

Summary and views of John Greenwood

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On 22 June 2010, Chancellor George Osborne delivered the 'Emergency' Budget, which outlined the new government's plans to reduce the UK's fiscal deficit. The Chancellor outlines plans for 77% of the funds required to come from spending cuts and 23% from tax increases. Among the main points of the speech were:

Public Sector Net Borrowing figures were revised lower - March Budget figures in brackets:

2010/11 - £149bn (£163bn)
 2011/12 - £116bn (£131bn)
 2012/13 - £89bn (£110bn)
 2013/14 - £60bn (£89bn)
 2014/15 - £37bn (£74bn)

GDP growth forecasts for 2010 and 2011 were revised lower, projections are:

2010 – 1.2% (1.0-1.5%)
 2011 – 2.3% (3.0-3.5%)
 2012 – 2.8% (3.25-3.75%)
 2013 – 2.9% (3.0-3.5%)
 2014 – 2.7% (3.0-3.5%)

Spending Cuts

- Government departmental budgets to face an average real cut of 25% over four years
- Two year public sector wage freeze for all those earning above £21,000, £250 per annum (pa) wage rise for those below
- Welfare benefits, excluding the state pension and pension credit to rise using the CPI rather than RPI measure of inflation – expected saving of £6bn pa by the end of the Parliament
- Child benefit frozen for 3 years
- Tax credits will be reduced for families earning over £40,000
- Housing benefit reforms, including new upper limits, are expected to save £1.8bn pa by the end of this Parliament

Tax

- VAT to rise to 20% from 4 January 2011 – expected to raise £13bn pa by the end of this Parliament – zero rated items will remain exempt
- Corporation tax cut by 1% pa for 4 years from 2011 to take the rate from 28% to 24%
- Small companies corporation tax cut to 20% from 2011
- The threshold at which employers pay National Insurance will rise by £21 above the rate of inflation
- CGT increased to 28% for higher rate tax payers from 23 June 2010, 18% will continue to apply to basic rate tax payers and annual allowance of £10,100 to rise with inflation
- 10% CGT rate for entrepreneurs to apply to lifetime limit of £5m, up from £2m
- Income tax personal allowance increased by £1000 to £7475 in April 2011
- Higher rate tax threshold frozen until 2013/14

Other measures

A bank levy applying to the balance sheets of banks and building societies will be imposed from January 2011. It is expected to raise

£2bn pa, covering UK banks and the UK operations of overseas banks.

The Chancellor also outlined planned asset disposals, including NATS, High Speed One and the student loan book.

Invesco Ltd Chief Economist, John Greenwood, commented:

"The coalition government's first Budget makes a bold attempt to roll back a decade of ill-targeted welfare programmes and wasteful spending by government departments as well as by no less than 1200 quangos in order to avoid a Greek-style debt crisis. It does this by adding £40bn of extra budget measures to the £73bn already pencilled in - but not spelled out - by the previous government, with £32bn coming from spending and benefit cuts, and £8bn coming from tax increases, to narrow the deficit by £113bn in 2014-15. The plan will effectively eliminate the structural deficit (the part that does not disappear with economic recovery), cutting it from 8.7% of GDP in 2009-10 to 0.8% of GDP in 2014-15.

There is some risk to real GDP growth in this plan, as private sector employment may not pick up quickly enough to counterbalance public sector cuts. The OBR projections imply GDP growth will be only 1.2% in 2010, 2.3% in 2011, and 2.8% p.a. out to 2015 (which is more realistic than the previous cabinet's projections). The government is betting that a variety of incentives to small business investment plus the effect of low interest rates, weak sterling and reviving exports will counter public sector cuts. This may carry risks, but what was the alternative? In the coalition's view, a debt crisis with higher interest rates and a longer slump was looming if nothing was done.

Unfortunately the 2.5% hike in VAT will unavoidably impact headline inflation from January 2011. Most forecasters had previously expected CPI inflation to drop below 3% in November and stabilise around or below 2% during 2011. However, the VAT change will temporarily raise inflation again to 2.7- 3.2%, requiring BoE Governor Mervyn King to write letters to the Chancellor. Effectively this means it will be impossible for the Bank to conduct further QE operations (due to high inflation), though I would expect them to keep interest rates at 0.5% well into 2011 (due to low real GDP growth)."

Important information

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Where John Greenwood has expressed views and opinions, these may change and are not necessarily representative of Invesco Perpetual views.

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