



15th June 2010

Rt Hon George Osborne MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ

Dear Chancellor,

Circumstances dictate that the forthcoming Emergency Budget will contain a combination of public spending cuts and tax increases. Small businesses have lived with the realities of financial crisis for long enough to know that painful decisions are necessary in order to plot a course back to economic recovery. Difficult times require responsible behaviour and the Federation of Small Businesses (FSB) supports the Government in its expressed determination to deal decisively with the deficit.

However, we strongly believe that the necessary pain of cuts and tax increases must be offset by measures that help those who aspire to grow their businesses and employ more people. The last 10 years were characterised by debt fuelled public sector growth. The next 10 years must be defined by sustainable economic growth based on wealth generation and job creation in the private sector, specifically among the small businesses that make up 99.8 per cent of UK enterprises.

The figures speak for themselves. Between 2002 and 2007, over 84 per cent of new jobs were created by small businesses and, in spite of the recession, 57 per cent would like to employ at some point in the future. These figures sound impressive until you consider that in the UK the average small business employs only 4.5 people, while in the United States, the average small business employs 6.2 people¹.

In short, the engine for job and wealth creation is more powerful in the US than it is in the UK. In the Emergency Budget, and in the coming months and years, the Coalition Government should make it a stated objective to create the conditions in which it is possible for the average business to grow from four employees to six employees. The reward would be the recalibration of our economy, which would be more balanced, more sustainable and ultimately stronger.

This letter sets out some tangible steps you can take to make this a reality, but we would also urge you not to overlook the tone and language used by the Coalition Government at a time when business confidence is on a knife edge. Recent data from the UK's largest business survey panel, the FSB's Voice of Small Business Index², revealed the following:

¹ US - 2004 Census Bureau, Statistics about Business Size (Including Small Business); UK – FSB-ICM Voice of Small Business Annual Survey 2010

² FSB's Voice of Small Business Index March 2010:

<http://www.fsb.org.uk/policy/assets/voice%20of%20small%20business%20index%20-%20april%202010.pdf>



- The majority of small businesses are operating below capacity. In the three months to March 2010, 70 per cent of firms operated below capacity and over half of businesses expect to be below capacity in the next three months;
- Employment intentions remain muted. Most businesses are keeping headcount on hold for now and there was a net decline in employment in the three months to March 2010;
- Businesses expect performance levels to pick up over Q3 2010 but recovery is very fragile;
- Sales growth was weak with roughly 40 per cent reporting a decline in revenue.

We understand that the forthcoming Budget will contain bad news, but this must be tempered by measures that inspire confidence in the future, and delivered in words that speak to the aspirations of the millions of entrepreneurs who want to grow, innovate and employ.

National Insurance Contributions – sending a signal to UK job creators

National Insurance Contributions (NICs) was a defining issue during the General Election campaign and it will remain so in the forthcoming Budget. The level of employers' NICs is the single biggest block on job creation and the FSB calculated that the increase planned by the previous government would have cost 57,000 jobs, whilst raising relatively little money for the Treasury.

If the Coalition Government is serious about job creation and wants to send a positive message to the business community, it will reverse in full the planned NICs increase and implement a revised version of the Conservative's plans for a NICs holiday.

The plan to introduce a NICs holiday for new businesses for the first ten employees over two years was good in principle. However, in practice it will not deliver the job creation its authors anticipated.

Instead, the FSB is proposing that a business currently employing between zero and four staff should be exempt from employers NICs on the next three staff it employs. This initiative would only last for one financial year and would drive employment in those businesses currently trading. It would also serve as a potent message that the Coalition Government is serious about job creation, rebalancing the economy and growing the size of the average small business³.

We envisage that the relief would apply up to the Upper Earnings Limit of £844 each week per employee, or about £44,000 a year. Three new employees, on an average weekly salary of £489 would save a small business £7,567.86 in one financial year. This is an individual saving per employee of £2,522.62 in one financial year to the business.

³ An Ambition to Grow UK Enterprise 2010:
<http://www.fsb.org.uk/policy/images/an%20ambition%20to%20grow%20uk%20enterprise%20-%20government%20proposal%20140610.pdf>



Contrary to the idea that this would cost the Treasury money at a time of fiscal constraint, the FSB's proposal would generate revenue. For example, one employee at an average weekly salary of £489 would still contribute £5,958.48 per annum. This, for three employees would generate £17,875.41 for the Treasury or an additional £10,307.55 (once the relief has been removed).

Cutting waste and targeting the remaining resources where most needed

The FSB would like to see less money spent more wisely. For example, it is estimated that £10-12 billion is spent every year on government funded business support. However, only five per cent of this goes to the micro-business sector, which accounts for 95 per cent of all businesses.

The current business support budget should be cut, streamlined and dedicated to small and micro-businesses that are most in need of support, rather than subsidising medium and large businesses. During these difficult economic conditions we must apply good business sense to business support and get better service for less money.

Capital Gains Tax – clarity and protection for the UK's job and wealth generators

The FSB is concerned that the Government will look to significantly increase Capital Gains Tax (CGT) from the current 18 per cent to a potential 40 or even 50 per cent. While the coalition document stated that there would be "*generous exemptions for entrepreneurial business activities*" the business community is worried that this will dampen investment, send the wrong signals to savers and potentially lead to a mass fire sale.

The FSB would like a generous taper system so that the longer an asset is held, the lower the taxable liabilities are. For example, if an asset is held for one year, a rate close to 50 per cent can be charged on the capital gains (after allowances and annual relief). This could then be tapered down to 20 per cent for assets held for a considerable period. This approach would encourage long term investment.

The FSB is also concerned that an increase in CGT close to the top rate in income tax may not bring in the large amounts of money to the Treasury as expected. When the US increased its CGT levels, the level of Government income did not increase. In 1968 real CGT receipts were \$33 billion when capital gains tax was 25 per cent. Over the next eight years the tax rate was raised four times, peaking at 35 per cent. Yet with the tax rate almost twice as high in 1977, CGT revenues were only \$24 billion – a figure 27 per cent below the 1968 level⁴.

⁴ Cato Institute 1995, <http://www.cato.org/pubs/pas/pa242.pdf>



Value Added Tax – striking the right balance

There is a distinct chance that VAT will be raised, possibly to 20 per cent. If this is the case, the FSB urges the Government to be mindful of two points. Firstly, a decision on timing is vital for small firms. The previous Government's shambolic move to reduce VAT from 17.5 to 15 per cent for one year cost the average small business £1,500 in administrative burden⁵.

Secondly, the FSB believes that any increase in VAT must include a sunset clause. This will allow small firms to plan for the reduction and allow them to decide how to financially manage the increase. It would also send a strong message that, while tax increases are necessary in the current climate, this Government is, by nature and inclination, a low tax administration.

If the level of VAT does increase to 20 per cent it will help reduce the deficit by £11 billion, however this should be tempered by lower rates in some areas, which would serve as a stimulus to some crucial growth sectors, not least the construction industry.

Flat rate VAT is charged to the smallest businesses with a turnover of less than £150,000 and aims to minimise the red tape around administering VAT, thus providing a slightly lower rate which varies dependent on the sector the business operates in. The FSB has discovered that the flat rate VAT charged by HMRC to the smallest of businesses has risen to a higher level and the FSB urges the Government to review this issue immediately.

FSB analysis of the rates has found that businesses operating within the agricultural services sector have seen rates increase by a huge 2.5 per cent⁶. For grocers, newsagents, clothing shops and tobacconists rates rose by 1.5 per cent as has those for businesses involved in social work. At the other end of the scale, estate agency and property management services have their rate decrease by 0.5 per cent and computer repair services by 1.5 per cent.

When VAT was lowered in December 2008 many rates stayed the same and a number were reduced by up to 2.5 per cent. What has become apparent is that after VAT was put back to 17.5 per cent in January 2010, nearly half of the flat rate schemes have seen the VAT level rise above the pre-decrease level. This has had the detrimental impact of harming smaller firms in cash terms and making them less competitive.

The FSB would also like the Government to look at the registration threshold for VAT. Currently the threshold stands at £70,000 which was raised by £2,000 in the last budget. A co-ordinated increase from £70,000 to £90,000 would help small firms reduce the bureaucracy around filing VAT returns while allowing them to increase turnover without losing competitive advantage to larger firms.

Additionally, the Government should strongly consider doing what other EU countries have done and reduce the VAT on construction to five per cent. As shown later in this letter, this has helped create jobs and increase revenues to the relevant tax authorities.

⁵ HMRC Impact Assessment, 24th November 2008; "Impact Assessment of changes to the standard rate of VAT" VAT

⁶ FSB Flat Rate Analysis March 2010; <http://www.fsb.org.uk/News.aspx?loc=pressroom&rec=5981>



Finance – funding the recovery

Access to finance was, and remains, a huge issue for the small business community. The FSB believes that this will become an even greater issue in an economic upturn as the underlying problems remain. Therefore, it is essential that the Enterprise Finance Guarantee (EFG), which to date has helped over 10,000 businesses, is renewed indefinitely.

Evidence from our members also suggests that the scheme could be speeded up and made more predictable. We also urge the Government to put forward details of the major loan guarantee scheme and the net lending figures which are referred to in the Coalition Document.

The FSB supported the merger of Lloyds TSB and HBOS, which created Lloyds Banking Group. The market failure of either of the banks would have had a catastrophic impact on the UK economy and on the SME community. However, the government must now look towards the future of small business banking and consider radical ways to change the behaviour of the credit market. We cannot return to *'business as usual'*. The government must:

- Not sell its shareholdings in nationalised and capitalised banks to other banks⁷;
- Use Regional Development Agencies (or Local Enterprise Partnerships) to disseminate Enterprise Finance Guarantee and European Investment Bank loans to SMEs;
- Promote a Corporate Mediator to help viable small businesses unable to access finance⁸;
- Create a Post Bank offering support for small firms by utilising the Post Office Network and operating either as a solely state owned bank or as mutual or trustee bank⁹.

The previous Government's attempts to start the financial adjudicator scheme were welcomed by the FSB but the manner in which they envisaged the scheme working was not appropriate for small businesses. Rather than being run from a central government department with powers to force banks to lend; the FSB proposes a mediation service provided either through Business Link, RDAs or in future through Local Enterprise Partnerships.

This mediation services could be used to collate information for the Government on lending conditions and behavioural differences between sectors, banks and regions, which is currently unavailable. Of course the main role of a mediation service would be to step in where viable businesses are unable to obtain finance and to help re-establish working relationships and trust between businesses and the banks at local level. This might sound unimportant in the grand scheme of things, but it is the existence of trust and good working relationships between small businesses and banks that will finance the recovery.

⁷ FSB Competition in SME Credit Market;

<http://www.fsb.org.uk/policy/assets/comp%20in%20banking%20sector%20one%20page%20briefing.pdf>

⁸ FSB Corporate Mediator 2010; <http://www.fsb.org.uk/policy/images/proposal%20for%20a%20corporate%20mediator.pdf>

⁹ <http://www.fsb.org.uk/policy/images/post%20bank%20one%20page%20briefing.pdf>



IR35 Legislation – clearing the route to entrepreneurship

This legislation favours large contractors and suppresses an important route from employment/unemployment into entrepreneurship. It is an administrative burden for small businesses and also for HMRC so should be withdrawn.

The FSB welcomes moves from the Coalition Government to review the legislation around this area. The FSB feels that during an economic downturn all forms of entrepreneurship should be encouraged and past experiences demonstrates that facilitating the route from employment or unemployment to entrepreneurship is at the heart of an economic recovery.

Employment status continues to cause problems for small businesses and IR35 legislation is continuing to cause administrative problems for professional contractors who have to operate through limited companies.

Fuel Duty – demonstrating that we are all in this together

Sixty-six per cent of FSB members place fuel duty at the top of their list of concerns and the FSB welcomed the Conservative policy of a 'Fair Fuel Stabiliser' in their general election manifesto. So it was disappointing that this was not mentioned in the coalition document.

We would like to see the previous commitment to a fuel stabiliser realised in the Emergency Budget, ensuring that the tax proceeds of higher than predicted North Sea oil prices are shared with hard-pressed, consumers, motorists and small business owners. A fuel stabiliser would cut fuel duty when prices are high and increase it when prices for fuel are low. It would be a popular and fair measure¹⁰.

Cutting VAT on Construction – stimulating growth

The current VAT rate on renovating homes is bizarre and wrong-footed, stifling potential demand for construction services and distorting the construction sector in a way that is contrary to the green, low carbon agenda. The FSB is calling for the VAT rate to be lowered to a flat rate of five per cent to give homeowners the incentive to spend and give a boost to builders and small firms in the construction industry at an already difficult time¹¹.

Evidence from other parts of the EU suggests that this cut in VAT can actually result in greater revenue from tax due to increased trade. The Isle of Man Treasury stated that *"the actual tax take increased despite the 12.5% differential in VAT for the comparable organizations"*. The Belgian Government has seen the measure increase both turnover and employment. The French economy benefited from the creation of some 53,000 new jobs in the construction industry and seven per cent growth in turnover of approximately €2 billion. In Italy, 35,000 enterprises emerged from the informal economy and started paying VAT for the first time. Not to mention Portugal's construction industry that enjoyed well above average growth of 20 – 25 per cent.

¹⁰ FSB Survey Panel April 2010; http://www.fsb.org.uk/policy/assets/fsb-icm%20panel%20survey_april%202010_report.pdf

¹¹

<http://www.fsb.org.uk/policy/images/reduction%20of%20vat%20on%20construction%20work%20one%20page%20briefing.pdf>



The construction industry accounts for around 10 per cent of Britain's Gross Domestic Product, so it is essential to the economy that it is supported through the recovery via a cut in VAT.

Late Payments – shifting behaviour

Paying an invoice late leads to business closures and job losses, it should be regarded as an extreme form of anti-social behaviour. According to Government statistics 4,000 businesses closed in 2008 as a direct consequence of late payment. A third of FSB members report that they have been paid late, and the average delay is up to 20 days after agreed payment terms. This squeezes already tight cash flow and leads to difficulty in paying amenity bills, fulfilling wage responsibilities and reducing new orders. Ultimately it leads to job cuts.

Ever since the Companies Act of 1985, publically listed companies have been obliged to submit their payment terms to Companies House. However, this has not been fully enforced and Companies House lacks the resources to fulfil its role. Companies House should be given the resources to properly carry out its duties in the Companies Act 1985 so it can name, shame and fine companies that do not submit payment policies every year¹².

This is just one measure that the Government should deploy to shift behaviour towards making late payment unacceptable. Another measure should be to introduce and enforce a social clause in all public sector contracts, which demands that sub-contractors are also paid on time. Any company found in breach of this clause should be banned from all future public sector contracts.

This extended letter provides a snapshot of the measures the FSB would like to see adopted in the forthcoming Emergency Budget. As the UK's leading business group, representing over 213,000 small businesses, we stand ready to provide more detailed information on each of these points and anything else relating to the small business community.

Yours sincerely,

John Walker
National Chairman

¹² Late Payment, Squeezing money out of SMEs, January 2010;
<http://www.fsb.org.uk/policy/images/late%20payment%20policy%20paper%20jan%202010.pdf>