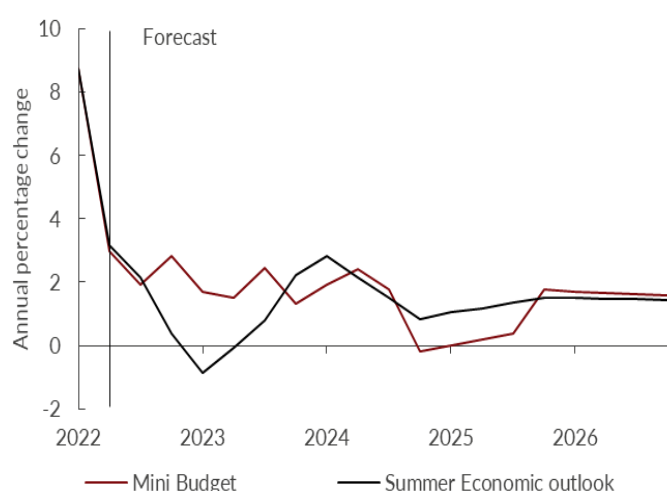
As income tax generates the most revenue for the government among all the taxes, accounting for 24 per cent of government revenue in 2021-2022, an income tax, a cut in income tax rates causes a large decline in government revenue, leading in turn to a large increase in public-sector borrowing, which in turn increases public-sector debt.

Overall Macroeconomic Impact

Given the absence of an independent forecast from the OBR, we believe it to be particularly important to provide an independent assessment of the overall effects of this morning's policy announcements. So, we have produced a forecast using our global macroeconomic model, NiGEM, that applies these policy changes, which we can then compare with the forecast underlying our [Summer UK Economic Outlook](#). Specifically, we assumed that the support for households' energy bills would be worth £100 billion over two years and the support for firms would be worth £25 billion over the next six months and we applied the tax cuts as announced today.

In our [Summer UK Economic Outlook](#), we suggested that the United Kingdom was already in a recession. The ONS's first quarterly estimate suggests that UK GDP fell by 0.1 per cent in the second quarter of 2022 and we expect a further fall in GDP of 0.1 per cent in the third quarter of 2022. We think the announced government support measures will shorten the length of this recession: whereas previously we expected negative GDP growth in the fourth quarter of this year and the first quarter of next year, we now expect positive GDP growth in the fourth quarter of this year. In addition, we now expect annual GDP growth to remain positive through 2022 and 2023.

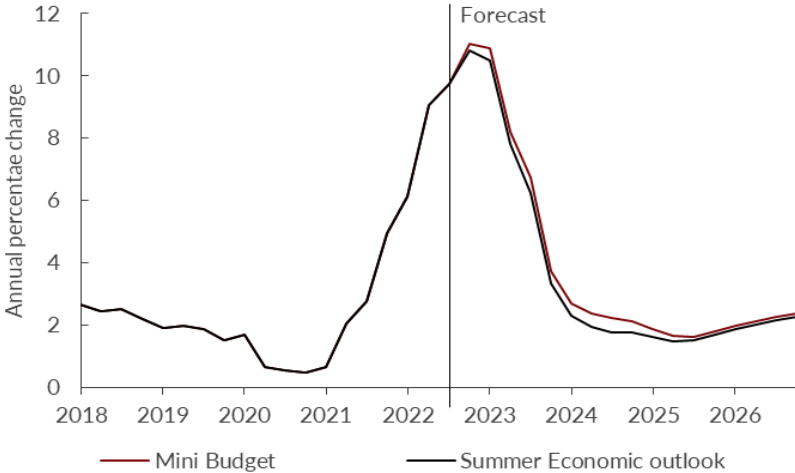
Figure 4: GDP forecast



Source: NiGEM

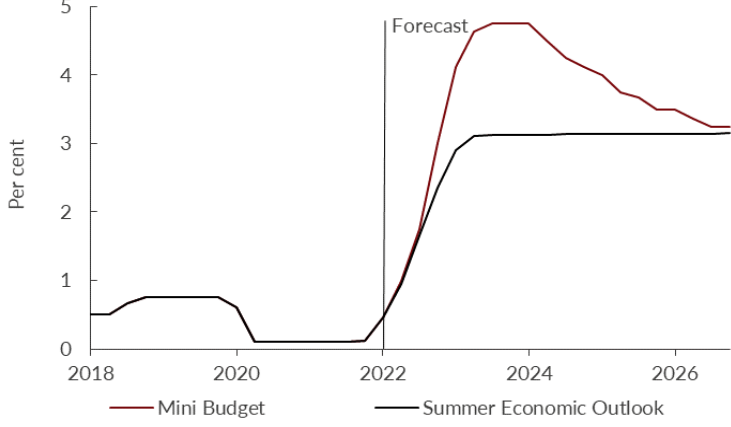
The government's intervention, in the form of the Energy Price Guarantee, means that CPI inflation will rise by less in the short-term, peaking at around 11 per cent at the end of 2022. A combination of the government's announcement and continued monetary tightening by the Bank of England have significantly reduced the degree to which energy prices are expected to add to the level of headline CPI inflation. At its latest meeting, the Monetary Policy Committee moved to increase Bank Rate by 0.5 percentage points, to 2.25 per cent. Our updated forecast expects the MPC to set rates on a path in line with market expectations.

Figure 5: Inflation forecast



Source: NiGEM

Figure 6: Bank Rate

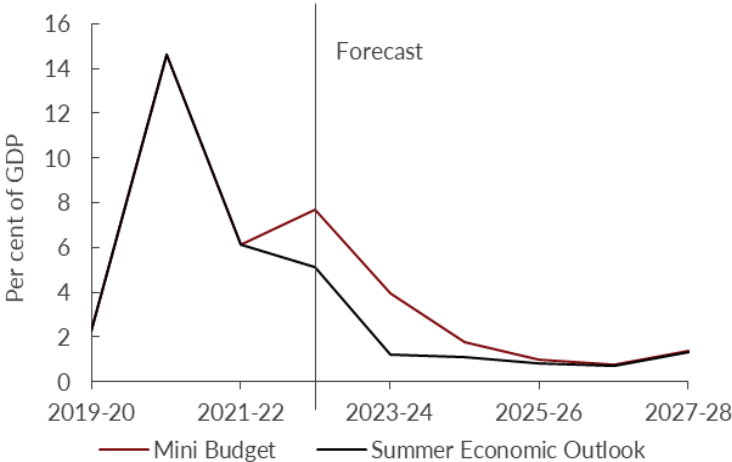


Source: Bank of England and NIESR

Impact on the Fiscal Position

Our central forecast for public finances in August was conditioned on announced spending plans, with no further loosening taking place other than the planned cut to income tax rates in 2024. However, the combination of increased spending and considerable tax cuts announced this morning now means borrowing is running at a significantly higher level than we forecast in August. We expect public-sector net borrowing to rise to nearly 8 per cent of GDP in fiscal year 2022-23. Note that, even after the Energy Price Guarantee has elapsed, we forecast borrowing to be running at over £100 billion a year as a result of the tax cuts and increased interest payments.

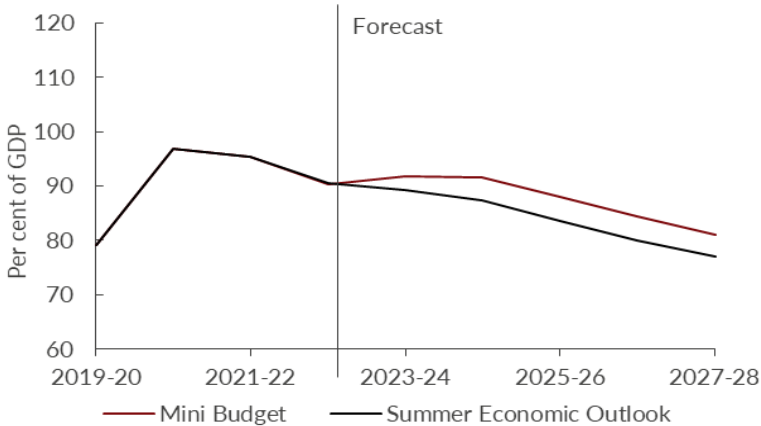
Figure 7: Public sector net borrowing



Source: NiGEM

We now expect the public-sector debt to GDP ratio to rise to 91.6 per cent of GDP in 2024-25, rather than fall to 87.5 per cent of GDP, and to remain high even after the Energy Price Guarantee has ended as a result of lower tax receipts and higher debt interest payments.

Figure 8: Public sector net debt



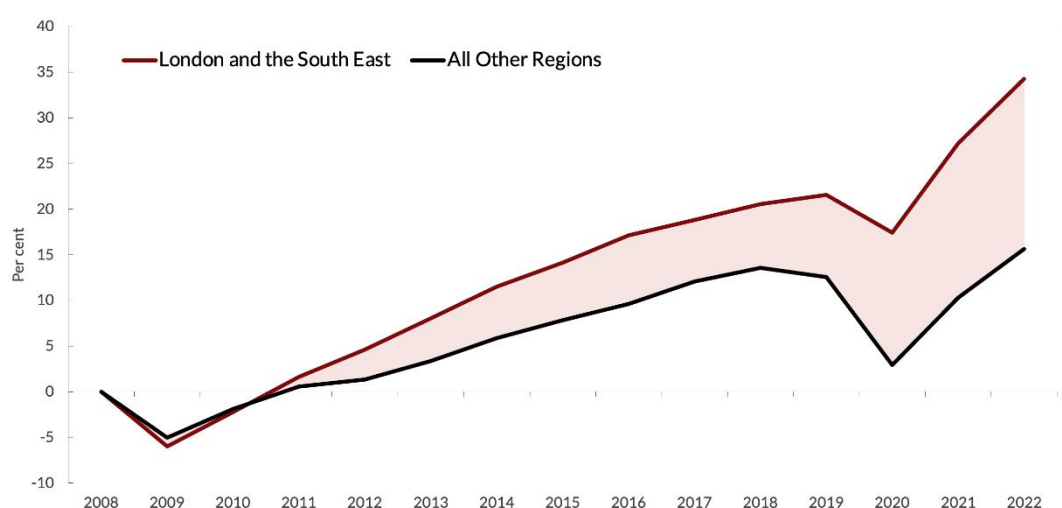
Source: NiGEM

Impact on Regions and Households

We welcome the government's focus on growth and the acknowledgement that since the financial crisis of 2008-09, the country's growth and productivity performances have been significantly below the pre-crisis trend along with low business investment. Both the Covid-19 shock and once-in-a-generation inflation shock have had the effect of exacerbating regional disparities, with London and the South East bouncing back more quickly and powering ahead of the remaining parts of the UK.

We show in Figure 9 that the growth of economic output as measured by Gross Value Added (GVA) has diverged significantly between London and the South East compared with the rest of the country in the wake of the financial crisis of 2008-09. Since then, London and the South East have grown by 34 percent whereas the rest have grown by 15 percent. In annual terms, London and the South East have grown by 2.4 percent and the rest by barely 1 percent, well below the government's targeted trend growth rate of 2.5 percent.

Figure 9: Regional GVA growth since the financial crisis of 2008-09



Source: NiReMS

The danger with the government's plan for growth is that any new spending will mostly benefit those areas that are already affluent, which would deepen disparities rather than levelling up 'left behind' communities. 38 new investment zones with liberalised planning rules and other incentives have the potential to increase growth, but we question whether there will be significant spill-over effects to surrounding areas and beyond. A balanced policy package needs to target larger areas in the regions that have fallen behind London and the South East, notably parts of the North East, the North West and the Midlands but also parts of the devolved nations. Sustained regional regeneration requires a long-term, joined-up strategy underpinned by public expenditure to help unlock private investment.

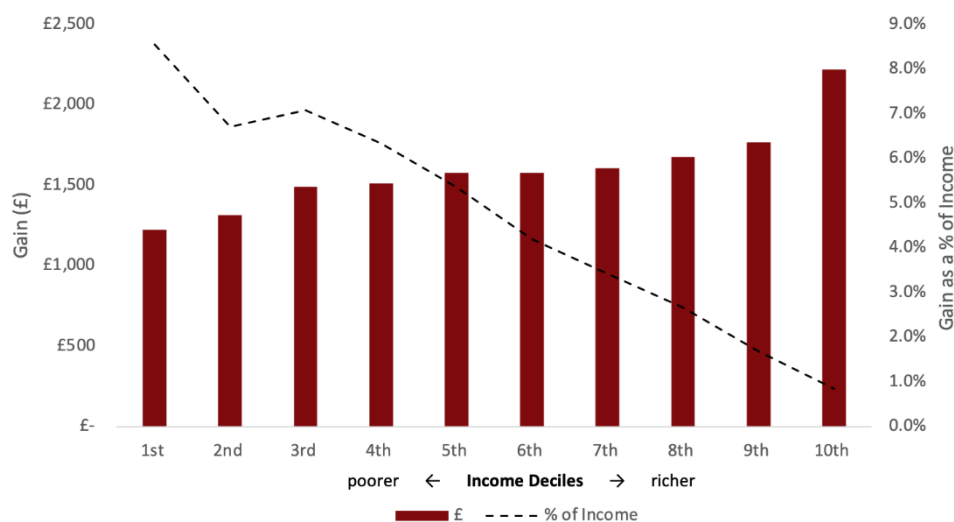
Today's announcements, together with the Prime Minister's energy price plan, are intended to provide support worth £1,400 for all households and £2,200 for the most vulnerable households (those in receipt of tax credits, pension credits, legacy benefits or Universal Credit). While this will cushion the impact of the energy price shock, there are two problems with the chosen approach. First, this policy represents a general subsidy for all households rather than targeted assistance for those who need it most, which is not only costly but also fails to introduce incentives for energy saving. Second, those low-income households that do not qualify for tax

credits, pension credits, legacy benefits or Universal Credit will receive financial help well below the increase in energy bills (nearly £2,000) and in food bills.

Specifically, the problem with the government’s energy price cap freeze is that it disproportionately benefits high-income households. Their energy use is typically much higher than that of low-income households. Capping the unit price of electricity and gas provides a larger subsidy for those with high energy usage.

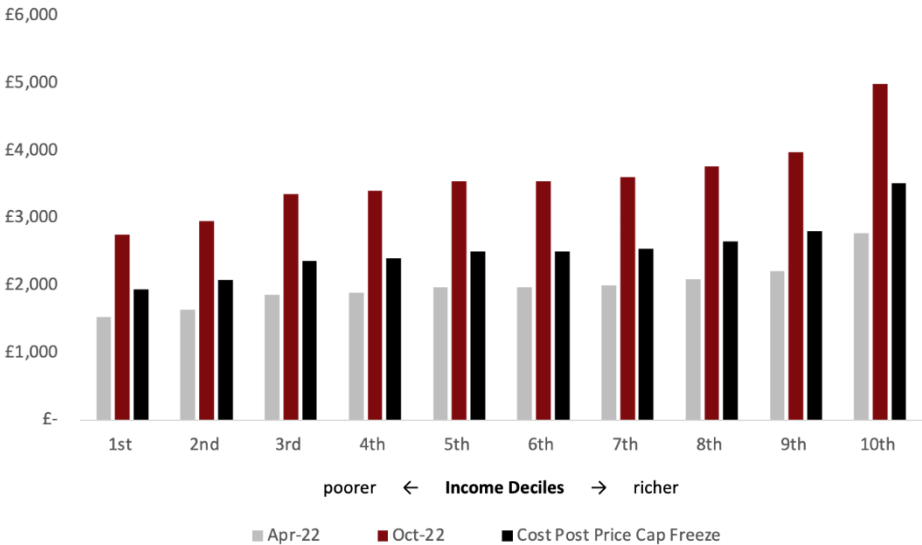
Figures 10a and 10b highlight who gains from the energy price cap freeze in cash terms and as a percentage of income. The richest households gain the most in cash terms, being around £2,200 better off as a result of limiting the unit price of energy, but this represents a small percentage of their total income. Conversely, the gain for poorest households in cash terms is approximately £1,200, but this represents around 9 per cent of their income. We have previously argued for a [variable price cap](#) whereby the unit price of energy increases with usage, which would help the hardest hit households more and could have been designed in such a way as to be revenue neutral.

Figure 10a: Who gains from the energy price cap



Source: LINDA

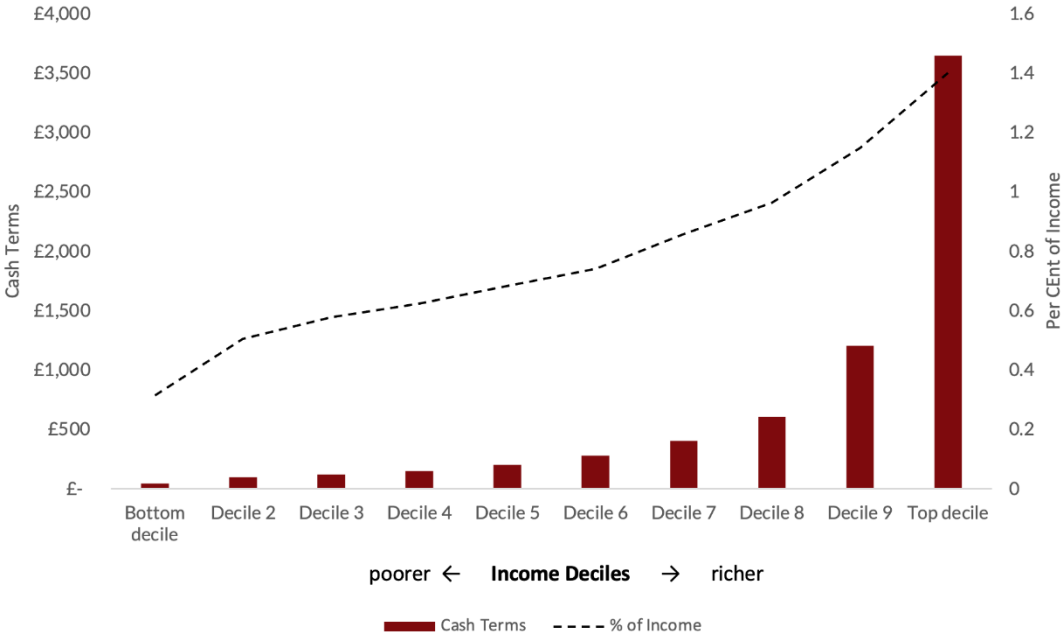
Figure 10b: Who gains from the energy price cap



Source: LINDA

We welcome the reversal of the 1.25 percentage rise in National Insurance Contributions (NICs), which [we argued against](#) because as a tax on labour it hit hardest the labour-intensive sectors that suffered most from the Covid-19 pandemic. We also welcome that the government has left in place the higher threshold at which employees start making NICs. While we note the Chancellor’s estimate that this reversal will save almost 28 million people an average of £330 per annum, our work highlights the distributional impact, with households in the bottom income decile paying £45 less and households in the top decile paying £3,600 less.

Figure 11: Who gains from the reversal in the NIC rate increase



Source: LINDA

The Chancellor also announced changes to Stamp Duty that will see the threshold raised to £250,000 for all home purchases and the threshold at which first-time buyers begin to pay Stamp Duty to £425,000. We welcome the reduction in transaction costs but the success of this policy depends on a substantial increase in new-built homes, otherwise the danger is that increased demand will translate into higher house prices.