

A short guide to the June 2010 Budget

Yesterday Chancellor Osborne unveiled the coalition government's first Budget, aimed at tackling the UK's deficit and debt dynamics. This short note sets out the key changes and their impact on the economic outlook.

1. Tax and spending changes

There were many tax and spending changes in the Budget: this section highlights the most relevant aspects.

Capital Gains Tax

- Increase from 18% to 28% for anyone with gains and income above the higher rate (40%) threshold, making the UK uncompetitive with other countries (see **Table 1**).
- Increase in lifetime allowance for Entrepreneurs' Relief, but no change to definition – PE and VC funds still excluded.

Table 1: Headline Capital Gains Tax rates for individuals

Ranking	Country	Rate	Ranking	Country	Rate
1	Netherlands	0%	9	India	20.6%
=	Hong Kong	0%	10	Spain	21%
=	Switzerland	0%	11	Canada	22%
4	Italy	12.5%	12	Ireland	25%
5	USA	15%	=	Sweden	25%
=	Brazil	15%	14	Germany	26.4%
7	China	20%	15	UK	28%
=	Japan	20%	16	France	30%

Source: Ernst & Young. Where relevant, a share holding of at least 12 months is assumed

Corporation Tax

- Phased decrease in headline rate to 24% by FY14/15, and Small Profits Rate cut to 20% from FY11/12. This is an effective increase in real profits for all CT-paying companies. Expectation of higher future profits may act to increase the present value of (PE-backed) companies, increasing gains on disposal.
- CT reduction twinned with reduction in capital allowances to 18% (8% for long-life assets), and reduction in 100% Annual Investment Allowance to £25,000.

Bank Levy

- Introduction of a bank levy of 0.04% (0.07%) of banks' balance sheets, from January 2011.
- Levy will be based on the total size of banks' balance sheets, minus their insured retail deposits and Tier 1 capital, and with a lower rate applicable to longer-term wholesale funding.
- Could act to increase banks' cost of lending, alongside the ongoing restructuring process, making funding scarcer and more expensive for PE funds.

National Insurance Contributions (NICs)

- Increase in the employer threshold by £21 per week from April 2011, reducing labour costs and boosting profitability (therefore increasing business value) in the short term. Over the longer term, we think businesses will pass this on in wages or price.
- Introduction of a scheme to reduce NICs for regional businesses outside London and South East taking on their first 10 employees. May have minor positive impact on VC investments.

Other measures

- Increase in headline rate of VAT to 20%, which will push up inflation and weigh on consumer demand (see below).
- Package of spending cuts, including a reduction in Departmental Expenditure Limits by 25% (excluding Health) in real terms. Specific measures announced yesterday include a two-year freeze in pay for most public sector workers, and a series of reforms to benefits. However, the precise detail behind the spending cuts will only become clear during the Spending Review in the autumn. Overall, spending cuts are forecast to account for 77% of the overall deficit reduction plan, and will hit GDP growth.
- Commitment to look at revising, in a revenue-neutral way, the pensions tax relief changes for those earning over £150,000 – potential to have positive impact on some fund managers if the new scheme increases the tax base, thereby decreasing the average tax liability.
- Commitment to review the taxation of non-doms – potential to have negative impact on some fund managers.
- Commitment to look at the potential of introducing a General Anti-Avoidance Rule (GAAR). It is unclear whether HMRC currently have the resources in place to effectively administer and enforce such a system.

Overall, the government's decisions are expected to lower the structural budget deficit by 2% of GDP by FY14/15, compared with the Labour government's plans. Net debt is expected to peak at 70.3% of GDP in FY13/14, before then falling to 69.4% in the following year.

2. Macroeconomic outlook

What impact will this fiscal tightening have on the UK economy? According to the new Office for Budget Responsibility (OBR), GDP growth will be a little weaker this year and next (see **Table 2**), but then stronger between 2012-14, due to lower interest rates and debt payments, so that the overall level of nominal GDP in FY14/15 is unchanged from the Pre-Budget forecast. Given the staggered programme of tax rises and spending cuts, such a relatively small impact seems broadly sensible.

However, while the GDP growth forecast is definitely more realistic than the March Budget forecast, which saw growth of 3%+ from 2011 onwards, we think there are still significant downside risks to the OBR's projections, as there were in the Pre-Budget forecast (PBF). In particular: the maintained assumption that the UK's share of global trade stabilises over this parliament, after falling for decades, looks highly questionable; and the expected strong bounceback in business investment also looks to err on the optimistic

side, in part because the OBR has revised down the amount of spare capacity in the economy (the output gap). The extent of the decline in the unemployment rate also looks somewhat optimistic, given potential long-term effects from mismatch and the fact that public sector payrolls will be declining: it is worth remembering that between 1999 and 2006, a period of robust growth, private employment grew by less than 1% a year.

Table 2: Macroeconomic forecasts

	2010	2011	2012	2013	2014	2015
PSNB*, % of GDP	11.0	10.1	7.5	5.5	3.5	2.1
<i>Change since PBF (ppts)</i>	<i>-0.1</i>	<i>-0.4</i>	<i>-0.8</i>	<i>-1.1</i>	<i>-1.5</i>	<i>-1.8</i>
GDP growth, %	1.2	2.3	2.8	2.9	2.7	2.7
<i>Change since PBF (ppts)</i>	<i>-0.1</i>	<i>-0.3</i>	<i>0.0</i>	<i>+0.1</i>	<i>+0.1</i>	<i>n.a.</i>
CPI inflation (Q4, Y/Y)	2.7	2.4	1.9	2.0	2.0	2.0
LFS unemployment rate	8.1	8.0	7.6	7.0	6.5	6.1

*Public sector net borrowing, financial year ending in year shown. Source: OBR

CPI inflation is also expected to be higher as a result of the Budget, most obviously due to the VAT increase, which will raise those prices affected by around 2% if passed on in full. This means that CPI inflation, which is likely to gradually fall back to 2% over the rest of 2010, will probably jump again at the start of 2011, and remain higher throughout that year. The OBR thinks that firms will absorb some of the VAT rise in margins, thereby limiting the boost to inflation. We think this is possible in the short term, but not indefinitely – at some point, the higher VAT rate should be passed on to consumers.

Does this higher inflation mean higher interest rates? Arguably, only if the MPC gets monetary policy wrong. Inflation measures the change in prices – but, provided it is credible, the MPC should ignore one-off movements in individual items (like VAT), as they will drop out of the inflation calculation after a year. (As an example, CPI inflation was actually below the 2% target at 1.7%Y/Y in May, once indirect taxes are excluded.) Instead, the MPC should focus on broader underlying inflationary pressures – and, here, wage inflation is arguably the best guide. Private sector regular pay growth, at 1.1%Y/Y in April, is still well below the 4.5% rate that the MPC regards as consistent with the inflation target. There is, however, some disagreement on the MPC: Adam Posen certainly understands this argument, but Andrew Sentance appears unconvinced so far. For now, we expect Bank Rate to remain on hold at least until 2011.

All told, the Budget is likely to only have a modest impact on the economic outlook. But, while the OBR’s forecast is more sensible than the previous government’s assumptions in March, the economy still faces significant downside risks. This means that UK portfolio companies could well see relatively lacklustre demand growth overall; and investor sentiment, particularly in financial markets, is likely to remain fragile until the recovery really takes hold, impacting on IPOs and fundraising.

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