



Scottish Council for
Development and Industry

POLICY SUBMISSION

Budget 2009

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SCDI is an independent and inclusive economic development network which seeks to influence and inspire government and key stakeholders with our ambitious vision to create shared sustainable economic prosperity for Scotland.

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Introduction

1. SCDI is an independent membership network that strengthens Scotland's competitiveness by influencing Government policies to encourage sustainable economic prosperity. Its membership includes business, trades unions, local authorities, educational institutions, the voluntary sector and faith groups.
2. The past year has seen a severe downturn in the UK economic environment and a relatively long period of macroeconomic stability has been brought to an abrupt end. The full impact of the financial crisis that was first manifested in the US sub-prime housing and mortgage markets in 2007 has spread around the globe resulting in a "credit crunch" that has severely constrained access to finance for business and consumers despite billions of pounds of Government intervention, caused stock markets to plummet, brought about the merger and effective nationalisation of major Scottish banks, seen the disappearance of demand in the economy and left consumer and business confidence at extremely low levels.
3. It is this bleak economic environment that Budget 2009 must seek to address and for that reason, this could be said to be the most important Budget that the UK has seen for at least the last two decades. Government policies must look to address the extremely difficult conditions and support people, businesses and other organisations and the economy as a whole through this very testing time.

Macroeconomic Environment

4. Of the most widely identified items of economic data – GDP, unemployment and inflation – all either are clearly showing, or beginning to show, troubling signs of the significant challenges that must be faced by the UK over the next few years.
5. After 63 quarters of unbroken growth in the economy, UK GDP was flat in the second quarter of last year and fell in both the third and fourth quarters at an increasing pace indicating the official onset of recession for the country. This pattern is set to continue into 2009. The Bank of England's central projection published in February's *Inflation Report* is that UK GDP will fall on average by 3% this year, with a weak recovery beginning in the second half of the year. But there is a wide degree of uncertainty with the risks weighted on the downside.
6. Scottish economic performance has also started to deteriorate sharply. Official figures show that the Scottish economy contracted by -0.8% between quarter two and quarter three 2008, a faster pace than the UK economy as a whole. At present, the central expectation according to the latest report from Strathclyde University's Fraser of Allander Institute (FAI) is for Scottish GDP in 2009 to fall by -2.6% and in 2010 only grow by 0.5%. This compares to growth of 1.9% in 2007.
7. As a result of this slowdown in GDP, and the world economic situation, employment levels are starting to fall, albeit from historic highs and unemployment is starting to rise. The Labour Force Survey headline rate now stands at 6.5% in the UK and 5.1% in Scotland compared to 5.2% and 4.9% respectively a year earlier. These are set to rise further. FAI estimates that Scottish unemployment will reach 7.9% in 2010 and stay above 7% during 2012.
8. Inflation, as measured by the Consumer Price Index (CPI), after rising above the Monetary Policy Committee's (MPC) target rate in 2007 peaking at 5.2% in September 2008, is trending downwards. While the latest CPI figures show an increase from 3.0% in January to 3.2% in February, the concern for the monetary authorities is that inflation will fall too low with price levels starting to decline. Retail Prices Index inflation slowed to 0.0% in February down from 0.1%. Such deflation, over a prolonged period, would be extremely damaging and would most likely result in an extensive recession. In an attempt to combat this, base interest rates have been slashed to 0.5% in March, the lowest ever recorded.
9. It is, therefore, paramount for Budget measures to aid economic development in Scotland to help address the contraction of the Scottish economy. In relation to this, it is to concern to SCDI that

HM Treasury plans may reduce the Scottish Government's Budget by £1 billion over two years. SCDI supports measures to ensure that government money is spent as efficiently as possible and that there is constant improvement in public sector efficiency. However, given the current economic circumstances, government at all levels is looking to utilise budgets to support economic activity and such a substantial reduction at this time would not be regarded as helpful. HM Treasury should publish independent analysis of the impact of these cuts on the Scottish economy and public services. It should be prepared to allow some flexibility in the implementation of efficiency measures to ensure that government action is not compromised at this very difficult time.

Pre-Budget Measures - Comments

10. The package of measures announced in the November 2008 Pre-Budget Report including the temporary reduction in the rate of VAT for the course of 2009, bringing forward £3 billion of capital spending from 2010-11, mortgage guarantees, the new Small Business Finance Scheme, deferring of the increase in small companies' rate of corporation tax for one year and extra resources targeted at support for those made unemployed was welcomed at the time by SCDI. In total the fiscal stimulus package is valued at around 1% of GDP.
11. At the time of the Pre-Budget Report it was felt that the package of measures put in place, alongside reductions in interest rates, would, if part of a global response, allow the recession to be relatively short and recovery to be clearly apparent by the end of 2009. Unfortunately, this does not now seem to be likely. At best, recovery may not become apparent until well into 2010 or even 2011.
12. Official growth forecasts set out in the Pre-Budget Report show the UK economy contracting by between -1.25% and -0.75% in 2009 before recovering to grow at between 1.5% and 2% in 2010 and 2.75% and 3.25% in 2011. Recent Bank of England and independent projections indicate that these are overly optimistic and downward revisions to these growth estimates will be required in the Budget reflecting the economic circumstances. This downgrading of forecasts will have consequences for the projections for public finances. By some estimates public sector net borrowing could rise to well over 10% of GDP in the next two years.
13. SCDI is supportive of increases in Government Spending to bolster the economy during the recession. There must be clarity over the measures that will be put in place to address the resultant rise in Government borrowing and debt levels in the medium term in order to avoid confidence being undermined and the risk of high debt levels impacting negatively on levels of taxation, interest rates, inflation and ultimately longer term growth. But SCDI would question whether, given the recent projections of a deeper, more prolonged recession and a weaker recovery, the scope and timing of the Government's planned efficiency savings, with regard to the Scottish Block Grant, would support economic recovery.

Budget 2009 Measures - Recommendations

Supporting Businesses

Access to Finance

14. By far the biggest problem facing businesses at this time is access to finance. Since the "credit crunch", the willingness of financial institutions to extend credit or finance to business has reduced dramatically. The package of measures set out in the Pre-Budget Report as mentioned in paragraph 10 above are welcome, as are the various support packages provided to the lenders alongside measures such as the Asset Purchase Facility announced in January to ease the burden on banks' balance sheets and hopefully allow them to commence lending once more. However, currently, the problem of access to finance persists and is having an extremely serious impact on business and economic performance.

15. SCDI is aware of concern that SMEs have found the Enterprise Finance Guarantee Scheme, the Working Capital Guarantee Scheme and the Capital Enterprise Fund confusing and that they have not yet provided effective support.
16. SCDI has supported the expansion of the money supply through quantitative easing measures. Buying up assets from financial institutions should free up funding which would allow banks to start lending again. It is imperative that the banks respond to this injection of liquidity by improving the access to finance for individuals and companies, and by investing in business activity. SCDI also notes that the option of establishing a “Bad Bank” to take on the toxic assets currently sitting on the banks’ balance sheets has not been ruled out by the Chancellor of the Exchequer. All options need to be considered to address the situation.

Supporting Small Businesses - VAT

17. The UK’s economic and social wellbeing is dependent on the continuing ability of our businesses to sustain their operations and develop, particularly in the current economic climate and when unemployment levels are set to rise significantly. Growth in businesses comes from both encouraging those already in existence and supporting new start-ups. SCDI recommends that the threshold for VAT registration should be increased significantly from the current £67,000 to support small businesses and recognise their role in improving economic prosperity.
18. SCDI welcomed the reduction in VAT to 15 per cent until January 1st 2010. SCDI members are concerned about the disruption the restoration of the 17.5 per cent level of VAT would cause during a holiday period and a busy time of year for the retail sector. We therefore request that HM Treasury postpones the restoration of VAT until February 1st 2010 to allow a much easier transition for all businesses.

Reducing Business Costs - Fuel Duty

19. Increasing business costs in a fragile economic environment in which there is decreasing demand - whether through higher taxation or a greater regulatory burden - threatens the sustainability of many companies and employment levels. The Government should avoid, postpone or abandon fiscal or regulatory changes which are likely to intensify the cost pressures on businesses at this time.
20. Whilst the December 2008 2 pence per litre increase in fuel duty announced in the Pre-Budget Report has been offset by the temporary reduction in 2.5% VAT, the announcement that further increases in fuel duty in April 2009 and April 2010 by 1.84 pence and 0.5 pence per litre must be kept under review and, dependent on oil prices and the economic situation at the time, the option not to implement these increases should be taken. These fuel duty rises will further impact on the freight sector and on rural areas, especially the Highlands and Islands, where fuel costs are already placing a heavy burden on economic sustainability.

Boosting the UK’s Productive Industries and Exporters

21. The UK’s financial services industry, on which much of our recent economic growth has been founded, will retrench sharply as a result of the credit crunch. Thus, it is vital for the UK economy and public finances that our productive industries retain capacity and skills during the global economic downturn, and are able to take advantage of any export opportunities created by the weakness of the pound. The UK must seek to position itself as a world technology leader for industries which are expected to experience unprecedented growth in the next few decades - such as oil and gas production and clean energy – and also support other sectors involved in the production and export of high-value goods.

Support for Exporters

22. SCDI has collected figures on Scottish manufactured exports for over 30 years and has been running trade missions since 1961. It is our view that substantial benefits are gained from

encouraging more firms to export, particularly SMEs. Unfortunately, over the last few years Scottish manufactured exports have been declining. Having peaked at just under £20bn in 1999, Scotland's manufactured exports are now a quarter lower. Figures in SCDI's recently published *Survey of Manufactured Exports 2007/08* show a further contraction of 2.4%. This covers the period immediately before the global economic downturn and an even more substantial fall should therefore be anticipated in next year's survey for 2008/09.

23. One of Sweden's key responses to its economic problems in the late 1990s, including the depreciation of the Krona, was to greatly increase the support to its business base to access overseas markets. SCDI believes that the UK Government should be taking immediate action to maximise the opportunities of the historically low level of Sterling against other major currencies, notwithstanding the reduced level of worldwide demand, by investing in increasing the support and advice to UK companies looking to start exporting or to increase their foreign sales. As well as improved advice, SCDI recommends that the rate of corporation tax levied on SMEs that export over 40% of their turnover should be lowered from the current small companies' rate of 21%.

UK Oil and Gas Industry – Maximising UK Output and Supporting Global Exports

24. Oil and gas producers invested £5.7bn of capital in 2006, 37% of the total by production and manufacturing industries. Recent work reported in the Oil & Gas UK Economic Report 2008 demonstrated that each £1 billion of investment provides employment for around 20,000 across the supply chain. The UK oil and gas industry provides employment for 450,000 people. The latest *Survey of International Activity in the Oil and Gas Sector* produced by SCDI and Scottish Enterprise shows that total sales by Scotland's oil and gas supply and service specialists increased by 9.9% to reach £14.2 billion in 2007/08, more than double the value in 2000. International sales were 19.5% higher, while, in comparison, domestic sales into the North Sea sector were only 4.3% higher. International activity accounted for 40% of the Scottish supply chain sales total. This latest research identified sales activity in 103 different markets across the world, the highest number of different destinations recorded in the history of the research.
25. Sustaining activity in the UKCS is critical because of the benefits to the economy and energy supply, and also to anchor the economically important supply chain in the UK as international activity becomes a greater proportion of its total sales.
26. Tax payments to the Treasury for 2008-09 should be around £13.3bn, more than double those of 2004-05, despite the declining trend in production and higher capital and operating costs. The UK's balance of trade in goods and services would have been £-78bn last year had it not been for the production of North Sea oil and gas. The industry has shown that effective tax incentives will lead to larger returns for the Exchequer. It is especially important to sustain activity in the UK oil and gas industry as the financial services industry retrenches and public finances are rebuilt over the next five years. It is also important that HM Treasury considers the multiplier effect from supply chain companies. Taxation on the burgeoning profits which they are generating is an important source of revenue. Oil & Gas UK has estimated that the Exchequer benefits by around £5-6 billion a year in corporation tax, payroll taxes and national insurance contributions from the supply chain, in addition to the tax revenues generated by exploration and production companies in the UKCS. Sustaining activity in the UKCS and anchoring the supply chain in the UK will sustain the benefits to the Exchequer.
27. The industry is under pressure from falling oil and gas prices. Oil & Gas UK has said that if investment were to be sustained at around £5 billion a year over the next five years the production decline rate would average 4.5% per annum, compared to the natural decline rate of the basin of 15% per annum. But its 2008 Activity Survey anticipates that capital investment will fall from £4.8bn in 2008 to £3.5bn in 2009 and £2.5bn in 2010. While it was predicted a year ago that 113 wells would be drilled in 2009, 77 wells are now planned and only 34 have a drilling rig committed. For 2010, planned wells have fallen from 30 to 10. The problems are exacerbated by the credit squeeze which has developed in the second half of 2008. This has already impacted on the ability of some of the smaller independent oil companies which

moved into the UKCS to raise the capital required to proceed with drilling and field development programmes. Much of the exploration in the UKCS is undertaken by these companies and their exploration budgets are currently very likely to be reduced.

28. The UKCS fiscal regime is increasingly inappropriately balanced. International investors regard it as unsustainable for a mature and costly province. Oil prices are now back in the same range as in 2004 when the supplementary corporation tax was half what it is today. SCDI believes that cutting the rate would be the simplest and most effective measure to promote the necessary investment.
29. SCDI has responded to the HM Treasury and HM Revenue and Customs consultation *Supporting Investment: A Consultation on the North Sea Fiscal Regime*. SCDI has supported the introduction of incentives for existing and new fields, providing that they are easy to implement, simple to assess at the point when decisions on investment are made and substantial enough to be attractive. It has recommended that, if workable proposals are made, the incentives should be extended to incremental projects in existing fields, all future UKCS exploration and, if they are set at sufficiently high levels, west of the Shetlands projects.

'Green New Deal'

30. SCDI is encouraged that the UK is on track to meet its emissions reduction targets under the Kyoto Protocol. These gains must be continued if the target for an 80% reduction in emissions set out in the Climate Change Bill is to be met.
31. Access to finance is an increasing problem for low carbon SMEs. Overall investment from venture capital and private equity in these companies was \$854m in 2007, over twice the \$342m invested in 2006. But, following the onset of the credit crunch in the first quarter of 2008, investment dropped to \$108m.
32. SCDI welcomes the UK Government's support for proposals in the EU to provide funding for up to 12 demonstration projects on carbon capture and storage (CCS). Fossil fuels will continue to be the dominant element of the UK's energy mix and CCS is needed to hit the UK's carbon emission reduction target. In the North Sea, the UK has one of the world's best locations for CO₂ storage. The procurement for the design and build of a full-scale demonstration of the full capture, transport and storage chain has been supported by SCDI. But CCS cannot currently be regarded as economic without further financial support. The challenge cannot be underestimated - existing technologies have to be scaled up by 50-100 times, there are rising engineering and construction costs and significant investment is required in pipelines, both onshore and offshore.
33. Current economic difficulties must not result in any delay to this project due to financial pressures on Government. SCDI is concerned that delays in the UK Government's CCS competition would, following the failure to support BP's Miller Field Project, further damage the UK's competitive position in this emerging industry. It would welcome a decision to support more than one demonstrator project and technology. SCDI believes that it is critically important that tax relief should be available for the reuse of existing oil and gas infrastructure for CCS. It has also suggested that the Government considers if the proposed incentives for the oil and gas industry should be extended to utility companies involved in CCS.
34. SCDI published the first major independent report on *The Future of Electricity Generation in Scotland* at the end of last year. This found that Scotland can hit its target of 50 per cent of electricity from renewable sources by 2020 and that this is essential if the UK is to achieve its renewable energy and climate change commitments. The report identified the critical contribution of wind energy, in particular onshore wind, which will provide more than 80% of the increase in renewable electricity by 2020. But these targets can only be met with £10bn of investment in new electricity generation in Scotland between now and 2020. SCDI welcomes the UK Government's extension of support to the industry through the Renewables Obligation. However, the credit crunch and the impact of the falling value of the pound on development costs are threatening investment. This risks project postponements and cancellations which would undermine the rapid

expansion of capacity needed to hit the 2020 targets. HM Treasury should consider whether an improved financial package is necessary.

35. The UK and, in particular Scotland, have the potential to be the world-leaders in marine energy technology. We have the resources, technological lead and the transferable skills and expertise of the offshore oil and gas industry. However, this nascent industry will need access to significant finance to move from the development stage to demonstration and, finally, to commercial deployment. The credit crunch and lower energy prices are threatening this process and Government intervention is considered important. Renewables Obligation Certificates only benefit revenue, and are intended for commercial projects, not commercial demonstration. A mix of capital support, which mitigates against construction and installation risks, and revenue support is required at present.
36. In its submission on the UK Renewable Energy Strategy, SCDI highlighted potential funding streams could be utilised to develop renewable energy technology and for which HM Treasury has responsibility - the £42m UK Marine Renewables Deployment Fund (MRDF) and £120m from the Scottish Renewables Obligation. These could be made available to spend on renewable energy in Scotland. However, the absolute value of MRDF support is now, in itself, too small for the commercial demonstration projects (c. 5MW) which it is intended to encourage. An order of magnitude increase in the amount available for a project is needed to take technological development to the next stage.

Food and Drink - The Tax Treatment of Scotch Whisky

37. SCDI's recently published *Survey of Manufactured Exports 2007/08* showed that the food and drink sector has grown from just under 12% of Scotland's manufactured exports in 1999 to just over 24% in 2007/08, thereby more than doubling as a percentage of the total. It has grown in value by over £1bn from £2.4bn in 1999 to £3.5bn in 2007. Overall, domestic and international food and drink sales are now worth about £7.5bn to the Scottish economy. The Scottish food and drink industry has ambitions to grow in value to £10bn in total by 2017.
38. This success has been driven by the Scotch whisky industry which in the last year was up by 13.9% (with gin and vodka up by 12.5%). Exports of Scotch whisky alone generated £2.82bn in 2007. This has resulted in unprecedented investment in new capacity. Much of this export growth is taking place in emerging markets and the success of Scotch whisky in China and India will be critical in the sector's drive to export more premium UK food and drink products. But the Scotch whisky industry also faces discriminatory trade barriers in a number of markets which need to be overcome if the targets are to be achieved.
39. The UK alcoholic drinks sector directly employs more than 650,000 people in the production and retailing of alcohol and supports a further 1.1 million jobs in the wider economy. Capital expenditure in production facilities in 2007 was £556 million. The alcoholic drinks industry contributes 2% of the UK's total output (£28.6 billion). It paid nearly £15 billion in excise duty and VAT in 2007/08.
40. It was announced in Budget 2008 that all alcohol duties would increase by 6% above the rate of inflation and that an alcohol duty regulator would be applied in the four subsequent Budgets. This was followed by the announcement in the Pre-Budget Report of a further increase in excise duty to negate the effect of the temporary cut in VAT. A report by Oxford Economics has found that these increases threaten at least UK 75,000 jobs and that excise duty and VAT revenue will be £1.675 billion lower by 2010/11 in real terms than the original Treasury projections. The alcoholic drinks industry is by no means immune from the recession. Anything which makes the indigenous market less competitive and more unstable will discourage international companies from investing in the UK. Furthermore, increases in excise duty in the UK are monitored closely and are regularly used to justify discriminatory tariffs on imports of Scotch whisky.
41. The indications are that HM Treasury will not reverse the increase in excise duty when VAT reverts to 17.5% at the end of this year. This would mean that the alcoholic drinks industry would

have absorbed the impact of the planned alcohol duty regulator in just one year. SCDI can see no justification for HM Treasury to proceed with the regulator. It recommends that excise duty should be frozen.

42. The decision in the Pre-Budget report to increase the duty on alcohol while reducing VAT without taking proper cognisance of the disproportionate effect on the vitally important Scotch Whisky industry was regrettable. SCDI was relieved that this mistake was rectified quickly by the Government. However, Scotch Whisky remains discriminated against in the United Kingdom market. The only fair treatment of this industry is to tax its alcohol content at the same level as competing alcoholic beverages and this should continue to be the long-term goal.

Building the UK's Future

Housing

43. The construction industry has been the largest source of private investment within Scotland, contributing £12billion (around 10%) to Scotland's GDP.
44. Construction is one of the industries worst affected by the financial crisis. The sector's output in Scotland has shrunk by 3.4 per cent between the year to September 2007 and the year to September 2008. This has resulted in job losses and is impacting on the wider economy. It also means that Scotland will probably produce 9000 new homes in 2009 well below its long term average of 25,000 and the lowest number since 1924. It will be further away than ever from the 35,000 new units per year which the Scottish Government believes that the Scottish economy needs. Unless capacity can be maintained during this downturn, to ensure the industry's ability to respond when the economy recovers, the cyclical nature of the industry will be perpetuated, leading to inflated construction costs, damaging recruitment and retention, and investment in skills and training.
45. Government and banking industry action is essential to improve the availability of lending to potential homebuyers, especially first-time buyers. SCDI welcomes the announcement by The Royal Bank of Scotland that it will offer £1.7bn worth of mortgages in the Scottish market over the course of this year, which is supported by £500m released through HM Treasury's Asset Protection Scheme. It is important that mortgage terms are eased, in respect of pricing and loan to value.
46. The Council of Mortgage Lenders (CML) forecasts 75,000 repossessions of UK homes and 500,000 people at least 3 months in arrears by the end of this year. SCDI is aware of concern that the Homeowners Mortgage Support Scheme has become extremely complicated and may not prove as attractive to borrowers as intended, and that the Government's schemes to boost income support for homeowners who lose their jobs and support defaulters are insufficient in scale.
47. In November last year, SCDI convened a meeting of representatives of Scotland's housing and construction industry. This resulted in an action plan with recommendations for UK and Scottish Government policy to help support the construction industry at this time. Those that are relevant for Budget 2009 are:
 - **Recommendation 1 – Tax Relief for Investment in Housing.** Targeted tax relief on investment in housing to encourage private investment in the sector. Extending relief to the housing sector could generate new demand in the market place and allow existing stock that was built for sale to be acquired by Venture Capital Trusts and utilised for low, mid and upper market rental accommodation.
 - **Recommendation 4 – Cut VAT on investment in refurbishment and maintenance.** Introduction of a targeted cut in VAT to encourage spending on building improvements and energy efficiency to increase investment in our building stock.

- **Recommendation 5 – Government Guarantee for Homeowners.** With repossessions rising, consideration should be given to a government guarantee for home owners unable to meet their mortgage payments. This would work by assisting with mortgage payments, rather than the provision of housing benefits further down the line to pay for temporary accommodation. This will give home owners and banks confidence and is another small step to getting the property market moving again. SCDI welcomed the Government's subsequent decision to introduce the Homeowners Mortgage Support Scheme, but it is disappointed that this will not be made available until April.

Stamp Duty

48. For first time buyers, lack of provision of mortgage finance, the requirement to provide a significant deposit and, although house prices are falling, issues of affordability are combining to make it extremely difficult to enter the housing market. First time buyers pay a significant amount in stamp duty. Following last September's suspension of stamp duty on properties worth less than £175,000, SCDI sees merit in increasing the threshold on that to all properties below £500,000.
49. The UK Government should also consider structural changes to stamp duty. These could include a change to a "slice system" from a "slab system" and the individual treatment of multiple purchases by residential landlords rather than as a single collective entity, to offer effective help to institutional investors, Real Estate Investment Trusts and others. Residential investments in Sips could also introduce a new source of demand. This could be restricted to UK properties.

New Forth Crossing

50. The new Forth Crossing is a once in a generation project. The Scottish economy cannot afford to run the risk that the route will be closed first to freight and, then, to all traffic. The condition of the current bridge has necessitated a new crossing. At a cost of £2bn, the new Forth Crossing will be the biggest capital project in Scotland's history and take up a substantial proportion of Scotland's capital spending over a number of years. SCDI is concerned that this will mean that there is very little funding available for other capital projects, including important transport infrastructure upgrades, at a time when the construction industry will be recovering from the current recession. It trusts that the UK and Scottish Governments will reach an agreement which enables a new Forth Crossing to be funded in such a way that other big capital projects can proceed simultaneously.

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