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One less thing to worry about...

Post Emergency Budget Special - June 2010

A Budget to encourage the recovery

In the first Budget of the new coalition government, George Osborne set out plans to put the economy back on a sound footing.

There is very little need to set out the reasons why this emergency Budget is necessary. The recent general election that led to the formation of the first coalition government for many years was fought largely not on *whether* public spending cuts and tax increases were necessary, but rather *when* they should be implemented.

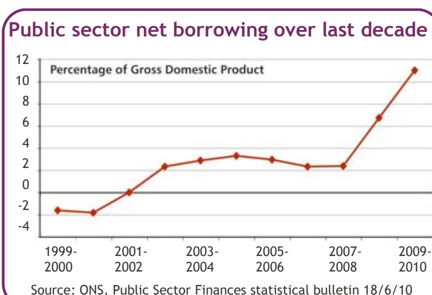
The credit crunch that is still impacting on the economy was really only the 'straw that broke the economy's back' after a decade of apparently unrestricted growth of government spending, as a proportion of the nation's gross domestic product. David Cameron famously accused the previous government of failing to fix the roof while the sun was shining (i.e. the economy growing strongly); now George Osborne has to get his toolkit out—with the help of Danny Alexander, Chief Secretary to the Treasury—and get the job done.

How the changes announced today perform will take some time to become apparent; but all of us must hope that they will succeed if we are to avoid a slow decline into the same state as Greece. There are systemic reasons why we are in nowhere near as bad a state as they are, but failure to convince money markets that we are serious about reducing debt will make it more difficult for us to borrow in future by increasing the cost and shortening the period over which loans are offered.

The economy

All investors are affected by the economy and it is therefore revealing that the Chancellor says that the previous government's "golden rule" about borrowing over the economic cycle will be missed by a massive £485bn in the current one. He has, not surprisingly perhaps, abandoned this unreliable measure for the future, preferring instead to rely on the new independent Office for Budget Responsibility to say whether he is achieving his targets or not.

Public sector net borrowing over last decade



Source: ONS, Public Sector Finances statistical bulletin 18/6/10

After the election comes the pain of paying for so much borrowing

The key Budget data indicate that the economy (measured by gross domestic product or GDP) will rise by just 1.2% this year, peaking at 2.9% in 2013 and falling back to 2.7% in 2014 & 2015. Borrowing is targeted to gradually fall from £149bn during this tax year to £20bn in 2015/16; just 1.1% of GDP, rather than the current level of 10.1%.

More importantly, the structural current deficit is targeted to be in balance by 2015/16 while consumer price inflation, which will hit 2.7% by the end of this year, should return to its 2% target within the medium term.

Spending cuts

The plans contained in the Budget allow for 77% of the measures taken to reduce borrowing to come from spending cuts and 23% from tax increases. This is a slight variance from the original 80% to 20% target, but the admission reflects George Osborne's desire "not to hide hard choices from the British people or bury them in the small print of the Budget documents."

There are significant cuts outlined in the Budget affecting many sections of the community, but with the aim of ensuring that the pain is spread fairly. In fact, the Chancellor made the point that this is a progressive Budget—one that places the burden more on the better off, than those less able to make sacrifices. So many in the past have proved regressive, that is where the worse off share a disproportionately large part of the burden.

The main changes that will directly affect savers were relatively well signposted but, as ever, there were some surprises.

Predictably, higher earners lose out in a number of ways with tax credits being reduced for those earning in excess of £40,000 a year and all benefits other than pensions being linked to the Consumer Prices Index which is generally lower than the Retail Prices Index, to which they were previously linked.

Housing benefit will also be cut back, to combat the situation where some families can currently receive as much as £104,000 a year.

On the other hand, additional help has been given to families with the lowest incomes in the form of an increase of £150 above inflation next year to the child element of the child tax credit. This will benefit lower earning families by £2bn.

Public sector pay

Public sector workers will also take their share of the pain with a two-year freeze on pay for anyone earning £21,000 or more. Everyone below that level will receive £250 a year more each year, which benefits those on lower incomes disproportionately.

In addition, there will be a review of the pension benefits enjoyed by public sector employees, who had previously been insulated from the pressures suffered by most private sector workers, but will now face a similar trade-off between pay and benefits cuts and further job losses.

Personal taxation

While there are no changes to the rates of personal income tax, the Chancellor has (as well sign-posted) increased the personal allowance by £1,000 to £7,475 from next year, although this will not benefit higher rate taxpayers and the thresholds at which the 40% and 50% tax bands cut in will not be increased in April.

The main change to personal tax was also already expected in that capital gains tax increases from just after midnight on 23rd June. The surprise is that this increase will only apply to those with total income including taxable gains above the higher rate threshold, and it will only be at 28%, rather than the expected 40% or even 50%. The higher rate will, however, apply to trustees and the personal representatives of the deceased.

The reason for this change is, the Chancellor says, that any higher would have reduced the revenue take. In other words, he listens. In addition, introducing some form of taper relief would have been too complicated and the administration involved, self-defeating.

In addition, the annual exemption remains at £10,100 and will be indexed in future.

To promote enterprise, the 10% capital gains tax rate that applies to entrepreneurs, which currently applies to the first £2m of qualifying gains made over a lifetime, is to be extended to the first £5m of lifetime gains.

It is important to remember that investments within Individual Savings Accounts (ISAs) and pensions are free of income tax and capital gains tax (although the Chancellor clearly does not feel that he can yet afford to reverse the situation where the 10% withholding tax on UK dividends cannot be reclaimed by either form of investment).

Pensions

The Chancellor took a balanced view on his predecessor's plan to limit tax relief on pension contributions made by those on very high earnings. He accepted that the new rules are frighteningly complicated, but needed to protect the £3.5bn of revenues this policy was set to raise from high income people. He will therefore consult with the industry to determine how this might be achieved, including the possibility of reducing the annual allowance for some individuals, which is currently £255,000.

Many pension plan holders will be pleased to see in the Budget document a comment that the Government will "end the existing rules that create an effective obligation to purchase an annuity by age 75 from April 2011 to enable individuals to make more flexible use of their pension savings". The Government is to launch a consultation on the detail of this change and will introduce transitional measures for those yet to secure a retirement income who will reach 75 in the meantime.

Businesses

Major changes for businesses include a long term approach to the taxation of foreign profits, the treatment of intellectual property and the proposals on research and development. To assist small businesses struggling to obtain credit the Enterprise Finance Guarantee Scheme, which supports SME access to lending, is to be extended. This will benefit at least 2,000 small businesses and there will be further proposals in the summer to expand the availability of credit, to ensure the economic recovery is properly financed.

Both large and small businesses will benefit from a reduction in corporation tax with the headline rate falling from its current level of 28% to 24% in one-point reductions over the next four years. This is intended to make it more attractive for businesses to establish and remain in the UK. For smaller firms, the proposed increase from 21% to 22% proposed for next April will now not take place, but the rate will instead be reduced to 20%, in line with the basic rate of tax.

In another widely heralded change, the starting point for employers' National Insurance contributions will be increased by £21 per week in excess of inflation, from next April. This will make the cost of hiring people on incomes lower than £20,000 less than currently.

In addition, anyone setting up a new business outside London, the South East and the Eastern region during the next three years will be exempt from up to £5,000 of employer national insurance payments, for each of their first 10 employees hired.

Spending tax

As widely predicted, the rate of VAT is to be increased on 4th January 2011 from 17.5% to 20%. Importantly, there are no changes to the exemptions enjoyed by food, children's clothing and similar items.

This is expected to raise £13bn a year by the end of this parliament, and, while it is hoped that such a modest increase will not reduce high street activity significantly, one could wonder whether this will serve

indirectly to increase the savings ratio, as people find putting money aside more attractive than spending. There could be potential benefits of such an out-turn, in terms of increasing the amount of deposits with banks as well as reducing the level of consumer debt. When the Chancellor said that “the truth is that the country was living beyond its means when the recession came … if we don’t tackle pay and pensions, more jobs will be lost” he was talking about public sector borrowing. But such a comment could also have been applied to individuals.

Even as recently as the end of April, total UK personal debt stood at £1,460bn—0.8% higher than a year ago. Individuals currently owe more than what the whole country produces in a year.

As expected, Insurance Premium Tax was increased, but by far less than expected from 5% to 6%, although the rate on some forms of insurance such as on travel insurance and for domestic/electrical appliance policies, IPT will rise from 17.5% to 20%, in line with VAT.

Help for pensioners

As the Chancellor pointed out, it was a previous Conservative Government that infamously removed the link between earnings and the basic state pension. Since earnings usually rise faster than retail prices, this meant that pensioners tended to become progressively worse off, relative to those still at work, the longer they were retired. The fact that RPI does not genuinely reflect the costs faced by older people made the link even more inappropriate.

The Government has finally put this right by announcing that, from April 2011, pensions will be protected by a new ‘triple lock’ which will guarantee every year a rise in the basic state pension in line with earnings, prices or a 2.5 per cent increase—whichever is the greatest. This should avoid the situation whereby more and more pensioners were drawn into the means test each year, punishing those who had done the right thing and saved for their retirement.

On the other hand, the government will also accelerate the increase in the State Pension Age to 66 and will be investigating this soon.

Making the banks pay

The Chancellor pointed out that it was failures within banks that imposed a huge cost on society, so it is fair that in future banks should make a more appropriate contribution.

The government has therefore taken the initiative by introducing a bank levy, from January 2011, that will apply to the balance sheets of UK banks and building societies, and to the UK operations of banks from abroad.

Once fully in place, this is expected to generate over £2 billion of annual revenues.

While not waiting until every country in the G20 was ready to introduce a bank levy (which could have taken forever despite recommendations from the International Monetary Fund) the French and Germans have joined the UK in committing to introduce this approach.

Miscellaneous issues

In a number of other comments, the Chancellor announced that Council tax will be frozen next year, provided that the councils cooperate in keeping their costs down.

He also announced that while there would be no increase in alcohol and tobacco duty, the previous 10% in excess of inflation increase in the duty on cider will be reversed at the end of June.

In addition, steps will be taken to ascertain whether it is possible to stabilise pump prices for fuel to reduce the impact of sharp fluctuations in the price of oil on the public finances. The Treasury will also look at whether a rebate for remote rural areas could work.

Possible changes to the aviation tax system will be considered, including switching from a per-passenger to a per-plane duty.

Summary

In what George Osborne called an “unavoidable Budget”, it is hoped that dramatic action will help us avoid double-dip recession, while money markets gain confidence from the aggressive action taken to reduce a structural deficit that will be some £12bn larger next year than previously expected.

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The next comprehensive Spending Review will take place on 20th October 2010 and we will then see the details of how those government departments that are not ‘ring-fenced’ aim to make the savings that will have to add up to about 25%, in real terms, over the next four years.

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