New Minerva Report

Gordon's Failure

Benjamin Franklin once said: "In this world nothing can be said to be certain, except death and taxes." After reading all the twists and turns in Gordon Brown's 2004 Budget you can see exactly what he meant. Overall, the budget was much as expected. The pre-budget speech in 2003 afforded us much of the detail. Many political commentators believe that this will be the last budget before the next general election. Hence the one- off £100 gift to the over 70s, to help them with their council tax.

Gordon can be proud of one thing, he was right about his prediction for GDP Growth last year. Most commentators thought that his projections for growth of between 2% to 2.5% were too optimistic; we thought so ourselves. In fact growth came in at 2.3%, meeting the Treasury's target. So it would be a foolish person that would not argue that the projections of 3 to 3.5% for this year and next will not be met. Some of our indicators are suggesting that growth will slow later this year and next. Whilst we don't wish to look foolish, we think the Treasury's projections are too optimistic. Which probably means that the political commentators are right, and an election could be earlier than some think. It would be better to jump early, than wait for an economic slowdown that would start to unwind all your economic 'prudence' since 1997. The stock market would be an early warning signal for this potential, as it tends to foresee economic slowdowns six to nine months in advance.

Talking of 'prudence', one subject about which Gordon has become slightly less vociferous, is the budget deficit. This is hardly surprising. We looked back over his last four budgets to see what predictions the Treasury were making for future budget deficits. We see in the 2001 Budget he predicted a surplus of 8bn, and in the 2002 Budget a surplus of £9bn. In 2003's Budget he predicted a deficit of £8bn. Finally with this Budget he suggests the outcome will be around £21.3bn. So in just four years, the prediction for 2004 has gone from a surplus of 8bn, to a deficit of £21.3bn. How prudent is that? This is why gilt issuance will rise from the £13.7bn in 2000, to greater than £50bn in both 2006/7 and 2007/8. It is only the desire of pension and life funds to move away from investing in shares towards the predictable income streams offered by fixed interest securities, that gilts have not fallen further.

Very simply the Treasury are not estimating their tax-take properly. This looks as if it will get worse. The Budget is predicting that the tax-take will grow faster than nominal GDP. It thinks revenues will grow by 8% year on year. The problem is, much of the UK's growth is coming from the public sector, which produces less tax revenue. So we can all expect taxes to rise in future (after an election). Tax avoidance schemes like those for IHT are already under attack. Very few home owners will be able to avoid IHT in the future.

The Budget did take some observers by surprise, in that it did nothing to try and slow the upward move in house prices. After the first increase in interest rates by the Bank of England in November, it looked as if house price inflation was easing. Despite a second increase, prices have started to re-accelerate in the first two months of this year. This is disturbing for the longer term. Firstly, it means that Gordon Brown has placed the problem firmly on the shoulders of the Bank of England. He does not want to be seen as the nasty politician that spoiled the party.

Secondly, the market is being pushed higher by an increase in buy-to-let purchasers. These are filling in for the lack of first time buyers, who can no longer afford to step onto the property ladder. These are not the professional buy-to-let buyers that were the main participants in the market five years ago. This is a new breed of 'investor' who do not believe that buying a property carries with it any risk of losing money. In fact there is anecdotal evidence that the buy-to-let professionals are selling-on to this new breed of buyer. The problem is that, as we have seen in Australia, these trends can go on for some time. Down-under, the buy-to-let grew to be nearly 50% of all new mortgages last year. One in six households has an 'investment' property. It is estimated that household debt has risen to 140% of disposable income. In the last quarter, Australia's equivalent to the Bank of England, the Reserve Bank of Australia raised rates twice, partly to cool the housing market. In the same period house prices continued to surge. Only recent data suggests that things may be on the turn. New mortgage lending fell by 16% in January. It was rising by 30% last autumn. There are the first signs that prices are falling in Sydney and Melbourne. At the moment it looks as if we are at least a few months behind them. We are not helped by the rising stock market, which has meant that city personnel are once again buyers in London. The problem the Bank of England has is it does not want to create the straw that breaks the camel's back. Interest rates are a very

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