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THE MAIN PARTIES' TAX AND SPENDING PROPOSALS

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NOTE
A previous version of this briefing note contained an error in its analysis of Liberal Democrat health spending plans. Previously these were understated. Page 64, section 7.3 now contains the correct figures.

The main parties' tax and spending proposals

This Election Briefing Note looks at the planned levels of borrowing under Labour, the Conservatives and the Liberal Democrats and the differences in terms of tax and public spending for the period up to March 2004. In addition, we analyse differences between the parties in their plans for expenditure in particular fields.

1. Plans for public borrowing

There is currently little disagreement between the three main parties about the appropriate levels of public borrowing, at least in the period to March 2004. Both the Labour Party and the Liberal Democrats have committed to keeping to the 'golden rule' that Gordon Brown adopted in the July 1997 Budget.[1] Although the Conservatives have not explicitly committed themselves to this, their tax and spending plans imply similar levels of borrowing to those forecast by Gordon Brown going forward to 2003–04, i.e. planning for the cyclically adjusted surplus on current budget stabilising at around 0.6% of GDP.

Should either Labour or the Liberal Democrats win the next election, there may be a further constraint on fiscal policy. This is because both parties have, subject to a referendum, left open the possibility of joining the single European currency in the next Parliament. Joining or being in a position to join the single currency formally requires UK fiscal policy to be set in accordance with the Growth and Stability Pact. This requires member countries to plan for a balanced budget. Planning in this way implies either higher taxes or lower public spending than just meeting the golden rule, since it prohibits the government from borrowing to invest.

Is a balanced budget rule more desirable than the golden rule?

The golden rule makes a distinction between current spending and capital spending on the basis that current spending is considered to benefit only the current generation while capital spending is considered to be an investment that will be of benefit in the future as well. A balanced budget rule would not recognise a difference between current spending and investment spending. As long as there is a genuine benefit to future taxpayers from an element of government spending, it seems reasonable that they should contribute towards its cost. An analogy is with individuals, who do often choose to fund purchases for the long term by borrowing – for example, by taking out a loan to buy a car or a mortgage to buy a property. Another example is companies, which often borrow to carry out investments.

[1] For more detail on the 'golden rule', see Election Briefing Note 2.

One criticism of the golden rule has been that the distinction between capital and current spending is inadequate: it implicitly assumes that future generations only benefit from spending that falls under the National Accounts capital category. But this categorisation may be crude, and some spending classed as current, such as some education spending, might actually benefit future generations. The golden rule risks inappropriately preventing such spending.

The danger with a balanced budget rule is that it would aggravate this situation by ruling out any spending being financed by future generations. This seems undesirable, since investment projects that were extremely beneficial to society as a whole but prohibitively expensive to finance from current taxpayers alone would not go ahead under a balanced budget rule.

2. Tax and spending: how big is the choice on offer?

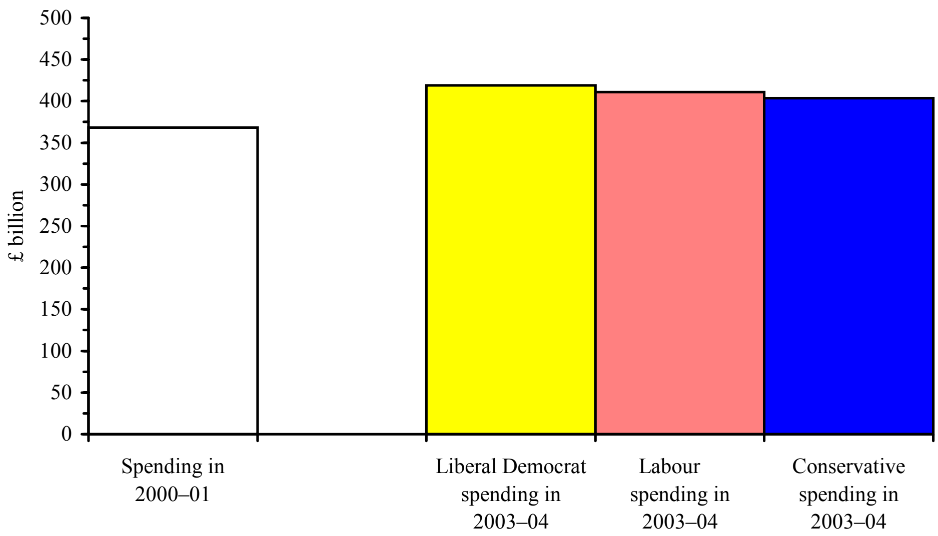
All three major parties have outlined spending plans for 2003–04, the last year of Labour's Spending Review 2000 plans. The Conservatives' plans represent £8bn less government spending compared with Labour, while the Liberal Democrats are proposing spending that is higher than Labour's plans by £8.6bn.

How big is this difference? Figure 1 shows total real spending under Conservative, Liberal Democrat and Labour plans, and shows that, relative to total government spending, the differences seem modest. In fact, the £8bn cut that the Conservatives advocate represents a reduction of just 1.8% of the £442.6bn that the Labour Party is proposing to spend in 2003–04; alternatively, this should be around 0.7% of national income. The Liberal Democrat plans involve moving by a very similar magnitude in the opposite direction. While these differences in public spending are relatively small as a share of national income, if focused on particular public services their effect on service quality could be amplified.

In nominal terms, we could expect to see spending increase by £66.3bn between 2000–01 and 2003–04 under the Conservatives, by £74.3bn under Labour and by £82.9bn under the Liberal Democrats. The lower growth in spending proposed by the Conservatives is not sufficient to stop public spending as a share of national income growing between 2000–01 and 2003–04.

None of these proposed levels of public spending would significantly alter Britain's ranking in the international public spending league table that appears in Election Briefing Note 2. In the low-spending US, the public sector is almost 10% of GDP smaller than in the UK, while in high-spending countries, such as Denmark and Sweden, public spending is up to 15 percentage points higher.

Figure 1. Planned public spending under a Labour, Conservative and Liberal Democrat government in 2000–01 prices



Source: HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html); Conservative manifesto (The Conservative Party, *Time for Common Sense*, 2001); Liberal Democrat manifesto (The Liberal Democrats, *Freedom, Justice, Honesty*, 2001).

But the choice might seem more significant if it is seen as being between embarking on alternative paths that would continue to diverge after 2003–04. Table 1 shows the average growth rate of public spending under each of the three parties' plans. If the parties' preferred growth rate for public spending over the next three years were to persist across a five-year Parliament, or, indeed, even beyond it, then the difference in the level of public spending would become far more significant.

Table 1. Public spending: the main parties' proposals

	Planned annual real growth in spending to 2003–04	Planned spending as % of GDP in 2003–04	Planned increase in spending as a share of GDP to 2003–04
Labour	3.7	40.3	1.4 ppt
Conservatives	3.1	39.6	0.7 ppt
Liberal Democrats	4.4	41.1	2.2 ppt

ppt = percentage point.
Notes: Unlike in Table 1 of Election Briefing Note 2, spending financed by the windfall tax is included; this increases measured spending in the base year, and so reduces the measured rate of spending growth. As a result, figures for growth in total spending under Labour's plans in this table are slightly lower than those reported in Election Briefing Note 2.

The Conservatives have argued that, in the longer run, public spending should not grow faster than national income. This would allow reductions in taxation or borrowing as a share of national income towards the end of the Parliament. It would also mean that growth in at least some areas of public spending would have to be lower than it is set to be over the next three years. In particular, if the Conservatives were to try to continue the large increases in health and education spending that they are committed to for the next three years, there would have to be extremely low growth in other areas of public spending. Still, it is not obvious that differences in public spending growth that the parties have planned can confidently be extrapolated forward in this way – for example, because Labour has not, as yet, announced plans for public spending beyond 2003–04.

A final way in which we might gauge the scale of the choice available in this election is to contrast it with that on offer in other recent elections. There is now perhaps more of a gap between the main parties on public spending than there was in 1997, when Labour pledged to stick precisely to the Conservative plans for total public expenditure for their first two years in office. By contrast, the choice on offer in 1992 was slightly more significant than that being presented today. Labour's early commitments to extra public spending implied an increase in total spending of 2.6% by way of comparison with the projections of the Conservative government after three years in office.[2]

We now turn to look more closely at the choices between the parties in terms of their spending commitments in individual areas.

3. Spending on the NHS*

There is little disagreement between the government and the Conservative Party over total NHS spending, at least as planned over the next three years. The Conservatives have pledged to match government plans until March 2004. But the Liberal Democrats propose additional total spending of £1.6bn by 2003–04. Since the NHS budget in that year is forecast to be almost £69bn, this is equivalent to an increase of 2.3%. Labour and Conservative plans imply annual real increases in NHS spending of 5.7%, while the Liberal Democrats budget for 6.5% a year. Both figures represent growth in health spending that would be large by historical standards.[3] The Liberals assert that their plans would, amongst other things, allow higher NHS pay, expanded training and free personal care for the elderly, but these plans would depend on successful delivery of savings on the NHS drugs bill.

In spite of relative agreement on the appropriate level of total NHS spending over the short term, there is debate over the detail of policy. Both the Conservatives and the Liberal Democrats have proposals to reduce the demands placed on the NHS budget. We assess each in turn, before considering alternative means of targeting improvements in the NHS.

Subsidising private medical insurance

One way in which the gap between health spending in the UK and that seen elsewhere could be closed is through growth in the role played by the private

[2] Calculation based on information in E. Davis et al., *Alternative Proposals on Tax and Social Security*, Commentary no. 29, IFS, London, 1992.

[3] For more details, see Section 1 of Election Briefing Note 3.

* Some figures in this section, relating to the Liberal Democrats' proposals for health spending, were understated in the original version of this document, but have now been corrected.

sector. While the private sector already plays a significant role in the provision of healthcare in the UK, it is much smaller than the role played elsewhere. Increased use of privately financed healthcare should save NHS spending that would otherwise have gone on those who have chosen to pay privately. The Conservative Party's manifesto states that

> 'Labour imposes a tax penalty on employers who offer their employees private medical insurance, and then taxes any employee who has this benefit. It doesn't make sense and, when affordable, we will abolish both taxes'.

Removing employers' and employees' National Insurance from employer-provided private medical insurance (PMI) would cost the government nearly £½bn in lost revenues. It would lead to an increase in the numbers covered by PMI schemes, and hence a reduction in demands on the NHS. An alternative use of the £½bn would be simply to increase NHS spending. An interesting question is whether such a subsidy on the purchase of PMI would be self-financing in that its cost is more than outweighed by the savings made by the reduction in demands on the NHS. This seems unlikely for two reasons:

1. There are currently 6.4 million individuals with PMI, two-thirds of which is provided through an employer.[4] These individuals would receive any tax relief given on PMI without giving any additional benefit to the NHS.[5]
2. It is not the case that an additional pound of spending on PMI leads to a reduction in demand of £1 on the NHS, since the NHS is likely to be able to provide healthcare more cheaply than the private sector. This is because PMI clearly offers a better quality of service in at least some dimensions – for example, private rooms with *en-suite* bathrooms. In addition, it is possible that the NHS is able to pay lower wages than the private sector. There is evidence that consultants' pay is lower in the NHS than in the private sector.[6]

Saving on the NHS drugs bills

An alternative way of improving the quality of the NHS, without further increases in spending, is to try to save on elements of current spending. If such savings were possible without any adverse consequences, we might expect any party would undertake them.

The Liberal Democrats argue they could save substantially on the NHS drugs bill, by almost £500m in 2003–04 and by more in subsequent years. The drugs bill currently stands at £6bn a year. It is largely determined by drugs prices, which are in turn set by government regulation. The Liberal Democrats' proposed savings would be delivered by lowering these prices: according to its

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[4] Laing and Buisson, *UK Market Sector Report 2000,* Laing & Buisson Publications Limited, 2000.

[5] For a more detailed discussion of these issues and for estimates of the price elasticity of PMI, see C. Emmerson, C. Frayne and A. Goodman, 'Should private medical insurance be subsidised?', *Health Care UK*, Spring 2001 (www.ifs.org.uk/healthindex.shtml).

[6] Monopolies and Mergers Commission, *Private Medical Services*, Cm. 2452, HMSO, London, 1994.

manifesto, the party would 'use the purchasing power of the NHS to drive down the price of established drugs and secure the more sophisticated medicines and drugs at lower prices'.

If the policy could be successfully implemented, it would save resources in the highly stretched NHS. Further, there is a sense in which the policy would increase economic efficiency. Typically, producing an extra course of drugs costs a company far less than the sales price charged to the government. This means high prices will very likely deter the NHS from purchasing drugs in some cases, even though the value of the benefit to the patient exceeds the cost to the drugs company of providing it.

But cutting drugs prices runs risks. First, lowering the prices of new drugs may blunt the incentive to innovate that the profits earned in pharmaceuticals deliver. This effect might be thought small, as most profits are earned outside the UK, which accounts for only about 4% of the global drugs market. But lower UK prices would have more effect if they triggered lower prices elsewhere. They might do this in two ways:

- directly, in countries such as Italy, Austria and Holland, which set their own drugs prices on the basis of an international reference pricing system;
- indirectly, particularly in the US. Prices in the US are already more than double those in the UK, so there is already strong pressure for reductions, which price cuts in the UK might strengthen – especially since the UK has a similarly large pharmaceutical industry.[7] Since the US accounts for about half of the world drugs market, any price cuts there would have potentially drastic effects on incentives.

An additional risk is that the large UK pharmaceutical industry, which employs about 60,000 people, would respond to aggressive price cuts by relocating overseas. If this risk is seen as significant, besides the effect on jobs, the effect on government coffers of the forgone corporation tax and other taxes must be considered.

Measuring quality in the NHS

The 1997 Labour manifesto pledged to reduce waiting-lists by 100,000. In March 1997, there were 1,158,000 people on an in-patient waiting-list in England. In February 2001, this figure stood at 1,033,000 – which is a reduction of 125,000, so the pledge has been met.[8] But, by historical standards, the number waiting for treatment remains large. While waiting-lists have existed since the birth of the NHS in 1949, the number on them never exceeded 1 million until March 1993.[9]

[7] This is discussed in N. Bloom and J. Van Reenen, 'Regulating drugs prices: where do we go from here?', *Fiscal Studies*, vol. 19, pp. 321–42, 1998.

[8] Latest waiting-list statistics from Department of Health Press Release 2001/0180, *Statistical Press Notice: NHS Waiting Lists – February 2001*, 6 April 2001 (www.doh.gov.uk/public/statpress.htm).

[9] C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary no. 81, IFS, London, 2000 (www.ifs.org.uk/health/nhsspending.pdf).

But, however these figures are interpreted, is the focus on the length of waiting-lists useful? Exclusive focus on waiting-lists can be especially misleading. For example, while the in-patient waiting-list has shortened since March 1997, the number of people waiting for more than 12 months has increased by 45% to 31,300. Patients presumably care about the time they have to wait and the quality of care that they eventually receive. Waiting-lists are not necessarily related to either of these.

No single statistic accurately captures NHS quality, but alternative targets to waiting-lists, such as waiting times, might be more closely related to meeting patients' needs, especially if different targets are set for different conditions. Perhaps in recognition of this, the 2001 Labour manifesto focuses on reducing maximum waiting times as opposed to waiting-lists.[10] Likewise, the Conservative Party's manifesto proposes a 'patient's guarantee' on maximum waiting times, which would be set dependent on the gravity of the patient's specific condition.

But even such refined targets can pose problems. In April 1999, the current government pledged that all patients with suspected breast cancer would see a specialist within two weeks of being referred by their GP.[11] This proved hard to deliver, although 95.6% of affected women in England were seen within the two-week target by the end of 2000, a small number were not.[12] Diverting considerable resources to ensuring such a target was met in 100% of cases is unlikely to represent the optimal way to use resources to meet clinical priorities.

Explicit targets provide transparent criteria of NHS success which might help galvanise its managers to improve quality. The danger is that they will be targeted at the expense of all else and that clinical priorities will be distorted in consequence.

4. Spending on education

As with the NHS, the Conservatives have pledged that they will match the substantial increases in education spending that Labour has planned until 2003–04. The Liberal Democrats have pledged that they will spend an additional £3.1bn in 2003–04, which they will finance through a 1p increase in the basic rate of income tax.[13] This extra money is equivalent to 5.5% of

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[10] The Labour Party, *Ambitions for Britain*, 2001.

[11] This pledge was first made in Department of Health, *The New NHS, Modern, Dependable*, The Stationery Office, London, 1997 (www.official-documents.co.uk/document/doh/newnhs/newnhs.htm).

[12] Department of Health Press Release 2001/0122, *Statistical Press Notice: Waiting Times for Suspected Breast Cancer Patients Quarter Ended 31st December 2000*, 8 March 2001 (www.doh.gov.uk/public/statpress.htm).

[13] This is a similar, but not identical, policy to the one that the Liberal Democrats had at the 1997 election, since increasing the basic rate of income tax now raises far more than it did in 1997. This is because, in addition to changes in employment and incomes, the 10p starting rate, introduced from April 1999, replaced the wider 20p lower rate. The result is that the basic-rate band now covers a wider range of income than previously was the case.

planned education spending in that year. As a result of these pledges, education spending over the next three years would increase by an average of 7.5% a year under the Liberal Democrats compared with 5.6% under either Labour or the Conservatives. Spending as a share of GDP would rise to 5.6% of GDP, compared with 5.3% under either of the other two main parties.

Labour has pledged to use some of the increase in spending over the next three years to employ an additional 10,000 teachers. This is an increase of about 2%. The additional spending proposed by the Liberal Democrats is intended, among other things, to be used to employ additional teachers and classroom assistants and to abolish tuition fees for higher education.

Alternative means of delivering education spending

Currently, the responsibility for school provision rests with local authorities rather than with central government. Local councils receive a general grant, which they may allocate across their spending responsibilities in order to meet local priorities. In addition, councils can, if they wish, increase the council tax in order to increase total spending on local services. In both these ways, they can alter their education spending.

But the central government's education policy also clearly has a great deal of influence on schools, and the current government has attempted to exert a more direct influence on schools' finance than has traditionally been the case. In particular, it has tried to increase school spending by announcing new payments that go direct to schools after local councils have set their annual budgets, as opposed to increasing the finance received by local councils. This happened in both the March 2000 (£1bn) and the March 2001 (£0.3bn) Budgets. Yet, under the current arrangements, it is not possible for central government to guarantee increases in funding received by schools since councils could adjust their planned budgets in anticipation of any 'additional' funding.

The Conservative manifesto proposes to take this process of direct finance further:

> 'We plan to spend [on education] what the government has planned. We will save money currently wasted on government and council bureaucracy, giving this money directly to schools according to the number of pupils.'

Several issues raised by this policy are beyond the scope of this Election Briefing Note. But the proposal does highlight the trade-off to be considered when fixing the appropriate level of local autonomy over public service spending.

The current system of locally elected councils determining the level of spending on education has the advantage that, if some areas of the country would like to have higher spending, they can fund this through higher council tax on local residents.[14] Conversely, if an area would like to spend less, in

[14] Under the current funding arrangements, an additional £1 in local spending leads to a £1 increase in local taxes. The only exception to this is the proportion of council tax bills paid through council tax benefit. Under rules introduced by the current government, councils with

return for lower taxes, the local council has the choice of adjusting its spending according to residents' wishes. The system increases the amount of choice individuals have about how they wish their taxes to be spent. A similar debate is whether the European Union should be allowed to dictate the levels of public spending and taxes in member countries, or whether they should remain free to make their own choices over the levels of taxation and spending that they would prefer.

There are also some strong arguments in favour of direct funding of schools. It may be the case that we do not want to see education provided as a local service since, as a society, we may decide that regional variations in quality are not acceptable. This is currently the case with healthcare, since NHS funding across England, Wales and Northern Ireland is both determined and allocated centrally.[15] Of course, this does not guarantee that there will be no regional variations in the quality of service provided – there are clear examples of regional variations in the quality of the NHS.[16] It would, however, make more uniform standards of service easier to achieve – which was the main objective of the introduction of the national curriculum back in 1988. In addition, if most voters see central rather than local government as responsible for the standard of education provided in their local schools, then, all else being equal, concentrating political responsibility in central government could enhance electoral accountability.

5. Social security spending

All three main parties have pledged further social security reform. If successfully implemented, the Conservatives' proposals would reduce spending by a total of around £2.5bn,[17] while the Liberal Democrats' proposals for benefit reform would increase costs by a total of £2.9bn. More details of these reforms can be found in Election Briefing Notes 7 and 8. The planned real annual increase in costed proposals for social security spending over the next three years would average at most 1.5% under the Conservatives, 2.2% under Labour and 3.0% under the Liberal Democrats.

In fact, should Labour be re-elected, the actual planned increases in spending may turn out to be greater than this. The Labour Party has proposed several

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increases in council tax above a centrally determined bench-mark level have to fund part of the increase in council tax benefit liabilities themselves.

[15] The Scottish Parliament does have limited tax-raising powers, which could be used to increase, for example, NHS spending. So far, it has chosen not to use these powers. The Scottish Parliament does have the ability to allocate funds between spending areas, including the NHS.

[16] See Chapter 6 of C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary no. 81, IFS, London, 2000 (www.ifs.org.uk/health/nhsspending.pdf).

[17] This assumes that none of the bureaucracy savings proposed by the Conservatives fall within the Department of Social Security. In addition, we ignore the extra expenditure flowing from the Conservatives' proposed state pension increase, but also offsetting savings on the working families' tax credit, the New Deal and the Social Fund.

further reforms to the social security system that are still under consultation. These proposals remain uncosted and are not included within the current spending totals. They include the introduction, from April 2003, of the employment tax credit, the integrated child credit and the pension credit. IFS estimates suggest that, in total, they are likely to cost around £2½bn a year. Furthermore, there are manifesto commitments to introduce the Child Trust Fund and the Saving Gateway at some point in the next Parliament.[18]

The Conservatives have also proposed further reform to the UK pension system. This will allow younger individuals to choose between retaining their entitlement to the basic state pension or forgoing entitlement in return for lower National Insurance contributions. In the long run, it is not certain whether this policy would strengthen or weaken the public finances, but social security spending on pensions would fall. In the shorter term, this policy would have a net cost to the government, since National Insurance contributions would decline but pension expenditure would be unaffected until some time in the future. For more details of this proposal, see Appendix A.

6. Other areas of government spending

Both the Conservative Party and the Liberal Democrats have pledged to keep to Labour's spending plans for defence.

The Conservatives have also pledged to keep to the Labour Party's spending plans on law and order, while the Liberal Democrats have pledged a relatively small increase in funding of £200m. The Conservative Party's manifesto contains a number of law and order reforms that might have cost implications, although it might be possible to meet these within the planned total if spending in other parts of the law and order budget is tightly controlled.

Under both Labour and the Conservatives, spending on international development is set to grow by an average 4.9% a year in real terms. The Liberal Democrats have also pledged additional funding, sufficient to raise this growth to 6.3% a year. Since the overall budget is relatively small, this increase in funding only costs an extra £125m by 2003–04, though under the Liberal Democrats this increase would reach £500m by 2005–06.

[18] For more details of all these policies, see Election Briefing Note 9.