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THE VOICE OF BUSINESS

CBI ANALYSIS OF THE AUTUMN 2006 PRE-BUDGET

EXECUTIVE SUMMARY

1. On balance, there was mixed news for business in the Pre-Budget Report. The package of independent reviews announced in the run-up to the Chancellor's speech will help to address some of the long–term challenges for the UK economy. In particular, the announcements from the Leitch review on skills and training, along with the improvements to the allocation of university research including funding for applied research. However, the business community will be disappointed that business tax competitiveness did not feature.

2. Some of the announcements (and re-announcements) of this year's Pre-Budget will provide some benefit to both business and the UK economy in the areas of:
   - Independent Reviews (Leitch, Barker, Gowers, Eddington, etc.)
   - Extra £155m of direct payments to schools.
   - Release of further government brownfield sites for housing development.
   - Permanent extension of tax-free ISAs beyond 2010 to encourage saving.
   - 3% per year departmental savings over the 2008/09 to 2010/11 spending window.

3. However, business will have some reservations:
   - Failure to reduce the business tax burden, or to signal any intention in this area.
   - Failure to get a tighter grip on spending.
   - New 'anti-avoidance' measures which may exceed countering genuine 'abuse'.
   - Doubling of Air Passenger Duty, as opposed to extending emissions trading.
   - Large duty rises for red diesel (19%) and fuel oil (21%).

4. Economic growth is expected to be stronger this year – 2.75% rather than the 2% to 2.5% the Chancellor forecast in the March Budget – and the trend rate of growth of 2.75% has been extended beyond the end of this year. Despite the stronger economic backdrop, revenues are projected to be only marginally higher than previously and even then due mainly to the Pre-Budget's modest revenue-raising measures. Yet the Chancellor has chosen to increase spending by a little more than this. As a result the public finances have deteriorated further with £7bn of extra borrowing by the end of 2010/11 relative to his March Budget forecast. The share of taxes in the economy stabilises at 38.1% in 2008/09 – still the highest burden since 1984/85, but short of that projected in March.

This analysis is set out as follows:
- An overview of new measures with a specific fiscal impact.
- CBI views on specific areas of policy.
- An overview of the projections for the economy and public finances.

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(A) AN OVERVIEW OF MEASURES WITH A SPECIFIC FISCAL IMPACT

5. Table 1 sets out the impact of the new policy announcements in terms of revenue transfers between the state and other parts of the economy. For business, the only significant tax 'benefit' came from the postponing of the planned rise in the main road fuel duties from September to December.

6. The doubling in Air Passenger Duty, the introduction of new 'anti-avoidance' measures under the guise of 'protecting tax revenues' and other business measures will result in a net increase in business taxation. The 'headline' business tax rise is a net £3.1bn over the remainder of this year and the next three years, with a little under half of the total net tax rise directly affecting business. The overall impact of the Pre-Budget policy changes is a modest fiscal tightening of £6.8bn over four years.

7. The CBI does not object in principle to changes to environmental taxes, provided they are designed to change behaviour and provided that they are revenue neutral. Equally where there are genuine 'anti-avoidance' schemes, we do not disagree with measures to clamp down on these provided any revenues raised are handed-back to the taxpayer. Indeed, we warned against increasing the business cost and tax burden further – the net impact of the Pre-Budget package will only worsen the deterioration in international tax competitiveness experienced over recent years.

Table 1: Total Impact of Pre-Budget policy changes

Approximate £mn yield (+) or cost (-) to Exchequer relative to baseline[1]	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Air Passenger Duty (business share)[2]	+55	+333	+367	+400
Fuel duty measures (business share)[3]	-115	-5	0	0
Protecting tax revenues[4]	+235	+490	+535	+535
Other business tax measures[5]	0	-15	+110	+165
Measures directly affecting business	**+175**	**+803**	**+1012**	**+1100**
Personal taxes, tax credits & benefits	0	+35	+5	-5
Air Passenger Duty (consumer share)	+110	+667	+733	+800
Fuel duty measures (consumer share)	-95	0	0	0
Other changes[6]	+0	+670	+560	+340
Spending measures	0	-155	0	0
Total Impact	**+190**	**+2020**	**+2310**	**+2235**

[1] The baseline includes up-rating many duties and levies in line with inflation. Hence the exchequer 'loses' for example by road fuel duties having been frozen for three-quarters of the current fiscal year even though there is no actual cashflow benefit to business.
[2] Includes a one-third share of Air Passenger Duty.
[3] Including increased rebated fuel duty, changes to the accepted vehicles schedule for rebated oils and a half share of the main fuel duty change. Negative exchequer yield as all of these duties had been assumed to rise in September rather than December, but of course in cashflow terms businesses (and consumers) will be worse off than before the Pre-Budget.
[4] Measures to combat 'anti-avoidance'.
[5] Includes: film tax reliefs; life assurance companies reform; simplification of general insurers' reserves and partial VAT exemption.
[6] Includes: changes to Managed Service Companies, countering CGT avoidance measures, changes to Construction Industry Scheme deduction rates and extension of landlords' energy saving allowance.

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
Recommendations for the Independent Reviews (Leitch, Barker, Gowers, Eddington, Varney, etc.). Allocation of £60m for user-focused university research from existing spending. Release of further government brownfield sites for housing development. All new homes to be zero-carbon within a decade with a time limited stamp duty exemption for new homes that meet this standard. Permanent extension of tax-free ISAs beyond 2010 and consultation on proposed reforms to the ISA regime. 3% per year departmental savings and 5% admin budget savings over the 3-year 2007 Comprehensive Spending Review (CSR) period. Further early CSR settlements, including a real terms -3.5% for the Department for Constitutional Affairs. Interim report on the third sector action plan to improve public service delivery. Varney report of public service transformation to improve efficiency and delivery to users. Duty for rebated fuels mixed with biofuels (piloted by train operators) slashed from 53p to 8p. Extra £155m of direct payments to schools.	Further increase in government spending and taxation relative to the March Budget projections. Further large increases in duty on rebated oil and gas. Further ‘anti-avoidance’ measures, which may go beyond countering genuine abuse. Doubling of Air Passenger Duty, as opposed to extending emissions trading. Consideration of a larger rise in the landfill tax in 2008 that would exceed the current accelerator of £3/tonne per annum rises. Intention to proceed with the planning gain supplement on property development.	Reduction in the business tax burden to help reverse the loss of international tax competitiveness. Commitment to a firmer grip on public spending. Improving the R&D tax credit so firms can realise its full value Support package for small employers to mitigate the cost of compulsory pensions. Addressing CBI concerns regarding progress against the Gershon targets.

(B) VIEWS ON SPECIFIC AREAS OF POLICY

Skills and training

8. The Leitch report on skills has backed CBI calls for business to be at the heart of a new demand-led training system. Key recommendations include: all public funding for workforce training to be demand-led through the Government's Train to Gain initiative and Adult Learner Accounts by 2010; employers to take the lead in a new Skills and Employment Commission and be given a clearer role in Sector Skills Councils; and all public funding to be restricted to vocational courses accredited by Sector Skills Councils. The downside is the threat of a new compulsory entitlement for level 2 training if the UK is not meeting the ambitious targets by 2010.

Science, technology and innovation

9. The Chancellor has announced a specific stream of funding for user-focused research in universities within the current quality-related funding stream distributed by the Higher Education Funding Councils. The fund will start at £60m in 2007/08 as a pre-cursor to a radical change in the research assessment and funding system to be introduced post 2008. The new system will be based on research income, research student data and bibliometric indicators. These moves are very welcome and directly address issues raised in recent CBI lobbying. With time, we will expect the proportion of funding for user-focused research to increase considerably.

10. The DTI has released a set of case studies with the PBR highlighting some of the great success stories that have spun off directly or indirectly from the UK science and research base. This is a welcome move, but it only scratches the surface of what is really out there: ultimately, it is not just the research that is important to the UK economy and well-being, but the people and skills developed through this work. Now the challenge for the UK is to build markets and customers for innovations derived from our investments in the science base. We will continue to focus our work on opening up the annual £150bn public procurement budget to innovative solutions and for the government to become an early adopter of new ideas.

11. The government has announced that it will establish an Office for Strategic Coordination of Health Research to bring together the health research budgets of the MRC and Department of Health. OSCHR will set the government's health research strategy, identifying priorities, coordinating activity and monitoring delivery. There will also be a new fast track approach to the development of new technologies and treatments in close partnership with business. This is a welcome development which recognises the global importance of our health research base and will provide greater opportunities for UK business innovation.

Business taxation

12. The CBI was disappointed that on the critical issue of tax competitiveness, there were no measures to help reverse the rise in the business tax burden. At the very least we were looking for some recognition of the growing disparity between the UK’s headline rate of corporation tax and those elsewhere, with a clear signal or intent in this area. This, together with the complexity and compliance burden, risks business investment shifting overseas.

13. Although the Varney Report on HMRC was welcome, much remains to be done. We also remain concerned that the extension of 'anti-avoidance' measures generally is having the effect of raising the overall tax burden on companies. CBI research published last month found that seven in ten business leaders believe the UK is a poorer international business location than in 2001. The CBI believes further consultation with both HM Treasury and HMRC is needed not just on the taxation of foreign profits but also on other aspects of the current tax regime, administration and policy, burdens, complexity and uncertainty, which impact on the UK's overall international competitiveness. In addition the CBI will be responding to government on the material put out for consultation with the Pre-Budget Report.

Better regulation agenda

14. The CBI is supportive of the general thrust of the government's actions to date, and will continue to engage with the Better Regulation Executive and with individual departments (once their simplification plans have been published) to assist them in achieving the 25% reductions in the administrative burdens that they place on business. We will also seek to ensure that any new regulatory proposals are given full and exacting scrutiny against the Hampton principles, and once published, the strictures given by the revised (regulatory) impact assessment model. Lastly we will continue to lobby both in Brussels and Whitehall to ensure that during the EU legislative process, regulations and directives are duly scrutinised, and that in their transposition, directives are passed into UK law following the Hampton and Davidson recommendations.

Intellectual property

15. The CBI's recommendations on promoting and protecting intellectual property are broadly reflected in the Gowers Review. Of specific benefit is the strengthening of enforcement, and measures to improve and increase the efficiency of the registration procedure. The reshaping of the Patent Office, and the establishment of a Strategic Advisory Board for IP Policy could make a real difference to the creation and utilisation of IP within the UK economy.

Transport and the environment

16. The CBI welcomed publication of the Eddington report into the links between transport provision and the future economic prosperity of the UK. In particular we were pleased with the report's emphasis on improving the performance of existing transport networks, especially in tackling congestion, and the call for streamlining of the planning system, widely seen as an impediment to successful delivery of projects. The need for road pricing to be linked with sustained investment in transport infrastructure was also welcome.

17. While the CBI does not object in principle to changes to environmental taxes, the doubling in Air Passenger Duty (APD) appears to have been purely revenue-raising rather than to change behaviour through for example reducing emissions. APD was first levied in 1994 as air travel was perceived to be undertaxed relative to other goods and services due to the VAT exemption for fuel. The proceeds from the doubling in APD should be used either to cut taxes, or to encourage emission savings to meet our two tests of revenue neutrality and genuinely changing behaviour.

18. The extension of carbon trading to aviation is the sensible way forward. It delivers a clear cap on emissions and lets the market decide how to reduce them in the most economically efficient way - rather than the Chancellor setting arbitrary tax rates. The increase in fuel duty in line with inflation, though following a period of easing oil prices, will further harm the competitiveness of UK hauliers relative to their continental based rivals.

19. The announcement that all new homes are to be zero-carbon within a decade with a time-limited stamp duty exemption for new homes that meet this standard is an idea we support in principle. We have called for stamp duty incentives to encourage household energy efficiency, though the details will need to be hammered out with the house building industry. And the tendering for consulting engineers to help enable a 2007 decision on whether government should support a UK carbon capture and storage (CCS) demonstration plant is a positive step in developing technology to help tackle climate change.

20. The inflation only increase in the Climate Change Levy, though expected, will create a greater burden on hard-pressed energy intensive companies. The confirmation of the further rise in the landfill tax to by £3/tonne to £24/tonne in April 07 was expected. However, the announcement that a steeper increase is being considered in 2008 needs to be supported by the evidence-based analysis.

Property and planning

21. Many of the CBI's long-standing concerns on planning are addressed in the Barker Review on land use planning. The recommendations should reduce bureaucracy and speed up applications and appeals. Proposals to encourage a more positive local planning culture and introduce more effective incentive mechanisms were also recommended. The report reinforced the Eddington proposals to radically reform the planning process for major infrastructure projects, and extended their relevance to energy, waste and water in addition to transport projects.

Public service efficiency

22. Following several years of public sector expansion, we support the spending constraints placed on individual Departments, including the latest early Spending Review settlement for the Department for Constitutional Affairs. The government must not only ensure the delivery of efficiency savings, but also embed efficiency and continuous improvement in Whitehall. The opportunity to do this remains, though we are concerned not only at the lack of progress against the Gershon efficiency targets, but also about the credibility of the reported progress. The announcement that further rounds of efficiency savings will emphasise net cashable savings is welcome, but we remain to be convinced as to how serious this will be. Too many of the claims of savings in the current round have lacked credibility because of the inability to point to such cashable returns.

23. Sir David Varney's report into public service delivery channels is therefore a welcome step to help implement service transformation as part of the 2007 Comprehensive Spending Review. New and innovative delivery channels and the development of one-stop-shops will improve the services delivered to the public and offer real scope for efficiency. Local authorities should be working across geographical and political boundaries to offer joined-up and user-focused services. Central government departments should be sharing HR, finance, procurement and IT functions to

streamline their operations and deliver savings to the taxpayer. Indeed, the CBI's report on Shared Services suggested savings of £560m over two years could be achieved in central government, while improving service quality.

Third sector review

24. Private companies share many of the frustrations experienced by voluntary sector providers in working to improve public services. We support the concept of harnessing the best of the voluntary and private sectors to help deliver better services, and the action plan is a step forward. Public services must be delivered by the best provider, regardless of sector, and the key to getting the most out of all providers is fair competition. Any inherent bias in how services are commissioned harms the innovation and value for money offered by a diversity of supply.

(C) PROJECTIONS FOR THE ECONOMY AND PUBLIC FINANCES

25. The new economic growth forecasts show the economy expanding by 2.75% this year, rather than the 2% to 2.5% the Chancellor forecast in the March Budget. This revised forecast is slightly above the CBI's projection of 2.7% and the unchanged Treasury forecast range of 2.75% to 3.25% for 2007 remains significantly above our own projection. As widely expected, after re-examining the economy's estimated trend growth rate, the Treasury has extended the 2.75% rate beyond the end of this year as a result of an increase in the working population which has largely been driven by immigration. This move appears justified given the supporting analysis.

26. Despite this stronger economic backdrop and associated boost to tax revenues, the Chancellor has chosen to increase spending by more than the projected improvement in revenues. As a result the public finances have deteriorated further with £7bn of extra borrowing by the end of 2010/11 relative to his March Budget forecast and the share of taxes in the economy only stabilising at 38.1% in 2008/09. Even if this stabilisation is achieved it would mark the highest tax-to-GDP ratio since 1984/85 when the UK economy was emerging from recession.

Table 3: The Pre-Budget and the public finances[1]

£bn	**04/05**	**05/06**	**06/07**	**07/08**	**08/09[1]**	**09/10**	**10/11**	**11/12**
HMT forecast of PSNB[2] - 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	27	26	24	22
Change (Dec'06 to Mar'06)	***-0.5***	***0.4***	***0.9***	***1***	***2***	***2***	***1***	***-***
Of which: Rise in planned spending	-	**-0.4**	**2.3**	**2.3**	**3**	**3**	**3**	-
Fall in projected revenues[2]	-	**0.8**	**-1.5**	**-0.8**	**-1**	**-1**	**-2**	-
Due to economy, etc.	-	-	**2**	**1**	**-0.5**	**0.5**	**1**	-
Due to Budget policy decisions[3]	-	-	**0.2**	**-2.1**	**-2.3**	**-2.2**	**-2.0**	-

[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).

27. Based on the associated forecast for tax revenues, the Chancellor expects his self-imposed golden rule to be met in the current economic cycle. The CBI, however, remains less sanguine about the state of the public finances.

- The Chancellor still expects to meet his golden rule on his shortened economic cycle running now from 1997/98 to 2006/07 (previously 2008/09) by a somewhat smaller margin than previously of £8bn. However, the next economic cycle will now begin with the current budget in deficit, as opposed to the surplus which was forecast in the March Budget.
- He is also forecasting higher borrowing for this year and all subsequent years to up to 2011/12, than he was in March.

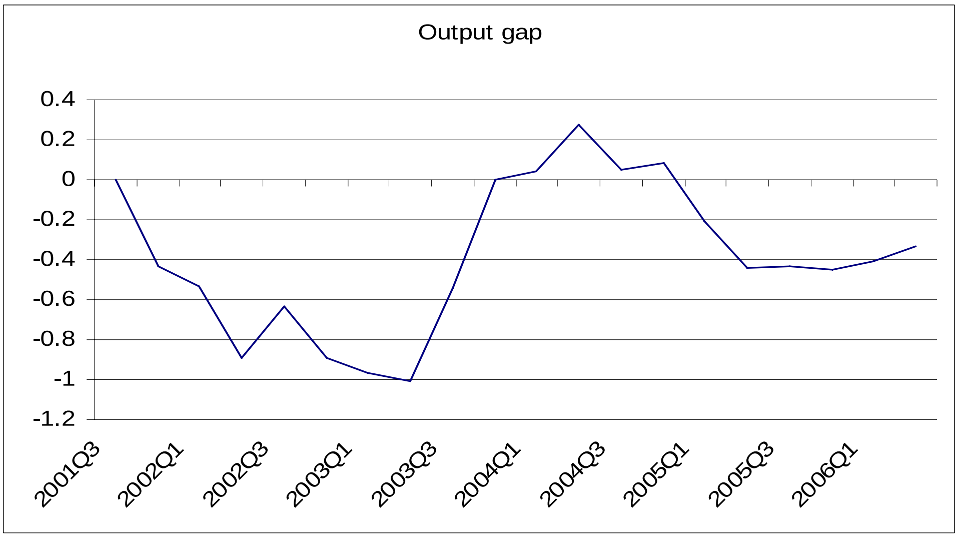
28. Though the shortening of the economic cycle to 2006/07 on this occasion appears justified, the CBI has reservations about the current fiscal framework. In particular, the Treasury's judgement of the timing of the economic cycle and its implications for the golden rule and the fiscal stance more generally.

29. There is a suspicion that the government has repeatedly adjusted the length of the cycle to remain within the limits of the golden rule. While some Treasury judgements on the dating of the cycle may have been plausible (although there is considerable uncertainty about such judgements), we along with a number of other experts estimate that the current cycle began in 2003, as opposed to 1997 as the Treasury currently judges. Indeed, if the current cycle were judged to begin in 2003, the government would almost certainly fail to meet the golden rule in this cycle.

30. In order to improve the transparency and credibility of the current use of the golden rule in fiscal policy, we would support a decision to hand over the judgement of the timing of the economic cycle to an independent external panel of experts. While the current Treasury methodology for judging the timing of the cycle has some economic merit, it leaves too much room for discretion and the risk of political interference.

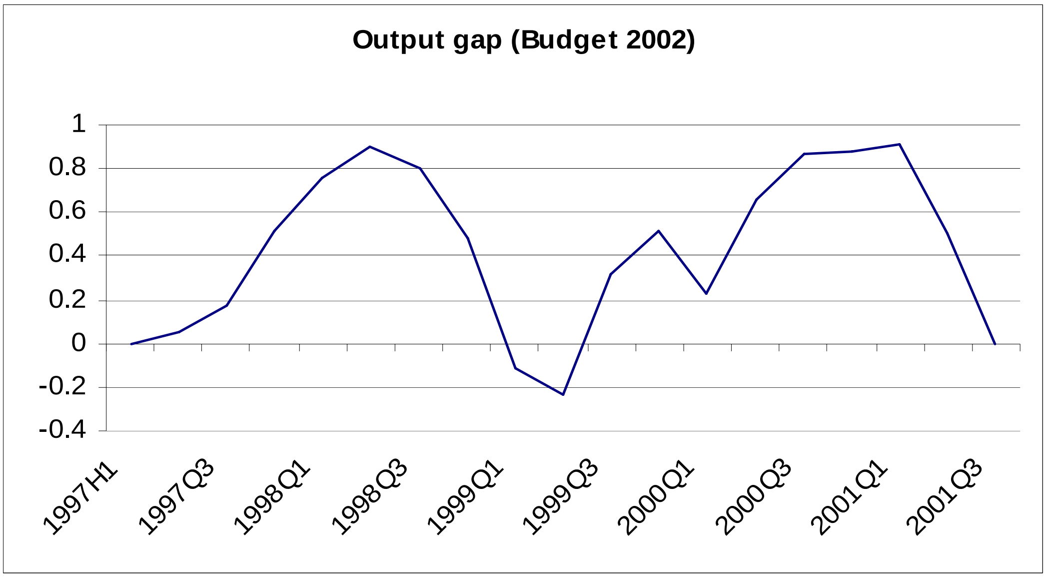
31. Furthermore, while in July last year the Treasury applied its methodology consistently in its decision to move the beginning of the cycle back to 1997, the decision that the current cycle continues to have started in 1997 after the summer National Accounts revisions is inconsistent with previous Treasury methodological practice.

32. In PBR 2006, the Treasury's estimate of the output gap was presented in this graph:

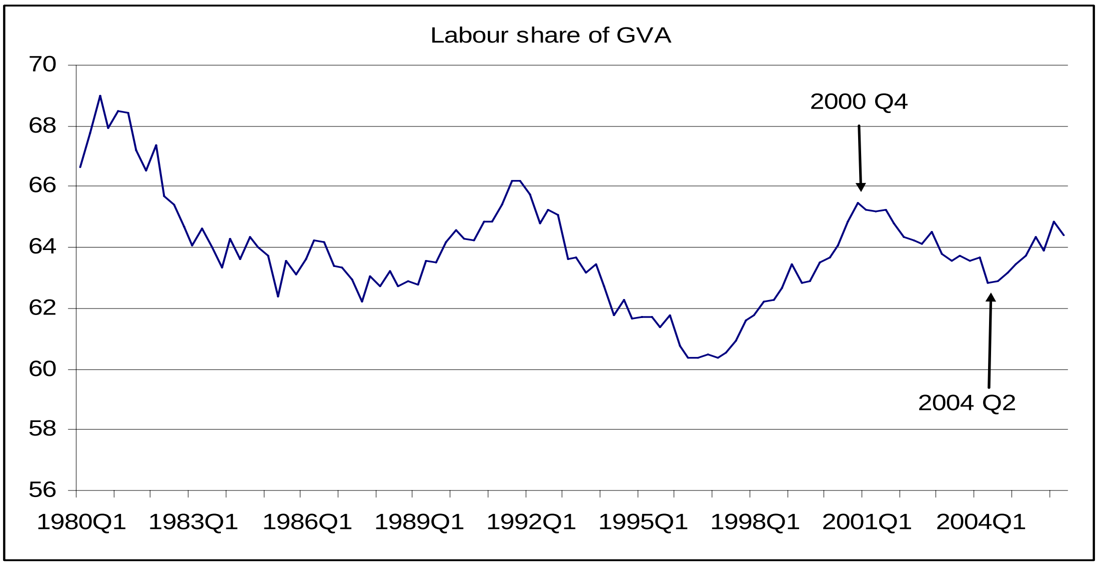


33. The output gap was positive in late 2003 and 2004, though other institutions judge that there was a larger output gap over this period. The Treasury used discretion to judge that 'output did not move decisively through trend and quickly moved back below trend'. While it is true that in technical documents (e.g. Evidence on the UK economic cycle, July 2005) the Treasury has set out and justified a degree of discretion in this area and it is true that this judgement is not inconsistent with the one made last summer about 1999, it is inconsistent with previous Treasury practice.

34. In Budget 2002, the Treasury judged that there was a full cycle beginning in 1997 and ending in 1999. The output gap, as then estimated, looked like this:



35. The (negative) output gap in 1999 was smaller that the one in 2003/04 and shorter (two quarters as opposed to five). We see this judgement as a clear precedent about the size and length of the output gap needed to justify the existence of a cycle. Furthermore, the Treasury uses other cyclical indicators to help judge on-trend points. Although rarely conclusive, it is true that cyclical indicators can be useful for such judgements. One indicator which the Treasury endorsed and used to justify the decision to move the start of the cycle from 1999 to 1997 was that turning points in the labour share of GVA are an approximate guide to on-trend points. While we would not put too much emphasis on this series, we note that there was a turning point in 2004, as can be seen below.



36. We feel that while there is inevitably a large degree of uncertainty regarding the timing of the cycle, the Treasury has broken with previous practice in order to remain on track to meet the golden rule. The judgement that the output gap in 2003/04 was not significant enough to justify the beginning of a new cycle in 2003/04 is inconsistent with past Treasury practice. The CBI believes that while the golden rule has been successful in allowing proper long-term planning of public investment, the fiscal framework should be reconsidered with judgements over technical economic issues being made independent of government.

37. Furthermore, we believe that the current uncertainty about the cycle highlights the deterioration in the public finances since 2002/03. The current budget was in deficit by a total of £67.4bn between 2002/03 and 2005/06 (in 2005/06 prices) and is set to remain in deficit for the next two fiscal years. We fail to see why surpluses from 1998/99 to 2001/02 should be so relevant to today's fiscal policy and why, in conjunction with a rules-based fiscal framework, surpluses of almost a decade ago should be used to justify current and future deficits.

38. We believe that it should be a government priority to prevent further deterioration of the public finances by reigning in spending growth (which has averaged 7.6% since 2001/02). The spending totals for the forthcoming Comprehensive Spending Review 2007 (CSR'07), which embody real spending growth of 1.9% per annum and the Pre-Budget announcement that this real rate of growth has been pencilled-in for 2011/12 are therefore welcome announcements. However, we would have preferred the government to restrain spending ahead of the CSR'07 window commencing in 2008/09. And we also note that in the past the government has tended to ratchet up real spending growth more than planned through discretionary spending and by over-estimating inflation. It therefore remains to be seen just how tight the CSR'07 spending round will turn out in practice.

CBI Economic Analysis Group
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