

# The Budget – a briefing paper

March 2012

## Background

Much of the focus of the media commentary leading up to the Budget has focused on the reduction to the higher rate of income tax from 50p to 45p, as well as the introduction of a so-called 'mansion tax' for those properties worth over £2m. To that end, much of the commentary had been political rather than economic. Little concentration had been given on potential new measures to promote growth and to help businesses even though growth throughout 2011 had been weak.

To that end, the announcement of an additional cut in corporation tax – over and above what has already been laid out by the Coalition Government - was somewhat unheralded. In the below briefing we draw out some of the main announcements made and, where possible, discuss implications for the South West.

## Revisions to growth & borrowing forecasts

As expected, the Chancellor stated that the economic outlook in the near-term would remain broadly unchanged. The latest GDP forecast by the Office of Budgetary Responsibility (OBR) has been marginally revised up to 0.8% for 2012 (from 0.7%), confirming that the picture in the immediate future remains rather weak. It is important to remember that in the Budget 2011 the projection was for 2.5% growth during 2012. Clearly, the anaemic growth throughout the second half of 2011 has affected the confidence for growth over much of Coalition Government's fiscal period.

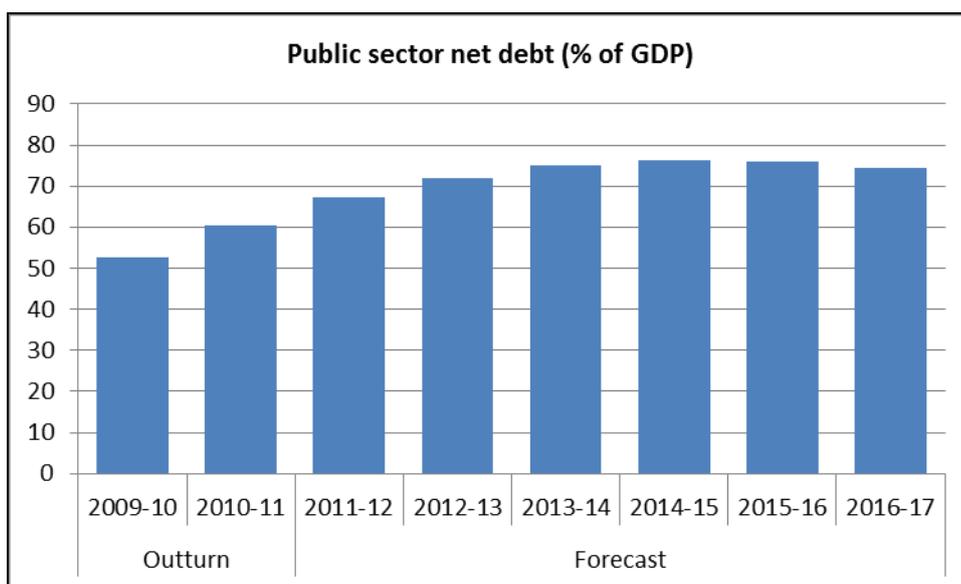
The forecast for the remainder of this period does show some strengthening (2% in 2013, 2.3% in 2013 and 3% in 2014 & 2015) but, of course, is below trend and will remain dependent on a number of external factors such as the euro-zone fiscal crisis and strength of recovery in markets such as the US and the BRIC economies.

The timing of the Budget on the same day as disappointing public sector borrowing figures for February 2012 was slightly unfortunate. Borrowing of £15.2bn in February was above consensus forecasts and compared to £8.9bn for the same month in 2011. This was due to a slowdown in the growth of tax revenues and some Government departments bringing forward spending into the current fiscal year. Nevertheless, the Government expects to marginally exceed its borrowing target of £127bn for the year 2011-12 (the expectation is for borrowing of £126bn) – although the outturn will now not be as good as expected at the turn of the calendar year.

The medium-term fiscal outlook has largely remained unchanged. Public sector net debt is still expected to peak in 2014-15 at 76.3% (see below chart).

The important aspect to note is that none of the fiscal figures – either the outturn (what has happened so far) or forecasts has altered the Government's stance on public expenditure cuts. The chancellor remains broadly happy (particularly when an election is not imminent) to remain within the fiscal 'straight jacket' that he set himself in 2010.

It is also important to remember that the majority of the spending cuts previously outlined in the Spending Review are still to occur over the remainder of the fiscal period to 2016. The majority of the fall in Government borrowing that has occurred to date has been through increased tax receipts i.e. through the VAT rise and not from cuts to Government spending. The projections are that the ‘contribution’ of increased tax receipts to the overall reduction in net Government borrowing will remain broadly static going forward<sup>1</sup>, however the ‘contribution’ of spending cuts will increase dramatically. The tax rises have been much more front-loaded than the spending cuts. In that sense, much of the pain is still to come.



(Source: Office of Budgetary Responsibility)

## Support to businesses

The headline change has been the accelerated rate of reduction of corporation tax and this has to be welcomed as a positive and generally expansive policy. The Chancellor announced that the corporation tax rate has been cut by a further 1%, taking effect immediately in April 2012. This is in addition to the already planned 1% cut – taking the tax rate down to 24% (in effect a 2% cut). The Chancellor has an already stated objective to move the UK economy to a low corporation tax-rate area and towards a 20% rate, making the UK one of the lowest tax areas. The stated aim is to increase competitiveness and HM Treasury estimates this will effectively ‘save’ UK companies £800mn in the period to 2014/15. It is hoped that much of this is reinvested by businesses.

Again, the already stated aim of the Government is to equalise corporation, small profits and income tax rates to 20% in the medium-to-longer term.

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<sup>1</sup> The Institute of Fiscal Studies estimates that by the end of 2011-12, we would have experienced 73% of the tax rises, 34% of the investment cuts, 12% of the benefit cuts, but just 6% of the cuts to non-investment spending on public services.

The Enterprise Finance Guarantee & UK Export Finance schemes are to be expanded. This is again to be welcomed; although it is unclear what the historical take-up levels have been. There is also the newly launched National Loan Guarantee Scheme which aims to provide up to £20bn of finance to small businesses (effectively through a guarantee to banks), although we will need to wait to see how successful this will be compared to other schemes that had the same aim. As in most Budgets, there were further noises about simplifying the tax system for small businesses - although judging by history this intention has always seemingly been difficult to achieve.

The indication that the Government is looking at a scheme to provide enterprise loans for young people is potentially intriguing. It may prove a sufficient enough incentive for some to exchange furthering their education for starting a business.

In general though, the Budget was notable for the absence of any further policy announcements regarding training/skills development or tackling youth unemployment. Given this area has experienced a major policy shift over the previous two years – through such things as the Youth Contract and the Work Programme – this was perhaps not surprising.

## Support to places

As announced in the National Infrastructure Plan 2011, the Government aims to facilitate a greater role of private investment in the provision of the UK's infrastructure. This is recognition that infrastructure plays an important short-term and long-term role in boosting growth and competitiveness, but needs to take place in an age when public expenditure is constrained.

A greater role for private sector investment is being pursued in areas such as transport infrastructure, and the Government are actively looking to attract investment by overseas sovereign wealth funds and UK pension funds. Clearly some of the difficulties associated with the previous Government's promotion of the PFI scheme have not affected this aim of drawing in private money for public provision. The need to reconcile the requirement for the private sector to generate returns alongside the public desire for free and equal access could be one of the main economic quandaries over the next few years.

There was no real mention of any South West specific infrastructure schemes, with most being concentrated either in the congested Greater South East (in terms of roads) and the relatively depressed North (in terms of rail). The concern is that the region gets left behind in terms of infrastructure provision as politics plays out.

There were also announcements with regards to some new funding for investment in the Government's new economic development environment. An additional £150mn is being made available from 2013-14 through the Tax Increment Financing scheme, enabling local authorities to borrow against future growth in business rates. As is the current Government's seemingly preferred approach, these funds will be allocated on a competition basis and there is no guarantee that the SW will benefit. There will be an £270mn through the Growing Places fund (although £70mn of this is to be allocated to London), although this is to be funded through existing departmental budgets.

One of the biggest impacts on our communities will come through the publication of the National Planning Policy Framework at the end of this month. How the increased emphasis upon reducing obstacles to development will play out is difficult to predict at this moment, but we would expect it to be controversial in many parts of the South West as the debate between economic growth and landscape protection continues.

It is welcomed that Bristol was among the cities to be included in an investment programme to provide ultrafast broadband and a Wi-Fi network, with a further 10 smaller cities to receive funding in a second wave.

There was relatively little mention of further measures to support the renewable energy sector – a key part of the region's aspirations. Instead, more emphasis was placed on providing support for the oil and gas industry (perhaps partly compensating for last year's tax charge) and helping the industry access the dwindling finite resources in UK waters.

Finally, the concentration on kick-starting the housing market was confirmed in the Budget - particularly for first-time buyers. There are several schemes to improve the flow of finance – primarily through public underwriting – that aims to improve demand. There is also a concentration on improving the supply-side through the freeing up of public sector land for housing development.

## Personal finances

The headline of the reduction of the top rate of tax from 50p to 45p will affect relatively few people in the region, and its impact appears to be largely more political than economic (although not for the individuals concerned). Although there are no specific figures for the number of people earning more than £150,000 in the region, given that only 10% of those in employment earn more than £43,000 it is likely that numbers are small and therefore the macro impact commensurate.

The same can be said of the implementation of 7% stamp duty for those properties sold for greater than £2mn. Stamp duty has previously acted as a distortion to behaviour at lower levels and it may have some impact at the top-end of the South West property market.

The increase in the personal tax allowance to £9,205, however, is largely a progressive move - the aim being that the overall tax burden for most working people will be reduced. The Treasury estimates that this will annually cost £3.5bn in the period 2013-17. Given that roughly 20% of those working in the South West earn less than £10,000<sup>2</sup> then a considerable part of the regional workforce will pay very little income tax at all. Generally, due to it being a lower wage economy, the benefits of the increase in personal tax allowance will be greater in the region although the geographical impact will be marginal.

Given the region's demographics, there will be some greater detrimental impact of the personal tax allowance for the over-65s being frozen – effectively an increase in tax for those impacted.

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<sup>2</sup> Annual Survey of Hours and Earnings

One of the major ‘non-announcements’ in the Budget related to fuel duty. Residents in rural areas in the region are being particularly hard hit by the historically high petrol prices and the Chancellor did not provide any new respite. The planned 3p increase in fuel duty for August was not withdrawn and therefore we will expect these high prices to be sustained (remembering that 70% of the price of petrol is tax and instability in the Middle East continues). Fuel prices will continue to act as a drag on people’s disposable income and it is perhaps surprising that the Chancellor did not provide any new support, whilst effectively easing the income tax burden for most through the increase in personal tax allowance threshold.

## Regional pay

The possibility of regional pay rates for the public sector could have a wide-ranging economic impact on the region. The latest figures show that the average wage of those working in the public sector in the region is 17% more than in the private sector<sup>3</sup>. At the same time, overall wages in the region are 92% of the UK average (with many areas far below that level). Therefore the region could be one of those areas seen as a prime candidate for the implementation of regional/local pay awards.

Any policy to effectively ‘deflate’ public sector pay to reflect local pay conditions could have a detrimental impact upon the purchasing power of many in the region. Of course, the differential between public and private sector pay has increased over the past decade and there are reasons why this differential could begin to close through normal market mechanisms anyway. First, the public sector is experiencing a pay freeze imposed by the Government. Second, as economic conditions improve we would expect private sector pay to strengthen. Given that the Government have stated any regional/local pay award system will not take place until the end of the current pay freeze period, and that its implementation will be difficult (the public sector being one of the most unionized parts of the workforce), then its impact may not be as great as currently feared. However, it is largely unknown at this stage.

## Conclusion

The inescapable truth is that any Budget during this current parliamentary period will play out in an environment that is somewhat pre-determined by the fiscal and public expenditure targets already set out by the Coalition Government. Weaker economic growth than previously envisaged has not weakened this stance and we should not forget that much of the pain in the form of spending cuts is still to occur.

Nevertheless, the Budget has seen the Government attempt to improve both the supply-side and demand in the economy. Whilst much of the media interest has focused on the reduction in the top rate of tax, perhaps more emphasis could have been placed on the accelerated reduction in Corporation Tax. This is positive. The difficulty now for the Government is to encourage investment levels, given that many businesses – particularly larger businesses –

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<sup>3</sup> This does not take into account differences in the workforces’ characteristics that may account for that differential i.e. qualification levels, age etc. A recent study by the ONS at a national level attempted to ‘control’ for these differences and found that there was a differential of 7-8%.

have decent cash levels on their balance sheet but investment levels are low.

There are a number of unknowns that potentially could have a major impact on the UK and South West economies. The increased focus on attracting private funding into public project provision could represent a significant shift in the economic landscape. The lessons from PFI would need to be learnt. It remains a concern that this private finance may be attracted to those areas where potential returns are the greatest and more peripheral areas like the South West could lose out. Certainly, it appears as though the region is not at the front of the current pipeline for major infrastructure projects. Another unknown is how further substantial welfare cuts will play out.

At an individual level, the decision not to ease the cost of petrol will hit many motorists in the South West hard. For many the use of a car is a necessity rather than a choice and we expect that high fuel prices will remain one of the drags on personal disposable income and consequently the strength of consumer demand.

The threat of regional pay awards in the public sector will be a potential threat that looms on the horizon for some time to come and it is hoped that private sector pay can increase to negate the differential rather than public pay deflating in a 'race to the bottom'.

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