GLAECONOMICS

The 2011 Budget: Focus on London

MAYOR OF LONDON

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GLA Economics provides expert advice and analysis on London's economy and the economic issues facing the capital. Data and analysis from GLA Economics form a basis for the policy and investment decisions facing the Mayor of London and the GLA group.

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Background and fiscal mandate

This was never going to be a Budget which radically changed the fiscal outlook – the ten-month old Coalition had already done that with its October Comprehensive Spending Review and its June emergency Budget, which itself filled in the gaps of the previous government's final Budget a year ago, in March 2010. Taking the Chancellor's tax and spending announcements together, they will – if delivered undiluted – constitute the biggest fiscal tightening to deal with the biggest fiscal deficit that the UK has seen since World War Two.

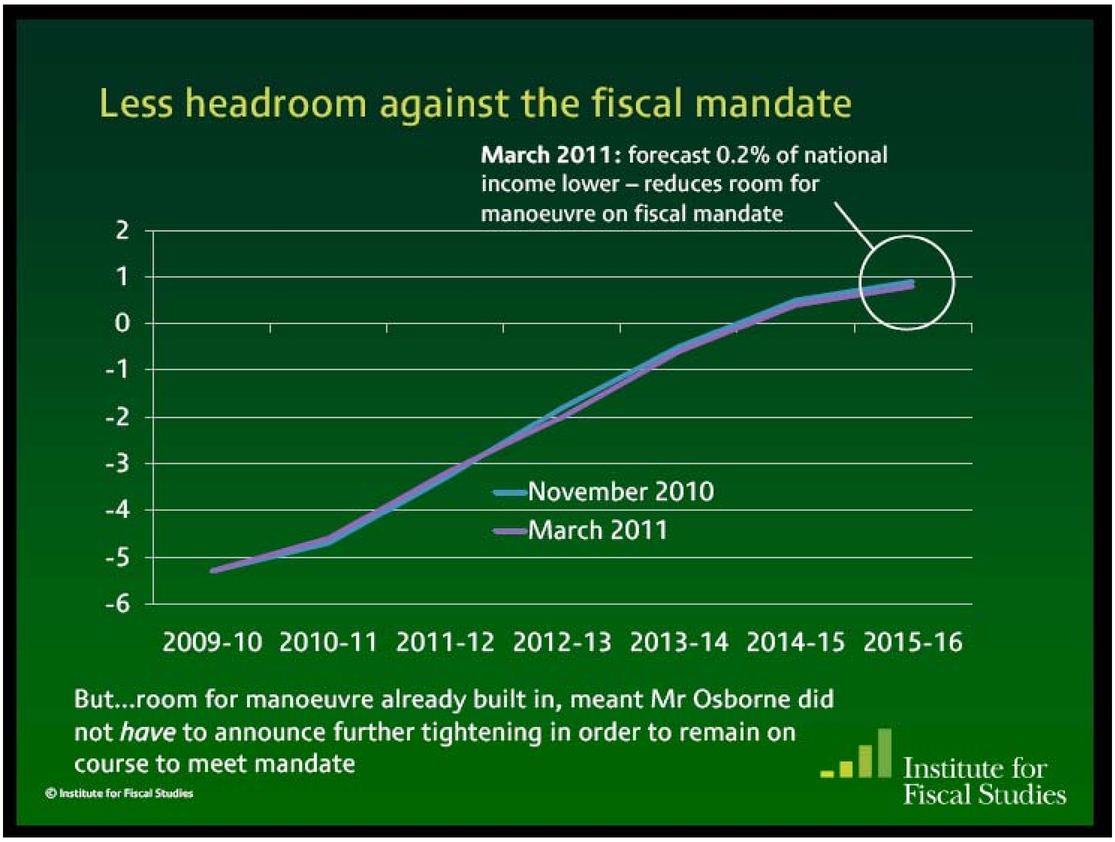
Moreover the March 2011 Budget was constructed at a time of unusual uncertainty. Not only did the snow hit GDP in Q4 (-0.5 per cent on the previous quarter) but events abroad (the Japanese earthquake and tsunami and the oil price rise triggered by popular unrest in the Arab Middle East, in particular the military action against Gaddafi in Libya) meant that it was particularly hard to have confidence in forecasts of the external environment facing the UK.

The Office for Budget Responsibility (OBR) responded to these uncertainties – in particular to the unexpectedly soft Q4 – by trimming its growth forecasts (as compared with those in November) for 2011 and 2012. The forecast for 2011 falls from 2.1 per cent to 1.7 per cent; that for 2012 falls from 2.6 per cent to 2.5 per cent. (The revisions take the OBR into line with the consensus for 2011 though they are still above the 2.1 per cent consensus for 2012).

This means that the 'output gap' is bigger than previously thought in the near term so there is more headroom for GDP to recover faster further out and the forecasts for 2014 and 2015 have been edged up slightly. However the level of GDP in 2015 is still forecast to be 0.7 per cent lower than in the previous OBR forecast. Inflation (CPI inflation 4.4 per cent in February) has been higher than forecast (as the China deflationary effect diminishes; on the back of stronger commodity and oil prices; and with the VAT rise and weakening of sterling) but the OBR sees it drifting back down to the target level of 2 per cent in the medium term, as these base effects fall out of the annual comparison.

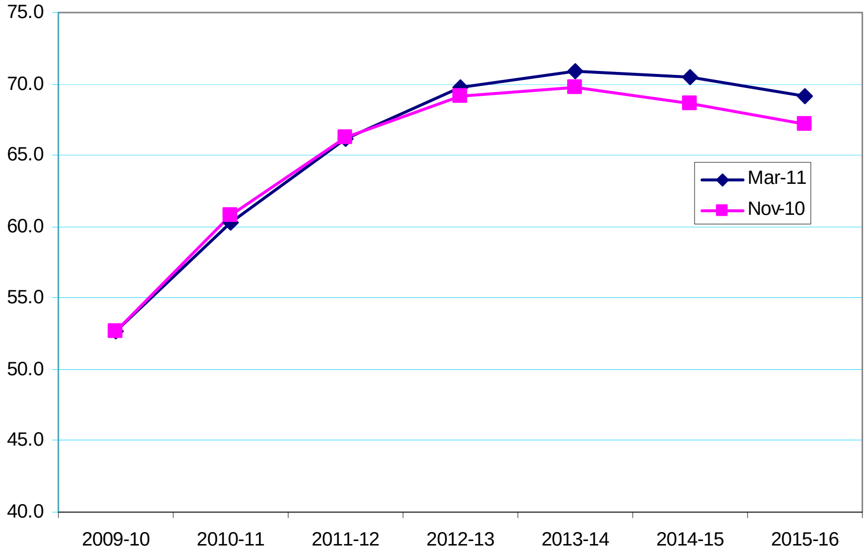
Although the dramatic tightening is preserved by this Budget, there is a marginal worsening of the fiscal forecasts. Public sector borrowing now falls to 1.5 per cent in relation to GDP by the end of the forecast (2015-16) from 11.1 per cent in 2009-10; in November it was forecast to reach 0.9 per cent by the same year. Both weaker growth and higher inflation are responsible for this slippage.

However – and importantly for the markets – anticipated progress on the Coalition's "fiscal mandate" is hardly altered as compared with November. The principal target under that mandate is to achieve balance in the structural current deficit (ie, excluding investment spending) by the end of the rolling, five-year forecast period - that is, by 2015-16. In November this was achieved with a margin to spare, with a surplus of 0.5 per cent in 2014-15. Now that surplus is 0.4 per cent.



This mandate will be supplemented by a fixed target for public sector debt, which in this Parliament is to ensure that debt is falling as a share of GDP by 2015-16. In November this was fulfilled, with the ratio falling from a peak of 70 per cent in 2013-14 to 67 per cent in 2015-16. Now it is still fulfilled but slightly less convincingly, with the ratio falling from a peak of 70.9 per cent in 2013-14 to 69.1 per cent by 2015-16.

Debt:GDP Ratio (per cent)

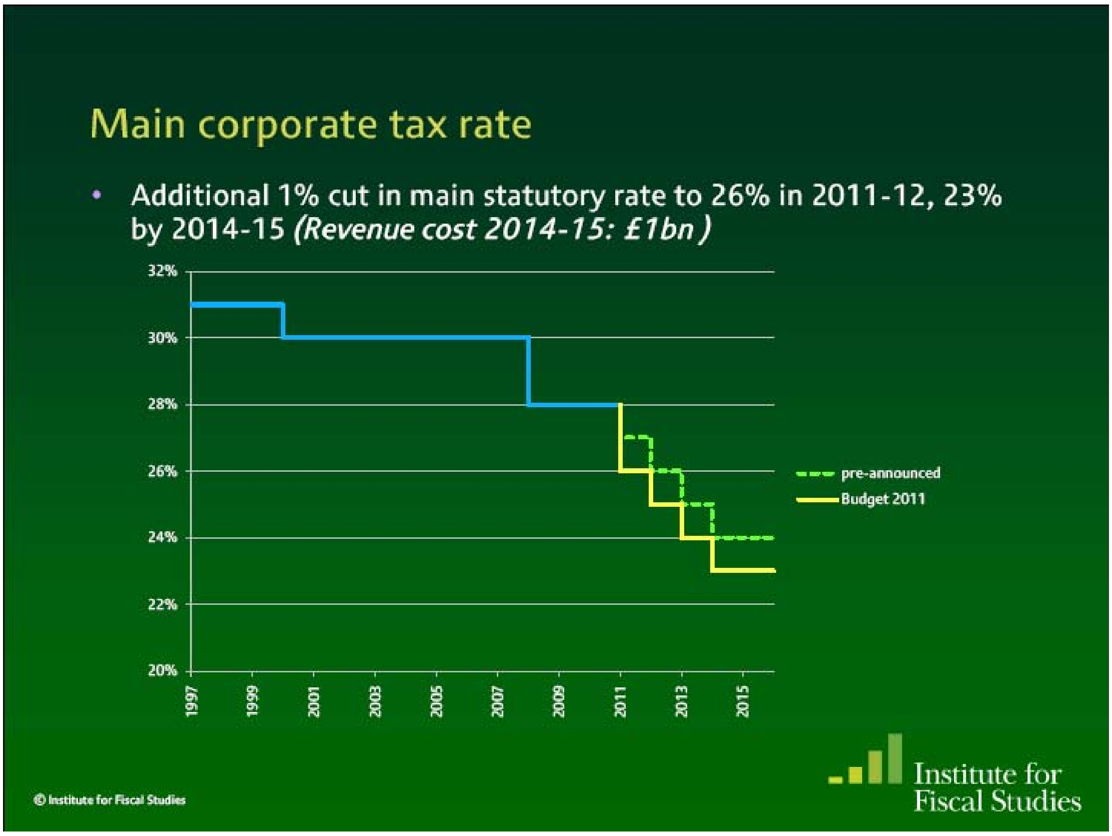


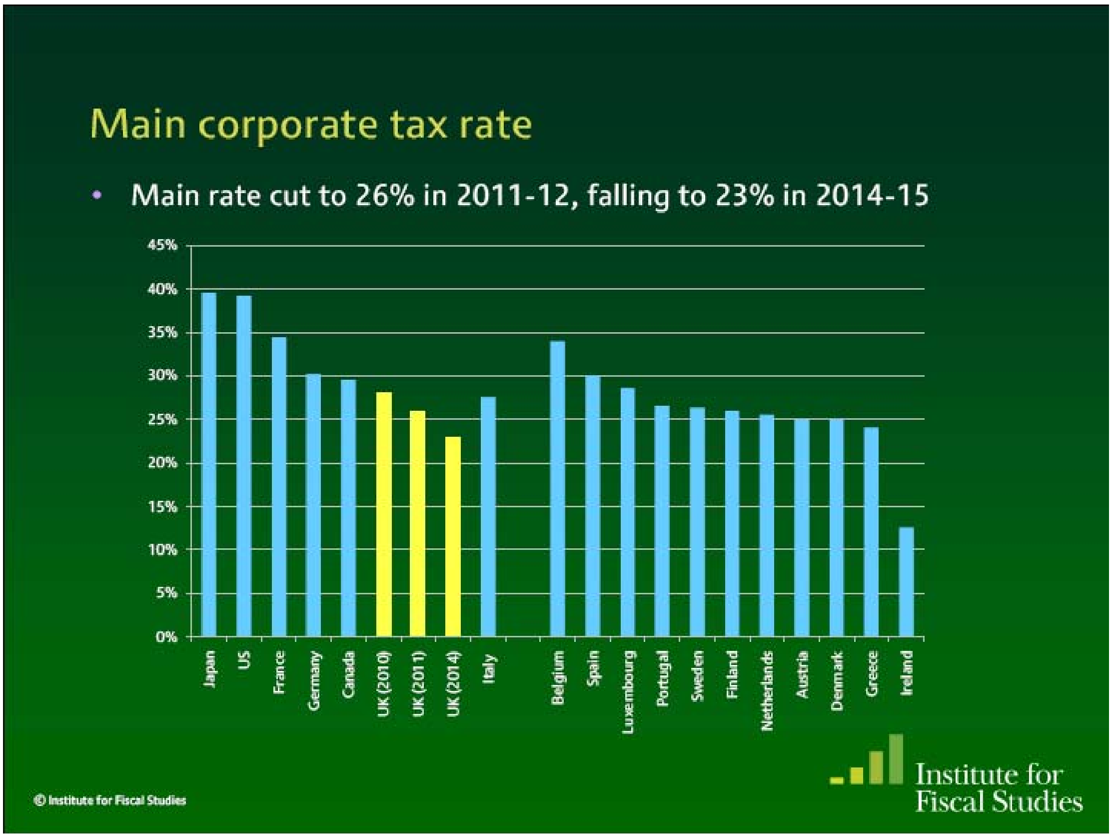
Source: HM Treasury

The Budget and London

Although the Budget was fiscally neutral it was "micro-based" and there were a number of positive features for London, especially for businesses in London. The Chancellor even went so far as to voice (for the first time) support for the City ("Yes, we want the City to remain the world's leading centre for financial services but we should resolve that the rest of the country becomes a world leader in advanced manufacturing, life sciences, creative industries, business services, green energy and so much more").

With his "Plan for Growth" the Chancellor appeared to recognise the competitive threat to London and other UK centres of highly mobile Internet-based businesses. San Francisco for example is planning to introduce an exemption from payroll taxes for a five block area in a relatively poor part of the city. This will exempt for six years new jobs (both from new and existing businesses) from the 1.5 per cent tax levied on businesses with payrolls over $250,000.





Below are listed those parts of the Budget that are most supportive of London.

1. Corporation tax is being further reduced. Already scheduled to gradually fall to 24 per cent, the rate will now drop by 2 per cent rather than the previously scheduled 1 per cent from April 2011 to 26 per cent, before falling in stages to 23 per cent by 2014. The motivation is to promote the competitiveness of the UK economy. The rate will be the lowest company taxation rate in the G7, though in some non-G7 centres (notably Dublin (12.5 per cent)) the tax rate will still be much lower than in the UK[1].

2. Planning: All planning bodies must prioritise growth and jobs. Sustainable development will have the default of being allowed. (In the Conservative manifesto this was termed 'open source' planning). The motivation is to speed planning decisions and reduce uncertainty. It will mean that major infrastructure projects can be 'fast-tracked' through.

3. The Enterprise Investment Scheme (EIS) will become more generous from 2012. The amount an individual can invest through the EIS will double, and from April 2011 the rate of tax relief will rise (there are further concessions still). At a time when finance for new ventures remains constrained this will help to ease the access of startups to equity finance.

[1] The reality is that relatively few firms pay Corporation Tax because of the offsets – eg spending on investment goods – which can be set against it, so the new move will have a full year cost of only £1.075 billion in 2015-16. To put this into context, it is less than the cost of switching the default indexation basis for direct taxes from the RPI to the CPI from April 2012. In other words, the Chancellor's decision on Corporation Tax has an important signalling effect but in terms of the revenue forgone is not a major policy move.

4. Small businesses' rates relief was scheduled to end in October. In the Budget the Chancellor extended it to October 2012.

5. The Chancellor accepted that "the 50 pence tax rate would do lasting damage to our economy if it were to become permanent" and he has asked HMRC to report on how much it raises. This is an issue on which the Mayor has been outspoken. The 50 pence rate has been directly responsible for the relocation of some hedge fund staff to Geneva.

6. A further nine new university centres for 'innovative manufacturing' will be funded (one will be at UCL) and the number of University Technical Centres to receive funding will double to 24. One hundred-thousand pupils will be offered work experience over the next two years; an estimated 11,300 young people in London could benefit. Forty-thousand additional apprenticeships will be funded. This will help to reduce the very high rate of youth unemployment in London (23 per cent or over 100,000 people, versus 18 per cent for the rest of the UK) though it will not go far, given the problem.

7. The small companies R&D tax credit will rise to 200 per cent and from 2012 it will rise to 225 per cent; and the limit on capital allowances for short-life assets will be doubled from four to eight years.

8. London is to have one of the new Enterprise Zones (see Appendix[2]) – with 100 per cent business rate relief for new businesses. This Zone has been named as Royal Docks by the Mayor. The Royal Docks has the advantage of excellent connectivity to the rest of London (eg through Crossrail) and to Europe (through City Airport and Stratford International Station) as well as proximity to "Tech City", the emerging cluster of technology and creative businesses bounded by Shoreditch to the West and the Olympic Park to the East. Oxford Economics has recently analysed the growth potential in Newham and other Olympic host boroughs. They see the potential for 80,000-90,000 net new jobs by 2030 and the closing of the productivity gap between the Olympics region and the rest of London (supporting the Mayor's statutory obligation under the 2007 Act to promote the reduction of health inequalities in London). Some new investment has already been committed with Excel investing over £160m to increase the space in the Exhibition Centre by 50 per cent and Siemens deciding to locate its 'global sustainability showcase' in the Royal Docks.

9. The highly competitive tax rate on profits derived from patents in industries like pharmaceuticals is important to London's pharmaceutical and creative industry sectors which are significant in UK terms. Business services will be helped by reform of money laundering and the trusted business visa arrangements.

10. In life sciences, the Government intends to "radically reduce the time it takes to get approval for the clinical trials" – this sector is important for London, as are the digital and creative sectors, where the Government will improve the intellectual property regime.

[2] See also http://www.centreforcities.org/assets/files/2011%20Research/11-02-25%20Enterprise%20Zones.pdf

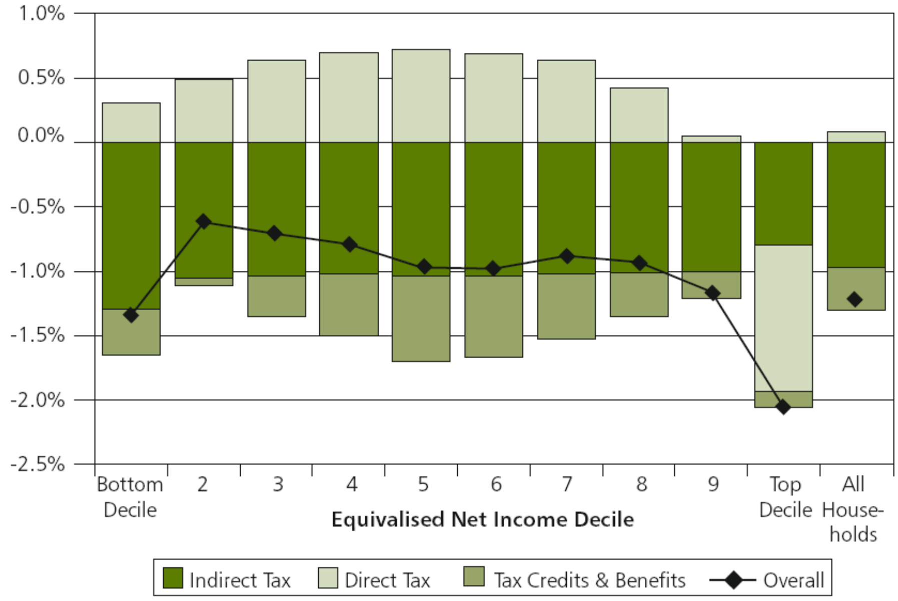
11. Last but not least, London will get a major share of the £100 million to help councils repair the winter potholes on the roads.

Significantly Sir Martin Sorrell said after the Budget that the advertising multinational WPP would return its domicile from Dublin to London after the announcements on business taxation.

However there is one Budget measure – the "First Buy" scheme to subsidise first time buyers buying new homes – which is slanted away from London. The scheme gives first time buyers access to a 20 per cent equity loan provided jointly by the Government and house builders. The Chancellor has pledged £250 million to the scheme but it is only open to households earning below £66,000. Because salaries in London are higher than in other regions, a lower proportion of first time buyers in London will be eligible for this assistance.

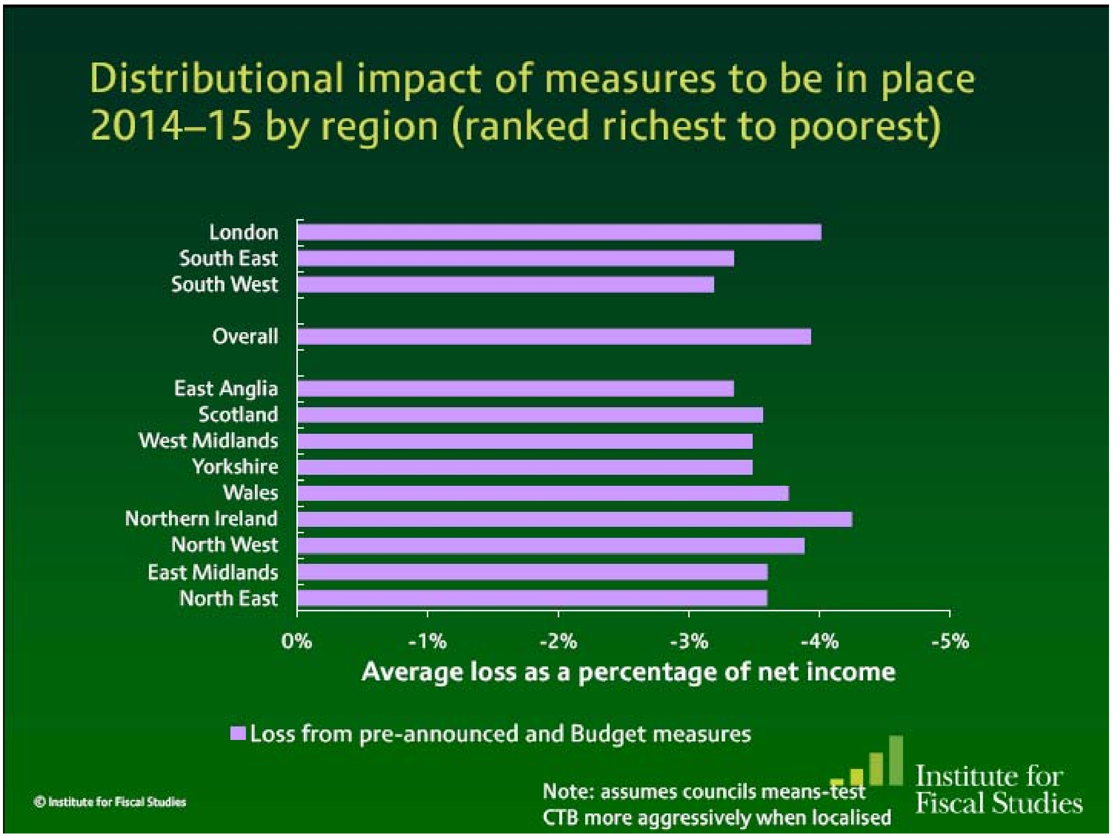
Distributional impact of the Budget

Chart A.3: Impact of all tax, tax credit and benefit measures as a per cent of net income by income distribution (2012-13)



Source: HM Treasury tax and benefit microsimulation model.

The above chart – from the Treasury's Budget document – shows that the impact of all measures coming into effect in 2012-13 is relatively evenly spread across the income distribution, at least in terms of the net income of each decile group. No regional breakdown is published but with top decile earners disproportionately concentrated in London, London is among the hardest hit of regions by the Coalition's measures (the IFS chart below shows measures to 2014-15 so is not strictly comparable).


Distributional impact of measures to be in place 2014–15 by region (ranked richest to poorest)
London
South East
South West
Overall
East Anglia
Scotland
West Midlands
Yorkshire
Wales
Northern Ireland
North West
East Midlands
North East
0%
-1%
-2%
-3%
-4%
-5%
Average loss as a percentage of net income
Loss from pre-announced and Budget measures
Note: assumes councils means-test CTB more aggressively when localised
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Appendix: Enterprise Zones

The concept of "Enterprise Zones" (areas where startups and relocations receive a range of fiscal privileges and incentives) proved its worth in London with the Isle of Dogs (Canary Wharf) EZ proving possibly the most successful of the 1980's Enterprise Zones.
The Enterprise Zone instruments that were used in the 1980's Zones included:

- exemption from business rates for new businesses;
- enhanced capital allowances against corporation and income tax liabilities for investment in property;
- exemption from Development Land Tax (a 60 per cent tax on gains in value which was abolished in 1984);
- a simplified planning regime;
- faster planning and other decisions;
- less onerous criteria for applications for customs facilities;
- less onerous statistical obligations.

During the first two rounds of Enterprise Zone implementation, employment in the zones increased by between 96,000 and 125,000 people. Of this, 58,000 are estimated to be net additional jobs (see Potter J & Moore B (2000) 'UK Enterprise Zones and the Attraction of Inward Investment.' Urban Studies, 37(8): 1279-1312).

However, of those "additional" jobs created, many were simply shifted from other areas. On an employment-weighted basis, 24 per cent of firms relocated from within the region and 17 per cent from other parts of the UK. This means that the total figure of additional jobs is likely to be much less than 58,000.

The full Enterprise Zone designations were originally limited to ten years. Thirty-eight zones were designated between 1981 and 1996. The Docklands Zone was designated in April 1982 for ten years. It covered 195 hectares. A criticism commonly levelled at Enterprise Zones is that they simply displace development that would have happened anyway but in the case of the Docklands Zone there is little evidence that the financial businesses that set up in and around Canary Wharf were displaced from the City. Indeed there is evidence that the City relaxed planning regulations to meet the competitive threat from Docklands.

In the Budget the Chancellor announced that eleven local enterprise partnerships will be invited to come forward with proposals for Enterprise Zones. All Zones will benefit from:

- a business rate discount worth up to £275,000 per eligible business over a five-year period;
- all business rates growth within the zone for a period of at least 25 years will be retained by the local area, to support the Partnership's economic priorities and ensure that Enterprise Zone growth is reinvested locally;
- Government help to develop radically simplified planning approaches for the zone using, for example, existing local powers to grant automatic planning permission;

- Government support to ensure that superfast broadband is rolled out throughout the zone, achieved through guaranteeing the most supportive regulatory environment and, if necessary, public funding.

The Government will work with Local Enterprise Partnerships on additional options, to suit local circumstances, including consideration of:

- enhanced capital allowances (instead of business rate discounts) for plant and machinery, in a limited number of cases, where there is a strong focus on manufacturing;
- Tax Increment Finance to support the long-term viability of the area;
- UKTI support for inward investment or trade opportunities in the zone.

The thinktank "Centre for Cities"[3] argues that the strategy should be to focus on investment in people, jobs and growth. This implies that unlike the 1980's Enterprise Zone policy – which focused on the most deprived areas – the new strategy should be to focus on the areas with the greatest development potential. This judgment is supported by the decline in manufacturing industry since the need for large tax offsets to finance heavy capital expenditure no longer exists.

It also suggested that local areas should have a major say – possibly the deciding say – in choosing the most appropriate set of interventions from a list of options – as opposed to the "one-size-fits-all" approach adopted with the 1980's Enterprise Zones. This would ensure that 'localism' is reflected in the policy and alongside devolution will help to ensure 'value for money'. "Centre for Cities" argues that different areas might choose from the following menu of options:

- Rapid planning zones;
- Corporation tax concessions;
- Skills support – eg tax rebates for accredited training;
- Labour market coordinator – assisting firms in advertising high skills positions and liaising with local labour market programmes;
- NIC rebates for additional jobs created;
- Priority processing of applications to the Business Growth Fund – this is the government's £2.5bn equity fund designed to help small businesses in their first year;
- Free patent assistance – to encourage investment in R&D;
- Creating a single point of contact – to coordinate the range of policies and ensure that companies can exploit the Enterprise Zone offer to the full.

[3] http://www.centreforcities.org/assets/files/2011%20Research/11-02-25%20Enterprise%20Zones.pdf

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