

# Briefing Paper

## The Budget 2010

### July 2010

#### Introduction

The coalition government has revealed an Emergency Budget that has been described by Edmund Conway, the Telegraph's Economics Editor to be "exceptionally rich in measures, policies, changes in tone, figures and analysis".

The new Chancellor has been put in the precarious position of balancing the need to cut the country's budget deficit without threatening the fragile economic recovery.

Financial markets were expecting the 2010 'emergency' budget to lay out a credible and decisive plan for bringing the deficit down to sustainable levels.

This has been without doubt one of the most brutal budget announcements in United Kingdom history and the coalition government considers that failure is not an option.

The coalition government and the Chancellor George Osborne know that investors will punish the pound and drive interest rates up across the economy if the budget isn't credible or if it seems unlikely to work.

#### The scale of the challenge

The new government is facing a deficit the size of which has never been seen before, partly as a result of the financial crisis that led government to 'bail out' the banks and led to a reduction in government revenues and partly because the previous Labour Government took a decision to continue to spend in an effort to avoid a severe recession.

The previous Labour government had committed to spending cuts and tax increases of a combined and expected £73billion by 2014/15. The coalition government is now planning to cut a further £40billion on top of this.

The figure that the treasury is aiming for of £113billion of fiscal tightening amounts to the biggest squeeze the United Kingdom has ever seen and ever had to endure since comparable records began post war in 1948. Perhaps the great depression of the 1930's may be the best comparison for the issues facing the United Kingdom today.

It must be noted foremost that this budget plans the biggest squeeze of the United Kingdom's economy the country has ever seen with £128billion to be cut in the financial year 2015/16.

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This is beyond the horizon of the previous Labour government and will be the biggest cut in British history.

## **Key Announcements**

Key announcements made by the Chancellor George Osborne include:

- VAT to go up to 20% from 17.5%
- Capital gains tax for higher rate tax payers rises to 28%
- Child Benefit to be frozen for the next three years
- Two year pay freeze for public sector workers
- Basic state pension linked to earnings once again, from April 2011
- No new tax increases on alcohol, tobacco or fuel to be introduced

## **Overview of the 2010/11 Budget**

### **Council Tax Freeze & VAT Rise**

In the budget announcement the Chancellor George Osborne has laid forth plans to freeze council tax and to increase VAT. Osborne has stated that government funding to help councils keep tax down could come at a price.

The Chancellor said:

*“If you can keep your cost increases low, then we will help you to freeze council tax for one year from next April”. Meanwhile, a 2.5% hike in VAT to 20% will raise up to £13billion a year for the treasury.*

*“The changes which will come into effect from January 1st 2011 were essential to ensure that the further cuts were avoided elsewhere in the economy”*

George Osborne also added that:

*“Essential items, such as food, clothing and zero-rated items, including newspapers and printed books, will remain exempt from VAT over the course of the Parliament”.*

It was also announced that banks would be made to contribute to the costs of the recession that was sparked by a collapse in the international banking system in 2008.

There will be other measures put in place with changes to Capital Gains Tax that means the very richest in society cannot ‘dodge’ tax payments as easily and freely as they have in the past.

Osborne said that 23% of the money needed to pay off the country’s £149billion deficit needed to come from tax increases and that this type of increase in taxes was unavoidable.

However, VAT on such things as food, children’s clothing and other VAT-free items remain exempt in the new budget.

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Other areas of the tax system have been given a re think. Capital Gains Tax (CGT) is to increase to 28% on higher rate tax payers. Capital Gains Tax for basic rate tax payers will remain at 18% while the Capital Gains Tax exempt amount remains at £10,000 for this year.

There will be an increase in personal income tax allowance by £1,000 in April 2011 meaning personal income tax allowance will be set at £7,475. This is one of the initiatives that the Liberal Democrats were successful in negotiating into the coalition agreement.

Higher rate income tax however will remain frozen until 2013/14 when this will be re evaluated. Also, the national insurance threshold will increase by £21 in the coming year.

The Telegraph's personal finance editor Ian Cowie stated that:

*"Many owners of second homes and buy-to-let landlords who pay basic rate income tax will be caught by the new higher rate of capital gains tax".*

The 'Sin' Taxes have been left alone and there will be no increase in tax on tobacco, alcohol or fuel and the Labour planned increase on cider duty to 10% above inflation has been scrapped by the new Conservative/Liberal Democrat Coalition for the coming year.

### **How to tackle the deficit and growing debts**

The new coalition government have said previously that one of their biggest challenges they face is reducing the United Kingdom's vast deficit and the country's huge debts.

The Chancellor has announced plans to cut the deficit and the level of public borrowing in the United Kingdom. George Osborne has laid down his plans to allow the deficit to fall to 1.1% of gross domestic product (GDP) by the year 2015/16.

This would be a huge drop from the 10.1% which is hoped to be achieved in 2011.

The budget deficit is hoped to be £149 billion in 2010/11, this is lower than forecast by the previous Labour government.

The plan the Chancellor has put in place is to make huge spending cuts from all public sector departments and to reduce the budget deficit to £116 billion in 2011/12.

Business Columnist Jeremy Warner wrote that:

*"The main challenge was the deficit, and on that the Chancellor gets close to full marks,"*

Again as with so much of this 'emergency' budget some will like the cuts and new measures and many will dislike them.

Without doubt there will be a large amount of public sector workers losing out because of these new policies, however, this is the 'only way' according to George Osborne.

### **Spending & Growth**

Government spending will be £637billion in 2010/11, this is set to rise to £711 billion in 2015/16.

The growth of the United Kingdom economy is forecast by the Chancellor to grow by 1.2% in 2010 and again to grow to 2.3% in 2011 and 2.8% in 2012.

### **Spending Cuts v Tax Rises**

Prior to the election the Chancellor George Osborne stated openly that he intended to cut spending by around 4p for every penny of tax increases.

The target ratio of 80:20 that was the main goal of the Conservatives in the spending cuts against tax rises issue wasn't quite achieved in the budget 2010.

However, the Chancellor did manage to get very close, a ratio of 77:23 in spending cuts against tax rises was found and this has been implemented with the new budget.

By 2014/15 we will be seeing about £8.23billion in net tax rises and spending cuts of £31.9billion (of which £11 billion will come from the welfare budget).

Although a ratio in spending cuts to tax rises of 77:23 is very near the 80:20 ratio George Osborne was looking for there are two provisions that have had to be accommodated.

Firstly, the ratio only closes in on 80:20 by the end of the Parliament's term. This is because in the first year of the Parliament the balance is far more shifted towards tax rises. The ratio then is closer to 60:40, which is far from ideal from the Conservatives' point of view.

The explanation offered by the coalition government for this is that it takes a much longer time to cut spending than it does to raise taxes which can be implemented nearly immediately. It is also the case that tax increases can be introduced quickly and reversed if they prove to have been too great without too much difficulty or too much political opposition. Who would complain if this year's tax increases were reversed next year?

This however, underlines the fact that the fiscal consolidation cannot be achieved purely through a bit of state frugality.

The second point that must be recognised is that the spending and tax totals is a net one of both. Although in total £8.2billion is being raised in new taxes by 2014/15, this total is only due to rather massive value added tax increases being balanced out by some smaller tax reductions. The increase in value added tax has concerned some economists who see it as potentially having a very depressing effect on the economy.

It must also be noted that the value added tax yield is a rather large £13.5billion by the year 2014/15, while the increase in Capital Gains Tax raises only to £925 million.

Something that is close to being put into action is changing and raising the capital allowances rate. This will affect manufacturers and small business' in particular.

However this increase will double the amount of money generated by the capital allowances rate by the end of the Conservative-Liberal Democrat Coalition.

### **Benefit Reform/Public Sector Cuts**

In the budget announcement the Chancellor George Osborne has laid forth plans to make welfare cuts in the vicinity of £11billion by 2014/15. This also includes a range of other plans to cut public sector spending.

Child benefits are to be frozen for at least the next three years and benefits are to rise in line with consumer prices. Also, there is to be a tax credit reduction for families earning more than £40,000 a year.

There will be a tax credit increase in the child element of tax by £150 above inflation. Housing benefits will be restricted to a maximum of £400 a week. This is calculated to save £1.8billion – a testament to the number of people who live in private rented accommodation with inflated rents financed by the benefits system. A medical assessment for disability living allowance will be introduced from 2013 for new and existing claimants.

Public sector workers will have a two year pay freeze. However, public sector workers who earn less than £21,000 a year will be given an extra £250 each year for two years.

The basic state pension rate will be linked to earnings from April 2011, also pensions are guaranteed to rise in line with earnings, prices or 2.5%. This will be decided up on whatever is greatest at the time.

A move that has caused controversy throughout the country since the announcement is the rise in state pension age to 66 years old and the swift nature in which the government are hoping to implement the change.

Political commentator Janet Daly tells us that:

*"Many of the benefits that George Osborne is removing were things that should never have existed in the first place".*

This is something that is widely debated and is sure to create many conflicting views in the forthcoming months.

## **Business in mind**

Mr Osborne's budget announcement with regards to business is set to affect companies up and down the United Kingdom. Again, this is not to be unexpected as the Conservatives have been making their thoughts and policies on business clear throughout the general election.

Corporation tax is to be cut to 27% in the next year. Also, corporation tax cut by 1% a year for three years to 24%. Small companies will have their tax rate cut to 20% and tax relief for the video games industry will be scrapped.

There will be a United Kingdom bank and building society levy from 2011 and the levy will also be imposed on United Kingdom operations of foreign banks. However, smaller banks will not be liable for this levy.

This levy on the major banks will be expected to raise more than £2billion a year to go towards the treasury. There will also be a 10% Capital Gains Tax rate for entrepreneurs extended to the first £5million of qualifying gains.

With unemployment reaching its highest rate in decades the new Coalition government has predicted that unemployment will peak in 8.1% in 2010/11 and that unemployment will fall each year to 6.1% up to 2015. Many economists disagree as they cannot see how the demand in the economy that is now provided by the public sector will be replaced by business investment, consumer spending or exports.

## **Reaction and Conclusions**

This budget, when it comes to welfare, amounts to a major squeeze of benefits and those who can receive benefits. The Retail Price Index (RPI) is the real cost of living and this is why the benefits in the United Kingdom have always been linked very closely to it or indeed to earnings.

Consumer Price Index (CPI) does not include the impact of house prices, council tax, mortgage costs and a number of other factors which means it is always around 1-2% lower than the RPI.

This means that calculating benefits with CPI and not RPI could cause many to lose out on an extra few pounds in their benefits they desperately need.

This may not make such an impact in the first year of the parliament but when you reach the final year the government is saving in the region of £5.8billion through this accounting change alone.

This will be by far and away the largest of all the welfare savings. In some quarters this could be seen as resembling the Brown pensions grab early in his time as Chancellor.

Possibly this time the only difference is it is not pensioners being left without but now those on benefits.

## **Budget for the Rich of for the Poor?**

This budget will force the richest 10% of the population in the UK (those with incomes over £49,700 a year) to pay nearing £1,600 extra per year as a result of its measures.

Although this is true these new plans do incorporate some of the measures in the previous Labour Government's budgets plans. This includes the National Insurance increases.

However, even the poorest are hit hard, with the poorest in society having to pay an extra £200 per household in new taxes.

As a proportion of household income the richest will end up losing 2% of their incomes. The poorest 10% of the population in the UK will lose 1.5% of their annual incomes.

The average loss of money across the entire population will be around 1.4%. It will be seen by many that the lowest paid and poorest in the United Kingdom will lose most in the budget while the richest 10% lose little in comparison to their earnings.

It would seem that this is the bottom line of this budget, as the Chancellor said:

*"Everyone will suffer".*

There is a good deal of political expediency tied to this budget with the scale of the cuts being so vast that if there is any suspicion that if some parts of the population are not pulling their weight and paying their part there will be widespread social disaffection which could threaten to boil over before this parliament is finished.

This must also be put into perspective with the sustainability and togetherness of the coalition not yet being fully tested. The first sign of problems may mean the ending of the coalition if all members are not speaking with one voice.

## **Market Reaction**

One big question that the markets had for the Chancellor before the budget announcements was what kind of target he and the government were setting themselves on cutting the deficit.

In the end the George Osborne stated that the challenge ahead is twofold. The first phase is the elimination of the current structural budget deficit. The second phase is the removing of net public investment by 2015/16 and to have net public debt falling as a share of Gross Domestic Product by that year.

In general the markets and the pound sterling seem to be pleased with the coalition's plans. The pound sterling is always moved more by international factors than internal domestic affairs. However, during the budget announcement the pound sterling did strengthen against the dollar.

This kind of performance is being seen as encouraging by the treasury.

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## Response and Conclusions

The CIPFA response to the budget 2010 was to ask the question:

*“Can this very ambitious budget be delivered without decimating services on the front line?”*

Steve Freer, the Chief Executive of the Chartered Institute of Public Finance and Accountancy said:

*“It’s a great relief that we now have a clear set of proposals to rebalance public finances.*

*“In our view the Government is being very ambitious in attempting to tackle this challenge in a single Parliament.*

*“The proposed reductions in public spending are right at the top end of the scenarios that had been considered by CIPFA and SOLACE amongst others. The question now is whether the plan can be delivered sustainably without decimating services.*

*“The focus shifts to those responsible for delivering services in public bodies who have some very painful decisions to make.*

*“As for the Council Tax freeze, it seems paradoxical to introduce a scheme to incentivise the control of costs at a point when those costs are clearly going to be reducing significantly. We await the details with interest.*

*“It feels as though this may have more to do with the political window dressing of the Budget rather than the rebalancing of the public finances.”*

It would see that public front line services are certainly going to suffer as a result of spending cuts.

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