

Tax Options for 1992

The Green Budget

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Preface

On New Year's Eve 1991, the *Financial Times* published an interview given by the Chancellor to the FT's Peter Norman:

Peter Norman

Your first Budget last year suggests that you are interested in tax reform. We realise that you can't go into details with the 1992 Budget less than three months away. But do you want to be a reforming Chancellor and where do you think the UK tax system needs overhauling in the short and medium term?

Norman Lamont

Wait and see.

This document is the *Green Budget* not because it discusses taxation and environmental policy, although it does, but because it aims to fill the gap in pre-Budget discussion left by the refusal of government in the UK to discuss options for change in advance of the Budget in its own Green Paper. Our aim is to make it less necessary to wait and see, and to facilitate a sensible pre-Budget debate.

As long ago as 1977 Geoffrey Howe commented that

as long as we continue to worship in accordance with long established rites at the altar of the annual Finance Bill, so long will our tax laws be confused and confusing.... The Budget is shrouded in secrecy until the Chancellor unveils his master plan. He presents it as a fiscal *fait accompli*, receptive to neither the benefit nor the opportunity of prior examination or constructive comment.... There follows the by now traditional struggle on Finance Bill Standing Committee.... Because of the debating nature of the proceedings, the Minister often feels no compunction about glossing over questions that are beyond him.

In 1980 IFS published the Armstrong Report, putting forward the case for reform, and in 1982 the Treasury and Civil Service Committee concluded that 'the advantages of more and earlier discussion of tax changes more than outweigh the administrative problems involved in their earlier formulation'.

Despite this recommendation, the Government continues to hold to the absurdity of Budget secrecy. Since 1982, IFS has published its own Green Budget, for the last five years in collaboration with Goldman Sachs. Each year this aims to set the background to the Budget, describe problem areas in the tax system, and outline the range of options which are being, or might be, considered within the Treasury. The recent announcement by John Smith, the Shadow Chancellor, that Labour favours a move towards a more open and coherent Budget-making process is welcome. Were the Labour Party to be elected we must hope that Mr Smith will not change his mind as Sir Geoffrey Howe seemed to.

Since the Budget this year seems likely to be determined by short-term political considerations to an even greater extent than usual, and since the general election is so close, we have included in this year's Green Budget an analysis of the likely state of the economy and the public sector finances into the medium term, and some consideration of the tax and spending policies that the main parties would seem likely to want to implement, alongside an assessment of the scope for achieving their aims.

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1 Overview

Macroeconomic Considerations

An election Budget The run-up to the 1992 Budget is dominated by the imminent general election. This year the contents of the Budget will more than ever be determined by political rather than economic considerations. The 1992 Green Budget therefore looks not only at this year, but at the medium-term outlook for the economy, public sector finances, and tax policy.

The UK economy The UK economy has suffered a deeper-than-expected recession. Our expectation is that the economy will move into a recovery in 1992, although there is still a risk of a second downturn this year. Three factors should operate to drive the economy towards recovery: the easing of monetary policy since autumn 1990; downwards pressure on the savings ratio since mid-1991; and the near-elimination of the corporate sector financial deficit. The balance of evidence indicates that the economy is embarking on a slow recovery path which is likely to gather momentum as the year progresses.

Active fiscal policy? A case can be made for greater fiscal activism: full membership of the EMS restricts the scope for using interest rate changes to affect domestic demand; the automatic stabilisers do not necessarily produce an optimal degree of cyclical stabilisation; and it is possible within a regime of increasingly fixed exchange rates for real interest rates to move perversely for the purposes of cyclical stabilisation. But any move to greater fiscal activism would seem to conflict with the Government's long-held views.

PSBR overshoot in 1991-92 We expect the PSBR for 1991-92 to exceed the Autumn Statement forecast of £10.5bn. Our projection is for a PSBR of £11.8bn.

PSBR £19.5bn in 1992-93 The PSBR will rise further in 1992-93, to around £19.5bn on unchanged policies, some 3% of GDP.

Small net give-away We expect a small net reduction in taxes to be announced in the Budget, of some £1-£2bn. There is a strong case for concentrating any such giveaway on business rather than the personal sector.

Prospects for Tax Changes

Income tax Changes to income tax are often seen as setting the tone for a Budget, and this seems likely to be especially true this year. Some reduction in income tax seems probable, with the main decision being whether to cut the basic rate or increase allowances. Increasing allowances gives more help to those on low incomes, but is far less memorable than cutting the rate. Taking a first step towards a basic rate of 20% must seem attractive to the Chancellor, and has the merit for him of forcing Labour to say it would reverse the cut if elected. The final decision will be made very close to the Budget.

Green Budget 1992

Raising money It may be that any tax cuts will be partially or fully funded by increases elsewhere. Possible methods of raising money include freezing the married couple's allowance, freezing the higher rate income tax threshold, and restricting the value of allowances to the basic rate. Further real increases in company car taxation, long a source of extra revenue, seem unlikely.

Housing Although the housing market is still slow, there have been fewer calls than usual in the run-up to this Budget for increases in the £30,000 mortgage interest relief (MIR) ceiling. This may reflect the perception that any further measures in this area are unlikely after the stamp duty and mortgage rescue scheme announcements. A further argument against any increase is the cost. We do not expect any change in the 1992 Budget.

Savings Major new initiatives or dramatic reform seem unlikely this year, but some tinkering with TESSAs and PEPs may occur. In particular, time limits on TESSAs might be relaxed.

NICs Raising the UEL would make Labour's task easier, smoothing out the employer's schedule is too expensive, and adjusting the tax base is too complex.

Company tax The Government may wish to do something to help companies. Changes to corporation tax have only a lagged effect, and help only those businesses which pay corporation tax. A more attractive option may be to halt the increases in non-domestic rates payments which may affect many companies, especially in the South-East, from April.

The Economy in the Medium Term

Trend growth The Treasury has based its fiscal plans on the assumption that the economy will grow by an average of 3% p.a. in the period up to 1994-95. Although the UK should be emerging from a recession over these years, this growth assumption seems high. Whichever party is in power, we think it prudent to plan on the central assumption that the growth rate will be 2.25% p.a. This figure is lower than is suggested by an analysis of domestic productivity trends, but it is higher than the growth rate which appears consistent with an unchanged balance of payments position. Although the balance of payments constraint may not be binding (since the present deficit stems from an unusually high level of business investment for the present stage of the cycle), it seems unwise to plan on the central assumption that it will not be.

Devaluation It has been widely suggested that sterling should be devalued in order to ease the balance of payments constraint and reduce unemployment. But, for the moment at least, there are powerful arguments against this. Most estimates for the fundamental equilibrium value of sterling against the European currencies do not suggest that it is seriously overvalued. Given the high degree of uncertainty attached to these estimates, and the damage to policy credibility which devaluation would bring, a unilateral devaluation now does not look justified.

- Personal savings** A different problem which the economy might face in the medium term could be a persistently high personal savings ratio, which could prevent activity from recovering at the rate we assume. High personal debt, and the weakness of the housing market, are the prime reasons for these concerns. However, our analysis of consumer debt sustainability, and of the 'steady-state' level of the savings ratio, indicates that the medium-term trend in the savings ratio should be downwards. If this proves correct, then there should be scope for the government deficit to be reduced in the medium term. If, on the other hand, personal savings remain high, it will be difficult for any Government to reduce the PSBR without killing off the economic recovery.
- Public finances** In order to leave the Government's debt / GDP ratios constant over the medium term, the PSBR needs to be no higher than £12bn. However, privatisation is running down the asset side of the balance sheet by £8bn a year. Allowing for this, the PSBR needs to be held down to about £4bn to leave the Government's net asset position constant. However, even if the PSBR averages 3% of GDP in the next five years, the increase in the debt / GDP ratio would not be very marked, and would still leave the UK ratio well below the European average. Debt sustainability is not therefore a major problem for the next Government.
- Party programmes** Even assuming that the Autumn Statement targets for public spending are met (which past experience suggests is improbable), it seems unlikely that a re-elected Conservative Government would be able both to cut taxes and to achieve a balanced budget by the end of the next Parliament. Indeed, achieving a balanced budget even without any tax cuts requires annual GDP growth to be as high as 3% p.a. Labour, if elected, would have little scope for increased spending in the early years, unless it were willing to increase taxes by more than it has indicated. By the end of the Parliament, Labour could increase spending by about £14bn a year, but only if it is willing to keep the PSBR at 3% of GDP (the limit in the Maastricht Treaty). Unless the economy performs better than can be reasonably expected, neither of the main parties will find it easy to attain its political goals in the next Parliament.

2 The Economic Forecast

2.1 The World Economy

The major developed economies experienced a marked weakening in economic activity last year. In terms of aggregate real GDP, growth in the OECD area was barely 1%. Moreover, this average figure masks a considerable divergence in economic performance between different countries. The US, UK and Canadian economies all experienced a decline in the level of output last year, while Japan and Germany both registered strong increases in GDP between 1990 and 1991. The growth performance of other major economies lay somewhere between these two extremes, although most economies experienced below-trend growth for the second year in succession. By the end of last year there seems to have been a greater convergence in economic performance, though at the weaker end of the scale. Growth slowed sharply in Japan and stagnated in Germany during the second half of the year, while output stopped falling in the US, UK and Canada.

Forecasts of global economic activity were generally too optimistic last year. A year ago the OECD Secretariat was predicting growth of 2.0% in 1991, double the latest expected out-turn. In retrospect it seems that insufficient weight was given to the tight policy environment in most countries, and possibly also to the impact of last year's Gulf War on business and consumer sentiment. This lower-than-expected growth performance has also resulted in a better-than-expected inflation out-turn. Consumer price inflation in the OECD area is now projected to have been 4.5% last year compared with a forecast of 5.6% this time a year ago, although part of this error may also be attributed to a more favourable out-turn for oil prices.

Consensus forecasts project a moderate pick-up in economic activity during 1992. The main supportive factor comes from a drop in global interest rates, of which the most marked to date has been the decline in US short-term rates to around 4% from a peak of 10% in early 1989. Short-term interest rates have also fallen in Japan, Canada, Australia and the UK over the past year. Furthermore, bond yields have fallen in most countries over this period. The full effect of this monetary easing has probably yet to be felt on demand. In the normal course of events, inflation should drop in response to the significant slack that has developed in many economies. This will help to bolster consumer confidence and consumption will be helped both by this and by a lower debt-servicing burden. Residential investment will be boosted by lower interest rates, and a revival in business investment should follow the pick-up in consumer demand. As demand picks up in each economy, so too should world trade,

Table 2.1. Forecasts for the World Economy

% change from previous year	1990	1991	1992	1993
OECD real GNP				
HMT	2.5	1.3	2.5	-
OECD	2.6	1.1	2.2	3.3
Goldman Sachs	2.2	0.6	1.5	2.8
OECD consumer prices				
HMT	5.0	4.3	3.8	-
OECD	4.7	4.5	3.8	3.6
Goldman Sachs	5.0	4.2	3.3	3.2
UK export markets				
HMT	4.3	1.0	4.8	-
OECD	5.9	4.6	6.1	7.7

Notes: Goldman Sachs and HM Treasury figures for GNP and inflation relate to major seven only. OECD inflation forecasts relate to consumers' expenditure deflators. HMT figures for world trade are not weighted by UK shares; OECD figures relate to manufactures only.

Sources: HMT - HM Treasury, 'Autumn Statement', November 1991.

OECD - 'Economic Outlook', December 1991.

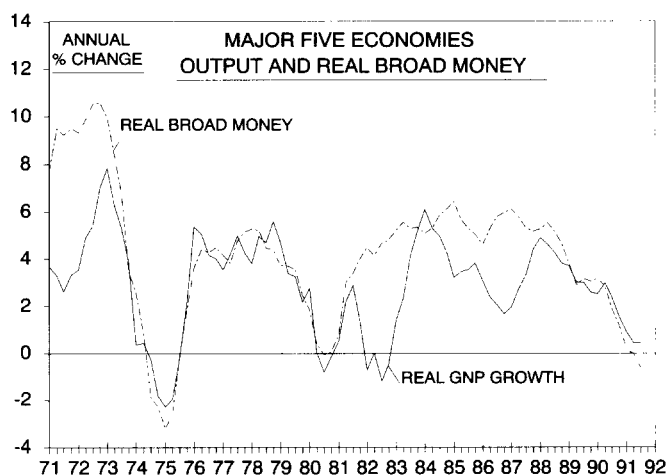
Goldman Sachs - 'UK Economics Analyst', February 1992.

leading to a reinforcement of the recovery. Reflecting these linkages, consensus forecasts point to growth of 2-2.5% in the OECD region this year. Inflation is expected to improve to around 4%.

On the face of it these forecasts seem quite encouraging. However, most of the risks seem to be accumulating on the downside. Perhaps the biggest risk stems from the fact that the US economy seems to have weakened again in the final months of 1991. In the previously strong economies of Germany and Japan, business and consumer confidence weakened steadily throughout 1991 and have shown no immediate signs of stabilising. Weakness in the three major industrialised economies may have an adverse effect on confidence generally throughout the OECD area. This raises the prospect of a much more sluggish global economic environment in 1992 than is built into consensus forecasts.

There are two additional concerns about the extent of the recovery in world activity this year. The first relates to sluggish rates of monetary growth world-wide. With the exception of Italy, the rate of broad monetary growth slowed sharply in all the major OECD economies last year. Historically, there has been a reasonably close relationship between real broad monetary growth in the major OECD economies and the strength of global economic activity. These sluggish rates of monetary growth may therefore inhibit the pick-up in economic growth in the OECD area. However, it is worth noting that turning-points in real monetary growth and economic activity have been broadly coincident in the past. Current sluggish growth rates of money may therefore be indicating little more than the obvious, namely that economic activity is still very weak globally.

Figure 2.1



A second concern relates to the accumulation of household debt in most OECD economies during the 1980s. In most cases the ratio of household debt to income is at a historical peak. Thus households are much more vulnerable to the effects of high real interest rates, particularly at this stage of the cycle when cyclical falls in income add to the problems of debt servicing. At the same time the value of housing wealth, which is by far the most important asset counterpart to the indebtedness of households, has probably fallen in relation to income in the US, Japan, Canada and the UK over the past year. As a result, not only are households having to devote a larger part of their incomes to service their debt burden, but the underlying value of their most important asset has been declining. This could result in a more prolonged period of retrenchment by consumers as they seek to build up precautionary savings which could delay and slow the recovery.

These factors point to the likelihood of a rather fragile recovery in world economic activity this year which, given the scale of private sector indebtedness and continuing high levels of real interest rates, may be somewhat weaker than normal. Consensus forecasts of 2-2.5% growth in the OECD area this year may well prove too optimistic. Within the total, it seems likely that Europe will lag the general recovery in economic activity since monetary policy still seems exceptionally tight for this stage of the cycle. The problem facing most European countries is that interest rates are being held up by the Bundesbank's desire to suppress inflationary pressures that still exist in Germany. While these are largely absent in most other European economies, a commitment by these countries to membership of the exchange rate mechanism of the European Monetary System has prevented their domestic interest rates from falling below those in Germany. A relaxation in German monetary policy may not emerge until much later this year, thereby delaying a general recovery in Europe perhaps until 1993. In planning the Budget, therefore, the

The Economic Forecast

Chancellor for the second year running cannot assume that world economic activity will provide much support to UK economic activity during 1992.

2.2 The UK Economy

A Deeper-than-Expected Recession

At this time last year, the consensus view was that output growth would slow to about zero in 1991. We commented then that this seemed far too optimistic, given the collapse in business and consumer confidence that had taken place, and it now appears that real GDP in calendar 1991 will turn out to be around 2.5% lower than it was in 1990. In last year's Green Budget, we identified three major risks to consensus forecasts: the state of corporate finances, the personal sector's response to high levels of debt, and the Gulf War. All three factors seem to have been important contributors to a deepening of the recession last year.

Taking the Gulf War first, the impact of this seems to have been mainly on sentiment. The direct economic impact was probably rather small since oil prices fell back sharply following the outbreak of hostilities to around the levels prevailing just before the Iraqi invasion of Kuwait. But the onset of war was accompanied by a sharp fall in business confidence in most economies at a time when world economic activity was already weakening. This added to the downward momentum on world activity and trade, thereby providing a less favourable background for UK exporters.

Another mistake made by forecasters was to underestimate the personal sector's desire to forgo consumption in order to rebuild its savings. A combination of rapidly rising unemployment and falling housing wealth contributed to a further rise in precautionary savings, taking the savings ratio from an average of 8.9% in 1990 to an estimated 10.5% last year. With real disposable income stagnating last year, this seems to have resulted in a drop of almost 2% in real consumer spending in 1991, the largest calendar year fall recorded in the post-war period.

As consumers retrenched, the company sector had little option but to cut back sharply on investment and stockbuilding in order to improve its desperately poor financial position. Following these actions, the company sector financial deficit has been cut from a peak of 5.2% of GDP in the first half of 1990 to just over 1% of GDP during the latest six months for which data are available. Consensus estimates suggest that investment now seems likely to have fallen by over 11% in 1991 while cut-backs in stockbuilding may have reduced GDP by just over 0.5% last year.

A Cyclical Upswing or a Prolonged Recession in 1992?

Going forward, the key question is whether the economy will embark on a cyclical upswing during 1992. Consensus estimates are for growth in the region of 1.5-2% this year, suggesting a fairly normal cyclical recovery. More recently, commentators seem to have become more pessimistic about the outlook for economic activity in 1992 but in most cases this is due to greater caution about the precise timing of the recovery rather than a fundamental questioning of its existence. Even so, the dispersion of forecasts around the consensus is extremely large. There are some

Table 2.2. Demand Prospects

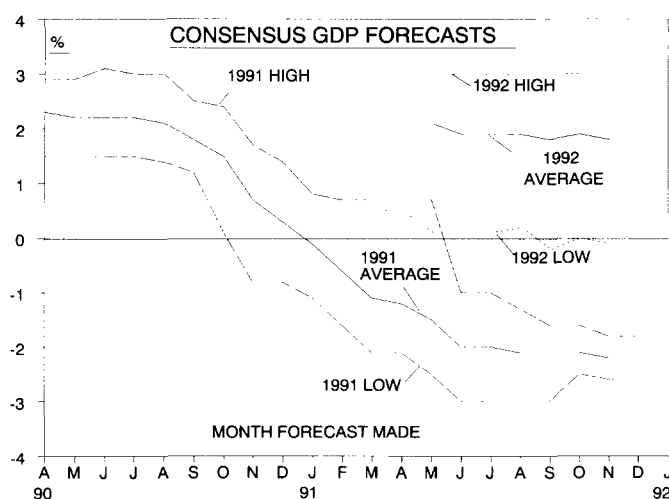
Annual % change, volume	1990	1991	1992
Private consumption			
HMT	1.0	-0.7	2.6
LBS	1.0	-0.6	1.9
NIESR	1.0	-0.9	1.2
Goldman Sachs	1.0	-2.0	1.7
Consensus	1.0	-0.8	1.7
Total fixed investment			
HMT	-2.5	-10.8	1.4
LBS	-2.4	-11.3	-1.9
NIESR	-2.4	-8.2	0.3
Goldman Sachs	-2.2	-10.9	-0.6
Consensus	-2.2	-11.7	-1.9
Exports of goods and services			
HMT	4.8	1.4	6.0
LBS	4.8	1.8	5.0
NIESR	4.8	0.5	5.8
Goldman Sachs	4.9	0.8	3.6
Consensus	4.9	1.2	3.9
Imports of goods and services			
HMT	1.3	-2.6	7.6
LBS	1.3	-2.9	4.5
NIESR	1.3	-2.3	5.6
Goldman Sachs	0.3	-2.9	4.5
Consensus	1.0	-2.5	4.9
Real GDP			
HMT	0.9	-2.1	2.3
LBS ^a	0.9	-2.1	1.9
NIESR ^a	0.9	-1.9	2.1
Goldman Sachs	1.0	-2.4	1.6
Consensus	0.9	-2.2	1.8

^a Output-based.

Sources: HMT and Goldman Sachs - as Table 2.1.
 LBS - 'Economic Outlook', October 1991.
 NIESR - 'National Institute Economic Review', November 1991.
 Consensus - 'Forecasts for the UK Economy', HM Treasury, December 1991.

important forecasters who are warning of the dangers of a secular depression in activity, largely generated by slow rates of growth in broad money supply, high personal sector debt ratios, and declining asset prices. On this view the economy could shrink further before beginning to recover, or at the very best suffer a much more prolonged period of significantly below-trend growth.

Figure 2.2

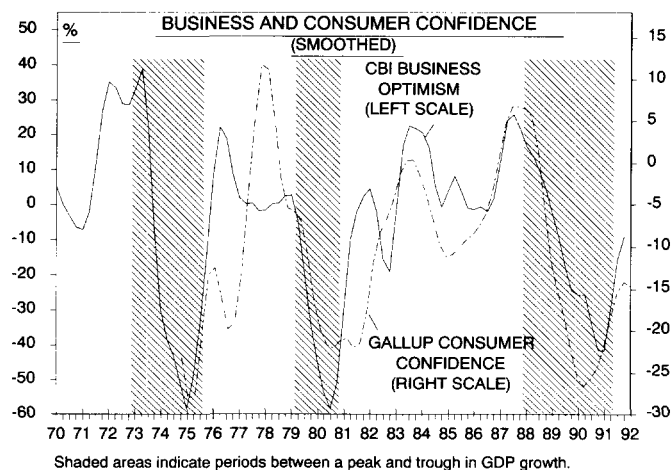


The CSO leading indicators offer the most encouraging signs that recovery is in the pipeline. Historically, the longer leading indicator precedes the cycle by around ten months, while the shorter leading indicator runs around four months ahead of the cycle. These troughed in May 1990 and May 1991 respectively. Although the lag between the various leading indicators and the economic cycle varies very substantially from cycle to cycle, both the longer and shorter leading indicators suggest that recovery was underway before the end of last year. Part of the rise in the leading indicators stems from an improvement in business sentiment recorded in the CBI Survey. More generally, all of the key business survey indicators relating to orders and activity are substantially above the troughs that were recorded in the early part of last year. A similar picture is painted by consumer confidence. Consumer confidence deteriorated slightly in the final months of 1991, but this was relatively minor when compared with the continuous recovery in confidence recorded since its trough in early 1990.

Labour market statistics have also been reasonably encouraging. Although the level of unemployment is a lagging indicator of economic activity, the change in unemployment has generally been a reasonable coincident indicator. In recent months the increase in unemployment has been about 30,000 a month, roughly one-third of the peak rates of increase recorded last spring. The decline in manufacturing employment has also started to ease, while the decline in vacancies and overtime has stopped. All of these indicators suggest that the trough in economic activity has been passed.

It is also possible to draw some comfort from the monetary statistics. While broad monetary growth remains very weak, there has been a pick-up in the growth of narrow money. The trough in the annual growth of M0, which is the only monetary aggregate officially targeted by the Government, was recorded in April 1991. Indeed real M0 growth, which in the past has had a broadly coincident relationship with the annual

Figure 2.3



growth of consumer spending, has recovered quite strongly in recent months. This would be consistent with the resumption of an upward trend in consumer spending.

Not all economic data provide such encouragement. Manufacturing output still seems to be declining; export volume is no longer rising; capital goods orders have fallen back after rising in the middle of last year; and housing market activity remains very depressed. But this is not that surprising. At a turning-point in economic activity, some sectors are always going to turn before others. Evidence of declining activity in certain parts of the economy while other parts recover is quite normal at this stage of the cycle.

Nevertheless, there obviously remains a risk that the recession will experience a second downleg in 1992. The risk is heightened by the deterioration in growth prospects in other major OECD economies, by high levels of consumer indebtedness and by sluggish rates of broad monetary growth. So far a second downleg for activity does not seem to have occurred, nor has the reduction in business optimism and consumer confidence been great enough to suggest that a new downward impetus to output is likely. Indeed it is rather difficult to find examples of 'double dip' recessions in the UK in the post-war period. The only recession which really comes close was that of 1974-75, when the initial drop in GDP in the first quarter of 1974 was followed by a rebound in the summer of that year, only for a renewed sharp decline to follow in 1975. But the initial drop in GDP was due entirely to the three-day week. Once allowance is made for this, the recession is clearly revealed as a single dip occurring from mid-1974 to mid-1975. Nor did the 1980-81 recession actually develop into a double dip. After the economy hit its trough in the first quarter of 1981, the growth rate was extremely sluggish at first and there were quarters when some measures of GDP fell back a fraction. However, the basic path for activity during 1981 was fairly flat which is similar to that which occurred during the final three quarters of 1991. This was

followed in 1982 by a modest recovery in economic activity, despite a combination of sharply rising real interest rates and recession in the rest of the OECD. In some ways the experience of the economy in 1982 is highly reassuring, since it demonstrates that the recovery forces in the domestic economy can be powerful enough to offset both high real interest rates and a world recession.

Forces for Recovery

There are three fundamental forces which may operate to drive the UK economy towards recovery during 1992. These are: the easing in economic policy since the autumn of 1990; the downwards pressures which have emerged on the savings ratio since the middle of 1991; and the near-elimination of the corporate sector's massive financial deficit.

It is difficult to make clear-cut statements about the present stance of monetary policy compared with that at similar stages in previous cycles. There is no doubt that monetary policy has been eased substantially since October 1990. Since it usually takes 12 to 18 months for the effects of monetary policy changes to be fully reflected in economic activity, there is probably still a significant monetary boost stored up in the economic system. Real interest rates remain quite high for the current stage of the cycle, but real monetary growth (both M0 and M4) is rather more buoyant now than it was in the previous two cycles. The budgetary stance is unequivocally supporting the economy at present. While the sharp move into budget deficit mainly reflects the impact of the recession on the Government's accounts, the willingness of the Government to allow this to happen is in direct contrast to the equivalent stage in the 1981-82 recovery.

The second factor that may help the economy to recover is the possibility of a renewed willingness by the personal sector to run down savings to support consumer spending. This judgement may well prove to be crucial since, as we noted above, it was a failure to forecast the rise in the personal savings ratio from early 1988 to mid-1991 that led to a severe underestimation of the slump in final demand over this period. Recent Goldman Sachs research has shown that it is possible to explain the behaviour of the savings ratio quite satisfactorily in recent years with reference to the behaviour of the change in unemployment, real interest rates, inflation and personal sector net financial and housing wealth. Even on the plausible but pessimistic assumption of no increase in house prices over the next two years, this relationship would suggest that a combination of a moderation in the rise in unemployment along with lower interest rates and inflation would lead to a cyclical decline in the savings ratio of around 1% a year in both 1992 and 1993.

A third factor that may help the economy to recover is an easing in the pace of adjustment by the company sector to its financial deficit. Rather unusually for this stage of the cycle, the company sector is still running a financial deficit but this should be reduced further as profits recover, without the need for further savage cut-backs in company spending. Most of the sharp cut-backs in investment and employment may therefore now

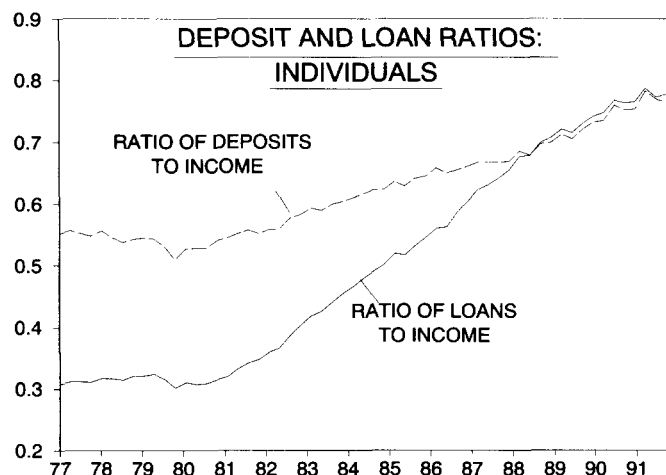
be complete. Stocks may continue to be run down for a time, but at a slower rate than last year. As in past recoveries, a turn-round in the stock cycle should provide a positive impact on economic activity during 1992.

The Broad Money Slow-Down

Consensus forecasts are therefore based on the assumption that the normal cyclical forces in the system are in the process of reasserting themselves and that this should become increasingly evident as the year progresses. As we mentioned above, though, there are a number of forecasters who argue that the economy faces the threat of a secular depression. This view is based on the belief that households have been caught out by high levels of debt and in response will want to repay borrowing, leading to a secular rise in the personal savings ratio. A further retrenchment by consumers would inevitably lead to a further cut-back in spending by companies, thereby prolonging and deepening the recession. They argue that this view is supported by the sluggish growth of broad money recorded in recent months. How, ask the broad monetarists, can the economy recover when people are so reluctant to borrow?

Prospects for the savings ratio in the longer term are considered in Section 5.5. But what about the monetarists' claims for the sluggish growth of broad money? Clearly, it would be foolish to ignore the fact that broad money growth is at a 20-year low point, even though monetary growth in real terms is comfortably above the rates recorded during the last two recessions. However, it is misleading to suggest that individuals have been using financial assets to pay off debt. What has happened since 1988 is that personal sector loans have grown in line with deposits. Both have risen slightly in relation to personal disposable income. The same behaviour was recorded during 1991. This suggests that the main reason for the slow-down in monetary holdings by individuals has been the drop in income growth itself.

Figure 2.4



Green Budget 1992

The slow-down in broad monetary growth has been compounded by a reduction in the demand for money by companies as they have curbed capital spending in order to improve their financial positions and as they have resorted much more to the capital markets rather than to the banking system to finance their activities. Once the behaviour of broad money is broken down by sector, the slow-down in the growth rate of M4 seems much less worrying. The main reason that broad monetary growth is at a 20-year low point appears to be the fact that nominal GDP growth is also at a 20-year low, with the main direction of causation going from income to money rather than the other way around.

Although there are a number of risks and a great deal of uncertainty, the balance of evidence seems to indicate that the economy is now embarking slowly on a recovery path which is likely to gather momentum as the year progresses. Within the components of demand, the consensus expects a positive contribution to GDP from consumer spending (although not nearly as great as the 2.5% growth forecast by HM Treasury in the Autumn Statement) and from an improvement in the stock cycle. Taking all these factors together, GDP is projected to rise by 1.5-2% this year. Unemployment is expected to remain on a rising trend throughout 1992 with most forecasts suggesting that the level will reach around $2\frac{3}{4}$ million by the end of the year before stabilising. Given the clear evidence of a moderation in wage pressures in recent months, it seems likely that the unemployment rate is now in excess of the rate consistent with stable inflation (that is, unemployment is above the so called 'non-accelerating inflation rate of unemployment' or NAIRU). There is as yet no clear consensus about economic prospects for 1993, though several forecasters project a further acceleration in the growth of GDP to around 2.5%.

Inflation

The headline rate of retail price inflation fell sharply last year to a low point of 3.7% in October. Inflation has now moved back to around 4.5% as the beneficial effects of lower mortgage rates have begun to wash out of the annual comparison. Core inflation is on an improving path but the pace of decline has been much slower. The greatest improvement has been seen in producer output price inflation. Excluding food, drink and tobacco, the annualised rate of increase in manufacturers' output prices has fallen to about 3% in recent months. The underlying rate of retail price inflation (excluding mortgage interest payments, poll tax, petrol and VAT) is still running at just over 6% compared with a peak of almost 8% in the final months of 1990.

Although the reduction in underlying retail price inflation is proving very slow, particularly given the depth of the recession, the pace of decline is not unusual. Evidence from the last five economic cycles in the UK suggests that retail price inflation reaches a trough approximately two years, on average, after the trough in real GDP growth. This suggests that a trough in inflation is unlikely much before the middle of 1993. The reason for this is suggested by Figure 2.5. The shaded areas in the graph show periods in which economic activity is below trend as measured by

Table 2.3. Other Key Indicators

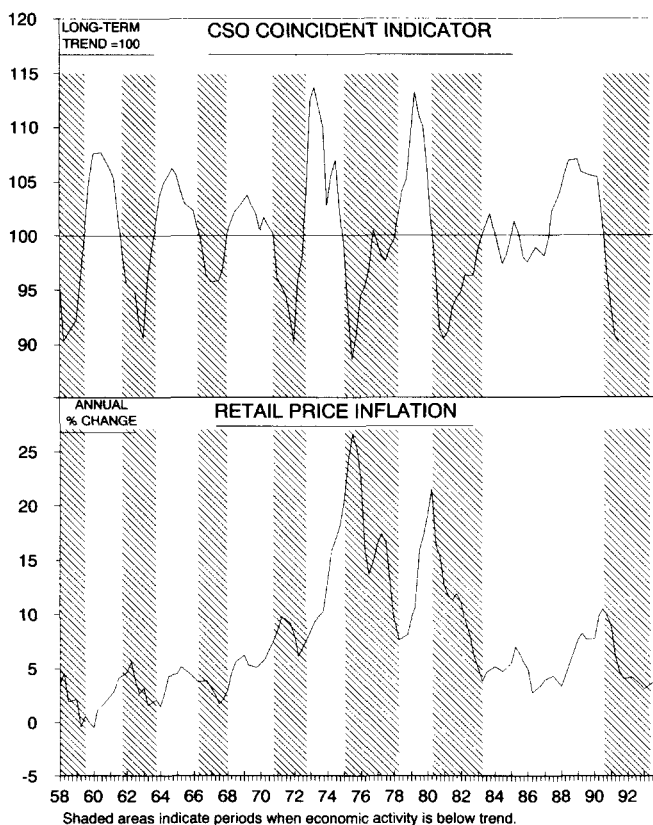
	1990Q4	1991Q4	1992Q4
Price inflation (%)			
HMT	10.0	4.0	4.0
LBS	10.0	3.6	3.3
NIESR	10.0	3.9	3.5
Goldman Sachs	10.0	4.2	3.5
Consensus	10.0	4.1	4.1
	1990Q4	1991Q4	1992Q4
Unemployment (m)			
LBS	1.8	2.5	2.7
NIESR	1.8	2.5	2.8
Goldman Sachs	1.8	2.5	2.7
Consensus	1.8	2.5	2.7
	1990	1991	1992
Current account (£bn)			
HMT	-14.5	-6.5	-9.5
LBS	-13.5	-6.2	-8.0
NIESR	-14.4	-6.3	-9.0
Goldman Sachs	-15.2	-5.9	-9.8
Consensus	-15.2	-6.4	-9.0

Sources: As Table 2.2.

the CSO's coincident economic indicator. (The coincident indicator is a composite index made up of variables whose turning-points occur at the same time as economic activity. The values of the index have no intrinsic meaning other than that readings above 100 indicate that the economy is above its long-term trend while readings below 100 indicate that it is below the long-term trend.) It is clear from Figure 2.5 that UK inflation generally remains on a downwards path for as long as economic activity is below trend. This should be the case until well into 1993. Thus a continued easing in underlying inflation is quite likely over the next 18 months.

A further feature of the inflation process in the UK is that inflation tends to exhibit a high degree of inertia. That is, once inflation has settled down at a new level it tends to stay there, at least until it is 'shocked' again by a new inflationary impulse from, say, the labour market or commodity prices. The inertia arises because once inflation has been shocked, this tends to get built into wage and price expectations, thereby reinforcing the new rate of inflation. Over the past 12-18 months, the recession has produced a sizeable negative inflationary shock, working principally via the labour market in the form of lower pay settlements. Given the inertia in the system, the prospects for a sustained reduction in inflation therefore seem quite good. However, with underlying inflation still running at around 6%, it is difficult to know whether the recession has been

Figure 2.5



sufficiently deep to force the inflation rate down to ERM levels more than temporarily. We are unlikely to know this for certain until later next year once the new equilibrium inflation rate has been reached. On past evidence, though, the recession seems likely to have been severe enough to bring underlying inflation into a 3-4% range which would be tolerably close to inflation among our major European competitors.

External Trade

Non-oil import volume reached a trough in early 1991 after falling steadily during the second half of 1990, and the trend has been gently upwards since then. Non-oil export volume held up well during the recession but there has been a definite flattening in recent months, perhaps reflecting the slow-down in German economic activity and the renewed weakness in the US. As a result, the improvement in the visible trade deficit seems to have come to an end with the current account deficit running at an annual rate of £5-6bn. Export volume should maintain an improving trend over the next two years as Britain now seems capable of maintaining its share in world markets. Even so, consensus forecasts suggest a rise of only 4% in export volume this year and even this may be vulnerable to any further disappointment in world economic growth. There is a risk that import

The Economic Forecast

volume will rise rapidly during the early stages of the recovery as it has done on previous occasions, although in the past this has tended to reflect a rebuilding in the level of stocks which may be absent this time around. Consensus forecasts are for a 5% rise in import volume this year as domestic demand picks up steam. Most forecasters therefore expect a small deterioration in net trade volumes, leading to a slight worsening in the trade and current deficits. The Treasury's forecast of a current account deficit of £9.5bn this year, compared with an estimated deficit of £6.5bn in 1991, is in line with the consensus expectation.

3 1992 Budget Strategy

3.1 The Debate on Fiscal Fine-Tuning

During the 1960s and early 1970s, the whole of economic policy was dominated by the so-called 'budget judgement', which was the name given to the decision whether to use the annual Budget measures to increase or decrease aggregate demand. Several factors contributed to the willingness of governments at that time to use an active fiscal policy in this way to manage the development of aggregate demand. First, sterling was part of a fixed exchange rate system which left little room for interest rates to be changed in response to variations in economic activity. Second, the prevailing wisdom in economic theory was supportive of the view that fiscal policy could affect demand (especially under fixed exchange rates, which limited the scope for fiscal changes to 'crowd out' investment and net exports by interest rate and exchange rate shifts). Third, there was a growing belief in the ability of economists to forecast short-term activity accurately, using the computer models which were then being developed. This implied that fiscal policy could not only affect demand, but also succeed in dampening the amplitude of the cycle.

By the early 1980s, this prevailing wisdom had been completely jettisoned, and the Thatcher Government argued strongly that fiscal policy should have no role whatever in demand management. The Keynesian orthodoxy of the 1960s had been overthrown at every turn. It was now believed that fiscal policy changes would largely be 'crowded out' by the effect they would have on interest rates, an idea which was made more plausible by the switch to a floating exchange rate during the 1970s. Furthermore, there was increasing scepticism about the ability of macroeconomists to forecast economic developments accurately, with the consequence that fiscal policy was thought likely to exacerbate rather than dampen the economic cycle. In some quarters, there was even a belief in the 'super rationality' of the private sector. This implied that private saving would rise if the Government attempted to stimulate demand by raising the PSBR, since private agents would anticipate a long-term need to pay higher taxes to service or repay the public debt. If this were the case, fiscal changes would be ineffective in managing demand, even if they were not actively destabilising for the economy.

Influenced by these arguments, the incoming Thatcher Government initially decided that it should set a target path for the PSBR over the medium term, and then stick to this path largely regardless of other developments in the economy. The PSBR target was officially stated to be subordinate to the target for monetary growth, which was the real corner-stone of the first versions of the Medium-Term Financial Strategy in the early 1980s. It was believed that adherence to the monetary target

was both necessary and sufficient for the control of inflation, but that the PSBR target was crucial in enabling the monetary target to be hit without imposing unacceptable strains on interest rates.

Almost immediately, however, it became obvious that the Government would not choose to suppress entirely the impact of variations in economic activity on the budget balance. As early as 1981, the Financial Secretary to the Treasury, Nigel Lawson, suggested that the PSBR might trace out the path of a step function, declining in years of economic upswing, and remaining fixed during downswings. By the mid-1980s, Chancellor Lawson was showing increasing interest in exchange rate targets, with a consequent downgrading in the role played by monetary targets, and correspondingly less concern about following a fixed path for the PSBR over the medium term. The boom of the mid-1980s, primarily caused by a surge in private borrowing, had a much larger effect on public borrowing than the Treasury expected, and any form of medium-term planning for the PSBR became increasingly difficult. By the late 1980s, the government finances were in large surplus, and the medium-term PSBR / PSDR targets were changing markedly from one Budget to the next (though always in the context of an eventual return to budget balance).

By this time, it was clear that the automatic stabilisers built into the fiscal system were being allowed to work in full, with any net tax / expenditure changes in the Budgets themselves having only a trivial effect on the path for the PSBR compared with the very large impact of variations in economic activity. However, while this became clear from simply observing the way the Treasury was behaving, it was not made specific by the Treasury until Mr Lamont hinted late in 1990 that the fiscal stabilisers would be allowed to work in full during the forthcoming downswing in economic activity. The subsequent deterioration in the Government's finances in 1991-92 has been almost exactly what would have been expected from the normal relationships between the economic cycle and government borrowing; in other words, the Government has so far allowed the automatic effects of economic activity on the PSBR to come through in full, but has not so far chosen to go further and deliver an exogenous fiscal boost to the system on top of this.

There have been recent hints, however, that even this may now be back on the agenda as a possibility. The temporary stamp duty relief for housing transactions announced in December 1991 looked very much like an act of fiscal fine-tuning. Furthermore, the Economic Secretary to the Treasury, John Maples, seemed to suggest on the BBC's 'Money Programme' on 5 January 1992 that active tax changes made in the annual Budget itself would not necessarily be classified as 'fine-tuning'. Finally, the provisional PSBR assumption which the Treasury has announced for 1992-93 (3% of GDP) would appear to represent some exogenous fiscal easing, coming mainly on the expenditure side. Based on the Autumn Statement forecasts for GDP and the PSBR, the PSBR will increase in 1992-93 by about 1% of GDP more than can be explained simply by the automatic impact of the decline in activity. This is one very rough measure of the extent of the exogenous fiscal easing now in the system.

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In last year's Green Budget, we discussed in considerable detail the case for a more active fiscal policy now that the UK is inside the ERM. This case has now become fairly familiar, so it is not necessary to repeat all of the arguments in full detail this year. However, the main planks of the argument in favour of greater fiscal activism are as follows:

- (i) The acceptance of an exchange rate target necessarily limits the extent to which interest rate changes can be made in response to variations in domestic demand. Even though sterling remains within a wide ERM band, which allows for some flexibility for domestic monetary policy, there can be occasions when this flexibility is heavily circumscribed (as at present). Unless the Government is willing to respond to such situations by varying the fiscal stance, it will be entirely powerless to influence the development of demand in the system. This would be a much tighter policy strait-jacket than was ever accepted by the Thatcher Government, which always accepted the need to 'fine-tune' demand by making frequent changes in interest rate policy.
- (ii) Reliance solely on the 'automatic stabilisers' is not necessarily optimal. Although this clearly results in greater cyclical stabilisation than would be provided by a fixed nominal target for the PSBR, the degree of stabilisation is at present an entirely arbitrary by-product of the structure of the tax and spending system, which would not be the case with an optimally designed tax system. Admittedly, relying solely on the automatic stabilisers has the advantage that tax rates remain stable through the economic cycle, thus allowing the private sector to plan its activities in a stable fiscal environment. But it has the disadvantage that output may be less stable than would otherwise be the case. Uncertainty about output prospects may be much more damaging to private sector planning than occasional changes in tax rates.
- (iii) The tendency for interest rates to continue converging in the ERM in the last few years has increased the likelihood that fiscal policy changes within any individual country will have powerful effects on demand in that country, since the potential for 'crowding out' through interest rate changes is now rather slight.
- (iv) In a regime of increasingly fixed exchange rates, there is a risk that real interest rates will move perversely for the purposes of cyclical stabilisation. In a cyclical upswing, domestic inflation pressures are likely to rise, but the existence of fixed exchange rates prevents nominal interest rates from responding to increased inflation. Therefore real interest rates tend to fall in economic upswings and rise in economic downswings. The more credible is the commitment to fixed exchange rates, the less scope there is for nominal interest rates to move, and the more serious this problem could become. The only instrument left for dealing with this problem is budgetary policy. (Of course, the problem only arises if

the economic cycles in the various European countries are out of synchronisation, but recent experience makes it obvious that this can easily happen.)

It remains to be seen whether the Treasury is now ready to acknowledge the force of these arguments. Last year, both officials and the Chancellor generally refused to admit that ERM membership had any implications for the setting of fiscal policy, and they may wish to maintain this posture at least until the election. However, it is a posture which may now even be beginning to undermine the stability of the ERM commitment itself. There is only so much strain that any political process will take without demanding sudden and unpredictable lurches in policy. If economic policy is seen to be totally powerless (or, still worse, perverse) in the face of a continuing recession in demand, the pressure to leave the ERM or to devalue the currency could become politically impossible to resist. A more responsive fiscal policy - undertaken in the context of a clear medium-term plan to maintain fiscal sustainability (as defined, for example, in the Maastricht Treaty) - could reduce the risk that political discontent with the ERM will rise to breaking point. This is a point which applies not only to the UK, but also to France and other ERM members.

3.2 The Public Finances and the 1992 Budget

The PSBR in 1991-92

The PSBR for the current year had already reached £18bn (excluding privatisation proceeds) by December, a substantial deterioration on last year's position. Simple extrapolation of the monthly figures, based on past experience of the seasonal pattern of the public finances, suggests that the PSBR will top £12bn this year (see Appendix Table A.1). Without exception, revenues have been coming in more slowly than anticipated. Our judgement is that the Chancellor will announce further slippage from the Autumn Statement forecast of a £10.5bn PSBR, and we predict a PSBR for the current year of £11.8bn. This would be a disappointing out-turn, given the £8bn projection in the last Budget.

What accounts for this overshoot? The Autumn Statement last November revised central government spending up by £5bn and local authorities' expenditure up by £1.8bn (Table A.1), though the Chancellor was able to maintain the planning total originally envisaged. The majority of the increase was met from the reserve and higher-than-expected privatisation proceeds, leaving just £1.3bn of additional general government expenditure. Most of the increase in the PSBR is a result of deficiency in receipts. Spending taxes have been depressed so far this year, but we expect Customs and Excise receipts to reach the FSBR level; it is Inland Revenue receipts, notably the income and corporation taxes, which look set to fall £2.5bn below target.

The PSBR in 1992-93

Our "unchanged policy" projections for the coming fiscal year, starting from the lower base in our 1991-92 forecast, suggest that the PSBR will continue to rise to a level around the 3% of GDP envisaged in the Autumn Statement last year. Note that the £19.5bn estimate in Table 3.1 assumes, perhaps optimistically, that the latest public spending targets will be hit. Compared with the prediction in the last FSBR, we expect a little over £3bn less in receipts and over £4bn extra spending, giving a PSBR some £7.5bn larger.

As in the current fiscal year, the figures in Table 3.2 understate the extent of additional spending, as an extra £2.5bn of privatisation proceeds are expected compared with previous plans.

On the revenue side, the income tax forecast assumes indexation of allowances and thresholds. The £1bn cost of this uprating is offset to an extent by extra money raised from the abolition of higher rate mortgage interest relief, increases in the tax burden on company cars and freezing the married couple's allowance, all announced in the 1991 Budget. Corporation tax will continue to slide, reflecting lower profitability over the last year and the full effect of the rate reduction and extended carry-back of losses. Indirect taxes will benefit from the forecast increase

in consumer spending and the full-year effect of last year's VAT increase. We again assume the Chancellor will take account of inflation over the past year and revalorise specific duties.

Table 3.1. The Public Finances 1991-92 and 1992-93 on Unchanged Policy

£bn	1991-92	1992-93
Income tax	58.3	62.1
Corporation tax	18.3	17.1
Petroleum revenue tax	0.0	0.0
Capital gains tax	1.4	1.5
Inheritance tax	1.2	1.2
Stamp duties	2.2	2.6
Total Inland Revenue	81.4	84.5
VAT	36.0	39.8
Petrol	10.9	11.6
Tobacco	6.1	6.4
Alcohol	5.1	5.4
Betting and gaming	1.1	1.1
Car tax	1.3	1.4
Customs duties	1.7	1.7
Agricultural levies	0.2	0.2
Total Customs and Excise	62.4	67.6
Vehicle excise duties	2.9	3.0
Oil royalties	0.5	0.5
Rates	14.4	14.8
Other taxes and royalties	3.8	3.9
Total taxes and royalties	165.4	174.3
National Insurance contributions	36.7	39.4
Community Charge	7.6	8.5
Interest and dividends	5.7	5.9
Other receipts	8.7	8.7
General government receipts	224.1	236.8
Central government own expenditure	157.0	168.6
Central government support for local authorities	53.2	58.6
Public corporations	2.7	3.5
Privatisation	-8.0	-8.0
Reserve	0.0	4.0
Planning total	204.9	226.6
Local authority self-financed	10.2	8.5
Central government debt interest	16.7	16.5
Accounting adjustments	4.3	4.5
General government expenditure	236.1	256.3
General government borrowing requirement	12.0	19.5
Public corporations borrowing requirement	-0.2	0.0
Public sector borrowing requirement	11.8	19.5

Green Budget 1992

Table 3.2. The Government's Finances

£bn	1991-92			1992-93		
	FSBR 1991	Autumn Statement	Green Budget	FSBR 1991	Autumn Statement	Green Budget
General government receipts	226.5	225.4	224.1	240		237
General government expenditure	234.8	236.1	236.1	252	256	256
General government borrowing requirement	8.3	10.7	12.0	12		19.5
Public corporations borrowing requirement	-0.4	-0.2	-0.2	0		0
PSBR	7.9	10.5	11.8	12		19.5
Money GDP	580	588		624	631	
PSBR (% of GDP)	1.25	1.75	2.0	2.0		3.0

What would happen to the public finances if consumer spending were less buoyant, corporate profits continued their decline, or employment declined more rapidly? The prospects for the economy in the coming year are more than usually uncertain. A recovery more or less rapid than anticipated would also alter the prospects for the PSBR. The sensitivity of tax accruals to the main economic working assumptions is shown in Table 3.3, which gives our baseline assumptions and the revenue effect of a different rate of growth. One of the most volatile taxes, and also difficult to forecast, is corporation tax; we estimate that a 10% increase in corporate profits would boost revenues by some £2bn. A 1% growth in wages increases revenue by more than a 1% growth in employment, because marginal tax rates are higher than average tax rates. Conversely, a 1% growth in consumer prices increases revenue by less than a 1% increase in consumers' expenditure, because marginal rates of indirect tax are lower than average rates, as a result of the preponderance of specific excise duties.

Table 3.3. Sensitivity Analysis: The Revenue Effect of 1% Change in Economic Working Assumptions

	Assumption (% growth)	Revenue change (£bn)
Wages	6.5	1.3
Employment	-1.2	0.8
Consumer prices	4.4	0.3
Consumers' expenditure	1.7	0.5
Corporate profits (previous year)	0.0	0.2

3.3 Demand Management and the 1992 Budget

If the Chancellor decides to stick with the view that fiscal policy should not become more activist, then the scope for fiscal changes will be relatively small. As noted above, the 1991 Autumn Statement forecast that the PSBR in 1992-93 would be around 3% of GDP, which is equivalent to about £19bn. Given an estimate for the PSBR of £19.5bn on unchanged policies, if the Chancellor wishes to maintain the pretence of a non-activist fiscal stance, then he will presumably ensure that the tax changes in the Budget are approximately offsetting in revenue terms, at least in the first year of their application. If, on the other hand, the Chancellor decides to go further (introducing a Budget which reduces net revenue from taxation in the coming year), this will represent a further clear step towards greater fiscal activism.

In deciding whether or not a fiscal boost is desirable this year, the Chancellor will need to ask (a) does the overall macroeconomic policy stance need to be eased, given the likely development of the economy in the year or two ahead, and (b) could such an easing be achieved through monetary policy within the ERM? If the answer to question (a) is 'yes', while the answer to question (b) is 'no', then the case for a fiscal easing would appear to be quite strong.

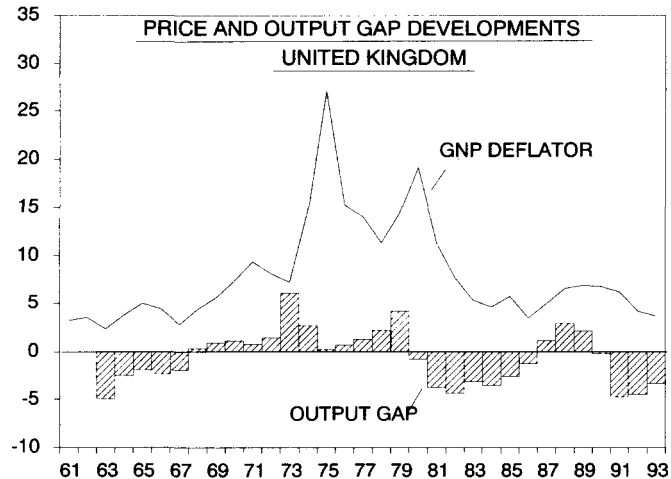
On the first question, there would appear to be a clear prima-facie case for an easing in overall demand policy (i.e. the combination of fiscal and monetary policy taken together) this year. Economic activity has been in a broadly flat phase since the spring of 1991, and virtually no mainstream economic forecast shows growth in real GDP above the long-term trend rate of 2-2.5% in 1992. Inflation pressures on an underlying basis appear to be easing substantially, and although the current account of the balance of payments remains in modest deficit, this is not at present causing any severe financing difficulties.

The Overall Policy Stance

The OECD estimates that the level of GDP in the UK this year will be around 4.5% below trend and, even in 1993, GDP is thought likely to be 3.3% below trend. This holds out the prospect of a fairly long period of disinflation in the quarters immediately ahead. This is also suggested by the present level of unemployment, which is probably above the NAIRU (i.e. the non-accelerating inflation rate of unemployment). The latest estimate of the NAIRU published by Professor Nickell of Oxford University is that it stood at around 8.7% of the labour force on average from 1988-90. This, however, is based on the OECD standardised definition of the unemployment rate, which is around 1% higher than the national definition used in the UK. Allowing for this, Nickell's calculation suggests that the NAIRU on domestic definitions of unemployment is around 7.7% of the labour force. Meanwhile the actual unemployment rate had risen to 9% at the end of 1991. Furthermore, all forecasts for 1992 agree that the unemployment rate will continue to rise for most of the year,

thus ensuring that the NAIRU will be exceeded by a comfortable margin during the year as a whole. Even though estimates of the NAIRU are subject to considerable uncertainty, the present degree of slack in the economy would appear to guarantee that a further downward adjustment in pay settlements will take place over the balance of the year, with core inflation dropping correspondingly.

Figure 3.1



Even this, however, does not conclusively make the case for an easing in macroeconomic policy. The Government could legitimately take the view that the pace at which inflation is falling is appropriate, and that the present build-up of short-term output losses is worthwhile in order to achieve long-term inflation gains. (In order to achieve a given degree of disinflation, it will probably be necessary to suffer a fixed amount of output loss, and it is to some extent irrelevant whether this output loss is suffered quickly or slowly.)

At present, the main objective for the UK must presumably be to reduce its core rate of inflation at least to the level enjoyed by the average of all ERM countries, and possibly to the level enjoyed by the best-performing ERM members. Currently, the ERM inflation rate (excluding the UK) is 4.8%, while the average for the lowest three countries is 2.3%. (In order to qualify for monetary union, the UK rate would need to be no higher than 1.5% above the average for the best three performers, which at present implies a rate of 3.8%.) It is not yet clear whether the degree of disinflation which is now in the system is sufficient to achieve these inflation targets without further output losses. However, with output set to remain below potential for at least two more years, it would seem probable that the economy is currently embarked on a course which will enable these objectives eventually to be achieved, or at least closely approached. Furthermore, the downside risks for activity relative to the consensus forecasts discussed above currently appear to be rather larger than the upside risks. Overall, then, it would seem reasonable to conclude that the

'output gap' below potential may be larger than required to meet the Government's objectives over the next couple of years, in which case there is a case for some easing in overall macroeconomic policy.

Interest Rates in the ERM

The next step of the argument is to consider whether this easing in macro policy is at all likely to come about via a reduction in interest rates. If sterling were not a member of the ERM, the Government would almost certainly have reduced base rates by now to below 10.5%, so the operation of the ERM is clearly constraining domestic interest rate policy. This was not the case in the first 12 months after sterling joined the system in October 1990. During that period, UK base rates fell by 4.5%, despite the fact that three-month interest rates in Germany rose over the same period by 0.7%. This narrowing of 5.2% in the interest rate differential between UK and German assets probably occurred more rapidly inside the system than it would have done outside. However, as we have seen, the reverse has probably applied in the last few months.

The scope for interest rates to vary among ERM countries depends on many factors. For most of the past ten years, nominal interest rate differentials within the ERM have been fairly closely related to inflation differentials. Why has this happened? According to foreign exchange theory, the interest differential between any two countries will be equal to the expected change in the exchange rate, plus or minus a risk premium. This risk premium will be affected by the risk of default on the financial instruments concerned, and the volatility of returns on these instruments. Inside the ERM, there has been a tendency for exchange rate changes at realignments to reflect the changes in relative prices which have occurred between countries since the previous realignment. Over time, the markets have built this experience into their expectations, so the expected exchange rate change in the system has been closely connected to the inflation gap between countries at any given point in time. This, in turn, means that the interest rate gap has closely reflected the inflation gap.

However, this relationship can only exist for as long as the markets continue to expect exchange rate realignments to take place in future. If, instead, the markets start to expect that there will be no further realignments prior to monetary union, then the expected exchange rate change will be zero, and nominal interest rates will converge completely (except for a small risk premium). There have been some signs that these factors have been at work at the long-end of the bond markets in recent months, where the successful outcome to the Maastricht Summit seems to have given a further kick in the direction of bond yield convergence. If this process continues, it will mean that there is less and less scope for long-term interest rates in the UK to respond to domestic economic conditions.

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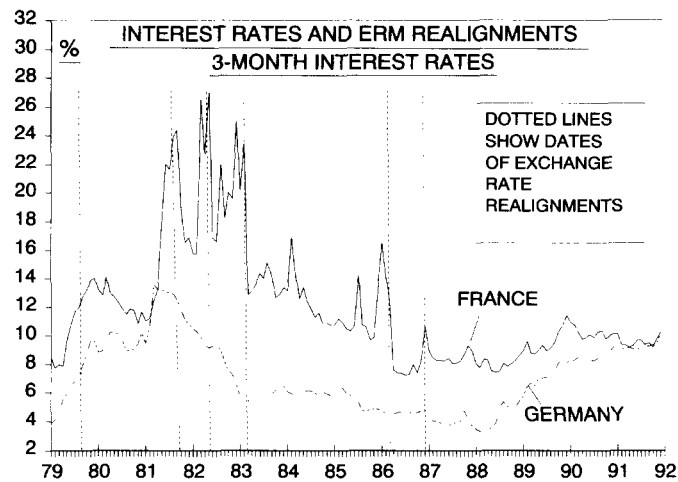
At the shorter-end of the yield curve, there should in theory be more scope for nominal interest rates to continue to diverge in the ERM for some time ahead. This is because the band width within which currencies are allowed to fluctuate in the ERM (4.5% for most currencies and 12% for sterling and the peseta) means that the expected exchange rate change over short periods can be a long way from zero. In theory, this should allow considerable flexibility for short-term interest rates to differ from each other, including the possibility that short rates in countries like France and the UK might move below their equivalents in Germany. However, in practice, this does not seem to have happened; even in France, where inflation has been below the German level for some time, the recent attempt to push short-term interest rates below the German level proved to be a failure. For all practical purposes, it still appears to be the case that the bench-mark currency (the Deutschmark) sets the floor for short-term nominal interest rates in the system. This is unfortunate, since it means that the high nominal interest rates in Germany are likely to prevent significant further falls from taking place in short-term interest rates in France or the UK, at least in the early part of this year.

This situation might be ameliorated later in the year, provided that German pay settlements fall markedly from the 6.5-7% range which was seen last year. If last year's high levels of pay settlements were to be replicated in 1992 in Germany, it is most unlikely that the Bundesbank would allow any reduction in short-term interest rates to take place, which would in turn mean that any significant easing in monetary policy in the rest of Europe would look problematic. If, on the other hand, pay settlements in Germany fall to 6% or less this year (which looks on balance more probable), then the Bundesbank is likely to allow some easing in German monetary policy, and this is likely to carry through to other European countries. Even then, however, any further decline in UK interest rates may be painfully slow.

Naturally, this raises the question of whether sterling should be devalued within the exchange rate mechanism. It is far from clear whether a relatively small devaluation (as opposed to the more radical step of leaving the ERM altogether) would in fact succeed in getting UK interest rates down faster than the present parities will allow. Figure 3.2 shows how French interest rates have moved in the years since the ERM started in 1979. In the first four years, there were frequent devaluations of the franc, so the markets persistently required a risk premium for holding francs, and the interest rate gap between France and Germany on average widened considerably. Only when devaluations became less frequent from 1983 onwards did the interest rate in France begin to drop towards the German level, and only when devaluation ceased altogether did French rates entirely eliminate the gap.

Within this broad picture, the graph shows that there were frequent short-term 'blips' in French interest rates just before each realignment, and these were eliminated immediately following the parity change. Hence, realignments have generally been followed by lower interest rates in countries like France, but only from the very high emergency levels which tended to precede the parity adjustment. Today, we have no emergency

Figure 3.2



levels for interest rates either in France or the UK, so there is nothing to be eliminated by a realignment. A small devaluation for sterling would raise questions about when the next devaluation would occur, and the markets might react by asking for higher, not lower, interest rates on sterling assets to compensate them for the extra risk.

Of course, if the UK were to devalue by a very large amount (say 20%, in the unlikely event that such a large change would be permitted by other ERM countries), then the prospects for interest rates might be different - as they would be if the UK left the ERM altogether. But either of these drastic policy changes would raise serious medium-term problems which are discussed in Section 5.4. In the absence of such a volte-face on the main plank of the Government's economic policy, it seems prudent to plan on the assumption that further reductions in UK interest rates this year will at best be slow.

3.4 The 1992 Budget

This, finally, leads us to the 1992 Budget judgement itself. The arguments above have suggested that the UK economy is operating well below capacity, and is likely to continue doing so for some time. This should ensure that the reduction in inflation which is now underway continues, probably taking core inflation well below the ERM average by the end of the year. Furthermore, the balance of risks on activity seems to be stacked on the downside. This indicates that the overall macroeconomic policy stance should probably be eased, but our analysis of the interest rate outlook inside the ERM suggests that it may not be possible to ease the monetary stance to any significant extent this year. Therefore, there is a case for a net tax reduction in the Budget, even though the PSBR is already rising rapidly.

If this were to be done, however, it would need to be accompanied by a convincing medium-term plan to ensure that the UK's public debt position remains acceptable within a European context, which would require the conditions of the Maastricht Treaty to be observed. What this would involve is discussed in Section 5.6. It is also clear that any attempt to stimulate the economy using fiscal policy would run counter to the economic philosophy espoused by the Conservatives in the last 13 years. We therefore think it unlikely that there will be a large boost announced at Budget time, but that the Chancellor could introduce a package of tax changes with a net cost of between £1bn and £2bn in 1992-93. The precise make-up of any changes will be decided only a few days before the Budget, with political factors the main consideration. There is a strong case for concentrating any net fiscal stimulus on the business rather than personal sector, either through tax changes aimed at business; or through government spending measures. Our task in attempting to forecast the detailed content of the Budget is more difficult than ever this year, but many options are open to the Chancellor and it is to these that we now turn.

4 Analysis of Tax Options for 1992

4.1 Income Tax

1992 will see the fourteenth consecutive Conservative Budget, but seems unlikely to include any very large net cuts in taxation because of the state of the macroeconomy. If cuts are to be made in personal taxes, income tax seems very likely to be the chosen vehicle, since it is much the most visible tax, as well as having been the major tax most frequently and substantially cut since 1979, as illustrated in Table 4.1.

Table 4.1. Income Tax Changes Since 1978

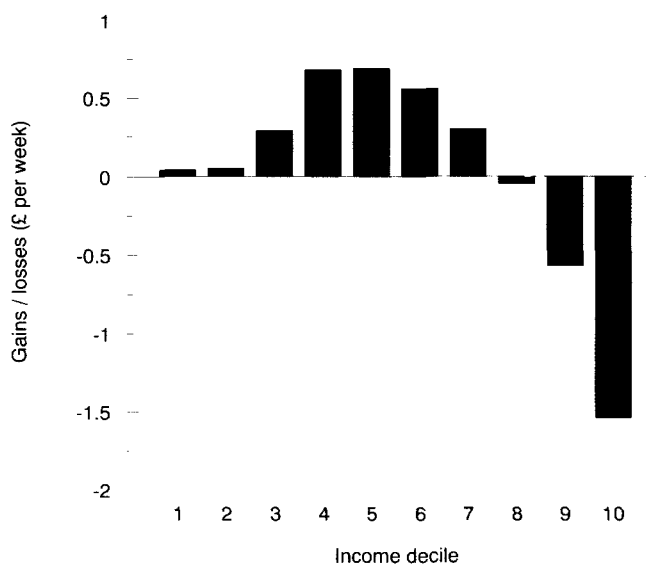
	Basic rate (%)	Top rate on earned income (%)	Real level of single allowance (1978-79=100)
1978-79	33	83	100
1979-80	30	60	102
1980-81	30	60	104
1981-82	30	60	93
1982-83	30	60	99
1983-84	30	60	108
1984-85	30	60	115
1985-86	30	60	119
1986-87	29	60	122
1987-88	27	60	122
1988-89	25	40	126
1989-90	25	40	126
1990-91	25	40	126
1991-92	25	40	126

The Government may decide that any reduction in income tax would either seem too much like bribing the electorate, or unsettle the markets, but if it does decide to cut tax, two main options are open: cutting the rate or increasing allowances.

The political attractions of cutting the basic rate are clear. The basic rate of income tax is a relatively well-known number, easy to remember, whereas the precise level of the personal allowances is readily forgotten. The Government has already announced a desire to reduce the basic rate to 20%, and making some progress would emphasise its intent. Perhaps most important of all, the Labour Party is committed to reversing any reduction in the basic rate of income tax, and would have to promise to increase tax for all income taxpayers if they were to be elected following a reduction in the rate. There are corresponding political dangers, in particular the risk of appearing to panic and attempt to buy votes. And if opinion polls are to be believed, there is evidence that a majority of voters are prepared to pay additional income tax in return for higher levels of public spending.

The main argument for increasing allowances rather than cutting the basic rate, if income tax is to be reduced at all, is that such a change is far more progressive, as shown in Figure 4.1.

Figure 4.1
Effect of Moving from Lower Basic Rate to Higher Allowances



The figure shows the effect of a cost-neutral move from a tax system with the present levels of allowances, but with a 24% basic rate, to one with a 25% basic rate but with allowances increased by 7.5%. Such a change would result in gains, on average, for each of the bottom seven deciles and net losses for the richest three deciles. This indicates the comparative progressivity of higher allowances as opposed to a lower basic rate.

In addition to being progressive, raising allowances has the attraction that it removes people from the tax system altogether. An increase of 9%, double the rate of inflation, would reduce the numbers paying income tax by 1.1 million, of which about half would stop paying tax as a result of the 4.5% real increase in allowances.

A purely political attraction to this route is that Labour would find it hard to reverse such a change, but if they did not, would presumably find their scope for increasing public spending correspondingly reduced.

The main problem with raising allowances is cost, with even a 4.5% real increase costing £1bn in the first year. Any increase much larger than this might need to be funded by offsetting increases in some other parts of the tax system.

An alternative form of income tax cut also deserves mention, albeit purely negative. One of the most common fallacies about taxation is that introducing a reduced rate band (RRB) such as existed in the UK between 1978 and 1980 is a good way of helping the poor. It cannot be written too frequently that if the objective is to reduce the tax bills of the least well-off, raising allowances is always more effective: it is better to be taken out of tax altogether than to face a reduction in the amount of tax paid.

Raising some Money

If Mr Lamont does choose to cut income tax in some way, he may need to raise funds elsewhere to pay for some of any cuts. Obvious targets would be the married couple's allowance (MCA), which was frozen last year, the higher rate threshold, which was frozen the year before, and perhaps even higher rate deductibility of the main personal tax allowances. Freezing the MCA in nominal terms would raise £150m, freezing the higher rate threshold £170m. These two changes have the attraction that they would not impose cash losses.

Restricting the value of personal allowances to the basic rate would raise perhaps £1bn, but could impose cash losses of almost £15 p.w. on a married man, and affect almost 2 million taxpayers. It would none the less be consistent with the abolition of higher rate relief on mortgage interest in last year's Budget, and the cash losses could be offset by an increase in the higher rate tax threshold while retaining real losses and thus some revenue gain.

One area where we seem unlikely to see further revenue-raising this year is the taxation of company cars. Many years of real increases in the scale charges have brought them to a level now quite realistic, and the state of the car industry after last year's increases, combined with the employers' National Insurance contributions reform, makes further real increases in the scale charges seem unlikely in the 1992 Budget.

Housing

One possible area for headline-grabbing tax change is the housing market. The depressed state of this market is both politically and economically damaging, so the Government must be tempted to attempt some stimulus. The main problem facing it is that the obvious time to make such changes was last year, when stamp duty was abolished for a time and the mortgage rescue scheme set up. To take further action now might seem indecisive, although other political considerations might outweigh such arguments.

One obvious candidate for boosting house prices is an increase in the mortgage interest relief (MIR) ceiling. This has stood at £30,000 since 1983, since when general price inflation has exceeded 50% and house prices have doubled. Such a change now seems unlikely and unwelcome, for a number of reasons. First, any increase in the MIR ceiling would only directly help those with mortgages in excess of £30,000. Second, any such change would be expensive: an increase to £35,000 would cost around

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£300m, to £40,000, around £550m. Third, lower interest rates seem a more sensible way of helping home-owners, and raising the MIR ceiling might even delay further rate cuts. Finally, the steady withering of this distortion as house prices have risen has been one of the most substantial achievements of this Government in tax reform, albeit a passive one. To throw this away now would be foolish, and would hint at desperation. More targeted measures, such as extra subsidies for first-time buyers, have superficial attraction, but would create new distortions, and be very hard to administer.

Childcare

The 1990 Budget announced that subsidised workplace nurseries would no longer be treated as a benefit in kind for income tax purposes. This seemed ill-considered. Very few workplace nurseries existed, and it is unlikely that such provision is the best or cheapest method of using public funds to make it easier for the parents of young children to work. A wide range of alternatives exist, from increasing spending on state nursery provision to childcare vouchers. If Mr Lamont hopes to be remembered as a tax reformer rather than a tax tinkerer, further *ad hoc* changes should be avoided, and much more thought given to the problem and its possible solution.

Child Benefit

There has recently been some speculation that the Budget might contain some increases in public spending. One obvious candidate would be child benefit. An increase could be paid for from the contingency reserve, and might seem politically attractive.

Savings

The suggestion that the tax system could or should be used to encourage savings was never very sensible, although it was politically powerful. New schemes for tax-privileged savings tend simply to shift savings around from one form to another, rather than actually increasing their aggregate level. Now that one of the main macroeconomic problems is the high level of personal savings, we hear fewer calls for new tax incentives to save. But the problems affecting the tax treatment of saving have not disappeared. It is still true that the choice of the form in which to save is distorted by the tax system. Most saving goes into assets that are highly tax-privileged, with owner-occupied housing and private pensions being the most obvious examples.

Recent years have seen the introduction of schemes such as PEPs and TESSAs which allow tax-free returns on equities and interest-bearing accounts respectively. These schemes should not be seen as conferring privilege, but as giving more nearly equal status with assets such as housing and pensions. In an ideal world, the tax system would treat all forms of saving in the same way. Given that the bulk of assets are already excused tax on the income they generate, further extension of this regime seems the right way forward to a more neutral system.

Analysis of Tax Options for 1992

Very large changes seem unlikely in the run-up to the election, but we may see some further extension of PEPs or TESSAs. The most likely changes to TESSAs would be increases in the maximum amount that can be contributed, a reduction in the minimum holding period, or some change which allowed continuing tax relief at the end of the five-year life of a TESSA. Such a package could help many relatively poor interest recipients, and have some political advantage to the Government, with a fairly low revenue cost.

4.2 National Insurance Contributions

National Insurance contributions (NICs) are no longer the forgotten tax. The Conservative Government has made three large strides towards a better NIC system. In 1985 the NIC ceiling was removed for employers' contributions, and the structure for both employees' and employers' contributions made more progressive at low earnings. In 1989, the structure of employees' NICs at low earnings was improved still further with the effective transformation of the lower earnings limit (LEL) into an allowance. Finally, in last year's Budget, employers' NICs were imposed on benefits in kind in the form of company cars.

Despite these improvements, much still remains to be done. The continued existence of the NIC ceiling on employees' contributions is anomalous and inequitable. The continued existence of steps in employers' NICs at low earnings is anomalous and distorts the labour market. The NIC treatment of the self-employed is in dire need of reform. And although the inclusion of company cars within the employers' NIC base is desirable, the sensible long-term solution is the full alignment of the income tax and NIC bases for both employee and employer contributions.

Major changes in this area seem unlikely in the 1992 Budget. The Government is unlikely to want to reduce the number of voters who would be hit by Labour's promise to abolish the NIC ceiling for employees, so is unlikely to raise the ceiling. The cost of any sensible change to the structure of employers' NICs is too high to make it possible within the likely PSBR constraints. Reform of self-employed NICs will probably await the reform of Schedule D income tax. Further change on benefits in kind should probably await clarification of the current confusion.

The problems with NICs are now much more widely recognised, and we can expect further reform in the next Parliament, but significant changes in the March Budget seem unlikely.

4.3 Taxation of Companies

In last year's Budget, the Chancellor announced several measures to help Britain's business sector. These mainly involved relatively modest adjustments to the corporation tax system. Most notable was the cut in the corporation tax rate which fell from 35% to 34% for profits made in the tax year 1990-91, and to 33% for profits made in 1991-92.

While this cut was welcomed by business - and was estimated to reduce the corporation tax paid in the financial year 1992-93 by £830m - it was evidently not sufficient to reverse the rapid deterioration in the health of Britain's firms last year. The fiscal effect of the cut in the tax year just ending was only estimated at £380m.

It might be that the Chancellor will do nothing new for business in the Budget this year. He could reasonably argue that companies will enjoy the full 2% tax cut from now on, and that this will significantly reduce the tax burden facing them. Certainly, we would not expect him to undermine his own credibility by tampering with the tax changes that he has already announced, and the last Budget of a government term is hardly the time to pre-announce future tax changes.

At the same time, there is some reason to think that a second 'Budget for businesses' would make economic sense.

British firms are going bankrupt at a rate well in excess of that which most commentators feel is necessary for sensible corporate restructuring. The cash predicament of British firms has improved markedly in the last year, mainly as a result of destocking and a fall in investment, but is still not in the surplus that one would expect at this stage of the cycle, and is still not strong enough to prevent many firms going under.

A second argument in favour of a 'Budget for business' is that generosity to firms is less likely to be perceived as being overtly cynical and electioneering than confidence-boosting tax cuts to individuals, whatever the relative economic merits of the different measures.

If the Chancellor does wish to loosen the business tax burden, there are two significant taxes on which he can work. The first is mainstream corporation tax and the second is national non-domestic rates. Both are expected to raise about £15bn this year. Of the two, however, it is business rates which provides the easier option for a quick injection of cash.

One reason for this is that there are long lags between the generation of profits and the payment of corporation tax. In 1991, for example, companies were still paying tax on some profits earned in 1989. Any changes made to the corporation tax regime today either have to be imposed retrospectively (as was the case with last year's first 1% drop), or they have a negligible effect on payments in the year of their announcement. A second reason is that firms are unlikely to respond very significantly to such changes, whatever their timing.

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It is possible to affect immediate investment decisions by announcing future changes to the system, particularly if those changes are temporary since this gives firms an incentive to squeeze in the investment while the change prevails. It would also be possible to improve corporate cash flow by announcing a payments 'holiday' for some limited period, but corporation tax cannot easily be used to manipulate the economy within anything that resembles a stable planning framework.

Corporation tax is also hampered in its effectiveness by the limited number of firms which actually pay it. In 1990-91, only 335,000 firms paid mainstream corporation tax, as opposed to some 1.7 million, for example, which are registered for VAT. Changes to the corporation tax system do not affect partnerships (the typical business form in the crisis-ridden business services sector), the self-employed or unincorporated entities, nor may they affect those firms which are making low or negative profits. For firms which are 'tax-exhausted' - those whose profits are so low that they are unable to exploit all the allowances available - reductions in the tax or increased allowances are of little immediate value.

If all this is true, it would be quicker and easier to change non-domestic rates. However, there is still considerable room for doubt over the desirability of tampering with business taxes in order to manipulate the macroeconomy. Firstly, firms make better investment decisions when confronted with a stable tax regime. Secondly, designing taxes for macroeconomic ends often means subverting their microeconomic efficiency.

Corporation Tax

Although the Chancellor is unlikely to change the statutory rate of tax, this does not mean that there is nothing he can do to corporation tax. One option would be to alter the balance of capital allowances to give companies greater tax relief in the year in which they carry out any investment and less relief in later years. Since the first-year allowances were reduced by Nigel Lawson in his 1984 reform package and the idea of raising them is strongly propounded by the Opposition, it is unlikely that such a change will occur in the coming Budget. As we show in discussing the prospects for industry under a different Government in Section 6.3, the problem with an increase in allowances is that it is an extremely expensive way of generating a small amount of new activity. This is because a lot of investment would occur anyway, and also attracts the more generous relief, as well as any genuinely new investment that is stimulated. In addition, firms appear to wait until demand is growing before committing themselves to much new investment and thus more generous allowances may do little to make additional investment attractive.

A second corporate tax measure would be to reintroduce stock relief. It is an anomaly of the current system that companies are taxed on the capital gains they make in holding stocks, even though these gains typically only maintain the stocks' real value, merely compensating for inflation. It is not a desirable feature of a tax that its burden should arbitrarily rise or fall with the inflation rate. But given the high level of destocking in recent

years, and the falling level of inflation, the distortionary effects of the current system are at their smallest for some time. We do not expect the Chancellor to announce any change here. Moreover, in the Government's view, an attempt to make the system less vulnerable to inflation might be interpreted as implying a lack of confidence in the effectiveness of the Government's anti-inflation policy.

A more radical measure would be to extend some corporation tax relief to equity capital. At the moment, nominal interest payments on company debt are fully tax-deductible, but the profits that accrue to shareholders in the form of dividends or retained earnings are fully taxed. This provides a bias in favour of debt financing over retained earnings. A strong case can be made for offering an allowance for a normal return on shareholders' funds, which are regularly topped up with retained earnings, and such an allowance would both simplify the tax system and increase its neutrality.¹

Such a fundamental reform is extremely unlikely at the moment, primarily because macroeconomic need currently provides the Government with a more pressing motivation for tax changes than microeconomic logic.

Any changes to corporation tax are likely to be modest. One option would be to increase the level of turnover at which the reduced small business rate applies. This was done last year. Another would be to alter the treatment of advance corporation tax. ACT is essentially a prepayment by firms of the income tax due on dividends paid to shareholders. Under the current imputation system this can be offset against firms' mainstream corporate tax liability. In any one year, dividends may exceed taxable profits by an amount such that the ACT payable cannot be fully offset against mainstream corporation tax. The law allows this unrelieved ACT to be offset against tax payable in other years. However, there are some companies, particularly those that earn a substantial proportion of profits overseas, which never pay sufficient mainstream UK tax to offset all their ACT. This is probably one of a number of problems best dealt with in the context of international tax treaties, or as a part of a sensible European harmonisation programme.

While substantial reforms of the corporation tax system would not be misplaced, there is little that the Chancellor could do to the tax which would both make microeconomic sense *and* be attractive as a significant short-term macroeconomic tool.

National Non-Domestic Rates

The national non-domestic rating system (NNDR) was introduced throughout England and Wales in April 1990. It replaced a similar local tax, removing the power to set the tax rate - the rate poundage - from local authorities. Revenue collected from the new national tax is hypothecated to local authority spending, and distributed to councils on a per capita

¹ See *Equity for Companies: A Corporation Tax for the 1990s*, IFS Commentary no. 26, 1991, for a full discussion.

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basis. Legislation held that rate poundages would not grow by more than the retail price index. This was also to be true in Scotland, where rate poundages were not set at a uniform level but based on the prevailing levels.

The bills sent out in England and Wales in 1990 were not only affected by the uniform poundage; they also reflected a revaluation of the rateable values of property for the first time since 1973 (Scotland had been revalued more recently). One of the main problems of the old business rate system was that the property values used were seriously out of date. The new valuations were based on the 'annual net rental value' of business premises in April 1988. The next revaluation is due to affect the bills sent out in April 1995.

Overall the redistributive nature of the revaluation and the introduction of the uniform rate have meant a reduction in the tax burden faced by businesses in the North and Midlands with a corresponding increase for those in the South and East Anglia, relative to the local rating system. Figure 4.2 highlights the redistribution of the local business rates burden in 1990, distinguishing between the effect from revaluation and the uniform rate on the change in rate bills. In general if we omit Inner London¹ the major factor influencing the change in rate bills was the revaluation, not the change in rate poundages. Of course, this was to be expected, given that there had been a number of years of sharp rises in property values in the South prior to the revaluation.

At the time of the introduction of the NNDR, there was considerable criticism that the reform had been poorly timed, with the economy heading into downturn and those firms in the South which were bearing the brunt of the business rate reform being most severely squeezed. Leaders of the small business community suggested that 40,000 firms would go to the wall. The CBI warned of a 'hurricane' of protest from the business sector.

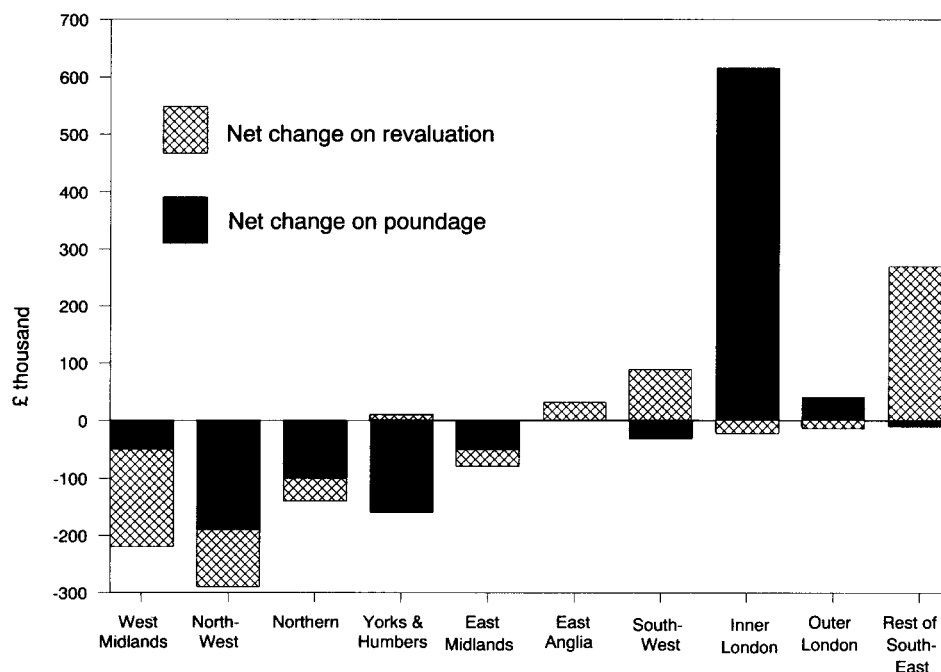
To cushion the impact of the new system the Government introduced a five-year transitional scheme. The increase in rates would usually be capped at 20% in real terms for each year (or 15% for firms with low rateable value properties). The transitional scheme was designed to be self-financing and so reductions in rate bills were graduated in the same way. No benefits from transitional arrangements are allowed for companies which change location, so new occupancy is generally taxed at the level that would have prevailed in the absence of the transition.²

Even though the rate poundage is pegged to the RPI, the total take from the NNDR can change in real terms, either as a result of revaluation or because of a change in the total amount of commercial property.

¹ Inner London was a special case because most authorities had their rate poundages kept artificially low in the years before the reform.

² There is an asymmetry in the system, because those firms which benefited from the change to the NNDR, and which thus lose out from the existence of the transitional arrangements, take the transitional loss with them when they move.

Figure 4.2
Changes in Business Rate Bills: The 1990 Reforms



All this background is extremely relevant to the Budget calculations being conducted at the Treasury. Since the NNDR was introduced, the total revenue from the tax has risen by far more than the rate of inflation on account of new commercial property. An increase in revenue of 18% is expected this year, the second year of the tax. Next year, it is forecast that the yield will level off.

As the total annual interest payments of the industrial and commercial sector are about £25bn, and as industrial and commercial companies are responsible for about 80% of the NNDR, the tax represents something between a third and a half of the cost of servicing the debt burden.

If the tax has the unintended effect of extracting cash from the corporate sector at a time of deepening recession, its effects on the region suffering most - the South - have been more severe.

Table 4.2 shows that, assuming the NNDR rose by the rate of inflation, over the five-year transitional period, of the 1.8m firms in England and Wales, 710,000 properties in 1990-91 and 539,000 in 1991-92 would be liable for a rates increase of 20% plus inflation.

Table 4.2 indicates that the additional rates burden on the losers in 1992-93 above that caused by the RPI increase is some £291m (in 1990 prices).

Table 4.2. Effects of Transitional Arrangements

England and Wales 1990 prices	Shift in rate bills after transitional arrangements (£m)	Amount held back by transitional arrangements (£m)	Properties facing maximum increase (000s)	Properties facing maximum reduction (000s)
1990-91	613	1,244	710	408
1991-92	1,039	818	539	269
1992-93	1,330	527	390	154
1993-94	1,528	339	273	82
1994-95	1,653	214	188	41

Commercial properties in Enterprise Zones, until now exempt from business rates, are also to be affected. They will have to start paying them from April this year, assessed on the rental value they would have had in 1988 in the absence of any transitional relief. This will sometimes represent a considerable burden. Canary Wharf, for example, will start paying what is expected to be about £4 or £5 a square foot on unoccupied space, this being the statutory 50% of the rate payable on occupied property. Vacant properties in the South particularly suffer from the fact that their potential occupants lose transitional relief on moving.

One means by which money can be directed at business, therefore, is in the form of a cut in anticipated NNDR receipts. The business sector would benefit quickly as the tax is paid in exactly the same way as the Community Charge, typically in ten monthly instalments. In contrast to corporation tax, all commercial activity benefits; but the benefit is biggest to those who pay the highest bills, often those who are suffering most due to the recession.

Aside from the pragmatic reasons for believing this to be the simplest way of directing resources to the corporate sector, there is also some microeconomic justification for a reallocation in the NNDR burden. The strongest is the effect of the recession on the commercial property market. Rents have been depressed nation-wide, and particularly in those areas most burdened by the recession. In London, for example, quoted rents have fallen by at least one-third since the middle of 1989. Were there to be a revaluation now, the burden on properties in London and the South-East would fall, although that on those in the North would presumably rise unless the total burden of the NNDR were to be cut.

There is an argument that the tax is simply too high in aggregate. Business now finances the equivalent of about a third of local government spending, which on some calculations is about twice as high as its share of the benefits of that spending.¹ It is not clear that if we were designing the tax

¹ See Richard Jackman, 'Paying for local government: an appraisal of the British Government's proposals for nondomestic rates', *Government and Policy*, vol. 5, no. 1, 1987.

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system from scratch, we would want to extract as much in aggregate from corporate occupancy of property as we would from, say, the profits earned by firms.

If the Chancellor wanted to help business in this way, the simplest method would be to defer the losses that are about to be suffered under the transitional arrangements. The CBI has called for him to maintain the gains that are being made under transitional arrangements, while suspending the losses. From the Government's point of view, this has the advantage of targeting help in those areas worst hit by recession, and it implies no U-turns on the principle of the NNDR. A more modest measure would be to allow firms in the South that move to take their transitional relief with them.

An alternative option would be to simply cut the rate poundage. While such a move would be consistent with the view that the NNDR should not be allowed to become too high a proportion of rents, an increase based on the RPI was announced in September. Any change in the rate would also be undermined by the transitional arrangements which would take back much of what was given, unless they too were altered at the same time.

A large decrease in NNDR is expensive, some £150m for each percentage decrease, and might look rather like the business equivalent of last year's poll tax reduction. It would also stir yet more murmurings into the whole issue of local government finance as the NNDR is often considered to be a local tax. In fact, it is now no more a local tax than any other: it is essentially a national tax whose revenue is hypothecated to local authorities. While there are strong arguments for making it a local tax again, such a fundamental reform is not on the immediate agenda. Nevertheless, as long as the perception that it is a local tax exists, it may be wiser to modify the transitional arrangements, however limited an effect this has on the cash flow of firms.

The merits of a cut in anticipated NNDR receipts depend on the degree to which it is felt that business illiquidity is a problem. It would make more sense than the alternative proposals to 'kick-start' the economy by encouraging investment through tax concessions if companies are seriously cash-constrained. The Government has, however, declared its unwillingness to engage in much fiscal fine-tuning, trusting automatic stabilisers to do all that is necessary. The fact that the current NNDR poundage is not in any way linked to business rents, except through the occasional revaluation, seems suboptimal.

Other Measures

Quite apart from general help to industry, the Government may want to furnish more selective help to industries in distress. At the top of the list may be the motor industry, which has survived a disastrous 1991 in the home market on the back of an export boom. That boom now appears to be subsiding.

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Rather than reversing the trend to heavier taxation of company cars, if the Chancellor wanted to help the industry, he could reduce or abolish the 10% wholesale tax on new cars. It raises something under £1.5bn a year, and is a tax with no clear justification. Again, it would make little sense to adopt industry-specific measures of this kind if they conflicted with the desirable shape of the tax system in the long term.

4.4 Indirect Taxes

An important annual consideration is the question of maintaining the real value of excise duties by uprating the current duties in line with inflation. While to do this would undoubtedly raise the headline inflation figure relative to leaving duties unchanged, to allow the value of duties to be eroded would cost the Chancellor £1bn over 1992-93 in forgone revenue. Moreover, given that the rate of inflation has fallen over the past year, the trade-off between inflation and revenue is less of a problem now than it has been in recent years.

Table 4.3. Real Values of Excise Duties

1985 = 100	Beer	Wine	Spirits	Tobacco	Petrol (4 star)
1991	90.2	90.6	88.02	109.72	105.24
1990	86.2	86.1	84.2	99.7	95.6
1989	86.0	86.1	82.4	98.0	93.9
1988	91.9	92.0	88.0	103.4	100.3
1987	91.2	91.2	91.2	103.8	98.5
1986	94.6	94.6	94.6	106.8	102.2
1985	100.0	100.0	100.0	100.0	100.0
1984	97.1	96.7	102.7	96.8	100.0
1983	91.9	127.0	106.1	89.1	100.0
1982	91.7	126.6	106.5	89.1	100.6
1981	90.6	126.3	112.2	87.8	100.1
1980	75.3	124.4	112.7	77.1	83.5

Table 4.3 shows that the real values of excise duties on beer, wine and spirits uprated by inflation are still below their 1985 levels, with those on spirits and wine below their 1980 levels. The duties on petrol and tobacco have both risen to their highest levels for 10 years. In general these real increases in duties reflect the revalorisation contained in the last Budget, which was based on a higher rate of inflation than subsequently arose. Nevertheless, the greater rise in tobacco duty reflects health concerns over its decline in recent years and is driven by the 15% increase in the rate contained in last year's Budget. The price effects of revalorisation at 4.5% are given in Table 4.4.

So far none of the major political parties have announced any plans to alter either the VAT rate or the indirect tax base. In the last Budget the Chancellor raised VAT by 2.5% to 17.5% in order to generate an extra £3.6bn in 1991-92 and £5.5bn in 1992-93. Since much of the revenue raised was spent on reducing Community Charge bills, this actually reduced measured inflation. Should the Government again decide to use indirect tax instruments as a method of financing public expenditure, a further increase in VAT of 1% would have the effect of raising an additional £1.7bn in 1992-93.

Table 4.4. Price Effects of Revalorisation

	Beer (pint)	Wine (70 cl. bottle)	Spirits (75 cl. bottle)	Tobacco (packet of 20)	Petrol (litre of 4 star)
Before					
Price	123	287	1069	202	49
VAT	18.3	42.7	159.2	30.1	7.3
Duty	22.3	84.7	569.6	80.3	25.9
<i>Ad valorem</i>				42.4	
After					
Price	124.2	291.5	1099.1	208.1	50.4
VAT	18.5	43.4	163.7	36.5	7.5
Duty	23.3	88.5	595.2	83.9	27.1
<i>Ad valorem</i>				43.8	
% price change	0.97	1.56	2.81	3.02	2.86

Neither of the leading political parties has announced plans to adjust the indirect tax base. Furthermore, as indirect tax rates are increased, the extension of the base to cover goods currently exempt or zero-rated becomes more of a politically sensitive issue. Indeed the extension of VAT to goods such as children's clothes and food, even at a lower rate than other goods, would be difficult, although in the case of fuels this may be justified on environmental grounds. Plans to introduce a luxury rate of VAT on certain goods, however, would fall foul of the European Commission's proposals for fiscal harmonisation in Europe.

The duty differential between unleaded and four-star petrol is currently 3.44 pence per litre. The major growth in the use of unleaded petrol occurred in 1989-90 and followed the third increase in the differential to 2.7 pence per litre. Since then the move away from leaded petrol has slowed considerably. This may simply show that all the consumers who wish to, have now had their cars converted to unleaded petrol. As a result, unless the Chancellor makes another adjustment to the differential, the use of unleaded petrol is likely to increase only as fast as the stock of cars in Britain is replaced by new cars which are manufactured to run on unleaded. Currently Britain lags behind both Greece and Denmark, which have differentials in duty and consequential VAT of 6.3 and 6.98 pence per litre respectively.

Another green measure which the Government could take would be to introduce variable rates of vehicle excise duty levied on private cars, linked to disparities in engine size, just as a differentiated scale of VED currently applies to commercial vehicles, reflecting axle weight. However, this would remain principally a tax on vehicle *ownership* and not on *use*, and would be hard to justify in terms of a reduction in petrol consumption

and pollution. Arguments relating to damage to the road surface are more easily applied to commercial vehicles, and the system currently reflects this.

Given that environmentally motivated taxes on petrol may be more usefully directed at vehicle use rather than ownership, an alternative tax option is to increase the level of indirect taxation currently levied on motor oils. Current estimates indicate that a 10% increase in the price of petrol brought about by means of fiscal instruments would reduce consumption by around 2.7%. Such a move would have obvious environmental benefits, given that road transport is a major pollutant accounting for 45% of the UK's total emissions of nitrous oxides, 85% of carbon monoxide emissions, 28% of hydrocarbons and 16% of carbon dioxide, and is a principal contributor to global warming (source: Department of Transport).

European Harmonisation and the Single Market

In January 1993 the Single European Market is destined to come into being. The last year has seen agreement reached on the structure and rates of VAT and most excise duties to be adopted within the European Community. In setting excise duty rates, discussion has shifted from setting single common rates across countries, via the setting of maximum and minimum rates, to the current position based upon the setting of minimum rates of taxation. For VAT, discussion has focused as much on the coverage of tax as it has to the rates to be set. Whereas many of the original indirect taxation proposals would have had major implications for the UK, the agreement now reached should not require any immediate adjustments.

In June, at the Economic and Financial Affairs Council (ECOFIN) meeting, EC Finance Ministers agreed to the setting of a minimum standard VAT rate of at least 15%, below the current UK rate of 17.5%. The agreement also provides for the continuation of lower rates on particular goods and services. In the case of the UK, this latter provision protects the existing zero rates, most importantly on basic foods, fuel and children's clothing. Agreement was also reached on minimum excise duty rates for beer, cigarettes, petrol, derv and heavy fuel oil. Provisional agreement was obtained for a zero minimum rate for wine, heating kerosene and heating gas oil. Details of these rates are given in Table 4.4 alongside the equivalent current UK rates. As can be seen, the current UK rates meet the requirements of the agreed rates and so no adjustment will be necessary. The agreed minimum rates are to be reviewed every two years.

Agreement on the excise duty rate for spirits remains outstanding. The minimum rates which have been proposed (around £2.40 on a 75cl bottle of whisky) are well below current UK rates (£5.69) and, as with other types of alcohol, would require no UK adjustment. They have, however, met with strong objections, most noticeably from the Scotch whisky industry. If adopted, the proposed rate would be considerably in excess of rates currently imposed in Spain (£1.21), Portugal (£1.11) and Greece (£0.55). There has been a rapid growth in exports to these southern

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European markets which will be threatened by the increase in excise duties implied by the current proposals. Strong lobbying is set to continue against what is seen as discrimination against both distillers and brewers in favour of wine producers. At issue will be not only the spirits duty rate but also the provisionally agreed zero minimum rate for wine. In the worst-case scenario, the situation may become deadlocked, delaying the start of the Single Market. If agreement is reached at the expense of the distillers, the Chancellor may feel obliged to respond by lowering or at least failing to revalorise the UK spirits duty rate.

The lack of any necessary adjustments to UK indirect tax rates implies that the direct effect on revenues should be minimal. The relaxation of controls on personal importation of alcohol and tobacco which will accompany the abolishing of fiscal frontiers may, however, encourage cross-border shopping. Estimating the potential loss of revenue this would cause is particularly difficult, although figures from HM Customs and Excise suggest a figure of £150-250m from legitimate personal purchases.

Table 4.5. EC Agreed Excise Duty Rates and Current UK Equivalents

Product	Agreed minimum rate	Current UK rate
Leaded petrol	337 ECU per 1,000 litres	371 ECU per 1000 litres
Unleaded petrol	287 ECU per 1,000 litres	321 ECU per 1000 litres
Road diesel oil	245 ECU per 1,000 litres	314 ECU per 1000 litres
Cigarettes	57% of retail price of cigarettes in the most popular price category	61% of retail price of cigarettes in the most popular price category
Beer	0.748 ECU per degree Plato (per hectolitre)	6.09 ECU per degree Plato (per hectolitre)
Still wine	Nil rate (provisional)	173 ECU per hectolitre
Sparkling wine	Nil rate (provisional)	286 ECU per hectolitre

Source: Single Market Report no. 4, HM Customs and Excise, Summer 1991.

4.5 Tax Legislation in an Election Year

The imminence of the general election and the uncertainty of its outcome invite comparisons with previous election years to see how the 1992 Budget might unfold. While the parallels between 1992 and 1964 have been drawn by the political commentators, the spring budgetary process in 1964 was little affected by the autumn election. Nevertheless, a brief review of some contemporary criticism of the 1964 Budget and a comparison with that in the previous election year, 1959, revealed some material of interest for 1992.

In 1959 the Chancellor, Julian Amory, felt able to offer tax reductions of some £295m, including *9d* off the standard rate of income tax and *6d* off the three reduced rates. *2d* was also cut from the price of a pint. By 1964, however, Reginald Maudling faced a rather more difficult situation. In the event, he decided to increase taxation by £100m. To do this, he chose to increase taxes on alcohol and tobacco substantially - a decision described at the time as 'courageous' in an election year. Fortune did not, however, reward a brave Chancellor in the subsequent election.

A better guide to the 1992 Budget and Finance Bill process can perhaps be found in 1970. In that year, the Budget was held on 14 April, with the Bill receiving the Royal Assent on 29 May, immediately before the start of the election campaign which culminated in Edward Heath's victory on 18 June. The Finance Act 1970 contained 36 Clauses and 8 Schedules, being 74 pages of legislation in all.

Nevertheless, with Easter on 19 April this year, an April or May election date will severely restrict the time available for the introduction of any substantive measures in any Bill. An alternative scenario might, therefore, be 1979. In 1979, Chancellor Healey, with no overall majority in the House of Commons, introduced a caretaker Budget on 3 April. The Finance Bill, a three-page affair, was introduced to the House of Commons, passed all its stages and received the Royal Assent on 4 April.

This did little more than ensure that the annual taxes - income tax, corporation tax and advance corporation tax - could continue to be collected after 5 May 1979. It left the budgetary field open to whoever was Chancellor after the election to present further measures. In the event, Sir Geoffrey Howe duly obliged in a further Budget on 12 June 1979 in which - to critical acclaim - the top rate of income tax was cut to 60% and VAT increased from 8 to 15%.¹

The difference in reaction to such an eventuality may indicate how far perceptions of tax rates have altered in the intervening years. However, were such an eventuality to occur, it is clear that there would be no time for the new Chancellor to consider what structural changes may flow from

¹ If further parallels between 1979 and 1992 are to be sought given the subject addressed here, one can also note that the capital gains tax was first consolidated in 1979 and is in the process of reconsolidation in 1992.

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such rate changes. In particular, a number of fundamental issues would arise for future legislative action if the number of personal tax rates increased, if top marginal income tax rates diverged significantly from the corporation tax rate and if the capital gains tax rate were decoupled from income tax rates.

A pure caretaker Budget and Finance Bill, such as that in 1979, looks very unlikely, given that draft clauses on some topics have already been published or promised and that Norman Lamont may wish to establish the Government's tax-cutting credentials in the electorate's mind at the start of the election campaign. As a guide from the past, he may also prefer to look to 1983 and 1987 for the 'before and after' of the election. However, it is clear that neither year provides a particular parallel to the Budget and Finance Bill procedure in 1992. Both years involved the full panoply of a mid-March Budget, followed by the normal Finance Bill which was then interrupted and considerably truncated by the election. In 1992 it is known that the election must shorten the Finance Bill timetable, and its contents will have been planned accordingly.

The return of the Government in 1983 and 1987 enabled it to reintroduce some of the measures dropped from the original Bill to accommodate the timetable necessitated by the election. In both years no formal Budget statement followed the election. Ways and Means Resolutions were merely presented to Parliament enabling a further Finance Bill to be brought forward containing a number of the previously discarded measures. In 1983 these passed through Parliament and received the Royal Assent within a matter of 26 days, while in 1987 the Government was able to improve on this and do it in 23 days.

Indeed, the Government's achievement in 1987 was rather greater than a mere three days might suggest, as the second Finance Act of 1987 was some nine times longer at 134 pages¹ as compared with the 15 pages of the second Finance Act of 1983. In 1983 the Government chose to delay a large number of its 1983 measures until 1984. In 1987 the measures were passed, largely undebated.

In this respect 1987 represented an exception to the normal election year. Most election years in the post-war period have, not surprisingly, been characterised by a drop in the output of tax legislation. In 1987, however, 279 pages of tax legislation were placed on the statute book as compared with 265 pages in 1986 and 242 in 1988. None of these compare with 1989 at 366 pages. A reversion to the more 'normal' pattern was evident in 1990 and 1991 when a mere 255 and 246 pages of tax legislation were added.²

¹The Finance (No. 2) Act 1987 is in fact 102 pages in length, but in larger A4 format as compared with the smaller formal Finance (No. 2) Act 1983. 134 pages represents the adjusted size for the 1987 Act.

²None of these figures take account of the increasing amount of secondary legislation through which direct and indirect tax legislation is being implemented.

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These figures merely reflect the continuing explosion in tax legislation since 1965. The number of pages of fiscal legislation that have been enacted between the main elections in the post-war period is as follows:¹

1945-51 (Labour)	592
1952-55 (Conservative)	245
1955-59 (Conservative)	272
1960-64 (Conservative)	388
1964-70 (Labour)	1,091
1971-73 (Conservative)	468
1974-79 (Labour)	1,037
1979-83 (Conservative)	751
1983-87 (Conservative)	979
1987-91 (Conservative)	1,242

Thus in the 20 years from 1945 to 1964, on average 74.85 pages were enacted each year. In the following 27 years, on average 206.22 pages have been enacted per year,² with the present Government's record between 1979 and 1991 being an average of 228.62 pages per year.³

The complexity of legislation is not a new issue. Mr Gladstone, in replying to a Member of Parliament who in 1853 urged the cause of simplicity, noted that:⁴

... the Honourable Gentleman said that laws of this kind ought to be made intelligible to all persons who had not received a legal education. To bring the construction of these laws within the easy reach of such persons, was no doubt extremely desirable, but far from easy.... The nature of property in this country, and its very complicated forms, rendered it almost impossible to deal with it for the purpose of the income tax in a very simple manner.

Commenting on this 127 years later, the late presiding Special Commissioner, Hubert Monroe, added the footnote that 'the plea today is that it would be some advance if laws of this kind were intelligible to those who have received a legal education'.⁵

¹The figures cover Finance Acts plus the taxation sections of the Land Commission Act 1967, the Development Land Tax 1976 and the Oil Taxation Acts. Finance Acts since 1987 have been printed in A4 format and the numbers of pages have accordingly been adjusted (pages x 1.33) to correspond with the previous smaller format.

²For these purposes, the Finance Bill introduced in November 1964 by the incoming Labour Government has been attributed to 1965. The Finance Act 1974 which was enacted under a Labour Government included measures, such as the development gains tax, that had been proposed by the previous Conservative Administration.

³The figures do not take account of the amount of tax legislation repealed over the period by one or other Government. For the state of tax law in 1990, in terms of the amount of original legislation repealed, spent or still operative, see Malcolm Gammie, *The Process of Tax Reform in the United Kingdom*, Appendix 4, The Law Society, March 1990.

⁴*Hansard*, 27 May 1853, col 722.

⁵H. H. Monroe, 'Intolerable inquisition? Reflections on the law of tax', Hamlyn Lecture, May 1981.

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Under any tax system in which there is a wide range of expertise, simplicity and complexity are relative concepts. The degree of complexity that we can tolerate in respect of any particular part of the tax system is closely linked to the sophistication, or lack of it, of the agents who must handle it - both within and outside the Revenue Departments. In addition, as Gladstone appreciated, tax law does not exist in a vacuum: it is intimately shaped to take account of the existing legal and social framework of the country. As that changes, so the tax system must change with it.

Nevertheless, the volume of legislation over time might be regarded as an indication of the general health of the tax system. And the ability of even the most sophisticated tax agents to implement complex legislation depends to a large measure upon its satisfactory enactment to an appropriate standard.

What is apparent from the figures presented above is that, irrespective of the complexity of tax legislation, sheer volume increasingly presents difficulty for taxpayers and their advisers. And the volume seems unlikely to abate, whichever party wins the election: reforms to the taxation of trusts, of the self-employed and to the whole administration of the personal tax system, changes in corporate taxation as part of the continued integration of the European market and the development of open capital markets, reforms of the tax appeals procedures and the taxation of foreign exchange gains and losses and of financial instruments. These are all the subject of current consultation and, over time, may be on the agenda of both the main parties.

At least, however, in managing much of the change in the tax system and the volume of legislation it produces, very considerable strides have been made in the consultative process. This has enabled proposals to be exposed for comment well in advance of their presentation in the Budget and adoption in the Finance Bill. Little progress has, however, been made in adapting the legislative process to take account of both the volume and complexity of modern tax legislation.

In this respect, tax is no different from many other technical subjects that are subject to legislative action. Tax legislation is favoured to the extent that a Finance Bill must come before Parliament each year, offering the opportunity for refinement and amendment. The disadvantage is that the annual nature of tax legislation itself offers Chancellors an irresistible opportunity to tinker with the system. In addition, the legislative timetable is curtailed and the legislation is scrutinised by one Chamber of Parliament only. Whatever the constitutional sense of such procedural restrictions in the past, they should now be reviewed.

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Even in a normal year, legislation contained in the Finance Bill may receive scant parliamentary scrutiny as it passes its various stages.¹ This becomes more critical in any election year when the parliamentary process may be shortened and measures passed on the nod. In this respect, it is encouraging that a number of the technical measures already promised for the 1992 Bill have been or are promised to be published in draft for comment in advance. Nevertheless, the publication of draft legislation is still the exception rather than the rule and the process involves little 'negotiation' on the statutory texts comparable to what occurs in formulating many public documents and commercial agreements.

In the absence of sensible policy decisions, no amount of consultation and draft legislation will bring about a simpler and more comprehensible tax system. Nevertheless, they can ensure that the Government's policy objectives are implemented in as satisfactory and understandable way as possible. This can only be done if politicians will accept the need for time, both for consultation and for the drafting and enactment of legislation.

Whatever the date of the 1992 election, we are unlikely to have a Caretaker Budget as we did in 1979. If the election is on April 9th, almost all of the Finance Bill will be dropped, with a truncated Bill rushed through. Much the same will be true if the election is called for May 7th. If the election waits until June, the full Finance Bill should be put through.

¹ The longest period since 1979 between the introduction of the Finance Bill and its receiving Royal Assent was in 1982 when it took 127 days. In fact, the effective period is much shorter, given the inability of the House of Lords to alter the Bill as sent from the Commons.

5 The Economy in the Medium Term

5.1 Introduction

The 1992 Budget will obviously be the last before the next general election - and indeed it is quite possible that the election will prevent the intended Finance Bill from being passed into law, in which case there might need to be a second Finance Bill, and if Labour were selected, even a new Budget in the summer. In any case, this is clearly a timely moment to consider the shape of the medium-term economic prospects which will confront the new Government.

In this section, we look at these issues. We start by examining the prospects for GDP growth over the next five years, taking account of the alleged 'balance of payments constraint' on output growth, and discussing whether this constraint would be relieved by devaluing the pound. We then consider whether the overhang of debt in the private sector is likely to lead to a prolonged period of exceptionally slow growth in domestic demand, and consider what impact this might have on the budget deficit in the next Parliament. Finally, we consider whether the medium-term path for the PSBR under Conservative and Labour Governments would be likely to result in public debt 'sustainability', as defined by the Maastricht Treaty.

5.2 Trend Growth in UK Output

The starting-point for any analysis of the medium-term growth rate of the economy is to consider how fast productive potential might expand. Having done this, the next step is to consider how actual output is likely to behave relative to productive potential over the relevant time horizon.

There are essentially two methods commonly used by economists to assess the trend rate of growth in productive potential. The first is simply to take past growth rates in output, and to assume that these will be extrapolated into the future. In order to ensure that these trend growth rates are not distorted by different rates of capacity utilisation in the beginning and end years, it is normal to select years which are at approximately the same stage in the business cycle, commonly either the peak or the trough in the cycle.

For example, the growth rate in real GDP between the 1979 cyclical peak and the 1988 peak was 2.3% per annum; alternatively, the growth rate between the cyclical trough in 1981 and that in 1991 was 2.4% per annum. These figures lie somewhere in between the relatively low trend growth rates achieved in the 1970s, and the much higher rates achieved in the late 1960s. (From 1973 to 1979, the growth rate was just 1.4% per annum, while from 1964 to 1973, trend growth averaged 3.1% per annum.) In fact, growth in the 1980s has been very close to the figure of 2.5% per annum which has been achieved throughout the whole of the post-war period.

A more sophisticated way of estimating the trend growth rate is to make direct estimates of the behaviour of potential output, which is generally defined as the maximum level of output consistent with stable inflation. Both the OECD and the IMF attempt to do this on a regular basis for all of the major developed economies. Essentially, the framework is as follows. Equations for wage inflation and price inflation are used to calculate the NAIRU - the minimum level of unemployment which is consistent with stable inflation. These critical unemployment rates are then used to calculate the growth in business sector potential employment; and the resulting employment figures are combined with estimates of the capital stock to explain total output (via a production function). Technical progress is generally estimated by adding trend terms to the equations.

The results of recent IMF and OECD exercises of this type are shown in Table 5.1. Taking an average of the two estimates, the growth rate in productive potential in the UK from 1988 to 1990 was 2.7% per annum, as compared with 2.3% per annum from 1980 to 1987, and 1.4% per annum from 1974 to 1979. This improvement in the growth of potential output is mainly explained by an increase in the rate of growth of total factor productivity (i.e. the productivity of labour and capital combined), which is now estimated to be running at 1.7% per annum, compared with 1.5% per annum in the period from 1980 to 1987, and only 0.8% per annum from 1974 to 1979.

Table 5.1. Estimates of UK Potential Output Growth

	1966-73		1974-79		1980-87		1988-90	
	IMF	OECD	IMF	OECD	IMF	OECD	IMF	OECD
Potential output	2.7	2.5	1.0	1.8	2.5	2.2	2.6	2.8
Growth in:								
Capital stock	0.7	1.1	0.4	0.9	0.6	0.6	0.6	0.8
Labour supply	-0.9	-0.5	-0.8	-0.3	-0.3	0.2	-0.2	0.2
Total factor productivity	2.2	1.3	0.8	0.8	1.6	1.5	1.7	1.7
Public sector	0.7	0.6	0.6	0.3	0.6	-0.1	0.5	0.1

The IMF uses these calculations, along with estimates of likely capital expansion and labour force growth, to produce forward estimates of possible growth rates in productive potential. It calculates that potential output in the UK might grow by 2.5% per annum from 1991 to 1996, which would be a little more than was achieved on average during the 1980s.

However, none of these estimates of productive potential takes much account of the so-called 'balance of payments constraint' on the UK economy. It has been widely pointed out that the current account deficit in 1991 was unusually large for the trough of a business cycle, which suggests that the recent rate of economic growth may have been achieved partially by importing resources from overseas. Not only may this artificially have increased the trend rate of growth in the 1980s, it might actually need to be reversed in the first half of the 1990s. If so, then it would be prudent to plan on a growth rate in output potential from 1991 onwards which is somewhat lower than the 2.5% per annum suggested above.

5.3 The Balance of Payments Constraint

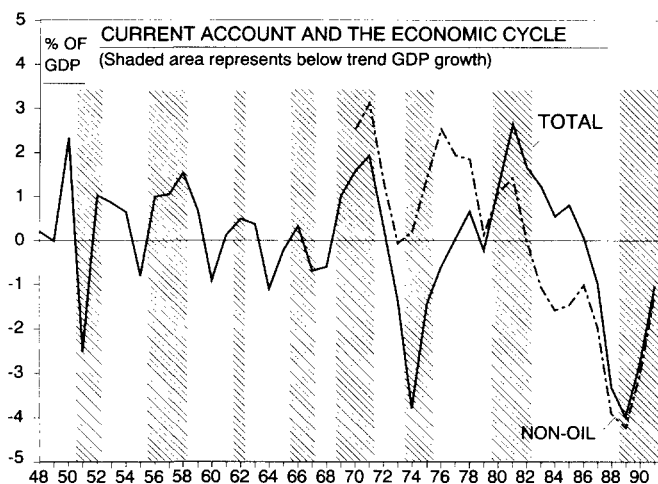
Debates on the balance of payments constraint, and its possible solution by a devaluation of the currency, are among the most familiar in British economics. These debates have been rekindled by the decision to take sterling into the ERM in 1990, with critics now claiming that the poor performance of the balance of payments will constrain the British economy to an unusually low rate of output growth over the next five years.

These fears, which have in the past been most associated with Keynesian economists from Cambridge, now appear to have spread also to the monetarist wing of the economic spectrum. The key concern is that the underlying performance of the traded goods sector in the British economy (mainly manufacturing) has been systematically worse than that in other similar economies over several decades, and that this manifests itself in a worsening balance of payments position whenever the UK economy grows at close to the OECD rate. In order for the balance of payments position to be acceptable over the medium term, the economy must therefore grow less rapidly than other similar economies.

This proposition is particularly pertinent at present, since (as Figure 5.1 shows) the current account deficit is at present considerably larger than it has been at similar points in previous cycles. The current account deficit of around 1% of GDP recorded last year compares with surpluses of around 1-2% of GDP at previous troughs in the economic cycle. Incidentally, the point is sometimes made that the non-oil current account deficit has deteriorated even more than the overall current account position compared with previous cyclical low points, a fact which is taken to draw even more pessimistic conclusions about future growth potential. Although this is true, it is also irrelevant. If there are long-run reasons for believing that the overall current account must balance - which is the basis for concern about the balance of payments in the first place - then the advent of North Sea oil must inevitably lead to a worsening in the remainder of Britain's trade performance, probably by 'crowding out' the surplus in manufacturing trade. So part of the deterioration in the non-oil balance is automatic, and is not an indication of a worsening underlying trade performance over the past decade. In 1992, oil and gas production is likely to improve Britain's current account position by 1-2% of GNP, so if the overall current account must balance, the remainder of Britain's trade must earn an increased deficit of that amount. This explains part, though not all, of the worsening in the non-oil deficit since 1979.

Nevertheless, it is hard to deny that the underlying current account position has worsened, and it is worth asking what this might imply for the future. It is comparatively easy to perform econometric calculations which give us some idea of how fast the economy can grow while the balance of payments position remains unchanged. For example, recent calculations at Goldman Sachs have concluded that, if UK price and cost competitiveness remains unchanged, then the British economy needs to grow about 1% less

Figure 5.1



rapidly than the OECD average in order to leave the current account position constant over the medium term. If the OECD area were to grow at 3% per annum, which would seem a reasonable estimate for the medium term, this would permit 2% growth in the UK without a trend worsening in the current account. If Britain grows faster than this, then the real exchange rate would need to fall (i.e. price competitiveness would need to improve) to head off a worsening in the deficit. For example, for every 1% extra UK growth relative to the OECD average, competitiveness would need to improve by 2% a year if the current account position is not to worsen.

These calculations suggest a rather lower trend growth rate for the economy than was derived from the calculations for output potential outlined above. This, in fact, is perfectly understandable. As explained above, the OECD / IMF estimates of output potential are based on estimates of the NAIRU, which can themselves be distorted by the behaviour of the balance of payments. For example, the rapid rates of growth in the economy in the 1980s would probably have had a greater impact on inflation if the balance of payments position had not worsened considerably.

To look at this another way, the real exchange rate at the end of the 1980s might have been somewhat higher than can be sustained over the long term. This high real exchange rate improves the terms of trade by reducing import prices relative to export prices, and curtails the rate of inflation in the domestic economy. One consequence of this is that the economy can run with a lower rate of domestic unemployment while achieving stable inflation. The implication is that estimates of the NAIRU might therefore be biased downwards, with the corollary that estimates of the potential labour supply, and of potential output, might correspondingly be biased upwards. If the trend deterioration in the current account now has to stop - or still worse if it has to be reversed over the medium term - then potential

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output will grow less rapidly than estimates derived from data for the 1980s would imply. It is therefore clear that the balance of payments position can have important effects on the medium-term growth rate of the economy; although the Cambridge and monetarist economists sometimes put these arguments in over-simplistic terms, their arguments cannot for all that be shown to be a priori invalid.

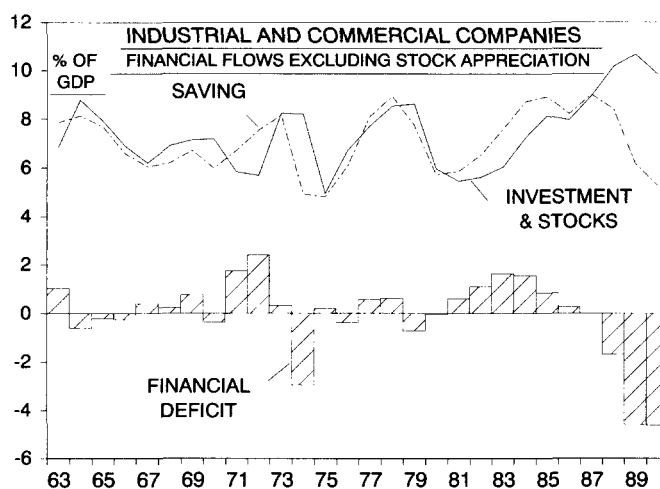
However, assessing the importance of these gloomy views in practice is much more problematic. It is very difficult to be sure whether the current account deficit will in fact markedly reduce the growth rate of the economy over the next five years, or will be easily absorbed in the massive world capital market. Although it is clear that the current account deficit is unusually large at present (on a cyclically-adjusted basis), it is not obvious that it is proving difficult to finance (in sharp contrast to the position in 1987-88). One of the reasons might be that the UK currency is now in a semi-fixed exchange rate system with the rest of Europe, which gives this country access to a very large 'domestic' capital market, inside which foreign exchange risk has presumably been substantially reduced.

This might make the present situation comparable to that which exists when regions of a single country run financial deficits and surpluses against each other. Within any large currency union, certain regions might run financial deficits for lengthy periods because the availability of high-return capital projects in those regions outstrips the supply of savings in the same region. Provided that the capital projects eventually earn a sufficient rate of return to pay back the investment, there need be no problem with such regions running substantial financial deficits. Translated into the situation which the UK currently faces, it is arguable that the present deficit on the current account may not reflect an unusually inadequate trading performance over the past few years, but may instead reflect a relatively high rate of investment in capital projects.

Some evidence in favour of this proposition comes from the pattern of financial deficits in the economy at present. The financial deficit of the corporate sector in 1991 was above 2% of GDP, which is considerably larger than the average deficits which have occurred at similar stages in previous cycles. Furthermore, this has occurred despite the fact that corporate sector savings have not been unusually depressed. Instead, corporate investment (including stockbuilding) has been running at a considerably higher level (by about 2% of GDP) than at similar points in previous cycles. This might imply that it will be easier to finance this deficit than in the past.

Nevertheless, the balance of payments would appear likely to place some constraint on medium-term growth prospects for the economy. As noted above, Goldman Sachs has recently calculated that 2% per annum growth in real GDP is consistent with a broadly stable picture for the current account, which would imply that it would remain in modest deficit (around 1-2% of GDP) over the next five years. Growth as high as 2.5% per

Figure 5.2



annum, as implied by the OECD / IMF calculations of productive potential, could conceivably lead to a widening in the current account deficit which might eventually prove unfinanceable.

What does all this mean for the likely actual growth rate of the economy over the next five years, on which the Treasury will be basing its fiscal plans? A reasonable compromise would be to plan on real GDP growth of about $2\frac{1}{4}\%$ per annum, somewhere in between the growth rate implied by the potential output calculations and that implied by the calculations on the trade constraint. The illustrative projections for the MTFs included in Section 5.8 take this as the central bench-mark growth rate for the medium term, and then show what might happen to the government accounts on somewhat slower and somewhat faster growth variants.

We assume that these growth constraints would apply to both Conservative and Labour Administrations, so we are making no allowance for beneficial supply-side effects from macro and micro policy innovations by either party. Although both parties might consider this unfair to their package of policies, much depressing experience in the past has suggested that the beneficial effects of supply-side reforms should not be assumed in government spending plans before they become clearly apparent in the actual behaviour of the economy.

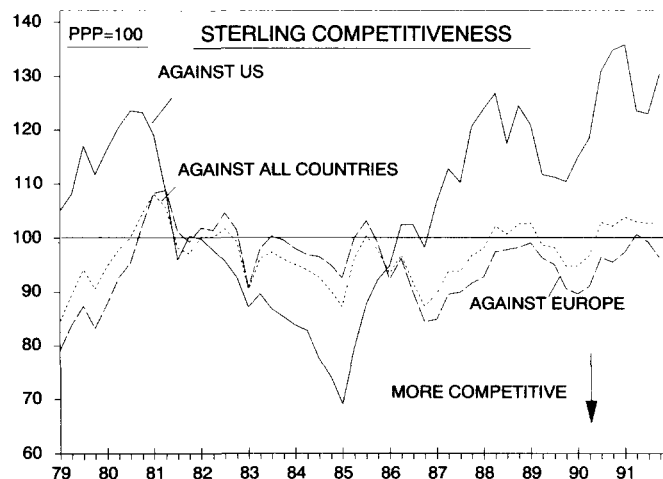
However, there is one policy adjustment which has been widely recommended by economists as a means of considerably alleviating the long-run growth constraint which Britain faces. This would be a devaluation of the pound sterling. We now turn to a consideration of what this might achieve.

5.4 The Devaluation Option

One possible way out of the growth strait-jacket might be to devalue the pound in the ERM. Since joining the ERM in October 1990, sterling has been in a semi-fixed exchange rate relationship with virtually all of the European currencies, which taken together account for 63.4% of sterling's effective exchange rate index. The fact that 36.6% of sterling's index consists of currencies outside of the ERM, taken together with the fact that sterling is allowed to fluctuate within a 12% band width against the ECU, of course leaves substantial room for the overall value of the pound to move up and down despite its ERM membership. Nevertheless, the UK is now closer to being in a fixed exchange rate regime than in a floating rate regime.

The Green Budget last year discussed in considerable detail whether the Government had made the 'right' decision on sterling's entry rate to the ERM. Calculations of purchasing power parity made at that time by Goldman Sachs suggested that, if anything, sterling was slightly undervalued on entry to the ERM. However, these calculations are contentious. They are based on the actual selling prices of a basket of internationally traded goods at a base date of 1985, updated since then by wholesale price indices. This procedure can lead to distorted measures of purchasing power parity, both because the goods in the basket are not strictly comparable between countries, and because the profit margins built into prices at the base date may not be 'normal'.

Figure 5.3



Many economists therefore use an alternative procedure for judging the appropriateness of real exchange rates, which is simply to compare the current level of the exchange rate with long-run averages over previous periods. The argument here is that the real exchange rate is unlikely to stray very far from equilibrium for extended periods, so averages calculated over many years are as good a way as any of assessing the true

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value of the equilibrium real exchange rate. Using this method, we find that the real exchange rate for sterling on entry to the ERM was very close to its 20-year average against the ECU - a fact which also supports the notion that the Government did not choose an overvalued entry rate.

Developments in the past year have not changed this conclusion in any important way. Unit labour costs in the UK business sector rose by 7.1% last year, as against an average of 5.6% for all European countries. If the exchange rate for sterling against the ECU had been totally fixed, the underlying level of UK cost competitiveness would therefore have deteriorated by about 1.5% against other ERM countries. However, this slight deterioration measured in domestic currencies has been more than offset by the decline in sterling against the ECU within the parity grid.

In fact, if anything, recent levels of UK cost competitiveness have been improving slightly against the rest of Europe, since the decline in the exchange rate within the parity grid has been greater than the worsening in domestic costs. This is likely to continue in 1992-93. According to OECD forecasts, UK unit labour costs in the business sector will rise by an average of 2.3% over the next two years, as compared with an average of 3.3% in Europe as a whole. Even if the nominal exchange rate against the ECU remains constant, competitiveness should therefore improve.

These relatively reassuring calculations on competitiveness are substantiated by the behaviour of UK export volume over the past couple of years. In 1990, UK trade-weighted export market growth was 5.9%, while manufactured export volume rose by 7.6%. Last year, world markets expanded by 4.6%, while export volume was up by 3.2%. Thus, over the last two years, the cumulative growth in export volume has been broadly the same as that in world markets. This would not appear to be a symptom of a chronically overvalued currency.

Why, then, are there such strident calls for devaluation? First, while the recent valuation of sterling against the ECU is quite close to its average over the past two decades, it is considerably higher than the average level of competitiveness in the 1960s and early 1970s. Although many see this as an understandable upwards shift in the real exchange rate in response to the exploitation of North Sea oil, it has enabled some economists to claim that the real exchange rate has been overvalued for the whole of the 1980s, thus making comparisons with recent real exchange rate levels irrelevant.

Second, it is very clear that sterling's valuation against currencies outside of the ERM bloc, especially the dollar, is less comforting than its valuation within Europe. This has led some economists to argue that, in order to produce a satisfactory level of competitiveness overall, sterling must be undervalued against the ERM currencies to offset its overvaluation against the dollar. Logically, this may be true, but it misses the point that the dollar's overvaluation can, and probably will, be corrected by the foreign exchange markets at some point in the future. The European countries are not attempting to fix the value of their currencies against the dollar so there is nothing in the operation of the ERM which prevents the dollar's undervaluation from being corrected. It would not seem sensible to allow

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the (supposedly) permanent level for sterling inside the ERM to be determined by reference to the temporary behaviour of the dollar outside the system.

Third, and probably most telling, proponents of devaluation point out that the current account of the balance of payments remains in large deficit, despite the fact that the economy is clearly working below capacity, with exceptionally high rates of unemployment apparently becoming a permanent feature of the landscape. If unemployment is to be brought down to a 'tolerable' level, these economists claim that sterling will have to be devalued in order to allow the balance of payments to follow a financeable path.

To some extent, the proponents of devaluation appear confused on exactly why unemployment is high. Over the long term, economic theory suggests that internal balance in the economy (i.e. stable inflation) can only be achieved if unemployment is at the NAIRU. There is no point in attempting to push unemployment below the NAIRU by devaluing sterling, since this will simply result in accelerating inflation. As we have seen in Section 3.3, recent estimates of the NAIRU suggest that it is currently around 7.7% of the labour force, as compared with an actual unemployment rate of around 9%. Attempts to reduce unemployment below the NAIRU by devaluing the currency would not only be foolish, but may also prove counter-productive, since the level of the NAIRU is itself partially determined by the real exchange rate.

This works as follows. The lower the real exchange rate, the more adverse the terms of trade, and the higher the level of import prices relative to domestic prices. High import prices add to inflation pressures within the domestic economy, and therefore require that unemployment needs to be higher, not lower, to achieve any given rate of stable inflation. Therefore reductions in the real exchange rate can increase the NAIRU - something which is, indeed, estimated to have occurred during the 1980s.

It is only if an external financing constraint is forcing unemployment to remain above the NAIRU that there is a case for reducing the real exchange rate to combat unemployment. This, in essence, is what lies behind the concept of the 'fundamental equilibrium exchange rate' (or FEER), a concept pioneered by John Williamson. The FEER is the real exchange rate which produces external balance, assuming that the economy is working at precisely that level of activity which ensures internal balance (i.e. the NAIRU).

In order to calculate the FEER, it is usual to proceed in two stages. First, it is necessary to make an assessment of what is meant by 'external balance'. This is contentious, since it need not be the same thing as current account balance. We have already seen above that it is possible for net capital flows into or out of a country to exist in long-run equilibrium. If net capital flows are not zero, then the current account will not balance over the long term. So the first step is to estimate what the balance of capital flows into the economy is likely to be over the medium term. This then produces an estimate of the sustainable current account position.

Once an estimate of external balance has been made in this way, the next step is to use an econometric model to assess what level of the exchange rate would be needed to achieve this external balance, assuming that the economy is operating at the NAIRU. This, too, is a highly hazardous procedure, since it is entirely reliant on the precise structure of trade equations built into a macroeconomic model. Not only do these vary between models, but they can vary considerably over time.

The concept of the FEER is therefore not one which is easy to pin down in practical terms: it depends both on arbitrary estimates of sustainable capital flows and on the uncertain structure of macroeconomic models. Nevertheless, economists have boldly attempted to perform the required calculations. Two recent estimates of sterling's FEER were published in the *National Institute Economic Review* for August 1991. First, John Williamson estimated that, on entry to the ERM, sterling's central rates were around 10% overvalued (with the overvaluation against the DM being over 20%). Second, the National Institute itself estimated that sterling's effective rate was about 5% overvalued in the third quarter of last year, and about 10% overvalued when sterling first entered the ERM (with the difference being explained by the change in the value of the dollar between these two dates). Taken together, these estimates imply that sterling would now be some 5-10% overvalued, assuming that it were trading close to its central ERM parity rates.

If true, would this justify a devaluation? There are several strong arguments against this conclusion. First, the width of the ERM bands allows sterling to depreciate by up to 6% below its central rates, which would largely eliminate the overvaluation suggested by the FEER estimates just given. Second, we noted above that inflation in the UK is now running below the average for other ERM countries, and if this continues then the real exchange rate will decline even if nominal exchange rates are fixed. Although not an intended feature of recent macroeconomic policy, this might be the best way from here to reduce the real exchange rate, if that were to prove necessary. Third, in the real world the Government must bear in mind that there are considerable uncertainties attached to any estimate of the equilibrium exchange rate. The FEER estimates themselves should be seen as having wide margins of error. Meanwhile, we have seen above that other estimates of sterling's valuation are not so pessimistic as the FEERs, while the recent behaviour of British exports does not seem to be consistent with a serious overvaluation. Fourth, we have argued that a devaluation of sterling would be likely to move the NAIRU upwards, which implies that a slightly high real exchange rate may be the best way of holding the NAIRU down. If this is the case, then the Government's tactic of joining the ERM at a rate which is slightly higher than some economists would like (but with scope for a 6% variation in sterling either side of the central rate should the entry rate have been wrongly chosen) seems justified. Fifth, there is the question of policy credibility. Entry to the ERM was intended to put the nominal variables in the economy in a strait-jacket which would prove more effective than domestic monetary control had been in the 1980s. To

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devalue sterling at the first hint of trouble, and before a decisive and permanent downwards shift in UK inflation had been achieved, could be very damaging for policy credibility in the medium term. Not only could this lead to a perverse upward movement in interest rates after devaluation, but it could easily cause the process of disinflation to be more painful than it otherwise need be. (This is because any erosion of nominal policy credibility would need to be compensated by higher unemployment in order to attain the same degree of disinflation.)

These arguments against an early and unilateral devaluation of sterling seem strong, though it should not be assumed that they need apply for ever. Once inflation has settled at a new low level, it is possible that some downward adjustment in sterling's central rate might be thought appropriate, especially if this is achieved in the context of a generalised ERM realignment. Provided that sterling is not seen as the central participant in the adjustment, and provided that a rapid further move towards full monetary union is announced at the same time, the damage to policy credibility need not be fatal. But based on the above arguments it would not seem appropriate to sue for a unilateral devaluation now as a means of easing a potential 'trade constraint' which may or may not prove biting over the medium term.

5.5 The Personal Sector Debt Problem

Apart from the balance of payments constraint, the main feature of the present economic environment which is causing pessimism about the economy's medium-term outlook is the exceptionally high ratio of consumer debt to income. Some analysts have argued that the economy is unlikely to recover while the personal sector faces a much greater overhang of debt than anything which has been experienced in the past. Their basic line of argument is very straightforward. Debt-to-income ratios for individuals are at all-time peaks, with debt generally fixed in nominal terms. This debt was incurred at a time when interest rates were relatively low, so that the debt-servicing costs could initially be managed comfortably on the levels of income which were then prevailing. However, the higher nominal interest rates which have been seen from mid-1988 onwards have greatly increased debt-servicing costs, forcing the personal sector to reduce consumption in order to maintain interest payments. This has resulted in a recession in the economy, which in turn has caused rising unemployment and declining income levels. As a result, debt-servicing problems have become even worse, and the economy has faced a downwards spiral.

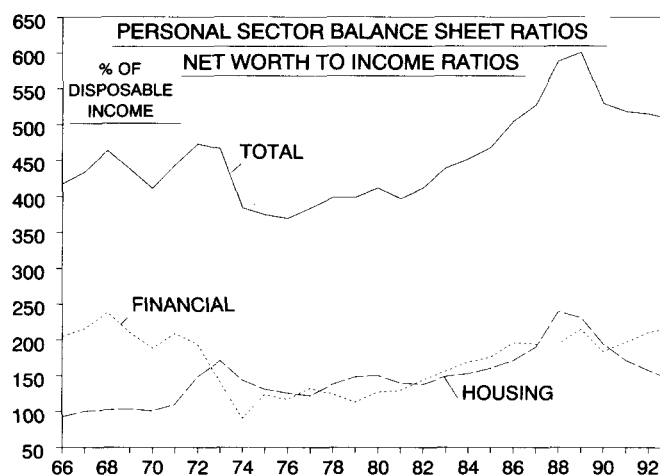
Furthermore, the argument goes, this downwards spiral has started to undermine the asset prices (mainly housing) which were originally underpinning the debt. Those individuals who have found it impossible to service debt have been forced into precipitous housing sales, or have simply allowed their homes to be repossessed. Repossessed houses have been dumped onto the market, usually at knock-down prices, and this has undermined house prices generally. This has then resulted in a decline in the net worth of the personal sector: asset prices have been declining, while outstanding debt has been fixed in nominal terms. This decline in net worth has then been a factor tending to increase the savings ratio further, since households have attempted to replenish their diminishing net worth. Thus, what was originally a debt-servicing problem has turned into a declining net worth problem, resulting in negative wealth effects on consumer spending.

In analysing this problem, it is useful to start with a little history. The economic boom of the 1980s was largely generated by a drop in the personal sector's net savings ratio, from 13.3% of disposable income in 1980 to 5.4% in 1988. This drop was wholly explained by an increase in gross borrowing, which rose from 6.5% of disposable income to 16.5% over the same period. (Meanwhile, gross savings flows into financial assets fell only slightly, from 17.3% to 15.3% of disposable income.) As a result of the rise in borrowing, the ratio of debt to income rose from around 53% in 1980 to over 100% in 1988.

Taken at face value, this looks remarkably like reckless behaviour. However, there were two mitigating circumstances. First, the existence of direct controls over credit in the 1960s and 1970s had probably led to the ratio of debt / income being artificially depressed, so the growth in this

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Figure 5.4



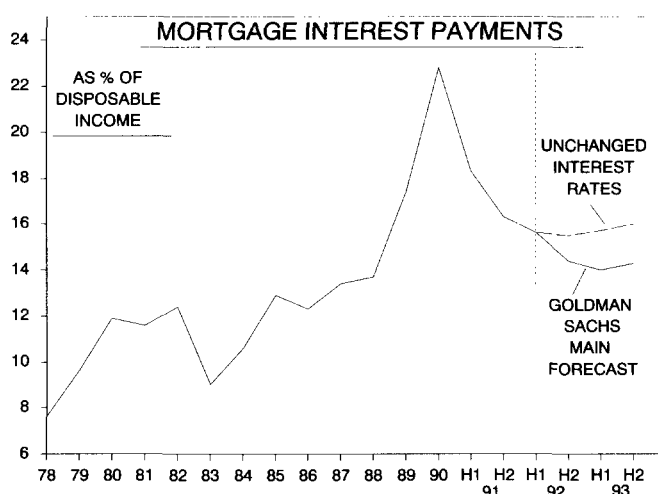
ratio in the 1980s may simply have taken the debt level up to where it would always have been in a free market. (There is nothing wrong with consumers borrowing at times during their life cycle, provided that they are able to service the loans, and then repay them at a later stage. Indeed, the suppression of such behaviour by the imposition of direct controls on lending may lead to a suboptimal out-turn for the whole economy.)

Furthermore, although consumer debt rose very rapidly, it rose no more rapidly than personal assets, so that the ratio of personal net worth to income actually increased up to 1988. One important item in this was, of course, the rapid rise in the value of housing assets, which in 1988 accounted for 42% of all personal assets. The increase in housing assets boosted consumption in several ways. First, consumers were able to extract part of their rising equity in housing, either by moving down market or by borrowing against it. Second, rising wealth encouraged a decline in net savings. Third, the rapid housing turnover which generally accompanies a buoyant housing market boosted the sales of furniture and other durables.

Since 1988, all of these processes have been working in reverse. House prices have generally been falling in a market characterised by low turnover, and the amount of equity withdrawal from housing has fallen sharply. Personal sector net worth has actually been falling in nominal terms for the first time in at least 30 years. Consumers have responded by cutting back sharply on the amount they have been willing to borrow, with the result that the net savings ratio has risen to around 11% of personal income. This has been the main factor explaining the depth and duration of the present recession.

From now on, the growth in private demand will be heavily influenced by whether consumers take the view that the savings ratio has now adjusted upwards sufficiently to allow for their impaired financial position. To argue that the savings ratio will stay unchanged or rise further, it is not sufficient simply to point out that balance sheet ratios are adverse, since savings may already have adjusted enough to take account of this fact. The question now is whether likely future developments in the financial position of the personal sector will persuade individuals to increase or reduce their net savings from here. This is likely to depend on (i) the development of debt-servicing ratios and (ii) the long-run debt / income and asset / income ratios desired by the personal sector. We will discuss each of these issues in turn.

Figure 5.5



First, debt servicing. There is no doubt that debt servicing as a percentage of personal income has been running at extremely high levels in recent years, as Figure 5.5 shows. At the peak in mid-1990, mortgage interest payments were absorbing around 23% of personal disposable income, as against an average of around 11% in the years from 1981-87. It is scarcely surprising that this led to a very depressed period for consumers' expenditure, and to a significant increase in the savings ratio. However, the key point is that this debt-servicing ratio has now started to improve, and a continuing rise in disposable income over the next few quarters, taken together with an assumed further 1% reduction in base rates, should reduce the ratio to around 15% of disposable income by the middle of 1992. This will still be somewhat higher than the average for the 1980s, but the fact that it is improving may encourage the savings ratio to come down from its present high level. Again, the key point is that the consumer sector may have fully adjusted its level of spending downwards to reflect the exceptionally high debt-servicing ratio it faced during 1990; as this ratio declines, consumption might recover, even though the absolute level of the debt-servicing ratio could remain above what might be construed as normal.

5.6 Debt Sustainability

We now turn to the more complex area of the debt and asset ratios that might be desired by the personal sector. It is clear that debt / income ratios are still extremely high, even though they have flattened out as consumers have controlled their borrowing over the last couple of years. On present trends, there seems little prospect that these ratios will come down very much in the near future, since the outstanding stock of debt has continued to grow roughly in line with income, even in the depressed circumstances of 1991. The key to the future will depend on whether consumers find this acceptable. To what extent are present debt levels capable of being sustained in the medium term?

One logical way of approaching this question might be to apply to the consumer sector the same kind of debt sustainability analysis which is frequently applied to the public sector. The gross outstanding debt of the personal sector at the end of 1990 was £442bn, which was equivalent to 90% of gross personal income. Goldman Sachs has estimated that, at 'steady-state' interest rates and income growth rates, the gross borrowing requirement of the personal sector required to stabilise this debt ratio on trend would currently be about £43bn, equivalent to 8.7% of personal income. (This assumes that the trend rate of growth of the economy is 2.25% per annum, the real interest rate is 4%, and the long-term inflation rate is 4%.) In 1990, the identified total borrowing of the personal sector was £39bn, slightly less than the 'sustainable' rate of borrowing. Even if we add the personal sector balancing item of £9bn to total borrowing - which is a pessimistic way to allocate the unidentified items in the personal accounts - the implied increase in debt (£48bn) was only a little higher than the sustainable borrowing rate.

These calculations suggest that, over the long term, the savings ratio has already returned to sufficiently high levels to stabilise the consumer sector's debt / income ratio. However, the relevance of these calculations is extremely limited, since (unlike the public sector) the personal sector has a very large stock of liquid assets against which to set its gross debt. While the gross outstanding debt of the personal sector was £442bn at the end of 1990, the net outstanding debt (total borrowing less holdings of liquid assets) was only £31bn. It is not clear why debt sustainability calculations should be applied only to the liability side of the balance sheet.

Nor is it clear why other financial assets should be ignored. If we look at the total financial asset holdings of the personal sector, including holdings in life assurance and pension funds, we find that the sector enjoyed positive net worth of £733bn at the end of 1990. Another way of looking at sustainability is therefore to ask what level of net savings would be necessary in order to maintain the ratio of financial net worth to income at unchanged levels, making certain assumptions about the steady-state rates of increase in asset prices and the various levels of interest rates on different asset classes.

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This is a much more complicated procedure than simply looking at gross borrowing figures, but it is probably more appropriate for the personal sector, since the mix of financial assets and liabilities is so much more complex than it is in the case of the public sector. The latter has few financial assets, so that (apart from privatisation) there is relatively little potential for building up or running down both sides of the balance sheet. The consumer sector, by contrast, can reduce its borrowing by running down its financial assets, or can decide to take on extra debt in order to build up assets further. Therefore it seems appropriate to look at both sides of the personal sector's balance sheet simultaneously. (Of course, there are potential aggregation problems here, since any given individual may not choose simultaneously to hold both assets and liabilities.)

Goldman Sachs estimates that the personal sector held around £436bn of interest-bearing assets at the end of 1990, along with £713bn of equity-related assets and £13bn of non-interest-bearing assets. Meanwhile, it held £288bn of mortgage liabilities and £154bn of other interest-bearing liabilities. Using different estimates for the interest rates paid and earned on each of these asset and liability types, and making due allowance for tax deductibility, Goldman Sachs estimates that the personal sector would need to run a financial surplus equivalent to 4.5% of its personal disposable income in order to stabilise the ratio of total financial net worth to disposable income in steady state.

The financial surplus of the personal sector is estimated to have been running at an annual rate of £20bn in the first half of 1991, which is equivalent to more than 5% of personal disposable income. The personal sector therefore already seems to have made a sufficient upward adjustment in its savings ratio to enable it to stabilise its ratio of financial net worth / income at present levels, assuming steady-state performance by the financial variables concerned.

Although these calculations may be reassuring, they are not sufficient. Unlike the public sector, the personal sector is not a single entity, so as we have seen, it is not possible for it to take a single decision about its preferred debt and asset holdings. Instead, what we observe in the official statistics is the result of millions of separate decisions taken by individual households each year. In making calculations about what is needed to stabilise net worth / income ratios for the sector as a whole, there is a risk of ignoring important aggregation problems. Furthermore, we have no particular reason for assuming that the personal sector will choose to hold indefinitely into the future any particular debt / income or assets / income ratio which is in place at any given moment. Thus, while we can say that, in steady state, the present level of net savings is sufficient to maintain financial wealth / income ratios at existing levels, there is a possibility that individuals might choose to increase their wealth / income ratios, in which case savings would need to rise. Alternatively, they may feel that the present ratios are rather high, in which case they could run down savings and allow their wealth ratios to decline. The personal sector may also take a wider view of wealth than is implied only by looking at financial assets

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and liabilities. In particular, a decline in house prices may persuade them to build up their financial wealth in order to leave overall wealth unchanged.

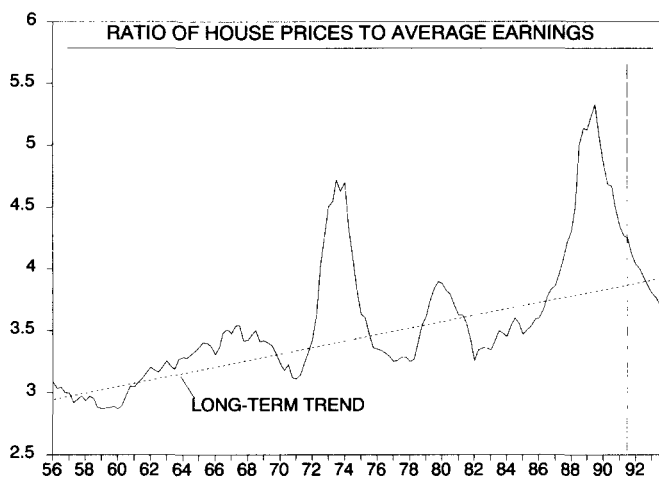
One way of tackling some (but not all) of these problems is to estimate direct econometric relationships between the savings ratio and the many other variables which may affect individuals' decisions on how much to save - including inflation, the change in unemployment, interest rates, house prices and financial net worth. The long-run solution to these equations produces an estimate for the desired 'steady-state' savings ratio which is behaviourally driven. Goldman Sachs has recently made estimates in this area. Assuming that both housing and financial wealth remain close to present levels, the long-run solution of its econometric equation suggests that the savings ratio could eventually settle at around 8-9%, roughly 2-3% below recent levels.

Again, this seems reassuring from the point of view of the development of consumer spending and economic activity over the next several years, since it indicates that the savings ratio has already adjusted by more than enough to reflect the financial and overall net worth position of the personal sector. However, one important caveat to this conclusion is the following. The personal sector may be influenced by the possibility that its housing wealth will in the future decline by a greater amount than is currently shown in house price indices. This may partly be based on a feeling that houses could not quickly be sold for the price levels implied by these indices. If this is a widespread fear, then savings may stay high in anticipation of further cut-backs in housing wealth.

Certainly, when house prices were exceptionally high relative to personal incomes in 1988, it was reasonable for the consumer sector to fear that a 'bubble' in house prices may have been taking place, in which case the underpinning of their financial wealth was tentative at best. However, much of this bubble has now disappeared. The ratio of house prices to average earnings should be back to trend by the second half of this year, and 'affordability indices' for first-time buyers are now back within normal ranges. If the high current levels of personal savings are being driven mainly by fears about future house price declines, then it is comforting to note that the fundamental determinants of house prices suggest that this decline should soon end. The market is now much better underpinned by economic fundamentals than it has been for many years.

Finally, it is worth pointing out that if the consumer sector were becoming more rather than less worried by its financial and housing wealth situation, we would not expect to find consumer confidence on a rising trend. Yet the Gallup consumer confidence indicators have moved sharply upwards since they reached a trough early in 1990, and even in recent weeks (when there have been fears that UK interest rates might need to increase) the set-back to these confidence figures has been relatively minor. Past relationships between consumer confidence and consumer spending indicate that the latter should rise by at least 2% this year, which is rather more than is suggested in consensus forecasts.

Figure 5.6



Overall, therefore, it seems reasonable to conclude that the present high levels of consumer debt, and worries about house prices, should already have been reflected in the increase in the savings ratio which occurred up to the middle of last year. Certainly, the personal sector's financial surplus is already extremely high by past standards. A reasonable view of the medium-term future would therefore be that personal savings are more likely to decline than rise from here, with the personal sector's financial surplus tending also to diminish. As this occurs, there should be some automatic tendency for the government deficit also to decline from the exceptionally high cyclical levels which will be seen over the next two years. However, if this analysis proves wrong, and the personal sector financial surplus remains unusually high, then it will be extremely difficult to eliminate the PSBR over the medium term, or perhaps even to reduce it substantially. What would this then imply for the development of public sector debt ratios over the medium term?

5.7 Public Debt and the Maastricht Treaty

In 1992-93, the PSBR seems likely to be around 3% of GDP including privatisation receipts, and around 4.3% of GDP excluding such receipts. These figures, if maintained, would certainly be much higher than those which would be consistent with a stable ratio of public debt / GDP in the medium term. Assuming that real interest rates average 4%, while trend real GDP growth is 2.25%, then the ratio of gross public sector debt to GDP can be stabilised over the medium term only if the public sector surplus (excluding interest payments) is around 0.5% of GDP. Since government interest payments will be around 2.5% of GDP in 1992-93, this would suggest an overall budget deficit consistent with debt stability of about 2% of GDP (or £12bn).

However, these figures exclude the impact of privatisation, which runs down the assets side of the Government's balance sheet. In order to allow for this, we need to subtract £8bn of privatisation receipts from the figure just given, indicating that the Government should run a PSBR of about £4bn, slightly less than 1% of GDP, in order to leave its net asset position stable in the medium term. This therefore clearly implies that the borrowing requirement will need to be substantially reduced from its 1992-93 levels if the public sector debt or net asset ratio is to be stabilised.

On the other hand, while public sector debt ratios would increase if the PSBR remained around 3% of GDP in the medium term, they would not increase very rapidly, and of course they start from relatively low levels in a European context. At present, the ratio of net public debt / GDP in Britain stands at around 32%, while the ratio of gross public debt / GDP is 38%. Assuming that the PSBR were to remain at 3% of GDP throughout the next five years, then the ratio of net public debt / GDP would rise from 32% to about 38%, while the gross debt ratio would rise from 38% to 41%. For Europe as a whole, the net public debt ratio stands at 42%, while the gross debt ratio is 58%. In both cases, the British ratio is therefore well below average, and would probably remain so even if the UK PSBR stayed close to 3% of GDP over the next five years.

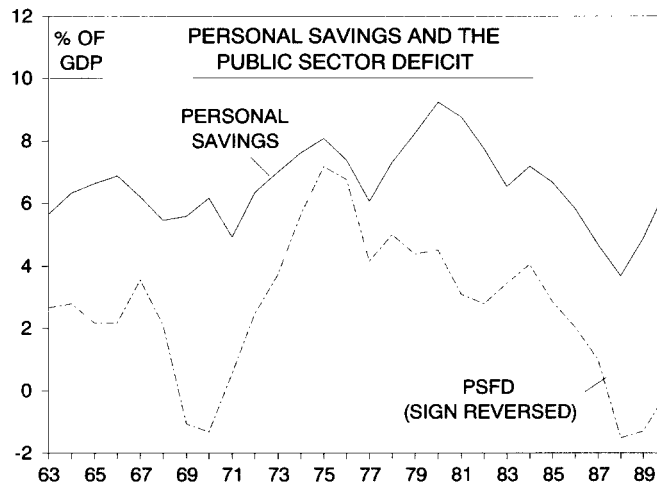
The Maastricht Treaty on European Monetary Union contains two broad guidelines which will in future be used to assess whether 'excessive' fiscal deficits exist in member states. The first is that the general government borrowing requirement should be less than 3% of GDP, and the second is that the ratio of gross government debt to GDP should not exceed 60%. The UK is likely to meet the second of these guidelines extremely comfortably at any time on the foreseeable horizon, but it is quite possible that the first guideline might be exceeded over the next two years at least. Would this be a problem in practice? It seems unlikely, since the consequence of exceeding a Treaty guideline is simply that the Commission would then prepare a report on whether an 'excessive' deficit exists - and in doing this it could take into account 'all relevant factors', including the medium-term economic and budgetary position of the member state. It is most unlikely that the Commission would rule that an

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'excessive' deficit exists in the UK at anything near present borrowing levels; if it does so, it will have to reach the same judgement on rather a large number of member states, including Germany.

This should therefore leave considerable scope for the UK to run a medium-term PSBR of around 3% of GDP, if this should prove necessary or desired by the Government. If the private savings ratio remains higher than is suggested by our discussion above, then a government of either main party would in effect be forced to take full advantage of this leeway, since any attempt to eliminate (or even reduce) government borrowing in such an environment could well leave the economy very short of demand over the medium term. If, on the other hand, the savings ratio falls to (say) 8-9%, then it should eventually be possible to reduce or eliminate the PSBR - but this would depend very largely on the policy choices of the Government in office at the time.

Figure 5.7



Even if the private sector savings ratio falls, a Labour Government would be likely to take full advantage of the scope for running a PSBR within the Maastricht guidelines, and would in effect allocate this scope to extra public spending. The Conservatives, by contrast, are currently committed to 'balancing the budget over the economic cycle'. This is a rather vague commitment, perhaps implying that the PSBR would be eliminated by the end of the next Parliament. But it is easy to be sceptical about whether the Conservatives would, in practice, choose to implement this commitment (unless the cyclical upswing in activity proves much stronger than anyone expects). Whatever they are now saying, it will be very tempting for the Conservatives also to use up the scope available in the Maastricht formulation to keep the PSBR at around 3% of GDP over the medium term. Without doing this, the political demands for tax cuts and expenditure increases will be rather hard for them to satisfy in the next

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Parliament. We now turn to a more detailed analysis of the likely path for the PSBR in the medium term, and the implications of Labour and Conservative government for the public finances.

5.8 The Public Finances to 1996-97

As we approach the general election, much attention is being given to the taxing and spending aims of the main parties, and the extent to which they can hope to achieve them. The Conservative Party has made it clear that it would like to return to a balanced budget, and cut the basic rate of income tax from 25% to 20%. The Labour Party would like to increase the level of spending on public services, and while prepared to finance short-term commitments on social security benefits from abolition of the NI ceiling and a new top rate of income tax, intends only to increase other spending as and when economic growth provides some room for manoeuvre. In this section of the Green Budget, we aim to provide a public sector finance framework within which to assess the objectives of the parties. While we accept that any projection to 1996-97 must be speculative, it seems sensible to attempt to outline a range of possible outcomes.

The main prerequisite to a projection of the public sector finances is a view of the likely path for the economy; ours is described earlier in this chapter. We assume that the political affiliation of the Government will have no impact on the rate of economic growth. This may seem unduly sceptical, but is quite consistent with prior experience, and in any case focuses our attention on the most important underlying issues.

Because of the uncertainty surrounding projections into the medium term, we project the public sector finances not only on our baseline projection for the economy, but also on a more optimistic and more pessimistic projection. The growth rates for GNP for these three scenarios are shown in Table 5.2. Details of the corresponding projections for wages, employment, prices, consumers' expenditure and profits, along with greater detail on the PSBR projections, are given in Appendix 1.

Table 5.2. GNP Assumptions to 1996-97

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Baseline	-1.8	2.5	2.5	2.2	2.2	2.2
Optimistic	-1.8	3.2	3.2	3.0	3.0	3.0
Pessimistic	-1.8	1.8	1.8	1.5	1.5	1.5

In our projections we have modelled receipts using the same techniques as for the normal Green Budget exercise. We use the Government's plans for public spending as far as 1994-95, and assume a real growth of 1.5% p.a. thereafter. We assume price indexation of all allowances and no change in tax rates, because our aim is to estimate the likely outcome based on unchanged policies. Table 5.3 shows the projections for the PSBR and its main components to 1996-97 using our baseline economic assumptions.

Table 5.4 shows the PSBR figures alone for the three scenarios.

Table 5.3. The Public Finances in the Medium Term - Baseline Case

£bn	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Inland Revenue	81.4	84.5	92.9	102.2	110.8	119.9
Customs and Excise	62.4	67.6	72.1	76.7	81.5	86.6
General government receipts	224.1	236.8	255.6	275.5	293.8	313.2
Central government spending	157.0	168.6	178.0	185.4	195.2	205.6
Privatisation	-8.0	-8.0	-5.5	-5.5	-5.5	-5.5
Planning total	204.9	226.6	244.5	258.0	271.1	284.7
General government spending	236.1	256.3	276.5	291.1	307.2	319.6
PSBR	11.8	19.5	20.5	15.5	11.2	6.4

Table 5.4. PSBR Projections to 1996-97

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Baseline	11.8	19.5	20.5	15.5	11.2	6.4
Optimistic	11.8	18.5	17.4	9.9	4.7	-3.5
Pessimistic	11.8	20.6	22.9	19.8	18.2	14.3

Perhaps the most important, albeit quite obvious, point to be made is that the out-turn for the PSBR on unchanged policies in 1996-97 is highly sensitive to the performance of the economy, with a projected PSDR of £3.5bn on the most optimistic scenario, and a PSBR of £14.3bn on the most pessimistic. One of the most marked features of the past six years has been the speed with which the public sector borrowing requirement fell, became a large public sector debt repayment and then returned to a large public sector borrowing requirement. Public sector finances in the UK are highly cyclical; government's scope for tax cuts, borrowing reductions or spending increases is highly dependent on the performance of the economy. While it is probably true that our two growth projections are at the extreme of what may happen, they are not absurdly so. If the next Government is to succeed in cutting tax rates or raising public expenditure, it will need to rely on economic growth.

Public Sector Finances under the Conservatives

Turning specifically to the Conservatives, it seems that to achieve their goal of a balanced budget would be quite hard in the next Parliament. Only if the economy grew at the optimistic end of our range, and if no tax cuts or spending increases are attempted until the 1996 Budget, could balance be achieved. It seems unlikely that a Conservative Chancellor, faced with a growing economy and a shrinking PSBR, would be able to forgo income tax cuts simply to accelerate the PSBR's decline. The realisation that this is the case seems likely to lead to some relaxation in the pursuit of a balanced budget.

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Even assuming acceptance by a Conservative Government of lengthy delay in the return to budget balance, it seems that the first years of the next Parliament would not be tax-cutting ones. Our projections suggest that the PSBR would not begin to decline until 1994-95, whatever the path for GNP. But provided the budget balance target can be put off, in the second half of the Parliament, the PSBR would fall by enough to allow some tax cuts. If growth were to be near the optimistic end of our range, those tax cuts could be large, with a 20p basic rate from 1996-97 consistent with a PSBR of some £9bn, or only 1% of GDP. If growth is slow, even small reductions in the income tax rate seem likely to leave the PSBR at over 2% of GDP.

Public Sector Finances under Labour

To assess the medium-term path under Labour, we impose the abolition of the NI ceiling and a higher rate of income tax of 50% on taxable incomes in excess of £40,000. Income tax allowances and reliefs are restricted to the basic rate of income tax, and NICs imposed on investment incomes over £3,000 p.a. We assume that only half the revenue from the changes accrues in 1992-93.

On the spending side, Labour has proposed a one-off increase in pensions and child benefit (and allied benefits) and to uprate pensions in line with the faster of earnings or prices growth from 1992-93 onwards. Privatisation proceeds would be lower under Labour, although some revenue from pre-election privatisation would still be received. Apart from this, our spending projections are the same as for our earlier projections.

Table 5.5 compares the PSBR on baseline economic assumptions under the Conservatives and Labour, on the assumption that no changes other than those noted were made to either tax rates or spending plans.

Table 5.5. The PSBR under Conservatives and Labour: Unchanged Policies

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Conservatives	11.8	19.5	20.5	15.5	11.2	6.4
Labour	11.8	19.5	22.2	18.1	13.9	9.2

From 1993-94 onwards our projections suggest a PSBR some £2-3bn higher under Labour than under the Conservatives. This is well within the margin for error on such projections, and should probably be interpreted as there being almost no difference. But whereas the Conservatives' ambitions are to cut taxes and the PSBR, Labour's goal is to increase spending as and when economic growth allows. As for the Conservatives, scope for changes seems likely to be limited in the first two years of the Parliament, with 1994-95 being the first year with any growth dividend to be spent. But Labour is not committed to reducing the PSBR to zero, as the Conservatives are. If Labour can keep the PSBR at 3% of GDP (the EMU limit), annual public spending could exceed the Conservatives' plans by around £14bn on our baseline economic assumptions, but much of that

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increase would have to wait until the second half of the next Parliament. If growth is high, more scope would exist, but if growth is low, or Labour felt the need to reduce the PSBR to below 3% of GDP during the high-growth years of the cycle, substantial increases in spending would be difficult.

Unless the economy performs far better than could reasonably be expected, our projections suggest that neither of the main parties will be able to achieve all their goals in the next Parliament. If the Conservatives won and wanted to reach a balanced Budget by 1996-97, they would have to forgo tax cuts. It seems likely in that case that they would relax their aim of balancing the budget, or at least put it off, and hope to be able to reduce tax rates in the second half of the Parliament. If Labour won, its Government would have very little scope in the first two years of the Parliament for spending increases in addition to the commitments on child benefit and pensions. Thereafter, provided it retained a relatively high level of borrowing, it would be able to begin to increase public sector spending, but not by amounts that represent a large proportion of total public spending.

6 Tax Policy in the Medium Term

6.1 The Parties' Tax and Spending Proposals

Not surprisingly the tax and expenditure proposals of the three main parties have been the subject of considerable interest and controversy. Unfortunately a good deal of the debate has been ill informed and not especially useful. We try here to look at what the definite proposals of each of the parties are using their latest available official documents. We make some assessment of the possible effects of the policies.

To a large extent, what we can say is determined by the amount of detail in which the various parties have spelt out their policies, and this varies considerably between the parties. The Liberal Democrats published a 36-page document¹ dealing specifically with their tax and benefit proposals. The Labour Party's most recent policy document contains only two pages under the heading 'Our approach to public spending and taxation'², although an earlier document contains ten or so pages.³ The Conservatives, by contrast, have published nothing containing specific pledges regarding their tax policies, though certain aspirations have been made clear.

Expenditure commitments tend to be at least as hard to pin down as taxation proposals. Clearly both the opposition parties would like to increase expenditure in a range of areas including health, education and training, and transport. However, they are unable to make immediate commitments to increase spending because of the cost and implied increases in tax. Therefore we do not look at the parties' long lists of spending targets or priorities but just at those where a definite and specific pledge to spend extra money immediately has been made.

We begin by examining policies on personal taxes and benefits, then consider business taxation, and finally assess the likely future development of taxation as it affects the environment.

¹ Social and Liberal Democrats, *Common Benefit: Liberal Democrat Policies for Reform of the Tax and Benefits Systems*, Federal Green Paper no. 11, 1989.

² Labour Party, *Opportunity Britain*, 1991.

³ Labour Party, *Meet the Challenge, Make the Change*, 1989.

6.2 Personal Taxes and Benefits

Labour Policy

The Conservatives have made a number of claims concerning what the tax burden might be under the Labour Party, including the assertion that the basic rate of tax would have to be raised by 10% if all Labour's spending commitments were to be met. We concentrate here on those aspects of the tax system which the Labour Party has promised to reform in the short term, and the two definite spending commitments it has made on raising child benefit and raising the state pension.

Most attention has been focused on two of Labour's proposed changes to the tax system - the abolition of the upper earnings limit (UEL) on National Insurance contributions (NICs) and the introduction of an extra 50% rate of income tax at the top of the income distribution. However, Labour's policy documents contain a number of other significant proposals. With regard to the income tax system they propose 'moving toward a starting rate below 20%' and 'a series of tax bands ending in a top rate ceiling of 50%' (Labour Party, 1991). In other words, they want to introduce a rather more banded income tax system than the present one. With regard to tax reliefs and personal allowances, it is proposed that they be 'of equal value to everyone' rather than worth more to higher-rate payers as at present. A cash limit will be set on total reliefs available, or a minimum tax set for those on top incomes to prevent excessive tax avoidance. The married couple's allowance will be frozen, but it will become possible for it to be split between husband and wife.

Furthermore, Labour aims not only to remove the National Insurance UEL but to make two other significant reforms to the NI system. Firstly, NI will be levied on the investment incomes of non-pensioners, once those incomes exceed a level of £3,000 per year. Secondly, it is the party's eventual aim to replace the NI lower earnings limit (LEL), on income below which a rate of 2% is levied once the LEL is reached, with a personal allowance similar to the personal tax allowance.

Between them these proposals represent a fairly radical restructuring of the personal tax system. We examine each proposal in turn.

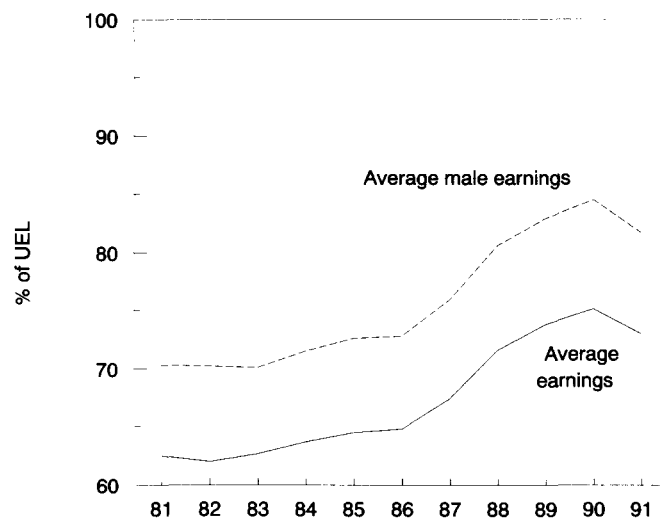
The removal of the NI UEL will remedy one of the more ludicrous aspects of the direct tax system. At present, people earning under £20,280 per year (the UEL) pay a marginal rate of tax of 34% (25% income tax + 9% NI), whereas those earning above the UEL, but below the higher rate threshold, pay a marginal rate of just 25%. Because the UEL increases only in line with prices, it has been affecting a greater and greater proportion of the working population over the 1980s, as real earnings have grown. The UEL is now just above average male non-manual earnings. The result is a marginal rate structure which is inconsistent with a progressive and sensible tax system.

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Figure 6.1 shows how average earnings and average male earnings have grown as a percentage of the UEL since 1981. Average male earnings grew from 70% to over 85% of the UEL by 1990, overall average earnings from 62.5% to 75%. Clearly if this trend continues, average male earnings and the UEL will be coincident by the early years of the next century and we will reach a situation such that those on just-above-average earnings are paying a lower marginal tax rate than those just below. This is already very nearly true of non-manual male earnings. The final consequence is that the longer reform is delayed, the more difficult it will be as more people are affected.

Figure 6.1

Average Earnings as a Percentage of the UEL



The proposed abolition of the UEL is therefore to be applauded on the grounds of coherence in the tax system. It will also raise a substantial sum of money, perhaps around £3bn. On the other hand, it will adversely affect a large number of people - some 3.2 million employees will have earnings over the UEL in 1992. These people will lose, all else being equal, 9% of their earned income in excess of the UEL. Hence someone on £25,000 a year would lose £424.80 per year, someone on £30,000 would lose a further £450, and so on. Each extra £1,000 in earnings would result in a further loss of £90 per year. Substantial losses, though, will be confined to a smaller group. The majority of those affected earn only a little above the ceiling. Losses of £600 per year, or £50 per month, start to bite at salaries of £27,000 and losses of £1,200 per year or £100 per month will affect only those earning over £33,500 per year, the top 3-4% of full-time workers.

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The introduction of a new 50% rate of income tax will also hit those at the top of the income distribution. However, far fewer people will be affected. If, for example, 50% became payable on *taxable* income of over £35,000, one would have to have gross income of around £40,000 before being affected. Yet around £2bn could be raised like this. Set at this level, even a married man on £50,000 per year would lose less than £1,000 per year compared with £2,700 from NI. Only the top 1% or so of taxpayers would be affected by more than this.

The combination of the removal of the UEL and the new top rate of tax would result in a top effective marginal tax rate of 59%, still one point lower than that which was in force until the 1988 Budget.

At the bottom of the income tax structure, the policy proposals are no less radical. In particular the conversion of the main personal allowance into a 'zero rate band' would make it of equal value to all taxpayers. At present the single personal allowance of £3,295 reduces a basic-rate taxpayer's bill by about £824, but it reduces a higher-rate payer's bill by £1,318. Conversion to a zero rate band would make it cheaper to increase the allowance which takes people out of tax entirely. This is another policy with a potential to hit higher-rate taxpayers, though any potential losses could easily be offset by increasing higher-rate thresholds.

This change will help Labour to meet its commitment to alleviate the income tax burden on low-income people 'by adjustments in personal allowances' (Labour Party, 1991, p. 13) so that the income level at which people start to pay tax will rise. Labour also believes that the initial rate at which income tax is paid is too high and will move 'toward a starting rate below 20 per cent'. This starting rate would be part of 'a series of tax bands' ending at the top rate of 50%. The rationale behind a policy of this sort is less clear. Such a change would complicate the tax system, and yet would probably achieve less than would an increase in tax allowances. The complications would arise especially in connection with investment income. Now that the composite rate has been abolished, investment income is taxed at source at the marginal rate of the taxpayer. With a multiplicity of marginal rates, this form of taxing investment income at source will become very difficult. It is *always* more helpful to the poorest taxpayers to increase allowances than to reduce tax rates.

This point is most obviously made if we compare the effect on somebody with £500 of taxable income of introducing a lower starting rate of tax of 20%, with increasing personal allowances by £500. The former measure will save him £25 (5% of £500) per year, the latter measure would save him £125 (25% of £500). On the other hand, the reduced tax rate would be worth more to people further up the income distribution, and would be

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worth most to people at or above the limit at which it applies. Here it would be worth 5% of the full taxable income band over which it applied to those with incomes above that level.¹

The one clear advantage to increasing the number of tax bands is to introduce more flexibility into the system, making it easier to design a system with a series of particular objectives in mind.

The final structural change to the income tax system proposed by Labour relates to the taxation of husband and wife. The new system of independent taxation introduced in 1990 gives to each person a single personal allowance and to each married man an additional married couple's allowance (MCA), which can be transferred to his wife if he has inadequate income to make full use of the MCA. Labour proposes to give couples the right to split the MCA between them so that both partners can receive equal benefit from it. In its original document, it proposed to phase out the MCA entirely, but this proposal was dropped in favour of freezing it at its current nominal level. The original proposal was founded on the belief that it is wrong that the amount of tax one pays should depend upon sex or marital status. The revised proposal will ensure that gender need not affect tax liabilities but will retain the present bias in favour of marriage. Freezing the MCA will, of course, gradually reduce this bias as time goes by and reduce the estimated annual cost of £5.4bn, associated with its retention, in real terms.

Returning to National Insurance contributions, Labour proposes two changes in addition to the removal of the UEL. The first would be the introduction of NICs on unearned income of above £3,000 per year for non-pensioners. To be receiving this amount of unearned income, one would tend to need investments totalling at least £30,000. The stated aim behind the policy is to go some way to remove the distinction between earned and unearned income, in that the former is presently subject to NI while the latter is not. As such it appears to be a reasonable proposal designed to improve the coherence of the tax system. However, the taxation of savings is a notably difficult area. The problem is that different forms of saving are taxed very differently. Housing, personal and occupational pensions, and personal equity plans, for example are tax-privileged forms of saving, and the proposed 9% increase in the tax on investment income would not apply to these. It would apply, however, to income from bank and building society accounts and stocks and shares. These are already relatively tax-penalised forms of saving. Hence the result of introducing NICs on investment income might be to exacerbate the already unequal treatment of different forms of saving and add to the incentives to move savings into tax-privileged assets. Of course, to the extent that there is any rationale for charging the same rate of tax on

¹ It is worth noting that it is not necessary to increase the number of tax bands to increase the progressivity of the income tax system. Increasing the tax-free allowance will do this as well, because progressivity depends on the *average* tax rate at each income level and *not* on the marginal tax rate. Increasing the allowance decreases the average tax rate on those with low incomes far more than that on higher-income people.

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unearned income as on earned income, then NICs should also be charged on the former. The exemption of pensioners from this extra tax on investment income could, however, lead to strong incentives to delay the receipt of interest until pensionable age for some older sections of the population.

Labour has promised to institute a more general review of the taxation of savings, which would be welcome, given the lack of a clear direction in this area in the last 13 years. It might have been better if proposals to charge NICs on investment incomes had been left to such a review.

The other aim for NI reform is the eventual conversion of the LEL into an allowance, like the income tax allowance, instead of the present system whereby 2% is levied on income below the LEL once the LEL is reached. This appears to be an entirely laudable proposal. Employer NI contributions have an even less satisfactory structure with bands of 5%, 7% and 9%, with these proportions becoming payable on all income once the relevant earnings threshold is reached. Thus at each threshold there is a strong incentive for the employer to hold wages down in order to save tax. Thus, says Labour, 'employers should in principle be liable for a contribution in respect of all employees including those earning under £43 per week (the LEL)' (Labour Party, 1989). This would solve the present problem regarding thresholds and could be used as a way of ensuring very low earners are covered by National Insurance benefits. On the other hand, it could be administratively complex, especially for companies employing part-time workers. Incorporating a low NI-free allowance, as is proposed for employee NICs, might be a more efficient way of achieving this objective.

The proposals for income tax and NICs are more fully discussed than are those for other taxes. However, specific proposals regarding capital gains tax and inheritance tax also exist. At present, an individual can receive capital gains of up to £5,000 per year without paying any tax. The exemption level for a married couple is thus £10,000. These levels of exemption are very high by comparison with, for example, income tax allowances. Labour promises a substantial reduction in their size.

The abolition of capital transfer tax in 1986 means that only transfers of wealth on or close to death are taxed, and then only transfers above £140,000. Labour intends to introduce more effective and progressive taxation on inheritances, including lifetime gifts. One option under consideration is the possibility of taxing wealth on receipt rather than on donation, i.e. instituting a recipient-based tax. This would create some incentive for the wider dispersal of wealth. It is also more rational to tax the person receiving the advantage of the wealth. A second policy under consideration is 'assessing transfers of wealth and any exemptions from liability on a lifetime basis so that tax is charged according to the accumulated amount a beneficiary has received in gifts and bequests over a lifetime'. This would add administrative complexity to the system but could be a step towards a more effective and equitable system of taxation on the transfer of wealth.

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Table 6.1. Labour's Tax Plans at a Glance

Proposal	Numbers affected	Cost / benefit
Remove NI UEL	3.2 million employees	About £3bn
Convert NI LEL to allowance	All employees earning over LEL	Depends how it is implemented
Impose 50% top rate of tax	Possibly 0.5 million depending where it is set	£1-£2bn
Impose NI on unearned income over £3,000	?	£800m?
Introduce lower starting rate of tax and more tax bands	All taxpayers	Could be implemented on cost-neutral basis
Freeze married couple's allowance	All married taxpayers	£200m
Restrict income tax allowances and reliefs to basic rate	Higher-rate and near higher-rate taxpayers, about 2 million	Around £2bn
Reduce capital gains tax allowances	?	?
Reform inheritance tax	?	?

Note: All numbers are approximate. Benefits should not be added together, the combination of different policies in different ways could make large differences. Not all these policies would be implemented immediately.

On the spending side we restrict ourselves to consideration of Labour's commitments to increases in benefit levels. The main part of these increases involve raising retirement pensions by £5 per week for a single pension and £8 for a married couple, and child benefit by 30p for the oldest child and by £2.05 for second and subsequent children. These increases would involve concomitant increases in income support and housing benefit for pensioners and families with children to ensure that the poorest members of these groups also gained. Furthermore, benefits such as the invalidity pension and widow's pension which are linked to retirement pension levels by statute would go up by the same amounts as the retirement pension. The net cost of these pledges would be of the order of £3bn, with around £2bn extra being spent on pensions, £700m on child benefit, and £450m on the other benefits. About £200m would be recouped in resulting increases in income tax receipts. We have not taken account of the cost of Labour's short-term proposals for encouraging investment and helping industry.

Who will the NI and benefit reforms affect?

All those earning over £20,280 per year would be affected by the removal of the employee NI UEL. Here we look in more detail at who these people are.

First, as is to be expected, losers are concentrated at the top end of the income distribution. Over 40% of the population's richest decile will lose from the change, as against only one-fifth of the ninth decile and just 13% of the eighth decile. Very few of the bottom 70% of the income distribution will lose at all.¹ Losses for the top decile as a whole will average around £8 per week, but only £3 in the ninth decile and £1 in the eighth. These figures emphasise the concentration of big losses right at the top of the income distribution.

If we now look at the distributional effects by region, some interesting results can be found. Nation-wide 9% of families will be affected by the change. Note that a considerably higher proportion of families than of individuals will be affected since the majority of those earning over the UEL are married men whose wives will probably be earning below the UEL. Only one member of the couple needs to be affected for the family to be affected. Figure 6.2 shows the proportion of families which are affected in each region. Particularly noticeable is the relatively large proportion affected in London and the South-East where about 15% of families lose. This proportion falls to 6% in Yorkshire and the North-West. Average losses are also greater in London and the South-East.

The distribution of losers by age is equally marked. As Figure 6.3 shows, only a very small proportion of families headed by someone in the under-24 age-group loses, rising to 13% of 25- to 34-year-olds and 24% of 35- to 44-year-olds, falling back to 16% of 45- to 54-year-olds and just 12% of the 55 to 59 age-group. Pensioners, of course, are unaffected.

This, like the regional breakdown, reflects the distribution of earnings, which tend to be considerably higher than the average in London and the South-East and among people (particularly men) in their mid-thirties and early forties. Again it should be remembered that most of the losers will lose relatively little as the earnings distribution is much denser just above the UEL than higher up.

Of course, concentrating purely on the numbers who would lose from the abolition of the UEL shows only one side of the story. The money thus raised will be spent on increasing pensions and child benefit, benefiting other sections of the population. To show the overall effect, we have modelled the abolition of the UEL together with the promised child benefit and pension increases. We have also modelled a similar increase in the levels of means-tested benefits for pensioners and families with children. This ensures that the poorest members of these groups will gain from the

¹ Here we have ranked all families in the population by gross equivalent income such that the richest 10% of families are in the top decile, the next richest 10% in the ninth decile etc.

Figure 6.2
Losers from the NI Change, by Region

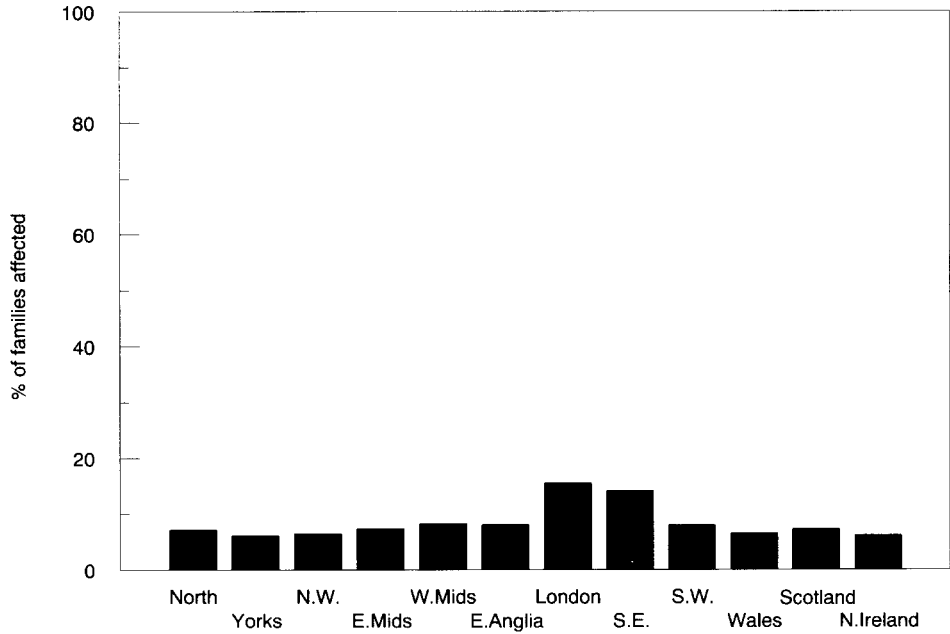
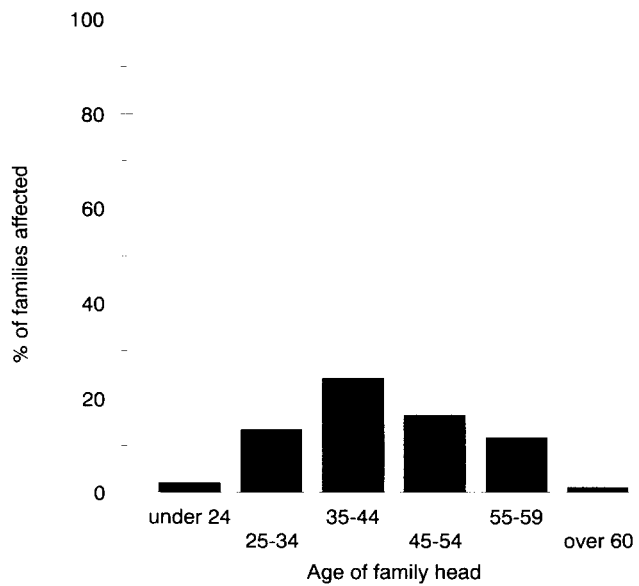


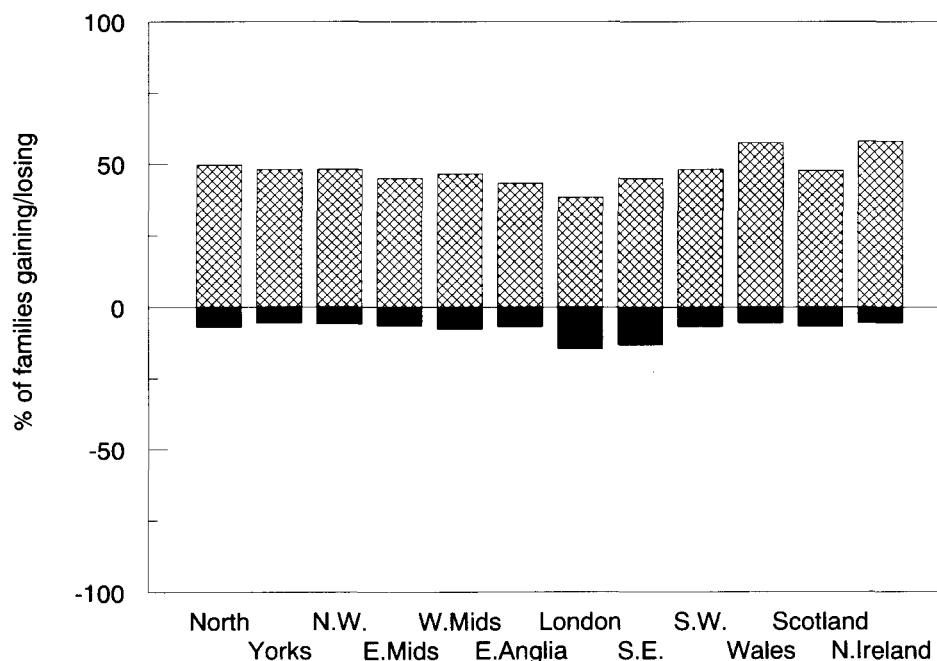
Figure 6.3
Losers from the NI Change, by Age of Family Head



benefit increases and is part of Labour Party policy. We do not attempt to show the effects of a higher top rate of tax partly because we do not know at what level it would be introduced, also because the UEL increase would be more than adequate to pay for the benefit increases modelled.

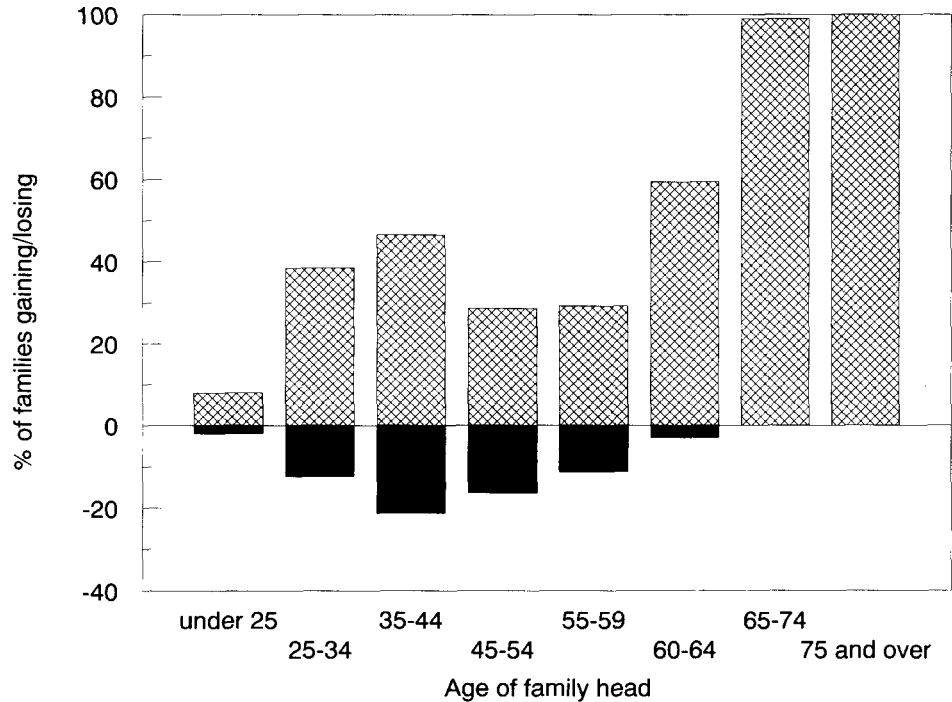
The number of losers in London and the South-East resulting from the abolition of the UEL is not much reduced but there are still more gainers than losers in these regions, as in all other regions. Whilst 15% of families in London lose, 38% gain from the overall package. At the other end of the spectrum, in Wales 6% lose and 57% gain. These results are shown in Figure 6.4, confirming the pattern of more gainers than losers country-wide.

Figure 6.4
Gainers and Losers from Labour's NI and Benefit Changes, by Region



The distribution of gainers and losers by age range shows interesting effects. Virtually all those over pension age gain. Very few of the youngest group either gain or lose since few have children and few have high earnings. Among 25- to 34-year-olds three times as many gain from the child benefit increases as lose from the NI changes. The gap between winners and losers is smaller among 35- to 44-year-olds when there are more high earners. The numbers affected then fall as both high earners and families with children become less common - about 16% of 45- to 54-year-olds lose while 29% gain. By the time the age-group 55-59 is reached, just 11% lose and 29% gain.

Figure 6.5
Gainers and Losers from Labour's NI and Benefit Changes,
by Age of Family Head



The combination of changes would benefit around 46% of families while 9% would lose overall. Only in the top two deciles are there more losers than gainers, though there are average losses in each of the top three deciles. Losers lose more on average than gainers gain. The lowest decile gains around £2 per week. The second and third deciles, where most pensioners are concentrated, gain most, around £4 per week. Gains then gradually diminish until in the eighth decile they become losses of 50p per week. In the richest decile, losses average £7 per week.

Liberal Democrat Policy

Many individual aspects of Liberal Democrat policy are similar to those of Labour Party policy, including for example the effective imposition of NICs on investment income and removal of the UEL. The framework within which these policies are based, and in particular the long-term aims, are, however, quite different.

The long-term aim of the Liberal Democrats is ‘to move towards a citizen’s income system, under which everyone will be paid as of right a monthly tax-free amount which for taxpayers will replace tax allowances’ and ‘to integrate tax and benefits, so that as far as possible tax records can be used as the basis for calculating benefits, and the need for a separate means test will be eliminated’ (SLD, 1989, p. 3). In other words, they want

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to introduce a guaranteed basic income and integrate tax and social security. In the short term, they propose to integrate income tax and National Insurance into a Broad Income Tax (BIT) payable at rates of 34%, 42% and 50%, and convert the personal allowance into 'a specific sum which can be set against their total liability to Broad Income Tax' (SLD, 1989, p. 11). They would also institute a radical reform of savings, moving towards an expenditure tax treatment, and reform inheritance tax and capital gains tax.

Immediate priorities for expenditure are again similar to those of the Labour Party, with increases in pensions and child benefit promised, but also increased income support levels for claimants under the age of 25.

The combination of income tax and NI into a Broad Income Tax would simplify the direct tax system and can be seen as a logical extension of the policy of removing the NI UEL. Like the Labour Party's plans, this will hit those earning above the UEL. However, the rate structure proposed would only impose a total 42% rate on higher income earners and the top 50% rate would be *inclusive* of NI. This contrasts with Labour's plans which would result in a total top marginal rate of 59%. The 50% rate will be applied 'above a threshold not less than twice the level at which the 40% rate begins' (SLD, 1989, p. 11). These reforms, then, will hit high earners considerably less hard than the Labour Party's proposals. The maximum loss from the effective abolition of the UEL will be 9% of the difference between the present UEL and the starting-point of the present 40% band. The size of the loss will depend on tax allowances but will be in the region of £900 per year.

The converse of this will, of course, be a significantly smaller tax take from the reforms to the extent that, unlike the Labour Party, the Liberal Democrats would be unable to fund their pension and child benefit commitments from those changes alone. Preliminary calculations indicate that not imposing the extra 9% at higher incomes will result in the Liberal Democrats raising at least £2bn less than Labour from their policy towards the UEL. Their intention also seems to be to institute the 50% tax band at a higher level than would the Labour Party.

The combination of NI and income tax into a BIT would require the conversion of the NI LEL into an allowance and an amalgamation of this with the ordinary income tax allowance. It is proposed that this be done so as to leave the combined payments of most people unaffected. A higher allowance would operate in respect of investment income to prevent people with small unearned incomes being made much worse off as a result of the imposition of the extra 9% on investment incomes, for the BIT would apply to all income, unearned as well as earned. (Pensioners would be subject to a lower rate of tax at 25% on income up to a ceiling, which was proposed at £17,000 in 1989 prices.)

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Because the BIT would be payable on all forms of income, it would, like Labour's proposals, add 9% to the tax rate on unearned income. The allowance against this, although not specified, would probably be considerably lower than the £3,000 proposed by Labour. But the Liberal Democrats' policy towards the taxation of savings does not stop here. They intend to extend the availability of tax relief on savings 'by allowing every individual to set up a Registered Savings Account (RSA). Taxpayers could pay part of their income into an RSA, up to some specified limit, and obtain tax relief (or repayment of tax deducted at source) on their contributions. Income and capital gains arising within the RSA would, if reinvested, also be free of tax' (SLD, 1989, p. 13). Any type of investment would be allowed within an RSA, whether in shares, unit trusts or other interest-bearing assets. In doing this, RSAs would replace current tax-relieved forms of saving like PEPs and TESSAs, and possibly personal pensions as well.

In principle this proposal could move us a long way towards a more coherent system of savings taxation, replacing schemes like PEPs and TESSAs and opening up tax-relieved saving to a larger number of people. The current situation in which tax relief is applied to savings in certain forms and in certain schemes is undoubtedly incoherent and fiscally non-neutral. But the impact and costs of this change would depend crucially on the level at which the 'specified limit' was set on the amount that could be invested in the RSA.

The Government would effectively lose the tax on the returns to investments, not currently placed in tax-privileged assets, which were placed in an RSA. In 1990-91 the Inland Revenue received income of the order of £10bn from these sources. This could be the annual cost of introducing RSAs without limits on what could be invested in them. Of course, the party's policy does not imply this, and limits set at modest levels would reduce this cost enormously, particularly if money from other tax-privileged assets were moved into RSAs and counted towards the limits. But then the limits themselves would have to be very high, especially if RSAs are to replace personal pensions and allow housing in them. Their introduction could end up giving tax-privileged saving to a whole raft of the population at present not benefiting from PEPs, TESSAs and the like. But even with limits, the costs could be substantial if any real progress were to be made.

The Liberal Democrat proposals for inheritance tax are radical. Like the Labour Party, they want to bring lifetime gifts back into the tax net. But they would do this by 'taxing gifts and inheritances as broad income' (SLD, 1989, p. 14). There would be an annual exemption at a very low level (they suggest £3,000) but unused exemptions could be carried forward for up to ten years. The present exemption for transfers between spouses would be maintained. If made properly effective, such a tax could have a considerable impact. It might form an important step towards a more equitable distribution of wealth. It would certainly bring far more estates into the inheritance tax net. In 1987-88 only about 10% of estates were subject to inheritance tax.

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Other reforms proposed, on which we pass no further comment, include the eventual phasing out of the married couple's allowance, making basic state pensions tax-free, introducing a new system of childcare vouchers, reforming the structure of housing finance, and a reduced exemption limit for capital gains tax.

In the longer term the combination of income tax and NI will also form part of a fundamental strategy of replacing the whole edifice of the NI system and insurance benefits. The eventual intention is to replace income support, unemployment benefit and family credit with a new 'Low Income Benefit'. The state pension will become payable irrespective of any contribution record, and SERPS will be abolished, the savings from it being used to increase basic pension levels. In the long run the intention is to integrate the tax and benefit system fully and introduce a citizen's income which would give a non-withdrawable basic income to all. For taxpayers it would effectively replace the tax-free allowance. Given the avowedly long-term nature of these proposals, we do not comment further except to say that they represent an innovative and as yet untried response to many of the problems of the tax and benefit system as it presently stands.

Conservative Policy

Far less is known about future Conservative tax policy than about that of the other main parties. The one clear aim is a further reduction in the basic rate of income tax, from 25% to 20%. Such a change would cost around £11bn in 1992 prices.

The desire to cut the basic rate of income tax is consistent with policy since 1979. As to the rest of the tax system, the Conservatives can point to their changes over the last 13 years as exemplifying their approach. At present, there seem to be few areas where they would propose major restructuring. The only group of issues apart from income tax rates seems to be the taxation of savings and of wealth transfers. The early years of Mr Lawson's chancellorship seemed to move towards removing tax privileges for certain forms of saving, but that policy stalled after the 1984 abolition of life assurance premium relief. Since then, the trend has been in the opposite direction, with the introduction of PEPs and TESSAs. There have been some indications that a major reform of the taxation of savings could be part of a post-election Conservative programme; the most likely direction would seem to be to take still further the relief from income tax of the return on savings.

On the transfer of wealth, there have also been suggestions of reform. The most likely change here seems to be a further significant increase in the inheritance tax threshold.

6.3 Government and Business

Conservatives

When Mrs Thatcher resigned, there was a brief moment when it seemed that the Conservative Party would rediscover industrial policy. That chance receded with the election of John Major as leader and further diminished with the appointment of Peter Lilley as Secretary of State for Trade and Industry. If the present Administration is returned to office, there is only a remote prospect of any very significant change in government policy to industry. More likely would be a continuation of deregulation, further privatisation and a few limited measures to alleviate transitional pains where they occur in seriously depressed areas.

This is all supported by the Government's medium-term spending plans which foresee a drop in the budget of the DTI and continuing receipts from privatisation.

Labour and the Liberal Democrats

Probably of more novel interest is the policy of the Opposition. Labour has put great emphasis on the need to revive the manufacturing sector, reflecting a desire both to reverse Britain's long-run manufacturing decline and to respond to high levels of unemployment.

In order to help industry, the Labour Party proposes a range of fiscal incentives and other reforms. These are summarised in Table 6.2.

The Democrats' proposals for the business sector, outlined in their *Manifesto for Business*, are less detailed but include the stated intention of reforming the tax system so as to achieve neutrality with regard to inflation and different forms of savings. Like Labour, they have placed some stress on improving the infrastructure and training.

Perhaps the biggest contrast in outlook with the current Administration is in Labour's willingness to use taxes and subsidies to effect changes in the supply side and the level of demand in the economy. In particular, it is committed to using the corporation tax system to influence the level and composition of private non-domestic investment.

Its latest policy document, *Made in Britain*, proposes a Manufacturing Investment Expansion Scheme which would temporarily increase first-year capital allowances for some categories of investment, notably in plant and machinery, and in innovation and design. Precise details of the scheme have not been announced. The extended first-year allowances might apply to all investment in plant and machinery, or only investment in manufacturing plant and machinery (if 'manufacturing' can be defined).

To see the effect of the scheme, imagine a firm considering an investment of £100 in plant and machinery. Under the current system, it can write off 25% of the cost against tax in the year it spends the money, and it can then write off a declining balance on that investment in future years. If a firm invests £100 this year, its tax on this year's profits (which it actually only

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Table 6.2. Labour's Plans for Business

<p>INVESTMENT Manufacturing Investment Expansion Scheme: enhanced first-year capital allowances for investment in technology and equipment.</p> <p>Growing Business Initiative: tax incentives for individuals to invest in new and growing manufacturing firms.</p> <p>Establishment of National Investment Bank to channel private sector funds into infrastructure investment.</p> <p>Abolition of Business Expansion Scheme to finance the schemes above.</p>
<p>EMPLOYEES Statutory minimum wage, set initially at £3.40 an hour.</p> <p>Legal obligation to spend 0.5% of payroll on training.</p> <p>Full-time workers' rights to be extended to all part-time employees.</p>
<p>INNOVATION 25% additional tax credit for investment in R&D over and above that made in a base year.</p> <p>Creation of Technology Trusts to be run by technologists and business people. Aims include:</p> <ul style="list-style-type: none"> - improving the quality of technology transfer to smaller firms; - opening up laboratories to small and medium-sized firms; - furthering the commercial exploitation of scientific breakthroughs.
<p>REGIONAL POLICY Regional Development Agencies for England to match those already existing in Scotland and Wales. Responsible for:</p> <ul style="list-style-type: none"> - the development of property for industry; - providing advice for expanding firms; - helping to ensure local supplies for inward investors; - the promotion of new industries.
<p>SPECIFIC MEASURES FOR SMALL AND MEDIUM ENTERPRISES One-stop advice centres to provide advice, and access to specialist advice, for all small firms.</p> <p>A minimum of 5% of government industrial R&D to go to firms of less than 500 employees (equivalent to £23m).</p>
<p>HELP FOR EXPORTERS Creation of integrated export service, combining the trade functions of the DTI, FCO and British Overseas Trade Board.</p> <p>Regional export drives in collaboration with Chambers of Commerce and regional development agencies.</p>
<p>TAKE-OVER RULES Wider public interest test for all bids; onus of proof on the bidder.</p> <p>Requirement to disclose intentions at an early stage.</p> <p>Workers to get statutory right to be consulted.</p>

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pays next year) will fall by £8 (the 33% rate of tax on the 25% allowance). In subsequent years it can continue to write the machinery off against tax, giving the firm tax reductions with a present value to the firm of about another £18 (assuming a 10% discount rate).

Suppose instead that there are large first-year allowances. The most extreme system would give an initial allowance of 100% in the first year and nothing thereafter. If the firm chooses to invest £100, it would pay £33 less tax on this year's profits, but it would pay tax in full in later years, whether it invests or not.

The difference between the two systems of allowances is that they pace the stream of corporation tax receipts at different rates. The difference in the present value of the total tax paid (at an interest rate of 10%) is just over £7. The 100% first-year allowance is worth £7 more on an investment of £100 because it gives a tax reduction faster than the declining 25% allowance.

Is this a significant difference? It is as though a capital investment costing £100 under the 25% allowance only costs £93 under the 100% allowance. A company that borrowed the money to cover a £100 investment would save about as much from the 100% allowance as it would from a cut in interest rates by about $\frac{1}{2}$ -1% over the life of a long-term project.

If large first-year allowances were permanent, they may not have much effect. If they were temporary, they might be enough to entice firms to bring forward investment plans they had intended to carry out after the temporary increase in allowances. Quite what the magnitude of the effect would be depends on the costs of moving investments from one period to another.

The evidence of Nigel Lawson's 1984 reforms provides support for the idea that an investment boom can follow temporary cuts in the cost of investing - but the investment boom of the 1980s also came in the context of strong demand growth.¹

The cost of the scheme to the Exchequer depends on how much investment is covered. If any investment attracts relief, the scheme is very expensive as most of its cost is given to firms which would be investing anyway. Manufacturing investment in plant and machinery is about £12bn, so the first-year cost of 100% allowances would be about £3bn, although most of this would be recouped in higher tax revenues subsequently.

If the scheme could be designed so that it only covered new investment, it would cost a fraction of the amount, but would be substantially more complex to administer.

¹ For a discussion of the effects of the 1984 reforms, see Michael Devereux, 'Corporation tax: the effect of the 1984 reforms on the incentive to invest', *Fiscal Studies*, vol. 9, no. 1, 1988.

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There are a number of more general difficulties which arise from proposals of this kind. There are strong grounds for not using the structure of the business tax system as an instrument of macroeconomic policy. A corporate tax system is complex and likely to contain anomalies and distortions of one form or another. Always to set policy in line with current preoccupations distracts policy-makers from the task of making sensible reforms for the long term.

A second Labour scheme, the Growing Business Initiative, would encourage individuals to invest in new or growing manufacturing companies. Such a scheme would run for five years and, it is argued, would be paid for by abolishing the current Business Expansion Scheme, worth about £120m in 1990-91.

The Labour Party also intends to encourage additional investment in research and development. Since firms can currently write off 100% of their R&D expenses, the proposal is to give an additional 25% tax credit for R&D over and above that made in a base year. Clearly the running cost of the scheme will depend on its success in generating new investment. Each increase of £1 in R&D will cost the exchequer 8p in lost revenue, equivalent to around £6m for each percentage point of growth, taking 1991's total industrial R&D of just under £8bn as the base.

Labour plans that various further authorities and agencies would be created, such as English regional development agencies (the Scottish and Welsh ones cost about £177m), technology trusts and an integrated export service. Overall, unless Labour puts up the corporation tax rate substantially, its policies imply a more generous approach to corporate taxes and subsidies.

The downside, for companies, of a Labour Government is the cost of the extra regulations with which business would be expected to comply. Of these, it is the minimum wage which is most significant, with widely varying estimates of the cost. There is also a less onerous requirement that firms should spend at least 0.5% of their payroll on training - some £424m in 1989 - a figure which may not differ much from current levels.

6.4 Environmental Taxes

Environmental issues occupy a good deal of political attention at all levels of the political process - local government, national, European and even global - reflecting the broad range of environmental problems. The tax system is sometimes blamed as being a contributory factor encouraging environmental degradation - for example, the tax incentive (now much reduced) in favour of company cars - or alternatively use of the tax system is sometimes advocated in order to encourage more environmentally friendly behaviour. This use of the tax system in a positive way can take two forms: modification of *existing* taxes so as to modify economic decisions (as, for example, with a lower rate of tax on unleaded petrol) or introduction of entirely *new* taxes, such as the carbon tax recently advocated by the European Commission.

The reasons for considering taxes as environmental policy instruments are now well known. Taxes are particularly suited to controlling certain types of pollution. Much industrial production results in pollution as well as providing useful output. The same is true for the direct consumption of some goods. Firms can charge for the goods but are not usually charged for the damage the pollution does to the environment. Taxes on pollution would in effect introduce just such a charge, forcing companies (and consumers) to take into account the environmental damage caused by their actions and encouraging them to find ways of reducing the amount of pollution they produce, as a way of minimising tax payments.

Politicians of all parties have advocated their use in various circumstances. Nicholas Ridley has published a pamphlet¹ describing their advantages, and the Conservative Government has both altered certain aspects of the tax system to promote certain behaviour (use of unleaded petrol) and hinted that it will not be averse to more substantial tax changes in the future (see below). The Liberal Democrats have advocated an 'environmental tax', with many forms of pollution being allocated pollution damage 'points' and being taxed accordingly. The Institute for Public Policy Research (a left-wing think-tank with links to the Labour Party) has published a pamphlet entitled 'Green Taxes',² advocating a wide range of changes to the tax system. Environmental taxes appeal to advocates of the *laissez-faire* economics because they work with the market rather than against it by using the price system rather than *dirigiste* regulations and government intervention. They appeal equally to those concerned with social justice - the polluter is forced to pay for any damage done.

¹ 'Policies against pollution', Policy Study no. 107, Centre for Policy Studies, London, 1989.

² S. Owens, V. Anderson and I. Brunskill, *Green Taxes: A Budget Memorandum*, Green Paper no. 2, Institute for Public Policy Research, London, 1990.

Yet despite this underlying consensus in favour of environmental taxes, the UK has made less use of them than many other developed market economies. Perhaps the single most significant reason for this situation has been that using taxes to control environmental problems has conflicted with other policy goals, most notably the anti-inflationary priority (many environmental taxes would affect consumer prices and so lead to a one-off increase in prices) and the desire to privatise various state-owned utilities in the energy and water industries.

The desire to control inflation will remain strong regardless of who wins the election. Similarly, given the privatisation of public utilities, some reluctance to take measures which affect the profitability of such industries will persist whoever forms the next Government, although no doubt this would inhibit the Labour Party rather less than the Conservatives. Nevertheless, there are strong reasons for believing that the next four or five years will witness rather greater pressures to adopt environmental taxes than has been the case in the past. It is possible, for example, that the UN-sponsored 'Earth Summit' in Rio de Janeiro in June 1992 will set in chain a process leading to the UK being committed to reducing greenhouse gas emissions (which potentially could lead to irreversible global warming). One way to do this would be via a carbon tax on the burning of fossil fuels. Such a tax has been advocated by the European Commission, and several Scandinavian countries have already introduced such a tax. The 'example effect' of so many other countries having taxes on a wide range of goods such as fertilisers, pesticides, industrial waste discharges into rivers, batteries, plastic bags, non-returnable drinks containers etc. is bound to lead to calls for such taxes in the UK. The projected inexorable rise in car use is likely to keep the taxation of road transport on the public agenda. These pressures will exist over the next five years whatever the composition of the Government. There may, however, be small differences in the way in which different Governments might respond to such pressures, reflecting the weight given to objectives other than the desire to control pollution.

Global Warming

Global warming caused by the emission of certain gases into the atmosphere has perhaps the highest profile of any environmental problem at the moment. The Government is committed to maintaining emissions by 2005 at the same level as at 1990. The other political parties have suggested that they would go further and look to reduce overall emissions (Germany and the Netherlands have made such a commitment). Taxes could clearly be used as a policy instrument to help the attainment of whatever target is chosen. The principal greenhouse gas is carbon dioxide; the principal source of carbon dioxide is the burning of fossil fuels (gas, oil, coal). A tax on the burning of fossil fuels in relation to the amount of carbon dioxide given off would encourage a switch from 'dirty' carbon-based fuels to fuels taxed less heavily or not taxed at all, and to a

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reduction in the overall amount of energy consumed. None of the parties are explicitly against such a tax, although they have some difficulties in practice. For example, the current Government has said:

in the longer term the relative price of energy and fuel will have to rise if we are to meet the conditional target of returning CO₂ emissions to 1990 levels by 2005. This could be achieved by taxation or other means. Such measures can only sensibly be taken when competitor countries are prepared to take similar action. The Government has no early plans to introduce tax or other measures directly raising the price of energy outside the transport sector, but Britain will contribute to international discussions on what measures might be taken.¹

The European Commission has proposed just such a tax to apply throughout the EC. It has suggested that a tax equivalent to \$3 per barrel of oil should be levied at the start of 1993 on all forms of fossil fuels according to the amount of carbon dioxide given off when burned, and this tax should rise by \$1 per year until it reaches \$10 per barrel of oil equivalent. Clearly such a target date for the introduction of the tax is unrealistic - especially as the European Commission has made no proposals as regards the administration of the tax - but the proposal has strong support (in principle) from several countries, so will remain an issue throughout the next Parliament.

Assuming all this tax is passed on to consumers, this would increase the price of gas for industry by 34%, of heavy fuel oil by 45%, of coal by 58%, and of gas and electricity for consumers by 14% and 13% respectively. Petrol prices would rise by 6%. Such a tax would clearly lead to a switch away from coal towards other fossil fuels - which would reduce the emission of carbon dioxide, as burning coal gives off approaching twice as much carbon dioxide per unit of energy generated as does gas. In addition there would be a switch towards other forms of energy, including renewable sources and nuclear power.

These two aspects of the proposal - the shift away from coal and in favour of nuclear power - will be one source of controversy in the UK and elsewhere in the EC over the introduction of any carbon tax. There is some concern in the European Commission about the 'nuclear' effect, leading to suggestions that there might also be an energy tax component to the carbon tax, which would mean that nuclear energy would also be taxed. This would, however, dampen the beneficial change in the *relative* prices of energy products. The different attitudes of the Labour and Conservative Parties to nuclear power could well lead to a difference of opinion on the desirability of any shift in relative prices in favour of nuclear power.

In contrast, *both* parties will be wary about increasing the price of coal, albeit for different reasons. Mining constituencies vote Labour, and in any case the Labour Party is inclined to see coal as a strategic industry, useful in avoiding over-heavy reliance on imports from unstable regions. The

¹ *This Common Inheritance: The First Year Report*, Cm 1655, HMSO, London, 1991.

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Conservative Party will almost certainly commit itself to privatisation of British Coal in its election manifesto, and so may be reluctant to damage the commercial prospects of the industry. Indeed, before privatisation of the electricity generation industry, it ensured that there was a contract to buy British coal at a price above that prevailing in the world coal markets. Hence both parties have policy aims which conflict with the environmental benefits of reducing coal consumption.

One difficulty to be faced by any Government introducing a carbon tax will be the distributional effects. Household spending on gas and electricity hardly changes however rich the household is - the spending of the richest 20% of the population is only one-and-a-half times that of the poorest 20%, despite having seven times as much pre-tax income. Any tax on domestic gas and electricity is therefore very regressive - it will take far more tax from the poor as a proportion of income than it will from the rich.

The political difficulty with such a tax is clearly very large - large enough for domestic energy currently to be exempted from VAT, for example. Hence in the UK (and alone in the UK - all other EC countries do have VAT on domestic energy) not only is the tax system currently not used to discourage energy consumption, such consumption is actually fiscally privileged.

The failure to tax domestic fuel is in one sense more a failure of political will than of genuine concern over the distribution of income. Domestic energy expenditure takes up more of the total household resources of the poor than it does of the rich, but nevertheless the rich spend more in absolute terms. Hence it is possible to redistribute the tax revenue collected from the rich to the poor, leaving the poor better off than they were before the tax. This is especially so as a carbon tax will affect prices of other goods, in particular petrol, which take up a higher proportion of the resources of those with higher incomes. Depending on the precise variation of the tax introduced, a carbon tax of \$10 per barrel of oil equivalent could raise between £5bn and £10bn. The importance attached to the redistribution will determine the amount of this which is immediately recycled to offset any adverse distributional effects.

The sensitivity of raising the price of energy is accentuated by the poor energy efficiency of much of the UK's housing stock. Fiscal incentives and grants to undertake energy-efficient investment were phased out by the Conservative Government, but then reintroduced in recent years. The Home Energy Efficiency Office provides grants to lower-income households to help them improve the energy efficiency of their homes. Any increase in the price of energy is likely to lead to some pressure to extend such schemes.

The European Commission's proposals stopped short of extending the carbon tax to cover all areas of industry, instead raising the possibility of exempting some energy-intensive sectors open to international competition, such as the chemical industry, at least until other countries adopt similar measures. This would enormously complicate the

administration of the tax; it is not easy to see what measures taken by other countries would be sufficient to persuade the EC to extend the tax base to these other industries; and it seems rather bizarre to exclude from a tax designed to reduce energy consumption those industries which currently use most energy. On the other hand, a tax which simply shifted energy-intensive production out of the European Community to other countries would have little effect on the global output of CO₂ but would damage the EC economy. This problem is likely to be a cause of much controversy when serious consideration of the carbon tax begins.

Finally, it should not be forgotten that most countries currently do have *implicit* carbon taxes - in particular, the excise duty on petrol. These issues are more fully discussed in Section 4.4.

Water

The quality of British water (drinking, bathing and river) has been improving, but nevertheless does not conform with EC standards in several areas. Other countries have made far greater use of charges and taxes than has the UK, raising the possibility that a future Government may reconsider the use of market instruments in this area.

The complication is that the water industry was privatised in 1989, with a new set of regulatory agencies. It might have been thought that it is rather too soon for any changes to the new basic structure. However, research has been commissioned by the Government, the regulator (OFWAT) and the National Rivers Authority looking at 'the scope for charging schemes which take full account of the cost of pollution and provide a greater incentive to dischargers to reduce polluting discharges'.¹ Certainly, in both the Netherlands and Germany (and to a lesser extent France) large increases in charges for direct discharges of trade effluent into rivers were accompanied by significant reductions in such discharges. The advantage of such an approach is that the rate of tax can be tailored to the precise condition of each individual river. This would seem to be an area where some changes can be expected over the next five years. However, total revenue will remain small in comparison with other taxes - even in the Netherlands total revenue is only around £150m.

The possibility of introducing fertiliser and pesticide taxes seems much smaller. Fertilisers are generally held to be responsible for the high level of nitrates in drinking water in some parts of the country; similar experiences have led to fertiliser and pesticide taxes being introduced in Scandinavia. However, the fact that the problem is geographically limited makes the targetting of an appropriate tax rather difficult.

¹ *This Common Inheritance: The First Year Report*, Cm 1655, HMSO, London, 1991.

Adapting the Current Tax System

Short of introducing entirely new taxes on pollution, a new Government could still modify the *existing* tax system so as to promote more environmentally desirable behaviour. Apart from the wide range of possibilities relating to road transport (discussed in Section 4.4), VAT, corporation tax and personal income tax could all be altered. For example, a higher rate of VAT on environmentally damaging consumption could be introduced, with environmentally friendly alternatives taxed a lower rate. Deductions from income taxes could be given for spending on home insulation, or for investments in deciduous forests. Capital allowances could be increased when companies invest in energy saving machinery, or other such environmentally beneficial activity.

The problem with all these sorts of incentives is that they are difficult to enforce and can have unintended side-effects. With VAT, aside from the fact that the number of tax rates will be limited to two because of EC harmonisation, taxing similar goods at different rates can lead to all sorts of complications. This is clear from consideration of the current taxation of food - oranges are zero-rated, orange juice is not; biscuits are not subject to VAT unless chocolate-coated. Divisions of this sort are difficult to enforce, and are clearly arbitrary. A further problem arises when some goods are only *relatively* more environmentally friendly than others. To tax such goods at a lower-than-standard rate not only means that they are favoured over the similar but more damaging good, but also over all other forms of consumption.

With the direct taxes, the principal problem is one of dead-weight loss - some individuals invest in home insulation without the need for incentives; similarly, some companies invest in energy-saving machinery given existing capital allowances. Introduction of such allowances would reduce the tax paid by these people and companies, as well as by those induced to invest by the tax incentive. Such measures can easily be expensive - all the more so as concepts such as 'energy-saving machinery' can evolve into something rather more substantial in financial accounts than might be assumed when looking at actual physical investments. Nevertheless, some countries do manage to have such incentives (including increased capital allowances for certain investments in Luxemburg and Japan). The Labour Party is generally more inclined to make such changes to the tax system than the Conservative Party. Such measures are relatively inexpensive when new and easily introduced (as opposed to administered) so could be used by any Chancellor in some future Budget which was felt to be in need of added interest.

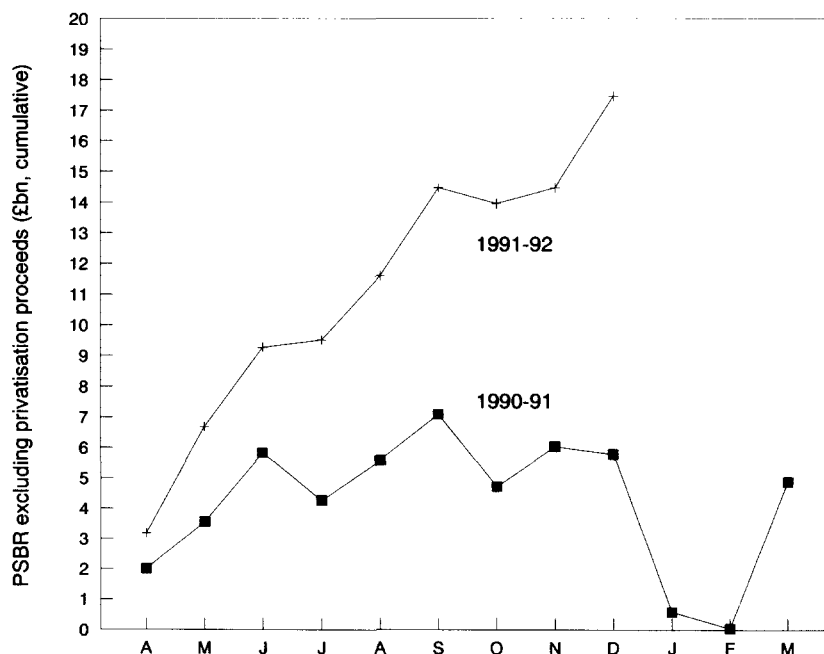
Appendix 1: Forecasting the PSBR

This Appendix details the method used to estimate government revenues and spending for 1991-92 and 1992-93, and to forecast the public finances into the medium term.

Fiscal Year 1991-92

The current year is the third in succession to see a deterioration in the state of the public finances, and will be the third in succession when the out-turn for the public sector borrowing requirement (PSBR) was worse than expected at the Budget at the beginning of the fiscal year. The Chancellor acknowledged the worsening situation in his Autumn Statement last November, when he announced an increase in the Government's forecast of the PSBR from the £8bn predicted in last year's Budget to some £10.5bn. The deterioration from last year's out-turn is illustrated in Figure A.1. This shows how the PSBR excluding privatisation proceeds developed over last year to result in borrowing of £4.9bn and has developed so far this year. The eventual out-turn for the PSBR in the current year will, as ever, be an important influence on the Budget package.

FIGURE A.1 The Public Sector Borrowing Requirement



Forecasting the PSBR

TABLE A.1 The Public Finances 1991-92

£bn	FSBR	Autumn Statement	Current Receipts	Modelled	IFS Forecast
Income tax	59.6	58.6	58.3	58.6	58.3
Corporation tax	19.5		18.3	18.6	18.3
Petroleum revenue tax	0.0		0.0	0.0 FSBR	0.0
Capital gains tax	1.4		1.3	1.4 FSBR	1.4
Inheritance tax	1.3		1.3	1.3 FSBR	1.2
Stamp duties	2.1		1.8	2.3	2.2
Total Inland Revenue	83.9	82.4	81.0	82.2	81.4
VAT	35.7		33.8	36.1	36.0
Petrol	10.9		10.7	10.8	10.9
Tobacco	6.1		5.6	6.3	6.1
Alcohol	5.2		5.0	5.1	5.1
Betting and gaming	1.1		1.0	1.0	1.1
Car tax	1.3		1.2	1.5	1.3
Customs duties	1.7		1.7	1.7 FSBR	1.7
Agricultural levies	0.2		0.2	0.2 FSBR	0.2
Total Customs and Excise	62.2	62.7	59.3	62.7	62.4
Vehicle excise duties	3.0		2.9	2.9	2.9
Oil royalties	0.5		0.5 FSBR	0.5 FSBR	0.5
Rates	14.4		14.4 FSBR	14.4 FSBR	14.4
Other taxes and royalties	3.8		3.8 FSBR	3.8 FSBR	3.8
Total taxes and royalties	167.6	166.8	161.9	166.4	165.4
National Insurance contributions	36.7	36.6	36.5	36.7	36.7
Community Charge	7.6	7.6	7.6 AS	7.3	7.6
Interest and dividends	6.1	5.7	5.7 AS	5.7 AS	5.7
Other receipts	8.4	8.7	8.7 AS	8.7 AS	8.7
General government receipts	226.5	225.4	220.4	224.9	224.1
Central government own expenditure	152.1	157.0	207.3	157.0 AS	157.0
Central government support for LAs	52.5	53.2		53.2 AS	53.2
Public corporations	2.3	2.7	2.7 AS	2.7 AS	2.7
Privatisation	-5.5	-8.0	-8.0 AS	-8.0 AS	-8.0
Reserve	3.5	0.0	0.0 AS	0.0 AS	0.0
Planning total	205.0	204.9	202.0	204.9	204.9
Local authority self-financed	9.1	10.2	10.2 AS	10.2 AS	10.2
Central government debt interest	16.7	16.7	16.7 AS	16.7 AS	16.7
Accounting adjustments	3.9	4.3	4.3 AS	4.3 AS	4.3
General government expenditure	234.8	236.1	233.2	236.1	236.1
General government borrowing requirement	8.3	10.7	12.8	11.3	12.0
Public corporations borrowing requirement	-0.4	-0.2	-0.2 AS	-0.2 AS	-0.2
Public sector borrowing requirement	7.9	10.5	12.6	11.1	11.8

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Although we have a lot of information regarding the current fiscal year, forecasts are still subject to a significant margin of error. The Treasury predictions for the current year published on Budget day, with 11 months of information, are subject to an error of £1bn; the estimates presented here, prepared two months earlier, are subject to a still wider margin.

Table A.1 shows a selection of forecasts for the public finances for the current year. Government predictions from the Financial Statement and Budget Report or **FSBR** (April 1990) and the Chancellor's **Autumn Statement** (November 1990) are reproduced in the first two columns.

The third column uses the information already available (mainly data to October, though we have taken account of later information when available) to predict the out-turn for the public finances for the whole year. This **current receipts** method allows for expected seasonal fluctuation in revenues. Estimates from the Autumn Statement and the FSBR (indicated by AS and FSBR) are used for some expenditures and revenues where monthly figures are unavailable or the pattern is extremely erratic.

Model estimates are shown in the fourth column of Table A.1. These are derived from estimates of the change in the tax bases (for example, personal incomes for income tax, consumers' expenditure for VAT) coupled with information from IFS models as to the rate of change of revenues with respect to rates of change in the tax bases.

The **forecast** shown in the final column is a judgemental average of these predictions.

Current Receipts Forecasts

The current receipts method allows for expected seasonal variation in tax revenue accruals and spending patterns using the following formula:

$$1991-92 \text{ forecast} = \frac{\text{April-October 1991 out-turn}}{\text{April-October 1990 out-turn}} \times 1990-91 \text{ out-turn}$$

These estimates are of course sensitive to one-off fluctuations, and so the accuracy of this method is reliant on the seasonal pattern of revenues remaining the same. An additional problem is that some taxes are collected in "lumps" and the proportion of annual revenues received by October from some sources is relatively low. Around half of total revenues accrue in the first seven months of the year for most taxes, but for some, such as capital gains tax, this proportion may be as low as one-fifth.

Modelled Forecasts

The modelled forecasts are based on a prediction of the change in the revenue base for each particular tax. The relevant bases are listed in Table A.2.

TABLE A.2 Tax Bases and Elasticities for Model Forecasts

Tax	Base	Elasticity
Income tax	Nominal wage bill	1.6
Corporation tax	Nominal gross profits	1.2
VAT	Nominal consumers' expenditure	1.0
Car tax	Nominal consumers' expenditure	1.2
National Insurance	Nominal wage bill	1.1
Petrol	Real consumers' expenditure	1.4
Tobacco	Real consumers' expenditure	0.3
Beer	Real consumers' expenditure	0.8
Wines	Real consumers' expenditure	1.5
Spirits	Real consumers' expenditure	0.9

The relationship between tax revenues and the change in the tax base varies for each tax. These are computed from detailed IFS models of different parts of the tax system.¹ The resulting relationships are described by the set of elasticities also shown in Table A.2.

Forecasts of the revenue bases for the different taxes are derived from the macroeconomic working assumptions in Table A.3.

TABLE A.3 Macroeconomic Assumptions for Model Forecasts

Percentage growth	1991-92	1992-93
GNP	-1.8	2.5
Wages	7.5	6.5
Employment	-2.2	-1.2
Consumer prices	7.0	4.4
Consumers' expenditure	-1.9	1.7
Corporate profits (previous year)	-10.0	0.0
Retail prices	4.8	3.8

Table A.4 shows the calculations lying behind the model forecasts. The predictions for the growth in the revenue bases shown in Table A.2 are derived from the working assumptions in Table A.3. Combined with the elasticities from Table A.2, a forecast revenue growth rate is generated (Table A.4, second column). However, this assumes that the tax system remains the same. We take account of the effect of the 1991 Budget

¹The income tax forecast is based on the results of Paul Johnson and Peter Lambert, 'Measuring the responsiveness of income tax revenue to income growth: a review and some UK values', *Fiscal Studies*, vol. 10, no. 4, 1989. Corporation tax estimates use the IFS model described by Michael Devereux, 'The IFS model of the UK corporation tax', IFS Working Paper no. 84, 1986. Indirect taxes (VAT and excise duties) are forecast using the SPIT model discussed by Paul Baker, Steve McKay and Liz Symons, 'The simulation of indirect tax reforms: the IFS Simulation Program for Indirect Taxation', IFS Working Paper no. 90/11, 1990. National Insurance contributions are predicted using the results of Edward Whitehouse, 'Earnings growth and revenues from National Insurance contributions', IFS Working Paper, forthcoming, 1992.

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package on revenues for 1991-92 (Table A.4, third column) using government predictions of the cost or yield of the Budget measures which are published in the FSBR each year. The resulting forecasts for individual revenues are given in the fourth column.

TABLE A.4 Derivation of Model Forecasts

	1990-91	Growth	Budget	1991-92
Inland Revenue				
Income tax	55.5	8.5	-1.6	58.6
Corporation tax	21.6	-12.0	-0.4	18.6
Customs and Excise				
VAT	30.8	5.1	3.7	36.1
Petrol	9.6	-2.7	1.4	10.8
Tobacco	5.6	-0.7	0.7	6.3
Alcohol	4.9	-1.9	0.3	5.1
Betting and gaming	1.0	5.1	-0.0	1.0
Car tax	1.4	5.9	0.0	1.5
Other taxes				
Vehicle excise duties	3.0	-2.2	0.0	2.9
National Insurance	34.9	5.8	-0.2	36.7
Community Charge	10.4	12.0	-4.3	7.3

Sensitivity The modelled forecasts are naturally sensitive to the underlying economic assumptions about conditions in the whole of the current fiscal year. Table A.5 shows the impact on revenues of altering various of the assumptions.

TABLE A.5 Revenue Effect of 1% Change in Assumptions for 1991-92 Forecast

Variable	Revenue change (£bn)
Wages	1.2
Employment	0.8
Consumer prices	0.3
Consumers' expenditure	0.5
Corporate profits	0.2

PSBR Forecast for Fiscal 1991-92

- Income tax** Income tax receipts have over the last few years been consistently underestimated by the Treasury. In 1990-91, for example, the FSBR prediction at the beginning of the year was £0.5bn lower than the out-turn. This year, however, the Autumn Statement implied a small downward revision in the forecast for the current year. Our forecast of £58.3bn based on current receipts is a little below the Autumn Statement.
- Corporation tax** The 1991 Budget forecast a £1.2bn fall in corporation tax receipts. Since corporation tax payments lag profits, the effects of the recession on profitability in 1990 are now being felt. Some of the effect of the cut in the main rate of corporation tax (around £0.4bn) is also coming through. The model forecast and current receipts figures are both pointing to a figure a little below that anticipated by the Government in last year's Budget; our judgement is that revenues will fall towards £18bn.
- Stamp duties** In his 1990 Budget, John Major proposed that stamp duties on transactions in shares should be abolished at a time to coincide with the introduction of the TAURUS paperless exchange system by the Stock Exchange. The delay in the implementation of the new system until at least April 1993 results in a PSBR saving of some £1bn over this and next fiscal year compared with the forecasts presented last Budget time.
- On 19 December 1991, the Chancellor proposed to increase from £30,000 to £250,000 the threshold for stamp duty charges on land and buildings as a temporary measure, until 19 August 1992, thereby exempting around 90% of transactions in residential property from liability to duty. The cost of this measure is expected to be around £420m.
- Taken together, these changes will increase stamp duty revenues by up to £100m in the current fiscal year.
- Indirect taxes** Consumers' expenditure has fallen substantially in the current year, though the Autumn Statement made an upward revision of £0.5bn in Customs and Excise receipts - the Government had predicted the outcome would be worse. Receipts so far this year have been very depressed, recording an increase over last year's receipts only half the 16% growth rate predicted last Budget time for the year as a whole. This is likely to have been affected by the increase in the VAT rate in the Budget, with some spending switching to the period before the end of the fiscal year when the VAT rate was lower. There is a further downside risk to this forecast: the increase in VAT will have encouraged consumers to shift spending patterns towards VAT exempt or zero-rated goods and services. The model suggests a slightly higher VAT take for the year, and our forecast of £36bn lies between the model and the FSBR prediction.
- Receipts from other indirect taxes have also been coming in at a slightly slower rate than suggested in the FSBR and by our models. Overall, our forecasts are slightly above the Budget and current receipts predictions and below both the Autumn Statement and model estimates.

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National Insurance The four forecasts of revenues from National Insurance contributions almost coincide; we take £36.7bn as our estimate.

Local authorities The 1991 Budget saw a dramatic shift in taxation, with a £4.3bn injection of VAT receipts into reducing the Community Charge. Last year £10.6bn was raised from the poll tax; this year's government forecast of £7.6bn implies a rate of increase in receipts after the shift to VAT is taken into account of over 12%. There is a strong downside risk in this prediction due to non-payment. The amount of Community Charge collected last year turned out to be some £1.2bn below the level predicted in the Autumn Statement. The latter estimate had made a "small allowance for non-collection"¹ which later proved inadequate; there is a similar risk this year.

On the spending side, the Autumn Statement contained an upward revision to anticipated expenditure financed both by central government and local authorities themselves amounting to £1.8bn. This is similar in magnitude to the increase for 1990-91 announced in the 1990 Autumn Statement, which by the end of the year proved to be still some £0.7bn short. Again, there is a risk that the Government's latest forecast could be based on too low a rate of growth in local authority spending.

Public expenditure The Autumn Statement increased the spending targets for the current year by some £6bn, though was able to maintain the planning total of £204.9bn since the extra spending was financed from the reserve and from greater-than-anticipated privatisation proceeds. In the first seven months of the year, spending has been running at a slightly lower rate of increase, pointing to an annual total of £207.3bn for central government spending, compared with the £210.2bn announced in the Autumn Statement. We expect that the Government will be able to contain spending within or close to this target.

The PSBR Both current receipts and model predictions point to a PSBR of similar magnitude to the revised figure announced in the Autumn Statement. Our judgement is that the Chancellor will probably report some slippage from the Government's most recent PSBR forecast - £10.5bn - of over £1bn. This will probably arise on the revenue side of the public finances: receipts so far this year have been running below government predictions.

¹ FSBR, 1990, para. 6.26.

PSBR Forecast for Fiscal 1992-93

The PSBR forecast for the coming fiscal year shows the deficit continuing to rise, to £19.5bn.

Receipts for 1992-93 are again estimated using a variety of IFS models, generating projected increases on the forecast out-turn for the current year. Table A.3 shows the macroeconomic working assumptions, and the revenue elasticities and tax bases used by the models are shown in Table A.2.

- Income tax** Assuming that the main allowances and thresholds are indexed in line with inflation and no other changes to the income tax, we forecast revenues rising to a little over £62bn in 1992-93. The £1bn cost of uprating allowances is offset to an extent by the extra revenues raised as a result of the 1991 Budget changes, notably restricting mortgage interest relief to the basic rate, increasing car benefit scales beyond inflation and the freezing of the married couple's allowance. If the Government again chose not to increase this allowance, around an extra £150m would be raised.
- Corporation tax** Mainstream corporation tax is collected in arrears, so the continuing decline in profits in 1991-92 will result in depressed corporate tax revenues in 1992-93. Also, the effect of the 1991 Budget changes will be felt in full. The cut in the main rate to 33% is expected to reduce revenues by around £0.8bn, and the introduction of three-year carry-back of losses for corporate tax purposes to cost £0.3bn. Corporate tax revenues look set to fall to around £17bn in 1992-93.
- Stamp duties** The delay in the abolition of stamp duty on shares and the temporary raising of the threshold for duties on property transactions described above will again affect the public finances in 1992-93. The net effect will again be to increase revenues, by over £400m.
- Indirect taxes** Having fallen in 1991-92, most analysts expect a relatively small increase in consumer spending in 1992-93. More of the effect of the increase in the VAT rate to 17.5% will feed through to revenues. Increases in tobacco and petrol duties beyond inflation in the 1991 Budget will have a small effect; note that the numbers assume that the Government merely "revalorises" specific duties (increases them in line with inflation) in the 1992 Budget, raising £1bn.
- National Insurance** National Insurance receipts will gain from the introduction of employers' contributions on the benefit of company cars and fuel, bringing in £0.6bn. We expect total revenues of over £39bn. Revenues from National Insurance contributions have increased relatively slowly over the past few years - since 1988-89 by only 16%, compared with an increase of 41% in receipts from the income tax and a 30% rise in earnings over the same period. This is a result of the 1989 reforms to the contribution structure and to the extra rebate of contribution given to those taking out personal pensions. The rebate will be cut in April 1993 as part of a regular quinquennial review of contributions, but this will not bring in extra revenue until 1993-94.

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TABLE A.6 The Public Finances 1992-93

	1991-92	Growth	Budget	1992-93
Income tax	58.3	7.5	-0.7	62.0
Corporation tax	18.3	0.0	-1.1	17.2
Petroleum revenue tax	0.0	0.0		0.0
Capital gains tax	1.4	2.8		1.5
Inheritance tax	1.2	3.8		1.2
Stamp duties	2.2	3.8	+0.3	2.6
Total Inland Revenue	81.4			84.5
VAT	36.0	6.2	+1.6	39.8
Petrol	10.9	6.2	+0.1	11.6
Tobacco	6.1	4.4	+0.0	6.4
Alcohol	5.1	5.5	+0.0	5.4
Betting and gaming	1.1	6.2	-0.0	1.1
Car tax	1.3	7.4		1.4
Customs duties	1.7	0.0		1.7
Agricultural levies	0.2	0.0		0.2
Total Customs and Excise	62.4			67.6
Vehicle excise duties	2.9			3.0
Oil royalties	0.5			0.5
Rates	14.4			14.8
Other taxes and royalties	3.8			3.9
Total taxes and royalties	165.4			174.3
National Insurance contributions	36.7	5.8	+0.6	39.4
Community Charge	7.6	12.0		8.5
Interest and dividends	5.7	3.8		5.9
Other receipts	8.7			8.7
General government receipts	224.1			236.8
Central government own expenditure	157.0			168.6
Central government support for LAs	53.2			58.6
Public corporations	2.7			3.5
Privatisation	-8.0			-8.0
Reserve	0.0			4.0
Planning total	204.9			226.7
Local authority self-financed	10.2			8.5
Central government debt interest	16.7			16.5
Accounting adjustments	4.3			4.5
General government expenditure	236.1			256.3
General government borrowing requirement	12.0			19.5
Public corporations borrowing requirement	-0.2			0.0
Public sector borrowing requirement	11.8			19.5

Public expenditure The 1991 Autumn Statement boosted spending for the present year and next year. If spending hits the target for 1992-93, then it will have increased 8.5% on the 1991-92 out-turn we predict. We do not anticipate that the Chancellor will add to this pre-announced increase in spending at Budget time, though the outcome for spending may be different: it is rare for government actually to hit expenditure targets made two years ahead.

Tax changes If the Government chooses to add to pre-announced reforms of the tax system in the current Budget, this will affect the PSBR forecast. Table A.13 (Appendix 2, below) shows the sensitivity of receipts to various changes in the parameters of the tax system.

The forecasts presented in Table A.6 assume an "indexed" Budget: that excise duties are revalorised and income tax allowances and thresholds increased in line with inflation. If the Chancellor over-indexes some excise duties, or changes some of the allowances and thresholds, as he did in his 1991 Budget, then the forecasts in Table A.6 would of course change.

Economic conditions There remains a good deal of uncertainty over economic conditions in the coming fiscal year, and the revenue forecast is very sensitive to these assumptions. Table A.7 shows the impact on the 1991-92 forecasts of changes in the economic working assumptions.

TABLE A.7 Revenue Effect of 1% Change in Assumptions for 1992-93 Forecast

Variable	Revenue change (£bn)
Wages	1.3
Employment	0.8
Consumer prices	0.3
Consumers' expenditure	0.5
Corporate profits	0.2

The PSBR Our forecasts suggest that the deterioration in the public finances will continue; a neutral Budget, neither raising nor cutting the overall burden of taxation, would result in the deficit rising towards £20bn.

The Public Finances in the Medium Term

With the election due in the next six months, we have taken a look into the medium term, and considered how the public finances might develop over the lifetime of the next Parliament. The PSBR will, as ever, exert a central influence on government's spending plans and the scope for tax reform.

Macroeconomic assumptions Table A.8 shows the macroeconomic scenario which forms our working assumption for the medium-term forecasts. We assume a moderate recovery of output in 1992-93 and 1993-94, converging on a medium-term GNP growth rate of 2.2% per annum. The rate of growth in wages is assumed to decline, as both real earnings increases and inflation fall. Consumer spending and corporate profits both make a recovery in 1992-93 and 1993-94.

TABLE A.8 Macroeconomic Working Assumptions for Medium-Term Public Finances Forecasts

Percentage growth	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
GNP	-1.8	2.5	2.5	2.2	2.2	2.2
Wages	7.5	6.5	6.0	6.0	6.0	6.0
Employment	-2.2	-1.2	-0.3	0.0	0.0	0.0
Consumer prices	7.0	4.4	3.8	3.8	3.8	3.8
Consumers' expenditure	-1.9	1.7	2.5	2.2	2.2	2.2
Corporate profits (previous year)	-10.0	0.0	12.0	12.0	6.5	6.5
Retail prices	4.8	3.8	3.8	3.8	3.8	3.8

We have shown how sensitive the forecasts for the present and coming year are to changes in the economic working assumptions. For the medium term, we consider two alternative macro scenarios: one more optimistic and one more pessimistic than the baseline assumptions. These alternatives are assumed to affect GNP, employment, profits and consumer spending; the other assumptions (wages and prices) are not changed. This reflects the fact that the ERM imposes an inflation constraint; the uncertainty surrounds the amount of growth consistent with that level of inflation. The range of assumptions is shown in Table A.9.

The public finances Table A.10 summarises the key variables in the baseline forecast for the public finances. On the revenue side, we have used the model predictions based on the elasticities in Table A.2 and the macro assumptions in Table A.8. We have assumed annual revalorisation of excise duties and indexation of income tax allowances and thresholds. Barring these uprating procedures, we have assumed the structure of the system remains unchanged. However, we have taken account of the impact of the 1991 Budget and of the change to National Insurance contribution revenues from 1993-94 onwards due to adjustments in the rebates for "contracting out".

TABLE A.9 Alternative Macroeconomic Working Assumptions

Percentage growth	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
GNP	-1.8	1.8	1.8	1.5	1.5	1.5
		2.5	2.5	2.2	2.2	2.2
		3.2	3.2	3.0	3.0	3.0
Employment	-2.2	-1.5	-1.0	-0.5	-0.5	-0.5
		-1.2	-0.3	0.0	0.0	0.0
		-0.9	0.4	0.6	0.6	0.6
Consumers' expenditure	-1.9	1.0	1.7	1.5	1.5	1.5
		1.7	2.5	2.2	2.2	2.2
		2.5	3.2	3.0	3.0	3.0
Corporate profits (previous year)	-10.0	0.0	11.0	10.0	6.0	6.0
			12.0	12.0	6.5	6.5
			16.0	16.0	7.0	7.0

On the spending side, the basis of the figures to 1994-95 is the prediction in the Chancellor's Autumn Statement of November 1991. Whilst government may not hit its public spending plans in the medium term, Table A.10 does show the scope for additional spending beyond previous plans. It is worth noting that public spending has often exceeded plans over the past decade.

TABLE A.10 The Public Finances in the Medium Term

£bn	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Inland Revenue	81.4	84.5	92.9	102.2	110.8	119.9
Customs and Excise	62.4	67.6	72.1	76.7	81.5	86.6
General government receipts	224.1	236.8	255.6	275.5	293.8	313.2
Central government spending	157.0	168.6	178.0	185.4	195.2	205.6
Privatisation	-8.0	-8.0	-5.5	-5.5	-5.5	-5.5
Planning total	204.9	226.6	244.5	258.0	271.1	284.7
General government spending	236.1	256.3	276.5	291.1	307.2	319.6
PSBR	11.8	19.5	20.5	15.5	11.2	6.4

The public finances look set to continue the deterioration that began in 1989-90, with the deficit likely to widen until 1993-94. On current policies, the PSBR would reach a peak of around £20bn, some 3% of GDP. From then onwards, the deficit follows a downward trend, and by 1996-97 would reach around £6bn. Thus, the moderate recovery in the

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macro economy contained in the baseline working assumptions takes a number of years to feed through to a marked improvement in the state of the public finances.

This result will clearly be sensitive to the working assumptions, so we have carried out the analysis looking at the effects on revenues of the two alternative macro scenarios. The range for the PSBR forecast using the baseline, optimistic and pessimistic assumptions is shown in Table A.11.

TABLE A.11 The PSBR in the Medium Term: Sensitivity Analysis

		1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
PSBR (£bn)	optimistic	11.8	18.5	17.4	9.9	4.7	-3.5
	baseline	11.8	19.5	20.5	15.5	11.2	6.4
	pessimistic	11.8	20.6	22.9	19.8	18.2	14.3
PSBR (% of GDP)	optimistic	2.0	2.9	2.6	1.4	0.4	-0.5
	baseline	2.0	3.1	3.1	2.2	1.5	0.8
	pessimistic	2.0	3.2	3.5	2.8	2.4	1.9

In the pessimistic scenario, the deficit again peaks in 1993-94 at a slightly higher level, but it is in the recovery that the difference is most marked. By 1996-97, the PSBR is still above the level recorded in 1991-92 at the depth of the recession. A more optimistic view of economic developments from the perspective of the public finances shows the recovery in the PSBR happening much earlier. In 1993-94 the deficit is already below the level recorded in the previous year, and the decline is much more rapid. A debt repayment would be made in 1996-97.

Public finances under Labour The Labour Party has made a number of commitments in its policy documents which would affect the public finances. It proposes to abolish the ceiling to National Insurance contributions and to introduce a further higher rate of income tax at a level of 50%. Allowances and reliefs would be restricted to the basic rate of income tax, and National Insurance contributions would be levied on investment incomes. It would not be possible for a Labour government to introduce all these changes in the 1992 Budget; we have assumed that measures raising a little over half of the total revenue change would be introduced in that fiscal year.

On the spending side, Labour has promised a one-off increase in pensions and child benefit, and to uprate the former in line with earnings and the latter in line with prices each year from then on. Finally, privatisation proceeds would be lower under Labour, though some revenues from privatisations before the election would still be received (£8bn in 1992-93 and £0.9bn in 1993-94).

Table A.12 shows the impact of these changes on the medium-term analysis of the PSBR. The manifesto tax commitments raise more revenue than the extra spending promised, but together with the absence of privatisation proceeds, Labour adds between £2bn and £3bn to the PSBR each year.

TABLE A.12 Public Finances with Short-Term Labour Commitments

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Effect on PSBR (£bn)						
General government receipts	0.0	-3.2	-6.7	-7.3	-7.8	-8.3
Central government spending	0.0	+3.2	+3.8	+4.4	+5.0	+5.6
Privatisation	0.0	0.0	+4.6	+5.5	+5.5	+5.5
Change in PSBR	0.0	0.0	+1.7	+2.6	+2.7	+2.8
PSBR (£bn)	11.8	19.5	22.2	18.1	13.9	9.2
PSBR (% of GDP)	2.0	3.1	3.3	2.6	1.9	1.2

The economy and the public finances The state of the economy clearly lies at the centre of future developments in the public finances. The figures given above cannot be regarded as a forecast, since tax and spending plans are bound to change whoever forms the next government. However, they do illustrate the scope for fiscal manoeuvring over the next five years. The Budget will not return to balance (even on the most optimistic assumptions) for some time; returning to a zero PSBR any earlier could require sizeable tax increases or reduced spending growth. If a future government decided to maintain borrowing at the 3% of GDP peak which is also the limit allowed under the convergence criteria for EMU, then between £8bn and £26bn of extra resources would be available by 1996-97. This difference underlines the importance of the performance of the economy.

Appendix 2: Tax Ready Reckoner

**TABLE A.13 Direct Effects of Illustrative Changes in Taxation
1992-93**

£m	Cost / yield	
	Indexed base	Non-indexed base
Income tax		
Change basic rate by 1p	1,950	1,950
Change higher rate by 1p	190	190
Index personal allowances and thresholds	0	980
Corporation tax		
Change full rate by 1%	340	340
Change smaller companies' rate by 1%	35	35
Capital taxes		
Change inheritance tax rate by 1%	10	10
Index inheritance tax threshold	0	20
Index capital gains exempt amounts	0	*
Indirect taxes		
Revalorise excise duties	0	1,050
Change VAT rate by 1%	1,725	1,725

Notes: The revenue effect is computed for 1992-93 at full-year cost. Negligible changes are indicated by *. Neutral or "indexed" Budget would raise all allowances, thresholds and specific duties in line with inflation, using the year-on-year increase in the RPI in December 1991 of 4.5%.

Source: Autumn Statement, 1991, Section 4.