

CBI ANALYSIS OF THE SPRING 2007 BUDGET

EXECUTIVE SUMMARY

1. The CBI welcomes the cut in the headline corporation tax rate to 28% from 30%, but only as a first step to help improve international tax competitiveness. Accompanying restrictions on the value of capital allowances will create 'winners' and 'losers' in the early years, with no overall cash benefit for the business sector as a whole in that time. In addition, many SMEs will be adversely affected by the rise in the small companies' corporation tax rate to 22% by 2009, from 19% currently, even though some may benefit from the new annual capital allowance.
2. The CBI also has significant reservations about some of the plans:
 - Failure to rein in a little further the overall public spending totals for the next four years, making a net reduction in the overall tax burden unaffordable in that time.
 - Accelerated rises in the landfill tax and aggregates levy, above-inflation increases in fuel duties, and abolition of business rates empty property relief. The result is that, overall, the Budget imposes a net cost on business in the next three years, in addition to the cost imposed by the Pre-Budget Report.
 - The possibility, raised in the Lyons review, of local supplementary business rates being imposed with or without broad support amongst affected businesses.
3. Some of the spending measures will benefit business and the economy:
 - Education – confirmation of a greater share of the public spending total in coming years, an increase in the school/training leaving age and new training incentives.
 - Science and research – improvements in the R&D tax credit for large and small firms and announcements concerning the public science budget.
4. The Treasury forecast for GDP growth this year, of 2.75%-3.25%, looks realistic, though we see the forecast of 2.5%-3% for each of the following two years as mildly over-optimistic, given the present, relatively small degree of spare capacity in the economy. The CBI forecast is for growth of 2.9% this year and 2.6% next.
5. The CBI is also concerned that the underlying position of the public finances is slightly weaker than reported in December. Planned spending is a little higher throughout 2007/08-2011/12 and this has resulted in a relaxation of borrowing of some £2-3bn per annum over the period.

The overall impact on business costs and government revenues

6. Table 1 sets out the arithmetic impact of the new policy announcements for the coming three years. Overall, the CBI is disappointed that there is once again a net additional cost for the business sector. Specifically:
- The corporation tax changes are broadly revenue-neutral over the three years, with the reduction in the main corporation tax rate offset by the changes to capital allowances and increase in the smaller firms' tax rate.
 - Other tax rises – affecting fuel duty, environmental levies and business rates bills for empty properties – will add to business costs.
7. The overall impact is to push up the business tax bill by some £2.8bn over the three years (excluding 'revenue protection' measures). By contrast individuals will gain modestly in aggregate, if the knock-on impact of the business tax measures is ignored. The package of changes to personal taxes, tax credits and benefits amounts to just over £4.6bn for the three years. Even allowing for offsetting changes to various duties, the household sector tax bill has been reduced a little at business' expense.

Table 1: Total impact of Budget 2007 policy changes			
<i>Approximate £m yield (+) or cost (-) to Exchequer relative to baseline¹</i>	2007-08	2008-09	2009-10
Main rate of corporation tax cut to 28% from 30%	-140	-1385	-2230
General plant & machinery capital allowances cut to 20%	0	+1490	+2270
R&D tax credit increase (SMEs and large firms)	0	-70	-150
Small Companies Rate of Corporation Tax raised to 22%	+10	+370	+820
Other changes to capital allowances	0	-85	0
Measures mainly benefiting SMEs ²	-35	-250	-810
Rationalisation of empty property relief	0	+950	+900
Increase in aggregates levy and landfill tax	-10	+215	+370
Fuel and vehicle duty measures (business share) ³	-68	+280	+362
Measures directly affecting business	-243	+1515	+1532
Personal taxes, tax credits & benefits	-15	-2105	-2510
Minor changes to the tax system	+45	+10	+75
Protecting tax revenues ⁴	+215	+290	+280
Duties changes (alcohol, tobacco, gaming)	+10	+20	+25
Fuel and vehicle duty measures (consumer share)	-137	+559	+723
Spending from special reserve	-400	0	0
Other largely non-business measures	-282	-1226	-1407
Total fiscal impact	-525	+280	+125
¹ The baseline includes up-rating many duties and levies in line with inflation.			
² Covers changes to Venture Capital Schemes, one year extension of 50% First Year Allowances for small enterprises and New Annual Investment Allowances for small enterprises.			
³ Including changes to Vehicle Excise Duty, increased road fuel duties, increased rebated fuel duties and continuation of differential to 2009/10 for biofuels and road fuel gas and the renewal of the reduced pollution certificate scheme for lorries.			
⁴ Measures to counter missing trader fraud, strengthening the disclosure regime, loss-buying in the Lloyd's insurance market, life insurance companies: financing arrangements.			

8. Though the Budget itself was broadly fiscally neutral, taking the Budget and Pre-Budget Report together there has been a modest fiscal tightening. The overall impact of the two packages is a net revenue increase of just under £7.4bn over the three years 2007/08-2009/10. Of this, measures directly affecting business amount to over £6bn.

Summary of CBI views on specific Budget measures

9. Table 2 summarises the CBI’s views on specific Budget measures, which the rest of this paper covers in more detail.

Table 2: Budget Report measures: CBI reaction		
Measures that the CBI welcomed	Measures of concern to the CBI	Measures that the CBI was disappointed not to see included
<p>Reduction in the headline rate of corporation tax to 28% from 30% to improve international tax competitiveness.</p> <p>Early CSR settlement for education spending in England amounting to 2.5% per annum in real terms over three years. Also raising the school leaving age and encouraging 16-18 year olds into training programmes.</p> <p>R&D tax credit for SMEs increased to 175% from 150% and for large firms to 130% from 125%. Also announcements relating to the public science budget.</p> <p>Various initiatives to encourage action on climate change both domestically and globally.</p> <p>Progress on the deregulatory agenda including employment tribunal rule reform.</p>	<p>Increase in the small companies’ rate of corporation tax from 19% to 22% by 2009/10.</p> <p>Restrictions on capital allowances, meaning a net cashflow cost for some sectors in the early years.</p> <p>Further small increase in the profile of total government spending, relative to Pre-Budget Report projections (mainly funded by yet another relaxation in the borrowing targets).</p> <p>Sharper than planned rises in the landfill tax escalator and aggregates levy in 2008 until 2010/11, and above-inflation rises in fuel duties.</p> <p>Restriction of business rates empty property relief.</p> <p>Uncertainty over the implementation of the Lyons Review recommendations, which allow for the levying of local supplementary business rates.</p> <p>The continued intention to proceed with the planning gain supplement on property development.</p>	<p>Commitment to a slightly firmer grip on total public spending, which is a pre-requisite for a much-needed reduction in the UK tax burden.</p> <p>Support package for small employers to mitigate the cost of compulsory pensions.</p> <p>Failure to tackle various longstanding tax anomalies facing SMEs and other firms.</p>

Corporation tax

10. The CBI views the cut in the main corporation tax rate as only a welcome first step to improving the UK's international tax competitiveness. While the reduction moves the UK up the OECD-30 corporation tax 'league table' – to having the 12th lowest rate from 19th – our rate remains above that of the Netherlands (25.5%) and Ireland (12.5%) amongst other competitors. Within the EU-27 the UK would have the joint 9th highest corporation tax rate rather than 7th highest. But our rate would still be above the EU average, even in the absence of further reductions elsewhere. More needs to be done to improve the UK's tax competitiveness to protect jobs and investment.
11. Furthermore, the potential benefit of the rate cut is reduced by the fact that it is mainly funded, in the early years, by a reduction in the major capital allowance rate. This will create many cashflow 'losers' in that time, especially in the more capital-intensive sectors. Other changes include the complete phasing out of the industrial buildings capital allowance, the rationale for which is unclear. The CBI is very concerned that many SMEs will be adversely affected by changes affecting them (see further below). We also note that the tax rates applied to the North Sea oil and gas sector have been left unchanged, following the adverse changes of recent years. Overall the business sector will be no better off in cashflow terms over the next three years.
12. We do however recognise that business cashflow would benefit from the corporate tax package after 3-4 years, as long as new and offsetting revenue-raising measures were not introduced in the interim.
13. We warmly welcome the further consultation on the tax treatment of foreign income including proposals to modernise Controlled Foreign Company rules and the follow up to the Varney Report. These are important components in enhancing the international competitiveness of the UK's tax regime. On managed service companies we will need to ensure that the finance bill prevents liability for non-payment of tax from being transferred to end clients. With regards to the review of HMRC powers and penalties we await publication of responses to the consultation and draft finance bill clauses.

Education and skills

14. The CBI supports moves to raise the education/training leaving age to address the lack of basic and employability skills amongst many young people entering the labour market. Raising the leaving age must, however, be part of a wider package which also includes government funding for reformed, 'fit-for-purpose' qualifications and high quality careers advice.
15. The skill levels of many young people leaving secondary school remain poor despite almost a decade of rising investment in schools. Basic skills remain a weakness in terms of the UK's competitiveness. As employers and taxpayers, business expects spending increases in this area to deliver improved competitiveness. We therefore welcome the new proposals aimed at encouraging 16 to 18 year olds into training who are currently outside the education system.

Science, technology and innovation

16. The CBI welcomes the increase in the R&D tax credit for SMEs to 175% from 150% and for large firms to 130% from 125% from 2008/09 (subject to State Aid approval). The impact of these increases has to be considered in light of changes to corporation

tax rates that will affect both the value of the tax credit and the value of the 100% tax allowance for R&D.

17. For large firms, the 150% tax credit from 2008/09 equates to a reduction in R&D costs of 8.4% (from 7.5% today). However, the overall cost of conducting R&D will *increase* slightly because the change to a 28% main corporation tax rate reduces the value of the 100% allowance. This means that from 2008/09, the effective cost of £100 worth of R&D for large firms will rise from £62.50 now to £63.60. We expect that this increase will be more than made up by the lower corporation tax burden. For SMEs the improved tax credit equates to a reduction in R&D costs of 10% for fiscal year 2007/08, 15.75% for 2008/09 and 16.5% for 2009/10 (from 9.5% today) as changes to the small business rates of corporation tax are also taken into account. The overall effect of the tax credit and corporation tax rate changes will be to reduce the effective cost of £100 worth of R&D from £71.50 today to £61.50 by 2009/10 (subject to State Aid approval).
18. The Budget also announced that, again, subject to State Aid approval, the small firms' tax credit rate (and the option of a payable cash credit for loss-making firms) will be extended to companies with less than 500 employees. This is likely to provide a significant boost to R&D-led firms seeking to grow.
19. The UK has a strong scientific base, which the increases in the science budget will help to sustain. The Science Budget will now grow in real terms by 2.5% annually to £6.3 billion by 2010. We would expect much of this growth to be directed to business-relevant research and development initiatives including the enhanced Technology Strategy Board and the new user-focused research strand for universities from the Funding Councils.

Small and medium-sized enterprises

20. The CBI is concerned about the tax package affecting small businesses, which centred on a rise in the small firms' corporation tax rate from 19% to 22%. A claimed rationale for this decision was to reduce the differential between incorporated and unincorporated businesses. But in this case it is not clear why the corporate tax rate will end up above the personal income tax rate, rather than being aligned with it. The aim to refocus investment incentives for small business is welcome, but many small firms will simply be unable to benefit. The improved SME R&D tax credit is of course welcome too, but state aid clearance needs to be gained, and SMEs will not benefit until 2008/09.
21. The Budget announcement that grants of £2000 to £3000 would be available for small firms to undertake staff training is also welcome. The government has committed to continue the funding of enterprise education, through DfES, at £60m per year over the CSR period. The National Council for Graduate Entrepreneurship will work with the government and other stakeholders to assess establishing an "enterprise foundation".
22. The Budget Report also provides an update on the ongoing government initiative to simplify business support. The DTI-led, government backed, business support simplification programme has the full support of the CBI. This should not be an exercise in reducing the funding available to businesses; efficiency savings identified through the simplification exercise should be ploughed back into the programmes. By 2010 the CBI wants to see a business support system that provides seamless and targeted support to businesses through their life cycle; particularly those seeking to grow their companies. All government departments, agencies and local authorities need to work together to achieve this result. The CBI welcomes the increase in funds

available to small businesses related to environmental information, available through the Business Link and RDA network.

Environment and transport

23. Climate change is a threat to the economy as well as to wider society, so business strongly supports incentives to help change patterns of behaviour and encourage households and businesses to reduce emissions and waste. (For example, new enhanced capital allowances for investment in energy/water efficiency equipment, financial incentives for households to become more energy efficient, streamlined resource efficiency advice for businesses through RDAs, tax relief on electricity sold back onto the grid from micro-generation.) These measures are generally welcome, and some, like stamp duty relief on low carbon houses, have been specifically called for by the CBI in the past.
24. A competition to select a demonstration carbon capture and storage (CCS) power plant for government funding is positive news and must be moved forward with urgency. This technology has potential to play a big role in enabling power companies to reduce emissions, and progress with a commercial-scale scheme is vital. However, there are questions over whether there is sufficient urgency (the results of the competition will not be announced till next year), and whether public funding is needed. More detail is promised in the postponed Energy White Paper.
25. The Climate Change Levy (CCL) is to rise in line with inflation. We still see the CCL as a blunt instrument of limited environmental value, but the inflation-only increase at least limits the impact and was expected. The various incentives to promote action to tackle climate change internationally including an £800m international environmental transformation fund are broadly welcome given the need to stimulate global rather than unilateral action.
26. The sharp increase in the annual landfill tax escalator to £8 per tonne from 2008/09 through to 2010/11 will merely add to the tax bills of business with little environmental benefit. In contrast to previous rises in the landfill tax, the additional revenues are not being recycled to business through the Business Resource Efficiency and Waste programme (BREW). While we had accepted the need for the existing escalator (£3 per tonne per annum) to rise, the planned rise in the escalator will take the new rate close to £50 per tonne by 2010. Failing to recycle the revenues to business risks reducing the incentive for diversion of waste from landfill and leaving hard-pressed manufacturing firms with higher costs. And the increase by itself will not bring forward more investment in the waste treatment facilities needed unless the planning system allows more waste facilities to be built.
27. Similarly, the inflation-busting increase in the aggregates levy to £1.95 per tonne from 2008 (from £1.65 per tonne) represents an additional cost for the construction industry. We do not believe that levy has had a significant environmental benefit and the increase has simply added to the business cost and tax burden.
28. The increase in the Vehicle Excise Duty rate for high emitting vehicles (band G) to £400 per annum over the next two years has been partially offset by reductions in lower emissions categories and enhanced support for biofuels. The above-inflation rise in the main road fuel duties from next year will not help UK hauliers competing with foreign haulage companies paying significantly lower fuel taxes. Meanwhile, October's further sharp rise in duties in red diesel and heavy fuel oil will again add significantly to

some firms' costs, although there will be some relief at the commitment to raise these duties in future in proportion to the main road fuel taxes.

Planning and property

29. The more we learn about how the proposed Planning Gain Supplement would operate, the less workable it looks. It is one more tax for business and risks undermining development with serious consequences for UK competitiveness, not to mention the supply of new homes. The Treasury should drop this proposal.
30. The CBI is also concerned at the recommendation in Sir Michael Lyons' Review to empower councils to levy a supplementary business rate to fund new infrastructure. Firms must have a vote on any plans to levy a supplement, as they currently do with Business Improvement Districts. Any project must be clearly defined and businesses will only agree to pay higher supplementary taxes for a limited time period.
31. We are however pleased that Sir Michael has chosen not to propose a return of business rates to full local authority control, though we are concerned that this remains a long-term option. Business needs certainty and we welcome the recommendation that future rises in the uniform business rate should not exceed inflation. However the restriction of Empty Property Rate Relief may limit the flexibility of businesses in how they organise their operations, given that changes to property use can take some time. The measure will cost business just under £1bn per annum from 2008 onwards.

Employment tribunals

32. The 2004 dispute resolution regulations failed to reduce the number of tribunal claims or cut down on vexatious claims so employers will be glad to see them go. But the government must not replace one unsuccessful, process-heavy system with another, so a risk based approach is right. It needs to ensure that the replacement focuses on the issues that matter and encourage early resolution of disputes wherever possible. And if early resolution is not possible, employers must not be penalised or made to jump through pointless hoops before the tribunal case is heard.

Projections for the economy and public finances

33. The forecasts for economic growth are unchanged from those published in the December Pre-Budget Report. The Chancellor still expects the economy to expand by 2.75-to-3.25% this year and the forecast range for 2008 and 2009 is unchanged at 2.5-to-3.0%. The CBI forecasts GDP growth of 2.9% for 2007 and 2.6% for 2008. We view the Treasury forecast as realistic for this year, but mildly optimistic for 2008 and 2009, given the relatively small amount of spare capacity in the economy.
34. The Chancellor announced as expected that the golden rule has been met in the economic cycle now coming to an end, though only by virtue of revisions to cycle's starting point. Of more interest is the new economic cycle which the Chancellor has decided will begin in 2007/08 and run to 2011/12. On this new cycle the Chancellor expects to meet his golden rule with a surplus on the current budget of some £27bn. However, had he included the last fiscal year of the previous cycle of 2006/07 – as has been previous practice – the forecast margin would be £17.5bn.
35. Despite the Budget package being broadly revenue neutral, and the golden rule having been met, the underlying position of the public finances is slightly weaker than reported

only in December. Borrowing is projected to be a cumulative £11bn higher over the next five years than set out in the Pre-Budget Report, and this is a concern.

36. The further relaxation in the borrowing targets mainly reflects small additions to planned public expenditure in 2007/08, and in the three years beyond that – the Comprehensive Spending Review period for which total spending (the so-called ‘envelope’) is now described as ‘confirmed’. By contrast, revenue projections have been left broadly unaffected, taking the Budget decisions and other recent developments together. Tax revenues are still set to level off at 38.1% of GDP. This is up from 34.8% in 1996/97, 35.2% in 2003/04 and 37.2% in 2006/07. It compares with the latest OECD average of 36.3% and will be the highest ever with the exception of the early 1980s.

Table 3: The 2007 Budget and the public finances

<i>£bn</i>	04/05	05/06	06/07	07/08 ¹	08/09	09/10	10/11	11/12
HMT forecast of PSNB²								
- December '05	38.8	37.0	33.5	31	26	23	22	-
- March '06	39.7	37.1	35.9	30	25	24	23	-
- December '06	39.2	37.5	36.8	31.3	27	26	24	22
- March '07	39.1	37.8	35.0	33.7	30	28	26	24
Change (Dec'06 to Mar'06)	-0.1	0.3	-1.8	2.4	3	2	2	2
Of which: Rise in planned spending	-	0.6	-2.4	1.5	3	3	2	4
Fall in projected revenues ²	-	-0.4	0.8	0.8	0	-1	-	-2
Due to economy, etc.	-0.1	0.3	-1.8	2.0	2.5	2.0	1.5	2.0
Due to Budget policy decisions ³	-	-	-	0.5	-0.3	-0.1	-0.5	-0.5

¹ For 2007/08 onwards, figures are available to the nearest £bn. Some calculations may be affected by rounding.
² A negative figure implies a rise in revenues.
³ A positive figure implies a negative yield to the Exchequer. (See Table 1 for a breakdown).

The public expenditure plans

37. Total government spending is expected to come in £2.4bn lower than previously set out in 2006/07, helping the outturn for borrowing this year. But an extra £1.5bn has been added to the 2007/08 total, in contrast to the CBI view that £2bn could and should have been shaved off that aggregate. The overall effect is to push spending growth in 2007/08 to 6.2% – above the growth of money GDP and some 3-3½% in real terms. The 2007/08 total does however include small additional provision in the security and related fields, which the CBI would support.

38. For the CSR period, £3bn has been added to each of 2008/09 and 2009/10, and £2bn to 2010/11. With the 2007/08 ‘starting point’ also higher, average annual expenditure growth over the three years is similar to that set out previously at 4.7% in cash terms, or around 2% in real terms.

39. This degree of restraint is sufficient for total spending to edge down as a share of GDP, from a peak of 42.6% in 2007/08 to 42.0% in 2010/11, but insufficient to fund a net tax

reduction, given the need to consolidate the public finances. In real terms spending will still be some 49% higher in 2010/11 than in 1999/2000, compared with growth in the wider economy of perhaps 33% over that period. The CBI had argued that, by 2010/11, spending should be lowered by £9bn compared with the PBR projection, to allow a net cut in the tax burden rather than the revenue-neutral package we have seen.

40. The spending profile has also been altered to push some of the relative restraint further into the future. Cash-terms growth is now set at 5.0% in 2008/09, easing to a more clearly below-GDP 4.7% in 2009/10 and just 4.5% in 2010/11.

41. The final allocation of funds between spending departments and functions will be unveiled with the Spending Review itself later in the year. However, some departments have settled already, and new announcements in the Budget were:

- Current spending to increase by an average 1.9% per year in real terms, with net investment edging up relative to GDP, to 2.25% of GDP.
- Education spending in England, and total public spending on science (via the DTI and DES together), to rise by a real 2.5% per annum (see earlier sections).
- All savings delivered under the CSR value-for money programme to be net of implementation costs and cash-releasing, to maximise resources for frontline services and new priorities.
- Real-terms year-on-year reductions in spending of 3.5% by the Attorney General's departments, and of 5% by the Office of Fair Trading.

42. The announcements that net investment, and spending on education and science, will be protected relative to the overall total is welcome, as is the continued focus on the achievement of further administrative-type savings.

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