

TAXES ARE COMING FALL 2021 UPDATE ON THE UK ECONOMY

Jean-Luc Proutat

After paying a heavy toll to the Covid 19 pandemic, the UK is getting back on its feet.

Now that more than 80% of the adult population has been vaccinated, the UK economy was able to reopen for business this summer and to operate almost normally despite the spread of the highly contagious Delta variant.

Just as the recovery is running up against supply-side constraints, the government of Boris Johnson is removing fiscal support measures as it proclaims the end of "whatever the cost".

Euphoric so far, the recovery should calm down somewhat by the end of the year.

The UK is finally getting back on its feet. Covid-19 was initially brushed aside by Prime Minister Boris Johnson before forcing the government to implement ever tighter restrictions. The pandemic triggered the worst recession in UK history (2020 GDP plummeted 9.8%) and caused 135,000 deaths, one of the heaviest tolls of the advanced economies. Now that more than 80% of the adult population has been vaccinated, the UK is finally exiting the crisis. Though still in the grips of the Delta variant, which is 40-60% more contagious than its predecessor, the "English" variant (renamed Alpha), the hospital system has reported only a mild upturn in severe cases (with at most 800 hospital admissions daily, down from nearly 4,000 at the height of the previous wave). With the reopening of business in phases since February, the economy has rebounded spectacularly, and has rapidly encountered supply-side constraints.

SUPPLY AND PRICING PRESSURES

Q2 2021 not only marked the end of a strict lockdown – it was even more severe than the one introduced during the first wave of the pandemic in spring 2020 – but was also a period of catharsis, during which British consumption surged at an annualised rate of more than 30%, and businesses bounced back, easily erasing the losses earlier in the year.

As in other countries where households benefited from massive support measures, curbs on spending led to the build-up of surplus savings, which are now flowing back into the economy. Indeed, demand is so strong that supply is struggling to keep up: in transportation, construction and throughout supply chains, delivery periods are getting longer and bottlenecks are forming. Companies are experiencing hiring troubles, even in recovering sectors like tourism and leisure, where job vacancies have reached record highs.

Of course, this is not a specifically British problem. It can be found just about anywhere due to a global shortage of components (Asia, the main supplier, is still struggling with the virus), congested maritime traffic, and commodity market pressures by China and the US. Yet in the UK, supply-side constraints have been exacerbated by Brexit, whose harmful effects are already palpable. With the return of immigration barriers to keep out European Union workers (visas, work permits, etc.), the obstacles to hiring and the recovery are not only cyclical. According to the Confederation of British Industry, the labour shortage could last two years.

These tensions are now carrying over to prices. At 3.2% in August, inflation has beaten the odds and soared to the highest level since 2012. Although base effects are to blame¹, the surge can also be attributed to the fact that coffee shops, hotels and restaurants were forced to operate at reduced capacity, leaving them no choice but to raise prices to meet the inflow of customers. The lifting of lockdown restrictions is also illustrated by strong pricing pressures on cars, notably used cars, much like the situation observed a few months ago in the United States.

¹ The acceleration in inflation in August 2021 can be attributed in part (for 0.3 points) to the fact that prices are compared to the very low levels of August 2020, which is notably when the government launched its "Eat Out to Help Out" scheme that allowed bars and restaurants to propose discounted meals under certain conditions.

ECONOMIC RESEARCH



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With the upcoming VAT hikes (see below), the Bank of England (BoE) expects inflation to reach 4% by the end of the year, largely surpassing its 2% target. This inflationary surge is nonetheless expected to be short lived, and the central bank does not intend to raise its base rate, currently set at 0.10%, until the economy has fully recovered. That condition has not been met yet. Although midway through 2021 economic activity is nearing pre-pandemic levels, there is still a shortfall of a little over 4 points of GDP. Yet closing the remaining gap is likely to be much harder, since the Johnson government plans to begin removing fiscal support measures this fall and to raise social welfare contributions in April 2022.

THE END OF “WHATEVER THE COST”

In the UK, like in most of the “liberal” advanced economies (such as the US, Canada and Australia), public support measures deployed during the health crisis have helped offset the relative weakness of social welfare shock absorbers. They have proved to play a vital role. According to estimates by the International Monetary Fund (IMF), the UK injected no less than GBP 340 billion (16 points of GDP) into the economy in 2020-21, a record for Europe. Although “whatever the cost” is no longer fully justified, its removal will nonetheless serve as a test case.

Fiscal support measures have already begun to be withdrawn. At the end of September, the government ended its main job retention schemes, namely the Coronavirus Job Retention Scheme (CIRS) and the Self-Employed Income Support Scheme (SEISS). Introduced in March and April 2020 these two programmes benefited roughly 14.5 million workers (payroll employees and the self-employed) and largely helped reduce the rise in unemployment, which barely rose above 5% at the height of the crisis. As the economy has recovered, these schemes have been allowed to expire. But for the 1.6 million employees still furloughed in their companies, this could prove to be a difficult awakening.

If the current labour shortage can facilitate the transition, things did not stop there. In addition to the job subsidies, the GBP20-a-week boost to universal credit was also eliminated for some 6 million British citizens. Moreover, all households will be hit by the increase in the reduced VAT rate for hotel and restaurant services (to rise from 5% to 12.5% in October 2021, then to 20% in April 2022). And the stamp duty holiday was reduced from GBP 500,000 to GBP 250,000 in July, and will be slashed to GBP 125,000 in October.

NO “SINGAPORE-ON-THAMES”

Last March, Rishi Sunak, the Chancellor of the Exchequer, announced that the corporate tax rate would be raised from 19% to 25% as of 1 April 2023, raising some grumbles from Brexit supporters who had been dreaming of a “Singapore-on-Thames”. The government’s plans, which aim to raise roughly GBP 12 billion in additional revenues annually, is not anecdotal. Granted, it only applies to a minority of companies (the 30% that report earnings of more than GBP 50,000 a year) and will be offset during the previous two fiscal years (2021-22 and 2022-23) by a “super tax deduction” equivalent to 130% of fixed capital investment. Even so, it is the first corporate tax hike since 1974, when the Labour government of Harold Wilson raised to corporate tax rate from 40% to 52%, and an earth-shaking move within the Conservative party, which has always made corporate tax cuts the hallmark of its policies.

Lastly, to support the National Health System (NHS), whose spending soared by roughly GBP 100 billion (2.5 points of GDP) during the

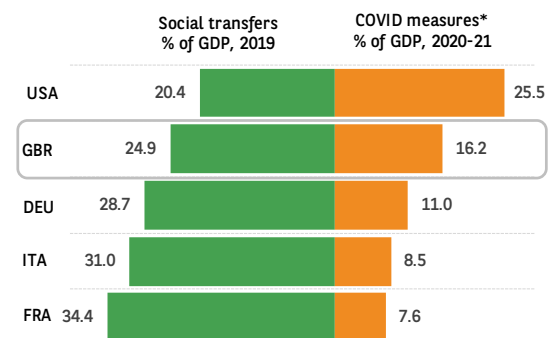
pandemic, Prime Minister Boris Johnson intends to raise the social welfare contribution by 1.25 points for employers (from 13.8% to 15.05%), employees (from 12% to 13.25%), and on dividends (from 7.5% to 8.75%). Effective as of April 2022, the permanent measure should generate additional revenues estimated at GBP 12 billion a year. It would also halt the erosion of NHS revenues, which as a share of GDP have declined constantly since 2010.

Already perceptible through the drop-off in real estate transactions and the downturn in purchasing manager indices (PMI), the slowdown in the economy is keeping pace with the shift in government policy. As it translates into growth figures, the economic slowdown could be especially visible by the end of the year, as the upturn in inflation erodes household purchasing power.

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THE GREAT MEANS



*Budget transfers excluding loans and guarantees

CHART 1

SOURCE: IMF (FISCAL OUTLOOK), OECD

TOWARDS A CALMING DOWN OF THE ECONOMY

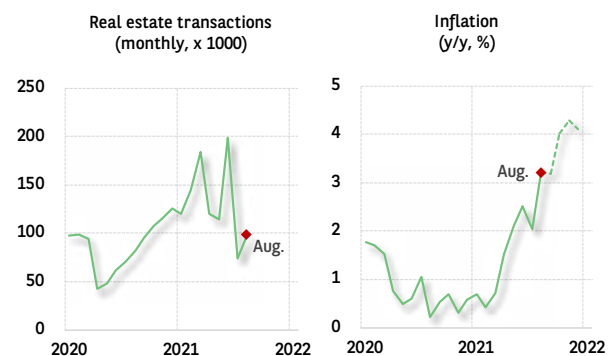


CHART 2

SOURCE: ONS, BNP PARIBAS





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