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Investment Event

UK Budget: a policy tightrope

UK Chancellor Sunak has announced an increase in corporation tax to 25% in 2023 from 19% currently, but has also extended important income support measures

The Treasury has made its first major step in signalling its intention to gradually fix the UK's battered public finances

Higher corporation taxes could weigh on growth, but the tax rate in 2023 will still be lower than the current G7 average

Our views

Amid a successful immunisation programme, the UK is well-placed to generate a strong economic recovery this year. We believe an overweight view on UK equities remains justified, although are cognisant of potentially subdued returns

Chancellor Sunak lifts taxes, but extends income support

In his annual Budget speech on 3 March, UK Chancellor Rishi Sunak announced that levels of taxation would rise in the coming years in order to close a gap in the public finances created by the Covid-19 pandemic. In particular, the rate of corporation tax will rise to 25% in 2023 from 19% currently, and income tax thresholds will be frozen from 2022 until 2026, meaning income taxes paid will go up as wages grow.

Importantly, however, income support measures remain in place. The UK Job Retention Scheme – which pays up to 80% of furloughed employees' wages – has been extended until September, protecting household finances as pandemic-related restrictions remain in place.

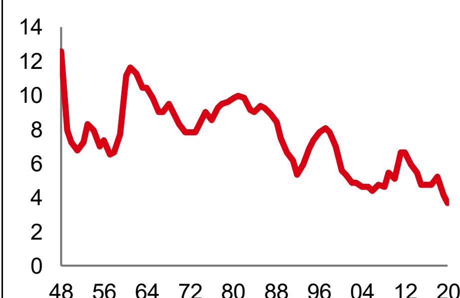
No rush to consolidate public finances

The Treasury has made its first major step in signalling its intention to gradually fix the UK's battered public finances. However, **it is facing a policy tightrope**. Taxation weighs on economic growth, so with UK economic activity still depressed amid a virus-related lockdown, the Treasury is significantly constrained in how much it can attempt to narrow the budget deficit.

Positively, however, features of the UK's public finances mean that there is limited pressure on the Chancellor to quickly consolidate public finances:

- **UK debt interest costs are very low** despite high and rising levels of public debt (see Figure 1)
- **The average maturity on UK gilts is around 15 years**, over twice as long as in many other developed countries. This cuts the risk of a steep rise in debt servicing costs when gilts are refinanced
- **Bank of England asset purchases of GBP 250bn have absorbed over 70% of new UK government borrowing since March 2020**. The Bank of England is unlikely to unwind its bond holdings in the near-term

Figure 1: UK debt interest (% of tax revenues)



Source: Office for National Statistics, as of 3 March 2021

Although higher corporation taxes announced in this budget could weigh on business investment or pass through to lower wage growth for employees, they only apply to large firms and take effect in two years. In 2023, UK corporation tax will still be lower than the current G7 average. Meanwhile, in a move that is likely to support the economic recovery, the Chancellor announced that firms will be able to reduce their corporation tax bills over the next two years by up to 130% if they increase investment commensurately.

Investments, annuity and insurance products

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Macro and market considerations

Overall, following the policies announced in the Budget we maintain our view that the UK is well-placed to generate a strong economic recovery from Q2 2021. We expect the successful vaccine rollout to lead to a gradual and durable lifting of restrictions, releasing pent-up demand as households run down savings accumulated over the past year.

- In this context, we think it makes sense to remain overweight UK equities, which are exposed to cyclical sectors that typically benefit from periods of strong economic growth. UK equity indices are also tilted to multi-national companies that can benefit from the wider global economic recovery (the "restoration economy" theme we have highlighted before)
- Nevertheless, we should be aware that potential returns could be limited by the strong rally witnessed in recent months and concern over possible bad news on Covid mutations in the future. There is also the risk that the Treasury announces more significant tax rises next year, or policy support is withdrawn too early

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