

# 1

## Budget Report

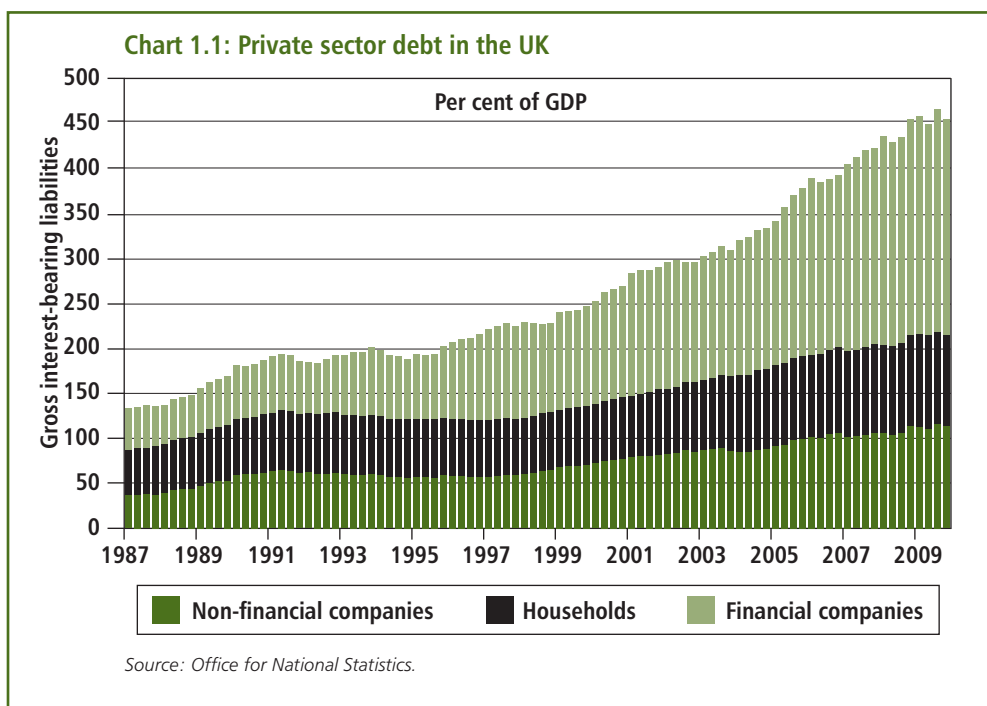
### Deficit Reduction

#### Rebalancing the UK economy

**1.1** Over the past decade, economic growth in the UK has been driven by the accumulation of unsustainable levels of private sector debt and rising public sector debt. This pattern of unbalanced growth and excessive debt has helped create the exceptional economic and fiscal challenges that the Government must address, to restore the economy to sustainable, balanced and private sector-led growth.

#### Private sector debt

**1.2** By 2008, the household saving ratio had fallen to the lowest level since the 1950s and household debt had risen to 100 per cent of GDP, as households borrowed heavily to purchase increasingly expensive property. Companies also took on rising levels of debt, reaching 110 per cent of GDP by 2008. Within the financial sector, the accumulation of debt was even greater. While rising debt was an international phenomenon, it was more pronounced in the UK than in most other countries. It has been estimated that the UK has become the most indebted country in the world.<sup>1</sup>



<sup>1</sup> *Debt and deleveraging: The global credit bubble and its economic consequences*, McKinsey Global Institute, January 2010.

**Unbalanced growth** **1.3** Increasing reliance on debt-financed consumer and government spending and on the financial sector drove growing imbalances in the UK economy, which were clear on many measures. According to the OECD, by 2007 the UK had the largest structural budget deficit in the G7.<sup>2</sup> The current account deficit was around 2¾ per cent of GDP in 2007, a figure that was flattered by a 2¼ per cent surplus on trade in financial services. Between 1997 and 2007, government consumption increased from 18 to 21 per cent of GDP, while business investment fell from 11¾ to 10 per cent of GDP. The recession has only compounded these imbalances, with government consumption accounting for 23½ per cent of GDP in 2009 and business investment falling over 25 per cent from its peak, to trough at just 8¼ per cent of GDP.

**Financial crisis** **1.4** Between 2002 and 2007 there was a near tripling of UK bank balance sheets<sup>3</sup> and the UK financial system had become one of the most highly leveraged in the world, more so than the US. As a result, the UK was particularly vulnerable to financial instability and was hit hard by the financial crisis. The loss of confidence and withdrawal of credit that followed precipitated the deepest and longest recession since the Second World War: output fell by more than 6 per cent according to the latest estimate from the Office for National Statistics (ONS).

**Public sector imbalances** **1.5** In the UK, a property boom and unsustainable profits and remuneration in the financial sector in the pre-crisis years drove rapid growth in tax receipts. The spending plans set out in the 2007 Comprehensive Spending Review were based on these unsustainable revenue streams. As tax receipts fell away during the crisis, the public sector was revealed to be living beyond its means. Public spending increased from 41 per cent of GDP in 2006-07 to 48 per cent of GDP in 2009-10, while tax receipts fell by 2 per cent of GDP over the same period. Revenue has averaged around 38 per cent of GDP over the past 20 years, not exceeding 40 per cent in that time. Chart 1.2 later in this chapter shows both the persistent gap between spending and revenue in the pre-crisis years, and the dramatic widening of that gap in the past two years. As a result, the overall budget deficit reached 11 per cent of GDP in 2009-10.

**1.6** As Box 1.1 illustrates, the result has been to leave the UK with one of the largest fiscal challenges of any major economy, reinforcing the case for accelerated action to put the UK's public finances back on a sustainable footing.

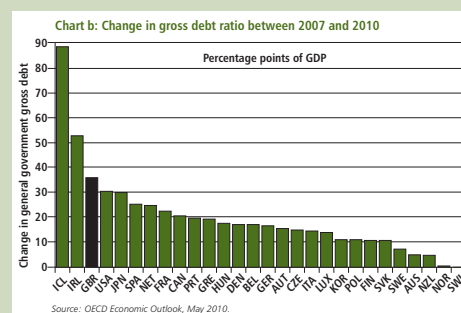
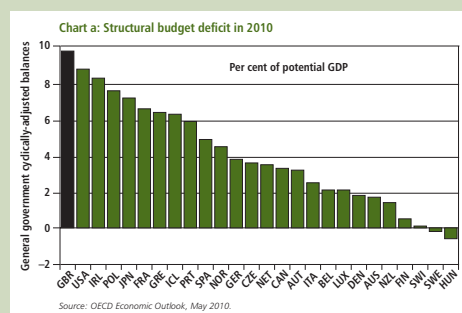
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<sup>2</sup>OECD *Economic Outlook No. 87*, OECD, May 2010.

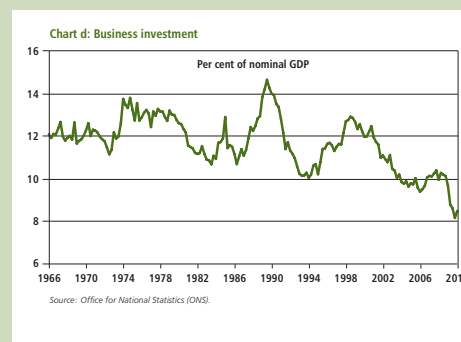
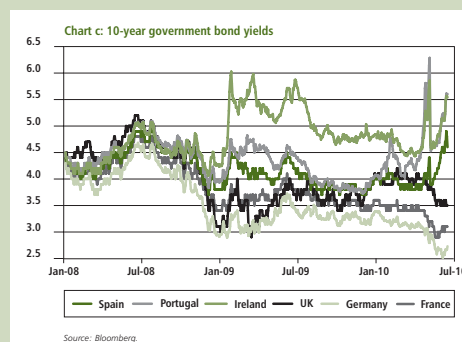
<sup>3</sup>Speech by Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 16 June 2010.

## Box 1.1: The scale of the fiscal challenge

The fiscal challenge in the UK is, on some measures, larger than in any other advanced economy. In May, the International Monetary Fund (IMF) forecast that UK public borrowing would be the highest in the G20 in 2010;<sup>a</sup> it is also estimated that the UK's structural deficit will be the highest among all OECD countries<sup>b</sup> and the 27 EU Member States.<sup>c</sup> The rating agency Fitch has pointed out that *"the rise in public debt ratios [in the UK] since 2008 is faster than for any other 'AAA'-rated sovereign."*<sup>d</sup>



While the fiscal position in the UK is very challenging, the financing environment has remained supportive and, among other factors, the new Government's fiscal credibility has already helped to keep long-term interest rates close to record lows, as shown in Chart c. Accelerated fiscal consolidation will help keep market interest rates lower for longer, supporting economic recovery and lowering the proportion of tax revenues devoted to debt service payments. The Government has set out a credible deficit reduction plan that should provide businesses with the confidence they need to plan and invest, supporting the necessary recovery in business investment.



<sup>a</sup> IMF Fiscal Monitor, IMF, May 2010.

<sup>b</sup> OECD Economic Outlook No.87, May 2010.

<sup>c</sup> European Commission Spring Forecast, May 2010.

<sup>d</sup> Special Report, Fitch Ratings Agency, June 2010.

## Role for Government

**1.7** Government policy has an important role to play in minimising risks to the recovery and supporting rebalancing towards sustainable, private sector-led growth, including through:

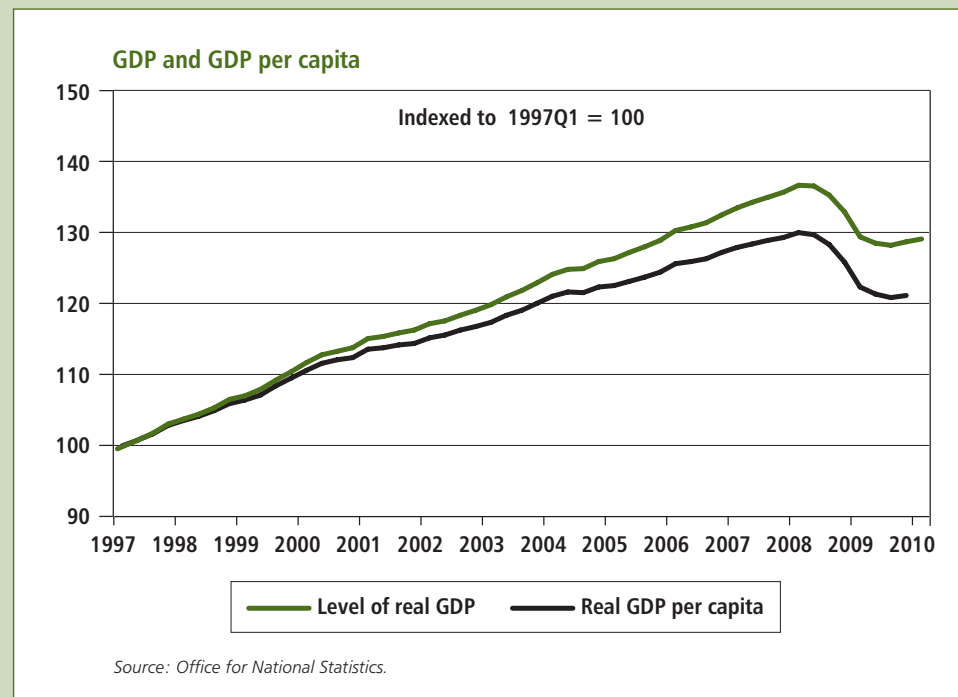
- an accelerated plan to reduce the deficit and place debt as a percentage of GDP on a downward path, which should underpin household, business and market confidence and provide the conditions for sustainable growth in the private sector; and

- action to prevent the build-up of systemic macroeconomic and financial risks, which will help ensure that the economy is no longer reliant on unsustainable, debt-financed activities.

**1.8** The Government's macroeconomic strategy will help provide a stable economic foundation for private sector growth. Measures to promote enterprise will reduce regulation and tax rates and refocus support towards infrastructure, the low-carbon economy, and regional development. Measures to create a fair tax system will reward work and promote economic competitiveness. The Government's policies in these areas are discussed in the enterprise and fairness sections of this chapter.

### Box 1.2: Economic performance

There is widespread acknowledgement that GDP is not the ideal measure of well-being. GDP per capita is a better measure, as it reflects economic output per person. As shown on the chart below, GDP per capita has fallen below the level it reached in 2004. A recent Stiglitz, Sen and Fitoussi report makes recommendations on the measurement of both current well-being and sustainability, as well as changes needed to 'classical GDP', where the report notes: "... perhaps had there been more awareness of the limitations of standard metrics, like GDP, there would have been less euphoria over economic performance in the years prior to the crisis; metrics which incorporated assessments of sustainability (e.g. increasing indebtedness) would have provided a more cautious view of economic performance.." <sup>a</sup>



The Government is committed to developing broader indicators of well-being and sustainability, with work currently underway to review how the Stiglitz, Sen and Fitoussi report should affect the sustainability and well-being indicators collected by Defra, and with the ONS and the Cabinet Office leading work on taking forward the report's agenda across the UK.

<sup>a</sup> Report by the Commission on the measurement of economic performance and social progress, Stiglitz, Sen and Fitoussi, 2009.

## Macroeconomic strategy

**1.9** Providing the right macroeconomic conditions will help correct the imbalance between the public and private sectors that built up over the past decade, underpinning a sustainable recovery that is more evenly balanced across regions and industries.

### Fiscal policy framework

#### Role of fiscal consolidation

**1.10** The current, historically high level of public borrowing risks undermining fairness, growth and economic stability in the UK. Borrowing must be brought under control and debt as a percentage of GDP must be placed on a downward path, as:

- reducing public sector borrowing will underpin private sector confidence and reduce competition for funds for private sector investment, supporting growth and job creation over the medium term;
- failure to address rising public sector debt in the UK risks pushing up long-term interest rates, which would affect not just the Government, but also families and businesses through the higher costs of loans and mortgages. The IMF has estimated that every ten percentage points of additional debt could raise interest rates by around  $\frac{1}{2}$  percentage point and reduce long-term economic growth by around  $\frac{1}{4}$  percentage point.<sup>4</sup> Public spending on debt interest is unproductive and squeezes out spending on public services;
- reducing the deficit and so placing debt as a percentage of GDP on a downward path provides scope to absorb the impact of future economic shocks; and
- public borrowing is, in essence, taxation deferred, and it would be irresponsible and unfair to accumulate substantial debts to fund spending that benefits today's generation at the expense of subsequent generations.

#### Fiscal policy

**1.11** This Budget sets out a comprehensive set of policies to bring the public finances back under control. It demonstrates the Government's determination to reduce public sector borrowing and debt, promoting domestic and international confidence in the sustainability of the public finances, including by:

- creating the new Office for Budget Responsibility (OBR), which introduces independence, greater transparency and credibility to the economic and fiscal forecasts on which fiscal policy is based;
- setting fiscal policy to restore the public finances to a sustainable position; and
- a clear and measurable fiscal mandate, which will guide fiscal policy decisions over the medium term.

#### The Office for Budget Responsibility

**1.12** The Government's fiscal policy decisions will be based on independent forecasts for the economy and public finances, prepared by the OBR. The OBR has already transparently laid out the full scale of the fiscal challenge. The Chancellor has also asked the OBR to judge whether the Government's fiscal policy is consistent with a greater than 50 per cent chance of achieving the fiscal mandate. The establishment of the OBR places the UK at the forefront of

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<sup>4</sup> IMF Fiscal Monitor, November 2009 and May 2010.

institutional reform internationally. The IMF has advocated the benefits of such a model.<sup>5</sup>

**1.13** For this Budget, the OBR has operated on an interim basis. The Terms of Reference for the interim OBR were agreed on 8 June 2010 and published on the OBR's website.<sup>6</sup> The OBR will be put on a permanent footing once the necessary legislation has been enacted. The OBR's pre-Budget forecast was published on 14 June 2010.<sup>7</sup> Full details of the OBR's Budget forecast are provided in Annex C.

**1.14** For this Budget, the National Audit Office (NAO) has examined the process by which the interim OBR's forecasts have been arrived at. The Comptroller and Auditor General's report confirms that, based on the NAO's criteria, *"the key economic and fiscal assumptions underpinning the interim Office for Budget Responsibility's forecasts have been independently arrived at."*<sup>8</sup>

**Fiscal mandate** **1.15** The Budget announces the Government's forward-looking fiscal mandate **to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period.** At this Budget, the end of the forecast period is 2015-16.

**1.16** At this time of rapidly rising debt, the fiscal mandate will be supplemented by **a target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16,** ensuring that the public finances are restored to a sustainable path. The Government has asked the OBR to assess whether policy is consistent with a greater than 50 per cent chance of meeting the target for debt.

**1.17** This fiscal mandate, supplemented by the target for debt, will guide fiscal policy decisions over the medium term, ensuring that the Government sets plans consistent with accelerating the reduction in the structural deficit so that debt as a percentage of GDP is restored to a sustainable, downward path. This will help reduce the risk of pushing up long-term interest rates and provide scope to absorb the impact of future economic shocks.

**Design of mandate** **1.18** The fiscal mandate is based on:

- the current balance, to protect the most productive public investment expenditure; and
- a cyclically-adjusted aggregate, to allow some fiscal flexibility at a time of economic uncertainty.

**1.19** The fiscal mandate applies to the end of the five-year forecast period, set at this Budget as 2015-16. In the future, when the forecast period moves forward a year, the deficit target will continue to apply in the final year, so anchoring the Government's medium-term fiscal stance.

**1.20** The forward-looking fiscal mandate addresses a key failing of the framework that was in place from 1997 to 2008: the formulation of the golden rule adopted during this period required the Government to balance the current budget over the economic cycle. This resulted in an approach that

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<sup>5</sup> *Code of good practices on fiscal transparency*, IMF, 2007.

<sup>6</sup> <http://budgetresponsibility.independent.gov.uk>.

<sup>7</sup> *Pre-Budget forecast*, Office for Budget Responsibility, June 2010.

<sup>8</sup> *Examination concerning the forecasts prepared by the interim Office for Budget Responsibility for the emergency Budget*, National Audit Office, June 2010.

proved too backward looking, especially at the end of the economic cycle, allowing persistent fiscal deficits when growth was strong, on the basis of past surpluses.

**1.21** Under the framework in place from 1997 to 2008, the Government determined the dating of the economic cycle over which the golden rule applied, calling the credibility of the framework into question. The OBR will be responsible for key judgements relevant to achieving the fiscal mandate, in particular the cyclical position of the economy, which determines the structural position of the public finances.

**1.22** The previous golden rule and sustainable investment rule were suspended following the financial crisis. The first replacement, the temporary operating rule, was criticised as insufficiently specific to guide the fiscal position back to sustainability. The second replacement, the Fiscal Responsibility Act 2010, was insufficiently rigorous – public sector net borrowing was only required to be 5½ per cent of GDP by 2013-14.

**1.23** The Government's fiscal mandate requires that the cyclically-adjusted current budget be returned to balance over the five-year forecast period. The target for debt is a fixed requirement for debt as a percentage of GDP to be falling in 2015-16, which will not move forward with the five-year forecast period, ensuring that the public finances are restored to a sustainable path.

**Future approach** **1.24** The choices of a five-year rolling forecast period for the fiscal mandate, supplemented by the fixed date for the debt target, reflect the exceptional environment in which the Government must address the fiscal challenge. They are designed to ensure that fiscal consolidation is delivered over a realistic and credible timescale. Once the public finances are closer to balance the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

**Stability and Growth Pact** **1.25** The Stability and Growth Pact (SGP) provides a framework for fiscal policy in the European Union. The Excessive Deficit Procedure of the SGP recommends the Government reduce the Treaty deficit below 3 per cent of GDP by 2014-15. The OBR's pre-Budget forecast showed the plans inherited by this Government leaving a Treaty deficit of 4.0 per cent of GDP in 2014-15. The plans set out in this Budget are consistent with reducing the Treaty deficit below 3 per cent of GDP by 2014-15 and placing the Treaty debt ratio on a downward path from 2013-14.

### Macro-prudential policy framework

**1.26** The recent crisis shows that price stability alone is not sufficient to ensure wider economic and financial stability. During the years preceding the crisis, there was no single body or organisation with responsibility for addressing the build-up of systemic risks in the financial sector. As outlined in the Chancellor's Mansion House speech of 16 June 2010,<sup>9</sup> the Government is therefore introducing a new system of regulation, which will give the Bank of England control of macro-prudential regulation and oversight of micro-

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<sup>9</sup> Available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)



prudential regulation. This new regulatory structure will ensure that there is clear responsibility for monitoring and acting upon the build-up of systemic risks. The Government has also established an independent commission on banking, chaired by Sir John Vickers. This commission will consider the structure of the UK banking sector and make recommendations to the Cabinet Committee on Banking Reform by the end of September 2011.

## Monetary policy framework

**1.27** While price stability has not proved sufficient for wider economic stability, it remains a necessary condition. The Government is therefore fully committed to maintaining price stability. **The Chancellor has decided that the independent Monetary Policy Committee (MPC) of the Bank of England will continue to target 2 per cent inflation, as measured by the 12-month increase in the Consumer Prices Index (CPI).**

## Deficit reduction

### Scale of the fiscal challenge

**1.28** Compared with the March Budget forecast, the OBR estimates that a lower proportion of the UK's budget deficit results from the cyclical position of the economy and a greater proportion reflects an underlying structural deficit. The OBR's pre-Budget forecast estimated that the cyclically-adjusted or 'structural' deficit in 2010-11 was 0.6 per cent of GDP higher than estimated in the March Budget.

**1.29** The OBR's pre-Budget forecast showed that, without further action to tackle the deficit:

- public sector net borrowing would remain at 4 per cent of GDP in five years time, having been above 5 per cent of GDP for six consecutive years, unprecedented in the post-war period;
- the structural deficit would be 2.8 per cent of GDP in 2014-15, while the structural current deficit would be 1.6 per cent; and
- debt would still be rising in 2014-15 to 74.4 per cent of GDP, with debt interest payments set to reach £67 billion in that year.

**1.30** The OBR's pre-Budget forecast used market expectations for short-term and long-term interest rates. The OBR recognised that those market rates reflected investors' expectations about the measures to be introduced in the Budget and the possible response of the Monetary Policy Committee to further consolidation. As a result, the OBR made clear in its pre-Budget forecast, *"in present conditions the likely result is that these economic forecasts are biased upwards: to the extent that market expectations factor in tighter fiscal policy than assumed in these projections, then following the fiscal path assumed here would lead to higher interest rates and so lower economic activity than set out in this projection."*<sup>10</sup>

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<sup>10</sup> Pre-Budget forecast, Office for Budget Responsibility, June 2010.



## Approach to deficit reduction

**Choice of levers** 1.31 The Government's fiscal consolidation plans have been designed with growth and fairness in mind, as far as possible:

- protecting the most productive public investment expenditure;
- avoiding punitive increases in tax rates on capital and labour; and
- reforming the welfare system to reward work.

1.32 The greatest contribution to the Government's fiscal consolidation will come from public spending reductions, rather than tax increases. This approach is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that largely rely on spending restraint promote growth.<sup>11</sup> Tax measures can be an effective tool for reducing the deficit quickly, allowing for phased reductions in public spending. The Government's consolidation plans therefore involve a rising contribution from public spending over the forecast period.

**Scale of consolidation** 1.33 This Budget delivers additional consolidation on top of the plans set in the March Budget for the period to 2014-15, with additional spending reductions of £32 billion a year by 2014-15 and additional net tax increases of £8 billion. This results in plans for a total consolidation of £128 billion per year by 2015-16, consisting of total reductions in spending of £99 billion and a net increase in taxes of £29 billion.

1.34 Plans in the March Budget were for 71 per cent of the consolidation by 2014-15 to be delivered through lower spending. By 2014-15, 80 per cent of the additional consolidation measures set out in this Budget will be delivered through spending restraint. Taking the consolidation as a whole, 74 per cent of the total will now be delivered by lower spending in 2014-15, rising to 77 per cent in 2015-16. This is set out in Table 1.1.

**Table 1.1: Total consolidation plans over the forecast period**

	£ billion					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
<b>Discretionary policy announced at Budget <sup>1</sup></b>	<b>8.1</b>	<b>15</b>	<b>24</b>	<b>32</b>	<b>40</b>	
Spending	5.2	9	17	24	32	
Tax	2.8	6	7	9	8	
<i>Spending share of consolidation (per cent)</i>	65	59	71	74	80	
<b>Policy inherited by the Government</b>	<b>0.8</b>	<b>26</b>	<b>42</b>	<b>57</b>	<b>73</b>	
Spending <sup>2</sup>	0.0	14	25	39	52	
Tax	0.8	11	17	18	21	
<i>Spending share of consolidation (per cent)</i>	0	56	60	68	71	
<b>Total discretionary consolidation</b>	<b>8.9</b>	<b>41</b>	<b>66</b>	<b>90</b>	<b>113</b>	<b>128</b>
Spending <sup>3</sup>	5.2	23	42	63	83	99
Tax	3.6	18	24	27	29	29
<i>Spending share of consolidation (per cent)</i>	59	57	64	70	74	77

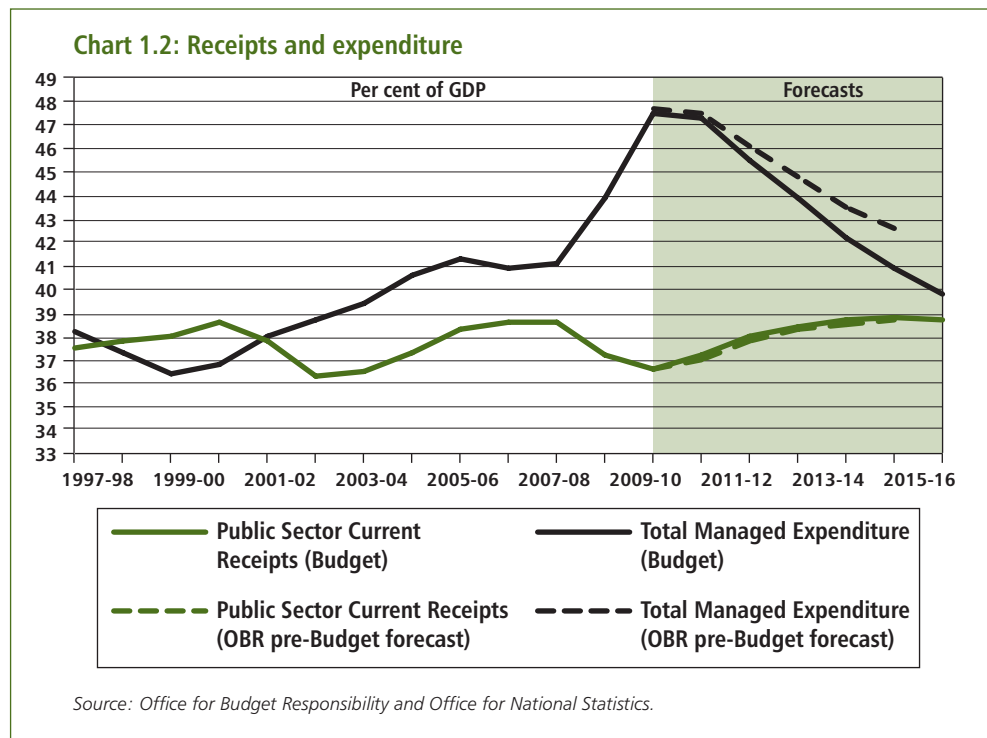
<sup>1</sup> Including savings in 2010-11 announced before Budget.

<sup>2</sup> Spending reductions against baseline of growing DEL in line with general inflation in the economy, in line with Table 4.8 in the OBR pre-Budget forecast and AME as forecast at Budget, including estimated debt interest savings from 2011-12 onwards of £0.5bn, £2bn, £4bn and £7bn.

<sup>3</sup> Baseline as in footnote 2, but extended to 2015-16 using the same methodology, with estimated total debt interest saving of £16bn in 2015-16.

<sup>11</sup> See UK Article IV Consultation, IMF, May 2009 and Economic Outlook No.81, OECD, June 2007.

**1.35** Spending is projected to fall from 48 per cent of GDP to 40 per cent by 2015-16 and receipts are projected to rise from 37 to 39 per cent. Cyclically-adjusted public sector net borrowing will be reduced by 8.4 percentage points, from 8.7 per cent of GDP in 2009-10 to 0.3 per cent of GDP in 2015-16.



## Spending measures

**1.36** The Government has already identified £6.2 billion of savings in 2010-11 and cancelled nearly £2 billion of projects approved since 1 January 2010. Further detail, and confirmation of Departmental Expenditure Limits (DELs) for 2010-11, is provided in Chapter 2.

### The future path of public spending

**1.37 The Budget announces the path of public spending for the period until 2015-16.** The figures for Total Managed Expenditure (TME), public sector current expenditure (PSCE) and public sector gross investment (PSGI) are set out in Table 2.3 in Chapter 2. **In 2015-16, TME will grow in line with general inflation in the economy.**

**1.38** The forthcoming Spending Review will, for the first time, set spending plans for the four years to 2014-15. Compared with departmental expenditure remaining constant in real terms and the OBR's pre-Budget forecast for Annually Managed Expenditure (AME), public expenditure will be £83 billion a year lower by 2014-15. £52 billion of these spending reductions were implied in projections that this Government inherited, but were not underpinned by specific plans for delivery. **This Budget announces:**

- **additional reductions in current spending totals of £30 billion a year by 2014-15; and**
- **no further cuts in capital spending totals beyond those announced as part of the £6.2 billion of savings in 2010-11, in order to protect the most productive public sector investment.**

## The Spending Review process

- **This Budget announces that the 2010 Spending Review will be published on 20 October 2010.** An engagement programme will launch on 24 June 2010, giving public sector workers and members of the public an opportunity to feed in their ideas for how to reduce spending while protecting the quality of public services.

## The Spending Review envelope

**1.39** The Spending Review will set DELs for every department and for the devolved administrations.<sup>12</sup> It will also announce plans for any further savings and reforms in significant elements of AME, including social security, tax credits and public service pensions.<sup>13</sup> The Budget sets firm and fixed envelopes for the areas of current and capital spending included within the Spending Review. These are published in Table 2.3 in Chapter 2.

**1.40** To promote transparency and understanding of the broad magnitude of spending changes, Table 2.3 presents indicative figures for the overall level of current and capital DEL spending in the years to 2015-16. These are based on the OBR's Budget forecast for AME, as set out in Annex C, which takes account of specific AME measures announced so far. Based on these implied DEL figures, and once the Government's commitments on protecting health and overseas aid are taken into account, other departments could see average real cuts to their budgets of around 25 per cent over the four years. This compares with the average real cuts of around 20 per cent for unprotected departments implied by the March Budget.<sup>14</sup> The final split between AME and DEL will be decided at the Spending Review, and any further AME savings will reduce the size of cuts to departmental budgets.

## Budget spending measures

**1.41** The Budget also announces significant measures on public sector pay and welfare reform that contribute to spending consolidation. Savings from these measures will help to protect the quality of public services as overall public spending is reduced.

**1.42 The Government announces a two-year pay freeze for public sector workforces, except for workers earning less than £21,000 a year who will receive an increase of at least £250 per year in these years.** This will save £3.3 billion a year by 2014-15. An independent commission chaired by John Hutton will undertake a fundamental, structural review of public service pension provision by Budget 2011 and consider the case for short-term savings in the Spending Review period, by September 2010.

**1.43** Spending on social security and tax credits has increased by 45 per cent, around £60 billion, in real terms over the past 10 years. Welfare reform measures in this Budget reduce overall expenditure on social security, saving £11 billion in 2014-15. **The Government will adopt the CPI for the indexation of benefits, tax credits and public service pensions from April 2011. The Government will also introduce measures to control spending on tax credits, housing benefit and disability benefits.** Alongside these reforms, it is introducing measures to protect pensioners and low-income families with children. Further details are set out in the fairness

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<sup>12</sup> For further information, see *The Spending Review Framework*, HM Treasury, June 2010.

<sup>13</sup> Central government debt interest, BBC domestic services, National Lottery and net expenditure transfers to EU institutions will be excluded from the Spending Review process, as they are either self-financing or not directly within Government control.

<sup>14</sup> This included commitments to protect resource spending on NHS, overseas aid, schools, 16-19 education, Sure Start, and police numbers.

section of this chapter. The Government is also reviewing how the CPI can be used for the indexation of taxes and duties while protecting revenues.

## Tax measures

**VAT and IPT 1.44** The Budget announces tax measures to reduce the deficit and reform the tax system:

- **the standard rate of Value Added Tax (VAT) will increase from 17.5 per cent to 20 per cent from 4 January 2011.** VAT is a sustainable source of revenue and is less distortionary than other major tax bases. The increase will raise £13.5 billion a year, on a scorecard basis, by 2014-15. Following this increase, the main rate of VAT will remain below the European Union average. This Budget makes no changes to the VAT zero rating for household essentials, nor to the reduced rate of VAT; and
- in line with the increase in the VAT rate, **the higher rate of Insurance Premium Tax (IPT) will increase on 4 January 2011, from 17.5 per cent to 20 per cent, while the standard rate will increase from 5 per cent to 6 per cent.** This will raise £0.5 billion a year by 2014-15.

**Tax reform 1.45** As set out in more detail in the fairness and enterprise sections of this chapter, the Budget also announces wider changes to the tax system. These include reform and rebalancing of business taxes, including the introduction of a bank levy, and an increase to the personal allowance, in part financed by an increase in capital gains tax.

**1.46** Taken together, the tax measures announced in this Budget rebalance the tax system to increase its overall economic efficiency, improve its sustainability and support a fair reduction in the deficit. In total, the net tax contribution in this Budget is £8 billion a year by 2014-15.

## Economic and fiscal forecast

### Economic forecast

**1.47** Table 1.2 provides a summary of the OBR's Budget central economic forecast. Further detail is provided in Annex C.

**Table 1.2: Summary of OBR's Budget central economic forecast<sup>1</sup>**

	Percentage change on a year earlier, unless otherwise stated						
	Forecasts						
	2009	2010	2011	2012	2013	2014	2015
Gross domestic product (GDP)	-4.9	1.2	2.3	2.8	2.9	2.7	2.7
CPI inflation (Q4)	2.1	2.7	2.4	1.9	2.0	2.0	2.0

<sup>1</sup> All growth rates in this table are rounded to the nearest 1 decimal place. This is not intended to convey a degree of unwarranted accuracy.

**Economic prospects 1.48** The OBR's Budget economic forecast is for a gradual recovery, as the legacy of unbalanced growth and excessive levels of debt continue to weigh on the economic outlook. The OBR forecasts the economy to rebalance, with net exports and business investment making a greater contribution to growth than in the recent past, and government spending making a negative contribution to growth as fiscal consolidation is implemented. This is a crucial part of the rebalancing of the economy that is required for a sustainable recovery. Box 1.3 further explains the impact that fiscal consolidation will have on the economy.

**1.49** As set out by the OBR, significant uncertainties and risks to the outlook remain. Some of these uncertainties relate to their key forecast judgements, including their estimate of the underlying supply potential of the economy; developments in the euro area, credit and bank funding conditions also remain key risks to the UK outlook.

### **Box 1.3: Economic impact of fiscal consolidation**

The overall economic impact of fiscal consolidation depends on the combination of:

- *direct and indirect effects*, from reduced public spending or increased taxation. These will tend to reduce demand growth in the short term; and
- *wider economic effects*, which depend on the reaction of the private sector and monetary policy to the changed fiscal environment. These will tend to boost demand growth, could improve the underlying performance of the economy and could even be sufficiently strong to outweigh the negative effects.

Wider economic effects include:

- *the reaction of the Monetary Policy Committee to tighter fiscal policy*: as the Governor of the Bank of England said in his Mansion House speech on 16 June 2010, “...monetary policy must be set in the light of the fiscal tightening over the coming years... If prospects for growth were to weaken, the outlook for inflation would probably be lower and monetary policy could then respond.”<sup>a</sup> Monetary conditions are already expansionary, but further support could come from conditions remaining expansionary for longer than would otherwise have been the case;
- *the reaction of the bond market* to an accelerated and more credible fiscal consolidation plan could leave long-term interest rates lower for longer; and
- *the effect on private sector confidence and spending*: reassuring the private sector that concrete measures have been put in place to limit the rise in government debt could prompt households and companies to reduce precautionary saving, increasing consumption and investment relative to what they would have been otherwise.

A simple comparison of the pre-Budget and Budget forecasts produced by the OBR suggests that fiscal consolidation will negatively affect the economy in the short term. However, the OBR has stressed that “*it is potentially misleading to interpret the difference between the pre-Budget and Budget forecasts as the economic impact of the Budget measures.*” The OBR note that interest rates would have been higher in the absence of the fiscal tightening announced in this Budget, and it has provided an illustrative calculation that long-term interest rates might have been 0.3 percentage points higher. Higher interest rates would negatively affect output and employment.

As the OBR makes clear, its forecasts are surrounded by a significant degree of risk and uncertainty. A key benefit of taking decisive action on fiscal consolidation is to reduce the risks associated with failing to correct the fiscal position, in particular that high levels of public debt could trigger a sudden loss of market confidence, leading to higher market interest rates. Since the end of March, the spread of government bond yields over German bunds has increased sharply in those countries where market concerns about fiscal credibility have heightened: by around 1½ percentage points on average in Spain, Portugal and Ireland. In the UK, the change has been close to zero. A simple comparison of forecasts would not reflect the significant economic benefit of reducing the risk of such adverse outcomes.

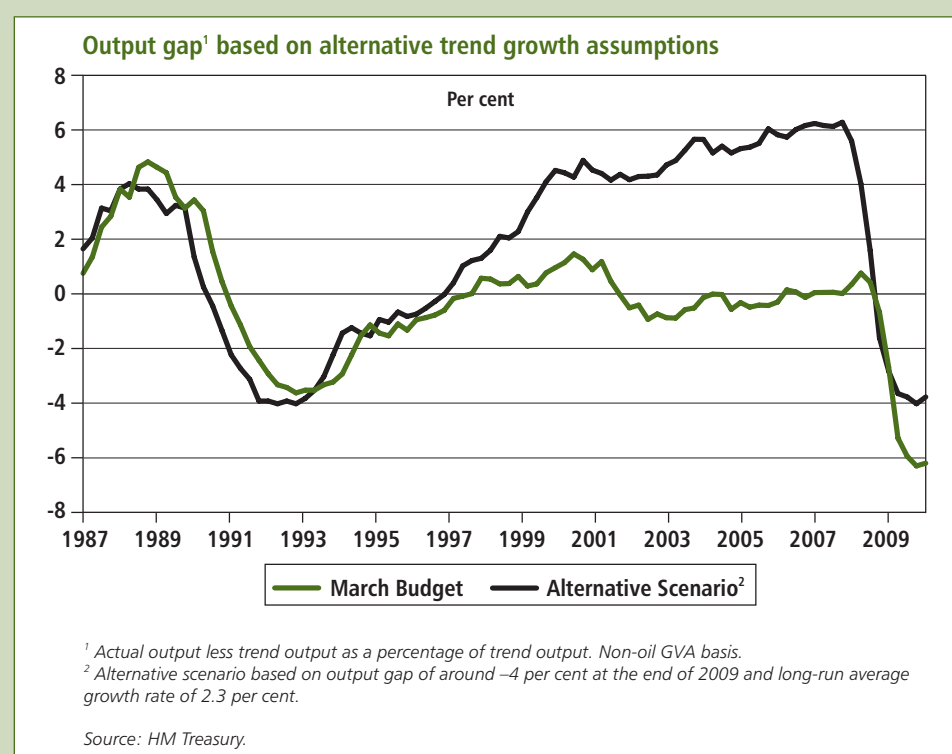
<sup>a</sup> Available at [www.bankofengland.co.uk](http://www.bankofengland.co.uk)

**Trend output** 1.50 The OBR's forecast is based on the judgement that the current level of trend output is lower than assumed in the March Budget, and the negative output gap is therefore smaller. Their projection for trend growth is also lower, at around 2¼ per cent over the next three years, slowing to just over 2 per cent from 2014. That compares with 2¾ per cent a year assumed for the March Budget economy forecast and 2½ per cent underpinning the public finance projections.

#### **Box 1.4: Output gap assessment**

The depth of the recession means there is great uncertainty about what has happened to 'trend' or 'potential' output over the recent past. Previous official estimates assumed that the financial crisis had brought about a downward adjustment to potential output. In particular, the March Budget estimated that trend growth would average just under 1 per cent between mid-2007 and mid-2010, before reverting to a pre-crisis projection of 2¾ per cent. As shown by the chart below, this implied a negative output gap of just over 6 per cent at the end of 2009. The OBR's central judgement is that a range of indicators point to a smaller negative output gap of around 4 per cent at the end of 2009, and that the current level of trend output is therefore lower than assumed for the March Budget.

It is difficult to judge the extent to which the downward revision to trend output reflects economic changes *resulting* from the financial crisis, as opposed to those *revealed* by it. One possibility is that trend output has undergone a significant adjustment as a result of the recession, reflecting for example the impact of an increase in the cost of capital on the productive capital stock. An alternative view is that trend output growth was lower before the crisis. For example, over the past 50 years GDP growth in the UK has averaged a little over 2¼ per cent a year. Using the OBR judgement of a negative output gap of around 4 per cent at the end of 2009, and assuming a trend growth rate of around 2.3 per cent a year prior to this point, would imply that a large positive output gap had opened up in the years preceding the recession, reaching over 5 per cent by 2007. This would, in turn, imply that the structural position of the public finances prior to the crisis was worse than estimated at the time. This is illustrated in the chart.



Many external forecasters have assumed the crisis negatively affected trend output. Indicators of the cyclical position of the economy prior to the recession also point to a somewhat smaller output gap than implied by the alternative scenario. However, the previous Government's assumptions about trend growth before the crisis were at the upper end of external estimates and many commentators have suggested that the economy was further above trend by 2007 than was assumed in the March Budget. For example, the OECD has estimated that the UK economy was just under 2 per cent above trend in 2007, compared with the March Budget estimate of around ¼ per cent.

<sup>3</sup>OECD Economic Outlook No.87, OECD, May 2010.



## Fiscal forecast

**1.51** Table 1.3 provides a summary of the OBR's central forecast for the public finances. Further detail is provided in Annex C.

**Table 1.3: Overview of OBR central fiscal forecast**

	Per cent of GDP							
	Outturn		Estimate					
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
<b>Deficit</b>								
Public sector net borrowing	6.7	11.0	10.1	7.5	5.5	3.5	2.1	1.1
Surplus on current budget	-3.5	-7.5	-7.5	-5.7	-4.0	-2.3	-0.9	0.0
Cyclically-adjusted net borrowing	6.3	8.7	7.4	5.0	3.4	1.8	0.8	0.3
Cyclically-adjusted surplus on current budget	-3.1	-5.3	-4.8	-3.2	-1.9	-0.7	0.3	0.8
<i>Total policy decisions<sup>1</sup></i>			0.5	1.0	1.5	1.9	2.2	
Treaty Deficit <sup>2</sup>	6.8	11.3	10.1	7.6	5.6	3.6	2.2	1.2
<b>Debt</b>								
Public sector net debt <sup>3</sup>	44.0	53.5	61.9	67.2	69.8	70.3	69.4	67.4
Treaty Debt ratio <sup>4</sup>	55.8	71.2	78.9	83.6	85.5	84.9	83.1	80.4
<i>Memo: Output Gap (per cent of GDP)</i>	-1.0	-4.1	-3.7	-3.5	-2.8	-2.3	-1.6	-0.9

<sup>1</sup> Equivalent to the 'Total policy decisions' line in Table 2.1, which includes debt interest savings.

<sup>2</sup> General government net borrowing on a Maastricht basis.

<sup>3</sup> Debt at end March; GDP centred on end March.

<sup>4</sup> General government gross debt on a Maastricht basis.

**Impact on fiscal position** **1.52** As a result of the action the Government is taking, the OBR projects that:

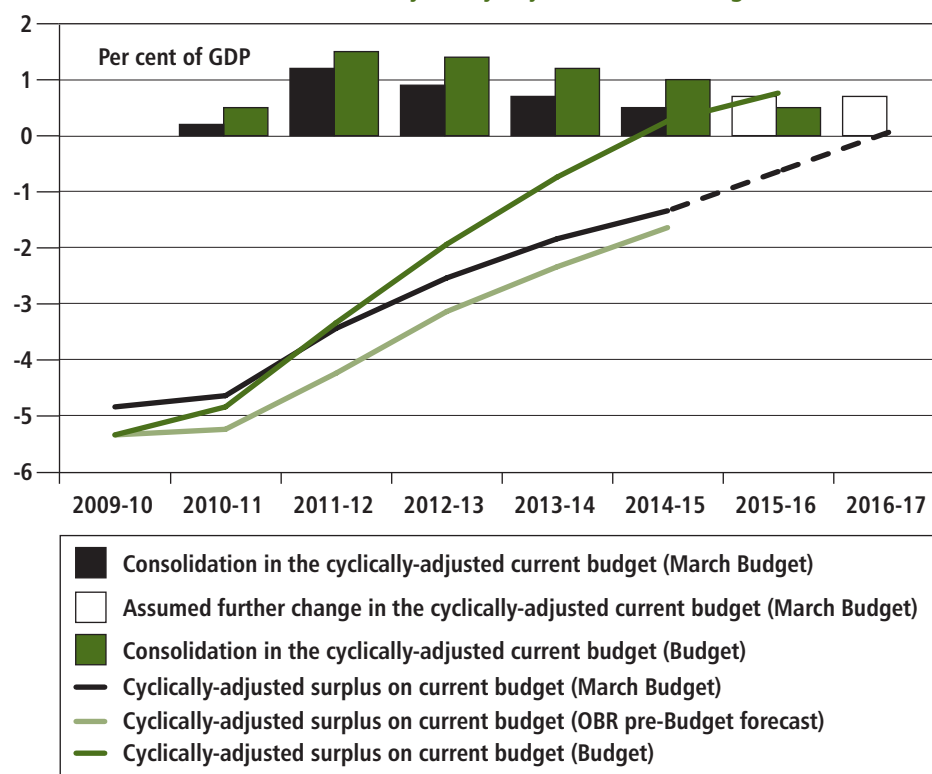
- public sector net borrowing will decline from its peak of 11.0 per cent of GDP in 2009-10 to 1.1 per cent of GDP in 2015-16;
- the cyclically-adjusted or 'structural' current deficit will be eliminated by 2014-15, two years earlier than planned in the March Budget, with a projected surplus of 0.3 per cent of GDP in that year, rising to 0.8 per cent of GDP in 2015-16; and
- public sector net debt will peak at 70.3 per cent of GDP in 2013-14, one year earlier than projected in the March Budget and around 4½ percentage points lower, before declining to 69.4 per cent of GDP in 2014-15 and 67.4 per cent of GDP in 2015-16.

**Performance against the mandate** **1.53** As set out in Annex C, taking account of uncertainty, the OBR's judgement is that the policies set out in this Budget are consistent with a greater than 50 per cent chance of achieving the Government's fiscal mandate.

**1.54** It is also the OBR's assessment that the Government's policies have a greater than 50 per cent chance of meeting the target for debt in 2015-16.

**1.55** As the OBR have highlighted, all forecasts are subject to uncertainty, but this applies in particular to fiscal forecasts at the present time. Recognising this, the Government has set policy to achieve a surplus on the cyclically-adjusted current budget, so that moderate shocks can be absorbed should they arise. The OBR's central Budget forecast is for the fiscal mandate to be achieved in 2014-15, a year early. The forecast also shows the debt target being achieved a year early in 2014-15.

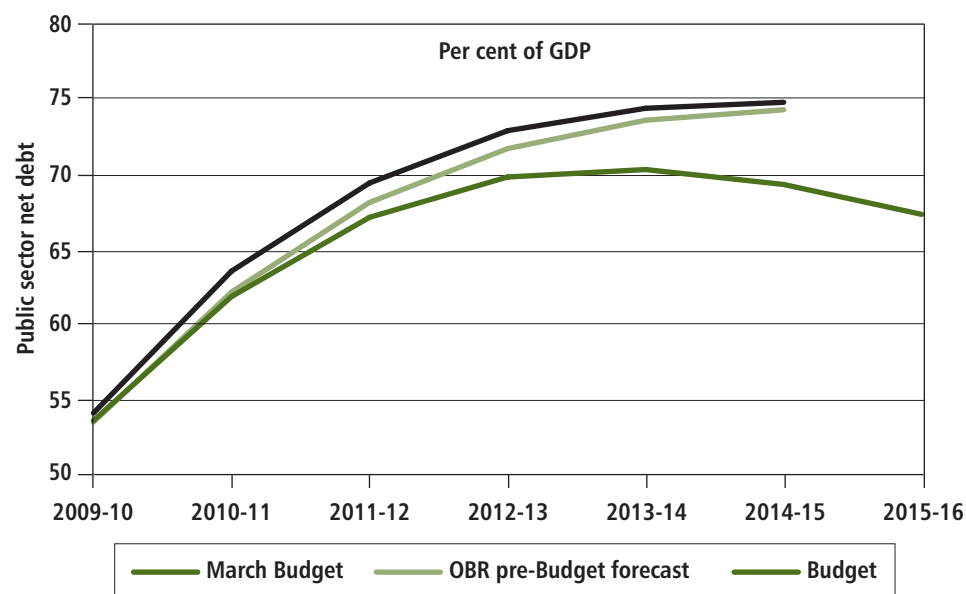
**Chart 1.3: Consolidation in the cyclically-adjusted current budget**



Source: Office for Budget Responsibility and HM Treasury.

Note: The March Budget forecast extended to 2014-15 and assumed further consolidation to 2016-17. This Budget forecasts to 2015-16.

**Chart 1.4: Public sector net debt**



Source: Office for Budget Responsibility and HM Treasury.

## Historical and international context

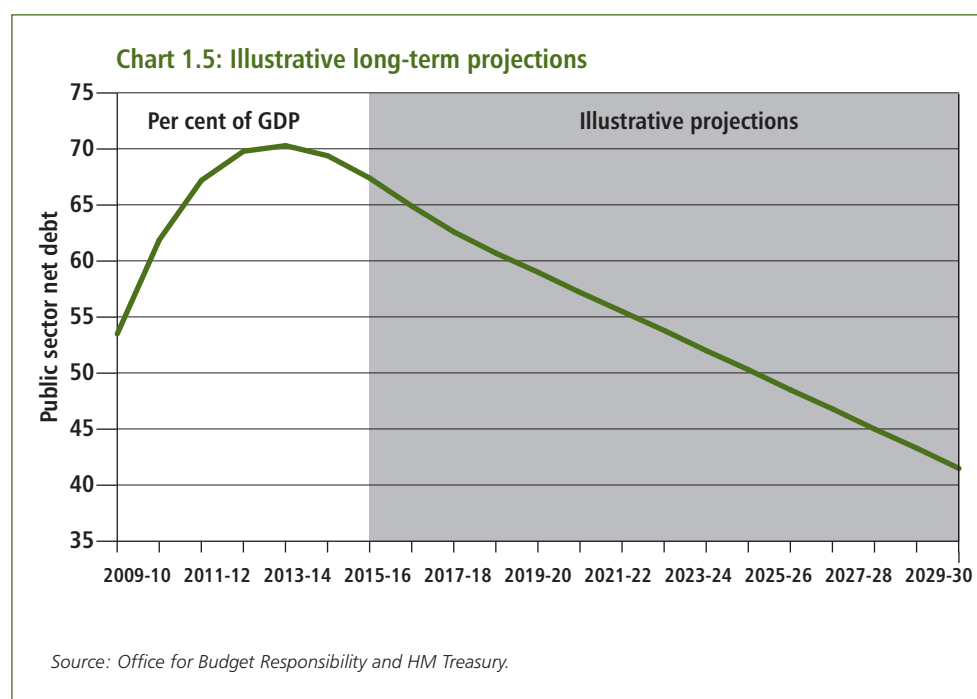
**1.56** Overall, the consolidation set out in this Budget reduces cyclically-adjusted public sector net borrowing by 8.4 per cent of GDP between 2009-10 and 2015-16. This is of a similar magnitude to the fiscal consolidation achieved: in the UK between 1993-94 and 1999-00, when the structural deficit was reduced by 6.5 per cent of GDP; in Sweden between 1993 and 1998, when the structural deficit was reduced by 9.4 per cent of GDP; and in

Canada between 1992 and 1999, when the structural deficit was reduced by 7.5 per cent of GDP.<sup>15</sup>

**1.57** The Government's plans bring the UK into line with international agreements on the need for fiscal consolidation, including the June 2010 G20 Finance Ministers' conclusion that *"those countries with serious fiscal challenges need to accelerate the pace of consolidation."*<sup>16</sup> The path set for fiscal policy in this Budget is also consistent with the UK meeting its recommendation under the European Union's Excessive Deficit Procedure to reduce the Treaty deficit below 3 per cent of GDP in 2014-15. The Budget judgement will also restore the Treaty debt ratio to a downward path from 2013-14.

### Illustrative long-term projection

**1.58** Chart 1.5 shows illustrative projections for the profile of public sector net debt beyond the OBR's forecast horizon, using a set of neutral assumptions. The key assumptions are that policy neither loosens nor tightens further beyond the forecast horizon, and that interest rates and growth rates are equal. These projections are purely illustrative and do not provide a full account of long-term fiscal pressures. The interim OBR set out its initial assessment of the public sector balance sheet and fiscal sustainability, including assessing the impact of ageing, public service pensions and PFI contracts in their pre-Budget forecast report.<sup>17</sup>



<sup>15</sup> IMF World Economic Outlook, April 2010.

<sup>16</sup> Available at [www.g20.org](http://www.g20.org).

<sup>17</sup> See Chapter 5 of Pre-Budget forecast, Office for Budget Responsibility, June 2010.

# Enterprise

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**1.59** Over recent years, the UK has become less competitive and the economy has become more dependent on growth in the public sector. The World Economic Forum's Global Competitiveness Index showed the UK's ranking falling from seventh to thirteenth place between 1997 and 2009-10.<sup>18</sup> If growth is to be balanced and sustainable, it needs to be based on an expansion in the private sector, not the public sector, and UK businesses need an environment which helps them compete in a global market place.

**1.60** The measures in this Budget are intended to give businesses the confidence to invest for the long term, and to reduce the burden of tax and regulation. They aim to encourage firms to create new jobs and to help those out of work back into the labour market. Where small businesses continue to have problems accessing finance, measures in this Budget are designed to address this. This Budget also helps to create the right incentives for building a sustainable low-carbon economy, and for attracting private sector investment in the UK's infrastructure. This Budget seeks to make sure that all parts of the UK benefit from sustainable economic growth, especially those regions most dependent on public sector employment.

## Competitiveness

### Roadmap for corporate tax reform

**1.61** The Government aims to create the most competitive corporate tax system in the G20. As a first step, this Budget announces a major package of reforms to reduce corporation tax rates. This Government will:

- **reduce the main rate of corporation tax from 28 per cent to 24 per cent over the course of four financial years from April 2011.** This will give the UK the lowest rate of corporation tax in the G7 and the fifth lowest rate in the G20;
- **reduce the small profits rate<sup>19</sup> to 20 per cent**, instead of the planned increase to 22 per cent, from April 2011;
- **reduce the capital allowances main rate from 20 per cent to 18 per cent, and the special rate from 10 per cent to 8 per cent from April 2012.** This will ensure allowances remain broadly aligned with economic depreciation rates. The manufacturing sector as a whole will pay less corporation tax as a result of the Government's reforms;
- **reduce the Annual Investment Allowance from £100,000 to £25,000 from April 2012.** It is expected that over 95 per cent of businesses will still have all their annual investment covered by this allowance;
- **reform Controlled Foreign Company (CFC) rules**, a key priority for UK multinationals. New CFC rules will be legislated in spring 2012 allowing time to consider carefully how to make the rules more competitive, to enhance long-term stability and to provide adequate protection of the UK tax base. **Consultation will take place over the summer on interim**

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<sup>18</sup> *The Global Competitiveness Report 2009-2010*, World Economic Forum, September 2009 and *The Global Competitiveness Report 1997*, World Economic Forum, May 1997

<sup>19</sup> Formerly known as the small companies' rate.

**improvements, to be legislated in spring 2011**, to make the current rules easier to operate and where possible increase competitiveness;

- **move to a more territorial basis for taxing the profits of foreign branches**, and consult in summer 2010 on options for retaining foreign branch loss relief as part of this, reforming the rules in spring 2011; and
- **consult with business to review the taxation of intellectual property, the support R&D tax credits provide for innovation and the proposals of the Dyson Review.**<sup>20</sup>

**1.62** The Government understands the importance of the whole corporate tax system to business and will set out a more detailed programme for reform in the autumn. This will allow it to take a considered approach to implementing tax reforms and to listen to the needs of business through greater consultation. The Government will provide greater certainty for business by committing to principles for corporate tax reforms. In particular, it intends to develop its view that in general a broad tax base, a low rate and a more territorial approach will improve competitiveness. **It will establish a business forum, chaired by the Exchequer Secretary to the Treasury, to consult with multinational businesses on the UK's tax competitiveness**, including the long-term aims of reform of the corporate tax system.

**Bank levy** **1.63** Alongside these reforms, **the Government will introduce a levy based on banks' balance sheets from 1 January 2011, intended to encourage banks to move to less risky funding profiles.** The Government believes that banks should make a fair contribution in respect of the potential risks they pose to the UK financial system and wider economy. Final details of the levy will be published later this year, following consultation. The levy will result in a rebalancing of the burden of taxation between banking and other sectors.

**Tax policy making** **1.64** Tax competitiveness is not just about rates and incidence of tax. Predictability, stability and simplicity are also important. **Alongside this Budget, the Government is publishing proposals to improve the way tax policy is made to support these objectives.**<sup>21</sup> **The Government also confirms its intention to create an independent Office of Tax Simplification and will announce further details shortly.**

**Deregulation** **1.65** The volume and complexity of regulation can damage UK competitiveness. The Government has announced that it will reduce regulatory costs by introducing a one-in-one-out system for new regulations. The Department for Business, Innovation and Skills will publish more detail in July 2010. The Government's plans for reducing burdens include:

- fundamentally reviewing all regulation scheduled for introduction over the coming year. **These regulations will not be implemented until they have been reviewed and re-agreed by the Reducing Regulation Committee;**
- imposing sunset clauses on regulations. **Regulations will cease to be law after seven years unless Parliament has confirmed they are**

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<sup>20</sup> *Ingenious Britain: Making the UK the leading high tech exporter in Europe*, James Dyson, March 2010

<sup>21</sup> *Tax policy making: a new approach*, HM Treasury and HMRC, June 2010

**still necessary and proportionate, or they were explicitly set to have a longer timeframe;**

- **requiring each relevant Department to start immediately a review of the employment laws for which they are responsible** to ensure maximum flexibility, protect fairness and promote competitiveness. Changes to employment law will be made as part the Government's one-in-one-out approach to regulatory reform; and
- working with European partners to ensure that new proposals for EU regulation are rigorously costed at an early stage, and that existing legislation is reviewed with the aim of reducing the burden on European businesses.

## Employment and enterprise

- National Insurance Contributions** **1.66** The Government will promote employment by reducing the cost of retaining and hiring staff. The Government inherited plans for National Insurance rates to increase by 1 per cent in April 2011. **The negative effect of the employer rate rise will be largely reversed by increasing the threshold for employer National Insurance Contributions (NICs) by £21 a week above indexation.** As a result, the number of employees for whom employers pay no NICs will rise by 650,000. This will benefit a number of sectors, including manufacturing.
- Business rates** **1.67** Business rates can be a significant cost, particularly for smaller businesses. The Government has already legislated to freeze payments of certain significant backdated business rates bills until April 2011, including for businesses in ports. To resolve this issue, **it will bring forward legislation to cancel such bills for newly assessed properties that were split from a larger rateable property.** Legislation will also now be laid for a temporary increase in the level of small business rate relief, for one year from October 2010. It is estimated that over half a million businesses across England will benefit.
- Procurement and SMEs** **1.68** As part of introducing greater transparency in the way that it does business, the Government plans to promote small business procurement by publishing central Government tenders online and free of charge. This facility will be made available by the end of 2010.
- Small business tax review** **1.69** The Government remains committed to a review of IR35 and small business tax and will release further details shortly.

## Business finance

- 1.70** Small and medium-sized enterprises (SMEs) are fundamental to the economic recovery and to tackling unemployment. However, some SMEs continue to have problems accessing the affordable finance they need. To address this, the Government is announcing measures to help SMEs access the funds that they need.
- Bank lending to SMEs** **1.71** The Government is clear that UK banks need to promote lending to SMEs. The banking industry has today published a new set of principles that the high street banks will follow when lending to SMEs. The Government will

also be working with the banking industry on the disclosure of regional lending data.

**Enterprise Finance Guarantee** **1.72** The Enterprise Finance Guarantee (EFG) supports lending to viable small businesses that lack sufficient collateral or the financial track record to access a normal commercial loan. To ensure that more businesses have access to credit as the economy recovers, **the EFG facility for this year is being increased by £200 million to support additional lending of up to £700 million for small businesses until 31 March 2011. In addition, a processing target of 20 business days will be introduced for all major lenders participating in the EFG.** This will provide certainty for businesses about how long their applications will take to process.

**SME non-bank finance** **1.73 The Government will create the Growth Capital Fund.** This is to address the Rowlands Review findings that, for some fast-growing SMEs, capital for growth is not being provided by the market and that this problem was exacerbated by the recession.<sup>22</sup> To support small businesses with high growth potential, a new Enterprise Capital Fund is being launched. This new Fund will form part of the existing £237 million programme of Enterprise Capital Funds and will provide an extra £37.5 million in equity finance. It will be funded through a £25 million Government contribution and £12.5 million in private co-investment.

**Green Paper on business finance** **1.74** The Government wants to ensure that the banking system and financial markets meet the needs of the economy over the long term. **This Budget therefore announces that the Government will publish a Green Paper on business finance before the summer recess.** The paper will consider the broad range of finance options for businesses of different sizes including bank lending, equity and corporate debt. It will invite views from business, investors and lenders on priorities and approaches to enhancing the access of credit-worthy businesses to appropriate sources of finance.

## Low-carbon economy

**1.75** Climate change is one of the most serious threats that the world faces. The Prime Minister has pledged to make this the greenest government ever, including reducing the Government's own emissions by 10 per cent between mid-May 2010 and mid-May 2011.

**1.76** The Government is committed to playing its part in moving to a low-carbon economy. The transition will change the shape of industry, growth and jobs. As part of this, the UK needs £200 billion of investment to 2020 to provide secure low-carbon energy. This will require reform of the energy market and action to attract additional private sector funding.

**Carbon price** **1.77** Alongside wider market reforms, the Government will assess how the energy tax framework can provide the right incentives for investment. **In the autumn, the Government will publish proposals to reform the climate change levy in order to provide more certainty and support to the carbon price. Subject to consultation, the Government intends to bring forward relevant legislation in Finance Bill 2011.**

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<sup>22</sup> *The Provision of Growth Capital to UK Small and Medium-Sized Enterprises*, BIS, November 2009



**Green Investment Bank** **1.78** The Government is also determined to address other barriers to investment in the low-carbon economy. **Following the Spending Review, the Government will put forward detailed proposals on the creation of a Green Investment Bank to help the UK meet the low-carbon investment challenge.** The Government is considering a wide range of options for the scope and structure of the Green Investment Bank. The options will be evaluated for effectiveness, fiscal affordability and transparency.

**Green Deal for households** **1.79** The Government will establish a Green Deal for households through legislation in the Energy Security and Green Economy Bill, to help individuals invest in home energy efficiency improvements that can pay for themselves from the savings in energy bills. These improvements provide substantial and cost-effective carbon reductions but the initial cost can be significant, especially for low-income households. The Government will also continue to work on green financial products to provide individuals with opportunities to invest in the infrastructure necessary to support the green economy.

**1.80** These measures are expected to have positive environmental impacts by enabling investment in low-carbon infrastructure and technologies. The environmental impact of Budget measures will be assessed in more detail as proposals are developed.

## Infrastructure

**Infrastructure investment** **1.81** The Government recognises the important role investment in infrastructure plays in supporting economic growth and UK competitiveness. As the Government acts to reduce the fiscal deficit, it will continue to encourage increased funding for infrastructure projects from the private sector. It will target public sector investment in infrastructure on those projects with the greatest economic benefit for which private sector capital is not available.

**1.82** As set out in the deficit reduction section of this chapter, apart from the capital element of the £6.2 billion savings in 2010-11 (worth £2 billion a year until 2015-16), the Government will make no further cuts in public sector gross investment compared with the plans that it inherited. Instead it will undertake a fundamental review of all capital spending plans to ensure they are affordable and to identify the areas of spending that will achieve the greatest economic returns.

**Infrastructure UK** **1.83 This Budget confirms the establishment of Infrastructure UK (IUK) to lead work within HM Treasury to enable greater private sector investment in infrastructure, and improve the Government's long-term planning and delivery. In the autumn, the Government will publish a national infrastructure plan that will set out goals for UK infrastructure.** This will include priority public and private sector investments and proposals for delivering and supporting investment on a cross-sector basis. IUK will also carry out an investigation into how to reduce the cost of delivery of civil engineering works for major infrastructure projects. This will be chaired by Terry Hill (Chair of Transport Market, Arup).

**Digital infrastructure** **1.84 The Government will not introduce a tax on landlines.** Instead, it will drive private sector investment in superfast broadband by making regulatory changes to reduce the cost of roll-out. The Government will also fund three pilots to bring superfast broadband to hard-to-reach areas while

working towards a universal broadband service at two Megabits per second. These will be funded by a portion of the Digital Switchover underspend within the TV licence fee.

**UK oil and gas fiscal regime** 1.85 The Government recognises the importance of a stable and fair UK oil and gas tax regime that provides certainty for businesses. It will take forward discussions with the industry to ensure the regime encourages continuing investment and the exploitation of remaining resources.

## Growth in all parts of the UK

1.86 The Government is determined that all parts of the UK benefit from sustainable economic growth, and that the private sector recovery is particularly strong in areas that are currently overly dependent on the public sector. The difference in real gross value added per capita growth rates between the Greater South East<sup>23</sup> and all other English regions widened towards the end of the last decade, from 0.6 per cent (1989-2002) to 0.7 per cent (2002-2008).

**Regional growth** 1.87 The Government's strategy to support private sector enterprise in all parts of the UK aims:

- to encourage the creation of private sector jobs in regions reliant on public sector employment, through reducing the cost to new businesses of employing staff. **The Government will shortly announce details of a scheme to help new businesses in targeted areas of the UK that need it most. During a three year qualifying period, new businesses which start up in these areas will get a substantial reduction in their employer National Insurance Contributions (NICs).** Within the qualifying period, these employers will not have to pay the first £5,000 of Class 1 employer NICs due in the first twelve months of employment. This will apply for each of the first 10 employees hired in the first year of business and operate in selected countries and regions<sup>24</sup>. Subject to meeting the necessary legal requirements, **the scheme is intended to start no later than September 2010. Any new business set up from 22 June 2010 which meets the criteria set out in the forthcoming announcement will benefit from the scheme;** and
- to help areas and communities particularly affected by reductions in public spending make the transition to private sector-led growth and prosperity, **the Government will create a Regional Growth Fund in 2011-12 and 2012-13. This Fund will operate in England only and support increases in business employment and growth.** The Devolved Administrations will be encouraged to undertake similar action.

**Northern Ireland** 1.88 **The Government will publish a consultation paper, in autumn 2010, on rebalancing the Northern Ireland economy.** This will include examining proposals for economic enterprise zones, possible mechanisms for changing the corporation tax rate and other economic reform options. The Government will consult the Northern Ireland Executive fully as the paper is prepared.

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<sup>23</sup> London, the South East and the East of England.

<sup>24</sup> The measure would apply in Scotland, Northern Ireland and Wales, and the following English regions: the North West, North East, Yorkshire and Humber, West Midlands, East Midlands and South West.

## Local enterprise partnerships

**1.89** The Government will enable locally-elected leaders, working with business, to lead local economic development. As part of this change, Regional Development Agencies will be abolished through the Public Bodies Bill. **A White Paper later in the summer will set out details of these proposals. As part of this, the Government will:**

- **support the creation of strong local enterprise partnerships**, particularly those based around England's major cities and other natural economic areas, to enable improved coordination of public and private investment in transport, housing, skills, regeneration and other areas of economic development;
- **consider the most appropriate framework of incentives for local authorities to support growth**, including exploring options for business rate and council tax incentives, which would allow local authorities to reinvest the benefits of growth into local communities; and
- as part of the shift to a more locally driven planning regime, **promote the role for a simplified planning consents process in specific areas where there is potential or need for business growth, through use of Local Development Orders.**

## Fairness

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**1.90** The Government is committed to creating a fair and responsible tax and benefit system that rewards work and promotes economic competitiveness.

**1.91** To achieve these objectives the tax and benefit framework must incentivise work and tackle welfare dependency. More than five million households are currently dependent on benefits, and spending on social security and tax credits has increased by 45 per cent, around £60 billion, in real terms over the past 10 years.<sup>25</sup> Despite these levels of spending, performance in tackling poverty and inequality has stalled or deteriorated. The Government believes this is neither fair nor affordable. A fair and responsible benefit system supports those in most need, without creating dependency for those who would be better off in work. A fair tax system should reward work for those on lower incomes while ensuring that those on higher incomes pay their fair share of tax.

**1.92** This Budget sets out immediate tax and benefit reforms to address these challenges. This Budget announces measures to: support low and middle-income earners; tackle welfare dependency and unaffordable spending; support the most vulnerable; and encourage personal responsibility. The measures set out in this Budget will reduce overall expenditure and tackle unfair payments while recognising the needs of pensioners and low-income families with children.

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<sup>25</sup> Public Expenditure Statistical Analysis 1995-2010 and the June Budget for the 2009-10 outturns. The 10 years in question are 1999-2000 to 2009-10 and the figures are in 2010-11 prices using a GDP deflator.

## Personal tax

**Personal allowance** **1.93** The Government is committed to increasing support for lower and middle income earners and improving the rewards to work, and has a long term objective to raise the personal allowance to £10,000 with real terms progress towards that goal every year. This Budget announces **that the personal allowance for under 65s will be increased by £1,000 to £7,475 in 2011-12.** As a result, the Government estimates that the 880,000 lowest income taxpayers will be removed from tax altogether, and 23 million taxpayers will benefit by up to £170 per year.<sup>26</sup>

**1.94 To ensure that support will be focused on those on low and middle incomes the Government will reduce the level of the basic rate limit. The National Insurance Upper Earnings/Profit Limit will also be reduced to keep it aligned with the income tax higher rate threshold.** Based on current Retail Prices Index (RPI) forecasts the basic rate limit will be reduced by £2,500 and the higher rate threshold by £1,650 below plans the Government inherited. Exact figures will be confirmed in the autumn. These changes will mean that higher rate-taxpayers will not benefit from this measure.

**Basic rate limit** **1.95** To help fund increases in the personal allowance, and ensure that those on higher incomes pay their fair share, **the basic rate limit for income tax will be frozen in 2013-14.**

**Capital gains tax** **1.96** As set out in the Coalition Agreement, to partly fund the increase to the personal allowance, increase fairness and reduce tax avoidance the Government will reform capital gains tax to align it more closely with income tax rates. Effective from 23 June 2010, **capital gains tax will rise from 18 to 28 per cent for those with total income and taxable gains above the higher rate threshold.** This strikes the right balance between fairness and international competitiveness. A substantial part of the revenue from this measure comes from higher income tax receipts as the incentive to convert income into capital gains is reduced. Basic rate taxpayers will continue to pay an 18 per cent rate on their gains. **The 10 per cent capital gains tax rate for entrepreneurial business activities will be extended from the first £2 million to the first £5 million of qualifying gains made over a lifetime. The Government confirms that the annual exempt amount for capital gains tax will continue to rise in line with inflation and will remain at £10,100 for 2010-11.**

**50p rate of income tax** **1.97** The 50p rate of income tax took effect from April 2010 and will remain in place for the time being.

**Taxation of non-domiciled individuals** **1.98** As announced in the Coalition Agreement, **the Government will review the taxation of non-domiciled individuals.** This will assess whether changes can be made to the current rules to ensure that non-domiciled individuals make a fair contribution to reducing the deficit, in return for greater certainty and stability for those bringing skills and investment to the UK.

**Bank bonuses** **1.99** In addition to introducing a bank levy, the Government is taking action to tackle unacceptable bank bonuses. The Independent Commission on

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<sup>26</sup> Estimates calculated using HMRC Personal Tax Model, based on 2007-08 Survey of Personal Incomes data projected to 2011-12 and modelling assumptions.

Banking will look at structural and non-structural measures to reform the banking system and promote competition. The Government will also consult on a remuneration disclosure scheme and, working with international partners, will explore the costs and benefits of a Financial Activities Tax on profits and remuneration. The Government has also asked the Financial Services Authority as part of its forthcoming review of its Remuneration Code to:

- **consider imposing more stringent requirements on the deferral and award of variable pay;**
- **examine mechanisms for strengthening the link between performance and remuneration to ensure that incentives are aligned with the long-term performance of the firm; and**
- **consider how to vary capital requirements to offset risk in remuneration practices.**

## The benefit and tax credit system

**1.100** The Government is committed to reforming the working age benefit and tax credit system so that it is fair and affordable. The Government's reforms will reduce benefit dependency and promote work, while protecting those who are most vulnerable and have the highest level of need.

**Lone parent conditionality** **1.101** To support more lone parents into employment, **those with their youngest child over five will be moved onto Jobseekers Allowance rather than Income Support from 2011-12.** The Government estimates that this could move up to 15,000 lone parents into employment which will help reduce child poverty.<sup>27</sup> The Government does not think that lone parents with children under school age should be required to seek work.

**Housing Benefit** **1.102** Housing Benefit is often criticised as making excessively generous payments that damage work incentives. To address this, the Government will remove payments that trap benefit claimants in poverty instead of providing incentives to work as well as being unfair to the millions of families on low income who do not depend on welfare. **The Government will introduce a package of reforms to Housing Benefit from April 2011 onwards. This includes changing the percentile of market rents used to calculate Local Housing Allowance rates, and uprating these rates by CPI from 2013-14, capping the maximum Local Housing Allowance payable for each property size, time-limiting the receipt of full Housing Benefit for claimants who can be expected to look for work, and restricting Housing Benefit for working age claimants in the social rented sector who are occupying a larger property than their household size warrants.**

**Disability Living Allowance** **1.103** The Government will reform the Disability Living Allowance (DLA) to ensure support is targeted on those with the highest medical need. **The Government will introduce the use of objective medical assessments for all DLA claimants from 2013-14** to ensure payments are only made for as long as a claimant needs them.

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<sup>27</sup> Estimate calculated using DWP benefits stock-flow model, based on 2006-09 data from the Work and Pensions Longitudinal Study, Family and Children's Study, New Deal for Lone Parents statistics, and the DWP Destinations Survey.

- Tax credits and Child Benefit** **1.104** This Budget announces a number of reforms to tax credits, to ensure support is targeted on those most in need by reducing unaffordable support for higher earners, and to simplify the system. As part of this package **the Government will reduce tax credit eligibility for families with household income above £40,000 from April 2011 and make further changes to this threshold in 2012-13 to focus tax credits on lower income families. The Government will also increase the rate at which tax credits are withdrawn once household incomes rise.** The Government will freeze Child Benefit to help fund significant above indexation increases in the Child Tax Credit which is better targeted on low-income families. This means that support will be better targeted at low-income families with children and that this Budget will have no measurable impact on child poverty in the next two years.<sup>28</sup> In the meantime, the Government has also asked Frank Field to lead an independent review on poverty which, among other things, will make recommendations on potential action to tackle the underlying causes of poverty and enhance life chances, consistent with the Government's fiscal strategy.
- Maternity payments** **1.105 From April 2011 the Government will restrict eligibility to the Sure Start Maternity Grant to the first child only and abolish the Health in Pregnancy Grant from January 2011.** Mothers that are already pregnant should not be affected.
- Indexation** **1.106 The Government will use the CPI for the price indexation of benefits and tax credits from April 2011.** The CPI provides a more appropriate measure of benefit and pension recipients' inflation experiences than RPI, because it excludes the majority of housing costs faced by homeowners (low income households are subsidised separately through Housing Benefit, and the majority of pensioners own their home outright), and differences in calculation mean it may be considered a better representation of the way consumers change their consumption patterns in response to price changes. This will also ensure consistency with the measure of inflation used by the Bank of England. **This change will also apply to public service pensions through the statutory link to the indexation of the Second State Pension. The Government is also reviewing how the CPI can be used for the indexation of taxes and duties while protecting revenues.**
- State pensions and benefits** **1.107** In the last Parliament, the basic State Pension was uprated by the higher of prices or 2.5 per cent. **This Government will uprate the basic State Pension by a triple guarantee of earnings, prices or 2.5 per cent, whichever is highest, from April 2011.** CPI will be used as the measure of prices in the triple guarantee, as for other benefits and tax credits. However, to ensure the value of a basic State Pension is at least as generous as under the previous uprating rules, **the Government will increase the basic State Pension in April 2011 by at least the equivalent of RPI.** To ensure the lowest income pensioners benefit from the triple guarantee, **the standard minimum income guarantee in Pension Credit will increase in April 2011 by the cash rise in a full basic State Pension.**
- 1.108** The Government has also committed to protect key benefits for older people, including Winter Fuel Payments, free off-peak local bus travel, eye

<sup>28</sup> Estimate calculated using the HM Treasury's tax and benefit microsimulation model, based on 2007-08 Family Resource Survey data projected to 2011-12 and 2012-13.



tests and prescriptions for those aged over the female State Pension Age, and free television licences for those aged over 75.

**State Pension Age** 1.109 Given the challenges posed by an ageing society, **the Government will review when the State Pension Age will rise to 66.** This will be supported by a call for evidence to be launched shortly. The review will be conducted quickly in recognition of the urgent need to press ahead with implementing these changes fairly. The Government will also consider future increases to the State Pension Age and how best to manage the ongoing challenges posed by increasing longevity. To ensure that those who wish to work beyond 65 are able to, **the Government will consult shortly on how it will quickly phase out the Default Retirement Age from April 2011.**

## Housing costs

**Council tax** 1.110 **The Government will work in partnership with local authorities in England to implement a council tax freeze in 2011-12.**

**Stamp duty land tax** 1.111 **As announced in the Coalition Agreement, the Government will review the stamp duty land tax relief for first time buyers** taking into account its impact on affordability and value for money.

**Support for Mortgage Interest** 1.112 The rate at which Support for Mortgage Interest (SMI) is paid is set at 1.58 percentage points above the Bank of England Base rate, and it has been frozen at 6.08 per cent since late 2008 although interest rates have fallen significantly. To put SMI on a more sustainable footing and to better reflect mortgage costs, **SMI will be paid at the level of the Bank of England's published Average Mortgage Rate from October 2010.**

## Savings and pensions

1.113 As part of its commitment to achieving a more balanced economy, the Government is committed to creating the conditions to support higher savings. For individuals and families the Government wishes to encourage financial responsibility, and saving for retirement, through well targeted and affordable support.

**Financial healthcheck** 1.114 **The Government has asked the Consumer Financial Education Body to develop a new annual family financial healthcheck.** This will be introduced in spring 2011 as part of the national financial advice service.

**ISAs** 1.115 It is estimated that over 20 million people currently hold an ISA.<sup>29</sup> **The Government confirms that it will index link the annual ISA subscription limit from 2011-12.**

**Child Trust Fund & Saving Gateway** 1.116 The Government announced on 24 May 2010 its intention to reduce and then stop Government contributions to Child Trust Funds. The Government also announces that **the Saving Gateway is not affordable given the need to reduce the deficit. It will therefore not be introduced in July 2010.**

**Annuity by age 75** 1.117 **The Government will end the existing rules that create an effective obligation to purchase an annuity by age 75 from April**

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<sup>29</sup>HMRC estimate based on information supplied by financial institutions from April 2007 to March 2008.



**2011** to enable individuals to make more flexible use of their pension savings. The Government will shortly 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.

**Pensions tax relief** **1.118** The Government will continue with plans it inherited to raise revenues from restricting pensions tax relief. The Government is committed to protecting the public finances by introducing reforms that raise no less revenue than existing plans. However, it believes that the approach legislated for in Finance Act 2010 could have unwelcome consequences for pension saving, bring significant complexity to the tax system, and damage UK business and competitiveness. An alternative approach involving reform of existing allowances, principally of a significantly reduced annual allowance, might better meet the Governments objectives. Provisional analysis suggests that an annual allowance in the range of £30,000 to £45,000 would raise the necessary yield. The Government wishes to engage employers, pension schemes, experts and other interested parties to determine the best design of a regime.

## Excise duties

**1.119** The Government is committed to fair excise duties that contribute to deficit reduction while also encouraging personal responsibility.

**Alcohol duty** **1.120 The Government confirms the across the board increase in cider duty rates of 10 per cent above inflation announced in the March Budget will be reversed from 30 June 2010. Secondary legislation will be introduced shortly to increase tax on cheap, strong ciders. The Government will also review alcohol taxation and pricing and will report in the autumn. There will be no increases in the rate of duty on beer, wine or spirits at this Budget but the Government will continue with the plans it inherited to increase the rates by 2 per cent above inflation each year to 2014-15.**

**Fair fuel stabiliser** **1.121 The Chancellor has asked the Office for Budget Responsibility to undertake an assessment over the summer of 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.

**Remote rural areas** **1.122** Reflecting the Coalition commitment to investigate measures to help with fuel costs in remote rural areas, **the Government is considering the case for introducing a fuel duty discount in remote rural areas. This includes possible pilot schemes in Scotland.**

**Air transport** **1.123 The Government will explore changes to the aviation tax system, including switching from a per-passenger to a per-plane duty, which could encourage fuller planes.** Major changes will be subject to public consultation.

## Tax compliance

**1.124** The Government is committed to maximising tax compliance by delivering a tax system that is predictable, stable and simple. The Government

has published proposals to improve the way in which tax policy is made and delivered.<sup>30</sup>

**1.125** In support of this approach, the Government will make every effort to improve tax compliance and protect revenues. **This year, HMRC will use debt collection agencies to collect £140 million of additional tax revenue from existing tax debts.**

**Tax avoidance** **1.126** The Government is committed to tackling tax avoidance and intends to develop strategic responses to address long-standing avoidance risks. Further details on specific measures can be found in Chapter 2. As part of this work, **the Government will examine whether, as one element of strengthened defences, there is a case for developing a General Anti-Avoidance Rule.**

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<sup>30</sup>*Tax policy making: a new approach*, HM Treasury and HMRC, June 2010

