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Rt Hon Alistair Darling MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Chancellor

A credible plan for balancing the budget and supporting economic growth

This year has been challenging both for government and for business. Public borrowing is set to reach record highs, while business investment – both levels and intentions – has plummeted. And the outlook is set to remain challenging on both fronts. Our September forecast shows output falling by 4.3% this year and rising by only 0.9% next year. Nonetheless, it looks as though the worst of the recession may be behind us. However, the lingering effects of the financial crisis present an ongoing risk to this outlook which could undermine the strength of the recovery. Despite a robust response by both the government and the Bank of England to the financial crisis, lending flows have yet to show significant improvement.

Beyond the recession, the drivers of economic growth will almost certainly be different to the recent past, with consumer and government spending expected to be more constrained. So business investment, exports and import-substitution will need to make a much greater contribution to economic growth. With activity in the financial and housing sectors unlikely to return to previous levels, there will need to be structural change in the economy to fill the gap. A great deal of private as well as public sector investment will be needed to support UK competitiveness, help the transition to a low-carbon economy and secure the nation's future energy and infrastructure needs.

Although the automatic stabilisers have played a welcome role in supporting the economy during the downturn, the high level of public sector borrowing presents a further risk. Without a fully



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Richard Lambert Director-General

credible plan for achieving budget balance, there is a danger that the Sterling adjustment becomes disorderly and risk premia on UK debt go up. With a lacklustre recovery in prospect, and a structural loss in output, it is vital that the government takes steps to support both a cyclical and structural improvement in the economy and the public finances.

Against this difficult background, the 2009 Pre-Budget Report needs to achieve two objectives:

1. There should be a robust and credible strategy for achieving budget balance:

- An earlier date for budget balance of 2015-16 rather than 2017-18 as in current Treasury plans
- A focus on current spending restraint rather than tax increases to reduce the deficit
- Protection of the capital budget to support future economic growth
- A robust strategy for achieving reform of public service delivery using private sector skills to help deliver such change
- Detailed plans for delivering savings while protecting vital services
- A new fiscal framework

2. The policy environment must support a robust economic recovery:

- Measures to accelerate the shift to a low carbon economy
- Support for SME capital raising and cashflow
- Regulatory changes to help alleviate burdens on business
- Potentially damaging tax increases should be reconsidered

1. A Credible Fiscal Strategy

Budget balance in 2015-16

The 2009 Budget shows current budget balance being achieved by 2017-18. This is too long a time horizon to underpin the credibility of the government's public finance management and risks destabilising financial markets. Being so far ahead, it is not possible to firmly outline how this will be achieved. It would be appropriate, therefore, to return to the PBR 2008 target of 2015-16 for achieving budget balance. The CBI estimates that this may require up to a further £120 billion to be taken out of the cumulative current budget deficit between now and 2015-16 relative to Budget plans. This figure incorporates a potentially higher budget deficit if the economy performs as the CBI expects, and further tightening in addition to current plans and projections from 2012 onwards.

The earlier date for budget balance requires the cyclically-adjusted budget deficit to reduce more rapidly than is currently planned. The total per year tightening required rises to 1.2% of GDP between 2012-13 and 2015-16 compared with Budget plans for an average 0.8% of GDP tightening from 2012-13 to 2017-18.

Spending rather than taxation

The fiscal plans that have been set in place so far have fairly evenly spread the burden of fiscal tightening between spending cuts and tax increases. There should be no moves to further increase the tax burden for business – either overtly or covertly – as this will increase the likelihood of businesses locating outside the UK and jeopardise the long-term sustainability of the UK tax base.

It was disappointing to note the sharp cuts in future capital spending that were announced in the Budget, which risk undermining the productive potential of the economy. Capital investment is essential for delivering economic efficiency and effective public services. The government must urgently reconsider its current plans to cut investment to 1.25% of GDP. These plans will have significant repercussions for areas such as transport and energy infrastructure and risk undermining the economic recovery. To underpin a sustainable future, net investment must be restored to 2.25% of GDP as soon as possible.

The achievement of budget balance without substantial increases in the tax burden or capital spending cuts will require total current spending to fall by around 8% of GDP from its 2009-10 peak by 2015-16. Bringing forward the date of budget balance entails a faster pace of adjustment in the public sector and slower spending growth than Treasury plans imply. Only a small proportion of this adjustment can be achieved automatically through an increase in economic growth, given the structural shortfall estimated in the 2009 Budget. The rest will need to be achieved through discretionary policy.

Achieving budget balance by 2015-16 would require a reduction in nominal spending growth of around 1%pt between 2012-13 and 2015-16, relative to that implied by the 2017-18 target. The CBI calculates that this implies a reduction in nominal spending growth over this period from around 3% to 2% per annum, reducing nominal current spending over that period by around £70 billion compared with the Treasury trajectory.

Public sector reform

The scale of the required adjustment in spending means that strategic re-engineering of service provision is the only way to improve public sector productivity sufficiently, without politically unacceptable cuts in services. The skills necessary to achieve the required efficiency savings are scarce across the economy, but can be found to a greater extent in the private sector. It is essential that the public sector accesses these skills to ensure that productivity improvements are delivered effectively. The public and the private sector can and should work together to help deliver fundamental public sector reform.

Given the rate of growth in the public sector in recent years, and its poor productivity performance, there would seem to be significant scope for improving efficiency in the public sector. Current spending grew by 30% in real terms between 1999-00 and 2005-06, a period during which productivity fell almost every year. If public sector productivity had been as high as the private sector in the recent past, then the same volume of output could have been produced with 14% lower input volumes. Improving public sector productivity would support the delivery of public services at a lower cost.

Accompanying this letter is a paper setting out a menu of ideas for achieving efficiency savings in the public sector. The proposals are not exclusive, but are a list of costed savings using methods that could be applied in other areas. The CBI estimates that, to achieve budget balance by 2015-16, up to £120 billion will need to be taken out of current spending by 2015-16, if the economy

underperforms relative to Budget forecasts. The CBI's analysis suggests that £136 billion of savings could be achieved over this period, over and above the Treasury's existing efficiency commitments.

A new fiscal framework

The 1998 fiscal framework and original fiscal rules played a valuable role in anchoring market beliefs about the public finances. However, the golden rule and sustainable investment rule had shortcomings which are worth addressing. It is the CBI's view that the previous fiscal rules and the subsequent temporary operating rule have not proved sufficiently rigorous, either to prevent public spending rising too quickly during boom years, or to achieve an appropriate pace of deficit reduction.

The government should commit to the implementation of a more rigorous public finance framework. This would help anchor market beliefs regarding the probity of the public finances, thus ensuring that movements in Sterling remain orderly and that borrowing costs are not pushed up through increased risk premia.

The most appropriate action to take in the short-term would be to announce the creation of a Fiscal Policy Committee (answerable to Parliament) to scrutinise the government's public finance and economic forecasts, including the underlying assumptions. This would move beyond the current role of the NAO in auditing Budget assumptions. Another key policy that could increase the transparency of the public finances would be to take greater account of economic growth risks in the forecasts, e.g. by moving to probability bands for the GDP forecasts.

The CBI's preferred rules (which we submitted alongside our 2008 Pre-Budget Report proposals) to replace the golden and sustainable investment rules are:

- Over a nine-year period, centralised on the current year, the government should aim to balance the current budget, and limit total borrowing to an average of 3% of GDP.
- Surpluses generated from GDP being above trend should be used only to improve the public sector financial balance, i.e. spending should not be increased in response to a financial surplus.

2. Supporting the economic recovery

The 2009 Budget contained forecasts for a buoyant recovery, with economic growth rising to 3.5% by 2011. However, this is built on expectations of pickup in business investment and consumption. With lending flows unlikely to rebound to previous levels and unemployment yet to reach its peak, it is difficult to see where this growth will come from.

We recognise that the state of the public finances limits the scope for further support for the economy. However, we believe that there are steps that can be taken in the short-term to help make life easier for businesses facing significant pressures and to help support the economic restructuring ahead.

Supporting R&D and high-technology manufacturing

It is essential that changes in the tax system, e.g. those for Controlled Foreign Companies, support and enhance the UK's position as an attractive location to undertake R&D and high-tech manufacturing. The aim should be the optimisation of UK international competitiveness to make the UK "the place to locate" for high-technology businesses.

As part of this approach, low-carbon innovation must be better supported by government. The research and development (R&D) tax credit scheme, which encourages investment, must be maintained and improved to help Britain lead the way in low-carbon innovation. The call is one of ten recommendations for government made by the CBI in our recently published report, "Pulling ahead: innovating for low-carbon leadership".

The government should also explore seriously the concept of a "royalty box" system, which, if appropriately structured, could support growth in high-technology manufacturing and R&D in the UK, provided it is not at the expense of the R&D tax credit. Many businesses prefer to co-locate R&D, manufacturing and ownership of IP in one jurisdiction. The current lack of competitiveness of the UK tax system (when compared with countries such as Ireland that are attracting high-technology investment) has resulted in many companies being incentivised to locate ownership and exploitation of IP developed in the UK in jurisdictions with a competitive tax regime; this has resulted in core elements of manufacturing and R&D also being located outside of the UK. This results, not only in a net outflow of tax receipts, but also the loss of direct and ancillary employment and services related to the IP. The implementation of a royalty box, providing a low rate of tax on income attributed to IP, and in conjunction with the R&D tax credit, will help to reverse the decline in investment activity associated with the exploitation of IP and strengthen the economy.

Support for SME capital raising and cashflow

Make equity raising tax deductible for SMEs

It is anomalous that the costs of raising equity finance are not deductible for corporation tax purposes when the costs of raising loans are. The only real distinction between equity and other forms of finance is in the degree of risk involved. This anomaly either penalises or deters businesses from undertaking certain types of spending. The decision on the most appropriate source of finance should be made for commercial and not tax reasons.

The CBI has already recommended that all genuine business expenses, including the costs of raising equity, should be tax deductible. If the government, initially, does not wish to commit to making the issuance of all new equity tax deductible, then the relief could be limited to private companies seeking to raise up to £20 million. This would apply to a single fundraising event only, and not for equity release purposes. While little data exists on the use of equity finance by SMEs, the CBI estimates that this measure would cost the Exchequer around £260 million.¹

¹ CBI SME Report, "Supporting Enterprise through Taxation", March 2009.

Based on no more than 5000 profitable SMEs seeking an average of £705 thousand and paying 7.5% in fees. The NESTA report "Shifting Sands" reports that sub-£2 million investments typically account for between 70% and 80% of all venture capital investments and that the average sub-£2 million investment was £705 thousand in 2007.

Appropriate pace of business support withdrawal

A number of welcome schemes have been implemented during the crisis to help support business cashflow, for example, the HMRC tax deferral and Enterprise Finance Guarantee schemes. As the recovery gains momentum, it is to be expected that some of this support will be gradually withdrawn. It is crucial that the Treasury and BIS carefully consider the timing of their withdrawal so as not to jeopardise fragile businesses.

Regulatory changes

In the light of continuing pressures on business, there are a number of regulatory changes which would provide some welcome support and clarity:

- Extend the Pensions Regulator's trigger
- Deregulate small mergers
- Boost minimum wage enforcement efforts rather than focussing on a rise in the level

Reconsider forthcoming tax increases

There remain a number of tax increases for business in the pipeline which present an unwelcome burden in an already challenging environment.

Landfill tax

As noted in the CBI's response to the government's consultation *Modernising Landfill Tax*, changing the definition of inert waste to determine tax liability could severely damage the environment and the economy. The government's proposal will force many businesses which are currently paying £2.50 per tonne to landfill inert waste, to pay £48 per tonne from 2010-11 and £72 per tonne from 2013-14. This significant rise in tax liability risks encouraging unsustainable waste management practices and discouraging investment in energy from waste schemes. The electricity industry alone could be burdened with an additional £841.5 million in tax liability over five years whilst other equally important sectors, including steel, could face a 20-fold increase in their tax bills. Wholesale electricity prices could rise by 5-10 percent and businesses seeking a more competitive environment could be forced overseas.

Tax treatment of pension contributions

The proposals in Budget 2009 to reduce, then withdraw, pensions tax relief on incomes above £150,000 will seriously damage confidence in pensions saving, and should be reconsidered. They will raise little revenue and force senior staff out of company pension schemes, reducing boardroom engagement. At the very least, a year's delay in any change is essential, as many people earning significantly below the threshold may accidentally trigger punitive tax payments associated with unexpected non-wage income. An additional year would allow firms and individuals appropriate time to set their affairs in order before the change is made.

Business rates

In the current climate, caps on transitional business rates after the April revaluation must reflect the pressures that businesses are under and the large property cap must be lowered from 12.5% in the first year to 7.5%. This should be funded by a reduction to the capped decrease. Businesses that will see large increases are under a lot of pressure and should be protected in the current climate.

Air Passenger Duty

Recent changes to air passenger duty are expected to yield £2.6bn for the Exchequer in 2011-12, a substantial increase from the £971m collected in 2006-07. The CBI is deeply concerned about the effect of increased APD rates on the competitiveness of the UK.

Empty property rates

We continue to believe that the system of business rates relief for empty properties should be restored to the pre-2008 position.

Increases in employer NI

As noted in previous CBI submissions, this represents a tax on employment at a time when unemployment will still be high.

Timing of the VAT rise

Changing the tax rate on the 31st of December will create practical problems for businesses which will have to adjust their prices during the busy post-Christmas sales period. We continue to call for a short extension in the VAT cut to help manage business pressures.

Small companies' corporation tax

The increase in the corporation tax rate for small companies, due to come into effect in April 2010, should be postponed to allow SMEs a longer timeframe in which to adjust to the challenging economic and financial environment.

These are the CBI's key messages ahead of the Pre-Budget Report.

We believe that economic and fiscal sustainability go hand-in-hand. In order for the economy to restructure in response to the changed environment, all potential sources of instability and uncertainty must be addressed. This drives our focus on a robust plan for restoring the public finances to health, delivered through wide-reaching and fundamental public sector reform. The supportive economic and financial conditions that will result from this approach will help deliver the strong economic recovery that is needed.

Yours sincerely



Richard Lambert
Director-General