Economic Perspective

THE BUDGET AND THE SCOTTISH FINANCIAL INSTITUTIONS

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If the Budget produced the sound of popping corks along Throgmorton Street as the brokers and jobbers celebrated, the noise of asprin bottles rattling was probably more audible in the banking and insurance halls over the way in Lombard Street and four hundred miles to the north in Edinburgh. Remarks about 'Black Tuesday' probably overdo things a bit, for not all was bad news, but the Budget clearly has complex and in many cases difficult implications for the nation's major financial institutions.

The most immediately visible impact on the clearing banks was the effect on their tax position of the proposed phasing out of 100% capital allowances and the progressive reduction in the rate of corporation tax. The allowances made possible the banks' substantial business in leasing capital assets to customers. The allowances accruing on these assets enabled the banks effectively to defer large amounts of tax (with most of the benefit being passed on to the customers leasing the equipment from the banks). With their abolition, much of the deferrred potential tax liability will crystallise and must be provided for in profit and loss accounts. By way of illustration, the Bank of Scotland have had to make extraordinary provisions of £56.3 million, and the Royal Bank £90 million. In each case, these amounts are nearly equivalent to total pre-tax profits for a full year. In addition to the sharply increased tax burden, it is likely that in the longer run the demand for leasing business is likely to fall. (In the near future, the reverse is likely to be true as companies seek to take advantage of capital allowances while they last.)

Besides the obvious impact noted above, there are a number of more subtle, more long-term effects stemming from the Budget. The trend of the banks' aggregate lending business, as well as leasing, will of course be affected by the probable bringing forward of capital spending by industry: a short-term boost which will be offset by a falling away in demand later. More important in the long run are a number of structural changes which follow from the Chancellor's measures. He has clearly signalled his intention of boosting the capital markets - equity and fixed interest - as a source of new money for industry. The eventual cut in corporation tax to 35% will encourage companies to shift their funding away from bank borrowing to equity finance. Interest payments are wholly deductible from taxable profits. Dividend payments are not. This has favoured bank borrowing in the past, but,with the proposed tax reduction, in the Chancellor's words 'The closer the corporation tax rate comes to the basic rate of income tax, the smaller this undesirable distortion becomes.' In addition, the halving of stamp duty will improve equity turnover and so marketability, which should encourage more individual shareholdings at the margin. Long-term debt companies' other principal source of external finance apart from bank borrowing, long-term debt ought also to receive a boost from the Budget. The provisions for capital gains tax exemption, the concessions on 'deep discount' bonds, and on eurobond interest will all combine to revive interest in this sector, which has been moribund since inflation began to accelerate in the early 1970's.

Overall, therefore, the longer term outlook is that, for any given rate of growth of national output, a higher proportion of corporate financing will come from the markets and the growth of bank lending will be slower: a bonus, of course, for a Chancellor who attaches such importance to limiting money supply growth.

The mirror image of these changes are the ones the Chancellor has made which affect how and where individuals save their money. It is here that the insurance industry has taken its knocks, though the banks have not escaped either. The Chancellor's strategy appears clear enough. It is to reverse the long-standing trend towards collectivised savings and encourage the resurgence of the private investor with his savings decisions in his own hands. Some of the measures noted above contribute to this end, but the most important are the abolition of investment income surcharge and the end of tax relief on life assurance premiums (first introduced by Pitt the Younger). For the first time in living memory the standard-rate taxpayer now must pay a tax penalty for savings through life insurance rather than receiving a substantial subsidy. Life funds now have no advantage over the ordinary tax payer, and even the value of their special 37.5% tax rate as compared with ordinary corporation tax at 52% will disappear. Unit trusts, on the other hand, now compete on a much more equal footing. They benefit not only from the halving of stamp duty, but also from the reduction in corporation tax.

As it stands, the life assurance companies now find themselves effectively in a different market place. Things may be difficult for a time as a necessary re-orientation of products and marketing techniques is undertaken. They do, however, have advantages in outlets and in investment expertise which will allow them to become more diversified institutions.

It may be noted that the Chancellor has not gone the entire length that his own logic would seem to indicate. If tax subsidies on one form of saving (life assurance) are an undesirable distortion, why not go the whole way and have a go at pension schemes and house purchase as well?

Similar arguments apply to the proposal to extend the composite tax rate on building society deposits to the banks. This has long been a distortion and it might have been expected that the Chancellor would abolish it rather than actually spreading it wider. In this instance, however, rationality has succumbed to the temptation of getting the banks to act as unpaid tax collectors, and the prospect of snaffling the bulk of non-taxpayers' liquid savings for the public sector. It is more likely to please only the National Savings movement. It will not make it any easier to spread the banking habit among the young.

While the leading financial institutions have good grounds for carping at the Budget, not all its direct effects are undesirable. The abolition of NIS will benefit everyone, especially in a labour-intensive sector like financial services. The unit trusts, as noted above, have grounds for rejoicing. So too have all those involved in the provision of financial advice services. If the Chancellor really succeeds in making **personal** investment more diversified, more interesting and more attractive, it is likely that savings in aggregate will be stimulated. And there will be a profitable role for any business - bank, insurance broker, stockbroker, or unit trust who can offer a competitive service.

There is, moreover, no reason to assume that the Chancellor will stop where he is now. Succeeding Budgets should go further in removing anomalies. Nor are the Budget changes in the savings markets taking place in isolation. They are accompanied by a major de-regulation of the capital markets and a rate of technical innovation which together promise to change the established shape of the financial system in Scotland and the rest of the UK. The next decade will see some new births, some unlikely alliances, and a number of fatalities.