



# Post Budget Briefing 2011

Welcome tax cuts and hidden nasties

## Introduction

In response to the Budget, Matthew Sinclair, Director of the TaxPayers' Alliance, said:

*"Taxpayers will appreciate a cut in Fuel Duty that will be a welcome relief from crippling motoring taxes. Increasing the personal allowance will take lots more people out of tax and thankfully middle class families aren't going to pay the price by being dragged into the higher rate as they were with earlier increases. The freeze in Air Passenger Duty is a good start, though it comes ahead of a major EU tax hike on flights. Unfortunately the rhetoric about simplifying taxes wasn't matched in the reality of the Chancellor's policies and there were too many fiddly little changes that will create new loopholes and make tax harder to understand. In order to pay for it all, we got a major tax hike that will increase electricity prices, a new tax on the North Sea that will increase our dependence on foreign oil and a pledge to tackle avoidance. The Government need to do more to ease the burden on ordinary families and businesses by cutting back on those budgets that are rapidly rising and scrapping wasteful projects."*

This report provides further analysis on a number of the changes made in the Budget. It looks at the following areas:

### 1. Growth

Senior economist and Economic Adviser to the Arbuthnot Banking Group, Ruth Lea investigates the growth forecasts in the Budget and the extent to which they have changed and are credible.

### 2. Spending and the public finances

Former Treasury and City Economist and TPA Research Fellow Mike Denham studies the Budget forecasts for the public finances and the reasons for higher borrowing over the forecast period.

### 3. The burden on families

TPA Research Director John O'Connell looks at the extent to which the personal allowance and higher rate threshold have failed to keep up with average earnings. He also looks at how other policy commitments mean a fiscal crunch by 2020 for households. Finally, he looks at why lower Fuel Duty and Air Passenger Duty rates are justified.

#### **4. Tax simplification**

TPA Research Associate Rory Meakin looks at the extent to which reliefs and other adjustments which complicate the tax system have been removed and introduced. He attempts to assess the balance and whether this is a tax simplifying Budget, leaving aside a future potential abolition of National Insurance.

#### **5. Energy policy**

TPA Director Matthew Sinclair assesses changes to energy policy and particularly the carbon price support, which will add to electricity bills. He also looks at some of the potential consequences from a new tax on the North Sea.

#### **6. Council Tax**

TPA Policy Analyst Chris Daniel looks at how Council Tax has increased over time and puts the current freeze in context.

## 1. Growth

Ruth Lea

Detailed summary of central case forecast: selected variable, per cent change on year earlier, unless otherwise stated

	2009	2010	2011	2012	2013	2014	2015
<b>Euro area GDP</b>							
November 2010	-4.0	1.6	1.3	1.8	2.0	2.3	2.4
March 2011	-4.0	1.7	1.4	1.8	1.8	1.9	1.9
<b>UK export markets</b>							
November 2010	-11.5	9.1	4.8	6.3	6.9	6.5	6.6
March 2011	-11.4	10.7	5.8	5.8	5.8	6.1	6.0
<b>UK, GDP</b>							
November 2010	-5.0	1.8	2.1	2.6	2.9	2.8	2.7
March 2011	-4.9	1.3	1.7	2.5	2.9	2.9	2.8
<b>Household consumption</b>							
November 2010	-3.3	1.1	1.3	1.5	1.9	2.1	2.2
March 2011	-3.2	0.8	0.6	1.3	1.8	2.1	2.2
<b>GGFC</b>							
November 2010	1.0	1.8	-0.4	-1.3	-1.8	-2.4	-1.7
March 2011	1.0	1.0	0.8	-1.2	-1.8	-2.4	-1.8
<b>Business investment</b>							
November 2010	-18.8	1.3	8.6	8.4	10.2	9.8	7.6
March 2011	-18.9	2.5	6.7	8.9	10.6	10.2	7.8
<b>Exports, g &amp; s</b>							
November 2010	-11.1	5.4	6.9	7.1	6.4	5.9	5.6
March 2011	-10.1	5.8	7.9	6.5	6.2	5.7	5.6
<b>Imports, g &amp; s</b>							
November 2010	-12.3	8.1	3.8	3.4	3.9	3.9	4.1
March 2011	-11.9	8.5	5.0	2.9	3.8	3.8	4.1
<b>CPI (Q4)</b>							
November 2010	2.1	3.0	2.8	1.9	2.0	2.0	2.0
March 2011	2.2	3.3	4.2	2.5	2.0	2.0	2.0
<b>Unemployment rate (ILO, %)</b>							
November 2010	7.6	7.9	8.0	7.7	7.2	6.7	6.1
March 2011	7.6	7.9	8.2	8.1	7.6	7.0	6.4

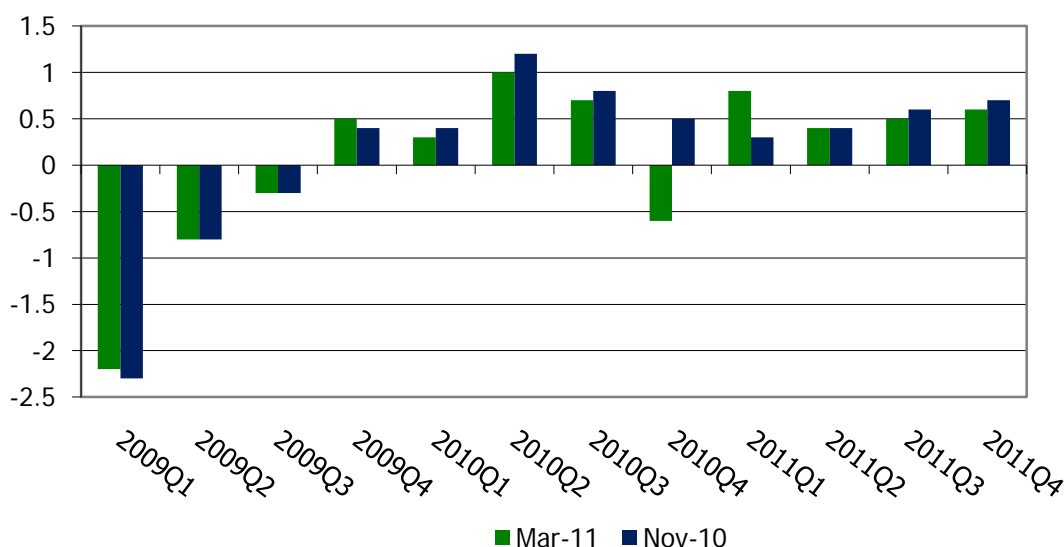
Sources: OBR, Economic and fiscal outlook, November 2010; HM Treasury, Budget 2011, March 2011

The table above gives the major Office for Budget Responsibility (OBR) data for November's forecast and March 2011's forecast. The first point to note is that the GDP forecast has been downgraded for 2011 (from 2.1 per cent to 1.7 per cent) with marginal changes elsewhere. But it should be questioned whether this downgrade is sufficient, given the very

## Budget 2011

weak 2010Q4 figure and the rather patchy evidence to date from the Markit PMI surveys – manufacturing (12 per cent of GDP) is doing well but services (70 per cent of GDP) growth could be slowing. As can be seen from the chart below the OBR is forecasting 0.8 per cent quarterly growth for 2011Q1, which seems optimistic.

### Quarterly GDP forecasts (quarter on quarter, per cent growth)



Sources: OBR, Economic and fiscal outlook, November 2010; OBR, Economic and fiscal outlook, March 2011, chart 3.3

Given the projected cuts in Total Managed Expenditure over the next 4 years (a cumulative 4 per cent in real terms), the private sector will have to perform very buoyantly over this period, growing by about 5-6 per cent a year.

There is a precedent for such growth in the mid-1990s after the UK was evicted from the ERM. But the British economy was more competitive then and the world economy, and more specifically Britain's export markets, was healthier. Given that the OBR is partly relying on exports growth comfortably outstripping imports growth to drive GDP forward this has to be a concern. It could be argued that such optimism is something of an act of faith, especially as imports growth easily outstripped exports growth in 2010 – despite the weak pound. Of course the OBR's forecast for exports and imports may be vindicated, but it should be regarded as vulnerable.

The other major vulnerability is the very positive forecast for business investment, which has been upgraded (with the exception of 2011). This is despite the fact that the OBR has increased the estimated output gap throughout the forecast period (see chart 3.5, OBR, Economic and fiscal outlook, March 2011). Given the persistent, albeit shrinking, output gap over the forecast period, the buoyant business investment forecast has to be questioned.

## 2. Spending and the public finances

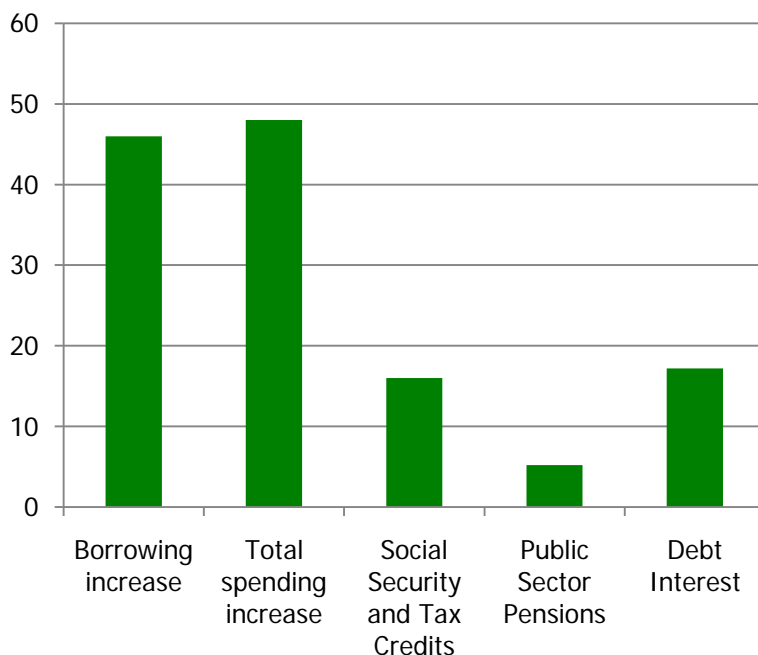
Mike Denham

The Office for Budget Responsibility's forecasts for public sector borrowing and debt have increased for all future years. Over the period 2011-12 to 2015-16 borrowing is a cumulative £46 billion higher than forecast last November.

The entire increase is attributable to higher spending, which is a concern at such an early stage in the Government's consolidation programme. Three familiar areas are responsible:

- **Welfare.** Spending on social security benefits and tax credits has increased by £16 billion, largely attributable to higher inflation.
- **Public sector pensions.** Net spending has increased by £5 billion, again largely reflecting higher inflation.
- **Debt interest.** Up by £17 billion, reflecting higher gilt yields, higher inflation, and higher borrowing.

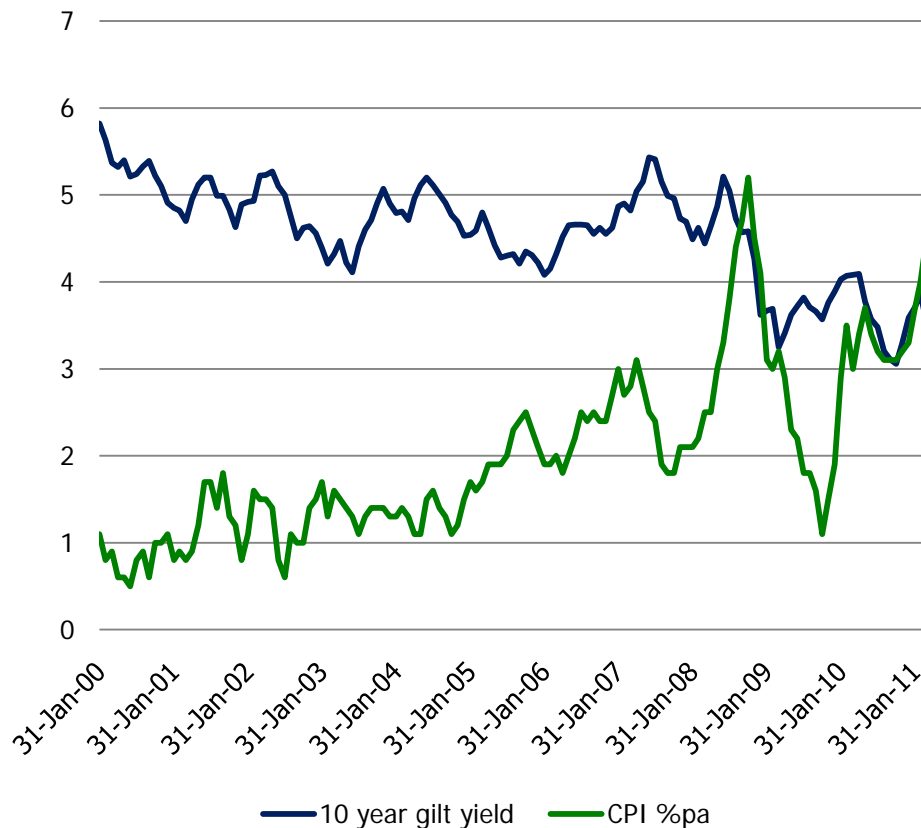
### Cumulative increase in borrowing and spending, 2011-12 to 2015-16, £ billion



This deterioration in the fiscal outlook highlights the vulnerability of the Government's consolidation programme to changes in the prospects for inflation and the cost of borrowing. In particular, it underlines the vital need to maintain market confidence.

So far the gilt market has been remarkably docile in the face of accelerating UK inflation. But inflation is now running higher than average gilt yields:

10 year gilts vs CPI inflation, 2000 to 2011, ONS and Bank of England



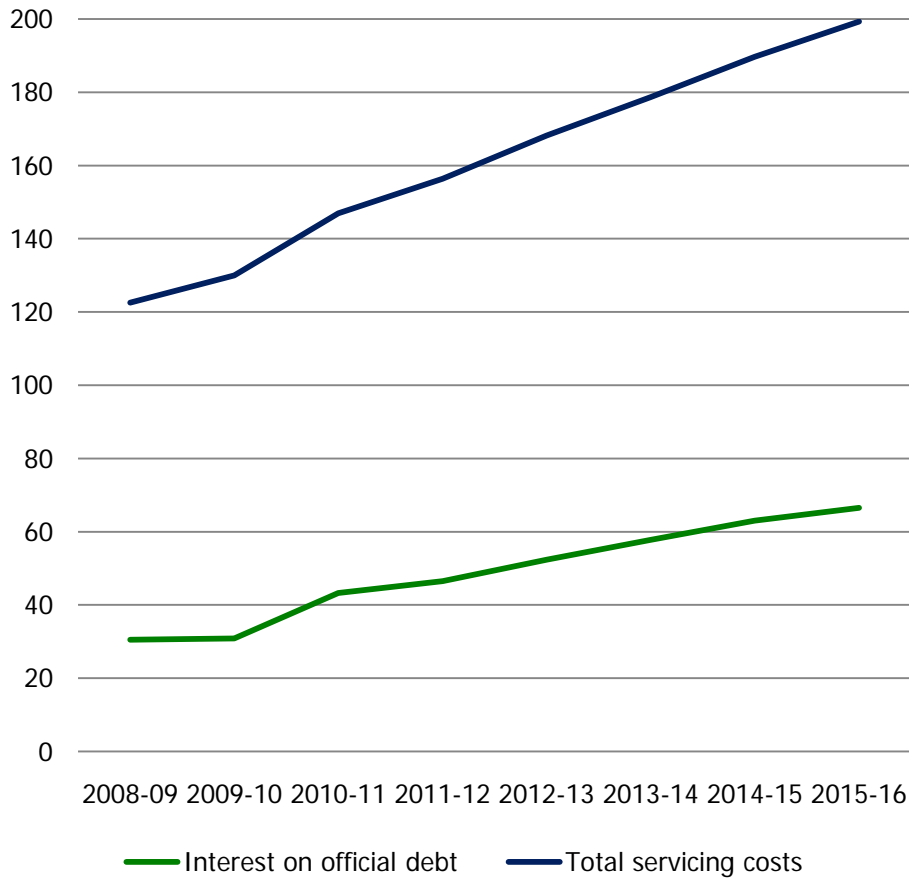
The lesson of history is that such a position does not last. At present the market is giving the authorities the benefit of the doubt, trusting that they will get inflation back down to the 2 per cent target. But if market confidence should weaken, yields could spike up very quickly.

The OBR is allowing for some increase in average gilt yields – a rise from 3.8 per cent today up to 5.1 per cent in 2015-16. But given the background, the increase could easily be much bigger. And according to the OBR, for every one percentage point increase in yields above their baseline assumptions, debt interest payments would be £6 billion per annum higher by 2015-16, with further cumulative increases beyond that.

Moreover, the official debt is only one component of the real national debt. To get a complete picture we also need to take account of the Government’s off-balance sheet debts. These include its unfunded pension liabilities and PFI contracts. Servicing of those liabilities means that the true cost of debt servicing over the next few years will be around treble the official debt interest forecast:

Budget 2011

Debt interest *plus* public sector pensions *plus* state pensions *plus* PFI, £ billion



The important message from this is that the government must redouble its efforts to restrain the growth of public spending. Which is why we support the OECD's proposal – reiterated just last week – that the fiscal framework should include an explicit target or rule for expenditure to bolster the targets for borrowing and debt.

### 3. The burden on families

John O'Connell

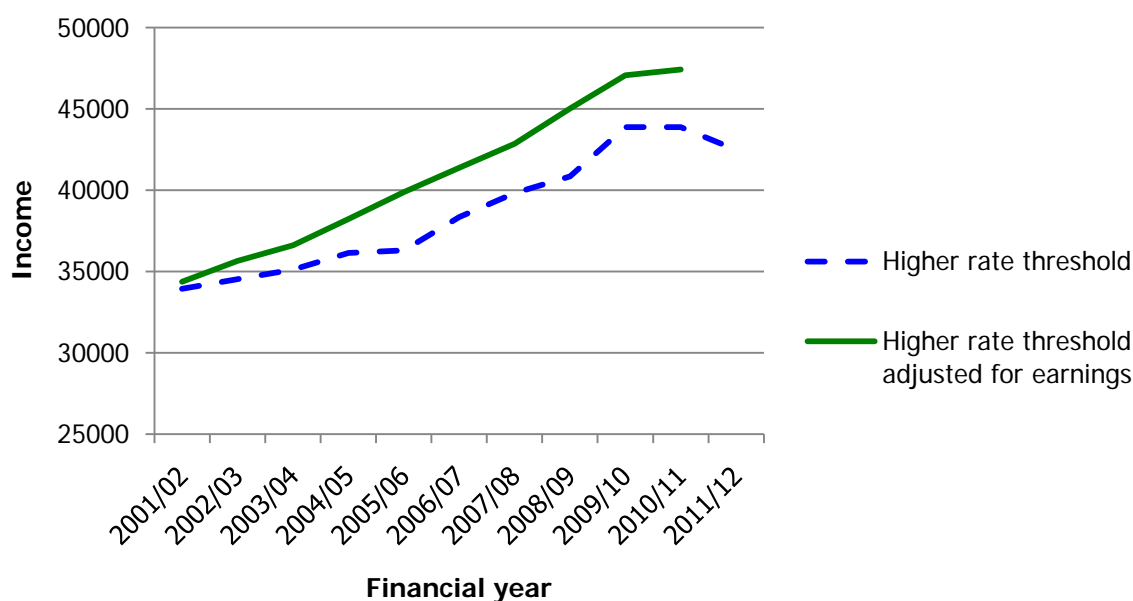
Times are tough for families right now. Inflation is way above target, making trips to the shops much more expensive; fuel is at record prices, meaning expensive commutes to work and pricier school runs; taxes on flights make holidays ever more costly. But this has not just been preceded by a financial crisis; it follows a decade of tax rises and a huge hike in public spending that will have to be followed by a significant fiscal consolidation. This section looks at how decisions made in the Budget will affect pressures on household budgets, and the justifications for those decisions.

#### Fiscal drag

In the Budget, George Osborne announced new measures to increase the personal allowance, in keeping with the Coalition Government's longer term plans to move it up to £10,000. This is good news. To compensate, however, the June 2010 budget announced the basic rate limit – the level used to calculate when taxpayers move in to the 40p bracket – would be reduced to £35,000. Fortunately, that has not been repeated for Budget 2011.

But the change in the basic rate limit has dragged middle earners into a higher rate of tax for the last ten years. This is because it has not kept pace with earnings. When we adjust the basic rate limit for average earnings, it should have been £3,500 higher in the 2010-11 financial year. Shifting this limit down to £35,000 will have greatly increased the number of taxpayers moving in to the bracket in the coming year:

#### Fiscal drag: how the higher rate threshold has not kept up with earnings

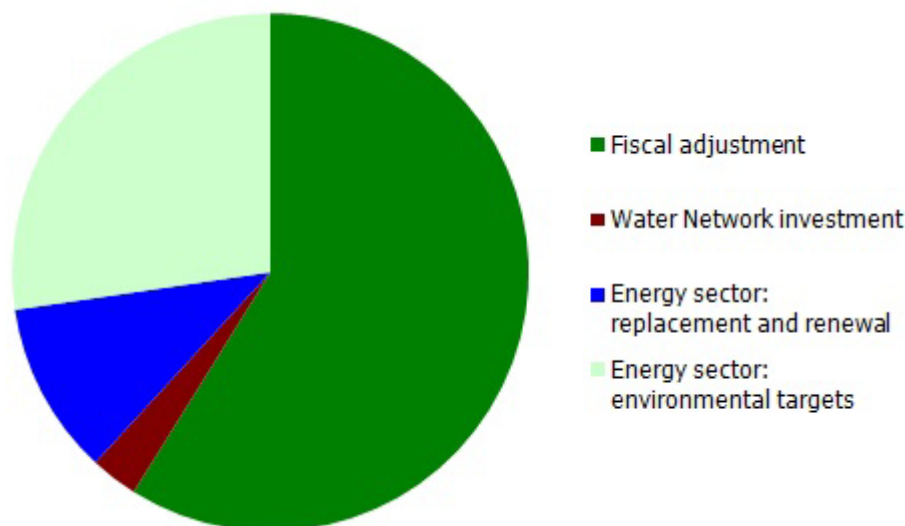


## The 2020 fiscal crunch

Other policy commitments will place an additional burden on already hard-pressed taxpayers. They need to be taken into account when assessing spending reductions and tax changes. The table and chart below show four major sources of pressure on household budgets. We can see the Government's plans for fiscal consolidation; along with Citigroup Investment Research estimates from last year of capital expenditure needed in the energy sector, which will increase energy bills; and Ofwat's estimates for capital investment required in water networks, which will increase water prices.

### Fiscal crunch: the burden facing households over the next decade

Item	Amount, £billion	Timescale
Fiscal adjustment	435.4	2010-11 to 2015-16
Water Network investment	22	2010-11 to 2015-16
Energy sector: replacement and renewal	80	By 2020
Energy sector: environmental targets	202	By 2020
<b>Total</b>	<b>739.4</b>	<b>By 2020</b>



## Fuel Duty cut and Air Passenger Duty freeze

Fuel Duty and Vehicle Excise Duty single out motorists for additional taxation, on top of the VAT normally charged on goods and services. There are reasons why motorists might be singled out, such as to pay for road building or correct for their potential contribution to



## Budget 2011

climate change. But motorists are taxed excessively, well above and beyond any reasonable application of these standards. In the TPA's recent research note *Excessive Motoring Taxes*<sup>1</sup> we calculated that motorists paid excessive taxes of £18 billion in 2008-09. This means they already pay far more than their fair share. Budget 2011 gave some relief to families by removing planned increases and cutting Duty by 1p, but even with that change they will continue to face excessive taxation.

In *Relative Transport Spending* the TPA showed that railways received ten times as much spending per passenger kilometre and eight times as much spending per tonne kilometre of freight as the roads.<sup>2</sup> That further suggests that motorists get a bad deal at present, and the cut in Fuel Duty is only a small step towards addressing that.

George Osborne delayed the increase in Air Passenger Duty in Budget 2011. This will need to be followed by cuts in future, as inclusion of aviation in the European Emissions Trading Scheme will mean flights are taxed twice. Standard's and Poors have calculated that an extra €40 could be charged per ticket after that happens. Passengers already pay more than the cost of aviation emissions. A 2008 Department for Transport study found that when the Government more than doubled revenues from Air Passenger Duty in 2007-08, passengers then overpaid for the cost of aviation emissions by £100 million.<sup>3</sup> Since then, revenues for APD have held relatively steady at around £1.8-£1.9 billion per year, while an economic downturn has reduced the amount people are flying substantially.

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<sup>1</sup> <http://www.taxpayersalliance.com/excessivemotoringtaxes.pdf>

<sup>2</sup> <http://www.taxpayersalliance.com/transportspending.pdf>

<sup>3</sup> <http://www.dft.gov.uk/pgr/aviation/environmentalissues/aviationemissionscostassess/aviationemissionscost.pdf>

## 4. Tax Simplification

Rory Meakin

The Chancellor proudly boasted about the 43 reliefs the Government plans to abolish. Many of these are obsolete anyway, such as “exemptions for certain assignments by seamen” and “Millennium Gift Aid”. Of course, it's right that rules and regulations which are irrelevant to economic life are removed from the tax code. But simplification of rules that don't affect anyone's actual tax bills clearly do not simplify the tax code in practice nearly so much as those which do affect the amounts actually paid. After all, no-one's tax affairs will be simpler after the demise of the Millennium Gift Aid scheme.

We have examined the Budget policy decisions and extracted those which simplify or complicate Britain's tax code, as listed in table below. The total figures ignore whether a measure raises or loses the Treasury money. Instead, they show the total gross impact on tax bills of the measures.

The measures listed below which simplify the system will have a total impact of more than £1.44 billion annually by 2013-14. This is great news but it's almost entirely wiped out by the Chancellor's meddling in other areas. These policies, which will complicate the system, are forecast to have a £1.38 billion impact, fully 95 per cent of the value of the simplification.

While it is probably impossible to quantify tax complexity accurately, these figures do show that the simplifying impact of this budget is in doubt and certainly fails to live up to the Chancellor's encouraging rhetoric.

Budget policy decisions which simplify the tax code	2011-12 (£m)	2012-13 (£m)	2013-14 (£m)	2014-15 (£m)	2015-16 (£m)
Corporation tax: interim improvements to Controlled Foreign Company rules	-55	-15	-25	-25	-25
Corporation tax: corporate capital gains simplification	5	-5	-15	-35	-55
Corporation tax: full reform to Controlled Foreign Company rules	0	-210	-540	-770	-840
Disguised remuneration: avoidance	750	760	730	770	760
VAT: supply splitting using printed matter	40	50	50	50	60
Qualifying Time Deposit accounts: change to tax treatment	0	*	35	40	40
Gift Aid: small donations scheme	0	0	50	85	-
<b>Tax raising measures</b>	<b>795</b>	<b>810</b>	<b>865</b>	<b>945</b>	<b>860</b>
<b>Tax cutting measures</b>	<b>-55</b>	<b>-230</b>	<b>-580</b>	<b>-830</b>	<b>-920</b>
<b>Total impact</b>	<b>850</b>	<b>1,040</b>	<b>1,445</b>	<b>1,775</b>	<b>1,780</b>

## Budget 2011

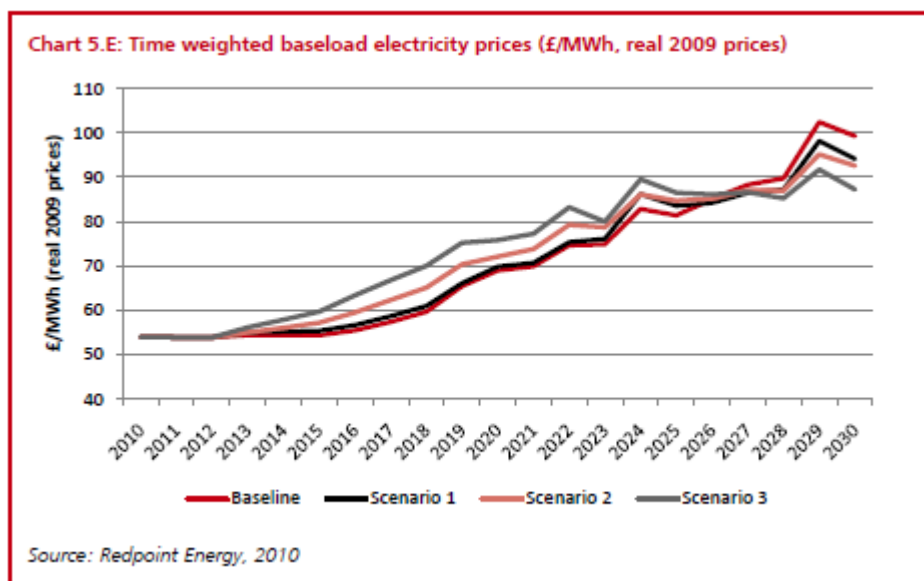
Budget policy decisions which complicate the tax code	2011-12 (£m)	2012-13 (£m)	2013-14 (£m)	2014-15 (£m)	2015-16 (£m)
Corporation tax: taxation of foreign branches reform	0	-30	-70	-80	-80
Bank Levy: increase first year effective rate to 0.075% and rate to 0.078% from January 2012	630	285	100	105	100
Business rates: Enterprise Zones	0	-20	-40	-65	-80
Stamp Duty Land Tax: bulk purchasing	-70	-90	-120	-130	-150
Fuel duty: rural rebate	*	-5	-5	-5	-5
Carbon price floor: introduce from 2013-14 with £30 per tonne of CO2 target	0	0	740	1070	1410
Currency for tax calculations: avoidance	60	60	60	60	60
Stamp Duty Land Tax: avoidance	30	30	40	40	50
VAT: fraud on imported road vehicles	0	0	125	110	105
Inheritance tax: reduce rate to 36% for estates with charitable donations of more than 10% from 2012-13	0	-25	-75	-125	-170
<b>Tax raising measures</b>	<b>720</b>	<b>375</b>	<b>1065</b>	<b>1385</b>	<b>1725</b>
<b>Tax cutting measures</b>	<b>-70</b>	<b>-170</b>	<b>-310</b>	<b>-405</b>	<b>-485</b>
<b>Total impact</b>	<b>790</b>	<b>545</b>	<b>1,375</b>	<b>1,790</b>	<b>2,210</b>

## 5. Energy policy

Matthew Sinclair

Two of the principle means by which the tax reductions and spending increases proposed in the Budget are financed over the medium term are changes to energy policy. By 2015-16, the increase in the Bank Levy will raise £100 million. By contrast, the rise in North Sea oil taxes is expected to increase revenue by £1.87 billion in that year and the carbon price floor another £1.41 billion.

The carbon price floor is intended to be £30 /t CO<sub>2</sub>. That would entail roughly doubling the impact of the emissions trading scheme on wholesale electricity prices as the price is currently roughly half that. The Government expect it to add around 1 per cent to average household bills in 2013 and around four per cent in 2016. That is on top of a number of other policies such as renewable energy subsidies which are also adding substantially to energy prices. In the consultation document for the carbon floor price the Treasury projected electricity prices with a number of different floors, rising at different rates.<sup>4</sup> The proposal in the Budget roughly matches Scenario 2, with a target carbon price of £30 /t CO<sub>2</sub>. That appears to mean significantly higher prices in 2020.



They argue the carbon floor price will lead to reductions in the longer term, in the late 2020s, as it will increase investment in low carbon energy generation. That is highly speculative though as there is still substantial construction risk and investors may not be confident that the Government will stay the course with the scale of medium term rises. Peter Atherton from Citigroup recently told the Energy and Climate Change Select Committee that:<sup>5</sup>

<sup>4</sup> [http://www.hm-treasury.gov.uk/d/consult\\_carbon\\_price\\_support\\_condoc.pdf](http://www.hm-treasury.gov.uk/d/consult_carbon_price_support_condoc.pdf)

<sup>5</sup> <http://www.publications.parliament.uk/pa/cm201011/cmselect/cmenergy/c742-iv/c74201.htm>

*“The fact is that we are going to try and put these very expensive, not very robust, very challenging technologies on the ground very quickly. If we do that, the price of energy will be high—I am for ever shocked that anybody thinks anything other than that—and what’s more, the profits are going to be high. What investors have to be able to imagine is a situation where, in 2018 or 2019, the Secretary of State is standing up to the media and Parliament and saying, “It is a really good thing that your bills have just gone up by 15%, and will be going up 15% next year, the year after and the year after. And it’s a really good thing that SSE and the other utilities have just reported record profits, and will be reporting record profits for the next 10 years.” Institutional investors ask, “Do we have confidence that, when that becomes the case, the mechanisms will be supported and fully kept in place?” Maybe if you have contracts for difference, the mechanisms stay in place, but you can just tax them in another way.”*

Serious reform of energy policy focussed on improving affordability could result in lower prices than any of the options in the Treasury chart.

The Government argue that measures have been taken to avoid an undue impact on energy intensive industries:

*“To mitigate the impacts, the Budget also announces an increase in the discount from CCL for electricity from 65 per cent to 80 per cent from 1 April 2013 for energy-intensive sectors with Climate Change Agreements.”*

That is deeply misleading though. The discount was reduced from 80 per cent to 65 per cent in the Pre-Budget Report 2009. It has now been increased back to the original rate. As such, those industries have only had their original position with respect to the Climate Change Levy restored and this does not mitigate the substantial increase in costs resulting from the carbon price floor and they are also facing highly unstable taxes. It is unlikely they will be able to invest on the basis of such an unreliable discount.

The changes to taxation on North Sea oil may also have significant consequences. A study by the Surrey Energy Economics Centre argued that higher tax rates may not be an efficient means of generating strong long term revenues from the North Sea:<sup>6</sup>

*“In the late 1970s and early 1980s, the UK Government leant towards generating high revenues from the oil industry. From 1983 to 2002 the emphasis was on encouraging new developments and growing production thereby extending a period of UK self-sufficiency. Then, after 2002, squeezing out more revenues from the UKCS*

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<sup>6</sup> <http://www.seec.surrey.ac.uk/Research/SEEDS/SEEDS116.pdf>

*became once again a high priority given the need to fund a rapid growth in public expenditure. However, this came at the wrong time in the life of the UKCS, since the Government's concern should have been to encourage more oil production from its declining province, especially in the light of the rising concern surrounding the security of supply (Nakhle, 2005)."*

[...]

*"Finally, a high level of Government take is not recommended in cases of high-risk exploration and high-cost development, or for those provinces with remaining modest petroleum potential, as is the case in the UKCS. The cost of producing oil can overwhelm any price incentive. Large price incentives are needed to increase production while the costs of production are rising. In the UKCS, there are still substantial volumes to come. But this requires very large investment, given the rising costs and the shrinking of fields' size. Besides, the UK Government's priority should be to extend the life of its oil province (Nakhle, 2005). Even at lower oil price, the Government can generate higher revenues if production is sustained. The rapid increase in production during the 1990's resulted in a sharp increase in tax revenues despite the static oil price, which averaged under \$20/bbl."*

In the end, substantial reserves – with a substantial value – could be left in the ground, increasing Britain's dependence on foreign oil and gas at a time when significant geopolitical instability makes domestic production particularly valuable. The Investors Chronicle reports that:<sup>7</sup>

*"Despite the chancellor building in a mechanism to reverse the tax hike should oil fall back below \$75, the proposal comes at the wrong time for the industry. North Sea firms will incur rising costs just as the industry faces "a compelling need for serious investment", according to Jim Hannon of North Sea consultants Hannon Westwood.*

*The North Sea has witnessed increased, and successful, drilling activity over the past decade. But Mr Hannon points to a rising stock of discoveries that smaller, cash-strapped companies haven't been able to develop, particularly given looming decommissioning liabilities and ageing pipelines. He estimates that the industry needs to invest \$35bn (£21.5bn) over the next five years to exploit these undeveloped discoveries. Without this finance, the industry could end up leaving in the ground a substantial proportion of the estimated 4.4bn barrels of oil and gas that the small and medium-sized firms are looking to develop."*

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<sup>7</sup> <http://www.investorschronicle.co.uk/MarketsAndSectors/Sectors/article/20110323/8be605ae-556b-11e0-afcb-00144f2af8e8/Tax-blow-to-North-Sea-oil-and-gas.jsp>



## Budget 2011

British policy does not exist in a vacuum and higher taxes are likely to mean investment is diverted to other parts of the world, at the UK's expense. Analysts have reported that "the global exploration/development dollar is a lot less likely to make its way to the North Sea tomorrow than it was yesterday."<sup>8</sup> High oil prices do not mean that there is no cost to higher taxes in the form of less North Sea production.

Other energy and climate change policies did emerge yesterday including the Green Investment Bank. They may have significant long term consequences as well. The carbon price floor and the tax on North Sea oil are particularly notable for the effect they will have on energy affordability and security though.

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<sup>8</sup> <http://www.iii.co.uk/investment/detail?code=cotn:XEL.L&display=discussion&id=8018869&action=detail>

## 6. Council Tax

Chris Daniel

The news that all councils will freeze Council Tax in the coming year is very welcome. Every local authority in England has taken the Government's offer to compensate for any loss in revenue. The Government's support to freeze Council Tax partly compensates for a relatively tough grant settlement for local authorities at the Comprehensive Spending Review.

The result is an average saving for households of £72 a year. Forty-three councils have gone further than this and cut Council Tax for 2011-12, which shows that when councils are run well they can find savings and cut Council Tax bills. The graph below shows how the tax has increased between 1993-94 and 2011-12 and shows that even in real terms the major increase in earlier years is only starting to be reversed.

### Band D Council Tax adjusted by GDP deflator

