



EMERGENCY BUDGET JUNE 2010

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THIS IS GOING TO HURT

The key theme of the first Budget under the new coalition government is acceleration of the process of deficit reduction. Mr Osborne's fiscal squeeze is aimed at cutting the government deficit from an expected 10.1% of GDP in 2010/11 (£149 billion of borrowing) to 1.0% by 2014/15. The bulk of this reduction is to come from elimination of the structural deficit with a smaller contribution from economic growth removing the cyclical part of the deficit resulting from the recession.

The fiscal package is split 77%/23% between spending cuts and tax rises. The Budget policy decisions cumulatively will take £120 billion out of the economy over the next 5 years. Within this total, tax changes add to an extra £30 billion of revenue over the next 5 years. In terms of impact, the tax burden on business will fall through reductions in corporation tax and increased NICs thresholds for employers, partly offset by reduced capital allowances and a new bank levy. Households will pay more tax, principally through VAT rising to 20%, although the lowest paid taxpayers will benefit from a higher personal allowance.

Household incomes will also be hit by a cumulative £26.3 billion reduction in welfare spending, including a switch to CPI indexing of benefits (in place of RPI), changes to the tax credit system and housing benefit reforms.

Elsewhere, public spending outside the protected areas of health and overseas aid will see cuts of around 25% by 2014/15. The Chancellor indicated no further cuts in capital spending from those already planned, which will reduce public capital spending by 60% over five years; there will be strict prioritisation in infrastructure spending. Details of how the reductions in departmental budgets will be implemented will be elaborated in the Public Spending Review in the autumn. The planned departmental cuts presage a severe public sector recession over the next five years and will pose major delivery challenges.

ECONOMIC IMPACT

Fiscal retrenchment on the scale set out in the Budget is going to affect the pace and pattern of economic growth, at least in the short term and perhaps for longer. In light of the Budget measures the Office of Budgetary Responsibility (OBR) has trimmed its central forecast for GDP growth in 2011 to 2.3% (down from 2.6% in its first forecast and even further below the 3.0%-3.5% growth in the Treasury's March forecast). The OBR expects growth to strengthen in 2011 and 2013, reaching 2.9% in the latter year, but it is noteworthy that the forecasts do not show growth breaking through 3.0% per annum in contrast to experience in the recoveries from the early 1980's and early 1990's recessions when the economy enjoyed several years of expansion over 3.0% per annum. This recession and its fiscally constrained aftermath appears to have left the economy with a reduced speed limit, in the OBR's view.

In large part, the reason for this modest growth outlook is the prediction of sustained weakness in consumer spending. The Chancellor indicated the Budget was intended to achieve a rebalancing of the economy away from household debt and government consumption. The OBR forecast bears this out, with household spending showing minimal growth this year and managing expansion of only 1.3% in 2011 and 1.7% in 2012 in the context of similarly weak growth in household real disposable incomes.

More positively, the OBR expects a strong pick-up in business investment, with 8.1% growth in 2011 rising to 10.0%-11.0% pa growth in 2012-13. In addition, UK export growth is expected to outstrip import growth over the medium term. The OBR forecast overall is thus of an economy driven less by consumption than in the past and more by investment and exports.

This economic outlook is clearly not without significant risks. There is concern in some quarters that the tighter fiscal squeeze the Chancellor is applying will depress short term growth more than the OBR forecast implies. The external economic environment may also prove unhelpful. In particular, the fragility of the Eurozone's economic recovery, now beset by sovereign debt problems and with fiscal austerity programmes also in train in a range of economies, seems unlikely to be conducive to a rebalancing of the UK economy from domestic consumption to exports.

One positive implication of moderate growth and subdued consumption is that this should enable the Bank of England to keep interest rates lower for longer. A positive bond market reaction to deficit reduction would also help avoid upward pressures on UK gilt yields.

SOME SPECIFIC MEASURES

VAT rises to 20.0% on January 4 2011, widely expected but still unwelcome for retailers especially in the context of weak household income growth. The resilience of retail spending will be tested, but sales could be boosted ahead of the rise next January as consumers bring forward purchases to beat the increase.

Capital Gains Tax rises immediately from 18.0% to 28.0% for higher rate tax payers. This is a more modest increase than some had feared and the additional revenue is only expected to be around £1 billion. It does not look to be a game-changer for the buy-to-let residential investment market or for demand for second homes.

A **Bank Balance Sheet Levy** is being introduced with the UK emerging as a first mover in this regard, although similar taxes are expected to be adopted shortly in other countries. The impact will vary between banks, depending on the extent to which their lending is financed by customer deposits, and could dampen the capacity and willingness of banks to expand their lending in some cases. The levy is expected to generate £2.5 billion of tax revenue by 2013/14. The potential for a Financial Activities Tax, aimed at bank bonuses, remains to be explored.

Stamp Duty affecting property was left unchanged, although additional anti-avoidance measures are to be reviewed with respect to high value property transactions. The effectiveness of the Stamp Duty exemption for first time buyers of properties below £250,000 will be reviewed. The 5.0% rate of Stamp Duty for residential transactions over £1 million announced in the March 2010 Budget takes effect next April. Residential portfolio sales of more than six properties appear to be able to avoid the higher Stamp Duty rate as these are classified at "commercial transactions".

REITs will benefit from changes to be made in the Finance Bill in the autumn to allow them to issue optional stock dividends as part of their property income distribution requirement.

The government is to examine ways to **promote more balanced regional growth in the UK** in a White Paper. It has decided to abolish regional development agencies and give more support to "local enterprise partnerships". A Regional Growth Fund is to be established to fund regional capital projects. In regions outside London, the South East and East of England, a three year scheme to exempt new businesses from up to £5,000 of employer NICs for each of their first ten employees is being introduced.

PROPERTY MARKET IMPLICATIONS

For the housing market the budget measures appear likely to have only limited direct impact. The immediate implementation of the CGT rise removes the motivation for any rush to sell among private investors and second homeowners. The changes to housing benefit are likely to have some impact in parts of the private rented sector, but probably most significant for the housing market as a whole is the affect of forthcoming expenditure cuts on support for the development of affordable housing.

Wider impacts of the fiscal squeeze will be felt in the commercial property market through its economic effects on property demand. Consumer-facing sectors of the economy will be most exposed to the impact of tax rises, public sector pay freezes and job cuts with retailing in the front line. The squeeze on consumption will create a tougher trading environment. Retailer responses are likely to include scaling back of store expansion plans by some chains, rationalisation to concentrate on the most profitable stores and an emphasis on cost containment overall. All of these will subdue aggregate retail space demand and curb rental growth momentum.

Slower retail sales growth is likely to feed through to the logistics market, potentially affecting overall demand but also pushing retailers to achieve greater efficiencies in the supply chain.

Office demand will be affected by the assault on departmental spending and the drive for economies in the cost of government property occupancy. This would be particularly significant in those office markets where the public sector makes up a sizeable proportion of office demand, especially in some UK regional centres. The public sector accounted for 23.0% of CBD office take-up in the seven largest regional cities over the past 2 years.

This in turn highlights the likelihood of significant regional differences in the overall impact of the fiscal squeeze over the medium term, given the marked regional variations in economic dependence on public spending; for example, around 65.0% of regional GDP in North East England and Wales is accounted for by public spending compared with 36.0% in London. Regional and local variations in the impact of the fiscal squeeze will accentuate differences in property market performance prospects between different parts of the country.

The main potential upside for the property investment market associated with the fiscal contraction lies with its implications for monetary policy. Although far from guaranteed, the scale and pace of deficit reduction set out in the Budget increase the likelihood of the maintenance of low interest rates for some considerable time. Availability of debt is likely to remain an issue, but property income returns will remain favourable relative to the returns on cash or government bonds. This in turn should be positive for both investor demand and values.

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