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What the Budget means for businesses

24 June 2010

- **VAT will rise from 17.5% to 20% in January 2011, consumer facing businesses will feel this most.**
- **Corporation tax will fall over the next four years from 28% to 24% but capital allowances will shrink.**
- **Investment allowances will fall sharply from April 2012 encouraging the front-loading of investment spending.**
- **Employer National Insurance Contributions will rise next year, but from a higher starting wage.**
- **Capital Gains Tax will rise from 18% to 28% for all higher income tax rate payers**

The Budget, the deficit, and the macroeconomic backdrop

George Osborne, Chancellor of the Exchequer, set out this week what he described as "the unavoidable budget." The focus was to reduce the public sector's deficit and debt over a five-year period in a way that strengthens and rebalances the economy. He said that economic growth needs to be built on saving, investment and enterprise instead of debt, with sustainable, private sector led growth, balanced across regions and industries, driving this transition.

Tuesday's budget builds on the measures of the previous administration to rein in the deficit. In his last Budget, Alistair Darling announced measures that would have reduced the deficit in 2014-15 by £73bn. Yesterday's budget will lower the deficit by an additional £40bn over this horizon. Spending cuts will deliver £32bn (77%) of this extra tightening, with higher taxes delivering the balance (£8bn). Consequently there will be a significant burden on the economy, and the corporate sector will shoulder its share. This document highlights the main messages and key policies from the emergency Budget for the business community.

The outlook for economic growth is weaker than previously estimated. The Coalition Government has outsourced economic forecasting to the new Office for Budget Responsibility, removing political interference. Their forecasts are much closer to industry expectations and are compared below to the previous Budget. **Tighter fiscal policy is not expected to lead to a double-dip recession.** Tighter fiscal policy will mean monetary policy (interest rates and quantitative easing) can be kept looser for longer. The weaker growth profile would suggest interest rates can remain on hold well into 2011, as the economy will not return to what was considered "trend" growth until 2012. As a result of measures in the budget and external factors, consumer price inflation will be higher over the next few years before falling back to the 2% target.

Comparison for forecasts for growth, the deficit, debt and inflation

		2010	2011	2012	2013	2014
GDP growth %	March Budget	1.3	3.3	.3.5	3.5	3.5
	June Budget	**1.2**	**2.3**	**2.8**	**2.9**	**2.7**
Deficit as % of GDP	March Budget	11.2	8.6	6.9	5.3	4.2
	June Budget	**10.1**	**7.6**	**5.6**	**3.6**	**2.2**
Debt as % of GDP	March Budget	80.5	86.0	88.7	89.2	88.7
	June Budget	**78.9**	**83.6**	**85.5**	**84.9**	**83.1**
CPI Inflation %	March Budget	2.0	1.5	2.0	2.0	2.0
	June Budget	**2.7**	**2.4**	**1.9**	**2.0**	**2.0**

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Measures affecting UK businesses

The Government announced it will set out a program to reform the whole corporate tax system in the autumn, including reducing the administrative burden of regulation and red tape. In this Budget, the majority of measures affecting the business community are changes to taxation and allowances.

Value Added Tax (VAT)

VAT will increase from 17.5% to 20% from 4th January 2011. There will be no changes to the zero rating for household essentials, nor to the reduced rate of VAT on utilities. This is the biggest tax raising policy in the Budget, expected to net the Exchequer £13.5bn in total by the end of 2014/15. It fits into the government's objective of taxing consumption rather than jobs and enterprise. The new 20% VAT rate is exactly equal to the EU 27 average.

The timing of the change means it will come into effect one year after the restoration of VAT from its temporary lower rate of 15% to 17.5% in January 2010. From a macroeconomic perspective this means that inflation will remain elevated for an additional 12 months, until January 2012. The high level of inflation in recent months is in large part due to the change in the rate of VAT, as well as changing energy prices and the weaker value of the pound. This will make it harder for the monetary policy committee of the Bank of England to see through to underlying price trends – which are expected to be weak due to the protracted nature of the economic recovery.

The outcome of the higher rate of VAT will be weaker consumer spending, impacting consumer facing industries (in particular the retail sector) more acutely than other industries. However, there are two other likely consequences. Firstly, we would expect higher retail spending in the period leading up to the change. The short run affect of announcing a delayed VAT increase will be stimulative. Spending in the Christmas period is likely to receive a boost, as will any spending in the post-Christmas sale period. Secondly, with other pressures on household income, we would expect retailers to bear some of the burden rather than pass on the entire price change to customers. This would dampen profits and could result in further price-competition, especially at the lower end of the market.

Insurance Premium Tax (IPT)

In line with VAT, the Insurance Premium Tax will increase. The higher rate will rise from 17.5% to 20% and the standard rate will increase from 5% to 6%.

Corporation Tax

The main rate of corporation tax will fall from 28% to 24%, by one percentage point each year from April 2011. This will be the lowest rate of business taxation in the G7, and the 5th lowest in the G10. The government's aim is to increase the competitiveness of the UK as a destination for businesses to locate. It is part of the government's program to encourage enterprise and create jobs through private sector growth.

The small profits rate will fall to 20% in April 2011. Previously known as the small companies' rate of corporation tax, this was due to rise from 21% to 22% in April 2011. Instead, this increase has been cancelled and the rate will fall to 20%. HMRC estimated this will help around 850,000 small businesses.

Lower business taxation will benefit all firms, particularly those that earn a greater share of their profits in the UK. The reduction in the tax rate will more valuable to more profitable businesses. Office for National Statistics figures show these are businesses operating in extraction, utilities, manufacturing and distribution sectors. In contrast, a lower tax rate reduces the value of existing taxable losses for companies carrying forward such losses to set against future profits. As a result we may well see these losses written off sooner than they would have been otherwise, to make the most of the current rate.

However, the lower rates of corporation tax are to be paid for by lower allowances (i.e. write-offs against tax due) elsewhere, in particular the **annual investment allowance** and **capital allowance.**

Annual Investment Allowance (IAI)

There will be a reduction in the annual investment allowance from £100,000 to £25,000 from April 2012. The AIA doubled on 1st April 2010 from £50K to £100K, and will now fall to £25K from April 2012. The AIA allows the first £100K of capital expenditure in a given year to be fully offset against taxable profits. Capital expenditure above the limit is eligible for

standard capital allowances but these are also changing (see below). The Government estimates that 95% of businesses will still have all their annual investment covered by the allowance. This would suggest the reduction will mostly affect large businesses and medium sized firms trying to grow quickly.

The more capital intensive the sector, the more painful the reduction in allowances will be. The hotels and catering sector is likely to be among the worst hit, according to the Oxford University Centre for Business Taxation, as it has high capital expenditure but low profitability. Also acutely affected will be transport and communications, utilities and manufacturing.

One likely impact is the front loading of investment. With the tax free allowance falling so dramatically in April 2012, there is narrow window in which the tax incentive to undertake large scale investment is huge. We would expect investment spending to increase in the period to April 2012, provided there is the credit available to finance this.

Other rates of capital allowances will also fall from April 2012. The main rate will drop from 20% to 18%, and the special rate from 10% to 8%. Once the lower AIA and the normal capital allowances come in to force, businesses will have less incentive to invest in capital. **This may provide support to the capital leasing sector** as businesses choose to lease plant and machinery rather than purchase them outright.

National Insurance Contributions (NICs)

Employer, employee and self-employed national insurance contributions will rise by 1% in April 2011. This policy has not been removed but has been watered down. The threshold for employer NICs will rise by £21 a week above indexation from April next year. Excluding the affects of indexation, the rate below which no employer NICs will be payable will rise from £110 p/w to £131 p/w. The rate of employer NICs will rise from 12.8% to 13.8% for wages above £131 p/w. The government estimates that the number of employees for whom employers pay no NICs will rise by 650,000.

This is an important policy; it will increase the cost for most employers and has largely been overlooked in the media coverage of the Budget. The increase in the number of employees for whom employers do not pay tax will be of greatest benefit to those with a low skilled and low paid workforce. The higher the size, skill and pay of the workforce, the more expensive this policy will be to UK businesses. According to data from the Annual Survey of Hours and Earnings, less than 10% of the workforce currently earns less than £110pw. The higher threshold may reduce employer NICs for an additional one to two percent of the workforce, but ultimately it will increase payments for the over 85% of employed workers.

New start-ups in targeted areas of the UK will benefit from paying lower national insurance contributions. A regional growth fund will be set up to support increases in business employment and growth. New businesses which start up in targeted areas of the UK (which means everywhere except London, the East and South East) will be eligible for a substantial reduction in their employer NICs. Employers will not have to pay the first £5,000 of NICs due in the first 12 months of employment for the first ten employees hired in the first year of business. Although the growth fund is unlikely to be functional until September, any business set up from the day of the budget will benefit.

The number of new businesses has averaged almost 24,000 each month this year in the targeted areas. In Wales there were on average 1,960 start-ups each month this year; in Scotland there were 2,000 and in England (excluding London, the East and South East) there were 19,800. If this were to continue then there could be approximately 864,000 new start-ups that benefit from this scheme.

Capital Gains Tax (CGT) and Entrepreneurs Relief

Effective immediately, the **rate of capital gains tax will rise from 18% to 28%** for those with total income and taxable gains above the higher rate threshold. This means that if your capital gain takes your total annual income above the higher rate income tax threshold, you will be liable to pay the higher rate of capital gains tax. There will also be a lower rate of CGT: basic rate tax payers will continue to pay 18% if their income and capital gains remain below the higher rate tax threshold. The annual exempt amount will remain at £10,100 but will rise in line with inflation.

The lifetime limit for Entrepreneurs Relief will be extended from £2 million to £5 million. Until April this year the limit was £1 million, so the five-fold increase is aimed at encouraging enterprise in the economy.

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