

The Unavoidable Budget

22 June 2010

What's the politics?

The Chancellor proved today that the Coalition Government means business with the acceleration of the structural deficit reduction programme in order to balance the books by 2015/16. George Osborne is no doubt aware that this is the furthest he will be from a general election date and did not avoid deep cuts to the welfare budget or an increase in VAT. Simplicity won the day with the Chancellor choosing, for example, to freeze child benefits rather than limit their application. He also cited simplicity when justifying his changes to Capital Gains Tax. While he has attempted to spare the less well-off from the harshest of the new proposals, all groups of society will feel the squeeze. In response, Labour seemed unclear where to direct their fire – should they attack the Liberal Democrats for the VAT rise (unlike George Osborne, Nick Clegg specifically ruled out a rise while in Opposition) or the Conservatives for delivering an 'old Tory' package?

The Chancellor showed the courage of his convictions today with a Budget consistent with his philosophy set out in Opposition. It's coherence as a set of tax reforms and spending cuts will make it easier to defend and explain (at least for Conservative MPs) than many might have expected given the state of the public finances.

Osborne has said the test of this Budget is not tomorrow's headlines, but how it is perceived in five years. To reap the political benefits depends on maintaining the Coalition for long enough to create the scope for lower taxes. That is the next challenge facing Cameron and Clegg...

Economic overview

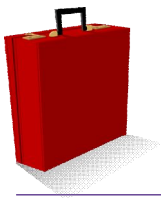
Unsurprisingly, the Chancellor took an early opportunity to blame the previous government for the 'unavoidable' nature of the Emergency Budget and took pleasure in informing the House that Gordon Brown's golden rule had been missed by £485 billion in this cycle. The Coalition Government, he pointed out, has been left with the second largest deficit in Europe, after Ireland.

key facts and figures...

- The UK is set to miss the previous government's "golden rule" in this cycle by £485bn.
- The structural current deficit "should be in balance" by 2015-16.
- The measures are forecast to result in public sector net borrowing of £149bn this year, £116bn next year, £89bn in 2012-13 and £60bn in 2013-14. Mr Osborne said by 2014-15 borrowing would reach £37bn, falling to £20bn in 2015-16.
- There would be no further reductions in capital spending totals in this Budget but "careful choices" would be made about how it was spent

Tax

- VAT rises to 20% from 17.5% from January 2011. Food, children's clothing and other VAT-free items remain exempt from VAT for the current Parliament



But the surprise package in Osborne's speech was how quickly the Coalition Government intends to deal with the situation. This would be through focusing on spending cuts (77%) rather than increased tax revenues (23%). A Guardian/ICM poll suggested that as many as three quarters of the public backed spending cuts rather than tax rises to bring the deficit under control.

Growth forecasts

Interestingly, today's updated growth projections from the Office for Budget Responsibility (OBR) had been revised downwards for 2011, from 2.6% to 2.3% for 2011, taking into account the measures announced in the Budget. Treasury forecasts in March suggested that the economy would grow between 3%-3.5% in 2011.

The new forecasts for later years in the five year cycle were, however, higher than the OBR predicted last week, with stronger growth expected in the years up to 2015.

Departmental spending cuts

Taking into account the Government's aim to deliver a balanced budget by 2014/2015 and the revised forecast, Osborne outlined the need for dramatic departmental spending cuts. The detail was deferred until the Spending Review, set for 20 October, but he announced that unprotected departments, other than health and international development, would face an average real cut of around 25% over the next 4 years. Defence and education were highlighted as priorities where cuts may not be as deep, and Osborne promised that there would be no further capital expenditure reductions as a result of the measures. He set out his belief that savings can be made on projects already underway as well as by cancelling planned work.

Tax changes

The Chancellor was apologetic but firm about the need to raise taxes, saying in his statement that he believes in low taxation. In order to achieve this he has had to raise taxes across the board with the main revenues coming from an annual levy on the banks and a rise in VAT.

VAT will rise by 2.5% to 20% from 4 January 2010. The Government will not extend the tax to items currently taxed at zero or at the reduced rate of 5%, allaying fears expressed by the retail industry that everyday items would be included in VAT's net. While a rise in VAT was expected, many had expected the increase to be staggered or introduced at a later date than was announced. This will raise about £12.5 billion in additional revenue by the end of this Parliament.

Harriet Harman, the Leader of the Opposition, said the VAT increase was regressive and would hit the poor hardest. She described it as a 'broken promise' from the Lib Dems to not raise the rate. Meanwhile, the Chief Secretary to the Treasury Danny Alexander argued that, without it,

- **Capital gains tax to rise for higher-rate taxpayers to 28% from midnight but remains at 18% for basic-rate taxpayers. The capital gains tax exemption limit remains at £10,100 this year**

- **The personal income tax allowance has increased by £1,000 in April to £7,475 while higher rate income tax rate remains frozen to 2013/14**

Growth

- **The UK's economy is forecast to grow by 1.2% in 2010, 2.3% in 2011 and 2.8% in 2012**

Spending

- **Government spending will be £637bn in 2010/11, increasing to £711bn in 2015/16**

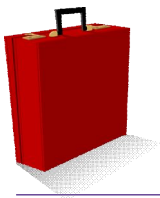
Banking

- **The Chancellor confirmed that there will be a UK bank and building society levy from 2011. The Levy will also be imposed upon UK operations of foreign banks, This is expected to raise more than £2bn a year and will not affect smaller banks**

Business

- **Corporation tax is cut to 27% next year, falling by a further percentage point a year for next three years to 24% by 2013**

- **The small companies' tax rate is to be cut to 20%**



departmental budgets would have to be cut even more steeply.

As set out in the formal Coalition Agreement, the Government pledged to reform **Capital Gains Tax** to align it more closely with income tax rates. The tax was widely debated in the run-up to the Budget and vehemently opposed by the right of the Conservative Party, responding to speculation that the top rate could rise to 40%.

There was little doubt that CGT would be increased, the question was to what level and with what exemptions and reliefs to satisfy all sides of the Coalition. Effective from tonight, CGT will rise from 18% to 28% for higher rate taxpayers. Basic rate taxpayers will continue to pay an 18% rate on their gains. The Chancellor ruled out tapering, claiming it would add too much complexity. The 10% CGT rate for entrepreneurs remains untouched and will be extended to the first £5 million of capital gains from the current £2 million. For individuals, the Annual Exempt Amount for CGT will remain at £10,000 for 2010-11 and will continue to rise in line with inflation.

The net take from these CGT changes will be less than £1 billion. The changes were, however, a key Liberal Democrat demand and part of the compromise the Conservatives have had to accept for Coalition Government.

In the spirit of Coalition politics the government has raised the **income tax** allowance by £1000 so that anyone earning less than £7,475 will be exempt from paying from April 2011, taking 880,000 of the lowest earners taken out of income tax altogether. The Liberal Democrats made a manifesto commitment to raise the threshold to £10,000 but that would have been too expensive a concession to make when the treasure chest is empty. The top rate of tax for those earning over £150,000 per annum, which came into effect in April this year, will remain in place until the end of this parliament and is expected to raise £9bn for the coffers by 2013/14. The basic rate of income tax will be frozen in 2013.

National Insurance contributions (NIC) will increase by a percentage point from April 2011, as instigated by the previous Government. The Budget reverses planned increases for employer NIC by raising the threshold by £21 a week above indexation. To encourage business growth, the government have factored in some relief for companies set up in certain areas of the country (outside London and the South East) over the next three years. They will enjoy a NIC holiday for their first year of operations for the first ten employees hired, in a scheme to start no later than September 2010.

Osborne also announced a freeze in Council Tax in England for local authorities who have been successful in cutting spending. Details on how this will work are yet to be released.

A key plank of the Chancellor's fair budget and a certainty to be included today was a **levy on the banks**, which will be in place next January. The news that France and Germany are to introduce a levy provides cover from the accusation that acting outside of the G20 will damage the UK's

- The 10% Capital gains tax rate for entrepreneurs is extended to the first £5m of qualifying gains

Public sector cuts

- The basic state pension will be linked to earnings from April next year, while the Government will accelerate the increase in state pension age to 66

- There will be a two year pay freeze for public sector workers

Welfare reform

- Child benefit is to be frozen for next three years and removed from families on an income of more than £40,000

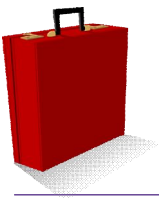
- Tax credits are to be reduced for families earning more than £40,000 while housing benefit restricted to maximum £400 a week

Unemployment

- Unemployment is set to peak at 8.1% in 2010/11, falling each year to 6.1% in 2015

'Sin' taxes

- There will be no new increase on alcohol, tobacco or fuel



competitiveness.

The levy will be on balance sheets, rather than on profits. Although the Treasury will consult on the shape of the tax later this year, it proposes that the levy will be set at a rate of 0.07 per cent, with a lower initial rate of 0.04 per cent in 2011. Based on these figures, Osborne has estimated that the levy will raise in the region of £2bn per year.

It was rather less clear exactly what the Chancellor would announce as part of his pledge for “further restraint on **pay and bonuses**”. There is no immediate action in this area, with Osborne instead wanting to analyse the costs and benefits of the IMF’s proposed Financial Activities Tax on profits and remuneration, with a view to global coordination. This will be in addition to requests to the FSA as part of its forthcoming review of the remuneration code

Other tax changes include an increase in the insurance premium from 5-6% from next year. This will see the cost of home, travel and motor insurance increase and spark fears of under-insurance in each of these areas.

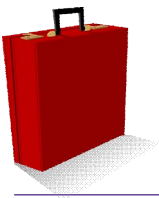
Wielding the Axe

With a budget of £190 billion a year it was inevitable that welfare spending would be targeted for significant cuts. Ahead of the Budget, Osborne warned that the **welfare bill** had got ‘completely out of control’ and needed to be tackled to protect spending in other areas. The plans announced today will deliver savings of £11bn by 2014/15.

In a move which will be attacked as penalising the poorest in society, he announced that **benefits and tax credits** will be uprated on the basis of the Consumer Price Index (CPI) rather than the Retail Price Index (RPI) measures of inflation. This will deliver savings of £6bn a year. In a sign of a tougher approach, medical assessments will be introduced for all Disability Living Allowance claimants from 2013-14. While child benefit will remain a universal benefit, it will be frozen for three years. The Chancellor sought to mitigate criticism by curbing the so-called ‘middle class welfare’ bill by cutting tax credits for families earning over £40,000.

Having vigorously rebutted Labour’s claims during the election that benefits for the elderly, such as the winter fuel allowance, would be cut, the Chancellor decided the political price of removing what independent commentators consider poorly targeted spending was too high.

Today announcements are only the pre-cursor to more radical reforms. David Cameron has argued that the only way to reduce spending in the long term is by reducing demand for state services. The Comprehensive Spending Review will be used to set out a fundamental rethink of welfare to make work pay and reduce a budget that increased by 45 per cent in real terms under the last government.



It had been widely trailed that **public sector pay and pensions** would be in the firing line alongside cuts in welfare. In his statement to the House, the Chancellor announced that the public sector pension bill was set to place a burden of £10bn a year on the public purse simply to meet the gap between pension contributions and payments to the unfunded pensions that they support. Rather than make any recommendations for rectifying the situation immediately, the Chancellor announced that these “spiraling costs” will come under scrutiny by an independent review led by former Labour DWP Minister John Hutton, described by Osborne as an “unbiased” voice. The Commission is set to produce an interim report by September with a full set of recommendations for next year’s Budget

The Chancellor announced a pay freeze for public sector workers, but making important changes to pre-election pledges. The freeze will now last for two years, up from the initial estimate of one year. To soften the blow of the extended freeze, and in the interests of presenting a ‘fair’ budget, Osborne announced that those earning under £21,000 (and not the £18,000 which originally mooted) would be exempt from the freeze. This group will enjoy a pay rise above the rate of inflation of at least £250 a year over the next two years.

To explore the longer-term changes needed to make public sector pay fairer and more sustainable, Osborne also re-announced an independent review, to be headed up by economist Will Hutton. The Government has asked Hutton to make recommendations to the Chancellor and Prime Minister by March 2011 on promoting pay fairness in the public sector by tackling disparities between the lowest and the highest paid in public sector organizations. An interim report is expected in the autumn.

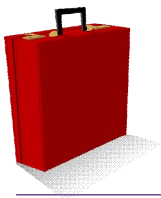
Pensions and Savings

As anticipated, the Chancellor announced a restoration of the link between basic state pensions to earnings from April 2011. Pensioner income will also be protected by a new “triple lock” system which will guarantee an annual rise in the basic state pension in line with earnings, prices or a 2.5 per cent increase – whichever is the greater.

The Chancellor said that that he will review the taper on pension relief for higher rate taxpayers, suggesting an annual allowance of up to £45,000. While industry will welcome the move, it will no doubt be pushing for a higher threshold to encourage further pension savings.

The Government will also accelerate the process for increasing the State Pension Age to 66. A call for evidence will be launched later this week followed by a short consultation on how the Government quickly intends to phase out the Default Retirement Age from April 2011.

The Budget has made no mention of the review into the National Employers Saving Trust (NEST) which Pensions Minister Steve Webb has recently alluded to. Also of disappointment to the insurance industry will be the discontinuing of the Saving Gateway which saw the Government match savings for lower-earners.



Supporting business and fostering competitiveness

Amid the clouds of an austerity budget, Osborne tried to identify a silver lining for business, focussing much of his speech on re-opening Britain for business, and unleashing private sector potential to drive economic growth.

As expected Osborne unveiled ambitious plans to improve Britain's competitiveness, with a widespread tax and regulatory liberalisation programme that survived the Coalition negotiations. **Corporation tax** will be cut to 27% on 1 April 2011, and by 1% annually for the next three years, until it reaches 24% in 2014-15, giving the UK the lowest rate of corporation tax in the G7 and the fifth lowest rate in the G20.

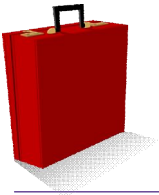
At the heart of economic recovery was government support for SME's to foster and enterprise based recovery. To this end the Chancellor extended the **Enterprise Finance Guarantee Scheme** by £200m to support additional lending of up to £700m for small businesses until March 2011. In addition the Government plans to implement a 20 business day processing target from all major lenders participating in the scheme.

The Government expressed its commitment to work with the banking industry to increasing **bank lending**, a measure to be fleshed out when the Business Secretary Vince Cable details further proposals to expand the availability of credit in a Green Paper on Business Finance due out before the summer recess. The consultation will consider a range of financing options including bank lending, equity and corporate debt, and will invite views from business, investors and lenders.

Non-bank lending to SMEs is being boosted by the creation of a **Growth Capital Fund** - a measure announced in the previous government's final Budget. A new **Enterprise Capital Fund** will be launched, providing an extra £37.5 million in equity finance for growing businesses. This will form part of the existing £237 million Enterprise Capital Funds programme.

Certain SME sectors were highlighted: for small businesses in the tourism industry, the Chancellor pledged to reinstate the favourable tax rules for furnished holiday lettings. He also announced measures to cancel certain backdated business rates bills, including for many businesses in ports. The Budget reiterated a number of existing policy commitments, such as plans to introduce greater transparency in government procurement, to increase the number of SMEs that bid for government contracts; and the commitment to a full review of IR35 and small business tax (further details are to be released shortly).

The Coalition Government will also reform Labour's complex **Controlled Foreign Companies** (CFC) rules that have 'driven businesses overseas', and will consult on interim improvements to the current rules to be introduced in the Finance Bill 2011. However, the final



updated rules will be legislated the following year allowing the Treasury time to provide adequate protection of the UK tax base.

On corporate taxation Osborne announced moves towards a territorially-based system, whereby the Government only taxes profits generated in the UK. Again this will be put out to consultation over the summer with a view to reforming the rules in the Finance Bill 2011. The Treasury also plans to review the taxation of intellectual property and **support R&D** tax credits provide for innovation and the proposals of the Dyson Review. More broadly, the Government has also published proposals to improve the way tax policy is made and has confirmed its intention to create an independent Office of Tax Simplification with further details to follow shortly.

These positive moves will be tempered by an expansion of the tax base on which tax is paid. Some reliefs and allowances have been reined back and Britain's relatively generous regime for deducting interest costs on borrowings from corporate tax bills will be restricted. Osborne's move to reduce the rate of capital allowances on machinery will be a blow for manufacturing.

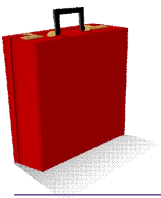
In an attempt to tackle the volume, complexity and cost of regulation, Osborne announced proposals for a **one-in-one-out system for new regulations**. Other measures include a requirement for all new regulation to be reviewed by The Reducing Regulation Committee, as well as the imposition of "sunset clauses". To foster flexibility and competitiveness, there will be changes to current employment laws and greater cooperation with Europe to review existing legislation and reduce the burden on European businesses. More details on deregulation are set to be published by BIS in July.

Sin Taxes

One omission from the Budget was the hitherto standard increases on alcohol, tobacco and fuel duty. The government will continue with the plans it inherited to increase alcohol duty rates by 2% above inflation each year to 2014-15. Alcohol taxation and pricing will be reviewed with a view to tackling binge drinking and any changes will be considered this autumn. Cider producers will welcome the announcement that the 10% cider tax hike introduced by Labour in March will be reversed (in time for the World Cup final).

The Chancellor has asked the OBR to undertake an assessment over the summer on the effect of oil price fluctuations on the public finances. Informed by this assessment, the Government will examine options for the design of a fair fuel stabiliser. Reflecting the Coalition commitment to investigate measures to help with fuel costs in remote areas, Osborne also announced that the Government would consider the case for introducing a fuel duty discount in remote rural areas. This includes possible pilot schemes in Scotland.

Green/Energy



Having pledged to make this 'the greenest government ever', the Coalition budget may be disappointing for those who hoped for fast, decisive action on pressing energy and infrastructure issues. The Chancellor chose not to slash capital spending, expressly recognising the required £200 billion investment in infrastructure over the next decade to decarbonise the economy. He also referred to welcome policies such as reform of the energy market and the climate levy. A number of previous positive announcements were restated, including an increase in the standard rate of landfill tax and measures to encourage green vehicles. However many big decisions, including on the Green Deal, the **Green Investment Bank**, and the manifesto pledge from both Coalition parties to increase air passenger duty, were delayed pending further consultation over summer and autumn. The language was tentative in many places, referring to 'assessing', 'exploring' and 'examining options', sitting uncomfortably with the pre-election commitments to think big and act quickly on green issues. Overall nothing much new here, and the Coalition is certainly heading in the right direction, but probably not fast enough for many.

Digital

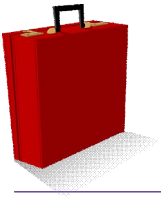
Digital issues were not a prominent feature of George Osborne's first Budget. However, the Chancellor did confirm the previous Government's landline duty would be abolished before it is even introduced and will instead run three pilots to bring superfast broadband to hard-to-reach areas, funded by a portion of the Digital Switchover under-spend within the TV licence fee.

Healthcare

Contrary to speculation that the Coalition Government might backtrack on earlier pledges to ring-fence NHS funding, Osborne today confirmed his commitment to providing the NHS with real increases throughout the Parliament.

Government Sales

The Chancellor announced a long list of assets that he plans to dispose of so that they can 'rightly be in private ownership'. He confirmed the auction of High Speed 1, which runs from St. Pancras International Station to the Channel Tunnel, which he hopes will raise between £1.5-2bn. The privatisation of High Speed 1 was announced by the previous Labour administration with Osborne confirming its sale and setting a timetable for completion. Osborne also announced plans to facilitate a capital injection into the Royal Mail Group, resolve the future of the Tote, sell the Student Loan Book - whilst also looking into options for early repayment to individuals - release the 800MHz and 2.6GHz spectrum to support super-fast mobile services and to dispose of its shareholding in air traffic body NATS. The Budget also announced that decisions on the

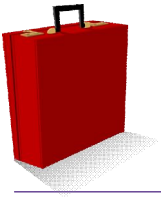


future capacity at the Dartford Crossing would be made at the conclusion of the Spending Review.

Regional Growth

In an effort to encourage economic growth in regions of the UK over-dependent on public sector employment the Government committed to a series of targeted economic measures. Businesses in these regions will receive a substantial reduction in their National Insurance Contributions including new businesses set up in the next three years. In addition the Government has committed to the creation of a Regional Growth Fund in 2011-2012 and 2012-2013 to encourage private sector led growth in the regions that most need it. This will only be in operation in England but the devolved assemblies will be encouraged to introduce similar measures.

Following Vince Cable's confirmation last week that Regional Development Agencies would be abolished, Osborne confirmed that a White Paper this summer would provide detailed proposals for their replacement. The proposals will include proposals for the creation of local enterprise partnerships, incentives for local authorities to support growth and a simplified planning consents process through Local Development Orders.



The Emergency Budget 2010 – what happens next

1. Budget Day: Wednesday 24 April

12:30pm: Chancellor delivers the Budget Statement
1:30pm: HM Treasury issues full Budget Report with all accompanying materials
1:30pm: Response by the Leader of the Opposition

2. Budget Debate

Tuesday 22 June	Budget resolutions and economic situation (First day)
Wednesday 23 June	Continuation of the Budget debate
Thursday 24 June	Continuation of the Budget debate
Monday 28 June	Conclusion of the Budget Debate

3. Treasury Select Committee – Budget 2010 Evidence Sessions:

The Treasury Select Committee has confirmed that, since departmental select committees have not yet been formed, there will not be any immediate evidence sessions on today's budget.

4. Legislation

The Finance Bill 2010 announces new measures affecting:

- Company Distributions
- Insurance Premium Tax (IPT) Increase in the Standard and Higher Rates
- VAT: Increase in the standard rate and anti-avoidance.

First Reading: HM Treasury publishes updated Finance Bill imminently (containing budget resolutions)

Second Reading: Within 30 days of Budget Statement

Committee of the House: Key clauses of Finance Bill debated in Commons chamber

Standing Committee: Finance Bill scrutinised line by line

Report Stage and Third Reading: Amended Bill returns to the Commons chamber for further debate and approval

Lords consideration: Scrutiny of the Bill by the House of Lords is purely formal and usually the Bill passes through all its stages in the Lords on a single day.