



making business sense

## Tax revenue from financial service sector down by £28 billion – equivalent to four fifths of the entire defence budget

A special study by **cebr** estimates that the tax take from the financial service sector in financial year 2009/10 will be only £39 billion, down from £67 billion in 2006/07. While the bank recapitalisations and asset guarantee schemes have attracted most attention, it is the collapse in revenues that is the greatest risk to the government's finances in the post credit crunch era.

Our study corroborates the recent research by Kenneth Rogoff and Carmen Reinhart on the aftermath of financial crises. They point out that the real value of public debt tends to explode post financial crisis. Interestingly, they find that the 'main cause of debt explosions is not the widely cited costs of recapitalizing the banking system' but rather, the 'collapse in tax revenues that governments suffer in the wake of deep and prolonged output contractions, as well as often ambitious countercyclical fiscal policies aimed at mitigating the downturn.'

The accountants Price Waterhouse Coopers have estimated that the financial service sector generated £67 billion in tax revenue in 2006/07 based on a detailed study of the accounts of a number of major financial institutions and extrapolating. This estimate looks roughly right and is in line with our calculations. The biggest item is of course income tax - £15 billion – followed by corporation tax at £12 billion. But the other items are more surprising - £10 billion from VAT which is unexpected from a sector that is VAT exempt (but VAT is of course collected in its inputs); £8 billion from employers National Insurance contributions which are collected all the way up the earnings scale on all earnings including bonuses; £7 billion from withholding taxes on interest payments and the rest mainly from stamp duties, employees NICs and business rates.

But the huge losses, job cuts and bonus cuts together with the fall in interest rates paid will cause these sources of revenue to collapse. The Chancellor is set to lose £9 billion in corporation tax revenue, £10 billion from less income tax and National Insurance contributions, £2 billion from stamp duty and £3 billion from withholding tax. Adding in all the other sources of revenue, the total tax take is forecast by **cebr** to drop from £67 billion to £39 billion. Moreover, some of these hits are likely to be long lasting. The scale of the losses that the banks can bring forward means that they will have to pay little corporation tax for many years. Our forecasts indicate that job numbers and bonuses will remain depressed until 2013 at least. Our tentative forecast is that the tax take will rise to only £46 billion by 2012/13.

This hit on tax receipts is a real blow to Chancellor Alastair Darling's budget hopes. His predictions in the Pre-Budget Report do not appear to have factored in more than half of the tax revenue decline for 2009/10 and there is little evidence that the longevity of the problem is yet fully understood in the fiscal part of the Treasury.

Crudely, UK spending policy in the New Labour years has been to use the heavy tax take from the financials sector to fund lavish public spending, particularly in the Labour fiefdoms of Scotland, Wales and the North of England. Now the money is no longer there and the **cebr** evidence to the House of Lords Select Committee on the Barnett formula suggest that public spending in these areas will need to be slashed by around 5% of local GDP (or by about 9% of local public spending) to take account of the loss of revenue from the financial service sector.

There is scope for argument about whether the bank bailouts represent real public spending, since it is more than likely that the government will eventually get most or even all of its money back. But this loss of tax revenue is a real long term revenue hit – equivalent in scale to 29% of the NHS Budget, 57% of the schools budget, or 79% of the defence budget.

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