The Economic Record of the Labour Government

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POLITEIA

2005

First published in 2005
by
Politeia
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Policy Series No. 48

Support for this study has been granted by the
Foundation for Social and Economic Thinking

ISBN 1 900 525 88 7

Cover design by John Marenbon

Designed and Printed in Great Britain by
Fieldfare Press Ltd
52 Clifton Road
Cambridge CB1 7ED

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I
Introduction

The great political achievement of the new Labour project has been to enable a Labour Government to remain in office without a financial crisis. Almost every previous Labour administration had foundered on the rock of economic and financial crisis. Ramsay MacDonald in 1931, Stafford Cripps' devaluation in 1949, the Wilson and Callaghan Governments' devaluation and IMF crises in 1968 and 1975 created an enduring pattern in political folk memory. Ambitious spending plans, financed through borrowing and accommodated by a loose monetary policy, led swiftly to a financial crisis accompanied by a collapse in financial market confidence, a sterling crisis and a sharp rise in inflation. Crisis was then followed by a painful period of deflationary measures that stabilised the economy but provoked political rejection of the Labour Government at the following general election. As a result until 2001, no Labour Government had lasted more than one full parliamentary term. The interesting question is whether things are as good as the macro-economic outlook currently appears. The aim of this pamphlet is to consider the true economic achievement of the Labour Government and consider whether the accurate position has been correctly understood. Is there a danger that this country may face a more problematic future as a result of Gordon Brown's eight years as Chancellor of the Exchequer? The concern is that rising public expenditure and a more regulated labour market will constrain future economic growth.

The new Labour project aimed to ensure that the established pattern was not repeated. Tony Blair and Gordon Brown in opposition in the mid-1990s set out to demonstrate to the electorate that a Labour Government could be trusted not to provoke a short-term financial crisis and, in the context of a stable macro-economic environment, could achieve realistic and genuine democratic socialist objectives in terms of collective provision of public services and a tax and benefit system that is more directed at redistributing income. This pragmatic realism on the part of Tony Blair and Gordon Brown resulted in an emphasis on working with the private sector, supporting British business, financial prudence and stability in macro-economic management.

This in turn led many commentators to regard the Labour Government elected in 1997, as a sort of market-orientated administration, which in practice could not easily be distinguished from its contemporary Conservative opposition. This was always a misleading view of what Labour actually represented. Gordon Brown's fiscal policies from the start displayed a strong commitment to the redistribution of income and the collective provision of public services. In its first term Labour returned to taxing and spending with the purpose of achieving policy objectives that had been at the heart of the agenda of democratic socialism for more than a generation. Unlike previous Labour Chancellors, however, Gordon Brown's spending was financed in an orderly manner that would not provoke anything much in the way of a disturbance in the financial markets, still less a financial crisis. Moreover, the financial markets were reassured by the decision to create an independent Monetary Policy Committee with responsibility for meeting an inflation target.

In the Comprehensive Spending Review in 1998 spending plans, were increased significantly. But this increase in spending took place in the context of a sharply improving budget balance inherited from Kenneth Clarke and large increases in taxation announced by Gordon Brown in his first budget in 1997, when he raised taxes by over £6 billion. This principally resulted from the change made to advance corporation tax that effectively imposed a £5 billion tax increase on occupational pension funds. In 2000-01 there was a budget surplus of £37 billion equivalent to 3.9 per cent of GDP. Whatever concerns some economists may have had about the structural implications of such spending and taxation for the economy's supply performance, few people recognised that Gordon Brown was creating the conditions for a large structural budget deficit. Yet by the end of the Labour Government's second term of office such a deficit had been created. The turn-around from surplus to deficit over five years in the UK represents the largest and swiftest deterioration in the budget balance of any G7 economy, with the exception of the United States. The UK now has one of the largest structural budget deficits in the OECD.

This year the Chancellor is forecasting a budget deficit of £32 billion, representing 2.6 per cent of GDP. A deficit of 2¾ per cent is on the cusp of what is sustainable in the long-run. It is possible to run large budget deficits and to finance them for a few years, but to do so permanently would court financial trouble, because a government in that position would accumulate debt service charges at a faster rate than the increase in its tax base. The significant feature of the present budget deficit is not just its size, but the fact that it has been incurred at a time when the economy was steadily expanding and there is little or no spare capacity. This suggests that it is a permanent or structural deficit that can only be corrected by discretionary policy measures either to raise taxation or to cut spending programmes.

Concern about the scale of government borrowing prompts public concern and is a political embarrassment to the Government. The issue of how public spending is financed between taxation and borrowing, however, is essentially a secondary issue compared to the principal issue of whether the spending itself yields benefits at the margin than exceed the costs using the resources involved, including the deadweight costs imposed by the taxation.

The scale of increased spending under Labour is plain. Public spending has risen by about a third since 1997. The benefits of this rapid increase are less clear. There has been a controversy over the measurement of real outputs in the public sector. When the Office of National Statistics (ONS) initially examined the issue it produced the arresting conclusion that despite large increases in cash spending, productivity in the public sector had actually fallen. This work turned out to be so contentious that the Warden of Nuffield College Oxford, Sir Tony Atkinson, an economist whose principal area of interest is in the distribution of income and wealth, was asked to conduct an inquiry into these difficult issues. The OECD warned in its *Economic Survey-United Kingdom 2004: The Fiscal Challenge* that it is difficult for the public sector to make efficient use of large increases in spending. Moreover, the OECD has pointed out even that where there appears to have been an improvement in public services, the improvement had become evident before spending increased. The OECD has also warned about the malign economic consequences of an increase in the gap between what a person is paid by an employer and the wage that a person receives after paying tax and payroll social security taxes. Gordon Brown's rising tax burden has drawn more people into tax at lower thresholds in relation to average earnings and resulted in more people paying the top rate of tax. In addition the complex tax credits created by the Chancellor's decision to re-badge social security benefits as tax credits, have in the judgement of the OECD aggravated the problem of an increasing 'tax wedge'. This means that the relationship between work effort, education and training and take-home pay is weakened and labour market incentives are distorted and blunted.

Gordon Brown's historic achievement: central bank independence

Monetary stability and low inflation are the sine qua non for economic success. The decision to make the Bank of England independent was a bold measure that improved the UK's monetary institutions. The inflation target of $2\frac{1}{2}$ per cent that the Chancellor set the new Monetary Policy Committee, however, represented a slight relaxation of the previous Government's target to keep inflation to below $2\frac{1}{2}$ per cent. But no fair-minded observer would fail to applaud this audacious decision taken by Gordon Brown within days of his appointment as Chancellor of the Exchequer. It was welcomed by financial markets and lowered inflationary expectations.

The Government's decision to switch from targeting the Retail Prices Index (RPI) to a harmonised Consumer Price Index (CPI) has had the advantage of focusing attention on a measure of it that on average reports inflation to be lower than the RPI by between 0.5 per cent and 1 per cent. The disadvantage is that the new measure is less well known. A CPI target comparable to the previous $2\frac{1}{2}$ per cent RPI target would have fixed at $1\frac{1}{2}$ per cent. Since the 2 per cent target chosen by the Chancellor in the 2004 Budget is equivalent to an RPI target of 3 per cent, represents a further relaxation of the inflation target inherited from the previous Government.[1]

Having handed monetary policy to the Bank of England and having rightly resiled from using an active fiscal policy as part of macro-economic demand management, the Chancellor has had a narrower economic policy field in which to operate, but this field is neither insubstantial nor unimportant. Since May 1997 the Treasury's principal policy territory has been narrowed to the level, and composition, of public expenditure and how it is financed.

1 In terms of the RPI the upper boundary is now 4 per cent, because under the terms of the symmetric targeting regime inflation may go one per cent below the 2 per cent target and up to 1 per cent above it. An upper boundary of 4 per cent is much higher than an upper boundary of $2\frac{1}{2}$ per cent. This difference is significant, because of its cumulative impact on the price level. A $2\frac{1}{2}$ per cent rate of inflation leads to a 50 per cent increase in the measured price level after 17 years and a 100 per cent increase after 28 years. A 3 per cent rate of inflation would lead to a 50 per cent increase in the measured price level after 14 years and a 100 per cent increase after 24 years.

Both public spending and the financing of it through borrowing and taxation are crucial for economic management. If a finance minister gets these matters wrong, the economy will labour under a damaging handicap. While price stability may be a necessary precondition for economic success, it is not in itself sufficient to guarantee that a country will make the most of its opportunities and maximises the economic welfare of its citizens.

Tax, Spending and Regulation: The Supply-Side Challenge faced by OECD Economies

The UK, along with most OECD countries, has serious supply-side issues that it ought to address. OECD economies have large and expensive welfare states that offer extensive social protection. Expenditure on their social programmes will rise as their populations age. This increase in expenditure will require a higher tax burden that will constrain future economic growth and with constrained growth the future expansion of the tax base will be become less buoyant. Government spending adsorbs around two-fifths of national income. This expenditure has to be paid for either by taxation or borrowing, which is essentially, delayed taxation. Taxation imposes a deadweight cost on an economy. Policy-makers, therefore, have to be sure that public expenditure yields benefits that at least match or ideally exceed its cost. When governments spend over 40 per cent of a country's GDP, many of its expenditure programmes will fail to meet the test of yielding benefits that exceed the costs involved. Government regulation also imposes costs on an economy and distorts the allocation of resources.

OECD economies face complex challenges that arise from the scale of public intervention and regulation in their economies, and their ageing populations. Most OECD economies have commitments to welfare programmes that are expensive in public expenditure terms, and they will

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As Chancellor, Gordon Brown was right to resist pressure in the late 1990s to use fiscal policy and taxation as either a substitute for monetary policy or as a means of off-setting the impact of a higher exchange rate. In the twelve months to July 1997 the sterling index rose by over a fifth. There was a lot of pressure on the Chancellor to use his first Budget to raise taxes, in hope that the Bank of England would run a looser monetary policy to weaken the exchange rate. Leaving aside the potential damage that such a tax policy would have on the economy's long-term supply-side performance, it would not have worked. Inflation is essentially a monetary phenomenon requiring monetary measures to control it. In terms of macro-economic management, fiscal policy has a relatively weak impact on the economy. Where fiscal policy has been used as a substitute for monetary policy, it has failed.

become more expensive as their populations age. In some countries where governments have avoided certain social care responsibilities, which only the state can effectively and efficiently finance, already expensive social and health care programmes will have to be extended. This places a premium on ensuring that the public sector concentrates principally on those things that only collective provision can effectively and efficiently provide. Moreover, spending should only take place on programmes where the benefits that arise match the full costs incurred in providing them. It also means that it is essential for governments to do everything they can to nurture dynamic economies and to avoid hindering economic growth. This is to ensure that there is a buoyant tax base to finance steadily increasing levels of welfare spending arising from an ageing population.

In his presidential address to the American Economic Association in 2003, Robert Lucas set out the challenge that faces economies throughout the OECD. Lucas argued that the 'potential welfare gains from better long-run supply side policies exceed by far the potential from further improvements in short-run demand management'. In a broad assessment of contemporary economic research, Lucas concluded that 'in general these studies found that reducing income taxation from its current US level to zero (using other taxes to support unchanged government spending) would increase the balanced growth and capital stock by 30 to 60 per cent'.

He went on to say that 'the stakes in choosing the right monetary and fiscal policies are high. Sustained inflation, tax structures that penalise capital accumulation and work effort, and tax financed provision of private goods all have uncompensated costs amounting to sizeable fractions of income. We see these economic costs in differences in economic performance across different countries and time periods. Even in the United States which visibly benefits from the lowest excess burden in the modern world, economic analysis has identified large potential gains from further improvement in long-run fiscal policy.' Obviously in other advanced economies such as the UK and in its European neighbours these structural economic issues present more acute challenges. These structural problems are more acute in Europe, because of higher ratios of public spending and taxation, and less flexible and more heavily regulated product and labour markets.

Notion of Excess Tax Burden or Deadweight

The economic cost of raising a given amount of tax revenue is greater than the actual cash sum raised because of the distorting effect that taxes have on economic behaviour. In the 1960s economists in the United States became interested in trying to measure the deadweight losses that taxation imposed on the American economy. In 1964 Arnold Harberger, who started this area of economic analysis, estimated that incomes taxes imposed welfare losses of 2.5 per cent of tax revenue raised. More recent American studies have arrived at much larger estimates of deadweight losses. The Congressional Budget Office reports that 'typical estimates of the economic cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised'. The Office of Management and Budget employs a 25 per cent deadweight loss assumption when it carries out cost benefit analysis on federal government spending programmes. OMB's rules require that each additional dollar of tax revenue is scored as a cost of $1.25, because taxes 'create an excess burden that is a net loss to society'. This means that a new spending proposal should generate benefits that are at least 25 per cent greater than the explicit financing costs involved.

Discussion of the deadweight consequences of taxation, or the excess burden of taxation as it is sometimes referred to, is at the heart of the American policy debate. For example, in its annual Economic Report, this year, the President's Council of Economic Advisers, devote a significant part of their analysis to the effects of this on economic behaviour. The Report describes how taxation of savings and income distorts economic behaviour and results in the inefficient use of the resources that leads to reductions in economic welfare that can exceed the amount of tax collected. These 'costs above and beyond the revenues collected are called the "excess burden" of the tax system'.

The damage done to economic incentives increases as marginal tax rates increase. As the tax burden in the UK has increased over the last eight years, more people have been drawn into tax and into paying tax at higher rates. And effective marginal tax rates have increased as a result of the Chancellor's decision to increase National Insurance Contribution Rates. In addition, the introduction of the Chancellor's chosen system of tax credits has resulted in many more households facing high net rates of withdrawal, of what is effectively a social security benefit rebadged as a tax credit, as income rises. These high net rates of withdrawal are effectively marginal tax rates that penalise work incentives. This has further aggravated the deadweight costs of taxation across a wide rage of earnings for families with children. Since 1997, the tax system has become more complicated and more convoluted in its structure. This is plain from the additional bands and thresholds in income tax, the changes that have been made to National Insurance Rates, the structure of Capital Gains Tax and the complex range of business tax reliefs that have come and gone.

Moreover, in an economy where the public sector is spending around two-fifths of national income, spending has risen by 64 per cent, while national income has risen by 43 per cent. Increasing spending at this rate raises fundamental questions about the efficiency of the spending decisions being made. Much of this increase in spending would probably fail to meet the policy tests that Robert Lucas or the OMB's policy guidance suggests for analysing proposed spending programmes.

II
Assessing the Government's Fiscal Policy The Supply Side Record and the Government's Inheritance

How can we look at public spending and tax and how can we assess its overall impact? There are a number of different considerations. This section sets out a framework for looking at public expenditure, borrowing and taxation.

Public Spending

The appropriate starting-point for assessing fiscal policy is the recognition that the central matter is the level of public spending. This is the total amount of resources used by the state and allocated through expressly political channels and away from the mechanism of the market and relative prices. How that expenditure is financed, by borrowing and taxation is an important, but secondary issue. The crucial question is the total amount of money that the government is allocating. Resources used by the government cannot be used for private investment and consumption. Given the high ratio of government spending to national income in most OECD economies, marginal increases in public spending are unlikely to bring the same benefits as using those resources in the private sector.

Government Borrowing

While the financing of government spending is a second order issue, it has important implications for the allocation of resources and overall economic efficiency. Government borrowing is effectively delayed taxation, because the debt has to be serviced in terms of interest payments and repayments of principal, which requires taxes. Government deficits financed through debt sales can raise long-term interest rates. This increases the cost of capital and crowds out private sector investment. A further concern is that governments should not run deficits that result in debt service payments compounding at a faster rate than the underlying growth in the economy. Such deficits have important malign consequences for future public expenditure and taxation.

Structure of Taxation: *Basic Principles*

Tax policy is crucial. The structure of the tax system and its tax rates can either minimise or aggravate the inherent costs of extracting resources from the private sector to pay for government spending. There are several broad principles that ought to inform tax decisions.

Income tax regimes effectively tax savings incomes twice. This undermines the incentive to save and damages investment and capital formation in the long term. It is therefore better to tax expenditure than income. It is also sensible to find ways of mitigating this double taxation of savings income and to identify and remedy particularly egregious examples of it.

The starting point or threshold for paying tax and marginal income tax rates are important, because they have a critical influence on individual decisions to work, save and invest. The higher the threshold for paying income tax is in relation to average earnings, the better. A high tax threshold means that more people will be out of the tax system altogether. Marginal tax rates should be as low as possible and an important test for a tax system is how many people pay a particular tax rate. A low starting tax rate, for example, is of little use if relatively few people actually face that as their marginal tax rate. Likewise a moderate top rate of income tax may still do a great deal of damage, if in practice, it begins close to average earnings.

A broad tax base is desirable for two reasons: it enables marginal tax rates to be held down and tends to create a neutral tax system. A neutral tax system is desirable in itself, because it limits the distortion that the tax system imposes on the economy. Neutrality results in a generally efficient allocation of resources that roughly accords with what individuals choose to do in a free society. Few governments are, however, happy to accept such an allocation of resources. The damage that certain behaviour does leads governments to try and curb it through the tax system, while the perceived benefits of certain activities result in governments trying to use tax reliefs to encourage them. This does not undermine the case for a broadly neutral tax system. If anything it enhances it. If politicians want to make progress on a particular objective, it is more likely to do so in the context of a generally neutral tax system. The specific tax measures to punish or encourage behaviour are not only more clearly signalled, but they can be more expensive in terms of revenue forgone. What makes little sense is a complicated tax structure, where individual measures often cancel each other out. These achieve little in terms of actually changing behaviour, but create a complicated and incoherent tax policy, that often ends up distorting the economy for little result in terms of the intended policy objective.

Along with simplicity, clarity ought to be an important objective for fiscal policy. The tax system should be as simple as possible and tax policy should be set out and explained as clearly as possible. Clear, consistent and accurate statistics should be published in the principal budget document - and presented in a manner that is consistent with agreed international conventions. Where there are departures from these international conventions attention should be drawn to the fact. The reason for such a departure should be explained and the statistics should also be presented in accordance with the international convention. The budget documents should be lucidly drafted and tables for public spending, borrowing and taxation should be consistently set out. There needs to be historical information, so that the evolution of policy can be tracked, and this has to be matched by comparable forecasts and projections. The government ought to present its fiscal decisions in a transparent and lucid manner.

Regulation and the Trend Rate of Growth

Decisions on expenditure and taxation are the principal influence that a government has on the evolution of an economy's supply performance, but they are not a government's only means of influencing the economy. Government social policy, employment policies and regulation in general have a profound effect on the flexibility and efficiency of product and labour markets. Regulation can set up barriers that prevent markets from working and allocating resources efficiently. Increasing these impediments in the medium-term damages the productive capacity of the economy, reduces its ability to generate employment and income and damages the economy's trend rate of growth.

Labour’s Fiscal Inheritance

Against these criteria the record of the Labour Government since 1997 is disappointing. The starting-point for making a sensible appraisal of Labour has to be the position that Gordon Brown inherited in 1997. Between 1979 and 1997 the Conservative Governments of Margaret Thatcher and John

Major achieved a great deal. But their genuine achievement also exposed the political constraints they were operating within. The rise in the ratio of national income spent by the government was halted. Privatisation reduced the scope of public enterprise and lowered the external financing requirements of the nationalised industries. A succession of social security measures mainly taken in the early 1980s reduced the growth of public spending. These included breaking the link between earnings and social security payments such as unemployment benefit and the basic state pension, and restricting SERPS. John Major's Government equalised the pension age, by raising it for women from 60 to 65. These measures reduced the share of state spending within national income and stabilised the ratio of government spending at around 40 per cent of GDP.

These measures stabilised rather than resolved the problem. Apart from reducing the Department of Trade and Industry's role, and the privatisation of nationalised industries, the state withdrew from few functions. Immense efforts were made to make public services more efficient. These included contracting out, the internal market in health and a variety of value for money initiatives, but the public expenditure challenge that Britain faced, when the Conservatives presented their first public expenditure White Paper in 1980 remained, albeit on a more manageable scale, at the end of the Conservative Government in 1997.

The state still used too many resources that would have been better used elsewhere and imposed a damaging tax burden. In areas from education to health there was widespread public dissatisfaction with government organised and funded services. During sensitive periods in the political cycle this resulted in large discretionary increases in spending. Growth in spending was later held back to contain public borrowing and taxation. Following big increases in priority programmes such as health, there was little show for the money, in terms of actual results.

While the Conservatives rightly made cuts in marginal income tax rates, the total tax burden rose. The basic rate of income tax fell to 23 from 34 per cent and top rate fell to 40 per cent from 83 per cent or 98 per cent, when the investment income surcharge was included. The income tax base was broadened and simplified and the role of expenditure taxes like VAT increased. In effect higher rates of VAT, the abolition of some reliefs and fiscal drag financed headline-grabbing cuts in marginal income tax rates, which were desirable, but disguising a rising tax burden.

This rising tax burden helps to explain why despite the immense structural reforms, the denationalisation, the trade union reforms, and the de-regulation of product and labour markets - there was not a greater observable improvement in the economy's trend rate of growth in the 1980s and 1990s. For the great majority of people with incomes around average earnings there were reductions in marginal tax rates, but they were not that dramatic particularly when considered in the context of the full impact of National Insurance Contributions and indirect taxes.

Between 1986 and 1992 there were large increases in government spending. These reflected three factors. Political pressure raised spending ahead of the elections in 1987 and 1992. The pressure to raise government spending between 1987 and 1989 when strong economic growth above trend created a large Public Sector Debt Repayment, led people to assume that higher spending could easily be accommodated. The recession in 1991 and 1992 also created political pressures which led to further increases in spending.

The impact of this higher spending affected the public finances at a time when tax receipts were under pressure. In the 1988 and 1989 budgets a series of measures was announced that remitted a small proportion of the additional tax revenue collected as a result of fiscal drag in the late 1980s. These included the cut in the top marginal tax rate from 60 to 40 per cent and the introduction of independent taxation for married couples. These reduced tax receipts and took full effect at a time when tax receipts were generally reduced by the prolonged fall in output in the early 1990s. That combination of falling tax revenue and increased spending resulted in the return of a large public sector borrowing requirement. Measures were then taken to rectify the fiscal position. Public expenditure programmes were squeezed in cash terms, although in the context of sharply lower inflation in the early 1990s the real squeeze was less pronounced. And taxes were raised.

The result was that by the November 1996 budget government borrowing was falling. The total tax burden was on strongly rising trend. Given the tight spending plans for set out for 1997-98 to 2001-01 the public finances were not only returning to balance, but heading towards a sizeable surplus. The Labour Government inherited in 1997 a strongly improving fiscal position and public finances that appeared to be in better shape that at the time of the previous Budget in November 1996.

III

Labour's Stewardship of the Public Finances Tax and Spending: A Coherent Policy?

Gordon Brown's starting-point was a commitment to stick to the spending plans of the previous Conservative Government until the financial year 1999-2000. The spending plans bequeathed to Labour by Kenneth Clarke were perceived as 'exceptionally tight'. In British public debate these words are used in a manner almost empty of meaning. For Treasury Ministers, officials and economic commentators alike every spending round is exceptionally tight, even those that plainly represented a substantial loss of public expenditure control. The spending plans that Labour held to did represent, in the Alice Through the Looking Glass world of British public expenditure, a tight squeeze on departmental spending ambitions. Experience over the last twenty years suggests that sooner or later perceived public expenditure squeezes are followed by relaxation in control over the political and economic cycle. This process is inevitable unless the government is willing to cut its functions. Labour's pledge about sticking to Conservative spending plans in their first two years meant little. The real pressures come in the second half of a Parliament.

In 1997 a lot of fiscal tightening was already built into the public finances by Kenneth Clarke. However, Gordon Brown raised taxes further despite more optimistic official revenue projections. The discretionary tax increases that Mr Brown announced in his first Budget cumulatively raised an additional £18 billion over three years. Moreover, if anything those official projections deliberately underestimated the revenue yield from the tax system.

The justification for those tax increases was the alleged need for sustainable and stable public finances. That may have been a persuasive justification for the tax increases that Norman Lamont and Kenneth Clarke made in the mid-1990s, but it was not plausible in for Gordon Brown's case. First, Kenneth Clarke's last Budget Redbook indicated that there would be a budget surplus of 2 per cent of GDP by 2001-02. Even so, the forecast for tax receipts set out in Mr Clarke's final budget in November 1996 was significantly revised upwards by the Treasury in July 1997. Second, if Mr Brown had any doubts about the stability of the public finances he should have re-examined his predecessor's spending plans and cut them. The truth is there was no problem with the medium-term stability of Britain's public finances. As a result of the additional tax increases that Mr Brown made in his first budget in July 1997, the Treasury projected that the country was heading for a surplus of over 2 per cent of GDP in 2001-02.

It appears that Gordon Brown deliberately increased the tax burden at the start of the 1997 Parliament, in order to give Labour the maximum fiscal flexibility in the run-up to the next general election. This was to enable the Government to announce higher spending on priority programmes, presentational tax cuts that merely compensated for some fiscal drag, and an apparently prudent budget surplus. It represented a dramatic presentational coup de theatre, but a costly one. Moreover, by deliberately increasing the tax burden rather than curbing Britain's long-term public expenditure problem Labour aggravated both. This is precisely the cul-de-sac that the Conservatives inadvertently found themselves in. Moreover, in the late 1990s an apparently large budget surplus fuelled spending ambitions both across Whitehall and the wider political spectrum. This was a repetition of what happened the late 1980s when the public sector borrowing requirement was transformed into the Public Sector Debt Repayment. In both periods apparently strong public finances were accompanied by large discretionary increases in government spending.

Labour's Comprehensive Spending Reviews

While Labour stuck to its inherited spending plans in their first two years in government, the Treasury carried out a Comprehensive Spending Review and announced the results in July 1998. It had three principal features. First, it was intended as a three-year settlement. Second, there was an emphasis on public sector capital spending. Third, there were performance agreements between individual spending departments and the Treasury on modernisation initiatives intended to improve the efficiency of policy and value for money. The result was that spending rose faster in real terms than at any time since the unprecedented peacetime increases in spending under Mr Heath's Conservative Government in the early 1970s.

Almost every area of public provision, except defence, received large increases in programme spending. Nevertheless, it was plain that the Government would have difficulty in making its three-year plan stick and that previously agreed spending plans would have to be reopened. The area where this was most likely to happen was health and it did. Problems in the National Health Service not only resulted in more money but a full-blown health review in the first part of 2000. A second Comprehensive Spending Review was therefore carried out within two years and announced in July 2000. In practice the third year of the spending plans announced in 1998 was completely written. There were also discretionary additions to the second year planning totals originally set out in both the 1998 spending review and the 2000 review. Labour has now increased spending in four spending reviews.

The broadest measure of public spending, Total Managed Expenditure, has risen by 64 per cent since 1997-98 in cash terms. Since 2000-01 it has gone up on average by 6 per cent a year. Within this, government spending on capital projects has been rising at an annual average rate of about 20 per cent. Between 2000-01 and 2004-05 total public sector capital spending, on a national accounts basis, rose by 82 per cent from £18.1 billion in 2000-01 to £32.9 billion in 2004-05.

General Government Consumption is a narrower measure of public spending, which excludes transfer payments along with capital spending and approximates to the measure of public spending used in the National Accounts to measure GDP. Government spending growth since 1998 has been faster than the increase in GDP whether the comparison is made using current cash prices or constant prices adjusted for inflation. Between 1997 and 2004 GDP grew by 42.9 per cent in nominal or cash terms. Household Consumption grew by 43.9 per cent, while General Government Consumption grew by 66.2 per cent. In real terms since 1997, GDP has grown by 20.8 per cent, Household Consumption by 27.2 per cent and General Government Consumption by 23.5 per cent. The fact that in cash terms government consumption has risen by 66.2 per cent, but in real terms by only 23.5 per cent illustrates the way that increased cash spending in the public sector has been consumed in inflation rather being used to generate increased output. It also shows that inflation within public spending has been running at roughly twice the rate as in the rest of the economy.

Total Managed Expenditure has increased by a third in real terms since 1997 at an average annual rate of 4.1 per cent. Between 2001 and 2005 it has increased in real terms by 17.6 per cent at an average annual rate of 4.4 per cent. Over the next two financial years, the Treasury projects that real spending will continue to increase, but at a much slower rate of about 3.5 per cent between 2005-06 and 2007-08.

Economic Assumptions for the public finance projections in the 2005 Budget							
Annual percentage change							
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Real GDP	2.5	3.25	3	2.5	2.25	2.25	2.25
Deflator	3	2	2.5	2.75	2.7	2.75	2.75
Percentage change in cash spending							
Total Managed Expenditure	8.4	6.5	7.1	5.9	5.6	4.4	4.7

Source: FSRB and Public Expenditure Statistical Analyses 2004

	Percentage Change constant market prices	
	General Government Consumption	GDP
1997	-0.4	3.3
1998	1.2	3.1
1999	3.5	2.9
2000	2.3	3.9
2001	2.6	2.3
2002	3.8	1.8
2003	3.2	2.2
2004	4.7	3.2

Source: FSRB and HM Treasury Databank

Each of the Labour Government's four Comprehensive Spending Reviews resulted in increases in public spending in relation to national income, during a period when the economy was steadily expanding. The Government is planning further rises in expenditure that will increase the ratio of government spending in relation to national income between now and 2009-10 at a time when economic activity is expected to be weaker. But not only has the Government increased current spending plans, it has also entered into expensive future commitments – such as its Minimum Pension Guarantee and its pledge to increase the share of national income spent through the public sector on healthcare.

The Tax Burden

The total tax burden has risen sharply under Labour since 1997. Total public sector receipts have risen by 2.2 percentage points from 37.1 per cent of GDP in 1996-97 to 39.3 per cent in 2005-06. The 2005 Budget Redbook projects that they will rise by 1.3 percent to 40.6 per cent of GDP between now and 2009-10.

The Chancellor prefers to emphasise an incomplete measure of the total tax burden that treats the Working Families Tax Credit as a reduction in income tax. Yet even by this measure there has been a significant rise in the tax burden from 34.8 per cent in 1996-97 to 37.3 per cent estimated for 2005-06. The national accounts indicate that national income in cash terms has grown by around 52 per cent since 1996, while total tax receipts have increased by 70 per cent between 1996-97 and 2005-06.

The result has been to slow the growth of real personal disposable income. The large cumulative increase in taxes since the Budget in July 1997 that increased taxes by £6.6 billion and the 2002 Budget that added £9.9 billion to the tax burden, largely as a result of higher National Insurance Contributions, has reallocated income from private use by households to the public sector. This is now being reflected in disposable income. The recent IFS report, *Poverty and Inequality in Britain*, indicates that average incomes after tax and benefits fell by 0.2 per cent in real terms between 2002-03 and 2003-04.

Taxing Savings and Business

The principal feature of Labour's tax increases has been the additional burden placed on companies and savers. The great fault of an income tax system is that it gives rise to the double taxation of savings income. Where savings are held in the form of equities and an income tax system is combined with corporation tax, there is the potential for the triple taxation of savings income. This problem is the reason why many economists have a preference for expenditure taxes.

That is why a serious attempt was made between 1979 and 1997 to shift taxation towards spending rather than income. The proportion of tax revenue raised from expenditure taxes such as VAT and excise duties rose between 1979 and 1997. And the proportion of total revenue raised from income and capital taxes fell back.

Since 1997 this desirable trend has been reversed. Taxes on income and capital have increased from 44.3 per cent of total receipts in 1996-97 to 49.5 per cent in 2005-06, while proportion of revenue collected from taxes on expenditure has fallen.

The Special Position of Pension Funds

Some of the worst effects of income tax on savings have been mitigated by a combination of accident and design. First, contributions to occupational and personal pension funds received upfront tax relief and were only taxed when income was taken on retirement, while investments accumulated in the fund free of income and capital gains tax. These arrangements were largely the result of accident. When the first pension funds were established at the start of the century the average working man did not pay income tax. When a trust is taxed the intention is to tax the trust in the same that the underlying beneficiaries would be taxed. The Royal Commission on Taxation in 1920 therefore recommended that pension funds should be exempted from income tax given that the underlying beneficiaries had no tax liability.

The second mitigation was created in the 1970s. In a so-called classical system where there is a corporation tax regime and an income tax, the double taxation of savings income is aggravated. To prevent the effective triple taxation of savings held in the form of equities as a result of corporation tax being added on top of income tax, dividend payments were accompanied by a tax credit. This was offset against part of the investor's income tax bill. The system was known as 'partial imputation' and was imperfect, because it did not fully protect savers from triple taxation. The budget imperfection was made worse by the decision in 1993 to reduce the value of the credit. The interaction between the tax credit and the method used by the Inland Revenue to collect corporation tax, Advanced Corporation Tax –ACT– also created a number of practical problems for companies with relatively large overseas profits paying dividends to UK investors. Despite these problems this regime of dividend tax credits represented an important attempt to minimise the damage done to savings held in the form of equities.

Expenditure Tax Treatment of Some Savings

The third mitigation of the defects of income tax went to the heart of the problem. Special accounts were developed that enabled savers and investors to accumulate investments free of tax and effectively gave savers the opportunity to hold a portion of their savings in a form that overcame all the defects of income tax. The first initiative, personal equity plans (Peps), announced by Nigel Lawson in the 1986 Budget, enabled a set cash amount to be invested free of income or capital tax. Initially it was conceived as a tax relief to encourage wider share ownership rather than as a measure to mitigate the worst features of income tax. However, tax specialists soon recognised that Peps had that desirable effect.

As Chancellor of the Exchequer in 1990 John Major built on Peps by introducing the tax exempt special savings accounts (Tessas). These enabled cash bank accounts to build up interest free of income tax provided the cash deposited was left for five years. This effectively extended expenditure tax treatment to savings deposits.

Labour and the Taxation of Savings

Labour has driven a coach and horses through the taxation of savings. Gordon Brown has gone out of his way to stress the importance of savings and investment. Yet his decisions as Chancellor damage both. There is plenty of scope for further radical improvement in the taxation of savings. A straightforward annual amount of savings that could be put into tax exempted accounts of one sort or another would make much more sense than the current range of plans and accounts, each with their own rules. It would be legitimate to consider ending the tax-free lump sum in pensions or to examine the balance of tax relief that pensions receive in relation to other forms of saving.

Reforms of this sort would have been controversial and would have taken political courage. It what a radical and imaginative Chancellor, at the start of a Parliament with the support of a massive majority, should have done. Instead Mr Brown abolished the tax credit on dividends. At a stroke he reimposed on a significant proportion of savers who hold their savings in equities the triple taxation of their income. The real prize for the Chancellor is that pension funds cannot reclaim tax paid on their dividends. It gives the Treasury a tax increase of £5.4 billion. The lion's share of this tax increase is being paid by occupational and personal pension funds. The full impact of this decision made in the Chancellor's first budget in July 1997 has now become clear. The number of traditional occupational pension schemes has fallen and increasingly final salary schemes are being replaced by cheaper money purchase schemes.

Instead of establishing a generous amount of income that could be set aside tax free each year, the Chancellor decided to replace Tessas and Peps, with Individual saving accounts (Isas). The principal feature of this change has been a reduction in the generosity of the total tax relief available. Under previous arrangements a taxpayer could put in total £9,000 into a Peps, and £1,800 into a Tessa each year. Under Labour's Isa regime the total annual limit has been reduced to £7,000. Moreover, the scheme has been accompanied by a lot of complicating rules. Within the £7,000 annual limit no more than £3,000 may be in cash. The limit also includes a maximum £1,000 life assurance component, which previously would have been available in addition to the amounts of money that savers could put into Tessas and Peps. Since 1997 each of the principal mechanisms that mitigated the double taxation of savings income has been significantly eroded. The ONS reports that in 2004, the saving ratio was 4.2 per cent the lowest since the series began in 1963.

The Threshold for Tax and Marginal Tax Rates

The income tax system is only indexed to prices and not to increases in average earnings. Given that average earnings have a tendency to rise faster than prices this means that each year more and more people are drawn into tax and more people are drawn into paying higher rates of tax.

Before World War II a person had to have an income close to average earnings before they were drawn into income tax. In 1939 only 3,800,000 people paid income tax. By the mid-1970s the tax threshold had fallen to less than a quarter of average earnings. Since 1997 it has fallen from 19 per cent to 17.5 per cent of average earnings. As result more people than ever are being drawn into tax at very low multiples of average income. Over the last five years the total number of people paying income tax has steadily risen from 25,700 in 1996-97 to 30,000 in 2004-05. This partly reflects increased employment but its principal cause is an income tax system that descends too far down the income distribution.

The number of people paying the basic rate of income tax has risen from 16,200 000 in 1996-97 to 22,500 000 in 2004-05. While the number of people paying the top rate of income tax has risen by over 60 per cent from 2,080 000 to 3,360 000. Since 1997 more people have been drawn into tax and more people have been drawn into higher marginal tax rates. For many people earning much above average earnings the top rate of tax has become the standard rate.

Tax Credits

The Government has replaced Family Credit by the Working Families Tax Credit. Family Credit was an in-work benefit targeted on low-income households with children. It had the great merit of targeting help to people in work who needed it, but there was also a great problem since its progressive withdrawal as household income rose damaged the work incentives of the people claiming it. The policy choice is to have either a relatively small number of households, over a narrow range of the income distribution, with very high net rates of benefit withdrawal as their income rises. Or to have less steep tapers, that withdraw benefit more slowly, over a wider range of the income distribution, involving many more households.

Gordon Brown redesigned Family Credit as a tax credit and made it more generous, withdrawing it more slowly as income rose. This has created significant problems – reducing incentives, creating poverty traps and producing a series of practical administrative difficulties. While the number of households with marginal deduction rates of over 70 per cent has fallen from 740,000 in 1998 to 235,000 in 2005-06, the number of households facing marginal deduction rates of over 60 per cent has increased from 760,000 to 1,730,000. The Chancellor has repeatedly exacerbated the effects of the complex poverty trap that he introduced. In the Budget Redbook in 2001 estimated that 900,000 households faced a net rate of deduction of 60 per cent. The Pre-Budget Report in December 2004 the estimate for 2005-06 was 1,715,000, but as result of measures announced in the Budget in March 2005 this estimate increased to 1,730,00. The Government's chosen system of tax credits extends this poverty or benefits trap into households with incomes of over £40,000 a year. This means that the number of households that face high net rates of withdrawal has more than doubled since 1998.

In an ideal tax and benefit regime there would be a clear gap between the point in the income distribution in which someone was entitled to means-tested social security benefits and where they had a liability for income tax. An over lap between benefits and taxes is a classic example of fiscal churning. The state takes money out of the pocket through the tax system only to return again through the social security system or now the Inland Revenue's PAYE arrangements, with all the administrative costs and inconvenience involved. The WFTC is particularly defective, because it carries this overlap to the point where households with incomes that could carry them into the top tax bracket are affected.

The tax system has been made more complicated and is less neutral than it was in 1997. There have been a succession of complex business tax measures to promote capital investment and research and development. The most dramatic departures in neutrality have principally affected the tax treatment of families and the environmental consequences of pollution.

In 1997 the tax system was broadly neutral in the way that it treated families with children. Married couples and lone parents had the same tax treatment, whether or not they were in work. The married couples allowance, which was paid in addition to the personal allowance, was not only paid to married couples but also to unmarried people with children (when it was paid to lone parents it was called the additional personal allowance)[2].

While the MCA existed it meant that the tax system was moderately biased against households without children as opposed to married couples and lone parents. The abolition of the MCA has effectively created losers among the

2 The introduction of independent taxation had in 1990 removed the tax system's bias against marriage, but ran the risk of creating a problem of serious losers. This was because the new personal allowance was less than the previous married man's allowance. In the case of a married couple, where only one of them worked, and the other neither had an income from work or investments and savings, they would be worse off because while the spouse without an income had a personal allowance they were unable to use it. These households, moreover, were often low-income families. That was why the MCA was introduced as a temporary measure to protect such married couples until personal allowances could be raised and there would be no further need for these special arrangements. The alternative would have been a larger personal allowance for every one. That would have been expensive in terms of lost revenue and would have principally benefited higher income households, especially those with investments that could be transferred into the name of a non-working wife.

category of household that it was introduced to protect. The Working Families Tax Credit and the new Child Tax credit takes things further. The tax system has been decisively shifted in favour of people with children whether they are married or unmarried. And by only paying the WFTC on condition that the parent works biases the tax and benefit system decisively in favour of parents that choose to work and against those that choose to remain at home to care for their own children. Sorting out the consequences of taxes and benefits on households and the perverse biases and incentives that well intended measures generate is always difficult. However, the present arrangements do appear to be an inappropriate intrusion into the way families and individuals choose to arrange their affairs in a free society. The fact that these biases have resulted from deliberate public policy is reprehensible.

Protecting the Environment

The Government's approach to environmental pollution has lacked coherence, made the tax system less neutral and appears devoid of purpose. The Chancellor in July 1997 fulfilled Labour's pledge to cut VAT on domestic fuel and power from 8 to 5 per cent, reduced revenue and blocked a sensible, albeit politically difficult, move to a broader and more neutral expenditure tax base.

Any Chancellor seriously thinking about using the tax system to prevent unnecessary greenhouse gas emissions should start by ensuring that ordinary consumption taxes are fully applied to the use of fossil fuels rather than reducing them. In 1997 budget the Chancellor increased the fuel duty escalator to 6 from 5 per cent. This was described as a measure to protect the environment. The revenue raised from this was £440 million, but that was more than offset by the £510 million foregone by cutting VAT on domestic fuel and power. This was plainly a tax policy on the environment that purported to be one thing when it was plainly another. It claimed to be green, but when it merely clothed a fiscally maladroit piece of political populism.

The incoherence of the Government's policy on the environment is also illustrated by the three-year moratorium that it has announced on the granting of licences to build new gas-fired power stations and the subsidies that it has given to the coal industry. Since 1997 Labour's policy on the environment and its treatment of the tax issues involved amounts to little more than policy at war with itself.

IV
The Government's Record. Fact or Fiction? Growth, Fiscal 'Rules' and Borrowing

Adjusting the Growth Figures

Gordon Brown announced in his first budget in July 1997 that, according to new Treasury estimates, the economy's trend growth rate was not 2½ per cent (the previous estimate), but 2½ per cent. It has since been revised back to 2½ per cent and is now estimated to be 2½ per cent.[3] The decision to lower the estimate of the trend growth rate was surprising. If anything the balance of informed economic debate would have suggested nudging it up.

The suspicion that the Chancellor's decision was politically motivated was confirmed by the discussion of the impact that welfare reform might have on the trend growth rate, set out in the Budget Redbook in March 1998. This appeared to suggest that training programmes and work experience schemes have few deadweight costs and will increase the employability and productivity of unemployed people, raising the trend rate of growth. The Chancellor's Redbook that year suggested that GDP growth could potentially be raised by ½ a per cent from 2½ to 2½. Given that the total amount the Government was planning to spend on its New Deal for jobs programme was around £5 billion over four years in an economy where annual money GDP was some £840 billion, the Chancellor must have been expecting an extraordinary high rate of return on the spending involved. The Chancellor appeared to have lowered the official estimate of trend growth below its realistic level so that he could later raise it, explaining that the better than expected growth rate was the direct result of his policies. In the autumn of 1999 the Pre-Budget Report the estimated for the trend rate of growth was revised up, but the Chancellor said that the more cautious

3 Estimating the trend rate of growth is at best difficult and requires long runs of historical data. There had been broad agreement that 2½ per cent was an appropriate rule of thumb. Some economists were more optimistic and thought that it could be raised. In the second half of the 1980s the Government Economic Service had become more optimistic about it during the long period of economic expansion, when the growth rate averaged around 3 per cent, but following the long recession in the early 1990s returned to the view that 2½ per cent was the best rule of thumb.

assumption of $2^{1}/_{2}$ per cent would continue to be used for planning public spending and forecasting the public finances.

This is not to suggest that active labour market measures are themselves unwelcome. While there may be little to justify them in strict economic terms, they may yield worthwhile social benefits. Britain has had a variety of make-work and training schemes since the mid-1970s and they play an important part in benefit testing. What these schemes cannot overcome are fundamental defects that have been repeatedly demonstrated in Britain and other countries – namely, deadweight costs and substitution effects. Either such programmes subsidise people who would have got jobs anyway or create jobs that displace other work.

As regards the New Deal and Labour's other training and work experience schemes, risible economic claims that have been made for their success. Furthermore, Labour's decision to sign the European Social Chapter, tighten a host of employment regulations and to introduce a national minimum wage and then progressively **to** raise it, are doing serious damage. The effect of these decisions in the medium term will be to raise employment costs and to make the British labour market less flexible and efficient. In addition, there is a fundamental inconsistency between the offering job subsidies through its New Deal, while the Department of Trade and Industry is legislating to increase employers' costs. A more costly and less flexible labour market will damage the supply performance of the British economy in the medium term.

Brown's Fiscal Rules

Much has been made of the Chancellor's prudence. Government borrowing is subject to two supposedly 'strict' rules. The first is that it will only borrow to finance net capital spending. This is the so-called 'golden rule'. The second is that over the economic cycle the ratio of net public sector debt to GDP should be set at a stable and prudent level defined by the Chancellor as 40 per cent of GDP.

These rules have too often been accepted at face. In fact, they are more elastic than many people have assumed. First there is the concept of 'over the economic cycle'. How is the cycle defined? How long is the cycle? One of Labour's Chief Secretaries gave evidence to the Treasury Select

Committee about balancing the budget over the cycle and explained that some cycles can be very long.

The golden rule was always likely to accommodate an increase in spending, because investment spending has been low. It could be increased and some areas of current spending like repairs of school buildings could be re-classified as investment, as has happened. Labour and Conservative politicians have a long history of making politically attractive investment decisions that turn out to be expensive white elephants. Mrs Barbara Castle's decision to build the Humber Bridge is notorious. But there are plenty of other examples like tower blocks and dangerous pedestrian underpasses, where public investment some times even yields negative results but taxpayers continue to pick up the bill for generations. Why should Labour's investment decisions now be any better? What rate of return is the Chancellor expecting on the capital investment programme he has initiated? How does that compare with previous investment and to the rate of return expected in the private sector? None of these issues were properly addressed in the documents published as part of the Government's Comprehensive Spending Reviews or its Budgets.

The National Institute for Economic and Social Affairs is sympathetic to the Government's objective of raising investment, but has made the pertinent point that there is little point in a golden rule, where borrowing is held down by the imposition of taxes, which are paid mainly by savers. The key defect of the Chancellor's fiscal rules is that they place no constraint on either the total level of public spending or the total tax burden.

The OECD made an assessment of Brown's fiscal rules which it published in *Managing Public Expenditure: The UK Approach* in December 2001. The OECD recognised that the rules 'do not imply any restrictions on overall public expenditure' and identified several potential drawbacks for resources allocation. It noted that the distinction between capital and current spending embodied in the golden rule is not always relevant from an economic perspective. A good example, education spending that is principally defined as current spending, but adds to the stock of human capital and could therefore be regarded as a form of investment. To the extent that the golden rule favours fixed over human capital formation there is a risk of a misallocation of resources.

The OECD pointed out that since the 'fiscal rules play out strongly in favour of public investment, there is, at least at the aggregate level, little trade-off between current and capital expenditure based on their respective marginal costs and benefits'. The implication is that the marginal benefits from public investment are so great that the risks of overshooting its optimal level are negligible. But the OECD warned that 'the marginal benefits from public investment may fall quickly'.

The OECD also pointed out that while the fiscal rules applied to general government expenditure and to the broader public sector including public corporations, they do not apply to private-public partnerships. As a result investment under private-public partnerships is treated as private sector spending and only the services purchased by the Government are recorded as current expenditure by the public sector. As a result the golden rule could distort the choice between traditional public investment and private partnerships with the public sector.

When the IMF examined the fiscal rules it identified as a serious concern the 'wide scope for discretionary loosening which would be consistent with the debt ceiling of the sustainable investment rule, even, under the most stringent interpretation of the rule'. Devising effective fiscal rules is difficult, because of the tension between reconciling the desire for effective fiscal constraints and the need for flexibility, so that automatic stabilisers can work over the economic cycle. Rules that are too tight, for example, can have a pro-cyclical effect that magnifies the amplitude of the cycle. The UK rules are more flexible and looser than they have been presented by Gordon Brown.

Government Borrowing

The Government inherited in 1997 a budget moving towards balance. Ken Clarke's final Redbook published in November 1996 forecast a move into broad budget balance by 1999-00 and a surplus with a debt repayment of some£18 billion, or around 2 per cent of GDP, projected for 2001-02.

On taking office, however, the Chancellor announced that there was a problem. He cut the estimate of trend economic growth to $2\frac{1}{2}$ per cent from $2\frac{1}{2}$ per cent and announced tax increases to deal with the unstable public finances that he claimed he had inherited. The PSBR forecast for 1997-98 was lowered to £13.3 billion and the forecast for 1998-99 was lowered to £5.4

billion compared to Clarke's November 1999 Redbook. But £3.3 billion of the £5.4 billion revision came from 'forecasting changes' as did £6.7 billion out of the £6.8 billion improvement in the 1998-99 PSBR figure. In effect the Treasury revised upwards its estimates of revenue receipts, principally from corporation tax. The big improvement in the PSBR had little to do with the Chancellor's decisions but stemmed from those of his predecessor.

The hallmark of Labour's fiscal policy over the last four years has been the transformation of the overall budget balance from surplus to large-scale borrowing during a period of steady economic growth. In the late 1990s there were large surpluses. In 2000-01 there was a surplus on the Government's preferred measure of £15.4 billion equivalent to 1.6 per cent of GDP. In 2004-06 the Chancellor estimates that Public Sector Net Borrowing will be £32 billion or 2.6 per cent of GDP. Given the lack of spare capacity in the economy the implication is that the budget deficit is now a structural or permanent borrowing requirement, unless an adjustment is made to planned spending or taxation.

Four years ago in the 2001 Budget Redbook the Chancellor projected net borrowing for 2004-05 of £11 billion equivalent to 1 per cent of GDP. Public sector net debt was forecast at £347 billion or 29.9 per cent of GDP. In the March Budget 2005 actual estimated borrowing was more than three times as great at £34.4 billion and the level of debt was £415 billion or 34.4 per cent of GDP. In 2001 a steady surplus on the current budget was projected for the next five years, with a £9 billion surplus 2004-05. In fact the Chancellor in his March Budget reported a £16.1 billion deficit on the current budget for 2004-05. But these bleak statistics do not tell the whole story.

The Budget Redbook now projects that government borrowing will fall from £32 billion in 2005-06 to £22 billion in 2009-10. Borrowing will not, however, fall below 1.5 per cent of GDP. Labour's return to borrowing has meant a large increase in net public debt which has risen by a third since 2001-02. Between 2004-05 and 2009-10 net public debt is predicted to rise by a further £158 billion from £415 billion to £573 billion, a further increase of over 38 per cent. A return to borrowing and rising public debt are inevitably leading to increased spending on servicing debt. Having fallen, debt service charges are now projected to rise from a £20.9 billion in 2002-03 to 28.8 billion in 2007-08, an increase of over 37 per cent in five years.

Transparency

On the international stage - for example, at the IMF - Gordon Brown preaches transparency in the way that Presbyterian ministers used to preach predestination. At home he practises obfuscation. The Treasury Select Committee investigation into the 1999 budget dissolved into a heated discussion as to whether the Chancellor was hiding a rising tax burden by the clever use of sleight of hand and fudging figures.

The Chancellor regards the Working Families Tax Credit as an income tax reducing measure rather than a social security benefit. He nets it off against income tax receipts to reduce the total tax burden. This is inconsistent with the internationally agreed accounting conventions used by the OECD and with the approach taken in the national accounts. Even if the Chancellor's preference to score the measure as a tax credit rather than a social security benefit were acceptable, he has chosen to treat the WFTC and the old Family Credit benefit, which it replaced, inconsistently. In historical data Family credit was, by contrast scored by the Chancellor as a social security benefit and is not netted off against income tax and the total tax burden.

The exact nature of the confusion and obfuscation in the presentation of the public finances goes beyond wrangles over the rising tax burden. All governments put the best gloss on their financial transactions. The Conservatives in the heyday of privatisation, counted asset sales as negative public expenditure. This was defended as consistent with international conventions and the practice of previous Labour Chancellors, but it was also extremely convenient given that it lowered both spending and borrowing. Treasury officials are past masters at drafting documents to create ambiguities and elisions of meaning.

That said, the public accounts are now more opaque and confusing than for many years. There are two causes: deliberate ministerial decision and the perverse consequences of well-intended changes actually intended to increase transparency.

The Budget Redbook has ceased to be a coherent document that lucidly explains economic policy and attaches numbers to the principles that inform it. It has become a discursive document that confuses more than it informs. This is the fault of the Chancellor. Information on the proportion of direct and indirect tax that households will pay is no longer provided. Charts illustrating the threshold at which people started paying tax, which for years appeared in publications such as Inland Revenue Statistics have been dropped. This means that making historical comparisons about the evolution of the tax burden are now much harder.

The Comprehensive Spending Review in 1998 and the introduction of the new European System of Accounts transformed the presentation of public expenditure, government borrowing and the framework of GDP. The result is that even experts who have studied the public finances for most of their professional lives find the material impenetrable. It is impossible to make comparisons over time because, as the Fraser Allander Institute has pointed out, the Treasury has not made any attempt to reconcile the new and the old presentations.

Some of the confusion arises from the complexity of resource accounting, which represents an attempt to present the public accounts like those of a business. This reflects a genuine effort to increase transparency, initiated by Ken Clarke, which draws heavily on work done in New Zealand whose officials helped. Well intended it may be, lucid it is not. The real concern is that having replaced the 'funny money' of the Plowden years, when government spending was planned in volume terms - a recipe for raising spending as a share of GDP- with cash plans, we are now moving backwards.

The framework in which government spending and borrowing are presented and controlled has been turned upside down. At the same time the measurement and presentation of GDP has been subject to the biggest change since the national accounts were first developed in the 1940s. The result is a statistical nightmare. On important issues such as the size of the public sector, the level of taxation and government borrowing in relation to GDP, consistent historical comparisons are now very difficult.

Gordon Brown and New Growth Theory

The study of economic growth has been transformed over the last twenty years, with the emergence of new approaches to growth theory. The traditional neo-classical growth model identified population and technical innovation as critical factors in explaining economic growth, but assumed them to be exogenous or beyond the scope of the model and hence had to be explained outside it. For economists this was an awkward intellectual problem, because it meant that they had little that they were able to say about the crucial things determining economic growth.

The work of David Aschauer, Robert Barro and Paul Romer attempting to explain innovation and technical progress, bringing the critical issues back into economic models stimulated renewed interest in what drives economies forward. From the start, this new or so-called 'endogenous growth' theory offered practical fodder to the policy debate. Initial emphasis on infrastructure, spending, research and development spending, encouraged social democrats and American liberals. However, the broader body of literature that emphasised the need for property rights, cautious levels of public spending, tax and borrowing and well functioning markets offered a blueprint for a more market-orientated economic policy. The beneficial effects of spillovers from research and development and certain forms of manufacturing investment and the increases in productivity as a result of education spending and public investment in infrastructure, helped to stimulate a new Keynesian policy agenda. This translated easily into increased public spending on education, research and transport and an active industrial strategy with subsidies and tax allowances to encourage research and development and manufacturing investment. Gordon Brown famously promised, when in opposition, to transform the British economy by using 'post neo-classical endogenous growth theory'.

What was less appreciated was that while spending on education and research and development appeared to yield clear benefits, the growing body of academic literature seemed to suggest that economies would grow faster where markets were competitive, public spending was controlled, taxes were lighter and government borrowing did not crowd out private sector investment. While President Clinton may have campaigned in the poetry of infrastructure spending, to borrow a phrase from the political lexicon of Governor Mario Cuomo, he governed in the prose of bond market management and deficit reduction. Even before the Republicans took control of Congress in November 1994, the Clinton administration's principal economic concern was to reduce the federal government's deficit, because it was perceived to be crowding out private sector capital formation and depressing long-term growth. As the 1990s progressed the growth literature emphasised the importance of property rights, neutral tax systems, and macro-economic stability.

In the 1990s patterns of per capita growth in the OECD ceased to converge. In some of the most affluent countries growth accelerated, while in continental Europe and Japan it slowed down substantially. In 1999 OECD ministers asked their economists to analyse the causes and to 'identify factors, institutions and policies that could enhance long-term growth prospects'. The results of the work were incorporated in an OECD publication, *The Sources of Economic Growth in OECD Countries.*

The OECD's conclusions are plain. The need for macro-economic stability is emphasised, along with the damage done by excessive tax burdens in distorting proper resource allocation. The importance of capital formation in the broadest sense is underlined, with the rider that business rather than public sector research and development appears to yield higher rates of return. Competitive markets, where capital and labour markets are flexible enhance growth by promoting the diffusion of new technology. In particular the OECD emphasises that many countries need more competitive product markets and labour markets that adjust better and more rapidly to shocks. The OECD placed at the centre of its analysis the importance of the size of government and its precise role.

The surprising thing about Gordon Brown's record as Chancellor is that, having taken a keen interest in modern economic growth theory, he has ignored its policy implications for the UK. Instead of embarking on an agenda to raise the trend rate of growth through structural reform he has led the way in aggravating the structural rigidities in the economy that hinder incentives in labour markets and damage saving and capital accumulation. A rising tax burden, a greater allocation of resources on political grounds and a tax system that is less neutral in an economy that is more regulated, are hard to reconcile with a modern approach to economic growth. Moreover, the measures that the Chancellor has taken in response to modern growth theory, such as tax relief for research and development have been introduced in a manner that aggravates the complexity of the tax system. The Clinton Administration presided over a market-orientated economic policy that emphasised competition, the benefits of international trade and a flexible and competitive labour market. Moreover, the distinguishing feature of the Clinton Administration was the progress it made in reducing the growth in federal government spending which helped to create large federal government budget surpluses. Gordon has Brown increased government spending dramatically and returned the public finances to a position where there is a significant structural budget deficit. Whereas the Clinton Administration championed the role of markets, since 1997 the British Treasury has championed its capacity to identify market failure.

V
Tackling the UK’s Public Expenditure Challenge

The cumulative impact of Labour's decisions on spending, taxation and regulation will in the medium-term damage the performance of the British economy. The public finances have not been prudently managed. The Chancellor’s fiscal rules, and the golden rule in particular, do not provide a tight financial discipline. They place no ceiling on either public spending or the total tax burden.

Both spending and taxes have risen sharply. In the 1980s and 1990s the government reduced its long-term spending commitments. The Labour Government has entered into expensive long-term spending commitments such as the Minimum Pension Guarantee and the increase of public spending on health as a share of national income.

The overall fiscal position has deteriorated rapidly since 2001 and we now have a structural budget deficit that is higher than can be sensibly sustained in the medium term. The rapid and sustained increase in public expenditure has not yielded increased benefits to match the public’s perception of what should have been achieved for the amount of additional money spent on them. Nor have independent outside experts such as the economists at the OECD been able identify improvements in measured output from the public services that are commensurate with the increased resources being devoted to them.

The tax burden has gone up, and the tax system has become less neutral, more biased against saving and much more complicated than it was seven years ago. More people have been drawn into tax than ever before and into the top tax bracket.

The proportion of revenue raised from expenditure taxes has fallen, the double taxation of savings income has increased and pension funds have been drawn further into tax. The fact that since 1997 the savings ratio has halved is unlikely to be an unrelated coincidence. In the second quarter of 1997 the savings ratio was 10.6 per cent; in the first quarter of 2004 it was 5.8 per cent.

In his first budget in July 1997 the Chancellor revised downwards the Treasury's official estimate of the economy's trend rate of growth from the generally accepted estimate of 2½ per cent to 2½ per cent. Within two years he returned to the previous estimate of trend growth and then went on to raise it to 2½ per cent. But the combination of large increases in government spending, a higher tax burden, a less neutral tax system and employment regulations that make the labour market less flexible will in the medium-term depress the economy's growth rate.

These economic policies will damage the economy's supply performance. Beneficial supply-side reforms take a long time before their full effects on an economy are evident. The impact of damaging policies on the supply side also only becomes clear after a time lag, which can be protracted. So the cumulative impact of Labour's policies will not be fully apparent until there is an adverse economic shock. Then the malign consequences will be clearly evident and the need for systematic structural reform will be plain.

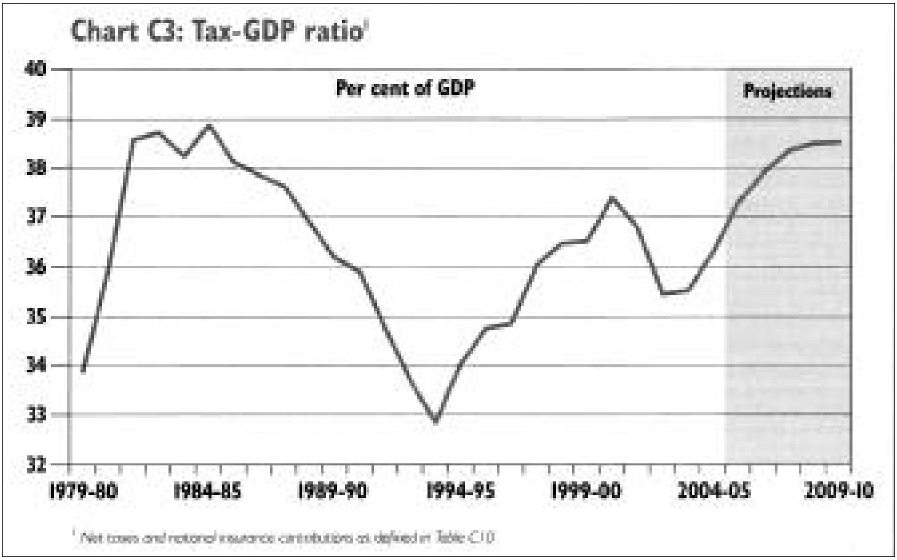
What can be done to improve matters?

Given the critical importance of fiscal policy in shaping the framework of incentives that determines how well an economy will perform, the quality of debate about fiscal policy needs to become more sophisticated. A more informed discussion is required of the costs and benefits of public expenditure programmes along with a wider public understanding of the additional or deadweight costs of taxation.

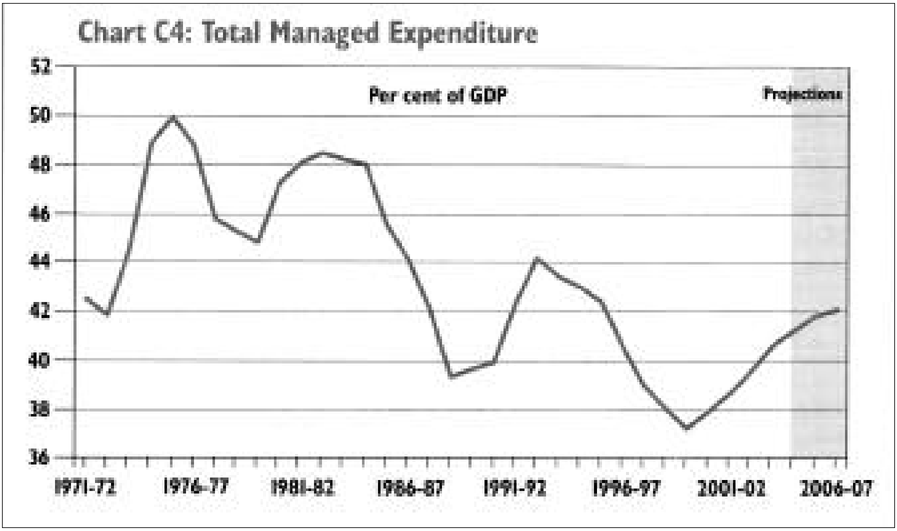
The quality of information and economic analysis available to Parliament needs to be improved radically. There ought to be 'an equality of arms' between Members of both Houses of Parliament and ministers. Parliament should be equipped with a body that can analyse proposals before they become the subject of legislative implementation. At the moment the House of Commons' Public Accounts Committee and the National Audit Office can analyse how efficiently money is spent after the event, but Parliament is not equipped effectively to scrutinise key economic proposals before the government embarks on a policy or programme. Often the executive in the UK is in possession of incomplete information about the precise costs and consequences of its own programmes. Part of the reason is that government departments are not obliged to explain properly the costs of their programmes to Parliament. As a consequence they do not break down their costs fully.

Considerable political advantages accrue to Ministers. They can avoid politically inconvenient scrutiny by simply pleading that they do not have the information. The convenience of this was illustrated by the debate in the run-up to the Iraq war. When asked how much such a war would cost Ministers were able to plead that they did not know and could not say. This was in marked contrast to the United States, where, at the request of the Senate and the House of Representatives, the Congressional Budget Office provided a detailed note setting out the potential costs involved. One effect of the note was to show how the United States Defense Department was not allowed to inflate the costs of such a military operation by including such as normal pay of soldiers that would have to be incurred whether or not troops were in action. The note even had an estimate of the scale of military assistance that could be expected to be provided by the UK.

The costs of the wrong fiscal policy and the damage it can do to economic performance are significant. The issues and the character of the choices to be made are complex. In order to clarify them and to expose them to proper public scrutiny the creation of a body modelled on the Congressional Budget Office to serve Parliament would be an important contribution to creating the conditions for a more informed and sophisticated debate about fiscal policy in the UK.



Source: Financial Statements & Budget Report 2005



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