Investment*Update*

4 March 2021

# Budget 2021: A lot of give and take

## More stimulus spending now, with the largest tax hike in decades to follow

The Chancellor has given the economy a much-needed, but nevertheless generous, fiscal boost this year. He has extended many of last year's emergency support measures, while implementing some new ones designed to stimulate the transition to a vaccinated world. Tax and spending decisions together will tally almost £60 billion in the 2021-22 fiscal year. However, he has scheduled the largest tax rise announced at any budget since 1993 to coincide with the moment that the economy is just about getting back on track. We think this is unnecessary and increases the risk of long-term economic scarring from the pandemic, cementing the UK's position as an economic laggard. Indeed, we thought the absence of international comparisons in the Chancellor's speech was quite telling.

**A recap**

By international comparison, the UK government rolled out an extremely generous support programme in 2020. But it needed to: the UK nevertheless had the second-worst economic fallout from COVID-19 among 42 developed and emerging countries that we monitored, as measured by the contraction in 2020's GDP relative to 2019's (only Spain fared worse). It has also suffered the second-worst health outcome to date, as measured by per capita deaths from the virus (second to Belgium). The latter tragedy fed into the former because the health outcome demanded more stringent restrictions throughout the year. In addition, because the UK has a larger consumer services sector than most other countries, it was more sensitive to such measures. Key sectors were already ailing before the pandemic, while the private sector was more indebted than many countries' too, increasing its fragility and limiting its propensity to bounce back.

UK firms' employment intentions have remained notably weaker than average, according to international surveys. And a Europe-wide survey of unemployment expectations shows UK households are more fearful, which correlates with a lower propensity to spend. While surveys of other countries' business investment intentions improved in the third quarter of 2020, and investment spending contributed more to GDP accordingly shortly after, in the UK they remained stuck at the lowest level since the survey began in 1997 – substantially worse even than during the financial crisis. They have risen in 2021, but remain weak.

While the highly successful vaccination programme should allow the UK recovery to start quickly from June, that recovery is likely to take longer to complete than elsewhere. Quarterly economic output is likely to exceed the pre-COVID level this year in the US, Japan and Germany, despite far slower starts to vaccination programmes in the latter two. By contrast, the Office for Budget Responsibility (OBR) forecasts that UK GDP will reach the pre-COVID high-water mark only midway through 2022. We think the risks around this prediction are skewed to the downside.

**A self-fulfilling prophecy**

Thereafter, the OBR predicts that economic output will remain permanently 3% below the pre-COVID *trend* (i.e. the size of the economy if the pandemic had not occurred). This is at the more pessimistic end of a range of professional forecasts. Disconcertingly, rather than trying to counter this prognosis with fiscal policy, the Chancellor has leaned into it. We think this risks turning a gloomy forecast, around which there is always considerable uncertainty, into a self-fulfilling prophecy.

We would have rather seen more policy measures to encourage long-term private sector investment to complement the significant increase in public investment set out at the November spending review. These could also have been built on (or at least elaborated by) the Chancellor but weren't. More government spending to help make the recovery more complete, and to step in where private sector spending – particularly business investment – is forecast to be deficient, is likely to pay off fiscally as well as economically in the long term by ameliorating the downside risks to the tax base and reducing the possibility of long-term economic scarring. As we set out in our Investment*Update* on government debt sustainability in November, balanced budgets are a matter of political expediency not economic necessity.

**Balanced budgets are a matter of ideology not economic axiom**

Ideology drove governments to austerity a decade ago, together with academic evidence that high government debt is associated with low growth. That academic evidence is much, much more contested now, especially the direction

of causality – it could well be that low growth leads to high government debt. By extending stimulus today, the government has partially learned the lesson of 2010's exceptionally premature fiscal tightening. But we believe it is a mistake to tighten when the economy is still forecast to be a long way below the pre-crisis trend. A safer approach would be to wait until the next Parliament, when monetary policy may have begun to normalise so that there is room to cut interest rates if tighter fiscal policy proves too much for the economy to bear (reversing a fiscal policy mistake takes a lot longer).

For sure, the national debt has risen to its highest level in more than half a century, and it will rise again to 109% of GDP by 2023. But – and this is a very important but – the cost of servicing it, expressed as a percentage of government revenues, is cheaper than it has been in the last three centuries.

Government borrowing costs have not been driven lower by the caprice of central bankers, or indeed much by the COVID shock to growth. They are low because both the real rate of interest and inflation have been driven lower since the 1980s by profound structural forces, such as demographic change, rising inequality, falling productivity and technological disruption. None of these forces are likely to have been reversed by COVID and some of them have been reinforced. In other words, while borrowing costs are likely to rise as the economy continues to normalise, they are unlikely to return to anything like the average of the last few decades.

With the second lowest debt burden among the G7 economies, its own currency and structurally low interest rates, UK public finances are sustainable. Concentrating on ensuring that economic growth exceeds the cost of debt servicing is, we believe, the better strategy. More money should be borrowed to invest in projects that will grow the future tax base. This, paradoxically, will improve fiscal soundness in the long run. The only major constraint is inflation, which we think is likely to stay tame for the foreseeable future as it falls back after a short, sharp spike in the spring (we'll write more on this in a forthcoming Investment*Update*).

**The giveaways**

Evidence from studies of historic economic and health-related shocks suggest that the main channels of long-term scarring this time are likely to be long-term unemployment and what's called 'belief scarring' – consumers left with a lower propensity to spend and, far worse, firms having a lower propensity to invest. The majority of the almost £60 billion of new tax and spending measures this year are aimed at combatting these perils and that was very pleasing to hear.

We note, however, that the outgoing fiscal year's borrowing to fund emergency measures has come in £40 billion lower than the OBR expected in November. This was due to higher-than-expected tax revenues and stronger-than-expected economic output at the end of 2020. Offset against this, £60 billion may be less generous than it seems, especially compared to the stimulus our friends in America and Japan have tabled, despite being much more indebted and much less damaged by COVID.

The furlough scheme will be extended to September, with only 10% employer contributions from July and 20% from August. Self-employed income support is also extended, and the 600,000 newly self-employed that were shut out of the scheme last year now have an opportunity to claim. Business grants of £5 billion are available to COVID-hit service and hospitality companies; business rates discounts are extended to December and the reduction on VAT applied to hospitality industries to September. A new recovery loan scheme will also commence.

To date, these schemes have successfully kept a lid on unemployment. But the latest ONS Business Impact of COVID Survey suggests that 15% of businesses have low confidence they will survive beyond spring. Clearly, the extra support was needed to ensure that future layoffs are made at a time when the rest of the economy is in better health.

More targeted schemes would have been preferable, to avoid propping up businesses that were failing before COVID. This may save jobs today, but it may also jeopardise job creation and wage growth further down the line. However, the UK is not alone in favouring a somewhat retrogressive approach to supporting business.

Unlike in the US, Germany or France, UK household disposable income has already been allowed to fall, so it was pleasing to hear the 2.2% rise in the National Living Wage was going ahead as planned and that the £20 a week uplift in Universal Credit has been extended until September. That said, removing this benefit at exactly the point that the OBR estimates unemployment will be at its highest seems perverse.

**Stamp duty**

The stamp duty cut has been extended again for all owner-occupiers. The initial cut certainly appears to have bolstered the housing market, but we are sceptical that it has had positive spill-overs into broader economic growth. And we doubt it is an efficient use of £1.5 billion of government funds. Sectors feeding off housing, such as homeware, are doing well by themselves, as they also are in other countries without equivalent tax cuts.

A pronounced positive correlation between house prices and consumption spending has been observed since the mid-1980s. However, economists dispute which way the causation runs, as well as the channels through which any causation from housing to consumption may operate. There are also questions about whether these channels would operate today after 15 years of exceptionally strong house

price growth and a plunge in home-ownership rates back down to mid-1980s levels, when the consumption effect was first meaningfully observed.

In a survey of economists in 2017, only 44% agreed that widespread weakening of the UK housing market would slow UK GDP growth significantly. An interesting international study published by the US National Bureau of Economic Research examined housing cycles in 19 developed economies. The authors found that house price depreciations can actually *raise* economic growth, as long as they do not trigger a financial crisis. The logic here is that *excessive* rises in house prices may crowd out investments in productive sectors, which reduce long-term economic growth. While nationwide house price growth over the last three decades can largely be explained by the fall in interest rates and the rise in personal income alone, that is not the case in the South East of England where house price appreciation could be deemed excessive.

Finally, this policy initiative isn't well-targeted. The economic fallout from COVID has had a strikingly disproportionate effect on younger or less affluent cohorts that are far less likely to own property. The rate of homeownership has fallen sharply among the under-45s over the last two decades (by almost 20 percentage points). The revival of an old mortgage-guarantee policy is unlikely to do much to reverse that trend.

**The future of corporation tax**

By far the biggest *single* stimulus measure announced in March was a 130% "super deduction" for business investment spending, particularly equipment and machinery. This costs the government £25 billion over two years. Extra incentives to invest in research and development and intangible assets associated with the new digital economy would also have been welcome, but this is still a good policy given that UK firms' investment intentions are lagging behind.

However, the policy will last only for two years. As a result, the OBR estimates that it won't increase the overall level of capital employed in the UK over the medium term, just the timing of its accrual. Recent analysis of the Bank of England's Decision Makers Panel survey suggests that the pandemic could reduce private sector productivity by c.1% in the medium term. Combined with the fact that business investment and foreign direct investment have lagged the UK's peers by a huge degree since the 2016 referendum, policies to permanently increase the rate of investment are sorely needed.

Yet the very large increase in corporation tax from 19% to 25% in 2023 is a disincentive. It is the first rise in the headline rate since Denis Healey's Budget of 1974. Because successive tax cuts since then also broadened the "tax base" (by eliminating loopholes, exemptions, etc.) the corporate tax take relative to the size of the economy has stayed relatively steady. The announced tax increase will not simultaneously narrow the tax base, and so the OBR estimates that corporate tax take *and* indeed the broader total tax take will reach a percentage of GDP not seen since 1969 or, before that, 1949.

The academic literature tells us that economic growth is far more sensitive to changes in corporation tax than it is to taxes on personal income, consumption or property. Still, it's important not to get carried away. A paper by HM Treasury modelled the long-run impact of the eight-percentage-point reduction in the corporate tax rate between 2010 and 2015. Its work suggests that GDP would be just 0.6% to 0.8% higher after 20 years.

The model probably underestimates the effect on foreign direct investment. The new tax hike could have a bigger reverse impact in the short term, particularly given the decrease in export competitiveness due to Brexit, while proving less harmful to long-term growth than some fear.

**Building back better**

In November, we applauded the ambitious plans for public net investment set out in the Spending Review, greatly increasing from £42 billion in 2019 to an average of £73 billion in the years between 2023 and 2026. The economic fallout from COVID, and the drag on productivity from Brexit could be eclipsed by a publicly backed wave of digitalisation, green energy infrastructure, as well as initiatives to raise productivity outside of South East England. Overall, public investment has been lower than in other leading economies in recent years, and investment in digital infrastructure still lags investment in transport, energy and utilities, which in turn lags the best performing advanced countries.

It was disappointing not to see more news on these plans in March. In particular, it was surprising not to hear any new investment measures to tackle inequality, a problem that we believe has likely been greatly exacerbated by the pandemic.

**Green bonds**

We did like the announcement of a new National Savings product linked to green public investment. This paves the way for green sovereign bonds, which we've been lobbying for in our quarterly trips to Whitehall for nearly a decade as members of the Investment Association's Debt Management Office (DMO). The DMO has indicated a green gilts issuance is likely this summer. Our head of fixed income remembers on an early occasion one peer of the realm looking over the top of his spectacles in a sceptical manner when he suggested the government should issue green gilts.

In more recent years the larger players around the table, with mandates from increasingly environmental, social and governance (ESG)-minded large pension funds, have also been calling for them. With other countries starting to issue green sovereign bonds the UK government has finally woken up to the idea that they could help meet climate change goals and objectives.

There are a lot of factors to consider. For green bonds, strict use of proceeds is required. In order to ensure that financing is used only for projects aiming to achieve an environmental and social benefit, the legal documentation for the green gilt should explicitly note how proceeds are being used. A separate account should be set up to monitor and track any proceeds that have not been allocated. However strict segregation of accounts is currently prohibited under UK legislation, so an amendment may be required to achieve this.

There should also be an audit committee that reviews the sustainability objective, what projects can use the cash, and environmental and social due diligence. Furthermore, the government should report on the use of proceeds in a full and transparent manner and seek certification of the bonds. Reporting should demonstrate allocation details as well as the impact of the investment of green-gilt proceeds, including performance against both qualitative and quantitative measures.

The project timelines over which bondholders are investing should ideally be linked to debt with similar maturity lengths. In the case of medium to long-term infrastructure financing, investors would expect these to be funded through the issuance of medium to long-dated green gilts. This would also allow investors, such as those managing pension funds, to meet their long-term liabilities. This in turn ensures that green gilts could finance vital environmental and social projects, while also helping the UK's citizens meet their long-term investment needs. The final question is whether they should be included in the Bank of England's (BoE's) QE (bond buying) programme. In the early days of issuance, we suspect the demand form ESG investors will be strong enough not to warrant it, but over time as issuance increases there is no reason the BoE should not be included.

Along with the International Capital Markets Association's widely used Green and Social Bond Principles, the government should consider a number of frameworks such as the UN Sustainable Development Goals, Nationally Determined Contributions (NDCs), determined as part of the Paris Agreement on climate change and the EU Taxonomy for Sustainable Activities principle of 'Do No Significant Harm'.

**First small step in a long journey**

The overall market reaction to the Budget was muted. The pound was more or less unchanged on the Chancellor's announcements. More stimulus today, but tightening further down the line, leaves expectations for monetary policy more or less unchanged too. The risks of baking in a permanent economic loss could begin to weigh on the pound, but our long-term currency valuation frameworks suggest the outlook is still one of appreciation (we don't believe currency forecasts can be made with sufficient certainty over the short term).

A greater supply of bonds in the short term caused minor volatility in the gilt market and yields may increase by a small amount. But, again, we do not foresee this budget proving particularly game-changing for gilts.

As for equity markets, the Chancellor hasn't changed our preference for companies that earn their revenues overseas. Our equity research team will be working hard over the next few days to understand how the impending tax changes may alter the outlook for individual companies, both in absolute terms and relative to the overall market.

In this next section, our financial planning team discuss the personal finance implications.

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**Financial planning implications**

As the chancellor noted, it will take many governments many decades to repay the cost of the pandemic, and he made the case for starting this journey now. But as is the case for this Budget, even the most epic journeys can start with a small step; changes to tax regimes were very limited.

**Keeping personal tax promises?**

The chancellor has maintained the pre-pandemic promise not to raise the rates of income tax, national insurance or VAT. But the chancellor plans to raise tax *revenues* by freezing the personal allowance at £12,570 and the higher rate income tax threshold at £50,270, from April 2022 to April 2026.

A freezing of the basic and higher rate of income tax from next year through to April 2026 will impact those on lower incomes, which feels at odds with the 'levelling up' agenda. The Chancellor's promise that 'nobody's take home pay will be less as a result' relates to their nominal pay rather than real value. That could ultimately be eroded by inflation, which we'll be writing more about in an Investment*Update* coming soon.

The adult ISA annual subscription limit for 2021-22 will remain unchanged at £20,000 and the Junior ISA (JISA) and Child Tax Fund allowance will also remain unchanged at £9,000. JISAs give children control at 16 and access at 18, an ideal way to teach children about money and investing.

**Pensions 'stealth tax'**

The pensions lifetime allowance has been frozen at £1,073,100 until April 2026. Pension tax relief has otherwise been left alone. But we see this as essentially a stealth tax that runs the risk of driving people away from pensions to other tax efficient savings.

**Savings tax frozen too**

Despite recommendations to the contrary by the Office of Tax Simplification, no changes to the capital gains tax regime were announced. The annual capital gains tax allowance will be frozen at £12,300 for individuals (and personal representatives) and £6,150 for trustees of settlements, until April 2026.

The band of savings income that is subject to the 0% starting tax rate will remain at its current level of £5,000 for 2021-22. The starting rate for savings is aimed at supporting savers on incomes of less than £17,570 for 2021-22.

**Inheritance tax: planning is key**
The inheritance tax (IHT) nil-rate bands will also remain at existing levels until April 2026. That gives certainty to consumers. But if families' wealth increases along with a recovery in the economy, so could their IHT liabilities. That makes financial planning all the more important for families wishing to pass on a legacy to younger generations.

The nil-rate band will continue at £325,000, the residence nil-rate band will continue at £175,000, and the residence nil-rate band taper will continue to start at £2 million. Qualifying estates can continue to pass on up to £500,000 and those of a surviving spouse or civil partner can continue to pass on up to £1 million without an inheritance tax liability.

**Enterprise tax unchanged**
The business asset disposal relief, where entrepreneurs pay a reduced 10% rate of capital gains tax on qualifying disposals, remains unchanged with a lifetime limit of £1 million.

**More support for home buyers**
The government will extend the temporary increase in the residential stamp duty land tax nil-rate band to £500,000 in England and Northern Ireland until 30 June 2021. From 1 July 2021, the nil-rate band will reduce to £250,000 until 30 September 2021 before returning to £125,000 on 1 October 2021.

The government will also introduce a new mortgage guarantee scheme in April. This will provide a guarantee to lenders across the UK who offer mortgages to people with a deposit of just 5% on homes with a value of up to £600,000. The scheme will be available for new mortgages up to 31 December 2022, increasing the availability of mortgages on new or existing properties for those with small deposits.

**COVID: who will pay the cost?**
The chancellor has chosen to strengthen the public finances with an investment-led recovery plan with various incentives for firms to drive new growth in the economy. The government expects the recovery to be durably underway by April 2023, at which point corporation tax on company profits will rise from 19% to 25%. But the rate will be kept at 19% for about 1.5 million smaller companies with profits of less than £50,000.

**Is that it?**
Not quite. As noted in the Budget, the government intends to hold some separate consultations on tax policy, which will be outlined in more detail in a paper due out on 23 March 2021. This may look at the reformation of tax regimes such as council tax and stamp duty land tax. But the Chancellor has so far ignored calls from the Office of Tax Simplification to implement sweeping changes to the inheritance tax and capital gains tax regimes. So we will have to wait and see if he decides to act on the proposals later this month.

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# Contact us

If you would like further information or to arrange an initial meeting, please contact us on 020 7399 0000

Head Office
8 Finsbury Circus, London, EC2M 7AZ

For ethical investment services:
Rathbone Greenbank Investments
0117 930 3000
rathbonegreenbank.com

For offshore investment management services:
Rathbone Investment Management International
01534 740 500
rathboneimi.com

@Rathbones1742

Rathbone Brothers Plc

Rathbone Brothers Plc